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PRODUCTIVITY COMMISSION

**INQUIRY INTO REGULATION OF DIRECTOR AND
EXECUTIVE REMUNERATION IN AUSTRALIA**

**MR G. BANKS, Chairman
MR R. FITZGERALD, Commissioner
PROF A. FELS, Associate Commissioner**

TRANSCRIPT OF PROCEEDINGS

AT SYDNEY ON TUESDAY, 16 JUNE 2009, AT 8.45 AM

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MR BANKS: Good morning, ladies and gentlemen, and welcome to this, the first day, of public hearings for the Productivity Commission's national inquiry into executive and director remuneration in Australia. My name is Gary Banks, I'm chairman of the Productivity Commission, the presiding commissioner on the inquiry. On my left is Robert Fitzgerald who is a commissioner with the Productivity Commission working on the inquiry as well and Allan Fels, who has been appointed as an associate commissioner for this inquiry, is on my right.

As you will be aware, the commission's inquiry started with a reference from the government in March and since then we have talked to a wide range of organisations and individuals and submissions have been coming into the inquiry. We are getting up towards 100 submissions so far, many of them quite detailed and very helpful. The purpose of these hearings is to give interested parties the opportunity to discuss their views and their submissions on the public record and this will help the Productivity Commission in its task of understanding the drivers and trends in executive remuneration and any systemic problems warranting changes in regulation and governance frameworks.

After these first hearings in Sydney we will be in Melbourne next week and in Brisbane in July. We will then working towards completing a draft report for public scrutiny in late September and we will hold another round of hearings in November when people have had time to respond to that report. That feedback will be taken into account in producing a final report which is to be submitted to government before Christmas. Copies of the draft report and indeed the final report will be circulated to all those who have made submissions or appear at hearings or registered an interest in the inquiry.

The hearings are conducted as informally as possible, although a transcript is made to provide a public record of discussions. There is no formal oath taking required but the Productivity Commission Act does require participants to be truthful in their remarks. Transcripts of the hearings and submissions themselves are public documents and can be obtained from the commission's web site and copies can also be purchased and I believe that order forms are available from staff here today or by contacting the commission. I should add for the record that participants needn't feel constrained to making a single submission. For example, participants may wish to make submissions in response to the submissions of others and we will continue to accept submissions after these public hearings.

To comply with the requirements of the Commonwealth occupational health and safety legislation you are advised that in the unlikely event of an emergency requiring evacuation of the building that exits are located in that direction. I believe you need to go through the door that says "toilets" and you will see the stairway from there. Staff will be here to assist you in any respect today. With those formalities

out of the way, I would now like to welcome our first participants, Guerdon Associates and CGI Glass Lewis. Welcome to the hearings. Could I ask you to give your names please and the capacity that you are here today.

MR EASTERBROOK (CGIGL): Yes. My name is Sandy Easterbrook. I am a director of CGI Glass Lewis. We are a proxy advisory house. We are a member of the Glass Lewis Group which is based in San Francisco and our responsibility in Australia is to report on the ASX-listed and New Zealand Stock Exchange-listed companies to our institution and investor clients.

MR BANKS: Thank you.

MR ROBINSON (GA): My name is Michael Robinson. I am a director of Guerdon Associates. Guerdon Associates is a board advisor on executive and director remuneration matters.

MR BANKS: Thank you. Thank you very much for appearing this morning and also for the submission which is a very good submission and there is plenty of substance in it and I'm sure we'll have lots to talk about. I will give you the opportunity to perhaps make some opening remarks drawing on some of the key points in the submission.

MR EASTERBROOK (CGIGL): Perhaps I'll just explain why we decided to make a joint submission and it was because we thought that combining our respective areas of expertise, particularly on Guerdon Associates' side with their detailed knowledge of remuneration and our governance expertise, it seemed to us that those two things ought to be brought together in putting some facts and opinions before the commission for it to consider. We apologise that it is a very long submission but it's actually a very important topic. It tends to be addressed from - I'm not sure whether you'd say a sensational aspect, but actually it is a very important aspect because it really is one of the main drivers of businesses and it's very important for the economy that businesses succeed and so remuneration is quite an important part of that. So it needs to be looked at logically and dispassionately, if I can put it that way, and we have tried to do that in the submission.

The submission has a summary at the front which sets out the conclusions that we come to through the body of the document and then it has the particular recommendations and we've cobbled them together in summary at the front of the various recommendations and the various sections later in the report. We decided to put in - this is on pages 11 to 17 - a preamble because again this is to try to set the dispassionate tone, if I can put this way, and the background as to what we're actually all talking about. It's a 101 on how a modern corporation operates and what are the things that we need to bear in mind when we come to look at remuneration.

Michael suggested that we should particularly draw your attention to section 2.6 of that which again is trying to look at the thing in a broad way which is basically indicating, "Look, there are a lot of other things than remuneration that are important and you need to bear all those things in consideration when you're looking at the governance of corporations and the things that are important for their success."

MR ROBINSON (GA): Just some high points with our findings and recommendations. Firstly, what is happening in Australia is a reflection of what is happening globally. It has happened at other boom-bust cycles as far back as I can remember and I've been in this sort of business for over 20-odd years. But it was evident in the early 80s, the late 80s, the early 90s and right now. So when you cross the threshold from boom to bust there is a lot of criticism of executive pay because, of course, it rises quite significantly during the boom times and there is a lag effect, with disclosures between what's reported and the state of the company at the time it's reported.

What's happening in Australia does reflect a global concern, so we're not alone in that regard.

The rates of pay increase have been high, there is no doubt about that in relative terms. But those rates of increase appear to be related to increases in market value, and the symmetry of pay has improved over the past couple of decades. By symmetry we mean the extent of pay that is variable with performance versus that which is fixed. So we expect that in disclosures for the year ended 31 December this year and 30 June next remuneration will decrease. Unfortunately, the commission's report is due prior to those results being known. But that is our expectation and that is certainly what was witnessed in the past boom-bust cycles.

Then we look at the system that we have. Have we got constraints on executive pay? We certainly have better constraints than what we used to have, with the non-binding pay vote and better disclosure requirements compared to other boom-bust cycles. We have what has been labelled in the US by two well-respected academic researchers, Bebchuk and Fried, as an outrage constraint and we have an avenue for that to be expressed on a regular basis through the non-binding vote. This appears to work quite effectively and maybe Sandy can come out with a few examples later. We're often called in after shareholders have expressed dissatisfaction. Dissatisfaction by major board directors is considered to be a vote of higher than 5 per cent, and certainly 10 per cent is regarded as a very bad thing. Hence the remuneration report vote tends to work quite well in encouraging boards to review and amend their remuneration frameworks and policies.

So there has been quite an effective constraint Board responses are improving.

But we're on a journey; it's a continuous improvement process. We have witnessed improvements, certainly there is a way to go but I think we have quite good mechanisms already in place for that. Could aspects of executive remuneration be improved? Yes, primarily in disclosure aspects such that shareholders can make an easier assessment of how well the board is doing in terms of managing pay. I think that's my primary high points. Sandy, do you have anything else?

MR EASTERBROOK (CGIGL): I would like to echo what Michael is saying about the non-binding vote is working. We find that the standard of remuneration reports has increased hugely from when it started off and we do know that just about every company is - the board is very apprehensive when it puts its remuneration report out in case it doesn't get a vote of confidence. There is a lot of misunderstanding about what the non-binding vote is about. It was brought in in the UK basically as a mechanism for publicly embarrassing boards if they made a hash remuneration. That is probably the easiest way to put it. It's a sort of name and shame. I'm an escaped lawyer, I used to be a partner in a large law firm. When it first came in, a number of my former partners said, "What on earth is the legal effect of a non-binding vote?" I said, "It has something or - is the effect of it from a legal point of view. It's purpose actually is to get the board to do a better job."

We do see this, we see companies, if they get a big vote against their remuneration report - very frequently we get a call from the remuneration committee chairman, it might be the chairman will want to come and talk to us about it and afterwards there's an improvement. By the way, this is typical of all the sort of governance areas.

When a company gets into trouble on a governance issue and gets attention from its shareholders it tends to learn from the lesson, and probably the best example I can think of is BHP in the mid-90s. BHP had a really serious performance issue which actually, from our analysis, went back to the faulty construction of the board. It had lots of worthy independents on it but it didn't have anyone, apart from management and former management on the board, who virtually knew about the resources industry.

So when management lost the plot, the board didn't know that and didn't pick it up early enough. So the damage actually was much worse than it should have been. Now, if you look at BHP today its governance is very good. So, you know, it got hammered by its investors and it has learned a lesson. Well, exactly the same thing happens with remuneration.

Probably the most surprising one to me recently was Austar. Now, we have referred to that in here, which is it's wholly controlled by quite a gung ho American media company, Liberty Global, which owns 55 per cent. It dominates the board.

But there was a surprisingly large vote against its remuneration report in May, and, if you look at the transcript of the annual meeting, you'll see that the board was very sensitive about that, even though they have got the power, with the major shareholding, to get the remuneration report accepted.

Nevertheless, the fact that there was a significant minority vote against it and they have encouraged you to look at the (indistinct) it actually said, "We will be addressing these issues. We are not going to change the existing structures we have got, because that would probably be breaching their contract with their employees, with their executives, but they have said they will look at it at the time of going forward. That's how these things tend to work.

So our message basically is let's improve the tools that we have to make this system work, and in particular you will see that we have referred to cleaning section 300A, which is the vital section in the Corporations Act. CGI was actually instrumental, along with IFSA's predecessor, which was AIMA, the Australian Investment Managers Association, in getting the original section 300A into the Corporations Act. It was originally that three or four paragraphs and several pages; it has sort of grown like Topsy and it does need attention.

Part of the problem at the moment is that the information that's disclosed, particularly on long-term incentives, is the amortised cost over a number of years of long-term incentives; it doesn't actually tell you what the executive got during the year that remuneration report is on. So it's very imperfect information on which shareholders try to assess whether they approve the remuneration, the report, coverage for the last year, or not. So that's an area that really does need some attention, and we have volunteered with Guerdon Associates to have a go at re-doing section 300A, if that would be of interest to the commission.

MR ROBINSON (GA): We are also suggesting changes to what we call soft law, which is, "Do this, or explain why you're not doing it." That is expressed in the ASX governance principles. These are quite useful because it does allow flexibility in those quite numerous circumstances where a board has to design a remuneration framework that is unique to that particular company's circumstances that might deviate from what are otherwise considered to be good governance guidelines. But they have to explain why. We suggest amendments to the soft law - additions, rather, although we don't like additional regulation, but we feel that some is necessary on the soft law side.

MR EASTERBROOK (CGIGL): Yes, and I'd just like to add that there are guidelines out there on remuneration. But basically, from our perspective, the guideline is there saying, "Look, this is what is generally accepted as being good practice, but we know that there are lots of companies out there in which the business

drivers in it dictate something else. So the advantage of the guideline system is that if the remuneration framework actually follows the best practice, well, they don't need to spend ages explaining that, because they're within the guidelines.

But if they are outside the guidelines, what they need to do is to explain not only the what, which is, you know, what is your framework, but they need to explain why it's appropriate for the company and why it's not, you know, to the extent that it doesn't suit the guidelines. To give you a very simple example, best practice normally says, "Look, if you're going to give equity, it ought to be long-term, and long-term means at least three years."

But you could well have a company, particularly in the early stages, where they have got some very important key milestones that they want the executives to make, much shorter than that - you know, the next one or two years might be really important; so obviously that company should design its remuneration to reward that, and when it's coming to do its remuneration report it should explain, "Look, this is why we're doing it," and some of them do.

MR BANKS: Too many don't.

MR EASTERBROOK (CGIGL): Yes, too many don't. I mean, when we first started we got the what but we never got the why, and now the companies are getting the idea of explaining the why. Some of them, as Michael says, are good at it; but some of them are still learning, I suppose is the best way to put it.

MR BANKS: Okay. Thanks for those remarks. There's so much we could talk about on the basis of what you have said and your submission, but we will obviously confine ourselves to what we can get through in the time available to us. I thought perhaps a good place to start might be just in terms of your perception of what have been the key drivers in what has, you know, almost been an exponential increase in senior executive remuneration levels, and it has led to some of the headlines, particularly with pay-outs, etcetera, and particularly in the context of a downturn.

You have talked about that being associated with the boom and that the downturn to some extent will see some unwinding of this, which suggests that do see it very much related to the wider economic market conditions. But you have also talked about disclosure and how that could be done better. I guess I'd ask whether you see that as being part of the mix in terms of what we have seen with executive salaries.

Of course we have had events in the USA and others who have been telling us that what happens in Australia can't be disconnected or seen separately from what is happening in the rest of the world, and you have made that point yourselves. But I

thought perhaps just a good place to start might be to get you to reflect on that mix of things and what you would see as perhaps the more important elements of that.

MR ROBINSON (GA): It's important to realise there's no one driver; there's several drivers. If you just look at the growth in pay being aligned to the increase in market value, "Is that a valid way to manage executive pay?" I think is a good question to start with. With growth in market value, there's also a growth in complexity associated with running an organisation that grows in size. So the available supply of people to run such organisations becomes less.

So if you look at the relationship of executive pay to the average worker pay for companies that haven't grown over that boom period, you won't find that much of a disparity in terms of multiples. But certainly for most of our companies, ASX listed companies, ASX-200 companies, they have increased hugely in market value, their complexity and so on. So just trying to find people to manage those, as executives turn over and retire and so on, has been quite difficult, and that has certainly been a driver of executive pay. That's one factor.

There are other factors too, and Australia is not immune from international forces. We should put this in context. Australia's pay relatively appears to be quite well managed. If you compare us to other OECD countries on executive pay, we're in the lower quartile, if you take just the chief executive's pay, across a range of similarly-sized international companies.

MR BANKS: Could I just get you to comment on the source of that information.

MR ROBINSON (GA): That was a 2006 Towers Perrin report. There's no more recent data than that, unfortunately. Towers Perrin has very good methodologies and there's so many ways that they look at this. But this in both gross and net pay, as well as and taking purchasing power parities into account and so on. Our submission mentions just gross pay; so just on that, we're in the lower quartile. But if you look at net after tax and purchasing power parity associated with the currency you're paid in, Australia is also in the lower quartile.

What is interesting is that, even if you take a larger group of OECD plus major developing countries' remuneration, we're about the middle. So from an international perspective, it appears to be that executive pay here isn't relatively high. It may appear high to you and I, but it is not that high.

Despite our low relative ranking on executive pay, we are still subject to international influences.

I think John Colvin, AICD, may talk to this later, because he has talked to

several search firms out there, and, according to John, the top search firms typically search internationally for any executive vacancy in ASX-200 companies, not at just the chief executive level but also the direct report level and the third level. So a global search is conducted for vacancies that occur in most of the ASX-200 companies; and I suggest you ask John just to confirm that.

So when you are searching internationally, to attract people here you not only have to pay something that's at least similar to their domicile country but there's also additional things to consider such as the risk of uprooting yourself and your family to come to a place you don't know that well; the cultural risks, and so on. So that has certainly been a pay driver.

Also, international pay is reflected in the management of foreign subsidiaries that are resident here, and these companies do not disclose their pay publicly. But while those executives have lower accountability than executives of a listed company, and they don't have the liabilities associated with management of listed companies - their pay is at least on par and sometimes higher than listed company pay.

Why are other countries paying higher than Australia? I don't think their governance frameworks are quite as good as ours. The other thing is that the country that has the most influence on global pay has probably the poorest governance framework, and that's the United States.

That's where there is I think quite legitimate grievances about executive pay, and it's heartening to hear people like Mary Schapiro, who is head of the SEC, putting through changes associated with giving US shareholders more power on the selection of directors and a non-binding remuneration vote. There is a senator there, Chuck Schumer, who is putting through a bill to put this into place. So if the US keeps a lid on it, it will reduce the pressures on other countries to pay high levels of pay. Because the United States, for all its faults, is just such a deep pool of management talent that, if you do a global search, its executives have to be included, because they have got so many experienced people.

MR EASTERBROOK (CGIGL): The thing I'd like to just add about the States is - I mean, it's extraordinary to us who were brought up in the system we are that in America you can't fire directors. So if the owners of the company can't fire the agents that are running the company, you can expect that the position of the agents is going to be terribly powerful. That's why they tend to get paid so much at the top of the company, because there isn't a board there to monitor things and actually control them.

MR ROBINSON (GA): The typical US board is chaired by the chief executive.

MR EASTERBROOK (CGIGL): Yes, and actually it's going to be really interesting to see, if we get real reform in America, so that it's the same system that we have here; it's going to be fascinating to see what that does to their efficiency and competitiveness and productivity. As the Productivity Commission, that's something I think you should in the future look at. I mean, it's probably going to be three or four years before we get the change through, because one thing I've learnt in this governance business is things always take much longer than you think to happen.

But it will happen I think, and you will find that over a period the system will change in America. Once the boards actually learn to control management - as is the way that, generally speaking, happens here - I think it will be really interesting to see what that does for their competitiveness.

MR FITZGERALD: Can I just ask this, a general question. What do you believe the Australian community's reaction should be to the quantum of the pay and what do you say to them in relation to the concerns that they have expressed about the quantum, given all that you've said about the arrangement? It's linked to a couple of things.

One of the things: in a number of the codes that exist, including the ASX governance codes and in actually the Corporations Act where they talk about this notion of reasonableness, some of them talk about fear and reasonable remuneration, does that have any meaning and what is it fair and reasonable in relation to; in other words, what is the relativity? Is it simply that fair and reasonable is what the market bears and whatever the market bears is therefore and reasonable; or do the notions of fair and reasonable have some other sort of connotation, because they certainly appear in a lot of documents?

The second thing: as you say in your submissions, just about every remuneration consultant recommends that the base pay is at the median or higher; nobody every recommends a base pay lower than the median, so you get this constantly ratcheting up, nobody is in the lower 50 per cent. Now, it doesn't make any sense that that could be the case. So does quantum matter; does in fact fairness and reasonable have any real meaning; and how does this sort of endless pursuit of the median plus impact on total salaries?

MR ROBINSON (GA): They're all good questions.

MR EASTERBROOK (CGIGL): Yes.

MR ROBINSON (GA): Maybe if I take a shot, and I think, Sandy, may also address the current zeitgeist of paying at median, because that's something that

governance bodies also advocate. You look at governance guidelines, and they do change over time, but currently there's this argument to pay at the median. Now, I don't think many remuneration consultants would now recommend paying at above median, unless there's very exceptional circumstances, and perhaps we can go into those later. But you're right; if everyone pays at median, those lower than median will be moving up, so the median moves up. Those paying higher than median will not be reducing pay (although they may hold it steady). So you get a ratcheting effect.

How do we overcome that? We generally try and put forward in our work that there are alternative frameworks. For example paying a lower fixed pay but a much higher proportion of performance pay to attract those willing to take that risk and who have a good self-belief in their ability to get certain performance outcomes. This framework allows for fixed pay to be less than median. So that is an alternative, for example. There are some companies that have that framework, but not many. Of course the majority try and set pay at what they consider a fair rate of pay, and a fair rate of pay is middle of the market; 50 per cent pay more, 50 per cent pay less at that point. Sandy, do you want to comment some of the other things?

MR EASTERBROOK (CGIGL): Well, when we do our reports on companies, and particularly on the remuneration report, we have a table in our report which sets out what is the pay of the chairman and the other non-executive directors. By the way, it's very important to bear in mind that the pay of non-executives is quite separate from the pay of executives. It has to be separate because the non-executives are supposed to be controlling the executives, so you want to have their pay structures separate. Just like APRA wants to have the line management's pay separately structured from the compliance people; that's a rough sort of symmetry there.

We also show the CEO's pay. We have a running table that we calculate on the other side which shows what is the median pay for this market cap group; whether it's ASX 20, ASX 20 to 50, 50 to 100, or whatever. So we do show comparatively how this particular company looks in comparison with the median, and we know that our clients like seeing that, and that does tend to show when something is way out of kilter. If it is way out of kilter, we expect the remuneration report to actually tackle that issue and explain why; and in fact if it's really seriously out of kilter and it doesn't explain why, on that alone we will recommend voting against the remuneration report. The reason for that is to actually try to control these things.

If you read particularly the preamble, it's not possible for the owners of the company to actually set the pay. They have not got the information to be able to do that, and it would be hugely dangerous to give them actually control of the pay, because they hire the directors to do that. The solution is if the directors aren't doing a good job, replace the director. That is how the animal is supposed to work.

What we are seeing in Australia is that we are getting, as Michael says, in some cases outrage against the remuneration report. We are not yet really seeing that translating into voting against who might be the accountable directors; for example, the chair of the remuneration committee. We actually have a policy in CGI Glass Lewis that if the remuneration chair is up for re-election and the remuneration report is really bad, we will actually recommend against the re-election of that person. I think that is how the system has to work. I have to say that we are not actually seeing that particular recommendation being implemented as yet. But with the downturn, the recession, who knows? It will start sometime. The question is when.

MR ROBINSON (GA): One of Robert Fitzgerald's other elements of his question, I don't think we adequately answered, which is the reasonableness of pay. I think the perspective that the board, institutional shareholders and the board's advisers have is that pay tends to be reasonable in a market context, rather than reasonable in an absolute sense or relative to what non-executives are paid. So I think it's really what a response that you may want, but these aspects have not really featured in an assessment of reasonableness.

It's really, "Is it fair, given the market?". So a fundamental question has to be, "Is the market efficient? Does it allocate resources efficiently?" "Efficiently" is, "Are we paying the least we can get for the most competent we can get to deliver the best value?" So this is an important question, "Is it an efficient market?" There's lots of elements to this; it's very complex.

But on an international comparative basis, Australia, despite its growth and its need for migrant executives constantly, does seem to have the lowest cost for the resources and productivity you could see delivered. Executives have delivered quite good productivity for less risk, that is, less volatility, than other countries. So it's quite good value for money we appear to be getting. But relative to the regular worker, that's not a concept in the assessment of reasonableness.

MR FITZGERALD: Is it your view that that's an appropriate position? That in fact the relativity to the average worker, be it in the company or the community generally, is an inappropriate way of seeing it? Or does it have any place at all, to put it in a more general sense? Many people have said to us it doesn't. Some people have said it should. But I'd just be keen to know whether you have a view as to whether it should in fact play any part at all in the consideration of remuneration.

MR ROBINSON (GA): Okay. I should preface my comments by saying I'm not the economist in our firm.

MR FITZGERALD: That's fine.

MR ROBINSON (GA): But I think it might be good for the commission to consider what is the greater good. To have a growing healthy economy and having people creating wealth that is distributed; throughout to superannuants, for example, or people that have superannuation funds; employment growth; as the economy grows, the earnings of everyone grows, so how best to achieve that.

You do need good people, experienced people, competent people, to deliver the productivity gains. In Australia, as I said, on a comparative basis, if you look at value delivered, in terms of value to our pension funds, versus others, and the riskiness of those listed companies, compared to other countries, the executives appear to have delivered for lower cost. So it seems to work from a greater-good perspective.

MR FITZGERALD: Thank you for that.

MR EASTERBROOK (CGIGL): Just one other comment on that is that it would be nice to use the reasonableness, but I ask you how are you actually going to do it. Given the way the corporation is structured, if you accept that it's the board that has to do it, and I don't see any alternative to that, then the way that you get things done properly is you make sure it's a damn good board. Really what has to happen is that the institutions have to insist a bit more on getting a damn good board. That is the heart of it. The animal is such that you can't deal with that outside the animal. You have to have people inside the animal who actually have got all the information to make the right decisions.

So in a sense, talking about reasonableness, it's a nice concept; but how are you going to implement it? Actually one way I think, the best way that you can do that, is to get the right disclosure. Part of the problem at the moment is that there's a lot of sensationalising about people's pay. In fact often what is disclosed - and this will particularly be the case in the downturn - the executives don't actually realise it, because they don't make their performance conditions. So what we would like to see, and this is what we will be suggesting, if you would like us to deal with 300A, is to get the right information in there so it's disclosed, and then you can put the acid on institutions to actually use that information in their monitoring and holding to account the boards.

PROF FELS: So I have a few things. One thing I just wanted to follow up from Robert Fitzgerald's questions, which to some extent you addressed, but putting it another way. You I think expressed a degree of satisfaction, or low dissatisfaction, with the current system I think, and yet there is a very big mismatch, in my view, between sort of those views, which we are hearing from a lot of people who are interested in this inquiry and what appears to be general public opinion, and I

wondered if you had any comments on what seems to be a mismatch.

Now, on a couple more specific things. On the non-binding note, as you mentioned, it has no legal consequences. It may have these other consequences you have mentioned. You also suggested that it has implications for the chairman of the remuneration committee, and so on. Have you given any thought to the possibility of making the vote have some consequence, for example, that it would force an election at the next meeting of, say, the person who is chairman of the remuneration committee, or having some consequence attached to a vote, maybe not a binding vote but so that it has some impact.

Just on another thing, what are the actual market constraints on executive pay? I mean, normally with wages we are told, "Well, these are a very big cost and it will be harmful to the firm, it will price itself out of the market with high costs." Executive pay is a tiny fraction of costs. I just wonder what are the real constraints if someone digs in.

Also it's a bit like the situation when you're buying a house, that some people they see a house and that is the house of their dreams and it is the only possible thing that they will consider and then they end up being trapped into paying lots for it, when they should really look at a set of houses at different prices and choices. This doesn't seem to be the way it's done with executives. You don't ever hear people bidding for a job on the basis of they'll be a bit less costly, and so on. So I was just wondering about the market constraints. So there's three questions; if I you can remember any of them.

