

How should regulators deal with overpaid and deeply entrenched company executives?

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ABSTRACT:

The regulatory framework for corporate governance, both Australia and internationally, shifts between rules based regimes and principles based approach. The rules based regimes are typified by legislation that imposes mandated compliance based rules, such as the Sarbanes Oxley Act. Other regimes, such as Australia's CLERP 9 and the ASX principles, have opted for a disclosure approach. This paper examines these approaches in the context of the non-binding vote rule, which arguably combines aspects of both. The non-binding vote on executive remuneration granted to the general meeting is prescriptive in that it provides a mandatory rule that the vote must be taken, but it is principles based given that there is no mandated response to the outcome of the vote. In those jurisdictions where the non-binding vote was introduced, there was some speculation that a mandatory rule with no enforcement would have minimal impact. This article reviews the commentary and provides evidence for measuring impact. Evidence based commentary on the non-binding rule is relevant and timely, given that the US is currently engaged in a similar 'say on pay' debate.

How should regulators deal with overpaid and deeply entrenched company executives?

‘The sad reality is in Australia that 96 per cent of directors known to be underperforming badly somehow manage to get re-elected’ Greg Hoy, journalist, The 7.30 Report, 9.12.08.

1.0 Introduction:

Concerns about executive remuneration have resulted, particularly in this decade, in proactive regulatory responses both in Australia and internationally. In Australia the changes for listed companies range from increased executive remuneration disclosure (for example, the convoluted changes to s300A Remuneration Report) to the creation of the non-binding vote at the annual general meeting (AGM) endorsing the Remuneration Report in s 250R(2)(3).¹

The most recent changes in Australia, particularly the Remuneration Report non-binding vote, took effect 1 July 2004.² Since then, the US has considered adopting the non-binding vote, and the newly elected federal government in Australia (November 2007) has been exhorted to further regulate executive remuneration.³ The federal government appears to be taking this seriously, so further corporate governance reforms based around the issue of executive remuneration are to be expected. In Australia, the federal government has already signalled its intention to reform executive pay. For instance, on 15 October 2008 Prime Minister Rudd said that:

“the government would be working with local regulators to draw up a model to be used in Australia and overseas to keep exorbitant executive pay packets under control”⁴

¹ Although there has been voluminous literature on the controversy of the executive pay debate, recent articles inspiring this question include Hill, J, “Evolving ‘Rules of the Game’ in Corporate Governance Reform” (July 2007). Sydney Law School Research Paper No. 07/47; Vanderbilt Law and Economics Research Paper No. 07-19. Available at SSRN: <http://ssrn.com/abstract=1000085>; Schoenemann, A, “Executive Remuneration in New Zealand and Australia: Do Current laws, Regulations and Guidelines Ensure ‘Pay for Performance’?” (2006) 37 *Victoria U Wellington L Rev* 31.

² As part of the *Corporate Law Economic Reform Program (Audit and Disclosure) Act*, (Cth) 2004 (also known as the CLERP 9 Act).

³ Cornell, A, “Is the boss paid too much?” *Australian Financial Review* 10 January 2009 p 15.

⁴ Grattan, M, “Rudd to take swipe at fat cat salaries”, *The Daily Telegraph*. 2008.

The question posed in this paper is perhaps overly rhetorical and unduly normative – there is no clear answer as to how regulators “should” deal with overpaid and entrenched managers. However, change is within reasonable contemplation, and we have observed generally the corporate governance debate that switches between prescriptive, rules-based vis-à-vis guidelines, principles-based approaches.⁵ Although Australia, the US and the UK have acted decisively with legislative changes aimed directly at the capital market participants,⁶ the manifestation of this regulation can be distinguished along a loose scale:

1. a ‘soft’ approach – regulations that are not law, but are voluntarily adopted, in the nature of a code of conduct;⁷
2. the regulated guidelines or principles based approach;
3. prescriptive or rules based regulation, that imposes some mandatory aspect of compliance;
4. personal responsibility - imposing personal sanction on company managers and officers to ensure corporate compliance.

The objective of this study is to examine the appropriateness of guideline or principle based regulation in the Australian context. Regulatory guidelines, that have no prescription or personal sanction attached, have been criticised as impotent and ineffective.⁸ The study is framed in the context of the non-binding vote on executive remuneration, as the reform has characteristics of both approaches - legislative, but with no particular sanction or outcome enforced. The non-binding vote on executive remuneration granted to the general meeting is prescriptive in that it provides a mandatory rule that the vote must be taken, but it is principles based given that there is no mandated response to the outcome of the vote. As the outcome of the vote at the AGM is a public event, we use evidence based on the voting patterns of shareholders at successive

⁵ Hill, 2007, op cit n 1.

