10 March 2013

Mr Scott Rogers
General Manager - Corporations and Capital Markets Division
The Treasury
By Email: corporations.amendments@treasury.gov.au

Dear Mr Rogers,

Re: Corporations Legislation Amendment (Remuneration and Other Measures) Bill 2012

Regnan represents investors with long term stakes in public companies, and obligations as fiduciaries to assure themselves of the governance arrangements in these companies. Executive remuneration arrangements are among these. Regnan has been analysing remuneration practices and disclosures in this context for more than a decade[1].

The Corporations Legislation Amendment (Remuneration and Other Measures) Bill 2012 ("*The draft Bill")* proposes, among other things, reforms intended to improve and streamline executive pay disclosures to shareholders.

It is important to recognise that investors have a number of distinct information needs that remuneration disclosures should address. We set out below a series of questions against which disclosures, as stipulated by the Bill, should be tested. The extent to which these are presently addressed varies greatly, and we would caution that any reforms should take particular care to address those where the gap is greatest.

[1] Prior to 2007, Regnan was the BT Governance Advisory Service.

1. **How much does executive pay cost us?**

Shareholders require all information relevant to understanding the probable and maximum cost to them of executive pay arrangements, whether direct or indirect (for instance through potential dilution of equity where grants consist of company securities issued to the executive).

Regnan views this as among the better addressed of the information needs, although we would note exceptions (such as companies that do not disclose maximum potential incentives that an executive might achieve).

2. **What does this pay structure reward?**

Incentive payments (generally short and long term incentives) for executives are often explained as a means of "aligning" executive interests with those of shareholders, typically through elements that correlate with shareholder returns or other financial measures. An extensive body of research calls into question whether such arrangements do in fact promote (or even reward) executive performance. Some of this research is summarised in the attached Regnan working paper *Evidence Based Pay – Remunerating for shareholder value.*

However where incentive payments are nonetheless employed as part of pay packages, it is imperative that investors be provided with the information necessary to assess for themselves the extent to which both the various elements and the overall mix align with stated corporate strategy. Because such pay structures can support or negate the disclosed strategy, this is important corroborating information for investors. For instance, a pay structure that rewards earnings growth irrespective of impacts on the balance sheet might not support a company's stated objectives for organic growth, and may consequently contribute to an investor's reassessment of the suitability of the investment for their own objectives.

Regnan notes that significant progress has been made towards disclosures offering improved information on this subject. Notable gaps remain, however, particularly adequate explanations of the hurdles against which executive performance is assessed for short term incentives. While in many cases we recognise that disclosing such targets might involve divulging information to competitors, Regnan sees no reason why boards should not disclose the hurdles, and executive performance against them, after the fact, in order that shareholders may assess these.

3. How does this executive pay structure contribute to talent management?

Overemphasis on the questions of *cost to shareholders,* and *what it rewards* has resulted in near-total neglect of a more fundamental question about how executive pay arrangements support the company's overall talent strategy, including the recruitment, management, and retention (or eventual separation) of executives. This is the question that is most germane to shareholders' understanding of the boards' efforts on their behalf, and one that remains least well addressed by corporate disclosures.

Many remuneration conventions are based on discredited fallacies (also summarised within Regnan's working paper *Evidence Based Pay – Remunerating for shareholder value)* about the impact of particular executives on corporate results, the scarcity of suitable talent, and the impact of incentives on human motivation and performance. Investors should be able to observe the reasoning underpinning pay structures in order to assess its merit. In order for this to be possible, the rationale for each pay element and the overall mix should be clearly disclosed.

E.g. Payments that depend heavily on factors outside an executive's control (for instance the ubiquitous use of total shareholder return relative to competitors as a hurdle for long term incentives) cannot be properly understood as "incentives" so would seem to be means by which to pay executives more in good times. This can contribute to pro-cyclical talent management pressures (inflation / retention) without meeting stated objectives of promoting performance. Disclosure of the rationale for such payments allows investors to assess the merit of such an arrangement in delivering the stated objectives (in this case, incentivising additional efforts from the executive).

4. **How reasonable is the amount received?**

Importantly, this question is distinct from the earlier question about costs to shareholders; it instead looks to address externalities. High executive pay packages have at times been linked to critical media reportage, industrial action, customer dissatisfaction and political impetus for regulatory intervention, often associated with a perception that executive pay has become divorced from appropriate benchmarks against which an executive's efforts should be compared.