MR EASTERBROOK (CGIGL): Can I deal with the suggestion about what else would one do about the non-binding vote. I mean, it is supposed to be a warning shot across the bow, you know, that the shareholders feel they're not handling it properly. By the way, it's not just that the report gets voted down, there are very few of those. So if you were going to do anything, you were have to say, "If there's a material vote against it," and we would discuss what might be material, but we know that the directors are extremely sensitive even if there's a 5 or 10 per cent vote against them. You could have a situation where maybe the chair of the remuneration committee comes up for re-election next year.

PROF FELS: We did consider that.

MR EASTERBROOK (CGIGL): We know actually that quite a lot of boards regard being the chair of the remuneration committee as being a poisoned chalice, if I could put it that way. But nevertheless, it's a very important job, because it's really important that the board actually handles this properly, for a whole lot of reasons, including the reasons that Robert Fitzgerald has raised, because you don't want to

have a mismatch in the public perception about this.

MR BANKS: Would it make it harder to get people to volunteer for the remuneration committee if the sanctions were elevated?

MR EASTERBROOK (CGIGL): Well, yes, it's interesting. I mean, some companies remunerate their non-executive directors according to what committees they are on and whether they're a committee chair. I wonder whether there would be a special high price for the remuneration committee chair. I think, as Michael says, we are on a journey, and, you know, the boards are getting much better at handling remuneration.

But even among some of the big companies, in our view, there are still some people on remuneration committees that don't seem to have the right skill sets. That is another issue. The committee's job is to handle the nitty-gritty for the board on remuneration, because it's a complex issue, so you need people who actually have got the technical ability to do that. Michael, I don't know whether you want to make any comment about that. But we are amazed sometimes at the sort of babes in the wood some directors are on this.

MR ROBINSON (GA): I think it's a legitimate thing for you to consider, which is, if there's a large against vote, should the directors of the rem co be up for election. We didn't recommend that. We think there are other things that can be done that will improve the efficiency of executive rem. But the assumption underlying a special election vote for rem co directors with large "no" votes on their rem report is that they're more accountable than the full board, and if you're considering that I think you need to consider the full board, because the rem co is doing the nitty-gritty but it's the full board that's really accountable for remuneration decisions for the top execs. So you need to consider the accountability aspects.

MR BANKS: Just following that on a little bit further, I mean, some have said to us that there's a range of things that could be done as a consequence of a significant no vote. Another one, a very basic one, in the realm of communication might be that an explanation came back to the next AGM as to how the board responded to the negative vote at the previous one, how it interpreted that, what it did in terms of communicating with shareholders and what in turn it did as a consequence of that. Would you see any value in that?

MR ROBINSON (GA): I would see value in that, because a lot of the time you get a large no vote not because the remuneration framework is actually faulty, it's just that they have poorly disclosed the rationale. They haven't explained why a pay-out outcome was the way it was, yet there may have been a good rationale but they have poorly disclosed it. So I think giving them another bite at the cherry to say, "Look,

explain why that happened or what you have done about it," I think is not a bad approach. But then again we have got to establish the threshold. What constitutes a threshold whereby you have to do that? Is it 10 per cent, 20 per cent, 30 per cent no votes. Sandy, have you got anything to add?

MR EASTERBROOK (CGIGL): No.

MR ROBINSON (GA): Actually Allan Fels mentioned a couple of other things.

MR EASTERBROOK (CGIGL): Yes, what we are all talking about is how do you get the board to do a better job and what incentives can you apply on the board to do that. We do know that boards do react if there's a significant vote against it, and that's reflected in the fact that they come and talk to us. So they are getting the message. What you're suggesting might have been a good idea to put in at the beginning. Whether it's necessary now, I'm not sure, because they actually are getting the message.

Again I go back to the fact that when I first got into this governance business, and I'd left Mallesons in 93 and I was all bright-eyed and bushy-tailed and thought, you know, I'm going to change the world and all of that, but in fact it does take an awful long time. It's like a market, you can't push a market faster than it will actually want to go itself.

MR ROBINSON (GA): Allan Fels mentioned something else, if I can get back to him; what constraints really apply to pay. Well, let's take a couple. One is the supply and demand, and I think that's the primary driver really, when you get down to it. With supply and demand, there are two situations that can have very different outcomes. You can have a supply that is met by internal resources, you've done your succession planning, you've developed people and they are promoted up into the job.

So for any executive vacancy, assuming a span of control of about eight, you've got eight potential prospects to be promoted up into the job. So it's a competition amongst them, you've got a good adequate supply. Maybe only two or three might be eventually deemed suitable. It's a promotion, so, you know, their power is somewhat less in the negotiating process; it's a buyer's market, and the board has considerable power. This situation contrasts with an external appointment where the board perhaps hasn't done its job, or, for other circumstances, there was an unexpected vacancy in the top job, or top jobs. Then you go to the external market, you do a search. If you're talking an ASX-200 company, the smallness of this market means that it is comprised of oligopolies. You've really only got three or four direct competitors.

You are searching for an external executive, they're well ensconced in their

job; if they're performing well they're pretty secure, they're getting paid okay; you'll have to pay a premium to unseat them, and even then you may not be successful. It's a seller's market in that situation, particularly if you're going offshore. If you focus on the one or two executives that you believe would meet the job requirements then certainly a seller has got the negotiating power. So it depends on how well a board has managed its supply.

We estimate that about 30 per cent of vacancies are filled externally, the rest are internal, which is I think one reason why Australia performs quite well versus, say, the United States, where there's a lot more external appointees than internal. There is quite a disparity between chief executives and the next level in the US that you don't get here, where pay is a lot more egalitarian. So that supply/demand is critical, and how well a board does its job in terms of ensuring there are potential successors is a critical component of that.

The other is something known as the outrage constraint, which we have mentioned before, which was first put forward in a thesis by Bebchuk and Fried in the United States. They talked about the concept of managerial power saying it was excessive there and that would explain the high rates of increase, and to some extent I'm sympathetic to that view.

In Australia and the UK it's quite different than for other countries because you have this vote on pay and there is an outlet for outrage and it's a formal mechanism to let the board know how they are managing these operational matters and that is, we believe, to be a quite effective constraint.

MR FITZGERALD: I'm conscious of the time but I just want to ask one question in relation to termination. If there has been an outrage in the Australian community it's about the termination pays and we're well aware that a lot of what's reported is not necessarily accurate in terms of what the amount is or what it covers. But nevertheless there is obviously a concern. The government has responded in one particular way in relation to termination payments. I was wondering what do you think should be the appropriate response, both from the government and from the ASX governance bodies and so on, in terms of termination pays? I think most of us would have this view that sometimes we find it incomprehensible that poor performing companies end up paying very large sums despite all the complexity.

The other thing too is it's very interesting that it appears that very few people are actually terminated. They all seem to resign and yet they're given termination payments. Most workers would not get those. So there seems to be a couple of things happening at the time when it comes to an end and even when performance hurdles haven't been met, ex gratia payments are almost paid at that point. So what is the right approach to try to deal with this area where I think people are genuinely

concerned and confused as to how people can attain payments after two or three or four years in the role?

MR ROBINSON (GA): Maybe if I can respond to that and, Sandy, you've probably got some good examples. I think being promoted to an executive role is a career limiting move. That's a good way to think of it. It is a very high risk appointment. The average executive tenure in an Australian listed company is about five years and the job is like drinking from a fire hose. Your performance is assessed on the market value that you deliver. But already the market has factored into your share price future expectations of what you're going to earn. So, therefore, to perform you've got to exceed market expectations on a continuous basis. It is a high-pressure job of which the failure rate probability is going to be quite high - the enormity of expectations, competing against other alternative investments. I think the failure rate is probably a lot higher than you see with resignations. People are asked to move on.

So it is a high-risk job, it's probably your last job because it's a small world in this space and people do know your circumstances and how you performed.

MR FITZGERALD: When you say "probably" is that an empirical statement? "It's probably your last job once you get elevated."

MR ROBINSON (GA): In most circumstances probably your last executive role, yes, and then you're booted upstairs and maybe you might take a few board jobs, although it's interesting most executives are reluctant to take on board jobs; they don't like being in the public domain. It's a very non-private job compared to, say, private equity where a lot do end up, for example, or in private companies where things aren't disclosed. So a lot do go there. It's unfortunate, we'd prefer to have more of that experience on boards. So, yes, many of them don't secure another executive position. These people are late 40s, early 50s, a long work life ahead that is perhaps terminated early.

In terms of the termination provisions, I think most people - in fact I have yet to meet anyone who thinks that seven times, which was the original Corporations Act requirement for a shareholder vote under Section 200, was reasonable. I think most people would say it was just too much. Where should it be set? The government has set 12 months' annual salary. Is that reasonable? I think to most people that is a reasonable limit. Should it be set in hard, black letter law before you need to go to a shareholder vote? Our belief is that it shouldn't; it should be soft law, as in explain "if not, why not". Primarily this is to allow companies flexibility for the attraction of migrant executives, because no other OECD country, to my knowledge, has a 12 months' termination provision.

In the European Union their governance code says twice is okay. In the United States the generally accepted level because of tax limitations is 2.99 times average base plus bonus. So by limiting termination pay to 12 months limits our available migrant executive pool that we can recruit. If we said three times as the maximum in hard law, that might enable us to attract off-shore migrant executives, while in our soft law we say 12 months or explain why not. This allows us to access a migrant pool, but otherwise 12 months pay is an acceptable level.

MR BANKS: Could you just explain why it impacts particularly on recruitment of executives from overseas?

MR ROBINSON (GA): If you're looking overseas, executive termination provision is more generous. So why should they go to a job with lower termination provisions; particularly a job that is as insecure as an executive role where the tenure is quite short and is likely to be their last career job? This is an important consideration.

MR FITZGERALD: But can I ask this: why are the risks associated with this not evidenced in the annualised pay and the incentive pays. It's an odd thing that the risk is in the termination end whereas you would expect that risk, given that we know that they are very short terms now, three and a half years, four, five, so all executives know that. They know there is a reasonable risk they may not serve that out. Why is that not reflected in the normal base pay and incentive arrangements? Why is it end-loaded, I think, as Gary said in one of the speeches, "You can have a dowry up-front or you can have a divorce settlement at the end." But it seems odd to me that so much is at the tail end when in fact the risks normally would be spread throughout the term.

MR ROBINSON (GA): I think it is. The reason that it doesn't appear so is that the disclosure is inadequate. I am talking about the accounting value of long-term incentive that is paid in equity. You don't see that realised value of the amount.. Anything that is based on share price or share value is called a market measure. The accounting standards require an accounting value that's set at the beginning and it's amortised over the service period and it doesn't vary. Whereas in reality good performing executives realise that value or more - usually more - and other executives realise zero.

So what the remuneration reports don't disclose is what we call realised remuneration, what's received in the hand. If you saw this it would evidence a huge disparity in pay based on performance. We know that because as a firm we have done that work for our clients where boards are very concerned that their pay appropriate for the performance that is being delivered.

MR FITZGERALD: Why don't boards disclose that now? We've had a number of boards say to us they're concerned about what the public is told doesn't bear any relationship to what is actually paid. Our view is, "Well, why don't you put it in the report." No-one has said they do and all of them have said, "Oh, no, it's a complexity." My simple view of that is, well, you can't have your cake and eat it. You can't criticise the public for not understanding what people are paid when you actually don't disclose what they were paid. So why is that not happening?

PROF FELS: In some cases they get more. We hear all about when they get less - well, we hear a bit about when they get less.

MR ROBINSON (GA): You are quite right, there is a reluctance to go down that path because once you set a precedent you're stuck with it and there might be examples where they get an outcome that isn't properly aligned with performance. I think a lot of them have considered this and just say, "We should just stick to the minimum required in the law and that's it." I think you'll see some exceptions this reporting season going round, that is, you'll see more realised pay. But once they go down that path they can't go back. But while you will see more of it you'll get inconsistent standards in how it's worked out. Some companies will not be doing it. But I think from a shareholder perspective it will be valuable to see that outcome.

So, yes, I think there is a lot more variability than we have witnessed. It will be good to actually observe that. Pay on the whole does vary with performance.

PROF FELS: So if it went up 96 per cent versus wages 32 per cent in the upswing as some research suggests, are we now going to get executive pay falling 60 per cent below wages? Are we going to get a symmetrical downturn.

MR ROBINSON (GA): I think there is reasonable symmetry. It's not a perfect symmetry and where the market value of firms have lost 20 or 30 per cent you certainly won't see the reduction in the remuneration of that order, it will probably be in the order of around 10 per cent.

MR BANKS: Because of base pay?

MR ROBINSON (GA): Yes. Base pay being the fixed element, so you get that irrespective.

When you set the performance requirement for a short-term incentive, most boards take the view of, "Where are we today" when they set the performance requirement, "so what's a reasonable benchmark performance to set given the circumstances today?" So it's got to be an improvement on where we are and to be motivating it still has to be within reach. So some get it, some don't.

MR BANKS: So short-term incentives could go up in a falling market?

MR ROBINSON (GA): It's possible, yes.

It is important to understand for ASX-200 companies over 60 per cent of the variability in market value for a particular company responds to market sentiment. The rest is the alpha, what management contributes. So a lot of the rise and falls from individual companies is attributable to general views of the market, and our pension funds invest in all the ASX-200, because it's such a shallow market. If it was a much bigger market, you may not get such uniform increases and falls across all companies that you get here, because here you do not get much to invest in. It's not a very deep market. Sorry, this gets complex.

MR FITZGERALD: Just a technicality on the termination, if I can just go back to that. Some people have criticised the government's response, not only in terms of whether the 12 months is appropriate or it should be some other figure but the unworkability of it; that is, they say, "Well, how can you have a vote when you've already terminated the person and given them the remuneration?" So I am just wondering, how do you deal with that. Whether it's 12 months or twice or three times, how do you deal with this issue? I presume you have to in fact disclose in the earliest remuneration point when you employ somebody. But how do you deal with that issue about a shareholder vote, when the person has actually been terminated and paid out?

MR ROBINSON (GA): It's very difficult. It's pretty unworkable really, the framework that is going to be legislated, depending on the Senate. Our concern, from a market efficiency point of view, getting the best value is going to constrain our ability to recruit offshore, even though that's a small component. We rely on migrants all throughout our economy to meet our growth needs, and it's going to limit the pool. So they will make it up in one aspect of pay, so base pay might increase markedly to make up for the termination pay limitations. It's going to distort the market in all sorts of ways.

MR FITZGERALD: That concern would have existed when you had the seven-times rule or the seven-year rule, and so we have had a law that said seven times and then you have to get the shareholder vote. Now we have shortened it. Is that because people said nobody gets to seven years, so it's never been a problem, because it's the same structure?

MR EASTERBROOK (CGIGL): What will happen is you won't be able to agree to pay termination beyond the statutory limit. The current statutory is seven years, and if you want to pay more than that you'll have to get the shareholders to approve

it; you clearly can't do it. The same situation will occur with the one year, and I think what Michael is saying is that to go from seven years to one year maybe that's sort of overcooking the rabbit.

But I agree with you that boards should disclose what they're doing in these situations, and we have given you some examples at the back - some egregious examples, as Michael referred to them, and I think there are a couple in there of termination. In fact we recommended against it, because they told you the what, they didn't tell you the why; and there might have been a good reason, although in those two cases it's pretty difficult what it was.

We think actually disclosure has got problems because it has ratchets effect. But we are not going to go backwards in disclosure, we're not going to sort of go the other way, so let's get the disclosure right so that these sort of things are properly disclosed, and that is one of the things that we might take into account in 300A as to that. Coming back to STI, last year we were particularly looking at companies if that don't seem to have performed particularly well last year.

There were quite a few companies in that category, and yet there was quite a big STI and there was no explanation of why it was, well, that was a bit of an issue for us. In fact in a number of cases we recommended against a remuneration report because they didn't explain, it didn't look right. In fact there were other companies which did explain it well, and I don't want to sort of name companies here but I'm happy to do that confidentially.

There was one particular company I can think of where specifically in the remuneration report they said essentially, "Look yes, we haven't performed as well as we did last year, but the reason we gave this STI was X," and actually it made sense as to why they did it in that situation. If you're going to have disclosure, our message I suppose at the core is let's get the disclosure right so that the information is there, particularly for the institutions because they're the ones that have got the voting power and the engagement power. But also if you do get the right information out there, maybe that will help the public perception as well, because they will actually see, as Michael says, that the real remuneration that people get, it does move in line with performance.

MR BANKS: I was going to ask you about equity holdings. You have made a number of recommendations to encourage I guess new sort of long-term equity holdings in the suite of remuneration. One of your recommendations relates to taxation and changing tax regulations to promote those outcomes, and you had one in particular relating to the alignment of taxation with benefits received. I just thought I'd give you the opportunity to comment on developments in that space recently, in terms of the draft proposal in relation to the taxation of share schemes and whether

you believe now that that's working or whether you believe that that's going to create a tension with that objective that you're highlighting here.

MR ROBINSON (GA): Okay.

MR EASTERBROOK (CGIGL): Well, can I? We partially got into this global crisis because there were remuneration systems, particularly in America, which were driven by tax to be structured in a particular way, with executives being provided with incentives to take huge bets with the company, they had vast amounts of options. We haven't had that this year and that's partially why we haven't had some of the problems. This is a journey we're on. I mean, we're all still learning about governance, if I can put it this way, and so what has come out of that is, well, look, that was just a silly thing to do. We shouldn't have been providing people with these incentives, because what happens is that some of them did badly - the company - and it didn't come off.

So where governance is going in terms of best practice now - and it's actually turned on its head because the previous concept was, "You shouldn't be giving executives long-term incentives going beyond their departure from the company because they're not working there, so why should they have it?" and we actually were in approval of that in the past - but the lesson that has come out of the crisis is actually the legacy is pretty important. You can see this in what APRA is proposing, which is that there should be an element of clawback. You don't get either/or or a portion of your long-term incentive unless you leave a good legacy. In other words, the performance period goes beyond your departure, significantly beyond your departure. So that, for example, you attend to succession planning properly, so you make sure you've got someone to run the company that's actually not going to stuff it up, because your money is at stake. This is where the sort of best practice is going.

The problem is that under the current tax system, the guillotine has come down as to when you have to pay your tax and measure your incentive when you leave the company. That's no longer appropriate. If you accept the logic of, "Let's make these executives leave a good legacy behind," so they won't get it until a number of years after they have left the company, you need to address the tax system to enable that to happen because it can't happen if you tax the executive when they leave because they have got no money to pay the tax with because they can't realise - - -

MR ROBINSON (GA): I think Sandy has summarised on the termination provisions quite well, and I think Regnan, who will be speaking later today, will have a point of view on this, and Erik I know will point this out. So yes, I think that's one of the issues associated with termination. On termination you are taxed at cessation of employment on any equity that you have in the firm. That still may be subject to forfeiture provisions because you haven't performed after you've left the firm. We

think that is wrong.

There are a couple of other unintended consequences of the tax on equity as proposed. Our concern here is that at the smaller listed end of the spectrum and I think we shouldn't lose sight of the unintended consequences of any regulation or any taxation on all listed companies, or all companies for that matter, because a lot of the sources of wealth for this country and growth are at the small end. At the small end, particularly start-up companies or immature companies, you want to attract good talent to run those companies, and particularly in Australia it's noted in the resource and energy sector. And often that training and talent is nurtured in large companies to attract them out of a large company where they are getting quite high pay. They say, "Look, we can't match the pay, because we're a small listed company, we've got limited cash flow, so we'll give you equity." That equity is sacrificed for salary that they have forgone. You are getting far less cash. "Here is equity. It's what you can make of this company and you will get the benefit through options."

Now, under the current draft regulation on tax, immediately on receipt, that equity will be taxed, so that will reduce its incentive power. It will reduce the ability of the small companies that are primary sources of growth for this economy to attract talented individuals for far less actual cash money. This I think is not a good outcome. There are other examples. The United States, for example, despite all its faults in governance, managed to develop the most successful technology industry in the world because they were able to attract executives from large companies for very low cash by giving them equity in start-up companies, the same as here in mineral and energy companies. That's how the Fortescues and so on can transform themselves from the very small twinkle-in-the-eye companies to significant forces over time. That needs to be considered.

Another area of concern are the private companies, start-up companies, and also the little more mature companies, but their share registry is such that it is not particularly open. So you might give them equity and it might be subject to performance. If you hit the performance targets, your equity vests. Under the new law that triggers a tax event, but there may be no market to sell that equity into to get the cash to pay the tax.

PROF FELS: Can I ask you - it's a slightly oversimplified question - but supposing someone is paid \$100 cash, and I think you say they should be taxed at the marginal rate of income tax. I think I've read that in there. Now, supposing they are paid \$100 worth of equity. Should they be taxed at the same marginal rate or not? That's a slightly oversimplified question, but I'm trying to get at the principle of whether payments in equity should be taxed at the same rate as other forms of income.

MR ROBINSON (GA): The short answer is, on that simplified approach, yes. If

it's a supplement for cash, why shouldn't it be at the marginal tax rate? I think Erik will probably talk about the capital gains tax provisions, but one of the faults of the old tax regime on equity is that certainly in a lot of private companies, not so much listed companies, a lot of people elected to be taxed up-front and then got capital gains tax when they eventually sold the stock, which was half the nominal income tax rate. We suggest that basically equity be taxed at the deferral point, not up-front, which would be at an income tax - - -

PROF FELS: Accrual.

MR ROBINSON (GA): Yes, on a fair rate of pay, what you would otherwise get for cash.

PROF FELS: On the realised side.

MR EASTERBROOK (CGIGL): I'd agree with you that the medium in which you're paid shouldn't affect the tax, but the difference with shares is that if you're going to tax equity, logically the employee has to be in a position where they can turn that equity into cash to pay the tax. Part of the problem with the current proposals is that that won't actually be possible because there may still be some performance conditions. Again, looking at it simply, if you get equity, if you can cash a portion of it in to pay your tax, you should, or if you want to keep the equity, you can use the equity as security to borrow to pay the tax. But conceptually, I agree with you, it should be the same rate of tax you should pay. There shouldn't be one way where you can actually pay less tax.

I've sent the commission the submission that we put in to Treasury, and it's quite a short submission, Allan, in comparison to all this, but thanks to the questions you're asking there, you will see what we are suggesting.

MR BANKS: There can be a confusion between wealth and income, in the sense that if one is given shares at a particular point and that's given in lieu of income and you pay income tax on those at that time, but then those shares appreciate in capital value, it is appropriate to pay capital gains tax at the end of them, and you do that if you'd received them and you had them in a private capacity with a discretion to sell them at any time. But once it's within a kind of income plan, it's seen differently. Are there any other questions? We'll just have a quick look to see whether there was anything else we wanted to - - -

MR FITZGERALD: Just while Gary is doing that, you make a comment I think in the paper about limiting the disclosure to key management personnel. At the moment it's about the top five, roughly. What's your view on that? Some people have said to us that apart from fixing up disclosure, it should only apply to the chief

executive officer and some have said the chief financial officer and that's about all the shareholders are interested in. Others have a view that it needs to be broader. Do you have a view as to whom the disclosure should in fact apply?

MR ROBINSON (GA): I think that it really should be applicable to those that can influence remuneration policy and framework for the entire company and that it's harder to find but "key management personnel" under the current accounting standards seems to be an okay definition for that. The top five paid, the highest paid, may include personnel that should have a significant influence over company-wide rem policy. It's just the reason for amongst the top five is a market supply/demand.

MR FITZGERALD: But as an adviser to investors, are you concerned with anybody other than the CEO and the CFO really? Is there any reason to go beyond those two positions?

MR ROBINSON (GA): I think that's a good point and I think that that is worthy of consideration. In the UK of course it's just directors, rather than executives, and we have gone in this country further than that. So there is an argument for just the CFO and the CEO, particularly if there's a requirement to sign off on accounts that may be coming in - - -

MR EASTERBROOK (CGIGL): Yes, in the UK of course you tend to have more executive directors on the board.

MR FITZGERALD: Right.

MR EASTERBROOK (CGIGL): So although it's confined to directors you get more people, you do get bigger disclosure. But I suppose what we were concentrating on here is conceptually we are saying the people that may have a conflict should have their remuneration disclosed, that's the key issue I think. You could say, "Well, do you need actually five?" or whatever. It may depend on the company. I mean, if it was just a small mining company there may only be two KMP, but if it was BHP there might be more than five. So those are the sort of things I think we need to think about.

MR BANKS: The last thing I was just going to mention was that you have kindly provided examples of what I think you called egregious cases of termination payments and other things. Just to get you to comment on what you see as some common themes in those examples, the extent to which it's I suppose systemic. I think what you're saying is that the boards in those cases weren't doing their jobs and therefore if the boards are changed over time that will be sort of self-correcting, I guess.

MR EASTERBROOK (CGIGL): The number of cases - Erik probably wouldn't agree with this, but from our perspective, they're pretty isolated.

MR BANKS: So do you see these as exceptions?

MR EASTERBROOK (CGIGL): Yes, these are pretty exceptional situations, and because they are exceptional I suppose that is why they hit the headlines. I mean, if it was systemic, you would get many more reported but you would just get - you know, the sensations come out because they are pretty unusual situations. The other thing that I think you need to bear in mind on termination pay is that to get someone to take on the role initially, they normally have - well, when we first started it was pretty usual that you'd hire the CEO on a five-year contract; well, if it doesn't work out you end up with a pretty large termination payment to get rid of the CEO because he's contractually entitled to five years.