⁶ Von Nessen, P, “Corporate Governance in Australia: Converging with International Developments” (2003) 15 *AJCL* 1.

⁷ For example, in May 2008, Ernest & Young reported that top 100 companies routinely provide shareholders with information beyond the statutory requirements – see “Reporting to shareholders: Good practice guide” http://www.group100.com.au/publications/g100_EY_Reporting-to-shareholders200805.pdf.

⁸ Sykes, A, “Overcoming Poor Value Executive Remuneration: resolving the manifest conflicts of interest” (2002) 10 *Corporate Governance: An International Review* 256-260.

AGMs to track both changes in voting behaviour and changes in remuneration policy for the companies involved in the study.

Accordingly, this study examines the effectiveness of non-binding vote as a guideline based measure to control executive pay. In the context of this paper, the vote is deemed to be ‘effective’ where it prompts changes to the remuneration package in the subsequent reporting period. Significantly, the analyses in this paper find that the vote is effective. That is, where the remuneration package receives a substantial ‘no’ votes (greater than 10% vote ‘no’) the evidence shows that the package is subsequently changed in a manner acceptable to shareholders.⁹ Evidence that the vote is effecting a change in behaviour in remuneration matters is useful to policy makers in determining whether the provision forms a useful platform to shareholder democracy.

Further, on the basis of the analyses, company reactions to substantial ‘no’ voting appears to be idiosyncratic and more dependent on company specific factors than systematic factors present across the sample. This idiosyncratic response reflects one of the key advantages of the guideline approach. That is, guidelines can be flexibly administered by boards to reflect the company’s particular circumstances.

Framing this paper in the context of remuneration facilitates an analysis of the two alternate regulatory approaches and their effectiveness. Importantly, although the vote as a corporate governance reform has been commented on in the literature, the effectiveness of the vote as a non-prescriptive regulatory mechanism has not been comprehensively measured.

The remainder of this paper is structured in the following way. Section 2 deals with the regulatory regime both surrounding and creating the non-binding vote on the Remuneration Report. Section 3 outlines the advantages and disadvantages of guideline based regulation. Section 4 outlines the analyses and results which demonstrate that the

⁹ ‘Substantial’ is defined for the purposes of this study as percentage of ‘no’ votes equal to 10% or more. Note however that this study does not have in place a methodology for measuring the ‘effectiveness’ of the “yes” vote.

vote is effective in changing subsequent behaviour. Section 5 speculates as to why the vote is effective and finally Section 6 concludes with some thoughts on future directions.

2.0 Regulatory Regime Creating the Non-binding Vote of the Remuneration Report

2.1 Statute

The mandatory disclosure regime discussed in this section forms the framework for shareholder voting in s250R. The vote under s250R(2)¹⁰ requires listed companies to put the Remuneration Report (the details of what must be included are prescribed under s300A) to shareholders as a resolution at the annual general meeting. Importantly, s250R(3) specifically states that the resolution is advisory only¹¹. It is worth noting that S250R(2), (3) mirror s241A of the *Companies Act* (a UK provision) which came into force on 1 August 2002.

The vote on the Remuneration Report must be put to shareholders at the AGM, and can be passed or rejected at the 50% level. Section 250R however, provides no further guidance as to the consequences of a majority of ‘no’ votes. The necessary implication of this is that ultimately the vote *guides* the board. There is no required response and the board is free to respond in any manner it thinks fit, although their decision could potentially result in a shareholder backlash if it is inconsistent with shareholder intentions.

Simplistically, the non-binding vote ought to be considered ‘effective’ if it secures some change in the board’s behaviour or conduct – that is, that the board is responsive to the shareholder view. The response may be immediate, but a useful way to track the effectiveness is to examine the following year’s Remuneration Report.

Given that shareholders are voting on the remuneration package, the disclosure framework obviously plays an important role in the voting regime. A brief summary of the development of the disclosure framework is set out below in order to provide an

¹⁰ Section 250R(2) ‘At a listed company’s AGM, a resolution that the remuneration report be adopted must be put to the vote.’

¹¹ Section 250R(3) ‘The vote on the resolution is advisory only and does not bind the directors or the company.’

understanding of the regulatory framework within which the vote operates. As with most corporate reporting, company behaviour is bound by a combination of legal regulations and accounting standards. The development and relevant components of the disclosure framework are outlined below.

