

Submission to the Productivity Commission

Executive Remuneration inquiry

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The submission is made from the experience and knowledge of the author as:

- One of seven owner/managers of a private equity group, Tjuringa Securities Limited¹ that acquired control and re-organised a dozen Publicly Traded Companies (PTCs) from 1967 to 1974.
- Chairman, Chief Executive and/or a director of a number of PTCs, some of which were founded by the author. Director of Australian Shareholders Association 1992–84 with other directorships listed at <http://www.linkedin.com/pub/0/aa4/470>;
- Initiator in 1971, co-author in 1975 and presenter until 2000 of the first course in the world to provide an educational qualification for company directors;
- Co-founder in 1986 and currently a Vice President of the Australian Employee Ownership Association – www.aeo.org.au;
- Undertaking PhD research² into corporate governance with two³ core chapters of the dissertation selected to be re-published with the seminal contributions of leading international scholars in the Corporate Governance volume of the *History of Management Thought*, ed. R. I Tricker, Ashgate Publishing, 2000, London.
- A social science researcher whose writings posted at <http://ssrn.com/author=26239> are downloaded more than any other Australian from the Social Science Research Network that has over 110,000 contributing scholars from around the world.

Recommendations:

- 1) No cap on executive remuneration should be required by the law and/or by regulators only shareholder approved differential between highest and lowest paid employee.
- 2) Remove absolute power of directors to manage absolutely their conflicts of interest.
- 3) Executive pay determined or vetoed by a democratically elected shareholder committee.
- 4) Shares/options obtained by any one executive subject to shareholder approved multiple of shares/options obtained by lowest paid employee among 75% of all employees
- 5) Network governance introduced to enhance performance without excessive pay

Appendix attached: Trevor Sykes interview with David Gonski: 'Why two boards may work better than one', *The Australian Financial Review*, Weekend 23–4, p.14, June, 2001.

¹ Everingham, S. (2009), *Gordon Barton: Australia's Maverick Entrepreneur*, Allen and Unwin, Sydney.

² *The governance of firms controlled by more than one board: Theory development and examples*, PhD dissertation, Macquarie University, 2000 available at <http://ssrn.com/abstract=858244>.

³ Corporate Governance: Its scope, concerns & theories', pp. 415–40 and 'Stakeholder Governance: A cybernetic and property rights analysis', pp. 401–13 in *Corporate Governance: The history of management thought*, R.I. Tricker, ed, Ashgate Publishing, 2000, London.

Outline of submission

Australian law, regulations, regulators and the Australian Securities Exchange (ASX), like many overseas, are irresponsible in allowing corporations to be publicly traded while allowing their directors to possess absolute power to corrupt both themselves and the business. Refer to my 2007 post on the 'Harvard Law School Forum on Corporate Governance and Regulation' at <http://blogs.law.harvard.edu/corpgov/2007/11/08/are-regulators-and-stock-exchanges-irresponsible/> and the "inappropriate powers" of directors detailed by the international doyen of shareholder activism Robert Monks⁴.

In particular, directors obtain absolute power to manage their own conflicts of interest in regards to their own remuneration and tenure as well as control of the auditor who is appointed to judge their accounts on which shareholders can hold them accountable.

It is undesirable, inefficient and impractical for the law, regulations, regulators, ASX and/or the dispersed shareholders of PTCs to directly determine Executive Remuneration so an indirect approach is required by establishing a shareholder committee. This provides a basic building block for establishing network governance described later. The knowledge required to evaluate senior executives and the nuances of their personalities makes it impractical for public shareholders to make an informed decision on their remuneration. An independently elected shareholder committee with access to advice from any insiders or others they wish to consult with references from outside the executive chain of command provides a superior basis for making objective judgements not compromised by loyalty to board colleagues and/or director dependency on management.

One must conclude that the most appropriate, constructive and efficient method to control executive remuneration cannot be achieved by allowing directors absolute power to determine their own remuneration. Instead, shareholders, ASX, the law and/or regulators must require the introduction of a division of power to remove and/or manage all director conflicts of self-interest. These would include determining their remuneration, nomination, retirement and governance of the Auditor.