Michael has explained the risk element, you know, why you need to have some period there, and there was one particular remuneration report that had a very big vote against it because the CEO was actually was on quite a long-term contract, and this particular company had been a very big company and it was now rather a small company, so when you looked at its peers it was way out of whack as far as he CEO was concerned. So there are these sort of historical issues that you need to be aware of when you're looking at individual cases.

But we are getting to the situation where the practice in the UK is, after the first period that the CEO has been employed for, you normally then tend to have rolling one-year contracts after that, and we're starting to see that in here, and that actually of itself helps on this termination payment side because the contractual entitlement is much less.

MR ROBINSON (GA): Yes, but I think that our perspective is that you get these egregious examples because of poor board decisions. There is no malicious intent, it's just the lack of expertise at the time. With the disclosure requirements and non-binding vote, I think that's not a bad constraint on these sort of instances from happening again. The number of instances, among broadly based, widely dispersed shareholding companies is actually quite small. Over three years the number as a proportion of the ASX-200 is not very high. One egregious example is one more than we need. But, you know, how do we make it more perfect or a better system?

MR BANKS: That's our job. That's a good note to end on. Thank you very much for taking all that time to go through it. It's a very good submission. We will be drawing on it obviously and preparing a draft report. So thank you very much.

MR BANKS: Our next participants this morning are Regnan Governance Research and Engagement. Welcome to the hearings. Could I ask you please to give your names and your positions.

MS BENNETT (RGRE): Pru Bennett. I'm the head of corporate governance at Regnan.

MR BANKS: Thank you.

MR MATHER (RGRE): Erik Mather, managing director.

MR BANKS: Thank you very much for attending today and also for your submission, and also for insights that have come from other forums where we have been in discussion in the past. So I will hand over to you two to outline the key points.

MR MATHER (RGRE): Thank you to the commission for hearing us. We have a couple of brief points that we just wanted to introduce from the perspective of institutional owners. Institutional owners who retain us and in fact own us invest around 5 per cent of the entire capital of the ASX-200 index and those who have signed off are involved with the submissions we are putting forward.

The issue that we bring to the commission is a question of fundamental governance in operation of markets. We would observe that the growth in executive salaries has elevated executive salaries even in the average into the realm of rewards for entrepreneurship, and yet we would raise with the commission that the risks of entrepreneurship have not moved also with those entrepreneurial rewards, and we would see that as anti-capitalism to some extent. That is, it's inconsistent with conventional business practice. If we went out and created our own company on our own we would potentially enjoy significant profit, but if the business was not successful we would achieve, in some cases, no reward.

So therefore we think that there is an issue of efficient markets, fairness, and for the groups that we represent, in particular superannuation members, there is a fundamental issue that the person on the street is looking at their private savings, and part of our national savings, and their comment is, "This is not working for me." We have used the term in other fora in relation to executive remuneration "casino". That is, that an executive can preside over a period where the performance of the company is not successful, or immediately after departure is unsuccessful, as you have heard, and the executive under the current governance system has the opportunity to retire with their pocket full of cash; and as the superannuant on the street says, "They can retire because I can't."

This is significant for capital markets because our work suggests that superannuation has underwritten the value of the entire market capitalisation to the extent of 3 and a half per cent per annum on data that we have had available from APRA since 2001. In fact over the four years to June 2007, we would suggest, 19 per cent of the growth in our capital markets are simply the flows of superannuation. The risk for the commission is that if we don't get this issue on remuneration right and those superannuants direct their investments elsewhere then that is significant for our market.

So we have put forward to you a model that we believe addresses a number of these issues. The five key elements of that model are, firstly, total remuneration should be set by the directors. The key performance indicators also should be set by directors, they should as directors consult and engage with a variety of stakeholders, including those who own the company, but at the end of the day it's for the directors to exercise a discretion in that regard.

We then go on to say that in each company - and we're talking listed companies - the directors should set a cash threshold for their remuneration in any particular year, which could vary between years. Having set that cash threshold, the market reward that they have presided over, the difference between the market reward and the cash threshold that they have set, ought to be invested in equity in the company, common stock, the same as those people who own the company, and it should be vested for a minimum five years, and we believe it should be paid out on a five to 10 year vesting period, as we have put in our submission, at 20 per cent per annum.

We also accept that there are different needs of corporations and so therefore there should be the ability to opt out of such a model. So we don't believe it should be a rule but we do believe that it should be the standard; and therefore, to use a legal term, it should be a reverse burden of proof, rather than the current situation, which, from a superannuant's perspective, is farcical, that you must justify why you ought to have long-term strategies in remuneration in place. We believe that all companies should be paying over the long term unless they have compelling reasons otherwise. Our submission has documented our research that suggests that 78 per cent of all rewards in the 2008 year were cash and short-term benefits.

One of the issues that is a feature is that we believe that we must have post-retirement deferral of equity to align executives to their legacy. It's the old hollow stack log stack. We often don't find the benefits afterwards of the tenure of an executive. We see the situation now for example with a number of good businesses that, because the Chinese purchasing officer for example has stopped pressing the buy button, the executives and the company in fact are in distress; and, despite all of the wonderful good management for which there have been substantial payments, the solution in some of those cases is, "Well, we'll have to sell part of the

farm in order to pay for our management."

The investors that we represent understand and accept the notion of risk. But paying very good money for what in fact was illusory performance, and not related to necessarily the stewardship, doesn't seem to be a capital market that is working in the interests of long-term savings. However, at the moment the upfront tax proposal that exists in relation to equity, which is a moot point in the community at the moment, we believe is a disaster for efficient capital markets.

We think that the proposal at the moment that all rewards be taxed in the most cases upfront is a disaster waiting to happen and what we're looking at at the moment in terms of the community and the proposals that the government has put forward is in fact a hard-coding of a tax incentive in favour of cash and away from equity; and, ironically, that is a time when short-termism has been associated with the global financial crisis and investors and owners around the world are saying, "We want to align our executives for the long term." So at exactly the time when we would want every structure working towards an alignment over the long term, that is actually not occurring, and so we believe that this issue is significant.

Finally, on the termination benefits issue that the commission has been looking at, we would say that the strict application of the model that we have submitted, whereby whatever the market reward - being always a combination of cash, short-term incentives, long-term incentives and any termination if that does occur - be subject to a cash threshold. What we would be proposing is that termination benefits, assuming that they are above the cash threshold, ought to be invested in equity and paid over a five to 10 year period.

So therefore if the legacy of that executive is not fruitful, then we would see that as being reflected in the value of that termination benefit, through equity. Not all but a significant amount of the angst would go away because they would have what the person on the street would call "hurt money" aligned with the average owner of the company. Those are the opening remarks that I have. I will just ask Pru Bennett if she'd like to add any further points.

MS BENNETT (RGRE): I guess just to add on to that would be in terms of disclosure and the remuneration reports as they are at the moment. I've spent the last 12 years as a proxy adviser so I've probably read more remuneration reports than most. They are cumbersome and the reports themselves have irrelevant and confusing information for shareholders. We would support a rewriting of section 300A to provide meaningful information and comparable information for shareholders amongst listed companies.

MR BANKS: Including realised remuneration?

MS BENNETT (RGRE): Realised remuneration and also fair value, particularly fair value at grant date.

MR BANKS: Thank you. Just one point for clarification, in terms of your proposed reforms, what's the sort of regulatory form of implementation? You see this occurring through the ASX governance principles on an if not, why not basis? Is that what - - -

MR MATHER (RGRE): Correct. We believe that the ASX Corporate Governance Council under principle 8 which deals with remuneration, implementing such a model on an if not, why not basis would provide that clear signal that remuneration should be paid on this basis, but provide also companies with the flexibility to opt out of that. In a previous capacity, I've been involved with the implementation review group at the ASX, looking at those principles. When they were first introduced on 1 April 2003, companies struggled with moving away from the explain element of "comply or explain". There was a tendency towards boilerplate adoption of recommendations.

We have seen over time there has been, thank goodness, a maturing of companies in their understanding of those principles, so therefore we're confident that companies would now be able to move away from that model where they saw fit, again provided they explained to the owners of the company their reasons for so doing.

MR BANKS: Could you just comment further on why you would see that kind of approach being better than a more formal regulatory approach or black letter law approach?

MR MATHER (RGRE): The issue that I think everyone struggles with with black letter law is that as soon as you put up a legal constraint or mechanism, then there is an enormous industry which is motivated for one thing: how do we get around this? The resources available in that capacity are almost unconstrained. What we have is forces of lawyers and accountants creating structures whereby there will be a movement around this. So therefore the hard regulatory approach, it's difficult to have an enormous amount of confidence, despite the best work of drafting or whatever, that will actually achieve the outcome that it is looking to achieve. We're also not so naive that also share owners have to exercise and perform their role, which is to remove those directors who struggle to implement appropriate remuneration strategies. Having said that, in the words of Justice Neville Owen in the HIH royal commission, he said this, in chapter 6.3, that:

If shareholders as owners do not convey or feel constrained in conveying

their expectations to managements and directors, then those managements and directors will lack guidance from those whose interests they are supposed to serve.

We would say that the regulatory regime, including the corporate governance principles of the ASX, have so far underachieved in providing a very clear signal in relation to the need for long-term strategies in relation to remuneration, and whilst Australia has a very good governance regime, the reality is for the person on the street, we have a very poor practice because irrespective of the performance of the company, an executive can be paid handsomely in relation to their tenure, and in particular, as we have seen in more than just a couple of instances - and we have deliberately provided you with examples in our submission that are not in the financial services sector - whereby the opportunity arises and continues to exist whereby the executive can walk out the door with pockets full of cash and the only person who bears the risk is the continuing owner.

As you've heard in your previous discussion, because of the diversification of superannuation investments in Australia, the reality is that most superannuation funds and most superannuation strategies will always invest, in the vast majority, of the top 200 companies, and therefore will always be exposed to the legacy - and therefore my point again that I'm emphasising, a dysfunction - because the legacy is borne wholly by those share owners and completely absent by those who created the legacy, and we say that's not capitalism.

MR FITZGERALD: In a regime that has an if not, why not explanation regime, what gives you confidence that that will actually perform better than the current governance arrangements? I mean, the signalling from all of the governance guidelines that we see in relation to rem are about a right balance between base pay, short-term incentives, long-term incentives. It's been around for a while. You say that in your view, the governance arrangements under the ASX governance guidelines are underperforming. Why do you think your regime will in fact perform better?

MR MATHER (RGRE): I think that what's happened so far with the governance regimes and the various protocols that are out there is that what they are articulating is an optimal standard and for a significant number of companies to a degree it's preaching to the converted. There are a number of companies who do get this, who are progressive, their boards are progressive and they're seeking to implement the right kind of strategies. The real issue is that we need to provide a minimum standard, a minimum standard whereby all companies need to abide, and one of the reasons that we focus on the ASX 200 is that membership of an ASX 200 index to some extent in today's market is a licence to print money. Simply by nature of your size, you will have investors buying your stock for reasons of diversification. The

notion that share owners can just simply sell their stock in this market is no longer true for the vast majority of superannuation. Technically it's true, you do have the option of selling the stock, but you'll have your asset consultant yell at you that you'll have to broaden your basket. So therefore those top 200 companies experience an enormous privilege of liquidity, and arguably it's moving towards the 300, so therefore it is appropriate to set a minimum standard of behaviour at least in that area.

The ASX Corporate Governance Council Implementation Review Group in relation to audit, recommended a prescription in relation to audit standards and independence of the audit committee that was applied to the ASX 300, significantly recognising the liquidity benefit that companies of that size achieved through compulsory superannuation and other savings. Has that answered your question?

MR FITZGERALD: Yes.

PROF FELS: Just a couple of things about termination payments in excess of 12 months. There's a couple of different bits of what you've given us; one is for 12 months and then elsewhere you mention I think two times 12 months' provision. I was just wondering if you could clarify exactly where you are lining up on that issue. Then I had a slightly more general question: you've emphasised very much this idea that there's a mismatch in that executives are paid on the basis of short-term outcomes and you believe that is harmful, it should be long term. This was written in a sense very compellingly, but can you point to evidence that would actually support the contention that the short-termism in pay is actually having these harmful effects that you have in mind. What's the evidence on that one?

MS BENNETT (RGRE): Just on the termination pay, our view is that the standard should be one year's base pay and up to between one year and two times, two times base pay, subject to an if not, why not analysis, and that makes most companies accountable for one year. Then there may be a plethora of reasons why it should be greater than one year and the companies have the opportunity to explain that on an if not, why not, and then above two years, subject to shareholder vote, because there are some unintended consequences that can come out by just fixing it at one-year pay. Some companies tend to set their base pay quite low. Macquarie Bank would be an example of that. It may encourage large sign-on payments. It may encourage much higher base pays. So I think by having the if not, why not sort of equation in between the one year and the shareholder vote does make companies accountable or more accountable than they are now for termination payments.

PROF FELS: Could I just follow that up for a minute. Say your rule was adopted, then people would say the same about the two-year modified rule, that is, that it would in turn possibly not meet all the situations of concern. So if one year is

arbitrary, two years is arbitrary. Do you have any comment on that?

MS BENNETT (RGRE): Looking through the statistics that we've been collecting, most companies tend to have one year base pay, plus pro rata performance conditions. A few - and I can't quote the exact numbers - ASX 200 companies would have higher than two, so I think that rule would cover the majority of ASX 200 companies that are behaving well and would catch those that do want to go outside the two times.

MR MATHER (RGRE): I think the other thing we need to remember is that what the proposal is on termination payments, including our own proposal, is that the board can still award a termination payment of whatever they want. All they have to do is they have to take it to the people who own the company, inform them and get their agreement. We don't think that there is anything outrageous with such a proposition that the proposal is that, "If you go beyond a certain level" - and I think your point, Prof Fels, in relation to where is that level, we've come up with what we think is a workable level, we don't think there is a perfect level - we think that what we've put forward which is 12 months, you're okay; 12 to 24 months gives you some flexibility, and you have to explain, and then beyond that, you have to take it to the members of the company. But the worst-case scenario is that the board has to go to the people who actually own the company and say, "This is what we're proposing to do." The only board who is not going to be successful in that regime is a board who doesn't have well-considered reasons and cannot communicate those reasons to the shareholders. We have to say that if a board here is incapable on both of those heads, it probably is not just incapable in relation to termination payments.

MR BANKS: Just on that, the previous participants were talking about impacts of that kind of provision on recruitment overseas. Would this be ameliorated by what you're suggesting or would that still be a problem or do you not see it as a problem?

MR MATHER (RGRE): It depends; if you're going to hire out of the Japanese market, which doesn't happen very often, but of course remuneration isn't an issue in that market at all compared to our rates. I mean, what we're really talking about - to call a spade a spade - we're talking about whether you're going to recruit out of the American market. We're talking about the American market where enormous amounts have been paid for some time with a banking system which has all of the things that we have now seen in relation to the banking system, of course their car manufacturing et cetera, so I think we need to take a bit of a cold shower about the difficulties of recruiting out of those markets and the benchmark that's been provided because we would put forward that the rewards that have been provided out of that market in the United States probably have been to a large extent illusory and on a broad scale.

Again, the consequences need to go to the members of the company. If the termination issue is so fatal, then perhaps it's not the right person for the job. It's as simple as that. We don't agree that it is so incredibly difficult to recruit these individuals. It is difficult to recruit a star who's got all of the sort of bells and whistles and every single mod con under the sun, and unfortunately shareholders have seen these stars come in; some of them work, some of them don't. It's a bell curve with a big tail.

MR BANKS: Falling stars.

MR MATHER (RGRE): This is it. So we don't want to be in the regime of saying therefore they are failures, and there's been some debates and prominent Australian CEOs have said we can and should only recruit in this market. But the other thing that should be observed is also governance is now a global phenomenon. In fact the International Corporate Governance group will meet in Sydney in a couple of weeks' time. The European pension fund investors and sovereign wealth fund investors and the Australian and the Asian and American investors are all getting together and they are discussing these issues and they are working collaboratively to normalise some of their concerns and these concerns are not an Australian concern, they're a concern across the board. I think in the previous hearing you heard that the practice in the United Kingdom is 12 months.

Could I just talk about the mismatch. I think the issue, Prof Fels, is a question of externalities, so it's just not the shareholders, there's an external with the shareholders - that is, that the executive performs in a certain way. For example, "I'll grow my loan book by pursuing unsustainable lending practices," having built that loan book and the market has priced that in an inappropriate way and beyond a reasonable value. I then cash in my chips, which is the remuneration casino, I retire, I take my termination payments or the other benefits that are accruing to me and I walk out the door. Then as a consequence and the legacy for the next executive is that they see the unsustainable practices that occurred.

You've got also the legacy of, if you look at examples that we have seen with the Australian Wheat Board, unsustainable business practices and facilitation payments that not only destroyed shareholder value but they resulted in community costs, in terms of every single Australian company I dare say that's going into some of those markets today gets asked, "Are you going to do an AWB on us?" In a similar way with James Hardie, the year before the externality was starting to be borne in the share price the CEO of that company at the time received a \$1.4 million bonus, and I think very few investors would say that the bonus was well earned, given what actually occurred with that company over a long period of time. So we would say that there are a number of examples where that could be documented. We've given you also three examples in our submission - again, deliberately outside of the

financial services sector - to suggest to you our position which is it's across the board in terms of the potential for this to occur.

MR BANKS: Again, the previous participants also had their list of egregious examples, but I think they saw them more as exceptions to the rule and generally attributed them to failings at the board level of the companies concerned. Do you want to comment on that, just in terms of the performance of the boards in these cases?

MR MATHER (RGRE): The performance of the boards in these cases, our position would be that there is no one group that can be blamed in relation to this, if you look at convertible debt obligations or other exotic instruments that have also been associated with failures. The reality is that somewhere, some investor was buying those and that investor, whether it was a fund manager or a pension fund directly, someone was mandated and permitted to do that under their mandate. So I think that all investors have had an awakening, as you do with these cycles, and these cycles come and go. This one has just been a bit more pronounced than the last few. So everyone has played a role.

We would say there is a systemic failure for the fact that an executive can produce what appears to be a good level of performance and under the current system in 2008, 78 per cent of the reward was cash and year term benefits. You could walk out the door and in a number of cases, within months of executives walking out the door, a bonus is being paid, the company was in administration or near administration or liquidation. You've got significant companies like Babcock, the OZ Minerals experience for investors. There are a number of different examples that you could pick. But whilst they have been the manifestations, the reality is that systemically, that could happen again tomorrow.

In a food and beverage company, for example - and this is a hypothetical situation - they could load up their product with a whole heap of sugar, and that of course is very tasty, implement it through a distribution system, for example, in schools, so we get mum and dad as well as the kids eating it and drinking it when you go to the drive-through takeaway place - you know, "Super size me, would you like your three-litre Coke to go with your hamburger?" or whatever it might be - and it looks really good. Sales go through the roof. Then in three years' time we have the community outrage with claims for obesity or whatever the other factors might be, say dental health. Those executives who built those wonderful sales, if they're as smart as they ought to be, they will have retired from the business and said, "I've got it to the peak," got out of the market and the share owners are left with that legacy.

MR BANKS: But isn't that again, that quite dramatic example, a failure at the board level to understand the implications of decisions in how production is being

cast or what innovations are occurring in product? I suppose it gets back to this question of boards and any comments you might want to make about I guess their role in getting better outcomes in the future.

MS BENNETT (RGRE): There's no question that the board is the important player in remuneration. The board - and particularly the remuneration committee - has the information and the knowledge to be able to structure appropriate remuneration plans and they know what drives the value of the business and will incorporate those drivers into any type of short-term incentive or long-term incentive. So you're right that those examples are as a result of - you know, come down to favour the board. What the Regnan model does is provide a delivery system of rewards, so it's not interfering in that process of structuring remuneration as the board sees fit. Shareholders cannot get involved and black letter law cannot get involved in structuring, particularly when it comes down to performance hurdles. One of the criticisms of some of the guidelines that are around is that companies tend to follow them so that they get a tick from the proxy advisers. I've been in this situation, talking to a chair of a rem committee and they said, "Pru, you'll really like this structure. It's a TSR against the ASX 100. It's over three years." I said, "Why did you choose the ASX 100 as a performance measurement?" He said, "That's what you proxy advisers want." So the Regnan model provides a delivery system to encourage long-term sustainable thinking of entities, without the interfering in the actual structure performance hurdle model part of the rem, because that really is the domain of the board and not shareholders.

MR MATHER (RGRE): I think the other thing, why we would say the commission does have a role to promulgate some sort of a minimum standard is that the way the market will work is let's take a hypothetical of the four major banks - again this is a hypothetical, in the same way as my previous example, as you said, was deliberately exaggerated, so I want to get that on the record - but let's say we've got the four major banks and three of the four have sensible regimes and they adopt, "Well, we're going to lock you in as the chief executive and your executives for rewards, the majority of which will be paid over five to 10 years, because that's better aligned with the majority of the people who own the company and it's consistent with our duty to the company in perpetuity as directors." Now, I'm the chairman of the fourth major bank and I say, "Well, I want to recruit Pru. I think Pru can really drive the share price over the short term," and I'm interested in the short term because that's the way I am for some reason - self-interest starts favourite in every race. Pru is going to come on board, and to recruit Pru, whether here or overseas - you know, all the others lock everyone up for five years - "I'll give you it all for 12 months. You deliver it all and I'll pay it out to you over 12 months."

So then Messrs Fitzgerald, Banks and Fels who are the CEOs of the three other major banks, they turn around to their boards and say, "Hang on, Pru over there, she's

got a great gig, she gets it all in 12 months. If you don't give me what she's getting, I'm going to terminate and I'm going to go over and work for them," and that's how markets work. So if we allow minimum standards to lob around too low, there will be a race to the bottom.

PROF FELS: What worries me in these kind of examples is that in a lot of areas where companies incur costs, there are quite a few constraints, like, "If this is a costly way of doing business," for example, "then it won't occur." Where the executive pays a tiny fraction of costs, it seems to me maybe the calculus is a little bit different. So are there serious market constraints on executive pay and indeed what are the constraints? I mean, are the boards doing their jobs or have they been a bit weak? The market, are there real market forces? Is it the law? What holds back executive pay?

MR MATHER (RGRE): The best reading that I have done in the face of the global financial crisis and whatever was actually by Hans Christian Andersen who wrote a little story called The Emperor's New Clothes, and that is the closest that I have personally found to explain this situation. Now, our day job is that we meet with a lot of senior executives and boards and chairs and a lot of chairs of major companies are former CEOs. We have a standard question which is, "Fred," or, "Mary, in your day, running a prominent company in the 70s or 80s, did you have this problem?" After they have gone through - because they are always in there to sell us on their remuneration strategy - as soon as we ask that question which is at the end of the meeting, the shoulders drop, the body language changes to a sensible conversational tone and they very quickly say, "No, it was never like that in our day. We got a decent salary, a discretionary bonus and we were very happy for that." I said, "Did you work any less for your reward in that regime?" and they said, "Absolutely no." The only explanation they have been able to give us is, "But we imported this from America in the 90s," and I say that advisedly because I don't think any shareholder in Westpac would complain with Bob Joss's reward, given the legacy of his tenure during that period. But of course that to some extent is a bit of a high-water mark example of when things work the right way. There are examples of where things don't work the right way.

I do think that The Emperor's New Clothes seems to be the only explanation I can see in terms of, "We can't pay any less than that because everyone else is doing it," and quite frankly, in the words of Hans Christian Andersen, anybody who can't see that paying a ridiculous amount of money regardless of the outcome is stupid, and everyone seems to have fallen for the trick. Pru?

MS BENNETT (RGRE): I just want to support what Erik has said there, but I do want to comment that there has been a failure of the boards. I've been monitoring proxy voting statistics over the last 12 years and there is increasing shareholder

activism when it comes to voting against shareholders. I think that was seen in the last proxy season, where a couple of widely-held companies had against votes up around 30 per cent. So I would hope that there would be increasing activism in the voting area and also in the engagement area which is what Regnan is involved in to try and get change at the board level.

MR BANKS: But the good old days that you're talking about though, just on that, you said it was base pay and they got a discretionary bonus.

MR MATHER (RGRE): Yes.

MR BANKS: Again, that's short term. You're saying we need to move to longer term. That's the trend that came from America, to move into equity and so on. The problem I think that you're referring to has been perhaps lack of performance evaluation contingent on those rewards being given or - - -

MR MATHER (RGRE): A lot of the KPIs tend to be in the realm of widget sales and widget margins and those sorts of KPIs don't tend to factor in longer-term consequences and externalities more broadly. An example of this is ethics in business. We've just done some work that suggests that 85 per cent of the top 200 companies have an ethical policy set by the board. The same survey concluded that 4 per cent of all of those top 200 companies actually have KPIs that include those ethics as part of the business. When you think about the financial services sector, where ethics and trust are your paramount asset alongside your physical assets, it does seem that we do not value those sorts of long-term issues in a way that would be appropriate in an effective market.

Can I just go back to a question that you raised earlier and build on what Pru was responding to in terms of the role of boards and market and what the commission may do and remind that our view is that notwithstanding five years of disclosure on remuneration, and copious disclosure in some instances, and a non-binding vote, the success of remuneration outcomes for the interests of shareholders hasn't exactly been stellar. I mean, you wouldn't be putting any of the performances on a platform and giving medals given what we've now seen, and the only organisation where we've seen a level of symmetry in remuneration - and I think it's fair to say we're still yet to see the next reporting season - is Macquarie Bank, where there does seem to be a level of symmetry down. That's because of the way their system is structured. We've put out that we think that there should be a five to 10-year vesting over the majority of remuneration and Macquarie has for some time adopted that for about 35 per cent of their long-term rewards up until they made some amendments recently. It's the only example we're familiar with.