Detailed executive remuneration disclosure was first required following the introduction of The *Company Law Review Act 1998 (CLRA98)*. After 1 July 1998 all listed companies were bound by s300A of *CLRA98* which required a broad discussion of remuneration policy for determining the nature and amounts of emoluments for the board and senior executives. It also required discussion of the pay-performance relationship. ASIC subsequently enhanced and clarified the disclosure requirements of *CLRA98* in *Practice Note 68 (PN68)* in 1998 and *MR03-202* in 2003. However, this broad principles based approach (even after PN68 and MR03-202) failed to provide the type of disclosure originally envisaged by regulators.¹² Following the introduction of *CLRA98* remuneration disclosure did not improve substantially¹³. Thus the regulator stepped up the campaign by securing a range of more prescriptive provisions. This prescriptive approach is ultimately reflected in CLERP 9.

CLERP 9 Act superseded *CLRA98* by greatly expanding s300A and the prescriptive items to be disclosed in the Remuneration Report. As mentioned above, CLERP 9 marked a shift away from a principles/guidelines based legal approach to a comprehensive prescriptive statutory regime (with the exception of the non-binding vote). The objective of CLERP 9 in respect of remuneration disclosure was to ensure shareholders had sufficient information about company performance to make informed decisions about managerial performance¹⁴.

¹² Walker, J. K. (2008) "CEO Remuneration: Structure and Levels" <ssrn.com/asabstract+1232722>; Clarkson, P., A. L. Van Bueren, J Walker, "Chief executive officer remuneration disclosure quality: corporate responses to an evolving disclosure environment." (2006) 46 *Accounting & Finance* 771-796.

¹³ Walker, J. K. (2008). "CEO Remuneration: Structure and Levels", <ssrn.com/asabstract+1232722>

¹⁴ Chapple, L., B Christensen, "The non-binding vote on executive pay: A review of the CLERP 9 reform." (2005) 18 *Australian Journal of Corporate Law* 263.

The prescriptive approach to remuneration disclosure contrasts sharply with the non-binding vote, which also arose from CLERP 9. Interestingly, when the non-binding vote was introduced there was significant controversy both in parliament and the wider community due to concerns it would be ineffective¹⁵

2.2 Future Developments

Further reforms:

In the last couple of months, media commentators have picked up several suggestions of mooted reforms to executive pay – linked to the non-binding vote discussion. These include:

1. Changing the vote to binding – this has occurred in other European jurisdiction, that a non-binding vote becomes binding in a later round of reforms. Although Malcolm Turnbull (Leader of the Opposition) has suggested this idea,¹⁶ there is no clear direction on the consequences of the vote in this circumstance.
2. Focussing on executive termination packages – requiring the termination package to be subject to shareholder approval at lower thresholds than currently. Part 2D.2, Division 2, currently deals with termination payments requiring shareholder approval.
3. Tax rate changes – the share based component of the package is taxed differently to cash based component – this means company executives are subject to different tax treatment than ‘other’ salaried workers.
4. Target policy to particular sectors – at the moment APRA has been tasked to explore a remuneration template in the banking sector consistent with the government’s bail out package due to the financial crisis.¹⁷

¹⁵ Chapple, L., B.Christensen, "The non-binding vote on executive pay: A review of the CLERP 9 reform." (2005)18 Australian Journal of Corporate Law 263.

¹⁶ Address to the National Press Club, 24th November 2008, <http://www.malcolmturnbull.com.au/Pages/Article.aspx?ID=97854>

¹⁷ "In October 2008, the Prime Minister announced that the Government would be examining with the Australian Prudential Regulation Authority (APRA) what domestic policy actions on executive remuneration would be appropriate to avoid excessive risk-taking in Australia’s financial institutions" see Media Release No 08.32, "APRA outlines approaches on executive remuneration", http://www.apra.gov.au/media-releases/08_32.cfm.

Case Law:

In addition to the legislative changes, there is potential for Australian case law relating to the impact and particularly the consequences of the non-binding vote. Although it has been observed in the past that the courts have a “general reluctance” to judge remuneration packages,¹⁸ it is reasonable that this coming decade may see a more proactive approach when the court is examining substantive issues of reasonableness or fairness. This was foreshadowed by Santow J in *ASIC v Adler (No 3)*.¹⁹

For example, in the United States *In re Walt Disney Company Derivative Litigation*²⁰ the Delaware Court of Chancery found that shareholders could establish liability for breach of fiduciary duty on the basis that the directors conscientiously and intentionally disregarded their responsibilities by paying excessive executive salaries. While the shareholders were ultimately unsuccessful, the Court left open the possibility of future legal action on the issue. However, even in less litigious jurisdictions including Germany and Canada, shareholder voting on remuneration has been the subject of legal action.²¹ For instance, in Canada, the Court of Appeal found directors liable for the payment of unreasonable executive remuneration packages²² (*UPM-Kymmene Corp v UPM-Kymene Miramichi Inc (4th) (CA)*).

