CORRECTING POWER IMBALANCES IN AUSTRALIAN CEO REMUNERATION: ALIGNING THE INTERESTS OF SHAREHOLDERS AND CEOS

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* This essay was written during the Productivity Commission’s review into Executive Remuneration and proposes potential solutions to increase the effectiveness of CEO remuneration. The main focus of this essay is an alternative framework to implementing caps on CEO remuneration, a move that both the Productivity Commission and Rudd Government currently endorse. Neither the ‘two strikes rule’ to increase Board accountability nor potential ‘clawback’ mechanisms were considered as the author’s analysis concluded that there were other potential solutions which better addressed the causes of inefficient remuneration packages.
CORRECTING POWER IMBALANCES IN AUSTRALIAN CEO REMUNERATION: ALIGNING THE INTERESTS OF SHAREHOLDERS AND CEOS

I INTRODUCTION

The global financial crisis has heightened media attention towards Chief Executive Officer remuneration in relation to the ‘average’ Australian. The Productivity Commission is currently undertaking a review into executive remuneration because of a fear expressed by many shareholders of ASX-listed corporations at Annual General Meetings that CEOs are not earning their bonuses. As the shareholders’ agent, CEOs are responsible for managing the corporation and implementing and developing strategies to increase shareholder value. CEO remuneration is determined by a Remuneration Committee (hereafter referred to as a ‘Committee’) and assisted by remuneration consultants.

Amendments to the Corporations Act 2001 (Cth) in 2004 required ASX-listed corporations to increase their minimum disclosures to the market of payments to senior executives. Some corporations, such as Mining Project Group, only provide minimal disclosure in their Remuneration Report; in 2009 it totalled less than two full pages. Conversely, investors may be overwhelmed with information, for example, Macquarie Group’s 2009 Annual Remuneration Report amassed 59 pages. Other corporations such as Westpac Banking Corporation and Tabcorp Holdings Limited go beyond the minimum requirements to ensure that they provide decision-useful information to shareholders and other users of Financial Statements about remuneration and performance without being excessive.

Occasionally, disclosure causes public outrage. In 2006-07, Sol Trujillo, then CEO of Telstra, received a $1.5 million bonus simply for delivering a strategic plan to the

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4 Corporations Act 2001 (Cth) s 9, 198A(2), 198D(1)(a); Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Act 2004 (Cth).
5 Corporate Law Economic Reform Program (Audit Reform & Corporate Disclosure) Act 2004 (Cth) sch 5.
Board of Directors (hereafter referred to as the ‘Board’). Trujillo was not required to personally prepare or implement the report. Trujillo outsourced the report to the United States at a cost of $54 million, received the bonus and subsequently faced scrutiny from the media and the Prime Minister, John Howard.

This essay will focus on the potential effectiveness of any legislative intervention in relation to the quantity and quality of CEO remuneration in Australia to align the CEO’s interests with those of shareholders. Part II will outline the current structure, process and regulation of CEO remuneration in Australia compared with other jurisdictions and across various industries. Part III will investigate some flaws with the current processes including managerial power theory, positive accounting theory and the hedging of incentive payments. Part IV will propose some potential solutions to the issues raised in Part III. Part V will conclude that whilst the quantity of CEO remuneration may appear to be excessive, it is the quality of remuneration practices which are lacking in the current legislative mechanisms to align the interests of the CEO and shareholders.

II THE STRUCTURE, PROCESS AND REGULATION OF CEO REMUNERATION

A Australian Remuneration Practices

The majority of American research into CEO remuneration and board dynamics is relevant to Australia because the agency relationship arises in both jurisdictions. In comparison to the size and complexity of American-based multinationals, Australian corporations are significantly smaller. When the same sized firms are compared, Australian CEOs considerably receive less than American and English CEOs. For corporations sized $5 billion to $30 billion, Australian CEOs receive $3.45 million whilst the United Kingdom CEOs receive $5.56 million and the United States CEOs receive $7.36 million. Between 1997 and 2000, Australian CEOs also received a much smaller percentage of their remuneration in the form of long term incentives (‘LTIs’) when compared with the United States.