Such stakeholders (who may or may not also be shareholders) may be applying a lens to the issue of executive pay that encompasses considerations of fairness, wage justice, social cohesion and related issues, however the resulting tensions pose risks to and impose costs on companies (and consequently, their investors). For instance, general wage inflation within a larger company can dwarf the executive pay that triggered it. Clear information about the total *received* by executives of public companies (whether earned in present or prior periods) is a necessary defence against inaccurate representation of these amounts by stakeholders, whether mischievous or unintended. It should be noted that this does not require a "single figure" summary.

Regnan trusts these observations will be useful in testing the effectiveness of the Bill in ensuring the various distinct information needs and concerns of investors are addressed by the proposed reforms.

Yours sincerely,

Amanda Wilson
Managing Director
Regnan - Governance research and engagement
www.regnan.com
+612 9299 6999

Attachment: Regnan working paper *Evidence Based Pay – Remunerating for shareholder value.*

Evidence-based pay: Remunerating for shareholder value (working paper)

Executive Summary

In its long history of engaging with companies, Regnan has found that amongst asset owners, fund managers and company directors, few subjects are as likely to cause angst as executive remuneration.

However, a commercial, evidence-based approach should view executive remuneration as just one among many components of talent management. The most important consideration when formulating and evaluating a remuneration plan should be its fitness for this purpose.
In practice, this is likely to mean pay arrangements can and should differ according to individual and organisational circumstances. In many cases, amplifying the extent to which pay varies with shareholder returns will be counterproductive for shareholders. The orthodoxy around aligning executives with shareholders is based on fallacies about attribution of performance, alignment of interests, and the psychology of incentives.

This paper argues that:

- CEOs alone, other than in very rare circumstances, are not solely responsible for corporate performance, and should not be rewarded as such;
- In response to the excesses preceding the GFC, the design and implementation of executive remuneration structures has been overwhelmed by technical "fixes", rather than an examination of the underlying premise of such arrangements;
- These "fixes" have led to a herding mentality with regard to structuring pay, universalising particular features that are neither relevant, appropriate to existing business (or executive) needs, with the potential for value-destructive unintended consequences;
- The over-engineering of executive pay, the subsequent complexity in disclosure, and, the inherent outcomes – other than in rare circumstances - do not serve the interests of genuine *long term* shareholders.

In short: restraint, simplicity and fitness for the talent management task are key to ensuring the remuneration arrangements support the interests of long term investors.

Introduction

The financial crisis highlighted numerous examples of listed companies' senior executives being handsomely rewarded despite decisions and behaviours demonstrably damaging to company value. Understandably concerned, investors have sought ways to correct the misalignment between executive reward and enduring enterprise value.

Preventing inappropriate outcomes remains important. However, attempts to address these concerns have relied heavily on aligning executive pay with investor interests via "incentives" that amplify the correlation between executive reward and financial measures such as shareholder returns. This simplistic understanding of "alignment" grossly overestimates the extent to which enterprise performance can be attributed to an individual or a small group of senior executives. It is also based on erroneous assumptions about the impact of variable rewards on individual performance.

Attempts to align performance and pay have also led to an expansion of the performance measurement and reward industry, resulting in much airplay given to the technical aspects of such arrangements, and scant critical attention paid to the logic that underpins them. Thus stakeholder attention is absorbed by the complexity within this subject, rather than directed to questioning the overarching premises.

The current accepted remuneration practices will over time entrench systemic agency issues as those with vested interest in the status quo (such as remuneration and executive search consultants[2]) seek to establish it as the only viable approach to attracting, retaining and motivating executive talent. Long term, only a proper functioning board making targeted and restrained remuneration policies can negate this systemic risk in an individual company.

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[2] Executive search consultants' fees are generally derived from the total target remuneration of successful candidates.

Having executive pay practices diverge so dramatically from the talent management frameworks underpinning pay arrangements for other employees is not only unjustified, resource intensive, and overly complex, but also rife with unintended consequences that operate to the detriment of value. Boards, with the support of institutional investors with a genuine long term interest in company value, should redress this progressively as opportunities arise.

The attribution fallacy

CEO pay often departs significantly from the principles that guide pay for other employees, both in structure and quantum, a circumstance often unchallenged on the basis that this role is uniquely positioned to create or destroy value.

