

17 July 2009

The Secretary
Senate Economics Legislation Committee
PO Box 6100
Parliament House
CANBERRA ACT 2600

Business
Council of
Australia

By Email: economics.sen@aph.gov.au



Dear Sir / Madam

CORPORATIONS AMENDMENT (IMPROVING ACCOUNTABILITY ON TERMINATION PAYMENTS) BILL 2009

The BCA appreciates the opportunity to make a submission to the Senate Economics Legislation Committee's inquiry into the *Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009*.

The BCA represents the chief executives of over 100 of Australia's leading companies. The BCA develops and advocates, on behalf of its members, public policy reform that positions Australia as a strong and vibrant economy and society.

In considering measures to strengthen the regulatory framework relating to the payment of termination benefits to executives, it is important that a sense of proportionality is retained, and also that the matter be considered in the context of the current inquiries into executive remuneration being undertaken by the Productivity Commission and Australian Prudential Regulation Authority. Considering the issue of termination payments in isolation runs the risk of poor and inefficient regulations being imposed which will be detrimental to Australia's economy and growth prospects.

In relation to the specific issue of termination payments, it is important to bear in mind the nature of the termination event. Is it for poor performance or for some other non-performance related reason, e.g. the executive has reached retirement age or the company has been acquired? This is germane to the extent that for terminations not related to poor performance it is not uncommon for CEOs to receive a pro-rata amount for performance hurdles already achieved.

It is also important to recognise that CEO jobs are by their nature risky and uncertain and are characterised by relatively short tenure in Australia. The Booz & Co 2007 Turnover Study found that:¹

- Australian CEO turnover in 2007 was 18 per cent, the highest since they commenced the Australian study and an increase of 60 per cent since 2000.

¹ Booz & Company, *CEO Turnover Study 2007 – The Performance Paradox*, 2007

- CEO turnover in Australia was among the highest in the world, and well above the 2007 global average of 13.8 per cent.
- CEO tenure in Australia dipped to 5.7 years, significantly lower than the global average of 8 years.

Employment agreements for CEOs and other senior executives typically provide for termination with very little notice. And, when a board decides a CEO is not delivering acceptable results, it is in everyone's best interests to encourage the CEO, through mutual agreement, to leave sooner rather than later. Protracted poor performance or public contractual disputes can be damaging to the business, including through the potential to affect important commercial factors such as public reputation, client relationships and staff morale. This means compensation for the risk of early termination is a priority issue in contract negotiations.

The Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009 has been introduced into parliament, less than a month after the submissions on the exposure draft legislation were due.

As drafted, the BCA considers that the Bill runs the risk of significant regulatory over-reach with the potential to capture matters to do with the ordinary course of business. In particular there is a risk that a substantial compliance burden could be imposed on companies following the retirement of long-serving employees.

In addition the BCA is concerned that under the proposed laws, boards will find it more difficult to manage termination arrangements not least because of the breadth of their application and the lack of details on the definition of what actually constitutes a termination benefit.

The BCA considers that reforms in the area of termination payments should be targeted towards aligning executive remuneration with company performance as well as ensuring that Boards are able to deal effectively with poor performance. The BCA does not consider that the Bill achieves this policy objective.

The BCA supports regulatory reform where there is a clearly identifiable problem to be addressed, where regulation is the most effective response, and where the costs of the regulation do not outweigh the benefits. It is also important that legislation, when passed through Parliament, contains sufficient detail to enable its true impact to be understood.

In this instance, much of the detail of the Bill has yet to be finalised and will be included in regulations. This includes definitions of 'base salary' and 'termination benefit'. These definitions are fundamental to the practical operation of the legislation. It is not possible to assess whether the Bill achieves the aims and intentions of the legislation much less the broader impacts of the legislation in the absence of this additional information and detail.

The BCA considers that the regulations should be finalised and a proper cost-benefit analysis of the legislation be conducted, in order for the Committee to make a comprehensive assessment as to how this legislation will work in practice.

