CHARTERED SECRETARIES
AUSTRALIA

Leaders in governance

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To whom it may concern

Executive pay: shareholder voting rights consultation

Chartered Secretaries Australia (CSA) is the independent leader in governance and risk management in Australia. 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 have a thorough working knowledge of the operations of the financial markets, the needs of investors and the corporations law.

We welcome the opportunity to comment on the consultation paper, *Executive pay: shareholder voting rights consultation* (the paper).

CSA's submission on this paper, and our earlier submission on the original discussion paper are due to the fact that they referenced the changes in law relating to executive remuneration that had been introduced in Australia. Importantly, any reform in the UK will affect dual-listed companies as well as the increasing convergence of regulation globally.

CSA believes that shareholders should have the capacity to hold directors accountable for their decisions on remuneration, as well as other decisions affecting the performance of a company. We support in principle the proposals to ensure that governance arrangements are in place to ensure director accountability when setting executive remuneration. Notwithstanding this, we have taken the opportunity to point to the very practical challenges inherent in some of the proposals.

Our comments on the consultation questions follow.

Yours sincerely

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CHIEF EXECUTIVE

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1. The Government proposes to require an annual binding vote on remuneration policy. What are the costs and benefits of this approach?

Investor engagement with boards on remuneration since the introduction in Australia of the non-binding shareholder vote in 2005 on the remuneration report has seen marked changes in the remuneration structures at companies where shareholders had concerns with remuneration plans. Both institutional and retail investors in Australia have noted that the introduction of a non-binding shareholder vote on a company's remuneration report was one of the single biggest catalysts for improved levels of engagement between shareholders and company directors.

The Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011, which took effect on 1 July 2011 introduced a 'two-strikes' rule for the non-binding vote on the remuneration report.

- The *Corporations Act 2011* was amended to provide that if 25 per cent of the votes cast at an AGM oppose the adoption of the remuneration report, and shareholders make comments at the meeting on the report, then in the following year the board must state in its annual report how it has responded to those comments, or explain why it has not responded.
- If 25 per cent of the votes cast at two consecutive AGMs oppose the adoption of the remuneration report, then at the second AGM the company must put a resolution to shareholders to 'spill' the board.
- If 50 per cent or more of votes cast are in favour of a 'spill',the entire board (except the managing director) must stand for re-election at a further general meeting. This meeting must take place within ninety days.

The introduction of the 'two-strikes' rule in Australia in 2011 has not provided shareholders with the responsibility to set executive remuneration through a binding vote. Directors remain responsible to manage the CEO and executives in terms of attracting and motivating them through remuneration practice. Rather, if directors are recipients of shareholder dissatisfaction with their decisions on executive remuneration, and if shareholders believe that directors have failed to respond to their concern and express that through the non-binding vote in two subsequent years, shareholders can 'spill' the board at a special meeting in the second year.

CSA is of the view that a binding vote on the remuneration report would inappropriately blur the line between owners and managers to the detriment of the company. This view has been supported by shareholder groups.[1]

CSA is very pleased to see that the consultation paper recognises that there are numerous practical difficulties in making the vote on the remuneration report binding, including that:

- the remuneration report deals with events that have already occurred — it is not clear what a negative binding vote in respect of past events would mean, for both the company (in terms of Pay As You Go liability) and the individual (in terms of certainty of pay and consequences of expenditure)

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[1] For example, the Australian Council of Superannuation Investors issued a media release in 2009 when this idea was being discussed in Australia, noting that: 'Shareholders do not want to run companies – this is the role of the CEO managed by their boards. Boards manage their CEO and executives in terms of attracting and motivating them through remuneration practice. Shareholders want boards to ensure remuneration practice incentivises executives for the long term.... Shareholders do not have the expertise to develop policies that accommodate each individual company's strategy — they can advise the board as to their satisfaction with long term alignment. We do not require a binding vote on remuneration policy.'

- if remuneration decision making is removed from the board, there may be ambiguity as to who is accountable for the performance of executives — this would be a governance quagmire
- remuneration reports are complex, and the shareholder vote is binary
- the remuneration report covers a number of different aspects of remuneration including the chief executive, other executive directors and non-executive directors, as well as the operation of salary, short-term incentives and long-term incentives.

