

Are the fat cats pouring their own milk?

Executive remuneration in listed companies in New Zealand

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Introduction

Executive remuneration, in particular the multi-million dollar salaries of chief executive officers of listed companies, is often in the media spotlight. A recent and particularly bright example of this was the remuneration of Telecom chief executive officer Paul Reynolds. Media attention leads to accusations that executive pay is “excessive”, which raises legal and political questions about how executive pay should be determined, what information about it should be disclosed, and who should be responsible for monitoring it.

This dissertation provides a critical analysis of the weaknesses in the company and securities law framework surrounding the remuneration of executives in listed companies in New Zealand. This critique is from the perspective of shareholders as it is based on the assumption they are the owners of listed companies. Shareholders view remuneration as a tool for achieving a complex set of business strategies and goals, in particular, ensuring managements interests are aligned with theirs. Viewing remuneration as a tool, whether executive remuneration is excessive becomes a question of the executive’s impact on company performance.

The connection between executive remuneration packages and company performance is important from a number of different economic perspectives. Shareholders, as residual claimants, want corporate resources to be used most productively and capital market regulators want New Zealand companies to attract both domestic and foreign investment to reduce the cost of capital. As listed companies represent some of the largest market players in our economy, the flow-on effects of productivity and the cost of capital affect all participants in the New Zealand economy.

There are two things that are needed from a corporate governance framework in order for remuneration to be used as a tool effectively. The first is to ensure the focus of executive remuneration discourse is on *how* executive pay is being structured, and not simply *what* executives are being paid in absolute dollar terms. The second is to put adequate

measures in place to prevent this tool being used to loot the company. This dissertation evaluates the measures that are in place from the perspective of managerial power theory. This theory rejects the assumption that executive remuneration contracts are the result of arm's length contracting in order to explain distortions in remuneration that are not attributable to market forces. It contends that executives are able to use their position to exert undue influence over boards to distort remuneration in their favour. This includes both executive directors, who have an inherent conflict of interest due to the board of directors' responsibility for determining executive remuneration, and non-director executives, who can also wield substantial power within the company structure.

Chapter one identifies the dominant company law and securities law theory that provides the basis of this critique. It explains why executive remuneration is the prism through which we look at the risks of executives pursuing personal interests over those of the company. Chapter two explains why the executive remuneration paradigm needs to shift beyond focusing on the absolute amounts of executive remuneration to concentrate more closely on its structure. Chapter three provides a critique of the corporate governance framework surrounding executive remuneration in New Zealand. The framework is broken down into three areas: the procedures of the board of directors when determining executive remuneration; what information must be disclosed to shareholders; and the involvement of shareholders. Chapter four evaluates the more regulation-based corporate governance framework in Australia, in particular, the measures that country has introduced in response to managerial power theory. Chapter five identifies the empirical evidence of problems in executive remuneration in New Zealand and the need for reform. As the response to perceived problems or weaknesses in securities law is often to cherry pick mechanisms from Australia, this chapter looks at whether adopting measures from their framework would be consistent with the existing company and securities law framework in New Zealand.

I Company law and securities law theory

A Introduction

This chapter outlines the nexus of contracts theory of the company and the shareholder primacy view of the relationship between shareholders and management as one of principal and agent. This principal-agent paradigm gives rise to the risks identified by agency theory and managerial power theory facing shareholders. This chapter sets the scene for why excessive executive remuneration is a problem, and why it is the prism through which we look at the risks identified by agency theory and managerial power theory.

B Relationship between company law and securities law

Executive remuneration in listed companies¹ is an interesting intersection between company law and securities law. The legislative framework is comprised of three overlapping sources whose application depends upon the nature of the company. The Law Commission designed the modern company law framework in New Zealand on the premise that companies that raise funds from the public would be subject to additional and more onerous standards imposed upon them by securities legislation.² When designing this framework it distinguished company law as being concerned with the incidents, benefits and abuses of the corporate form in contrast to the wider concern of securities law with the integrity and efficiency of capital markets.³ The Securities Act 1978 protects the public interest by imposing higher standards of disclosure and less

¹ The term “public issuer” is used in the Securities Act 1978 to refer to companies which raise funds from the public widely, whereas it is used in the Securities Markets Act 1988 to refer to a party to a listing agreement with a registered exchange. The term “listed company” will be used throughout this dissertation to refer to companies listed on a registered exchange as there is no such ambiguity and it is more intuitive.

² Law Commission *Company Law: Reform and Restatement* (NZLC R9, 1989) at [134]. This report conducted a review of the company law framework, in particular the Companies Act 1955, and formed the basis of the Companies Act 1993.

³ *Ibid*, at [20].

flexibility upon companies which raise funds from the public.⁴ The Securities Markets Act 1988 imposes additional obligations upon companies whose securities are listed for trading on registered secondary markets.⁵

Efficient capital markets are important for investors, so they can confidently make financial decisions appropriate for their financial goals, and also firms, so they can efficiently and effectively source funds and hedge financial risk.⁶ As company law and securities law are necessarily intertwined when companies choose to raise funds from the public, securities law regulation of the capital-raising process and the ongoing relationship between listed companies and their investors needs to be coherent with company law.⁷

Listed companies which focus on creating long-term value for shareholders help create a stronger economy, greater prosperity, and greater ability to raise capital for productive growth that benefits all participants in an economy.⁸ This dissertation focuses narrowly on executive remuneration in listed companies because of the important role they play in the performance of the entire economy and the heightened risk of foul play due to the separation of ownership and control. There is no class of persons universally caught by the term “executive” in company and securities law in New Zealand.⁹ A publication released by the New Zealand Stock Exchange (NZX) in 2011 highlighted this ambiguity and recommended using the concept of “officers” in the Securities Markets (Disclosure of Relevant Interests by Directors and Officers) Regulations 2003 as a rule of thumb.¹⁰

⁴ Ibid, at [132].

⁵ Securities Markets Act 1988, Part 2B Registered Markets.

⁶ Ministry of Economic Development *Review of Securities Law* (Discussion Paper, June 2010) at 12.

⁷ See for a discussion of this relationship Shelley Griffiths "Securities Regulation" in John Farrar (ed) *Company and Securities Law in New Zealand* (Thomson, Wellington, 2008) at 985.

⁸ Joseph Healy *Corporate Governance & Wealth Creation in New Zealand* (Dunmore Press, Palmerston North, 2003) at 19.

⁹ See Part *IV B* for an explanation of the “Key Management Personnel” concept introduced into Australia, which is widely used throughout company and securities law.

¹⁰ NZX *Guidance Note – Continuous Disclosure* (29 April 2011) <www.nzx.com/marketsupervision/rules/-nz-markets-disciplinary-tribunal-rules> at 5.

This definition includes persons who report directly to the board of directors or to a person who reports directly to them.¹¹

C Nexus of contracts theory of the company

Nexus of contracts theory conceptualises the company as a complex nexus of contracts, chief among which is an agreement between the shareholders and executive officers to run the firm in a fashion that maximises shareholder wealth.¹² Companies are considered the private property of shareholder “owners”, and directors and executives are seen as their “agents”, under a duty to maximise profits on the shareholder’s behalf. This duty requires disregarding the claims of various non-shareholder constituencies whose interests may be adversely affected, meaning that managerial accountability is seen as corporate law’s central problem.¹³ The narrow focus on the pursuit of wealth is premised upon a faith in the ability of free market mechanisms to allocate preferences most efficiently, where increasing efficiency and maximising wealth are accepted as appropriate proxies for what is in the public interest.¹⁴ Critics argue a nexus of contracts is not something that is capable of being owned by shareholders. However, in response, the principal-agent paradigm is argued as still being conceptually useful on the basis that shareholders carry out an important function in being the firm’s residual claimant and having residual control rights.¹⁵

¹¹ Securities Markets (Disclosure of Relevant Interests by Directors and Officers) Regulations 2003, s 4.

¹² Margaret Blair and Lyn Stout "Specific investment and corporate law" (2006) 7 *European Business Organization Law Review* 473 at 474.

¹³ David Millon "Communitarians, contractarians, & the crisis in corporate law" (1993) 50 *Wash. & Lee L. Rev.* 1373 at 1374.

¹⁴ Paddy Ireland "Property and contract in contemporary corporate theory" (2003) 23 *Legal Studies* 453 at 485; see Millon, above n 13, at 1381; see William Allen "Our schizophrenic conception of the business corporation" (1992) 14 *Cardozo L. Rev.* 261 at 269.

¹⁵ See generally for an explanation of the Law and Economics movement Frank H. Easterbrook and Daniel R. Fischel *The Economic Structure of Corporate Law* (Harvard University Press, Cambridge, Mass, 1991).

In reality, company law and securities law in New Zealand are not completely aligned with nexus of contracts theory and the shareholder primacy view.¹⁶ Company law places a number of restrictions on the ability of shareholders to interfere with the management of the company, separating ownership from control. The statutory presumption in the Companies Act 1993, subject to the company constitution providing otherwise, is that the board of directors as a group has all of the responsibility and power necessary to manage the business and affairs of the company.¹⁷ This statutory presumption of the modern company law framework was introduced to “make it clear that powers of management are to be exercised by the directors, and that the powers reserved to shareholders are powers to make decisions affecting their proprietary rights”.¹⁸ These restrictions on the rights of shareholders in the modern company law framework are consistent with arguments that a “legitimacy crisis” is caused by the separation in ownership and control.¹⁹ It is argued that shareholders, particularly those in listed companies, no longer fit the “owner” paradigm as they do not necessarily provide leadership or contribute the initial capital to the company. Opponents to nexus of contract theory and shareholder primacy argue shareholders are more akin to “rentier investors” and as such they do not necessarily deserve all of the rights of ownership.²⁰

Despite the presumptions of restrictions on shareholders’ rights in company law, nexus of contracts theory and shareholder primacy will form the theoretical basis of this critique due to their dominance in company and capital market thinking. It is widely accepted that the primary objective of companies is to generate returns for shareholders by seeking profits. Throughout legal and academic discourse in New Zealand shareholders are

¹⁶ See, for a critique of the strength of nexus of contract theory in modern company law in New Zealand, Neil Campbell; Christopher Hare; and Peter Watts *Company Law in New Zealand* (LexisNexis, Wellington, 2011) at 435.

¹⁷ Companies Act 1993, s 128.

¹⁸ Law Commission, above n 2, at [160].

¹⁹ Adolf A. Berle and Gardiner C. Means *The Modern Corporation and Private Property* (Rev. ed, Harcourt, Brace & World, New York, 1968) at vii.

²⁰ Ireland, above n 14, at 474.

regularly referred to as the owners of the company.²¹ The Companies Act 1993 has shifted away from the old terminology of referring to shareholders as “members”.²² It is argued that shareholder primacy has always been intrinsic to the Commonwealth model of company law and continues to underlie the Companies Act 1993 given the de facto and legal power of shareholders over the board of directors they leave in control.²³ In the context of listed companies, where this separation in ownership and control is greater, securities markets are also predicated on a faith in the ability of free market mechanisms, with regulators being primarily focused on efficiency.²⁴ The regulatory regime is designed to increase efficiency by countering market failures when the free market mechanism is not itself efficient, such as informational asymmetries.²⁵ Nexus of contracts theory and shareholder primacy as a theoretical basis leads to the concern in executive remuneration being issues relating to company performance, as this is what generates all forms of return to shareholders.

D Agency theory

Agency theory starts from the assumption of the principal-agent paradigm that shareholders are the “owners” of companies,²⁶ and suggests that there is a natural divergence in the interests of shareholders and executives.²⁷ Executives may gain greater utility from pursuing objectives other than company performance, such as self-

²¹ See reference to shareholders as “owners” in Campbell; Hare; and Watts, above n 16, at 265; and also in Ministry of Economic Development, above n 6, at 12; see reference to shareholders as the “ultimate owners” who have “important rights and functions in corporate governance” in Securities Commission *Corporate Governance in New Zealand Principles and Guidelines, A Handbook for Directors, Executives and Advisers* (February 2011) <www.fma.govt.nz/keep-updated/reports-and-papers/handbook-corporate-governance-in-nz-principles-and-guidelines/> [*Handbook*] at 23.

²² Companies Act 1955, s 39.

²³ Campbell; Hare; and Watt, above n 16, at 266; Companies Act 1993, s 156.

²⁴ Ministry of Economic Development, above n 6, at 12; Capital Markets Development Taskforce *Capital Markets Matter* (Report, December 2009) at 82.

²⁵ Ministry of Economic Development, above n 6, at 12.

²⁶ Productivity Commission of Australia *Executive Remuneration in Australia* (Inquiry Report No. 49, 2009) at 23.

²⁷ Healy, above n 8, at 169.

enrichment or building corporate empires to increase social standing.²⁸ These costs to shareholders are referred to as agency costs.²⁹ The use of incentives and controls to tie executive remuneration to company performance are suggested as an effective means of reducing agency costs by aligning the interests of shareholders and executives.³⁰ The use of performance hurdles and the issue of new shares in executive remuneration practices in New Zealand demonstrate that commercial practice and legal theory have at least started to respond to agency theory.³¹

E Managerial power theory

Optimal contracting theory assumes that boards are able to contract at arm's length with executives to maximise value for shareholders through removing agency problems.³² Managerial power theory attempts to remove this dominant paradigm of arm's length bargaining which it argues forms the basis of legal rules and public policy in the corporate world.³³ It suggests executives are able to use their power to exert undue influence over boards in order to distort executive remuneration in their favour and extract "rents".³⁴ Boards who respond to this undue influence are referred to as compliant or captured. Managerial power theory does not reject optimal contracting theory entirely,

²⁸ Ibid, at 168.

²⁹ Ibid, at 169.

³⁰ Productivity Commission of Australia, above n 26, at 102.

³¹ NZSX/NZDX Listing Rules (6 August 2010), r 3.5.1. This rule explicitly provides for director remuneration in equity. NZSX/NZDX Listing Rules Appendices (6 August 2010), Appendix 16 Corporate Governance Best Practices Code at 2.7 recommends director remuneration include a portion of performance-based equity compensation.

