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Dear Sir or Madam

Submission on Exposure Draft of the Corporations Legislation Amendment (Remuneration Disclosures and Other Measures) Bill 2012

1 Summary

This submission is made by the Head Office Advisory Team at Herbert Smith Freehills in response to the Exposure Draft of the Corporations Legislation Amendment (Remuneration Disclosures and Other Measures) Bill 2012 (**Exposure Draft**) released by Treasury on 14 December 2012. Although the Exposure Draft addresses a number of topics[1], we have limited our submission to the remuneration disclosures aspect of the Exposure Draft, specifically s300A(1)(ca).

In summary, our position is that the proposed remuneration outcomes disclosure requirements should not be introduced. We are concerned that the proposed disclosure requirements under s300A(1)(ca), as currently drafted, will not improve disclosure or provide greater links between pay and performance. Instead, we consider that the changes will further complicate Remuneration Reports and undermine the efforts that companies have voluntarily taken to improve their remuneration disclosures (in particular through the use of 'actual remuneration' tables).

The issues we focus on in this submission are:

1 **Section 300A(1)(ca) (disclosure of past, present and future pay) is a flawed concept:** As currently drafted, this provision will be burdensome, difficult to implement and difficult to understand. In our view, it is unlikely to lead to meaningful disclosures which provide shareholders with a clear understanding of the relationship between performance and remuneration outcomes in respect of the financial year being reported on;

2 **'Actual remuneration' tables as the unintended casualty of the proposed changes**: Following the introduction of the two strikes rule, boards are even more accountable to shareholders for their remuneration reporting practices. The increasing use of 'actual remuneration' tables in Remuneration Reports demonstrates that many companies are already identifying innovative ways to improve their executive remuneration disclosures and meet shareholders' expectations in this regard. These voluntary practices which have proved beneficial for shareholders, are likely to be displaced by the new requirements; and

[1] We note that the Exposure Draft proposes changes to the *Corporations Act 2001* (Cth) ('the Corporations Act') in four key areas: the dividend payments test, remuneration disclosures, termination benefits disclosures and remuneration clawback.

3 **The ongoing evolution of reporting practices in Australia:** In our view, this is not the time to introduce prescriptive legislative provisions which depart from, and impede, the evolution of current remuneration reporting practices. If a new requirement is introduced, we believe that it should be principles-based, so that companies have appropriate discretion to adopt an approach that is best suited to their particular remuneration structure and most likely to result in meaningful disclosures for their shareholders.

2 Section 300A(1)(ca) is a flawed concept

The Exposure Draft proposes to amend the Corporations Act through the insertion of s300A(1)(ca), which would require companies to disclose remuneration outcomes for each member of its key management personnel (**KMP**) in the categories of past, present and future pay. These categories are derived from the report on executive remuneration published by the Corporations and Markets Advisory Committee (**CAMAC**) in 2011. CAMAC's review of Australia's executive remuneration framework was conducted in response to the Productivity Commission's (**PC**) 2009 Inquiry Report 'Executive Remuneration in Australia'.

In our view, the Exposure Draft fails to build upon the PC's findings or recommendations. In this section we consider the ways in which the Exposure Draft diverges from the core aims of reform as expressed in the PC report: simplifying disclosures and enhancing their usefulness for investors.

(a) Section 300A(1)(ca) disclosures will not meaningfully show alignment between pay and performance

The driving policy objective behind remuneration outcome disclosures should be to ensure that shareholders and other users of the Remuneration Report are able to meaningfully assess how a company's performance aligns with the remuneration outcomes of its senior executives in respect of the reporting period. The PC report recognised this.

The proposed section 300A(1)(ca) does not achieve this objective because it:

- combines pay that has crystallised and pay that is yet to crystallise in a single table;
- results in 'double counting' of amounts in successive years, distorting total figures disclosed; and
- uses imprecise terms such as 'paid' and 'granted', which are capable of multiple varying interpretations.

Companies set up remuneration structures to deliver reward over staggered cycles reflecting short and long term business horizons. The aim of any remuneration outcomes disclosure should be to isolate the value of remuneration an executive becomes entitled to (i.e. that ceases to be "at risk", even if the value has not yet been paid or realised) in the year being reported on. When combined with an explanation of the remuneration cycle and the time horizons over which different remuneration components are delivered, shareholders can use this information to assess whether executives' remuneration outcomes align with the performance of the company.

Rather than recognising the inherent limitations of any 'one size fits all' approach in capturing the nuances of a company's remuneration structure and the inadequacy of Accounting Standards to give shareholders a clear understanding of remuneration outcomes as they relate to performance, the Exposure Draft instead adds complexity with a further layer of disclosure. There is also extensive overlap with existing provisions of the Corporations Act, such as disclosure of grants of remuneration made and equity that has vested during the year.

(b) Practical example of difficulties in the application of s300A(1)(ca)

Short term incentives (**STI**) are a central component of most ASX200 companies' remuneration policies. Because STI is almost always tested over a full year's performance, the date at which performance is tested for the purposes of determining the

STI is often in a different financial year to the year in which the performance actually occurred. In addition, it is not uncommon for some or all of the STI to be deferred into equity, which is subject to a holding period. In this case the executive is not 'paid' anything in the sense of having an immediate and present entitlement to the equity until the end of the holding period – which again, is likely to be in a different financial year.

