

**Regnan Submission on Corporations Amendment  
(Improving Accountability on Termination Payments) Bill 2009  
17<sup>th</sup> July 2009**

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## 1. Introduction

- 1.1 Regnan welcomes the invitation to provide comment to the Senate Economics Legislation Committee (Economics Committee) on the *Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009* (Termination Payments Bill) introduced into Parliament on 24<sup>th</sup> June 2009.
- 1.2 Regnan is a specialist governance adviser that since 2001<sup>1</sup> has undertaken research and engagement in relation to executive remuneration (and other ESG issues) on behalf of institutional investors. Regnan is owned by eight leading institutional investors, and at the time of this submission was retained by thirteen institutional investors with a mandate to proactively identify potential governance risks and engage investee companies in relation to these risks.
- 1.3 Regnan clients invest around A\$39 billion in S&P/ASX200 companies (approximately one in six dollars invested by institutions in the Australian stock market) as at 31<sup>st</sup> December 2008.
- 1.4 This submission reflects the views of Regnan and does not necessarily represent its client organisations.
- 1.5 In March 2009, Regnan released the *Regnan Remuneration Reform Proposal* in accordance with its mandate to contribute constructively to the public debate on this issue.
- 1.6 Regnan welcomes Treasury's Termination Payments Bill as an important means of addressing the issue of executive remuneration in Australian listed companies. We are aware that it complements the Australian Government Productivity Commission's Executive Remuneration Inquiry (Productivity Commission Inquiry) and the Australian Prudential Regulatory Authority's consultation package on remuneration for authorised deposit-taking institutions and general and life insurance companies (APRA Review).
- 1.7 We maintain our concern in relation to the ability to pay material/significant ex-gratia termination payments to executives in circumstances where it may be deemed as 'rewarding failure'. For this reason we fully support the Government's move to reduce the threshold above which shareholder approval must be sought for termination payments. However Regnan recognises the need to respond to concerns around implementing a strict shareholder approval threshold of 12 months' base salary for termination payments, and we believe these concerns ought to be considered as part of the planned post-implementation review.

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<sup>1</sup> Then as the BT Governance Advisory Service, until it re-launched as Regnan in May 2007.

## 2. Threshold for shareholder approval

- 2.1 The Termination Payments Bill lowers the threshold for shareholder approval of termination benefits from seven times total remuneration to 12 months' base salary, consistent with the *Regnan Remuneration Reform Proposal* released in March 2009 (which accompanies this submission).
- 2.2 Since Regnan released its Remuneration Reform Proposal, consultation with various stakeholder groups has strengthened our resolve regarding the appropriateness of the suggested reform of termination payments (see 2.1) but has also raised concerns/risks around the implementation of a strict shareholder approval threshold of 12 months' base salary for termination payments.
- 2.2.1 Past experience with the introduction of strict regulation around executive pay in the United States<sup>2</sup> has illustrated the unintended consequence of restricting a single aspect of executive remuneration; other elements of remuneration are increased to compensate for/bypass the element of remuneration that has been restricted (the "squeeze the balloon" effect). It is therefore our concern that other elements such as base salary or sign-on bonuses may experience artificial upward pressure in response to a strict shareholder approval threshold of 12 months' base salary for termination payments.
- 2.2.2 There are many possible scenarios where an executive may leave a company for reasons unrelated to performance. In some of these circumstances a termination payment of more than 12 months' base salary may be in shareowners' interests, and submitting such termination payments to shareholders for approval at cessation of employment may not always be practical.
- 2.3 Regnan accepts that these concerns/risks are addressed by the freedom of companies and shareholders to reach agreement on the termination payment that will be made via a shareholder holder vote at a general meeting in advance of an executive's retirement.
- 2.4 Regnan understands that a post-implementation review of the new amendments will be made within one to two years of the commencement of the new requirements. We suggest this review includes a search for evidence of whether the risks identified in 2.2 above have been materially realised since the introduction of the Termination Payments Bill. If this post implementation review does find evidence that these risks have been realised in a material way, then we advocate the following adjustments to the Termination Payments Bill as a potential solution that retains the spirit of the Government's original reform proposal;
- 2.4.1 Termination payments in excess of 12 months' base salary, but less than two times 12 months' base salary, be subject to an "if not, why not" provision via ASX Listing Rules

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<sup>2</sup> For example, tax rules around bonuses in the US that led to very large option payments.

requiring the board to explain to shareholders why a termination payment of the chosen size was considered by the board to be in the interests of shareowners, and

2.4.2 Termination payments in excess of two times 12 months' base salary be subject to a binding shareholder vote.

2.5 Regnan believes that these adjustments would retain the strong governance signal that termination payments above 12 months' base salary should only be made in exceptional circumstances and for good reason. However it would also reduce the likelihood of other elements of remuneration experiencing upward pressure (or other unintended consequences) and provide important flexibility for company boards in determining appropriate termination payments in difficult and unforeseen circumstances. The "if not, why not" buffer zone still ensures the key shareowner concern of careful use of payments is made transparent and always in an arena of full review/scrutiny.

2.6 If companies then abuse this "if not, why not" buffer zone by inappropriately rewarding executives via termination payments despite this material strengthening of the governance signal around termination payments, then shareowners should vote to remove the directors who presided over such decisions at their next re-election.

### 3. Meaning of termination benefit

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3.1 It is unclear whether under the regulations that will accompany the Termination Payments Bill, accrued leave, long-service leave and voluntary superannuation contributions will be included in the termination payment calculation.

3.2 We believe that such benefits as listed in 3.1 are genuine remuneration accumulations which have already been earned through past service to the employer, and are materially different from an ex-gratia termination payment. We therefore believe that the Termination Payments Bill will be unworkable to the extent that shareholders are required to approve what are otherwise statutory benefits.

3.3 We also believe that any payments related to early vesting of equity for the purpose of meeting an executive's realised tax liability upon cessation of employment<sup>3</sup> should also be exempt from the termination payment calculation (see the cover note to the accompanying *Regnan Remuneration Reform Proposal*).

3.4 Regnan advocates that the Senate Committee ensure such benefits and tax-related payments are excluded from the termination payment calculation by the regulations that will accompany the Termination Payments Bill.

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<sup>3</sup> All tax on equity benefits (regardless of whether they have vested) currently falls due upon an executive's cessation of employment.

3.5 Separately, Regnan understands the Termination Payments Bill operates so that once remuneration has been earned (earned in the sense that any performance hurdles have been met) then it may be paid out to an executive upon cessation of their position with the company without its inclusion in any termination payment calculation, regardless of whether such rewards were otherwise subject to an ongoing holding lock.

Holding an executive's remuneration in escrow for a defined period of time, even after required performance hurdles have been achieved, is a legitimate means of aligning executives with longer-term shareowner interests. This mechanism features prominently in the *Regnan Remuneration Reform Proposal*. If the Termination Payments Bill was to act in the way that Regnan currently understands, this would be undermined by the ability of executives to receive remuneration upon their retirement that would otherwise have been subject to a holding lock, without requiring approval from shareholders.

3.6 Regnan therefore advocates that the Senate Committee ensure the Termination Payments Bill captures the accelerated release of any remuneration from escrow (aside from tax-related payments, see 3.3 and 3.4) in the termination payment calculation, regardless of whether performance hurdles have already been met.

## Cover Note

### *Comment on Termination Payments*

We note that the Government is in the process of implementing a Corporations Amendment Bill that includes a shareholder approval threshold of 12 months' base salary for termination payments, which is consistent with the *Regnan Remuneration Reform Proposal* released in March 2009. We remain committed to our proposal, but wish to address the following concerns around the implementation of a strict shareholder approval threshold of 12 months' base salary for termination payments;

- Past experience with the introduction of strict regulation around executive pay in the United States<sup>1</sup> has illustrated the unintended consequence of restricting a single aspect of executive remuneration; other elements of remuneration are increased to compensate for/bypass the element of remuneration that has been restricted (the "squeeze the balloon" effect). It is therefore our concern that other elements such as base salary or sign-on bonuses may experience artificial upward pressure in response to a strict shareholder approval threshold of 12 months' base salary for termination payments.
- There are many possible scenarios where an executive may leave a company for reasons unrelated to performance. In some of these circumstances a termination payment of more than 12 months' base salary may be in shareowners' interests, and submitting such termination payments to shareholders for approval at cessation of employment may not always be practical.