Whilst we recognise that there are some boards now who are arbitrarily

changing the CEO's remuneration, whether it's a single or even double-digit percentage decrease in their base salary or a 12-month moratorium on bonuses or whatever it might be, what we would say is that that is a reactionary, rather than a systematic approach to produce alignment. It's a reactionary after-the-event approach, not a proactive approach.

MR FITZGERALD: We tested this with a group of CEOs recently just in consultations and when we talked about the fact of a longer-term vesting period, people were saying, "Yes, we think that's right," but their view of "right" was no longer than 12 months after you leave the job. The best we got was two years after you leave the job. In your scenario, you are talking five to 10 years potentially after you leave the job. It would seem to me that CEOs put this case: they simply say, "We can't be held responsible for what management does 12 months, 18 months, two years, three years, five years after we've left." So on face value, there's no problems if they're still in the firm, but once they leave, their view seems to be, "Hang on, we can't be held responsible for that after a period of time." You're at the extreme end of that position, particularly going five to 10 years. How would you justify this sort of length of time that you're proposing?

MR MATHER (RGRE): At the very least, we would much prefer the problem that the CEO is sweating over the legacy of their successor rather than the current situation, which is that they walk out the door, throw the keys away and never have to worry ever again. That's the minimalist approach. The second thing is that the response that you have been provided with has some substance to it, but there has not been a real exercising of the great minds that exist in our capital market as to how we might deal with that situation. We have, within existing remuneration strategies, change of control provisions; that is, if there's a change of control or certain events occur that we've agreed in advance, then certain consequences. Our model does not prevent the notion that if the board changes the strategy or whatever it might be that that would then be an unlocking of those previously subject to preservation benefits and that could be agreed. This is where boards could exercise their minds to create strategies that are appropriate for the business. But we do want to put out there that from a shareholders' perspective, it is not acceptable to have the current situation whereby the executive in almost all cases, subject to their ego and personal legacy, throw away the keys and walk away.

MR FITZGERALD: Can I ask you also a question: when you talk about common stock, in that expression are you talking about vesting of equity rights and options as well or do you draw a distinction between options and share rights?

MR MATHER (RGRE): I might get Pru to respond on that, other than to say that there is a potential that if you just structured it the right way, all you need to do is get the right number of shares and it takes care of itself.

MS BENNETT (RGRE): It could be share rights or options, and it depends on the particular entity and their strategy. Also, it could be a mix, depending on what type of risk behaviour that the board is wanting to encourage of the executives, so there's no restriction on the type of securities. But if there were options or rights issues which were subject to performance hurdles when those performance hurdles have been vested that maybe a certain percentage of those would then be subject to this delivery system which involves a holding over a period of time.

MR BANKS: But the threshold would be determined by the board at its discretion?

MR MATHER (RGRE): Correct.

MR BANKS: Given some of the concerns that we could attribute perhaps to weak boards in the past, would there be a problem that there would be big pressure to raise that threshold significantly?

MR MATHER (RGRE): There undoubtedly would be pressure and share owners have to play their role in this market to convey to the boards that if a board is weak in the face of that pressure or does not have a well-articulated position, then we want a process whereby the reasoning for that threshold needs to be explained. We're not looking to prescribe what the position must be, and it's the role of share owners to make sure that those boards who struggle to come up with an appropriate threshold look for another job. Shareholders have not done a good job in ensuring that there is a healthy transition process amongst company boards.

PROF FELS: With this inquiry, do you think there would be value or not in guidelines being laid down on executive remuneration or do you think that might be counterproductive?

MR MATHER (RGRE): Guidelines in what sense?

PROF FELS: In regard to best practice in both process but also in terms of the actual principles.

MR MATHER (RGRE): By the commission or elsewhere?

PROF FELS: Yes, by this inquiry, which governments in turn - or I could put it another way, because after all, all we do is report to government and then it's up to them. Is there any value in governments then setting some guidelines for executive pay (a) about the process, but (b) even more importantly, about some of the principles, like the principles you espouse on relating it more to longer-term performance and so on?

MR MATHER (RGRE): An initial response, without having given it more thought initially it could only be helpful in terms of providing a signal. The only example we've seen in this space recently is in fact the termination payments where the Institute of Company Directors in February put out an excellent publication that tested the waters and suggested that deferred benefits and other behaviours that we would support strongly ought to be considered by boards. Interestingly, what they did was they suggested that as the executive's tenure extends in time, then the risks to both parties on termination are lessened through that relationship and knowledge of each other and therefore there should be a ratcheting down of the termination provisions. There is a company director who has gone on the record to say that they found that very helpful in negotiating with a new CEO, so there is a precedent for those sorts of publications.

In some cases we feel that company directors are in need of and are looking for help from elsewhere because they are in the difficult position of arguing their case and setting a high-water mark; without share owners and guidelines to support them, they're put in a difficult position. I'd have to take it on notice as to whether government is the ideal mechanism. We've put out there that we think that the best mechanism at the moment would be the ASX Corporate Governance Council because they're prominent, they're flexible and historically they have been regarded as having a broadly balanced approach and representative of those are the owners of companies and the issuers of capital.

MR BANKS: Just on that, if they failed a "why not" test, what happens?

MR MATHER (RGRE): Share owners then have to roll their sleeves up and express their views, and probably in those cases get more active in the voting. Our observation would be share owners are much better than they have been, but it's coming off a low base.

MS BENNETT (RGRE): There's been a significant improvement but Erik is right, that it has come off a low base. My concern with the government being involved in guidelines, particularly if they become too prescriptive, in executive remuneration, that will become a standard and boards won't think about the best structure for that company to drive the value on behalf of shareholders. They will be just looking at the guidelines and structuring something around that which happens today with some of the industry guidelines, such as IFSA and ACSI, RiskMetrics and CGI Glass Lewis. I think guidelines have a role, don't get me wrong there, but I think that if governments are going to get involved in that, they would have to have a very broad-based principles approach.

MR FITZGERALD: But your preferred mechanism is through the ASX

governance. In relation to the top 200 companies or top 300?

MR MATHER (RGRE): We think all listed companies. We cannot see that any listed company has anything to fear from a regime that pays for performance that's developed over time.

MR FITZGERALD: Given that they're guidelines, it's probably not such a significant issue but some people or in fact a large number of people we've spoken to that are either CEOs or directors of public companies have said to us, "Whatever you do in the space of the ASX companies, you should do for private companies." If there's any cost burden at all, there should be a level playing field. Nevertheless, it seems to me that a lot of these don't relate to private non-closely held companies, but it's been put to us quite a lot that whatever the commission does, it should apply across the board, not simply to publicly traded companies. I was wondering if you have a view.

MR MATHER (RGRE): It's a useful exercise to whip out the private company every time you're trying to get up a tenuous argument, I have to say. The people that we speak to who are in private companies right now, what they say to us is, "We would kill for the liquidity that the listed companies have and the support of the market mechanisms," and the people that we speak to who are in private companies who are not enjoying good times are saying, "We are actually taking minimal salaries, if anything, this year and the next year, and our base salary is way, way, way below the companies that we invest in through our personal superannuation," and we've given you the figures in relation to the enormous support that the listed market receives from superannuation flows and the benefit of capital raisings. So we would say that the private company thing is, quite frankly, a bit of a bogeyman in relation to these things.

We have put a strong view forward in relation to the ASX as a mechanism to deliver this. We would also observe that we are a very tolerant society of capital markets despite the complaints on governance. Shareholders are probably the most tolerant beast ever developed, given what they have tolerated. We would suggest that the commission has an opportunity to give the market an opportunity to solve this through a carrot approach, and we have suggested a review within two years, so that if that carrot approach is not embraced significantly then the commission would be invited to come back and support government in coming out with a big stick.

MR BANKS: All right. Well, that has been a really interesting discussion and I thank you for the submission, it has some quite tangible proposals in it that we are going to have to consider.

MS BENNETT (RGRE): Thank you for giving us the opportunity.

MR MATHER (RGRE): Thank you.

MR BANKS: We will just break for morning tea now for about quarter of an hour.
Thank you.

MR BANKS: Our next participant is the Australian Shareholders Association. Welcome to the hearings. Could I ask you to give your name and your position, please?

MS DOHERTY (ASA): It's Claire Doherty, and I'm the policy and research manager.

MR BANKS: Thanks for coming in today and thanks also for the submission, which is a good substantial submission, like the other we have been discussing this morning. We also had a very good conversation with you when we visited you in Sydney. So as I said, I will just give you an opportunity to highlight some of the key points and then we will have some questions.

MS DOHERTY (ASA): Certainly. The Australian Shareholders Association is a not-for-profit member based organisation. Our members are retail investors in share market, and, more broadly, we represent the interests of retail shareholders generally. We produced a submission to the inquiry and tried, as far as we could, to answer many of the questions that the inquiry asked. The Australian Shareholders Association has been very active on the issue of executive remuneration and it's a longstanding concern of our members, probably predating it becoming a major public concern in the last 12 months to two years.

The Australian Shareholders Association is particularly concerned, and I think it can be seen in our submission, about the increasing expectation that executives will receive incentives and bonuses, not simply base pay, that this has now become an expectation that this is part of their remuneration, rather than an expectation that it's an award for superior performance well above what would be expected simply to be remunerated by base pay.

In the last 12 months in particular we have witnessed the disconnection between performance of companies and the growth in executive remuneration and the bear market has effectively thrown that into quite sharp relief, as far as the Australian Shareholders Association is concerned. In March of this year the Australian Shareholders Association launched a new policy on executive remuneration.

Our policies have in the past been relatively tight, but we have tightened up particularly around the issue of long-term incentives and the periods which are appropriate to assess performance which is required under those incentives and the hurdles. Insofar as regulation with regard to this area, there has been a lot of speculation in the press about whether a binding vote on remuneration would be helpful, and obviously we have considered this area in some detail. We have

however come down against a binding vote on remuneration.

We see that the advisory vote on remuneration has achieved at least incremental success in the last couple of years, but we would see that further regulation would be of most assistance by giving greater teeth to that resolution. That really means making boards more accountable and making them actually consider what that vote means and to react and respond to it in a timely manner. Those are largely what the recommendations we have made are set out to achieve.

MR BANKS: Just picking up on that, you recommended that you require 75 per cent support for the remuneration report to be carried. Do you want to comment on how that will sharpen things up in your terms.

MS DOHERTY (ASA): Yes. I think this has been identified by other submissions as well, I haven't had a chance to read all of them but I know I read RiskMetrics' submission and they made the point quite clearly, that it is largely a reputational issue for directors. In some companies where there are shareholders with large holdings it is much easier to get over the threshold for the ordinary resolution. So if they are required to have a 75 per cent majority, it simply makes it that bit harder to get over. It potentially makes the voice of retail shareholders much stronger on this resolution. Because it's not a binding resolution, it should be there to say something to directors about how shareholders feel. So if it can be more sharply defined, then that would be of benefit, we believe, to shareholders.

MR BANKS: You have not sought a binding vote, nor have you recommended regulatory caps or ratios or anything of that kind. In relation to those other proposals that some other participants have put forward, do you want to make any comment about that as to why you haven't made a recommendation of that kind?

MS DOHERTY (ASA): A binding blanket vote, so for instance changing the current advisory vote simply to a binding vote on a retrospective report has practical difficulties, as to potentially it means the winding back of remuneration that is already paid, so that's the first thing. The second thing is that it's not necessarily hugely helpful because different shareholders will have different views on different aspects of the remuneration report. So whilst three different shareholders might vote against, they might vote against on very different parts of the report. So in that sense we don't see that it's necessarily helpful or practical.

A better way is to look at parts of remuneration that could be hived off to shareholder approval. So for instance, termination pay, which is the subject of a separate consultation. We have recommended, and I think a number of other organisations have also recommended, that equity schemes be made the subject of approval by shareholders. So it's one aspect of remuneration. It's very clear a

particular scheme is being to shareholders, they vote for or against. It's much clearer to see what it was that they liked or didn't like, rather than simply a blanket vote on the whole report. So we would see that as being much more helpful at the end of the day.

PROF FELS: You know you said this has become increasingly important in the eyes of shareholders. Have you got anything to say about why that is? I mean, there are many aspects of company performance. You might say, after all, this is only a small amount of money, and the evidence on the connection of pay and performance anyway is slightly mixed, particularly outside the financial sector maybe. Yes, it is a huge focus of concern. So have you any explanation of why that is? People are really concerned about it distorting performance? Or is it a more general set of feelings by people that there's something wrong about executive pay?

MS DOHERTY (ASA): It's a difficult one. Obviously we have a lot of direct contact with retail shareholders, and for them it's often an issue of fairness as well, particularly in this current environment; they see their share price decreasing, they see their dividends cancelled and they find it very difficult to understand why the remuneration report should show that executives' salaries have increased in the last 12 months during that same period. So a lot of it is an argument about them being remunerated equitably.

But underlying that of course is this issue of performance, and that if performance is down why would remuneration be up. You know, it simply doesn't make sense if we are paying for performance that those two things should suddenly be disconnected. I think on another level also there's the issue about what type of behaviours do these performance schemes drive. If they don't drive effective and good behaviour, they can drive bad behaviour, they can drive short-term behaviour. Retail shareholders do understand and grasp that as well, from our conversations with them.

PROF FELS: What is the state of the evidence on the link between pay and short-termism in management? We keep hearing this. It sounds credible, but I just wondered if there's any evidence out there on this point, re implications of, say, this non-evidence can go in all sorts of directions. Some people say, "Well, there's no real connection anyway and therefore the case for bonuses and incentives is overstated," others would draw a different conclusion, we keep hearing about it. But what is the evidence on the distorting effects of short-term rewards on behaviour.

MS DOHERTY (ASA): I think that we can only deal with it really on a case-by-case basis with companies that we monitor through our company-monitoring program. We haven't done a quantitative research project on it. There's a lot of academic literature, but it appears to not really be conclusive either way; there's

arguments certainly for and against achieving that alignment.

However, what we would see is an increase in short-term payments during periods where long-term incentives are not going to deliver, and that is a concern for the Australian Shareholders Association, that's effectively moving the goal posts to suit the environment in which company executives find themselves. So that if the long-term incentives are under water, suddenly there's an increase in either base pay or short-term incentives. That's the concern for us, actually what are the outcomes. There seems to be an acceptance that there is a link between pay and performance. We're willing to accept that possibly that's the case. But poorly-structured remuneration packages are our greatest concern, because, if there is that link, they don't produce it, in any event.

MR FITZGERALD: When you talk about alignment of interest with the shareholders, we have heard this morning different proposals about what that means in terms of the holding over of the vesting of share rights or share option rights. Do you have a particular view as to what the ideal length of this is? One of the things, in talking to various companies, of course they have often said that shareholders of course have become in fact part of the problem; they are so short-term in their focus, the day traders and so on, that the market itself has changed and they are simply responding to that market. So when you say that you want an alignment with longer-term shareholder value or company performance, what do you have in mind in relation to that?

MS DOHERTY: Our new policy on executive remuneration that we released in March specifically deals with that issue, and what we say is that long-term incentive plans should have a component which is held back from executives for a period of at least two years; and we don't seek to be prescriptive about what proportion that should be, but we say a meaningful component, so that companies can decide what that is, and obviously there are tax implications as well that would need to be taken into account. We came down on the side of two years.

Regnan are talking about a different plan, I think it's five to 10 years. Macquarie Bank, which is one of the only companies who does this or a version of this already, I think is 10 years. Shareholders generally are said to have longer-term horizons of five to seven years. So it is all a bit, you know, "Take a number, double it," but we have sort of said, "Well, let's look at two years." We say that the performance period for any equity long-term incentive plan should be at least four years, and then part of that should be held for at least another two years.

So that we're moving to a sort of a six-year horizon at the longest, which moves more towards what shareholders have and also allows the flexibility that some of the incentive would be able to be dealt with after that four years so that there is

that greater alignment with shareholders' interests. It is difficult. I know you brought into play day-traders and others who aren't in the long-term; I'm not sure to what extent that is a relevant issue.

I think that companies should be looking to their long-term focus regardless, and executives, and particularly the CEO, their remuneration should be based on mainly achieving the long-term goals of the company. Obviously there will be circumstances and there will be points in the business life cycle where short-term incentives are appropriate for CEOs, but we would say that that's something that a company must particularly justify to shareholders, why they have granted short-term to a CEO.

MR FITZGERALD: Can I just flesh that out a little bit. I mean, again the companies would say that the short-termism is not an invention of the company. It is an invention of the stock market itself; continuous reporting and the shorter reporting cycles and so on and so forth. They would say to us that that has in fact changed, so that the short-term term incentives that are being pursued by CEOs is a reflection of the desire by the market to see short-term results.

So there seems to be a disconnect taking place. Either we have moved to a short-termism, as people say - if so, what has driven that, something has driven that; or in fact it's an aberration, and in fact that aberration is not so, that in fact, for some reason or another, we are packaging, but it's not because there has been a short-termism creeping into the marketplace. I was just wondering how you see that particular issue.

MS DOHERTY (ASA): Look, I think it's one of those things that is going to be very difficult to prove one way or the other. We would say that one of the important factors in an increase of short-term incentives is that it's a way that companies react to long-term incentives being under water. So that's another issue that comes into play. So I'm not entirely certain whether we would simply accept at face value that it's market-driven; I don't think that that's the only factor involved, and it's difficult to separate those factors out and say which is more important. But certainly it's not in companies' interests and they are not going to acknowledge that they're increasing base pay or they're increasing short-term incentives as a reaction to the environment that they find themselves in.

MR BANKS: But you're not ruling out that in certain circumstances in difficult economic times those short-term incentives can become even more important for certain companies, in terms of their strategy for dealing with rocky times?

MS DOHERTY: It's a company-by-company issue. What we say is that, *prima facie*, short-term incentives are something which should not be encouraged

when you're pursuing long-term strategy. If the company can justify a reason for giving a CEO a short-term incentive, then we wouldn't vote against their remuneration report. But it's an issue that companies are on notice about from the ASA because it's in our policy that if this is something you're doing, we expect you're going to justify it and we want to know why you're doing it and how that's a benefit to shareholders and whether you've tested what the unwarranted consequences are and what could be the potential downsides of doing this before you simply put it in place.

MR BANKS: You mentioned earlier and it's in your submission that you would like to see shareholder approval for all equity based remuneration schemes and I think you talked a bit about this when you were in Sydney, but if I could get you just to explain why you would want to extend it beyond those allocations which could potentially have a diluting effect and others which would be brought on market.

MS DOHERTY (ASA): The underlying reason for the listing rule now is the issue of dilution, so it's not really about remuneration, it's about dilution. So we're saying this should actually be a remuneration issue. This is one issue that we can take, we can hive off, we can let shareholders approve. What we see approval of these types of schemes doing is making boards be accountable, making them justify a particular scheme, making them explain it well to shareholders, make sure that it is tested and that they are accountable for what happens as a result of it. So we really see it as a way of bringing this whole issue of the board actually having to sell to shareholders and having to gain their approval for particular schemes rather than instituting them, putting something in their remuneration report about it, putting that remuneration report to an advisory vote, and it effectively just turns around the responsibility so that it's a responsibility of the board to convince shareholders that this is a good thing for shareholders and a benefit to the company before it's approved, rather than retrospectively. It's in the process now and if there's an against vote, then they try to prove that it's appropriate.

MR BANKS: If the rationale has changed, is it because you see the equity component of remuneration as being most fraught in terms of some of the problems?

MS DOHERTY (ASA): Yes, for the association it's the one that we see as being highly significant. There are certainly problems around base pay, particularly in relation to increases in base pay which are clearly put in place to prop up the lack of pay that's coming through equity schemes that are under water. That's a big issue, but it's probably something which is much more transparent to shareholders. The equity based schemes, they need to be properly explained and, to use that word again, to be sold to shareholders for them to be convinced that this has been properly thought through. There's been a lot of talk recently about stress testing of plans. I know the AICD in their new remuneration guidelines say, "Do stress tests. Make

sure that you understand as far as you can all the potential consequences of this plan in different circumstances." If it's done ahead of time, then the expectation from shareholders would be that they have that information.

PROF FELS: On the disclosure, are there any aspects that could be improved? For example, realised money as opposed to reported pay or simpler reporting or things of this kind?

MS DOHERTY (ASA): That is a difficult issue to address. How do you actually show what was earned in this year rather than, "This is the potential," in several years' time. We would like to see it so that it is simpler and so that shareholders can see exactly what an executive earned in a particular year and that's something that we'll be addressing with companies directly during the next year: how can they do that in a way that allows shareholders a much clearer idea of what they've actually earned. Obviously the accounting standards now make it slightly difficult but that's certainly something we'd like to see addressed.

PROF FELS: I tend to think of it in two ways. There are a lot of virtues in something simple that a lot of people can understand and then sometimes there's very long reports that have got something tucked away and there's a small set of people who work through them in detail and they pick up on these finer points that actually can be quite important. Even if you've only got a very small number of people who can pick up on the detail, that may be sufficient to have them exposed. So I'm kind of a bit torn between the simple and the complex and whether we try to have both.

MS DOHERTY (ASA): I think the reports are unnecessarily complex, this is what we say in our submission, and whether that is because the schemes that they report on are sometimes highly complex or whether it's done to obscure the true value is something that is very difficult to know, but obviously it's something that we keep discussing with companies, how they can be clearer. One of our policies which is appended to our submissions around the annual review, which is actually the document that probably most shareholders now read rather than the annual report, and we ask that there at least be a summary of remuneration in that annual review and perhaps that's one place where companies could put what their actual remuneration for the year is.

MR BANKS: In talking about performance hurdles, I think it's about page 10, you say that:

All measures of company performance used to reflect executive performance have inherent weaknesses.

But then you go on to say that:

The ASA approach is to ask companies to link equity rewards in long-term incentives to two different hurdles; one which is a measure of performance closely aligned with shareholder interests and a second measure which reflects the growth in earnings of the firm.

You imply a divergence between those two things. I just might get you to explain how you see a measure reflecting growth in earnings of the firm as not being aligned with - - -

MS DOHERTY (ASA): I think the way that we stated in our policies sounds as if they are two things you can kind of cut out from one another, but they could potentially be the same; some will be the same metric. We look at total shareholder return as being a good measure but there are difficulties with it. I think it gets criticised and we've dealt with those difficulties in a broad sense in our submission. Obviously it's external; it compares you with your peer group, it's very dependent upon who you choose as your peer group. If that's badly done, it's not necessarily very helpful. It depends upon a number of factors which are outside the control of the executive. So essentially we say that if you're going to use one measure of performance for a tranche of the grant, then use a different measure of performance for the other half and that way at least some of the rewards will not vest if there are these external issues or issues which can't be controlled. So the idea is to try and find two hurdles which complement each other, in the sense that they may make up for some of the weaknesses in the other, or if one can be manipulated, it won't have the effect on the other.

It is difficult because often the hurdles themselves are interconnected, so it's one where companies need to try and choose hurdles that do complement each other. What companies who do have the twin hurdles - and there are only very few of them - tend to us is TSR for one hurdle, and earnings per share for the other hurdle.

MR FITZGERALD: Just a couple of things specifically: going back to the binding vote or the non-binding vote issue, you've recommended that should a remuneration report fail to gain 75 per cent, then the chair of the remuneration committee should automatically face re-election at the next AGM. Some people have said to us that at the end of the day, directives collectively have a responsibility and that singling out one or other of the directors on the remuneration committee (1) is in fact very poor governance practice because you're actually abrogating responsibility to those couple; secondly, they say that in the end, nobody will want to be on those remuneration committees; thirdly, if they do, they might only stay for very short periods of time. Now, I'm sure some of that is exaggerated, but how do you answer the criticism that, by targeting the chair of the remuneration committee rather than the board itself? How do you justify that sort of position?

MS DOHERTY (ASA): It's difficult because the only other option would be for the entire board to be placed for election and that throws up practical problems of its own. If there's a vote against the entire board, do you actually damage the company a lot more? So I suppose it's a halfway house. It has some problems but it's preferable to putting the entire board up for re-election.

At this time, what our policy is that we will vote against any director who stands for election during the next 12 months if there is a substantial vote against and the issues are not dealt with during those 12 months. So that will be our new policy and that will start from the financial year 2010 for any relevant company. So that's not an ideal way of dealing with it either but it's the power that shareholders have. I can't remember whose submission I read it in, I'm sorry, whether it was one of the proxy advisers or ACSI, but there was certainly a suggestion from one of the other institutional advisers that they vote against the chairman of the remuneration committee if that person comes around for re-election, but that's all fairly random because they may not come around for election for another three years and the momentum is lost. So it's an issue about making boards accountable, finding that momentum.

We don't recommend a binding vote on the remuneration report because it is for boards to continue to decide what happens with remuneration. They must be accountable to shareholders so we need to find mechanisms of making them more accountable. This is simply a mechanism. It may not be ideal but it is maybe all that we have.

MR FITZGERALD: Some people would say - and obviously you've got this 75 per cent threshold but just take the current arrangements where you require 50 per cent to vote it down, 50 per cent plus one to vote them down - a number of the companies have said to us, "But very few votes are lost. They can't muster more than 50 per cent." Now, I don't think any company is saying that 10, 20 or 30 per cent is insignificant, nobody is saying that to us, but in some senses, they are saying at the end of the day, if the resolution passes, the resolution passes, and if it's by 51 per cent, that shouldn't have a consequence. It might have a consequence in going back and fixing it up, but a vote is a vote is a vote, and the corporate law works on that. So what is the justification for reducing this effectively down to a 25 per cent vote?

