The Senate

Economics
Legislation Committee

Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009 [Provisions]

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Chapter 1

Introduction

Background and conduct of the inquiry

1.1 The Government announced its intention to amend the *Corporations Act 2001* on 18 March 2009.[1] The principal change announced was to lower the threshold for shareholder approval for termination payments paid to company directors and certain other persons from the current seven years' *total remuneration* to one year's *base salary*.

1.2 On 5 May 2009, the Treasury released an exposure draft of the Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009 for public consultation. It also released an exposure draft of regulations to be made under the bill. This process led to a number of changes to the bill prior to introduction.[2]

1.3 The bill was introduced into the House of Representatives on 24 June 2009.

1.4 On 25 June 2009, the Senate referred the provisions of the bill to the Senate Economics Legislation Committee for inquiry and report by 7 August 2009. It was later agreed to extend the reporting date to 7 September 2009.

1.5 The committee invited written submissions by 19 July 2009. Details of the inquiry were placed on the committee's website and the committee also wrote to a number of organisations inviting written submissions. Submissions received by the committee are listed at Appendix 1.

1.6 A public hearing was held in Sydney on 25 August 2009. A list of witnesses appearing at the hearing is at Appendix 2.

1.7 The committee thanks those who participated in this inquiry.

Existing rules governing termination payments

1.8 Termination payments are governed by Division 2 of Part 2D.2 (Sections 200A to 200J) of the *Corporations Act 2001* ('the Act').

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1 The Hon Wayne Swan MP, Treasurer, at Joint Press Conference with Senator the Hon Nick Sherry, Minister for Financial Services, 18 March 2009, http://www.treasurer.gov.au/DisplayDocs.aspx?doc=transcripts/2009/041.htm&pageID=004&min=wms&Year=&DocType=2, viewed 8 July 2009.

2 Treasury website, http://www.treasury.gov.au/contentitem.asp?NavId=066&ContentID=1584, viewed 22 July 2009.

1.9 Sections 200B and 200C of the Act prevent the payment of a benefit to a person in connection with their retirement from a 'board or managerial office' without the approval of members of the company (i.e. shareholders in the case of a listed company).

1.10 Under section 200D of the Act, receipt of a benefit in contravention of sections 200B or 200C is an offence. Section 200E sets out the rules for obtaining member approval.

1.11 Sections 200F and 200G provide exemptions to the requirement to obtain member approval. The most relevant to this inquiry is that member approval is not required for retirement benefits which are less than seven years' total remuneration.

1.12 Section 200H provides that benefits do not require approval if failure to give the benefit would 'constitute a contravention of a law in force in Australia or elsewhere'. Section 200J provides that benefits paid in contravention of section 200B are taken to be held in trust by the person for the company.

1.13 Additional guidance on termination payments is provided by the ASX Corporate Governance Guidelines, which state in relation to termination payments:

> Termination payments, if any, for chief executive officers should be agreed in advance, including detailed provisions in case of early termination. There should be no payment for removal for misconduct. Agreements should clearly articulate performance expectations. Companies should consider the consequences of an appointment not working out, and the costs and other impacts of early termination.[3]

Other inquiries currently underway

1.14 On 18 March 2009, the Government also announced a Productivity Commission inquiry into executive remuneration more generally. The Commission is due to release its draft report in September and its final report by 19 December 2009.[4]

1.15 On 24 May 2009, the Australian Prudential Regulatory Authority (APRA) released a discussion paper on remuneration for authorised deposit-taking institutions. Subject to consultation, it is expected that the final prudential standards and associated prudential practice guide will be released in September 2009 and effective from 1 January 2010.

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3 ASX Corporate Governance Council, *Corporate Governance Principles and Recommendations* (2nd Edition), 2007, p. 36.

4 Productivity Commission website, http://www.pc.gov.au/projects/inquiry/executive-remuneration, viewed 21 July 2009.

Previous parliamentary consideration

1.16 In June 2004, the Parliamentary Joint Committee on Corporations and Financial Services noted concern about the current thresholds:

> …the provision sets down a formula that establishes a relatively high benchmark-a payment above this point requires shareholder approval, a payment below it is exempt from approval. The benchmark appears to be set at quite a high level and in effect appears to sanction or even encourage termination payments that would fall just below this level.[5]

1.17 The committee unanimously recommended that 'all payments made to directors be subject to shareholder resolution including payments such as the maximum annual cash payment and any retirement benefit or termination payout.'[6]

1.18 Australian Labor Party members of the committee called for the Act to be amended so that shareholder approval is required for termination payments which exceed one year's salary (excluding statutory super).[7]

1.19 Treasury cited the work of the Parliamentary Joint Committee as evidence that 'there has been concern for a number of years about the need for reform to these arrangements'.[8]

Provisions of the bill

1.20 In summary, the bill:

- lowers the amount that a termination payment may be before shareholder approval is required. The threshold will go from seven years' total remuneration to one year's base salary. The term 'base salary' will be defined in regulations;
- extends the Act to cover termination payments for all 'key management personnel' (i.e. not just the CEO and directors but other senior people). In the

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5 Parliamentary Joint Committee on Corporations and Financial Services, 'CLERP (Audit Reform and Corporate Disclosure) Bill 2003, Part 1: Enforcement, executive remuneration, continuous disclosure, shareholder participation and related matters,' June 2004, p. 95.

6 Parliamentary Joint Committee on Corporations and Financial Services, 'CLERP (Audit Reform and Corporate Disclosure) Bill 2003, Part 1: Enforcement, executive remuneration, continuous disclosure, shareholder participation and related matters,' June 2004, Recommendation 16.

7 Parliamentary Joint Committee on Corporations and Financial Services, 'CLERP (Audit Reform and Corporate Disclosure) Bill 2003, Part 1: Enforcement, executive remuneration, continuous disclosure, shareholder participation and related matters,' June 2004, p. 259.

8 Mr Geoffrey Miller, General Manager, Corporations and Financial Services Division, Treasury, *Proof Committee Hansard*, 25 August 2009, p. 73.

case of reporting entities, this consists of all key individuals that are disclosed in the company's remuneration report;

- prevents directors and executives from voting in relation to their own benefit (except in relation to proxies);
- requires that any payments made without required approval must be repaid; and
- increases penalties for payments made without approval.

1.21 These provisions will commence the day after Royal Assent, but will only apply in relation to contracts which are made, renewed or varied after commencement.

1.22 The bill establishes four new regulation-making powers:

- The definition of 'base salary' (under section 9 of the Act);
- A list of things to be specified as benefits (under section 200AB(1));
- A list of circumstances in which a benefit can be given in connection with retirement (under section 200A(1A)); and
- Cases where the restriction on voting by retirees or associates on their own termination payment does not apply (under section 200E(2C)).

1.23 The committee understands that Treasury is currently engaged in further targeted consultations on the content of the regulations.

Chapter 2

Termination Payments

What problem is the bill trying to fix?

2.1 The principal justification provided for the bill is mounting community concern. The Minister stated in his second reading speech:

> There is significant community concern about the levels of termination benefits paid to company management. Such payments are given to outgoing company directors and executives at a time when they are no longer able to influence the company's future performance. The government's reforms will empower shareholders to more easily reject such payments where they are not in the best interests of the company, the shareholders or the community.[1]

2.2 In announcing the measure on 18 March 2009, the Treasurer referred to community concern about 'obscene' and 'outrageous' termination payments, and the need to 'ensure that executive pay is in step with good corporate governance, provides the correct incentives and meets decent community standards'.[2] The Explanatory Memorandum also refers to community concern as motivation for the bill.[3]

Trends in executive remuneration

2.3 Executive remuneration as a whole is a matter beyond the scope of this inquiry. However, the committee received evidence that the topic of termination payments cannot be seen in isolation from the wider context of executive remuneration. Concern about the level of overall executive salaries also helps to explain community concern about the level of termination payments.

2.4 The committee received evidence that there has been a significant increase in executive salaries in recent years. Professor David Peetz of Griffith University provided evidence that:

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1 Hon Chris Bowen MP, Minister for Financial Services, Superannuation and Corporate Law, *House of Representatives Hansard*, 24 June 2009, p. 20.

2 The Hon Wayne Swan MP, Treasurer, at Joint Press Conference with Senator the Hon Nick Sherry, Minister for Financial Services, 18 March 2009, http://www.treasurer.gov.au/DisplayDocs.aspx?doc=transcripts/2009/041.htm&pageID=004&min=wms&Year=&DocType=2, viewed 8 July 2009.

3 Explanatory Memorandum, paragraph 2.2.

The growth in CEO pay, of something around 470 per cent over the period 1971-2008, was nearly nine times the 54 per cent growth in real average weekly earnings over the same period.[4]

2.5 Mr Gary Banks, Chairman of the Productivity Commission, which is currently undertaking an inquiry into executive remuneration, has noted:

…it is hardly a revelation to say that both executive and (non-executive) director remuneration have been increasing relatively rapidly — at least until last year — albeit with executive pay at much higher levels and increasing at a faster rate than for directors.[5]

2.6 Mr Banks noted that there is a lack of data, particularly in relation to non-executive directors. He also stated that media reports sometimes exaggerate the extent of executive salaries due to the complexity of incentive packages and other factors.[6]

2.7 An alternative view of executive remuneration was provided by the Australian Chamber of Commerce and Industry. They argued that that claims that executive remuneration are significantly higher than other sectors of the economy are sometimes overstated:

…it must also be recalled that there are other professionals, for example, in our sports, entertainment, business, medical and legal industry, that are remunerated above and beyond most average Australian incomes and corporate executives. These professions are not subject to detailed regulatory interventions or restrictions in terms of total remuneration packages or termination payments. Such persons would earn many times over that of an average Chief Executive Officer or senior executive in most Australian firms, and without any clear measurable benchmark to overall performance or result.[7]

2.8 Other submissions referred to executive remuneration as unbalanced:

Also in need of correction are the imbalances between those rewards and the rewards given to other employees of the same corporations, and the rewards for work given to workers in society generally. These imbalances must be corrected if social equity

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4 Professor David Peetz, *Submission 15*, p. 4.

5 Mr Gary Banks, Chairman, Productivity Commission, 'the Productivity Commission's executive pay inquiry: an update on the issues,' paper presented at FINSIA forum, 4-5 June 2009, p. 2, http://www.pc.gov.au/__data/assets/pdf_file/0011/89579/cs20090603.pdf, viewed 26 June 2009.

6 Mr Gary Banks, Chairman, Productivity Commission, 'the Productivity Commission's executive pay inquiry: an update on the issues,' paper presented at FINSIA forum, 4-5 June 2009, pp 2-3, http://www.pc.gov.au/__data/assets/pdf_file/0011/89579/cs20090603.pdf, viewed 26 June 2009.

7 ACCI, *Submission 4,* p. 5.

and a reduction in inequality are to remain goals of Australian society, and goals of the Government of that society.[8]

Are termination payments 'excessive?'

2.9 Discussion of termination payments often refers to certain high profile cases.[9]

2.10 In announcing the government's decision, the then Minister for Financial Services, Senator the Hon Nick Sherry, referred to payouts provided to Mr Owen Heggarty of Oz Minerals (who in 2008 'received a bonus of $8.35 million, which was 642 per cent of his base salary') and Mr John Anderson of Consolidated Media who in 2008 'received a $15 million golden parachute, 468 per cent of his salary'.[10]

2.11 Regnan's submission provides some further examples. These include Mr Kim Edwards of Transurban Group, who received $16 million remuneration in his final year, including a termination payment of $5.2 million. After his retirement on 4 April 2008, the share price at Transurban fell from $6.60 to $3.91 on 12 March 2009.[11]

2.12 Professor David Peetz provided examples in his submission of media reports of large individual payments. These include among others a '$16 million golden handshake' provided to Mr John Ellice-Flint (Santos)[12] and a 'farewell package' of $32 million provided to Mr Chris Cuffe (Colonial First State).[13]

2.13 One topical example at the time of the bill was announced was that of Mr Sol Trujillo of Telstra. Media reports suggest that Mr Trujillo 'would get $3 million

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8 Australian Manufacturing Workers Union, *Submission* 10, p. 3.

9 See for example Adam Schwab, 'Curbing golden handshakes: nothing succeeds like failure,' 19 March 2009, http://www.crikey.com.au/2009/03/19/curbing-golden-handshakes-nothing-succeeds-like-failure/, viewed 8 July 2009; Catherine Fox, 'Pay Check,' AFRBOSS.COM.AU, July 2009.

10 Senator the Hon Nick Sherry, Minister for Financial Services, at Joint Press Conference with the Hon Wayne Swan MP, Treasurer, at Joint Press Conference with, 18 March 2009, http://www.treasurer.gov.au/DisplayDocs.aspx?doc=transcripts/2009/041.htm&pageID=004&min=wms&Year=&DocType=2, viewed 8 July 2009.

11 Regnan, *Submission 7*, *Attachment 'Regnan Remuneration Proposal – March 2009*, p. 19.

12 Michael West, 'Golden chutes back in vogue', *Sydney Morning Herald*, 27 November 2008, cited in Professor David Peetz, *Submission 15*, p. 24

13 Stephen Mayne, 'Biggest golden parachutes in corporate Australia,' *Mayne Report*, cited in Professor David Peetz, *Submission 15*, p. 20.

termination payments on top of his base salary of more than $13 million'.[14] Telstra has pointed out that Mr Trujillo's payment would be within the new standards.[15]

Are 'excessive' payments standard practice?

2.14 It is not clear the extent to which these individual examples are representative of standard practice among companies.

2.15 In 2004, an article in the *Australian Financial Review* found:

> An analysis…of the latest annual reports released by 50 of Australia's largest companies reveals that nearly a third of chief executives are entitled to termination payments worth more than the equivalent of 12 months salary, as well as performance-linked bonuses and entitlements to shares and options. Eight CEOs are entitled to payouts of at least $4 million if their employment is terminated, while some agreements have controversial provisions that trigger big payouts to the CEO if control of the company changes.[16]

2.16 In 2005, Geof Stapledon estimated that in Australia termination payments range from $800,000 to $9.9 million. The mean payment was $3.65 million and the median was $3 million.[17]

2.17 In 2007, Kym Sheehan and Colin Fenwick of the University of Melbourne examined termination provisions in executive service contracts:

> Given a hypothetical termination date of 1 March 2006, nine of the 28 companies examined would have paid an amount equivalent to at least 18 months' cash remuneration by way of contractual termination payment to the managing director.[18]

2.18 All these figures predate the Global Financial Crisis.

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14 ABC Online, PM, 'New law to tackle corporate pay excess,' http://www.abc.net.au/pm/content/2008/s2519973.htm, viewed 7 July 2009.

15 Mr David Quilty, Telstra Ltd, quoted in ABC Online, PM, 'New law to tackle corporate pay excess,' http://www.abc.net.au/pm/content/2008/s2519973.htm, viewed 7 July 2009.

16 Damon Kitney and Fiona Buffini, '$100m payout bonanza to CEOs,' *Australian Financial Review*, 6 December 2004.

17 Geof Stapledon, 'Termination benefits for Executives of Australian Companies', *Sydney Law Review*, Vol 27, p. 700, 2005. http://www.law.usyd.edu.au/slr/slr27_4/Stapledon.pdf, viewed 17 July 2009.

18 Kym Sheehan and Colin Fenwick, Research Report, 'Seven: the Corporations Act, corporate governance, and termination payments to senior employees,' Centre for Corporate Law and Securities Regulation, University of Melbourne, 2007, p. 10., http://cclsr.law.unimelb.edu.au/download.cfm?DownloadFile=722D87A5-1422-207C-BA2DF86F9596602F, viewed 10 July 2009.

2.19 Some submissions argued the upward trend in termination benefits has stalled. According to the Hay Group, 'there has been a progressive downward trend towards contracted termination payments of between 10 and 15 months fixed annual reward over the last five years'.[19]

2.20 Table 1 provides an indication of the size of current termination provisions in the ASX20 companies in Australia.

2.21 Treasury cited RiskMetrics data (released November 2008) which indicates that the average CEO receives just over $3.4 million as a termination payment, or 201 per cent of their salary, based on entities in the S&P/ASX 100 in the previous three years. Based on these data, Treasury found that 20 of the 33 CEOs included in the sample (around 60%) would exceed the proposed new threshold, with the rate expected to decline for smaller companies. They conclude:

> Based on this research, it would appear that between approximately 50 to 60 per cent of termination benefits would be captured by [the 12 month] threshold, which Treasury considers to be an appropriate level.[20]

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19 Hay Group, *Submission 6*, p. 2.