Accounting Standard Developments:

Around the same time as *CLERP 9 Act*, the accounting standard *AASB 1046* (Director and Executive Disclosures by Disclosing Entities) was effective for companies disclosing on or after 30 June 2004. It was introduced in response to s300A of *CLRA98* (specifically the controversy regarding the quality of disclosures relating to executives and directors). The standard was comprehensive and included rules for valuation and disclosure of equity based compensation²³. It also required disclosure regarding the pay performance

¹⁸ Quinn, M., ‘The Unchangeables – Director and executive Remuneration Disclosure in Australia’ (1999) 10 *AJCL* 2, 3.

¹⁹ (2002) 41 *ACSR* 583 at [para 458].

²⁰ (2003). *In re Walt Disney Company Derivative Litigation Del. Ch.*, Court of Chancery. 825 A 2d 275.

²¹ Kolla, P., "The Mannesmann Trial and the Role of the Courts." (2004) *German Law Journal*.

; Hill, J. G. (2007) *Evolving 'Rules of the Game' in Corporate Governance Reform*, <ssrn.com/abstract+1000085>.

²² *UPM-Kymmene Corp v UPM-Kymene Miramichi Inc (4th) (CA)*. *DLR*, Court of Appeal. 250 526

²³ Tomasic, R. "The modernisation of corporations law: corporate law reform in Australia and beyond"

relationship. For example, it required a statement in regard to how contracts for services and bonus grants would impact future accounting periods. This was much more specific than the broad policy discussion required under s300A of *CLRA98*. Interestingly, the introduction of the prescriptive accounting standard requirements coincided with the prescriptive regulatory requirements introduced following CLERP 9.

In more recent times, *AASB 1024* has been superseded and replaced by *AASB 124* (Related Party Disclosures) and was introduced following the adoption of the international financial reporting standards (IFRS). It is effective for companies reporting on or after 31 December 2005. The key changes relate to who and what must be disclosed. Specifically, it requires the disclosure of the relationship to performance, details of performance conditions, justification for performance criteria, and methods used to assess performance in information about external benchmarks for 'key management personnel'.

AASB 2 (Share-based Payment) is effective for companies reporting on or after 1 January 2005. *AASB 2* requires a company to recognise share-based payment transactions in its financial statements without exception. These share-based payments include transactions with employees or other parties to be settled in cash, other assets, or equity instruments of the entity.

The prescriptive disclosure regime consisting of both regulatory and standard based rules forms the foundation upon which the non-binding vote operates.

3.0 Advantages and Disadvantages of the Guidelines Regulatory Approach

This study considers the appropriateness of a guidelines based regulatory approach. To this end, the key advantages and disadvantages are relevant. In order to remain consistent with the framework of this paper this discussion will be in the context of executive remuneration and in particular the non-binding vote (as a guideline). Nevertheless, the discussion is equally applicable to regulation in general.

The key criticism of prescriptive regimes is that they are inflexibly ‘one size fits all’. This can mean that companies are required to act in a manner that does not further their interests. For instance, if the remuneration vote we are discussing were to be binding, it would require boards to respond to a specified level of ‘no’ votes based on arbitrary thresholds and mandated responses. This raises a number of issues regarding the types of thresholds and responses that should be regulated.²⁴ For example, what threshold of ‘no’ voting should prompt the mandate responses – a majority (> 50%), a substantial shareholding (for the purposes of the empirical analysis this is set at 10% - see Section 4 for more detail) or any other percentage? The difficulty facing regulators is that the precise percentage of protest that is sufficient to motivate the board to change is unknown, and in any event is likely to be different for each company.

Consequently, there will inevitably be times when boards would like to respond but may not do so because it is not required and may therefore send the wrong signal to the market. Conversely, other boards that must respond may do so despite it not being in the shareholders’ interest. This situation is magnified when the types of mandated responses are considered. For example, the general thinking is that shareholders object to the quantum of remuneration and therefore the mandated response should address the quantum. However, the results of the analyses demonstrate that the quantum of remuneration does not always motivate shareholder voting. Shareholder voting behaviour is dependent on the idiosyncratic factors relating to both the company and the remuneration package itself.

