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

PwC Submission

27 January 2011

PwC submission

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What would you like to grow?

To the Hon. David Bradbury,

PwC are pleased to respond to the exposure draft on improving accountability on director and executive remuneration. PwC provides advice to both large and small companies globally on remuneration issues as part of our accounting and consulting services. Our views are based on our knowledge and expertise in this area.

In our submission, we have responded to the specific recommendations that relate to remuneration and its governance. Our views are summarised on page 2.

We commend the Productivity Commission and Treasury's focus on strengthening Australia's remuneration framework and support a number of the proposed recommendations.

We consider that two proposals would have negative consequences on shareholders and companies and would not achieve the objectives set out by Treasury or the Productivity Commission to improve accountability on director and executive remuneration:

- 'Two-strikes' test
- Disclosures and use of remuneration consultants.

Our submission outlines our concerns and provides an alternative proposal that would better address Treasury's objectives.

We suggest strengthening two proposals that may, in their current form, cause unintended confusion or challenges for particular stakeholders:

- Prohibiting key management personnel (KMP) from voting on remuneration matters
- Prohibiting hedging of incentive remuneration.

We would be pleased to discuss our views in more detail.

Yours sincerely

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Summary of PwC's point of view

Proposed legislation	PwC's point of view
Strengthening the non-binding vote – the 'two-strikes' test	• Where companies receive a 'no' vote of at least 25 percent on their remuneration report, we support the concept of requiring boards to report to shareholders how they have addressed shareholder concerns or, if they have not done this, the reasons why. • We do not support the proposal to require directors' to stand for re-election if the company receives a 'no' vote of at least 25 percent in two consecutive remuneration reports. This is because this leads to a range of negative consequences for shareholders.
Improving accountability on the use of remuneration consultants	• The proposals are significantly more onerous than those proposed by the Productivity Commission and we believe they would have significant unintended and detrimental consequences to shareholders and boards. In particular: – CEOs would have limited access to external advice about remuneration for their direct reports – The role of non-executive directors would fundamentally change, resulting in a dilution of the separation of duties from management – There is a high risk of unintentional breaches of the requirements – Disclosures would become more complex and unwieldy – Companies would be put in the position of potentially breaching obligations of confidentiality • We recommend the legislation be re-worked to ensure that relevant information is provided to shareholders and the requirements do not impinge on the board's oversight role. Our alternative proposal is outlined in this submission.
Prohibiting KMP from voting on remuneration matters	• We support the underlying principal behind this proposal, however we suggest the requirement is incorporated into the ASX Corporate Governance Guidelines rather than the Corporations Act. • This is particularly important for companies where KMP and / or their closely related parties are major shareholders. Incorporating this requirement into the Corporations Act means that there could be the unintended consequence of a small percentage of shareholders controlling the remuneration strategy for the company.
Prohibiting hedging of incentive remuneration	• We support the proposal that KMP's and their closely related parties be prohibited from hedging unvested KMP's incentive remuneration. • However, if the equity has vested we believe the executives should be able to hedge this equity if desired.
Persons required to be named in the remuneration report	• We support this proposal. The proposed approach would reduce detail and length of remuneration reports and reduce compliance costs for companies, while maintaining the appropriate level of accountability.

Contents

1 Strengthening the non-binding vote – The 'two-strikes' test

We support the concept of requiring boards to report to shareholders on how they have addressed shareholder issues. However, we do not support the proposal of a 'second strike' to require directors to stand for re-election.

The 'first strike' occurs where a company's remuneration report receives a 'no' vote of 25 percent or more. Where this occurs, the company's subsequent remuneration report must explain whether shareholders' concerns have been taken into account, and either how they have been taken into account or why they have not been taken into account.

The 'second strike' occurs where the company's subsequent remuneration report receives a 'no' vote of 25 percent or more. Where this occurs, shareholders would vote at the same AGM to determine whether the directors would need to stand for re-election within 90 days. If this resolution passes with 50 per cent or more of eligible votes cast, then the 'spill meeting' would take place within 90 days.

Comments

First strike

We support the concept of requiring boards to report to shareholders how they have addressed shareholder issues or, if they have not addressed the issues, the reasons for this.

Companies are increasingly engaging with key shareholders and stakeholder bodies to understand their perspectives before making material changes to their executive remuneration structure. A requirement to report whether shareholders' concerns have been taken into account and, if not, why not, would further encourage companies to thoroughly consider shareholder perspectives.

PwC's point of view

Where companies receive a 'no' vote of at least 25 percent on their remuneration report, we support the concept of requiring boards to report to shareholders how they have addressed shareholder concerns or, if they have not done this, the reasons why.