20 Treasury, *Submission 22*, p. 7.

Table 1: Termination Pay Arrangements in the ASX20

Company	Less than 12 month base	Summary of Termination arrangements for key management personnel
AMP Ltd	No	12 months' fixed pay. Executives retain unvested equity incentives subject to performance hurdles.
ANZ Banking Group	No	CEO is entitled to greater of the remainder of employment contract or 12 months' fixed.
BHP Billiton Ltd	Yes	12 months' base pay.
Brambles Industries Ltd	Yes	12 months' fixed pay.
Commonwealth Bank of Aust.	Yes	6 months' notice for CEO. Other executives between 6 and 12 months base.
CSL Ltd	No	12 months' fixed pay plus 6 months notice.
Foster's Group Ltd	Yes	12 months' fixed pay.
Macquarie Group Ltd	Yes	4 weeks' notice plus profit share already accrued.
National Australia Bank Ltd	Yes	12 months' fixed pay for CEO, similar for other Key Management Personnel.
Newcrest Mining Ltd	Yes	12 months' fixed pay.
Origin Energy Ltd	Yes*	Senior executives three months' payment in lieu of notice plus a severance payment based on length of service, to a maximum of 74 weeks. Managing director 12 months' fixed pay if terminated for poor performance.
QBE Insurance Group Ltd	Yes	12 months' fixed pay.
Rio Tinto Ltd	No	12 months' fixed pay plus pro rata STI. Unvested LTIs retained and subject to hurdles
Suncorp-Metway Ltd	Yes*	12 months' fixed pay for CEO and most key management personnel. Some former Promina executives entitled to up to 18 months fixed pay.
Telstra Corp Ltd	Yes*	CEO and COO 12 months' base pay. Some key management personnel are entitled to 18 months' base pay.
Wesfarmers Ltd	No	Two years' base pay.
Westfield Group	Discretionary*	Termination payments are discretionary.
Westpac Banking Corp	Yes*	12 months' fixed remuneration for most executives. 12 months' fixed pay for CEO if terminated for poor performance otherwise sign on shares may be awarded if terminated prior to December 2009.
Woodside Petroleum Ltd	Yes	12 months' fixed remuneration.
Woolworths Ltd	No	12 months' fixed remuneration plus pro-rated STI.

* As a general standard. Some exceptions may apply.

Source: Australian Council of Super Investors (document tabled at public hearing, 25 August 2009).

Are claims of 'excessive' termination payments exaggerated?

2.22 The Australian Institute of Company Directors (AICD) pointed out that publicity given to individual payments made to individuals often overstates the size of termination payments:

> Another source of difficulty has been that the nature of payments made at the end of employment is often misunderstood by members of the public. Such payments can consist of a number of components such as unpaid leave, long service leave, superannuation and other ordinary contractual entitlements. To this a sum is often added to compensate for loss of office, either pursuant to a pre-agreed contractual arrangement or a negotiated settlement in lieu of damages for breach of contract. To the public eye the aggregate sum may seem excessive whereas only the latter elements can be influenced by the board.[21]

2.23 The Business Council of Australia (BCA) and ACCI presented similar arguments.[22] Geof Stapledon also noted this phenomenon in his 2005 study.[23]

2.24 Ernst & Young referred to the lack of clarity surrounding the disclosure of remuneration arising from complex accounting rules:

> The disclosed remuneration for an individual does not therefore relate to the *cash value* received by the executive. This disconnect results in frequent misinterpretation by shareholders, media and the public, resulting in the sometimes false perception that an executive is overpaid. Similarly, an executive may receive significant remuneration value that is not immediately apparent from the disclosure.[24]

Risk and tenure

2.25 Several submissions from industry provided arguments that high termination payments represent compensation to executives for the risky nature of such positions.

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21 AICD, 'Executive Termination Payments,' Position Paper no. 13, Oct 2008, p. 2. http://www.companydirectors.com.au/NR/rdonlyres/17559EF2-5AB7-47DF-A647-46B5A3C05E93/0/AICDPositionPaperNo13ExecutiveTerminationPayments.pdf, viewed 16 July 2009.

22 BCA, *Submission 9*, p. 1; ACCI, *Submission 4, Attachment*, p. 3.

23 Geof Stapledon, 'Termination benefits for Executives of Australian Companies', *Sydney Law Review*, Vol 27, p. 708., 2005. http://www.law.usyd.edu.au/slr/slr27_4/Stapledon.pdf, viewed 17 July 2009.

24 Ernst & Young, *Submission 20*, p. 2.

2.26 The AICD point out that 'the average term of office for a CEO in Australia is now less than five years. CEOs are therefore keen to ensure that they are financially protected in the event that their term of office is shorter than anticipated'.[25]

2.27 The BCA put the average tenure of an executive at 5.7 years.[26] The BCA also pointed out high turnover of CEOs, noting that CEO turnover was 18 per cent in 2007, an increase of 60 per cent since 2000, and the highest level in the world.[27]

2.28 The AICD gave a further illustration of risks faced by directors:

> There are 267, we think, state laws making directors liable. One of the biggest problems in this country at the moment, we would argue, is that, under federal laws for example, you have laws which reverse the onus of proof, which say, 'You are guilty until you have proved yourself innocent.' That transgresses fundamental laws like the Magna Carta. It transgresses fundamental laws like the bill of rights...And you have a system now where there are class actions against directors. You have a system now where there is a massive amount of federal and state laws making directors liable. Is this a big issue? Yes. What happens when liability goes up and risk goes up? Price goes up. So there is definitely a very high coefficient between risk and reward...[28]

2.29 Professor Peetz argued in his submission that other employees in the economy also face risk:

> If there is increasing risk facing CEOs, it is no greater than the increased risk facing ordinary employees compared to two decades ago, as they work in what is sometimes referred to as the 'risk society'…The increased casualisation of employment has transferred many of the risks of employment from capital onto labour…
>
> The argument about greater risk faced by CEOs is especially difficult to sustain when we compare the termination packages to which that CEOs typically have access with those available to ordinary workers…The substantial safety nets in event of dismissal provided by the 'golden parachutes' of CEOs are much more generous than those available to ordinary workers.[29]

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25 AICD, 'Executive Termination Payments,' Position Paper no. 13, Oct 2008, Footnote 1, http://www.companydirectors.com.au/NR/rdonlyres/17559EF2-5AB7-47DF-A647-46B5A3C05E93/0/AICDPositionPaperNo13ExecutiveTerminationPayments.pdf, viewed 16 July 2009.

26 Mr Peter Crone, Policy Director, Business Council of Australia, *Proof Committee Hansard*, 25 August 2009, p. 6.

27 BCA, *Submission 9*, pp 1-2.

28 Mr John Colvin, Chief Executive Officer, Australian Institute of Company Directors, *Proof Committee Hansard*, 25 August 2009, p. 46.

29 Professor David Peetz, *Submission 15*, p. 19.

2.30 The Australian Council of Super Investors (ACSI) submission also noted that such payments 'exceed anything available to the rest of the workforce'.[30]

2.31 ACCI argued that 'restraint of trade' clauses in executive contracts may prevent executives from seeking employment with a competitor for a reasonable period of time. 'Because of the lengthier and more excessive restrictions on an executive than other employees, the *quid pro quo* is often a higher than average premium to the executive'.[31] The Law Council of Australia also noted the impact of restraint of trade clauses.[32]

Consequences of 'excessive' termination payments

2.32 Some submissions and commentators have argued that excessive termination benefits have an impact on the wider economy, justifying government intervention.

2.33 A frequently stated view is that termination payments constitute a 'reward for failure'. Treasury cited this perception in its submission:

> A service contract may provide that no termination benefit is payable in cases where the executive is dismissed for cause, for example, in the event of misconduct. However, this has not prevented the payment of termination benefits where the executive's performance has been below the expected standard, but not to the extent that it would constitute 'cause.' This has reinforced the perception that termination benefits are a reward for poor performance.[33]

2.34 ACSI also noted that 'excessive termination payments appear to not only reward executive directors for mediocre performance, but in some cases, for failure'.[34]

2.35 Some submissions argued that excessive payments promote risk-taking behaviour by executives. The argument appears to be that an executive may be willing to endorse a high risk in order to obtain high returns, in the knowledge that he or she will receive vast bonuses if the 'gamble' comes off and at worst still get millions in the event that the 'gamble' fails. This could lead to CEOs having a perverse incentive to undertake a risky project with a negative expected return, against the interests of shareholders and the broader community.

2.36 The Australian Manufacturing Workers' Union (AMWU) argued:

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30 ACSI, *Submission 13*, p. 1.

31 ACCI, *Submission 4*, p. 7.

32 Law Council of Australia, *Submission 23,* p. 6.

33 Treasury, *Submission 22*, pp 2-3.

34 ACSI, *Submission 13*, p. 1.

> It is becoming increasingly apparent that highly leveraged short term incentives for executives and directors inappropriately promote: a short-term focus, excessive risk-taking and highly individualistic behaviour.[35]

2.37 This does not take into consideration other impacts on executives who might be removed for poor performance, for example damage to reputation:

> There is a risk reputationally. I don't think there is any question that, in our experience, a person who strives for a senior executive position or a board position is very concerned about their reputation and their performance.[36]

Is legislation required?

2.38 Some submissions argued that legislation is required to fix the 'problem'. Other submissions asserted there was a risk of regulatory overreach.

2.39 The AMWU argued that the imbalance in executive salaries 'must simply be corrected to prevent – or at least stem – society's loss of faith in the social entity of the corporation'.[37] Indeed, the AMWU argued the further regulation is required in addition to this bill:

> …it is only one strand of a web of regulation that is necessary to constrain the tendency of the corporation to act without concern or acknowledgement of its responsibilities to the community in which it exists and the workforce which generates its wealth.[38]

2.40 Professor Peetz noted that while there had been some reduction in executive termination payments in recent years, for reasons including changing economic circumstances and responsiveness by business to community sentiment, further regulation was justified:

> This bill is important not only for promoting good practice in executive termination payments. It is also important that the parliament send a signal that, like the community, it is no longer willing to welcome excess in executive remuneration generally. While sending signals will not in itself halt excessive remuneration, if parliament fails to pass this bill it will send exactly the wrong signal and we could expect a return in the near future to not only the excessive termination payments that characterised the recent

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35 AMWU, *Submission 10*, p. 3.

36 Mr Peter McAuley, Director, Guerdon Associates, *Proof Committee Hansard*, 25 August 2009, p. 61.

37 AMWU, *Submission 10*, p. 3.

38 AMWU, *Submission 10*, p. 2.

> past but also the excessive growth in executive remuneration generally that has been witnessed.[39]

2.41 Other submissions asserted there was a risk of regulatory over-reach. The BCA described the bill as running 'the risk of significant regulatory overreach with the potential to capture matters to do with the ordinary course of business'.[40] The BCA also argued:

> 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' 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.[41]

2.42 Other organisations asserting this risk include the Hay Group, the Australian Bankers' Association, the Australian Industry Group, and ACCI.[42]

2.43 The Investment and Financial Services Association (IFSA) argued 'the current governance regime over remuneration in Australia has experienced no systematic failure even in the recent market turbulence. Evidence is growing that the current regime is adjusting of its own accord to the changing financial environment'.[43]

2.44 ACSI provided evidence that of the top 20 ASX companies, thirteen used one year's base salary for termination payments for executive staff.[44] However, as these companies were likely to be the most responsible due to their size and concern for their reputation, ACSI still regarded legislation as necessary to send a signal to the market (particularly smaller companies).[45]

2.45 Whilst BHP Billiton argued that reducing the threshold to 12 months' base salary is 'too extreme',[46] it acknowledged that the current thresholds in the Act 'allow for extremely high pay-outs' and do 'not strike an appropriate balance'. The AICD also

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39 *Proof Committee Hansard*, 25 August 2009, p. 12.

40 BCA, *Submission 9*, p. 2.

41 BCA, *Submission 9*, p. 3.

42 Hay Group, *Submission 6*, p. 4.; ABA, *Submission 24*, p. 1.; Mrs Heather Ridout, Chief Executive, Australian Industry Group, Media Release, 'Australian Industry Group comment on Federal Government's announcement on executive salaries and Productivity Commission inquiry into "golden handshakes",' 18 March 2009; ACCI, *Submission 4, Attachment*, p. 2.

43 IFSA, *Submission 25*, p. 4.

44 Ms Ann Byrne, Chief Executive Officer, ACSI, *Proof Committee Hansard*, 25 August 2009, p 22.

45 Ms Ann Byrne, Chief Executive Officer, ACSI, *Proof Committee Hansard*, 25 August 2009, pp. 25-26.

46 BHP Billiton, *Submission 5*, pp 2-3.

'accepts that a reduction in the current shareholder approval threshold for termination payments is warranted',[47] although it too opposed the reduction to 12 months.

Committee View

2.46 Whilst many business submissions warned against the risk of over-regulation, it is notable that none of the submissions received argued that termination payments of up to seven years' total remuneration are appropriate.

2.47 Based on the evidence provided, the committee is persuaded that there is a case for imposing further regulatory constraints on executive termination payments.

47 AICD, *Submission 12*, p. 2.

Chapter 3

Consideration of the bill

3.1 A number of issues were raised in connection with the bill. These included the timing of the measure prior to the report of the Productivity Commission (PC) inquiry into executive remuneration, and questions relating to the extent that shareholders should be able to deal with remuneration matters.

3.2 In relation to the bill itself, major areas of discussion included whether the 12 month threshold was appropriate, whether termination payments should be based on 'base salary' or 'total remuneration', and any possible adverse impact the bill might have on the ability of Australian companies to recruit.

3.3 A number of possible unintended consequences were raised, including the possibility of other aspects of remuneration being increased, and the possible burden imposed on subsidiaries and unlisted companies.

3.4 This chapter summarises some of these issues.

Timing of the bill

3.5 Several submissions proposed that it would not be appropriate to proceed with the bill before the outcomes of the PC inquiry and the APRA inquiry. Organisations which have called for delay until after completion of the PC report include ACCI, Guerdon, BHP Billiton, Hay Group, the AICD, the BCA, KPMG and Abacus.[1]

3.6 The AICD highlighted the risk that the PC might advise against the adoption of measures such as the bill:

> I put to the Productivity Commission at one stage whether, if they actually thought our idea—namely, not to have termination payment legislation of this sort—was a good one, they would say so. And they said that their job was independent and, if they came to that view, they might. So the issue was: if legislation went through and the Productivity Commission said it was a really bad idea, it would seem to be not the best result for anybody.[2]

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1 ACCI, *Submission 4*, p. 1; Guerdon Associates, *Submission 1*¸ p. 6; BHP Billiton, *Submission 5*, p. 2; Hay Group, *Submission 6*, p. 1., AICD, *Submission 12*, p. 3.; BCA, *Submission 9*, p. 1; KPMG, *Submission 16*, p. 3, Abacus, *Submission 21*, p. 1.

2 *Proof Committee Hansard*, 25 August 2009, p. 46.

3.7 Regnan, a governance consultancy, argued that issues surrounding executive remuneration should be looked at as a whole:

> Analysis of the proposed reform of termination payments that you are looking at today, we think, would be best viewed as part of an overall package. It is a bit like dealing with the muffler of a car and not considering at the same time, if you are talking about vehicle emissions, how other issues such as the efficiency of the engine, the quality of the fuel et cetera ought to be considered as a package.[3]

3.8 Treasury advised that it was a policy decision of government to proceed with the bill prior to the outcome of the Productivity Commission report. Without commenting on the decision either way, Mr Miller did make use of the 'muffler analogy' to observe:

> …if the car is very noisy at the time it might be best to put the muffler on first and work the rest out later.[4]

Giving shareholders a greater say

3.9 Mr Gary Banks recently summarised some of the varied views received by the PC during its inquiry into executive remuneration on the desirable level of shareholder involvement in setting pay:

> It seems generally accepted that the shareholder body en mass and over time 'owns' the company, in the sense that they have claim over the profit residual. By the same token, shareholders, whether individual or institutional, face 'limited liability' and can sell their interest in the company at any time.
>
> Shareholders are a heterogeneous group. They can hold different and often quite divergent views about company strategy and policy, reflecting their different risk preferences and time horizons. Indeed, it's been put to us that investors often are more focused on the short term than executives and boards, who need to make investment decisions with long-term pay offs.
>
> The modern corporation emerged largely to circumvent problems created by divergent interests of asset owners and their competing claims for profits. Hence, the legal responsibility of executives and boards quite deliberately is to the company (which has a legal life of its own), not

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3 Mr Erik Mather, Managing Director, Regnan Governance Research and Engagement Ltd, *Proof Committee Hansard*, 25 August 2009, p. 29.

