Exposure Draft - Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011

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- [X] contains NO confidential material
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- [ ] contains confidential material and the WHOLE submission is provided 'IN CONFIDENCE

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Introduction

About Hay Group

Hay Group is a global management consulting firm that works with leaders to transform strategy into reality. We develop talent, organise people to be more effective and motivate them to perform at their best. Our focus is on making change happen and helping people and organisations realise their potential. We have over 2500 employees working in 86 offices in 47 countries.

Locally, we operate out of seven offices across Australia and New Zealand with over 100 employees. We consult to listed, private and public sector organisations as well as the not-for-profit sector.

We provide advice to and work with leaders and their teams in the areas of:

Building effective organisations

- Strategy clarification: translating strategy into actionable plans
- Operating model definition and alignment
- Organisation and job design

Leadership and Talent

- Team facilitation and improving team effectiveness
- Executive leadership development
- CEO and leadership succession
- Executive coaching

Reward

- Executive remuneration
- Reward strategies
- Reward Information

Hay Group interest in Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011

Hay Group's submission to Treasury stems from our belief that we will add value to the legislative process as we:

- have proven expertise locally and globally in executive remuneration based on vast experience
- have deep insight into the issues that impact on executive remuneration
- maintain a significant database of executive remuneration globally, including many of the publicly listed companies on the world's major stock exchanges

- believe that reward is a powerful tool for company boards to use to improve company performance to the benefit of all in an economy.

In Australia our remuneration information is used by many of the top ASX listed organisations and we also advise Boards and management on director, executive and management remuneration in a number of ASX listed organisations.

We were active participants in the Productivity Commission enquiry into Executive and Director Remuneration having provided an initial submission, presented at a hearing and responded to the draft recommendations produced by the Commission. In addition the Commission made substantial use of Hay Group remuneration data in its analyses of remuneration of Executives in Australia and globally. The Productivity Commission made over 20 references to the Hay Group in its discussion draft of September 2009.

Our approach to this submission

Hay Group is supportive of the general direction that Treasury has taken with its Exposure Draft.

We have made comments on the seven chapters in the Explanatory Memorandum but have provided more detailed comments on those where we feel we have specific expertise in remuneration strategy and practice and particular value to add., or areas with substantive differences from the Productivity Commission's recommendations.

Chapter 1 - Strengthening the non-binding vote — the 'two-strikes' test

New law	*Current law*
A 'two-strikes and re-election' process will be introduced where a company faces significant 'no' votes on its remuneration report over two consecutive years.	The Corporations Act does not set out any consequences where a board proceeds with its remuneration policies despite a negative shareholder vote.

We do not support this new law.

If a proposed 2 strikes model was adopted we would advocate that the trigger for a Board spill in the second year should be in excess of 50%. It is democratically unacceptable for a majority of shareholders to be overruled by a minority. We have no knowledge of any other element of corporate law in Australia allowing for a minority vote to make change and fail to see how such a dramatic action can be taken where 75% of shareholders do not see a problem.

It needs to also be remembered that since the introduction of the non-binding vote on the Remuneration Report, Australian Boards have been very responsive to strong negative votes. Boards have almost universally taken the concern of shareholders very seriously and ensured that the next Report addressed the areas of shareholder dissatisfaction. Given this we do not see a significant need to strengthen the power of the current non-binding vote.

Chapter 2 – Improving accountability on the use of remuneration consultants

New law	*Current law*
Companies that are a disclosing entity will be required to disclose details relating to the use of remuneration consultants. Remuneration consultants must be engaged by non-executive directors, and must report to non-executive directors or the remuneration committee, rather than company executives.	Currently, companies are not required to disclose any details relating to the use of remuneration consultants. In addition, there is no requirement for remuneration consultants to be engaged by, and their advice provided directly to, non-executive directors or the remuneration committee.

We strongly support the desire behind the draft legislation to ensure that there is not the appearance of any conflict of interest in any way regarding the use of remuneration consultants.

- It is appropriate that the market should be aware that a company in formulating its remuneration structures received a range of inputs.
- Definitive clarity that the client for executive remuneration is the Board is a welcome development that Hay Group fully supports.

However, it is important to note that the Productivity Commission found that the overall governance structure in relation to executive remuneration in Australia was sound and compared favourably with other jurisdictions. In the development of its recommendations, the Productivity Commission did not identify the need for particular measures aimed at remuneration consultants in any respect.

