CLERP 9 and executive remuneration

The recently released draft CLERP 9 Bill sets out the Government’s proposed legislative response on audit reform and corporate disclosure, as well as incorporating recommendations made by Justice Owen in the HIH Royal Commission Report. As Partner Richard Alcock and Senior Associate Carl Bicego explain, the amendments will impact on the design of executive remuneration policies and their disclosure to shareholders.

The Government anticipates the draft Bill will be introduced into Parliament in December this year and will amend the Corporations Act (the Act) from 1 July 2004. The proposed amendments include:

- changes to continuous disclosure offence provisions, including the controversial power given to ASIC to fine for breaches;
- CEO & CFO sign-off on the accounts to the Board;
- Management Discussion & Analysis (MD&A) disclosure in the annual report;
- changes to audit oversight and auditor independence;
- licensing obligations for financial services licensees to manage conflicts of interest; and
- amendments to the fundraising provisions in Chapters 6D and 7 of the Act.

However, one significant reform proposal that was not in the original CLERP 9 Discussion Paper issued in 2002 is the introduction of a non-binding vote on remuneration reports and expanded executive remuneration disclosure, which will apply in respect of annual reports and AGMs of listed companies after 1 July 2004. This will impact on companies with financial years ending 30 June 2004 and 31 March 2004 (if they do not release their annual report before 1 July), and perhaps even some companies with a 31 December 2003 year end where seeking to adopt early best practice. We discuss these amendments in this article.
The Remuneration Report

The draft Bill proposes amendments to the Act that would require listed companies to disclose to shareholders the details of directors’ and executives’ salaries and bonuses in a dedicated Remuneration Report (the report), and to submit this report for shareholder advisory approval at the company’s AGM. Approval will take the form of a non-binding resolution to adopt or reject the remuneration disclosures. The non-binding nature of the shareholder approval means that a majority vote against the report will not prohibit the directors from implementing the proposed remuneration policy outlined in the report, although it may present a range of difficulties for companies as outlined below. The chairman also must give shareholders the opportunity to ask questions about, or make comments on, the remuneration report at the company’s AGM.

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The key features of these proposed amendments to the Act relate to:

• Whose remuneration must be disclosed?
• Which remuneration details must be disclosed?

But in applying these new provisions, the questions are:

• What does this mean for companies?
• What aspects of a remuneration policy are likely to attract shareholder opposition?
• How can companies avoid shareholder dissent?

Whose remuneration must be disclosed?

The proposed amendments retain the current requirement in section 300A of the Act that the remuneration of the five most highly remunerated senior managers and all of the directors of a listed company must be disclosed. The draft Bill also extends the disclosure requirements to the top five executives in the entire corporate group (group executives) if consolidated financial statements are required by the Act. This may lead to the situation where the remuneration of up to 10 senior managers must be disclosed.

The new definition of ‘group executive’ includes the following members of each of the various entities within the consolidated group:

• directors of the companies or bodies;
• secretaries of the companies or bodies;
• senior managers of any corporation;
• partners and senior managers of any partnership;
• trustees and senior managers of any trusts; and
• senior managers of any joint venture.

In some circumstances, it may well be the case that the five most highly remunerated group executives in the consolidated group are the same as that for the listed company and are in fact the five most highly paid employees. However, this will not always be the case and top scientists, information officers, salespeople, artists and stock pickers in the group will not necessarily fall within the definition of group executive.

Which remuneration details must be disclosed?

The specific details of remuneration to be disclosed will be prescribed in regulations to be enacted (but not yet drafted). Companies will be required to explain the full details of the qualitative and quantitative aspects of the remuneration packages of the executives and directors mentioned above, and how this relates to the group’s performance.

The regulations will require disclosure of information such as performance hurdles relating to the exercise of options, the payment of short-term and long-term incentives together with an explanation of the appropriateness of these hurdles and the criteria against which performance is measured.

The valuation of options will be undertaken in accordance with AASB ED 106 Director, Executive and Related party Disclosures and the final accounting standard, which is expected to come into force on 1 January 2004.

What does this mean for companies?