²⁴ Cai, J. and Walkling R. A (2008), “Shareholders' Say on Pay: Does it Create Value?”, <ssrn.com/abstract+1030925>

The key difficulty with prescriptive requirements is that they are inflexible and inevitably involve a trade-off between company efficiency and regulatory compliance²⁵. The Sarbanes Oxley Act (SOX) in the United States (a comprehensive prescriptive regime) demonstrates this issue in the extreme. There is significant discussion in both the academic literature and within the business community surrounding the compliance costs of SOX²⁶. These compliance costs are arguably not reflective of the benefit to investors and are consequently value erosive²⁷.

In contrast, the guideline approach provides a flexible albeit unenforceable regulatory mechanism. Therefore, it avoids the potential inefficiencies resulting from the ‘one size fits all’ regime because companies can make the requisite changes in light of their own idiosyncratic factors. Given that the board is meant to be in the best position to understand their company and have the most information available to it (certainly more than regulators do) this means that they can alter the remuneration package to best address the reason(s) the shareholders voted ‘no’. Of course the key difficulty is that this entire mechanism is dependent on boards voluntarily altering the package. Therefore, firms with deeply entrenched management may not alter the package at all²⁸. Despite the lack of prescriptive obligations, compelling reasons remain as to why the non-binding vote will motivate change to the remuneration package. For example, Macquarie Bank adjusted the hurdle rates, and increased transparency in mid to long term incentive plans following 22.4% of votes cast against the remuneration package²⁹.

Additionally, a large proportion (close to 50%) or majority of ‘no’ votes is akin to a vote of no confidence which, if ignored, may force shareholders to show their discontent in votes that are binding, such as the re-election of directors³⁰. This position is indicative of the point raised above, that boards may, and based on the empirical results do, change the

²⁵ Hage, J. (2007) “Building the World of Law”, <ssrn.com/abstract+1115278>

²⁶ Krishnan, J., Rama, D. & Yinghong, Z. , “Costs to Comply with SOX Section 404” (2008) 27. *Auditing*, 169-186.

²⁷ Idid.

²⁸ Duffy, M., "Shareholder Democracy or Shareholder Plutocracy? Corporate Governance and the Plight of Small Shareholders." (2002) 25 *University of NSW Law Journal* 434-436.

²⁹ Bartholomeusz, S. (2007). Suncorp's Story admits past sins. [Business Spectator](#).

³⁰ Bartholomeusz, S. (2007). Suncorp's Story admits past sins. [Business Spectator](#).

package following a substantial proportion of ‘no’ votes rather than a majority of ‘no’ votes.

The Australian Securities and Investment Commission (ASIC) has also taken a strong view regarding the non-binding vote. For example, following the 2005 reporting season, ASIC put out an information release stating that:

“the fact that the vote is non-binding does not mean that companies can ignore the requirement and disenfranchise shareholders”³¹.

Similarly, ASIC appears to have implied an obligation on boards to explain to their shareholders what action, if any, they intend to take³².

Nevertheless, there are likely to be situations where boards will not alter the remuneration package to reflect shareholder disapproval even where there is a majority ‘no’ vote. For instance, firms with highly entrenched management are unlikely to alter the remuneration package unless the change is mandated³³. This position is similar to rent extraction theory in that the potential for change to the remuneration package is limited by the extent to which executives can influence their own compensation scheme³⁴. Where executives have significant influence, the remuneration package approved by the board is more likely to be sub-optimal or inefficient. This is due to board behaviour, specifically, the board may be influenced by management, sympathetic to management, confident in their position at the company, or simply ineffectual in over-seeing compensation³⁵. Inevitably, this results in remuneration that is in excess of what would be optimal for shareholders despite the non-binding vote informing management of shareholder disapproval.

³¹ Australian Securities and Investments Commission. (2005). "Not good enough - 43 listed companies fail to notify shareholders about non-binding vote on director and senior executive pay." Media and Information Release 05-404.

³² Australian Securities and Investments Commission. (2005). "ASIC asks Novogen to set the record straight on director pay vote." Media and Information Release 05-346.

³³ Krus, C. M. and L. A. Morgan, "Who Gets a "Say on Pay"?" (2008) 16(2), Corporate Governance Advisor 4-7.

³⁴ Bebchuk, L. A., Fried, J. M, et al. "Managerial Power and Rent Extraction in the Design of Executive Compensation." (2002) 69(3)University of Chicago Law Review 751.

³⁵ Ibid.

