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TRANSCRIPT
OF PROCEEDINGS

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 WEDNESDAY, 17 JUNE 2009, AT 8.43 AM

Continued from 16/6/09 at Sydney

INDEX

MR BANKS: Good morning, everyone. The first participants this morning in the second day of hearings here in Sydney are from the Chartered Secretaries Australia Ltd. Welcome to the hearings. Could you please give your names and positions.

MR SHEEHY (CSA): Tim Sheehy, Chief Executive.

MS FOX (CSA): Judith Fox, Director, Policy.

MR BANKS: Thank you very much for taking the time to attend today, and in particular for the submission, which, as I said, is a submission of substance, and we thank you for that. I will give you an opportunity to draw out the main points.

MR SHEEHY (CSA): Thank you to the commission for inviting us to speak. I think the way I'd like to start is first to position our organisation and the scope of what it chose to comment on. Chartered Secretaries Australia represents professionals involved in governance. We feel that our membership is qualified to speak on the adequacy of the legal framework in which companies operate; on the adequacy of the internal structures which companies have set up for themselves, and they vary from company to company.

In general our members are not those that set executive remuneration; our members are those that assist the board in the process of setting it. Henceforth, the comments that we have made have focused greatly on the adequacy of the framework. In some cases we may have touched a little bit on the levels and so forth or the specifics about the level of remuneration, but by and large that is not our area of expertise, just to position it in that way.

In regard to CSA's views in particular, CSA is of the view that considerable regulation is already in place in regard to director and executive remuneration. We note that corporations legislation in Australia and other common law countries is very clear on the division of responsibilities in companies. We are of the view that the business of a company is to be managed by or under the direction of a board of directors appointed by and, most important, accountable to the shareholders. So while we believe regulation is adequate, we also believe that the role for shareholders is holding directors accountable.

On the issue of remuneration in particular, we strongly believe that directors should have the responsibility to determine executive remuneration. As boards are best placed to take into account the financial and operating circumstances and to take into account those things which will shift from year to year, only boards are in a position to assess most adequately. We do not believe shareholders have a role to play in the exact setting of executive remuneration. However, we do believe that shareholders continue to have the capacity to hold directors accountable. One very effective way is through the non-binding vote on executive remuneration; and we say

later in our paper our view is on keeping it as a non-binding vote.

We would also like to make the point that it would be misleading to make determinations in this country based on events that have happened in other countries, most notably in the United States; there are different governance frameworks between the two countries and different adequacies of governance practices. Finally, in terms of my overall comments, the Productivity Commission's task is to assess executive remuneration in terms of its effects on the productivity and performance of Australia's economy and community wellbeing.

We would commend both the CAMAC paper to you and the PJC special report on the social responsibilities of companies, as we believe these two reports deal with the responsibilities of corporations to the community. Specifically, a couple of recommendations that we have made in the paper and which I would like to highlight, we do believe that companies have the right and should reserve the right, at the discretion of non-executive directors, to claw back executive remuneration where there has been wrongdoing or malpractice - we're very comfortable with that - and should not make payments if results are found to have been manipulated.

Second, we believe legislation governing the remuneration report could be reviewed to assess the level of statutory information included in that report with a view to streamlining it. We believe the remuneration report is a valuable addition to the setting of remuneration but over time it has become too weighty.

We are comfortable with the idea of the chairman of the remuneration committee being available to speak to the remuneration report at the AGM and we also - in regard to remuneration consultants, because we know they have played an increasingly important role in the setting of remuneration - believe it would be best practice for boards to engage their own remuneration adviser, quite separate from the remuneration adviser that senior executives may employ when setting remuneration for the organisation as a whole, and ensure that that remuneration adviser is appointed by and solely accountable to the remuneration committee. We believe that separation of powers and responsibilities is essential.

Finally, we strongly oppose a binding shareholder vote on the remuneration report. We know that that has been in the media from time to time. We believe it will blur the distinction between owners and managers, and we note in our paper the what we believe extremely small number of times companies have had greater than 20 per cent no votes and the exceptionally small number of times that companies have had two greater than 20 per cent no votes. So by and large, we believe the mechanism is working.

We have made some comments in regard to termination payments - that is, as you know, the subject of a separate submission, but we have it attached as an

appendix. We do have support for a capping of termination payments at one year without shareholder approval, we think that's appropriate. Anything beyond that, we think it's quite appropriate to go to shareholders for approval. We have suggested a mechanism to streamline the shareholder approval process, but by and large we support the one-year cap without shareholder approval.

We do point out in our paper that there are some problems in regard to the definition of termination benefit, we believe it has gone too wide to include those things such as long service leave which one would get anyway whether one was retiring, retrenched or whatever, and we think that perhaps the net has gone too wide in defining the range of people that would be included in the termination benefit proposal. It goes on, for example, to directors of subsidiary companies, and we cite in our paper companies such as BHP or the banks, which have a couple of hundred subsidiary companies. So we think that may be an unintended consequence. Thank you.

MR BANKS: Thank you for that. I suppose a good place to start might be with the role of boards. Your submission states and you commented just then that boards are best placed to determine remuneration. How do you reconcile that position with the concern that lots of people have expressed to us that we have had some quite poor outcomes from that process, and therefore at the very least the arrangements around the governance of boards and issues of transparency and accountability and so on need to be enhanced. Some have gone further of course and would like to constrain boards by imposing other rules in relation to executive remuneration. So I will just give you an opportunity to comment on that.

MR SHEEHY (CSA): I guess where we would come from is that there are some 2000 listed companies. It's easy to point to some quite legitimate examples where perhaps remuneration levels and the linkage between the remuneration level and incentives have been broken. But the amount of attention given to a situation which may have gotten out of alignment is somewhat disproportionate to the number of companies which are operating, we would say, quite well within appropriate levels of executive remuneration. So I guess the first point is there is a disproportionate amount of attention being paid to legitimate but not an overwhelming number of examples.

The second point I would like to make is in how we have seen companies of late take note of concerns and take note of a change in economic environment. I think we quote in our paper what Telstra has done. It certainly had one year of a very high no vote, 66 per cent I think, and then came back the following year with 96 per cent in favour.

We could cite, for example we have seen a new chief executive appointed to Telstra and I believe that there has been a decrease in the level of remuneration. So I

think in order to see the full picture the number of instances needs to be seen in context relative to over 2000 listed companies operating every day, with the majority never getting in the paper, and also the changes that we are seeing with remuneration levels in some of those companies which will continue to always be in the press.

MR BANKS: Can I just come in on that one? By the way, I accept your opening comments about your particular role and expertise in this area. But nevertheless, you have quite strongly endorsed the present system and you've said it should be with the boards. Indeed, the other implication of that is that the boards then have to take responsibility for what has happened to executive pay in the last few years. It's also true, as you say, there have not been that many shareholder revolts. How much did pay go up? According to the ACSI, it went up 96 per cent in six years.

Most of the public, it is my impression, and I have certainly heard from a number of people that opinion polls and those kinds of things all show that the vast majority of the community thinks that there has been overpay, that the thing has got out of hand, that the boards have not done the job well; and that is starting to have consequences. I pick up the paper today and I see that the government can't even get some pro-business legislation through because of votes in the Senate based on executive pay concerns. Should we be so confident that the boards have done their job? That would be a view quite a few people would have. Have you any further comment on that?

MR SHEEHY (CSA): I do. The economy is a cycle. We are in that part of the cycle now which is obviously a downturn. One could say that the calls for limiting of executive remuneration becomes louder cyclically, and it was only a matter of time when the music stopped and things were not as good, that people would turn to those things which are easy to pinpoint.

In terms of the community's dissatisfaction with executive remuneration, I can understand how probably the vast majority of the community have a disconnect between average weekly earnings and what they see as a multi-million-dollar remuneration, but most people would probably not appreciate the complexity of the role in some of these companies and, most importantly, the impact that those people have on that company and on the community at large. So some of our large employers, as you know, have a huge impact on the health and wellbeing of a community, and remuneration is always at that level set cognisant to the degree of impact a person may have.

PROF FELS: On the cyclical, we did have some evidence yesterday from the CFMEU suggesting that the rise in executive pay relative to other pay is a longer-term phenomenon, has been going on for quite a long time, and they cited some academic relevant evidence, of what is in the evidence directly, suggesting that that is (indistinct) and then of course the other thing about the cyclical point is that,

fine, in the downturn maybe executive will fall a bit, we learnt yesterday it might fall by 10 per cent, but what about the next upturn, are we going to have a repeat. Should we not look forward to that and think about what the consequences of that would be?

MS FOX (CSA): I think that one of the most useful things that is probably coming out of the current situation is a focus on boardroom behaviours. But I'm not sure that regulation is necessarily the most appropriate tool for changing behaviour. It can be used but it's not necessarily always the best means. If boardrooms are beginning to actually revisit their behaviours, that's a useful thing, and we are seeing that; as Tim said already, we are watching, various companies have already begun to change their remuneration structures.

They have already been responding to the community disquiet, and also to the downturn. We are also seeing that some of the structures that were put in place were actually set in place to accommodate changed circumstances; not all were, but some were. So that as the financial and economic situation shifts, the remuneration structures are already shifting to reflect that. So I think it is a question not just of market cycles but of also understanding there is a element of human behaviour and whenever anything is under intense scrutiny, as it is at the moment, that in itself always leads to some sort of shift in behaviour.

MR FITZGERALD: I can understand your point. While I appreciate that one has to be very careful about regulatory responses and the commission is very mindful of unintended or perverse consequences of that, it is true to say that the governance arrangements we have in Australia are significantly different from that in America but on each and every occasion they have been opposed. The non-binding vote was vigorously opposed by the business community. Today people say, "It's actually helpful, it's signalling to the board." Shareholder entitlements are much more substantial in Australia than they are in America. When they were introduced again it was the same issue. So what we see is the role of regulation as an underpinning has in fact been quite important and in fact had we listened to the critics, we would have the same governance regimes as we have in America, but we didn't. We've taken progressive steps to change that.

So are there not regulatory responses that, whilst not prescriptive in nature, improve the process a stage further? One of the concerns I have at the moment is that a large percentage of the business community are responding, but they don't believe in it; that is, they say, "The system is perfectly fine, but we are responding because there is a public concern" but whether that is a belief or simply a short-term response. The second is, "When we get through the recession it will be different, that is, people will see that salaries have come down." They're likely to come down marginally in most cases but not a lot. So we will go into a another up-cycle where in fact the ratios that we're seeing will continue to go the way they have been going for two decades. So trying to get the balance right is important but I'm not convinced

at all by the view that the system is so right that some regulatory response in a proportionate way might not be approached.

I know you made some recommendations around changing the disclosure regime. People have talked to us about improving the governance of boards. I just want to test this theory that in fact consistently Australia has tweaked the governance arrangements through regulatory responses, as well as through behavioural responses and are we not in a stage where maybe some of that would be appropriate?

MR SHEEHY (CSA): We acknowledge that there are some regulatory changes that could take place but where we do not believe that they're appropriate is in the area of the actual setting of the levels of remuneration. We are and will remain wedded to a disclosure based regime which is principally what Australia operates on and those regulatory changes that we think appropriate are principally in that area. But I would like to make a comment on the role of regulation in underpinning and the comment that you made that when the non-binding vote was discussed the business groups opposed it.

One of the foundations the governance of this country relies upon is the Australian Stock Exchange Corporate Governance Council's guidelines. Those guidelines are not regulatory in nature. They are principles based and they're if not, why not and they were put in place by 21 or 22 business groups voluntarily.

MS FOX (CSA): Or investor groups, and business groups.

MR SHEEHY (CSA): Investor groups, business groups, shareholder groups all sat around the table and developed those and they have gone a long way to improving disclosure of governance practises within organisations. I believe, and there is ample evidence, that there is a willingness of business to engage in the regulation of its industry, self-regulation of its industry. There is perhaps a role to play in disclosure but we remain of the view that it would be inappropriate and probably modified behaviours with unintended consequences to regulate in terms of levels.

MS FOX (CSA): On the question of the council, I think it is very important to understand that it's not prescriptive black letter law, that it was not only a diverse group of all the relevant parties that came together but there has been consensus that it has improved the governance of Australian companies considerably.