³² Lucian Bebchuk and Jesse Fried "Executive Compensation in America: Optimal Contracting or Extraction of Rents?" (NBER Working Paper #8661, 2001) at 7 as cited in Healy, above n 8, at 171.

³³ Lucian Bebchuk and Jesse Fried *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press, Cambridge, Mass, 2004) [*Pay Without Performance*] at 2.

³⁴ Ibid, at 62. "Rents" is the term used by economists to refer to extra returns that firms or individuals obtain due to their personal advantages.

but rather attempts to account for distortions in executive contracts (in favour of executives) that are not attributable to market forces.³⁵

The risks identified by managerial power theory include the power and influence of executive directors (or “inside directors”³⁶) from within the board of directors, and also the power and influence of non-director executives from outside the board. Chief executive officers are able to provide economic incentives to directors, such as assisting with election through their influence in nomination committees and also their ability to benefit directors directly and indirectly through wider business interests.³⁷ In the wake of the high-profile corporate collapses in the United States in 2001 evidence emerged of chief executive officers having essentially “bought off” directors.³⁸ There are also various social and psychological factors that make boards of directors vulnerable to chief executive officers and senior executives, such as prior connections of friendship and loyalty, collegiality and professional courtesy, respect for the chief executive officer’s authority, and cognitive dissonance when an executive director is included in a remuneration committee.³⁹

The ability of executives to extract rents is limited by “outrage costs”, which are the costs to directors of the negative reactions of outsiders, such as reputational damage or increased vulnerability to takeover in the market for corporate control.⁴⁰ As outrage costs are a function of the perception of outsiders, compliant boards may simply attempt to hide or “camouflage” rent extraction in order try to avoid or minimise outrage costs.⁴¹

³⁵ Lucian Bebchuk and Jesse Fried "Executive compensation as an agency problem" (2003) 17 *Journal of Economic Perspectives* 71 at 72.

³⁶ See Christopher Stone *Where The Law Ends: The Social Control of Corporate Behaviour* (Harper & Row, New York, 1975) at 122.

³⁷ Bebchuk and Fried *Pay Without Performance*, above n 33, at 25.

³⁸ For example the director who chaired the compensation committee at WorldCom was allowed by the CEO really cheap use of the corporate jet, see Susan Pulliam; Jared Sandberd and Deborah Solomon "WorldCom board will consider rescinding Ebberts's severance" *Wall Street Journal* (United States, 10 September 2002) as cited in Bebchuk and Fried *Pay Without Performance*, above n 33, at 27, n 18.

³⁹ Bebchuk and Fried *Pay Without Performance*, above n 33, at 31.

⁴⁰ *Ibid*, at 64.

⁴¹ *Ibid*, at 67.

Bebchuk and Fried provide managerial power theory as an explanation for the upward trend in executive remuneration in recent history.⁴² They have gone so far as to argue that executives in the United States dominate boards to such a degree that they effectively set their own pay, subject only to outrage costs.⁴³

F Conclusion

Agency theory identifies why executive remuneration plays such a pivotal role, and demonstrates why it is the prism through which we look at the risks of executives pursuing personal interests over those of the company. Paradoxically, whilst remuneration is where the risks identified by agency and managerial power theory become most acute,⁴⁴ it is also the most effective avenue for reducing these risks to shareholders more broadly. A strong corporate governance framework that mitigates the risks of distortions in executive remuneration is important, because if the board does get it right the incentives of executives to act contrary to the interests of the company are minimised.

⁴² See generally Bebchuk and Fried, above n 35.

⁴³ Productivity Commission of Australia, above n 26, at XXII.

⁴⁴ *Ibid*, at 22.

II “Excessive” executive remuneration

A Introduction

Nexus of contracts theory and the shareholder primacy view lead to focusing on the alignment of executive remuneration with company performance. This chapter explains how this perspective shapes the measure of excessive remuneration adopted in this dissertation and the need to shift the executive remuneration paradigm to monitor this more effectively. It identifies the implicit assumption of “talent” in pursuing the alignment of executive remuneration with company performance, and looks at how the public concern might be placated. This chapter also discusses the implications of any reform of corporate governance on company law theory and commercial practice that utilises shareholders as a mechanism to mitigate executive power.

B What is meant by “excessive” executive remuneration

The emphasis on maximising the wealth of shareholders in nexus of contract theory, and the natural divergence of shareholders and executives in agency theory, lead to seeing executive remuneration as a tool to benefit company performance. Company performance is optimised where remuneration rewards executives for the contributions they make to the long-term success of the company.⁴⁵ This is the mantra that skilled executives should be able to get rich with their shareholders, by creating value for companies, but not at their expense.⁴⁶ Any additional remuneration an executive is able to garner from the company, by virtue of their position on or power over the board of directors, is a form of corporate looting as it represents a shift in wealth from shareholders to executives.⁴⁷

⁴⁵ Healy, above n 8, at 176.

⁴⁶ Ibid, at 188.

⁴⁷ Andreas Schoenemann "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 at 35.

From the perspective of shareholders, remuneration can be distorted in terms of “quantum”, where executives are overpaid, and in terms of “structure”, where remuneration is not sufficiently aligned with company performance.⁴⁸ The incentive for executives to decouple remuneration from company performance is to make life easier for executives than having to invest the effort and skill required to manage the company well and out-perform competitors in the marketplace.

The costs to companies and shareholders caused by the structure of executive remuneration distorting executive decision-making can be much more significant than the costs caused by issues of quantum.⁴⁹ For example, if performance hurdles are too low or relate to the wrong areas of the business, the cost to the company of foregone performance or of pursuing business goals that are not in the best interests of the company may be much larger than the remuneration expense. There is evidence that executive remuneration in New Zealand is not high by Western standards but that packages may be among the most poorly designed.⁵⁰ Media discourse contributes to this problem, as reporting tends to be unsophisticated, focusing on only the absolute levels of executive remuneration.⁵¹

As this dissertation is premised upon viewing executive remuneration as a business tool, remuneration is excessive where the executive is not providing a commensurate contribution to company performance, rather than by reference to any absolute dollar amount. This is hard to measure and is in a sense aspirational, but it is trying to shift the executive remuneration paradigm from a focus on quantum, or *what* executives are paid, to a focus on structure, or *how* they are paid.⁵² Focus on the relationship between

⁴⁸ Ibid.

⁴⁹ Productivity Commission of Australia, above n 26, at 11.

⁵⁰ Healy, above n 8, at 168.

⁵¹ Neil Crombie and Vicki Tan "The Legitimacy of CEO Pay: The Discourse of Telecom, the Media and the Public" (Working Paper, University of Canterbury, 2011) at 31. For a recent example of media reporting without considering the structure or providing any other sophisticated economic insight see Tim Hunter "Growing pay gap between CEOs, staff" *Stuff Business Day* (New Zealand, 28 July 2012) <www.stuff.co.nz/business/money/7366296/-Growing-pay-gap-between-CEOs-staff>.

⁵² Healy, above n 8, at 169.

remuneration and company performance centres the debate on managerial accountability, consistent with nexus of contract theory. Executive and shareholder interests can never be perfectly aligned through remuneration, as executives will always demand a certain level of fixed salary, and at some point the marginal cost to shareholders outweighs the marginal benefit. The alignment of remuneration and company performance however provides a more effective objective criterion than attempting to quantify, *ex ante*, the value of an executive to a company in absolute dollar terms or trying to mimic the executive labour market.

C Procedure over substance

Broadly speaking, the two options available to regulators are to either reform the procedure surrounding executive remuneration, or to reform the substance of executive remuneration directly. Viewing executive remuneration as a business tool does not fit with notions of reducing flexibility to use this tool effectively. Listed companies need to deal with agency problems on a case-by-case basis. What executive remuneration is optimal from the perspective of a particular company is subject to many context dependent variables such as the degree of income-risk aversion of the manager or the risk preferences of the company owners.⁵³ Direct regulatory intervention in the substance of executive remuneration, through mechanisms such as salary caps, risks “throwing the baby out with the bathwater”.⁵⁴ A pay vehicle that delivers “money for jam”, or even dangerous incentives in one situation, could promote desirable alignment in another.⁵⁵

Substantive limits on the quantum of executive remuneration would not get to the root of the problem of excessive executive remuneration. Whilst it might stem the outflow of corporate resources, the negative externalities of regulatory intervention in the executive marketplace may be detrimental to company performance. The marketplace would likely

⁵³ Productivity Commission of Australia, above n 26, at 107.

⁵⁴ *Ibid*, at XXVII.

⁵⁵ *Ibid*, at 107.

respond to salary caps with greater pressure for fixed pay or the provision of other non-monetary benefits.

D The “talent” debate

Whilst industry or market indexes could be incorporated into performance hurdles to account for any buoying effect of the economic climate on company performance,⁵⁶ large, sometimes multimillion dollar, remuneration packages attribute executives with a significant portion of credit for what is achieved by the entire company. Pursuing the alignment of executive remuneration with company performance presupposes the controversial assumption that executives can actually possess such “talent”.⁵⁷ This assumption is criticised as operating ideologically and only remaining dominant due to the difficulty in determining the true value of an individual’s performance in a large company.⁵⁸ The talent debate demonstrates two things: that the public perception of executive remuneration may benefit from increased transparency; and that focusing on procedure rather than substance is more consistent with the dominant ideas in New Zealand’s legal and political theory.

A comparison is regularly drawn with the earnings of sports stars and entertainers whose talent is generally accepted by society at large.⁵⁹ Analogous to shareholders, it is the fans and audiences of these persons who are ultimately paying their wages. It is argued that celebrity talent is accepted as a commodity capable of objective valuation because it appears to be openly determined by non-monopolistic competition and it is easier to monitor their exceptional performance.⁶⁰ This suggests the public distaste with executive remuneration possibly stems from the perception it is not gained by fair means,⁶¹ or that

⁵⁶ Ibid, at 358.

⁵⁷ Healy, above n 8, at 188.

⁵⁸ David Bolchover *Paycheck: Are Top Earners Really Worth It?* (Coptic Publishing, London, 2010) at 8.

⁵⁹ Productivity Commission of Australia, above n 26, at 14; and Bebchuk and Fried *Pay Without Performance*, above n 33, at 21.

⁶⁰ Healy, above n 8, at 188.

⁶¹ Productivity Commission of Australia, above n 26, at 14.

executive roles are not perceived as being that difficult. It follows that making board processes in determining executive remuneration more transparent, and also encouraging more effective communication of information about the performance required from executives, may help to placate public concern.

The different perspectives on the talent debate are typically built upon different political ideologies.⁶² Support for the idea that an executive's role is capable of objective valuation and the concept of an executive labour market are typically built upon faith in efficiency and free market mechanisms, consistent with the classic liberal assumptions beneath nexus of contract theory. Without these underlying beliefs, economic efficiency does not necessarily justify the absolute pay gap between the remuneration of executives and average workers.⁶³ Whilst there may be imperfections that arise from the board of director's central role in determining remuneration and reliance on the free market, there is no evidence New Zealand is about to deviate from these mechanisms, which are so prevalent in Western models of company and securities law.

E Utilising shareholders in response to managerial power theory

The complexity of executive remuneration can be used as a smoke-screen not only to keep out the visible hand of the state, but also to keep out the hands of shareholders, in order to justify executive remuneration being the exclusive domain of the board of directors. Arguments of complexity however highlight the importance of insulating boards where possible from the influence of self-interested executives so that they are able to determine remuneration to the best of their ability. Utilising shareholders as a mechanism to achieve this has both legal and commercial implications.

The inconsistency between nexus of contract theory and the separation in ownership and control in the modern company law framework can for the most part be papered over by

⁶² Crombie and Tan, above n 51, at 23.

⁶³ Bebchuk and Fried *Pay Without Performance*, above n 33, at 8. This may be considered the “moral”, “fairness-based” or “populist” opposition to large executive pay.

the argument that shareholders are simply content to leave decisions in the hands of specialist managers. Abridging the separation of ownership and control by imposing any additional obligations on the board of directors in respect of shareholders, or giving shareholders any additional powers at the annual general meeting, therefore needs to have a justification outside of company law. As explained above, securities law has jurisdiction to impose more onerous obligations on companies that raise funds from the public in order to promote the integrity and efficiency of capital markets.

There is a lot of academic literature surrounding the history of the firm and the listed company structure. The advantages have been summarised as being an effective mechanism to aggregate large amounts of capital for investment, to efficiently allocate and manage risk, accumulate expertise and knowledge, and to minimise the costs of doing business.⁶⁴ Procedural reform of executive remuneration is effectively a commercial balancing act. The potential benefits in substantive remuneration outcomes from shareholders being used to mitigate the risks of managerial power theory, and the market-wide benefits of increased investor confidence, need to be balanced against the additional frictions this generates. Frictions from having to coordinate with shareholders more extensively translate into increased costs of doing business, cutting into profit margins. For example, requiring shareholder approval may cause negotiating problems for the board or pre-approved prescriptive guidelines may undermine the board's need for discretion.⁶⁵

F Conclusion

The executive remuneration paradigm needs to shift beyond *quantum* to a more sophisticated focus on *structure*. The structure of executive pay is of greater significance when looking from the perspective of shareholders and company performance, and would

⁶⁴ Business Council of Australia "Submission to Productivity Commission Inquiry on Director and Executive Remuneration in Australia" (Submission 101, Australian Productivity Commission, July 2009) at 7 as cited in Productivity Commission of Australia, above n 26, at 20.

⁶⁵ Productivity Commission of Australia, above n 26, at 286.

be more consistent with the emphasis on managerial accountability in nexus of contract theory. Accepting that New Zealand is unlikely to shift away from the Commonwealth model of executive remuneration being the responsibility of the board of directors, and the commercial problems that are likely to arise from regulation interfering directly with the substance of remuneration, the most likely avenue is to pursue procedural reforms with the goal of achieving better substantive remuneration outcomes.