It is recommended that a condition for any corporation to become a PTC or regulated by the Australian Prudential Regulatory Authority (APRA) is that the governance power of directors are separated from their management powers by the establishment of a separately democratically elected: (i) "Corporate Senate"⁵ as established by the Author for a public company in 1988 or (ii) "Governance Board" as proposed by Senator Andrew Murray in his 1998 *Minority report, report on the company law review bill, 1997*, Australian Parliamentary Joint Committee on Corporations and Securities, as posted at http://www.aph.gov.au/senate/committee/corp_sec_ctte/companylaw/minreport.htm. When an APRA regulated identity has only a single shareholder then one or more stakeholder councils could be formed to provide advice on remuneration and act as

⁴ Monks, R. and Sykes, A. (2001), *Capitalism without owners will fail: A policy maker's guide to reform*, New York Centre for the Study of Financial Innovation, p.9, New York and London.

⁵ Turnbull, S. (2000), 'Corporate Charters with Competitive Advantages', *St. Johns Law Review*, St. Johns University, New York City, 74:44, pp. 101–59, Winter, <http://ssrn.com/abstract=10570>.

co-regulators. The impossibility of achieving even inefficient regulation without co-regulation is explicated in my PhD Thesis and in other articles⁶.

Discussion of points raised in Issues Paper

Remuneration needs “to be competitive internationally” (Issues paper p.8)

This self-serving argument that Australian firms need to adopt internationally competitive remuneration to attract and retain executives should not be accepted because:

- (a) This argument assumes that attracting and retaining talented executives is largely dependent upon the level of remuneration. This is clearly not the case as shown by the many talented and gifted executives employed in the public sector, non-profit organisations and in the substantial majority of firms in the private sector that cannot remunerate their executives with publicly traded shares or options. The Power, Status and Influence of being a CEO of a major organisation provide its own rewards and incentive to excel.
- (b) If remuneration is the principal motivating factor in attracting and retaining talented executives then such executives possess values that are inconsistent with social responsibilities and furthering the public good that is supposed to be unwittingly achieved by the “invisible hand” of Adam Smith.
- (c) Corporate performance, however it may be measured, should not be dependent upon a few top executives but also on the directors, all employees, and the other stakeholders on whom all firms depend for their existence. It is unacceptable for PTCs to maintain a culture and/or organisational structure where the performance of the firm becomes critically dependent upon a few individuals for its success. Research has shown that superior performance is achieved by replacing centralised command and control organisational architecture controlled and so dependency upon a few individuals with “Network governance”⁷. Network governance allows ordinary people to achieve extraordinary results by introducing distributed: intelligence; communications, and decision making as commonly emerges in firms developing the most advanced technology in the most dynamic markets⁸.
- (d) If a PTC is so structured that its success is dependent upon a few critically important individuals then the business is put at risk if directors have not established an internal executive development program to allow: (i) internal replacement and/or (ii) an internal market for executive talent to reduce pressures for increasing remuneration. If directors have failed in this regard then there are grounds to consider directors as not “fit and proper persons” for firms subjected to prudential regulation by APRA. This could

⁶ Turnbull, S. (2007), ‘The Theory and Practice of Government De-regulation’ presented to a UK Financial Reporting Council staff seminar, Thursday, August 13th, 2007 and to the 2nd Cambridge University Conference on Regulation, Inspection & Improvement, Centre for Business Research, Judge Business School, University of Cambridge, September 12th, 2007. The paper is available at http://papers.ssrn.com/abstract_id=1008453. Also, Turnbull (2009), ‘Mitigating the exposure of corporate boards to risk and unethical conflicts’ in *Risk Management and Corporate Governance*, Wiley-Blackwell Publishing, Loyola University Monograph Series, Chapter 7, pp. 143–74, http://papers.ssrn.com/abstract_id=1106792.

⁷ Turnbull, S. (2001), *A New Way to Govern: Organisations and society after Enron*, The New Economics Foundation, 2002, London, http://ssrn.com/abstract_id=319867.