Yet although CEOs do have greater responsibility for deploying appropriate human, financial, technical and physical resources in pursuit of the business strategy, their effectiveness relies on factors outside their control, including resources inherited from predecessors (human and intellectual capital, technology, organisational culture and initiatives already in train) and factors that are entirely external, such as competitor decisions, macro-economic conditions, or regulatory and socio-political constraints. A leader's ability to influence corporate performance also varies with industry, business maturity, and market dynamics[3].

These factors make it impossible to estimate an individual's contribution to financial outcomes ahead of time. Even after the fact, it is not possible to compare performance against that which would have resulted under different external conditions or from a different CEO under the same business conditions.[4] When appraising the performance of employees, line managers are often urged to recognise and transcend well-researched cognitive biases that lead to false attribution (such as the tendency to underestimate the role of luck, external or system factors on performance). Yet such over-attribution pervades pay arrangements at the most senior levels, where performance relies at least equally on myriad factors outside the individual's control.

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[3] Daines, Robert, Nair, Vinay B. and Kornhauser, Lewis A., *The Good, the Bad and the Lucky: CEO Pay and Skill* (August 2005). U of Penn, Inst for Law & Econ Research Paper 05-07; NYU, Law and Economics Research Paper No. 04-035. Available at SSRN: http://ssrn.com/abstract=622223 or http://dx.doi.org/10.2139/ssrn.622223

[4] See, for example, Rosenzweig, P. (2008), *The Halo Effect*, Pocket Books.

The alignment fallacy

Linking significant proportions of total executive remuneration to shareholder returns and other financial measures is generally explained as "aligning" executive interests with those of shareholders to reduce agency issues. A common practice is to base long term incentive payments (LTIs) at least in part on total shareholder returns relative to other companies (relative TSR).
In practice, alignment of this kind is partial at best. Unlike an investor who has purchased company shares with their own funds, the extent of effective "skin in the game" created by these instruments will vary with executives' absolute level of fixed pay, life stage and existing personal wealth. Continued employment, reputation or future career prospects will be of greater significance in many cases.

Share-price linked alignment measures of performance (such as relative TSR) are particularly problematic when varied shareholders are considered. In 1955 the average fund in the US held a stock for seven years; in 2005 this was 11 months. The average holding period for Australian shares has fallen from more than six years in 1986 to less than 12 months.[5] It is neither fair nor desirable that executives be remunerated on the basis of market sentiment.

Amplifying the correlation between executive pay and shareholder returns is in any case a haphazard means to reward executive efforts, owing to the many external factors that drive corporate performance, as discussed above. It produces windfalls when the stars align, and short-changes executives (in relative terms) when as-great talents and efforts are applied to steering a company through tougher periods, or to important initiatives that bear fruit years or decades after the executive's departure[6]. In so doing, such pay arrangements add to pro-cyclical pressures, increasing retention challenges in more difficult times[7]. To counteract this, standalone retention payments are often made to compensate executives for foregone incentive payments, undermining

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[5] "Investors caught in excessive short-termism", Sydney Morning Herald, 13 October, 2011, http://www.smh.com.au/money/investing/investors-caught-in-excessive-shorttermism-20111014-1loyj.html

[6] Eg Jan du Plessis, Chairman of Rio Tinto, during an address to the Australian Institute of Company Directors in October 2011 stated that the company does not reap the rewards of its investments for thirty to forty years http://www.riotinto.com.au/documents/111104_JanduPlessis_AICDSydney.pdf

[7] A report from Goldman Sachs early in 2012 found the the median length of service for chief executives of the top 100 Australian listed corporates had declined to 3.9 years since 2007.

even the semblance of alignment and consequently calling into question the value of these elements within a pay plan.

Even apparently simple attempts at alignment can deliver unintended consequences. For instance holding periods for vested shares are often used to secure longevity of executive tenure. Yet in many cases executives simply have their shares bought out by the company that poaches them – having the effect of ratcheting pay throughout the market, without delivering the intended retention.

The incentive fallacy

The idea that payments can incentivise executives to deliver better financial returns is at odds with one of the most robust findings in the social sciences. Unlike unanticipated rewards delivered after the fact in a discretionary manner, rewards known in advance to be conditional on performance have been shown repeatedly to be counterproductive for all but routine tasks; eroding intrinsic motivation, inappropriately narrowing the focus and limiting creative thinking, promoting short-termism, and increasing risk-taking.[8] These drawbacks combine with the problems of attribution and alignment to make many conventional incentive payments counterproductive in promoting shareholder returns.