In Australia, CEO remuneration levels vary significantly at the domestic level depending on remuneration philosophies favouring cash or equity. Remuneration rises with both market capitalisation and corporation size. In 2003-04 the average ‘mix’ of remuneration components was 59 per cent base salary, 30 per cent short term

10 Ibid.
13 Productivity Commission, above n 11, 72.
14 Ibid xix.
15 Wright, above n 12, 13.
17 Productivity Commission, above n 11, xvii.
incentives (‘STIs’) and 11 per cent LTIs.\textsuperscript{18} This is a noticeably different mix from those awarded in 2007-08, where average CEO remuneration comprised 43 per cent base salary, 29 per cent STIs and 28 per cent LTIs, indicating that contracts are now being designed with a slightly greater focus on ‘at risk’ remuneration.\textsuperscript{19}

Between industries, remuneration mixes of base salary, STI and LTI incentives vary considerably.\textsuperscript{20} This can be explained by differing time horizons for product life and business cycles and requirements for aligning interests successfully.\textsuperscript{21} However, significant differences exist within particular industries. For example, in the banking and finance industry CEOs were paid much more when paid in a mix of equity, cash and cash bonuses than in a mix of just cash and cash bonuses during the 2000 financial year.\textsuperscript{22} This poses a challenge for any potential regulation that attempts to impose uniform standards, as it is unlikely that such an approach would solve all the issues faced by a broad range of ASX-listed corporations.\textsuperscript{23}

\subsection*{B CEO Tenure and Turnover}

Drawing an analogy to baseball managers, Jensen and Murphy argue that underperforming CEOs in the United States are often kept on for many years despite poor strategic choices, even though underperforming baseball managers may be fired after only one poor season.\textsuperscript{24} Like in baseball and other employment relationships, CEO turnover can create institutional change and inefficiencies. However, employing an underperforming CEO for multiple years is a much more detrimental alternative. In Australia in 2007 the CEO turnover rate was higher at 18 per cent annually compared with the European average of 17.8 per cent and 13.8 per cent per year globally.\textsuperscript{25} This continues a long-term trend despite varying global conditions.\textsuperscript{26} Australian CEO tenures were also shorter in 2007 with the average tenure being 5.9 years compared with 8.0 years globally and 5.6 years in Europe.\textsuperscript{27} This suggests that the Australian market is a tougher environment for CEOs, with less time to implement successful strategies, and a greater likelihood of redundancies due to poor performance.\textsuperscript{28}

\begin{thebibliography}{99}
\bibitem{18} Ibid xx.
\bibitem{19} Ibid.
\bibitem{20} Wright, above n 12, 26.
\bibitem{22} Wright, above n 12, 19, 26.
\bibitem{26} Ibid.
\bibitem{27} Ibid 8.
\end{thebibliography}
C Justifications for ‘At Risk’ Remuneration

CEOs are risk-averse and will trade off risk and return.\(^{29}\) However, shareholders require CEOs to take some risks to increase shareholder value.\(^{30}\) Without ‘at risk’ remuneration the CEO, as the shareholder’s agent, may not perform to the best of their ability and take risks to increase shareholder value.\(^{31}\)

The prospect of future employment is contingent on managerial ability, thus the CEO’s reputation serves as an incentive to work hard without additional bonuses.\(^{32}\) Even though market forces may reduce remuneration offered to poor performing CEOs, it is not a complete solution.\(^{33}\) Instead, monetary bonuses and variable, market-valued remuneration based on performance are generally seen as the most effective measures to align interests between shareholders and CEOs.\(^{34}\) This process requires placing a portion of salary ‘at risk’, thus making the salary variable based on the performance of the CEO when judged according to pre-determined criteria.\(^{35}\)

D Australian Regulation

The regulation surrounding CEO remuneration issues in Australia is a web of black letter law, ‘soft law’\(^{36}\) and advisory measures, some of which overlap.\(^{37}\) When aggregated, they regulate the process through which CEOs are hired, dismissed and how remuneration is reported to shareholders. The different sources of regulation will be discussed in turn.

1 The Corporations Act 2001 (Cth)

The *Corporations Act 2001* provides the majority of legislation regarding corporations which is overseen by ASIC.\(^{38}\) In the absence of any ‘replacement’ of s 198A by the corporation’s Constitution, the directors manage the corporation.\(^{39}\) Any powers of the directors can be given to a ‘managing director’, for example the CEO.\(^{40}\) Directors have a duty of good faith to act in the corporation’s best interests and cannot use their position for personal advantage.\(^{41}\) However, when the CEO makes a poor decision, the business judgement rule will exclude civil liability in the absence of any

