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Guerdon Associates
Equity and Executive Pay

13 July 2009

Mr. John Hawkins
Committee Secretary
Senate Standing Committee on Economics
PO Box 6100 Parliament House
Canberra ACT 2600

Dear Sir,

Re: Inquiry into Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009

We are pleased to present our submission to the Senate Standing Committee on Economics in response to the inquiry on the Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009.

1. Summary and Recommendations

.1 The Bill does not complement or recognise the role of existing corporate governance frameworks
.2 The unintended consequences of the Bill could include significant increases in base salaries for those covered by the bill
.3 Excess termination payments above the defined limit should remain subject to shareholder approval, but should be applied to directors only, as at present
.4 We agree that the elements of termination pay should be clearly defined in the Act and should exclude unvested performance pay and deferred incentives that have been previously earned. Accrued superannuation entitlements should also be excluded, but additional payments into superannuation co-incident with the termination should be prohibited
.5 The threshold payment level above which shareholder approval is required should be set at three times base salary plus bonus (using an average based on the previous three years' experience)
.6 An estimate of full year base salary should be used where the service period is less than one year and it should not be pro-rated

2. About Guerdon Associates

Guerdon Associates is Australia's largest independent consulting firm specialising in board and executive remuneration matters. Our mission is to provide advice on executive and director remuneration, performance measurement and management, related governance matters and employee equity data and solutions that contribute to improved total shareholder returns.

Clients are board remuneration committees of listed and unlisted Australian companies. These include a significant proportion of Australia's largest ASX-listed companies.

Note that as an independent adviser (i.e. as a board adviser we do not also provide services to management), we do not have a conflict of interest that could influence our recommendations on executive pay matters.

Our website is at http://www.guerdonassociates.com.

3. Purpose of this Submission

Guerdon Associates acknowledges that the current termination payment provision allowing payment of amounts of up to seven times total annual remuneration without shareholder approval is excessive given the growth in levels of executive remuneration over the past decade, and is out of step with international standards. We therefore support the need for reform of the current arrangements, provided that:

- The amendments complement existing governance frameworks that have served investors well
- The changes proposed reflect the commercial needs of companies operating in the Australian market and
- The reforms do not present difficulties in practical application

This submission presents arguments for the modification of certain aspects of the proposed legislation. Each of the issues is addressed in sequence in the following section.

4. Complementing existing governance frameworks

The current corporate governance framework consists of:

- "Hard law", such as the Corporations Act, that requires full compliance
- "Soft law", embodied in the ASX Corporate Governance Council's Principles, which requires company boards to confirm adherence to the Principles, or explain why Principles have not been adhered to
- Governance guidelines promulgated by various stakeholder groups, such as fund managers (IFSA), industry based superannuation funds (ACSI), retail shareholders (ASA), proxy advisers to institutional investors (RiskMetrics, CGI Glass Lewis), as well as various fund managers and superannuation funds, that serve to provide a basis for supporting or rejecting shareholder resolutions

The framework has evolved over time, incorporating lessons learnt from major failures that include the bursting of the asset bubble in the late '80s to, most recently, HIH.

The absence of significant failures during the global financial crisis indicates that the current framework is basically sound.

The reason that the current system is so robust is the presence of flexibility via the ASX Corporate Governance Council "if not why not?" principles, backed up by a Corporations Act that gives shareholders the right to nominate and vote for directors.

The Corporations Act amendments being proposed set the bar for termination payments lower than any other OECD country, and do not make allowance for an existing framework that could set termination payments at average 12 months' salary as the standard, but allow flexibility on the few occasions where this may be justified.

5. Aspects of the Draft Bill that require further consideration

1. The Bill precedes the Productivity Commission review of executive and director remuneration. This review is taking all aspects of remuneration into account, and presumably will examine the unintended consequences of regulating one aspect of remuneration without consideration of other aspects. Given the very few instances of poor practice over prior years, there does not seem to be an urgent requirement for this legislation to be introduced prior to the Commission report.

2. There has been no apparent consideration of current Australian governance frameworks, and how amended Corporations Act law and regulation can make use of this. In particular, a reasonably flexible approach that would still keep a lid on excessive termination pay could incorporate both an ASX Governance Principle "if not, why not?" soft law and Corporations Act section 200 hard law to work together.

3. Termination payments for North American executives are typically 2.99 times base salary plus bonus[1], while the Europeans, in their new governance guidelines released recently (see HERE) are content to set the level at twice base salary. Although the UK has a 12 month contractual period requirement, the UK practice is voluntary (on a comply or explain basis) under the Combined Code, and no shareholder approval is required for variation. Given that 17% of ASX 200 executives are recruited from overseas (according to the ACSI

[1] This seemingly odd multiple is the maximum allowed before punitive taxes are levied. The tax was introduced in 1987 to cap excessive termination payments. The unintended consequence was that the market standard for executive termination increased from an average of 6 months pay to this "maximum", so that the "maximum" in effect became the minimum. By extending shareholder approval to cover employees other than executive directors, it is possible that an unintended consequence of the proposed Australian Corporations Act changes could be a rapid increase in termination benefits for employees below the CEO, from the current median of about 4 months' pay.

