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Dear Ms Woods,

Consultation Document – Directors’ Remuneration

Thank you for providing us with the opportunity to comment on the Consultation Document, *Directors’ Remuneration* (Consultation Document).

The Australian Institute of Company Directors (Company Directors) is the second largest member-based director association worldwide, with individual members from a wide range of corporations: publicly-listed companies, private companies, not-for-profit organisations, charities, and government and semi-government bodies. As the principal professional body in Australia representing a diverse membership of directors, we offer world class education services and provide a broad-based director perspective to current director issues in the policy debate.

While we are based in Australia, we believe that it is important to comment on the proposals set out in the Consultation Document as:

- some of our members sit on the boards of UK companies; and
- there is a tendency for Australian regulators to look to the regulations that are in place in other jurisdictions when developing regulation for Australia.

While we do not intend to comment specifically on each of the issues raised in the Consultation Document, we would like to take this opportunity to make some general comments regarding the issues that the FRC is seeking views on.

Also, we attach *Executive Remuneration: Guidelines for Listed Companies* and provide links to the following documents which set out our general policy positions with respect to executive remuneration:

- *Position Paper No. 15: Remuneration Reports*; and
- Our submission in response to the Australian Federal Government’s Discussion Paper, *The clawback of executive remuneration where financial statements are materially misstated*.

General comments

Our comments are as follows:

- As there is no “one size fits all” approach to executive remuneration or corporate governance more generally, it is important that companies are allowed maximum flexibility in adopting the remuneration and governance arrangements that are the most appropriate for their circumstances.
- While the Code applies on a “comply or explain” basis so that companies are not required to comply with a particular provision of the Code if it is not appropriate for them to do so, the reality is that the practices set down in the Code will be treated by most market participants (in particular proxy advisory firms and the media) as being the practices that companies must ascribe to. This has the effect of making them quasi-prescriptive in nature – ultimately resulting in companies being less inclined to choose the practices that are most suited for their particular organisation, and instead treating the Code as a corporate governance check-list.
- As such, we would caution against the introduction of further principles without there being sound governance reasons to do so. A matter should only be introduced as a requirement under the Code where there is a reasonable expectation that adopting the practice will lead to better corporate governance and a better outcome for investors. We are not convinced that this is the case with these proposals.
- The significant concerns that have arisen with respect to executive remuneration in recent years almost exclusively involve companies in the financial services industry. Legislation and other regulation have already been introduced to deal specifically with these concerns within that industry. In our view, there is no real evidence to suggest that further requirements regarding executive remuneration need to be introduced into the Code to regulate companies outside the financial services industry.

If you would like to discuss any aspect of our views please contact our Senior Policy Advisor, Gemma Morgan on +61 2 8248 6600.

Yours sincerely,



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EXECUTIVE REMUNERATION

GUIDELINES FOR LISTED COMPANY BOARDS



Executive Remuneration

Guidelines For Listed Company Boards

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While care has been taken in the preparation of *Executive Remuneration: Guidelines For Listed Company Boards*, the information contained herein is not intended to be advice and no person should act specifically on the information without first obtaining competent advice.

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Introduction

A core part of a board's activities involves appointing and managing the performance of an appropriate chief executive officer (CEO), and overseeing the appointment of other senior executives. These activities require the establishment and maintenance of contractual and remuneration arrangements that are in the best interests of the company.

The Australian Institute of Company Directors (AICD) is firmly of the view that executive remuneration should remain a matter for boards, and that further regulation in this area is unnecessary and often counterproductive to the outcomes sought.

AICD has published a range of guides and policy papers on executive remuneration, including:

- *Executive Termination Payments*, Position Paper, October 2008
- *Non-Recourse Loans Provided to Executives*, Position Paper, May 2008
- *Executive Equity Plan Guidelines*, Position Paper, March 2007
- *Remuneration Committees: good practice guide*, 2004
- *Shareholder Consideration of the Annual Remuneration Report of a Listed Company; A Guide for Consideration of the Issues*, 2004

This booklet adds to that body of work by articulating a set of guidelines to assist boards of publicly-listed companies when designing and negotiating remuneration arrangements for CEOs and when overseeing the basis on which other senior executives are appointed.

While it is acknowledged there are many possible arrangements and contractual outcomes, and no "one size fits all", these guidelines are designed to be useful in a wide variety of circumstances confronting listed companies. Some guidelines may also be applicable to large unlisted entities.

Overview

The guidelines set out in this booklet have been divided into the following categories:

- Putting in place an appropriate framework and processes
- Remuneration policies and terms
- Reviewing arrangements
- Other matters.

For each category AICD outlines instances of good practice, poor practice, and various matters that may warrant consideration by boards.

The guidelines are summarized in Table 1, and elaborated on in the following sections.

Table 1 : Summary

	Good practice	Poor practice	Matters for consideration
Putting in place an appropriate framework and processes	<i>Do</i> establish a remuneration committee of the board comprised entirely of non-executive directors, where the size of the company warrants this.	<i>Do not</i> have executives involved in setting their own remuneration for the obvious conflicts that may arise.	<i>Think about</i> the necessary steps in advance from recruitment to contract, including appointing any search consultants.
	<i>Do</i> have in place remuneration processes that incorporate independent opinion, expertise and transparency.	<i>Do not</i> overly rely upon advisers at the expense of board discussion and the exercise of board judgment.	<i>Think about</i> the board providing the first draft contract to executive candidates after detailed consideration.
	<i>Do</i> ensure the board maintains control of negotiations with CEO candidates, and where appropriate, other executives.		<i>Think about</i> putting in place a “Chinese Wall” in the event the board needs executive help (for example, Human Resources Director, Finance Director, General Counsel, and so on), where such executives report only to the board.
	<i>Do</i> obtain appropriate expert advice, independent of company management, when entering into employment contracts with executives and setting their remuneration.		<i>Think about</i> the type, experience, expertise, reputation and so on, of all advisers before commencing the process.