Regnan accepts that these concerns/risks are addressed by the freedom of companies and shareholders to reach agreement on the termination payment that will be made via a shareholder holder vote at a general meeting in advance of an executive's retirement.

Should the post-implementation review of the Government's Corporations Amendment Bill addressing termination payments find evidence that the above concerns have been materially realised, then Regnan advocates the following alternative position on termination payments as a potential solution that retains the spirit of the Government's original reform proposal;

- Termination payments in excess of 12 months' base salary, but less than two times 12 months' base salary, be subject to an "if not, why not" provision via ASX Listing Rules requiring the board to explain to shareholders why a termination payment of the chosen size was considered by the board to be in the interests of shareowners, and
- Termination payments in excess of two times 12 months' base salary be subject to a binding shareholder vote.

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<sup>1</sup> For example, tax rules around bonuses in the US that led to very large option payments.

Regnan believes that this alternative position retains the strong governance signal that termination payments above 12 months' base salary should only be made in exceptional circumstances and for good reason, while also reducing the likelihood of other elements of remuneration experiencing upward pressure (or other unintended consequences) and providing important flexibility for company boards in determining appropriate termination payments in difficult and unforeseen circumstances. The "if not, why not" buffer zone still ensures the key shareowner concern of careful use of payments is made transparent and always in an arena of full review/scrutiny.

If companies then abuse this "if not, why not" buffer zone by inappropriately rewarding executives via termination payments despite this material strengthening of the governance signal around termination payments, then shareowners should vote to remove the directors who presided over such decisions at their next re-election.

#### *Comment on Tax*

The recent taxation changes to ESOPs (employee share and option plans) result in tax being incurred a maximum of seven years after equity is granted. This decision impacts on the ability of companies to establish pay structures that align executives over the long-term, and is inconsistent with Regnan's advocated position of equity-based remuneration vesting over a five to ten year period. However, we see scope for early vesting provisions for a portion of equity equivalent to an executives' tax liability as offering a simple solution to this issue of tax liabilities crystallising after a maximum of seven years.

As described in section 3.3 of the *Regnan Remuneration Reform Proposal* all equity-based rewards are currently taxed upon an executive's cessation of employment, regardless of whether those equity-based rewards were to remain in escrow for a period during retirement. Regnan continues to encourage reform of this tax disincentive to holding equity during retirement. However until this disincentive is removed, we also see early vesting provisions for a portion of equity equivalent to an executives' tax liability as offering a solution to this tax limitation, as long as such tax-related payments are not included in any termination payment calculations.



## Regnan Remuneration Reform Proposal – March 2009

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### Executive Summary

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The interests of institutional investors are served through a better alignment of executive remuneration with the long-term sustainable growth and sound risk management of a company.

There are numerous examples in Australia and elsewhere of excessive executive remuneration that has no correlation with the long-term value of companies. Shareholders, tax payers and other stakeholders are wearing the costs of executives' risky behaviour.

Current practices encourage executives to behave in a manner which is not aligned with the long-term sustainable growth of a company and to ignore risk. Increased disclosure on its own has not achieved the desired alignment. In addition, current taxation legislation discourages remuneration structures that incorporate the holding of share-based payment equity beyond their term of employment.

Alignment is the key.

Regnan's proposed reform requires boards to apply a threshold on annual remuneration received by executives, above which all remuneration is paid in the form of equity which begins vesting after five years in five equal annual tranches. It also requires termination payments that exceed 12 months' base salary to be subject to binding shareholder approval, and will count towards annual remuneration subject to the threshold.

Boards would retain discretion to determine the quantum, short-term incentives, long-term incentives, performance hurdles and other parameters used in determining remuneration structures. Boards can also set short-term performance hurdles, allowing executives to earn in the short-term, but collect in the long-term.

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## 1 Introduction

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Despite significant increases in the level of remuneration disclosure, the over-paying of some senior executives and the increasing opaqueness and complexity of variable remuneration schemes indicates that executive remuneration continues to be dysfunctional in Australia. Whilst problems in executive remuneration are significant internationally in the global finance sector, this sector bias is not present in Australia. This is evidenced later in the paper through the choice of non-financial sector Australian companies as case studies. Increased shareholder activism through the introduction of the non-binding vote on remuneration reports has led to a rise in shareholder protest votes against remuneration reports, however boards continue to structure unsatisfactory methods of paying their senior executives.

A concerted effort to redesign executive remuneration is needed. This should be done in a way which ensures listed companies<sup>2</sup> continue to offer competitive packages while reining in excessive salaries and realigning executive remuneration with the long-term interests of the company<sup>3</sup>. This is not possible while the public debate continues to focus on issues of disclosure.

This Proposal aims to present a principles based approach to the delivery of executive remuneration in a manner designed to align executives with the long-term sustainable growth of the company and take into account sound risk management (i.e. address inappropriate risk taking).

It must also be recognised that competent boards combined with remuneration committees comprised of members who have the skills and expertise to use independent judgement are key to any remuneration reform. It is intended that boards and remuneration committees will be able to utilise the principles and approach advocated by this Proposal, when determining the remuneration policies for their own executives.

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<sup>2</sup> For the purposes of this Proposal, references to the terms “company” and “companies” refers to any publicly listed entity.

<sup>3</sup> While “shareholder interests” is the phrase often used when describing with whom executives’ interests should be aligned it must be recognized that shareholder interests can be quite divergent depending on their investment timeframe and purpose. It is therefore considered appropriate to instead refer to a company’s long-term sustainable growth, consistent with the fiduciary duty owed to that company by its executives and directors. It is also worthwhile noting that a company’s long-term sustainable growth is synonymous with the interests of long-term investors such as superannuation funds.

## 2 An International Perspective

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The global financial community is currently experiencing an unprecedented global financial crisis ("GFC").

While the factors that have contributed to the global financial crisis are numerous and will be debated for many years there has clearly been failure, particularly in the US, of basic corporate governance standards. Principally, the lack of a separation between the role of Chief Executive and Chairman had lead to a lack of independence on boards. Further, boards have allowed executive pay structures that have resulted in obscene levels of remuneration and have simply ignored the behaviour encouraged by such structures and the inherent risks associated with that behaviour. It is not just shareholders who have suffered. Governments have had to step in and support companies that have lost billions of dollars. The issue of the level of competence of the directors who approved and monitored such pay structures will also be subject to continuing debate, particularly in the US where accountability to shareholders is limited due to the inability of shareholders to remove company directors. Without change in the US on this front, global markets will continue to suffer from the consequences of poorly governed capital markets.

While this paper focuses on Australian remuneration, institutional investor groups globally must act together to ensure consistent standards in a global market place. If jurisdictions act independently, the desired outcomes may not be achieved.

### 3 What is wrong with the status quo?

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The following four characteristics of executive remuneration in Australia that have so far stymied the agenda of reform;

1. Remuneration schemes have been structured in ways that encourage executives to take inappropriate risks which are not aligned with the long-term sustainable growth of the company.
2. Lengthy disclosure has not resulted in sufficiently aligned remuneration practices.
3. Current tax legislation discourages remuneration structures that align executives with the long-term sustainable growth of a company.

Reform of these characteristics is required for meaningful change.

#### 3.1 Current remuneration practices

Australian listed company remuneration plans have been rightly criticised for excessive pay levels. These excessive pay levels are a global phenomenon, most notably the US practices.