4 Mr Geoffrey Miller, General Manager, Corporations and Financial Services Division, Treasury, *Proof Committee Hansard*, 25 August 2009, p. 76.

shareholders explicitly. So how much should company remuneration policy be driven by shareholders?[5]

3.10 The Australian Council of Super Investors supported giving shareholders a greater say. [6] Similarly, Professor Peetz stated:

> The interests of shareholders presently feature well behind the urgings of remuneration consultants in shaping excessive executive pay. Generous termination packages transfer risk from CEOs to shareholders, and shareholders should have a say in containing those risks.[7]

3.11 A contrary view was put forward by the Australian Compliance Institute:

> Whilst shareholders have always, to extent, had some say over benefits for directors, they traditionally do not intrude into operational matters associated with the actual running of the company. Shareholders delegate these aspects to the board of directors. Giving a binding vote on termination payments to non-director executives seems to go beyond this oversight function into operational management matters. It is also questionable whether shareholders would have access or exposure to the necessary information or history of performance to be able to assess the appropriateness of payment of termination payments due.[8]

3.12 Other submissions arguing that boards are responsible for such decisions included Origin Energy, the ABA and IFSA.[9] Guerdon Associates argued in their submission:

> 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.[10]

3.13 At the hearing, Mr Peter McAuley, Director, Guerdon Associates, further explained this point:

> …we think there is a line beyond which shareholders elect the directors to serve them and represent them on the board. Shareholders should clearly have a say in many issues but there are, what we would term, more

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5 Mr Gary Banks, Chairman, PC, 'the Productivity Commission's executive pay inquiry: an update on the issues,' paper presented at FINSIA forum, 4-5 June 2009, pp 10-11, http://www.pc.gov.au/__data/assets/pdf_file/0011/89579/cs20090603.pdf, viewed 26 June 2009.

6 ACSI, *Submission 13*, p. 1.

7 Professor David Peetz, *Submission No. 15*, p. 25.

8 Australian Compliance Institute, *Submission No. 3, Attachment*, p. 2.

9 Origin Energy, *Submission No. 2*, p. 1; ABA, *Submission 24*, p. 1; IFSA, *Submission 25*, pp 1-2.

10 Guerdon Associates, *Submission 1*, p. 5.

operational issues that we think belong with the directors in conducting the duties that they are elected for.[11]

3.14 BHP Billiton argued the bill shifts the balance too far towards shareholder decision making:

> We are also supportive of the general policy behind provisions of this nature – that at a particular level, shareholders should have a say in order to provide reassurance that arrangements struck by a Board are reasonable from the shareholders' perspective.
>
> However, the threshold set out in the bill – 12 months' base salary – represents an extreme adjustment in the other direction. It entails a very substantial shift from Boards' exercise of business judgement to other shareholder decision making.[12]

3.15 The AMWU proposed that decision making should be expanded to include groups other than shareholders:

> There is a general need to question, however, whether this method is sufficient to address the mischief of executive excess. First, when there are wider social concerns about executive corporate remuneration, it is inappropriate to leave control of this excess to shareholders alone. It is unlikely, whilst a company is rewarding its shareholders with higher profits, that shareholders will be overly concerned about corporate social responsibility…Secondly, it is often impractical to give more than advisory power to the body of shareholders in a corporation. If shareholders are given a veto over executive salaries, it is difficult to conceive an effective mechanism to negotiate salaries which are capable of approval by a group of shareholders with diffuse interests.[13]

3.16 The committee heard discussion about whether a shift to shareholders' approval will be successful, given the role of institutional shareholders. The argument here appears to be that decision makers at institutional shareholders, who are themselves likely to be senior executives or board members, are likely to be sympathetic to remuneration claims made by their fellow executives at other companies. This has been likened to a 'club'.

3.17 ACSI noted that there is a high degree of overlap between boards in Australia:

> …there is in fact a smallish number of people who move between boards. ACSI does research each year about the movements of boards and, if I remember correctly…the people who moved onto ASX boards not last year but the year before, 75 per cent were already on another ASX 100 board.[14]

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11 *Proof Committee Hansard*, 25 August 2009, p. 59.

12 BHP Billiton, *Submission 5*, p. 2.

13 AMWU, *Submission 10*, pp 4-5.

14 Ms Ann Byrne, Chief Executive Officer, ACSI, *Proof Committee Hansard*, 25 August 2009, p. 23.

3.18 In spite of this, ACSI argued a strength of the bill was to provide greater transparency on the way in which these decisions are made:

> There is a wonderful quote that we have come across in governance: 'Boards are like subatomic particles. They behave differently when they know that they are being observed.'[15]

3.19 Regnan Governance Research and Engagement Pty Ltd agreed that greater transparency offered by the bill will be advantageous, but noted that shareholders will need to play their part:

> We think that the bill is helpful because it forces companies to engage with their share owners and to give these issues a greater level of transparency than in the past. Remember that the bill takes the threshold from being seven times total remuneration to one times base salary, which is probably more than a sevenfold decrease in terms of the proportionality before companies are forced to engage with their share owners. So we think that that will be an opportunity, because, in the past, there has not been the ability to engage with the share owners. What does the share owner do? In the absence of information they go out and terminate a director because they suspect that something is there. At least now they will have the information. As we said earlier, it is important that share owners play their part in ensuring that those directors who struggle with termination payments perhaps get invited to be terminated themselves.[16]

3.20 Chartered Secretaries Australia argued that a more practical approach to giving shareholders a say on termination benefits would be for shareholders to approve a 'termination policy' containing a 'formula,' rather than approving each individual payment. Shareholders would then only need to approve subsequent payments which fall outside the approved policy or formula.[17]

The 12 month threshold

3.21 Several organisations argued the new 12 month limit was too low.

3.22 The BCA questioned the basis of 12 months, suggesting that the government has provided 'no explanation as to why such a "significant" reduction is required or

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15 Mr Phillip Spathis, Manager, Strategy and Engagement, Australian Council of Superannuation Investors, *Proof Committee Hansard*, 25 August 2009, p. 23.

16 Mr Erik Mather, Managing Director, Regnan Governance Research and Engagement Pty Ltd, *Proof Committee Hansard*, 25 August 2009, p. 37.

17 Chartered Secretaries Australia, *Submission 13*, pp 4-5.

discussion of the market failure which warrants the threshold being set at that level'.[18] BHP Billiton also opposes the 12 month period as too low.[19]

3.23 Alternative time frames were suggested. The AICD called for the threshold to be set at 2 years, or failing that, for the two year threshold to be adopted during the first year of a contract.[20] The Australian Compliance Institute also proposed two years.[21] Guerdon Associates support three times base salary and short term incentives,[22] whilst Origin Energy calls for the period to be equivalent to that used in the US or Europe.[23] Other submissions supported the proposed timeframe of 12 months.[24]

3.24 Professor Peetz argued one year is too generous:

> The legal minimum for termination payments set out in the Fair Work Act 2009 is a useful benchmark. It is unclear why CEOs should receive extraordinarily generous payouts on terms vastly superior to those available to ordinary employees dismissed for similar reasons.[25]

3.25 The National Employment Standard (NES) provisions in the *Fair Work Act 2009* provide that in general, employees will be entitled to 1-4 weeks notice of termination (or payment in lieu) depending on their length of service. This consists of 1 week for those who have served less than one year, rising to 4 weeks for more than 5 years, with an additional week in the case of employees who are more than 45 years old and who have completed 2 years' continuous service. This is based on an employee's full rate of pay, which may be inclusive of loadings, penalties, overtime and allowances.[26] Some awards and industrial agreements provide for greater amounts, including more than one year's base salary.

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18 BCA, *Submission 9*, p. 3.

19 BHP Billiton, *Submission 5*, p. 2.

20 AICD, *Submission 12*, p. 3.

21 Australian Compliance Institute, *Submission 3, Attachment*, p. 1.

22 Guerdon Associates, *Submission 1*, p. 6

23 Origin Energy, *Submission 2*, p. 4.

24 ACSI, *Submission 13*, p. 2.

25 Professor David Peetz, *Submission 15*, pp 25-26.

26 Australian Human Resources Institute/Holding Redlich, fact sheet, 'Notice of Termination and Redundancy Pay', pp 1-2, http://www.fairworkaustralia.ahri.com.au/docs/fwrc_notice_of_termination_and_redundancy_pay_factsheet.pdf, viewed 5 August 2009; Fair Work Ombudsman, Fact Sheet, 'Termination of employment', http://www.fwo.gov.au/Fact-sheets/Documents/FWO-Factsheet-Termination-of-employment.pdf, p. 2., viewed 5 August 2009

Pro-rata limit for service less than 12 months

3.26 For executives who have served less than 12 months with a company, the threshold reduces according to a formula established by items 31 and 37 of Schedule 1 of the bill. This was raised in some submissions as being too low in the initial stages of a contract.

3.27 The Law Council of Australia argued against a pro-rata limit for executives who have served less than 12 months.[27] The AICD suggested that higher payments are justified:

> This risk, and the potential cost, to an incoming CEO is greatest at the start of a contract. It is therefore common practice, in order to entice a CEO to join a company, for there to be a relatively high potential termination payment in the early part of a contract (typically expressed as a notice period), should a company terminate the contract.[28]

3.28 Guerdon Associates also spoke about the potential need for higher payments during the first year of a contract:

> That would be a particular concern, I believe, to an individual. That is the high risk time for them—the short period of time after leaving one employer to arrive in Australia and take on a role which is terminated shortly thereafter. They would be entitled after three months only to a payment of three months…We just feel it is unduly harsh to have a pro-rating in the first year. That is very limiting in terms of what can be achieved, unless of course there is an opportunity to go to shareholders to achieve something higher than that, but that brings obvious uncertainties to the individual at the critical time of recruitment.[29]

3.29 Similarly, in the case of persons who have held a position for three years or more, the bill states that the average salary will be based on 'the average annual base salary that the person received from the company and related bodies corporate during the last 3 years of the relevant period'.[30] Chartered Secretaries Australia argued 'this does not take into account a change in position that may occur for a particular executive, for example, an executive could be promoted to CEO'.[31] Origin Energy and Hay Group shared these concerns about the methodology used for setting 'average annual base salary'.[32]

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27 Law Council, *Submission 23*, p. 7.

28 AICD, *Submission 12*, p. 3.

29 Mr Peter McAuley, Director, Guerdon Associates, *Proof Committee Hansard,* 25 August 2009, p. 59.

30 Schedule 1, Item 31, paragraph 200F(4)(e); Item 37, paragraph 200G(3)(e).

31 Chartered Secretaries Australia, *Submission 18* p. 8.

32 Origin Energy, *Submission 2,* p. 2; Hay Group, *Submission 6*, p. 4.

3.30 Treasury advised that they were aware of these arguments:

> We believe that the pro rata is the fairest, most equitable outcome. We do note that, if executives are seeking a payment above that [either as a sign-on payment or agreement on a termination payment] before they start, there is capacity under the existing rules for them to negotiate that before they start…That would be allowed under the current framework, so you could get a vote on that grounds already. You would have to question, though, whether or not an executive saying that they needed a couple of years payment before they started would be an overly good way to start a new job.[33]

Global competition for talent

3.31 A number of submissions argued that the bill could put Australia at a competitive disadvantage in recruiting talented executives from overseas, or in restraining talented Australian executives from seeking more highly paid positions overseas. These views were noted by Hay Group, Origin Energy, the Australian Compliance Institute, Ernst & Young and IFSA.[34]

3.32 The AICD expressed this view as follows.

> A one year base pay approval threshold for termination payments is materially lower than approval thresholds in comparable jurisdictions overseas. Australian companies will be at a distinct disadvantage in the market for executive services compared to companies domiciled overseas or local subsidiaries of foreign companies…In other words, Australian companies will be put at a competitive disadvantage both overseas and in the domestic market.[35]

3.33 The ABA conceded that the majority of Australian banks currently provide for notice periods of between 6 and 12 months to their executives.[36] Even so, they argued the bill could impose a constraint in recruiting from abroad:

> What the boards are showing is that they have responded to pressure that has come from shareholders groups over—talking to some of their professionals in this area—probably four years and from the community in general. They do not like contracts that have got provisions for large termination payments. The banks have responded to that...But our point is that we do not want a legislative constraint because the banks may want to

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33 Mr Bede Fraser, Manager, Corporations and Financial Services Division, Treasury, *Proof Committee Hansard*, 25 August 2009, p. 79.

34 Hay Group, *Submission 6*, p. 4; Australian Compliance Institute, *Submission 3, Attachment*, p. 1; Origin Energy, *Submission 2*, p. 3; Ernst & Young, *Submission 20*, p. 7; IFSA, *Submission 25*, p. 2.

35 AICD, *Submission 12*, p. 1.

36 Mr Nicholas Hossack, Director, Prudential, Payments and Competition Policy, ABA, *Proof Committee Hansard*, 25 August 2009, p. 47.

> engage an executive who will not agree to a contract without two years or whatever it is. So we do not want that constraint on the banks.[37]

3.34 The ABA proposed that ideally, an international agreement (such as the recent G20 agreement on executive remuneration) should address termination payments. Failing this, they proposed an appropriate international benchmark (i.e. the US threshold of three times base pay plus bonus) should be adopted.[38]

3.35 Guerdon Associates provided data on the source of Australia's executives:

> Given that 17% of ASX 200 executives are recruited from overseas (according to the ACSI 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.[39]

3.36 A variation of these arguments is that it may not be possible to fill positions on subsidiaries of Australian companies abroad. The BCA raised this issue,[40] as did Insurance Australia Group Limited (IAGL):

> For overseas subsidiaries of IAGL there are also issues of the potential conflict between the regulatory requirements of their home jurisdiction and those under the Australian law. We understand that the EU is considering caps on termination payments at two years salary. This difference in the levels of termination payments is likely to have an adverse impact on the recruitment of appropriately qualified individuals in these jurisdictions.[41]

3.37 Mr Alex Christie, Deputy Head of Group, Human Resources, IAGL, expanded on this issue further before the committee:

> …if we have a company in United Kingdom, which we do, and we need a managerial person to sit as a director on that company, the standard in the UK may be two years— the cap for termination payments that has been talked about in the EU—then clearly we would have a different arrangement, which is one year. So we can see the potential for those managers, when we recruit them, raising that as an issue in the context of

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37 Mr Nicholas Hossack, Director, Prudential, Payments and Competition Policy, ABA, *Proof Committee Hansard*, 25 August 2009, p. 52.

38 ABA, *Submission 24*, pp 1-2.

39 Guerdon Associates, *Submission 1*, pp 3-4.

40 BCA, *Submission 9*, p. 5.

41 IAGL, *Submission 14*, p. 5.

> their remuneration. That could lead us to a higher fixed pay component or potentially to a sign-on payment or something else, restructuring them for that perceived disadvantage that they might suffer.[42]

3.38 This appears to suggest that the European Union is contemplating a hard 'cap', rather than allowing higher payments subject to shareholder approval. This would be much tougher than the proposal contained in this bill.

3.39 Ernst & Young argued that there may be a potential conflict between Australian and local laws allowing payments of over 12 months' base salary for overseas based executives. This 'may give rise to a claim against the employer under local employment law'.[43] QBE Insurance has also expressed concern about the application of the proposed law to its employees overseas.[44]

3.40 Other submissions questioned arguments about international competitiveness. Professor Peetz argued that the evidence did not support the view that there was significant leakage of Australian executives to other jurisdictions:

> …an examination of executive appointments and departures at the 50 largest ASX companies over the 2003-2007 period showed that only 4 per cent of confirmed departures 'were as a result of an executive being recruited by an offshore employer'. Indeed, only 17 per cent of departures were due to executives being recruited by another employer in Australia or overseas – most were terminations or retirements. Amongst CEOs, departures were even less common – only 7 per cent of CEO departures were to join another employer, including less than 4 per cent (one CEO) going overseas.[45]

3.41 Professor Peetz also disputed the argument that executive remuneration is influenced by international rates of pay more than that of ordinary workers:

> If the recent growth over the last two decades of executive remuneration was due to the move to this international labour market for executives while labour markets for ordinary workers were still national then you would find quite different rates of pay between countries in local labour markets because that would reflect those local labour market circumstances. It would reflect differences in productivity and technology between Australia, New Zealand, Sweden, the US and so on. So you would have big differences in wages for ordinary workers between countries that have similar wages for CEOs because they are all part of an international labour market… But the data does not actually support that. The data indicates that there are differences in CEO pay between countries. I mentioned Sweden and the US. A Swedish hamburger flipper gets about eight per cent more

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42 *Proof Committee Hansard*, 25 August 2009, p. 5.