\(^{29}\) Scott, above n 11, 323.
\(^{30}\) Ibid 216.
\(^{33}\) Scott, above n 11, 304-5.
\(^{34}\) Ibid 305-6.
\(^{35}\) Ibid 306.
\(^{36}\) Productivity Commission, above n 11, 124; *Australian Stock Exchange Listing Rules 2009* (ASX) r 4.10.3.
\(^{37}\) Productivity Commission, above n 11, 128.
\(^{38}\) *Corporations Act 2001* (Cth) s 5B.
\(^{39}\) *Corporations Act 2001* (Cth) s 135(2).
\(^{40}\) *Corporations Act 2001* (Cth) s 198C.
\(^{41}\) *Corporations Act 2001* (Cth) ss 182(1)(a), 184(1).
‘material personal interest in the subject matter of the judgment’.\footnote{Corporations Act 2001 (Cth) s 180(2); Australian Securities and Investments Commission v Adler [2002] 168 FLR 253, 353 (Santow J).} The powers of the directors can be delegated to any person, however, their directions must be followed and the resolutions are as if the directors exercised the power.\footnote{Corporations Act 2001 (Cth) s 198D(1)(d), (2), (3).} The Board of Directors can appoint a Committee to determine CEO remuneration.\footnote{Corporations Act 2001 (Cth) ss 9, 198D(1)(a).} The Committee can engage a Consultant to provide independent remunerative advice where appropriate.\footnote{Corporations Act 2001 (Cth) ss 198A(2), 198D(1)(a); Westpac Banking Corporation, above n 8, 46.}

ASX-listed corporations are disclosing entities that have a duty of continuous disclosure to the ASX.\footnote{Corporations Act 2001 (Cth) ss 111AC, 111AE, 111AL, 111AP(1), 674.} The corporation must comply with the Australian Accounting Standards Board Accounting Standards in preparing audited Annual Financial Reports with a Directors’ Report containing a Remuneration Report.\footnote{Australian Accounting Standards Board Standard 2 Share-based Payment 2007 (Cth).} The AASB Standards deal with a range of accounting issues including valuations of share-based payment\footnote{Australian Accounting Standards Board Standard  1046 Director and Executive Disclosures by Disclosing Entities 2004 (Cth).} and the content and format of disclosures about remuneration in the Annual Report.\footnote{Commonwealth Treasury, Corporate Disclosure: Strengthening the Financial Reporting Framework (2002) iii <www.treasury.gov.au/documents/403/PDF/Clerp9.pdf> at 23 October 2009.}

The CLERP reforms were underlined by principles of ‘market freedom, investor protection and quality disclosure of relevant information to the market’.\footnote{Ibid 12; Productivity Commission, above n 11, 121.} In response to the HIH collapse, these were undertaken in nine sequential stages.\footnote{Ibid 12; Productivity Commission, above n 11, 121.} Accordingly, the CLERP reforms did not require uniformity in CEO remuneration. Remuneration Reports must now discuss remuneration practices and the amount paid to ‘Key Management Personnel’,\footnote{Corporations Act 2001 (Cth) s 300A(1)(a).} remuneration’s relationship to performance,\footnote{Corporations Act 2001 (Cth) s 300A(1)(b).} why any security-based remuneration is not linked to performance conditions\footnote{Corporations Act 2001 (Cth) s 300A(1)(d).} and the relative proportion and value of performance-based remuneration.\footnote{Corporations Act 2001 (Cth) s 300A(1)(e).} Remuneration Reports must be put to an advisory vote at the AGM, thus allowing scrutiny by shareholders.\footnote{Corporations Act 2001 (Cth) s 250R(2), (3).}

2 The ASX Listing Rules and the ASX Corporate Governance Council

The corporation must satisfy the ASX that they will comply with the \textit{ASX Listing Rules} to qualify for ASX listing.\footnote{Australian Stock Exchange Listing Rules 2009 (ASX) r 1.16.} The majority of the ASX’s rules relate to market disclosure, adequate assets and share volume requirements, and are contractually and
legislatively binding.58 The Corporate Governance Council released the ‘Principles of Good Corporate Governance and Best Practice Recommendations’ in 200359 and released a revised edition in 2007,60 but the principles are not binding. Principle 861 requires corporations to remunerate ‘fairly and responsibly’,62 ensuring that remuneration is ‘sufficient and reasonable’ with a clear relationship to performance.63 The corporation’s hedging policy must be explained.64 A Compensation Committee is also recommended.65 Corporations are free to ignore these recommendations, but must give reasons for doing so, a form of ‘soft law’.66

3 Fair Work Act 2009 (Cth)

The Modern Awards do not apply to CEOs as the remuneration level they receive classifies them as a ‘high income employee’ when they are above the high income threshold.67 CEOs are therefore not ‘protected from unfair dismissal’ under Part 3-2 of the Fair Work Act because of their income level.68

4 Other Bodies

The Australian Prudential Regulation Authority regulates the financial services industry with obligations in addition to those mentioned above.69 Bodies representing the interests of super funds, fund managers, retail investors and company directors also have their own non-binding guidelines in relation to corporate governance.70 For example, the Australian Shareholders’ Association recommends that ‘LTI