The size of executive remuneration packages, combined with poor connection to sustainable growth is such that listed company executives are effectively receiving entrepreneurial levels of reward without personal financial exposure to the corresponding downside risk. Unfortunately, it is the shareholders and tax payers who have been left to bear downside financial exposure.

Executive remuneration levels have grown at a fast pace in recent years. This is evident from the most recent Top 100 CHIEF EXECUTIVE Pay report<sup>4</sup> released by the Australian Council of Super Investors (ACSI), which describes how the average Chief Executive's fixed pay alone rose by more than 100% between 2001 and 2007 – more than three times the rate at which Average Weekly Ordinary Time Earnings (AWOTE) rose over the same period of time<sup>5</sup>.

Current Australian executive remuneration conventions often encourage executives to meet specific short-term objectives with immediate pay-offs, while incurring long-term risk exposures that are not realised until after executive rewards have been received. Executive remuneration is typically structured in four key components; fixed salary, short-term incentive (one year performance), long-term incentive (three year performance) and a termination component.

Short-term incentives tend to be settled in cash, thereby offering immediate reward and removing any exposure to future consequences of the chosen short-term strategy. Long-term incentives which are typically settled after three years also fail to capture the longer term success or otherwise of the chosen strategies.

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<sup>4</sup> Conducted by RiskMetrics - ISS Governance Services, released on 27<sup>th</sup> October 2008.

<sup>5</sup> Page 1, "Top 100 CHIEF EXECUTIVE Pay Research Released", ACSI Media Release dated 27<sup>th</sup> October 2008.

Listed companies have also become notorious for rewarding executives even in instances of total failure with “golden parachutes”, while shareholders have been powerless to intervene under existing legislation<sup>6</sup>. Case studies detailing specific instances where company boards have granted inappropriate executive rewards where sustainable growth has not occurred are documented in section 7.

### 3.2 Lengthy disclosure has not resulted in sufficiently aligned remuneration practices

The introduction of Corporations Act Section 300A has led to increased remuneration disclosure and to a certain extent improved shareholder understanding of these structures. In particular, line-by-line disclosure of executive remuneration amounts provides insight into the treatment of a Chief Executive relative to other senior executives in an organisation, and can also provide evidence as to effective internal succession plans. It has also provided a detailed record of the rise in quantum of executive remuneration, but it must be acknowledged that there has been criticism of the relevance of some of the information S300A requires to be disclosed.

The level of meaningful disclosure offered by companies, even under the current regime of remuneration disclosure legislation, has often been insufficient to allow all shareholders (institutional and retail) to evaluate the appropriateness of remuneration policies adopted by a board. Various “boiler-plate” statements, generic references to benchmarking by remuneration consultants, and exemptions of detail on the basis of commercial sensitivity (particularly for short-term hurdles) are common-place in Australian remuneration reports. These characteristics have combined to create lengthy remuneration disclosures which fail to justify the increase in executive remuneration, and fail to adequately explain the method and rationale on which variable remuneration is awarded.

In addition, the detailed information which has allowed close tracking of the rise of executive remuneration has ironically been one of the key drivers of that increase. The ability of executives to access information on theoretical rivals’ remuneration levels has fuelled an unhealthy competition on pay, as each executive negotiates with its board using the argument that someone else of equal talent is getting paid more; commonly known as the “ratchet effect”.

Ultimately, additional remuneration disclosure is not anticipated to bring about the reform of executive remuneration practices for the following reasons;

1. Unclear remuneration disclosure is to some extent, unavoidable.  
*Many companies produce “vanilla” remuneration disclosure, and/or cite commercial sensitivities as a reason for withholding detail of short-term incentive hurdles. More specific requirements of remuneration disclosure may assist some companies’ understanding of what shareholders are looking for. However, further disclosure requirements cannot prevent*

<sup>6</sup>Section 200F of the Corporations Act 2001 provides that termination payments less than seven times total remuneration are exempt from shareholder approval, and ASX Listing Rule 10.19 provides that termination payments less 5% of the market capitalization of a listed company are exempt from shareholder approval.

*poorly written passages in remuneration reports, nor solve the dilemma of companies citing commercial sensitivities as a reason for withholding certain short-term incentive hurdles.*

2. Increased remuneration disclosure does not equal improved remuneration practice.  
*Current executive remuneration practices have evolved under the existing remuneration disclosure regime, where greater disclosure and the non-binding shareholder vote have accompanied increases in executive remuneration de-coupled from performance. It can even be argued that current executive remuneration conventions have evolved in response to the disclosure environment, where complex variable remuneration schemes have been designed with the appearance of alignment while still ensuring executives receive high rewards.*
3. Shareholder voting (non-binding or otherwise) does not provide constructive feedback.  
*The ability of shareholders to express their approval (or disapproval) of a board's chosen remuneration approach is a worthwhile exercise, essential for providing general guidance to boards. Unfortunately as mentioned in section 3.1, remuneration packages have grown in both size and complexity to the point where they are vastly different from what shareholders require. In this circumstance, even where disclosure results in more targeted protest votes from shareholders, the blunt instrument of a protest vote is insufficient to guide boards in the face of significant vested interests of executives and remuneration consultants, and well-established (but flawed) conventions.*

### **3.3 Tax legislation**

Currently, division 13A of the Australian Income Tax Assessment Act requires that all tax liabilities associated with share-based remuneration be realised when employment ceases. This means that tax liabilities relating to equities that vest post-employment will be brought forward to departure date. This is a significant disincentive for boards to award executives in this manner, and thus a significant disincentive to align executive remuneration with the long-term sustainable growth of a company.

Reform of any tax disincentives to holding of equity through retirement is fundamental to bringing about a better aligned executive remuneration practice.

## 4 Reform proposal explained

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1. The board or relevant sub-committee must continue to exercise their own judgement and expertise to take into account the financial and operational circumstances of the company when assessing remuneration structures. For example, when exercising discretion regarding the amount of remuneration paid and the performance periods and hurdles used in awarding remuneration to executives.
2. All remuneration for an executive in any given year<sup>7</sup> above a board-determined threshold must take the form of common equity vesting over a period of five to ten years following the grant date regardless of continued employment, with any dividends paid on common equity during escrow to be reinvested in more common equity.
3. Termination payments will count toward annual remuneration subject to the board-determined threshold on immediate pay (as with all other remuneration), and those termination payments exceeding 12 months' base salary to be subject to binding shareholder approval.

Key to the success of this reform is consistent application of the board-determined threshold, regardless of the pay components employed by a company. Even if companies reward executives through atypical pay components such as non-cash benefits or special payments, these additional pay components will count toward remuneration prior to application of the board-determined threshold. Executives will otherwise still have avenues through which they can receive a large amount of reward which is not aligned with the long-term interests of the company, thus defeating the purpose of the proposed remuneration reform. See Chart 1 below for an example application of the board-determined threshold.

Once an executive's remuneration in any given year below the board-determined threshold has been distributed to the executive in whatever manner is chosen (for example, cash, non-cash benefits, superannuation etc), the remainder of allocated remuneration above the threshold should be invested in common equity of the company via an executive share ownership plan, or XSOP. Each tranche of common equity invested via the XSOP should then remain in escrow for five years, after which 20% will vest each year for five years. See Chart 2 below for an example vesting schedule of 100 shares invested as a single tranche via an XSOP, noting that in practice dividends on shares held in escrow would be reinvested.

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<sup>7</sup> Remuneration in any given year should not be interpreted as being the same as the elements of annual remuneration required to be disclosed pursuant to Corporations Act S300A, but instead refers to the sum of base pay, the value of variable remuneration which has met performance hurdles plus all other benefits and any termination payments received in that year.