MS DOHERTY (ASA): That might be the letter of the law and it's very much a compliance-type mindset.

MR FITZGERALD: Sure.

MS DOHERTY (ASA): Obviously what issuers of capital are going to be more concerned about is, "Are we concerned about our capital fleeing because we've now just scraped over the line, just avoided an against vote or just got an against vote, "What is that going to mean for us?" It's advisory. It's a message. If you don't take the message, then that's where it begins to fail, so you can take a black and white view of it but that's really very unhelpful for companies and for their shareholders. It's essentially meant to be part of a principles based way of approaching remuneration. So having got the message, we would hope that companies' boards would then engage further with their shareholders, understand what the issues of remuneration are and correct those during that 12 months. If they are doing that process, then there should be no concern about directors being voted off boards in the meantime.

MR FITZGERALD: In terms of this approach - and I can't recall from your submission - are you suggesting there should be changes to corporate law or would you see the mechanism as being changes to the ASX listing requirements or the government's guidelines? What do you see as the mechanism by which any or all of these changes should come about? To what extent is the black letter regulation? To what extent is it a code or a set of principles put forward by the ASX?

MS DOHERTY (ASA): The recommendations at this point are very much that these are things we think the commission should investigate and through your questioning of other parties who are going to come before you. You may not necessarily decide to recommend both. They may not necessarily work as well together. The change to the voting is going to need to be in the Corporations Act and the election of the directors, that would need to be in the Corporations Act, I would imagine, if they were going to be - - -

MR FITZGERALD: Yes. Could I ask just one final question on that: are you satisfied with the way in which the ASX Governance Council produces its guidance and requirements and do you think that they're generally adequate? Notwithstanding the comments you have made, are you generally satisfied with the way in which the ASX Governance Council operates and what it produces?

MS DOHERTY (ASA): The council has a very broad group of stakeholders and they have very different interests. So coming to a consensus there is always going to be high level, and I think we've highlighted that in our submission. If you look at the principles, they are very high level because to dig into detail - you know, it begins to be a point at which different stakeholders have conflict. So as a set of high-level guidelines, they have been very helpful. They focus companies on the issue of remuneration and in that sense, they are helpful. We find them helpful in our monitoring of companies because they provide some guidelines as well as the recommendations. We certainly go out and tell companies where we feel that they

are not fully compliant with principle 8. So in that sense, they achieve what they can achieve, I think, given the diverse group of stakeholders who are part of the council.

MR FITZGERALD: Just my last question related to that: do you think that ASIC itself should play a different or more significant role than it currently does? I suppose that's related to the role of ASX versus the role of ASIC. I say that in line with the fact that APRA of course will play a slightly more significant role in relation to executive remuneration financial service bodies, given their new draft standards. So are shareholders generally happy with the role that ASIC currently plays?

MS DOHERTY (ASA): It's not an area where ASIC plays a great role.

MR FITZGERALD: Sure.

MS DOHERTY (ASA): Again, I think one of the submissions, RiskMetrics, talks about section 300A and about a lack of compliance with that by a number of the remuneration reports and that there could be a role there for ASIC to ensure that compliance. The issue they pick out is the detailed summary. Potentially that is a role that ASIC could play, ensuring compliance. I am not sure to what extent that would just then become an argument between lawyers about whether this detail is sufficiently detailed to meet the section, et cetera. So I think that is certainly something worth exploring, whether that could be helpful or whether it would simply become a compliance-type issue and not be particularly helpful.

The ASA's view is very much that the remuneration report is already fairly bogged down in compliance, it's very templated, it's very standardised, it's been lawyered to death in many cases, and that what boards need to get back to is saying that the primary function of this remuneration report is to inform shareholders, not to cover ourselves and make sure that we're compliant with the law but rather to inform shareholders and make sure that we give them what the law requires us to give them in order that they have the information to determine whether they will approve this remuneration report.

MR BANKS: I was just going to ask you, since you're very well placed to respond to this, in terms of the question of a shareholder say on pay and so on, you've put down some proposals there which I think would strengthen that, but others would argue, and I'd be interested in your comment on that, that there is a difficulty in going too far because the shareholder is not a shareholder and you get different shareholders with different perspectives. You've talked about shareholders on average taking a seven to 10 year view on things but there would be some who would have a much shorter time horizon on that, some who would have a longer one. But would you like to just comment on the diversity of shareholders, particularly I suppose any differences you would see between institutional shareholders and

others?

MS DOHERTY (ASA): I don't see a great deal of difference in terms of horizons for institutional shareholders and the type of retail shareholders who we are familiar with, and who are our constituency I suppose. People who are in the day-trading, who are in those types of realms, are certainly outside our understanding and whether they vote, whether they care about issues of remuneration, I'm not really sure and I'm not sure if there's anyone submitting to you who represents them. But institutional shareholders and ordinary retail shareholders wouldn't have dissimilar horizons, and I think that's clear from some of the submissions before you as well.

Again it is a person-by-person basis, and we can only talk in very general terms about those types of horizons. You noted that shareholders are very different; and they are and there's nothing that we can do to get away from that, and any vote is for or against, it can only say so much about how shareholders feel on an issue. Obviously companies engage with institutional shareholders, they engage with the Australian Shareholders Association, and so they do have an ability to work out why it is that a vote has gone for or against, at least for the most part. So that's not completely outside their control.

That's very much about engagement and it's about taking the right focus on remuneration, and that's something that is going to be difficult to resolve by regulation, that's about companies changing their own mindset. I don't want to appear overly critical, because companies certainly do engage with us and with their institutional shareholders, but it's about ensuring that there's not only that process of engagement but that they're also going to be responsive.

MR BANKS: I think you have said that there has been more engagement in recent times. Maybe just to confirm that that has happened and why. But also, clearly if there was a 75 per cent threshold for getting a remuneration report through, the ASA would be engaged in a lot more activity as well.

MS DOHERTY (ASA): Possibly, yes.

PROF FELS: One of the things, just as a general reaction, is that you have got very strong criticisms of the current unsustainable and unacceptable levels of executive remuneration, seem to have had lot of criticisms, they are quite substantial, and also in other points of your submission there are other criticisms. Now, on the other hand, the measures that you are suggesting are not particularly strong, it might be said, and don't quite perhaps the severity of the problems that you have identified. That's one possible interpretation.

I just wondered if you had any reflections upon that. Is it that you see the role

of the shareholders as not being critical in the end? I mean, there is a view all shareholders are owners and that if they feel strongly about things they should be able to change them. Others say no, they're not quite owners, that the responsibility of executives and boards is to the company rather than shareholders. I wondered if that was behind it.

Then again, with the question of binding votes and the various alternatives that have been talked about, often the significance of these measures is not quite in their direct use, it's the availability of the big stick; and at the moment the stick is not a very big one, it's just a non-binding vote, and people say, "Well, that has some effect on people who are a bit worried about it." Would you not have more leverage if there were a few big sticks hanging around to apply?

Probably shareholders and institutions would have the good sense not to over-use those sticks; it's a bit like fines in the law, you know, maximum penalties aren't that often applied. So I just notice a certain reticence everywhere over trying to get more powerful sanctions, and yet at the same time we're hearing current unsustainable and unacceptable levels of executive remuneration and all these sorts of things. I'm just wondering how we put these pictures together.

MS DOHERTY (ASA): I think what you're saying is that our recommendations, you don't think, necessarily go far enough if what we say is the problem is - - -

PROF FELS: I'm asking the question, yes.

MS DOHERTY (ASA): Yes. Look, I think part of the difficulty is coming down - and the Australian Shareholders Association is nothing if not practical. So we have looked at, "Well, how would a binding vote work? Practically, what would that mean, and is it doable?" Retrospectively, I think it's very difficult. I think the jurisdictions in which there is a binding vote are more in the sense of a vote ahead of time that says, "You can have X," so a cap, in terms of executive remuneration.

Now, we don't think that would be particularly helpful either, because if you're prescriptive about a cap then you simply have executives paid right up to that cap and you have companies trying to find ways and means around that to remunerate executives if they don't believe that it's sufficiently flexible enough, so that becomes a problem. So I don't think that that way of having a binding vote on remuneration is necessarily very helpful.

The retrospective vote - and, you know, we have investigated it - we can't see how that would work, in terms of winding back pay that has already been paid to executives, in terms of the contractual difficulties. So those are the two potential models of having a binding vote, and we don't really favour either of those. We don't

see that either of those is necessarily helpful. If we take both of those out of the equation, then we are left with an advisory vote. How do we give that more teeth? How do we make that a stronger message? How do we make boards actually become accountable then for the message that shareholders are sending to them, and to respond to them? I hope that answers your question.

PROF FELS: So you're sort of saying they're practical problems. I haven't given it any real thought, but on the contractual one I would have thought that's not really an issue, you just write it into the contract that either the payment is conditional on it not being reversed for the general meeting, or something like that. I would have thought there wouldn't be that much of a problem. Then on the first one, I'm not quite sure about that, but I just wonder if you have - you see, if it's purely practical - - -

MS DOHERTY (ASA): We see the way of dealing with it is to say, "Well, what are some of the big issues for shareholders in remuneration? How can we potentially hive those off?" So we would say, "Hive off termination payments. Hive off the equity based schemes so that they need to be approved before they are instituted, "and in this way you actually take out the issues that are of the most concern to shareholders, you make them the subject of a specific vote.

We believe that that is a better way of dealing with it than to put the entire remuneration report, either retrospectively or as some sort of remuneration structure or cap, ahead to shareholders. It seems like a better practical way of dealing with it, define these areas to make the board sell what they want to do to the shareholders ahead of time. It's in a sense a bit of a halfway house, which should work in the sense of practicalities and should make some difference and allow shareholders to have a vote in areas where it's practical to do that.

PROF FELS: So it's the practicalities, it's not necessarily the principle.

MS DOHERTY (ASA): It is also the principle. I mean, we'd be concerned about a vote on a remuneration structure which for instance says, "This is an overall cap on executive base pay for X period and shareholders have approved that," that would encourage potentially behaviour where they're simply then paid all of that cap, rather than behaviour where they consider what base pay is appropriate during this period of time.

So it's this tension between allowing boards sufficient flexibility in order to match their remuneration structure with their business model and their company strategy and allowing some sort of accountability in that relationship between shareholders having a say in what happens and holding boards accountable for the decisions that they have made. So that's in the end why we came down on the side of the recommendations that we have made, which are a number of different

recommendations that hopefully will improve board accountability, rather than binding vote.

PROF FELS: Could you comment further; I mean, some submissions have discounted the role of senior executives in firm performance generally, they have gone a bit further than that, and just how the ASA sees that. I mean, sort of implicit in what you're saying is that the ASA sees these people as being pretty important to shareholder wealth and therefore you know doing things that might impact adversely on them is something that you might want to think twice about, but do you have a view about how important these senior executives are, including the CEO, to the performance of the firm and therefore the benefits that shareholders receive?

MS DOHERTY (ASA): It seems commonsense that the decisions that they take shape the strategy of the company, the CEO and particularly the C level executives. So if they're incentivised there has to be a relationship between their incentives and that performance. On the flip side of that, there's also the question of their incentives encouraging behaviour or strategies which are not in the long-term interests of the company, and that maybe is the bigger issue. So those schemes need to be very carefully and properly structured and thought out. If a board has done that and is able to tell shareholders how that is to work, then they should be able to put it to a vote by shareholders prior to bringing it into play.

MR FITZGERALD: Just on termination, I just wanted to be very clear. The government has made some changes in relation to termination pays and it has been subject to considerable comment and criticism. What is the association's view in relation to how termination pays should be handled, and is the current government approach appropriate?

MS DOHERTY (ASA): The approach of not more than 12 months' base pay?

MR FITZGERALD: 12 months with a vote.

MS DOHERTY (ASA): Yes. No, we would approve of that. In a lot of circumstances that is what companies are doing in fact. The difficulty is that, you know, the devil is in the detail of how companies will define base pay and whether there is a risk that base pay will increase, and obviously that's in the regulation and the government has made attempts to make sure that that is dealt with, and there have been some criticisms. We submitted to that inquiry, and our submission is available on our web site. But we have been largely supportive of the principle that it should be no more than one year's base pay.

MR BANKS: Do you have more on that?

PROF FELS: No, that's fine.

MR FITZGERALD: That's fine. Thank you.

MR BANKS: Thank you very much. You bore with us for nearly an hour or more. So we really appreciate that, and we appreciate the contribution of the ASA to the inquiry.

MS DOHERTY (ASA): Thank you.

MR BANKS: We will break now for lunch and resume at 2 o'clock. Thank you.

(Luncheon adjournment)

MR BANKS: Okay, welcome back, ladies and gentlemen. Our next participant today is Dr Klaas Woldring. Welcome to the hearings.

DR WOLDRING: Thank you.

MR BANKS: Perhaps you could just begin by telling us the capacity in which you're here today.

DR WOLDRING: I'm here as an individual. I became interested in all this when I was an associate professor of management at Southern Cross University. I have written on these matters.

MR BANKS: Goodo. Well, you're very welcome and thank you for the submission that you have sent to us. I might just allow you to raise the key points as you see them, then we'll have some discussion about that.

DR WOLDRING: Okay. Well, first of all, I think it's commendable that this inquiry is taking place at all. Better late than never perhaps, we should say. Thank you for inviting me. I'll talk about and also add something to my submission. I wrote a conference paper about this for an ethics conference at Massey University in 94 about executive salaries and this was published and later it became the start of a book about business ethics and public sector ethics in Australia and New Zealand, and that came out in 96.

One of the first things that struck me in doing the research for this data, and it was also later confirmed by several Australian academics, is that there is basically no correlation between performance and the high salary packages, not positive and not negative. Many of the people who have made a submission to this inquiry, and I have read about 20 of them, make this point as well, and we can take this as a given. What also struck me was that the criteria for performance were often faulty and productive of poor management rather than the long-term benefits of the corporation.

The argument that high packages have to be provided to attract competent executives can be disregarded. The outrage about this trend which started in about 1985 and went right through the 90s and also the first decade of the 21st century has not resulted in voluntary moderation or the introduction of effective controls. Governments have done very little about it and the argument that market forces or corporate boards would correct the trend has proven false.

Shareholders in the main have been powerless to control executive pay trends. Even if they were to be given more power, there is no guarantee really that it will be used. All this means that good money is often paid for mediocre or even poor

performance. My submission is concerned with base pay only, not with short-term and long-term benefits, shares and options and termination packages, et cetera. These additional payments can be excessively high as well, even demonstrably quite undeserved; but I have left this to other critics to comment on.

I notice several have commented on this, including my associate, Shann Turnbull, who is here, whom I well know from the Australian Employee Ownership Association. I am also a member of that advocacy group but I'm not here in that capacity. I do want to draw attention to the comments in my submission that broadbased employee share ownership schemes in the US are associated with more modest executive salary packages. An ESOP is also a mechanism that better aligns the interest of boards and executives with those of shareholders, employees and the wider community. This is one of your reference points, I think number 3.

Where an ESOP is accompanied by institutions that provide employees with a meaningful voice in the organisation, the benefits of ESOPs are reinforced, they are strengthened; the research shows it very clearly. This form of social inclusion by employees in the business - that is, a stake in the business and a say in the business - is still very underdeveloped in Australia, largely a consequence of the dominant culture of adversarial industrial relations. If the meritorious performance argument does not drive the spiral, what does?

Dr Simon Moss, whose submission is listed here as number 2, has examined the psychological and sociological factors that drive individuals who seek elite type of rewards. He and other submitters make the valid point that these are not usually the people who are often innovative, progressive or even good leaders. He also highlighted hierarchical domination of the executive class, a situation that can become internalised by the rank and file employees and the general public over a period of time. Thus rank and file come to accept high packages as the norm and it's so-called justification as reasonably valid in the absence of government intervention.

But in the mid-1990s in Australia new research indicated that the public misjudged that reality substantially. Most respondents of a survey that the Research School of Social Science (ANU) answered that they thought it was fair for executive pay to be about three to four times that of the average wage. However, in that period, as the research has demonstrated, it was actually found to be 13 or 14 times higher, so that's an error of about 400 per cent. That 13 or 14 times higher is still a fraction of what it would be 10 years later.

Yes, the global drive towards higher salary packages for executives, particularly in the US, has had a major impact here as well. Lack of controls and misguided confidence in market forces in the US and in Australia are responsible for that. We all recognise of course that if CEOs get away with base packages that are

75 to 100 times the average wage, then there are also two, three, perhaps even four layers of execs below the CEO that, for the sake of interorganisational fairness and harmony - that is, harmony at the elite level - cannot be far behind. I heard just a few nights ago on TV that at Enron, just before its collapse, 140 executives at lower levels had annual incomes of over \$5 million per annum. At Macquarie Bank, if I remember this correctly, a couple of years ago there were 160 executives who were paid over the one million dollar mark.

So my argument is that in the absence of countervailing forces, government intervention and regulation is simply imperative. I propose that any CEO's base pay should be no more than a maximum of 10 times the average wage. This seems to be very generous to me. Yes, we do need legislation for that. This is supposedly an egalitarian society and here is a real opportunity for a government to actually demonstrate that. It would really mean a lot more than calling each other "mate".

But now we get to the nitty-gritty because as I have argued in my submission, politicians of the major parties are extremely shy of curbing salary packages of corporate chiefs. In spite of all the moral outrage from government leaders in the past 20 years, almost nothing effective has been done. Apart from the global pressures, there are two principal reasons for that. First, it could endanger corporate donations around election time and secondly, the most senior politicians may well be looking for a lucrative directorship on corporate boards after their parliamentary careers are over. How can that be changed here? Surely we don't have to wait for action elsewhere in the world to put our own house in order. In the US and in the UK, there is already evidence that especially banks will not accept government intervention. The political will is crucial in driving reform.

The election funding forms drafted by Senator Faulkner this year may show the way, even though the first quite modest attempt on his part was blocked in the Senate very quickly, by the coalition in particular. Ideally, elections should be financed exclusively from public revenue. There is much to be said for that, because there are other problems with current election funding; for instance, that it grossly favours the major parties at the expense of minor parties and independents. What corporation or developer, thinking of New South Wales, would want to support a small party that will never form government?

This brings me to the final point which I didn't mention in the submission, and that is the apparent love affair that Australian corporate boards have with CEOs from foreign nations. They tend to come from the UK, especially in the past; from the US, and more recently, post-apartheid South Africa. These people supposedly possess talents that apparently are not available in Australia and need to be extremely highly rewarded. There are several examples of such appointments. Some of them are reported on in some detail in last Saturday's Sydney Morning Herald. With a few

exceptions, these appointments have been disappointments. Contracts had to be cut short, huge golden handshakes paid out and the damage somehow absorbed. To recruit suitable executives from the United States has the disadvantage that people regarded as top performers there are paid very high incomes that would have to be matched here. As this is not always possible, a second or third class executive is attracted. Used to operating in the US corporate business climate suggests a particular approach which may not go down well at all here for many reasons, for instance, cultural reasons or in terms of the industrial relations system. It may take a year before a US executive gets the hang of things. Meanwhile, these high packages are pushing the pay trend upwards for no good reason. Why is it that so many Australians seem to think that foreigners paid immense packages will do a better job than the locals. We should have much more confidence in Australians.

The competence is here, in abundance, and the competent don't want to be paid outrageous salaries either. Their satisfaction comes from the prestige of doing a responsible job well for themselves and for Australia. It is good to know that there are many excellent Australian executives who are not paid excessive packages. We should start demonstrating this as best-practice examples. Thank you.

MR BANKS: Thank you very much for that. At the beginning of your remarks, you talked about the lack of a demonstrated link or indeed the contrary between executive pay and corporate performance. Could I just get you to talk a little bit about performance, perhaps both at the executive level and the corporate level and how you would measure that?

DR WOLDRING: Yes. It can be measured of course in terms of profits and in terms of the share price on the market. These are often the most important indices. But of course there are other indices, especially if you think of the health of a corporation in the long term that can actually only be built up over a period of time. So the faulty performance criteria that have been used by a lot of corporations in recent times are those first two, as a result of which of course managers or CEOs and executives are going to work on that because that is what will deliver them bonuses in the end. So that is a problem that can be addressed but apparently it has not been addressed much.

MR BANKS: Would you see that simply being a construct in the interests of executives or how would you see those indicators, profits and the share price from a shareholders' point of view? Presumably they're interested in high profits and high share prices.

DR WOLDRING: Absolutely, so one can say that the performance indicators that shareholders see - and shareholders are basically mostly absent people who have no further interest in the corporation other than the share prices and the profits and so

on, that's a bit of a short-sighted view of any corporation, but this is how it is. There's of course the limitation of the value of the views of shareholders.

MR BANKS: If we come back to the role of the corporation, would you see it as in a sense furthering the interests of the owners who are the shareholders or would you see it as having a much wider societal role?

DR WOLDRING: I think any large corporation should be seen in the much wider sense and I suppose this is one of the reasons why we are here, that executive salaries have really spiralled out of control and what can be done about this. I think we cannot any more see a large corporation only in terms of the profits and the share price. These corporations have such an enormous influence on society nowadays that our social responsibility and economic impact of what they do, what they make, is of such a character that I think society at large and governments at large must ask these sorts of questions, "What is happening here?" This of course is what we're seeing in the United States now, that large corporations like the motor car corporations there are being bailed out simply because their impact is so enormous on the economy that they just can't be let gone to the wall. So the interests of society in these large corporations is immense.

MR BANKS: Clearly if the taxpayer has got a major stake in General Motors, that is a consideration. Do you think there should be different rules for companies that have been bailed out in terms of executive remuneration to other companies?

DR WOLDRING: Yes, I think what Obama is doing in the United States is adding these sort of conditions. I totally agree with that. Then you have an example of a different kind of government intervention that is happening and it is happening because of the economic impact of the size and all the jobs that are involved in this for the total economy.

MR FITZGERALD: One of the issues that arises in relation to this ratio that you're talking about - I suppose there's two questions - one of the things that we have seen is that executive remuneration does seem to have some correlation with the size of the company in terms of market capitalisation. In a sense, your model doesn't allow for that at all. Do you believe that it's an appropriate response to simply say that there should be a mandatory cap on base pay, irrespective of the size or complexity of the organisation, because that's the one correlation that does occur. You could argue about the performance, but size and pay do seem to go together. Many people would say that's not an unreasonable linkage.

DR WOLDRING: I think the answer is yes. So in a company that has an enormous size and therefore a great impact on the economy as a whole, I think we can think of 10 to 1. If it's a company that doesn't have that sort of impact, a smaller

company perhaps, the board may say, "We don't go to the maximum in this company, we'll make it 5 to 1." That decision should be up to a corporate board to say, "Where are we on the scale of things?" I agree with you.

MR FITZGERALD: You said 1 to 10 as a maximum.

DR WOLDRING: A maximum.

PROF FELS: So the average wage, what's that, 30, 40 - - -

DR WOLDRING: The average wage is about \$52,000.

PROF FELS: Okay, so 500, all right, as base pay?

DR WOLDRING: Yes.

PROF FELS: Any particular reason for the number 10?

DR WOLDRING: No, there's no particular reason. I was led in my thinking by what happens in Mondragon and many other people who found Mondragon very interesting. This was in the late 80s. In Mondragon at the time, I think it was 5 to 1 and later it became 6 to 1. I understand it's larger now than that and the simple reason was that the economy generally picked up in Spain, so they got competition from the general economy and they had to do something about it. These are obviously cooperatives in Mondragon and I'm not suggesting that that model can be easily transferred. This is not so. But certainly it does mean that the CEO gets a substantial salary but there is a limit to it.

MR FITZGERALD: The second point with the ratio is whilst you've indicated you're only dealing with the base pay, isn't part of the concern in Australia and no doubt other countries that a large percentage of the very substantial increases has come from equity-related bonuses and incentives.

DR WOLDRING: Yes.

MR FITZGERALD: So whilst you might be able to hold the base pay at a reasonable level, in the end by other means, particularly share options and share rights, companies are going to reward their CEOs well above that minimum, yet you've decided not to address that issue.

DR WOLDRING: No, the submission is of a certain length and we could be here all day talking about that, but I certainly think that there should be limits there as well because you are quite right, in some cases these bonuses, long, short term and

termination packages have been absolutely staggering, quite ridiculous, I should say. So yes, there have to be limits there too. But I think if the government could bring itself to say, "We have a responsibility at least in terms of base pay," then I think that would be a great step forward.

MR FITZGERALD: You make a comment somewhere in your submission that in companies where employees have a reasonable stake in the company, 10 per cent I think you say or something like that, you get a different outcome in terms of executive remuneration.

DR WOLDRING: Yes.

MR FITZGERALD: What's that based on and why do you think that occurs?

DR WOLDRING: It's based on the survey by the National Centre for Employee Ownership in the United States, the peak body. They have done a survey on this and found that on the whole, companies that have ESOPs in place as compared to companies in the same industry, the same size and so on, who haven't got ESOPs in place, they find that the executive pay is decidedly lower, more modern and that this is described to employees having a stake in it and being concerned about excessive salaries of their executives, so that has an effect. It seems to me of course this effect is even greater if employees have a say in the organisation as in many European countries and companies, and of course this is also supported by the European Union, industrial democracy, that people have a say and in some cases have places on the board. Where employees have representation on the board, naturally when these things come up about what the CEO and the executives are going to get, the employees just say, "Isn't this a bit crazy?" They have a say in this. They will report back to their employees and say, "Look what's happening. The guy is going away with 30 million. It doesn't look good to us. We're going to protest about this." So they have a say about this as well. That's good news. The salaries in Europe are certainly much lower than in the United States as a result.