Even the prevalent practice of using equity incentives to promote a sense of "ownership" amongst executives is flawed. Studies in the field have found little evidence that equity incentives of any kind enhance organisational performance. For instance Jeffrey Pfeffer of Stanford University notes a review of more than 220 studies that concluded that equity ownership had no consistent effects on financial performance.[9]

The uncertain relationship between an executive's efforts and their expected rewards results in the value of variable remuneration being psychologically discounted. Many executives report that it is

[8] Many of these studies are summarised in Pink, Daniel 2010; *Drive, the surprising truth of what motivates us;*

[9] See, for example, Hard Facts, Dangerous Half-Truths, and Total Nonsense: Profiting from Evidence-Based Management. Copyright 2006 Jeffrey Pfeffer and Robert I. Sutton

de-motivating when there is a disconnect between their efforts and their rewards[10]. Perhaps partly because of these factors , fixed pay has continued to increase despite the growth of these "at risk" elements, in turn inflating "at risk" elements that are calculated as a percentage (or multiple) of fixed pay. The combined result is a ballooning of overall pay for executives, with a growing gap between executive pay and that of ordinary employees and between the CEO and other executives.

On quantum

It is often claimed that boards have no choice but to acquiesce to inflationary expectations from executives; paying the most to get "the best". Aside from the issues with assessing (and moreover predicting) what will lead to strong performance, evidence confirms that well-selected executives apply proven talents and appropriate discretionary effort to pursuing corporate objectives even when remuneration more closely resembles that of other employees in both structure and quantum[11]. This is evident from pay practices in other markets; other sectors within the economy; past practices in the private sector (including in publicly quoted companies) and from the reports of former executives[12].

Quantum of pay at the most senior levels appears to function for both executives and for boards primarily as a marker of esteem rather than as compensation *per se*. However such pre-emptive esteem (along with over-attribution) can inappropriately influence the way the CEO role is understood and performed. Pay structures and quanta that differ from those of their reports can, for instance, exaggerate hierarchical distance between the CEO and other executives, impairing team function, subduing contributions from others and hindering effective succession. It can also bias a CEO towards visible action that may be at odds with the needs of the business[13].

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[10] The lead author, in her capacity as both an executive compensation consultant, and head of performance and reward for one of the world's largest financial institutions, has interviwed more than 100 senior executives on this issue with almost unanimous responses.

[11] Eg, Jeroen van de Veer outgoing chief executive of the oil firm Shell, has admitted that the way he did his job was not affected by his pay. He told a conference in Abu Dhabi: "If I had been paid 50% more, I would not have done it better. If I had been paid 50% less then I would not have done it worse." http://www.guardian.co.uk/business/2009/jun/09/viewpoint-julia-finch-bonuses-lloyds-punch .

[12] Pfeffer and Sutton, 2006.

[13] Eg Khurana, Rakesh. *Searching for a Corporate Savior: The Irrational Quest for Charismatic CEOs*. Princeton, NJ: Princeton University Press, 2002

Remuneration need not and should not carry the burden of communicating positive regard. For other roles, it is a rarely challenged research finding that non-financial factors play a significant role in attracting, retaining and motivating talent, including satisfactions inherent in the performance of the roles[14].

Bridging the gap

While boards frequently review compiled statistics on current market pay levels, it seems scant attention is paid to robust longitudinal studies on the (in)effectiveness of "incentive pay". Fortitude and concerted effort will be required in many cases to restore simpler pay practices founded in demonstrable value, and to address the issues of quantum relative to average wages. Reforms can be implemented when opportunities present themselves (such as when determining the arrangements for a new CEO). Shareholder support for boards wishing to make judicious departures from unhelpful market conventions will be required. Where, in the individual circumstance, incentive payments are warranted, these should be carefully tailored to the specific challenges of the role and just as carefully explained with reference to these considerations. They should not simply replicate what occurs in peer companies.

The following are among the considerations that should guide board deliberations on executive pay.

The market

What talents are really required for this role? Have sufficient efforts been directed to identifying alternative candidates? The lack of diversity in senior executive ranks is one indicator that boards may not be adopting a sufficiently wide or sophisticated view of the market for executives. Research shows that the executive labour market is rife with artificial barriers to entry and promotion, and the perceived narrowness of the talent pool contributes to keeping executive pay artificially high.[15]

[14]Eg, PwC Study, *Managing people in a changing world: Key trends in human capital: A global perspective 2010*, http://www.pwc.com/gx/en/hr-management-services/hr-management-key-trends-in-human-capital.jhtml

[15] See for example, Schlefer,*How Economists Got Income Inequality Wrong*, http://blogs.hbr.org/cs/2012/11/how_economists_got_income_ineq.html, Nov 2012

The strategy

What are the goals for the company? What kind of growth is being pursued? What is the risk appetite? Will the CEO be leading wholly new endeavours – expansion into foreign markets, development of completely different income streams? Or is the executive team charged with returning an under-performing company to its former levels of performance? Alternatively, is the CEO taking the reins of a mature, stable company, with limited opportunity for growth?

