



# Impact of regulatory reforms on executive remuneration in Australia — AGMs in 2011

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- ‘No’ votes on remuneration reports at several AGMs, some precipitated by a very small proportion of shareholders
- Operation of two-strikes rule still ambiguous
- Translation of the two-strikes rule from theory into practice has highlighted the rule’s potential to be destabilising and may have unpredicted impacts such as inflated remuneration

incentives to promote responsible behaviour rather than unrestrained greed’ and to assist organisations regulated by APRA to ‘[manage] prudently the risks that may arise from their remuneration arrangements’<sup>2</sup>, support compliance with various APRA standards<sup>3</sup>, as well as provisions of the *Corporations Act 2001* (relating to disclosure), Principle 8 of the ASX Corporate Governance Council’s Principles and Recommendation.

Notably the Guidelines highlight board responsibility to ensure that directors are not placed in a position of real or perceived conflict of interest and provide some procedures, controls and oversight of remuneration to comply with the requirements of APRA’s Guidelines.<sup>4</sup>

## **There has been much discussion about executive remuneration and whether it was a contributing factor to the global financial crisis (GFC).**

In Australia, as in the United States, Europe and the United Kingdom, regulatory reforms were undertaken to address concerns raised about remuneration practices said to encourage excessive corporate risk taking and excessive remuneration of executives, paid irrespective of a corporation’s performance. Are those reforms working? There is no better place to start than with a look at the 2011 annual general meeting (AGM) season.

The following analysis takes you through Australia’s key regulatory reforms and examines the 2011 AGM season in light of reforms, in particular the two-strikes rule — the first of the reforms to have a readily measurable impact.

## **APRA Guidelines**

The Australian Prudential Regulation Authority (APRA) developed a set of Guidelines<sup>1</sup> to provide what former Prime Minister Kevin Rudd called ‘clear

## **Corporations Act amendments**

Reform around executive remuneration aims to ‘strengthen corporate governance to improve how boards set remuneration and engage with shareholders’.<sup>5</sup> For example, in its report on executive remuneration, the Productivity Commission noted that:

- remuneration practices should avoid creating conflicts of interest, for example, executives voting on the remuneration report at the AGM
- companies need to create ‘well designed pay structures [which] facilitate alignment of interests’<sup>6</sup>. For example, remuneration reports should be clear and disclose in greater detail remuneration of key management personnel (KMP)<sup>7</sup>
- there should be greater shareholder engagement — ‘better signalling mechanisms, voting opportunities and processes, and audit trails’, along with a need for shareholders to understand how remuneration of executives aligns with their interests through more effective disclosure.<sup>8</sup> This is where the two-strikes rule comes into play.



Regulatory changes in Australia, aimed at achieving the outcomes above, are summarised below. The new rules:

- apply to remuneration of KMP
- are focused around *remuneration recommendations*<sup>9</sup>
- ban KMP and their closely related parties (spouses, children, dependents, family members — in some circumstances — or companies controlled by the KMP) from entering into remuneration arrangements that *hedge KMP's remuneration*.<sup>10</sup> Significantly, the ban creates a strict liability criminal offence. That is, intention is not relevant. Criminal liability for a breach of the provision extends to a closely related party of KMP such as a spouse or a dependent<sup>11</sup>
- introduce significant changes in relation to *remuneration recommendations* for KMP at disclosing entities<sup>12</sup>, including regulation of remuneration consultants and their appointment and provide serious consequences for a breach (failure to comply with rules in relation to appointment of consultants is a strict liability offence on the part of the company)<sup>13</sup>
- reduce the threshold to one year's base salary for shareholder approval of termination payments and broaden the definition of termination benefit<sup>14</sup> to discourage excessive termination payments, or golden parachutes, being paid to outgoing executives
- build on the non-binding shareholder vote on the remuneration report introduced in 2005 through the two-strikes rule.<sup>15</sup> Relevantly, KMP whose remuneration may be disclosed in the remuneration report (or their closely related parties) and who hold shares in the company are excluded from voting on a resolution about their remuneration.<sup>16</sup> Again, failure to comply is an offence.<sup>17</sup>

The *two-strikes rule*<sup>18</sup> operates as follows.