43 Ernst & Young, *Submission 20*, p. 7.

44 QBE Insurance, *Submission 26*, p. 1.

45 RiskMetrics data, cited in Professor David Peetz, *Submission 15*, p. 10.

> than an American one. But an American CEO gets 4¾ times more pay than a Swedish CEO. So there is not an international labour market.[46]

3.42 ACSI stated that claims relating to international competition are overstated.[47] RiskMetrics data provided by ACSI indicates that the most common causes of retirement by CEOs were retirement (57.1 per cent) and termination (28.6 per cent).[48]

3.43 Treasury stated it does 'not believe the draft Bill will have the stated impact',[49] referring to the lack of consistent global requirements and ACSI data on reasons for executives leaving a corporation cited above. They also argue:

> The concerns raised by stakeholders would be more valid if a cap or upper limit on termination payments was being introduced. However, the proposed reforms do not introduce a cap, but rather allow payments of higher amounts provided that shareholder approval is obtained.[50]

Increased base salaries or 'golden hellos'

3.44 A number of submissions warned that a likely consequence of reducing termination payments to one year's base salary would be to increase base salaries, or to see increases in other aspects of executive remuneration.

3.45 AICD described this possibility in the following terms:

> …attempts to restrict termination payments are likely to result in a "squeezing the balloon" effect, by which we mean artificial restrictions on one component of executive remuneration will cause upward movement in another components.[51]

3.46 The Law Council of Australia expressed similar views:

> For many executives in large corporations, base salary represents less than half the value of their remuneration package…this proposal will actually limit termination payments to less than 6 months total remuneration, which is likely to be viewed as inadequate compensation for the risks to tenure of executives in these organisations…the likely consequence of the proposal will therefore be to increase base pay levels, both in absolute terms and as a proportion of an executive's total remuneration.[52]

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46 *Proof Committee Hansard*, 25 August 2009, p. 15.

47 ACSI, *Submission 13*, p. 2.

48 ACSI, *Submission 13, Attachment 1*, p. 6.

49 Treasury, *Submission 22*, p. 9.

50 Treasury, *Submission 22*, p. 9.

51 AICD, *Submission 12, Attachment,* p. 9.

52 Law Council of Australia, *Submission 23*, p. 2.

3.47 The Law Council warned that could lead to increased use of 'golden hellos' when executives commence a new position. The Law Council warned that this reduction in the proportion of an executive's remuneration linked to performance was a 'systematic distortion of remuneration structures in a manner which is disproportionate to the issue being addressed'.[53]

3.48 Two reasons were provided to the committee on why the increase in the size of base pay as a proportion of the total was undesirable. The first reason was that it would reduce the percentage of pay that is linked to good performance – in other words, it reduces the incentive to perform. Chartered Secretaries Australia noted this possibility:

> One thing that springs to mind is that the sort of behaviour it could lead to is that the fixed component of remuneration packages relative to the at-risk component could go up so that we might actually perversely end up encouraging less pay for performance and a bigger base…If I were an incoming executive wanting to look after myself the best, I would be trying to negotiate a higher fixed salary component rather than a variable component. It would be human nature that you would expect that.[54]

3.49 The other reason was the likely increased cost to business, given that base salary components are guaranteed whilst performance based aspects of salary only arise if the conditions are met:

> I think the issue we would see, for instance, is if the additional remuneration is in base salary, it is a certain additional cost to the company. A contingent remuneration based on the way of termination, whether it is redundancy or a merger or acquisition—whatever reason leads to that termination— is a cost that may or may not arise. From a company's point of view you would much prefer to have the possibility of not having to pay anything than clearly having a frontloaded or higher base. I guess it is a cost issue for the company from that point of view.[55]

3.50 Other submitters to warn about possible increases in base pay included Guerdon Associates, BCA, Ernst & Young, Origin Energy, ACCI, the ABA, the Insurance Australia Group and IFSA.[56]

3.51 The AMWU warned that treating termination payments in isolation could lead to manipulation of other aspects of remuneration:

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53 Law Council of Australia, *Submission 23*, p. 2.

54 Mr Peter Abraham, Chartered Secretaries, *Proof Committee Hansard,* 25 August 2009, p. 71.

55 Mr Alex Christie, Deputy Head of Group, Human Resources, Insurance Australia Group, *Proof Committee Hansard*, 25 August 2009, p. 9.

56 Guerdon Associates, *Submission 1*, p. 5; BCA, *Submission 9*, p. 3; Ernst & Young, *Submission 20*, p. 7; Origin Energy, *Submission 2*, p. 4; ACCI, *Submission 4, Attachment*, p. 5; ABA, *Submission 24*, p. 2; Insurance Australia Group, *Submission 14*, p. 5; IFSA, *Submission 25*, p. 1.

…there is a natural tendency of the self-interested to manipulate the form of remuneration for their own benefit. This realisation must be reflected in wider regulation of those same corporate players across the entire scope of their remuneration, or any attempted control of retirement remuneration will be ultimately meaningless.[57]

3.52 Professor Peetz stressed the importance of culture in setting overall remuneration, and argued that it did not necessarily follow that narrowing termination payments would lead to increases in other areas of pay:

It is not as though there is a fixed amount of money that goes to executive pay and it is just a matter of divvying it up; the amount of money that goes to executive pay is shaped by the relative power of the occupation and the culture that is involved in determining executive pay. If you create a culture that says excess is fine then all of the elements of executive pay will go up. Termination payments, base pay and bonuses will all go up. It is not as though you squeeze one and the other goes up. It is not a fixed balloon, the size of the balloon varies.[58]

3.53 The ACSI were less concerned about the likelihood of base salaries increasing due to existing rules allowing shareholder votes on the overall remuneration package.[59]

3.54 Treasury argued that current rules on setting executive base salaries would act as sufficient restraint on increasing salaries as a result of this bill:

…there is greater transparency and accountability with respect to the payment of base salary during the tenure of the director or executive. Such payments are required to be disclosed in the company's remuneration report, and the company is required to clearly explain the policy for determining the nature and amount of remuneration, and a discussion of the relationship between such policy and the company's performance. These requirements operate to provide a measure of accountability and transparency, particularly if a company seeks an unjustified increase in base salary. Shareholders also have the opportunity to cast a non-binding vote on the company's remuneration policies and anecdotal evidence suggests that companies are increasingly responsive to the non-binding vote.[60]

3.55 Or to use the analogy of 'squeezing the balloon':

I would expect that, generally, the balloon will shrink somewhat and that it is unlikely you will see exactly the same amount bulge out the other side if it changes. But even if it does…it is a bulge that will show up, for example,

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57 AMWU, *Submission 10*, p. 7.

58 *Proof Committee Hansard*, 25 August 2009, p. 14.

59 Ms Ann Byrne, Chief Executive Officer, Australian Council of Super Investors, *Proof Committee Hansard*, 25 August 2009, p. 26.

60 Treasury, *Submission 22*, p. 10.

> in the remuneration report, so it will be part of your normal salary and will be shown in the remuneration report and there is a non-binding vote sitting over the top of that remuneration report….at least it pops out somewhere where there are other rules.[61]

3.56 The Explanatory Memorandum indicates a post-implementation review of the amendments will be undertaken within 'one to two years of the commencement of the new requirements'.[62] The committee sees this review as an opportunity to examine any impacts that might occur on base pay.

A new 'floor'

3.57 A concern was raised in some submissions that lowering the threshold could lead to an increase in payments up to the new level, in effect transforming it into a 'floor.' Guerdon Associates raised this risk in their submission:

> 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.[63]

3.58 Professor Peetz referred to this risk as an argument in favour of a lower threshold for seeking shareholder approval:

> A danger, perhaps not large, is that the new ceiling on termination payments, of one year's salary before shareholders' approval must be sought, may also become a floor. Consideration should be given to a lower limit.[64]

3.59 In response to these concerns, it is worth noting that no evidence has been provided to suggest that payments are routinely being made up to the existing (admittedly very generous) 'floor'.

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61 Mr Geoffrey Miller, General Manager, Corporations and Financial Services Division, Treasury, *Proof Committee Hansard*, 25 August 2009, p. 77.

62 Explanatory Memorandum, p. 3.

63 Guerdon Associates, *Submission 1*, p. 3 (footnote).

64 Professor David Peetz, *Submission 15*, pp 25-26.

What is included in 'termination benefit'?

3.60 The definition of 'benefit' is to be determined by regulations (Item 7, Schedule 1 of the bill). Several organisations have put forward views about what should, and should not, be included in the list of benefits subject to shareholder approval.

3.61 Ernst & Young called for a distinction between payments for past service (e.g. equity awards that have already vested, mandated holding of bonuses, incentives, accrued leave) and ex-gratia payments made in respect of termination. Payments for past service should not be subject to shareholder approval.[65]

3.62 Chartered Secretaries Australia suggested currently the bill is not sufficiently clear that accrued statutory benefits are not subject to shareholder approval:

> In fact, we are saying that the people we are most concerned about under this draft legislation are the mail boys made good, who have worked their way up through the organisation, been there 30 years, got up to a very senior position and have been made redundant. We want to make sure that this does not work a mischief to actually put them in a worse position. Ironically, it can put someone in a position where they can decline a promotion because their accrued entitlements, unless this is made right, may actually be in jeopardy. That is the biggest mischief. We are putting our hands up to say, 'We don't want to take issue with this bill in general, but please make sure you get that right.'[66]

3.63 The ABA, BCA, Hay Group, Regnan, and Rio Tinto also sought the exclusion of statutory entitlements.[67]

3.64 BHP Billiton noted that its current remuneration includes long term incentives in plans which are already approved by shareholders. It argued that these benefits should not require additional approval by shareholders.[68]

3.65 Several submissions referred to superannuation, including voluntary contributions to superannuation. For example, Regnan, RiskMetrics and ACSI and IFSA argued that voluntary super contributions should not be subject to shareholder

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65 Ernst & Young, *Submission 20*, p. 6.

66 Mr Peter Abraham, LRC Committee, Chartered Secretaries Australia, *Proof Committee Hansard*, 25 August 2009, p. 67.

67 ABA, *Submission 24*, p. 3.; BCA, *Submission 9*, p. 6.; Hay Group, *Submission 6*, p. 4.; Regnan, *Submission 7*, p. 5.; Rio Tinto, *Submission 17*, p. 3.

68 BHP Billiton, *Submission 5*, p. 3.

approval.[69] Bluescope Steel, Guerdon Associates and KPMG also sought clarification of the treatment of superannuation.[70]

3.66 Regnan argued that the inclusion of superannuation benefits could lead to clashes in obligations for superannuation trustees:

> In particular we note that under the Bill, superannuation trustees will be subject to criminal penalties if a benefit is paid to a member where that benefit (taken together with other benefits covered by the proposed provisions) exceeds the new limits…Where the trustee is aware of the restrictions in relation to the particular member, and withholds payment, this will result in a breach of other superannuation law.[71]

3.67 KPMG, the ABA and IFSA sought clarification in relation to the inclusion of 'deferred bonus'.[72]

3.68 RiskMetrics urged that regulations on the definition of 'benefit' should clarify whether deferred benefits are to be excluded from consideration, but in so doing, care should be taken to ensure companies do not seek to avoid shareholder approval requirements by 'categorising amounts paid on cessation of employment as bonuses for services prior to departure'.[73]

3.69 ACSI also saw 'merit in "carving out" unvested performance pay and deferred bonus incentives from termination pay calculations', but urged caution to ensure that this did not become a 'loophole'.[74]

3.70 Treasury provided evidence that statutory benefits will be excluded by the legislation:

> The legislation itself does exclude the statutory entitlements. However, there is still clearly confusion as to whether they do or do not, and so we have made recommendations that those specific statutory entitlements go into the regulations just for clarity, I suppose.[75]

3.71 The committee welcomes this reassurance by Treasury.

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69 Regnan, *Submission 7*, p. 5; RiskMetrics, *Submission 11*, p. 2; ACSI, *Submission 13,* p. 2; IFSA, *Submission 25*, p. 3.

70 Bluescope Steel, *Submission 8*, p. 1; Guerdon Associates, *Submission 1*, pp 4-5.; KPMG, *Submission 16*, p. 2.

71 Mercer, *Submission 27*, p. 1.

72 KPMG, *Submission 16*, p. 2; ABA, *Submission 24*, p. 3; IFSA, *Submission 25*, p. 3.

73 RiskMetrics, *Submission 11*, p. 3.

74 ACSI, *Submission 13*, p. 2.

75 Mr Geoffrey Miller, General Manager, Corporations and Financial Services Division, Treasury, *Proof Committee Hansard*, 25 August 2009, p. 74.

Contract Disputes

3.72 Some submissions pointed to the risk that the bill could lead to increased numbers of contract disputes on key terms, and heightened risk of litigation as a result.

3.73 The Law Council of Australia noted that the proposed definition of 'benefit' (in regulations) includes 'voluntary out of court settlements' as a matter requiring shareholder approval. They argued:

> This provision will have the effect of forcing employees with legitimate claims against employers, for breach of contract, unfair dismissal, harassment, discrimination and other breaches of the law, to litigate at material expense in order to win damages award from a court, rather than accept a "voluntary settlement" from the employer. This is clearly an inappropriate consequence of these reforms.[76]

3.74 Treasury indicates that the explanatory statement to the Regulations will provide guidance on what is meant by voluntary out of court settlements.[77]

3.75 It should be noted that the Law Council do not question the scope of the regulation-making power relating to the definition of benefits, only the detail of what that regulation says.

3.76 The Business Council provided the following evidence in relation to the current role played by termination benefits in avoiding contract disputes or litigation:

> Employment agreements for CEOs and other senior executives typically provide for termination payments with very little notice. And, when a board decides a CEO is not delivering acceptable results, it is in everyone's interests to encourage the CEO, through mutual agreement, to leave sooner rather than later. Protracted 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.[78]

3.77 A recent media report by Ian McIlwraith in *The Age* described this phenomenon more bluntly:

> Another element of the system, one companies do not want to talk about, is that some termination payouts are the equivalent of "hush money" for failed executives. So a parting pay-off is negotiated on the understanding there will be no unfair dismissal claims.[79]

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76 Law Council of Australia, *Submission 23*, p. 7.

77 Treasury, note on revised draft regulations, July 2009, p. 2.

78 BCA, *Submission 9*, p. 2.

79 Ian McIlwraith, 'Capping Salaries: a fraught business,' *Age*, 19 March 2009.

3.78 The AICD has described some of the issues surrounding dismissing an executive for non-performance:

> It is not uncommon for a board to believe a CEO is performing poorly while the CEO believes he or she is performing well…The CEO's position in a company is atypical of other executive positions. The company's board needs to have full confidence in the CEO. If the board loses confidence in the CEO it may need to terminate the CEO's contract even if the company is otherwise performing well. If so, the board needs to consider terminating the contract in a manner that takes into account the best interests of all shareholders.
>
> It can be difficult to proceed under a non-performance clause in a contract because of the many views that exist on what constitutes poor performance and how it is measured. This is often a subjective issue. For this reason, boards may prefer to have a clause in the contract entitling the company to terminate the contract on notice without the need to provide specific reasons.[80]

3.79 ACSI argued that these matters could be addressed in the company's remuneration policy:

> Currently companies are required to have their remuneration policy approved by their shareholders…it is non-binding approval. But it is still persuasive. Those who get close to a no vote or get greater than 50 per cent in our experience do then look at that. So if they have an appropriate remuneration policy then some of those issues should be covered off in that. I cannot see what circumstances necessarily would say that they have to give someone a golden handshake to get them to go quickly. Most people are on contracts of three or five years. If they wanted to come to shareholders and say, 'Well, we sign up for five-year contracts. We would think it reasonable that if someone is in year 3 and we want to get rid of them then we pay them out the rest of their contract,' the shareholders will consider that to see in effect if that is reasonable. Most of these people are on contracts so the golden handshake cannot go on forever; it has to be confined to what that particular contract is.[81]

'Total remuneration' versus 'base salary'

3.80 A number of submissions discussed whether it was better for the threshold for shareholder approval to be based on 'base salary' or 'total remuneration'.