In light of the above discussion, the non-binding vote appears to be a potentially powerful governance strategy despite the lack of prescriptive consequences³⁶. The empirical results discussed in the next section show that on average across the sample, a substantial 'no' vote (> 10%) motivates the board to change the remuneration package. The analyses also demonstrate that there are a broad range of changes that result from a substantial number of 'no' votes. These changes include the quantum of remuneration package and the modification or introduction of performance benchmarks.

The question posed in the introduction of this paper – is not a trite one. Usually, the flippant answer to questions of shareholder direct control is to note that shareholders have power over the election of directors. The reality is thought that shareholders don't really control the inputs to the election process. The board elections and nominated candidate are presented to the public company shareholders as a 'fait accompli'. A research question to be explored further is the extent of this entrenchment.

³⁶ Hill, J. G. (2007). Evolving 'Rules of the Game' in Corporate Governance Reform, <ssrn.com/abstract+1000085>

4.0 Testing and Analysis of the Non-binding Vote

4.1 Empirical Methodology

The empirical method to test the effectiveness of the non-binding vote revolves around the observation that the non-binding vote may achieve a change in behaviour. Accordingly, the question posed is:

Does a remuneration package that changed following a substantial proportion of 'no' votes receive fewer 'no' votes in the subsequent year?

An answer in the affirmative to this question is strongly indicative of the effectiveness of the non-binding vote. For the non-binding vote to be effective as measured in this study, it must motivate managers to change the remuneration package to something that is more acceptable to shareholders as measured by the outcome of the non-binding vote at the subsequent year's AGM.

The analyses are based on a total sample of 351 (68 firm years of substantial 'no' votes) firm years over the sample period 2005 – 2007. The original sample of 750 firm years was reduced to 351 due to the following sample criteria. Firstly, companies that delisted over the sample period are eliminated (102 firm years eliminated on this basis). Secondly, companies that do not have 30 June financial year ends are eliminated to ensure consistency and minimise the exogenous impacts such as changes to accounting standards (276 firm years eliminated on this basis). Finally, 21 firm years are eliminated due to insufficient data.

It is important at this stage to explain how the 'substantial 'no' vote percentage'³⁷ has been determined. For the purpose of the analyses, a 10% threshold has been arbitrarily chosen as the measure of substantiveness. 10% is chosen because it is a reasonably conservative measure of significance or substantial influence. For instance, under s 9, a 5% shareholding is sufficient to become a substantial shareholder. Furthermore, it is arguable the 'no' vote cannot be entirely attributed to shareholder's perceptions of

³⁷ 'No' voting percentage = the number of 'no' votes in a single financial year/ (number of 'yes' votes + 'no' votes)

particular remuneration packages because there may be some residual percentage of ‘no’ votes irrespective of the package. Therefore, using 10% as the threshold for substantial ‘no’ voting should ensure that changes resulting from the non-binding vote are attributable to shareholders’ perceptions of the appropriateness of the particular remuneration package and not other exogenous factors.

4.2 Key Empirical Results

Table 1 below shows the aggregate voting behaviour of shareholders across the sample. The increasing percentage of votes across the sample period (the first three complete financial years in which the non-binding vote has operated) demonstrates the statistically significant increase in the proportion of ‘no’ votes (with a p-value of 0.031).³⁸ This is an interesting result from a regulatory point of view because it suggests the guidelines based approach has a more substantial impact over time. It is also indicative of a resolution to the key criticism of regulatory guidelines. That is, that shareholders would be apathetic and unconvinced that the non-binding vote is effective.

The increasing percentage suggests that as shareholders have gotten used to the non-binding vote and have become more willing to participate. This is important from a regulatory standpoint because it demonstrates that as confidence in the regime increases so too does effectiveness. The obvious alternate explanation is that remuneration packages are becoming more unacceptable across the sample and therefore more shareholders are voting ‘no’. Given the results below which demonstrate the non-binding vote is having an effect, it is more likely that shareholders are becoming more activist in their approach to remuneration and confidence in the non-binding vote and this is reflected in the increasing number of ‘no’ votes in Table 1. Both the mean/median percentage of ‘no’ votes increased over the sample period from 4.97%/2.4% in 2005 to 7.29%/3.9% in 2007 respectively.

³⁸ Statistically, “the *p*-value measures consistency between the results actually obtained in the trial and the pure chance” explanation for those results.” Thisted, R, “What is a p value?” (1998) <http://www.stat.uchicago.edu/~thisted>.