We do not support the proposal to require directors' to stand for re-election if the company receives a 'no' vote of at least 25 percent in two consecutive remuneration reports because of the range of negative consequences for shareholders.

Second strike

We do not support the proposed 'second strike' to require directors to stand for re-election. We believe this proposal would lead to a range of negative consequences for shareholders. In particular:

1 Misuse of the ability to 'oust' a board through the remuneration report vote

The 'two strikes' test is an opportunity for a shareholder or group of shareholders to use the remuneration report vote to drive for a 'spill', for reasons not related to remuneration.

2 Notice of the AGM to include the second 'spill' resolution

Under the proposals, shareholders who vote through proxies would be required to vote on the 'spill' resolution without knowing the outcome of the remuneration report vote at the second Annual General Meeting (AGM). We believe this requirement would impede shareholders from making an informed decision on the 'spill' resolution. This is because the level of the 'no' vote may impact shareholders' voting intentions on the

'spill'. For example, if the 'no' vote against the remuneration report was 26 percent, shareholders may be more inclined to vote in favour of the directors who are subject to the 'spill' as opposed to circumstances where the 'no' vote is more than 50 percent.

3 Impact on board effectiveness and loss of valuable corporate knowledge and skills

If a company's remuneration report receives a 'no' vote of at least 25 percent at two consecutive AGMs, the 'spill' meeting is required to take place at an Extraordinary General Meeting within 90 days.

We believe 90 days is insufficient time for boards to develop contingency plans in respect of sourcing potential replacement candidates. Given the difficulties that many companies face in finding adequate replacements and the time involved to source highly-skilled directors, this resolution would restrict boards from investing the required time in the recruitment process.

The resolution could result in frequent changes of directors which is likely to have a significant impact on the board's effectiveness. It could also lead to the possibility of companies losing valuable corporate knowledge and skills from directors who have added considerable value to the company.

Furthermore, we view the 'second strike' test as not necessary to be included in the law given there is already a mechanism in place for shareholders to vote against directors as they present themselves for re-election.

4 May 'blunt' the remuneration report vote

Given the potentially damaging consequences that could result from a 'spill' meeting being required, shareholders may become reluctant to vote against a remuneration report (especially if the previous year's report received a vote over 25percent against), even if they have genuine issues.

We note that that the Explanatory Memorandum states that the Government would instruct Treasury to conduct a post-implementation review within five years to ensure that there are no unintended consequences of the legislation. Given the large number of potential and significant unintended consequences of the 'second strike' test , we support the Government putting in place a mechanism to ensure there is a review within a five year period.

2 Improving accountability on the use of remuneration consultants

We do not support the detail of this proposal and consider it goes beyond that outlined by the Productivity Commission. While the underlying objectives are sound, we do not consider they are best served by the new rules which could have significant unintended and detrimental consequences for shareholders and Boards. We recommend the proposal be replaced by the alternative we outline below.

Under the new law, disclosing entities would be required to disclose details relating to the use of remuneration consultants. In addition, remuneration consultants are required to be engaged by non-executive directors, and must report to non-executive directors or the remuneration committee, rather than company executives.

The remuneration report must disclose the consultant's name, the name of each director who signed a contract with a consultant, the name of each person to whom a consultant directly gave advice, a summary of the nature of the advice and the principles on which it was prepared, the fees paid, the nature of any other work the consultant did for the company during the year, and the fees paid for that other work

A remuneration consultant means a person (a) who, under a contract for services with a company provides advice relating to the nature and amount or value of remuneration for one or more members of the key management personnel (KMP) for the company and (b) who is not an officer or employee of the company.

PwC's point of view

The proposals are significantly more onerous than those proposed by the Productivity Commission and we believe they would have significant unintended and detrimental consequences to shareholders and boards. In particular:

- CEOs would have limited access to external advice about remuneration for their direct reports
- The role of non-executive directors would fundamentally change, resulting in a dilution of the separation of duties from management
- There is a high risk of unintentional breaches of the requirements
- Disclosures would become more complex and unwieldy to the point of being unworkable.
- Companies would be put in the position of potentially breaching obligations of confidentiality

We recommend the legislation be re-worked to ensure that relevant information is provided to shareholders and the requirements do not impinge on the board's oversight role.

Our recommended approach for improving accountability in the use of remuneration consultants:

The proposed disclosure requirements outlined below would better address the underlying objectives sought by the Productivity Commission:

- Notification of whether external advice was sought with respect to KMP remuneration for the relevant year
- Notification of who appointed the advisers; management or the board / remuneration committee
- The process followed to engage the advisers and address potential conflicts of interest and independence
- The name of the external adviser, where the board formed the view that the adviser materially assisted with KMP remuneration determination.