3.81 Treasury argued that the change is justified due to the growing percentage of total remuneration represented by components such as performance pay. Treasury

80 AICD, Position Paper No. 13, 'Executive Termination Payments,' October 2008, p. 4.

81 Ms Ann Byrne, Chief Executive Officer, ACSI, *Proof Committee Hansard*, 25 August 2009, p. 24.

referred to anecdotal evidence that base salary often represents 'one third to one half of total remuneration'.[82] Treasury argued:

> The inclusion of performance pay has the potential to significantly increase the threshold for shareholder approval, potentially by millions of dollars, which would undermine the purpose of the proposed reforms.[83]

3.82 This is in itself not a conclusive argument. If the concern is that 'total remuneration' might be too high, it could be possible to set the threshold as, for example, six months' total remuneration.

3.83 Treasury also argued that the use of base salary rather than total remuneration is 'consistent with best practice guidelines developed by industry, referring to ACSI 2005 guidelines.[84] In its submission, ACSI supports the change to 'base salary'.[85]

3.84 A number of submissions expressed a preference for 'total remuneration'. For example, the Law Council argued that 'total remuneration' was appropriate, due to the risk that the bill could lead to a possible decline in the proportion of remuneration based on long-term incentives.[86]

3.85 Other organisations preferring the retention of 'total remuneration' include the AICD, the ABA, Guerdon Associates and IFSA.[87]

3.86 Ernst & Young argued that the threshold:

> …should be based on a multiple of *fixed remuneration* (which includes base salary, fringe benefits, salary sacrifice benefits and superannuation) as most Australian companies remunerate executives using such an approach.[88]

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82 Treasury, *Submission 22*, p. 10.

83 Treasury, *Submission 22*, p. 10.

84 Treasury, *Submission 22*, p. 10.

85 ACSI, *Submission 13*, p. 1.

86 Law Council of Australia, *Submission 23*, p. 2.

87 AICD, *Submission 12*, p. 3; ABA, *Submission 24*, p. 2; Guerdon Associates, *Submission 4*, p. 4; IFSA, *Submission 25*, p. 2.

88 Ernst & Young, *Submission 20*, p. 4.

Key management personnel

3.87 The bill expands the number of positions which require shareholder approval for termination benefits. This attracted comment in submissions.

3.88 Chartered Secretaries Australia argued that that any expanded requirement should apply only to key management personnel and the five most highly remunerated executives in the previous accounting year.[89] Ernst & Young, whilst supportive of the expansion, recommended against reference to the 'five highest paid executives' as this group may vary from year to year.[90]

3.89 The Law Council of Australia expressed concern about the coverage of all persons mentioned in the remuneration report for listed companies on equity grounds:

> For executives of listed companies, the entitlement to termination benefits depends on whether they are listed in the remuneration report. This is an arbitrary measure, for several reasons. Inclusion may change from year to year depending on total remuneration relative to other executives in the company. Executives will not know from one year to the next whether their termination benefits are limited under the proposed new laws. Perversely, the inclusion of termination benefits in total remuneration will often cause a person to be named in the remuneration report for the first and only time in the year the person retires. Further, a person earning $100,000 in a small listed company may have their termination benefits restricted, but a person earning $2 million in a large listed company may not. This is an odd result, and does not appear to have any sound policy basis.[91]

3.90 The Law Council of Australia argued that it would be 'logical and less anomalous' for the rules to apply only to executives whose annual remuneration exceeds a nominated amount, and to treat listed companies, including subsidiaries, as a single entity.[92]

3.91 ACSI supported the scope of the regulations expanding to include 'key management personnel'.[93]

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89 Chartered Secretaries Australia, *Submission18*, p. 4.

90 Ernst & Young, *Submission 20*, p. 8.

91 Law Council of Australia, *Submission 23*, p. 4.

92 Law Council of Australia, *Submission 23*, p. 5.

93 ACSI, *Submission 13*, p. 1.

Subsidiaries and unlisted companies

3.92 A number of organisations argued that the change would have a significant impact on companies with multiple boards of subsidiary corporations. Chartered Secretaries Australia explained the problem of subsidiary boards in the following terms:

> Large listed companies can have hundreds of non-listed subsidiaries in Australia. For example, BHP Billiton has over 200 (most of which are in Australia; ANZ has almost 100…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 termination payments are not at a level that would concern shareholders in the parent company or the community…if the definition of 'termination benefit' in the Regulations is extended to catch all types of payments, including accrued annual and long service leave and salary into superannuation, as was proposed in the exposure draft of the Bill, the calculation of termination payments to executives in subsidiaries could result in a payment larger that one year's fixed salary, as it would capture general managers retiring or resigning, or subject to retrenchment. CSA cannot point to any public benefit or benefit to shareholders in imposing a new and onerous requirement on companies that would require shareholder approval of termination payments of general management in the parent and subsidiary companies.[94]

3.93 Origin Energy, the BCA, Hay Group, KPMG the Law Council, the ABA, Rio Tinto and the Insurance Australia Group also raised concern about the impact on members of boards of subsidiaries.[95]

3.94 Rio Tinto gave an example of how their operations might be affected:

> In Rio Tinto's case, approximately 300 subsidiaries form the Rio Tinto Ltd group of companies and about 150 Rio Tinto employees would be classified as either a director or an officer. Importantly, a number of these employees hold positions within Rio Tinto below what would be viewed as senior management level. Given the new one-times base salary limit, this will mean that Rio Tinto will need to go to the trouble and expense of general meetings and accompanying notice papers to seek shareholder approval for payments to a large number of middle managers as they retire or leave.[96]

3.95 The Australian Bankers' Association also provided evidence on this issue:

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94 Chartered Secretaries Australia, *Submission18*, p. 4.

95 Origin Energy, *Submission 2*, p. 3; BCA, *Submission 9*, p. 5; Hay Group, *Submission 6*, p. 5; KPMG, *Submission* 16, p. 2; Law Council of Australia, *Submission* 23¸ pp 4-5; ABA, *Submission 24*, p. 2; Rio Tinto, *Submission 17*, p. 2; Insurance Australia Group, *Submission 14*, p. 4.

96 Mr Stephen Consedine, Company Secretary, Rio Tinto Limited, *Proof Committee Hansard*, 25 August 2009, pp 2-3.

> That has certainly been a concern of those HR professionals and compliance experts in the bank, but when they have looked at the legislation one bank with, I think, 200 subsidiaries and all are scratching their heads wondering whether this is going to apply. The reading of the legislation is that it is going to apply to all of those boards. That is just a compliance nightmare. I know a lot of the people serving on those subsidiary boards who are involved in issues with them and they are not the very senior people in the organisations. They are middle management.[97]

3.96 The AICD opposed the application of the measure to unlisted companies:

> …we would argue that the proposed reduction in the shareholder approval threshold for termination payments applying to companies regulated by the Corporations Act, which includes not-for-profits, charities, school boards, community boards et cetera, is too stringent. There is no evidence of any problem or community concern with the unlisted companies that would necessitate such changes.[98]

3.97 In response to concerns about the implications for subsidiaries, RiskMetrics proposed that any uncertainty 'could be resolved by specifying that in a listed entity, those holding managerial and executive office are *only* those persons whose remuneration details must be disclosed in the remuneration report'.[99]

3.98 Treasury clarified that the bill only will apply to middle managers if they are also the directors of companies. Treasury also clarified that the Act already applies to such persons. Treasury explained the prominence of this issue in submissions as follows:

> I am assuming that their termination payments before fell within the seven times and now their termination payments may be in excess of what this legislation is requiring. But we are not dragging in a whole group of people who were not there before.[100]

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97 Mr Nicholas Hossack, Director, Prudential, Payments and Competition Policy, Australian Bankers' Association, *Proof Committee Hansard*, 25 August 2009, p. 52.

98 Mr John Colvin, Chief Executive Officer, Australian Institute of Company Directors, *Proof Committee Hansard*, 25 August 2009, p. 37.

99 RiskMetrics, *Submission 11*, p. 1.

100 Mr Geoffrey Miller, General Manager, Corporations and Financial Services Division, Treasury, *Proof Committee Hansard*, 25 August 2009, p. 77.

Compliance cost

3.99 The Explanatory Memorandum states that the compliance cost for companies associated with the bill will be 'nil.'[101] This has been disputed by some of the submissions.[102]

3.100 Guerdon Associates noted that the expanded number of persons who might be subject to the requirement for approval could impose added administrative costs:

> It could require companies to include quite a significant number of individuals, potentially, with all that that involves including the requirement to have lengthy details in shareholder notices and meeting notices. The more that is involved, obviously, the greater the administrative costs incurred. It seems to us to serve little purpose when you consider the level of payment that might be involved in absolute dollar terms.[103]

3.101 No Regulation Impact Statement (RIS) is provided. The Explanatory Memorandum states that the Office of Best Practice Regulation advised a RIS is not required 'due to the Government's prior announcement to progress reforms in this area'.[104] The BCA and Rio Tinto expressed dissatisfaction about the decision not to complete a Regulation Impact Statement.[105]

Cause of Termination

3.102 The bill does not specify different treatment for retirements which occur for different reasons. Some submissions saw this as a flaw in the bill.

3.103 The Australian Compliance Institute argued that the circumstances of termination should be taken into account:

> …in circumstances where an employee's employment is terminated as a result of undertaking an activity that is deemed to be either a significant breach of the organisation's compliance or governance plan and/or also in breach of the law, then that employee should forfeit any claim to a termination payment.[106]

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101 Explanatory Memorandum, p. 3.

102 BCA, *Submission 9*, p. 5.; Rio Tinto, *Submission 17*, p. 2; Chartered Secretaries Australia, *Submission 18*, p. 8; ABA, *Submission 24*, p. 2.

103 Mr Peter McAuley, Director, Guerdon Associates, *Proof Committee Hansard*, 25 August 2009, p. 59.

104 Explanatory Memorandum, p. 3.

105 BCA, *Submission 9*, p. 7; Rio Tinto, *Submission 17*, p. 4.

106 Australian Compliance Institute, *Submission 3*, p. 1.

3.104 A number of submission argued that termination payments in cases of *bona fide* redundancy are appropriate, particularly if the redundancy early in an executive's tenure. Rio Tinto also referred to the need to protect cases of *bona fide* redundancy.[107]

3.105 Chartered Secretaries Australia argued that the focus of the bill should be on 'ex gratia payments that might be made to very senior people after a period of poor performance'.[108] They argue that bone fide redundancies should be excluded.[109]

3.106 In 2005, Geof Stapledon noted one of the arguments often provided in favour of termination payments is compensation in cases of *bona fide* redundancy:

> …if there is a possibility of a company merging or being taken over, termination payments ensure a measure of objectivity on the part of executives during negotiations. Executives may otherwise not act in the best interests of shareholders because they are more concerned about losing their jobs following the change in management that will occur if their company is taken over by another.[110]

3.107 However, Stapledon also acknowledges the counter argument:

> …termination payments can, in fact have the opposite effect. They may cause a passive attitude by executives who know that regardless of the actions they take, they will be compensated.[111]

3.108 The ACSI were supportive of exclusion of redundancy payments, provides such payments were genuine redundancies:

> …we can understand why in relation to the termination benefits you exclude the statutory benefits, why you determine that the superannuation is not a benefit if it is a bona fide contribution and why you exclude redundancy payments—as long as it is a genuine bona fide redundancy. Consistent with industrial law…we are talking about where a position is genuinely surplus to requirements…We need to make sure that we do not have a loophole…[112]

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107 Chartered Secretaries Australia, *Submission 18*, p. 7; Rio Tinto, *Submission 17*, p. 2.

108 Ms Judith Fox, Director, Policy, Chartered Secretaries Australia, *Proof Committee Hansard*, 25 August 2009, p. 70.

109 Mr Tim Sheehy, Chief Executive, Chartered Secretaries Australia, *Proof Committee Hansard*, 25 August 2009, p. 66.

110 Geof Stapledon, 'Termination benefits for Executives of Australian Companies', *Sydney Law Review*, Vol 27, 2005. http://www.law.usyd.edu.au/slr/slr27_4/Stapledon.pdf, viewed 17 July 2009, p. 712.

111 Geof Stapledon, 'Termination benefits for Executives of Australian Companies', *Sydney Law Review*, Vol 27, 2005. http://www.law.usyd.edu.au/slr/slr27_4/Stapledon.pdf, viewed 17 July 2009, p. 712.

112 Mr Phillip Spathis, Manager, Strategy and Engagement, Australian Council of Super Investors, *Proof Committee Hansard*, p. 25.

3.109 Treasury argues that the amount provided for by the bill represents a 'reasonable amount' for redundancies.[113] They have also indicated that legitimate redundancy payments are still a matter being considered by the government.[114]

Technical Matters

Delegation of critical terms to the regulations

3.110 Several organisations expressed concern that definitions of critical terms (such as 'base salary' and 'termination benefit') in regulations were not available at the time of preparing their submissions. These include the BCA, Chartered Secretaries Australia, Bluescope Steel; Origin Energy and Rio Tinto.[115]

3.111 These submissions argued the bill and regulations need to be considered by the committee as a package. It is not clear if these organisations object to the scope of the regulation-making provisions in the bill, or simply to the unavailability of the draft regulations.

3.112 Treasury released an exposure draft of the regulations in May 2009, and developed redrafts of the regulations for targeted consultation with stakeholders. It is understood that this targeted consultation includes all organisations who made submissions on the exposure draft and others who request participation.

3.113 Treasury argue that it is necessary to specify the definition of 'base salary' in the regulations to provide 'flexibility for the law to respond to, and to quickly address, any attempts to manipulate the definition'.[116] The AMWU support this as 'an attempt to remain flexible and fleet of foot in response to rapidly rearranged executive pay packages which will circumvent the strictures of this Bill'.[117]

3.114 Treasury argues that the power to make regulations prescribing things to be, or not to be, a benefit is required in order to address 'some legal ambiguity as to whether certain types of payments are considered to be a termination payment requiring shareholder approval'.[118]

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113 Treasury, *Submission 22*, p. 3.

114 Mr Bede Fraser, Manager, Corporations and Financial Services Division, Treasury, *Proof Committee Hansard*, 25 August 2009, p. 76.

115 BCA, *Submission 9*, p. 3; Chartered Secretaries Australia, *Submission 18*, p. 2; Bluescope Steel, *Submission 8*, p. 1; Origin Energy, *Submission 2*, p. 2; Rio Tinto, *Submission 17*, p. 4.

116 Treasury, *Submission 22*, p. 11

117 AMWU, *Submission 10*, p. 7.

118 Treasury, *Submission 22*, p. 5.

3.115 The committee notes that these suggestions for improvement of the draft regulations do not argue that it is inappropriate for such matters to be delegated to regulation. The committee urges Treasury to continue working with stakeholders to resolve any remaining concerns, where possible.

Lack of clarity of transitional clauses

3.116 The government has stated that bill 'will not affect existing contracts, and will apply all new contracts which are entered into, extended or substantially varied after the commencement date'.[119] In its submission, Treasury states that 'where an essential term of the service contract has been varied (including terms relating to remuneration), the contract will be subject to the proposed new laws.[120]

3.117 Several organisations expressed a view that the transitional clauses were not clear in regard to what constitutes a 'substantial variation.' These include the ABA, BCA, Chartered Secretaries Australia, Bluescope Steel, Guerdon Associates, Ernst & Young, Rio Tinto and IFSA.[121] Clayton Utz and Mallesons Stephen Jacques have both referred to this issue in online advisories.[122]

Penalties

3.118 The bill increases penalties under subsections 200B(1), 200C(1) and 200D(1) from 25 to 180 penalty units (currently $2,750 to $1,980) for a natural person and from 150 to 900 penalty units (currently $16,500 to $99,000) for a body corporate. These provisions remain strict liability offences.

3.119 The Explanatory Memorandum argues that the increase 'is intended to reflect the seriousness of giving a termination benefit where it has not been approved by shareholders in accordance with the Act, and to provide a sufficient deterrent to unauthorised benefits'.[123]

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119 Hon Chris Bowen MP, Minister for Financial Services, Superannuation and Corporate Law, *Proof House of Representatives Hansard*, 24 June 2009, p. 21.

120 Treasury, *Submission 22*, p. 9.

121 ABA, *Submission 24*, p. 4; BCA, *Submission 9*, p. 7; Chartered Secretaries Australia, *Submission 18*, p. 8; Bluescope Steel, *Submission 8*, p. 2; Guerdon Associates, *Submission 1*, p. 5; Ernst & Young, *Submission 20*, p. 8; Rio Tinto, *Submission 17*, p. 4; IFSA, *Submission 25*, p. 4.