Table 1 : Summary (continued)

	Good practice	Poor practice	Matters for consideration
	<p><i>Do</i> undertake stress testing of proposed incentive arrangements before accepting them and before agreeing to variations or renegotiations.</p>		<p><i>Think about</i> testing any independent opinion in this area.</p> <p><i>Think about</i> engaging with major shareholders and other relevant stakeholders about the company’s approach to remuneration, subject to continuous disclosure obligations.</p>
Remuneration policies and terms	<p><i>Do</i> establish executive remuneration policies that set out the aims of the various remuneration components, and any relevant conditions.</p> <p><i>Do</i> ensure remuneration is reasonable, having regard to the best interests of the company.</p> <p><i>Do</i> have an appropriate mix between base pay, short-term incentives and long-term incentives, where such components are included in remuneration packages.</p> <p><i>Do</i> link incentive elements of remuneration packages to appropriate performance measures, in such a way that short-term imperatives of the company are pursued while simultaneously promoting the company’s long-term interests.</p>	<p><i>Do not</i> put in place arrangements that promote excessive risk-taking or short-termism.</p> <p><i>Do not</i> provide for additional payments beyond basic statutory entitlements (for example, accrued annual leave) where an executive’s employment relationship is terminated for misconduct.</p>	<p><i>Think about</i> whether to have a discretionary bonus rather than a bonus that the board is contractually obliged to approve regardless of changed circumstances.</p> <p><i>Think about</i> placing an upper bound on short-term incentive and long-term incentive rewards, where such components exist, to minimise “surprises” of markets, products, and so on.</p> <p><i>Think about</i> putting in place arrangements whereby a percentage of a CEO’s long-term equity incentive benefits is held for a period that extends beyond the term of the employment contract.</p> <p><i>Think about</i> the range of metrics available for boards to examine other than just comparative market data, such as the net benefit to the company of different remuneration levels, differences in the remuneration of the CEO and his or her direct reports, and so on.</p>

Executive Remuneration: Guidelines For Listed Company Boards

Table 1 : Summary (continued)

	Good practice	Poor practice	Matters for consideration
	<p><i>Do consider the possibility of contract termination when negotiating executive contracts and include appropriate provisions in the contract.</i></p> <p><i>Do examine executive remuneration in the context of other employment terms and other benefits that may be provided by the company.</i></p>		
Reviewing arrangements	<p><i>Do undertake board post-mortems of remuneration outcomes.</i></p>	<p><i>Do not change performance hurdles midstream unless there is an exceptionally good reason or reasons.</i></p> <p><i>Do not allow double or triple counting of benefits for the same effort because of multilayered remuneration structures.</i></p>	<p><i>Think about engaging with major shareholders, where a material change in remuneration arrangements is made, subject to continuous disclosure obligations.</i></p> <p><i>Think about likely scenarios going forward (for example, share markets, industry development, and so on) and their effects.</i></p>
Other matters	<p><i>Do ensure remuneration packages are publicly defensible.</i></p> <p><i>Do keep abreast of general market sentiment on remuneration issues and latest developments in good governance practices.</i></p> <p><i>Do clearly communicate the board's approach to executive remuneration and the policies the company has in place.</i></p>		<p><i>Think about executive remuneration as a potential corporate reputation and sustainability issue.</i></p> <p><i>Think about director training on executive remuneration and associated issues.</i></p>

Putting in place an appropriate framework and processes

Much has been written about the appropriateness of various arrangements for the governance of executive remuneration matters. This section sets out some key guidelines for boards to consider when putting in place or re-examining the company's remuneration framework and processes.

Do establish a remuneration committee of the board comprised entirely of non-executive directors, where the size of the company warrants this.

Because of the inherent complexities and potential conflicts of interest, remuneration issues should, wherever practicable, be dealt with by a subcommittee of the board, comprised solely of non-executive directors. The Remuneration Committee plays a key role in assisting the board to fulfill its corporate governance responsibilities on remuneration issues, and provides a vehicle for enhancing the participation of non-executive directors.

The functions of the Remuneration Committee are to advise, recommend, monitor, and review remuneration decisions. However, the decisions on the matters with which the committee deals remain decisions of the board for which the entire board must take responsibility. The Remuneration Committee does not act for the board except where it is specifically delegated to do so under the company's constitution.

Do have in place remuneration processes that incorporate independent opinion, expertise and transparency.

In order to have confidence in remuneration outcomes, shareholders must have confidence in the processes adopted for determining executive remuneration. These processes should incorporate independent opinion, expertise and transparency. The use of non-executive directors on remuneration committees promotes independent opinion. Engagement of independent experts assists both independence and expertise objectives. Accountability to shareholders is aided through the company disclosing in its remuneration report how it makes remuneration decisions and what remuneration policies guide its decisions.

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Do ensure the board maintains control of negotiations with CEO candidates and, where appropriate, other executives.

Negotiation of the CEO employment contract and, where appropriate, the contracts of the CEO's direct reports, is a matter for which the board must accept responsibility and control. The board or its duly-appointed representative must undertake these employment negotiations in the company's best interests. Sometimes the negotiations will be undertaken, on behalf of the board, by the board chairman, chairman of the Remuneration Committee or another member of the board, in each case operating under proper authority. Care should be taken to control any representations made to candidates on matters such as the state of the company, the achievability of performance hurdles, or the prospects of promotion, and so on. Boards may, and often do, engage experts to assist them with appointing executives (see below), but the ultimate carriage of the negotiations must remain with the board.

Do obtain appropriate expert advice, independent of company management, when entering into employment contracts with executives and setting their remuneration.

Remuneration arrangements for executives have become increasingly complex. Boards cannot be expected, in isolation, to be completely across the legal,¹ financial modelling, accounting and tax aspects of many of today's executive remuneration packages, the intricacies of incentive plan design, market trends, and so on. Furthermore, many boards, particularly of modest scale companies, do not engage in this type of activity frequently and may in fact only seek to appoint a CEO every five-to-ten years. It may be the case that no member of the board including its chairman has the experience or skill to undertake these employment negotiations alone. It has become commonplace for companies to engage search firms, legal advisers, remuneration consultants and other advisers to assist with the negotiation and formalisation of an executive's employment contract.

If and when the board engages these advisers and consultants, it must ensure the advice is commissioned by, and provided directly to, the board, independently of company management. For example, legal advisers negotiating the contract on behalf of the company (board), must receive instructions solely from the board² and provide advice solely to the board.