Comments

We do not support this proposal because we can foresee significant unintended and detrimental consequences to shareholders and boards. In particular:

1 CEOs would have limited access to external advice about remuneration for their direct reports

The proposals appear to restrict CEOs from seeking external advice regarding the amount or nature of the remuneration for their KMP direct reports.

Typically, the CEO would make recommendations to the remuneration committee on the level of fixed pay increase, incentive outcome, and broader remuneration plan designs for their direct reports. These recommendations would be a culmination of considerations including internal and external advice, assessment of company and individual executive performance, and parameters set by the remuneration policy and remuneration committee.

The proposed restrictions limiting access to external advice is likely to negatively affect the quality of those recommendations. As a minimum, they appear to materially affect the role of the CEO in assessing and recommending the remuneration for their KMP reports.

Further, the potential exclusion of Human Resources (HR) from the process of remuneration plan design would create many practical problems. HR has traditionally provided the link between management and the board on remuneration issues based on its extensive experience and detailed knowledge of the company. External advisers would generally not have such knowledge. Management input is therefore an essential element in the current reward design process, facilitating appropriate reward decisions.

2 The role of the non-executive director would change, resulting in a dilution of the separation of duties from management

The requirement for KMP remuneration consultants to only be engaged by, and report to, the board is likely to fundamentally change the role of those directors and remuneration committees.

As an example, under the proposal a remuneration committee would be required to:

- Lead all aspects of KMP contract negotiation and drafting given the heavy reliance on external advice through such a process; and
- Lead all aspect of the KMP incentive plan design, including concept formulation, consideration of alternatives, data provision and analysis, tax and legal considerations, drafting of documentation etc, for the same reason.

It is unclear what role management would be expected to have in the future development of remuneration arrangements.

The proposals fundamentally challenge the concept of separation of duties between management and non-executive directors. This may have the unintended consequence of requiring the remuneration committee to independently review and critique a KMP remuneration plan that they have designed themselves.

3 High risk of unintentional breaches of the requirements

The proposals also present interpretation challenges, whereby companies may unintentionally breach the requirements. These challenges include:

- The changing composition of KMP means it would be very difficult for any of the parties to ensure compliance. As it would be a breach of the proposed legislation for consultants to provide advice on KMP to management, the individuals constituting the KMP would need to be known by all parties providing and seeking advice at all times. However, in many companies the KMP changes during the year through restructures, changes to individual responsibilities, incumbent

movements, and auditor review. As a result the KMP may not be finally determined until the end of a financial year when annual reporting is finalised. This is likely to place all parties in a situation where they may have unintentionally breached the legislation.

- The loose definition of 'advice' means it is not clear precisely what would be deemed as 'giving advice.' For example, where management calls a remuneration consultant to discuss a broad topic during the conversation they may ask a question that may affect KMP remuneration. If the consultant responds, would that be defined as providing advice in breach of the legislation? Or is advice a formal written report only?
- The broad definition of advice, capturing large numbers of advisers, would impose a considerable burden on large companies collating the required information. Validating its accuracy may also be very difficult.

4 Disclosures would become more complex and unwieldy which is contrary to the intent of the Productivity Commission's proposal to simplify remuneration reports

The proposals mean that considerably more information would need to be collated and included in the remuneration report, and this in turn would add complexity and length to remuneration reports. The key reasons for the increased complexity are:

- The proposed definition of 'remuneration consultant' (including anyone other than an officer or employee who provides advice 'relating to the nature and amount or value of remuneration for one or more members of the KMP'). This definition would cover a broad spectrum of advisers, from data providers, strategists, governance specialists, lawyers, accountants, equity valuations specialists (for example, those conducting the AASB valuations of equity), tax specialists and recruiters. Each of these experts would need to be engaged by the non-executive directors and their details disclosed in the remuneration report.
- As it would be an offence to be in breach of these provisions, companies are likely to go to great lengths to show compliance. This could lead to the inclusion of lengthy detailed disclosures in the remuneration report about issues that are irrelevant to remuneration advice (eg fees paid for 'other' work).

Sensitive matters being considered by the board would also need to be disclosed in the 'summary of the nature of advice' section of the remuneration report. If, for example, the board was considering terminating an executive but after receiving advice decided not to, a disclosure would have to be made even though the executive in question might have been unaware of the situation.

It is also unclear how disclosure of fees for remuneration advice would help shareholders better understand and appraise the remuneration decisions made by the board.

5 Required disclosure of the nature and consideration of other work would put companies in the position of potentially breaching obligations of confidentiality and legal professional privilege

The required disclosures of the nature and consideration paid for other work provided by remuneration consultants is likely to have the consequence of putting companies in a position of breaching obligations of confidentiality and / or legal professional privilege. For example:

- Potential disclosures may breach any privacy obligations established under the Privacy Act 1988 (Cth)
- A remuneration consultant may be engaged for a range of services or advice beyond matters relating to remuneration, such as legal, accounting or other consulting services. These engagements are likely to be subject to obligations of confidentiality. Advice or services may be provided for a purpose that is unrelated to remuneration matters. The disclosure of confidential advice may be detrimental to companies, remuneration consultants and individual employees.

