

Egan Associates Newsletter

Regulation and Control of Executive Pay

Government leaders and their advisors internationally have recently expressed concern about the reward levels of those involved in financial markets which are embroiled to a greater or lesser extent in the global liquidity and credit crisis now being experienced and its flow-on effect to the capital markets.

It is not our view that executive remuneration in the financial services sector or more generally should be subject to regulation. While Australia trades globally, it represents a modest proportion of the world market, though some attributes of Australia's high fliers' rewards embrace the style of bonus plans adopted in the world's largest trading markets.

There is clearly a flow-on effect of profits/losses made from trading transactions through to executive' reward in financial institutions and those trading in commodities. The earnings of senior executives with stewardship of these business activities are generally far less than those immersed in day to day market trades.

Clearly, when the market experiences the challenges of recent times the returns of many enterprises operating in the global market decline and shareholders' or investors' funds are impaired. This has a direct impact on the income and profitability of trading enterprises and therefore a direct impact on the earnings of the employed participants in these environments.

Incentive plans in Financial Market Companies

While earnings can amount to hundreds of thousands, or indeed millions, of dollars annually for the successful operators in these markets, over the past decade the activities of the star teams have been encouraged by investors who have also prospered as a result of the bull run in both capital markets and trading in commodities and a variety of alternate financial instruments. Investors' returns have been many times that which might have otherwise been anticipated as representing a stable, sustainable long term basis of return. Greed in the widest sense, or certainly expectations beyond reasonable rates of return, have encouraged some of the activity in the marketplace from which investors and employed staff have prospered.

Where shareholders' funds are involved, from our perspective it is critical that board Remuneration Committees are fully aware of how the incentive plans operate, what the risk parameters established are and to be further assured that management teams operate within thoroughly defined approved and prudent risk policies, at all times complying with appropriate regulation and the standards of good governance articulated in company Annual Reports.

Many Remuneration Committees would not engage in the intimate review of incentive plans for employees trading across various markets where significant bonuses are paid, those bonuses generally well in excess of those of the *executive class* whose remuneration is widely reported.

One of the issues which has clearly arisen in recent months is that both boards and shareholders have not had a detailed understanding of the breadth or complexity of the types of financial instruments in which shareholders' funds have been applied, nor an intimate understanding of the complex metrics which generate bonus payments. Certainly executives in these business areas oversighting trading transactions, though not actually trading, have an awareness of the incentive metrics and monitor their plans to ensure they reflect competitive practices, either having regard to a global incentive model or within a local and national framework to compete with national or regional participants in the various trading markets.

The Government has introduced regulation on and undertaken enquiries into various elements of the investment markets and has taken steps to ensure, for example, that financial planners (who on occasions receive commissions for referral of investments) have an appropriate and independent process in authorising investments which the organisation can recommend to their clients. Where these processes have been substandard they have led to significant criticism from investors and enquiry by regulators.

The recent experiences in the financial market which have been regarded conservatively as 'once in a generation' and more effusely described as a 'one in a hundred years' event clearly is not one which today's directors or executives would have been fully prepared for. For a start the majority of active executives in 'markets' trading were not employed twenty years ago and the majority of directors serving on boards in those organisations engaged in the global financial and capital markets were not doing so a generation ago.

The active engagement of regulators in Australia appears from global comment to reveal that local practice represents 'best in class'. Corporate governance standards established having regard to international practice and sponsored by the ASX are also among the most thorough in developed countries.

Monitoring of incentive plans

From our perspective the current experience, while requiring monitoring, would be best supported by a government-sponsored initiative involving regulators and participants in these markets, together with seasoned directors and relevant advisors, to develop further guidelines which might assist directors in their enquiries in reviewing these plans and their application, ensuring that shareholders' interests are protected and the reputations of the companies whom they serve are upheld. It would of necessity in some financial institutions require more intensive review of all incentive plans applying across the organisation where the potential for employee earnings is substantial having regard to their base remuneration and not just the executive class reported to the market.

While the immediate focus is on the financial services sector it would, in our judgement be inappropriate to isolate the sector from a review of current practice more broadly given both the growth in base pay over recent years and the variety and appropriateness of criteria now reported as driving 'at risk' reward and the periods over which performance is measured.

In tandem with a need for a more intimate engagement of Remuneration Committees is the increasing engagement of boards in the oversight of risk management and the formation of committees of independent directors or advisors who participate in a thorough review of the internal controls and guidelines which must be used to govern the behaviour of market traders.

In an Australasian setting we do not believe that executive reward requires special investigation. Incentive and related reward opportunities clearly require regular monitoring and transparent disclosure, including the basis upon which earnings over and above annual salaries are accessible to these executives and further, an explanation of the performance which led to the payment outcomes. Australia's leading companies have clearly progressed a long way in providing shareholders with this information.

The present crisis in financial and capital markets on a global footing has highlighted the need for further work and an independent overview of these programs. It also highlights issues which have been raised in the US Congress and are being raised in the United Kingdom and European parliaments regarding the independence of external advisors and their level of engagement in the provision of a diversity of professional services to corporations, as well as the level of expertise available to board Remuneration Committees and indeed the entire board across this complex area which increasingly requires expertise in risk management, accounting and tax, audit, remuneration plan design and governance, compliance and legal, that expertise unlikely to be available from one professional firm and certainly not available in its entirety from remuneration advisors.

Where governments are becoming substantial direct investors with tax payers funds, the complexity and desire for control increases exponentially – their first resort in mitigating their own risk would be regulation.

Independent sign-off

In this context a further question which arises is the role of directors and their level of engagement. Is the role of directors to seek advice and take that advice or is the role of directors to ensure that they are fully informed on all the relevant issues and once informed, as a collegiate group, make determinations which on the basis of their more intimate understanding of the organisation and its shareholders result in appropriate programs? Our experience is that there is no 'one size fits all' panacea. The best programs are tailored to an organisation's circumstance and are reviewed regularly.

A further potential complexity arises where an increasing number of decisions made by boards need an independent sign-off, generally only available from a remuneration consultant, to indicate that the decisions taken are reasonable in the context of the Corporations Act 2001. It is my understanding that very few sign-offs have been obtained by major organisations actively involved in the financial and capital markets as to the reasonableness of the incentive plan designs (subject to the current round of criticism), their application and payment determinations by an independent remuneration specialist. The payment outcome of these arrangements have rather been signed-off by auditors who are applying a different set of standards and tools for compliance in verifying entitlements, particularly in relation to accounting standards.

The current concern in regard to the financial markets has tended to focus on the examination of legal and accounting aspects of remuneration. Consultants are asked whether incentive and remuneration structures are "reasonable". While some aspects of these questions may be answered from a legal or accounting point of view, or considered in light of general market practice, it could be argued that a major element in the questions should be advised on by an ethicist or a moral philosopher.

A remuneration consultant can advise on market practice and on the efficiency with which a particular incentive plan reflects performance. However, in view of the complexity of the investment instruments and the wide range of risks being managed concurrently, it may be useful to have a consultant who is totally independent of the design and documentation of the incentive plan attest to its reasonableness in the context of both its intent and where appropriate the Corporations Act 2001.

This structure of consultation and advice might well see different advisors for the board from those consulted by executives.