

# Australian Government Response

To the Productivity Commission's Inquiry  
on Executive Remuneration in Australia

APRIL 2010



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## 1. BACKGROUND

### Background to the PC review

The remuneration of company directors and executives is an issue which has attracted considerable interest from shareholders, business groups and the wider community. The recent global financial crisis highlighted the importance of ensuring that remuneration packages are appropriately structured and do not reward excessive risk taking or promote corporate greed.

The crisis has also highlighted the need to maintain a robust regulatory framework that promotes transparency and accountability on remuneration practices, and better aligns the interests of shareholders and the community with the performance and reward structures of Australia's corporate directors and executives.

Internationally, remuneration practices have been considered by various forums, such as the Group of Twenty (G-20) and the Financial Stability Board (FSB). Both the G-20 and the FSB have made recommendations to improve remuneration practices in the financial sector as part of their responses to the crisis, which are being implemented in Australia.

In March 2009, the Government tasked the Productivity Commission (PC) with undertaking an extensive review of Australia's director and executive remuneration framework. The PC's terms of reference were broad to enable it to undertake an extensive review spanning all aspects of Australia's remuneration framework applying to listed companies. The PC's terms of reference are set out below.

The PC released a draft report on 30 September 2009 and undertook extensive public consultation on the draft recommendations before issuing the final report in December 2009.

The PC's final report has concluded that Australia's corporate governance and remuneration frameworks are highly ranked internationally. However, the report makes a number of recommendations to further strengthen Australia's remuneration framework. These recommendations are designed to improve board capacities, reduce conflicts of interest, encourage stakeholder engagement, improve relevant disclosure and to ensure well conceived remuneration policies.

### The PC's terms of reference

The PC's terms of reference are set out below:

- to consider trends in director and executive remuneration in Australia, and internationally, including, among other things, the growth in levels of remuneration, the types of remuneration being paid, including salary, short-term, long term and equity-based payments and termination benefits and the relationship between remuneration packages and corporate performance;
- to consider the effectiveness of the existing framework for the oversight, accountability and transparency of director and executive remuneration practices in Australia including:
  - the role, structure and content of remuneration disclosure and reporting, the scope of who should be the subject of remuneration disclosure, reporting and approval, the role of boards and board committees in developing and approving remuneration packages, the role of executives in considering and approving remuneration packages, the role of other

stakeholders, including shareholders, in the remuneration process, the role of, and regulatory regime governing, termination benefits, the role of, and regulatory regime governing, remuneration consultants, including any possible conflicts of interest, the issue of non-recourse loans used as part of executive remuneration, and the role of non-regulatory industry guidelines and codes of practice;

- to consider, in light of the presence of large local institutional shareholders in Australia, such as superannuation funds, and the prevalence of retail shareholders, the role of such investors in the development, setting, reporting and consideration of remuneration practices;
- to consider any mechanisms that would better align the interests of boards and executives with those of shareholders and the wider community, including but not limited to:
  - the role of equity-based payments and incentive schemes, the source and approval processes for equity-based payments, the role played by the tax treatment of equity-based remuneration, the role of accelerated equity vesting arrangements, and the use of hedging over incentive remuneration;
- to consider the effectiveness of the international responses to remuneration issues arising from the global financial crisis, and their potential applicability to Australian circumstances;
- to liaise with the Australia's Future Tax System Review and the Australian Prudential Regulation Authority in relation to, respectively, any taxation and financial sector remuneration issues arising out of this Review; and
- to make recommendations as to how the existing framework governing remuneration practices in Australia could be improved.

## 2. RECENT GOVERNMENT ACTION TO STRENGTHEN AUSTRALIA'S REMUNERATION FRAMEWORK

### Termination benefits

The Government has implemented initiatives to strengthen other aspects of Australia's executive remuneration framework, such as the recent reforms to provide shareholders with greater powers to reject excessive termination benefits, or 'golden handshake' payments given to company directors and executives.

Such payments are given to outgoing company directors and executives at a time when they are no longer able to influence the company's future performance. They provide little benefit to the company, and are often regarded by shareholders, and the wider community, as a reward for failure.

The key elements of the Government's reform included:

- significantly lowering the threshold for shareholder approval of termination benefits from the previous threshold (which allowed up to seven year's total remuneration) to one year's base salary;
- expanding the scope of individuals covered to senior executives (previously, only directors were captured by the regulatory regime);
- broadening the meaning of a 'benefit'; and
- implementing a number of other improvements to the framework, such as strengthening the integrity of the shareholder vote, facilitating recovery of unauthorised termination benefits and substantially increasing the relevant penalty provisions.