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60 ASX Corporate Governance Council, Principles of Good Corporate Governance and Best Practice Recommendations (2nd ed, 2007).
63 Ibid.
64 ASX Corporate Governance Council, Principles of Good Corporate Governance and Best Practice Recommendations (2nd ed, 2007) Recommendation 8.2.
66 Productivity Commission, above n 11, 124; Australian Stock Exchange Listing Rules 2009 (ASX) r 4.10.3.
68 Fair Work Act 2009 (Cth) s 382.
69 Australian Prudential Regulation Authority Act 1998 (Cth) s 8, 9.
70 Productivity Commission, above n 11, 119.
performance should be assessed over a fixed period of no less than four consecutive years, with vesting at completion of the full assessment period.⁷¹

E  Differing Philosophies of Corporations

No two corporations take the same approach to remuneration and increasing shareholder value because of different business cycles and demands from stakeholders.⁷² In 2008, both Westpac and GPT Group sought to attract, retain and motivate their employees.⁷³ Westpac sought ‘talented employees’ to achieve ‘high performance’ with ‘superior long-term’ results governed by risk management principles.⁷⁴ Conversely, GPT Group focused on a mix of financial and non-financial performance indicators whilst delivering a ‘mix’ of pay and promoting an ‘ownership culture’.⁷⁵

Remuneration philosophies are not static. In line with market conditions in 2008, GPT Group did not award short-term incentives to their Senior Executive Committee.⁷⁶ Currently, Macquarie Group ‘intends proactively to respond to emerging global remuneration trends to ensure ongoing long-term alignment with shareholder interests and to retain staff’.⁷⁷

F  Options for Remuneration

A brief summary of common CEO remuneration package components during their period of employment are discussed below:

1  Base Salary

The following components do not vary with CEO performance:

*Fixed Salary:* Provides the basic incentive to work by awarding a set amount;⁷⁸ and

*Post-Employment Benefits:* The CEO may receive superannuation and redundancy pay at the time of leaving the corporation.⁷⁹ A Bill is currently before Parliament to restrict the use of such payments.⁸⁰

2  ‘At Risk’ Remuneration

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⁷²  Bushman, Indjejikian and Smith, above n 21, 189.
⁷³  Stakeholders includes a broader class of individuals and entities including investors, lenders, managers, unions, standard setters and governments: Scott, above n 11, 51.
⁷⁵  Ibid.
⁷⁶  Westpac Banking Corporation, above n 8, 45.
⁷⁷  GPT Group, above n 74, 10.
⁷⁸  Ibid.
⁷⁹  Macquarie Group Limited, above n 7, 64.
⁸⁰  Productivity Commission, above n 11, 8.
⁸¹  Ibid 208.
⁸²  Corporations Amendment (Improving Accountability On Termination Payments) Bill 2009 (Cth).
In an attempt to motivate CEOs and focus their attention on particular timeframes, the following commonly awarded bonuses are awarded after achieving certain criteria:

(a) **Bonuses**

*Cash Bonuses:* Money payable upon meeting the criteria. The bonus only awards past performance, and therefore has no prospective motivational effects;

*Shares:* Shares in the corporation are given to the CEO when performance criteria are achieved. There are no sale or other restrictions imposed. They are ‘free’ for the CEO. However, in Australia they are not awarded very often because they encourage a focus on short-term gain.

*Stock Options:* Options are granted to a CEO at an exercise price, the vesting date can be at any time in the future, but is typically a period of more than one year. Westpac vests some LTIs over a period of 5 years. If the share price is below the strike price at the vesting date, the CEO does not exercise the option, thus bearing no downside risk. However, if the strike price is above the market price, the CEO can make an instant gain by selling the shares after vesting. Stock options in part contributed to the fall of Enron as the stock options encouraged behaviour to ‘pump up’ the share price significantly above its true value.

*Deferred Share Units:* Shares given in the future as part of the CEO’s remuneration package after meeting certain requirements either in the short-term or long-term. However, there may be strict requirements that the shares cannot be sold whilst the CEO is still working at the corporation, or for a period of time after the CEO has left. Thus they are an incentive to responsibly increase shareholder value over the long-term.

*Non-recourse Loans:* An interest-free loan granted purchase shares in the corporation. These loans are not commonly awarded. The dividends by the corporation are used to pay off the loan, effectively meaning that the shares come at no cost to the CEO, apart from taxation consequences. The CEO is insulated from losses as they can default with no claim to any assets other than the shares.