PROF FELS: Consensus by whom?

MS FOX (CSA): By investor groups as well as by the business groups. So it's not just the business groups saying it, the investor groups themselves strongly support the ASX Corporate Governance Council guidelines and they will speak to the fact that they believe it has had a considerable effect in improving governance in

Australian companies.

PROF FELS: What about the view that they're in the club?

MR SHEEHY (CSA): ACSI sits on the group, ASFA sits on the group.

MS FOX (CSA): The Australian Shareholders Association, IFSA.

MR SHEEHY (CSA): I don't think that I could say that the Shareholders Association and ACSI sits in the club with the BCA. They're not mortal enemies but the group comes together to find a way to put in place a very clear and broad framework of governance. Also the ASX then takes it upon itself to assess the degree of reporting against those guidelines and there is an extremely high rate - I don't want to use the word "compliance" but an extremely high reporting rate of listed companies against a plethora of recommendations.

MS FOX (CSA): The investor groups themselves will say that the beauty of it is the 'if not, why not'; that it's not about following a set list of rules, it's that there are recommendations about good practice. Any company is free to put in place a different practice but you must explain to your investors why it is to their benefit. So the 'if not, why not' framework allows for flexibility of practice according to the circumstances of the company, but it absolutely ensures an engagement between shareholders and company and the investor groups themselves will say that it has hugely improved engagement, that they themselves now speak to boards much more frequently and much more often and they can use the reporting against the ASX Corporate Governance Council guidelines in order to fuel that dialogue and to talk about the areas where they think there is room for improvement.

Just on your question, Robert, about the role of regulation underpinning change. I guess you can also look to an area, say, for example, health psychology which has done a lot of research on whether regulation effects change or whether education effects change and both have a role to play. Two of the famous campaigns that are referred to there are the seat belt campaign which was a regulatory response in order to effect behavioural change. On a particular day in history it was then law that you had to wear a seat belt in Australia and if you didn't you were breaching the law.

But on the education side another famous campaign is the slip, slap, slop campaign where it was realised there was a huge incidence of skin cancer in Australia and behaviour needed to change in order to protect people and it was decided that a regulatory response was not the appropriate response so an education campaign was developed and had tremendous success and is actually referred to around the world as a very successful campaign. So I guess we're coming from a position that there should not be an assumption always that a regulatory response will

of itself fuel the necessary behavioural change.

MR FITZGERALD: I want to be very clear, we're not making that presumption. I'm testing the water with you, except to say that I have become a bit more concerned as we've gone through that there is almost a dismissal of any regulatory response in relation to this. So it is the reverse, that is, no regulation as required as distinct from when it might be appropriate. But, for example, and correct me if I'm wrong, one of your recommendations, as I understand it, is that remuneration consultants should be directly appointed by the board. Where would you see that being regulated? In other words, is it part of the ASX governance arrangements? Should it be an ASX listing requirement or should it be a change to the Corporations Law if we were to accept that and I'm not in any way indicating our view about that recommendation. But just take that, what's your thinking as to where and how that would be implemented or is it simply a good principle that should be floated?

MR SHEEHY (CSA): We would see that the appropriate place for that would be in the ASX Corporate Governance Council guidelines because similar measures are in there. For example, the role of the audit committee, who the audit committee reports to, how should an audit committee be made up. In a way you can see an exact parallel to a remuneration committee; the use of consultants, the channels in which the external auditor reports through, then this would be the channels to which an external adviser on remuneration would report to and it's something which could quite easily fit within the guidelines. Then a company would have to report to the market against it that it did comply and if it didn't, so why did it choose to use a remuneration consultant which was chosen by the chief executive? It would have to explain why.

MR BANKS: Could I take that a bit further forward, that 'if not, why not' approach in relation to your strong opposition to a binding vote. Some have suggested that while they would agree that there are problems with the binding vote, that there are ways in which you can crank up the shareholder signal, if you like, that emanates through that vote and indeed if not, why not has been raised as one possible way that the board would be required to explain subsequently whether they had taken some action in response to a significant no vote and, 'if not, why not'. You've talked about having the chairman of the remuneration committee explaining the policy and indeed perhaps the outcomes at an AGM, it seems eminently sensible to me.

But is there scope to build on that and to have some consequences of that kind at the very least in terms of communication back from the board subsequently after a significant no vote.

MS FOX (CSA): There's also been discussion about the possibility if a substantial adverse vote - over 50 per cent - is received and the board does not respond to the shareholder discontent that the remuneration committee - their positions are under

threat at the following AGM. The main concern with that - and we spoke to this in our submission - is the concern about the unitary nature of the board, that the board acts as a collective whole. So the concern with that is simply that by separating out one element or one subcommittee of the board that you are in fact potentially interfering with the unity of the board. We didn't make that as a recommendation, we were very happy to put it forward as a suggestion for consideration.

MR BANKS: So you see scope in that area?

MS FOX (CSA): Yes, but again we would want it to be thought about because we would not want there to be other consequences that flowed from it in terms of what does that mean for the role of the board if there is a shareholder class action and they're actually only going for the remuneration committee? There are real considerations that would need to be thought about and dealt with there.

PROF FELS: Could I ask another one on that. The point you've made about it's a binary vote, say, that parliament said, "It's about time we sent a signal to corporate Australia to improve its act," and, say, it moved on the binding vote or something like, I would imagine that if there was some broad decision to send a legislative signal you would have a look at the details, you wouldn't necessarily have binary votes. Most meetings you don't take binary decisions, various resolutions can be put to meetings, it doesn't have to binary, does it? Is there any particular reason why it's binary apart from some feeling that you want to minimise the intervention?

MS FOX (CSA): No, it's just simply again the way the law was written it's a vote on the remuneration report and the remuneration report is one object.

MR BANKS: Take it or leave it.

MS FOX (CSA): Yes.

PROF FELS: You could have a vote on a particular aspect of a report. At the moment it's all or nothing unless there are special reservations.

MS FOX (CSA): Again, that's something that could be looked at. If you have a vote on different elements on the report so, for example, there could be discontent with one element and it might be the CEO's pay but the shareholders are not unhappy with the remuneration policy overall, I understand that is what you're getting at, that idea of breaking it down.

PROF FELS: Yes.

MS FOX (CSA): But then again if you're voting on just one thing and you're expressing discontent and, yes, it captures everything but does that also then give

more room for shareholders to come and engage with the board to begin to talk about why they voted against it and to be able to really drill down into a discussion with the board and get to the board's decision-making process, get into the why of decisions, no just the what of the decision. If you break that vote down - and I'm just thinking aloud here - and therefore you're already saying, "We were just really unhappy with the CEO pay and everything else is fine," is there as much room then for shareholders to start that process of engagement and dialogue and really be talking to the board and getting to the decision-making?

MR BANKS: Some have argued that, for example, any share based remuneration should be subject to a binding vote by shareholders. What would you say about that?

MR SHEEHY (CSA): There is the issue of companies buying shares on market so these are shares already listed. Our current position on that is where a share is purchased on market that doesn't need shareholder approval because it doesn't involve a dilution effect and it's simply exchanging cash for shares which are already trading, the remainder of remuneration by shares I think is adequately covered. It is pretty much argued.

MS FOX (CSA): It's already regulated.

MR BANKS: So you wouldn't want to extend it to on-market purchases?

MR SHEEHY (CSA): Most of the reason for regulating remuneration by shares is the dilution effect on shareholders. If the shares are already issued, then you don't have the dilution effect. So what you have is a company simply going out to the market and purchasing shares. I know a lot is said about it, but if you look behind it we don't think there is a big issue. It doesn't have a dilution effect.

MR BANKS: Could I ask you this, partly related to that, that you have argued on your proposal on page 38 of your submission that the at-risk component of remuneration should be reduced in size and that seems to go against what we've been hearing from others, including some of the proxy advisers who indeed would want to extend that and indeed extend the duration et cetera around it because of the alignment with the longer term interests of the shareholders and so on. Would you like to just elaborate on why you've gone in the other direction?

MR SHEEHY (CSA): Did we say "could" because I don't think we came so heavily, strongly - - -

MS FOX (CSA): No, we said it was a suggestion to look at. But what we were saying is that part of the concern is that when there is a very large at-risk component the outcomes can vary considerably from year to year and that can cause disquiet because it can be seen that one year there is a very large amount of pay and then

perhaps not so large the next year. But that very large amount is what actually causes disquiet and because it differs so considerably from the year before it is seen somehow as some additional payment. So we were simply saying that if you actually increase the base pay, you don't get such huge variations and that in itself could address some of the concern that is being felt at the moment.

We were in no way saying that we were against the idea of deferrals of payments and making sure that there were more longer term structures put in place, we think that's a very good thing. We were just trying to also talk to the idea that variation is always going to be more extreme when there is a very large proportionate risk.

MR BANKS: That accounts for some of the shock perhaps in the community?

MR SHEEHY (CSA): Yes. I remember I read that this morning before I came in, we put that in the context of a remedy which should not be forgotten; let's not forget that increasing the proportion of base pay is also a mechanism as it has a smoothing effect. We're not opposed, we know what the proxy advisory services are saying. I think we're generally comfortable with their points of view. We're simply saying, "Don't forget this as well."

MR BANKS: Could I just ask another question relating to shareholder say on pay or the processes around that. Some have recommended that the voting threshold for a remuneration report to be passed be raised from 50 per cent to 75 per cent, including the ASA which sees some advantages for its constituency in that. Others have also argued that the appointment of directors should require a 75 per cent vote yes vote rather than just 50 per cent. I will just give you the opportunity to comment on that.

MR SHEEHY (CSA): On the first, on the remuneration report, there is no level at which it is approved or not. So really I think what you're suggesting there is an introduction of a minimum vote in order for it to pass. That's what it sounds like. At the moment we have seen companies which have had a majority no vote but the remuneration report has gone through. So there is no minimum - - -

MR BANKS: It's a non-binding vote, so by definition it - - -

MR SHEEHY (CSA): That's right, by definition. So we continue to support a non-binding vote, and then implicit therefore in that is there is no minimum level one must need to get to.

MR FITZGERALD: Except in some cases, some of the submissions are saying that if you fail to get 75 per cent support then it triggers an event, and that event would be that the head of a remuneration committee, or the directors involved in that,

or the whole board would then stand for re-election at the next AGM. So whilst even if you maintain a non-binding vote there's a trigger mechanism at 75 per cent or, conversely, you can get a 25 per cent no vote that leads to something. Clearly what they're saying is that the shareholder registers are so dominated by institutional shareholders that the rest don't get a say. So there is a trigger event that flows from that.

MR BANKS: What about appointment of directors, then?

MS FOX (CSA): I was just going to speak to the special resolution notion. There are companies that have had a vote of 10 per cent against who have been concerned enough to actually then respond. So in a sense, that's why we were very interested to go back and, courtesy of Stephen Mayne, who had done all the research for us, and actually look at the exact number of no votes above 20 per cent, which is not even as high as what you're talking about. Of the 2000 listed companies over four years it was 25 over 25 per cent and only three of those had received a no vote more than once. So even a no vote as high as 25 per cent against, that engagement process has been occurring without a particular trigger.

MR SHEEHY (CSA): Robert, your comment then, perhaps it causes a trigger event if it's, say, over 75 per cent that you spill the remuneration committee or something, we have not gone down that path in our paper. As Judith has said, proceed with caution because of the nature of how a board operates and so forth.

MS FOX (CSA): We think it's worth more consideration, but we would actually like there to be a much fuller debate about that as an issue, rather than there being different sort of views coming in and that wasn't the specific issue that was being looked at. It is definitely something that is worthy of consideration, but it would need to be the subject of particular consultation.

MR BANKS: Coming to directors and the perception that there is a club of directors out there and that the experience has been that most directors put up for election generally get elected, what are your views about raising the threshold for election in terms of the percentage of the vote needed?