CSA supports the approach taken by the UK government to limit the binding vote to the company's remuneration policy, rather than the Australian approach which applies a binding vote to the entire remuneration report through the two-strikes rule. In Australian the vote reflects shareholder concerns with both past and future remuneration, as well as the remuneration policy. CSA is of the view that the UK proposal to limit the vote to the framework for future remuneration can be practically implemented.

Interestingly, proxy advisers spoke out against the two-strikes rule and noted their concern that shareholders would be much more conservative when voting on resolutions to adopt the remuneration report because the two-strikes rule could destabilise boards. For example, Dean Paatsch of the governance and advisory firm Ownership Matters noted that: ‘We’ve been against the two strikes rule because it conflates the right to remove a board with the feedback they’re being given on pay. I’ve detected no appetite on the behalf of institutional voters to start chucking out boards for getting aspects of the pay structure wrong.’[2] A director at proxy adviser CGI Glass Lewis, Aaron Bertinetti, stated that:[3]

> There are great unknowns this year because of the uncertainty on whether shareholders will be willing to pull the trigger on a “strike”. The early signs are that the reform has done the exact opposite of what was intended by the government, it has created a disincentive for shareholders to publicly have a go at companies. ... The great thing with a non-binding vote is that you could express your opinion without having any prescriptive consequences, but now there are outcomes which go far beyond remuneration and I think people are probably a bit wary.

More than 500 directors of listed companies face being removed by shareholders in the main annual general meeting (AGM) season this year, which gives credence to the views expressed above that shareholders have a disincentive to vote against the remuneration report in the second year, given the consequences. In 2011, 108 listed companies received a first strike, following the introduction of the two-strikes rule. Among the ASX top 200, 14 boards received a first strike, rising to 26 boards among the ASX top 300 and 82 outside the largest 300 listed companies. Importantly, the percentage of affected companies is less than six per cent of all listed entities, showing that the vast majority of Australian companies are obviously performing in line with shareholder expectations.

CSA is also aware of at least two companies where the first strike was used for reasons other than concern with remuneration. Cedar Woods received a no vote of more than 25%. The board had received a takeover offer that it rebuffed and a large shareholder was able to muster the numbers to vote against the remuneration-report resolution to show displeasure with the board decision. Tassal also received a first strike. A new shareholder with 19 per cent of the shares used the first strike as a means of exercising power as it sought to build a larger controlling interest in the company.

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[2] Rachel Alembakis, ‘Governance, environmental issues for AGM season’, *The Sustainability Report*, October 28, 2011

[3] Patrick Durkin and Jason Murphy, ‘No slowdown for CEO pay amid market turmoil’, *Australian Financial Review*, 26 September 2011

Importantly, because of the prohibition on key management personnel (which includes directors and the most senior executives) voting on the remuneration-report resolution that was introduced at the same time as the two-strikes rule, in many smaller companies only a very small percentage of shareholders may be voting on the remuneration report. This is because the share register may consist of far fewer shareholders than are to be found on the registers of large entities. The great majority of the 108 first strikes on the remuneration report last year were for small companies (median market capitalisation of just $26 million). For many of them, this was the first time they had experienced a high 'no' vote on the remuneration report and the question needs to be asked what percentage of shareholders was voting on the resolution. One company noted it could only count three per cent of its shareholders as lodging a vote. This was a concern of proxy advisers when the two-strikes rule was introduced. Dean Paatsch of Ownership Matters had noted: 'We are not a supporter of the two-strikes rule. There are aspects of the rule that tip the scales in favour of minority shareholders, which is not desirable.'[4]

2. In the event that a company fails the binding vote on remuneration policy, the Government proposes that it maintains its existing policy or returns to shareholders with amended proposals within 90 days. What are the costs and benefits of this approach?

The Australian two-strikes legislation requires the special meeting to re-elect all directors to be held within 90 days of the AGM at which the second strike was received and the 'spill resolution' passed. This requirement raises serious difficulties in practice.

CSA is concerned that the UK proposal to return to shareholders with amended proposals for future remuneration policy (to be approved by shareholders) within 90 days will impose substantial costs on and logistical difficulties for UK companies — costs which are borne by shareholders. These costs include:

- the need to book a venue, audit visual equipment and catering in advance, and risk losing any deposits, which are likely to be significant sums, in order to secure a venue for the potential extraordinary general meeting, given that a company will not know in advance if its remuneration policy will be accepted. AGM venues are not available at short notice (most AGM venues are booked one or two years in advance)
- typesetting, printing and postage of the notice of meeting and proxy forms
- share registry administration, including voting.