These are important reforms which have strengthened the accountability of company management who provide excessive termination benefits, empowered shareholders to reject excessive termination benefits and promoted the provision of responsible levels of termination benefits to company directors and executives. The reforms received Royal Assent on 23 November 2009.

### Australia's implementation of international financial sector remuneration standards

Australia has also played a key role in developing new global standards on pay in the financial sector. These standards will be implemented by the Australian Prudential Regulation Authority (APRA), ensuring remuneration arrangements do not lead to excessive risk taking in Australia's financial institutions.

APRA released finalised standards and prudential practice guides on remuneration on 30 November 2009. These apply to all Authorised Deposit-taking Institutions (ADIs), general insurers and life insurers.

The key components of the APRA standards are:

- all regulated institutions will be required to establish a board remuneration committee and have in place a remuneration policy;

- the performance based components of remuneration must be designed to align remuneration with prudent risk taking; and
- any performance based components must be able to be adjusted to zero ('clawed-back').

The standards formally took effect from 1 January 2010 and will be enforced from 1 April 2010 to allow institutions time to comply.

### 3. OVERVIEW OF GOVERNMENT RESPONSE TO THE PC INQUIRY

#### General comments

The Government commends the PC for its comprehensive report and the thorough and consultative approach used in the review process.

The Government fully understands the community's concerns about excessive and misaligned remuneration practices. The Government is committed to ensuring that Australia's remuneration framework promotes responsible remuneration practices and is in line with community expectations as well as international best practice.

While Australia's current remuneration framework is fundamentally sound, it is clear that some aspects require further strengthening and modernising to ensure that it meets the regulatory challenges of the 21<sup>st</sup> Century. The PC has identified a number of areas where the regulatory framework could be refined.

The Government understands the importance of taking action to put in place policies that promote transparency, accountability and responsible remuneration practices. As such, the Government intends to implement many of the PC's recommendations, and further strengthen six of the PC's proposals by expanding their scope, coverage and enforceability.

#### Government response — at a glance

Below is an overview of the Government's response to each of the recommendations. A more detailed response for each of the recommendations is set out under **Part 3 — Government Response to Recommendations**.

Rec	Summary of recommendation	Summary of Government response
1	Any declaration of 'no vacancy' at an AGM to be agreed to by shareholders.	The Government supports the recommendation. Importantly, and consistent with the recommendation, the flexibility of boards between AGMs to appoint new members where needed will not be impeded.
2	The ASX Corporate Governance Council's principles should provide, on an 'if not why not' basis, that: <ul style="list-style-type: none"> <li>remuneration committees should comprise at least three members, all non-executive directors, with a majority and the chair independent; and</li> <li>companies should have a charter setting out procedures for non-committee members attending meetings.</li> </ul>	The Government supports the recommendation in principle, but notes that this is a matter for the ASX Corporate Governance Council.
3	The ASX listing rules should prohibit executives in ASX300 companies from sitting on remuneration committees.	The Government supports the recommendation in principle, but notes that this is a matter for the ASX.
4	Prohibit key management personnel that hold shares from voting on their own remuneration arrangements.	The Government supports the recommendation and considers that it should be strengthened to expand the prohibition to closely related parties of key management personnel, to ensure the prohibition cannot be circumvented. Consistent with recommendation 6, key management personnel would continue to have the ability to vote <u>directed</u> proxies.