Chart 1

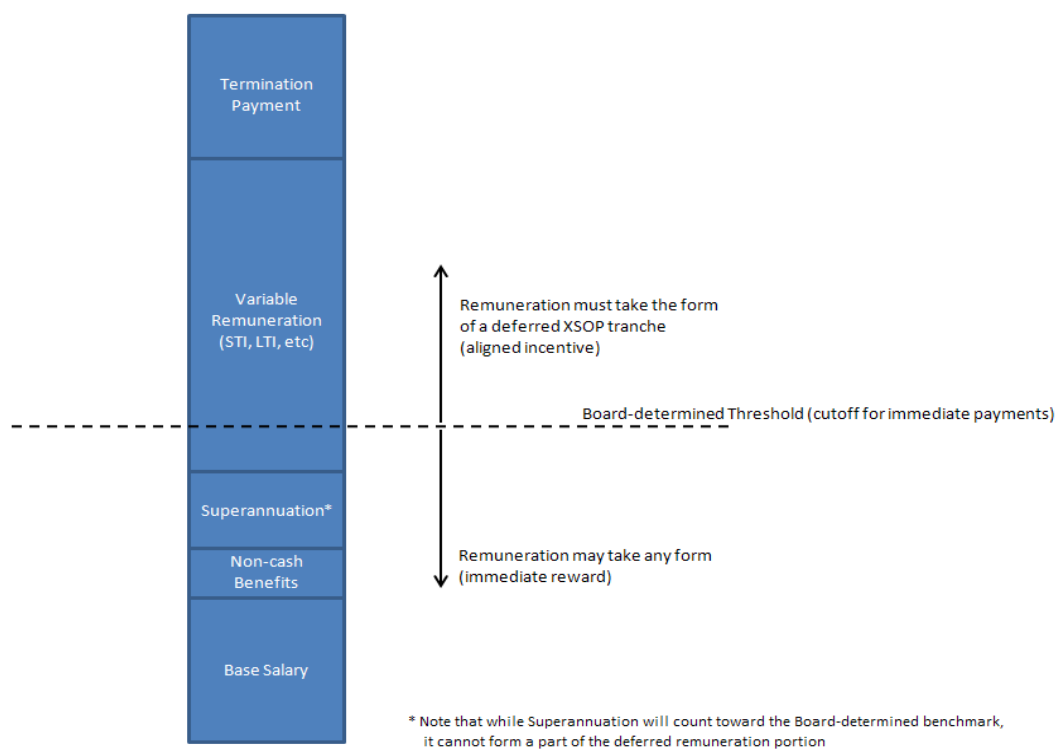
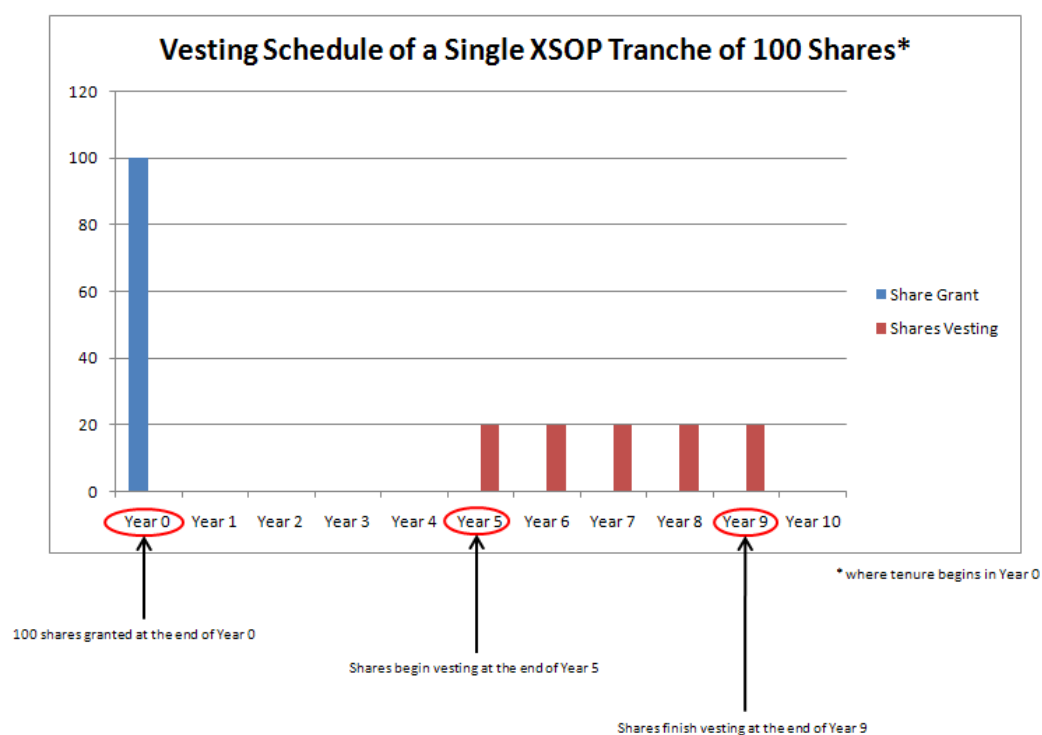
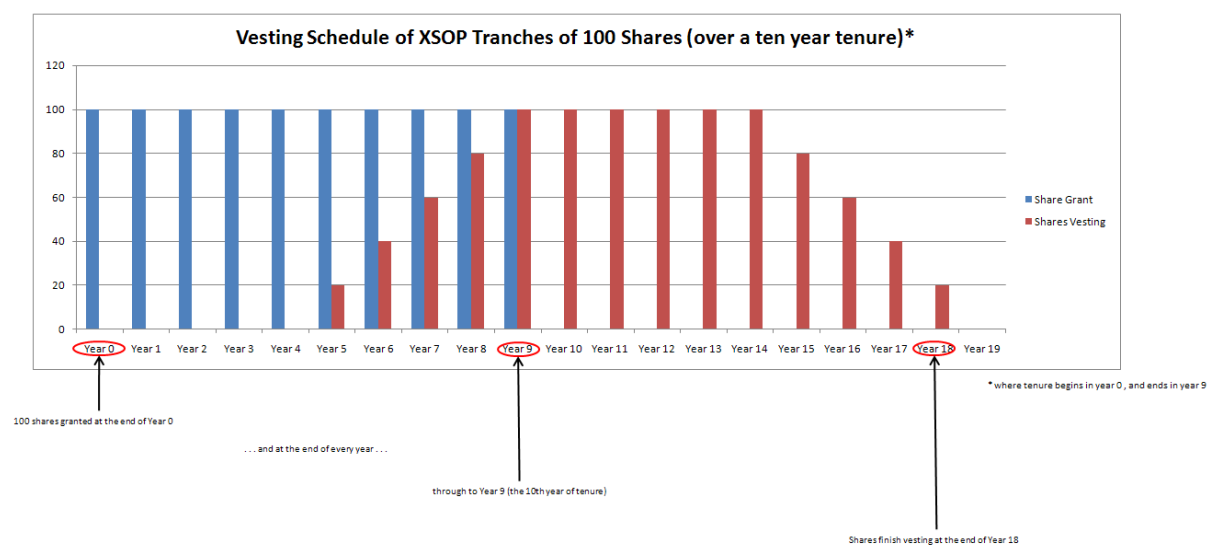


Chart 2



The effects of individual XSOP tranches being awarded every year will accumulate over time such that maximum annual payouts from the XSOP will not be achieved until after five years. See Chart 3 below for an example vesting schedule of an XSOP, in which 100 shares are invested every year over a ten year executive tenure.

**Chart 3**



## 5 Rationale for reform

This reform proposal is designed to facilitate better alignment with the company's long-term sustainable growth in a simple manner, while not restricting the board from offering market competitive salary packages. These changes are advocated to achieve the following three objectives;

1. Maintaining the ability of companies to attract executive talent by not restricting a board's ability to pay.
2. Achieving better alignment between executives and the long-term sustainable growth of the company, taking into account sound risk management.
3. Avoiding rewards for failure.