PROF FELS: You mentioned with the smaller businesses, excessive remuneration is not common, have you got an explanation of that?

DR WOLDRING: No, I have not. I don't know why exactly that is. I don't think there's much research about this, but the SMEs on the whole have much lower executive salaries than the larger corporations. A lot of SMEs are family organisations in Australia.

PROF FELS: It's a higher proportion of costs, I suppose.

DR WOLDRING: Yes, definitely, but it is a fact. There are also larger

corporations that have executives that have quite modest salaries, that have excellent performance with modest salaries.

MR BANKS: So how do you explain that then because some have argued that there's a real comparative wage justice thing occurring at the top of our executive ranks and they're all looking over their shoulders, so are some people above that and are simply taking lower salary, even though they could be using those comparisons to extract higher salaries themselves or are they in corporations that just can't afford to be paying that kind of remuneration?

DR WOLDRING: Probably the latter, I would think. I can't explain it. I haven't seen much research about this specific aspect - I don't think there is - but it is a fact.

MR BANKS: One thing just to mention, a number of submissions have talked about the risks of unintended consequences in this kind of area and I guess in the past we've seen partial measures directed at concerns about executive remuneration that have led to so-called balloon effects, where you squeeze one bit of a balloon and it bulges in another direction. Indeed, the move out of base pay or fixed pay into all sorts of share based, less transparent mechanisms occurred in the US in response to the tax provisions there that put a limit on tax deductibility. But I just wanted you to reflect on what you're proposing here. Would you see any risks of that happening with your 10 times ratio, particularly in terms of the capacity for executives to also look in the private equity sector as well, because this would be confined presumably to the public sector or would you see it being extended more widely than that?

DR WOLDRING: I could see it in the private sector.

MR BANKS: So you'd see this as a provision that would go right across the corporate sector entirely?

DR WOLDRING: Yes.

MR BANKS: Do you discount entirely the scope for executives, given what would be a very huge gap between what Australian companies would pay their people and overseas companies, any risks of a brain drain, of losing good people?

DR WOLDRING: Yes, I think some people will be attracted to very much higher salaries abroad, and I would say good riddance, let them go. There will be plenty of competent people here who can take their place, and maybe they won't find it all that easy abroad in a different culture, away from home. I don't think that there has been such a tremendous drain here, mostly to the United States, because that's where the salaries have been substantially higher, not Europe, or even the UK, it's mostly the United States. I would say if they find that so important, let them go, because these

people, you know, they have a need for wealth and status that we can do without here. We want competence in our corporations and not people who are looking for wealth; they can go somewhere else.

MR BANKS: I suppose it depends on how you view the wealth of the society related to the incentives on the individuals to create wealth themselves. But I guess what you're saying is that you'd see people who had much lower expectations about personal wealth still adding to societal wealth.

DR WOLDRING: Yes.

MR BANKS: Okay. I don't think we have any further questions. Thank you very much again for your contribution.

DR WOLDRING: You're welcome. Thank you.

MR BANKS: We will just break for a minute before our next participant. Thank you.

MR BANKS: Our next participant's organisation is the Institute for Self-Governance and the Australian Employee Ownership Association. Welcome to the hearings. Could you please give your name and I guess your relationship to those organisations, please.

MR TURNBULL (AEOA): My name is Shann Turnbull and I am the principal and only person in the International Institute for Self-governance. It's a business name which badges my interests, which is apropos self-governing of responsible corporations. I am a co-founder and currently vice president of the Australian Employee Ownership Association, which we set up in 1986, and Klaas Woldring is on the management committee with me. So we are colleagues together with what we call the AEOA.

MR BANKS: Thank you for participating today and for providing two submissions. There's some overlap between them, and I will give you the opportunity to raise the key points.

MR TURNBULL (AEOA): Thank you, chairman. I will start with my own submission first which incorporates the Australian Employee Ownership submission, which is just part of that. My own submission, where I'm coming from, and I've made five recommendations, basically from the view that you can't have boards determining pay because they have got conflicts of interest; and you can't have shareholders determining because they don't have enough asymmetry and information; and you don't want governments and bureaucrats intervening. So you need to find a middle road politically and operationally. Where I am coming from, I see it from the lens of excess of power. I am just wondering you and your colleagues would accept the dictum that power corrupts, and absolute power tends to corrupt absolutely.

MR BANKS: I think that has some pretty heavyweight sort of support, doesn't it, that proposition. But we will let you go on with it.

MR TURNBULL (AEOA): I'm just trying to establish a basis where you can have a discussion with me.

PROF FELS: A variant of it is that absolute power is absolutely delightful.

MR TURNBULL (AEOA): I know. It's a great self-indulgence. But where I'm coming from is that publicly-traded company boards have absolute power to manage their own conflicts of interest and that absolute power allows them to corrupt both themselves as individuals and the operations of the company. So the regulators, the stock exchange, the Corporations Act, are irresponsible in allowing companies to be

publicly traded where directors have inappropriate and an excess of powers. It's the excess of power which is driving excess of remuneration, and it answers a couple of the questions raised by the previous submission, when you raised about, "Why is it that bigger companies get more pay?" Because they have more power.

Why don't small and medium sized enterprises have such big pay? Because you've got the family-owned and you've got checks and balances exerted by the shareholders. As I said, we can't have shareholders having a direct say. So what my submission is proposing is that they have an indirect say by the formation of a shareholder committee, which can be in different forms, but it's instead of having a remuneration committee of the board. Forming a committee of the board does not remove the conflicts of interest, they are still there, the conflicts of loyalty; you need a separate board.

MR BANKS: Excuse me, would you mind, while you're talking about conflicts of interest, just elaborating a little bit on the nature of those conflicts at the board level. I think you mentioned loyalty then. I'm not expecting you to go on at great length about it. What is the main issue there, for you?

MR TURNBULL (AEOA): Self-serving conflicts, where they can nominate themselves, appoint themselves, reappoint themselves, determine their own pay and benefits, determine how they are monitored, how they are accountable to the shareholders, because they control the auditors. It's an untenable conflict, an unethical conflict, for directors to appoint the judges who judge the accounts for the shareholders.

It would be untenable and unconscionable in any law court for those in the dock, being the directors, appointing and paying the judge; and that's what we accept as best practice corporate governance. So you have these built-in conflicts. Even APRA have adopted the self-serving rules of the securities exchange, which says best good practice and corporate governance is having a committee of the board, an independent committee of the directors, controlling the auditor and remuneration and nomination. What that implicitly recognises is in all of those functions they are in conflicts of interest in remuneration, auditing and nomination.

MR BANKS: So you don't see the rights that shareholders have in terms of voting for directors or indeed voting for the pool of money that they can draw from, in terms of their own salaries, as having any - - -

MR TURNBULL (AEOA): It's nominal. It's like shareholders technically have the right to appoint the auditor but it's exercised by directors acting as agent for the shareholders. So that places the directors in a conflict of interest, because directors have a fiduciary duty to the company as a whole, not necessarily the shareholders.

One shareholder or the shareholders as a whole is different from the company as a whole. So there's all of these sorts of conflicts which are just not recognised and accepted. To remove these conflicts, as the present chairman of the Securities and Exchange Commission suggested, perhaps you'd be better off having more than one board, and this is common practice in Europe and there's different ways of constructing it.

What I did in this country, in a start-up company, I changed the corporate constitution, because I was the promoter of this company and we were wanting to raise money from our shareholders, mainly in America, but as the Australian directors on this board that would benefit from the new money raised, so the shareholders unanimously agreed to change the constitution to take away from the directors the absolute power to determine any conflict of interest which they had. Any time the board had a conflict of interest it could be vetoed by a shareholder committee, which I called a corporate senate.

Senator Andrew Murray took up this idea and proposed in his minority report in parliament a slightly different form of a corporate senate, he called it a corporate governance board, which is a much better name. But the corporate governance board that he envisaged actually had executive powers, not just veto powers, executive powers, to determine remuneration, nomination and control of the audit. What I suggested was a more moderate form where you had the shareholder committee elected on a different basis from the directors, which simply had veto powers.

Now, the veto powers could be overridden if the directors didn't like the veto; just like the American Constitution, the president can get it overridden if he gets enough votes in congress, or his veto can get overridden. The directors could always go to the shareholders voting on one vote per share to override the corporate governance board veto. The corporate governance board was elected on one vote per investor, and if you have a lot of employee investors this is where you get power for the workers, comrade, to moderate the excessive indulgences of the executive suite. In answer to the questions raised in the earlier submission, the more employee participation you have, and they have voting rights, the more moderate are the executive exuberances.

PROF FELS: What would be the powers of this shareholder committee? Would it be in relation to remuneration, or more general?

MR TURNBULL (AEOA): What I wrote into the corporate constitution was any time the directors had a conflict of interest, any one director had a conflict of interest, and I labelled all the conflicts of interest out in the constitution, like remuneration, audit and nomination, or any other conflict of interest, and I had the directors elected on cumulative voting. Cumulative voting is a preferential form of voting, so if you

were a minority shareholder with only say 10 per cent of the votes you could always get one board up, one member elected to the board if you had a board of 10.

This was mandated throughout the United States in the last century, but of course then you had a race to the bottom as people changed their state of incorporation to Delaware where they didn't have this such arrangement. So if you're talking about power, if you're looking for market forces to solve this problem by government intervention, you've got to do it indirectly through changing the power game, and to change the power game you need a division of power, checks and balances is the solution. The question is, what are the most appropriate divisions of power and checks and balances. This is why it's irresponsible for stock exchanges to allow any company to be publicly-traded, with directors having inappropriate and absolute powers without built-in checks and balances.

PROF FELS: But the directors would say, as they have said to us, that one of their primary functions, and some see as way and above the most important the appointment of the CEO, and they would say that's one of the key roles of the directors. The second thing is in the Australian context, as I understand it, we use non-executive directors much more extensively than, say, in the American situation where in many companies the CEO is also the president or chairperson. So some would say that the primary role is in fact to appoint the CEO and the terms and conditions associated with that; and our check and balance is in fact by having non-executive directors in the dominant numbers.

MR TURNBULL (AEOA): If you're a non-executive director on Rupert Murdoch's board you don't really have discretion, you are a cipher for the major shareholder and also you may have a loyalty. I agree with your proposition that the main purpose of the board is to select and remunerate and monitor the chief executive, but he doesn't have to be on the board. When I was a corporate raider in the 1960s we had general managers of all the banks, we didn't have managing directors, they don't have to be on the board; and it's probably better they don't, because then they get a conflict of interest because they're then part of the group that's determining their own pay and you get all the problems of loyalty.

The corporate senate idea doesn't take away from the directors any of their initiatives. It doesn't have any executive powers except controlling the auditor and chairing the shareholders meeting, because it's unconscionable for any director to chair a meeting of shareholders where the directors are being held accountable, that just should not fly, that's unethical, and yet we accept this; just like auditors, a test that they're independent, when we know they're not independent an they're actually lying, in the common use of the word "independence".

PROF FELS: About your general theory, let's say we buy it, that when the

executive pay has skyrocketed in relation to ordinary wages, it would seem in recent times, now, why has it happened recently; what explains the big discrepancy? I mean, from what you say, 20, 30 years ago there could have been a similar discrepancy between ordinary pay and executive pay. What explains the sharp rise in recent times and how does that bear on your theory, because your theory has applied since the dawn of time, so to speak?

MR TURNBULL (AEOA): Well, it's not a theory, it's in practice at Mondragon, where power is hardly divided. Part of my submission, one of my recommendations, which is a bit academic of course, is the introduction of network governance, to say that it's irresponsible for any firm to have all its risks managed by one super-executive and what you need is a decomposition of decision-making labour into many boards, and this is what the Mondragon worker cooperatives do, they have five different boards, so you don't have information overload, you have a division of power.

To answer your question though directly, it all goes back to the famous paper by Jensen and Meckling about the agency theory, where he suggested you have got to align shareholders' interests with the directors, and Michael Jensen I think is embarrassed by what he has created by agency theory, people have used it for self-serving interests, saying, "We have got to better align executives with the shareholders' interests; let's give them more shares and options," which brings me, before I forget, to that I'm wearing another hat here called the Australian Employee Ownership Association hat, whose submission to you suggests that you can't issue shares to executives, and options, without having shareholder approval under the Corporations Act.

The Australian Employee Ownership Association's submission is saying that there should be a cap on the ratio of what the maximum individual can get compared with the lowest in the top 75 per cent of all employees. But that cap, that ratio, be it 10 to 1 or 100 to 1, whatever it be, is determined by the shareholders, not parliament, not regulators. What would happen of course is some self-serving boards would have a very high ratio, maybe 100 to 1. Well, then if they wanted to get credibility in negotiating with the unions, there'd be public opprobrium against those boards which encouraged their shareholders to approve a very high cap.

So the Australian Employee Ownership Association has two objectives. One is that all this accomplish broadbased plans, not just for the executives, often there's two or three sorts of employee plans in publicly-traded companies, one is the broadbased plans, and under the Income Tax Assessment Act there's provision of having at least 75 per cent of all employees to define a broadbased plan. The other objective is then to have a cap on the ratio of the lowest issue of shares and options to any employee in that top 75 per cent with the top in executives.

So that compliments the earlier submission by Klaas where he was talking about executive pay, the base pay, and it answers the question raised by your colleagues on what do you do about the shares and options. But what we're recommending is the market forces using a shareholder controlled cap. Of course if it was abused in another five or six years and not done, then you'd be more robust in ways you could move in, but it's a way of testing the water to see if corporations become socially accountable.

MR FITZGERALD: I was going to ask a question of the previous speaker, but I noticed he was speaking. What is the evidence in terms of performance of companies that have - and I think the figure was about 10 per cent - of shares held by employees? It is indicated that the remuneration paid to senior executives is less. But is performance less? Is there any research that shows the comparison, if it is true that there is a correlation in relation to remuneration, some might say, "Well that might be true about remuneration, but maybe performance is less." So what is the evidence around that?

MR TURNBULL(AEOA): I can't give the evidence directly that my colleague, Klaas was referring to, but I can give you other evidence of firms which have network governance, where it's superior performance. The World Bank did a study of the Mondragon worker cooperatives and found that in both good times and bad times they outperformed the productivity of resources and efficiency of the firm more than the capitalist type of firms; and this is a study of over 20 years. There of course you had a ratio of 7 to 1 in those days between the top. The secret to this is that they decompose decision-making labour. The chief executive isn't responsible for all decisions. For instance, I don't know if you're aware, before Visa Corporation got publicly traded in the last two years, it had hundreds of different boards, each with absolute power over one function or geography, so it had tremendous decomposition of decision-making labour and built-in checks and balances. What I'm saying is that if you want to be competitive in this, you find network governance in firms - and there's a lot of academic literature about network governance in firms - and it's not on the radar screens of publicly traded companies because they all command and control hierarchies which is a specialised form of socialism, but in a market sense and what the research finds is that the more dynamic an industry is and the more complex it is, it gets beyond the ability of any gifted individual to manage complexity. So it's quite unfair and unjustified and unrealistic to believe just one man could be responsible for performance. In my written submission, I say we really should not accept the argument that just one individual can be solely responsible for the performance of a firm, it's a team effort and so it should be shared throughout the whole organisation and that's why the Employee Ownership Association says that at least 75 per cent of all those in a listed company - or any other company for that matter, but we're talking mainly here, for the political aspect, the listed companies -

be involved in broad based schemes. I haven't answered your question directly.

MR FITZGERALD: No, that's fine. Thank you very much for that. That's good.

MR BANKS: The World Bank study that you referred to, I'd be quite interested in getting a reference to that, if you could send it on to us later.

DR TURNBULL (AEOA): I certainly can. It's in my PhD thesis which is publicly available on the Internet on the Social Science Research Network and in a number of my other writings, but I can pull that out and give you a reference to that study on that.

MR BANKS: Okay. I don't think we have any further questions. Thank you very much for participating twice in the one session, so thank you for that.

DR TURNBULL (AEOA): Thank you for your time.

MR BANKS: We'll just break now for a moment before our next participants.

MR BANKS: The next participant today is the CFMEU. Welcome to the hearings. Could I ask you to give your name and your position, please.

MR SUTTON (CFMEU): John Sutton, I'm the national secretary of the CFMEU.

MR BANKS: Good, thank you. Thank you for attending today and also for the submission which we have read. I will give you the opportunity to address the main points.

MR SUTTON (CFMEU): Thanks very much and thank you to the review members for giving the CFMEU the opportunity to appear before you and speak to our submission. Our union's members work for some of the biggest companies in our economy and our members have been keenly observing the remuneration practices of their executives for some time now. I wish to speak briefly to our submission on some of the key points of substance. In doing so, I have to indicate that the CFMEU's submission is not exhaustive in terms of the various suggestions that are around and the various propositions that are being advanced in this area. We don't paint ourselves as absolute experts in the executive remuneration and corporate governance realm but we do come before you today with some concrete suggestions that we want to make.

In our submission we show clearly that executive and CEO remuneration has climbed well beyond the increases going to ordinary employees. From 1990 through 2005, the increases going to executives and CEOs has increased in the order of 560 per cent as opposed to 85 per cent for ordinary employees that we represent. This gap really started to widen in terms of percentage increases during the accord years when union members were restraining their wage demands for the sake of national productivity.

We also show in our submission that non-base salary components are constituting an ever-growing proportion of total remuneration for executives and CEOs and we point to information in respect of BCA members in that regard. The late Peter Drucker, a well-known author and commentator on management issues commented that enormous pay disparities between top management and their employees beyond a ratio of 20 to 1 destroyed mutual trust that characterised successful companies. As far back as 1984 he predicted that, "We will pay a heavy price for this disparity," and for the increases that are coming down the line in executive pay. So clearly it's not a new issue and it's been predicted some time ago to unfold in the way that it has.

We draw attention in our submission to the conflict of interest surrounding the practices of remuneration consultants. Typically boards and executives use

remuneration consultants to tell them what they want to hear. These consultants play to the piper's tune. We note of course in our submission that Warren Buffett sarcastically calls these remuneration consultants "Ratchet, Ratchet and Bingo." It seems pretty apt to me.

In our submission we advance a number of propositions regarding reform in this area. In particular we nominate four potential areas for reform, the Fair Work Act, taxation, corporate law and government procurement arrangements, government contracts. I'd like to focus particularly on the last of these, namely government procurement, and the additional issue of disclosure and transparency as regards executive and CEO pay.

On the issue of government procurement, we want to say that the federal government and through the COAG processes, state and local governments, will have increasing leverage over business as literally hundreds of billions of dollars are invested in nation-building economic and social infrastructure projects in the near and immediate term. The Howard government led the way in tying the granting of public contracts to prescribed outcomes in relation to the conduct of private businesses. Our strong submission to this review is that it should establish guidelines for fair and reasonable levels of executive remuneration that indicate best practice for executives and CEOs regarding their pay and incentives. Further, we submit that adherence to these guidelines should become a precondition for companies seeking to tender for government contracts.

In developing the guidelines that we speak of, we believe that close attention will need to be paid to the totality of remuneration packages. As the Australian Human Resources Institute's submission to your review makes clear, the recent changes by the government in regard to termination payouts are already ineffective in their view and likely only to solve the political perception of high termination payments.

Additionally, we wish to emphasise to the review that companies should be required to meet much higher standards of transparency than are presently the case and must be required to fully disclose the details of executive and CEO arrangements in reporting to government agencies and in their annual reports to shareholders.

I would like to conclude by saying that the interests of our economy will be best served by CEOs and executives who are focused on building long-term wealth and corporate performance, not the narrow interests of their opaque remuneration arrangements. Further, the mess we are currently in, known as the global financial crisis, illustrates all too clearly that many corporate practices today are seriously lacking in transparency and ethical foundations such that a substantial and systematic overhaul of these practices is urgently needed. That indeed is where hopefully this

review can fill the void, at least in part. So they are my opening comments and I'll try to answer any questions you might have.

MR BANKS: Thank you very much for that. Perhaps the first question, we've had a number of participants stressing to us the importance of the board having I guess the key say in relation to the structure and quantum of remuneration and many of them have argued that nevertheless there needs to be ways in which the governance, transparency and accountability et cetera in relation to boards could be improved to strengthen that role. But I would just like to give you the opportunity to talk about that because there's not much in here about what role - it's implicit I guess that you believe their role has been not effective in this area and perhaps not able to be improved sufficiently to address the concerns that you have got.

MR SUTTON (CFMEU): I know something of the debates about corporate governance and good practice and bad practice on boards but I guess the thrust of our submission is that these issues can't be left to boards alone or to any internal workings of companies alone and there needs to be external measures. That's where we're suggesting areas like changes to the Fair Work Act, taxation, corporate law and of course most particularly the one major sort of idea that we come here today with and really want to push hard is that focusing companies and their behaviour around good practice and meeting external guidelines will be a prerequisite or a precondition to getting the tick from government to go forward to spend public moneys. That's our big idea. We think that holds a hell of a lot of substance as something that can change corporate behaviour. We've got our doubts that any government in this country would be wanting to go too far in terms of hard-edged legislation and prosecuting people who have moved outside particular boundaries. I would hope governments would look at them in terms of if people pay themselves too much, they could be liable for prosecution but I don't think I will see it in my lifetime.

However, if government lays down what it regards as good practice, best-practice guidelines or what it regards as good corporate governance et cetera and companies give it the one-fingered salute and pay no heed to it whatever, they perhaps do so at some cost and they don't qualify for government contracts. That's the biggest proposition we come to you with. By way of coming back to your question, we don't believe these matters can be simply left to the board and the executives to sort out on their own.

PROF FELS: So with the government procurement contracts, I thought I knew what you were talking about, but maybe just explain what sorts of things you have in mind and I'll then ask you how far would you take it? Are there other areas of government intervention where this would be a condition like tariff protection, for example, or various other interventions, the bank rules and so on. So the principle that we're picking up a bit from the States also at the moment is where the

government is helping out, then there should be some conditions attached, so what are the possibilities in this? They're probably broader than procurement.

MR SUTTON (CFMEU): I am sure they are and hopefully your review will turn your mind to how broad these ideas could be. I guess "conditionality" is another way of putting it. To get assistance from government or to be acceptable or government or in other instances rewarded by government, it just seems to me that private actors should be prepared, if they want that assistance, if they want those rewards from government - you can't have it both ways. You should, it seems to me, also be prepared to accept the responsibilities and the obligations that governments urge and counsel.

I guess we can move into talking about bank behaviour and other related realms, interest rate increases and things, but I know that's not what you're here for today. But it seems to me that if you're in the business of wanting assistance from government or wanting to get the approval of government or various purposes, it's got to be a two-way relationship. So we are obviously urging that you come forth with substantial, in fact comprehensive guidelines about good practice in this area. Okay, that's step 1, you come forward with some really good stuff about good practice and good guidelines. How do you enforce it? This is the next big question, and it just seems to me that one of the areas that I think the community would accept, I think a lot of politicians would probably accept, is that for the companies involved to want to win government contracts, sometimes they're huge contracts, there's a lot at stake, then they should be prepared to meet the guidelines that hopefully you'll come out with and hopefully government will adopt those guidelines.

MR BANKS: Clearly that would address one component of the population and firms that we're talking about, but there would be a lot that weren't covered by that.

MR SUTTON (CFMEU): Yes. We've got experience in this area because under the Howard government we were on the receiving end. A lot of the companies across the industries we cover, companies that sometimes do government work but other times don't do government work, a lot of companies were forced to sort of say, "If we ever want to do government work" - you know, "We're not exclusively a government contractor but occasionally we want to tender for government work, but we can't make the list, we don't even get in the door unless we comply with certain Howard government guidelines," and that was about industrial relations and some other related practices et cetera, but it seems to me that you will capture - okay, you may not capture every company in the whole economy but you will capture a hell of a lot of businesses that will want to be on government lists and will want to, at least from time to time, chase government work. Now, that work can be in all different realms, it can be anything like construction work, contracting work, it can be supplying materials, supplying pencils, supplying computers, it can be all kinds of

procurement to government and the price of winning those kind of contracts should be preparedness to comply with government guidelines on this sort of important topic.

MR FITZGERALD: Could I go to this issue of the ratios. We've heard three submissions this afternoon, including your own, that deal with this ratio of CEO remuneration to average weekly earnings. When you look at the chart going from 18 to 1 to 63 to 1 in a period of just over 20 years, it seems extraordinary. But the question I suppose in one sense, we're being urged not to look at that as a significant issue, in the sense that really what we should be looking at remuneration to corporate performance, rather than remuneration to average weekly earnings or average earnings generally. I notice your quote from Peter Drucker in relation to the potential for a discord between workers and senior management if you have these exceptionally high ratios.

But beyond that statement is there real evidence that in the company in which your members are in fact employed the remuneration of the CEO makes much difference either to that relationship and/or to the performance of that company? I mean, most of the community would find 60 to 1 extremely high. But in and of itself that doesn't necessarily mean it should be in fact restricted to 20 to 1, as is your submission. So what are the fundamental reasons why that relativity should in fact be a major issue in any recommendations that we make or government impose?