1. For example, whether any shareholder, regulatory or other (such as, trustee) approvals are required for specific remuneration components.

2. In this context, the board can mean a board member or Remuneration Committee with proper authority.

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Any advice involving the law, tax, drafting techniques, and so on should go directly to the board and not through any executive unless that has been expressly authorised by the board (preferably in writing). Any remuneration consultant, including a consultant dealing with share plans, bonuses and the like, must also be engaged and must provide all reports, advice and so on, directly to the board. Regard should also be had to whether the advisers or consultants are, or have been, undertaking work commissioned by company executives. Good practice would ordinarily be for the board to engage different advisers and consultants to those engaged by executives.

While some of these practices sound unduly strict, they are necessary to ensure the confidentiality and integrity of processes and the proper functioning of the board, and to avoid conflicts of interest. Experience shows that unless these fundamental principles and precautions are adopted, the chance of things “going off the rails”, whether at the time of negotiation or in subsequent years, is more likely.

Do undertake stress testing of proposed incentive arrangements before accepting them and before agreeing to variations or renegotiations.

There have been numerous instances of unexpected outcomes in executive remuneration arrangements (with payments either too high or too low) because of unanticipated factors, such as a change in market or economic circumstances. In order to reduce the possibility of a misalignment between performance and executive rewards, boards should ensure they have considered how different sets of possible circumstances can affect remuneration entitlements. This might involve scenario or stress testing, where the effect of key assumptions proving to be wrong, is examined. This could include, for example, the effect on remuneration of the company’s share price doubling or halving over the period covered.

It is much easier to consider these matters up-front and to set appropriate remuneration and related terms (for example, performance hurdles), rather than to change them after an employment contract has been entered into. This is because such changes may require the executive’s consent, and it is sometimes difficult to obtain agreement to additional restrictions on remuneration (where future payments may be too high), without some form of compensation or trade off.

Another difficult area relates to benchmarking CEO remuneration through the use of peer or benchmark groups. The rationale for this is to ensure that remuneration levels are competitive and reasonable, and so increase the possibility of attracting and retaining an appropriate CEO, and reduce the possibility of the company paying more than is required to be market competitive. Careful thought needs to be given to what constitutes a useful comparison.

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Should overseas companies be included? Include only companies of similar size and with comparable lines of business? Is it reasonable to remove outliers from the comparison?

Boards should not simply rely on comparative data, but should also consider the amount of executive remuneration in the context of the executive's potential value to the company, the relativities with other senior executives and employees within the company and the differences in skills and experience (and cost) between internal and external candidates.

Do not have executives involved in setting their own remuneration for the obvious conflicts that may arise.

It is a fundamental principle of good corporate governance that executives should not be permitted to set their own rewards. Executives should not be involved in engaging consultants, such as lawyers and remuneration consultants for the purpose of setting CEO remuneration, or have the capacity in any way to influence the consultants' advice. This would give rise to significant conflicts of interest and undermine confidence in the company's governance arrangements.

Do not overly rely upon advisers at the expense of board discussion and the exercise of board judgment.

Boards are accountable for decisions made about executive remuneration, and should not treat expert advice as a substitute for exercising their own judgment. Under section 189 of the Corporations Act, reliance by a director on information, or professional or expert advice, about matters such as remuneration issues is taken to be reasonable if the reliance is made in good faith and after making an independent assessment of the information or advice. Ultimately, however, the board is answerable for the remuneration arrangements it approves.

Think about the necessary steps in advance from recruitment to contract, including appointing any search consultants.

When starting the executive search process, consider the appropriate steps necessary in advance, such as who on the board has carriage of the various processes. Is it the whole board, the Remuneration Committee, or the chairman? What obligations may be required for this? Do these delegations need to be limited in any way by the board (for example, approval of the whole board is required before signing or providing the first draft of the agreement to the candidate(s), and so on) or are delegations with updates to

Appropriate framework and practices

the whole board preferred? How will this process be agreed to by the board?

It may be prudent to engage advisers about contracts and remuneration arrangements in the marketplace before embarking on an executive search, particularly in cases where the board is replacing a long-serving and well-paid CEO, or replacing a CEO who has performed poorly and who may not have had the essential expertise needed by the company at a particular time. In this context, the drafting of contractual provisions acts as a useful stimulus, before consideration of the structural aspects of remuneration and other elements, which can both inform the search consultant of the board's views and help the board form its views on matters, such as internal relativities and reasonable remuneration for the role during the early stages of the search process. This should put the board in a better position when considering and negotiating with potential candidates.

Think about the board providing the first draft contract to executive candidates after detailed consideration.

It is usually considered good practice for a company to provide a draft contract to an executive candidate for consideration, rather than receiving a draft from the candidate. Experience has shown it is often difficult to renegotiate from an initial draft that proves subsequently to be unsatisfactory to the board. The board should think about obtaining advice on the draft employment contract before forwarding it to a candidate. This would include any letters to the candidate dealing with possible arrangements ahead of a formal contract. The board should be happy with the draft, and satisfied it :

- complies with existing laws and listing rules
- is consistent with the company's strategy and any of its remuneration guidelines that may be appropriate.

Think about putting in place a "Chinese Wall"³ in the event the board needs executive help (for example, Human Resources Director, Finance Director, General Counsel, and so on), where such executives report only to the board.

If the board wishes to use, say, the company's General Counsel, Human Resources Director or Finance Director, there must be clear instructions (preferably in writing) to these executives, including that the work they are

3. A "Chinese Wall" is used here to mean a set of procedures aimed at restricting the flow of information between parties.

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performing is for the board alone, and which make it clear that board confidentiality must be maintained. In particular, any such work must not be delegated to anyone else (for example, other executives) unless expressly agreed to by the board. This typically also means any notes, advice or files concerning the negotiation and finalisation of arrangements must be held by the board to ensure confidentiality is maintained and such advice, and so on, is not available to the CEO or other executives in future negotiations.

Think about the type, experience, expertise, reputation, and so on, of all advisers before commencing the process.

There are some quite separate and distinct aspects of executive contracts and remuneration arrangements, especially for CEOs. These can encompass employment law issues, remuneration planning, financial modelling, tax-related matters and executive search activities. In addition, the company may be operating on a global scale, and/or industry specific factors may come into play (for example, typical banking and finance industry incentive structures). It is important to consider the nature of the expertise being sought, and the appropriateness of prospective advisers (for example, reputation, competence, and so on) for any given tasks.