It is worth noting that the reform proposal has been partially implemented at ASX-listed Macquarie Group. Macquarie Group Executive Committee members have 20% of their profit share (the principle form of remuneration at Macquarie Group) invested in a portfolio of Macquarie managed funds for ten years, and a further 10% of their profit share over the past ten years must be invested directly in Macquarie Group shares<sup>8</sup>. The company itself describes its approach to remuneration as “designed to provide staff with the incentive to strive for sustainable earnings growth”, while at the same time “providing remuneration outcomes that are globally competitive”<sup>9</sup>.

### 5.1 Maintaining the ability of companies to attract executives

The ability for a board to award common equity above the board-determined threshold ensures that their ability to attract, retain and appropriately reward executives is not constrained.

### 5.2 Executives should be aligned with long-term sustainable growth, taking into account sound risk management

Some may argue that limiting immediate payments such as cash, and requiring common equity payments to vest over five to ten years is a “reaction” which will stifle entrepreneurship and drive executives elsewhere (thus ultimately harming a company's long-term interests). The proposed reform is not designed to stop executives from being rewarded for their good work, but simply to ensure that they are motivated and rewarded *only* for good work (by aligning executives with the long-term sustainable performance of the company).

The proposed remuneration reform ensures listed companies are able to offer competitive salaries in the form of common equity to attract executive candidates. If a candidate believes that through their contribution they can build and/or progress a sustainable business model with sound risk management, which will drive long-term sustainable growth, then rewards will be provided as common equity vests. If a candidate does not have the conviction that equity payments vesting over

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<sup>8</sup> P58, Macquarie Group Annual Report 2008.

<sup>9</sup> P57, Macquarie Group Annual Report 2008.

five to ten years will provide them with economic reward, then it is open to question whether they believe they have something to offer the company in terms of a lasting outcome through their tenure. Where agreement cannot be reached that a company's long-term prospects are sufficient to offer potential reward through common equity, then it is incumbent upon the board to consider the merit in continuing to seek to attract particular executive candidates.

It is recognised that a company's share price can at times be driven by short-term factors, and the current focus of variable remuneration structures on what is essentially current share price performance has been part of the problem. The vesting of common equity tranches over five to ten years should mean that any temporary falls (or spikes) in share price due to short-term drivers, are tempered by preceding and successive tranches which vest in other years – a “moving average” effect which better reflects the true value created. The key is that a long timeframe such as five to ten years following grant date be adopted, to ensure executives remain focused on sustained performance, and further the encouragement of sound risk management for the future.

Even in instances where short-term drivers impact share price in ways that a majority of common equity tranches awarded to executives vest at times where the share price is depressed, executives are not obliged to sell equity upon its vesting. They, like all other shareholders, have the freedom to retain ownership until such time that they believe the share price better reflects the true value of the company.

### **5.3 Avoiding rewards for failure**

The proposed threshold of 12 months' base salary for termination payments requiring shareholder approval has been selected as a reasonable amount, but which does not allow for any real “reward” without shareholders' consent. It is intended specifically to prevent executives from receiving excessive “golden parachutes”, particularly in instances where they have destroyed significant company value. Instances such as Kim Edwards' \$5.2 million termination payment from Transurban Group, Owen Hegarty's \$8.35 million termination payment from Oxiana (later Oz Minerals) and Paul Anthony's \$5.1 million termination payment from AGL Energy (all of which are discussed in section 7) are just some examples of the capacity for corporate Australia to reward executives for failure.

Currently shareholders have no effective means of protecting against such excessive and inappropriate termination payments. Section 200 of the Corporations Act provides that shareholder approval is not required for termination payments up to as much as seven times the equivalent of 12 months of total remuneration. Alternatively, ASX Listing Rule 10.19 provides that shareholder approval is only required for termination payments exceeding 5% of the market capitalisation of a company. Neither of these legislative requirements imposes a meaningful threshold on executive termination payments requiring shareholder approval, and current examples demonstrate the excessive termination payments which have been allowed to occur as a result.

## 6 Implications for remuneration practices

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Key to the success of any remuneration plan is for a competent board to exercise their own judgement and expertise to take account of the specific financial and operational circumstances of the company<sup>10</sup>.

All remuneration for an executive in any given year above a board-determined threshold must take the form of common equity vesting over a period of five to ten years following the performance period, with any dividends paid on common equity during escrow to be reinvested in shares bought on-market.

### 6.1 Base pay

It is anticipated that the majority of boards would select a threshold above the level of an executive's base pay, therefore leaving the current functioning of base pay being paid up front in cash largely unchanged.

### 6.2 Short-term incentive

Short-term incentive rewards earned by executives at the end of a performance period that fall below the chosen threshold would continue to be paid to executives in the form of cash. However, the portion of earned short-term incentive reward that exceeds the chosen threshold must be invested via an XSOP and held in escrow for the five to ten years.

### 6.3 Long-term incentive

It is expected that long-term incentive payments would typically exceed the chosen threshold, therefore all long-term incentive rewards earned by executives at the end of a performance period would be fully invested via the XSOP and held in escrow for five to ten years.

It is recognised that the natural alignment and motivation provided by a five to ten year vesting period, combined with appropriate initial performance periods, has the potential to reduce the instances of highly complex variable reward structures while retaining appropriate short-term and long-term aspects. boards may cease to divide variable remuneration programs into separate short-term and long-term components. It may instead become acceptable that a single performance period over which hurdles are measured (for example, three years) is chosen to capture short-term considerations, and exposure to share price over five to ten years would be relied upon to incorporate a long-term element. Key to the success of any variable remuneration plan would however, continue to be the board's utilisation of strategy-relevant hurdles, as a means to distinguish and reward exceptional performance by executives.

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<sup>10</sup> Consistent with principle 1 from the Financial Services Authority (UK) draft Code of practice on remuneration policies, issued 27<sup>th</sup> February 2009.

#### **6.4 Termination payments**

Termination payments would be crucially affected by the proposed remuneration reform. Not only would termination payments exceeding 12 months' base salary require shareholder approval, but consistent application of the threshold across all forms of pay would require any termination payment in excess of that threshold to be paid as common equity vesting over five to ten years. Therefore, even for shareholder-approved termination payments, the final worth of that termination payment would be influenced by the long-term success (or otherwise) of the company.

In addition to termination payments vesting post-employment for executives, it may be appropriate in many cases to allow tranches of common equity granted during employment to vest over the original five to ten year timeframes, despite the fact that the executive has left the company. While some may argue that this type of arrangement may unfairly punish former executives for the mistakes of their successors, it will in fact produce the very positive outcome of naturally embedding succession planning as a key measure of success.

#### **6.5 Board discretion**

The board will have discretion to determine appropriate thresholds for key management personnel. Boards may nominate a single threshold for their entire key management personnel, or alternatively determine appropriate individual thresholds. In cases where it is necessary to attract international talent, this can be achieved under the proposed reform by the board raising the threshold for either the Chief Executive or select senior executives to a level where immediate payments are considered competitive in the international market.

It may also be appropriate for boards to use discretion in the application of the proposed remuneration reform. Examples of discretion include; offering alternative forms of equity to be held in escrow via the XSOP, changing the vesting period of the XSOP, or allowing XSOP tranches to vest early (for example, in cases where the board changes the strategic direction of the company after an executive has retired). In cases where the board has used its discretion, the details and rationale for that discretion should be disclosed to shareholders using an "if not, why not" statement as is required of companies adhering to ASX Corporate Governance Principles.

## 7 Case studies

The following case studies were compiled using the assumption that company share prices remained steady from 12<sup>th</sup> March 2009 through to 30<sup>th</sup> June 2009. It should also be noted that were a dividend reinvestment plan in operation on the securities held in escrow via the XSOP, the total career rewards cited in the following case studies would vary upward depending on the company's dividend policy.