While the intent behind these inclusions is understood and supported, the mechanisms that have been incorporated into the draft legislation:

A. will deliver unintended consequences that may even drive outcomes opposite than the original intent; and
B. are inconsistent with the basic fundamentals of Board and Corporate governance in the area of remuneration development, and indeed cut across many of the best practice elements of such governance structures.

We also note that these mechanisms were not foreshadowed previously by the government, and included in legislation with an extremely short consultation period during the Christmas period.

We believe these mechanisms are not warranted and should not be included in the draft legislation. However, should the legislation be implemented, we comment on each of the areas noted above and include alternatives

A. Unintended Consequences of Current Drafting

We believe there will be unintended consequences from the current form of drafting as follows:

1. **Disclosure** of remuneration consulting activities without any indication of whether the advice was followed or not could be used by Boards to diminish their accountability for determining executive reward outcomes. It is common and absolutely appropriate that Boards may accept all, some or none of the advice provided by a remuneration consultant. The structure for disclosure as outlined focuses only on the nature of the advice, not how or whether the advice was used or not. This could lead to an inference that a Board sought advice widely in defence of their conclusions, when the advice was actually not utilised.

2. The **definition of advice** as structured could also include non-specific, generic information and data, as well as broader HR services that support a wide range of organisational needs, rather than advice prepared specifically for a company around executive remuneration, reflecting the company's circumstances. The concerns expressed by stakeholders driving the disclosure requirements relate to conflicts of interest for a remuneration consultant being influenced to provide advice that is different to what they may have provided another company due to the broader commercial arrangements that may be in place. Therefore, it is important that the definition of advice be more formally established to align with these instances. This concern extends to the drafting that relates to both the engagement and provision of advice.

3. The **definition of remuneration consultant** does not definitively capture the broad range of advice that can be provided in relation to executive remuneration, such as accounting, taxation, recruitment and legal and therefore needs to be extended.

4. **Strict criminal liability** for remuneration consultants without any defence, and when there is reliance on the organisation to determine and advise the identity of Key Management Personnel (KMP), is an onerous outcome that needs to be addressed. If Boards are under-inclusive in providing their consultants with the identity of their KMPs, or circumstances change the identity of the KMPs originally advised, that should not put consultants at risk of criminal violations.

In relation to these unintended consequences, we provide the following explanation and recommendations.

A.1. Disclosure

While the structure for disclosure as presented is reasonably straight forward, and the intent is understood, we feel the following section could create unintended consequences, particularly with respect to the Board responsibility for use of the advice:

2.6 – "A summary of the nature of the advice and the principles on which it was prepared"

- Many companies have been identifying the use of their remuneration consultants in annual reports for some time now. Based on our experience, companies can present references to the use of remuneration consultants that do not fully articulate the nature or use of the advice. For example, a number of companies would reference Hay Group as providing remuneration advice, where the only commercial arrangement between Hay Group and that company was the purchase of a market database without any supporting advice. There was an implication we had provided advice to these companies when we had not.

- Further, it is also common and absolutely appropriate that Boards may accept all, some or none of the advice provided by a remuneration consultant. The structure for disclosure as outlined focuses only on the nature of the advice, not how or whether the advice was used or not. This could lead to an inference that a Board sought advice widely in defence of their conclusions, when the advice was actually not utilised.

- Lastly, some advice can be commercial-in-confidence – for example, exploratory advice around termination benefits when deciding upon whether to terminate a CEO, which may not have happened by the time the financial year ends; or executive remuneration advice around potential re-structures post purchase of an intended takeover target. Companies will need to be able to not disclose commercial-in-confidence matters.

Recommendations*:*

- We strongly believe that companies need to also disclose whether the advice was followed in full or in part, and how, or whether it was not incorporated into the remuneration decisions of the Board. The disclosure should also not lead to any implication that the advisers support the contents of the Remuneration Report – in our experience this is often not the case.
- Advice that is commercial-in-confidence be excluded from the disclosure requirement.