III Corporate governance framework in New Zealand

A Introduction

The corporate governance framework surrounding the remuneration of executives in listed companies in New Zealand fails to adequately address executive power. This chapter provides a critique of three areas of the corporate governance framework: the procedures of the board of directors when determining executive remuneration; what information must be disclosed to shareholders; and the involvement of shareholders. This critique identifies how the corporate governance framework contributes to the focus in executive remuneration on quantum and the effects of optimal contracting theory. It also identifies the more onerous standards in place for the remuneration of persons in their capacity as a director abridging the separation of ownership and control, and the lack of any such measures in place in respect of executive remuneration.

B Corporate governance

Corporate governance refers to the “control of corporations and to systems of accountability by those in control”.⁶⁶ The control of executive remuneration in listed companies is presumed by statute to lie with the board of directors and the systems of accountability are to shareholders.⁶⁷ The corporate governance framework in New Zealand is a composite of hard law regulatory standards in legislation and stock market rules, and reliance on soft law and market forces such as best practice norms.⁶⁸ The systems of accountability can therefore vary between listed companies that implement different levels of higher standards and mechanisms voluntarily in response to market pressures.

⁶⁶ John Farrar *Corporate Governance: Theories, Principles and Practice* (3rd ed, Oxford University Press, South Melbourne, Vic., 2008) at 3.

⁶⁷ Companies Act 1993, s 128; see Campbell; Hare; and Watts, above n 16, at 266.

⁶⁸ Farrar, above n 66, at 4. See Part *I B* for an explanation of the relationship of company and securities law.

Empirical evidence has demonstrated that a corporate governance premium exists which makes it easier for companies with good corporate governance practices to raise funds and retain investors in capital markets.⁶⁹ Institutional investors⁷⁰ were prepared to pay a premium as high as 20 per cent.⁷¹ Despite the financial incentives of good corporate governance practices, there is still a role for regulation. Regulation can help to reinforce incentives and diminish any loss of confidence to New Zealand capital markets as a whole from the poor corporate governance standards of a minority of listed companies.⁷²

Two themes were apparent from the inception of the Securities Markets Act 1988 following the sharemarket crash in 1987; investor protection and the attraction of foreign capital to New Zealand.⁷³ The Securities Markets Act 1988 requires all listed companies to be a party to a listing agreement with the registered exchange which contains approved rules governing conduct.⁷⁴ All companies listed on the main board of the NZX are contractually bound to comply with the NZSX/NZDX Listing Rules (Listing Rules) contained in their listing agreement with the NZX. The Listing Rules, sometimes referred to as “hard soft law”,⁷⁵ are enforceable against each listed company for the benefit of its shareholders, who may enforce these obligations directly.⁷⁶

⁶⁹ McKinsey & Company "Three surveys on corporate governance" (2000) McKinsey Quarterly <www.mckinseyquarterly.com>. This study and the idea of a corporate governance premium has been adopted and cited by the Securities Commission *Review of Corporate Governance Disclosures by Selected Issuers* (Annual Review, July 2010) [Review] at 2; and academic texts such as Healy, above n 8, at 48.

⁷⁰ Productivity Commission of Australia, above n 26, at 30. Institutional investors are “specialised financial institutions that manage the collective savings of a number of small investors, with the aim of achieving particular risk, return and maturity objectives”. This is in contrast to retail investors who “consist of individuals who buy and sell securities in the course of maintaining personal investment portfolios”.

⁷¹ McKinsey & Company, above n 69.

⁷² Productivity Commission of Australia, above n 26, at 126.

⁷³ Griffiths, above n 7, at 987. The guiding criteria for the maintenance of securities markets rules expressly include these objectives, among others, in s 36FC of the Securities Markets Act 1988. These criteria are discussed in more detail at Part *V F*.

⁷⁴ Securities Markets Act, s 36H.

⁷⁵ Farrar, above n 66, at 4.

⁷⁶ NZSX/NZDX Listing Rules, r 2.1.1; see Campbell; Hare; and Watts, above n 16, at 24.

The Financial Markets Authority has the authority to request the NZX alter its Listing Rules, and the NZX must obtain the approval of the Financial Markets Authority in order to change the Listing Rules.⁷⁷ There is a non-exhaustive list of criteria the Financial Markets Authority is required to consider in the Securities Markets Act 1988 before making any change to the Listing Rules,⁷⁸ unless it is satisfied that it is not in the public interest to do so.⁷⁹ The New Zealand Markets Disciplinary Tribunal is the “frontline” regulator of enforcement of the Listing Rules.⁸⁰ It has the discretion to issue a broad range of penalties for a breach of any of the Listing Rules including: issuing a public statement that a company or a director has committed a breach; publicly stating that the retention of a director or executive is prejudicial to the interests of investors; imposing a pecuniary penalty of up to \$500,000; imposing an order to make restitution to a third party or remedial action; or cancelling the company’s listing on the exchange.⁸¹ The Financial Markets Authority is the new “super regulator” with overarching powers to intervene and conduct its own investigations if it is in the public interest to do so.⁸²

The main sources of soft law are the NZX Corporate Governance Best Practices Code⁸³ (Best Practices Code) and the Securities Commission Corporate Governance Principles and Guidelines⁸⁴ (SCNZ Principles). The Best Practices Code is voluntary in the sense the recommendations apply on a comply-or-explain basis. In the annual report, listed companies must provide a statement on whether and, if so, how the corporate governance principles adopted or followed materially differ from the Best Practices Code.⁸⁵ This hybrid approach, combining mandatory and voluntary requirements in the Listing Rules,

⁷⁷ Securities Markets Act, ss 36I-M; and Victoria Stace *Securities Law in New Zealand* (LexisNexis, Wellington, 2010) at 374.

⁷⁸ Securities Markets Act, s 36FC.

⁷⁹ Securities Markets Act, s 36L.

⁸⁰ Stace, above n 77, at 374.

⁸¹ NZX *Market Disciplinary Tribunal Rules* (16 August 2010) <www.nzx.com/market-supervision/rules/nz-markets-disciplinary-tribunal-rules>, s 11.5.1.

⁸² Stace, above n 77, at 374; Financial Markets Authority Act 2011, s 34.

⁸³ NZSX/NZDX Listing Rules Appendices (6 August 2010), Appendix 16 Corporate Governance Best Practices Code.

⁸⁴ See Securities Commission *Handbook*, above n 21.

⁸⁵ NZSX/NZDX Listing Rules, r 10.5.5(i).

is designed to leave it up to the market to reflect their opinion about the corporate governance structure adopted by the company through the share price.⁸⁶ The SCNZ Principles have no comply-or-explain mechanism in place.⁸⁷ In the last annual review of listed companies done by the Securities Commission before handing over responsibility for capital markets, it recommended the Financial Markets Authority conduct a review of the SCNZ Principles in light of any changes in corporate governance thinking since they were first designed in 2004.⁸⁸ However, the Financial Markets Authority has yet to express any intention to do so.

C General position

Generally speaking, executive remuneration is the exclusive domain of the board of directors. The board is not legally required to disclose to shareholders any details of executive remuneration beyond the total amount in absolute dollar terms.⁸⁹ The board is under no legal obligation to pre-emptively consult with shareholders on, or provide them with, an opportunity to influence executive remuneration.

The general position only changes where the remuneration package of an executive director is above a certain threshold (Exceptional Executive Director Remuneration).⁹⁰ The threshold is remuneration in any financial year that is in excess of \$250,000,⁹¹ and is likely to exceed one per cent of the average market capitalisation of the company.⁹² In assessing whether remuneration is “likely” to exceed this threshold the company must have regard to the total maximum amount that could become payable in any one financial

⁸⁶ Mark Fox; Alma Pekmezovic; and Gordon Walker "Corporate governance disclosures" [2010] NZLJ 329 at 332.

⁸⁷ Securities Commission *Handbook*, above n 21, at 6.

⁸⁸ Securities Commission *Review*, above n 69, at 2.

⁸⁹ Companies Act 1993, s 211.

⁹⁰ NZSX/NZDX Listing Rules, r 9.2.

⁹¹ NZSX/NZDX Listing Rules, r 9.2.4(g).

⁹² NZSX/NZDX Listing Rules, r 9.2.2(e). This threshold was previously 0.5 per cent, see NZX *Transactions With Related Parties and Major Transactions* (May 2006) www.nzx.com/files/assets/sxdx_9.-pdf, at 4.

year.⁹³ In the case of an Exceptional Executive Director Remuneration contract, the board must either get it certified by the independent directors⁹⁴ on the board as having been negotiated for at an arm's length commercial basis and disclose the material particulars in the next annual report to shareholders, or instead have it approved by an ordinary resolution of shareholders.⁹⁵ If the board elects to hold a shareholder resolution, the interested executive director and any associated persons are prohibited from casting votes on any shares they own.⁹⁶

D Procedure of the board of directors when determining executive remuneration

1 Executive remuneration generally

There is no regulation of the board's decision process in respect of executive remuneration. The shift from managing directors to non-director chief executive officers and senior executives, and the rise of managerial power theory, are relatively recent phenomena, which may help to explain this gap in the law. The Best Practices Code is also currently silent on executive remuneration. However, NZX has recently sought consultation on whether, like directors, use of a remuneration committee should be recommended in respect of chief executive officers and senior executives.⁹⁷ A remuneration committee is a smaller sub-group of the board of directors delegated the

⁹³ NZSX/NZDX Listing Rules, r 9.2.2.

⁹⁴ NZSX/NZDX Listing Rules, r 1.6. "Independent Director" is defined in the Listing Rules as a director who is not an executive officer of the company and has no "disqualifying relationship". Disqualifying relationship is given an inclusive definition, meaning "having any direct or indirect interest that could reasonably influence decisions in relation to the company in a material way". A disqualifying relationship is deemed where a director is, or has a relationship with, a substantial security holder as defined in the Securities Markets Act and is likely to derive a substantial portion of their annual revenue from the company, being 10 per cent or more. Substantial holding is defined in s 21 of the Securities Markets Act as having a relevant interest in five per cent or more of a class of listed voting securities.

⁹⁵ NZSX/NZDX Listing Rules, r 9.2.4(d).

⁹⁶ NZSX/NZDX Listing Rules, r 9.3.1. The definition of associated person in r 1.8 of the NZSX/NZDX Listing Rules includes a spouse for example.

⁹⁷ NZX "Main Board/Debt Market Consultation Memorandum" (press release, 30 March 2012) ["Consultation Memorandum"] at 16. The NZX considers "oversight of remuneration packages at all senior levels" necessary.

responsibility for determining remuneration to enable boards to deal more effectively and efficiently with this complex and specialised issue.⁹⁸ The SCNZ Principles already treat executive and director remuneration with the same regard. Principle five recommends transparent, fair, and reasonable director and executive remuneration practices,⁹⁹ which Guidelines 5.1 and 5.2 advise can be achieved by having a clear policy for setting remuneration and disclosing this policy to shareholders.¹⁰⁰

2 *Executive director remuneration*

The remuneration of executive directors in their executive capacity falls within the legal rules surrounding remuneration of directors generally.¹⁰¹ An executive director is permitted to participate as a member of the board of directors in determining their own executive remuneration, despite the general restrictions on interested transactions,¹⁰² due to the requirement in the Companies Act 1993 that all members of the board must sign a certificate in remuneration decisions.¹⁰³ The certificate imposes a combined subjective and objective standard of liability on directors, as they must believe the payment of remuneration to be fair to the company and list the grounds for that opinion.¹⁰⁴ The certificate also imposes personal liability.¹⁰⁵ It is simply left to a listed companies sense of prudent practice to prohibit executive directors from participating in decisions on their own remuneration.¹⁰⁶ The Listing Rules require at least one third of directors (rounded

⁹⁸ Productivity Commission of Australia, above n 26, at 173.

⁹⁹ Securities Commission *Handbook*, above n 21, at 17.

¹⁰⁰ *Ibid.*

¹⁰¹ Companies Act 1993, s 161; Victoria Law (ed) *Brookers Company and Securities Law* (online loose leaf ed, Brookers) at [CA161.01].

¹⁰² NZSX/NZDX Listing Rules, r 3.4.3. For the purposes of this rule “interested transaction” adopts by reference the definition in s 139 of the Companies Act 1993.

¹⁰³ NZSX/NZDX Listing Rules, r 3.4.4.

¹⁰⁴ Companies Act 1993, s 161(4); Law, above n 101, at [CA161.02].

¹⁰⁵ Companies Act 1993, s 161(5).

¹⁰⁶ Law, above n 101, at [CA161.02].

down to the nearest whole number) to be independent directors.¹⁰⁷ It is the board's responsibility to determine who are the independent directors and disclose this to the market and include it in the annual report to shareholders.¹⁰⁸ Frequently, independent directors will have formerly been executives, which gives rise to arguments both for and against their suitability in determining executive remuneration.¹⁰⁹ On the one hand, the distinction is criticised as being "blurred" as directors and executives could both be regarded as members of the same club or culture.¹¹⁰ On the other hand, it is argued they may be more astute in pay-bargaining matters than directors who lack first-hand experience and may be more resistant to allowing inappropriate remuneration.¹¹¹

The Exceptional Executive Director Remuneration safeguard is problematic for two reasons. Not only is the threshold too high,¹¹² but any mechanism that only requires more prudent procedure when remuneration possesses certain qualities ignores the systemic problem of executive power. Even if the threshold was reduced and the mechanism expanded to include all executives, a compliant board could easily camouflage executive remuneration to avoid triggering this safeguard. For example, remuneration could be camouflaged by structuring it to accrue over a longer horizon than one financial year under the guise of aligning executive interests with the long-term interests of shareholders. The Exceptional Executive Director Remuneration mechanism also exemplifies two structural problems in corporate governance in New Zealand. The first is the focus on quantum and how this is ineffective and obscures the real issue. The second is that the optimal contracting paradigm is operating below the surface of securities law. It is likely that requiring independent decision-makers in the designing and bargaining for

¹⁰⁷ NZSX/NZDX Listing Rules, rr 1.6 and 3.3.1. If there are less than eight directors in total then there must be at least two independent directors, and if there are eight or more directors, there must be at least three independent directors. For the definition of "independent director" see Part III C above at n 94.

¹⁰⁸ NZSX/NZDX Listing Rules, rr 3.3.2 and 3.3.3.