Rec	Summary of recommendation	Summary of Government response
5	Prohibit key management personnel from hedging unvested equity remuneration or vested equity subject to holding locks.	The Government supports the recommendation and considers that it should be strengthened to expand the prohibition to closely related parties of key management personnel, to ensure the prohibition cannot be circumvented.
6	Prohibit key management personnel from voting undirected proxies on remuneration resolutions.	The Government supports the recommendation. Consistent with the recommendation, voting of directed proxies would be unaffected by this reform (and would therefore represent an exception to recommendation 4).
7	Require proxy holders to cast all their directed proxies on remuneration reports.	The Government supports the recommendation and considers that it should be strengthened to cover all resolutions, not just those related to remuneration.
8	Remuneration reports should: <ul style="list-style-type: none"> <li>• include a plain English summary of remuneration policies; and</li> <li>• report actual remuneration received and total company shareholdings of individuals in the report.</li> </ul> Establish an expert panel to advise on revised Corporations Act architecture to support changes.	The Government supports the recommendation and will use the Corporations and Markets Advisory Committee (CAMAC) as its expert panel to advise the Government on how best to revise the legislation. The Government will also ask CAMAC to make recommendations on how the incentive components of executive pay arrangements could be simplified.
9	Confine remuneration disclosures to key management personnel.	The Government supports the recommendation and considers that it should be extended to also remove the requirement to include separate disclosures on the officers of a parent entity in order to further simplify the remuneration report.
10	The ASX Corporate Governance Council's principles should provide, on an 'if not, why not' basis that companies should disclose executive remuneration advisers, who appointed them, who they reported to and the nature of any other work undertaken for the company.	The Government has consulted with the ASX Corporate Governance Council, and the Government considers that this requirement should be included within the <i>Corporations Act 2001</i> and strengthened to include additional disclosures (such as the amount of fees paid to remuneration consultants).
11	Where an ASX300 company engages remuneration consultants, the consultant's services should be commissioned by, and their advice provided directly to, the remuneration committee or board, with accompanying disclosure in the remuneration report.	The Government has consulted with the ASX, and the Government considers that this requirement should be expanded to all listed companies that engage a remuneration consultant (not only ASX 300 companies), and included in the <i>Corporations Act 2001</i> .
12	Institutional investors should voluntarily disclose how they have voted on remuneration reports (and other 00remuneration-related issues). ASIC should monitor progress in relation to superannuation funds regulated under the <i>Superannuation Industry (Supervision) Act 1993</i> .	The Government notes that any voluntary disclosure is a matter for each institutional investor. The Government also notes that the Super System Review (the Cooper Review) is considering the exercise of superannuation fund voting rights. The final report of the review is due by 30 June 2010.

Rec	Summary of recommendation	Summary of Government response
13	Remove the cessation of employment trigger for taxation of equity or rights that qualify for tax deferral and are subject to risk of forfeiture.	<p>The Government does not support the recommendation.</p> <p>Cessation of employment as a deferred employee share scheme taxing point has been a feature of the law since 1995.</p> <p>Removing the cessation of employment taxing point would increase the concessionality of schemes, providing a disproportionately large benefit to higher-income employees.</p> <p>It would reduce the integrity of the tax system, and make it more difficult for the Tax Office to ensure the correct amount of tax was paid. The proposed change would have a significant cost to Government revenue.</p>
14	ASIC should issue a public confirmation to companies that electronic voting is legally permissible without the need for constitutional amendments.	The Government supports the recommendation in principle but notes that this is a matter for ASIC, which is an independent authority.
15	<p>Two strikes and re-election resolution process:</p> <ul style="list-style-type: none"> <li>• 25 per cent 'no' vote on remuneration report triggers reporting obligation on how concerns addressed; and</li> <li>• subsequent 'no' vote of 25 per cent activates a resolution for elected directors to submit for re-election within 90 days.</li> </ul>	The Government supports the recommendation and will consult further on the implementation details relating to this proposal.
16	The Australian Government to implement intent of recommendations 2, 3, 10 and 11 by legislation if the ASX and Corporate Governance Council do not make requisite changes.	<p>The Government supports the recommendation and has consulted with the ASX and the ASX Corporate Governance Council in developing its response to the PC's inquiry.</p> <p>The Government supports implementing recommendations 10 and 11 through legislative means by amending the <i>Corporations Act 2001</i>.</p>
17	<p>Review within five years to consider:</p> <ul style="list-style-type: none"> <li>• the effectiveness and efficiency of the reforms, including to termination payments and employee share schemes; and</li> <li>• the regulatory architecture.</li> </ul>	The Government supports the recommendation.

#### 4. DETAILED GOVERNMENT RESPONSE TO PC INQUIRY

### No vacancy rule

#### *Recommendation 1*

***For the election of directors at a general meeting, where the board seeks to declare no vacancies and the number of directors is less than the constitutional maximum, approval should be sought from shareholders by way of an ordinary resolution at that general meeting. Boards would retain their powers to appoint directors and fill or leave vacant casual vacancies throughout the year. This recommendation should be effected through amendments to the Corporations Act 2001 and relevant regulations.***

#### *Government's response*

The Government supports the recommendation.

The Government notes that the 'no vacancy' rule is used by only some companies and is implemented through their constitutions.

The 'no vacancy' rule provides boards with a disproportionately high degree of power over the composition of the board. It enables boards to effectively block the election of outside candidates. Given the crucial function of boards in overcoming the agency problem between company owners (shareholders) and controllers (managers), and the duty of the board to act in the best interests of the company, it is important that shareholders have an appropriate degree of control over its composition. The current operation of the 'no vacancy' rule is a significant blocker to this.