In the BCA's view, significant amendments to the Bill are necessary to avoid unintended consequences related to the ability of companies to compete for skilled and experienced executives. At the very least issues related to the breadth and scope of its application need to be addressed. The BCA's specific concerns are addressed in more detail below.

Lack of demonstrated problem at which proposals are aimed

A detailed discussion of the market problem at which these proposals is aimed has not been provided in the Explanatory Memorandum. The reforms are aimed at *'curbing excessive termination payments paid to company executives'*² however there is little further explanation or evidence of market integrity problems associated with that statement or explanation as to why existing laws (e.g., remuneration disclosure, governance and non-binding shareholder votes) are inadequate to address the issue.

The BCA considers that these proposals are drafted without clear policy objectives, and therefore risk inconsistency with other aims and objectives which have been articulated broadly. For example, as outlined below, the calculation of the threshold by reference to 'base salary' rather than 'total remuneration' may have an unintended consequence of encouraging executive remuneration packages to be more heavily weighted to 'base' rather than 'at risk' or 'performance-linked' remuneration.

Lower threshold at which termination payments are to be approved

The proposals introduce a 'significantly' lower threshold at which termination payments must be approved by shareholders.

The threshold is reduced from seven times, to one times annual 'base salaries'. However, there is no explanation as to why such a 'significant' reduction is required or discussion of the market failure which warrants the threshold being set at that level.

Also of concern is the measurement of 'base salary'. The definition of 'base salary' is to be specified in the regulations and finalised following further targeted consultation with industry. While we welcome the commitment to further consultation on this important issue, the definition of 'base salary' is a significant policy issue which will determine how this Bill operates in practice.

The BCA believes that this needs to be clarified prior to the passage of this Bill through Parliament. Given the importance of this definition for the operation of the legislation, if the regulations are not finalised before this Bill is passed, then 'public' rather than 'targeted' consultation should be undertaken to ensure the widest possible views are captured.

The BCA considers that the threshold measurement for determining whether shareholders should vote on a termination payment should be on the basis of an executive's 'total remuneration' package rather than 'base salary'.

² Explanatory Memorandum, p. 7

For many employees, base salary can be very low compared with the value of their total yearly remuneration package. For example, executives are likely to have a mixture of short-term and long-term incentives which account for more than half of their overall remuneration. If their termination payments are limited to one year's 'base salary', then the measurement threshold for termination approvals may be on amounts as low as six months of their remuneration. There is a concern that this doesn't adequately measure the contribution that those staff members have made to an organisation.

The application of 'base salary' as the threshold has a number of potential unintended consequences, such as:

- an increased incentive for companies to reduce the proportion of remuneration 'at risk' and to increase the proportion of 'base salary'. This outcome would be in contrast to the broader public policy aim of increasing the long-term alignment of executives' interests with those of the company (i.e., establishing the right balance between fixed and variable components of executive remuneration); and
- the potential for base salaries to escalate in an attempt to either avoid the risk of shareholder votes on termination payments or the risk of inadequate termination payments.

The BCA notes that governance advisers, shareholders and regulators are currently pressing for a greater share of executives' remuneration to be provided as variable, performance-based remuneration. There is a significant risk that the proposed Bill will have an effect that is directly counter to this aim.

Extension of the range of personnel to which the proposals apply

The Explanatory Memorandum states that the '*range of personnel whose termination benefits can be subject to shareholder approval is expanded from directors to also include senior executives or key management personnel.*³ An explanation of the rationale for expanding the range of personnel to include those in 'managerial or executive office' is not provided in the Explanatory Memorandum. The Second Reading Speech outlined the aim as:

'to ensure that all key individuals, who have their remuneration disclosed in the remuneration report, will be captured by the regulatory regime'.⁴

The expansion to 'key management' will, in the BCA's view, encompass a wide range of managerial staff. There are a number of possible consequences of capturing those whose remuneration would not ordinarily be subject to a shareholder vote on an individual basis. These consequences include:

- the potential to deter employees from taking promotions that might elevate them to 'key management'; and
- the potential incentive for qualified and experienced professionals to take employment in private companies, multinational organisations or overseas rather than publicly listed Australian companies.