The requirement that the report be subject to non-binding shareholder approval is consistent with the approach implemented in the UK since mid-2002.
During the 2003 round of AGMs in the UK, the remuneration reports of many companies were labelled as inadequate by corporate governance advisory firms and shareholder associations (including Pensions Investment Research Consultants (PIRC)) and the National Association of Pension Funds (NAPF). These UK organisations enjoy widespread membership – NAPF represents the funds that comprise 20 per cent of investment in the UK stock market – and their opinion is often influential. These associations are urging their members and other shareholders to either abstain from voting or to vote against certain remuneration reports.

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Consequently, when abstentions were counted together with the ‘no’ votes, quite a few remuneration reports of prominent listed companies were rejected by significantly large proportions of shareholders: 51 per cent in the case of GlaxoSmithKline; 40 per cent at Tesco; and 30 per cent at Barclays Bank.

Instances of shareholders voting against remuneration reports or abstaining from voting was widely reported in the media, both in the UK and in Australia, as these high levels of shareholder dissent were unusual, especially when compared to typical approval levels of around 95 per cent for the financial accounts and appointments of auditors.

It is likely that major ASX listed companies with remuneration reports that are opposed by Australian shareholders will receive significant adverse media coverage.

Fund managers and shareholder associations in Australia also may pressure companies to change remuneration practices that are perceived as being unjustified or inconsistent with shareholder returns. In the UK, several companies elected to make immediate alterations to remuneration arrangements in order to appease the concerns of shareholders and their associations (which had circulated and posted on their websites the specific aspects of the remuneration policy with which they disapproved). PIRC have stated that when the combination of votes against the remuneration policy and the abstention votes exceeds 30 per cent, the board is likely to reconsider its position on remuneration and there is some evidence to support this.

If a company believes that its remuneration policy is appropriate, the way in which this policy is communicated to shareholders may be a vital determinant of the level of approval that is obtained.

In an Australian context, if a board elects not to change its remuneration policies following substantial shareholder dissent, one possible consequence is that shareholder groups may use the provisions in the Act to propose resolutions in respect of executive remuneration at the next AGM. The Transport Workers Union already has adopted this tactic in part in their inclusion of a comprehensive suite of resolutions on remuneration as part of the agenda for the Boral 2003 AGM to be held in late October. Whether these resolutions can have any binding effect is another matter.

What aspects of a remuneration policy are likely to attract shareholder opposition?

In the UK, some of the reasons why shareholder associations have called for shareholders to vote against or abstain from voting on companies’ remuneration reports include:

- a general lack of transparency in relation to the total costs to shareholders of remuneration contracts;
- excessive directors’ bonuses, especially when bonuses are guaranteed and awarded irrespective of company performance – ‘payment for failure’;
- increases in executive remuneration in times of downgraded profit announcements and decreasing share prices;
- the making of ex gratia payments to executives
without prior shareholder approval;

- remuneration contracts allowing for immediate exercise of executive options, and the automatic satisfaction of all performance conditions in the event of a change in control;
- opaque and inconsistent performance targets for executive options;
- awarding bonus schemes that vest over long periods, providing executives with protection from market contractions and cyclical downturns;
- executive employment contracts containing what are judged by shareholder associations to be excessive minimum payments for early termination;
- unreasonable ‘golden parachute’ clauses that promise to compensate directors up to twice their annual package if a change in control results in their dismissal; and
- directors’ contracts with a term of up to two years in duration, and notice periods (and therefore obligations to pay severance remuneration) in excess of one year.

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Relevant to this last point, the Government’s proposals also amend the provisions for retirement benefits so that the current exception for payment of damages on termination of contracts will be limited to payments that would not otherwise require shareholder approval under the existing regime for retirement benefits. As a result, shareholder approval will be required if the payment would:

- for non-executive directors or employees of less than three years holding managerial office in the group, exceed the total of their remuneration in the past three years, or
- for other persons holding managerial office in the group, exceed seven times their average remuneration in the past three years.

The employment contracts of executives and senior managers in particular are likely to be affected by this requirement and contractual damages limited to amounts not requiring shareholder approval.

**How can companies avoid shareholder dissent?**

If a company believes that its remuneration policy is appropriate, the way in which this policy is communicated to shareholders may be a vital determinant of the level of approval that is obtained. Comprehensive disclosure of the reasons for the design of policies and not just the amounts of all remuneration or other benefits paid to directors and executives will be critical to minimise shareholder dissatisfaction with remuneration packages that might otherwise be perceived as being excessive.

Clear and compelling disclosure of remuneration review processes and executive performance achievements will support a board’s decision on remuneration.