The Government believes shareholders should have practical and workable mechanisms to address any concerns that their company's board is acting in its own interests in preference to the company's. For example, shareholders may be concerned their board is functioning in a 'closed shop' fashion, does not have sufficient independence from management, or fails to nominate and recruit new members with the right characteristics to ensure board decisions are made in the best interests of the company. While company members can vote off a board member, for many shareholders, particularly smaller retail investors, the monetary costs of garnering sufficient support or calling an Extraordinary General Meeting can be prohibitive. However, even if a director was removed, the board could deny shareholders the opportunity to vote in someone new.

In situations such as those outlined above, boards may seek to invoke the 'no vacancy' rule for reasons that are in their own interests, and would be able to do so with no checks and balances in place. As such, requiring boards to seek shareholder approval to declare no vacancies more fairly balances the power over board composition. It is also hoped that this requirement will lead to greater shareholder engagement in company affairs, improved communication from companies to shareholders, and increased transparency and accountability of boards.

Having a fair balance of power between boards and shareholders is particularly important to ensuring that boards are accountable for their executive remuneration structures. Remuneration packages are one of the primary means by which the board can align the interests of owners and managers. Because of the problems for the board and shareholders in monitoring the performance of executives, it is important that shareholders are confident that the board is providing incentives for executives to act in the company's best interests.

In taking this course of action, the Government is conscious that boards are often in the best position to determine their operational needs at a particular time. However, the Government believes, and the evidence presented by the PC demonstrates, that boards with shareholder confidence generally receive high levels of agreement to resolutions. For this reason, a board with

shareholder confidence that can demonstrate good reasons for declaring no vacancies should not have problems securing shareholder agreement.

Additionally, the Government understands that boards require flexibility to fill vacancies that might arise throughout the year (for example, due to retirement of an incumbent director); or to bring another director on board for succession planning or where an excellent candidate becomes available. For these reasons, the Government will ensure that boards retain their flexibility to make appointments during the year, subject to approval by shareholders at the next AGM. This aspect of the proposal will maintain the status quo in relation to board appointment procedures.

The Government is aware of concerns that requiring shareholder approval to declare no vacancies could lead to companies increasing board size to prevent the election of non-endorsed candidates. However, a person would still require 50 per cent plus one of the votes to get a board seat. This is not an easy feat, particularly given the difficulty of mobilising disperse retail investors, and the Government is not aware of any indications that this issue has proved problematic for companies in practice.

Finally, the Government notes that its response to this recommendation is not aimed at improving board diversity, however, this would be a welcome consequence. The Government is acting on this recommendation because it believes requiring shareholder approval for declaring no vacancies will strengthen corporate governance; improve shareholder engagement and participation; improve information flow from boards to shareholders; and result in the interests of shareholders being better aligned with management.

## Remuneration committees

### *Recommendation 2*

***The ASX Corporate Governance Council should introduce an ‘if not, why not’ recommendation specifying that remuneration committees:***

- ***have at least three members;***
- ***comprise non-executive directors, a majority of whom are independent;***
- ***be chaired by an independent director; and***
- ***have a charter setting out procedures for non-committee members attending meetings.***

### *Government’s response*

The Government supports the recommendation in principle, but notes that this is a matter for the ASX Corporate Governance Council.

### *Recommendation 3*

***In conjunction with recommendation 2, a new ASX listing rule should specify that all ASX300 companies have a remuneration committee and that it should comprise solely non-executive directors.***

### *Government’s response*

The Government supports the recommendation in principle, but notes that this is a matter for the ASX.

## Prohibiting key management personnel from voting their shares in remuneration resolutions

### *Recommendation 4*

***The Corporations Act 2001 should specify that company executives identified as key management personnel and all directors be prohibited from voting their shares on remuneration reports and any resolutions related to those reports.***

### *Government's response*

The Government supports this recommendation and considers that it should be strengthened to expand the prohibition to closely related parties of key management personnel, as an anti-avoidance measure.

The Government notes that there is a real, as well as perceived, conflict of interest that exists with directors and executives voting on their own remuneration packages. As these directors and executives have an interest in approving their own remuneration arrangements, allowing them to participate in the non-binding vote may result in a higher approval vote on the remuneration report than might otherwise be achieved. This can distort the outcome of the non-binding vote and diminish its effectiveness as a feedback mechanism.

Implementation of this recommendation will strengthen the effectiveness of the non-binding vote as a feedback mechanism for shareholders and companies, and will eliminate the potential conflict of interest that exists with management voting on their own remuneration.