82 Scott, above n 11, 346-7.
83 Productivity Commission, above n 11, 166.
84 Ibid 171.
85 Scott, above n 11, 232.
86 Ibid 233.
87 Westpac Banking Corporation, above n 8, 47.
88 Scott, above n 11, 234.
89 Ibid 6-7.
90 Productivity Commission, above n 11, 195.
91 Ibid.
92 Ibid.
93 Ibid 196.
94 Macquarie Group Limited, Submission to #52 to the Productivity Commission on Executive Remuneration (29 May 2009) 12.
95 Productivity Commission, above n 11, 196.
96 Ibid.
The criteria for bonuses can vary significantly and include financial measures such as ‘[e]arnings before interest, tax, depreciation [and] amortisation’ (‘EBITDA’) and non-financial goals such as market share or completing certain tasks, for example delivering a strategic report to the Board. Corporations like Tabcorp to use ‘relative performance evaluation’ to better evaluate performance in line with other similar corporations. A balanced scorecard approach may also take into account a range of organisation factors, thus broadening the scope of the CEO’s attention. The ‘test period’ for a bonus may be over multiple years, with the testing occurring annually, in an effort to better evaluate CEO performance. If the minimum requirements, known as the ‘bogey’, are not met, no bonus is payable. A ‘cap’ on a variable bonus is also common, thus allowing upside gains to be limited given that the bogey operates to limit downside risk.

III THE FLAWS IN THE CURRENT SYSTEM

The Australian process for determining CEO remuneration is undermined by a number of flaws, which will be discussed in turn.

A Managerial Power Theory and Independent Remuneration

According to Bebchuk, Fried and Walker’s Managerial Power Theory, the relationship between the Committee and the Board is influenced by powerful CEOs, leading to a sub-optimal contract. CEOs are able to extract rents in the form of a ‘necessarily undeserved [remuneration] package’. The factors that cause this influence include a sense of loyalty to the CEO and the influence of the CEO on the corporation, especially if the CEO has been at the corporation for many years. The ability to influence Board composition and more available time or resources are all problems for ensuring independent remuneration processes. The CEO is more
likely to have influence if there is a small Board.\textsuperscript{109} In some instances the CEO is able to influence the composition of the members of the Committee.\textsuperscript{110}

This relationship suggests that the Committee is not sufficiently independent from the CEO whose remuneration they are to determine.\textsuperscript{111} The result is that Committees may grant overly generous remuneration packages.\textsuperscript{112} Evidence of late-timing, unwinding and reloading of options suggest that managerial power theory is something which needs to be addressed;\textsuperscript{113} however, according to Kevin Murphy, the theory is too simplistic and other explanations exist for these practices.\textsuperscript{114}

Remuneration consultants, such as Mercer, act as external and independent advisors with regards to appropriate remuneration contracts for individual CEOs.\textsuperscript{115} In theory, the consultants hired by the Committee are independent from outside influence. However, consultants may experience direct CEO influence\textsuperscript{116} or face business pressures because of a need to design ‘favourable recommendations’ so that they will be hired again the following year.\textsuperscript{117}

Consultants have data based on contracts for other CEOs which can potentially include bonus mixes, performance hurdles and average remuneration.\textsuperscript{118} Most corporations do not want to pay their CEO the ‘average’, so consultants tend to recommend ‘above average’ remuneration, which is ‘fairly or very important’ to most senior executives.\textsuperscript{119} The rising remuneration levels in recent years\textsuperscript{120} may have been due to a ‘ratcheting up’ of remuneration without any clear link to performance by consultants.\textsuperscript{121}

B \textit{Positive Accounting Theory}

According to positive accounting theory, the accounting framework that determines reported profit and achievement of some remuneration contract criteria, for example EBITDA, provides CEOs with an opportunity to use their subjective discretion to manage earnings and bonuses.\textsuperscript{122} This involves shifting the components of their financial statements both upwards and downwards through subjective evaluations,