MS FOX (CSA): Our members haven't actually discussed it, so it would be remiss of us to comment. But I guess what we can say is that we have discussed diversity on boards and board renewal, as did the ASX Corporate Governance Council when the guidelines were revised in 2007 and Principle 2, which is about board structure, was really trying to get to the issue of board renewal. We have had companies now report against the revised guidelines and the ASX has not yet issued its first report on how companies are going in terms of reporting against the revised guidelines. It will be very interesting to see how that works in the ASX Corporate Governance Council guidelines in the second edition, around board renewal, whether it has actually

started to effect change. That will be interesting to see.

PROF FELS: Can I take up a couple of points. The first one is that yesterday we heard from Ian Matheson about problems over proxy voting and all this kind of thing. I don't know if you've even had a chance to consider it or have heard his views?

MS FOX (CSA): We know about the issue.

MR SHEEHY (CSA): Yes, missing proxy votes. Is that the issue you're talking about?

PROF FELS: Yes.

MR SHEEHY (CSA): We are aware of the issue and we believe it is true that in some cases proxy votes have gone missing. There has been a group of industry associations and Computershare and Link that came together under the umbrella of IFSA to try to solve that problem. We think the problem needs to be solved, that it's probably a cumbersome process which is largely a paper-based process, and in this day and age we should probably be moving beyond that. So those are the issues that Ian spoke about, we agree.

MS FOX (CSA): ASIC at the moment is embarking on a project of an audit of votes, and that is very much connected to this problem. We think that's a very good thing because having ASIC involved to actually audit votes so we get a clearer picture of what level of votes are going missing; what are we talking about and how prevalent is that? I think then also that starts to give greater urgency to the need to look at technological solutions, which is really what is going to solve it. Part of the difficulty is the cumbersome paper-based process at the moment.

PROF FELS: The thing that just slightly puzzled us yesterday was that he has been raising this issue for quite a long time and we kept asking him, "Sounds like you have some grounds for concern there and yet nothing has happened." He had a number of explanations: a bit of inertia, maybe ASIC was not moving at top speed, things like that.

MS FOX (CSA): ASIC has only just become involved. That was a reference from the Parliamentary Joint Committee which reported last year and actually specifically recommended that ASIC conduct an audit of votes. Now they're moving on that.

MR SHEEHY (CSA): We were pleased to hear that ASIC was moving in that direction and we commended them for it. So we would support it. But yes, I take your point, it seems to have taken an awfully long time and still not arrived at a resolution.

PROF FELS: Thank you for that. On another point, you have mentioned this issue of possible overload and maybe disclosure practices be streamlined, and you have mentioned the short form remuneration reports. Could you maybe say a touch more about what you envisage would be good practice in this area, and particularly if it's a favourite topic. Maybe I could just mention a couple of thoughts because it was also mentioned yesterday. On the one hand, the report seemed to be very complex and hard to read and interpret and so on. Maybe, and I would be very interested in your view, the case for them is that it is only by having a comprehensive disclosure requirement sometimes certain critical details do get found out, picked up, by the expert people pouring over these complex documents. That way the object of the disclosure law is fulfilled, it becomes known widely enough, some of the details. So there is some kind of a case for having something complex.

So then should you respond to that by saying, "Okay, we'll retain that but we should also encourage, at least, firms to put out short, readable statements so that people get a fairly good idea of what is occurring"? On that scenario you would have two reports. Is that a cumbersome thing? I'm just wondering how you would go about your suggestion that there should be some kind of short form remuneration reports.

MS FOX (CSA): We were very careful to say that we certainly didn't think it should be mandated, and we did talk about companies with very complex remuneration structures. We're talking about the large companies. We'd be very concerned that smaller companies felt compelled to have to put out a second report because that could be a very onerous obligation for them and they might not have the resources to do that. But overall we think the remuneration report could probably do with a revisit. We know that they are often considered impenetrable; they can be 20 pages long now, the rem report. While there can be a perception that somehow the detail is buried it is just that in order to meet all the statutory requirements companies need legal advice, and in getting that legal advice they end up with a legalistic document when many shareholders, and we're talking particularly retail shareholders but many shareholders, are looking for the company to actually explain the decision-making process. How did the board arrive at these decisions to put together this remuneration structure? That gets buried. The story, the why, gets lost in all the what of meeting all the statutory requirements.

So our suggestion around the short-form report was certainly encourage it but don't mandate. We were just simply referring to the existing practice with annual reports. There is an annual report which is a very long and complex document and it is available to all shareholders in all of its detail, but many of the large companies have, for some years now, been sending out short-form reports that aren't mandated. They're not statutorily required. They're really trying to talk very directly to shareholders about performance strategy, values; trying to actually have that dialogue

with the shareholders about where things are going. They're very greatly appreciated by shareholders and many shareholders - that's the only document they really want to look at. There are other experts, analysts, who really do pore over the full annual report.

So we were just saying if the rem report in its statutory form is going to be revisited, that process takes time. We were therefore just wanting to bring to companies' attention that you have the option of actually - especially if you're a larger company with the resources, you have the option of sending out something shorter to shareholders to give them the why. Meanwhile, you're continuing to meet all your statutory obligations and give all the detail in the long rem report. We know from our members' experience it's very hard to actually move away from a legalistic document. It's not that people don't want to. It's just very difficult to do that. So this gives the opportunity to have a different sort of narrative, a much more shareholder-friendly narrative.

MR BANKS: I can't recall now but in the streamline disclosure requirements did you see a role for disclosure of actual remuneration?

MR SHEEHY (CSA): We didn't go into the specific - and it's because the discussions of our members had not gotten as far as, "If we were to streamline it, what should that look like?" We know that we could perhaps have a role to play in coming up with a framework of what a streamlined user-friendly remuneration report should look like, because we firmly believe there's a role, but in a way that's the next step.

MR BANKS: Okay.

MR FITZGERALD: I'm aware we've run out of time, but just one final question. I can't quite find in the submission but you've made comment in relation to the executives sort of covered by those remuneration reports. Some people have suggested to us that in fact the scope of coverage should be reduced just to the CEO and the CFO and perhaps other executive directors and that's it. There's no real need to in fact have the top five covered or whatever the current requirements are. So I was just wondering what your position in the scope of coverage, who should be in fact - - -

MS FOX (CSA): Our members are very comfortable with the current requirement and we wouldn't see any need to move away from that.

MR SHEEHY (CSA): We had, as I said, specific comments on the extension of the termination payments, on how wide that has been extended, but we haven't called for a reduction in the scope of the remuneration report, no.

MR FITZGERALD: That's good. Thanks for that.

MS FOX (CSA): Just one other point that we did touch on in our submission that's probably useful to talk about is - we didn't go into great detail but we did talk about the fact that at the moment there's a very strong focus on executive remuneration in listed companies but we also feel that we need to look at the funds management industry because that industry is also being rewarded on short-term rewards and short-term performance. So in terms of misalignment, that whatever happens in one area really also needs to be reflected in the other.

MR FITZGERALD: Just to clarify, it's my ignorance here. Are fund management caught within the APRA guidelines, funds managers caught within APRA guidelines or do they fall outside it?

MR SHEEHY (CSA): I would have thought yes, most of them. They provide financial advice but they're not probably licensed deposit takers so they may not be - - -

MR FITZGERALD: They may not? We'll have a look at that because some people have said to us that - exactly what your point is, that in fact it's - whilst everyone understands why one's looking at the public companies, publicly traded companies, there are issues in other parts of the sector and certainly APRA goes well beyond anything that's just publicly traded; but anyway, that's fine, we'll have a look at that.

MR BANKS: You also said in your submission that the draft APRA government standards for financial institutions should not apply to all companies. I just thought I'd give you the opportunity to talk about that because that's obviously something that has been raised. We have another participant later today who sees it as inevitable that those standards will be extended more widely. So would you like to just elaborate on what distinguishes those standards and the sector to which they apply to the rest of the economy?

MS FOX (CSA): The APRA regulated institutions, there is a role for, if you like, a more interventionist approach from APRA, from the regulator, because they're protecting the interests of the depositors, the people who actually put their money with the banks. That's a different relationship from a shareholder. A shareholder - an investor has made an active choice to invest in a company and has a number of rights. There are considerable and quite robust shareholder rights in Australia. But someone who has put their money with the bank, there are no similar sorts of rights to actually engage with the company and talk to them.

So the financial sector has different systems characteristics and what we are saying is that whilst the APRA government standards - it's very useful to look at

them and some companies might themselves choose to take on elements of it, to actually assume that all of the characteristics that apply to the financial sector are just automatically applicable to all listed companies, it's not so. There is a fundamentally different systems characteristic.

MR BANKS: Okay. Allan, did you - - -

PROF FELS: No.

MR BANKS: Sorry, just one matter. I'll check whether there's anything else I was going to ask you. No, I think we've covered everything. Well, I won't say we've covered everything, there's a lot in the submission, but the things that we've talked about.

MR SHEEHY (CSA): If I could just make one comment, because it's briefly touched on here. Earlier in our discussion we talked about shareholder engagement and it's a disclosure-based regime and so forth. Over the last few years the role of proxy advisory services has played a far more important role than it ever used to. I think investor engagement with companies and the dialogue that they have, one can't forget the role proxy advisory services play. Institutional investors utilise their services to varying degrees but they do play an important role in making sure that engagement takes place and that dialogue is there and assist in the accountability part of the process. It's important to recognise.

MS FOX (CSA): It has been said by one governance adviser that shareholders have become very good at saying what they don't want and don't like and they have to get better at saying what they do like and do want.

MR BANKS: Just on the proxy advisers, do you see any scope for improvement there in relation to how proxy advisers are used, the nature of their advice et cetera?

MS FOX (CSA): Well, we published a booklet last year after we held a round-table that was attended by proxy advisory service firms, by directors, company secretaries, institutional investors, retail investors. It was a very productive meeting, very productive round-table. The booklet that we published was talking about better communication from both the listed entity side and the proxy advisory service side. We're happy to send the commission a copy of that booklet.

MR BANKS: Could you do that?

MR SHEEHY (CSA): Yes.

MS FOX (CSA): It just set out some very practical steps that each party could take to improve the dialogue and the communication and to take account of the needs of

the other. Particular times of year, for example, could be very difficult for the proxy advisory services because they're going through hundreds of rem reports at the same time. So the group as a whole came to a series of recommendations about good practice.

MR SHEEHY (CSA): We called the round-table because we had a view that the parties did not fully understand each other's needs and constraints and how they needed to operate. So we said, "Well, why don't you sit around a table?" It was interesting to see the eyes light up as each side understood the other's operating constraints. It's outlined in this booklet and we're happy to forward it to you.

MR BANKS: Good, okay. Well, thanks again for appearing today. Thank you.

MR SHEEHY (CSA): Thank you.

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

MR BANKS: Our next participant this morning is the Australia Human Resources Institutes. Welcome to the hearings. Could I ask you please to give your names and positions.

MR WILSON (AHRI): Thank you very much, Chairman. My name is Peter Wilson. I am the national president of the Australia Human Resources Institute.

MR BEGLEY (AHRI): I'm Paul Begley, the national manager, government and media relations of the Australia Human Resources Institute.

MR BANKS: Thank you very much. Thank you for taking the time to appear this morning, and also for the submission. It is another very good submission and we thank you for it, and we'll give you the opportunity to address the main points.

MR WILSON (AHRI): Thank you, Chair. It is a submission we spent a good deal of time on. By way of background, the Australia Human Resources Institute is the professional organisation for HR practitioners, including many that serve boards at the ASX level on this very issue. We have informed our submission with a survey of members, which tended to get a specialised response. There were about 400 respondents in total and 150 from the ASX subgroup. Also, we used some focus groups that I conducted among top HR practitioners, where the views were quite diverse. In fact within the focus groups, I don't think there was an unanimity of viewpoint, apart from a few issues. Also, I think somewhat inevitably, there is a bit of my own experience as a former HR director for Amcor and ANZ in our submission , in terms of what I've seen on how boards form their opinions on top pay.

I think by way of opening I'd like to perhaps just touch on three things: how we see the inquiry, the broad environment, and our perspectives on the terms of reference, and perhaps a little shorter form of reasoning on the rationale behind the five recommendations we've made. To us it is clearly an inquiry in the functioning of the labour market for very highly skilled and experienced executives and ultimately their price. We understand the focus the commission has to make on regulation. We've encouraged that to be done in two respects. One, the self-regulation or governance that boards of directors themselves make. At the end of the day, they are the prime filter and determiner on top executive pay. Also government regulation itself which to date we've seen manifest mainly through the taxation imperative rather than more directive forms.