### 7.1 Transurban Group – Mr Kim Edwards

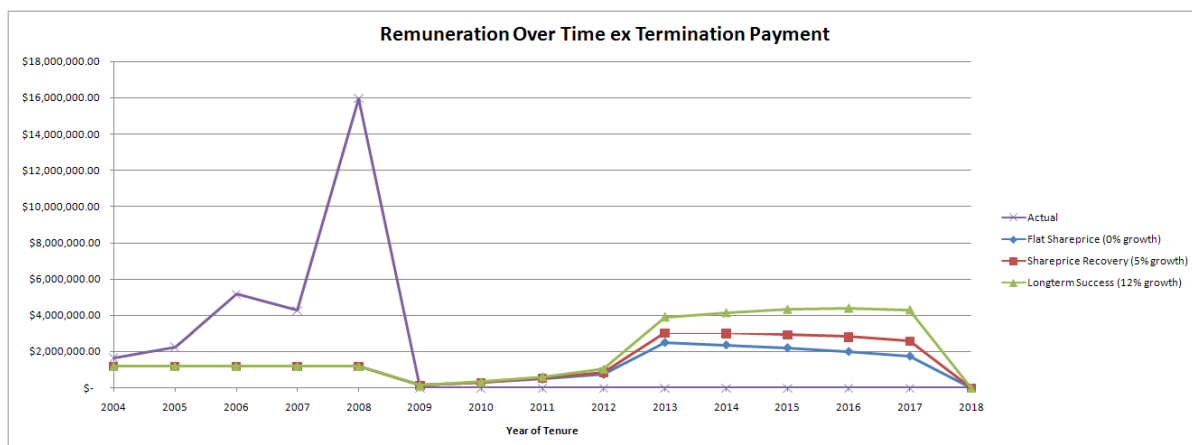
As the outgoing Chief Executive of Transurban Group retiring on 4<sup>th</sup> April 2008, Kim Edwards received \$16 million remuneration in his final year including a \$5.2 million termination payment. Two months later under a new Chief Executive, the company announced that the previous shareholder distributions of 58c were “substantially in excess of operating cash flow per security”. A capital raising, a halving of future distributions and a cost reduction program were subsequently announced. The stock price now sits at \$3.91 as at 12<sup>th</sup> March 2009, relative to \$6.60 on Kim Edwards' day of retirement.

#### *Treatment Under Proposed Remuneration Reform*

Under the proposed remuneration reform had the board chosen a threshold of \$1.2 million, Kim Edwards' remuneration over his last five years at Transurban Group would have been largely invested in Transurban Group shares which would continue vesting until 2017. In addition, it is anticipated that shareholders would have rejected Kim Edwards' termination payment of \$5.2 million, given that shareholders rejected the FY08 remuneration report (46% voted against, 21.3% abstained) in protest at his final remuneration package.

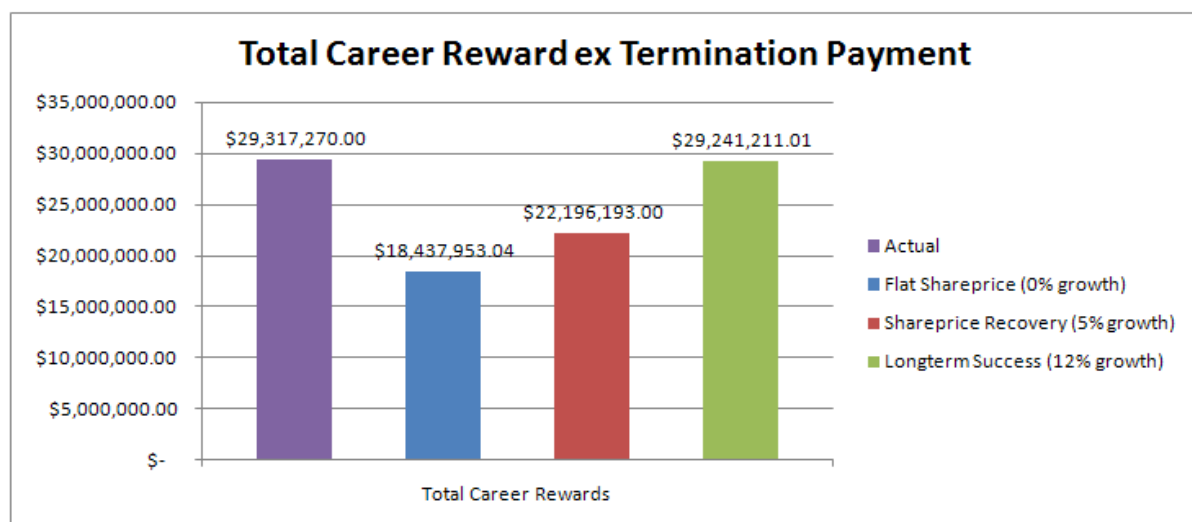
Graph 1 illustrates the gradual delivery of rewards excluding the \$5.2 million termination payment for three alternative share price scenarios (flat share price, share price recovery and long-term success) which would have taken place under the proposed remuneration reform. This is contrasted with the actual “lump-sum” delivery of rewards (actual) which completed in 2008.

**Graph 1**



Graph 2 highlights the alignment between executives and shareholders produced by the proposed remuneration reform, by demonstrating how total remuneration shifts relative to the long-term success (or otherwise) of the company. In the event of prolonged depression of shareholder value (flat share price), Kim Edwards' reward is curbed from \$29.3 million to \$18.4 million. If, however, Transurban Group recovered its value (share price recovery of 5% per annum) then his eventual reward would also have recovered its value to \$22.2 million. Only in the case of long-term success (share price growth of 12% p.a.) is Kim Edwards' remuneration under the proposed reforms equivalent to the actual payout of \$29.3 million by rising to \$29.2 million<sup>11</sup>.

**Graph 2**



<sup>11</sup> Note that the differences between actual reward and reward levels under the proposed remuneration reform in graphs 1 and 2 are different to the \$5.2 million quantum of the termination payment, because of two reasons; 1. the effect of compound growth on share price, and 2. the difference between stated value of long-term incentives at the time of their granting and the actual value of those long-term incentives when they vest.



## 7.2 Oxiana (now Oz Minerals) – Mr Owen Hegarty

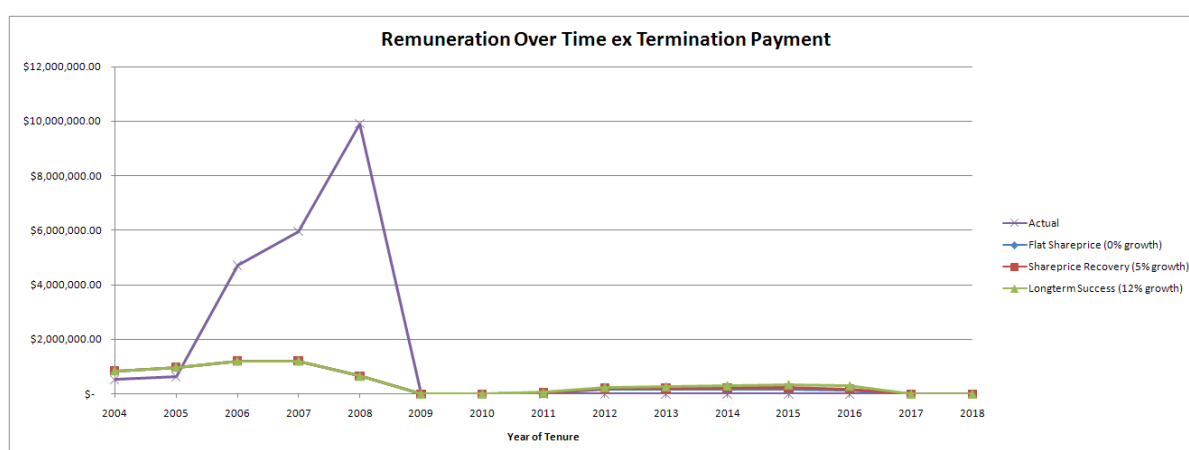
Toward the end of his tenure, Owen Hegarty engineered a merger of Oxiana with Zinifex which was very unpopular with shareholders and widely commented on as destroying shareholder value. Upon his retirement the Oxiana board proposed a \$10.6 million termination payment to shareholders under obligation from legislation (due to the size of the payout), which shareholders rejected. Later, the board of the new company, Oz Minerals, elected to award Owen Hegarty a slightly smaller termination payment of \$8.35 million which was not large enough to trigger a shareholder vote under ASX Listing Rules or the Corporations Act. Oxiana's share price has since fallen from \$2.63 at Owen Hegarty's retirement on 20<sup>th</sup> June 2008, to \$0.60 as at 12<sup>th</sup> March 2009.