MR SUTTON (CFMEU): It seems to me, you know, if you go down the road of preparing guidelines in this area, and hopefully you do, you have to make arbitrary judgments somewhere, and I guess we are put some arbitrary propositions and saying that 20 to 1 is something had some historical basis. It has blown well out from that now, but we think that's a figure that makes some sense. All I know is there's this inevitable grind, in terms of the figure going ever upwards. Now, whether you draw the line somewhere else, but, for God's sake, we have to draw a line.

MR FITZGERALD: No, but can I just push you a little bit. Is it the concern, I'm not so much interested in the 20 to 1, that's arbitrary, and we have heard 10 to 1 and others. But is your concern basically one of equity and fairness, vis-a-vis employees and the senior management, or is it that you actually believe that that sort of ratio, these very high ratios, actually cause detriment either to company performance or to some broader community good?

MR SUTTON (CFMEU): It's clearly based on fairness and equity, and the cynicism that it generates amongst employees; I don't know about shareholders, but certainly amongst employees, so it's certainly that. But in addition we do in our submission point to some of the experts in this field, in fact at page 6 we have a quote from some authors who say that, beyond 17 to 24 times average wage and

salary earnings, company performance begins to deteriorate, and they also go to the work of Drucker. I haven't delved back into it to see what kind of empirical basis they have for that; they assert that company performance starts to deteriorate. I can't tell you on what basis these experts say that, but there's at least some experts out there who say it.

PROF FELS: Just changing the subject for a minute. Within a company the executive pay and then there's wages, and I'm interested in kind of how the whole ladder works or where the break points are, almost two systems within companies. Have you got any kind of insights how those are?

MR SUTTON (CFMEU): Typically, with a lot of the large companies we deal with, they would have collective agreements, they would have certified agreements with the union, and generally they cut out somewhere just below middle management. You know, you'll have leading hands and sometimes supervisors, but those that are captured in collective agreements, generally are the so-called workforce or the - how would you describe it, the non-salaried employees. So if you're salaried staff, you tend to move into arrangements that are quite at variance with the arrangements in the collective agreement; you may work completely flexible hours for your fixed salary and, you know, the further you go up the tree you'll get access to share arrangements and share bonuses and other company incentives and stuff like that.

PROF FELS: The trends you're concerned about are at the higher salary levels than this, I suppose.

MR SUTTON (CFMEU): Well, I mean, we're here emphasising the disparity between CEOs and top executives compared to average wage earners, particularly a lot of our stuff goes to people on average weekly earnings.

MR BANKS: They should be seen, I agree, as a package, but one of your recommendations refers to abolishing the current tax deductibility for CEO pay over one million dollars. It illustrates a point that has also been made to us, and that is there was a comparable provision in the USA which is now seen in hindsight as having driven pay underground and into these various other opaque vehicles, including share options with shonky performance criteria, et cetera. I suppose it illustrates a bigger point about unintended consequences, that we are obviously going to need to carefully look at. But I just wondered whether you want to make a comment on that.

MR SUTTON (CFMEU): Look, I do accept that this is an area where if you move the goal posts then people find ways and means and they get the best accountants and the best lawyers, and I know it's a moving feast all the time; so I'm very conscious of

that. I believe the answer is you must be looking at total remuneration. You have to be looking at all the bells and whistles. You can't just say, "Well, we'll do part of the job and that will fix it," you really have to try and capture everything.

MR FITZGERALD: In a couple of the submissions we have heard, the issue about the decision-making processes in companies, and you may have heard the last couple of submissions of participants in relation to the way in which the directors have perceived conflict of interest and the way some of these remunerations are established; but also the issue about the impact of employees as shareholders.

It's not in your recommendations, but I was just wondering what the union view is in relation to employees as shareholders, as a means not only in this area but in terms of going forward. There was a period of time when there was a lot of discussion about those schemes. There has been a bit of controversy around the government's proposals. But does the union itself see any great value in pursuing employee share ownership, notwithstanding the fact that all of the employees have superannuation benefits, which are very active shareholders.

MR SUTTON (CFMEU): We would have members who do have arrangements through the company where they have share allocations, but at a relatively modest sort of level. We are cognisant of the recent debate about that and we haven't sort of bought into the issue front and centre. But some other unions have and they are concerned to ensure that their ordinary wage and salary earners are not hit too hard in that process, because, after all, that wasn't presumably the primary intention of the treasurer and the government in the budget.

I don't have a lot to say on that issue, other than it's a fact, it's a reality. It doesn't fundamentally alter the dynamics here. Where before you were talking about the real high flyers, and I can assure you their share allocations are sort of in a different stratosphere than the share allocations that go to our people. So the dynamics are quite different, and I don't see that those relatively modest share allocations change the dynamics.

MR FITZGERALD: Can I ask just one other question, which you may not want to comment on. As a union that has a very strong interest in the superannuation entitlements of its members, are you satisfied with the way in which the superannuations are acting as investors in this issue; and again you may not want to comment. But one of the things that is clear is that shareholders do have a vital role in ensuring the performance of both the directors, and, through that, the remuneration packages. Have you been satisfied with the way that has been handled or - - -

MR SUTTON (CFMEU): Do you mean the superannuation funds as such?

MR FITZGERALD: Yes, as investors and as voters.

MR SUTTON (CFMEU): Well, I'm not here authorised to speak on behalf of the super fund that I have been a director of for about 14 or 15 years, but it's one of the large industry funds, but I'll just venture a couple of comments I guess that I'm glad, and I think that my union is and most unions are, that the industry funds are much more active in this space these days. We do often, as far as I know, on most occasions vote our shares at general meetings and the like or direct the intermediaries to vote in certain ways and I think that is having a positive effect in terms of improving corporate governance and improving some practices. Indeed, I know of instances where executives have changed their original recommendation or stepped back from what you might call unethical practices because those super funds obviously collectively carry a pretty big shareholding in some of these companies. So that's all having a salutary effect, a very positive effect, but it's not determinative or generally it's not so powerful that it wins the day. Sometimes they're voting in a minority, but it's something that some companies are having to live with and reckon with, so it's generally a positive development at any rate.

MR FITZGERALD: Thanks for that.

PROF FELS: This does prompt the thought if you say governments should follow these standards, the 20 per cent and so on, why don't the industry funds follow similar criteria? I understand your point a minute ago, you're here for the union, but why don't you use your union influence to get these criteria adopted?

MR SUTTON (CFMEU): As I said, I don't think the super funds are determinative at this stage. I think they're a growing presence in the environment and they are getting larger shareholdings in companies and that is having some impact but it's generally not decisive or determinative. When you're a director of a super fund, you've got a fiduciary duty to maximise return for your members obviously. Obviously super funds want to also be trying to move in the direction of ethical practices and all that sort of thing and they are, as best they can, but you wouldn't want to cut yourself off from not being able to invest in any Australian companies or overseas companies overnight. These are evolving things, so if you're saying to me should the super funds be trying to leverage into higher standards and move in that direction, and I think they are, I don't think it's a question of laying down an edict tomorrow and ceasing all investments in all companies that don't quite meet that standard because it would just about prompt a crisis in the investment community. I don't know where the money would be put.

PROF FELS: Wouldn't governments have a similar dilemma?

MR SUTTON (CFMEU): Not really. You, I believe, should be developing

guidelines. Government can adopt guidelines and whether they're phased in or however they are brought into operation, governments should put the guidelines out there and expect companies to meet those guidelines, not one company or two companies but all companies meet those guidelines.

PROF FELS: I can see actually a couple of aspects of governments. One is some quantitative limit, like your 20, and the other is something a bit more at the process end, not entirely limited to that, but in some ways some process requirements are easier to envisage, although maybe they wouldn't go very far. Maybe that wouldn't satisfy you enough or whatever. There's a fair number of government contracts where there are already process requirements on for this and maybe there are some criteria about executive pay which may or may not go on to the qualitative restrictions you have talked about.

MR SUTTON (CFMEU): I can only say again that it's an area where we think governments should come out with guidelines as to what they regard as good practice, sound corporate practice, sound governance, and if companies just completely say, "Up yours, we're not interested in your government guidelines, we'll do what we like," and they're right off on the extreme end of things, why should they be turning around and expecting to get government largesse or handouts or assistance or win government contracts? I mean, they shouldn't expect it both ways, it seems to me. They either respect the government of the day's views and cooperate with them or they go into their own private sphere and operate free of government support or largesse.

MR BANKS: Do I take it from what you were saying earlier though that you would accept that there would need to be some sort of transition because the point you make about your fiduciary duty as a director, it applies to the duty of the government - - -

MR SUTTON (CFMEU): Of course. We're not unrealistic. This is all about improving practices and getting to best practice and phasing things in and getting to the goal where we want to get to and we're realistic enough to know that often that needs to be phased in.

PROF FELS: One other thing, have you any views on the current controversy about the new tax changes on the share schemes? You know in the budget, there were changes proposed in the share schemes and there's been criticism of that, including I think by the ACTU, the changed tax arrangements about share schemes. Maybe you haven't - - -

MR SUTTON (CFMEU): No, I was actually out of the country for the two weeks of the budget, so I'm not quite - - -

PROF FELS: So you missed the fuss.

MR SUTTON (CFMEU): Yes.

MR BANKS: Perhaps just related to that - and excuse me if you've picked that up - but just how you perceive share ownership among your members in terms of corporate performance. Having wider employee share ownership, do you see that as a plus?

MR SUTTON (CFMEU): I think it probably can improve company performance or build loyalty to the company but I don't carry the point too far because I do know of companies that have got poor industrial relations and hostility between workers and management where there are share arrangements in place, so it's not a guarantee or there's no automaticity that if you've got that, you automatically buy loyalty under any circumstances. It probably in a well-run company helps build loyalty, but it's not a substitute for good industrial relations, I don't think.

MR BANKS: Good, thank you very much for appearing. We'll just break for a minute before our next participants.

MR BANKS: Our next participant this afternoon is the Investment and Financial Services Association Ltd. Welcome to the hearings. Could I ask you please to give your names and capacity in which you're here today.

MR O'SHAUGHNESSY (IFSA): My name is John O'Shaughnessy and I'm deputy CEO of the Investment and Financial Services Association.

MR BANKS: Thank you.

MR SORBY (IFSA): My name is Joseph Sorby. I'm the senior policy manager for the Investment and Financial Services Association.

MR COOPER (IFSA): I'm Greg Cooper. I'm the chair of the investment committee for the Investment and Financial Services Association and also the CEO of Schroder Investment Management Australia Ltd.

MR GETHIN-JONES (IFSA): I'm John Gethin-Jones. I'm on the IFSA investment board and also the chief executive of Intech Investments, a member of IFSA.

MR BANKS: Good, thank you very much for taking the time to appear today and also we had the benefit of talking to at least three of you I think when we visited Sydney previously and we benefited from that conversation. So as we discussed, perhaps you might like to just raise the key points and we'll take it from there.

MR O'SHAUGHNESSY (IFSA): We'll most certainly do that. I'll leave you with a copy of the opening statement as well.

MR BANKS: Thank you.

MR O'SHAUGHNESSY (IFSA): Thank you for the opportunity to appear before the committee and provide evidence. I am joined by my colleagues and we're available to answer questions. We'd like to start by making this brief opening statement. IFSA is a national not-for-profit organisation representing wholesale fund management, superannuation and life insurance industries. We have over 145 members and over a billion invested on behalf of 10,000,000 Australians. The member companies comply with IFSA standards and guidelines and they are actively monitored to ensure the promotion of industry best practice.

IFSA members, both as custodians and managers of other people's money, as institutional investors and in their own right have a vested interest in ensuring that there is an alignment of remuneration with risk-management both in their own

operations and the companies in which they invest. Consequently, IFSA has developed and implemented two specific guidance notes on executive and director remuneration. We note that the principles enshrined in these guidance notes are consistent with the current governance regime.

IFSA's corporate governance guidelines, commonly referred to as the Blue Book, have been in operation since 1995 and have been revised and updated on five occasions. They also provide guidance on board and executive remuneration policy and disclosure. These also formed the foundation of the ASX Corporate Governance Counsel Guidelines. IFSA's Blue Book encourages fund managers and other institutional investors to establish direct contact with companies, including constructive communication with both senior management and board members about performance, corporate governance and other matters affecting shareholder interests and including remuneration.

Since 1 January 2005 it has been mandatory for IFSA members to comply with IFSA's proxy voting standard. Under the standard, IFSA members are required to vote on all resolutions regardless of the materiality and the size of their shareholdings. Only a few occasions since 2005 has there been an issue with executive remuneration. When there has been an issue, a clear and unambiguous and public message to the company's board of directors has been delivered. It is clear that these requirements have been successfully implemented by IFSA.

As outlined in our submission, Australia continues to be well-regarded in the region and globally for the strength of its regulatory regime underpinning remuneration of executives and directors. We specifically note that the current governance regime over remuneration in Australia has experienced no systemic failure under the recent market turbulence. Evidence is also growing that the current regime is adjusting of its own accord to the change in financial environment. However, we note that there are four remuneration-related inquiries under way in Australia at the present time.

We believe there is a need to avoid unintended results and consequences which operate against good governance practice and Australia's competitiveness. The regulatory framework underpinning remuneration should remain principles based and not unduly restrict companies' flexibility and the ability to attract, motivate and retain the highest quality executives and board members that are capable of driving improved company performance. In summary, we submit that transparency, accountability and fairness are all key principles that should guide companies when designing equity plans for executives and directors.

Whilst we acknowledge that there are concerns over corporate excesses and the current regulation of remuneration, particularly offshore, we strongly believe that it

is ultimately the responsibility of boards of directors to approve the design of all equity plans and to take specific responsibility for hiring executive staff and approving the terms of their employment. We expect that the Productivity Commission should ensure that we protect what is working effectively in this country and help reform principles that ensure our governance, market integrity and Australia's reputation is enhanced regionally and globally. We'd be pleased to answer any questions.

MR BANKS: Thanks very much. You cover all the terms of reference in your submission. One of those relates to the alignment of the interests of shareholders with those executives and boards, and you also note that aligning the interests of the company with the wider community is an important consideration. I thought I might give you the opportunity to talk a little bit about that and how in your view that alignment is best achieved, which probably draws on some of the principles that you have enunciated, with shareholders, and then, but more broadly, to talk about the concept of alignment with the community interests more widely and what that means to you.

MR O'SHAUGHNESSY (IFSA): Thank you for the opportunity to address this point. It's a point that IFSA has been dealing with really over the last couple of years. I'm actually going to pass it to John Gethin-Jones, who has also been responsible for the rewrite of the IFSA Blue Book that's about to be released. That essentially has canvassed the social responsibilities of companies, not just their economic performance. Would you mind if I give that to you?

MR GETHIN-JONES (IFSA): Sure. In that sort of community sense or the social sense, there's a growing recognition within the investment management industry that a company's wellbeing and value can be impacted not only by commercial and financial risks but also by social, environmental and other risks not associated normally with finances. So when we talk about alignment, it's more about aligning the executives and the company to focus on financial outcomes as well as other outcomes. There are clear examples throughout history of companies whose value has been impacted by non-financial issues.

MR BANKS: Just I guess in relation to remuneration, I mean, how do you see that playing out there? We had an earlier participant talk about the relatively high proportion of companies that profess to be interested in triple bottom line, but their performance is generally not judged certainly for remuneration in those broader terms.

MR GETHIN-JONES (IFSA): You need to align the key performance indicators of the executive with not just financial affluence. So measurable outcomes which focus on issues other than bottom line.

MR BANKS: What is your perception of the extent to which that's actually being done?

MR GETHIN-JONES (IFSA): I think it's an emerging thing. It's a debate that has been going on for a number of years and I think it will get better and better and better.

MR O'SHAUGHNESSY (IFSA): Can I add to that that a number of our members, I don't know whether I could say half or more than half of our members, are signatories to the UN principles. The support for those principles is quite apparent, but trying to get them linked to reward - you know, and I think that's at the heart of what you're talking about - is very, very key. The revised approach to our Blue Book is not just saying that these are important and why they're important, but trying to also get an alignment not just with economic performance but with broader community performance.

MR BANKS: In terms of alignment with shareholder interest, if we just look at that subset of the community that's particularly relevant to a corporation, I guess, what do you see as being the key elements there, and in particular I suppose the question of long-term versus shorter-term incentives. We have different views put to us and we have put all the focus on long based pay plus long term. Others have argued that short-term incentives are also important and have a role. But we'll just give you the opportunity to talk about that, if you like.

MR COOPER (IFSA): I would say just at the outset that I think it's very hard to be specific about. The sorts of companies that we're investing in vary across such a wide range of different industries and specialties that it's hard to be too overly specific, and I think that's always the danger in trying to enshrine certain things, be it regulation or guidelines or anything, that it always has to be based around principles rather than specifics, because there will always be exceptions to the rule.

In the context of individual, you know, trying to get the right level of alignment between long term and short term, again that's one of those things where I don't think there is an exact right answer, it's a balance, and it depends very much on the nature of the company. Clearly you want to see elements of both. You don't want to see, I think, all remuneration purely long-term nor do you certainly want to see it all short term. Our broad view there is that the executives of an organisation are there to build shareholder wealth over the long term, so there should be a bias towards the long term, but difficult to say exactly what those numbers should be, because it will vary by organisation.

MR FITZGERALD: You may or may not have seen the submission by Regnan

Governance Research and Engagement, they presented earlier this morning, which put forward quite a detailed proposal in relation to ensuring that equity rights in fact don't vest for between five to 10 years, and you may have seen that, and obviously they have a clientele that represents a number of super funds and what have you. So there they have actually come up with a model that, whilst not prescriptive, does in fact try to say the alignment can only be achieved if we have quite long tails. I was wondering what your view about that is. What is an appropriate tail that we should be looking at?

I just want to qualify that by another comment. We have met with a number of CEOs and when you talk to them they're not so much concerned about when they're still in employment, but when we have spoken to them about, "Well, how long could an equity not vest?" they say, "Well, one year after I leave," or "Two years after I leave," they were almost aghast when anybody suggested five to 10 years after they leave. Yet we know some companies, very few, have that. So do you have a particular view about the vesting of share rights after the performance benchmark has in fact sort of been met or the initial right has been granted?

MR COOPER (IFSA): This isn't a view that represents IFSA, because it's something that's under discussion at the moment, and certainly within the investment committee these are the sorts of issues that do come and we talk about in some detail. But what I'd say, from Schroder's perspective, we are fairly well aligned with what Regnan have been saying, and I'm not aware of the exact specifics of their submission but we are aware of the broad principles and we would certainly agree with those.

But again I think it's quite difficult to say, you know, "for every company the following should apply," there will always be different circumstances. To us, it's very much, well, we want to see a skew towards long-term incentives and some of those vesting post the completion of employment for particularly the CEO, because what he or she does during the term of their employment is going to impact on the business post-employment. You have to balance things out. There's particular balances with offshore.

The competition for talent is global, and so you don't want to have particular rules in place that will bias or make it more difficult to recruit senior executives in Australia relative to offshore because you're in a global talent pool. Secondly, I think you just have to balance out some of the individual circumstances of the corporation. To us, it's much more about recognising that the responsibility of the board is to set appropriate remuneration policies; and that's something the board should be held accountable to, as the representatives of shareholders.

MR O'SHAUGHNESSY (IFSA): Could I perhaps add to that? I think what Greg

has said for Schroder actually applies quite broadly. Most of our members do have a base model that they work from. I think there's not necessarily a prescribed model, but there's an ideal model that they work up and down from, depending on the nature of the company, the competitive market that they're in, the business that they're in. So I think that model isn't the exception, not that particular model but the models that are actually there, they work from almost a best-practice position up and down from that. So I think it's helped more broadly than just with Schroder's.

MR FITZGERALD: You think a period for example of five years or more post-termination or post contract end is not an unreasonable sort of period of time for a CEO or a senior executive to - - -

MR GETHIN-JONES (IFSA): No, there's one issue here which you need to consider. When does the activities of the retiring CEO and his influence on the company's performance stop and the new CEO's performance come in? So if you're a very successful, did a wonderful long-term job for a company and within two years of your departure the company has fallen apart due to the activities of the new CEO, it would seem a little bit unreasonable that he didn't get any vesting or equity.

MR O'SHAUGHNESSY (IFSA): Sorry, I want to just make sure that the record is right. That what I was saying wasn't endorsing a five-year period across the board.

MR FITZGERALD: No, I wasn't saying that. I was trying to get your sense, because, I mean, what we have got is some people that really do support the notion that when you cease your contract you get all the benefits and you walk out the door, there are others that say 12 months, some say two years; we have got propositions that are five to 10 years out. I'm just trying to get a sense of what you think is reasonable, not in every circumstance. The second part, just taking that up, is it up to the discretion of the board two years hence to say, "We have so changed the strategy of the company that at our prerogative we are in fact going to allow it to vest now." Is that the right approach?

MR COOPER (IFSA): Look, I mean, I would say something like three to five years is probably not unreasonable, and you've got to be very careful about the specific circumstances of the company involved. For obviously a CEO who is coming in to turn around a company in a very short space of time, something that's in trouble, then to some extent some sort of longer term pay-off, because there are decisions that that person could take that are short-term beneficial to the bottom line but long-term harmful to shareholder value crash, and there some form of, you know, stretching towards the longer end might be appropriate post their period of employment.

On the contrary, a CEO who has been in place for 10 or 15 years who has built a lot

of that value creation, who has already been with the company for a long time, then clearly you can have a shorter-term pay-off, and I think that's what it's quite hard to be overly prescriptive about exactly what the period is. We would say that some period beyond termination of employment is certainly the right sort of model to aim for, but how long that is and how much of the remuneration is deferred is I think again up to boards to interpret as to what is the most appropriate; and us, as shareholders, hold boards accountable for those decisions.

PROF FELS: I was going to raise something different. I just wanted to mention, we have been listening today and we've been reading submissions and we're getting at least two views of the world. One of them is, "This a matter for boards, it's their responsibility," you have said that, and also, "You should be very careful in prescribing as well." The three speakers I think before you had a completely different view.

So we have just been hearing for half the day, so to speak, "Well, we tried relying on boards and look what has happened, there has been an explosion of executive pay, it hasn't been linked to performance, it's having harmful results in short term, as in equity," and so on, "The boards are not up to it and something needs to be done." So I present those two different views. I wonder if you have any reactions to that. I think you're in the camp that says, "Well, it's up to the boards. There may have been some concerns, but leave it up to them and don't tinker too much, but make it transparent and accountable, which, to a degree, it already is."

MR O'SHAUGHNESSY (IFSA): Can I just say very much the theme of my opening statement was to say that so far we haven't identified any systemic issues, and I think that's important. That's not to say that there hasn't been a decrease in asset values. So real recognition that the valuations and performance of companies has been impacted. We would say that a lot of that is actually caused by global conditions, not necessarily domestic conditions, in that sense. That is why we recommend that we need to take not just this review but all these reviews very carefully and understand what is the causation of the issue.

The position we have got is that we don't necessarily think that the cause of this has actually been an issue with executive remuneration. Having said that, certainly we recognise that the earnings of executives have increased substantially over the years, but the need to address executive remuneration and its relation to performance I think is an ongoing challenge, and I lot of it is actually getting that balance right. But as far as saying that Australia needs to become prescriptive in that space, I think is a great concern.

MR COOPER (IFSA): Maybe part of the reason for the difference in views you're seeing is quite clearly we represent, members of IFSA represent, ultimately a large

chunk of the shareholder base of many of these companies, and so we have - and certainly we exercise it within our company - the ability to tell boards what we think and how we think remuneration should be structured; and if we disagree with some of their views, the ability to walk away from those companies. Therefore, having that ability, to us it is a fairly important part of the way we invest and we feel we have some say in how the executive remuneration is ultimately structured.

I would say that I don't think there is a tremendous issue with executive remuneration in Australia. I think there will always be situations, no matter where you go around the world, where you can pick out certain examples and identify them and hold them up as examples of improper practice, but no amount of regulation or anything else is ever going to solve that, and ultimately what you want is, you know, people who represent the views of the owners of the business acting in their best interest. Certainly in aggregate, when you look across the industry here, there's more examples of where it has worked than where it hasn't worked; and certainly; relative to global markets, I'd say that Australia comes out relatively good on that scale.

MR FITZGERALD: I suppose a fundamental that leads from that is this notion of fairness. In your paper and in your guidelines you have three major themes, transparency, accountability and fairness. One of the former participants would say that one of the fundamental problems is, "What is fairness in your language?" For example, we have just had a position showing that in the late 80s it was 18 times average earnings; it's now, on the BCA list, up to 63 times average earnings.

Some would say, innately, there is an issue of fairness in that; others would say that's exactly the wrong measure to look at, and in fact that's not the measure. So when you use the word "fairness", and I know this is always difficult, what is your sort of frame of reference for what is fair? It's clear to us, in some of the private conversations we have had with organisations, what they really mean by that is what the market bears. That's a very different view to what the community might have.

MR O'SHAUGHNESSY (IFSA): Could I perhaps just start the answer and then pass it over.

MR FITZGERALD: Sure.

MR O'SHAUGHNESSY (IFSA): I think that the starting point is that the relativity issue is not one that's been domestically driven. I would say that those benchmarks in Australia are probably no different or even less severe than perhaps in other areas. In part, that I suppose forces us to recognise that Australia operates in a global community. In our definition of fairness, I'd go back to the point we were making before and that is to make sure that the rem has a balanced approach and rewards people both with their base salary, short-term incentives and their long-term

incentives in a way that as much as possible represents their contribution to the corporate performance. It is not certainly a statement in relativity to other employees in the country but we do recognise executive rem, not just Australia but globally. It is actually in a different position to where it was 20 or 30 years ago. I don't know if anyone wants to add to that.