³ Explanatory Memorandum, p. 7

⁴ House of Representatives, Second Reading Speech, Chris Bowen MP, 24 June 2009

The proposals would expand the reach of the retirement benefit restrictions to cover large numbers of employees who are not likely to be considered key personnel and whose individual deferred remuneration is of little significance for most shareholders and regulators. For example, the proposals will potentially apply to:

- directors of subsidiaries (both listed and unlisted);
- 'key management' personnel employed in subsidiaries.

It is unclear why those employees should be subject to the Bill's provisions. In large organisations this will potentially include hundreds of people and/or subsidiaries, especially for large global organisations.

For large dual listed organisations, this may mean that overseas executives who are residents of an overseas country, will have their termination pay voted upon by Australian shareholders. The uncertainty that this poses for those overseas executives may be sufficient to deter them from working for dual listed Australian companies.

Additionally, the scope of application of the termination payments legislation will make it administratively costly and cumbersome to apply in practice – especially for large organisations where turnover can be high (for example in global services based firms). Increased complexity and compliance may increase the risk of unintended breach of the provisions with significant consequences given the increased sanctions for any breach of these provisions.

Indeed, this additional uncertainty and added compliance burden has the potential to work directly against other policy objectives the government is pursuing, for example in relation to its efforts to promote Australia as a regional financial centre.

The Explanatory Memorandum and the Second Reading Speech suggest that the shareholder vote on termination payments applies to those people listed in the remuneration report (although this limitation is not explicit in the Bill). In any event, requiring a shareholder vote for those listed in the remuneration report has additional problems:

- Individuals listed in the remuneration report may change from year to year. Shareholders and employees will never be certain about whose termination pay will be subject to a shareholder vote upon retirement.
- Those listed in the remuneration report are determined by reference to the pay levels of other executives in the organisation. Therefore, executives on lower salaries in smaller listed companies may have their termination pay subject to a shareholder vote.
- It is common for long serving employees to become listed in the remuneration report in their last year of employment, by virtue of the size of their termination payment. As such, many long serving executives will require a shareholder approval for their termination pay, merely by virtue of their retirement even when they have not been in a position of key influence at all, or only for a small portion of their career.

Accordingly, the number of executives to which the proposals apply should be limited to a specific defined set of individuals (e.g., to the chief executive, executive directors and key management personnel) employed in the listed parent company (rather than treating subsidiaries as separate entities).

Broader definition of ‘termination benefit’

Under the proposals, ‘termination benefits’ are yet to be defined and it is proposed that they be defined in the regulations. It is difficult for the community to comment on the Bill and the possible impacts on the market, in the absence of clear definitions.

The definition of ‘termination benefits’ is a significant policy issue and gets to the heart of determining how this Bill operates in practice. It is fundamental therefore, that the definition be clarified prior to the passage of the Bill through Parliament.

Given the importance of the definition of a ‘termination benefit’ for the operation of the legislation, if the regulations are not finalised before this Bill is passed, then public rather than ‘targeted’ consultation should be undertaken to ensure the widest possible views are captured.

Payments that will not require shareholder approval

The BCA considers that ‘termination benefits’ should not include any payments made to departing employees which are statutory entitlements or accrued during the term of their employment. These entitlements include annual leave, long service leave and superannuation. Accordingly, clarity is needed around what is meant by a termination benefit.

The Explanatory Memorandum states that:⁵

The draft regulations will also prescribe, for the avoidance of doubt, a non-exhaustive list of specific examples of payments that will not require shareholder approval, which could include for example, deferred bonuses...

It is unclear whether the exemption will cover a deferred bonus which is invested in equity. It is also unclear whether a deferred bonus which is subject to a vesting period or other restrictions would be exempt.

Circumstances where a payment is in connection with retirement

The Explanatory Memorandum states:⁶

...the draft regulations will prescribe circumstances in which a benefit is given in connection with a person’s retirement from an office or position. This could include for example, the automatic or accelerated vesting of benefits in the definition of ‘termination benefits’.