Think about testing any independent opinion in this area.

There are a wide variety of possible circumstances when it comes to engaging executives and setting their remuneration. In some cases it may be prudent to test independent opinion given to the board, whether this opinion is from the Remuneration Committee or an external adviser. This testing may involve internal discussion and debate by the the board and/or the appointment of another expert.

Think about engaging with major shareholders and other relevant stakeholders about the company's approach to remuneration, subject to continuous disclosure obligations.

There has been growing shareholder unease about the approaches adopted by some boards for tackling executive remuneration issues. It is important that shareholders remain confident with the way a company is being governed, and consideration should be given to actively engaging with major shareholders and other stakeholders about the company's approach to remuneration. Engagement could involve a series of individual meetings between the board chairman and/or chairman of the Remuneration Committee and key shareholders of the company. Ideally this would occur

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ahead of any annual general meeting⁴ (AGM) discussion on executive remuneration or shareholder approval being sought in general meeting, so boards can give consideration to answering questions or dealing with concerns raised (for example, through appropriate disclosures). Feedback from such discussions could also assist boards when putting in place new arrangements or amending existing remuneration arrangements (see “other matters” section below). Throughout any such discussions regard must be had to the company's continuous disclosure obligations contained in the ASX listing rules and the Corporations Act, and a director's obligation to act in the best interests of the company rather than the individual interests of any one shareholder or shareholder group. In some cases, boards may consider that it is not appropriate in their company's circumstances to engage with shareholders beyond what is required by law.

4. Shareholder approval may be required, for example, in the context of ASX listing rule 10.14 or under the termination payments provisions of the Corporations Act (Division 2 of Part 2G.2).

Remuneration policies and terms

The last section discussed the overarching framework and set of processes governing executive remuneration. This section focuses on remuneration policies and terms.

Do establish executive remuneration policies that set out the reasoning behind the various remuneration components and any relevant conditions.

Executive remuneration policies can serve as an important tool that assists the company to meet strategic objectives through :

- enhancing the company's ability to attract and retain talented senior staff
- promoting consistency between individuals and over time
- aligning the interests of executives with those of the company
- focusing executive efforts on priorities considered to be of paramount importance by the board.

It is important that the company has a well-articulated set of executive remuneration policies that take into account factors such as the nature of the company's business operations, the environment in which it operates, and its strategic objectives.

The company's policies should clearly set out the main elements of executive remuneration (for example, base salary, short-term cash incentive, long-term equity plan in kind benefits, and so on), any conditions that attach (for example, performance hurdles), and the reasoning behind both.

Do ensure remuneration is reasonable, having regard to the best interests of the company.

Company directors are under a legal obligation to act in the best interests of the company they serve. This reflects a sound principle of good corporate governance, which extends to the setting of executive remuneration.

Boards must balance the proposed remuneration to be paid to the executive, against prevailing market rates and the expected incremental benefit to the company of engaging the individual.

Remuneration policies and terms

Senior executives are often “related parties” of the company, as defined in the Corporations Act, and as such their remuneration must be “reasonable”.⁵ There is no guidance provided in the Act as to what is “reasonable” and little by way of precedent in Australian case law. The Corporations Act, makes it clear that reasonableness is to be tested by two objective factors, namely the circumstances of the company and of the related party. The company’s circumstances could require consideration of such factors as the:

- nature, scale (market capitalisation,⁶ total assets, revenue, employee numbers, and so on), and profitability of the company
- industries and markets in which it operates
- operating locations, including whether it is an international company
- structure and responsibilities of the board
- future prospects of the company
- risks, challenges, complexity and diversity of its business.

A company’s circumstances may be considered by reviewing comparative data for companies with similar operating characteristics. Similarly, consideration of an executive’s circumstances may encompass reviewing comparative data for other executives in similar roles and of equivalent calibre, including skills, experience and qualifications.

Factors to consider include:

- the executive’s qualifications
- the prevailing economic conditions
- the range of remuneration for comparable roles in the same industry
- the remuneration structure of the company (for example, intra-company relativities)
- the data for other CEOs
- the formality and timing of the decision of the board concerning remuneration
- the executive’s responsibility for the company’s inception and/or success
- remuneration paid to an executive in previous years
- remuneration paid to the CEO’s direct reports.

5. Corporations Act, sections 210 and 211.

6. A matter that adds further complexity to board considerations is that traditionally CEO pay has been partially linked to the company’s relative rank and market capitalisation. There may well be instances where the market capitalisation of particular companies has fallen dramatically, but fixed pay in each case has remained unchanged. When statistical analysis is undertaken of prevailing market pay levels for the purpose of considering future emoluments, the observed ratio between pay and market capitalisation may be of limited usefulness in some cases.

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It is important to bear in mind that executive remuneration may be “reasonable” at the time it is negotiated, but viewed as unreasonable with the benefit of hindsight. Boards should consider carefully documenting the reasons for adopting particular remuneration practices. Stress testing (see above) and expert advice can play an important role in this context.

Do have an appropriate mix between base pay, short-term incentives and long-term incentives, where such components are included in remuneration packages.

Most executive remuneration packages today comprise a base salary, together with short-term and long-term incentive elements linked to performance. The short-term incentive element is often paid in cash, while the long-term incentive element is typically delivered in the form of equity. There is no legal requirement for executives to be granted entitlements to incentive payments and other such benefits in addition to salary; rather this has been driven by market forces.

The mix of base pay, short-term incentive and long-term incentive elements is likely to vary from company to company, depending upon factors such as the existence of particular short-term imperatives (for example, the bedding down of a merger) and the variables that the board considers drive the company's long-term performance. It may well also vary from executive to executive. As a general rule the salary component of remuneration packages should not be so high that incentive elements are not regarded as remuneration “at risk” by the executive; and not so low as to impinge on the executive being able to meet his or her essential financial commitments. The overriding consideration for the board is whether its model or structure is appropriate to the company's particular circumstances. What other possibilities could be considered? For example, a base salary and long-term incentive plan (or short-term incentive plan only) plus superannuation may be more appropriate in some circumstances. What level of discretion is appropriate in the company's circumstances for the board to retain? (see below).