### *Treatment Under Proposed Remuneration Reform*

Under the proposed reform had the board chosen a threshold of \$1.2 million, a majority of Owen Hegarty's remuneration over his last five years at Oxiana would have been invested in Oxiana shares (now Oz Minerals) which would continue vesting until 2017. It is also very likely that shareholders would have rejected his termination payment of \$8.35 million, given that they had already rejected the \$10.6 million termination payment.

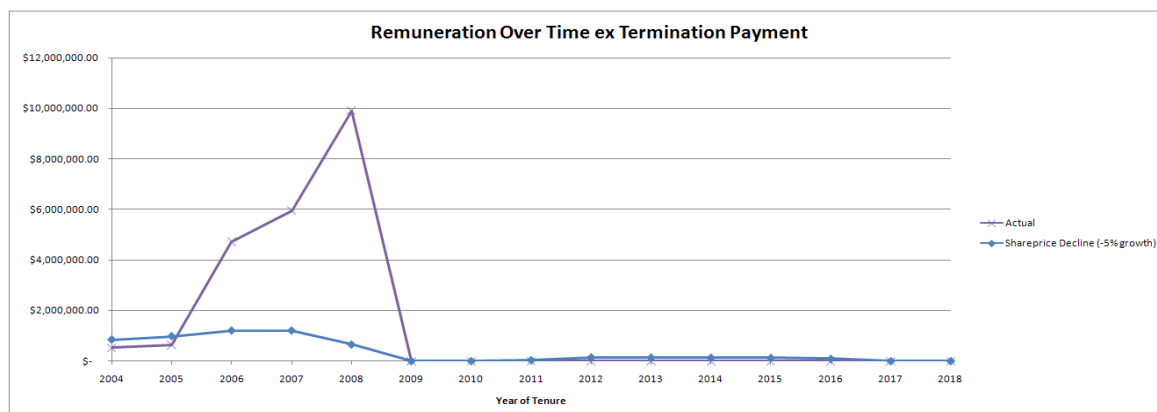
Graph 3 shows the gradual delivery of rewards excluding the \$8.35 million termination payment for three alternative share price scenarios (flat share price, share price recovery and long-term success) which would have occurred under the proposed remuneration reform. This gradual delivery of rewards clearly contrasts with the actual "lump-sum" delivery of rewards (actual) which finished in 2008.

**Graph 3**



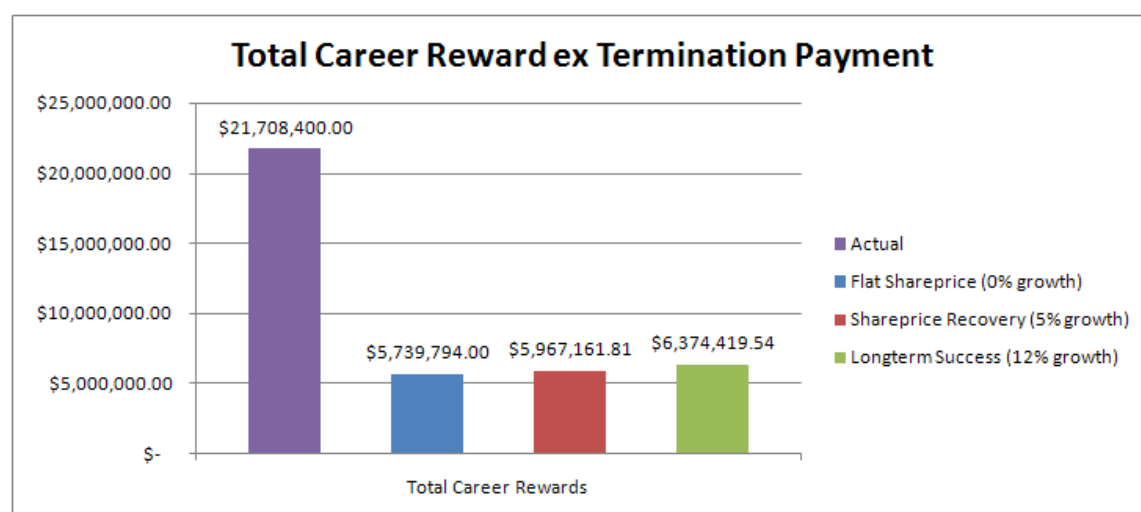
Graph 3a has also been included to demonstrate the delivery of rewards under a fourth scenario, where Oxiana's share price continues its current decline.

**Graph 3a**



Graph 4 highlights the alignment between executives and shareholders produced by the proposed remuneration reform, by illustrating how total remuneration shifts with the success (or otherwise) of the company. If shareholder value remains depressed for a long period of time (flat share price) Owen Hegarty's reward drops from \$21.7 million to \$5.7 million. Alternatively, if Oz Minerals recovers its value (share price recovery of 5% p.a.) then Owen Hegarty's reward recovers to \$6 million. In the event that Oz Minerals does experience long-term success (share price growth of 12% p.a.) then Owen Hegarty's reward would reflect that by rising to \$6.4 million, but note that this is still substantially less than the actual reward of \$21.7 million<sup>12</sup>.

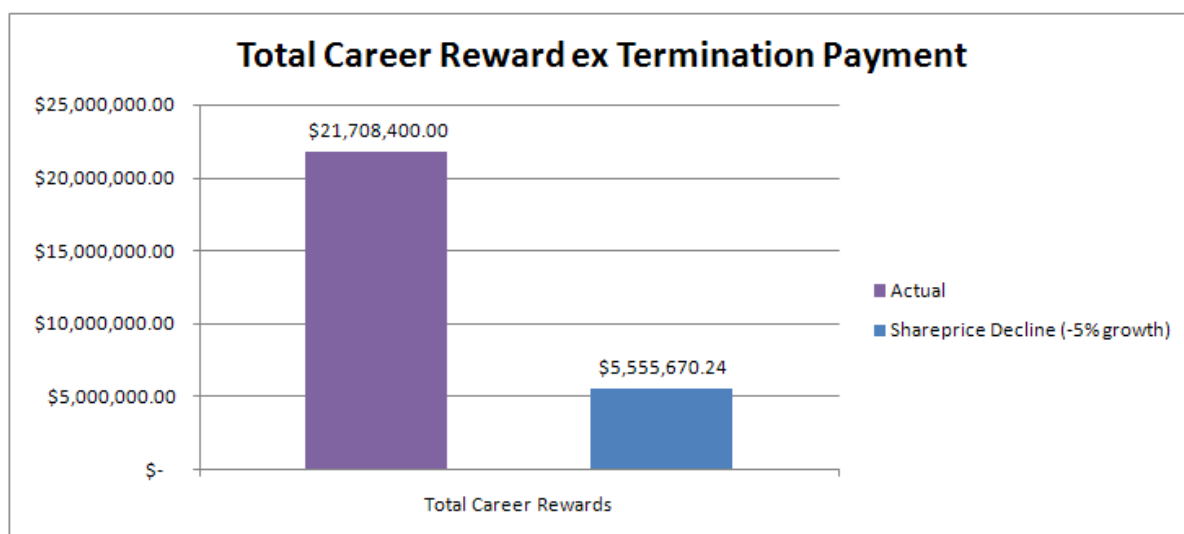
**Graph 4**



<sup>12</sup> Note that the differences between actual reward and reward levels under the proposed remuneration reform in graphs 3/3a and 4/4a are different to the \$8.35 million quantum of the termination payment, for two reasons; 1. the effect of compound growth on share price, and 2. the difference between stated value of long-term incentives at the time of their granting and the actual value of those long-term incentives when they vest.