¹⁰⁹ Productivity Commission of Australia, above n 26, at 94.

¹¹⁰ Ibid.

¹¹¹ Ibid.

¹¹² Crombie and Tan, above n 51, at 46. None of the chief executive officers in the listed companies considered, including the infamous salary of over \$7,000,000 of Telecom chief executive officer Paul Reynolds, were awarded remuneration close to one per cent of market capitalisation.

all executive remuneration contracts would be a lot more effective in mitigating the influence of executive power.

E Information which must be disclosed to shareholders

The board is only required in the case of Exceptional Executive Director Remuneration to disclose the material particulars of executive remuneration packages. The only information that listed companies must always disclose to shareholders is the number of executives who earn over \$100,000 per year, in bands of \$10,000, and the total remuneration of all directors.¹¹³ This presumably includes any remuneration in their executive capacity.¹¹⁴ These limited disclosure regulations were introduced after intense debate and overcoming strong political lobbying.¹¹⁵ Australia faced similar resistance in 1987 when the same disclosure bands were first introduced.¹¹⁶ Whilst qualitative factors of executive remuneration are harder to prescribe in disclosure regulation, they are more valuable to the informed decision-making of shareholders.¹¹⁷ Also it is argued there is a greater need for disclosure to be regulated than there is for remuneration practices to be regulated, as market forces are less able to achieve the desired result, which is to address the asymmetry of information.¹¹⁸

The executive remuneration disclosure requirements in New Zealand have been described as “woefully behind other Western countries” in addressing the asymmetry of information.¹¹⁹ To give this statement some perspective, Australia introduced regulations requiring disclosure of the details of remuneration packages of directors and the five most

¹¹³ Companies Act 1993, s 211. The requirements of Companies Act s 211 must be included in the annual report of listed issuers under r 10.5.5(a) of the NZSX/NZDX Listing Rules.

¹¹⁴ Schoenemann, above n 47, at 64, n 249.

¹¹⁵ Healy, above n 8, at 180.

¹¹⁶ Productivity Commission of Australia, above n 26, at 37.

¹¹⁷ Ibid, at 250.

¹¹⁸ Kym Sheehan "The regulatory framework for executive remuneration in Australia" (2009) 31 Sydney Law Review 273 at 292.

¹¹⁹ Healy, above n 8, at 173.

highly paid executives in 1998.¹²⁰ This gap widened further in 2005 when the remuneration report concept was introduced in respect of all Key Management Personnel.¹²¹ There are regulations in place in New Zealand that only inadvertently provide shareholders with more information about executive remuneration.¹²² For example, directors and officers are required to disclose any acquisition or disposal of a relevant interest in the shares of the company.¹²³ The purpose of this requirement is to promote good corporate governance, and to deter and assist in the monitoring of insider conduct and market manipulation by enabling shareholders to monitor their trade activity.¹²⁴ Whilst this purpose uses the broad term *corporate governance*, it is clear this requirement was not aimed at remedying the informational asymmetry between companies and shareholders in remuneration specifically.

Without material information about the structure of executive remuneration, it is not possible for shareholders to understand the incentives in place to align the interests of executives, who are their key agents, and it also heightens suspicions of inappropriate executive remuneration.¹²⁵ The lack of material information about the components of executive remuneration encourages discourse that is focused on the quantum of executive pay. A culture of more detailed disclosure, led by regulatory change, would stimulate the required shift in the executive remuneration paradigm.

F Involvement of shareholders

1 Executive remuneration generally

There is no general regulatory requirement that boards consult with, or obtain approval from, shareholders in executive remuneration. As long as boards operate within the broad

¹²⁰ Productivity Commission of Australia, above n 26, at 37.

¹²¹ *Ibid.* Discussed in more detail in Part *IV D*.

¹²² Schoenemann, above n 47, at 62.

¹²³ Securities Markets Act, s 19T.

¹²⁴ Securities Markets Act, s 19SA.

¹²⁵ Healy, above n 8, at 181.

parameters of their discretion, only retrospective mechanisms are available to shareholders.

Before issuing new shares, the board of directors is required to obtain approval of a majority of shareholders of any class whose rights or entitlements could be affected.¹²⁶ Just like the rules aimed at market manipulation discussed above, the involvement of shareholders in the remuneration context where new shares are issued was an accidental side-effect of the objective of protecting shareholders property interests from dilution.¹²⁷ The Listing Rules practically neutralise this by permitting the board to issue to employees up to three per cent of the total number of shares of a class already on issue in a 12-month period.¹²⁸

Communication between boards of directors and shareholders does feature in the soft law SCNZ Principles. Principle eight advises boards to foster constructive relationships with shareholders that encourage engagement by publishing shareholder relation policies and clearly communicating goals, strategies and performance with shareholders.¹²⁹ The latest review by the Securities Commission however revealed that such disclosure was low, with only 30 per cent of listed companies publishing their policies.¹³⁰

2 *Executive director remuneration*

The Listing Rules only require the remuneration of an executive director in their capacity as a director to be approved by an ordinary resolution of shareholders.¹³¹ This distinction represents an interesting schism in what I view as a rule aimed at mitigating the inherent

¹²⁶ Companies Act 1993, s 45; NZSX/NZDX Listing Rules, r 7.3. The NZX is currently seeking consultation on how to improve the drafting of the definition of “Equity Security” and r 7.3 in order to clarify that this includes any security with conversion rights, see NZX “Consultation Memorandum”, above n 97, at 7.

¹²⁷ Companies Act 1993, s 45; Law, above n 101, at [CA45.01]; Schoenemann above n 47, at 62.

¹²⁸ NZSX/NZDX Listing Rules, r 7.3.6.

¹²⁹ Securities Commission *Handbook*, above n 21, Principle 8 and Guideline 8.1 at 23.

¹³⁰ Securities Commission *Review*, above n 69, at 16.

¹³¹ NZSX/NZDX Listing Rules, r 3.5.1.

conflict of interest of directors. The distinction may have roots in the company law history that, as fiduciaries, the remuneration of directors needed to be approved by shareholders.¹³² Securities law is prepared to abridge the separation of ownership and control in the context of director remuneration, however it has arguably not yet done so in the context of executive remuneration. The Exceptional Executive Director Remuneration mechanism gives the board of directors the option, not an obligation, to obtain shareholder approval. Abridging the separation of ownership and control in a person's capacity as a director may be considered legitimate because shareholders appoint them as such but it is the board that hires executives. From a commercial perspective, any distinction in the treatment of these two inherent conflicts of interests is relatively arbitrary.

3 Retrospective mechanisms available to shareholders

The three options available to dissatisfied shareholders are to vote with their feet by selling their shares, to hold their shares and voice dissatisfaction, or to hold their shares and do nothing.¹³³ The three retrospective mechanisms available to shareholders to voice their dissatisfaction with executive remuneration practices are to exercise their right to comment on management, to remove the board of directors, or to pursue a derivative action.

Shareholders have a right to a reasonable opportunity at a general meeting to question, discuss, or comment on the management of the company.¹³⁴ Within this power, shareholders may pass a resolution relating to the management of a company, which unless provided for in the constitution, will not be binding on the board.¹³⁵ The right to comment on management enables shareholders to send a strong signal to the board of

¹³² Campbell; Hare; and Watts, above n 16, at 531.

¹³³ Healy, above n 8, at 192.

¹³⁴ Companies Act 1993, s 109(1).

¹³⁵ Companies Act 1993, s 109(2) and (3).

directors in respect of management decisions. There is evidence that management is sensitive to public criticisms of high compensation.¹³⁶

Shareholders can remove directors by an ordinary resolution in a meeting called for that purpose.¹³⁷ Exercising such a broad stroke response in reaction to discontent with executive remuneration is problematic as the board might be otherwise doing a great job, and it may have the effect of an economic sledge-hammer to the company. It is argued that executive remuneration is particularly significant for investor confidence as it provides a window on board performance more broadly.¹³⁸ As remuneration is the only real mechanism of control the board has over executives, the ability of the board to perform this task is also likely to reflect the nature of this relationship, specifically whether the board is compliant to executive power.

Shareholders have the right to apply to the courts for leave to bring a derivative action on behalf of the company.¹³⁹ The court may grant an application for the whole or part of the reasonable legal costs of bringing the proceeding to be borne by the company.¹⁴⁰ Executive director remuneration must comply with the statutory fairness provisions of director remuneration as discussed above.¹⁴¹ More generally, excessive executive remuneration may be a breach of directors' statutory or common law duty to act in good faith and the best interests of the company,¹⁴² or amount to prejudicial conduct to shareholders where there are distinct elements of bad faith or self-interest.¹⁴³

¹³⁶ Bebhuk and Fried *Pay Without Performance*, above n 33, at 68.

¹³⁷ Companies Act 1993, s 156.

¹³⁸ Productivity Commission of Australia, above n 26, at XV.

¹³⁹ Companies Act 1993, s 165.

¹⁴⁰ Companies Act 1993, s 166.

¹⁴¹ Companies Act 1993, s 161; Law, above n 101, at [CA161.02]. See Part III D 2 for the procedural requirements upon the board of directors in executive director remuneration decisions.

¹⁴² Campbell; Hare; and Watts, above n 16, at 495; Companies Act 1993, s 131. In *MacFarlane v Barlow* (1997) 8 NZCLC 261,470 (HC) leave for a derivative action was granted for breach of two managing directors' duties of good faith and to exercise powers for proper purpose where remuneration appeared to be excessive when compare to expert evidence prepared by business consultants. This dispute was presumable resolved by settlement, as the derivative action never appeared before the courts.

¹⁴³ Companies Act 1993, s 174; *Latimer Holdings Ltd v Sea Holdings New Zealand Ltd* [2005] 2 NZLR 328, (2004) 9 NZCLC 263,694 (CA) at [70]; this authority was followed in the context of remuneration in

Two significant procedural difficulties for shareholders trying to bring a derivative action are the lack of insight into internal board practices and the business judgment rule.¹⁴⁴ Courts have historically been reluctant to review the quantum of excessive remuneration and have refrained from setting limits on the amount of remuneration on the grounds it is a commercial matter to be determined by those with a relevant commercial interest.¹⁴⁵ The Court of Appeal in New Zealand has recently affirmed the view judges are ill-equipped to evaluate business strategies and have accordingly exercised restraint under the business judgment rule.¹⁴⁶ It is likely the courts would be even more reluctant to review the more complex question of the structure of executive remuneration packages.¹⁴⁷ Attempting to quantify the loss to the company and shareholders ex post facto as a result of distortions in the structure of executive remuneration would be particularly difficult as it involves considering the unobservable counterfactual.

The direct and indirect costs of taking any retrospective action against the company, such as the use of corporate funds in any derivative action, damage to the company reputation or effects on performance from distracting the board, are ultimately borne by shareholders as the residual claimants. The risks of such costs appear to discourage institutional investors from playing an active role in corporate governance in New Zealand in the absence of a crisis.¹⁴⁸ Not only are institutional investors an important group of shareholders because they have a large stake in equity markets, but also due to their expertise in acquiring and processing information.¹⁴⁹ The reluctance of institutional shareholder activism is a complex problem, but essentially it is a combination of a culture that seeks to avoid conflict and the right incentives not being in place.¹⁵⁰ They are

Duncan v Alan Reay Consultants Ltd HC Christchurch CIV-2006-409-251, 1 December 2008 but held remuneration was not “so far wide of the mark no reasonable director could have come to it” [147].

¹⁴⁴ Schoenemann, above n 47, at 56.

¹⁴⁵ *Re Halt Garage (1964) Ltd* [1982] 3 All ER 1016, 1023 (Ch) as cited in Law, above n 101, at [CA161.02]; Michael Quinn “The unchangeables – director and executive remuneration disclosure in Australia” (1999) 10 AJCL 2 at 2.

¹⁴⁶ *Latimer Holdings v Sea Holdings New Zealand Ltd*, above n 143, at [71].

¹⁴⁷ Schoenemann, above n 47, at 56.

¹⁴⁸ Healy, above n 8, at 190.

¹⁴⁹ Productivity Commission of Australia, above n 26, at 30.

¹⁵⁰ Healy, above n 8, at 191.

apprehensive to publicly express discontent where it is likely to have a destabilising effect on the company, which may negatively affect share price.¹⁵¹ Publicly expressing discontent or identifying distortions in executive remuneration practices may result in a stampede of retail investors calling for the heads of the board of directors.

G Conclusion

Commercial practice is leading the corporate governance framework in responding to the concerns of agency theory in executive remuneration by using performance hurdles and incentives whereas the corporate governance framework only encourages the use of such incentives in the context of director remuneration in the Best Practices Code.¹⁵² The corporate governance framework is yet to adequately respond to managerial power theory. No regulation, or soft law, has been put in place to mitigate the power of executives to distort executive remuneration generally and the only regulation relating to executive directors, the Exceptional Executive Director Remuneration mechanism, is flawed. It fails to address the systemic problem of executive power and reflects that the optimal contracting paradigm is still in place. Whilst securities law is prepared to abridge the separation of ownership and control in respect of remuneration of persons in their capacity as a director, it has not yet taken any clear steps to do so in response to executive power. The only virtue of the Exceptional Executive Director Remuneration safeguard is that it indicates recognition from capital markets regulators of the potential for shareholders to be utilised in remuneration issues.

¹⁵¹ Allan Fels "Executive remuneration in Australia" in Mohamed Ariff, John Farrar and Ahmed M. Khalid *Regulatory Failure and the Global Financial Crisis* (Edward Elgar Publishing, Cheltenham, 2012) 161 at 165.

¹⁵² NZSX/NZDX Listing Rules Appendices, Appendix 16 Corporate Governance Best Practices Code at 2.7.

IV Corporate governance framework in Australia

A Introduction

The Australian corporate governance framework places greater emphasis on the relationship between the structure of executive remuneration and company performance. A more sophisticated executive remuneration paradigm is illustrated in the comprehensive executive remuneration disclosure requirements. Australia has responded to managerial power theory by putting measures in place to reduce the ability of executive power to distort remuneration. The vulnerability of the board of directors to executive power is reduced by the use of independent remuneration committees, disclosure to shareholders of the components of executive remuneration packages, and utilising shareholders more effectively as a monitoring mechanism through an advisory resolution on executive remuneration at the annual general meeting. This chapter evaluates the strength of the Australian corporate governance framework in the three areas critiqued in the New Zealand context in chapter 3.