A.2. Definition of advice

Advice is where an opinion, view or recommendation is provided as to what or how remuneration outcomes are delivered for a *specific* company to reflect their *specific* circumstances. This needs to be distinguished from such activities as:

- the preparation, *purchase and use of generic market data/database/surveys or pre-prepared generic summary* of remuneration data that is sold/provided to companies as a view of the general market without differentiation, perhaps from global sources. This can not be included in the definition of advice as the same data goes to all companies. If remuneration surveys or databases is included or inferred to be included in the definition of advice there would be significant challenges for organisations:

  - Such databases and surveys can provide remuneration data for roles right across organisations, not just executive reward, and can include access to forums and newsletters, and automatically generated outputs. It is normal course for remuneration analysts within organisations to secure these databases for the benefit of remuneration analysis across the whole organisation. As the clause is currently drafted, a remuneration analyst purchasing a database/survey that also includes executive remuneration data could trigger contravention of the clause. This could leave the organisation without the benefit of data for the balance of the roles in the organisation. These databases/surveys are not always easily segmented, and what constitutes "executive remuneration" level remuneration can (and should) vary significantly from company to company depending on the size, scale and nature of such organisations. It would be practically impossible to identify and separate the executive remuneration data from all other remuneration data for other roles.

  - Once sold, organisations are in full control as to how they use, interpret and report the information in those surveys or databases. The company selling the survey or database is not in any control as to how the information is used and who uses the information within the organisation. It would be onerous for that to be included as advice and trigger contravention of the clauses, including criminal liability.

  - Most database/survey providers have a methodology to 'level' or "match' the role in order to decide how it should be included in the database to ensure 'like for like' analysis. This is for purposes of building benchmarks and can not be inferred as advice on what to pay a particular executive in a specific company; and

  - Additionally, the practical reality that Board members would log onto on-line databases and extract data themselves, get subscription details renewed, and provide reciprocal data into the database is impractical and not how a Board member should be spending their time;

- the provision of *broader HR services* that can have a broad range of applications, only one of which may include executive remuneration.

Recommendations:

Given the above potential issues we would recommend that a definition for advice be included where an opinion, view or recommendation is prepared specifically about the remuneration nature, structure, form, treatment, amount or value for ***that company*** **to reflect** ***that company's circumstances.***

A.3. Definition of remuneration consultant

It will be important that there is comfort that this definition of advice captures all of the types of advice provided in relation to remuneration, and is not limited by the statement of the definition such that advice can be characterised, for example, as 'legal' or 'accounting' to manage around this disclosure requirement. For example, tax structuring provided by an accountant or lawyer to optimise the remuneration outcomes; or legal advice on share plan rules. A wide range of advisors can provide remuneration advice – accountants, actuaries, tax advisors, lawyers, specialist remuneration advisors, management consultants as well as recruitment consultants.

Recommendations:

We would recommend that the definition be amended to: **nature, structure, form, treatment, amount or value of remuneration** to provide a more comprehensive definition of what consulting on remuneration matters includes.

A.4. Strict criminal liability

Ensuring the Board has access to independent advice on remuneration is an important way to support the capacity of the Remuneration Committee and Board to make strong and appropriate decisions on executive pay. The Hay Group philosophy is that we work only for companies and not for individuals. We therefore always consider our advice on executive pay from the point of view of the Board and not that of management. For some time we have had a policy that we will only provide information and advice on CEO pay directly to the Board.

Accurate identification of Key Management Personnel by a remuneration consultant represents a difficulty with this drafting, especially given the attachment of a criminal offence. Remuneration consultants are reliant on the Board correctly advising to them the roles that will be constituted Key Management Personnel for the next annual report ahead of the preparation for that report. (It should be noted that the auditor ultimately determines the Key Management Personnel at the time of the audit.) If the Board is incorrect in its assessment and advice to the remuneration consultant, or the Key Management Personnel change in determination, or due to promotion or organisational restructure, it is the remuneration consultant that is guilty of a criminal offence through no fault of their own.

Additionally, it is normal course for remuneration analysts within organisations to use pre-prepared surveys or databases for the benefit of remuneration analysis across the whole

organisation. As the clause is currently drafted, a remuneration analyst using a database/survey that also includes executive remuneration data could end up with the remuneration consultant being in contravention of the clause if that data could apply to that organisation's Key Management Personnel.

Recommendations:

- Removing the strict criminal liability.
- Require Boards to satisfy themselves that they have received independent advice without any influence (aligned to the APRA disclosure requirements – discussed further in Section B).
- Enabling the remuneration consultant to rely on undertakings from the organisation as to the identity of the Key Management Personnel when providing remuneration advice as a defence.
- Amend the definition of advice to be where an opinion, view or recommendation is prepared specifically about the remuneration nature, structure, form, treatment, amount or value for *that company* to reflect *that company's circumstances*.
- Allow the CEO to be part of the work in relation to his/her direct reports. (Discussed further in section B.)

