CHARTERED SECRETARIES
AUSTRALIA

Leaders in governance

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Dear Geoff

The clawback of executive remuneration where financial statements are materially misstated

Chartered Secretaries Australia (CSA) is the independent leader in governance and risk management. As the peak professional body delivering accredited education and the most practical and authoritative training and information in the field, we are focused on improving organisational performance and transparency.

Our Members are all involved in governance, corporate administration and compliance with the Corporations Act (the Act), with primary responsibility to develop and implement governance frameworks in public listed and public unlisted companies, as well as in private companies. Our Members also deal daily with the Australian Securities Exchange (ASX) and interpret and implement the Listing Rules. We have drawn on their experience in the formulation of this submission.

General comments and recommendations

CSA welcomes the discussion paper, *The clawback of executive remuneration where financial statements are materially misstated* (the discussion paper). CSA is on record as having recommended in its two submissions to the Productivity Commission in response to its inquiry into the regulation of director and executive remuneration that the company should reserve the right, at the discretion of non-executive directors to:

- reclaim performance-linked remuneration elements which were paid to or vested on executive directors on the basis of results that afterwards were found to have been significantly misstated because of wrongdoing or malpractice (a 'clawback' provision)
- not make such payments if the results are found to be manipulated.

CSA commends the government for recognising, in the discussion paper, that Australian governance frameworks are very sound and a legislative approach may not be the optimal one in relation to the clawback of executive remuneration.

CSA recognises that the community, and its political representatives, are keen to examine to what extent remuneration is a private matter to be agreed between executives and companies, applying whatever governance processes properly protect the interests of owners, and to what extent there should be a community or public right to intervene in remuneration arrangements.

CSA is of the view that the clawback of executive remuneration is best dealt with in the employment contract between an executive and the company, with directors accountable for their decision through disclosure to their shareholders whether such contractual arrangements are in place. While legislation appears to be a holistic solution, with a clear enforcement capacity, it is an inflexible approach that provides a one-size-fits-all solution that is not appropriate to apply to all companies.

CSA notes that the financial interest in a company rests with the shareholders, creditors and employees. The community does not have a financial stake in an executive's remuneration except if community members are shareholders. The ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* (the guidelines) provide a mechanism for the review of decisions takes by directors. The 'if not, why not' regime provides opportunities for engagement by shareholders to test the thinking and behaviour of boards and management, and to ensure that boards properly oversee management.

Recommendation

- **CSA primary recommendation is** that any clawback provision be dealt with in the ASX Corporate Governance Council's *Corporate Governance Principles and Recommendations* rather than in the Listing Rules or legislation. While legislation appears to be a holistic solution, with a clear enforcement capacity, it is an inflexible approach that provides a one-size-fits-all solution that is not appropriate to apply to all companies.

Legislation would mean that the provision would need to be narrowly confined to the CEO and the CFO as those who are required to provide certifications to the board on the accuracy of the financial statements, whereas a company might decide that it wants a clawback provision to apply more widely to other executives.

Legislation would need to be confined to intent, whereas a company might decide that its clawback provisions apply to any unjust enrichment even if the individual is not at fault.

Intent is very difficult to prove. ASIC has found it difficult to prosecute cases where the legislation provides for intent (for example, phoenix activity) and CSA is not aware of any successful recoveries on the basis of these provisions.

Our comments on the discussion paper are offered within the context of seeking a framework that balances shareholder scrutiny and engagement with a structure for efficient management and decision-making in a company.

Responses to detailed questions in discussion paper

Do you believe that a reform to clawback director and executive remuneration when financial statements are materially misstated is needed to further enhance Australia's executive remuneration framework? Would the benefits of such a reform outweigh the compliance costs? How would the mechanism be implemented?

CSA agrees that mechanisms to facilitate the recovery of amounts paid to executives based on financial statements subsequently found to be materially misleading are in the best interests of shareholders. It is appropriate commercial practice for a company to negotiate such an outcome and reflects good corporate governance. CSA is of the view that legislative prescription is not required to facilitate such recovery and for the reasons set out below, may be undesirable and counter-productive.