In addition, while it can be argued these particular disclosures are designed to provide some improvement of the accountability of the use of remuneration consultants, they also impose an additional burden on the directors of a company. This is because directors already have fiduciary duties and obligations under the Corporations Act 2001 (Cth) to act with care and diligence and in good faith in respect to the best interests of the company aside from having any obligation to make any particular disclosures in the nature of those proposed by the legislative changes (sections 180, 181, 184 and 191).

We understand the intention of the proposed changes is to provide shareholders with greater comfort and visibility in relation to potential conflicts of interests and independence regarding the use of remuneration consultants, however we believe the required disclosure of the nature and consideration paid for other work goes beyond that intention. In our view, the nature and consideration of other advice should not be a required disclosure to shareholders.

A more appropriate approach, that would meet the objective of improving information and accountability, would be to require companies to disclose to shareholders the process followed to engage remuneration consultants and the process of how any conflicts of interest or independence issues were dealt with.

3 Prohibiting KMP from voting on remuneration matters

We support this proposal, however recommend it is incorporated into the ASX Corporate Governance Guidelines rather than the Corporations Act to avoid unintended consequences for certain shareholders.

Under the new law, KMP and their closely related parties would be prohibited from participating in the non-binding vote on the remuneration report. In addition, KMP and their closely related parties would be prohibited from voting undirected proxies on all remuneration related resolutions.

Comments

Where KMP are not significant shareholders of the company, we consider that it is appropriate for these personnel to be prohibited from voting on remuneration matters. From our experience, many executive directors' already voluntarily abstain from voting on their own equity allocation. Likewise, many KMP also voluntarily abstain from voting on their company's remuneration report.

However, where KMP are significant shareholders, we do not consider that it should be a legislated requirement that these personnel cannot vote on remuneration matters. This is because there are companies where the vast majority of shares are owned by directors (or their closely related parties) and in this situation, it is not appropriate for the minority of shareholders to dictate the remuneration policies for the company.

We consider it is more appropriate for this requirement to be incorporated into the ASX Corporate Governance Guidelines on an 'if not, why not' basis rather than into the Corporations Act. Taking this approach would send the message that it is best practice for KMP (and their closely related parties) not to vote on remuneration matters. However, it gives companies the ability not to comply with this requirement if the board considers it is not in the company's best interests.

PwC's point of view

We consider that the requirement for KMP and their closely related parties not to vote on remuneration related resolutions should be incorporated into the ASX Corporate Governance Guidelines rather than into the Corporations Act. This is particularly important for companies where KMP and / or their closely related parties are major shareholders. Incorporating this requirement into the Corporations Act means that there could be the unintended consequence of a small percentage of shareholders controlling the remuneration strategy for the company.

4 Prohibiting hedging of incentive remuneration

We support the proposal that all company executives be prohibited from hedging unvested equity remuneration that depend on the satisfaction of a performance condition.

KMP and their closely related parties would be prohibited from hedging the KMP's incentive remuneration.

Comments

We agree in principle with the proposal that KMP should not hedge unvested KMP incentive remuneration. This practice is inconsistent with the notion that remuneration should be linked to performance.

We question the feasibility of incorporating this principle into the law in the manner proposed. Whilst we are conscious that the issue of what meets the definition of a hedge in the accounting literature can be the subject of much debate, we question the appropriateness of providing lists of the types of arrangements that would or would not be considered to be a 'hedge' by regulation. Our recommendation would be to establish only the principle within the law, acknowledging that companies would already have in place policies dealing with hedging remuneration.

We consider that the amendments to the law should make clearer that this prohibition does not apply to equity that has vested (even if it remains subject to a holding lock). This is because, once the equity has vested, the executive is absolutely entitled to it and, subject to trading restrictions and company policies, the executive is in the same position as other equity investors.

PwC's point of view

We agree with the proposal that KMP's be prohibited from hedging unvested KMP's incentive remuneration. However, if the equity has vested the executives should be able to hedge this equity if desired.

5 Persons to be named in the remuneration report

We support the proposal to confine individual remuneration disclosures to the key management personnel of the consolidated entity.

Under the new law, remuneration disclosures would only be required for the KMP of the consolidated entity.

PwC's point of view

We support the move to align the Corporations Act requirement with accounting standards.

This would reduce detail and length of remuneration reports and reduce compliance costs for companies, while maintaining the appropriate level of accountability.

Contacts

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