B. Impact on Board and Corporate Governance Protocols

The mechanisms used in the drafting of the amendments challenge many of the governance protocols followed by Boards and Corporates both generally and in the area of executive remuneration. Particularly:

- The role of the Board is to provide *independent review and approval* of key areas of an organisation's strategy and operations, one of which is executive remuneration. This has been achieved in the past by having management provide input and proposals to the Remuneration Committee but ensuring the decisions are made by independent directors. Remuneration Committees can then seek independent advice to use when assessing these proposals. The current drafting represents a forced structural independence that removes the capacity for an independent review, as it forces the Board to conduct the detail of the review, and leaves no party able to review the situation with perspective and distance.

- It is important that the CEO has a voice in the *critical business tool* of company remuneration strategy and policies, plan designs, performance targets and actual pay levels for subordinate employees. Executive remuneration structures are key tools to be used in the management of the enterprise and the CEO should have influence over how they can be used for his/her direct reports. The current drafting removes this business tool from the remit of the CEO in relation to their direct reports. The current drafting would mean that the CEO and HR can not play any role in formalising a contract and remuneration package for a direct report to the CEO – this activity must happen at Board level.

- The Board does not have an *administrative arm or function* to enable the implementation of executive remuneration decisions and outcomes. The drafting will see the time required from Boards increase significantly if they need to take on these aspects – a development that is likely to drive non-executive director remuneration as they make claims for greater compensation for their time! Additionally, the practical reality of work such as short-term incentive design requires remuneration consultants to work with employees of the organisation for access to information and to road test the applicability and relevance of the designs. This forced separation will have numerous practical implications and limitations by prohibiting such normal operating practices that have no impact on decision making, but are essential for practical executive remuneration outcomes.

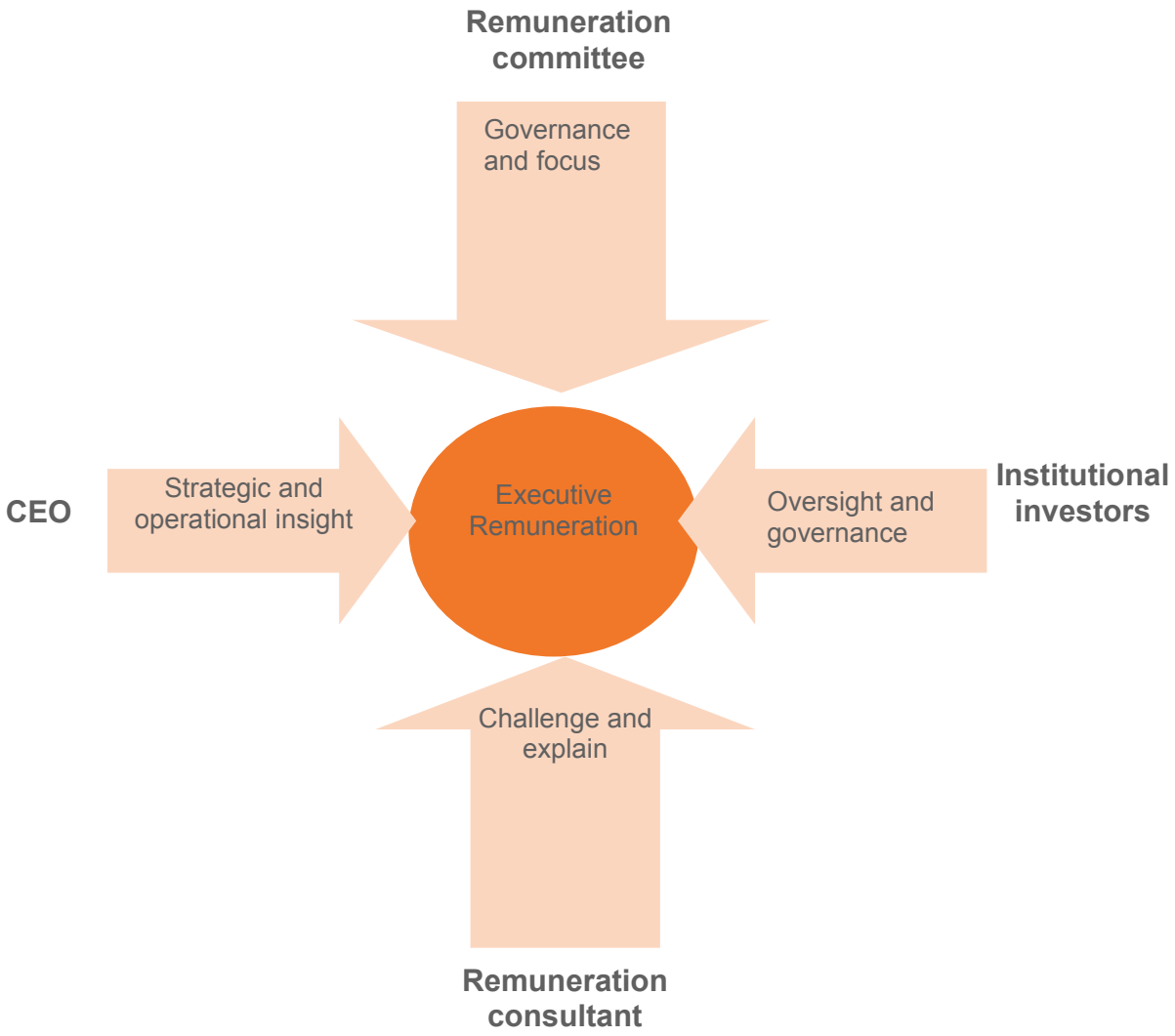
The risk that could emerge from the above is that Boards find it easier to not seek any advice, and do not incorporate market, motivation or organisational drivers into their decision making in the same way that advice can enable. Instead, we recommend it would be preferable to require Boards to satisfy themselves that the advice they have received is independent, which is aligned to the approach APRA is taking in relation to its disclosures.