CSA believes that a new Recommendation could be introduced to the ASX Corporate Governance Council's guidelines against which boards would need to report. The benefits outweigh the costs involved in any reporting against a new Recommendation in the guidelines, as it provides clarity to shareholders as to whether the companies in which they invest have entered into contractual arrangements that provide for the company to be reimbursed where there has been unjust enrichment

CSA recommends that Option A.3 is the most appropriate mechanism to provide for the company to reclaim performance-linked remuneration elements which were paid to or vested on executive directors on the basis of results that afterwards were found to have been significantly misstated because of wrongdoing or malpractice or not make such payments if the results are found to be manipulated. Our more detailed comments on this follow.

Rationale for not supporting implementing a clawback provision in legislation or the Listing Rules

While legislation appears to be a holistic solution, with a clear enforcement capacity, it is an inflexible approach that provides a one-size-fits-all solution that is not appropriate to apply to all companies.

While CSA recognises that it would be easier for companies to recover any unjust enrichment should the clawback provision be embedded in legislation, CSA is of the view that drafting a clawback provision would be extraordinarily difficult, attended as it would be by the risk of unintended consequences. For example, as recognised by the discussion paper, it should not be assumed that a material misstatement in the financial statements is intentional (that is, a deliberate fraudulent activity). In order for the legislation to operate, it would need to be narrowly confined to intent, as it would be an injustice to have executives held subject to the threat of legal action under the provisions of the Corporations Act where they have not committed any fraudulent activity. However, an employment contract freely entered into by an executive that provides that intent is not necessary in order for a company to reclaim performance-linked remuneration elements which were paid to or vested on executive directors on the basis of results that afterwards were found to have been significantly misstated is not unjust.

The Listing Rules are not an appropriate mechanism for a clawback provision, as they constitute a contract between the company and the exchange but do not supply the ASX with investigative powers or any enforcement power other than suspension of trading.

Rationale for supporting implementing a clawback mechanism in the ASX Corporate Governance Council's guidelines

The ASX Corporate Governance Council's guidelines have a long track record of having changed governance practice in Australian listed companies, as well as fostering the engagement of boards and shareholders. By providing greater transparency for shareholders, they have modified corporate behaviour, with boards actively promulgating better governance frameworks to enable them to disclose to shareholders their oversight of management. Communication between companies and investors is not a matter of information alone. It is also about building relationships, and providing clarification on both sides as to why decisions are made and in what context.

CSA believes that it is good practice for boards to:

- clearly articulate the board's remuneration philosophy and the process by which it determines executive remuneration
- engage with shareholders and clearly explain the company's remuneration framework, the rationale for the framework and the outcomes it produces
- structure incentives to drive performance that rewards shareholders over the long term
- take accountability for their remuneration decisions, including in response to feedback from shareholders through votes on the remuneration report
- ensure that there is a clearly agreed contractual right to terminate the CEO and any senior executives appointed by the board

- ensure that the contractual rights of the company in relation to clawback entitlements are fully disclosed to shareholders
- ensure that all vesting rights attaching to equity incentives are publicly disclosed at the time the CEO enters into a contract.

CSA is of the view that, by including a new Recommendation in the Council's guidelines, companies have the flexibility to strengthen contracts according to the particular circumstances of the company. Remuneration structured differently in individual companies. In addition, the greater liberty in designing and implementing provisions to recover erroneously awarded remuneration could expand to include unjust enrichment where there was no intent to fraudulently misstate financial statements, should that be appropriate to the company. That is, boards would need to decide when formulating their policy on clawback provisions if they intend it to apply to executives beyond the CEO and CFO, who sign off financial statements, or if it is intended to apply regardless of fault.

These questions are very important ones that boards need to consider and that cannot easily be dealt with by the prescriptive approach of legislation. For example, legislation does not and cannot cover the budgets on which short-term incentives are based — the payment of bonuses based on such key performance indicators are matters for the company policy on remuneration and the employment contract, which provides for a holistic approach. That is, the board is best placed to decide if the policy is not intended to penalise any employee unfairly, or if it is intended that the company not pay more remuneration than it should regardless of fault.

The discussion paper states that directors and executives would not be legally obliged to return overpaid bonuses if the mechanism for the implementation of the clawback provision rested in the ASX Corporate Governance Council's guidelines. CSA disagrees with this statement. Under contract law, the company would have the capacity to take legal action against any employee in under their employment contract. The choice as to how to recover the unjust enrichment is a matter for the company. This flexibility is in shareholders' favour.