Moreover, if the remuneration policy is rejected at the special meeting held 90 days later, does the company need to then hold a further special meeting 90 days later? Is the company required to return to shareholders again and again until such time as the policy is accepted? Such a requirement would not only impose substantial costs, but would also severely distract both the board and management from the operations of the entity.

CSA also notes that any reform to apply a binding vote to remuneration policy needs to take account of implementation issues, such as the time needed for global companies operating in different jurisdictions to reformulate employment contracts. It would be extremely difficult for companies to reformulate all employment contracts within 90 days on a global basis. This uncertainty is compounded by the lack of clarity as to whom the remuneration policy applies. If it applies to the company as a whole, it could be impossible to amend it within 90 days. If it applies only to the CEO and key executives, it could be possible to amend it within this time frame.

CSA notes that the proposed reform to give shareholders a binding vote on remuneration policy is conceptually very different from the Australian two-strikes legislation, where the 'second

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[4] James Frost, 'Sevior backs executive two-strikes pay rule', *The Australian*, October 29, 2011

strike' could 'spill' the board. The requirement to hold a meeting with 90 days is so that shareholders can determine if the board will be retained. In the UK proposal, shareholders are not determining whether the board will stay or go, but accepting or rejecting the policy relating to future remuneration. If the remuneration policy is rejected by shareholders, boards clearly need to engage with their shareholders to ascertain their reasons for rejecting the policy and their views on what would be an acceptable policy.

CSA recommends that there should be no time limit as to when companies go back to shareholders with revised policies. As the existing policy stays in place until such time as shareholders approve the new one, it should be left with the company to consult with shareholders appropriately and return to them with new proposals following that engagement. This time frame will be different for each company.

Annual elections of directors are already recommended under the 'comply or explain' provisions of the UK Combined Code. CSA notes that this provides an existing and effective remedy for voting off directors should the revised remuneration policy be unacceptable in the second year. The UK Government is also proposing to require companies to explain how the results of the advisory vote have been taken into account the following year. Using the existing remedy is a more practical approach than requiring companies to hold a special meeting — perhaps even more than one — with different iterations of the policy put to shareholders for decision.

3. The Government proposes that directors' service contracts and other arrangements should, if necessary, be amended to take account of the new requirement to seek shareholder approval of remuneration policy. What are the costs and benefits of this approach?

CSA notes that legislation will always override an employment contract.

However, CSA strongly recommends that the principle at law of legislation not taking retrospective effect should operate. Any new law should apply to new contracts only.

CSA notes that the Government is proposing that legislation take effect from 1 October 2013, subject to parliamentary time and process. CSA recommends that a 'grandfathering' period be introduced to provide sufficient time to amend contracts and implement the new law.

4. The Government proposes that remuneration packages offered to in-year recruits should be confined by the limits and structures set out in the agreed remuneration policy. What are the costs and benefits of this approach?

CSA notes that it is not clear what is meant by the remuneration policy. CSA recommends that the policy refer to the alignment of executive remuneration with shareholder interests, that is, the structure of remuneration rather than the quantum of pay. However, the proposals appear to contemplate a binding vote on the quantum as well as the structure of remuneration.

CSA notes that shareholder approval of quantum of pay would be unduly restrictive, in particular in relation to the CEO/CFO. If those positions were filled during the year, it is not feasible that the potential level of pay could be known the year before when the policy went to shareholders for approval. The company should not be limited to the existing CEO/CFO pay level in its search for the replacement to the existing executive. Similarly, shareholder approval of limits of pay would prove unworkable in the event of a merger or acquisition, where executive pay had already been set.

CSA is concerned that this proposal significantly reduces the power of the remuneration committee to negotiate remuneration packages for incoming executives, particularly the CEO.

CSA refers to earlier quoted comments by shareholders that they do not want to run companies — they want boards to manage their CEO and executives in terms of attracting and motivating them through remuneration practice.

5. The Government proposes that the report on future remuneration policy should provide more details on how approved LTIPs will operate for directors in that particular year. Do you agree with this approach?

CSA notes that shareholders already vote on LTIs in the UK — one-third of remuneration plans is already approved by shareholders. Many companies are already extremely transparent in their disclosures on this.