## Prohibiting hedging

### *Recommendation 5*

***The Corporations Act 2001 should specify that companies prohibit their executives from hedging unvested equity remuneration or vested equity subject to holding locks.***

### *Government's response*

The Government supports this recommendation and considers that it should be strengthened to expand the prohibition to closely related parties of key management personnel, as an anti-avoidance measure.

The Government is aware that the effect of hedging incentive remuneration is to 'de-link' remuneration from company performance. This practice is inconsistent with a key principle underlying Australia's remuneration framework that remuneration should be linked to performance.

Implementation of this recommendation will strengthen the remuneration framework by ensuring that the interests of management are aligned with the interests of shareholders, and that remuneration is genuinely linked to company performance.

Consistent with the PC's recommendation, the Government notes that the prohibition does not need to extend to vested equity that is not subject to holding locks, as key management personnel could hedge their exposure by simply selling their equity holdings.

## Prohibiting key management personnel from voting undirected proxies

### *Recommendation 6*

The *Corporations Act 2001* and relevant ASX listing rules should be amended to prohibit company executives identified as key management personnel and all directors from voting undirected proxies on remuneration reports and any resolutions related to those reports.

### *Government's response*

The Government supports this recommendation. The Government notes that, under the current framework, the Chair of the board can exercise undirected proxies, even on resolutions that they are otherwise prohibited from participating in (for example, a resolution to increase the total pool of fees paid to directors). The Government believes that it is inappropriate that directors and executives engaged in the design of remuneration arrangements should then be able to use undirected proxies to distort the outcome of the vote.

This recommendation will eliminate the conflict of interest that arises with company management voting on their own remuneration, and strengthen the effectiveness of the non-binding vote.

## Cherry-picking

### *Recommendation 7*

***The Corporations Act 2001 should be amended to require proxy holders, except in exceptional circumstances, to cast all of their directed proxies on remuneration reports and any resolutions related to those reports.***

### *Government's response*

The Government supports this recommendation.

The Government notes that under the current framework, non-chair proxy holders can choose to cast any directed proxies they choose. For example, they could vote only proxies that support their position, and not those that do not support their views. Importantly, shareholders may not be aware of this potential outcome when they choose to cast a directed proxy, and mistakenly believe that their voting wishes will be carried out.

This 'cherry picking' is particularly problematic where the proxy holder is a person (such as a director) who is prevented from voting their own shares because they have a conflict of interest. It also impairs the transparency and effectiveness of shareholder voting by enabling the wishes of shareholders to be ignored. Importantly, cherry picking can mute or completely change the shareholder signal on a resolution — a particularly relevant factor for remuneration resolutions.

The Government is aware that circumstances may arise that prevent a proxy holder from attending a meeting, and that it is possible a proxy holder might not be aware of their appointment. A defence would be provided for a proxy holder that fails to vote directed proxies due to such circumstances. The Government also notes that, usually, where a proxy holder does not attend a meeting the proxies default to the Chair.

The Government believes that taking action on this recommendation will create synergies with Recommendation 6 in relation to inhibiting the intrusion of conflicts of interest in shareholder voting.

The Government is of the view cherry picking should be prohibited for all resolutions, rather than just those related to remuneration reports. It is sound policy that votes on all resolution should reflect the views of the owners of the company. While this broader application of this prohibition was not within the scope of the referral, it was previously considered in 2008 in the Parliamentary Joint Committee on Corporations and Financial Services' (PJC) report *Better shareholders — better company: Shareholder engagement and participation*. The PJC consulted publicly on this issue and recommended cherry picking be prohibited. Placing a blanket prohibition on cherry picking will also avoid adding complexity to the voting system and increasing the regulatory burden for companies.

## Remuneration report

### Recommendation 8

***The usefulness of remuneration reports to investors has been diminished by their complexity and by crucial omissions. Remuneration reports should include:***

- ***a plain English summary statement of companies' remuneration policies;***
- ***actual levels of remuneration received by the individuals named in the report; and***
- ***total company shareholdings of the individuals named in the report.***

***The Australian Government should establish an expert panel under the auspices of the Australian Securities and Investments Commission (ASIC) to advise it on how best to revise the architecture of section 300A of the Corporations Act 2001 and the relevant regulations to support these changes.***

### Government's response

The Government supports this recommendation, however, considers that it would be more appropriate for the Government to use Corporations and Markets Advisory Committee (CAMAC) as its expert panel to advise the Government on how best to revise the legislation.