B General framework

The corporate governance framework in Australia consistently ranks high by international standards.¹⁵³ It uses the same composite corporate governance framework of hard law regulation, soft law and market forces as New Zealand. The main sources of regulation are the Corporations Act 2001¹⁵⁴ and the Australian Stock Exchange Listing Rules¹⁵⁵ (ASX Listing Rules), and soft law can be found in the ASX Corporate

¹⁵³ The World Economics Forum ranked the efficacy of Australia's corporate boards (meaning the extent to which investors and boards exert strong supervision of management decisions) third in the world for 2011-2012, see *World Economic Forum Global Competitiveness Report 2011-2012* (2011) World Economic Forum, at 103. Australia has been ranked in the top three countries since 2002-2003 according to the Productivity Commission of Australia, above n 26, at 126.

¹⁵⁴ Corporations Act 2001 (Cth).

¹⁵⁵ ASX Listing Rules <www.asxgroup.com.au/asx-listing-rules-guidance-notes-and-waivers.htm>.

Governance Council Principles and Recommendations¹⁵⁶ (ASX Principles). The ASX Principles operate like the Best Practices Code, in that the Australian Stock Exchange (ASX) produces them and all recommendations have the same comply-or-explain disclosure obligations.¹⁵⁷

The Key Management Personnel concept in Australian corporate governance results in almost all of the same measures being put in place in respect of director and executive remuneration.¹⁵⁸ The Corporations Act 2001 adopts the definition from accounting standards of Key Management Personnel, being “persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity”.¹⁵⁹

In 2009 the Australian Productivity Commission was asked to conduct a review of the remuneration of company directors and executives in response to concern amongst shareholders, business groups and the wider community.¹⁶⁰ The concerns, brought to the surface by the financial turmoil of the global financial crisis, were that executive remuneration practices were excessive and rewarded excessive risk-taking. There was a general perception executives were being rewarded for failure, as executive remuneration was perceived to have remained unchanged whilst shareholder value fell.¹⁶¹

Managerial power theory was referred to throughout the review, providing a theoretical basis for the Productivity Commission’s recommendations and the subsequent regulatory

¹⁵⁶ ASX Corporate Governance Council *Corporate Governance Principles and Recommendations With 2010 Amendments* (2nd ed, 2010) <www.asxgroup.com.au/media/PDFs/cg_principles_recommendations_with_2010_amendments.pdf>.

¹⁵⁷ ASX Listing Rules, r 4.10.3.

¹⁵⁸ The most notable exception to this is the requirement for shareholder approval of director remuneration in s 203D of the Corporations Act, which is also the case in listed companies in New Zealand.

¹⁵⁹ Corporations Act, s 9; and *Corporations and Markets Advisory Committee of Australia Executive Remuneration* (Information Paper, July 2010) at 9.

¹⁶⁰ Productivity Commission of Australia, above n 26, at IV.

¹⁶¹ *Ibid*, at 105.

response of the legislature.¹⁶² The Productivity Commission primarily attributed the rapid increase in executive remuneration prior to the global financial crisis to the shift towards performance-based pay with relatively permissive performance hurdles.¹⁶³ It did however conclude that this phenomenon could have been compounded by complicity of boards of directors, especially in the seemingly more egregious cases of reward for failure. The findings of the Productivity Commission led to an amendment of the Corporations Act 2001¹⁶⁴ (Director and Executive Remuneration Amendment). The Director and Executive Remuneration Amendment contained measures to empower shareholders to “hold directors accountable for their decisions relating to executive remuneration, to eliminate conflicts of interest in the remuneration setting process, and to increase transparency and accountability in remuneration matters”.¹⁶⁵ These reforms have been described as an illustration of Australia’s progressive approach to developments in the principles and practices of corporate governance, in contrast to New Zealand’s response which “at best, can be described as restrained”.¹⁶⁶

C Procedure of the board of directors when determining executive remuneration

The ASX Principles recommend that all listed companies establish a remuneration committee that consists of a majority of independent directors, is chaired by an independent chair, and has at least three members.¹⁶⁷ In respect of companies within the ASX300, hard law regulation requires remuneration committees to be composed entirely

¹⁶² The language of managerial power theory was used in the Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011 (Cth) (explanatory memorandum) at 27.

¹⁶³ Productivity Commission of Australia, above n 26, at 358.

¹⁶⁴ Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011 (Cth).

¹⁶⁵ Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011 (Cth) (explanatory memorandum) at 3.

¹⁶⁶ Trish Keeper "Two strikes, proxy voting and executive remuneration: Australian developments" [2011] CSLB 133 at 133.

¹⁶⁷ ASX Corporate Governance Council, above n 156, at recommendations 8.1 and 8.2.

of non-executive directors.¹⁶⁸ The definition of “remuneration committee” in the Australian framework includes reference to the remuneration of all Key Management Personnel of the company.¹⁶⁹ This is an example of how the Key Management Personnel concept results in director and executive remuneration being treated with the same regard. In theory, executives can assist remuneration committees to implement business strategies through remuneration policies and designs.¹⁷⁰ However, these potential benefits need to be balanced against the possible costs to investor confidence and the credibility of executive remuneration.¹⁷¹ The ASX felt that the negatives from a perception that remuneration committees were not adequately independent from executive directors outweighed the potential benefits from their contributions.¹⁷²

Whilst the recommendations of remuneration committees are still subject to the approval of the board as a whole,¹⁷³ the focus on independence reflects an appreciation of remuneration committees as a mechanism for mitigating the risks of managerial power theory when remuneration is being determined. It can be inferred from the New Zealand corporate governance framework, which currently has no such focus, that remuneration committees have simply been viewed as a mechanism for achieving better remuneration outcomes through expertise and efficient allocation of board resources. This fails to account for the systemic problems of executive power in the corporate structure, let alone the inherent conflict of interest of executive directors. There is a corporate culture of directors not wanting to clash with the chief executive officer,¹⁷⁴ and a strong emphasis

¹⁶⁸ ASX Listing Rules, rr 1.1 and 12.8. This became mandatory from January 1 2011 onwards see ASX "Analysis of corporate governance disclosures in annual reports for the year ended 30 June 2010" (2010) <www.asx.com.au> at 6 ["Analysis of corporate governance disclosures"]. See Part *VE* at n 278 below for an explanation of the ASX300.

¹⁶⁹ Corporations Act, s 206K(2)(b).

¹⁷⁰ Productivity Commission of Australia, above n 26, at 177.

¹⁷¹ See Perpetual "Executive Remuneration in Australia: Perpetual's Submission to the Productivity Commission on its Discussion Draft Report" (Submission DD128, Australian Productivity Commission, July 2009) and Australian Manufacturers Workers' Union "Submission to Productivity Commission Inquiry into Executive Remuneration in Australia" (Submission DD127, Australian Productivity Commission, July 2009) at 9 as both cited in Productivity Commission of Australia, above n 26, at 176.

¹⁷² ASX "Analysis of corporate governance disclosures", above n 168, at 6.

¹⁷³ Productivity Commission of Australia, above n 26, at 169.

¹⁷⁴ Bebchuk and Fried *Pay Without Performance*, above n 33, at 26, n 17.

on politeness and courtesy in board dealings.¹⁷⁵ Removing executive directors from remuneration committees makes it harder for them to influence remuneration policy and reduces these pressures on directors.

New Zealand corporate governance would be strengthened by the same reconceptualisation of the role of remuneration committees. There is potential for such change in the near future, as the NZX has started to recognise the issue of independence. It recently sought consultation on whether the Best Practices Code should be amended to require remuneration committee charters to include details of composition, such as, whether the company's remuneration committees require a minimum number of independent directors.¹⁷⁶

The compliance costs associated with imposing mandatory standards in respect of remuneration committees appear to be the main factor behind the bifurcated system in Australia imposing higher standards on companies with larger market capitalisation. The soft law recommendations in respect of all listed companies allow greater flexibility and avoid imposing too onerous arrangements on companies where the benefits are less likely to outweigh the costs.¹⁷⁷

D Information which must be disclosed to shareholders

Listed companies are required to include in their annual report to shareholders a separate and clearly labelled section of the report under the heading "Remuneration Report".¹⁷⁸ The Corporations Act 2001 requires certain aspects of the remuneration of Key Management Personnel to be explained in this report.¹⁷⁹ This includes a discussion of

¹⁷⁵ Ibid, at 32, n 34.

¹⁷⁶ NZX "Consultation Memorandum", above n 97, at 17.

¹⁷⁷ Productivity Commission of Australia, above n 26, at 178.

¹⁷⁸ Corporations Act, s 300A(1).

¹⁷⁹ Corporations Act, s 300A(1) and (1A). See Corporations Regulations 2001 (Cth), Chapter 2D for additional disclosure requirements in respect of benefits such as termination benefits, post-employment benefits (superannuation and pensions) and profit-sharing agreements.

board policy for determining the nature and amount of remuneration and of the nature of the relationship between such policy and company performance.¹⁸⁰ This discussion must specifically deal with company earnings and the consequences of company performance on shareholder wealth,¹⁸¹ which is determined by having regard to various factors including dividends, changes in share price, and any other return of capital to shareholders.¹⁸² If remuneration includes any performance conditions, there are very thorough disclosure requirements, such as having to provide a detailed breakdown and explanation of the performance condition and of the methods used in assessing whether the condition is satisfied.¹⁸³ Failure to comply with these reporting requirements is an offence.¹⁸⁴

The Remuneration Report concept reflects a shift in the executive remuneration paradigm from quantum to structure. Increasing executive remuneration disclosure increases board accountability, which strengthens corporate governance in order to constrain executive pay.¹⁸⁵ The two main lines of criticism of the higher disclosure requirements in Australia are: that it has led to “boiler plating” in remuneration reports, which reduces the effectiveness of disclosure to shareholders; and that they have had a “ratcheting effect” on executive pay leading to rapid growth prior to the global financial crisis.

The boiler plating criticism is that companies are using standard legalistic terminology to describe remuneration, which helps to shield them from liability but is not particularly helpful for investors.¹⁸⁶ There have been issues of length (they are frequently 20 pages and span up to 50) and complexity as companies have responded to the Remuneration Report requirements in lieu of any regulatory guidance, such as a template or best practice guide.¹⁸⁷ The substantial costs associated with drafting, engaging consultants on

¹⁸⁰ Corporations Act, s 300A(1)(a) and (b).

¹⁸¹ Corporations Act, s 300A(1AA).

¹⁸² Corporations Act, s 300A(1AB).

¹⁸³ Corporations Act, s 300A(1)(ba).

¹⁸⁴ Corporations Act, s 1311.

¹⁸⁵ Productivity Commission of Australia, above n 26, at 96.

¹⁸⁶ *Ibid*, at 247.

¹⁸⁷ *Ibid*, at 246.

specialist tasks and obtaining legal and audit compliance checks are criticised as undermining the report's intended purpose as a meaningful communication tool by turning them into a "compliance exercise".¹⁸⁸ The Productivity Commission was of the opinion that introducing any sort of template was unlikely to be appropriate given the diversity and varying degree of complexity in remuneration arrangements amongst companies.¹⁸⁹ It concluded that introducing an additional short form report would only add to compliance costs and could potentially mislead shareholders.¹⁹⁰ It can be difficult to provide a succinct and "plain english" explanation of complex remuneration issues and their relationship with company performance,¹⁹¹ and the law also faces difficulties in trying to prescribe and enforce such standards.¹⁹² In spite of a recommendation from the Productivity Commission that introducing "plain english" disclosure requirements or a best practice guide would provide a valuable signal for shareholders,¹⁹³ the Director and Executive Remuneration Amendment contained no such changes.

The ratcheting effect criticism is the claim that higher disclosure requirements have resulted in autonomous upward pressure on executive remuneration due to the desire of both companies and executives to position themselves in the upper quartile of their peer group.¹⁹⁴ It is contended that higher public disclosure provides stronger benchmarks for

¹⁸⁸ Freehills "Submission: Regulation of director and executive remuneration in Australia" (Submission 46, Australian Productivity Commission, July 2009) at 7 as cited in Productivity Commission of Australia, above n 26, at 252.

¹⁸⁹ Productivity Commission of Australia, above n 26, at 249.

¹⁹⁰ Ibid.

¹⁹¹ Australian Council of Super Investors "Regulation of director and executive remuneration in Australia" (Submission 71, Australian Productivity Commission, July 2009) at 11 as cited in Productivity Commission of Australia, above n 26, at 253.

¹⁹² Business Council of Australia "Submission to the Productivity Commission Discussion Draft on Executive Remuneration in Australia" (Submission DD152, Australian Productivity Commission, July 2009) at 13 as cited in Productivity Commission of Australia, above n 26, at 254.

¹⁹³ Productivity Commission of Australia, above n 26, at 255.

¹⁹⁴ This desire not to be "below average" is known as the Lake Wobegon effect, see Chartered Secretaries of Australia "Regulation of director and executive remuneration in Australia" (Submission 57, Australian Productivity Commission, July 2009) at 16 as cited in Productivity Commission of Australia, above n 26, at 96.

executives to establish their respective expectations and negotiating stances.¹⁹⁵ These criticisms are typically rejected by the long-held view that executives and boards have always had access to such remuneration data from remuneration consultants and other sources.¹⁹⁶ The Productivity Commission concluded there was little empirical evidence of an acceleration in the growth of executive remuneration in Australia due to the higher disclosure rules being introduced in 1998.¹⁹⁷ It felt that the most likely effect of greater public disclosure was simply more rapid readjustment in the executive labour market whenever equilibrium relativities were disturbed, for example, where a large salary is used to lure an executive from overseas.¹⁹⁸

In New Zealand there is evidence of a ratcheting effect following the introduction of the limited executive compensation disclosure requirements in 1998. In 1999 average chief executive officer remuneration, in companies that belonged to what was then called the NZSE40, increased from \$368,000 to \$655,620.¹⁹⁹ However such limited disclosure lends itself to crude benchmarking and trends in remuneration practices, such as stronger alignment with company size than company performance.²⁰⁰ The focus in Australia's disclosure requirements on the particulars of executive remuneration is less likely to lead to thinking of remuneration as something that can be *benchmarked*, but as something dependent on the particular executive, in the particular role in the specific company. This distinction emphasises the importance of shifting the executive remuneration paradigm in New Zealand.