Do link incentive elements of remuneration packages to appropriate performance measures in such a way that short-term imperatives of the company are pursued while simultaneously promoting the company's long-term interests.

Executive remuneration policies and practices should promote the long-term performance of the company and wealth creation for its owners.

Remuneration packages are sometimes wrongly weighted too much towards the short term (for example, too much emphasis on increasing

Remuneration policies and terms

current year profits or revenue), promoting actions that benefit the company and executives in the short term, but not necessarily the company in the long term. For example, the arrangements may encourage excessive risk-taking because the executive concerned does not bear fully the future downside of their actions.

There are a number of ways in which boards may be able to better align executive interests to long-term corporate performance. Companies are increasingly introducing deferral elements into remuneration packages. Such an approach could involve, for example, the allocation of shares on an escrowed basis, holding back part of the short-term bonus with payment dependent on the following years outcomes, or the vesting of securities upon the expiration of a sufficiently long period after the executive has retired from the company

Any performance measures adopted should reflect the company's corporate strategic objectives. This might entail :

- use of multiple performance metrics (possibly both financial⁷ and non-financial)⁸
- benchmarking performance against peer groups
- a mix of relative and absolute measures.

Any performance measures that are chosen should minimise the possibility of manipulation by the executive(s) eligible for rewards.

Do consider the possibility of contract termination when negotiating executive contracts and include appropriate provisions in the contract.

Termination payments to departing executives, in particular CEOs, have been the subject of legislation,⁹ industry guidelines¹⁰ and vigorous domestic and international debate in recent years. This is in part because such decisions often involve a high level of judgment, where all the relevant facts may not be able to be disclosed publicly, and where there are potentially

7. Such as total shareholder returns (TSR) or earnings per share (EPS).

8. Such as improved workplace safety, if this is an issue for the company.

9. Termination benefits (a form of financial benefit) must be "reasonable" or approved by shareholders (see Corporations Act, Section 208(1) & 211(1)). In addition, shareholder approval may be required unless a listed exception applies. One exception is where a termination payment is provided in return for past services rendered and does not exceed the greater of the average remuneration over the last 3 years multiplied by the years in office up to a maximum of 7 years or the remuneration or estimated remuneration for the last 12 months (Corporations Act, Sections 200B(1) & 200G).

10. For example, AICD, Executive Termination Payments, Position Paper, October 2008.

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broader issues associated with matters, such as the potential damage to the company and its shareholders of protracted litigation with uncertain outcomes. The public debate is expected to continue given the current downturn in world markets. It is essential to deal with the issue of termination arrangements at the time of drafting the executive's contract for all purposes, particularly for non-performance or changed circumstances.

Type of contract

When negotiating a new employment contract an important issue that boards need to consider is whether the contract should be for a fixed term ("pure fixed term" or "maximum term"), or an indefinite term with a notice period.

Contracts with an indefinite term typically provide for termination by either party at any time by the giving of specified notice. This notice period for CEOs is preferably no longer than 12 months, and may be reduced in the contract as time progresses (for example, 9 months and then 6 months).

Traditional pure fixed-term contracts by contrast provide for a fixed term of service, say three years, without any notice period. When the agreed end date is reached, the contract will automatically expire without the need for either party to terminate it, and hence without the need for a termination payment. Whether the employment relationship continues usually depends on whether the company offers the executive a new contract. Pure fixed-term contracts are only terminable for misconduct.

Under a "maximum-term contract" the company can terminate the contract before expiry on notice (for example, six months notice) without the need to provide specific reasons. Early termination would result in a termination payment using a formula specified in the contract (for example, six months pay in lieu of notice plus other usual entitlements; nothing beyond payment to date of termination and statutory entitlements in the event of misconduct). As with pure fixed-term contracts, if the contract runs its full term there is no additional termination payment made at the end of the contract unless otherwise provided for in the contract.

Maximum-term contracts impose a discipline on the board for evaluation of current arrangements and, if needed, provide a proper way of ending an employment relationship on notice during the term or by effluxion of time at the expiration of the term.

The pros and cons of each type of contract may vary from company to company and from executive to executive. In the case of a CEO, it is generally regarded that a maximum-term or indefinite-term contract is the most appropriate. Pure fixed-term contracts are generally not advisable because of the difficulties and costs if termination of the contract is required during the fixed term.

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Non-performance clauses

Companies sometimes include a non-performance provision within their contracts with executives, where the company can terminate the contract if the executive's performance is poor. Issues that arise include:

- what constitutes "poor performance" and how will it be managed?
- if the board was to terminate the contract, how would it prove poor performance?
- would the company be prepared to litigate if the executive claims wrongful termination and what are its prospects of success?

It can be difficult to proceed under a non-performance clause in a contract because of the many views that exist about what constitutes poor performance, differences between corporate and CEO performance, and how performance is measured. This can sometimes be a subjective issue.

Quantum of termination payments

Public criticism has been directed at large termination payments to departing CEOs who are perceived to be responsible for poor shareholder returns. This has not been as big a problem in Australia as overseas and guidelines such as AICD's policy of termination payments have assisted in this regard. The appropriateness of particular termination payments can vary from case to case, but as a guide CEO termination payments could be limited as follows:

- termination where there has been misconduct—payment to the date of termination and statutory entitlements only
- termination on notice, not involving misconduct—between six and twelve months' notice or payment in lieu of notice calculated on the amount of the CEO's base salary, and other entitlements specifically required by the contract, for example, previous bonuses not paid and which have vested.

There may be commercial circumstances where the payment of more than these amounts is justified. The guiding principle for boards should be to act in the best interests of the company.

Incentive payments

Care needs to be taken when providing in the executive contract for what happens to any incentive elements of a remuneration package for termination on notice. As a general rule, the contract should not provide for a termination payment to an executive in respect of bonuses not already earned, including on a pro-rata basis. Where the company makes a

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payment in lieu of a notice period, it is often acceptable for the contract to provide for entitlements to be paid up until the end of that notice period. In this context, while CEO contracts may be relatively short in term (for example, 3 to 5 years) compared to other employment contracts, a suitable notice period (for example, 6 to 12 months) should leave CEOs less exposed to a potential “financial hold-up” by the company.