The internal resources and external circumstances

Is there a strong team reporting to the CEO? What initiatives (underway or completed) may have an impact on value during his or her tenure? Have there been any major acquisitions that may take time for their value to be realised? What is the current market positioning of the company? Are there macroeconomic, regulatory, social, or cultural advantages enjoyed by the company that will provide a cushion should circumstances deteriorate? What competitive pressures are likely to intensify and what external support for the company exists?

Known unknowns

In light of factors mentioned above and their likely changes over time, how certain can the board be of the extent to which the efforts and talents of a particular individual will drive performance (good or bad)? Is it preferable to retain the ability to exercise discretion after the fact?

How do the remuneration arrangements play out in a range of scenarios? Suppose, for example, external factors cause a bear market, making threshold performance targets unattainable, what approach to remuneration would ensure the retention of executives?

Shareholders should acknowledge that it is during the most challenging times that companies need the most competent leadership. Likewise, they should have confidence that boards will structure plans to provide for restraint when external factors lead to a plan providing an unexpected windfall.

The individual

What will secure the commitment of this particular individual? A substantial body of research[16] states that appropriate recruits to senior executive positions are by definition already motivated.

[16] See, for example, Kohn, Alfie, *Punished by Rewards: The Trouble with Gold Stars, Incentive Plans, A's, Praise, and Other Bribes* (Boston: Houghton Mifflin, 1993 / 1999

Boards should be encouraged to communicate openly with executives about the need to maintain appropriate internal pay ratios, and to robustly review the relevance of market comparisons to securing the commitment of a given individual. All market comparisons are at risk of being inflated by stakeholders with vested interests.

Boards should also be encouraged to consider the executive's personal circumstances, with disclosure where appropriate. In many cases perquisites may be a relevant way to address individual interests. However care should be taken as they can also diminish transparency for the total remuneration package.

The wider context

Prevailing economic conditions and the potential impact of pay outcomes on the organisation's social licence to operate can be relevant to pay decisions – for instance media attention to high executive pay can prompt industrial action[17]. Alienation of the community by an individual company or corporate sector can result in a more disputative regulatory climate or more politically driven lawmaking.

To this end, disclosure of the ratios between total actual remuneration of key management personnel and benchmarks such as the average salary within the company may be appropriate. Boards should pay close attention to the gap between executive pay and that of employees, in addition to ensuring the gap between CEO and executive pay is not so wide as to potentially inhibit executive team functioning or succession, or to fuel employee resentment or industrial unrest.

Encouraging ownership

Arrangements that encourage and facilitate acquisition of shares by executives should be considered. However a healthy scepticism should be deployed against claims that shareholdings will drive the desired behaviours and decisions, particularly in the context of the individual's other financial assets, future career prospects, and intrinsic motivations.

For that matter real or perceived overexposure to the stock by executives (especially through leverage) should be discouraged as it is unlikely to promote cool-headed decision making in a crisis.

[17] See, for example, http://www.payscale.com/ceo-income

Summary

Executive remuneration plans should be fit for purpose, and should be established on the basis of a clear understanding of what they can – and cannot – achieve. Boards need to reflect realistically on the partial role played by pay arrangements in talent acquisition, management, motivation and retention and should cast a critical eye across pay proposals whose effect is to inflate quantum or add complexity.

Fortitude will be required in negotiating these arrangements with executives whose expectations are anchored in present conventions. Ingenuity and commitment is also needed to identify and dismantle artificial barriers within the executive labour market in order to broaden the talent pool. The increased supply from a more diverse candidature, for instance, would reduce upward pressures on pay.

Notwithstanding the challenges, the evidence is clear that the present norms neither promote performance nor serve investors, and investors need to provide both gentle impetus to, and vigorous support for corporate boards who take the necessary steps towards a new "normal".

Regnan was established by institutional investors to provide original research, engagement and advocacy services to the industry on environmental, social and governance (ESG) matters.