There is no doubt the last 10 or 15 years has seen enormous pay in top executive pay, and not unrelated to growth in the size, the market capitalisation of large companies, and the globalisation. But there have been excesses, nobody can deny that or should even try. I think a number of things we've seen happen would

stretch any reasonable standard of the community acceptance or indeed the credibility factor within the corporate empires themselves. But we do remark that most of those excesses occurred offshore. There have been some in Australia but relatively few. So I think our theme for the submission is whilst changes are needed it is an area for light-handed regulation rather than for heavy intervention.

From our perspective, Australia remains a small, open economy but the world has become heavily globalised, and as Thomas Friedman said, nearly every job on the globe will probably be contested at some point from any part of it. That is probably going bit far but it does show the measure that we've seen in our institute, a lot of people do have careers overseas for large periods of time and we are a very trade-exposed set of businesses. So there is quite a lot of competition both for the price of goods and for the price of labour.

We think there perhaps is a truism that is moving around political life. I think it might have been Abraham Lincoln who said the more you tax or regulate something the more likely it is to disappear. We think there is probably some political attraction in through having heavier taxing or more regulation, the excesses in executive pay, will disappear. I'm sure our political masters would be happy if these things all did disappear, and many in the community, but we don't think it is as simple as that. Overly extensive and broad-based regulation we think would run the risk that our top talent itself would disappear, and partial regulation does run the risk that if you change one part of the algorithm of executive pay in terms of present value income expectations that companies have the foregone impact would just be moved into another component.

However, we do believe change is needed and we have made five recommendations. The first, again underpinned by the AHRI results is that we think the structure of pay should reflect in fixed pay – the persons skills, experience and value to the organisation. We think top executives that do have a material impact on the value of the corporation should have the incentive to build value in the short and long term, but that should be genuinely at risk. So the issue of forfeiting when performance fails is clearly a key focus of the inquiry and one we would support.

MR BANKS: Would you mind if we just paused on that for a moment. You're asking us to endorse, essentially, a three-part pay structure with short and long-term incentives in their place. Does that reflect a concern on your part that as a consequence of recent events there might be a move back to short-term incentives?

MR WILSON (AHRI): Indeed and that concern I have is very much based on Wall Street itself. If you look at the excesses there over the last 10 years with sub-prime, the remuneration primarily was reasonably high level of fixed but also very high short-term annual bonuses, which encouraged churning and the sale and distribution of toxic assets because people took their gain annually, and whilst they

missed out on their 10th annual bonus there were still nine that they took home somewhere. So we would like to see it structured to encourage people to perform but some deferral characteristics and a transformation from cash into shares so executives would bear the same pain as ordinary shareholders if their value creation ideas don't ultimately work.

But also, forfeiture conditions need to be examined, and I'm afraid in some parts of the corporate area forfeiture only occurs in extreme situations like loss of employment for cause. So I think there needs to be genuine forfeiture issues built in for lack of performance. But in the date we've put before you you'll see the portion of short-term incentive to total remuneration, there are signs that's going up. There are signs that the KPIs being used are being internalised. So whilst I think some boards of directors have been shamed by their behaviour and the behaviour of their colleagues they have also been very frustrated that TSR and having the right comparator group has actually made executive attraction and retention like a lottery, or even a rollercoaster. They are trying to bring it back to internal variables that they have more control over.

I think if we see taxation intervention at the long end of incentives, short or long term, you'll see some contraction of them. Then you're basically left with a remuneration design which I think is exposed to short-termism, which is precisely what drove the global financial crisis. That is my concern or dilemma.

I think where we'd like to see the focus of effort is that if you think about remuneration at the moment, comparable to other areas like accounting and reporting, and even occupational health and safety, there is no standard. Boards make up their own principles and publish them. We see the opportunity now to have some form of remuneration code of practice, some general standard applied where acceptable principles of pay are established for all to see. We would think a voluntary one would be the most valuable. In terms of the binding, non-binding vote imperative on remuneration reports, rather than pushing it from one extreme to the other we've proposed, effectively, a three-part structure for that.

Very simply, if we have a remuneration code of practice we would think, say, looking at five years the board should put up their detailed plans and proposals for executive remuneration to shareholders based on that code of practice, and transparency on other things they would like to declare to shareholders, and that should be subject of a binding vote. Once that's done, then we think subsequent remuneration reports could be non-binding, but we think those reports should be audited as to conformity to the plan that shareholders have approved. If there are, as we know can occur elsewhere qualifications in the audit, based on some material diversions, from the approved plan, then those qualified matters should be excised and automatically triggered to a binding vote.

PROF FELS: Could I just go through that more. It's a very interesting idea. So the binding vote would be on a five year plan. Is that correct?

MR WILSON (AHRI): Yes.

MR BANKS: Which would be like a policy document. Could you think of it that way?

MR WILSON (AHRI): Yes.

PROF FELS: So could you even suggest what might be the elements of that plan, what would it have. Would it have principles, maybe not numbered, or numbers et cetera?

MR WILSON (AHRI): We'd put the first nine points in recommendation, I think they would all be in there. I didn't feel we had the philosopher's stone here but let's take an obvious case where there has been concern in our community, the appointment of a CEO from outside the country at sometimes twice what the previous person had. You could have in there a guideline of, say, "New CEO's are appointed at no more than 120 per cent of the salary of the predecessor." You can have some prescriptive guidelines in there that could be in the code of practice and boards might say we have to vary that for good reasons but again, that should be transparent to shareholders.

PROF FELS: So if they did vary it, they'd still have the freedom to vary it despite the binding vote accepting the five-year plan.

MR WILSON (AHRI): Freedom to vary it, but then it would be subject to another binding vote.

PROF FELS: Yes, another binding vote.

MR WILSON (AHRI): Yes.

PROF FELS: A binding vote on a variation?

MR WILSON (AHRI): If there was a material exception that the auditor said, "This doesn't conform to plan, you've got to go back to shareholders on this."

MR BANKS: That could be retrospective though, because that would then get into the question of the shareholders voting on something that has already transpired.

MR WILSON (AHRI): It could be, but if you think of it - and the timing of this is very interesting: you have three components of pay, fixed, STI and LTI. Bonuses

are usually determined when the accounts are done; between August and October short-term bonuses are determined and normally with long-term incentive plans, the plan actually has to go to shareholders. So the only practical area where there might be something that's paid that's very difficult to retrieve is probably going to be around fixed remuneration. If there is a qualification around, say, a bonus that's paid or payable, then if that qualification is made by the auditor, I would think the company should have an obligation to hold that amount in trust and not pay it out until the shareholders have had their say.

MR BANKS: Okay.

PROF FELS: That's interesting because as soon as you talk about making some change at all to anything, you're given this long list of practical-type objections as if they're impossible to overcome but here is a reasonably simple approach that would address the issue. The classical argument is that someone from overseas or somewhere signs up, again a deal that goes beyond the criteria, and then there is uncertainty, they don't know where they will stand and there is payments. The payments you've addressed to a fair degree by holding it in trust and that kind of thing. The uncertainty is not quite - so if someone wants 150 per cent and they're given that but they won't know until it's gone to a meeting a bit later.

MR WILSON (AHRI): I think the shares of such a company would say, "Here's our plan. We can only appoint to 120 per cent, the 30 per cent above that we have to hold for you in good faith and in trust. Are you going to come?" I really think we need to be doing a few things to stiffen resolve of chairs in the most important commercial decision-maker that they're appointing to the company and not have the first deal they do bringing home the bacon before starting work. Yes, that's the reason, it's transparent, you see it from the time they are coming in. I know it's a big decision to come from one country to another but there should be reasonable standards around that. It's a great country to work in here, and the shareholders do need to know what the new guy is going to get and that it’s reasonable.

MR BANKS: This five-year-plan, I can see a pretty strong incentive to make that as general and generic and as highly principled at a high level as possible and I guess the question then would be, how prescriptive the requirement would have to be to avoid that becoming such that it was really no constraint to it at all.

MR WILSON (AHRI): That's why I think you need some sort of a code of practice, putting in some minimum standards and asking boards to put up their plans by specific reference to the code of practice.

MR BANKS: But would you see the code of practice having quantitative information, like all the ratio information, in it?

MR WILSON (AHRI): It could. Remuneration reports were, like you said, fairly light and general and the same factor or the desire for information by shareholders has forced boards of directors to put more data in. Just thinking back to my own experience the board I worked for - it was Amcor basically - if someone was fully effective in the role then we would price them at median on the Hays survey for a comparable sized job and it normally took two years to become effective, it could take longer, and higher performers we tried to increase their at-risk pay but not let them go up to the third quartile. So there are some simple principles of remuneration design that you can put in. So when the auditor comes along he can get the Hay data for a job sized 1278 Hay points and look very, very unambiguously at first quartile, median, third quartile where this person sits, what the bonuses are payable for that size of job, where that person's bonuses come, the spread of bonuses in the company and whether they're skewed to the right or not, as the case may be.

It doesn't have to be rocket science. You can actually pick some reference points on the normal distribution of pay and pay within your own company as some standards that you should have. I know one of the concerns that is held in the community is that a company's bias to the right on a normal distribution, that is - they just overpay people and it's a fix and it gets stuck up there. Well, they should set forward the standards and I think the privacy issue can be protected by having - beyond the top people in the company - some statistical data about other senior people. Take the ANZ Bank where I worked, there were 50 or so people on 1278 Hay point jobs. You don't have to say what the occupant of any single role paid, but you could measure their pay against the market for that size job and put that in your remuneration report and everybody can see whether it's normally distributed or biased to the left or right. Obviously you will get tweaks in this from time to time and some bunching effects and people coming and going and also starting on a low salary and starts of very experienced persons. But over time you expect some sort of reasonable and statistical confirmity in that type of behaviour.

MR BANKS: Would that have the difficulty of enshrining what they call the Lake Wobegon effect where all the children above average?

MR WILSON (AHRI): I don't know that Prof Fels taught me that one, you'll have to explain.

MR BANKS: If every corporation is setting their pay at the median, then obviously you're going to have a ratchet effect through time by definition.

MR WILSON (AHRI): Absolutely. There is data in our survey of when someone is effective they price median. So absolutely the thundering herd I do understand and I think there are times where particular organisations lost their nerve a bit in the high access demand and you've seen the data move up suddenly from time to time. I think anchoring it around some reasonable distribution would help put some downward

pressure on that rather than the normal upside pressure.

MR FITZGERALD: Yesterday I was talking to one of the members of the audience who was here today about the difference between trying to value the actual role and what we seem to have into which is to valuing the individual. It seems to me your approach of a plan at around certain criteria actually takes us back to a position of trying to value the job itself or the role. What we seem to hear a lot about is the individual and we've got to pay more for that individual. So there does seem to me to be a real shift that has occurred and what you're proposing seems to me - and correct me if I'm wrong - is you actually go back to say, "What do we actually need in this role? We value that role. There may be a premium for a particular person," but what we seem to have done and certainly in the conversations we've had is it's all about you've got to find the right person and there are only a few of them and they're almost the megastar level.

MR WILSON (AHRI): It's a terrible hazard, that type of logic. I agree.

MR FITZGERALD: So does this actually bring us back to a more concrete way of assessing the role of CEO, CFO and those positions, given that you may or may not have to pay slightly above market for a particular person at a particular point in time?

MR WILSON (AHRI): You will. I think if you focus the core remuneration decisions on the size of the role then you are being equitable to the individual and to the market and market data will go from the 10th decile up to the 90th percentile, and what do you find at the 90th percentile? You find some very special people that are the top performers in that role. So within the framework I am advocating you can pay the top performers and structure their remuneration so they're being treated fairly and if they're a really top performer you know what they should be paid at the upper end. But those two things shouldn't get mixed because if they do, then you do get the market data moving upwards over time.