⁸ Jones, C., Hesterly, W.S. and Borgatti, S.T. (1997) ‘A general theory of network governance: Exchange conditions and social mechanisms’, *Academy of Management Review*, 22:4, 911–45, <http://www.analytictech.com/borgatti/oppamr6z.htm>.

- provide grounds for APRA to require the longest serving directors who made up say a third of the board to retire. As this policy would most likely include the chair, a very strong incentive would be established for prudentially regulated institutions to establish depth in management to avoid external hiring and establish internal market pressures to moderate executive remuneration. If an outside appointment is required to introduce a new culture to the business, then this requirement would also prima facie create a need to change directors to lead a cultural change, so retiring a third of the most senior board members would be consistent with the argument that a new culture was required.
- (e) The quality of life of living in Australia provides offsetting attractions. Foreign executives are less likely to be socially sensitive to national values and collegiate pressures without the need to be respected local citizen after their retirement as they return to another country. In a global downturn the opportunities for Australian executives to be hired away overseas is reduced.

Need to align executive pay with performance (Issues Paper, p.11)

The points made above for rejecting the need for executive remuneration to be internationally competitive also provide the arguments for not needing to align executive pay with performance. An exception is with newly established firms that are short of cash and so payment in equity rather than cash is required. In this situation the use of equity to in part reward all employees becomes appropriate. The acceptance of the risk of accepting equity rather than cash can justify more generous remuneration with success. The concern is then not the level of remuneration but its equity with all employees.

Is recommended that in both new start up firms and in mature PTCs that the ASX require all employees participate in any share or option plan with the differential in equity entitlements between the lowest and highest remunerated employee not being greater than some industry accepted basis like one to ten. The need for a higher ratio raises the arguments set out above that remuneration should not become the over-riding determinant for attracting and retaining management expertise. Because of the distributed intelligence and expertise in network governed firms a ratio of one to ten has proven to provide firms with internationally competitive advantages as described in chapter six of my PhD dissertation posted at <http://ssrn.com/abstract=858244>.

Observations in regards to the Terms of References (TOR)

TOR 1

Remuneration matters should be left for shareholders to determine provided that a legal framework exists that provides them with the *information, will and means to act*. These conditions cannot be met directly with diverse shareholders. In addition, the asymmetry of power of contemporary corporate constitutions is biased to favour the interest of directors who in turn can be captured by executives they are evaluating. The recommendations of this submission provide a way to correct the asymmetry of power and the inherent conflicts of interests arising from combining the power to manage a business with governance powers.

The need for a separation of powers was recognised by the current chairman of the ASX, David Gonski, as set out in the Appendix that reproduces an *Australian Financial Review* article, 'Why two boards may work better than one'. However, this article discusses only one board being elected by shareholders with the second board appointed by the first. The recommendations of this submission are based on shareholders electing two boards to protect

minority interests. Minority interests are protected by the Corporate Senate or Governance Board being elected on a democratic basis of one vote per investor while the management board is elected on a plutocratic basis of one vote per share to protect the property rights of investors.

The role of the Corporate Governance Board is to take over the role of board committees that have an inbuilt conflict of interest for directors such as those relating to remuneration, nomination and audit. In this way it removes the conflicts and simplifies the role of directors to protect them from liabilities⁹. It illustrates the power of network governance to decompose the complexity of decision making labour. The Corporate Senate established by the author for a start up company in 1988 only takes over the power of selecting, controlling and remunerating the auditor and chairing shareholder meetings but with veto rights over any other matter in which directors have a conflict. In this way it obtains veto rights over remuneration, nomination and related party transactions. Its veto can however be overturned by directors going to shareholders who vote on a plutocratic basis. But this would expose the conflict to public debate with the market price of the shares being the final arbitrator.