Table 1- Percentage of 'No' Votes Segmented by Year

Year		Total N	Mean	Median	Minimum	Maximum	Standard Deviation
2005	Percentage of no votes	117	.0497	.0240	.0000	.3017	.0630
2006	Percentage of no votes	117	.0627	.0289	.0000	.5257	.0904
2007	Percentage of no votes	117	.0729	.0390	.0002	.6618	.1001
Chi-Square		6.923					
Asymp. Sig.		.031**					

Table 1 sets out descriptive statistics segmented by year for the percentage of 'no' votes across the sample. Percentage of 'no' votes = number of 'no' votes / sum of 'no' votes + 'yes' votes.

*, **, *** signifies statistical significance at 10%, 5% and 1% levels respectively.

The next step in determining the effectiveness of the non-binding vote is to consider whether the changes made following a substantial 'no' vote were acceptable to shareholders. Table 2 shows the aggregate change in the percentage of 'no' votes for firms that received substantial 'no' votes in 2005, and 2006. Importantly the inter-year comparison is based on the same firms to ensure the change measure is reflective of only those firms that received the substantial vote in the originating year.

The results demonstrate that there is a statistically significant (at the 1% level) reduction in the percentage of 'no' votes at the subsequent year's AGM. Because shareholders are used as the benchmark of the appropriateness of the remuneration package, this result means that the non-binding vote is effective in prompting changes to the remuneration package that are acceptable to shareholders. This result has important ramifications for regulators because it is a statistically robust demonstration that guideline based regulatory frameworks can be effective.

Table 2
Panel A - Change in Voting Percentage Following a Substantial 'No' Vote

Year		2005-2006 Percentage Change for Substantial 'No' Vote	2006-2007 Percentage Change for Substantial 'No' Vote
2005	Mean	.157	.
	Median	.149	.
	Minimum	.024	.
	Maximum	.280	.
	Standard Deviation	.065	.
	Valid N	18	0
	Total N	117	117
2006	Mean	.094	.207
	Median	.050	.166
	Minimum	.001	.103
	Maximum	.526	.526
	Standard Deviation	.126	.108
	Valid N	19	24
	Total N	117	117
2007	Mean	.	.119
	Median	.	.077
	Minimum	.	.005
	Maximum	.	.662
	Standard Deviation	.	.145
	Valid N	0	24
	Total N	117	117

Panel B - Chi-Square Results

	2005-2006 Percentage Change for Substantial 'no' Vote
Chi-Square	7.986
Df	1
Asymp. Sig.	.005***

	2006-2007 Percentage Change for Substantial 'no' Vote
Chi-Square	11.158
Df	1
Asymp. Sig.	.001***

Panel A: sets out descriptive statistics for firms that received substantial 'no' votes. There are two categories, firms that received a substantial 'no' vote in 2005, and firms that received a substantial 'no' vote in 2006. For both of these categories the subsequent year 'no' voting percentage is provided to enable an examination of any change in percentage.

Panel B: sets out the results of Kruskal-Wallis tests for statistical differences between the years.

*, **, *** signifies statistical significance at 10%, 5% and 1% levels respectively.

4.3 Case Study Results

One of the key advantages of the guideline approach is that it is flexible and allows company management to respond in the most efficient way. The data demonstrates that there are a broad range of changes made to remuneration packages in response to a substantial 'no' vote including reducing the quantum of remuneration, introducing or removing options/shares/cash bonuses and introducing or altering performance benchmarks. The type of change appears to be largely idiosyncratic and dependent on the circumstances and remuneration package of each company within the sample. Therefore, while an aggregate analysis of changes is possible, a case-based descriptive discussion of three companies provides a more in-depth and relevant analysis of the efficacy of the non-binding vote.

The three companies are outlined below:

1. Mount Gibson Iron Ore (MGX)

MGX received a majority 'no' vote with 52.57% of votes cast against the remuneration package in 2006. It is worthwhile considering the possible reasons for this result. In the case of MGX the only factor that changed in the remuneration package compared to that of the prior year was the quantum which increased by 42%. Over the following year two key changes were made to the remuneration package. First, the quantum of the remuneration package decreased by 55% driven predominantly by a reduction in the number of options issued. Secondly, performance benchmarks were also changed. It would be artificial to try and isolate the impact each change had on the non-binding vote result, but the combination of these two changes resulted in a remuneration package that received an insubstantial number of 'no' votes in the subsequent year. This example demonstrates that although there are a broad range of potential changes managers can make to the remuneration package, the type and magnitude of the change is the key factor. This is an issue regulators would have to grapple with if mandating changes to the remuneration package when faced with strong shareholder protest. This example shows that boards are prepared to alter the remuneration package to make it more acceptable to

shareholders. Interestingly, the result also suggests that boards as insiders of the company do know how to change the remuneration package to make it more acceptable to shareholders.