PROF FELS: I'm really very interested in this plan because we have heard quite a lot about processes for setting pay and binding votes and all of that, but no-one has really been interested in the submissions we have heard in doing anything on the quantitative side, yet that is what the community concern seems to be about, a general rapid escalation of executive pay and so on. So this is one way of addressing to some extent some of the concerns. The code would come from - who would draw it up?

MR WILSON (AHRI): I would think a particular group of private bodies. I think we would have a role to play; the Institute of Company Directors; possibly the CPAs because the remuneration report currently is totally driven by the accountants, so they need to be in the room; and I would think Treasury officials with expertise in tax; prospectively perhaps some from your old stable, the ACCC. It would be a

mixed public-private group that could really drill into what is going on and what are reasonable standards for remuneration. That could be updated from time to time. I think it would be very hard to get it right first time.

PROF FELS: Yes.

MR WILSON (AHRI): But we should be able to get 90 per cent there.

PROF FELS: So anyway it said this code is compiled and you have already implicitly addressed one of my concerns that say the government picks up the idea and then just leaves it with purely the private sector the quantitative side might be taken out or it might descend to a lowest common denominator type of code.

MR WILSON (AHRI): Correct, yes, they're the two risks.

PROF FELS: So there's an issue about whether the lowest common denominator style of thing.

MR WILSON (AHRI): Yes. Any recommendation by the Commission for a remuneration code of practice should have strong and clear qualitative and quantitative criteria that materially add to the public benefit.

PROF FELS: Supposing there was this code it would still be essentially a voluntary thing for business. Boards would then have the option of adopting the code or their version of it and they would put it to the annual general meeting for an endorsement?

MR WILSON (AHRI): Yes.

PROF FELS: Would it be optional that they actually had any kind of code, would it just be a recommended best practice or would it be in some way written, not necessarily into the law but into the ASX or something like that?

MR WILSON (AHRI): I think it really should be part of the good corporate governance standards for the ASX.

PROF FELS: Yes.

MR WILSON (AHRI): That has a fair bit of force.

PROF FELS: So a company would then be locked into - well, it would have some explaining to do if it didn't put a plan to the meeting. It would have some further explaining to do if there wasn't conformity to it. The shareholders could vote it down and they could also vote down particular arrangements that went over the ceiling set

by the plan?

MR WILSON (AHRI): Correct.

PROF FELS: I keep using "ceiling" but there's a number of process requirements that you have in, yes.

MR WILSON (AHRI): Yes. Well, one of the things that concerns us is the role of directors. There's data in there that 80 per cent of my members feel that the right process is for there to be external advice put into the internal programs and plans remuneration put up to the board. But we do have a number of boards who, consistent with their sense of their duty, take their own advice only, taken by somebody from an external consultant that is unaware of the detail of remuneration planning or design within the organisation.

I think there is a best practice process in there which I would like to see in any such code. Again, that would be a matter for disclosure. I think we can presume that a number of the excesses that have occurred have been where people have acted without proper advice or information and the game has been given away to a new CEO; so I would like some process elements in there.

PROF FELS: With regard to the criteria that might be used in setting pay, we've already talked about various sources of information that are available, like Hays surveys and so on. What happens if you accept - I don't necessarily accept but say you accept that because of international factors pay needs to go up more than for other people, how would that play out in this code of yours in this proposal?

MR WILSON (AHRI): Well, again, I think the - thinking particularly. There's three major surveys: there's Hay, there's Mercer and there's John Egan. They pretty much have most of the work at the top end. They ask you whether you want the job referred to in an Australian market or a broader market. Primarily their benchmarking is the Australian market for that position. That's my understanding of what most corporates rely on. You can get data in international environments but then you have to tax adjust it, exchange rate adjust it, cost of living adjust it and it's bloody complex, you know. I've seen the results come back for a former CEO that I reported to.

Most people think we need to pay something broadly comparable in this global market. There are pressures in this market when we lose people, but there isn't a single global remuneration survey that we can really rely on closely. So I think you could reference it to standards in the Australian pay market. The data there is going to move in broad recognition of the value of the job internationally but I haven't seen a benchmark that gets that precisely right across boarders.

PROF FELS: Just digressing for a minute it's just interesting to hear your comments on international comparisons being so difficult. We've had a few submissions where it has just been asserted - fairly simple assertions have been made about Australian pay as compared to the rest of the world. We haven't heard a great deal of detailed evidence on that but it sounds like it's not an easy job to compare it.

MR WILSON (AHRI): No. I could see from the looks on your faces the three adjustments I was talking about, particularly between Philadelphia and Los Angeles: is he going to be based there or London or Tokyo or whatever – that all makes a difference.

MR BANKS: But are you saying that Australia is - which goes against what you were saying earlier and the quote you gave that we are an island, in a executive remuneration sense.

MR WILSON (AHRI): What I'm saying is that the data is very hard to get working as Friedman would like. I am aware of people that - I mean I ran an expatriate group offshore when I was with the ANZ Bank around the Asian banking operations and put people into overseas markets and they came back. They were concerned about the right level of consumption offshore, and to preserve savings here. Their movement in and out of the market and the pressure, the contestable pressure, they brought in did affect our domestic pay benchmarks. I just didn't see perfection in the way that could be anchored across the world in any one survey measure. It did have an indirect on Australian pay influence but it's not exact - the science defies you in its exactness.

PROF FELS: Now, with this code I think I know what the criticisms would be, that this is imposing a straitjacket and/or reduce the flexibility that is required for executive pay and all that kind of thing. Do you have any other responses to that?

MR WILSON (AHRI): I've spoken to a number of my former colleagues about that. They feel that the current remuneration report is a giant waste of time in the sense that it's very complex, very much driven by accounting values, there are different generation - vintages of information, different tables. They put in a lot of work for stuff that they find, and the AHRI survey results shows, their boards have difficulty understanding it all and certainly shareholders do. More recently you've had experience with companies that are having the head of their remuneration committee getting up and addressing the shareholders on the simple issues in the remuneration report. Well, that's what I think we should move to in the writing. I believe my profession would support that: a simpler remuneration report focusing on, the one hand, the accounting cost to the organisation, we must have that, but some transparent sense of the benefit to the individual at a point in time and the relative market positioning of that.

The annual reports that we now have audited and provide to the shareholders are quite complex beasts but the model has worked its way to the status quo over time. I think there's a learning curve in that criticism. People basically will get on with it and try to make it sensible. I think there's a strong demand amongst HR professionals to take the sting out of this debate, because it is generating a lot of heat within companies to comply with what they think shareholders want only to find that they've missed the mark; so there's an efficiency benefit in getting this right. There will be some squeaky wheels. But what we're trying to suggest is a regime that we can get on with, it makes sense, will help manage excessive behaviour and establish some credibility in the community again.

MR FITZGERALD: I suppose one of the things is there are already a number of codes around, and one of the exercises we'll do is to look at all those codes, and I suppose to see where there is common ground and divergence. I suppose a thing that I would be interested in at some stage is to understand in what areas your approach would differ from, say, the ASX governance guidelines and/or the Australia Institute of Company Directors' guidelines, because in some sense we already have codes, various and different. I am sure there are strengths and weaknesses in all of them. But what is alluding me just at the moment is to understand in what areas is this particular code of practice you're suggestion manifestly different from those. So that would be helpful.

MR WILSON (AHRI): I would certainly appreciate reading the review you do of codes. But the reading that I have done myself on the ones that are there, they are fairly bland. Most of the sharp edges have been shaved off. They're not terribly useful for anything other than, "You're going to pay the market." "Okay, well, how is the market set? Okay, well, yes – then it's not very helpful here." It's a non-sequitur to date.

The code of remuneration practice should really have some bite. It should go into the real drivers, how the decision to set somebody's pay is referenced by the value of their job, where they sit in the market, the value of that person, the value they're expected to drive, and then the process by which it is put through some appropriate review filters one or two levels away. You don't find that in the codes I've seen. It is not rocket science stuff, I did it on two pages for a major ASX board of directors, the principles by which the pay should be determined. They thanked me for it, they thought it was quite thorough, and it didn't take long to write.

MR FITZGERALD: An approach that is taken in a lot of the recommendations that people have been putting is the approach of if not, why not. They allow the company to deviate from whatever the company is provided they explain why they're deviated. When you talk about a binding vote in relation to a remuneration plan, in the subsequent years where there is variation, I just want to be clear, you're saying that if it is a material variation from the plan it needs another binding vote. Some

might say that all that would be required is an explanation as to why you've deviated, if not, why not. If you haven't followed it, why haven't you followed it. There is a difference.

At the end of the day, it seems to me that whether it is a binding vote or a non-binding vote most votes get accepted, and we look at whether it is a 10 per cent vote against or a 20 per cent or a 25 per cent vote against this. So I just want to understand if you're proposing that it would need to come back for another binding vote why is that a more preferable position than simply having to explain why you've deviated from it.

MR WILSON (AHRI): Again, I think of the parallel in financial accounts and what I've seen or been part of in discussion between my CFO and the auditors of the company. There are a lot of accounting conventions behind those accounts and auditors raise questions. If they're relatively minor or trivial divergences from the plan they accept the explanation, a note is taken, and we move on, we might do something next year to correct it or whatever. If it is a material variation, for example, if the board plan to shareholders has said, "The bonuses of this organisation will reflect a normal distribution for the market for all relevant jobs," and the auditor finds everybody is paid a bonus at the third quarter, that is a material variation. That sort of thing should be telegraphed out. There will be a number of other issues that are going to require judgment, which is normal for the course with financial accounts. So I think we can oblige that distinction as a healthy one and it's one that I think should appertain here.

MR BANKS: But in your case, if the auditor found that was a significant breach in terms of the plan that had been approved by shareholders that aspect then, that distribution, would have to go to shareholders for a vote. You don't think that would cause any difficulty from a management point of view? The point that Robert is making out the if not, why not, would involve management of the board going back and explaining to shareholders that in this particular reporting period there were exceptional circumstances that required this to happen. They'd have to do that anyway, in terms of a binding vote on it, but the binding vote cranks it up just that bit more.

MR WILSON (AHRI): As I said, let's just take the simple last year's bonus. It is determined in August, or it's calculated in August, and for very senior people that normally goes to the board for confirmation before it's paid. I think the timing won't need to defeat you on this. There is a way to include the auditing process to occur any pre-payment. So if it is qualified it just doesn't get paid. So people are going to be grumpy if they know they had a third-quartile bonus coming. But as executives, they can read their own company's plan and think, "Well, if everyone is getting a third-quartile bonus we've done something that's not proper here." Again, that's a transparency that's healthy for them. It trains them on the fact that, "This isn't just to

give me another part of fixed remuneration."

So I think if you double someone's pay during the year and in the middle of the year they've got half of it by the time the audit is done then that's much harder to retrieve. But the big excesses are generally around the amounts at risk, the two amounts at short and long term risk, and they can be caught in this process before there are inequities.

PROF FELS: In the broadest terms, there are two aspects of what you are putting. One is a code that goes further than what we've heard about present codes, and it takes you a bit more deeply into the kind of criteria that companies would use for setting pay. Most of the criteria we've heard about are mainly some points about process but they don't take you further down the path into criteria. The second aspect of it is that there would be some machinery and mechanisms to make the code effective, and we can distinguish those two things. So one might like your criteria for the code and so on and then want to fiddle with your ideas on exactly how it is going to be complied with, binding vote or non-binding votes, and vice versa, etcetera. So there would be two sets of things that would need to be thought through fairly fully.

MR WILSON (AHRI): Yes.

PROF FELS: Indeed, I could imagine that would take a great deal of work. You've given a very general framework, but nevertheless it is a bit different from other things we've heard at this hearing.

MR BANKS: We might encourage you to move on. I think you have a couple more - - -

MR WILSON (AHRI): Yes. I think the thing I'd like to talk about now is what is the right balance of power between the government, shareholders and boards of directors themselves in governance of this issue. My institute does favour fairly light-handed regulation, and I think the recent initiative and then change to executive and employee share remunerations is a case in point, that you're dealing with a fairly fragile thing, and we would encourage the government to allow the Henry Report to look at taxation of share instruments in the context of total taxation burdens and do no more quick fixes.