TOR 2

The existing framework of oversight, accountability and transparency of remuneration practices is irresponsible in providing excessive and inappropriate powers to directors. It is futile to require greater transparency with more information if those that obtain the information do not have the will or power to act. The need for corporate disclosure on remuneration, nomination, audit and corporate governance practices could be substantially reduced by the recommendations of this submission. Strategies for reducing the need for excessive regulation and the introduction of self-governing processes are set out in 'Streamlining Prudential Regulation with Self-enforcing Co-regulation', submitted February 14, 2007 to Australian Treasury Inquiry into "Rethinking Regulation Project" available from http://www.treasury.gov.au/documents/1251/PDF/Shann_Turnbull.pdf and also at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=979531. Refer also to 'Inquiry into shareholder engagement and participation', submitted, September 29th, 2007, to Australian Joint Parliamentary Committee on Corporations and Financial Services, http://www.aph.gov.au/senate/committee/corporations_ctte/sharehold/submissions/sub23.pdf

TOR 3

As discussed above consideration of the role of investors in remuneration practices should be minimal such as determining: (i) Total board remuneration (ii) The maximum number of shares or options that can be issued to employees and (iii) The maximum number of shares and/or options any single executive can obtain as a multiple of the shares and/or options obtained by the lowest paid employee among at least 75% of all those employed. Division 13A of the Australian Income Tax Assessment Act currently specifies at least 75% employee participation for a "qualifying" plan. Tying executive share and options issues to the existence of broad based employee share plans introduces a powerful incentive for directors to introduce employee equity participation. It would also moderate the number of shares and options available to any one executive and reduce unacceptable pay differentials.

⁹ Not with-standing the conflicts of interest created for both directors and auditors, APRA has required firms subject to its supervision to accept them by mandating the ASX corporate governance code. The problems of corporate governance codes are described in Turnbull (2009) 'Why "best" corporate governance practices are unethical and less competitive?' in *Global Perspectives in Business Ethics*, Hartman, L. and D. Bevan, Chapter 7: "Ethics in Finance, Governance & Accounting." London, UK: McGraw-Hill, available from: <http://ssrn.com/abstract=1260047>.

TOR 4
Mechanisms that would better align the interests of executives to shareholders are inherent in adopting all five recommendations of this submission listed on the first page.

TOR 5
Effectiveness of the international responses to remuneration issues from English speaking countries can be of little significance as they have not as yet addressed the problem of directors possessing inappropriate and excessive power to corrupt themselves and their businesses. Refer also to my submission to European Commission Consultation Document: “Fostering an appropriate regime for shareholders’ rights” posted in January 2004, pages 63 to 67 at <http://www.oecd.org/dataoecd/38/22/27211386.pdf>.

TOR 6
The current tax system provides a compelling incentive for executives of PTCs to increase the risk of insolvency because it creates a persuasive bias to use debt rather than equity. Interest is tax deductible but not the cost of servicing equity as exists for trusts, partnerships, joint ventures and cooperatives. A neutral enterprise tax system would not create a bias for corporations to use debt finance. The case for a neutral tax system is presented in my article: 'A Neutral Enterprise Tax System', *Jassa*, The Securities Institute of Australia, No. 2, pp. 22-24, June, 1979. This was appended to my submission of May 1, 2009 to the Treasury inquiry into "Australia's Future Tax System".

TOR 7
The existing framework governing remuneration practices in Australia is unacceptable and requires to be changed as set out in my recommendations. My recommendations are more fully explained in my paper judged the best presented to a conference last year at Loyola University now published as 'Mitigating the exposure of corporate boards to risk and unethical conflicts' in *Risk Management and Corporate Governance*, Wiley-Blackwell Publishing, Loyola University Monograph Series, Chapter 7, pp. 143–74, 2009, http://papers.ssrn.com/abstract_id=1106792. The collateral improvements in corporate social accountability and reduction in the need for reporting are explained in my submission to the Australian Joint Parliamentary Committee on Corporations and Financial Services inquiry into Corporate Responsibility, November, 2005, on 'Enhancing Corporate Operations and Social Accountability' <http://ssrn.com/abstract=800904>.