Do examine executive remuneration in the context of other employment terms and other benefits that may be provided by the company.

When setting remuneration, consideration should be given to other terms of employment, such as post-employment obligations (for example, restrictions on employment) and notice periods (which can serve as a financial buffer). Some companies also offer benefits in kind (for example, travel benefits) which may justify a reduction in salary compared to market rates.

Do not put in place arrangements that promote excessive risk-taking or short-termism.

A major concern among some long-term investors is that certain remuneration packages promote too much executive focus on short-term results and lead to excessive risk-taking. Executives may engage in behaviour that promotes short-term goals, at the expense of long-term goals, where for example, a short-term bonus is tied to sales growth, and sales are maximised at the expense of other factors (for example, financial viability, after sales service, product quality or client relationships) that affect long-term sustainability and profitability. Excessive risk-taking may occur, for example, where bonuses or “at risk” remuneration are tied to limited concepts such as revenue, EBITDA, or Total Shareholder Return.

Do not provide for additional payments beyond basic statutory entitlements (for example, accrued annual leave) where an executive's employment relationship is terminated for misconduct.

It is commonplace for executive contracts to provide for termination in the event of misconduct on the part of the executive. Misconduct is a concept that has been the subject of judicial consideration, but can be defined in a contract to include wilfully disobeying directions from the board, drunkenness, breaching a fundamental term of the contract, being in a position of conflict with the company, being charged with a criminal offence or becoming bankrupt. While the need to terminate an executive contract for misconduct is not common, the board should have provisions to protect the company if needed. In this situation the board is usually justified in providing

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in the executive contract that the termination is immediate and payment is limited to salary accrued to the date of termination, and other statutory entitlements (such as accrued annual leave). Bonuses not already accrued are normally forfeited. Where bonuses have accrued, but have not been paid, they need to be considered in the particular circumstances.

Think about whether to have a discretionary bonus rather than a bonus that the board is contractually obliged to approve regardless of changed circumstances.

Much time and effort has gone into devising complex formulae to determine performance-based remuneration, particularly in the last five years. The conventional thinking has been that an up-front, formula-based approach to executive remuneration is the most appropriate course. In other words, attempts are made to define the relationship between performance outcomes and rewards given, as precisely as possible from the outset. Is it realistic to expect that desired executive remuneration outcomes can be precisely mapped out, possibly years in advance? For some companies this may be appropriate. For others, where there is a range of potentially volatile factors that impinge on performance, there is more doubt and it may be that it is in the company's best interests to place less reliance on formulae and more emphasis on the exercise of board judgment at the end of the performance period in question. This could take the form of a discretionary annual bonus set by the board and related to observed performance against pre-specified key performance indicators (KPIs). Another approach that has been adopted by some boards is to retain some limited discretion to adjust the observed performance measures used to determine incentive-based pay where an anomalous outcome would otherwise occur.¹¹ Two key issues that may need to be addressed if a board is contemplating the use of discretionary bonuses for CEOs and other senior executives are:

- executive candidates may be seeking a high degree of specificity on bonus conditions
- some institutional investors and other investors have expressed a strong preference for executive rewards being based upon a formula involving the company's total shareholder returns, measured relative to a peer group of companies. It may be prudent to consider likely shareholder responses in the company's circumstances, including the degree to which the board is seeking to retain discretion.

11. For example, the ability to remove outliers in benchmarking comparisons or adjust for particular types of accounting treatment where statutory profit is used as a performance measure (such as a change in accounting standards, which of itself gives rise to a change in profits, or mark-to-market adjustments for long-term assets that are not held for the purpose of resale).

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Think about placing an upper bound on short-term and long-term incentive rewards, where such components exist, to minimise “surprises” of markets, products, and so on.

One way of reducing unintended remuneration outcomes is to place an upper bound on the amount of incentive-based payments: both short-term and long-term rewards. This could involve an absolute limit or a diminishing marginal relationship beyond some point between rewards and the various performance metrics chosen. A contrary argument is that executive performance may reduce once this bound is reached. If the latter possibility is a concern, it could be mitigated by setting reward bounds at sufficiently high levels, but such that the board or executive would be happy to defend publicly if required. The merits of a bound will depend on the design of the company's remuneration arrangements, including the level of complexity involved.

Think about putting in place arrangements whereby a percentage of a CEO's long-term equity incentive rewards is held for a period that extends beyond the term of the employment contract.

An executive nearing the end of his or her employment relationship can suffer from a “horizon problem”, insofar as the decisions they make are more likely to be made with short-term considerations in mind as the end of employment with the company approaches. To possibly assist in dealing with this horizon problem where the executive's role can have a material effect on the company's value (as in the case of a CEO), consideration could be given to lagging a component of remuneration. This would allow the long-term effects of the executive's actions to be taken into account. This might also assist with succession planning and the long-term sustainability of the company. It needs to be remembered that there is no “perfect solution” to executive remuneration and this is simply another possibility to consider.

Think about the range of metrics available for boards to examine other than just comparative market data, such as the net benefit to the company of different remuneration levels, differences in the remuneration of the CEO and his or her direct reports, and so on.

Boards should consider what is appropriate for the company in the relativity between remuneration of the CEO, his or her direct report and other employees. Such a consideration is relevant within the context of the desired culture of the organisation and issues around succession planning. This is not to say the CEO remuneration package should be used as a mechanism for

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driving up the packages of other senior executives (or vice versa) without any associated change in responsibilities, but boards should be mindful of the potential consequences of any material discrepancy and not look at executive remuneration in isolation from other corporate issues.

Reviewing arrangements

Having put in place a set of remuneration arrangements with the CEO and other senior executives, it is important that these are reviewed from time-to-time, particularly where there has been a material change in the economic environment facing the company. This is likely to involve a fresh consideration of some of the matters discussed earlier in this booklet (for example, ensuring remuneration is reasonable, that there is an appropriate package mix, and so on).

Do undertake board post-mortems of remuneration outcomes.