The Government recognises the importance of aligning executive remuneration with company performance and the usefulness of 'at-risk' remuneration in achieving this aim. Overly complex remuneration arrangements, however, can obscure this nexus between performance and remuneration. Consequently, the Government will also ask CAMAC to make recommendations on how the incentive components of executive pay arrangements could be simplified. The Minister for Finance and Deregulation will be consulted on the implementation of the expert panel's recommendations, given his regulatory reform responsibilities.

## Range of individuals reported on in the remuneration report

### Recommendation 9

***Section 300A of the Corporations Act 2001 should be amended to reflect that individual remuneration disclosures be confined to key management personnel. The additional requirement for the disclosure of the top five executives should be removed.***

### Government's response

The Government supports this recommendation and considers that it should be extended to also removing the requirement to include separate disclosures on the executives of a parent entity. Accordingly, the Corporations Act should be amended to reflect that individual remuneration

disclosures be confined to key management personnel of the consolidated entity. The additional requirement for the disclosure of the top five executives of the parent entity should be removed. Otherwise the remuneration of the five most highly remunerated executives, as well as the key management personnel of both the parent and consolidated entity must be disclosed. This means that a lot of the time the remuneration report has a doubling of information. This will reduce regulatory burden and simplify the complexity of disclosures in the remuneration report, while maintaining corporate accountability.

## Remuneration consultants

### Recommendation 10

***The ASX Corporate Governance Council should make a recommendation that companies disclose the expert advisers they have used in relation to the remuneration of directors and key management personnel, who appointed them, who they reported to and the nature of other work undertaken for the company by those advisers.***

### Government's response

The Government has consulted with the ASX Corporate Governance Council on this issue. Given the importance of ensuring transparency and accountability in relation to remuneration consultants, the Government supports this recommendation and considers that it should be mandatory for all companies (rather than being on a 'comply or explain' basis). As such, the Government supports implementing this recommendation through legislation rather than the ASX Corporate Governance recommendations. This will strengthen the enforceability of the requirement, and will ensure that there is transparency with the use of remuneration consultants.

In addition, the Government believes that this recommendation should be strengthened by requiring disclosure of additional details, such as:

- the amount the consultant was paid for the remuneration advice;
- the amount the remuneration consultant is paid for providing other (non-remuneration related) services to the company;
- the basis on which the consultant was paid; and
- a summary of the nature of the advice received and the methodology employed in formulating the advice. The summary of the nature of the advice would relate broadly to the type of the advice received, such as whether the advice included recommendations related to the quantum of pay. However, it would not require the content of the advice to be disclosed, as this information could potentially be commercially sensitive.

This will deliver greater transparency for shareholders, as they will be in a better position to assess potential conflicts of interests associated with the use of remuneration consultants.

### Recommendation 11

***The ASX listing rules should require that, where an ASX300 company's remuneration committee (or board) makes use of expert advisers on matters pertaining to the remuneration of directors and key management personnel, those advisers be commissioned by, and their advice provided directly to, the remuneration committee or board, independent of management. Confirmation of this arrangement should be disclosed in the company's remuneration report.***

### Government's response

The Government has consulted with the ASX on this issue. The Government notes the importance of ensuring transparency and accountability in relation to remuneration consultants. The Government supports this recommendation and considers that it should be extended to all listed companies that engage a remuneration consultant, not only the ASX 300 companies, and should be implemented through legislation rather than the ASX listing rules (consistent with recommendation 10).

## Institutional investors

### Recommendation 12

***Institutional investors — particularly superannuation funds — should disclose, at least on an annual basis, how they have voted on remuneration reports and other remuneration-related issues. Initially this should be progressed on a voluntary basis by institutions in collaboration with their industry organisations. The Australian Securities and Investments Commission should monitor progress in relation to superannuation funds regulated under the Superannuation Industry (Supervision) Act 1993.***

### Government's response

The Government notes that any voluntary disclosure is a matter for each institutional investor.

The Government also notes that the Super System Review (the Cooper Review) is considering the exercise of superannuation fund voting rights. The final report of the review is due by 30 June 2010.

## Cessation of employment trigger for taxation

### Recommendation 13

***The Australian Government should make legislative changes to remove the cessation of employment trigger for taxation of equity or rights that qualify for tax deferral and are subject to risk of forfeiture. These equity-based payments should be taxed at the earliest of: the point at which ownership of, and free title to, the shares or rights is transferred to the employee, or seven years after the employee acquires the shares.***

### Government's response

The Government does not support the recommendation. Options for removing the cessation of employment taxing point were thoroughly examined by the Government during its extensive consultation on the reforms to the taxation of employee share schemes.