2. Suncorp-Metway Limited (Suncorp)

In 2007, 42.55% of shareholders voted against the remuneration package. This may have been due to the 23% increase in remuneration, introduction of a share scheme and modification of the performance benchmarks. In response to this 'no' vote, company managers announced adjustments to the hurdle rates, and increased transparency in mid to long term incentive plans³⁹. This sort of response is not dissimilar to that of MGX and reflects the need for flexibility in company responses to substantial 'no' voting.

3. Downer EDI Ltd (DOW)

The two examples above demonstrate that high proportions of 'no' voting prompt change to the remuneration package. This example demonstrates the effectiveness of the non-binding vote with small amounts of 'no' voting.

In 2006, 11% of shareholders voted against the remuneration package. This result was likely motivated by a 7% increase in remuneration and alteration of the vesting period for performance bonuses. While the non-binding vote result was only just substantial, it still prompted a response by management. In the remuneration package for the subsequent year the quantum of remuneration increased marginally, but the vesting periods for the performance benchmarks were altered again. These changes resulted in 3.12% of shareholders voting against the package.

³⁹ Bartholomeusz, S. (2007). Suncorp's Story admits past sins. [Business Spectator](#). Australia.

4.4 Summary of Observed Changes

The examples above demonstrate the types of changes that can be made to remuneration packages to align them with shareholder expectations and ensure they are appropriate from a shareholder perspective. It is important to bear in mind that while the above examples discuss the characteristics of the particular remuneration packages, when voting, shareholders are likely to consider other factors specific to the company. These could include the operating and financial position of the company, the corporate governance, size of CEO ownership, management entrenchment, and size. This study does not purport to test the relational aspects of these factors, although it is of course arguable that all of these variables should be relevant to the non-binding vote outcome.

Answer to the Research Question:

In light of the methods and analysis within this section, the research question is answered in the affirmative. Therefore, on the basis of these analyses, the non-binding vote is measured to be effective, based on our criterion of changed behaviour.

5.0 Conclusion - Why the Non-binding Vote is Effective

The analyses in Section 4 Indicate that non-binding vote is effective on average across the sample. It is worth considering why this particular guideline based regulatory regime is effective.

Clearly, shareholder pressure is sufficient to motivate boards sufficiently to change the remuneration package. It is worth emphasising the statistically significant decrease in the percentage of ‘no’ votes in the year subsequent to the original substantial ‘no’ vote (Table 2). This result suggests that the changes made are acceptable to shareholders.

Moreover, the environment within which the non-binding vote operates is relevant. The argument that guidelines are ineffective is reflected in the development of disclosure regulation and accounting standards discussed in section 2. It is conjectured that one of the key factors underpinning the “success” of the non-binding vote is the prescriptive disclosure regime upon which it is based. Without this information the non-binding vote is more likely to be ineffective because shareholders will not be informed about what they are voting on. Additionally, the comprehensive disclosure regime arguably sends a clear message to management that executive remuneration is an issue that should be taken very seriously by company management. This position is underpinned by ASIC statements to this effect (see Section 3).

It is further speculated that effective regulatory guidelines are based on a solid prescriptive legal framework. This framework sets the foundation upon which the guideline operates and also signals the regulators’ intent that the guideline should be taken seriously. While it is impossible to isolate the non-binding vote from disclosure when considering effectiveness, it is likely that the combination of prescriptive and guideline regimes strengthens effectiveness.

In light of the global financial crisis and the likelihood of a new round of regulatory intervention (particularly in the area of remuneration) the findings in this study are both topical and relevant. The discussion above outlines the advantages and disadvantages of

the guideline approach to regulation, and the general regulatory regime within which the non-binding vote operates. Significantly, the analyses conclude that the non-binding vote is an effective regime to manage CEO remuneration (and by extension) executive remuneration.

However, there is recent evidence board turnover, especially CEO level, is minimal. Shareholders have a direct and binding vote on selection of executives who serve on the board, see s201E for appointment and s203D for removal. In a 2008 study, Booz and Company find that there is little correlation between poor performance and short term dismissals.⁴⁰ This suggests that for policy makers, issues of remuneration require a balance of disclosure and prescription, empowering shareholders, whilst attending to intended and unintended consequences

⁴⁰ Karlsson, P., Neilson, G. and JC Webster, "CEO Succession 2007: The Performance Paradox" (2008) 51 *strategy+business* reprint number 08208 <http://www.strategy-business.com/press/freearticle/08208>.