- If 25 per cent or more of shareholders who vote at the AGM (KMP and closely related parties, whose remuneration may be covered in the Remuneration Report and who own shares are excluded from voting), vote down the remuneration report, the next year's remuneration report must explain how shareholder comments at the previous AGM have been addressed.
- If at the next year's AGM, more than 25 per cent of shareholders who vote again vote down the remuneration report, a spill resolution is put to shareholders.
- If the spill resolution is passed by 50 per cent of shareholder votes, the directors who approved

the second remuneration report will have to stand for re-election.

### Will giving shareholders a say on pay help bring about change?

Some research supports the two-strikes rule. A recent study looking at CEO remuneration packages post-GFC has shown that internal corporate governance such as independence and expertise of the remuneration committee did not have a significant influence on CEO remuneration, rather it was more powerful groups of shareholders, such as institutional investors, who could influence the structure of the CEO's remuneration.<sup>19</sup>

The question remains however: is the two-strikes rule an effective vehicle for shareholders to exert influence?

### Key concern — ambiguity on chair's ability to vote undirected proxies on any resolution to adopt remuneration report

It is unclear whether a chair is prohibited from voting undirected proxies on any resolution to adopt the remuneration report if their remuneration details are included in the remuneration report.<sup>20</sup>

The Australian Securities & Investments Commission (ASIC) has reported that the government proposes 'to amend the law to make it clear that a chairperson is permitted to vote undirected proxies that have been vested in them, provided there is express authorisation by the shareholder'.<sup>21</sup>

Clearly this is an area in which the recent regulatory reforms are unclear. Companies and directors are now in the difficult position of determining how to comply with the new rules, with very little guidance and potentially very serious consequences.

ASIC has published some suggestions for dealing with the uncertainty, including the following options:<sup>22</sup>

- the chair not vote any undirected proxies on the remuneration report and advise shareholders that their votes will not be counted if they provide an undirected proxy on the remuneration report
- altering the proxy form such that a shareholder not voting on the proxy appointment form will not result in the shareholder's vote being undirected and not counted
- inserting wording on the proxy form explaining to a shareholder that their failure to vote either 'for' or 'against' will be taken as a direction to



**Table 1: Shareholder 'no' votes on remuneration reports at selected company AGMs in 2011**

|                               |     |                         |     |
|-------------------------------|-----|-------------------------|-----|
| Globe Australia Pty Ltd       | 74% | BlueScope Steel Limited | 38% |
| Clean Global Energy Limited   | 64% | Tassal Group Limited    | 37% |
| Ellex Medical Lasers Limited  | 62% | News Limited            | 35% |
| Crown Limited                 | 55% | Nexus Energy Limited    | 35% |
| Pacific Brands Limited        | 53% | UGL Limited             | 34% |
| Scantech Limited              | 52% | Watpac Australia        | 34% |
| Austock Group Limited         | 46% | Sirtex Medical Limited  | 33% |
| GUD Holdings Limited          | 45% | Carbon Energy Limited   | 28% |
| Cabcharge Australia Limited   | 40% | DEXUS Property Group    | 28% |
| Fleetwood Corporation Limited | 39% | Emeco International     | 26% |
| Paladin Energy Ltd            | 39% | Perpetual Limited       | 26% |

the chairperson to vote in accordance with the chairperson's voting intention

- shareholders nominating a proxy, for the purpose of voting on the remuneration report, who is prohibited from voting on the remuneration report.

## What happened at AGMs in 2011?

Table 1 summarises shareholder 'no' votes on remuneration reports at some 2011 AGMs.<sup>23</sup>

### Crown Limited

A microcosm of the two-strikes rule in operation can be observed at the Crown AGM. After shareholders voted against Crown's remuneration report, James Packer (Crown casino executive chairman and 46 per cent shareholder) is reported to have told shareholders that in the event that shareholders vote against the remuneration report again in 2012, triggering the two-strikes rule and resulting in a board spill, he 'will use [his] votes [as 46 per cent shareholder] to ensure all directors are voted back in immediately'.<sup>24</sup>

Packer's comments reflect the incongruities of the two-strikes rule — even if shareholders vote 'no' resulting in a board spill, a majority or large shareholder can vote the board back in, neutralising the teeth in the reform — a board spill.