In terms of boards of directors, 88 per cent of the AHRI survey respondents have called for greater disclosure. So my profession basically is encouraging there to be more put out publicly. But in simple English and particularly focusing on the benefit to executives rather than the accounting cost, which is sometimes high but in practical terms, in terms of share options, being out of the money, non-existent. We do think the remuneration report should provide statistical data for all employees

above, say, a level of $400,000 for the sake of argument, as well as full disclosure on the top 10 or 20 in the company. By that I mean market data being used to determine their pay distributions against that data and its structure: fixed, short-term incentives, long-term incentives, whether things are in or out of the money, say, over a five-year period on a statistical basis. This does maintain privacy for the individual.

The binding vote we've talked about and I won't go over that again, other than to say perhaps in terms of the position of the shareholders there has been much discussion of shareholders' power and their appropriate role. To inform that debate we've made a distinction, which I'm sure others have, between institutional shareholders and retail shareholders, which I have in previous life spent a fair bit of time with each group. Institutional shareholders are highly skilled, they have a resource base to develop and understand and probe into these things, but they're also very hard worked, have lots on and have a string of AGMs in a week that they have to provide proxy votes for. The retail shareholder is not as well informed but often more infuriated by what they see, and wanting to influence, and being substantially behind a lot of no voting but not being able to affect the ultimate outcome.

So in terms of governance of the board, we think the obligations on boards of directors are high. We've advocated that there be compulsory training and standards for them and that they be posted and transparent and there be some transparency in the appointment process to what we see as probably the most powerful closed shop in Australia at the most senior level. But breaking that down a bit, on the remuneration imperative we think that the burden on directors that are long serving is higher, the responsibilities are greater, they generally take more significant positions in the company as committee or company chairs over time. Whilst a simple vote seems sensible to elect a director for the first time we think subsequent re-election should be on the basis of a three-quarter majority, which I think would balance up the interests of institutional and retail shareholders. We've also recommended elsewhere that directors serve no more than 10 years on a company's board. So that's controversial perhaps so I'll pause there in case.

MR BANKS: Could you reflect on the market and the extent to which that change would have effected change in terms of reappointments.

MR WILSON (AHRI): At the moment I think, a rough rule of thumb, most directors get elected with 95 per cent plus votes. There is a recent case in point, Sir Rod Eddington got 61 per cent of Rio Tinto. Under these rules he wouldn't have got that seat back. I think lifting it up to 90 per cent is extreme. I think if you set a higher bar for a longer serving director - then when there is a big stuff-up the accountability of those coming up for renewal, you're more likely to get some contestability into it. But at the moment, 51 per cent just drives the incumbency factor, particularly as I've seen institutional shareholders cast proxies.

MR BANKS: So is this because in a sense we can't trust institutional shareholders to make the right call?

MR WILSON (AHRI): You can sometimes, but at the end of the day I believe in shareholders' sovereignty, and the very fact of the matter is that the power is very heavily concentrated, and so do they have adequate time? Are they enabled by their employers to have adequate time to go right through the long-term incentive plan being put up? No. They have a sense of the broad relationship of what is put up to shareholders value and they cast their votes, unless there's something really sour that's gone on, like the ruckus surrounding the Westpac board in the 1990s and Coles Myer at the turn of the millennium. But there should be some directors to think, "I'd better get this right. I'm coming up to my fifth year in the company. People are expecting me to really have some resolve and commercial acumen in the decisions I'm taking, particularly in recruiting the next CEO. I've got to get 75 per cent, if I have a giant stuff-up here ..." If you've got 51 there's almost no fear of flying. I think they're the main points.

MR BEGLEY (AHRI): I think so.

MR WILSON (AHRI): Really we've just given you all of our data and some of my arguments.

MR BANKS: Thank you for both. Both are valuable, but it's good to have data, and I think the size of your sample you've got means that it's data that we need to take seriously.

MR WILSON (AHRI): It really is significant, yes.

MR BANKS: So that's been very useful.

MR WILSON (AHRI): The people in my database are at a very interesting position – sitting between the executives that are getting paid top dollar and boards, and also they are the ones putting the material up for the boards to determine and then managing shareholders' votes on plans and reports through to completion. So it's a very informed audience.

MR FITZGERALD: I'm intrigued by a number of the recommendations you've made, and the submission is extensive. Can I come right back to it, in one sense people would see your submission as saying there's not a huge problem to be fixed. We don't have the excesses that we've seen in some other jurisdictions. Yet in another way your recommendations are more substantial than many of the recommendations that we've seen from other bodies associated with this. I suppose I just want to go right back to the beginning.

If you were to implement your recommendations, and given that nothing gets implemented fully, but if they were, what is the behavioural change you would expect to see as a consequence of your recommendations from where we are today? So what would change and why would that be a good thing? Because there's an awful lot of people out there that whilst they recognise the importance of the inquiry they really are saying, "It's perfectly fine, it's the public that don't get it." Your recommendations take us down another track and says whilst there's not the extreme elements, these things would improve it. But what would the scene look like if these recommendations were implemented? What would be different?

MR WILSON (AHRI): I think there are two or three significant changes or benefits from the proposals we've made. The first is that with a code of practice with bite the retail shareholders' and the general community would feel, like safety in the workplace, "There's something significant here." And there's something substantive, we can rely on, supported by simpler remuneration reports that clarify what people are getting and why and what the market is at the moment. Presently that's a total blind publicly.

I think executives too have a sense that their confreres out there are getting big payments that aren't completely at risk. So having some transparency on remuneration where if a company is doing well people are doing well, they seem to be getting the right sort of effort transferred through and into the remuneration, but elsewhere, amounts at risk are genuinely at risk and I see the forfeitures. I don't know who they are but I know that class of executive has missed out and I can see why, because the company is tanked and it's dropped from first to fourth in the market leadership stakes. So I think that type of transparency would be very healthy for executives, that their remuneration is significant but it is at risk to performance and there is a chance they mightn't get it. At the moment I fear they think the other.

I think ultimately governments would be more confident that with a proper auditing process and standards, like the annual report where they were concerned over the last 50 years and changes in the time immediately post Enron with Sarbanes-Oxley, when the shareholders or the outside person looks at a financial report that is the fair and reasonable financial position of the company. I'd like to see the same standard applied when they look at the remuneration report, that is a fair and reasonable standard for how executives get paid, "I am confident in those principles, I have seen them start in a formative way and evolve and get improved, as these things do, and I have confidence now that in the global market this is a good way of running things." That's the aspirations we have behind our recommendations.

MR FITZGERALD: Thanks for that, that's good.

MR BANKS: It's been a fascinating discussion and we thank you for it, including, as Allen said, for throwing some extra ideas into the mix that perhaps go a bit further

than some others but are based on your experience. So we thank you for that.

MR WILSON (AHRI): Thank you, Chairman and Commissioners. We wish you well in your deliberations. It's very important.

MR BANKS: Thank you. We'll break now for morning tea.

MR BANKS: Our next participant today is ACI, Australasian Compliance Institute. Welcome to the hearings. Could I ask you please to give your names and positions.

MR TOLAR (ACI): I'm Martin Tolar. I'm the CEO of ACI.

MS BURLEY (ACI): I'm Naomi Burley, the national manager.

MR BANKS: Thanks for taking the time to attend today and thank you for the submission, which we've read. I have some questions for you, but I'll give you the opportunity to make your key points.

MR TOLAR (ACI): Thanks. The key point we wanted to try to make, and I guess this is more of an observation as to how this is played out in the press rather than having been here for the last day or so, if we have got a bit of a concern that this may turn into a bit of a have versus have not old sort of class warfare, workers versus bosses type approach to how much people get paid.

I think there's really a more important issue underpinning all of this. That is that our remuneration should be seen as a reward for undertaking certain tasks. Bonuses should be seen as a way of incentivising people to undertake certain decisions and promote certain behaviours. That's pretty much the basis of our submission, if you actually alter and influence what behaviours those bonus payments actually influence then you can achieve the outcomes that meet the needs of shareholders, consumers, employers and the organisation for a longer period of time.

That's why our suggestion has been around the creation of manager KPIs for risk and compliance and governance. At the end of the day, executives, be it CEOs or boards, make decisions about the allocation of resources, make decisions about what sort of risk appetites will take, prepared to run the organisation. If they're measured on that performance and some of that performance does include longer term issues around the governance of the organisation and they are incentivised around payments in that context then they will make sure that those outcomes are achieved. If you have short-term KPIs that underpin some of the situations we have now in terms of risk appetite then executives will make decisions along those lines. So what we're suggesting here is there is a real opportunity to try to influence the behaviour of organisations by putting in place these KPIs.

We understand it can be quite difficult to try to encompass all of industry. I think we made a suggestion in the submission of trying to concentrate around the top ASX companies, maybe the top 200 organisations, which actually have the size and means to undertake this sort of work. But ultimately, the end goal should be to try to make sure that both the directors and the CEOs and senior management look towards

the long term with regards to running their business, to ensure that they have companies that will be there to serve customers for the long term, be there to make sure employers and employees have jobs for the long term, and make sure that shareholders have a realistic return on their investment over the longer term, particularly given the large amount of people who rely upon shareholder income for their superannuation and retirement. So I think this is an opportunity to try to change this behaviour. I think the way to do it is introduction of those risk, compliance, governance KPIs for these people in these roles.

MR BANKS: You're seeing this as a complement to other things, presumably. It would reinforce other incentives and signals for executives?

MR TOLAR (ACI): We've taken the approach in the submission that we don't won't to get into the whole discussion about how much people actually get paid or how large the actual incentives are in terms of bonuses. We understand it is an international marketplace for executive talent, so we've got to try to compete in Australia for that market. If we don't price accordingly we'll lose that talent overseas, or on the other side, we can't attract that talent to come to Australia. So I'm not so much concerned about how much a person gets paid to undertake their role, but how do you actually influence the decisions they make while they're in that role. I think that's where our suggestion will come into play, around incorporating these KPIs into their performance.

MR BANKS: These KPIs, as I read them, are to do with risk and compliance against certain sort of risk process resourcing issues. Obviously that's one part of what a senior executive has to think about, but that's the bit you're focusing on.

MR TOLAR (ACI): Definitely. I don't think there's a role for either the government or ACI to turn around and specify what those KPIs should be, and what we've found with our experience through using the Australian and New Zealand compliance standards, the compliance programs have to be a horses for courses approach. You have to ensure that your programs meet the needs of your organisation and industry sector.

So as a consequence, we need to have some flexibility around what they actually look like. That's why each organisation will address the situation differently. I should be allowed to, anyway, from a principle-based approach. The real concern is making sure that they're there, making sure that somewhere, whether it's in the Corporations Act or in the ASX listing requirements, there is a reference to the fact that you need to have as part of your KPIs for your organisation, your senior staff, something that actually specifies the need to have a compliance and risk and governance framework in place.

PROF FELS: Can I ask you a question, I know a bit about compliance programs,

obviously. I'm just wondering are you talking generally, the Australian Compliance Institute, which I have a lot of sympathy for, that businesses should have compliance programs and they should be written into the criteria for management performance that they do compliance? If so, I understand that, that would be not a bad thing. Some businesses certainly have that written into their KPIs. Are you linking it to the pay debate? That's what I wanted to ask.

MR TOLAR (ACI): Yes.

PROF FELS: So how, specifically, is what you are saying linked into the pay debate? I don't think it is as simple as this, but is it simply that you're saying, "You've got to have good KPIs so one of them should be compliance," or is it broader than that?

MR TOLAR (ACI): In it's simplest form, that's the crux of the argument. At the end of the day, if you're in charge of an organisation and you need to make decisions about how resources are allocated, what sort of business ventures we'll actually undertake and so forth, then part of what will actually drive those decisions that you make, or in terms of setting the tone and the culture of the organisation, part of what will drive how you achieve that would be how your performance is measured, both as an individual and as an organisation. If to receive your incentive payments you had to then meet all those KPIs, and then some of those happen to look at long-term issues around risk, governance and compliance then we believe that's actually a good outcome for the organisation and society as a whole.