122 Clatyton Utz website, http://www.claytonutz.com/publications/news/200906/24/termination_payments_good_news_bad_news.page, viewed 9 July 2009; Mallesons Stephen Jaques website, http://www.mallesons.com/publications/2009/Jun/9966946W.htm, viewed 7 July 2009.

123 Explanatory Memorandum, paragraph 2.45, p. 15.

3.120 The AICD opposes a breach of the termination provisions being a strict liability offence (as currently provided under the Act). They also oppose the proposed increase in penalties.[124]

3.121 The AMWU 'appreciate that penalties have significantly increased, but are concerned that manipulation by the recipients of termination payments may not be adequately controlled by these penalties'.[125] The AMWU argue that the bill would be strengthened by inclusion of 'sanctions against avoiding or conspiring to avoid the shareholder approval required by this Bill'.[126]

Amount in excess of 12 months not specified

3.122 RiskMetrics has suggested that the bill as currently drafted would allow the board to seek approval for payments in excess of the 12 month base salary limit without specifying the extent to which the payments would be in excess of 12 months base salary'. They argue that the bill should be amended 'to require any advance approval of a termination payment to specify a maximum dollar cap that may be paid under the authority sought from shareholders'.[127] This concern was also raised by the ACSI.[128]

3.123 If accurate, this would represent a significant loophole in the bill.

Recommendation 1

3.124 The committee recommends that Treasury examine the bill to ensure that shareholders have the opportunity to approve a specific amount, and not an unnamed amount greater than 12 months' salary.

Removal of exemption for pre-1991 contracts

3.125 The drafting of amendments to 200F(1)(a) appears somewhat complex.

3.126 Item 25 (Schedule 1, Part 1) inserts words into the paragraph. Item 42 repeals the paragraph, and replaces it with new words. It is not clear from the Explanatory Memorandum why it is necessary to amend the paragraph twice in this way.

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124 AICD, *Submission 12*, p. 2.

125 AMWU, *Submission 10*, p. 7.

126 AMWU, *Submission 10*, p. 7.

127 RiskMetrics, *Submission 11*, p. 2.

128 Mr Phillip Spathis, Manager, Strategy and Engagement, Australian Council of Superannuation Investors, *Proof Committee Hansard*, 25 August 2009, p. 25.

3.127 Item 43(3) provides that the amendments made by item 42 do not apply for contracts entered into before 1991. As item 42 removes the exception which currently applies to contracts made before 1991, item 43(3) appears to negate the effect of item 42. The EM does not explain why this approach has been adopted.

3.128 These provisions were not raised in submissions. Accordingly, the committee makes no further comment

Recommendation 2

3.129 The committee recommends that the Senate pass the bill.

Senator Annette Hurley

Chair

Coalition Senators' Additional Comments

> "Community sentiment about inequality or fairness cannot be ignored by governments, but neither should the national income consequences of any interventions. Government interventions to promote fairness can sometimes have perverse effects, including for those very groups whose interests are uppermost in governments' minds. Therefore, the full costs and benefits of any mooted intervention — both direct and, importantly, indirect — need to be carefully considered in advance."[1]

Introduction

Coalition senators broadly support the objective of the government's terminations payments amendment to the corporations law. However we are concerned about legislative overreach and that the parliament's intervention in the corporate sphere will introduce distortion – to the alignment with shareholder interests, and to executive recruitment, remuneration and retention, among other considerations.

In giving our support, we acknowledge the argument of witnesses to the inquiry (ACSI, Prof Peetz) that there is merit in the parliament sending a "signal" to corporations that they are answerable to shareholders. Termination payments made to departing executives are appropriations of shareholder wealth.

But we are aware that:

- this legislation is a kneejerk reaction to appease public opposition to *ex gratia* payments made to executives to remove them from office;
- the government is acting after the event insofar as companies are already reviewing their policies in this area , in response to community outrage, consultation with shareholder groups and governance consultants;
- there is a downward trend in executive payouts in the last 5 years (Hay Group) or reduction this year (Prof Peetz) in any case;
- there are reported instances of perceived excessive termination payments, but we recognise these decisions are matters for boards, and are generally taken for sound reasons; and
- the legislation pre-empts the report by the Productivity Commission into executive remuneration and is typical of the rushed approach of the Rudd government.

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1 Gary Banks, Chairman, Productivity Commission, update on the executive pay inquiry to FINSIA, June 2009

Strong corporate governance in Australia

Coalition senators have confidence in Australia's corporate framework and the capacity of boards to respond to community concerns. We are rightly cautious about this wholesale interference in the decisions of boards. We noted with satisfaction the ACSI study finding that most companies have policies in place which would deliver termination payments around the bill's proposed base pay threshold to executives departing now.

There is good evidence that the vast majority of large listed companies – the same group with the high profile headline offenders – are self-regulating on this issue, whether that be in response to cyclical changes, cash constraints, or other drivers such as community or shareholder outrage.

Coalition senators recognise the particular importance of oversight of executive remuneration packages in the banking and insurance sectors because of the potential for executives to chase the rewards of short-term risks at the cost of financial stability.

Adverse effects/unintended consequences

Having expressed our broad support for the signal effect of the bill, coalition senators are concerned that the government's bill may have unhelpful consequences for our corporate sector and protest that the legislation has been introduced before the Productivity Commission report into executive remuneration has been released. Coalition senators regard this as a further example of the unseemly haste the Rudd government has demonstrated on a number of issues, including the youth allowance backdown.

Coalition senators share the view of many that presented or submitted evidence to the inquiry that the bill has elements of regulatory overreach. We observe that in its rush to legislate in the area of executive termination payments, the government has foregone a Regulatory Impact Statement on this bill at its own peril.

The overreach features of the bill include:

- The scope of the provisions is broadened to include unlisted companies
- The lower threshold of provisions will capture middle managers serving as directors
- The definition of termination payment is broadened and there is concern it will catch genuine retirement of long-serving director employees, redundancies, deaths in office
- Anticipated impact on departing executives, particularly international recruitment and impact on firms operating internationally
- Expected compliance costs, a burden particularly for unlisted companies
- Anticipated difficulty securing senior managerial employees to sit on boards of overseas subsidiary companies

Distortion

Coalition senators foresee possible distortion arising in executive remuneration as new recruits negotiate packages around the revised shareholder-approval-required framework, producing what a number of witnesses to the Inquiry referred in terms of the "(squeezing the)balloon effect", that is, the shifting or re-weighting of remuneration components to achieve certainty or optimisation for the executive. The phenomenon is predicted to give rise to distortions variously described by witnesses as golden hello payments, frontloading, sign-on bonuses; these distortions are in addition to the expected increases in base salary.

Treasury gave evidence that any "squeezing the balloon" effect will be transparent in remuneration reporting, which is subject to non-binding shareholder vote, however, this will apply only to listed companies.

There is also the real possibility that companies may in fact face higher remuneration costs as a result of this legislation. This is because, if frontloading occurs, the sign-on payment is handed over with certainty whereas a contingent termination payment is not necessarily drawn down.

The legislation threatens to disturb the alignment of the interests of shareholders and directors. This is contrary to the aims of shareholder groups who argue against any disconnect between executive stakeholders sharing in the pain and the upside with shareholders. This misalignment occurs because the current form of the Bill may encourage executives to move away from incentive-based remuneration.

By adopting base salary in place of total remuneration as the threshold for shareholder approval, the amendment to the legislation will likely shift senior executives away from short and long-term pay incentives in favour of maximising base salary which will lead to an unintended distortion.

Executives are expected to prefer the certainty of a contracted fixed salary over the uncertainty of termination benefits that may be subject to a shareholder vote.

Unresolved issues

On the basis of the evidence presented, Coalition senators felt there are a number of issues requiring clarification or further scrutiny:

- The application to all companies, not just listed ones
- The scope of "key management personnel"
- The definition of base salary awaited in the regulations
- The definition of termination benefit awaited in the regulations
- The role of institutional investors in shareholder voting on termination payments
- The treatment of superannuation

- The treatment of statutory entitlements
- The average (over three years) annual base salary calculation
- The pro-rata limit for service of less than 12 months
- The treatment of voluntary out of court settlements

Conclusions

Coalition senators of course concur with the recommendation (3.124) that the draft bill be altered to permit shareholders to vote on a specific amount (over the threshold, in cases where it has been tripped). This oversight in the framing of the bill is cause for reflection on the government's undue haste to intervene in this area.

Evidence to the senate inquiry has highlighted once again that the government is legislating on the run, referring matters to this Committee before consultations on the all-important regulations are complete with the result that witnesses are forced to speculate on the content of legislation.

Once again as is seemingly become common practice in the Rudd government, this legislation is a bare skeleton of the main provisions with the key questions yet to be revealed in the regulations.

Coalition senators question the Rudd government's sense in announcing on the same day, a Productivity Commission investigation into executive remuneration, and at the same time, announcing how they will legislate on termination payments – jumping ahead of any Productivity Commission finding.

Given the Productivity Commission is due to present a final report by December 2009, surely it would be preferable to have the benefit of its analysis before any legislation is proposed?

We note that, in spite of this inquiry being limited to the terminations payment bill, many of the submissions, the evidence of many witnesses, the chair's report to which these comments append, and the questioning of Senator Cameron and others, all extended to the broader question of executive pay. In view of this and with reference to the quote of Productivity Commission chairman Gary Banks at the head of these comments, coalition senators are at a loss to understand why the government is rushing this legislation through the parliament.

Finally, Coalition senators welcome the focus this issue has received from APRA following the G20 meeting of world leaders in April 2009 and support APRA in the development of its guidelines for the setting of remuneration for executives of ADIs.

Recommendation

Coalition senators are of the opinion that there are sound reasons to await the final report of the Productivity Commission in December 2009 before enacting legislation on termination payments.

Similarly there are reasons to await the release of APRA standards due shortly.

Coalition senators accept the prevailing sentiment that the present threshold is high by international comparisons and indications. We heard a divergence of views on an optimal threshold.

Coalition senators consider that, in the first place, there is a case for adopting total remuneration rather than base or fixed pay as the threshold, on the argument that there will be less squeezing of the balloon distortion.

Coalition senators favour a multiple of total remuneration of one to three on the grounds that we think the regulations in this area should be designed to capture the extreme cases and not the 50-60 per cent of cases of termination payments that Treasury has in its sights.

Finally, coalition senators are of the opinion that the provisions in the bill should apply only to executives in the remuneration report. There is no cause for government to intervene elsewhere than in listed companies.

Senator Alan Eggleston

Deputy Chair

Senator Barnaby Joyce

Senator David Bushby

Additional Comments by Senator Cameron

Wider issues concerning executive pay

Many of the submitters to this inquiry, particularly from business, their organisations and their associates in the legal and consulting professions have argued that executive termination payments cannot be looked at in isolation from executive pay generally; including base salaries, short and long term incentive payments stock options, and sign-on payments.

Professor David Peetz also submitted to the Committee:

> The issue of termination payments for executives cannot be sensibly analysed separate from the broader issue of executive remuneration, as these termination packages are explicitly or implicitly part of executives' overall remuneration packages.[1]

These submissions are not without merit and therefore it is appropriate to make some observations about executive pay generally.

The growth trajectory of executive pay

There is no doubt that the rate of growth in executive pay has far outstripped growth in average weekly earnings over the past 25 years.

In his submission, Professor Peetz shows that in the period from 1971-2008, CEO pay grew by 470 per cent compared to growth in real average weekly earnings of 54 per cent over the same period. But the truly spectacular divergence between growth in CEO pay and average weekly earnings has occurred since the mid-1980s with the period since 1997 showing rates of growth in executive pay running out of control.[2]

What this means in dollar terms is amply illustrated by the Australian Council of Super Investors Inc. who last October published a voluntary survey of CEO pay in the top 100 ASX-listed companies for 2007.

Eighty CEOs were included in the survey, the results of which were adjusted for the withdrawal of News Corporation from the ASX/S&P 100 index when it moved its headquarters to Delaware.

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1 Professor David Peetz, *Submission 15*, p 2.

2 Professor David Peetz, *Submission 15*, pp 2-5.

The survey found:

- Average fixed remuneration of the CEOs (excluding performance-based pay) increased from $888,407 in 2001 to $1,833,228 in 2007; an increase of 106.4%.
- Median fixed remuneration of the CEOs (excluding performance-based pay) increased from $780,975 in 2001 to $1,533,948 in 2007; an increase of 96.4%.
- The fixed remuneration of the highest paid CEO (excluding performance-based pay) increased from $2,650,565 in 2001 to $8,885,278 in 2007; an increase of 335%.
- Average short-term incentive payments to the CEOs increased from $769,125 in 2001 to $2,178,274 in 2007; an increase of 283%.
- Median short-term incentive payment to the CEOs increased from $377,936 in 2001 to1,334,200 in 2007; an increase of 353%.
- The highest short-term incentive payment to a CEO increased from $6,239,739 in 2001 to$25,615,987 in 2007; an increase of 410.5%.
- Average total remuneration (including all performance pay) paid to the CEOs increased from $2,450,513 in 2001 to $5,532,515 in 2007; an increase of 125.8%.
- Median total remuneration (including all performance pay) paid to the CEOs increased from $1,843,987 in 2001 to $4,168,554 in 2007; an increase of 126.6%.
- The total remuneration (including all performance pay) paid to the highest paid CEO in the sample increased from $11,682,638 in 2001 to $33,489,818 in 2007; an increase of 286%.[3]

Income inequality and social inequality

The supporters of the vast sums earned by corporate executives argue that the income inequality generated by them is of no consequence because the number of vastly wealthy individuals involved is a tiny fraction of the population. They are wrong.

It is risky drawing on American data as Australia is inherently different due to its market size, company size, market capitalisation and social safety net, nevertheless there is sufficient consistency in both the quantum of executive pay increases and the justifications advanced for them on both sides of the Pacific for some lessons to be learned and warnings to be heeded. Many Australians are enthusiastic adopters of American cultural practices and fashions, none apparently more so than Australia's corporate elite in relation to executive remuneration.

3 Australian Council of Super Investors Inc, *CEO Pay in the Top 100 Companies: 2007,* Research Paper, RiskMetrics, ISS Governance Services.

In a paper entitled *The Productivity to Paycheck Gap: What the Data Show*, after making all the necessary adjustments for non-wage labour costs including taxes and health care costs, Dean Baker of the Centre for Economic and Policy Research found that there is still a large gap between the rate of usable productivity growth and the rate of growth of hourly compensation for the typical worker. Over the period from 1973–2006, median hourly compensation rose by 20.1 per cent while usable productivity grew by 47.9 per cent. This indicates that there was still a very substantial upward redistribution from typical workers to profits and high paid workers.

If gains in American productivity had been shared evenly across the workforce, the typical American worker's income would be about 35 per cent higher than it was in the early 1970s on productivity grounds alone. What actually happened was that every worker whose income lay below roughly the 90th percentile of income distribution saw their income grow less than the average rate of income growth. Only those above the 90th percentile in income distribution saw above average income growth.[4]

But the truly spectacular gains went to a very small group indeed. At about the time Oliver Stone's film *Wall Street* was making it big at the box office, an American income of $400,000 a year would have put someone in the 99.9th percentile of income distribution. Since then, the income of the top tenth of a percent of income earners has increased seven-fold.

Apart from sports stars and celebrities, the ranks of the richest one in ten thousand in the United States are made up of corporate executives, rather than the industrial barons of old who actually owned factories and who might have employed these executives as their agents.

These growing inequalities would account for much of the widespread public outrage and opposition to excessive executive pay in Australia.

Rightly or wrongly, corporate leaders are afforded considerable status as opinion leaders in this country but in order to be taken seriously, they must be seen to be acting far more clearly in the public interest than in their own interest.

Extreme inequality is damaging to society. Where vast income inequality becomes normalised, if not internalised into the workings of a society, then social inequality is bound to follow in its trail. Social inequality results in social dislocation, alienation and eventually, a breakdown in social order.

The following exchange between Senator Eggleston and Professor Peetz seems to sum up the principal strains of thought on the connection between income inequality and social inequality:

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4 Baker, Dean, *The Productivity to Paycheck Gap: What the Data Show*, Centre for Economic and Policy Research, Washington, April 2007 (available at http://www.cepr.net/index.php/publications/reports/the-productivity-to-paycheck-gap-what-the-data-show).