Interestingly, when comments made by Crown shareholders are analysed, it appears that the 'no' vote was born of shareholder concerns about Crown's disclosure standards for remuneration, rather

than the amount or manner in which executives were to be paid. For example, a representative of Perpetual (who did not vote against the report on the basis that Mr Packer does not take a salary), reportedly Crown's largest shareholder after Mr Packer, commented that 'this is an issue of disclosure ... the vote should result in the company increasing its disclosure around these issues'.<sup>25</sup>

The Australian Shareholders' Association reportedly considered that Crown's executive remuneration was not excessive. Rather, its concerns went to the lack of transparency in Crown's incentive plan because specific performance hurdles, their weightings and executives' performance were not disclosed.<sup>26</sup>

### Watpac Australia

Another area for concern is the power that the two-strikes rule can give a small percentage of shareholders and the associated potential for destabilisation. This was highlighted at Watpac's AGM where 8.37 per cent of shareholders voted against the remuneration report. This translated into a 34 per cent 'no' vote.<sup>27</sup>

On closer examination, it appears that some small retail shareholders and at least one corporate governance adviser supported some of Watpac's proposed increases in executive remuneration. For example, there was support for an increase in the non-executive directors' fee pool from \$800,000 to \$1.1 million. However, other increases were not supported; for example, the managing director's remuneration was reported to be relatively high.<sup>28</sup>



Kevin Seymour, Watpac's Chairman and largest shareholder with 15 per cent of company shares was highly critical of the two-strikes policy. In an ASX release shortly after the AGM, Seymour explained to shareholders that:

- there had been a reduction in KMP remuneration in 2011 compared with 2010 and no bonuses were paid as performance targets were not met
- directors took a voluntary reduction in remuneration during the GFC and their remuneration in 2010 was less than in 2008
- he made no apology for the modest payments received by executives and staff, which are fair and, in the case of directors, conservative.<sup>29</sup>

Watpac argued it adopted a conservative remuneration policy and is acting to the benefit of shareholders. For just eight per cent of shareholders to be able to cause a 'no' vote reflects the possibly destabilising nature of the two-strikes rule. The potential for instability was also separately identified as a concern by the Chairmen of both Stockland and QBE Insurance.<sup>30</sup>

### Emerging patterns and unforeseen side-effects

The potential for destabilisation was also reflected at Globe's AGM, where the 'no' vote resulted from only 8.2 per cent of shareholders votes, 5.8 per cent of which are owned by Solomon Lew. Speculation was that the vote was part of a move by Lew to take control of Globe.<sup>31</sup>

An area for serious concern is the thought that the reforms may, through the new disclosure requirements, lead to *increases* in executive salaries. Belinda Hutchinson, QBE Chairman, gave the example of a CEO paid a relatively limited amount who 'the minute this transparency came in ... wanted to be paid what everyone else was being paid'.<sup>32</sup>

It appears that many of the companies which faced scrutiny over their executive remuneration practices have large boards (that is, an average of nine members). This scrutiny may reflect suggestions that:

- firms with large boards tend not to perform as well as firms with small boards (for example, an average of six members)
- large boards are less likely to fire the CEO when the firm isn't performing well (particularly where board members, including the CEO, have substantial shareholdings)

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- large boards are less likely to remunerate members using incentive payments
- large boards tend to be cautious (because they need agreement from more members) and take fewer risks, resulting in decreased company performance.<sup>33</sup>

Following the 2011 AGM season, Martin Tolar, Chief Executive Officer of the Australasian Compliance Institute, commented that 'recent coverage of shareholder deliberations on executive remuneration packages as part of this year's seasons of [AGMs] highlight the shortcomings of the recently enacted two-strikes policy rules'.<sup>34</sup>

However, in some cases the reforms appear to have been successful. For example, Transurban, the company (dubbed a 'repeat offender'<sup>35</sup> following its failure to obtain shareholder approval for its remuneration reports since the introduction of reforms in 2005), undertook reform of its remuneration practices and improved shareholder engagement.