We already have examples which we have included in the submission that some of our members do use. There are some staff and some organisations that already have in some of their KPIs reference to the amount of training that is undertaken by the organisation. We actually had a breakfast this morning where one of our members explained how they rolled out their compliance training program over a number of years. Someone asked the question how do you actually ensure that staff members have undertaken the training, and they couldn't quite answer that. I said, "Do you have it as part of your KPIs?" I said, "Well, push them push them to get that." There's a very quick way, if every staff member said, "You must undertake your five hours of compliance training within the organisation each year as a KPI," then they actually would do that otherwise they won't have a satisfactory review at the end of their review period each year.

So we're saying the same should actually apply for an executive director level. The difference, of course, is this would be a much higher level, much more strategic as opposed to an operational, "Have you done your training program?" It would be more around, "Have you actually aligned the business strategy with the organisation's compliance framework? Have you actually allocated adequate resources within the organisation to fulfil these requirements. Have you set your risk appetite? What is

it? Does it meet regulators requirements as you're a prudential regulated organisation?"

Also, those sort of high level issues around perhaps the level of customer complaints, "Have they increased or decreased? If they have, how do you rectify them? How quickly do you rectify them? What then are the financial implications for the organisation in terms of the rectification process? Do you have breaches? If breaches take place, how many? How soon do you rectify them? Does a regulator have to get involved in that process?" So they can be quite measurable and quite tangible.

You can also look at climate surveys. I lot of HR people will conduct climate surveys to try to get a feel for what the culture of the organisation is. I think very quickly you could add some questions around, "Are we an ethical business? Do you think we comply with laws?" and some questions around those sort of softer aspects or perceptions of compliance can then produce some scores and measures that on a year by year basis can also be tracked as well. Depending on how they improve or go backwards may then reflect upon the executive's performance with regards to actually setting that compliance culture within the organisation.

MR FITZGERALD: Some would say the first hurdle for you to overcome is to say that in the top 200 ASX-listed companies or what have you that there are evident problems in relation to compliance and risk. A lot of what we're hearing would indicate that we don't have the extreme problems that have been experienced in other jurisdictions. Some of that goes directly to the way that we've dealt with risk, and there's a few. So again, if one were to take your approach, what are you trying to achieve by that? What problems are you trying to overcome, if they exist, or what improvements are you trying to make? Most firms would say to us that we spend an enormous amount on compliance divisions, and that's no doubt true in at least the top 100 ASX companies. What is the change you want to bring about by this proposal?

MR TOLAR (ACI): I guess the change is some thinking within the leaders of organisations to move away from short-termism, to move away from risk-taking behaviour which may have resulted from the way in which they incentivised in the past, to move towards creating organisations that will be around here for the longer term and for the reasons why I actually mentioned before. I guess some people may turn around and say, "Yes, we spend a lot of money on compliance," but you can actually ask questions, "How effective is that?" You can throw money at any particular program within an organisation, but how do you actually know it's getting the results and outcomes and you actually want to achieve? Are you spending money on a compliance program just to meet the needs of regulators, to try and make sure they don't come knocking on the door or are you quite serious about the longer-term impacts it's going to have upon the organisation? Are you actually quite serious about creating what we call a culture of compliance, that is, making sure

people do the right thing when there's nobody in the room watching?

How do you stop the Soc Gen situations happening with regards to the FX situation and the hedge fund situation in Europe recently? They had all the compliance programs in place but these people actually found away around that. So they actually undertook decisions by themselves to do the wrong thing when no-one was watching. So it's those issues we're trying to make sure that - it's almost verging to some extent around becoming the good corporate citizen and having to go above and beyond the law because at the end of the day the challenge for regulators is to try, if they want to, and prevent those market boom and bust situations and can they do that through legislation. My feeling is they can't. Do you expose yourself to that boom-bust cycle as an organisation by being the law as a base minimum requirement or do you try and do more than that? Do you try and achieve these long-term objectives? I think that's where the KPIs can come into play to try and start to change that mind-set around how people view compliance as a value-add as opposed to just a cost to the business.

MR BANKS: When you say that these would become mandatory, earlier on you were saying either through ASX Corporate Governance requirements or the Corporations Act and they're quite different vehicles, as you know. One is essentially a very large ended if not, why not approach, the other presumably would be more prescriptive. I'll just get you to comment a little more on that.

MR TOLAR (ACI): I guess from my point of view there are people who are much better trained at these sorts of things than what I am in terms of trying to identify the correct delivery vehicle to achieve the outcome but they were just some suggestions as to where they may or may not fit in. I think at the end of the day the approach needs to be one where while it could be a very simple line of reference around the need to have mandatory governance risk compliance KPIs for senior executives but then allow that principle to actually permeate throughout the organisations affected in terms of determining how that may look for those organisations, depending upon their particular needs.

So we're sort of quite mindful of the fact that there is a general preference from business on most occasions to have a principles based approach to regulation legislation and while sometimes they may come back and say, "Tell us what you want," and require more guidance I think to get the outcomes that are going to meet the needs of most industry sectors and most organisations, that principle based is the right way to go about this. In terms of the preferred vehicle, I'm happy to be guided by the commission or others with regards to whether that should fit. But from our point of view, it's more about trying to get that outcome.

MR BANKS: From your experience and awareness of what's happening in different organisations, how much of revolution would this be?

MR TOLAR (ACI): This is actually part of a broader discussion and for some organisations it would be business as usual. For others who are right now discovering the importance of compliance risk and governance because of the current market situation, it could be revolution. There are some firms out there right now who are waking up to the fact that these things are actually important and we get those inquiries all the time. There are other organisations who have been long-term members of ACI, if not founding members of ACI, and for them this is just power to go and do things. So you're going to have that spectrum and I guess some in between as well.

PROF FELS: What's your estimate about the extent to which they've been done at the present time?

MR TOLAR (ACI): I guess we have most contacts with our member organisation and when we put that submission together we just contacted a few of them very quickly and said, "By the way, can you give me some examples that you use," and the response came back fairly quickly. So for those organisations, and they are the bigger in the town, it was a very quick response. Those examples include a state government utility, they include one of the four large banks and also a manufacturing organisation. So there is a combination of three different companies or industry sectors represented in some of those examples. We made clear not to actually identify who the firms were but we did make a point of trying to get a broad range of how it's approached as well.

MR FITZGERALD: The APRA guidelines have just come out in relation to linking risk with remuneration and I note in your submission you talk about your recommendations apply not only to ASX listed companies but those that have some financial service licences and so on. I was wondering whether you have any view as to the approach that APRA was taking and in particular the way that their draft has dealt with the issue.

MR TOLAR (ACI): We have also made a submission to APRA as well. We did attach the submission because we did think there was a degree of synergy between the two lines on inquiry. We have raised some questions with regards to the APRA interpretation and how they intend to actually apply what they want to achieve, largely because there is an international group which makes recommendations and the name right now escapes me with regards to suggesting that all aspects of risks be covered off in setting up these guidelines and frameworks. It seemed to us - and this is where we wanted the clarification - that the APRA approach was a bit more narrow in focus and that perhaps the risk they speak about is more financial in nature as opposed to broad and operational, so we have sought clarification around that but otherwise the two submissions are fairly similar in nature as a consequence.

MR FITZGERALD: Just in relation to that, we've constantly been told that Australian firms have handled risk better than particularly their American counterparts but also I'm sure some of the UK and others. Is that your general perception? Do you have a view that Australia is better at managing, not only financial risk but broader risk and, if so, why so, and if not, why not?

MR TOLAR (ACI): It's an interesting question. I gave a presentation at an Austrade event in Hong Kong last week and basically the gist of the presentation was to try and showcase Australia's corporate governance to the Hong Kong market. I happened to use a diagram that came from the Financial Times that was published earlier this year and has since also been available on line. What's interesting about that is it shows that the top 20 financial institutions were market capitalisation and you can online go from 10 years ago to the present and if you just pick 08 and 09 to make that comparison you see very quickly that those firms change and all of a sudden you have two Australian banks in the top 20 by market cap, three Chinese firms on top and a lot of American firms aren't in that list any more.

Really that's largely not because of any great amount of capital growth under management now, it's more about the fact that those other banks have fallen over; almost a Steven Bradbury defence with regards to why these organisations are now on top. ASIC's - - -

PROF FELS: It didn't help though with the takeovers of St George and BankWest and various others but I accept your point.

MR TOLAR (ACI): Even someone at summer school - I think it may have been the former Reserve Bank governor made the point that the four-pillars policy actually played a part as well by reducing the amount of competition that could take place that wouldn't drive, I guess, organisations to take extreme positions with regards to risk because there wasn't the incentives to do so. But I think at the end of the day there are a couple of things which have really stood the Australian marketplace quite well with regards to banking. One is the fact that the twin peaks model of APRA and ASIC is actually now seen as the world's best practice by a lot of overseas regulators because it actually allows both organisations to concentrate upon their particular patch of the financial services industries whereas some feedback from the FSA, for argument's sake, their resources got put towards one part of the market and too much left, some of the other part of the market not as well regulated as others, whereas with the US you've got a multitude of regulators there which makes it very difficult to try to determine who is actually looking after who.

The other thing which has stood the industry here in fairly good stead, despite one or two outlines in the financial services industry as opposed to banking, is the fact we actually have a very strong compliance profession here, largely born out of the fact that one of the ASIC requirements with regards to licence - RG141 from memory - is

actually the need to have a compliance program in place and actually have it resourced adequately and actually have it independent from the business. So that reference, and I'm pretty sure it's 141, actually has created a strong compliance profession within the banking sector in particular, that coupled with having an Australian compliance standard and I guess organisations like us that also promote compliance and governance plus other risk based organisations as well I think all add up to a fairly robust system as to why we have stood the test.

MR FITZGERALD: It begs the question that I raised earlier with somebody else about the regulatory response. You more you ask people what has stood Australia in good stead is in fact based on regulatory underpinnings, the requirement by APRA that you have a compliance thing and we have seen this a number of times. I suppose I am curious that what has stood us in good stead is founded on a reasonable regulatory environment plus a whole lot of codes and practices and work such as your own institutions. When we come to remuneration, there is a great reluctance to recognise the role of regulation. It's almost as if that is tantamount to something that is completely inappropriate and yet every time I ask about what is a governance somewhere there is a requirement, albeit at a low level or a light-handed approach, and I am just wondering whether I am misreading that situation and I want to be very clear we're not obviously saying that regulation is the answer, nor have we got any view about the regulatory response in this area. But it does seem to me that where we are today relative to the world in part is due to the regulatory frameworks that we have in place.

MR TOLAR (ACI): There are a couple of points to make there - and hopefully I will remember them all. The first one is that, yes, while there is that requirement under the ASIC licensing conditions or regulatory guides to have that compliance program in place. The difference is the fact that you could create a compliance program and put it on your shelf and it never gets used or looked at until the regulator knocks on the door versus one that is actually embodied within the organisation that becomes part of what the company actually does.

To give an example of that, and I used this example last week, we'd like to call it the tale of two cities. If you look at Citibank in Japan versus Citibank in Australia, Citibank in Japan had an issue around its licensing requirements, particularly in its private business sector in about 2004 and the Japanese regulator actually took steps towards removing that licence and I think if you look at the papers at the moment, they've almost shut down the entire operations of Citibank in Japan largely because they found that while there was a compliance program in place, it was there in form not in substance.

Compare that to Citibank in Australia, they had an issue recently with regards to how they run their business. ASIC happened to lose that particular case in the courts which is actually a rarity because ASIC does like to do well when it takes

matters to court and the finding basically said that at the end of the day there is a compliance program in place, there is culture of compliance there and that contributed to the decision that was made.

So there is an example between actually having a program there to tick a box or meet a requirement versus one that actually does permeate throughout the organisation. So that's sort of part of the answer with regards to whether or not having the regulation is just enough.

MR FITZGERALD: Chicken and egg. But can I ask this question more bluntly: but for the regulatory underpinning - let me go back. I clearly understand that you can require something but unless it's actually embedded within the culture of an organisation it has no effect. It is also sometimes true that unless you're required to do it, you won't do it at all so you won't get the cultural change. So in a sense would it be correct to say that that regulatory underpinning created the platform by which you can start to deal with the embedding of a culture of compliance without which it may not happen?