¹⁹⁵ Mercer "Mercer's Submission to the Productivity Commission on the Executive Remuneration Inquiry" (Submission 41, Australian Productivity Commission, July 2009) at 5 as cited in Productivity Commission of Australia, above n 26, at 96.

¹⁹⁶ Australian Council of Super Investors, above n 191, at 2.

¹⁹⁷ Productivity Commission of Australia, above n 26, at 96.

¹⁹⁸ *Ibid*, at 97.

¹⁹⁹ Korn/Ferry International "Board of director's study in Australia and New Zealand" (2000) <www.kornferryasia.com> at 31.

²⁰⁰ See the empirical evidence of problems in executive remuneration in listed companies in New Zealand below at Part *V B*.

E Involvement of shareholders

Listed companies in Australia are required to hold a non-binding resolution on the Remuneration Report at the Annual General Meeting of shareholders (Advisory Shareholder Resolution).²⁰¹ An Advisory Shareholder Resolution was first introduced in the United Kingdom in 2002 and adopted by Australia in 2005.²⁰² This dissertation considers both the initial Advisory Shareholder Resolution, as it existed when introduced in Australia and the reformed Advisory Shareholder Resolution in light of the recent Director and Executive Remuneration Amendment.

Whilst determining the remuneration of executives is a function of the board, the board needs to be accountable to shareholders for their decisions and shareholders need to be in a position to exercise their rights in an informed way.²⁰³ The Advisory Shareholder Resolution was introduced to facilitate more active involvement by shareholders and improve the accountability of directors.²⁰⁴ It is intended to enable shareholders to operate more effectively in their role as an accountability measure of last resort; it is not intended to provide them with a means of interfering with the operational aspects of the company.²⁰⁵

The introduction of an Advisory Shareholder Resolution was strongly resisted by the business community.²⁰⁶ It was argued to be tantamount to suggesting executive remuneration decisions are a responsibility shared by the board and shareholders and that it would be the “thin edge of the wedge” setting a precedent for shareholder resolutions

²⁰¹ Corporations Act, ss 250R(2) and (3).

²⁰² Claire MacMillan "Impact of regulatory reforms on executive remuneration in Australia – AGMs in 2011" (2012) 64 *Keeping Good Companies* 100 at 100; and Productivity Commission of Australia, above n 26, at 280.

²⁰³ CLERP (Audit Reform and Corporate Disclosure) Bill 2008 (Cth) (commentary on the draft provisions) at p.101.

²⁰⁴ *Ibid*, at 105.

²⁰⁵ Productivity Commission of Australia, above n 26, at 278; see Stephen M. Bainbridge "The Case for Limited Shareholder Voting Rights" (Law-Econ Research Paper No. 05-15, UCLA School of Law, 2005) at 27.

²⁰⁶ Productivity Commission of Australia, above n 26, at 280; Fels, above n 151, at 165.

on other management issues.²⁰⁷ The case for the Advisory Shareholder Resolution however essentially rests on arguments from managerial power theory that boards might be captured by executives and not operate at arm's length.²⁰⁸ Enhanced remuneration disclosure, combined with an Advisory Shareholder Resolution, is intended to mitigate the risks of distortions in executive remuneration by making it easier for shareholders to express outrage without unduly reducing board discretion in devising pay.²⁰⁹ The Advisory Shareholder Resolution harnesses director sensitivity to protest votes from shareholders, which come from concerns about their reputation and chances of re-election.²¹⁰

The Advisory Shareholder Resolution appears to have fostered more productive engagement between shareholders and boards, with many boards amending executive remuneration in anticipation or response to a significant minority of “no” votes from shareholders.²¹¹ Its introduction has coincided with much greater use of performance-related pay and more demanding performance hurdles, which have been strongly advocated by investor groups.²¹² A submission quoted by the Productivity Commission reported experiencing a significant increase in dialogue instigated from non-executive directors on remuneration issues and greater engagement with institutional shareholders.²¹³

1 Reform of the Advisory Shareholder Resolution

Concern that the average rate of negative votes appeared to be rising, and at the few instances of prominent companies repeatedly receiving significant negative votes,

²⁰⁷ Productivity Commission of Australia, above n 26, at 280.

²⁰⁸ Ibid.

²⁰⁹ Ibid.

²¹⁰ CGI Glass Lewis and Associates "Submission to Productivity Commission Inquiry on Director and Executive Remuneration in Australia" (Submission 80, Australian Productivity Commission, July 2009) at 14 as cited in Productivity Commission of Australia, above n 26, at 281.

²¹¹ Productivity Commission of Australia, above n 26, at XXXI.

²¹² Ibid, at 281.

²¹³ CGI Glass Lewis and Associates, above n X, at 66.

prompted recommendations for reform of the Advisory Shareholder Resolution.²¹⁴ The Productivity Commission felt the key to achieving remuneration outcomes that are in the long-term interests of shareholders and companies is by making sure the board is a capable and properly motivated agent rather than by bypassing its central role.²¹⁵ The Director and Executive Remuneration Amendment restricted the ability of Key Management Personnel whose remuneration is included in the Remuneration Report to cast votes in order to remove the conflict of interest and introduced a “two-strike mechanism” to target unresponsive boards.

2 Conflict of interest restrictions

Allowing Key Management Personnel to cast votes in an Advisory Shareholder Resolution relating to their own remuneration can mute the signal of non-interested “outside” shareholders.²¹⁶ Key Management Personnel, and their closely related parties, cannot vote on their own shares and may only cast directed proxy votes on behalf of outside shareholders.²¹⁷ These restrictions of shareholder voting rights have been justified on the grounds the vote is only advisory, and that its purpose is to capture the views of shareholders external to its development.²¹⁸ Similar restrictions preventing interested shareholders from exercising voting rights already exist in New Zealand in shareholder resolutions approving the remuneration of directors and also Exceptional Executive Director Remuneration.²¹⁹

Initially due to poor drafting it was unclear whether these conflict of interest restrictions applied to the chairperson of the board if their details were included in the Remuneration

²¹⁴ Productivity Commission of Australia, above n 26, at 281.

²¹⁵ *Ibid.*, at XXVI.

²¹⁶ *Ibid.*, at 315.

²¹⁷ Corporations Act, ss 250BD, 250R(4) and 250R(5).

²¹⁸ Productivity Commission of Australia, above n 26, at XXIX.

²¹⁹ Directors and executive directors, whose remuneration is subject to a shareholder resolution, and their associated persons, are prohibited from casting votes in their capacity as shareholders by r 9.3.1 of the NZSX/NZDX Listing Rules.

Report.²²⁰ The Corporations Amendment (Proxy Voting) Act 2012 made it clear that the chairperson can only cast undirected proxy votes which expressly authorise them to vote in the Advisory Shareholder Resolution.²²¹ This has been criticised as appearing at odds with the intention of the conflict of interest restrictions.²²² As the restrictions require the undirected proxy vote to expressly permit the chairperson to cast a vote in the Advisory Shareholder Resolution, then the shareholder is choosing to take this risk. It makes sense that restrictions are only default protections, and not so protectionist that they infringe upon outside shareholders voting rights.

3 *The two-strike mechanism*

The first strike of the two-strike mechanism occurs when an Advisory Shareholder Resolution receives a “no” vote from 25 per cent of shareholders or more.²²³ If shareholders also make comments on the Remuneration Report, the board must provide an explanation of its proposed action in response, or its reasons for inaction, in the subsequent Remuneration Report.²²⁴ The second strike occurs if the subsequent Advisory Shareholder Resolution also receives a “no” vote of 25 per cent of shareholders or more.²²⁵ Where there are two strikes a “spill resolution” must be held which, if passed by an ordinary majority of outside shareholders, requires all directors who approved the Remuneration Report except the managing director to seek re-election at a “spill meeting” that must be held within 90 days.²²⁶ As all shareholders can vote at the spill

²²⁰ MacMillan, above n 202, at 101; Corporations Act, ss 250R, 250BD(1) and 250BD(2).

²²¹ Corporations Amendment (Proxy Voting) Act 2012 (Cth); Richard Moshinsky "Two-strikes with the legislative dagger slay the drafting error: The introduction of the Corporations Amendment (Proxy Voting) Act 2012" (2012) DLA Piper <www.dlapiper.com/australia>.

²²² Sue Lannin "Changes to two strikes rule angers shareholders" *The Business* (Australia, 16 July 2012) <www.abc.net.au/news/2012-07-16/changes-to-two-strikes-rule-anger-shareholders/4134908>.

²²³ Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011 (Cth) (explanatory memorandum) at 6.

²²⁴ Corporations Act, s 300A(1)(g).

²²⁵ Corporations Act, s 250U.

²²⁶ Corporations Act, ss 250V(1), 250W(5) and (6).

meeting to re-elect directors, the two-strike mechanism does not enable a minority of shareholders to control membership of the board of directors.

The separate spill resolution was included so that the second Advisory Shareholder Resolution did not become a de-facto binding vote.²²⁷ There were concerns that if the board were spilled automatically by two strikes, it would have a conflation effect on the second Advisory Shareholder Resolution by discouraging shareholders who were not prepared to risk spilling the board. This would defeat its purpose as a feedback mechanism²²⁸ and in particular silence institutional shareholders.²²⁹ The two-strike mechanism enables shareholders to voice their opinion on the Remuneration Report and then decide whether stronger action is required, giving shareholders control over the message they wish to send to the board.²³⁰ It provides shareholders with greater leverage over the minority of unresponsive boards without supplanting their role in setting pay.²³¹

The consequences of the two-strike mechanism are only starting to emerge as it only applies to Advisory Shareholder Resolutions held on or after 1 July 2011.²³² In 2011, 108 Australian listed companies received a first strike, fewer than six per cent of all listed companies.²³³ The three main criticisms of the two-strike mechanism are: the risks of executive remuneration practices becoming homogenised; the risk it will be used as a Trojan horse for strategic purposes; and the lack of practical effect where Key Management Personnel own a large percentage of shares.

²²⁷ Productivity Commission of Australia, above n 26, at 295.

²²⁸ RiskMetrics "Post Discussion Draft Submission to Productivity Commission Inquiry on Executive Remuneration in Australia" (Submission DD164, Australian Productivity Commission, July 2009) at 3 as cited in Productivity Commission of Australia, above n 26, at 298.

²²⁹ Fels, above n 151, at 166.

²³⁰ Productivity Commission of Australia, above n 26, at XXXII.

²³¹ Fels, above n 151, at 165.

²³² Rachel Launder "Two strikes, no vacancies and more" *Law Society Journal* (Australia, August 2011) <trove.nla.gov.au/work/157331139?versionId=171507832> at 70.

²³³ Patrick Durkin "515 directors face shareholder axe" *Australian Financial Review* (Australia, 5 Feb 2012) <www.highbeam.com/doc/1G1-279057015.html>.

There is a risk executive remuneration will become homogenised by boards taking the path of least resistance, adopting generic or “vanilla” pay practices.²³⁴ There is concern boards will use tick the box approaches and follow rules of thumb,²³⁵ rather than trying to devise unique remuneration packages which are optimal for the performance of the particular company.²³⁶ This criticism has been raised in the context of long-term incentives in the United Kingdom.²³⁷ If shareholders preferences are too immutable, boards will balance the costs to them of a negative shareholder vote against the costs to them of sub-optimal executive pay.²³⁸ Whilst greater pressure on boards to convince shareholders how proposed remuneration relates to company performance may reduce the risk of distortions, if it is too difficult to deviate from popular commercial practice, remuneration may become sub-optimal.

The Advisory Shareholder Resolution might be used as a Trojan horse by minority shareholders to spill the board for reasons unrelated to remuneration, such as strategic takeover plays.²³⁹ Recently at Globe International Ltd, there was speculation of an ulterior motive where the first strike was the result of only 8.2 per cent of shareholders of which 5.8 per cent were owned by one shareholder.²⁴⁰ Any Trojan horse strategy however is likely to be difficult to disguise,²⁴¹ and the majority of shareholders retain the power to re-elect directors.

The incongruity between restrictions on voting applying to the spill resolution, and not the spill meeting, has been criticised as “neutralising the teeth in the reform”.²⁴² For example, recently a 46 per cent shareholder attempted to discourage other shareholders

²³⁴ Productivity Commission of Australia, above n 26, at 300.

²³⁵ Ibid, at 285.

²³⁶ Ibid, at 387.

²³⁷ Main and others "The remuneration committee and strategic human resource management" in William Judge (ed) *Corporate Governance: An International Review* (Blackwell Publishing Ltd, 2008) 225 at 230.

²³⁸ Productivity Commission of Australia, above n 26, at 300.

²³⁹ Ibid, at 299.

²⁴⁰ MacMillan, above n 202, at 103.

²⁴¹ Productivity Commission of Australia, above n 26, at 299.

²⁴² MacMillan, above n 202, at 102.

by making clear his intention to ensure all directors were voted back in immediately.²⁴³ The alternative, however, preventing interested Key Management Personnel from being able to re-elect directors, would unduly interfere with their shareholder property rights.

F Conclusion

The focus on the structure of executive remuneration packages in the disclosure regulations in Australian corporate governance demonstrates an appreciation of the importance of executive remuneration to company performance. The use of independent remuneration committees to reduce the influence of executive directors over their own remuneration, and the greater accountability of the board to shareholders through the Advisory Shareholder Resolution, reflect an appreciation of the risks that come from the power executives have within the company structure. Whilst the effects of the reforms to the Advisory Shareholder Resolution are still emerging, the initial Advisory Shareholder Resolution appears to have had a positive effect on executive remuneration practices in Australia. The New Zealand corporate governance framework, by comparison, recognises the importance of company performance to capital markets but has not made the connection between executive remuneration and company performance. The natural corollary of failing to accurately appreciate the significance of the structure of executive remuneration is to fail to give adequate attention to putting the necessary safeguards in place to reduce the risks of distortions.