The Government strongly supports employee share schemes, as it considers that employee share schemes align the interests of employees and employers; boost productivity through greater employee involvement; reduce staff turnover; and encourage good corporate governance.

However, cessation of employment as a deferred employee share scheme taxing point has been a feature of the law since 1995. The taxing point was introduced as one of a number of changes designed to counter tax avoidance arrangements involving employee share schemes.

In setting tax policy the Government must consider the implications on the wider community, as the employee share scheme tax arrangements affect a diverse class of taxpayers from executives of prudentially regulated entities to non-executive employees of large corporates to employees of small business. Removing the cessation of employment taxing point would increase the

concessionality of employee share schemes, providing a disproportionately large benefit to higher-income employees who are the major users of the deferred tax concession.

The Government does not consider this additional concessionality a policy priority. There is no strong argument to provide concessional tax treatment past the cessation of employment, as the productivity and governance benefits of aligning the interests of employees and shareholders after an employee has left the company decline, and do not necessarily merit additional tax concessions.

Removing cessation of employment as a taxing point would raise a number of integrity concerns. For example, employees close to retirement may defer remuneration in the form of employee share scheme interests into later years in which they may be subject to a lower marginal tax rate. This tax treatment would not be equitable with their peers receiving cash salaries. Similarly, the proposal may enable employees to avoid the employment termination payment rules, which tax lump sums of remuneration received on termination of employment.

Further, it is very difficult for the Tax Office to monitor employee share scheme tax liabilities after the employment relationship has ended. The reporting and monitoring rules become difficult to enforce, and it becomes impractical to ensure employees who move overseas after ceasing employment pay their fair share of tax.

Finally, removing the cessation of employment taxing point would have a significant cost to revenue. The Government believes that the current taxation of employee share schemes strikes the right balance between providing concessions in support of employee share schemes, and tightly targeting expenditure to reflect key government priorities.

The issue of whether an individual taxpayer has enough money to pay a tax bill that arises on cessation of employment where employee share scheme interests are still subject to sale restrictions should be left to individual employee share schemes to address. Individual schemes may solve the problem by allowing partial vesting at termination of employment as part of the rules of the scheme, or through other financial arrangements between employee and employer.

## Electronic voting

### *Recommendation 14*

***The Australian Securities and Investments Commission should issue a public confirmation to companies that electronic voting is legally permissible without the need for constitutional amendments — as recommended in 2008 by the Parliamentary Joint Committee on Corporations and Financial Services.***

### *Government's response*

The Government supports the recommendation in principle but notes that this is a matter for ASIC, which is an independent authority.

## Strengthening the non-binding vote

### *Recommendation 15*

***The Corporations Act 2001 should be amended such that:***

- ***where a company's remuneration report receives a 'no' vote of 25 per cent or more of eligible votes cast at an annual general meeting (AGM), the board be required to explain in its subsequent report how shareholder concerns were addressed and, if they have not been, the reasons why;***

- ***where the subsequent remuneration report receives a ‘no’ vote of 25 per cent or more of eligible votes cast at the next AGM, a resolution be put that the elected directors who signed the directors’ report for that meeting stand for re-election at an extraordinary general meeting (the re-election resolution). Notice of the re-election resolution would be contained in the meeting papers for that AGM. If it were carried by more than 50 per cent of eligible votes cast, the board would be required to give notice that such an extraordinary general meeting will be held within 90 days.***

#### *Government’s response*

The Government supports the recommendation. The Government considers that this recommendation will provide an additional level of accountability for directors and increased transparency for shareholders.

The Government notes that, where a company faces significant ‘no’ votes over two consecutive years and the company has not adequately responded to concerns raised by shareholders the previous year, it is appropriate for the boards of such companies to be subject to greater scrutiny and accountability through the re-election process.

This recommendation strengthens the non-binding vote and maintains the fundamental principle underlying Australia’s corporate governance framework that directors are responsible for, and accountable to, shareholders on all aspects of the management of the company, including the amount and composition of executive remuneration.

There are a number of outstanding implementation details relating to this proposal (for example, whether additional rules are required in the event that all elected directors are removed from office). The Government will publicly consult on the draft reforms to provide a further opportunity for stakeholders to comment on these implementation details. Additionally, the Minister for Finance and Deregulation will be consulted on the outstanding implementation details, given his regulatory reform responsibilities.