MR COOPER (IFSA): Yes, I would say certainly in relative terms, one could pick out much greater examples of income disparity, if that's the way you want to describe it, using those sorts of measures, particularly in places like the US, and we've always got to be conscious in this country that again it's a global pool for talent, so to some extent if those sorts of excesses take place overseas, then by default Australians are competing in those markets, executive remuneration is going to get dragged up. So I don't think you can define fairness or not as being relative to average wages. I think there are broader measures of fairness and ultimately it comes back to long-term shareholder value creation. That's the thing that boards are in the best position to manage and it's the shareholders who hold those boards accountable who are in the best position to assess.

MR BANKS: We've had, as Allan was saying, some earlier participants today who have argued in favour of particular ratios of CEO pay to wages of employees, either the lowest or the medium or something like that. We'd maybe just get you to make further comment, drawing on what you've just been saying about what the implications might be of imposing a ratio, whether it's 10, 20 or whatever; there will be a submissions that you will see that have such suggestions in them.

MR O'SHAUGHNESSY (IFSA): Perhaps if I lead off. Our concern would be the competitiveness of Australia's industry. Many of those companies that are actually contributing to shareholder value in Australia I think would have a severe productivity limitation if there was a prescriptive regime put in place. Unfortunately part of the issue of being in a global community is that not just talent is exportable but we've seen instances where head offices are exportable and there are economies that want to grow, so when I say that it's competitive, there are other forces that solicit interest from Australia, particularly Australia's reputation over the last 18 months in a relative sense has probably been quite well enhanced.

The comment I would make is that it was interesting with the Blue Book or the governance notes that most of our peer organisations around the world are very interested how Australia's corporate governance develops. I am not suggesting that we actually have a leadership position globally but I think we do have quite a lot of influence globally. The mere fact that we are incorporating social responsibility in our corporate governance position has piqued the interest of many other organisations similar to IFSA around the world, so we do have some global influence. I don't want to mislead you to say that therefore a better relativity will be

attained between those different classes of workers, but we do have some influence.

MR COOPER (IFSA): I would just add if you start imposing fixed ratios of executive remuneration to, say, the average employee or broader Australian average wage levels, then a number of different things can take place. Firstly, you could encourage better performing CEOs to want to work for overseas companies where they might breach what those caps are that have been set in place. You might actually end up inadvertently creating a framework whereby those caps become the norm and that becomes the way CEOs get paid. There are various other things that could flow from putting in place such specific sorts of measures around CEO pay and all the more reason why we would say, in fact if anything, it would do more to de-link I think CEO pay from underlying shareholder value creation than actually link it.

PROF FELS: On another subject, do you see any different requirements for the banking and financial sector in this regard than the rest of the economy?

MR O'SHAUGHNESSY (IFSA): We've done a submission to APRA. The interesting part, when you have a look at the proxy voting standard that we've had in place and have a look at the issue with regards to executive remuneration and our proxy voting position, I might have this wrong but I think it was only one or two issues on executive remuneration have come through. So if we look backwards, then you would say that the financial sector is probably not an exception in Australia. You've obviously got then the responsibility or the linkage of their responsibility with their prudential position in Australia. Our view is that the paper that's been produced by APRA is probably well weighted in that. Obviously we've got points that we want to make but I think that they have come out with quite a good position and I think we've actually explicitly said that it is probably appropriate for the broader Australian community, not just the financial services sector.

MR FITZGERALD: Can I just test that. When you say that, do you think that the principles that APRA has come out with are applicable across other areas, not just financial, and specifically are you supporting the notion of linking risk to remuneration, as it's stated in that APRA paper, as applying across non-financial institutions, because many people have raised doubts as to whether or not the principles governing financial services should have broader application and it's an issue we're very keen to look at. So I just want to be very clear, that in general terms you think that risk of remuneration linkage is appropriate as articulated by APRA?

MR O'SHAUGHNESSY (IFSA): The starting point is that for our members - and I say very broadly, if not across 100 per cent of our members - that risk is an important factor anyway and has been for quite some time, so it's not a new factor at all in executive rem space. Because APRA are a prudential regulator, we can

understand why they have gone to a more explicit level in the risk area. We haven't completed our relationship with APRA but we're not finding across the board that there's a lot of member concern. I'll just get Joseph to add to that but I'm not aware of a high level of member concern with regards to their statements on this. Joseph?

MR SORBY (IFSA): As John said, we're still considering the paper and we'll be lodging a submission in response to it. I think generally when the paper came out, we were quite public that we were comfortable with the principles and their application more broadly.

MR COOPER (IFSA): Again, I think this is another one where one can look at the performance of the Australian financial services industry versus globally and say that actually again, things in Australia haven't worked too badly relative to globally and we certainly don't have the degree of issues that have cropped up in places like the UK and the US.

MR FITZGERALD: In the APRA environment, you've got APRA itself who is able to exert influence in different ways because it is in fact the supervisor or the prudential regulator. I was wondering whether or not you believe that the role of the ASX, the ASX Governance Council and ASIC - well, I suppose really ASX governance and ASIC, their current role and the way in which they perform their role is adequate or are there areas in which those two bodies could in fact act differently from how they do at the moment?

MR O'SHAUGHNESSY (IFSA): We are participants on the ASX Corporate Governance Council and I think what we've said in our submission is that we think the current system is working well, mainly because our members actually take an active interest, not just in shareholder remuneration but really in the value that's created for shareholders more broadly. We will continue to review, as we already have, the IFSA Blue Book going forward, but at the moment we're not calling for a major change in that area. Certainly we're understanding of APRA's powers and we're not calling for those to be extended outside of the financial institutions.

MR BANKS: Would it be fair to say, just going from that - I mean those powers that reside in APRA reflect the nature of that sector and the potential for contagion and systemic problems emerging from failure in an individual corporation, which we would not see more widely in the economy. There would be some areas of the economy where you would want to encourage risk, not curtail it, because that's the nature of the activity.

MR O'SHAUGHNESSY (IFSA): I'd just have to agree.

MR BANKS: You talk about transparency and accountability as well as fairness

and it gets into the question of the disclosure requirements. So we have had quite a bit of commentary about those and how transparent or opaque they may be in practice. Could I just get you to comment on where you see scope to improve those requirements?

MR O'SHAUGHNESSY (IFSA): Can instructions we start with the people who are managing equities first, and perhaps I'll add to it at the end?

MR GETHIN-JONES (IFSA): I think the disclosure currently - for a professional investor who does it every day of his life probably you could wade your way through it, but if you're a normal person investing in the share market and you read an annual report and looked at the remuneration section it's not as transparent as we might like to think it is. It is not simple, it is not easy to understand. I think when we talked before that we talked about executive remuneration being particularly complex in the way it is put together, making it even harder to understand. I also think there's issues there around about what realised remuneration is and potentially realised remuneration is, creating an expectation that somebody will get a large amount of money when they terminate but in fact quite often that doesn't come into reality. So I think those are some of the issues. I don't think it is as easy to understand as we would like it to be.

MR BANKS: Yes. Excuse me if you've made this point but in terms of your point about realised remuneration would you see that as being a desirable feature of a remuneration report that actually realised remuneration is apparent to someone who reads that report?

MR GETHIN-JONES (IFSA): Yes, I think so.

MR COOPER (IFSA): Yes.

MR GETHIN-JONES (IFSA): Yes, definitely.

MR O'SHAUGHNESSY (IFSA): I mean that's generally held across the membership.

MR COOPER (IFSA): I would support what John said. I think the other issue we face is quite often when remuneration is commented on, particularly broadly in the press, the numbers that are thrown around can often represent an aggregation of many years of accumulation of benefit rather than - you just see a headline number that gets printed and commented on. Sometimes that's down to reporting from the company themselves and sometimes it's down to the way the public interprets that reporting. I think that's where some of the confusion that John refers to can also come from. So more clarity around how remuneration - the numbers that are paid

and why they are paid and the structure of that would certainly be useful.

MR BANKS: Okay.

MR FITZGERALD: But in relation to the disclosure statement - it's not evident from your submission but in other areas - have you actually made concrete recommendations as to how that disclosure regime can be improved? I mean what you say is right but we sense a general level of discomfort with the way in which that disclosure regime is operating.

So I was wondering whether or not as part of your work you're actually looking at ways that it could become more comprehensible, not necessarily to the mum and dad investor but to a broader range of investors than it currently is. Part of that is also a question with - specifically in our terms of reference is, do we need to change the class of executives to whom this applies? In other words, there are two views. One is we should shrink it, simply to be reporting on the CEO and the CFO only. There would be another view that says we should expand it. So there's two issues. Have you got any concrete ways of making it better? Is its coverage appropriate or should it be narrowed or widened?

MR O'SHAUGHNESSY (IFSA): I think the general sense, and we haven't had a deep discussion on it, is that probably narrowing it would actually help the comprehension side - just talking about those executives, and I'm not necessarily saying it's just CEO or CFO but it's more the range of executives - I suppose, in more of an explicit way as to what their reward system is. With regards to the clarity of it, the Corporate Governance Council keep on revisiting the clarity. I think that there is room for improvement, as already has been recognised.

MR GETHIN-JONES (IFSA): At the moment neither the Corporate Governance Council nor IFSA have actually proposed any concrete suggestions about how that would be improved, but I think as a result of these inquiries we will be looking at those things in the very short term.

MR BANKS: The only other thing I was going to ask you about is that given your guidelines on executive equity plans and employee share ownership plans whether you would like to offer any comment on proposed changes to taxation of employee share plans and whether they could have some impact on what you see as desirable; importance of aligning the remuneration for longer term performance of companies.

MR O'SHAUGHNESSY (IFSA): We have sent a paper off on the employee share plan and it probably needs to be put into context, if you don't mind. What we have basically said is that over - now, a couple of decades - that the employee share payment plans in Australia tend to be working. There are more people aligned with

builder shareholder value within companies now than there has been. We understand the motivation, I suppose, for the changes in the budget but think that perhaps in dealing with an integrity issue that there has been a lot of unintended consequence. We have actually put that into our submission. So we essentially believe that if there is an integrity issue then integrity measures should be taken to deal with those issues, not necessarily a broad brush approach.

We believe that Australia would be much worse off if those plans are frozen or disbanded. Again, the thematic, I suppose, is very much in line with what we have got in our submission to the Productivity Commission but we would be very worried if Australia couldn't continue to reward a broader base of employees than just executives on the performance of the company.

MR FITZGERALD: Just on a related issue, the government's approach in relation to the requirement of shareholder approval for termination pays in excess of one year's base salary. What's your general approach in relation to that particular measure?

MR SORBY (IFSA): I think generally we have got - there are some concerns around how prescriptive that is and, I suppose, consistency with overseas regimes as well. I think where it's leaning is that it's out of step with overseas regimes.

MR FITZGERALD: In quantum or design? In other words, is it your concern with the 12 months, which I think is the UK approach, or is it the design of it?

MR SORBY (IFSA): It's a hybrid of both.

MR O'SHAUGHNESSY (IFSA): Can I say with both, the view that we have got is perhaps - it's an issue, but one that - I suppose one that we need to look at the reform carefully. We have got some concern with quantum but we have also got some concern with - I suppose that's one of the issues, of being prescriptive. When you get prescriptive you need to make sure that you minimise the unintended consequences. A lot of our commentary is around that prescription and how that is designed; but we do have concerns.

MR FITZGERALD: Can I just flesh that a little bit? I mean you obviously - well, sorry. I presume that you have no problem with shareholders having a voting right at some point - which we currently have anyway, although seven times seems very large by most people's reckoning - so it fits into the practicality of the proposal itself rather than the notion of the shareholders at some point having a right to vote on a particular termination arrangement. Is that right?

MR O'SHAUGHNESSY (IFSA): Yes.

MR COOPER (IFSA): I would just say ideally the construct of a good executive remuneration plan should be to address what happens on termination at the point of hiring, not at the point of termination, because that's when everyone is in a far better position to identify what measures account for success and what don't. So that should form - if you start getting prescriptive about the maximum amount payable on termination that can have quite, I think, unintended consequences in terms of constructing the right sort of pay mechanism during the term of employment.

MR FITZGERALD: But is that happening? Are most of the remuneration arrangements put in place with senior executives now taking account of what will occur on termination so that in fact the first remuneration in the first year of the CEO actually reflects that or are these sort of arrangements that are being done at the death knell?

MR COOPER (IFSA): I think on balance good remuneration programs actually do identify what happens on termination. I think the danger is if one makes it too prescriptive and the amount is too small on termination, then you're in more danger of actually bringing forward and reducing - particularly if we talk about a high - a better remuneration alignment is one where there is some vesting post termination of employment and the danger is if you actually put too great a restriction around what can be paid on termination, you will actually lose some of the benefits. The more restrictions you place on that, the greater the unintended consequences.

MR BANKS: All right, gentlemen. Thank you very much for taking the time to attend.

MR O'SHAUGHNESSY (IFSA): Thank you for the opportunity.

MR BANKS: We will break for a moment.

MR BANKS: Our final participant today is the Australasian Investor Relations Association. Welcome to the hearings. Could you give your name please and your position.

MR MATHESON (AIRA): My name is Ian Matheson. I'm the chief executive officer.

MR BANKS: Thank you very much for coming along to the hearings. You haven't been able to send us a submission proper but you indicated you wanted to comment on a document that we have received. I'll give you the opportunity to make the main points you want to make and we'll take it from there.

MR MATHESON (AIRA): Thanks, chairman. I wanted to talk specifically around aspects of the proxy voting process and more specifically how that process, that is the proxy voting process, is relevant to the inquiry and to the setting of remuneration.

The proxy voting process and its role in governance is obviously well recognised but particularly for the purposes of this discussion, its role in a remuneration setting in our view cannot be underestimated. The paper that the chairman just referred to that I was a part-author of and the association I represent was a party to as well as a submission made to the joint parliamentary committee on corporations and markets in September 2007 titled Improving the Proxy Voting System in Australia. I'd just like to draw out half a dozen odd points if I may, chairman, which we believe are germane to the Productivity Commission's inquiry.

We believe that greater transparency around proxy voting and indeed greater electronic facilitation of proxy voting could be very useful and instructive in the debate around remuneration in Australia. Specifically, some of the points that were made in that paper and some other points that I would like to make of which there are six, if I may, in no particular order, the first one is that we believe superannuation funds, to the extent that they are involved in the voting process and in turn obviously having a vote on remuneration policies themselves should be encouraged to have a policy on proxy voting which is available on their web site and also preferably that they should disclose how they voted their shares or how their shares have been voted, as I'm sure if IFSA didn't previously refer to it, the panel may well be aware that not all superannuation funds actually vote their proxies themselves. In many cases they delegate it to third party money managers or fund managers, many of whom are members of IFSA. So that's the first point, that superannuation funds should themselves be encouraged to have a policy on voting.

MR BANKS: Just pausing there - your next points might pick that up - but in terms

of what you see as the preferred approach in relation to that policy, do you have a view on that or do you just want to see transparency?

MR MATHESON (AIRA): That they should (a) have a policy, whatever that is, but ideally it should be that they vote all proxies, which is the - - -

MR BANKS: And they don't delegate that?

MR MATHESON (AIRA): I think that's a separate issue. Not all superannuation funds in Australia are big enough, and I'm talking specifically about the public offer funds as opposed to self-managed ones, but not all public offer funds themselves are big enough to justify, nor do they have resources internally to be able to set up an infrastructure to do that themselves, and there are good reasons therefore to outsource that to their third party fund managers. Does that answer your question?

MR BANKS: Yes.

MR MATHESON (AIRA): The second point, I think as you already know, having established a policy and disclosed that on their web site, they also disclose how they have voted their shares if and when they have voted. Thirdly, that ASIC issue a no-action letter on the issue of those listed entities who offer electronic lodgment of proxies to shareholders, even if the company's constitution does not explicitly provide for it. I'll explain that in more detail if you would like any further clarification of that. But in our view and certainly in the IFSA paper, that is an impediment to many companies not offering electronic lodgment of proxies which is a big issue for institutional investors, less of an issue for retail investors.

The fourth point is that we suggest that ASX amend the proxy voting information that listed entities are required to lodge with ASX following any meeting, again to provide more transparency and to make it easier to understand what has actually transpired at the meeting. Currently what's required to be submitted to the ASX following a meeting is the number of votes cast for, against and abstained, whether the resolution was passed on a show of hands or a poll and obviously whether the resolution was passed or not. What was suggested is that extra statistics, like the percentage of the issued capital that voted on each resolution et cetera, again we believe would go some way towards increasing the market's understanding and general transparency around what is actually happening in regards to voting, so there's if you like a full accountability chain.

Fifthly, we have also been trying to encourage the share registrars to develop systems to accept electronic voting instructions on a straight-through basis. As other participants may have told you, there is a quite lengthy and cumbersome process for the submitting of proxy instructions, and I'm confining this to the institutional

investor part of that process, that involves a number of different intermediaries, not just the company and its share registrar, but when it comes to institutional investors, there are other third party intermediaries in between institutional investors and the share registrars and the custodians themselves as well, that the proxy advisory firms who in turn - and to mention two specifically because they have electronic voting platforms, being RiskMetrics and also a firm called Broadridge, both two global firms that offer - two custodians in Australia - a service whereby their clients, being Australian based fund managers, can vote their shares electronically, but when it gets up to that point it can go no further electronically.

So one of the key recommendations in this paper, and we still strongly believe in, is, if you like, devising a truly straight-through processing system for the lodgment and processing of proxy votes, which in turn should provide for again greater ability to audit the process at each stage, and again reporting and accountability therefore just becomes that much easier as a result.

Lastly, the sixth point that I wanted to mention, again a recommendation of the paper, is that the record cut-off date be increased to five business days prior to the shareholder meeting from the current 48 hours before the meeting, and the suggestion there was that the ASX definition of "business day" be adopted so that weekends and Mondays are following long weekends, et cetera, be excluded from the current definition. Chairman, that's all I wanted to say, but, just perhaps to summarise, the main thrust of submission and remarks are to do with the proxy voting process as it relates to determining and accountability when it comes to remuneration.

MR BANKS: Thank you. I take it the underlying premise in all of this is the system is not working as well as it should and that the potential afforded through proxy voting to influence remuneration, among other things, is not being fully realised. Do want to just comment on that?

MR MATHESON (AIRA): I think that's true. I mean, I think there's a lot of noise around remuneration, obviously it's a very populist issue, and I think there's a frustration level on the part of many shareholders, not that they're not empowered or don't have the ability to vote - and I think there have been some catalogued examples, and AMP Capital Investors have done their own homework on this and discovered that where they were a substantial shareholder, for example, they looked at and voted all their shares that they had, when they looked at the subsequent voting announcements lodged with the ASX there were in fact a lesser number of votes voted against than they had voted for against, if that makes sense.

So I think when it comes to remuneration, part of that frustration is that votes aren't either being counted or they're being lost, hence we think one way of addressing that issue is (a) increased transparency, but (b) greater efficiency through

the whole chain, it should be fully electronic. The irony of this is that for a retail investor, in most cases now, and I'm sure you have all received notices of meeting and proxy forms yourselves, these days, certainly in the meeting season that has just been in May, I noticed a significant increase in the number of proxy forms that provided for electronic lodgement.

If you are a named shareholder on the company's share register, be that - in my case, Ian Matheson, I could vote electronically myself, but if I'm an institutional investor or a superannuation fund that holds my shares through a pooled account or through a custody account, in the name of the one of the bank custodial accounts, which more often than not funds and fund managers are not doing that to try and hide, they're just doing that as requirement of the Superannuation Industry (Supervision) Act; that is, they are required to use a custodian for safe-keeping and administration purposes.

So the custodian becomes the registered shareholder, and therefore the legal shareholder, so companies and their share registrar can only recognise currently a vote submitted by a named registered holder. In the case of an individual, that's fine, because, unless I'm investing through a private company name or a managed superannuation fund, I, as an individual, am named on the register, so they know who I am. But for all the dozens, if not hundreds, of underlying funds and fund managers underneath a bank custodial account they are not recognised by the share registrar because they're not named on the register.

The registrar doesn't know who they are, so they can't accept a vote lodged directly by that fund or by that manager unless they are specifically named on the share register. That's why I think some funds and some fund managers get frustrated by this, if you like, disintermediation that goes on in the voting process. So when contentious remuneration issues blow up, it's then, "Well, how do we vent our spleen?" if you like. One way is obviously to, as many managers and fund managers and funds do, vent that directly with the company themselves. But obviously an ultimate sanction is to vote and vote no against the remuneration policy. If they then discover that their votes are going astray or they have run out of time or whatever, then it just magnifies that frustration factor.

MR BANKS: Given that this paper was produced in September 2007 and you had a large number of participants both at the round table and I'm sure you consulted on, why has there been no implementation of the recommendations, if there is widespread support of them? Secondly, from what quarters is the pushback coming, if any, to these recommendations?

MR MATHESON (AIRA): ASIC seem to think there's not a problem, which I think, collectively, the parties to this paper would disagree with, that's specifically on

the point about issuing a no-action letter, they don't think that's necessary, but, you know, many companies do think it would be helpful for ASIC to come out and do that. When it comes to funds and fund managers voting more of the time, I think there has certainly been some evidence of that. But the audit trail, which is the issue that concerns some fund managers, including AMP Capital Investors, that has not been fixed. I understand that at least one of the share registrars has done some work on their electronic delivery receipt platform to at least allow electronic lodgment of proxies at an underlying level.

Again one of the problems that you have when you have a pulled nominee account on a company share register - just for the purposes of an example, let's say the registered holder is J.P. Morgan Nominees, which is typically one of the largest registered holdings on a top 100 company, it might be holding 100,000,000 shares on behalf of 100 different clients; some 60 of those 100 clients might want to vote no, the other 40 might want to vote yes. A typical proxy form gives you the option to tick yes or tick no, it doesn't give you in many cases the option to be able to split your vote. So in the case of my example, J.P. Morgan couldn't necessarily fill in a box to vote 60,000,000 no and 40,000,000 yes.

MR FITZGERALD: Some of these recommendations required they're just sort of changes to the Corporations Act, some don't. Some require action by the Australia Stock Exchange, and other don't. So just let's assume we thought these recommendations were all terrific, and, given the participants in it think that's the case, we're unlikely to disagree with that. But what is the sequence for action that you require. I suppose, again just trying to flesh it out, does ASX see merit in the recommendations that affect them and their members or is there some resistance at that point as well? You've mentioned ASIC doesn't see a significant problem in relation to one aspect of these issues, but other areas?

MR MATHESON (AIRA): I think why we tried to convene the working party that put this paper together to bring together all the parties, it really requires - given the number of vested interests and the sheer number of parties involved in the process, I think there's something like - in my experience just the number of parties involving the proxy voting process is such that there are different regulators for some parties and a number of different regulators involved, that someone to push all the issues forward requires - hence we thought it would be useful to raise these issues with the Productivity Commission inquiry into remuneration because it seemed to be a useful sort of segue to a lot of these issues which could in turn help promote the debate that the inquiry is fostering.

MR FITZGERALD: Sure. My third and last related point is who benefits from the current system? Sometimes systems are just chaotic because of the historical pool or poor administration and sometimes there are those that benefit from poor

governance and administrative difficulties, so who benefits from the current scheme?

MR MATHESON (AIRA): I wouldn't like to suggest any one particular party benefits any more than anyone else. I just think there's an administrative inertia because each party is but one party in a chain. No-one is taking responsibility for the totality of it. Hence you might get one party, one of the registrars who thinks, "Okay, we'll do that for our clients," being the listed companies, but the other parties in the chain don't see the bigger picture and therefore don't think that they are going to benefit from any change because some of it does require a bit of spend, IT development or whatever, which I know your previous presenters from IFSA, their members have actually said that they would be prepared to fund any IT development that was required to get some of these problems fixed. It is the totality of the problem that we're trying to focus on as opposed to the individual pieces - that's not to say individual pieces aren't important but it's the totality of the picture that needs to be addressed which we hope and believe that this inquiry could play a useful role in highlighting.

PROF FELS: I think all of us are wondering why it hasn't happened, what are the forces at work and who's pushing it, so you're the main pusher of this, are you?

MR MATHESON (AIRA): I wouldn't say that, but it's just I've been involved in either representing fund managers in a predecessor body to IFSA, about 15 years ago worked for one of the share registrars and now representing listed companies, and in all of that, the interaction between investors and listed companies, I see this as being a very important issue and one that has not kept up, if you like, with technological developments.

MR BANKS: Are there any countries that you would think of as best practice in this respect that do it better?

MR MATHESON (AIRA): I don't think so. I wouldn't hold the US up as a panacea to all this but it's interesting; recently in the US, there is a system now available for there to be fully virtual annual general meetings where a shareholder can vote remotely via the Internet and I'm told the company that was the first customer of that system which was Intel, the service was offered by a service provider that I mentioned earlier, a US-based firm called Broadridge, but if anyone is interested, as I understand it, the archive is available to view on the Intel company web site, in their investor relations section.

MR BANKS: Good. That's been very helpful to have that discussion first-hand, so we'll certainly think about all that in preparing our draft report. So thanks for taking the time to appear today.

MR MATHESON (AIRA): Thank you.

MR BANKS: We're going to adjourn the hearings now and resume at 8.30 tomorrow morning.

AT 3.30 PM THE INQUIRY WAS ADJOURNED UNTIL
WEDNESDAY, 17 JUNE 2009

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