Recommendations:

- Boards are required to satisfy themselves that they have received independent advice in relation to any executive remuneration matter, without influence from any party.

Set out on the following page below is a best practice outline as to how these governance arrangements should operate to deliver the appropriate balance of independent oversight, use of critical business tools and practical administration.

Executive Remuneration Governance – a best practice model



The remuneration committee – governance and focus

Remuneration committees are accountable for ensuring the executive remuneration outcomes are appropriate for the organisation to support shareholder value creation. Accordingly, their governance approach needs to see them take the lead in the review of the design and implementation of executive remuneration plans.

- All recommendations need to be understood, assessed and challenged to ensure they support the underlying goal of driving long-term increases in shareholder value. Decisions should not be rushed, but made based on discussions with management and in the light of independent advice.

- The remuneration committee must take time to incorporate the understanding they have around the corporation's strategy and the workings of the organisation. Members need to challenge the CEO on priorities and measures of success.
- Boards that limit their use of remuneration consultants to the provision of benchmarking data miss out on valuable expertise. Structuring incentive plans that motivate behaviour to sustain increased shareholder value is a complex challenge. Effective remuneration plans start with an understanding of the company's aims, the structure of individual and team roles and the behaviours and measures of success that will be required. Executive remuneration can then become the lever by which overall goals can be achieved.
- The remuneration committee (or the full board) should review performance in depth with the CEO on a regular basis. This review must cover critical success factors, not just financial results.
- The remuneration committee should meet with consultants to discuss the CEO remuneration plan, without management being present.
- The committee needs to examine the dynamics of performance-related plans to understand how they operate in various scenarios. It isn't enough simply to look at on-target payments or the fair values of long-term incentive grants.
- When considering changes to elements of a remuneration package, committees must look at the impact on the whole package – for example, to understand the impact a salary increase will have on pension entitlements.
- The chairman of the remuneration committee needs to invest substantial amounts of time to ensure that the above all happen and in preparing for meetings of the committee.

The role of the remuneration consultant – challenge and explain

The remuneration consultant's client is the corporation, represented by the board. It is not the CEO or the head of human resources. This holds true even if the remuneration committee has delegated some routine aspects of the relationship to executives, such as providing a briefing or fee payment.

- Consultants can and should use their expertise to do more than give a view of market practice or benchmark data. They should be prepared to challenge the views of the board and management (including on market comparators) to develop a real solution.
- Consultants must ensure that benchmarking comparisons cover truly comparable roles, and consider all aspects of the remuneration package. Where the client organisation specifies a comparator group that includes substantially different roles, the consultant's report must make this clear and state whether the chosen comparator group is endorsed or not.
- Consultants must give clear explanations of data being presented, without assuming that busy non-executive directors always understand jargon, methodologies and assumptions made.
- Individual consultants responsible for executive reward advice should not also be responsible for other services provided to management by their consulting firm, and firms should have clear protocols on how they prevent conflicts of interest.
- The consultancy firm should have clear principles for the advice it gives on executive remuneration, conducting peer reviews or setting up other quality assurance processes to ensure those principles are followed.