Given the importance of executive remuneration as a performance driver, and the many ways in which remuneration arrangements can be confounded or diverge from the company's changing needs, boards should conduct periodic reviews of executive remuneration structures and outcomes. A comparison could be made between expected and actual remuneration outcomes and consideration given to the reason for any variances. Remuneration outcomes can also be assessed against progress towards the attainment of the company's short-term and long-term objectives. Through such reviews boards should seek to develop a tailored set of arrangements that is appropriate in the company's contemporary and changing circumstances.

Do not change performance hurdles midstream unless there is an exceptionally good reason or reasons.

It is not unusual for boards, in the light of a company's experience or changed circumstances, to alter corporate performance objectives. The change in performance objectives may necessitate a change in the basis of executive remuneration, such as the performance hurdles set. The capacity to change hurdles will be affected by the remuneration arrangements the company has agreed to in advance with executives. Where it is possible, changing performance hurdles during the operation of a remuneration agreement may attract criticism from shareholders. This is because it may be viewed as changing "the rules of the game" midstream, particularly where hurdles are lowered. The view is also sometimes expressed that such changes tend to be one-sided, to the benefit of executives: performance hurdles being rarely raised midstream to the detriment of executives.

Reviewing arrangements

On the other hand, it is not usually in a company's best interest to retain a reward system that does not provide incentive for executives, and which could prompt them to seek employment elsewhere. A change in performance hurdles may be necessitated by changes in a company's circumstances, not envisaged when remuneration arrangements were originally entered into.

Where performance hurdles have changed, and relevant market disclosures (if any) have been made, it may be desirable for board representatives (for example, the board chairman or Remuneration Committee chairman) to discuss these changes with major shareholders. Such changes should also be clearly explained to shareholders in the company's annual remuneration report, including the basis for the decision. Continuous disclosure requirements and commercial sensitivities may well preclude shareholder discussions about proposed changes to hurdles.

Do not allow double or triple counting of benefits for the same effort because of multilayered remuneration structures.

When the board is undertaking remuneration reviews, varying existing contracts or renegotiating expired contracts, the board should ensure it has the full details of the remuneration package and carefully consider how a change to one part of a remuneration package might affect other parts of the package. For example, short-term and long-term incentives are often expressed as a proportion of base salary. An increase in base salary can have a knock-on effect of increasing other remuneration components. If the base is increased by 5 per cent, this could increase both the short-term and long-term incentive payments by 5 per cent or more (probably more than 5 per cent because of a leverage effect). Boards need to think about what constitutes a reasonable reward for executives and whether an upper bound on rewards is appropriate.

Think about engaging with major shareholders where a material change in remuneration arrangements is made, subject to continuous disclosure obligations.

The setting of remuneration arrangements can be a complex exercise, with elements specific to the company and the executive concerned. A material change in remuneration arrangements may be prompted by a number of factors including a change in corporate strategy or activities, altered executive market conditions, a change in executive personnel and/or a shift in what is regarded as good corporate governance practice.

Companies should think about engaging with major shareholders where material changes in remuneration arrangements are made. By doing this

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companies may lessen shareholder concerns—through shareholders gaining a better understanding of the basis for remuneration decisions by the board, or the board gaining a better understanding of shareholder concerns to examine what the company might do to deal with these. Again, attention must be given to the company's continuous disclosure obligations, which may preclude changes in remuneration practices being discussed at the time of contemplation.

Think about likely scenarios going forward (for example, share market movements, industry developments, and so on) and their effects.

As with setting initial remuneration arrangements boards should, when reviewing arrangements, think about likely scenarios going forward and the effect they might have on existing or contemplated arrangements.

Other matters

This section outlines some additional guidelines that do not fit within earlier categories.

Do ensure remuneration packages are publicly defensible.

Executive remuneration can be an emotive topic. Remuneration decisions by a board should be made on a sound basis, such that they can be defended publicly bearing in mind the above comments. It may assist to think in terms of the general rule, “what if the executive's remuneration appears on the front page of the financial news?”, and how the decisions are reflected in the annual remuneration report considered by shareholders at the company's AGM.

Among the challenges faced by boards in this context are:

- non-disclosure of commercially sensitive performance hurdles
- the discrepancy between reported and actual “take home” executive pay
- being judged with the benefit of 20/20 hindsight.

One instance where some boards have come under criticism is for not disclosing the specific details of performance hurdles, on “commercial grounds”. It is recognised that it may not always be in the best interests of the company to publicly disclose all remuneration details at a particular time, such as performance hurdles tied to commercially sensitive strategic objectives. Whether to link performance to such objectives and not fully disclose the relevant hurdles are assessments boards must make in their company's circumstances, and be prepared to defend, usually after getting appropriate advice.

Another issue for boards relates to the discrepancy between individual remuneration as set out in the company's annual remuneration report and actual “take home” remuneration for the CEO/executive concerned. The figure set out in the remuneration report is what is normally quoted in the financial press as the executive's pay. The reported and actual figures often do not correspond, in part because reported remuneration may include an equity element that has not yet vested (and may never vest if performance conditions aren't met). Further, in the case of equity options, a theoretical

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pricing model is used (for example, the Black Scholes model¹²), which may not be representative of actual value obtained by the executive.

Boards are also likely to be judged by commentators who have the benefit of “20/20 hindsight”. While this issue is not unique to executive remuneration, it can be particularly acute because remuneration arrangements may have been set some years before an unforeseen problem arises. Some actions that should assist boards are:

- anticipate issues raised by shareholders and others
- use appropriate benchmarks and performance measures
- undertake scenario testing and retain board discretion as needed to reduce possibility of anomalies or windfall gains under both cash and equity- based incentive plans
- consider an upper bound on both short-term term and long-term incentives
- try to structure arrangements so that “failure” by executives is not rewarded
- make arrangements no more complex than they need to be
- include as much flexibility as appropriate in the company's circumstances and best interests (for example, discretionary bonuses).

Do keep abreast of general market sentiment on remuneration issues and latest developments in good governance practices.

Debate over the quantum and details of executive remuneration has become a perennial issue, and this is unlikely to change in the near future. Much of the commentary is ill-informed and fails to take account of the market forces at play when appointing a new executive (especially a CEO) or renegotiating existing arrangements.