Following that reform, Transurban obtained shareholder approval of its executive pay arrangements. Chairman Lindsay Maxsted reportedly commented that 'it's good to know if you go about business the right way, and consult and it's appreciated, it's good to get the result'.<sup>36</sup>

Overall, we can make some observations about the 2011 AGM season.

- Some companies have moved towards greater transparency around remuneration decisions and have taken steps to ensure that principles and reasoning behind remuneration decisions are more effectively communicated to shareholders. Proxy advisers are reported as taking the view that the consciousness of company directors has been dominated by developing remuneration policies.
- Shareholders are prepared to use a protest vote to send a message to companies about their remuneration practices. However, it will take until next year's AGMs to understand properly the impact of the two-strikes reforms.

- The translation of the two-strikes rule from an idea into action is problematic. It has the potential to be destabilising and may have unpredicted impacts such as inflated remuneration.
- Where executives hold a large percentage of shares, the shareholder vote on the remuneration report may have no real impact.

## Conclusion

The GFC has been described as revealing a failure on the part of companies to pay proper attention to risk in the face of 'substantial personal incentives created by performance based pay schemes'. As Citigroup's CEO, Charles Prince, famously said, 'it was rational to keep dancing as long as the music played'.<sup>38</sup> It is that attitude, along with pay structures that encouraged high risk taking, win-at-all-costs behaviours that many argue need to be addressed by reforms.

However, Australia is in a unique position. The economy has been performing well, better the UK, US and Europe. Additionally, Australia has a strong prudential and regulatory framework. Following the post-GFC calls for changes to regulation of executive remuneration, APRA has introduced new guidelines and there have been two waves of reform to the Corporations Act, with more to follow.

Each of those reforms is targeted at increasing transparency, improving communication with shareholders and, in the case of remuneration reports, giving shareholders power to communicate their approval or otherwise of remuneration practices. Given the outcomes of the 2011 AGM season, the current two-strikes rule may not achieve that goal.

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## Notes

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- 2 *ibid*, p 3
- 3 Prudential Standard APS 510 — Governance, Prudential Standard GPS 510 — Governance, Prudential Standard LPS 510 — Governance
- 4 PPG 511, p 5
- 5 Productivity Commission, 2009, *Executive Remuneration in Australia*, Inquiry Report No 49, p 357

- 6 *ibid*
- 7 *ibid*, pp 376–377
- 8 *ibid*, p 357
- 9 s 9(B) Corporations Act
- 10 s 206J(1)
- 11 s 206J(6) and (7)
- 12 Part 2D.8 Corporations Act
- 13 s 206K
- 14 ss 200 and 200AB
- 15 s 250R(4)–(9) Corporations Act
- 16 *ibid*
- 17 s 1311(1)
- 18 ss 250BD, 250R, 250U, 250V, 250W, 250X and 300A
- 19 Nelson J, Gallery G and Reza P, 2011, 'The impact of corporate governance on CEO remuneration structures in the aftermath of the GFC', [www.afaanz.org/openconf/2011/modules/request.php?module=oc\\_proceedings&action=view.php&a=Accept+as+Paper&id=220](http://www.afaanz.org/openconf/2011/modules/request.php?module=oc_proceedings&action=view.php&a=Accept+as+Paper&id=220) [27 January 2012], p 11
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- 33 Swan P, 2011, 'Big boards invite two-strikes', *The Australian Financial Review*, 27 October
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- 36 *ibid*
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- 38 Winter J, 2011, 'The Financial Crisis: does good corporate governance matter and how to achieve it', Duisenberg School of Finance, DSF Policy Paper no 14, p 4, [27 January 2012] ■