Productivity Commission submission), where termination provisions are more generous, the new maximum of "one times" is too low. The combination of geographic isolation, onerous taxation structures and the dislocation of moving families extensive distances to Australia militate against Australian companies' success in attracting executives. This problem will be exacerbated if those potential recruits, required to relinquish existing financial and employment security to accept a role in Australia, cannot have reasonable certainty of adequate compensation in the event of early termination equivalent to what they would otherwise receive in their source country.

4. The low maximum in place may result in pay distortions, such as an increase in base salary or recruitment sign-ons (i.e. dowry versus divorce settlement) that are higher than otherwise may have been the case

5. The pro-rating of the 1 times cap for executives with less than one year's service will be unfair in situations where the executive is made redundant as a result of merger or acquisition, or some other sudden change outside the control of the executive

6. The Bill provides that "base salary" for the purposes of the Bill will be specified in the Regulations. Unless the Regulations define "base salary" broadly, the cap could be potentially quite low for executive employees whose remuneration comprises significant "at risk" or variable components rather than fixed remuneration.

7. In practice, a large number of companies will have to obtain shareholder approval for termination payments, especially as any reward paid at termination under a current short-term incentive plan will be counted against the limit, even if the reward is performance tested and pro-rated according to the proportion of the performance period completed to the date of termination. An exemption is to be provided for 'deferred bonus' – in principle, this is no different from the pro-rated and performance tested bonus payment referred to here.

8. Company superannuation contributions will be counted against the limit even where employers only contribute at the 9% SG rate on executive remuneration above the 2009-10 SG maximum earnings base of $160,680 per annum (the exemption for superannuation benefits funded by salary sacrifice assists where salary packaging arrangements are applied). We assume that the intention is to include any employer contributions (other than employee salary sacrifice contributions), in excess of the statutory SG requirements, that have been paid during the relevant period of employment over which the base salary amount is calculated. However, the description as it stands could be interpreted in a number of ways. We believe that this

issue needs to be clarified in the legislation.

We do not see a justification for the inclusion of bona fide superannuation savings accumulated during the total period of employment, and which have been set aside for and are restricted to the purpose of funding lifestyle in retirement and are quite distinct from termination benefits. In many, if not most, cases it will not be accessible at the time of termination. However, we agree that any additional payments made into superannuation at the time of termination should be included in the definition to avoid opportunity for the specified termination benefit limit to be circumvented.

9. The Bill continues to provide a look back period to include persons who held an "executive and managerial office" within 3 years of their retirement whether or not they hold such office at the time of their retirement.

10. The Bill applies to directors of private companies, including directors of subsidiaries of a listed company, whether or not the employee is named in the listed company's remuneration report. For large listed companies with many subsidiaries this is an undesirable outcome. While the current laws also operate in this way the reduction in the benefits cap makes the requirement to obtain approval more likely.

11. While shareholders have traditionally exercised some level of control over benefits paid to directors, it is difficult to reconcile the need for them to intrude into what are effectively operational matters associated with the actual running of the company, responsibility for which they delegate to their elected directors. This is particularly so given the transparency of decisions by directors that is now provided to shareholders through the extensive remuneration report disclosures. Interference by shareholders in operational matters traditionally delegated to the board of directors blurs the extent that directors can be held accountable on these matters.

12. The new laws apply where there is a "variation to a condition of a contract". This will have implications for companies looking to implement changes to executive terms or remuneration packages in the future - for instance, an increase in remuneration may result in an executive being covered by the laws unless their contract is drafted so that a remuneration increase does not constitute a variation to their contract.

13. Listed companies will need to take care with resolutions proposed at an AGM or EGM for approval of share/option schemes to ensure that the approval is effective to cover all benefits which may require shareholder approval under these laws.

14. Many companies will need to consider adding to the annual resolution "load" by seeking shareholder approval "up front" for benefits that might be caught by the new laws.

15. The aggregate effect of a series of "not quite right" changes to executive remuneration is almost certain to be increased total pay, not less pay; a sort of risk premium that will become payable to executives who are subject to seemingly-arbitrary risks to pay.

6. Recommendations

6.1. Wait until the Productivity Commission lodges its final report in December.

6.2. Assuming the Productivity Commission is supportive of reducing the maximum termination benefit for shareholder approval, consider a level set at three times base salary and short-term incentives. However, this is conditional on a coincident, enforceable ASX Governance Council Principle requiring maximum termination payments to be an average one times annual base salary and bonus, on an "if not, why not" disclosure basis.

6.3. Restrict persons covered to be those that have significant influence on, and accountability for, remuneration frameworks, i.e. executive directors and other executive key management personnel named in remuneration reports.

6.4. Clarify the definition of termination benefit to exclude bona fide superannuation contributions and pro rated and bona fide short term incentive payments.

Yours sincerely,

Peter McAuley
Director

Michael Robinson
Director