In the above scenario the relevant STI award would be reported in up to three remuneration reports – future pay in year one, past pay in year two (in relation to the cash component of the STI) and past pay in year three or four (for the deferred component). In our view, this would undermine the link between performance and remuneration outcomes and obscure the real value of the particular benefit as received in the hands of the executive in the relevant reporting period. While companies may try to address these shortcomings by including additional disclosures to explain the 'double up' in remuneration, there is a high risk that shareholders will nonetheless misunderstand the figures and believe that the company is paying inflated remuneration amounts.

(c) No guidance regarding valuation

There is no guidance in the Exposure Draft in relation to how companies are to value equity components granted during the reporting period. Whilst we understand that the purpose of these disclosures is to provide an alternative (and ostensibly clearer) figure than appears in the statutory accounting tables, it is not certain what valuation methodologies companies are meant to apply – for example, whether the Accounting Standards concept of "fair value" are to apply to these disclosures, or some other methodology (and if so, which one?).

(d) Failure to recognise the multi-dimensional nature of executive remuneration

The current remuneration landscape is complex and comprises numerous equity and non-equity based components. The goal behind any remuneration disclosure regime should be to distil these components into something that is clear, relevant and transparent for shareholders. In our view, s300A(1)(ca) fails in this regard given its inherent ambiguity and overlapping disclosure requirements.

Investors need to have a company's remuneration structure clearly explained to them. Attempting to implement a 'one size fits all' disclosure requirement for the purposes of comparison does not recognise the complexity of those structures and the need for companies to be able to select the best method for explaining the particular remuneration structure they have chosen.

3 'Actual remuneration' tables - an unintended casualty

As foreshadowed by the CAMAC report, the introduction of the two strikes rule has had a significant impact on Australia's remuneration disclosures regime.[2] Reporting practices have continued to evolve as companies strive to meet investor expectations by bringing greater transparency to their remuneration disclosures and providing more specific links between pay and performance.

Voluntary 'actual remuneration' tables have emerged as one way in which companies can communicate meaningfully with investors and provide the information that shareholders want to see that is not communicated in the statutory tables. The 'actual remuneration' tables typically break down remuneration into the cash, equity and other benefits to which an executive became entitled during the reporting period (irrespective of whether the executive 'crystallised' their reward or received their payment during the period). The approaches for classifying and quantifying remuneration components have varied between companies and there is no single approach that has become the "standard" for actual remuneration disclosures. Indeed, the absence of any prescriptive requirements has allowed companies to tailor their approach to best reflect their remuneration practices (recognising that it is in a company's interests to ensure that it presents the information as clearly and consistently as possible, so that shareholders understand and support its Remuneration Report).

[2] Corporations and Markets Advisory Committee, Parliament of Australia, *Executive Remuneration Report* (2011) 76

The use of 'actual remuneration' tables has been favourably received by shareholders. All but one of the ASX20 companies that included these voluntary disclosures in their last remuneration report received a vote in favour of their remuneration report of 90% or more, with two thirds receiving a vote of 95% or more.

We expect that companies will stop using 'actual remuneration' tables if they are required to also produce another remuneration outcomes table under s300A(1)(ca), as it would be difficult to explain to shareholders how three different sets of figures could be reconciled. We consider that the loss of the 'actual remuneration' table would be a detrimental outcome for shareholders.

4 The ongoing evolution of reporting practices in Australia

The increasing use of 'actual remuneration' tables in remuneration reports demonstrates that many companies are responding to the external motivation of the two strikes rule and are identifying innovative ways to improve their executive remuneration disclosures and meet shareholders expectations in this regard.

In our view this is not the time for intervention in the form of binding legislation. This accords with the view of CAMAC in its report:

> *… remuneration reporting practices are likely to change or evolve over the next few years in response to the two strikes rule. CAMAC considers that, once the rule has been in operation for a few years, it would be appropriate to draw on the evolving remuneration reporting practice as the basis for replacing s300A and the Regulation with a non-prescriptive approach to remuneration reporting.*[3]

It is our submission that the proposed reporting requirements in s300A(1)(ca) neither draw upon, nor allow for, further evolution of current reporting practices. Instead the gains in transparency and the recent positive developments in reporting practices are likely to be overshadowed by the new requirements.

We are aware that some stakeholders have suggested that the Exposure Draft be replaced by the 'total remuneration figure' approach adopted by the UK remuneration reforms. In our view, this approach is still untested and also highly prescriptive – and whilst it avoids the problems with 'double up' disclosures that the s300A(1)(ca) formulation would create, we would not favour adoption of a similar rule in Australia at this time.

If there is a perceived need to introduce new regulations, we consider that a principles-based requirement would be simpler, cleaner and more appropriate. For example, a requirement could be introduced for companies to explain how the remuneration outcomes for executive KMP align with the company's performance. A company could choose to explain its remuneration structure through whatever combination of tables, graphs and narrative it considered appropriate. If shareholders weren't satisfied with a company's explanation (either because it is inadequate or because they are not satisfied with the level of alignment being achieved), they could vote against the Remuneration Report (which would soon achieve a shift in practice). This would be far preferable to a 'one size fits all' approach that risks fitting nobody.

[3] Corporations and Markets Advisory Committee, Parliament of Australia, *Executive Remuneration Report* (2011) 76

Yours sincerely

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