6. The Government proposes to increase the level of shareholder support that should be required to pass the vote on future remuneration policy. Do you agree with this approach and if so, what would be an appropriate threshold?

The level of shareholder support required in Australia for passing the remuneration-report resolution is 75 per cent (of shares voted).

CSA notes that our support for raising the threshold for the vote on remuneration policy is contingent on the consequences attached to it. In Australia, CSA is on the public record as having opposed a threshold of an adverse vote of 25 per cent in the second year, as it is inappropriate to have a minority view as the trigger for putting the re-election resolution — a ‘spill’ resolution should not disregard the majority view.

In Australia, the threshold for the adverse vote is 25 per cent in the first year (the first strike) and 25 per cent in the second year, but the ‘spill’ resolution requires 50 per cent of the vote to pass.

Should the UK proposal be that an extraordinary general meeting be held 90 days after the AGM to again put the remuneration policy to shareholders, with such an extraordinary general meeting to be held again and again until such time as shareholders approve the remuneration policy, CSA is of the view that an adverse vote of 25 per cent is an inappropriate trigger. Otherwise, the interests of a minority of shareholders are being served while the majority of shareholders are ignored. Moreover, a minority of shareholders should not be able to impose the costs of ongoing special meetings on the majority of shareholders.

7. The Government proposes to require companies to explain how the results of the advisory vote have been taken into account the following year and to issue a statement to the market sooner than this where there is a significant level of shareholder dissent. What are the costs and benefits of this approach?

CSA is strongly of the view that this is the preferred approach. It mandates transparency and engagement, which are most likely to improve shareholder confidence.

8. The Government proposes to give shareholder a binding vote on exit payments of more than one year’s base salary. Do you agree with this approach or would an alternative threshold for requiring a shareholder vote be more appropriate?

CSA members agree with the introduction of a limit in relation to exit payments offered as ‘golden handshakes’. When exit payments are granted during or following a period of poor

company performance, shareholders can experience considerable disquiet at what is perceived as ‘reward for failure’.

However, there is a wide variety of circumstances that may lead to an exit payment. Commonly accepted bona fide payments can be made for:

- retirement (for example, accrued superannuation entitlements)
- resignation (for example, accrued annual leave entitlements)
- redundancy (for example, redundancy payments as per a company policy)
- death (for example, a death benefit payable by the superannuation fund to the person’s estate).

Having had experience of the Australian termination payments legislation, CSA Members are aware that ensuring a practical and workable implementation of policy is key. There are significant lessons from the Australian experience in this regard.

CSA strongly believes that payments of those ordinary-course entitlements that accrue according to length of service and that would apply broadly to employees within a company should be expressly excluded from exit payments. For example, if a senior executive is made redundant after working for a company for 20 years and has accrued annual and long service leave, that executive is entitled to a redundancy payment together with the payout of that accrued leave and the company should not be required to seek shareholder approval for a payment which other employees receive as a matter of course.

Another key issue is that the calculation of ‘one year's base salary’ must be realistic and aligned with how executives are paid. It is unworkable for a typical executive contract to allow for ‘one year’s notice’, which is based on payment of role salary, target bonus, vehicle, pension/superannuation, and other annual benefits, if the legislation provides they can only be paid one year’s role salary. There are also considerations about accrued short and long-term bonuses when a person leaves.

CSA recommends that the definition of one year's base salary should include ‘target short-term bonus on a pro rata basis’, the pension/superannuation applicable to that base salary and long-term incentives on a pro rata basis.

CSA recommends strongly that certain legal and other entitlements should be excluded from the calculation of the exit payment including:

- pension/superannuation
- annual leave entitlements
- sick leave entitlements
- long service leave entitlements
- deferred bonuses (that is, already earned with no further performance condition)
- insurance payments (for example, if the person leaves because they are disabled or died), and
- other applicable entitlements applicable in the UK and globally. The global issue is important — the United Kingdom is not the only jurisdiction in which FTSE companies employ and pay executives.

In Australia, the legislation also excludes from the cap a ‘bone fide redundancy payment’ which means that the executive can be terminated in genuine circumstances of redundancy and receive their redundancy payment. This is limited to redundancy payments which apply to the executive in the same way as they apply to the workforce generally.

It should be absolutely clear in the legislation that the person can be paid these legal and other entitlements upon termination and without waiting for the shareholder vote.