\textsuperscript{109} Productivity Commission, above n 11, 86.
\textsuperscript{110} Catherine Daily et al, ‘Compensation Committee Composition as a Determinant of CEO Compensation’ (1998) 41 \textit{Academy of Management Journal} 209, 211.
\textsuperscript{111} Ibid 210.
\textsuperscript{112} Bebchuk, Fried and Walker, above n 3, 785.
\textsuperscript{113} Ibid 760, 766, 824-5, 831.
\textsuperscript{114} Kevin Murphy, ‘Explaining Executive Compensation: Managerial Power Versus the Perceived Cost of Stock Options’ (2002) 69 \textit{The University of Chicago Law Review} 847, 851.
\textsuperscript{116} Productivity Commission, above n 11, 127.
\textsuperscript{117} Bebchuk, Fried and Walker, above n 3, 772.
\textsuperscript{118} Productivity Commission, above n 11, Appendix D, 9.
\textsuperscript{119} Bebchuk, Fried and Walker, above n 3, 791; David Peetz, \textit{Submission to #50 to the Productivity Commission on Executive Remuneration} (30 May 2009) 7, 12.
\textsuperscript{120} Productivity Commission, above n 11, 46.
without it amounting to outright fraud.\textsuperscript{123} If acting solely to achieve the bonus, it may a breach of s 182(1)(a) of the \textit{Corporations Act}.\textsuperscript{124} Whilst the accounting policy choices are disclosed in the financial statements, the CEO’s motives are not.\textsuperscript{125} This enables the CEO to choose policies in their own best interests and receive higher bonuses than they otherwise would have been awarded.\textsuperscript{126} In light of the earnings management debate at the American-based General Electric, some accountants have justified ‘income smoothing’, a form of earnings management, on the basis that it sends a signal of strong long-term performance to shareholders.\textsuperscript{127}

C \textit{Incentive Payment Hedging}

One of the key advantages of executive remuneration being awarded on the basis of performance is that CEOs only receive the bonus when the criteria are satisfied. However, some CEOs hedge their ‘at risk’ remuneration on the derivatives market, thereby opting to receive their unachieved bonus from an independent third party for a lower amount.\textsuperscript{128} Despite a potential devaluation of the CEO’s reputation,\textsuperscript{129} the CEO’s risk of not receiving a ‘bonus’ is eliminated, thus destroying the motivating and aligning effects of the contract.

IV \textbf{POTENTIAL SOLUTIONS AND THE ROLE OF THE LEGISLATURE}

There will always be some scope for management manipulation ways to achieve their bonuses, if the CEO’s performance evaluation is based solely on financial criteria that allow for subjective judgement. However, there are some measures available that could increase the likelihood of goal congruence between the CEO and shareholders.

A \textit{A Need for Legislative Intervention?}

In September 2009, Australia’s total employment rose by 4700 workers.\textsuperscript{130} The Australian Government has decided to intervene and provide a minimum set of standards in place to protect employees and to temper the employer’s power over employees.\textsuperscript{131} Of the current labour force of approximately 10 786 000 individuals, the \textit{Fair Work Act} was estimated to cover at least 79 per cent of employees in January 2008.\textsuperscript{132}

\textsuperscript{123} Scott, above n 11, 345-6.
\textsuperscript{124} \textit{Australian Securities and Investments Commission v Adler} [2002] 168 FLR 253, 353 (Santow J).
\textsuperscript{125} \textit{Australian Accounting Standards Board Standard 108 Accounting Policies, Changes in Accounting Estimates and Errors} 2007 (Cth) [29].
\textsuperscript{126} Scott, above n 11, 247, 348-9.
\textsuperscript{127} Ibid 346, 373.
\textsuperscript{128} Productivity Commission, above n 11, 200.
\textsuperscript{129} Scott, above n 11, 270.
\textsuperscript{131} Commonwealth, \textit{Parliamentary Debates}, Senate, 4 December 2008, 8357 (Joseph William, Minister for Human Services).
Whilst the market for CEOs is significantly smaller, as there are 2035 ASX-listed entities who require management, market forces do determine remuneration packages. Corporations are owned by the shareholders. In contrast to lower-paid workers, CEOs often have much higher bargaining power when applying for positions and their remuneration is not determined according to the concept of a ‘living wage’. So, despite the influence of corporations on the economy and society, government intervention into the contract’s content cannot be justified on the same basis as the National Employment Standards and protecting those in unequal bargaining positions.

To correct under-remuneration by the market, minimum wages ensure that those engaged in paid work earn the ‘living wage’ and can afford the basic necessities of life. However, once these needs are met, the market should be free to set the remuneration levels received by any member of the labour force, with CEOs being no exception. However, there is scope for legislation prescribing a fairer and better process of remunerating ‘fairly and responsibly’ by making adjustments to the web of regulation to encourage maximum shareholder benefit and the most appropriate remuneration for the CEO.