²⁴³ Andrew Cleary "Packer comes out swinging after first strike on pay" *Australian Financial Review* (Australia, 27 October 2011) <afr.com/p/business/companies/packer_comes_out_swinging_after_dNWi-4OnD3AqIpOnsksqiXN>.

V The case for reform in New Zealand

A Introduction

There is empirical evidence of executive power distorting remuneration practices in listed companies in New Zealand. This chapter discusses the need for reform of the corporate governance framework in New Zealand to respond to managerial power theory. As the measures presently available have proven ineffective in preventing executive power being used to distort remuneration, securities law needs to introduce more onerous obligations to achieve this desired result.

Broadly speaking, the first step is to shift the executive remuneration paradigm to focus on structure, in order to firmly establish the connection with company performance in remuneration discourse. Higher disclosure regulations are likely to facilitate executive remuneration that is more closely aligned with company performance and enable shareholders to monitor remuneration for misalignment. The next step is to introduce mechanisms to reduce the vulnerability of boards to executive power through independent remuneration committees and an Advisory Shareholder Resolution. In order for an Advisory Shareholder Resolution to be appropriate, any implications upon the tension between nexus of contract theory and the separation in ownership and control in the modern company law framework need to be justified on securities law grounds.

B Empirical evidence

Empirical analysis has identified that managerial power is not just a theoretical concern for executive remuneration practices in New Zealand. Empirical studies have identified a misalignment between executive compensation and company performance.²⁴⁴ Executive

²⁴⁴ Aleksandar Andjelkovic; Glenn Boyle; and Warren McNoe "Public disclosure of executive compensation: Do shareholders need to know?" (2002) 10 Pacific-Basin Finance Journal 97; and Fayez A. Elayan; Jammy S.C. Lau; and Thomas O. Meyer "Executive incentive compensation schemes and their

power has been identified as weakening the connection between compensation and company performance in the remuneration of chief executive officers and other executives in listed companies.²⁴⁵ Executive remuneration in New Zealand has also been criticised for the high fixed component by international standards²⁴⁶ and for the major determinant in executive remuneration being company size.²⁴⁷ Whilst tournament theory might attempt to justify higher executive pay in larger companies, this trend encourages extreme agency issues by providing an incentive to pursue expansion over performance.²⁴⁸

Another problem that has been identified in recent studies is the highly concentrated ownership in New Zealand equity markets, with the top five shareholders owning as much as 60 per cent of shareholdings on average.²⁴⁹ Greater rent seeking has been identified where there is a high concentration of ownership due to the conflict of interest of majority shareholders to pursue their own interests by cooperating with management at the expense of minority shareholders.²⁵⁰ This has led to a call for greater transparency in executive remuneration, especially that of chief executive officers, to allow shareholders to ensure remuneration is connected to company performance.²⁵¹

impact on corporate performance: Evidence from New Zealand since compensation disclosure requirements became effective" (2003) 21 *Studies in Economics and Finance* 54.

²⁴⁵ Helen Roberts "CEO power, executive compensation and firm performance" (PhD Thesis, University of Otago, 2005) at 29.

²⁴⁶ See Healy, above n 8, at 174, for extracts from the Tower Perrins world-wide remuneration database taken in 2000 of chief executive officer remuneration in 2000 found the base of in New Zealand to be about 80 per cent of total remuneration whereas none of the other countries (Australia, United Kingdom, Canada and the United States) were as high as 50 per cent.

²⁴⁷ Andjelkovic; Boyle; and McNoe, above n 244, at 99.

²⁴⁸ Healy, above n 8, at 171.

²⁴⁹ See Lloyd Blenman; Dar-Hsin Chen; and Jianguo Chen "Does institutional ownership create values? The New Zealand case" (2008) 47 *Quarterly Journal of Finance and Accounting* 109.

²⁵⁰ Ahsan Habib; Haiyan Jiang; and Clive Smallman "The effect of ownership concentration on CEO compensation-firm performance relationship in New Zealand" (2009) 21 *Pacific Accounting Review* 104. This study was testing the competing "efficient-monitoring" and "strategic alignment" hypotheses regarding the effects of large block institutional investors on managerial power theory.

²⁵¹ *Ibid*, at 126.

A post-global financial crisis study of chief executive officer remuneration found institutional investors to have a more significant influence on remuneration practices than stronger internal corporate governance such as independent remuneration committees.²⁵² Institutional shareholders will only be active where the extra returns justify the extra costs.²⁵³ Whilst such shareholder passivity is individually rational, it is to the collective detriment of corporate New Zealand.²⁵⁴ As much of this country's equity markets are owned by foreign investors and likely to represent just a small portion of portfolios, there is a particular need to reduce the costs to institutional shareholders of activism in order to obtain the benefits of their expertise.

C Pressure from Australia

There is pressure on New Zealand corporate governance from both the international marketplace and political agreements whenever Australia strengthens its corporate governance framework. Corporate governance standards have to compete on a global scale to attract investment, as capital markets are an interconnected global phenomenon. The significance of attracting domestic and international capital has been an initial theme since the passage of the Securities Markets Act 1988.²⁵⁵ In the wake of the global financial crisis the Capital Markets Development Taskforce was established to develop a blueprint for capital markets in New Zealand.²⁵⁶ Its report emphasised the importance to New Zealand, as a small open economy dependent on international capital flows, enhancing its international investment reputation by having a robust regulatory regime.²⁵⁷ Capital markets need to have a strong commitment to high standards of corporate governance and protection of shareholders property rights as credibility is “hard to gain and easy to lose”.²⁵⁸ The importance of providing adequate protection for investors, of attracting and maintaining exchange participants and maintaining competitiveness, and of

²⁵² See Gerry Gallery; Jodie Nelson; and Parveen Reza "The impact of corporate governance on CEO remuneration structures in the aftermath of the GFC" (2011) Accounting and Finance Association of Australia and New Zealand <www.afaanz.org> as cited in MacMillan, above n 202, at 101.

²⁵³ See Part III F 3 for a discussion on the apprehension of institutional shareholders to be active in New Zealand.

²⁵⁴ Healy, above n 8, at 190.

maintaining international best practices are given explicit recognition in the mandate of the Financial Markets Authority to maintain securities markets rules.²⁵⁹ At this stage, there has been no expression from the Financial Markets Authority of an intention to undertake any major review or reform of this area.

There are political pressures to coordinate business laws between New Zealand and Australia in accordance with obligations under the Memorandum of Understanding currently in place.²⁶⁰ This memorandum is just one of New Zealand's obligations in support of the Australia and New Zealand Closer Economic Relations Trade Agreement.²⁶¹ Examples of pursuing closer alignment in securities law can be seen in recent reforms to secondary markets such as the insider trading regime, market manipulation provisions and continuous disclosure provisions.²⁶² The commitment to recognising New Zealand's obligations under international arrangements is also given explicit reference in the mandate of the Financial Markets Authority.²⁶³ It has been argued that the pressures of globalisation and the increasing influence of the "law matters" thesis will further drive the "Australianisation"²⁶⁴ of New Zealand securities

²⁵⁵ Campbell; Hare; and Watts, above n 16, at 987.

²⁵⁶ Capital Markets Development Taskforce, above n 24, at 3.

²⁵⁷ *Ibid*, at 10.

²⁵⁸ *Ibid*.

²⁵⁹ Securities Markets Act, ss 36FC(2)(b), (c) and (e).

²⁶⁰ Memorandum of Understanding Between the Government of New Zealand and the Government of Australia on Coordination of Business Laws (signed 1 July 1988). The most recent revision of this memorandum was signed on the 23 June 2010, see Simon Power "Ministers sign revised memorandum of understanding" (press release, 23 June 2010).

²⁶¹ Australia and New Zealand Closer Economic Trade Agreement (came into force 1 January 1983); see Gordon Walker "The CER Agreement and Trans-Tasman Securities Regulation" (Submission to Australian Treasury and New Zealand Ministry of Economic Development on "Trans-Tasman Mutual Recognition of Offers of Securities and Managed Investment Scheme Interests", 2004) at 82.

²⁶² Walker, above n 261, at 96.

²⁶³ Securities Markets Act, s 36FC(2)(f).

²⁶⁴ Shelley Griffiths "Aussie rules? 'Reform' of New Zealand securities law" (2004) 22 *Company and Securities Law Journal* 73 at 74 which describes the policy trend in New Zealand to "Australianise" rather than "harmonise" securities law.

law.²⁶⁵ There are arguably differences in New Zealand’s general approach to regulation, such as our pragmatic spirit,²⁶⁶ and also qualitative differences in our capital markets, which lead to a tendency to modify Australian provisions where there are perceived practical difficulties.²⁶⁷ Whilst New Zealand will not necessarily follow the Australian blueprint to respond to managerial power theory, what Australia is doing is likely to be heavily influential.

D Shifting the executive remuneration paradigm

The first step in responding to managerial power theory is for the law to lead the shift in the executive remuneration paradigm by ensuring information about the structure of executive pay is available to shareholders through disclosure regulation.

The two objectives of disclosure regulation in New Zealand are to address the inherent asymmetry of information between listed companies and shareholder investors, and to provide a means of monitoring company performance.²⁶⁸ Shareholders as owners need to be able to make informed decisions,²⁶⁹ and “sunlight is said to be the best of disinfectants”.²⁷⁰ Reform of disclosure regulation requires balancing the two tensions of cost and efficacy. Any additional compliance costs or potential commercial disadvantage need to be offset by the value of increased accountability.²⁷¹ More comprehensive reporting needs to effectively communicate the important information to shareholders by

²⁶⁵ Walker, above n 261, at 101 argued New Zealand securities law would continue to adopt Australian law “verbatim” even where it is arguably sub-optimal, as in the case of the insider trading regime; also Griffiths, above n 264, at 74 argued the influence of the “law matters” thesis possibly signals a close in the era of light-handed regulation in New Zealand securities law.

²⁶⁶ Walker, above n 261, at 101 provided pragmatism as a caveat for the pressures of globalisation.

²⁶⁷ Griffiths, above n 264, at 74. Despite the risks of reducing the perceived benefits of having identical provisions, such as the relevance of case law.

²⁶⁸ See Griffiths, above n 7, at 987 for a detailed discussion of disclosure theory in capital markets in New Zealand.

²⁶⁹ Ministry of Economic Development, above n 6, at 12.

²⁷⁰ Louis D. Brandeis *Other People’s Money* (Frederick A. Stokes Company, New York, 1914) at 62.

²⁷¹ Productivity Commission of Australia, above n 26, at 241.

being in the appropriate format, timely, and accessible.²⁷² Listed companies cannot be encouraged or permitted to take a kitchen sink approach to disclosure in order to ensure compliance or camouflage executive remuneration.

The limited disclosure requirements in New Zealand and the comprehensive disclosure requirements in Australia have different strengths and weaknesses. The virtue of the New Zealand requirements is the ease of compliance. The problem however is that they are not achieving the two objectives of disclosure regulation in any meaningful sense. Without information about the structure of executive remuneration packages, shareholders are not informed about executive compensation, nor are they able to monitor its alignment with company performance. The weaknesses in disclosure regulation are part of a corporate governance framework that fails to adequately appreciate the significance of executive remuneration, and therefore also distortions, to company performance. Beyond the objectives of disclosure theory, it can also be argued that higher disclosure is a prerequisite for an effective Advisory Shareholder Resolution mechanism.

New Zealand could possibly achieve the change it requires without introducing as comprehensive disclosure regulation as Australia, to avoid the compliance problems they are having. Disclosure regulation is a sensitive balancing act and it would be improper for this dissertation to attempt to provide the ideal framework. What is clear however is that reform needs to ensure the details of executive remuneration packages are effectively communicated to shareholders in order to establish the connection with company performance, to enable shareholders to monitor this business tool effectively and to lead the shift in the executive remuneration paradigm.

E Mitigating executive power through independent remuneration committees

As securities law is unlikely to interfere with the corporate form by changing the role of executives or the nature of their relationship with the board of directors, executive power

²⁷² Ministry of Economic Development, above n 6, at 13.

is a necessary consequence of the listed company structure. New Zealand corporate governance, for the most part, does not place any real significance on protecting the determination process of executive remuneration from distortions. The Exceptional Executive Director Remuneration safeguard is not only vulnerable to compliant boards, but it fails to recognise the systemic risks of executive power. The remuneration committee concept needs to be reconceptualised in New Zealand as a mechanism for increasing independence in the remuneration of executive directors. The NZX is headed in the right direction by demonstrating an understanding that independence is a factor in remuneration committees.²⁷³ However, independent membership needs to be directly encouraged.

The difficult question is to what extent this should be achieved by regulation or soft law and market forces, and whether restrictions on composition should go as far as permitting only independent directors. It is generally accepted that a regulatory regime is necessary in order to counter market failures but there is long-running debate in securities law about the efficacy of mandatory rules versus market forces generally.²⁷⁴ The attempt to strike a balance can be seen in the composite corporate governance framework currently in place in New Zealand. The debate has come to a head in the context of high profile corporate collapses such as Enron in the United States,²⁷⁵ and in the wake of the global financial crisis such as the failure of 18 finance companies in New Zealand between 2006 and 2008 that resulted in a loss of more than two billion dollars of investors' funds.²⁷⁶ These provide sharp reminders of what can happen when companies are left without sufficient regulatory supervision.²⁷⁷

²⁷³ NZX "Consultation Memorandum", above n 97, at 17.

²⁷⁴ Griffiths, above n 7, at 988.

²⁷⁵ Ibid.

²⁷⁶ R.V.D. Bergh and L. Nichols "A systematic failure of an entire industry" *The Dominion Post* (New Zealand, 3 April 2008) <www.stuff.co.nz/dominion-post/archive/national-news/345666/A-systematic-failure-of-an-entire-industry> as cited in Ahsan Habib and Haiyan Jiang "The impact of different types of ownership concentration on annual report voluntary disclosures in New Zealand" (2009) 22 *Accounting Research Journal* 275 at 280.