CSA also recommends that the exit payments law should be limited to directors of a parent company, and not extend to subsidiaries. In Australia, the legislation was extended to directors of subsidiaries, which has proved extremely challenging and problematic to implement. The directors of the wholly-owned subsidiaries are often employees of the parent company, for example, general managers. These persons are often not senior at the scale of the parent company and their potential exit payments are not at a level that would concern shareholders in the parent company or the community.

9. The Government recognises that the circumstances under which a director leaves their post are complex and diverse and so invites feedback on the appropriate scope and breadth of the proposed legislative measures.

The circumstances where executives are terminated can be varied. CSA recommends that executives who die or retire through ill-health should be excluded from this regime. It will be extremely difficult to separate the company-based insurance and workers' compensation payments from any definition of one year's base pay, which could have a inequitable impact on the family of the deceased or the executive who is suffering ill health. It is also possible that a company may wish to make an ex-gratia payment to support the family of a deceased or ill executive. CSA notes that the circumstances surrounding such exit payments are not of concern to shareholders.

We recommend that these payments be disclosed in the remuneration report but not put to a shareholder vote.

CSA also notes that, where an executive is made redundant, a redundancy payment can be appropriate. Positions in companies are made redundant for a variety of reasons. Redundancy occurs at all levels and is often subject to a company's redundancy policy. A senior executive position could be made redundant because an industry is consolidating through mergers and acquisitions, because a company is restructuring, or because of difficult economic circumstances facing an individual company. Genuine redundancy is not about poor performance. It relates to the restructuring of the company in response to an adverse change in the circumstances of that entity. CSA points out that it is extremely rare to make a CEO or CFO genuinely redundant as a company cannot operate without a person in that position. Redundancy payments to a CEO or CFO would apply only in the circumstances of a takeover.

CSA believes that in circumstances of genuine redundancy it is widely considered to be appropriate to make a redundancy payment. Such a payment would often be minimal in circumstances of a short-term appointment. However, a long-serving employee, possibly promoted during that tenure for good performance, may be entitled to a significant payment.

Redundancy payments in such instances are not unreasonable payments. CSA recommends that the legislation exclude genuine redundancy payments from the exit payment requiring approval by shareholders.

10. The Government proposes that directors' service contracts and other arrangements should be amended to take account of the new requirement to seek shareholder approval for exit payments over one year's base salary. What are the costs and benefits of this approach?

In Australia, as anywhere, the law overrides private contractual arrangements such as an employment contract.

To avoid unjust outcomes, it should be absolutely clear in the legislation that the terminated executive can be paid their legal and other entitlements (pension, unused leave etc, as set out above in response to Q 8) upon termination and without waiting for the shareholder vote.

CSA notes that legal entitlements vary from jurisdiction to jurisdiction. For example, there is no legislative provision for annual leave in the United States. Therefore, US executives cannot be paid leave entitlements. **CSA recommends** therefore that the legislation should be general in terms of what is excluded from an exit payment, with a requirement to disclose what payments have been excluded and why.

CSA also recommends that the legislation reflect the Australian approach which prohibits legal action by an executive against the company where the company is bound by the termination payments requirements to wait for and observe the shareholder vote. Service contracts, together with share plans and long-term incentive schemes, are amended in line with various legal developments, which in turn means that mandating amendment of service contracts is not required.

A further recommendation is, if caps on exit payments apply to directors of subsidiaries (and therefore capture employees generally), it would be important that the full amount of the exit payment be available to long-serving employees, even if they have been in the role of director for a short period. One problem with the Australian regime is that it inappropriately discriminates against long-serving senior executives who have recently joined subsidiary boards. For example, a person with 25 years' service may have joined the board of the pension fund of the company as a director and been made redundant two weeks later. Their exit payment may be capped at two weeks' salary, despite the fact that all other employees will have exit payments that recognise their 25 years' service. The exit payment should be a full year.

11. The Government notes that a small number of directors could be entitled to generous pension enhancements if their contract is terminated early. It proposes not to legislate to override these rights, owing to the rarity of such arrangements and the complexity of legislation that would be required. Do you agree with this approach?

CSA supports this approach.

12. The Government proposes to leave unchanged the existing requirement in company law (section 188 of the Companies Act) to get members' approval for notice periods of more than two years. Do you agree with this approach?

In an effort to reduce rather than constantly increase regulation, **CSA recommends** that consideration be given to its removal.