> Senator EGGLESTON—They do, indeed. And it would be very interesting to know what the level of pay is for the chief executives of Nokia, Saab and so on. I am sure you would find they are comparable. You have raised this issue of the link between workers' pay and senior executives' pay. I suggest to you that in countries like China and Vietnam workers' pay is a lot less than chief executives' pay. But that is another point. You are only comparing work of pay in industrialised Western countries and not in countries where most things are made these days, and that is China, Vietnam and Third World countries—the new international division of labour, isn't it called? I just wonder why we think that as a society we have a right to seek to impose the views of government on the private affairs of a private company owned by private shareholders.
>
> Prof. Peetz—In a sense, this gets back to the question that was raised earlier about the social dysfunctionality of having high degrees of inequality. Do we really want a society where inequality is constantly growing? Why is that a good thing? It is one thing to say, 'Is it a good thing to have inequality?' or 'How much inequality should there be?', but it is another thing altogether to say, 'Should this inequality constantly get greater and greater?' I cannot see any good social reason why it should. Resources are basically being redirected away from ordinary people to a relatively small group.[5]

In the face of growing inequality it is incumbent upon the parliament to address the market failure that manifests itself in excessive executive remuneration by intervening in the public interest to ensure continuing support for our system of corporate governance, government and economy.

The role of remuneration consultants, comparative wage justice and pattern bargaining

During the course of this inquiry, the Committee received a considerable amount of evidence concerning the role of remuneration consultants in setting executive pay. Views about the role of remuneration consultants and whether their influence is a significant factor in the ratcheting up of executive pay varied widely.

The most benign view of the role of remuneration consultants came, predictably, from the consultants themselves and their clients.

During the hearing on 25 August 2009, Mr John Colvin, CEO of the Australian Institute of Company Directors offered this view following questioning by Senator Joyce:

> Senator JOYCE—Remuneration consultants—they are put up as putting some sort of arm's length between company directors and their pay. I was

5 *Proof Committee Hansard*, 25 August 2009, pp 15-16.

> looking at one of the previous submissions where they talked about evidence linking remuneration consultants to the upward racheting of pay of senior executives in the banking sector. And I can see the banking sector sitting at the back.
>
> Mr Colvin—I know who they are. But in terms of—
>
> Senator JOYCE—What are they?
>
> Mr Colvin—What are they? Well, they are a very valuable resource to directors who are trying to work out what the market is for particular positions. So they keep records and trawl through and do the scientific evidence basis for this, and they advise boards as to what those, if you like, comparable salaries, wages—
>
> Senator CAMERON—Comparative wage justice! Shock!
>
> Mr Colvin—Exactly. Comparative wage justice is just as strong at the top as it is anywhere else. So they provide that service and they provide boards, bearing in mind that boards—
>
> Senator JOYCE—Are they at arm's length? That is the question I am asking. To your knowledge, are they at arm's length?
>
> Mr Colvin—To my knowledge, when I was practicing in this area, they were at arm's length.[6]

During the hearing on 25 August 2009, representatives of the executive remuneration consultancy Guerdon Associates gave evidence to the Committee. During the course of that evidence, Mr Peter McAuley furnished the Committee with the following explanation of how they go about their work in advising boards on appropriate levels of remuneration:

> Senator CAMERON—You provide information to companies to help them establish and set the executive and director salaries. Is that correct?
>
> Mr McAuley—That is correct.
>
> Senator CAMERON—How do you do that?
>
> Mr McAuley—There are a number of facets to it. Clearly, the most basic element of it is determining overall remuneration levels or opportunity levels as in benchmarking the aggregate levels of pay but that is only one element. That is done by looking at the nature of the business and the fields in which it operates. We talk to directors of the business to understand the strategic and operational issues associated with that business, to look at the risks and the ability to retract and retain employees. We look at the industry and sector generally and sometimes more widely. We look at the levels of pay in that area and the size and scope of the roles within the business. More particularly, we look at the nature of the business. We look at whether it is a capital intensive business, whether it is a fast-moving consumer goods business and what the time horizon of performance is, if you like, for executives—some have very capital intensive decisions to make, it might

6 *Proof Committee Hansard*, 25 August 2009, p 45.

be an energy type business, a resource business or something which has a totally different time horizon. In doing that, we would look at the long-term versus short-term mix. There will be decisions taken around what is the fixed pay level, what should be the opportunity for short-term annual operational and financial performance and what should be the long-term measure of performance.

> Senator CAMERON—So basically there is an element of comparative wage justice in there.

> Mr McAuley—That is probably a reasonable way to put it. It is also obviously impacted by competitiveness and availability of talent.[7]

Essentially what Mr McAuley describes is not in any way a scientific approach to determining executive pay but a simple but nonetheless effective comparative wages survey designed to ratchet up executive remuneration. It is pseudo-science pure and simple.

Ms Anne Byrne, CEO of the Australian Council of Super Investors, indicated to the Committee that the work of these consultants is less transparent than might be the case in an ideal world:

> Senator JOYCE—I am very interested in these remuneration consultants who seem to work hand in glove with boards. Do you think that creates a grey area in how executives are remunerated?

> Ms Byrne—We actually do not know who they are. We think boards should be required to tell shareholders who their remuneration consultant is. We know who they are generally—who are the consultants around—but we think that, as part of the disclosure, that should be a requirement. We have suggested that to the Productivity Commission. But they go to look for the best person for the job.

> Senator JOYCE—So there should be transparency about who the remuneration consultant is?

> Ms Byrne—Yes.[8]

The most telling criticism of remuneration consultants and their methods put before the inquiry was made by Professor Peetz in both his written submission and during his appearance at the hearing on 25 August 2009.

Professor Peetz described the methods by which executive remuneration is determined as "dual asymmetric pattern bargaining":

> The determination for remuneration of senior executives is characterised by what I call dual asymmetric pattern bargaining. It is pattern bargaining because it is based on reference to the patterns of pay of other executives, in particular through the device of remuneration surveys. It is dual asymmetric

7 *Proof Committee Hansard*, 25 August 2009, pp 59-60.

8 *Proof Committee Hansard*, 25 August 2009, p 28.

> pattern bargaining because of two key asymmetries. First, the pattern is asymmetric; it is not based on bringing participants up to a common mean, as in traditional pattern bargaining, but often to a position above the mean in a leapfrog pattern. Second, the bargaining itself is asymmetric as there is not an effective countervailing force at the bargaining table, as there is with wage bargaining for ordinary employees. I suppose I could add a third asymmetry: the movements upwards when times are good are generally not matched by equivalent movements downwards when times are bad—but that is in large part due to the first two asymmetries.

In his written submission to the inquiry, Professor Peetz describes the process of pay leapfrogging that arises from asymmetric pattern bargaining:

> To express it crudely, the process is something like this. Private sector executive salaries are typically set by a body like a board remuneration committee. These may include outsiders (that is, senior executives and directors from other corporations) but in Australia they are rarely fully independent of executive influence (Schwab 2009b, Shields, et al. 2003). Particularly in large corporations, this committee typically looks at the results of executive salary surveys undertaken by remuneration consultants, and takes advice from such consultants. The committee members, who identify and network with the senior executives under scrutiny, are easily persuaded that the company needs to pay above the average in order to retain such high calibre executives. Otherwise the company may under-perform and be under threat of takeover. So a large number of firms raise their salaries so that they are paying above the median (the middle of the market), and others paying below the median raise theirs to match the median. Another survey is then published. Companies see that the market rate has risen, and they have to readjust their executives' pay so that they are paying above (or at) the market median again.

Professor Peetz also drew the Committee's attention to the recent report of the House of Commons Treasury Committee, who looked at the role of remuneration consultants in the British banking industry during the course of its inquiry into the banking crisis. The evidence received by the Committee cast considerable doubt on the integrity and rigour of the advice received by corporate boards from remuneration consultants.

Mr Montagnon[9] accused remuneration consultants of having "contributed to the general ratchet in executive remuneration because they seem to have business models which require them to earn fees which require them, therefore, to modify packages every year which, therefore, requires the packages to go up". Mr Barber[10] also spoke of the "ratchet" effect telling us that it was remarkable how many remuneration consultants "are given remits which refer to a benchmark of the upper quartile. If

9 Peter Montagnon, Director of Investment Affairs, Association of British Insurers.

10 Secretary-General, Trades Union Congress.

endlessly, year after year after year, you are referred to the upper quartile, then that is an endless ratcheting and an ever-increasing gap with the rest of the workforce”.[11]

> We have received a body of evidence linking remuneration consultants to the upward ratchet of pay of senior executives in the banking sector. We have also received evidence about potential conflicts of interest where the same consultancy is advising both the company management and the remuneration committee. Both these charges are serious enough to warrant a closer and more detailed examination of the role of remuneration consultants in the remuneration process.[12]

How this works in practice in Australia is illustrated in Professor Peetz's submission dealing with where companies position their executive pay structures in the marketplace:

> Most relevant, however, was the question on how companies sought to pitch or 'position' their senior executives' pay. Results are shown in Figure 8. Nearly two thirds of companies had a policy of 'positioning' their executives’ pay above the median and 92 per cent claimed to set them around or above the median. The 65 per cent who pitch their executive pay above the median comprised 35 per cent who pitched between the median and the 75th percentile and 31 per cent who pitched at or above the 75th percentile. Only 2 per cent aimed to position their pay below the median. Of course, it is mathematically impossible for all companies to achieve the position they are seeking. By definition, 50 per cent of firms will be paying below the median, not 2 per cent. As virtually all firms attempt to position themselves at or above the median, senior executive remuneration will increase even in an environment of zero inflation and zero productivity gains. A similar pattern was seen in the USA at that time (Crystal 1991).[13]

This phenomenon is the Lake Wobegon effect, named for the fictional town of Lake Wobegon from the radio series *A Prairie Home Companion*, where, according to the presenter, American humourist Garrison Keillor, “all the women are strong, all the men are good-looking, and all the children are above average.” Applied in the boardroom and despite its pretence to scientific rigour it is a statistical fiction.

Executives effectively set their own pay

Much of the evidence before the Committee from those submitters who could be characterised as generally representing the interests of corporate executives and the status quo tended to explain the process of executive pay setting in abstract terms. The following exchange is a good example of the degree of abstraction involved:

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11 House of Commons Treasury Committee, *Banking Crisis: reforming corporate governance and pay in the City,* Ninth Report of Session 2008-09, 12 May 2009, p 32.

12 House of Commons Treasury Committee, Ninth Report of Session 2008-09, p 33.

13 Professor David Peetz, *Submission 15*, p 12.

> Senator CAMERON—Do you want me to give you the figures, and then can you comment? Executive salaries have increased from about 1986 through to about 2007 from a median of 100 to 550—a huge increase. The average earnings have gone from 100 to about 110. I just do not understand. What are these executives being paid for? Why is this huge gap appearing between average weekly earnings and these executives? Why?
>
> Mr Crone—One possible answer to that, and you are talking about the pace of the increase in executive salaries compared with the pace of increase in salaries lower down the chain, is perhaps that turnover and job tenure of the CEOs is a lot shorter I would imagine than for workers lower down, and perhaps the CEOs feel that they need to be compensated for that.[14]

And this:

> There is a certain pool of available talent out there, there is a certain demand for people to run these companies. You are trying to get the best and the brightest.[15]

And then this:

> Senator CAMERON—It used to be the captains of industry, the entrepreneurs, who set the business up and invested their money into an industry. The Henry Fords were the captains of industry. Now it is this managerial class who are coming in and demanding these returns without, as you say, the risk. Why shouldn't they simply receive a fair day's pay for a fair day's work? Why do they have to be linked to this culture that they should make gains disproportionate to their input? That is still the problem. Your system can still give them gains disproportionate to the rest of society, disproportionate to the rest of the workers in the company and disproportionate to what is a fair thing.
>
> Mr Mather—The question of what is fair in remuneration is a very, very difficult one, because it is in the eye of the beholder. We do favour the market. The market is allowing these executives to extract this rent from the owners of companies, and there is no doubt that there is a significant amount of stress associated with running a public company.
>
> Senator CAMERON—That is not the market. How do you define the market in that sense?
>
> Mr Mather—The market is the willingness to pay and there are the challenges of being an executive. Managing people, being the company spokesperson and navigating the political environment as well as the business environment is challenging.[16]

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14 Mr Peter Crone, Policy Director, Business Council of Australia, *Proof Committee Hansard*, 25 August 2009, p 5.

15 Mr Peter Crone, Policy Director, Business Council of Australia, *Proof Committee Hansard*, 25 August 2009, p 7.

16 Mr Erik Mather, Managing Director, Regnan Governance Research and Engagement Pty Ltd, *Proof Committee Hansard*, 25 August 2009, p 31.

These are idealised norms of executive talent. Once they are stripped away it isn't difficult to see why executive pay is less connected to questions of supply, demand, global talent pools and competition for talent than it is to power and fashion.

Neither the quality of executives nor the amount they should be paid are hard numbers. It is far harder to assess the abilities and productive capacity of a corporate CEO than it is a bricklayer by measuring how many bricks are laid in an hour, how square and how true.

Even to the extent that corporate boards correctly judge the talents of those who they recruit, the amounts they end up paying them depends almost entirely on what <u>other</u> companies are doing. Even corporate boards that aren't smitten with the idea of astronomically well paid executive superstars are forced to pay high salaries firstly just to attract talent and secondly because it is highly likely that the financial markets will cast a suspicious eye at a company that doesn't give the outward appearance of hiring a superstar where the evidence of superstar status is found not in the appointee's record or performance but in the size of their pay cheque.

To the extent that there is a market for executive talent and it is as abstract as the Committee is led to believe, who are the buyers? Who determines how good a CEO is and how much she should be paid to ward off other suitors? The answer of course is that corporate boards, largely selected on the recommendation of the CEO in consultation with other CEOs and former CEOs, hire remuneration consultants, chosen by the CEO, to determine what the CEO is worth. It is a situation conducive to the development of a very powerful Lake Wobegon effect.

What this suggests is that the dollar value of the executive class is dependant on a range of 'soft' factors such as social attitudes, political background and above all, networks.

This view is made strongly by the authors of *Pay Without Performance*, Lucien Bebchuk and Jessie Fried who argue that top executives in effect set their own pay and that neither the quality of the executive nor the marketplace for talent have any significant bearing. The only real constraint, they argue, are the “outrage costs” of excessive pay; a concern that excess will lead to a backlash among the general public, shareholders, workers and politicians.

Professor Peetz put the task of the Senate this way in his appearance before the committee:

> This bill is important not only for promoting good practice in executive termination payments. It is also important that the parliament send a signal that, like the community, it is no longer willing to welcome excess in executive remuneration generally. While sending signals will not in itself halt excessive remuneration, if parliament fails to pass this bill it will send exactly the wrong signal and we could expect a return in the near future to not only the excessive termination payments that characterised the recent

> past but also the excessive growth in executive remuneration generally that has been witnessed.[17]

The parliament is in a position to send a strong signal on behalf of the community that it is no longer willing to tolerate excessive payments to departing executives without the express approval of the owners of the company. To do otherwise will only further corrode public confidence in the integrity of those corporate leaders in whose hands the economic security of most ordinary citizens lies.

Conclusions and recommendations

The common theme throughout much of the evidence presented to the committee is that information about how executive pay generally and termination payments in particular are calculated is in short supply. The committee heard that the calculus involved is based on abstractions including notions about innate talent, a global executive labour market that may or may not exist, assumed rather than measured productivity, the possibility of losing one's job, complexity and so on. These abstract ideas about executive worth don't appear to stand up to much close scrutiny.

What has been consistently absent is hard evidence and hard numbers to support the claims for ever higher levels of executive remuneration and the termination benefits that inevitably follow when an executive ceases their employment. It seems absurd that in every other labour market segment there is hard evidence and hard data by which the relative dollar value of each occupation and profession can be assessed. That it is not the case when it comes to the termination benefits and other remuneration of senior corporate executives simply beggars belief given the vast amounts of money involved.

The principal object of the bill is improved accountability in relation to certain executive termination payments. The mechanism that the bill provides for doing so is widely supported by the majority of submitters to the inquiry. But the paucity of information about how these payments are arrived at and who has influenced the decision to award the benefit will in all likelihood bedevil shareholders faced with approving any given proposal before them. As indicated above by Ms Byrne on behalf of the Australian Council of Super Investors, no-one seems to know with any certainty just who has their finger in the pie.