Boards should be aware of contentious remuneration areas (for example, termination payments, performance hurdles), the “trigger points” for negative investor reaction or adverse public comment and where changes occur in market sentiment about particular practices. Examples of such changes in recent years have included antipathy towards over-reliance on share options in incentive plans and the provision of non-recourse loans by the company to fund share acquisitions. Since the global financial crisis began in 2007, we have seen increased focus on the short-term term component of remuneration packages, and whether the arrangements are such that they promote excessive risk seeking behaviour that is counter to the long-term interests of the company.

12. The Black Scholes model is a widely-used model for pricing equity options. This model has known limitations, particularly for long-term options.

Where there are contentious areas, boards should take particular care in explaining remuneration decisions. A good case in point are executive termination payments, where there is merit in distinguishing between constituent amounts such as statutory benefits, payments made in lieu of notice and other accrued contractual payments, as opposed to “additional non-contractual payments” which are sometimes also referred to as “ex gratia” payments.

Do clearly communicate the board's approach to executive remuneration and the policies the company has in place.

Statements outlining a company's approach to remuneration matters, as well as the structures, processes and policies it has in place, can often be found in several places including corporate websites, annual corporate governance statements and other disclosures required under the listing rules,¹³ and annual remuneration reports prepared under the Corporations Act. In some cases, particularly in annual remuneration reports, remuneration disclosures can be so detailed that the essential features of the company's arrangements are obscured. Wherever possible, disclosures should be in plain English and designed to be both understandable and informative, drawing attention to factors specific to the company where relevant.

Think about executive remuneration as a potential corporate reputation and sustainability issue.

In some cases the approach taken by boards on executive remuneration can adversely affect how various stakeholder groups view the company, and consequently impede the company's ability to fully meet its objectives. The most obvious example relates to shareholders and the confidence they have in the company's board and management. A loss of confidence is likely to reduce, among other things, the company's share price and the willingness of investors to contribute further funds, and consequently increase the company's cost of capital. Another example relates to employees generally, where large discrepancies in remuneration levels between staff, or between company and market remuneration levels, can cause low staff morale, reduce productivity, and lessen the company's ability to attract or retain appropriate staff.

13. ASX has stated that under continuous disclosure requirements it expects “entities announcing the appointment of a CEO to disclose the key terms and conditions of the relevant contract entered into”. Refer to ASX Companies Update 1 May 2003.

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Think about director training on executive remuneration and associated issues.

Executive remuneration is a subject that is important to the proper functioning of companies, while at the same time having particular challenges, and it is constantly evolving. Much of what can go wrong in executive remuneration is influenced by the approaches boards adopt when CEOs and other senior executives are first appointed, and when contractual relationships between the company and its executives are being negotiated and set. For some boards, the appointment of a new CEO might be something they do not have a great deal of experience with; they may only need to appoint a new CEO every five-to-ten years. With these points in mind, executive remuneration is a topic where boards and individual directors might benefit from training about the different ways in which boards have attempted to tackle issues involved, potential “flashpoints” and recent developments in good practices.

Further reading

AICD, *Remuneration Committees Good Practice Guide*, 2004

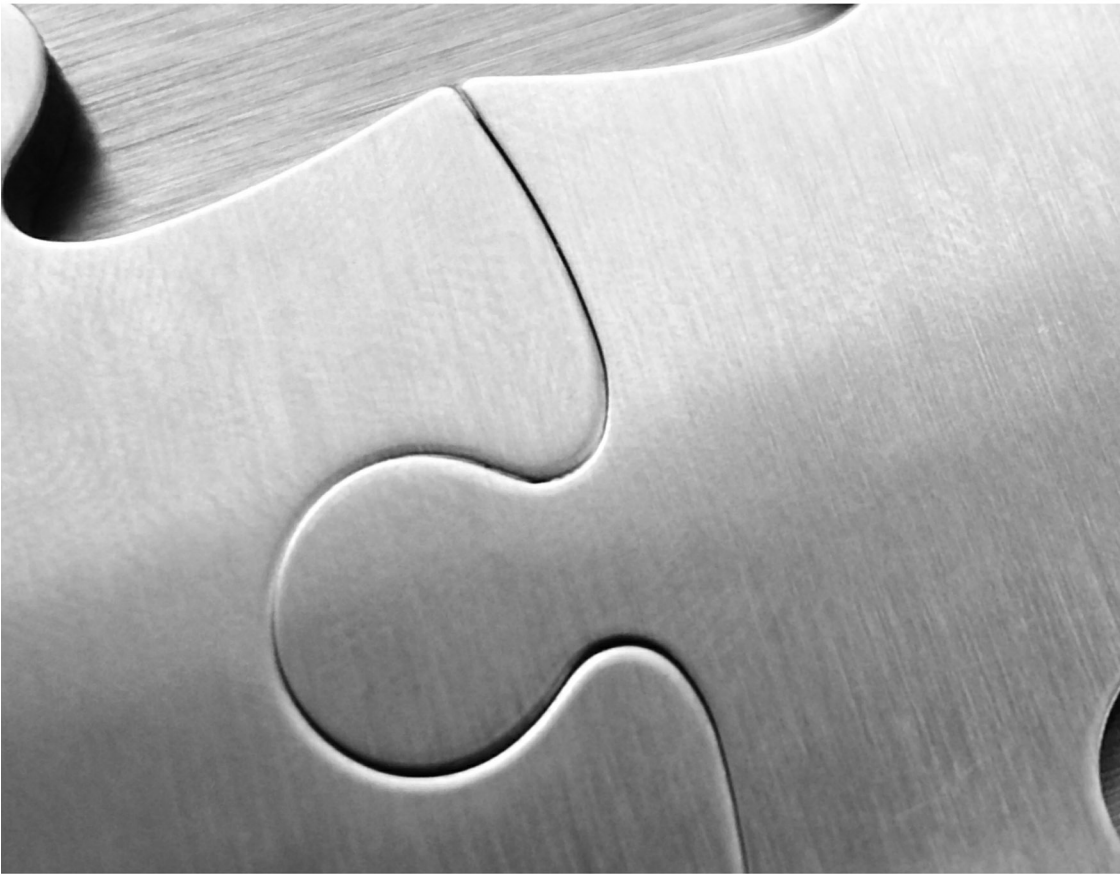
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