B A Cap on Remuneration is Not Appropriate

The potential market for CEOs is no longer confined to one country or industry. The advancement of globalisation has increased the ease of cross-border movement of human capital and creates a global pool of potential candidates. Australian corporations sometimes source CEOs from overseas because of their experience and expertise in managing other similar corporations. For example Sol Trujillo was CEO of Europe-based Orange SA prior to being appointed CEO of Telstra in 2005. Australia needs to be able to offer globally competitive remuneration packages so that corporations are able to attract and retain world-class leaders, especially since our remuneration levels are lower than the United States and the United Kingdom.
Corporations and other high-paid professions compete with each other for the best and brightest recruits. When a career choice by individuals is made, remuneration is a significant, but not the sole, factor. If a potential CEO could receive greater remuneration by being a lawyer where there is no cap on remuneration, they may choose this option instead of making a ‘lifetime investment’ to become CEO. A lost ability to pay high levels of remuneration would severely limit the ability to attract high-calibre individuals to the position from other industries. Furthermore, it would reduce incentives needed to take on promotions involving increased hours and greater responsibility.

In Australia, significant variation occurs between industries in the level and mix of remuneration. Any attempt to cap remuneration would only distort the current balance between these industries, where remuneration is designed with different weights depending on factors such as the time horizon determined by the business cycle. A cap on remuneration could have unintended consequences depending on the sector. For example, it would impact on the mining industry, which tends to pay more remuneration in fixed quantities than other industries. A cap on ‘at risk’ remuneration would be detrimental for the banking and finance industry where a much higher proportion of CEO remuneration is based on performance. A change in remuneration philosophies due to government intervention may force a changing of the corporation’s strategy.

C Encourage Better Quality CEO Remuneration

For interest alignment between shareholders and the CEO to be successful, higher remuneration levels may be required. In a study by Jensen and Murphy into CEO remuneration levels in the United States, they found that CEOs received only $2.59 for every $1000 of additional shareholder value. Increased incentives and ‘punishments’ have been suggested as a potential solution to discourage self-interested behaviour including lavish corporate headquarters and company jets.

Better quality remuneration involves providing greater incentives for CEOs to align their interests with shareholders through a higher proportion of ‘at risk’ pay even though this would probably result in higher overall remuneration. Ideally there would be no initial increase in base salary levels. Instead, increasing the proportion of ‘at risk’ pay would increase the rewards that result from meeting the targets whilst

145 Jensen and Murphy, above n 14, 145, 148.
146 Ibid 149.
147 Ibid 148.
148 Ibid 145.
149 Matolcsy and Wright, above n 16, 52-3; Productivity Commission, above n 11, XVII, XX; Wright, above n 12, 19, 26.
150 Bushman, Indjejikian and Smith, above n 21, 189.
151 Matolcsy and Wright, above n 16, 51-2.
152 Matolcsy and Wright, above n 16, 51-2.
154 Jensen and Murphy, above n 24, 139.
155 Ibid.
156 Ibid 140.
157 Ibid 139.
more accurately adjusting downwards due to poor performance. In theory the CEO would be more likely to work harder as the rewards for doing so are much higher, and the costs of undesirable behaviour are much greater if bonuses are contingent on meeting performance targets.

D  **Tighten Accounting Standards**

Financial measures are generally key criteria when evaluating CEO performance to determine remuneration packages. The Accounting Standards could be revised to reduce the extent of subjective measurements, which enable CEOs to manage earnings. As the AASB already reviews accounting standards where necessary in response to global changes, no legislative intervention is required.

E  **Increase Committee and Consultant Independence**

Increasing the independence between the CEO and the Committee as well as the consultants would address some issues raised by managerial power theory. However, this is not easily achievable as the problems are essentially due to relationships between decision-makers who also have other roles within the corporation. Prohibiting relationships between CEOs and non-executive directors could lead to unworkable Board dynamics and frictions.

An alternative framework would not permit the CEO to choose the Committee or the consultant. Recommendations by the consultant would be highly influential in the contract chosen by the Committee and adopted through s 198D of the *Corporations Act*. However, a non-replaceable exception should be imposed in Part 2D.1 Division 4 to prevent CEOs from choosing or giving directions to the Committee and Consultants in relation to remuneration. No exceptions would be appropriate for Board size, as the CEO’s influence may be even greater with small Boards.

Consultants may still feel pressured to recommend above-average remuneration packages to all clients to ensure that they are hired again next year. According to Draft Recommendation 11, corporations should disclose their use of consultants to the market. Additionally, ASIC could require submission of the directors’ remuneration contracts so that any over-remuneration by consultants can be isolated with a range of measures and civil penalties available against consultants.