It is my view that the scope of the information required to be provided to shareholders either in or accompanying the notice of the meeting at which the question is to be resolved should be extended to include a much wider range of information that will assist both retail and institutional shareholders to make more informed judgements about the merit or otherwise of a given termination payment.

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17 Professor David Peetz, *Proof Committee Hansard*, 25 August 2009, p 12.

Recommendation

That the details of the benefit required to be set out in or accompany the notice of the general meeting to consider the resolution include, in addition to the matters already set out in section 200E(2) of the Act, the following:

- The manner in which the value of the benefit has been or will be calculated whether or not the benefit is a payment or otherwise and whether or not the value of the benefit is known at the time of the disclosure.
- Whether the remuneration package that forms the basis of the termination payment was set as a result of advice from an executive remuneration consultant or similar entity.
- The quantum of the termination payment expressed as a ratio of the executive's normal weekly salary.
- The nature and source of any and all advice received by the board or any board nominee in relation to the decision to award the benefit and the determination of the quantum of the benefit.
- If the decision to be approved by the general meeting is based on advice from an outside consultant or other "arm's length" entity, the value of any contracts for services for whatever purpose between the company and that entity.
- A schedule setting out the formula used for calculating termination and/or redundancy payments for each class of employees employed by the company.
- Whether or not the remuneration of the recipient of the termination payment, during the term of the recipient's employment with the company, was set at a level above or below the median remuneration of comparable employees in the industry or sector occupied by the company and by how much.
- A schedule setting out increases in the recipient's remuneration during the term of the recipient's employment with the company compared with movements over the same period in the company's turnover, profitability, productivity, returns to shareholders and capital investment.

Recommendation

That the Productivity Commission public inquiry into executive remuneration:

- Considers whether there have been any social and economic benefits as a result of the growth in executive remuneration over the past 25 years.
- Considers developing a range of key performance indicators against which increases in executive remuneration can be measured at a national, sector, and enterprise level and the indicators be published annually to facilitate improved decision-making on executive remuneration.
- Examines the role of executive remuneration consultants in facilitating spiralling growth in executive salaries including their role in promoting comparative wage

justice, positioning executive remuneration above the median and asymmetric pattern bargaining.

- Inquires into the apparent incapacity of many Australian company boards to contain executive remuneration to levels that do not undermine public confidence in Australia's system of corporate governance.
- Examines the evidence received by the committee to the effect that excessive executive remuneration is driven in large part by a shortage of “talent”, and give consideration to the most efficient and effective means to increase the supply of labour in executive occupations as one initiative to reducing the unrealistic and unjustifiable cost of labour in executive occupations.

Senator Doug Cameron

Minority Report by Senator Xenophon

Introduction

1.1 The *Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009* amends the *Corporations Act 2001* to lower the threshold at which termination payments to company executives (including senior executives or key management personnel) must be approved by shareholders. It also specifies the types of benefits which are subject to shareholder approval, requires unauthorised termination benefits to be repaid immediately, provides that retiree shareholders cannot participate in a vote on their termination benefit (except as a proxy), and increases the penalties applicable to unauthorised termination benefits.

1.2 While I broadly support the intent of this Bill, a number of areas require further clarification. These areas include the conditions on which considerations of executive performance are made and the method by which payments are collected. This minority report addresses these and other areas requiring clarification.

Background

1.3 Submissions to the inquiry made it clear that the rate of corporate executive payments has grown at a significantly greater proportion than the average wage over the past twenty to thirty years. For instance, between 1971 and 2008, the growth in corporate salaries was around 470 percent, nearly nine times the 54 percent growth in real average weekly earnings over the same period.[1]

1.4 Today, the average CEO of a top 100 company reportedly receives a termination payment of $3.4 million, which is equivalent to twice their annual salary.[2]

1.5 The purpose of this Bill is to reduce the number and size of 'golden handshake' payouts made to corporate executives. Specifically, the Bill stipulates that the condition for shareholder approval of terminations payments be any payment that exceeds one year's base pay.

1.6 Under current Commonwealth legislation, corporate executives are eligible to receive up to seven year's total remuneration without need for shareholder approval. In its submission to the Committee, Treasury offered the following example:

> "For example, a person with seven years service and an annual average salary over the last three years of $10 million would be

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[1] Professor David Peetz, *Submission 15*, pg 4

[2] ibid, pg 23

entitled to receive a termination payment of up to $70 million without seeking shareholder approval".[3]

1.7 Treasury also referred to a November 2008 report by risk management and corporate governance analysts, RiskMetrics, which found that "out of a sample of 33 CEOs, only two (or approximately 6 percent) sought shareholder approval for termination payments".[4]

Consideration of executive performance and payouts

1.8 Submissions to the inquiry highlighted that Australia does not currently match international standards in reduction of thresholds for executive payments. Guerdon Associates (which specialises in board and executive remuneration matters) stated in its submission that "termination payments for North American executives are typically 2.99 times base salary plus bonus, while the Europeans... are content to set the level at twice base salary"[5].

1.9 This Bill, by reducing the threshold from seven year's to one year's salary, will match or better the accountability standards for termination payments of many Australia's international competitors.

1.10 However, a number of submissions to the Committee expressed concern that reducing the threshold to one year's base salary was too low and would affect Australia's ability to attract executives of international standard.

1.11 There are also concerns that eliminating 'golden handshakes' will only result in 'golden hellos', whereby executives will access increased base salaries on commencement, increased bonuses in other forms, or other loopholes by which they will be able to maximise their income.

1.12 There is also an existing loophole whereby executives can have their termination payment pre-approved and included within their contract at the commencement of their employment.

1.13 In its submission, RiskMetrics argues that:

> "… the Bill should be amended to require any advance approval of a termination payment to specify a maximum dollar cap that may be paid under the authority sought from shareholders."[6]

It goes on to explain:

> "Without this requirement, based on RiskMetric's experience, boards may seek to maximise their discretion to pay termination benefits."[7]

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[3] Treasury, *Submission 22*, pg 4

[4] ibid, pg 5

[5] Guerdon Associates Pty Ltd, *Submission 1*, pg 3

[6] RiskMetrics Australia*, Submission 11*, pg 2

1.14 Further to this, shareholders should be able to re-approve this pre-determined payment at termination, where all the criteria for the pre-approved payment is not satisfied (for example, the executive only serves two years out of their three year contract) and where the value exceeds the threshold.

1.15 Similarly, the Bill should allow shareholders to vote on a specific amount at the time of termination, where the payment is greater than the threshold and where it was not pre-approved. This will prevent executives from receiving a vote in favour of a termination payment above the one year's base salary and the Board then determining how much greater it will be.

1.16 Importantly, companies should not be able to avoid shareholder rulings regarding executive payments and shareholder votes should be made binding. In the past year, shareholders have voted against 15 out of 300 companies' remuneration reports[8], however the votes were considered 'simply advisory'.

1.17 This was clearly demonstrated in the case of ex-Telstra CEO, Sol Trujillo, in November 2007, when two-thirds of Telstra's shareholders voted against a pay increase for Mr Trujillo but this decision was not adhered to by the Board.[9]

Poor performance

1.18 While I support the proposed changes in this Bill in relation to shareholder approval of corporate executive payouts, I believe that the conditions upon which corporate executive performance is measured should be further clarified, especially where the reason for departure is due to poor performance.

1.19 In its submission to the Committee, Treasury referred to studies by Geof Stapledon which highlighted several instances of large termination payments being made following a period of very poor corporate performance.

> "In 2002, five senior executives of AMP departed with close to $12 million, despite the fact that they had been in office while AMP lost more than $13 billion of its market value."[10]
>
> and,
>
> "In 2003, Southcorp's CEO, Keith Lambert, departed with a termination payment of $4.4 million, even though during his 19 months at the helm, Southcorp's shares lost 40 percent of their value."[11]

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[7] ibid, pg 2

[8] Parliamentary Library, Bills Digest – Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009, 05 August 2009, pg 4

[9] Emma Alberici, ABC The World Today, *Telstra shareholders reject directors' pay rise*, 07 November 2007 http://www.abc.net.au/worldtoday/content/2007/s2084383.htm

[10] Treasury, *Submission 22*, pg 2

[11] ibid, pg 2

1.20 Professor David Peetz, Professor of Employment Relations, Griffith University, stated in his submission:

> "It is clear that a number of large payouts were made to CEOs who underperformed, or whose poor performance was the reason for their departure."[12]

Professor Peetz also referred to a study by RiskMetrics, which found that "one-third of the nation's top 100 companies in the past three years paid their chief executives a combined $112 million to 'go away'." [13]

1.21 Shareholders, by the very nature of their holdings, should be granted greater powers when it comes to approving and evaluating the performance of their executives. Unless all performance criteria are met, executives should not be entitled to receive payments above the termination payment threshold – in the same way as the average worker does not receive payment for poor work outcomes.

1.22 However it is apparent that companies are not detailing in full the reasons for departure. The Australian Council of Super Investors states in it's submission:

> "We remain concerned that companies should be more transparent with their shareholders with respect to whether executives have in fact resigned, retired or been terminated. There appears to often be an inconsistency arising where CEO's departures are not described as terminations, however later disclosures reveal that termination payments were still made."[14]

1.23 The definition of 'poor performance' should be more clearly defined, particularly in relation to whether it is determined by profit and share price in comparison to competitors, and the executive's performance against these measures should be presented to shareholders for their vote.

Methods by which payouts are accessed

1.24 Tax concessions were created to encourage employee share ownership but have become increasingly popular for CEOs themselves. According to analyst, Dean Paatsch from Riskmetrics Australia:

> "… tax need only be paid on a maximum of 20 percent of the value of the share component of CEO pay. Once the shares are safely ensconced in the hands of the executive, the capital gains tax regime kicks in to ensure that future gains after one year are taxed at 22.5 percent."[15]

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[12] Professor David Peetz, *Submission 15*, pg 23

[13] ibid, pg 23

[14] Australian Council of Super Investors, *Submission 13*, pg 2

[15] Dean Paatsch, The Age, *Tackling tax breaks is vital as CEO salaries soar*, 03 May 2008 http://business.theage.com.au/business/tackling-tax-breaks-is-vital-as-ceo-salaries-soar-20080502-2aeo.html?page=-1

Mr Paatsch goes on to state:

> "It's no wonder that there's been an explosion in share payments to CEOs – the average share payment to Australia's top 300 executives is now valued at about $600,000 a year (double five years ago). If the research about the routine undervaluation of options is right, that $600,000 ends up being worth about $2.1 million to the executive. And the tax on this largesse? Well, it seems many executives get to choose their own rate - and you can bet your life it's not the 46.5 percent top PAYG rate or, in many cases, even the 31.5 percent rate that the bulk of taxpayers cop."[16]

1.25 Corporate executives receiving significant termination payments should be prevented from using non-taxable bonuses, low-tax bonuses or 'salary sacrificing' of their payments to effectively maximise a termination payment above that approved by shareholders.

1.26 One way to address this would be to introduce a new high tax rate. Professor Peetz advocates the creation of a "new, higher marginal tax rate that cuts in at a substantially higher income range than at present (for instance, $400,000 per annum) but into which CEOs would typically fall"[17].

He also suggests wealth taxation on very high income individuals "for example, those with over $20 million in accumulated wealth"[18] as a means to address this concern.

1.27 A review of how executives are able to collect these payments should be carried out to close any loopholes executives may be maximising to their benefit.

Conclusion

1.28 While I support the premise of this Bill, I believe it requires amendment if it is to successfully match its intent.

1.29 The Productivity Commission is due to release its findings into executive remuneration in December 2009 and the Australian Prudential Regulatory Authority is also preparing a discussion paper on remuneration, to be published in September 2009. The findings from these reports should be considered to make further amendments regarding termination payments, and the legislation should include a sunset clause which would trigger a review based on the findings of these reports.

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[16] ibid

[17] Professor David Peetz, *Submission 15*, pg 27

[18] ibid, pg 27

Recommendation 1

That the Bill not be passed in its current form.

Recommendation 2

That the Bill be amended so that shareholders are able to vote on the exact amount of termination payment, not just in favour of "an amount greater than the threshold".

Recommendation 3

That the Bill be amended such that corporate Boards are required to specify whether an executive has resigned, retired or been terminated, and that the reason for resignation is stated.

Recommendation 4

That the Bill be amended for shareholders to be required to re-approve termination payments where the amount has been pre-approved at the time of employment, is greater than one year's base salary, and where performance by the executive has not been satisfactory.

Recommendation 5

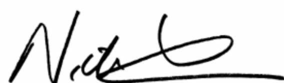
That the Bill be amended so that that shareholder votes for termination payments are binding.

Recommendation 6

That the Bill be amended such that executives are prevented from using taxation and other loopholes to maximise termination payments, such as non-taxable bonuses or share schemes.

Recommendation 7

That the Bill includes a sunset clause of two years from the date of release of the Productivity Commission's final report into executive remuneration in order to trigger a review of this legislation, taking into account the report findings.



Nick Xenophon
Independent Senator for South Australia
07 September 2009

APPENDIX 1

Submissions Received

Submission Number	Submitter
1	Guerdon Associates Pty Ltd
2	Origin Energy Limited
3	Australasian Compliance Institute Inc
4	Australian Chamber of Commerce and Industry
5	BHP Billiton
6	Hay Group
7	Regnan
8	BlueScope Steel Limited
9	Business Council of Australia
10	Australian Manufacturing Workers' Union
11	RiskMetrics Australia
12	Australian Institute of Company Directors
13	Australian Council of Super Investors
14	Insurance Australia Group Limited
15	Professor David Peetz
16	KPMG
17	Rio Tinto Australia
17	Rio Tinto Australia – Supplementary Submission
18	Chartered Secretaries Australia Ltd (CSA)
19	Joint Accounting Bodies
20	Ernst & Young
21	Abacus – Australian Mutuals
22	The Treasury
23	Law Council of Australia
24	Australian Bankers' Association Inc
25	IFSA Investment & Financial Services Association Ltd
26	QBE Insurance Group Limited
27	Mercer (Australia) Pty Ltd

Additional Information Received

Received on 1 September 2009 from the Australian Institute of Company Directors. Answers to Questions on Notice taken on notice on Tuesday 25 August 2009.

Received on 2 September 2009 from the Business Council of Australia. Answers to Questions on Notice taken on notice on Tuesday 25 August 2009.

Received on 4 September 2009 from Guerdon Associates. Answers to Questions on Notice taken on notice on Tuesday 25 August 2009.

TABLED DOCUMENTS

25 August 2009, SYDNEY NSW:

Australian Council of Super Investors:
'Termination Pay Arrangements in the ASX20'
Table summary of current termination arrangements in S&P/ASX20 companies in Australia

APPENDIX 2

Public Hearing and Witnesses

SYDNEY, TUESDAY 25 AUGUST 2009

ABRAHAM, Mr Peter, Legislation Review Committee
Chartered Secretaries Australia

BELL, Mr David, Chief Executive Officer
Australian Bankers' Association

BRISCHETTO, Mr Nicholas, Corporate Governance
Regnan Governance Research and Engagement Pty Ltd

BYRNE, Ms Ann, Chief Executive Officer
Australian Council of Superannuation Investors

CHRISTIE, Mr Alex, Deputy Head of Group, Human Resources
Insurance Australia Group

COLVIN, Mr John, Chief Executive Officer
Australian Institute of Company Directors

CONSEDINE, Mr Stephen, Company Secretary
Rio Tinto Limited

CRONE, Mr Peter, Policy Director
Business Council of Australia

FERNANDES, Ms Sonia, Policy Analyst, Corporations and Financial Services Division
Department of the Treasury

FOX, Ms Judith, Director, Policy
Chartered Secretaries Australia

FRASER, Mr Bede, Manager, Corporations and Financial Services Division
Department of the Treasury

HOSSACK, Mr Nicholas, Director, Prudential, Payments and Competition Policy
Australian Bankers' Association

MATHER, Mr Erik, Managing Director
Regnan Governance Research and Engagement Pty Ltd

McAULEY, Mr Peter, Director
Guerdon Associates Pty Ltd

MILLER, Mr Geoffrey, General Manager, Corporations and Financial Services Division
Department of the Treasury

PEETZ, Professor David Robert
Private capacity

RAM, Ms Ronita, Policy Analyst, Corporations and Financial Services Division
Department of the Treasury

SHEEHY, Mr Tim, Chief Executive
Chartered Secretaries Australia

SPATHIS, Mr Phillip, Manager, Strategy and Engagement
Australian Council of Superannuation Investors

STORY, Mr John, Chairman
Australian Institute of Company Directors