I would be pleased to answer question on this submission in person. I will be overseas from June 22nd to July 20th

Shann Turnbull PhD
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27 May 2009.

Sykes downtown | Trevor Sykes

Why two boards may work better than one

The Australian Securities and Investments Commission's lawsuit against former executives of GIO should send a shiver up the spines of managements around the nation.

It should also send a few shivers through the ranks of company directors, because the ASIC action – taken to its logical extreme – could imply they are becoming irrelevant.

ASIC has alleged that the former executives Geoffrey Vines (chief financial officer), Frank Robertson (chief executive of the subsidiary GIO Australia) and Timothy Fox (executive director of the reinsurance division) breached their duties as officers of GIO during the takeover of GIO by AMP in 1998-99.

They are alleged to have released information to shareholders that was misleading by forecasting a pre-tax profit of \$80 million from the reinsurance business for the 1999 financial year. At least a few GIO shareholders must have listened, because AMP managed to bag only 57 per cent of the company. After the takeover, the result was revealed to be a \$759 million loss.

Whether the executives are found innocent or guilty, the most interesting point about the case is that ASIC has flagged an intention to look past directors and auditors and target management wherever it



David Gonski

thinks appropriate. This means that in the space of about 12 years, corporate accountability has gone around in a circle.

This notion is largely a result of the excesses of the 1980s, when cowboys such as George Herscu and Christopher Skase ran amok in corporate empires where they were both chief executives and the largest shareholders. In the most bizarre cases, Alan Bond and Laurie Connell denied having control of Bond Corp and Rotowheel respectively, but nobody believed them. The solution seemed to be to control headstrong

chief executives by having boards with a majority of non-executive directors.

This has now been extensively tried, with very mixed results. Some companies where executives have strong control (Westfarmers, News, PBL, Westfield) have worked very well. On the other hand, every time a big company collapses, the non-executive directors wall that they never knew what was happening. If non-executive directors are going to imitate Pontius Pilate every time the going gets tough, it is worth asking what use they are at all, if any?

One possible solution that is getting some attention at the top of ASIC is the introduction of two-tiered boards. One advocate is prominent Sydney lawyer and director David Gonski, who has pointed out that the boards of mainland European companies are structured differently from those of England and Australia. Gonski's proposals still need some work, but broadly he is suggesting that Australian companies might consider the German structure of a management board and a supervisory board. In this model, the management board is responsible for the running of the company. The supervisory board comprises non-executive directors with limited functions and limited liability.

The supervisory board sets policy, such as whether the company goes into a new area of business or into new countries. Management makes the announcements to the stock exchange and regulator and controls the money generated by the business or invested in it.

In Germany, shareholders elect the supervisory board, which in turn appoints the management board. In Italy and France, both are elected by shareholders.

"Aficionados will be watching the ASIC case with fascination."

Gonski believes that managers tend to become insular without outside advice and guidance, and that total control by management tends to breed blind obedience to the chief executive. He also believes that his suggestion would improve the quality of boards because too many professionals do not want to run the risk of a directorship as long as the current system of liability is in place. It is not as radical as it may seem. The effective centre of power in most big companies is the executive committee, which would simply be renamed a management board. And as directors' duties would be

important but relatively light under the proposal, presumably we wouldn't have to pay directors so much.

This would remove one burden created by directors at present. Under the current system, directors' salaries, super, share schemes and insurance cost companies a heap. They also spend less time trying to run the company than they do trying to ensure their backside is covered in the event of anything going wrong. This means non-executive directors have become a significant cost centre and have still proved incapable of preventing collapses.

Meanwhile, corporate aficionados will be watching ASIC's case against the GIO executives with fascination. Two points in the case will be of great interest. The first, appealing mainly to actuaries and maths nerds, will be why the disparity was so great between the forecast reinsurance profit of \$80 million and the resulting loss of \$759 million.

The second will be whether the executives were under pressure from anyone to tailor their forecasts. For the moment, the former directors of GIO have been bypassed by the regulator. They will doubtless be hoping the evidence that emerges in this case keeps them on the sidelines. ASIC is very active these days.