CSA recommends that a new Recommendation be included in Principle 8 of the ASX Corporate Governance Council's guidelines, setting out that boards should:

- develop and disclose a policy or summary of the policy on the clawback of equity remuneration
- put in place a framework for managing the clawback of equity remuneration
- disclose a summary of the CEO's contract and any clawback provision in it and report on the framework for managing the clawback of equity remuneration.

The commentary and guidance attached to this new Recommendation would cover the issues that a company could consider when developing the clawback policy that could cover individuals beyond the CEO, as well as when structuring the employment contract of the CEO to reclaim performance-linked remuneration elements which were paid to or vested on the basis of results that afterwards were found to have been significantly misstated.

A new recommendation provides clarity as to which companies the clawback provision should apply to. It would apply only to public listed companies, as only public listed companies need to report against the *Corporate Governance Principles and Recommendations*. However, many unlisted companies also look to the guidelines as a reference for good governance practice, when looking at their own governance systems.

This recommendation differs from that suggested in the options paper and goes further to provide more concrete guidance on how companies may achieve recovery. The recommendation in the options paper is that the ASX Corporate Governance Council could introduce an 'if not, why not' recommendation, specifying that listed companies should clawback bonuses from their executives where based on financial information that turns out to be materially misstated. Listed companies that fail to do so would need to provide an explanation. Under the CSA recommendation, companies will be required to not only develop a policy but

also report on whether they have drafted the CEO contract to provide for recovery. This recommendation focuses on the creation of the obligation to repay, not on whether recovery has been effected 'after the event'.

The commentary attached to this new Recommendation would outline that it is for the company to decide if a clawback provision in an employment contract is to operate because of wrongdoing or malpractice or apply regardless of fault. The commentary would also outline that it is for the company to decide if a clawback provision is to apply only to the CEO and CFO, who sign off the financial statements, or is to apply to KMPs or all executives.

To whom would the provision apply?

CSA recommends that, while any clawback provision should not be provided for in legislation, if it is, then any provision should not extend beyond the CEO and the CFO, as they are the members of management who have a statutory responsibility to provide directors with certifications relating to the accuracy of the financial statements and their compliance with the Corporations Act and the Accounting Standards.

CSA also recommends that any such provision should extend beyond the current CEO and CFO to the former CEO and CFO who had the responsibility for the sign-off of the accuracy of the financial statements that are found to have been materially misstated, as the effect of materially misstated financial statements may not be apparent for some time.

CSA notes that our recommendations are relevant only if the provision is embedded in legislation. A legislative provision that extended to those without responsibility for the accuracy of the financial statements would unfairly penalise such persons. For example, a company secretary could be a KMP yet have no role to play in assessing or approving the financial statements.

However, if our recommendation to include provision for a clawback mechanism in the ASX Corporate Governance Council's guidelines is accepted, then it is for the individual company to decide to whom the contractual arrangements will apply. There would be companies that may choose to extend any clawback provision to KMPs or an even greater number of executive staff, regardless of their capacity to sign off the financial statements, and regardless of whether they were at fault. It would be for the board to explain to its shareholders its decision making on this issue.

How would the clawback event be triggered?

CSA recommends that the clawback event be triggered on the release of the recast financial statements by the company.

CSA does not support the clawback event being triggered by the public announcement of the material misstatement of the erroneous financial statements, as this could act as a disincentive to release announcements of material misstatements.

The release of the recast financial statements ensures that all information is known and available, which in turn provides for a realistic assessment of materiality.

If the company is insolvent, the clawback event could be triggered by assessment of when an announcement should have been made should the company not have been in liquidation. The liquidator could effect this.

How would the clawback amount be determined?

CSA recommends that, as a matter of fairness, the quantity of remuneration to be clawed back should be determined only from the executive's pool of performance-based remuneration.

CSA does not support adoption of a clawback from total remuneration. It would be unfair to have an executive's total remuneration, which is paid for undertaking the responsibilities of the role, subject to a clawback provision.