### Implementation issues

#### *Recommendation 16*

***If the Australian Securities Exchange does not give effect to recommendations 3 or 11 and/or the Australian Securities Exchange Corporate Governance Council does not give effect to recommendations 2 or 10, the Australian Government should give consideration to putting into effect the intent of those recommendations through legislative means.***

#### *Government’s response*

The Government supports the recommendation and has consulted with the ASX regarding recommendations 3 and 11, and with the ASX Corporate Governance Council regarding recommendations 2 and 10.

As noted above, the Government supports implementing recommendations 10 and 11 through legislative means by amending the *Corporations Act 2001*.

#### *Recommendation 17*

***There should be a review of the corporate governance arrangements that emanate from the Australian Government’s response to this report. The review should be conducted no later than five years from the introduction of the new arrangements. In particular, the review should consider:***

- ***the effectiveness and efficiency of the reforms in meeting their objectives both individually and as a package, including recent legislative reforms to termination payments and employee share scheme; and***
- ***any changes to the regulatory architecture that affects the operations of, or the balance of responsibilities between, the Corporations Act 2001, the Australian Securities Exchange listing rules and the Australian Securities Exchange Corporate Governance Council's principles and recommendations.***

#### *Government's response*

The Government supports the recommendation.

### Recovering bonuses where financial information is materially misstated

#### *Additional reform proposal for which a full discussion paper will be released*

Remuneration packages for company executives and directors are structured to ensure that the interests of executives and directors are aligned with those of the company. These packages generally comprise of a fixed component of remuneration together with performance-related ('at risk') remuneration.

While companies use a variety of performance measures/hurdles to determine performance-based pay, these measures are typically supported by information contained in the company's financial statements. In this context, it is important that a company's financial information is accurate and not materially misstated.

ASIC regularly reviews the financial statements of listed companies. If it is revealed that the financial statements are materially misstated, there is concern about the capacity to recover (or 'clawback') performance-related bonuses paid to executives. For example, the company's share price may be artificially inflated due to the misstated financial information. During this period, directors or executives may have received larger bonuses as a result of the company's artificially high share price.

Under the current framework, shareholders would only be able to recover overpaid bonus amounts by commencing legal proceedings. Such action would typically be taken against the company itself or against the company's appointed auditors. However, legal proceedings often result in a costly and arduous process for shareholders and companies.

The Government will release a discussion paper exploring an additional proposal, not identified by the PC, to 'clawback' bonuses paid to directors and executives where the company's financial statements are materially misstated

#### *Next steps*

The Government believes that the introduction of a 'clawback' provision warrants further consideration and analysis. This proposal has potential to strengthen the ability of shareholders to recover overpaid bonuses from directors and executives that have occurred as a result of materially misstated financial accounts. This proposal would also simplify the process for shareholders to pursue bonus overpayment and hold directors and executives more directly accountable to the determination of their own remuneration. This proposal would also be conducive in ensuring that directors and executives fulfil their duties as outlined in the Corporations Act, and that directors and executives are not rewarded for their failure to ensure true and fair financial statements.

The proposal is also consistent with the Financial Stability Board's Principles for Sound Compensation Practices — Implementation Standards (which was consulted on and adopted in

Australia by the Australian Prudential Regulation Authority's *Prudential Practice Guideline PPG 511 — Remuneration*), which allow for any performance based components to be able to be adjusted to zero ('clawed back'). This reform would further align Australian and international regulatory frameworks for remuneration.

The introduction of this type of 'clawback' provision is also consistent with the Government's recent reforms to termination benefits where unapproved termination benefits are now required to be immediately repaid to the company by the executive or director.

The Government will release a discussion paper shortly which will explore the possibility of introducing a 'clawback' mechanism. As the introduction of a 'clawback' mechanism was not identified in the PC's report, this proposal has not been subject to the same consultation process that was undertaken for the PC's recommendations. Consequently, an extensive public consultation on the discussion paper and on any draft legislative amendments that may be required will be undertaken. This will ensure that stakeholders have the opportunity to comment on the proposal. This work will be undertaken separately to the Government's response to the PC inquiry, in order to ensure that the implementation of the PC's recommendations is not delayed.

## **5. IMPLEMENTATION — TIMING AND CONSULTATION**

**The Government intends to introduce legislation in 2010 to implement the reforms that have been supported. It is envisaged that the reforms would take effect from 1 July 2011.**

**In addition to the consultative processes already undertaken by the PC, the Government intends to undertake a further round of public consultation on the draft reforms.**

**The Government will undertake a separate public consultation process on an additional reform proposal to ‘clawback’ bonuses paid to directors and executives where the company’s financial statements are materially misstated.**