²⁷⁷ These finance companies were not subject to the continuous disclosure regulations of the NZX as they were not listed, nor did the Reserve Bank of New Zealand regulate them, as they were not banks, see NZPA

Compliance costs were the largest factor behind the use of soft law for listed companies in Australia not within the ASX300. The ASX300 is, generally speaking, composed of the 300 listed companies on the ASX with the largest market capitalisation.²⁷⁸ To put this in perspective, the company with the smallest market capitalisation on the ASX300 is roughly the size of the 38th largest listed company on the NZX by market capitalisation.²⁷⁹

A surrogate system introduced into New Zealand could introduce soft law in respect of all listed companies, with hard law regulations applying only to companies listed on the NZX20 or NZX50. These companies would act as guiding lights of best practice for smaller companies, especially those with aspirations to make it into these indices. In striking the right balance capital markets regulators will need to quantify the various costs and benefits of different responses to company performance, capital markets and the economy. This requires expert financial and economic analysis. What is clear from a legal policy perspective however is that change in the legal framework is needed to reflect the role of independent remuneration committees as a mechanism for mitigating executive power.

F Mitigating executive power through an Advisory Shareholder Resolution

Whilst remuneration committees are a good measure for keeping executive directors at arm's length in remuneration discussions, any recommendations are ultimately subject to

"NZX seeks change to monetary policy" *The Christchurch Press* (Christchurch, 2 August 2007) as cited in Habib and Jiang, above n 276, at 280.

²⁷⁸ There are other qualifications such as minimum share turnover requirements, see S&P Dow Jones "S&P/ASX300 Australian indices methodology" (2011) <au.spindices.com/indices/equity/sp-asx-300> at 8.

²⁷⁹ I approximated this by finding the ASX300 company with the smallest market capitalisation of AUD\$296 million in the Australian Financial Review "Daily summary Sunday 23 September 2012: S&P/ASX300" (2012) <www.afr.com/share_tables/>; converting this into New Zealand currency at the prevailing exchange rate at NZForex "Currency converter" (2012) <www.forex.co.nz/our-services> to get roughly NZD\$373m, and ranking this against the market capitalisation of companies listed on the NZX "NZX 50 Index (NZ50)" (2012) <www.nzx.com/markets/NZSX/indices>.

approval of the board as a whole. An Advisory Shareholder Resolution increases the accountability of the board of directors, increasing the pressure of outrage costs, making it harder for executives to influence board decision-making. An Advisory Shareholder Resolution brings to the surface the tension in company law between nexus of contract theory and the separation of ownership and control. The question is whether it can be justified as a mechanism for shareholders exercising their proprietary rights within the modern company law framework, or if it interferes with the management responsibilities of the board or the appropriate functions of the annual general meeting of shareholders. If it does not fit within company law, it needs to be supported by the jurisdiction of securities law to impose more onerous obligations on companies that have raised funds from the public and are traded on a registered secondary market.²⁸⁰

1 Fit with the modern company law framework

Shareholders already have the power to hold a non-binding resolution of their own accord at annual general meetings.²⁸¹ The Advisory Shareholder Resolution is held out as an accountability measure of last resort, which does not interfere with the management of the company.²⁸² It could be seen as simply an ex post facto procedural requirement that facilitates feedback from shareholders. However, as the objective is to influence remuneration decisions it is difficult to argue that it does not interfere with the management of the company. It is even more difficult to argue in the case of the two-strike mechanism, which gives shareholders “greater leverage over unresponsive boards” and the ability to have a “real say on pay”.²⁸³ The two-strike mechanism gives a minority of shareholders an additional power to force the board to sit for re-election. However, control over the membership of the board is still retained by the majority of shareholders, which has always been the case.

²⁸⁰ See Part *IB* for an explanation of the relationship between company law and securities law.

²⁸¹ Corporations Act, s 156.

²⁸² See Part *IV E* for the justifications behind the Advisory Shareholder Resolution mechanism being introduced in Australia.

²⁸³ Fels, above n 151, at 165.

The Law Commission when developing the modern company law framework attributed only a limited role to the annual general meeting of shareholders. Its primary focus was privately held companies, expressly leaving it open to securities law to conduct its own review of the powers and rights of intervention of shareholders in decision-making at annual general meetings.²⁸⁴ The Law Commission did not consider the annual general meeting a suitable mechanism for protecting shareholders from the abuses of management as it had historically only acted as a cipher for directors to absolve themselves of responsibility.²⁸⁵ It considered the other methods open to shareholders to protect themselves from abuse more effective. The Law Commission also concluded, in the case of conflict of interest transactions, that a disinterested majority of shareholders in general meeting was not an appropriate substitute for the courts supervisory jurisdiction over the reasonableness of corporate decision-making.²⁸⁶ It felt a binding shareholder consent procedure was unwarranted and would be too intrusive in privately-held companies.²⁸⁷ The bases for this position were that it would be too difficult to determine disinterestedness of shareholders, there would be too much overlap between shareholders and management, and that the assessment of what is reasonable or in good faith is a proper function of the court.²⁸⁸

2 *Justification in securities law*

The current securities law framework has not abridged the separation of ownership and control in the context of executive remuneration. It has abridged the separation of ownership and control by requiring shareholders to approve director remuneration, although as this is likely grounded in directors' fiduciary responsibilities, it does not provide any real support for more onerous obligations in the context of executive remuneration. The Exceptional Executive Director Remuneration, on the other hand, is an example of securities law reconceptualising the function of the general meeting of

²⁸⁴ Law Commission, above n 2, at [142].

²⁸⁵ *Ibid*, at [197].

²⁸⁶ *Ibid*, at [140].

²⁸⁷ *Ibid*, at [141].

²⁸⁸ *Ibid*, at [140].

shareholders by imposing more onerous obligations on boards than company law, which may open the door to executives more generally. An Advisory Shareholder Resolution is less intrusive than the supervision mechanism contemplated by the Law Commission, as it is only an advisory vote and the courts would still retain their general supervision jurisdiction. Also the Listing Rules have already adopted a mechanism for determining disinterest in shareholder resolutions on remuneration and as share ownership is likely to be more diffuse in listed companies there is likely to be less overlap between shareholders and management.

Opponents of shareholder primacy have expressed concern that the more institutional shareholders are able to flex their considerable muscle, the greater the risk they will effectively control boards and close the separation of ownership and control.²⁸⁹ In response it could be argued that the Advisory Shareholder Resolution is not justified simply by virtue of shareholders ownership rights, nor is it intended to give shareholders greater power to shape executive remuneration generally. The purpose of the vote is to strengthen the resolve of the board against the power of executives, enabling them to make remuneration decisions that are in the best interests of the company, rather than undermining the management responsibilities of the board of directors.

A non-binding resolution is unlikely to be considered *unwarranted* or *too intrusive* in the context of listed companies given the evidence executive power is being used to distort executive remuneration in New Zealand. Shifting the executive remuneration paradigm through more comprehensive disclosure is a necessary first step as it enables shareholders to monitor for such distortions. Combining this with a non-binding vote reduces the risks of instability facilitating greater activism from retail and institutional shareholders when distortions appear. Introducing an Advisory Shareholder Resolution will help to remove the arm's length bargaining paradigm and bring the problem of compliant boards to the fore. There is nothing about the Advisory Shareholder Resolution that is inconsistent with the approach of securities law to date, although imposing more onerous obligations on listed companies in executive remuneration requires entering new territory. This is only

²⁸⁹ Millon, above n 13, at 1376.

new territory because regulation to date has generally failed to reflect the significance of executive remuneration to company performance and the strength of executive power. Soft law, such as the SCNZ Principles, on the other hand, have placed greater emphasis on executive remuneration for a number of years.²⁹⁰ Adopting an Advisory Shareholder Resolution would also be consistent with the mandate of the Financial Markets Authority in respect of securities markets rules by: promoting fair, orderly and transparent securities markets;²⁹¹ providing an appropriate level of protection for investors;²⁹² helping to maintain international competitiveness;²⁹³ and bringing the framework in line with international best practice.²⁹⁴

In terms of what form of Advisory Shareholder Resolution is most likely to be introduced in New Zealand, the conflict of interest restrictions in the recent reforms are unlikely to be a difficult step for securities law as interested shareholder voting restrictions are already in place in other shareholder resolutions.²⁹⁵ Adopting the two-strike mechanism however involves a lot more uncertainty. Whilst it is likely to make boards more responsive to shareholder discontent, it is not yet clear whether this translates into better executive remuneration practices. Introducing an Advisory Shareholder Resolution without the two-strike mechanism, at least initially, is consistent with New Zealand's pragmatic approach and what has occurred in both Australia and the United Kingdom. It would give listed companies a chance to adjust and also give the full effects of the two-strike mechanism on Australian capital markets time to come to light. The reforms discussed in this dissertation could be introduced by the Financial Markets Authority through the Listing Rules or be included within the new financial markets conduct framework that is likely to replace the Securities Act 1978 and the Securities Markets Act 1988.²⁹⁶

²⁹⁰ Securities Commission *Handbook*, above n 21, at 17; see Part *III D I* for an explanation of principle five.

²⁹¹ Securities Markets Act, s 36FC(2)(a).

²⁹² Securities Markets Act, s 36FC(2)(b).

²⁹³ Securities Markets Act, s 36FC(2)(c).

²⁹⁴ Securities Markets Act, s 36FC(2)(e).

²⁹⁵ See Part *IV E 2* for an explanation of the conflict of interest restrictions on shareholder voting already in place in New Zealand.

²⁹⁶ Financial Markets Conduct Bill 2011 (342-2).

G Narrow focus on executive remuneration and not executive conflicts of interest more generally

This dissertation has focused narrowly on the risks of executive power to executive remuneration and not the risks of corporate looting through other conflicts of interests such as self-interested and related party transactions. This is because there are natural limits on how much securities law can interfere with the company law model, so it has to be as efficient with reform as possible. Remuneration is the most efficient focus of reform, as it is where the conflict of shareholder and executive interests becomes most acute, and also because the level of public concern warrants the attention of capital markets regulators.

Introducing the use of Advisory Shareholder Resolutions more broadly may have fiduciary implications and would likely cause the company law framework to break down. The Law Commission, when developing the modern company law framework, expressed concern that the greater the role of shareholders at general meetings in the management of the company, the higher the need to develop a concept of fiduciary duty owed by the majority to the minority.²⁹⁷ This could undermine the concept of a share as property and make company decision-making and enforcement of obligations procedurally complex.²⁹⁸ Limiting shareholder resolutions to matters that directly impact upon their property interests enables them to act in their own self-interest, as they are not exercising any power entrusted to them for the benefit of others.²⁹⁹ The risk of causing the company law framework to break down comes from the provisions in the Companies Act 1993 designed to impose fiduciary obligations of directorship upon those who exercise management functions.³⁰⁰ There is a risk these mechanisms could become unworkable.

²⁹⁷ Law Commission, above n 2, at [210].

²⁹⁸ Ibid.

²⁹⁹ Ibid, at [211].

³⁰⁰ See Susan Watson “Allocation of Power Within the Company” in John Farrar (ed) *Company and Securities Law in New Zealand* (Thomson, Wellington, 2008), at 217.

The importance of public perception and investor confidence to capital markets has been a central theme underlying the call for reform in this dissertation. Whilst public concern requires the attention of capital markets regulators, it does not always justify a response as it may not be based on an adequate understanding of what is in the public interest and may not take into account the increase in market frictions or compliance costs of regulatory intervention.³⁰¹ In the case of remuneration however there appears to be a strong enough case for reform. Generally speaking, securities law does already have higher standards in respect of interested transactions than company law.³⁰² The Listing Rules prohibit directors from voting as a member of the board in transactions they have an interest in unless there is a statutory requirement to sign a certificate imposing personal liability. Any executive director who is able by virtue of their power over the board to misappropriate assets from the company is liable to pay any loss. The reason remuneration is a particular problem, as discussed earlier, is contributed to by the procedural difficulties of shareholders bringing a derivative action in the context of executive remuneration and the difficulty in quantifying the loss to the company.³⁰³

H Conclusion

The corporate governance framework in New Zealand overlooks the significance of executive remuneration to company performance and the systemic problem of executive power in the corporate structure. Its weakness from the perspective of managerial power theory is of serious concern as there is empirical evidence that executive power is being used to distort remuneration practices in listed companies in New Zealand.

³⁰¹ Geoff Hogbin "Submission to executive remuneration inquiry" (Submission 99, Australian Productivity Commission, July 2009) at 2 as cited in Productivity Commission of Australia, above n 26, at 30.

³⁰² See Part III D 2 above for an explanation of the procedural requirements surrounding the involvement of directors in interested transactions.

³⁰³ See Part III F 3 above for a discussion of derivative action in the context of executive remuneration.

At present, the information needed to monitor executive remuneration is not being communicated to shareholders, nor are the right incentives in place to receive the benefits of institutional shareholder activism. As these hurdles leave no reason to believe remuneration problems are going to be resolved by market forces, there is a strong case for regulatory intervention.

The objective of this dissertation was to try to achieve better substantive remuneration outcomes through a procedural framework that is more independent, more transparent, and imposes greater accountability. The first aspect of this is more comprehensive disclosure, to enable shareholders to monitor executive remuneration and to lead the much needed shift in the executive remuneration paradigm. The second aspect is to further reduce boards' vulnerability to executive power through greater independence in the processes of boards when determining executive remuneration and strengthening the resolve of boards as a whole through an Advisory Shareholder Resolution.

The implications of the reforms discussed in this dissertation upon the tension between nexus of contracts theory and the separation of ownership and control in the modern company law framework appear to be justified by securities law's wider concern with the integrity and efficiency of capital markets. A stronger regulatory framework will provide a dual response to managerial power theory: improving executive remuneration practices in listed companies where remuneration is actually being distorted; and helping to diminish any loss of confidence to New Zealand capital markets as a whole which has resulted from the failures of these companies to date, helping all listed companies in New Zealand compete in global capital markets.

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