F  **Permit Shareholders to Invalidate Particular Bonuses**

Whilst the content of the remuneration contract should be left significantly left unregulated by legislation, there is merit in requiring non-fixed pay to have a sufficiently ‘at risk’ character. Bonus payments could be declared invalid by a shareholder vote only following an ASX recommendation that the bonus was too easily attained, was too vague, was not in shareholder interests or was not sufficiently motivational. Bonuses would not be invalidated for perceived ‘excessiveness’. To avoid doubt, the definitions would be the ordinary natural meaning. Under this proposed solution, it would be mandatory for ‘at risk’ remuneration to be awarded

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158 Ibid 141.
159 See above n 109 and accompanying text.
160 Productivity Commission, above n 11, 315.
solely on the basis of identifiable criteria. This measure would also allow the late-timing, unwinding and reloading of options to be invalidated and would reduce discretionary payments. Increased disclosure of CEO and executive director performance evaluation criteria and success rates would also be preferable. However, disclosure of company secrets to the market could be detrimental to the corporation, so the requirements about this increased disclosure would need to be carefully drafted. Ideally, this mechanism would prevent bonuses like those awarded to Sol Trujillo being awarded because the requirements were too easily achieved.

Whilst the scope for management manipulation of financial measures such as EBITDA are unable to be eliminated, contracts can be designed with the CEO’s discretion taken into account by setting higher targets. However, as shareholder participation in Australia is quite low and shareholder turnover can be quite high, the vote is likely to be dominated by institutional investors who do not have the same interests as individual shareholders.  

G  Encourage the CEO to Hold More Equity

Even with very generous remuneration packages, ‘truly big’ corporations will never be able to ensure that their CEOs hold a significant proportion of shares. However, increased CEO holdings are advantageous for shareholders as the CEO receives higher benefits when the corporation performs well, and suffers greater losses when the corporation performs poorly. An increase in share holdings of the CEO through shares granted with restrictions on selling increases the likelihood of goal congruence.

However, legislated minimum requirements, such as generic terms imposed on LTIs, are problematic given the different aims intended by remuneration contracts. Instead of legislating that certain percentages of pay are paid in equity, an encouragement of this form of remuneration could be highly recommended by the ASX Corporate Governance Council. Alternatively, a shareholder vote could bind the corporation to pay a higher proportion of remuneration in equity after an explanation of the proposed policy and supporting reasons at the AGM.

H  Prohibit Incentive Payment Hedging

Direct and indirect hedging of incentive payments should be prohibited under the Corporations Act to eliminate the self-interested behaviour that can arise as a result of such practices. For high-performing CEOs, prohibiting hedging would increase their overall remuneration because of costs of entering the derivatives market, whilst underperforming CEOs would experience decreases in overall remuneration because of their inability to receive remuneration without meeting the criteria. Both of these outcomes are desirable as it is ensuring the integrity and motivational effects of the

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162 Jensen and Murphy, above n 24, 141.

163 Ibid 141.
contract are not undermined by the CEO.\textsuperscript{164} Therefore, it is not surprising that corporations such as Westpac and Tabcorp prohibit employees directly or indirectly hedging by making their bonuses ‘liable to forfeiture’ if hedged.\textsuperscript{165}

\section*{V Conclusion}

According to media reports, CEO remuneration is excessive and undeserved. However, well-structured remuneration packages encourage alignment of the interests of CEOs and shareholders by making the CEO bear some of the shareholders’ risk and adjusting remuneration according to firm and CEO performance.

The variety of aims and mixes of remuneration packages offered to CEOs by ASX-listed firms makes any legislative intervention problematic. A cap on CEO remuneration would distort the balances of risk and return within industries and prohibit Australian corporations from attracting high quality CEOs. Instead, a range of measures aimed at strengthening the process through which remuneration is determined is an appropriate measure to decrease the potential for CEO influence and undeserved remuneration. The shareholders should be able to invalidate clearly inadequate motivational tools and hedging by CEOs that undermines the integrity of the contract should be prohibited. This would promote a market which attempts to align the interests of shareholders and CEO through better quality remuneration.

In response to the anger that is bound to result from not capping CEO remuneration, the various domestic bodies need to educate the media and the public that CEO remuneration is designed to attract, motivate and retain high quality CEOs to Australian corporations whilst also adjusting for CEO performance. The proposed changes will not prevent another ‘Global Financial Crisis’. However, well-designed remuneration contracts should reduce its likelihood by encouraging CEOs to focus more on sustainable long-term growth in line with shareholders’ interests.

\textsuperscript{164} Australian Shareholders’ Association, \textit{Submission #54 to the Productivity Commission on Executive Remuneration} (30 May 2009), 21.

\textsuperscript{165} Westpac Banking Corporation, above n 8, 47; Westpac Banking Corporation, ‘2007 Annual Report’ (ASX Release, 8 November 2007) 41; Tabcorp Holdings Limited, above n 8, 36.
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