The role of the CEO – strategic and operational insight

The CEO's role is a vital one in ensuring executive reward drives personal and corporate performance in line with strategic objectives.

- The CEO has primary responsibility for ensuring the remuneration committee and remuneration consultants understand the strategy and key drivers of value, and have enough insight into the workings of the organisation.
- CEOs should agree priorities and plans with the remuneration committee to identify the critical success factors relevant for performance assessment, including all drivers of value creation.
- CEOs should keep the board and remuneration committee updated on progress towards achieving financial and strategic priorities – rather than taking priorities as 'set and forget'
- The remuneration committee will usually benefit from advice from the CEO on rewards for other top executives, but not their own to avoid any potential conflicts of interest.

The role of institutional investors – oversight and governance

Institutional investors have a critical role to play in reinforcing a shareholder perspective and maintaining a two-way dialogue between the board and shareholders.

- Institutional investors should insist that the board operates high standards of corporate and internal governance, including risk management. They should expect transparent dialogue on remuneration policies.
- Investors should avoid the temptation to want to manage remuneration plans – this is the role of directors, who are best placed to make the balanced judgments required. However, investors should hold directors accountable and take action if they are dissatisfied with the direction or outcomes of pay structures, for example through an advisory "say on pay" vote or voting against directors standing for re-election.
- Investors can be most effective where they are focused on changing poor practices that have become widespread. Individual companies may be reluctant to alter their practices unless they think other companies will do the same – investor pressure can force boards to 'lead the market' by discarding bad practices, as happened in the UK with the ending of three-year rolling contracts.

Chapter 4 - Prohibiting hedging of incentive remuneration

New law	*Current law*
Prohibit key management personnel (and closely related parties) from hedging remuneration that depends on the satisfaction of a performance condition.	Key management personnel can hedge their exposure to remuneration, and must disclose the company's hedging policy in the annual report.

We strongly support this new law.

Although we are not aware of this issue being a common problem, the objectives of incentive plans linked to the company share price are severely compromised if the executives are able to transfer the share price risk to a third party. Many of our clients already have policy and/or plan rule prohibitions against the use of hedging however they have limited enforcement capacity unless they become aware of the hedging before vesting. The Corporations Act will provide a more rigorous level of sanction.

Chapter 5- No vacancy rule

New law	*Current law*
Public companies will be required to obtain the approval of its members for a declaration that there are no vacant board positions, should the number of board positions filled be less than the maximum number specified in the company's constitution.	There is no current law equivalent to this provision.

We support this new law.

It may discourage unnecessary barriers to Board diversity. We have some reservations that it may lead to larger Boards and reduce the flexibility of Boards to manage renewal and replacement of specialist skills. The negative consequences for some companies could be greater than the benefits.

Chapter 6 - Cherry Picking

New law	*Current law*
Proxy holders will be required to cast all of their directed proxies on all resolutions.	Proxy holders, other than the Chair, are not required to cast all of their directed proxies on all resolutions, but may choose which proxies to cast.

We strongly support this new law.

Shareholders who give directed proxies would expect that those votes will be voted in line with their expressed wishes. The concept of directed proxies is somewhat outdated and electronic voting provides a more direct mechanism for shareholders to express their views on company meeting resolutions. While directed proxies are supported as a voting mechanism they should be exercised.

We share the Commission's view that appropriate provisions could be framed that would legitimise a failure to vote in specific circumstances when the proxy holder was acting in good faith.

Chapter 7 - Persons required to be named in the remuneration report

New law	*Current law*
Remuneration disclosures will be confined to key management personnel of the consolidated entity.	Remuneration disclosures apply to key management personnel of the consolidated and parent entities (and the five most highly remunerated officers, if different).

We strongly support this new law.

The current dual criteria for disclosure are confusing and unnecessary. The important governance issue is related to the remuneration of those executives actually running the company – the key management personnel. They will typically be among the highest paid but there are occasionally specialist staff who are also very highly paid but not in the key managerial roles. Disclosing remuneration for these other employees is about public fascination rather than governance.