Many equity incentive schemes allow boards to determine whether unvested or unpaid awards should vest or be realised on termination. Consideration should be

⁵ Explanatory Memorandum, p.13

⁶ Explanatory Memorandum, p.13

paid as to whether including these arrangements in 'termination benefits' is likely to act as a disincentive for boards to use equity schemes to align executives' interests to the long-term fortunes of a company.

Additionally, the Bill treats all payments as 'termination benefits'. The circumstances in which a payment is considered a 'termination benefit' is important and also requires additional consideration. For example, it is unclear why a person who is retiring after significant long service and is rewarded for good performance should be subject to the same legislative treatment as someone whose termination is due to poor performance.

The regulations will allow the government to include 'further categories' of termination payments at a later date. This introduces a large degree of uncertainty because long serving employees can suddenly have the nature of their remuneration altered due to a change in the regulations during their employment term.

Cost-benefit analysis

The BCA considers that reform of existing law should only be undertaken where the net benefits to the community of making the change outweighs the cost. The principal method of ensuring that such an assessment is undertaken is through the preparation of a regulation impact statement (RIS). In relation to this Bill, however the Explanatory Memorandum states:

The Office of Best Practice Regulation has been consulted and has advised that a Regulation Impact Statement is not required due to the Government's prior announcement to progress reforms in this area.

A policy that allows the RIS process to be avoided because of 'prior announcements by government' is not consistent with good policy development process. In the BCA's view the broader economic implications of the termination payments proposals, and the likely impact on the overall business environment justify a fully fledged RIS process.

A broader analysis should establish whether there are unintended economic consequences of the proposals. For example to determine whether they are consistent with best practice elsewhere and whether they will create new distortions to the employment market in Australia. One important factor to understand will be the impact any distortions may have for the ability to attract and retain qualified professionals in the listed sector in Australia.

Transitional provisions and operation in conjunction with existing rules

There appears to be some uncertainty attaching to the transitional provisions as between statements made in the Explanatory Memorandum and the Bill itself. For example, it appears from the Bill that a variation to the terms of an existing contract of employment creates a new contract. There is also no clarity around whether shareholder approval which has already been obtained continues to have effect under the new rules.

Concluding comments and recommendation

The BCA considers that Australia's corporate governance processes and practices are sound overall and have operated well. Our companies and economy continue to outperform when compared with global peers. Accordingly the BCA supports a principles-based approach and believes that more prescriptive, regulatory responses should be avoided and where considered they must be subject to rigorous cost-benefit analysis.

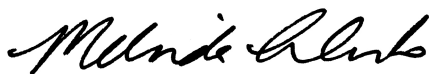
Finally, and more broadly, it is important that there is consistency in the approach taken by government and regulators to addressing the issue of executive remuneration. Since the beginning of 2009 no fewer than four separate policy actions and/or inquiries have been undertaken or initiated which have a direct bearing on executive remuneration. In addition to this legislation are the development of the APRA framework, the changes to the taxation of employees share schemes announced in the federal Budget (and later amended), and the Productivity Commission inquiry into executive remuneration. In addition to the resources and time required to manage and engage with all four, this 'multi-track' approach creates a greater risk of unintended consequences or inconsistent approaches being adopted.

The BCA believes that consideration of the appropriateness of termination payments for executives should have been dealt with through the Productivity Commission inquiry to enable a more comprehensive examination of where there is an issue to be addressed with termination payments, and how best to respond.

Given that this approach has not been adopted and in light of the issues and concerns outlined above, the BCA considers that significant amendments to the Bill are required (including clarity around core definitions such as 'base salary' and 'termination benefit'), following an appropriate assessment of the market problem, objectives of the proposals and a cost-benefit analysis.

Please feel free to contact me or Ms Leanne Edwards, Assistant Director – Regulatory Affairs, on (03) 8664 2614 or leanne.edwards@bca.com.au if you wish to discuss the BCA's concerns further.

Yours sincerely



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