Again an additional graph (Graph 4a) has been included to illustrate what Owen Hegarty's reward would be in a fourth scenario, where Oxiana's share price continues its current decline (share price growth of -5% p.a.). In the event that this occurs, Owen Hegarty's reward falls even further down to \$5.6 million.

**Graph 4a**



### 7.3 AGL Energy – Mr Paul Anthony

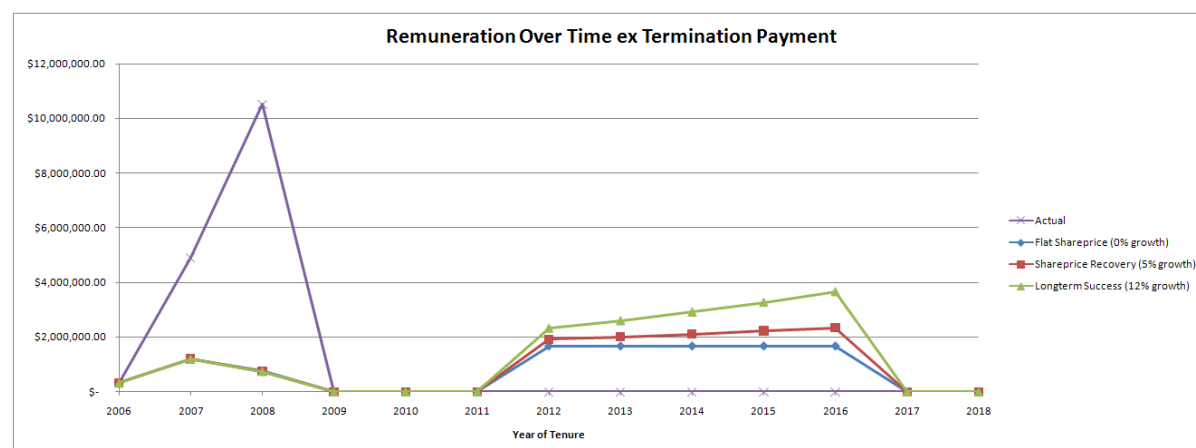
Paul Anthony experienced very high levels of remuneration during an 18 month tenure at AGL Energy preceding and following its listing on 12<sup>th</sup> October 2006. As part of sign-on, Paul Anthony received \$1.64 million cash and approximately \$4.7 million of AGL Energy shares held in escrow for two years. In addition, he received a \$1.56 million cash bonus during his first year of tenure. However on the 15<sup>th</sup> October 2007 AGL Energy issued a substantial profit downgrade, followed shortly by Paul Anthony's resignation on 22<sup>nd</sup> October 2007. Over the space of ten days from the profit downgrade to Paul Anthony's resignation, AGL Energy shares lost 17.4% of their value. Almost 12 months after Paul Anthony's resignation, shareholders learned via the FY08 Annual Report released in September 2008 that a termination payment of \$5.1 million had been paid.

#### *Treatment Under Proposed Remuneration Reform*

Under the proposed remuneration reform had the board chosen a threshold of \$1.2 million, much of Paul Anthony's remuneration over his 18 month tenure at AGL Energy would have been invested in AGL Energy shares which would continue vesting until 2017. This is similar to some aspects of Paul Anthony's actual remuneration package where \$4.7 million of his sign-on bonus was invested in AGL Energy shares, originally to be held in escrow for two years. Given the sudden profit downgrade and departure of Paul Anthony, coupled with an immediate share price fall of 17.5%, it is anticipated that shareholders would have rejected Paul Anthony's termination payment of \$5.1 million.

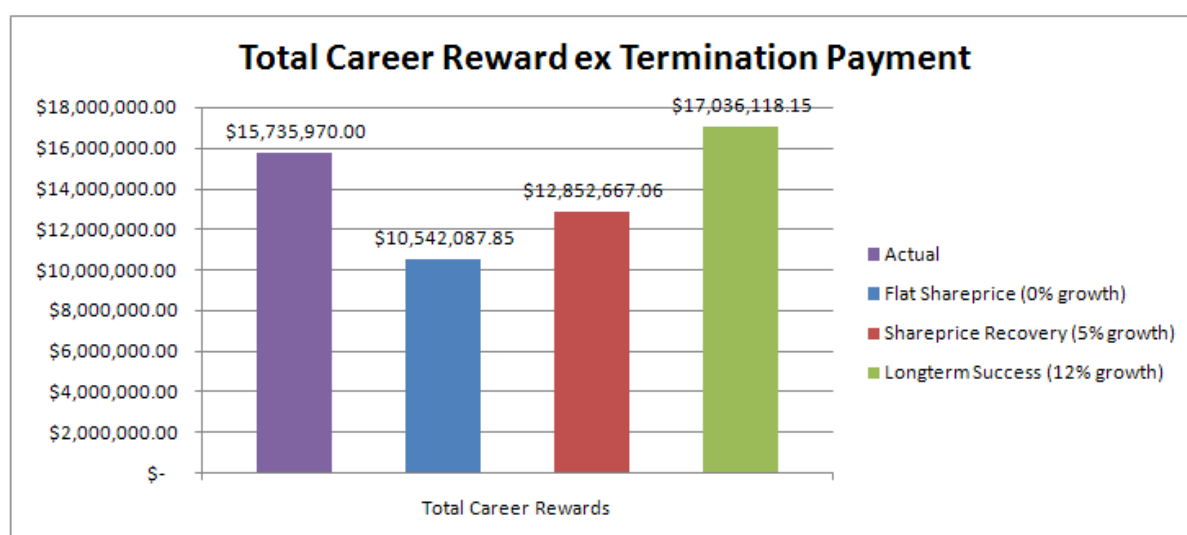
Graph 5 demonstrates the gradual delivery of rewards excluding the \$5.1 million termination payment for three alternative share price scenarios (flat share price, share price recovery and long-term success) which would have occurred under the proposed remuneration reform. This steady delivery of rewards is contrasted with the actual "lump-sum" style of payments (actual) which completed in 2008, albeit the "lump-sum" aspect was partially reduced by part of the sign-on bonus taking the form of AGL Energy shares held in brief escrow (two years at most).

**Graph 5**



Graph 6 illustrates the alignment between executives and shareholders produced by the proposed remuneration reform, by demonstrating how total remuneration shifts relative to the long-term success (or otherwise) of the company. In the event that AGL Energy's share price remains depressed (flat share price), Paul Anthony's total reward over 18 months is reduced from \$15.7 million to \$10.5 million. If shareholder value is to recover instead (share price recovery of 5% p.a.), then Paul Anthony's total reward also recovers to \$12.9 million. Alternatively, were AGL Energy to experience long-term success (share price growth of 12% p.a.) then Paul Anthony's total reward would rise with the rise in shareholder value to \$17 million. It is worth noting that the differences between Paul Anthony's actual reward and his rewards under the proposed remuneration reform are not as dramatic as in other case studies, due to the fact that \$4.7 million of sign-on bonus was exposed to the AGL Energy share price during its dramatic decline of 17.5% in October 2007<sup>13</sup>.

**Graph 6**



<sup>13</sup> Note that the differences between actual reward and reward levels under the proposed remuneration reform in graphs 3/3a and 4/4a differ to the \$5.1 million quantum of the termination payment, for three reasons; 1. the effect of compound growth on share price, 2. the difference between stated value of long-term incentives at the time of their granting and the actual value of those long-term incentives when they vest, and 3. Exposure of a \$4.7 million sign-on bonus to the AGL Energy share price during its 17.5% decline in October 2007.