CSA also points to the difficulty of drafting a provision in legislation that would address the difficulties of quantifying the amount to be reclaimed, without introducing unintended consequences. CSA believes that calculating the quantity of remuneration to be clawed back is not a matter easily addressed by the one-size-fits-all approach of legislation.

CSA is of the view that it is for the company to assess how it wishes to calculate the amount to be reimbursed and for the board to report that calculation in the subsequent remuneration report. The reported calculation would provide the opportunity for shareholders to question the board as to its decision making or to gain greater clarity.

CSA is also of the view that it is for the board to decide if the company may pay to the executive the extra bonus amounts that the executive is entitled to, should the a material misstatement in the financial statements result in the underpayment of the performance-based remuneration of a executive.

When would the clawback amount need to be repaid?

CSA recommends that an executive must repay the remuneration following a specified time period.

CSA notes that it cannot be assumed that an executive will have immediate access to the quantity of remuneration that needs to be repaid. For example, many employees allocate a bonus payment to particular personal expenditure and financing may need to be arranged. Alternatively, the bonus may have been paid in shares, which then need to be sold. This could have implications for the share price, and would need to be undertaken under the terms of the company's share trading policy.

CSA does not support an executive being obliged to repay the remuneration immediately after the company is aware that the clawback event has been triggered, for the reasons noted above.

A deliberate intention to mislead or act of misconduct

CSA is of the view that intention by an executive to mislead users through the release of false financial information is only applicable should a clawback provision be embedded in legislation.

One function of a legislative provision would be to confirm that, if a CEO or CFO misleads users through the release of false financial information or manipulates the results presented in the financial statements in order to bolster their own pay package, they are in breach of the law. This would apply even if a clawback provision was confined to the CEO and CFO, as recommended by CSA.

CSA is of the view that an intention element creates evidentiary issues and is difficult to prove. CSA notes that the intent provisions in the Corporations Act introduced to prevent directors abandoning a company and setting up a new one in order to avoid the payment of workers' entitlements have to date proved unsuccessful. Part 5.8A was introduced into the Corporations Act in 2000 following a number of high profile collapses where employee entitlements could not be recovered. ASIC has not been able to prosecute directors in such instances of phoenix activity due to the difficulties attached to proving intent. Moreover, CSA is not aware of any successful recoveries on the basis of these provisions.

As noted above, CSA is of the view that a legislative clawback provision will be difficult to draft and would need to be very narrowly defined.

However, if the objective is to change practice and behaviour, CSA is of the view that it is for the board to decide if contractual arrangements with executives require an intention element of misconduct. The robust discussion that would take place in the boardroom on the advantages and disadvantages of an intention element, the transparency afforded to shareholders of that decision making through the reporting requirement of the ASX Corporate Governance Council's guidelines and the upfront discussions with executives at the point of contracting them is much more likely to usher in different behaviours than a legislative provision.

Re-issue of financial statements due to subsequent events

CSA recommends that a subsequent externally-based event should not subject executives from the clawback provision. CSA believes that any other approach may signal the end of incentive remuneration altogether.

How far back should the clawback provision apply?

CSA recommends that a three-year period preceding the 'material misstatement' event is the appropriate period to which the clawback provision may be suitable to apply, as it may take time for information to emerge that would be relevant to any clawback provision. However, it should be for the board to determine what is a suitable time frame for their company in its particular circumstances.

Who is responsible for applying the clawback of bonuses?

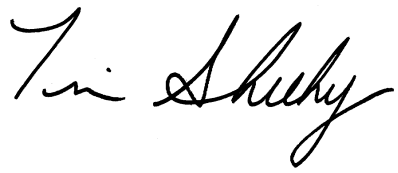
Given that CSA does not support a legislative approach to clawback provisions, CSA Members are firmly of the view that the onus is on the company to recover any bonuses which were based on financial information that subsequently turned out to be materially misstated.

CSA also notes that ASIC may pursue the recovery of overpaid bonuses under s 50 (b) of the ASIC Act 2001 as a matter of public interest should this be required.

Conclusion

In preparing this submission, CSA has drawn in particular on the expertise of its two internal national policy committees, comprising company secretaries and governance professionals from a range of listed and unlisted public companies. We would welcome the opportunity to discuss any of our views in greater detail. Please call me if you would like to set up a meeting. I can also arrange a meeting with our Members.

Yours sincerely



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