MR TOLAR (ACI): Possibly. I think a parallel to draw to that would be now that the rise in interest in TSO, corporate social responsibility, and there are some debates take place with directors that have argued that it shouldn't be mandated, it should be voluntary and you see some organisations out there looking to charge with regard to those more sustainable practices around how they deal with staff or the environment or how they source products via supply chains and what have you. I think ultimately there is an example where it is voluntary. Some organisations have taken the higher ground because they think it's the right thing to do.

But, ultimately, if you look at that and scratch the surface, you will see the reason why they have done it is because, one, they can see the generational change taking place with regards to attracting and retaining employees. They see the push that has taken place, the shift in consumer sentiment and also then the local community sentiment towards these issues being more important and they're trying to rely on their business to meet that need. Ultimately, time will tell whether that proves to be successful but I think to some extent market forces are making some organisations say, "You know what? That's an important decision for us to take." Others will be the firms that turn around and say, "You know what, we'll ignore that. We'll wait until we have to do it, if so." That is going to come down to some of the decisions at the top as to what sort of organisation they want to try and produce.

PROF FELS: If I remember rightly the Australian Compliance Institute was set up after some fairly big competition and the TPC got the big stick out. Up until then there had been total compliance programs and since then they've got more serious.

MR TOLAR (ACI): That's a fair call. I think at that point in time the ACCC -

ACCC at that point in time?

PROF FELS: TPC.

MR TOLAR (ACI): TPC were very clear to try and find a way to, I guess, encourage industry to do more than what the law required and that was one way to do it via the standard and also via the creation of the forerunner to ACI. That's the issue. Part of this argument also is at what point is too much regulation or is there enough regulation? If you have properly trained compliance professional who actually put in place these compliance programs, they can ensure that their firms go above and beyond and as a consequence if they're doing more than what the law requires and they're actually trying to achieve those outcomes, then there really shouldn't be a need for new ways of regulation legislation all the time. So one of the arguments you can put back to business and turn around and say, "We've had enough," is that if you can adequately resource your compliance programs, your compliance staff, then the charters are as legislators we won't need to go through this process all the time because you're actually doing more than what you are supposed to be required.

We won't have to go through this whole round of catch-up where there is a boom or a bust or there is a corporate failure as politicians and legislators are required to do something because of public demand or our electorate has demanded. One of the few tools we have available to us is the new law. When you're to pass that new law you have to go and enact it and then comply with it. It can be a continual cycle that if there isn't a way to try it found, then we'll go through this discussion again and again. We're hoping by taking a higher order of view of your compliance risk and governance framework you can actually help to contribute to breaking that cycle.

MR BANKS: That will be a good note to end on. Thanks very much.

MR TOLAR (ACI): Thanks very much.

MR FITZGERALD: We will just break for a moment before our next participant. Thanks.

MR BANKS: Our next participant today is Rodger Hills. Welcome to the hearings.

MR HILLS: Thank you.

MR BANKS: Could I ask you just perhaps to indicate the capacity in which you appear and then get you to outline some of the key points you want to make.

MR HILLS: Certainly. My name is Rodger Hills. I am a private individual, author of a book called The Consensus Artefact. Through the work that I have been doing and basically history and experience I have become somewhat of a constitutional awareness expert and a civic education expert. Throughout the research that I have been doing over the last couple of years governance keeps coming up and the whole issue of governance in relation to the Corporations Act is of great interest to me.

The submission that I have put forward really looks at, I suppose, two arguments. The submission takes a stand that not only are executive remuneration packages in my opinion too high, but that the excess is a symptom of a wider systemic problem. Contrary to a lot of colleagues in the corporate sector, I believe that the Corporations Act is somewhat out of step with community expectations, as opposed to the community just not getting what corporations are about. So that is the fundamental precis, I suppose, of the submission.

The submission has about 10 or 13 recommendations and actually covers four fundamental areas. The first area is that there should be a limiting or normalising of executive remuneration and the breaking of the cycle of elitism created by a preferential pay system between executives and the ordinary workforce. That would include termination payments and also directors' fees. The second area is creating a responsible share market by altering the corporate legislation around how shares are valued and redeemed and using a fixed share price model to significantly reduce the opportunity of speculative share market activity and reducing shareholder greed, excessive risk taking, which has contributed to the global financial crisis.

The third area is aligning the Corporations Act to community expectations, basically hard wiring a lot of the areas of community expectation like fair trade and environmental compliance and social responsibility into the DNA of a company from the day it is actually created, as opposed to trying to bolt it in from the outside. Also, giving the public a chance to deregister or delist and wind up a company if it doesn't meet the expectations of the community, which is I'm sure quite a controversial suggestion. The final thing is to try to alter the tax environment to discourage excessive remuneration packages, to reduce the amount of overt consumer advertising, unnecessary consumer advertising, and the use of company resources for inappropriate activities. So that, in a nutshell, is what the submission is about.

MR BANKS: Thank you. Your comment that you have been a former senior executive of several companies, could you indicate the nature of those companies in broad terms.

MR HILLS: I'm currently the company director of my own company, which is a small company, nothing major. I was the executive director of what has now become the industry capability network in Darwin for a year and half. I was a branch manager of Stramit Industries. I was also general manager of a company called Fiberslab in the building and construction industry, and I've held board positions with non-profit organisations as well, HPA being one, and the chairperson of what used to be the Queensland Disability Housing Coalition.

MR BANKS: Good, thank you. You make the observation that the board and executive markets function a bit like a club. I just thought I'd get you to elaborate a little bit on that.

MR HILLS: The employment market has developed quite a lot over the last 10 or 15 years to the point where if you're going for a senior management position you go through a battery of tests, psychological tests and all sorts of things to determine your merit for the job, and you're competing in a large pool of people who are also trying to get the same job. My experience in the director and senior executive, not so much the CEO but certainly in the board area, is that your resume is looked at, the primary requirement that I see come up again and again is the fact that you've actually had board experience with some other organisation.

So you see with a lot of the top corporations in Australia the same names popping up over and over again. It's like a board members' circuit, and in that circuit there is very little evidence of the company actually recruiting from outside on the basis of merit. They simply basically look at a corporation down the road and say, "That director there is doing a great job, we want them on our board," and they go about a process of trying to get that person on the board. I know that that is obviously not the case in all situations, but it seems to be a predominant activity, rather than putting a director through the usual recruitment process and then also measuring their performance at the end of the day as well to see whether they actually did a good job as a director.

The boards tend to regulate themselves and value and approve their own performance and evaluate their own performance, but there is nothing that the shareholders can do to evaluate a director's performance, apart from calling for resignations and things like that. So it's a heavy-handed approach.

MR FITZGERALD: Just relation to one of your recommendations about the tying of executive remuneration to 12 times of the lowest paid employee, we have had

yesterday a number of submissions that put forward various ratios, one to 10, one to 20 and what have you. Irrespective of the actual number, some people have questioned the necessity for and in fact the appropriateness of tying executive remuneration to average earnings. I suppose the question is what are you trying to achieve by doing so? What is the objective of this particular measure? Why is it appropriate to do this?

MR HILLS: In a lot of companies you see an elite group of executives because they have been preferentially paid through bonuses, through share options and things like that, which is inconsistent with the vast majority of employees within that organisation. So you end up with a military split, where in the military you have the commissioned officers, the non-commissioned officers and the enlisted people, and they separate those groups out. The logic behind that is quite clear, because you're going to send people into combat.

But in a company where the whole organisation is trying to achieve an aim and you're not actually sending people to their deaths you're actually trying to work as a collaborative group, it doesn't have a lot of logic where you're actually putting the people who are at the top in a pay structure and a pay remuneration process which is different and preferentially better off than the people who are actually doing the work and actually producing the goods or the services.

That's not to say that the people at the top of the organisation shouldn't be paid more because of the risk that they take on and decisions and responsibilities, but I feel that if you have two different ways of remunerating people or two different systems then you are creating an elitist group within a company, and you get a begrudgment by the normal employee as to how much their bosses are being paid. Then also from the bosses' perspective they're looking at, "That's just the employees," and there comes a disconnect. So the idea of tying the two together with a multiple, be it 12 or 10 or 20, whatever it happens to be, is to bring those two systems together, so you end up having the CEO and the directors very much concerned with what's happening on the shop floor, if you like, and also the people on the shop floor realising that some of the work is actually having some tie-in to the senior executive pay.

MR FITZGERALD: So it could lead to some higher minimum wages and all that?

MR HILLS: Exactly. But the idea would be better outcomes for the basic employee if there's a tie-in. People have said to me, "What happens if you look at a high-tech company where the basic employee wage is $110,000?" Well, that's great, the senior executive gets 1.2 or 12 million, whatever it happens to be. But then it's dependant on what the shareholders believe that that CEO - it doesn't have to be that the CEO gets 12 times. If that's the multiple, they might think the CEO is only worth 10 times or five times or six times.

MR BANKS: So what led you to that multiple as a maximum?

MR HILLS: That comes from historical research. If you look at the post-war years from 1935, 1945, right through until the 1970s the average multiple of CEO salary to base salary was about 12. It then started to take off in the late 70s and 80s and it's just kept going off. Now there's complete disconnection.

MR BANKS: You obviously don't see any efficiency reasons or market-related reasons or reasons in the interests of shareholders why you have seen a divergence?

MR HILLS: The divergence started to happen - my perspective is when Australian companies started to recruit overseas it was very difficult because we were a traditionally paying at that 12 times rate, or 10 or whatever it happened to be. Then we wanted to try to recruit people from overseas to come into the country and they wouldn't do it because the pay was so low. So the idea was to increase the pay to make us more competitive on the world market. But that presupposes the talent overseas is better than the talent in Australia, and that is not necessarily the case. We've often spent enormous amounts of money recruiting people from overseas who've done a terrible job due to recruitment processes that weren't thorough enough.

MR BANKS: Why would boards chose, with all the risk and extra cost attached to it, an overseas person to take over a CEO position rather than one in the home market, particularly one who might be in the very company and they have some familiarity with?

MR HILLS: Sometimes it's a change management process, where you want to actually close divisions down, change the culture, and it's very difficult to do that from a person who has actually worked within that company and has friends, colleagues and things like that who are working there. So it's very difficult for a person in an organisation to initiate a change management process. It's much easier to get somebody from outside the organisation. I don't really think there's any particular value in picking somebody from overseas, apart from the fact that that person may have extraordinary skills, and I would only think that that would be why you would do it. The fact that somebody has come from the UK doesn't necessarily make them a better manager. There's great evidence that there are a lot of CEOs in Australia that have gone overseas and done great work overseas.

MR BANKS: Your comment earlier about the club though might mean that you need to go overseas to get someone who wasn't in the club.

MR HILLS: Quite possibly. But there is also a lot of good management talent in Australia who don't get the chance to go into the directors' club because they're

simply not looked at because they haven't had - it's like a chicken and egg. You've got to be on a board somewhere to get a board position elsewhere. If you're not on a board then people don't look at you very favourably, and I've had that personal experience as well too. It's like, well, how do you get onto the board circuit to get more board work? Once you're on the board circuit it's very easy to get other board work but it's hard to actually get onto that circuit in the first place, which means they're not recruiting people on a merit basis.

MR BANKS: You seem to take a dim view of performance bonuses. I thought I might just get you to comment on that.

MR HILLS: Okay.

MR BANKS: Again, I suppose, I'm trying to get the underlying philosophy behind where you're coming from in terms of how you see the role of a public corporation and who it's really beholden to.

MR HILLS: Sure. To go back to that last point before I go on to the point of remuneration is that we seem to have adopted this idea that companies are here to do whatever they do. I mean I make the point in the submission that companies exist because the public allows them to exist through the constitution, through the Corporations Act. So realistically if you go back and rewind the clock, companies and corporations and businesses are there to serve the public good, they're there to provide growth, jobs, economic stability and all those sort of things. So those things are fundamental to what an organisation is supposed to do. They're not something that the organisation should do if it really feels like it might have to do it. I'm not making that clear, I sorry.

MR BANKS: Don't you see the origin of the limited liability company as being a more efficient way to amass capital and to specialisation of functions and so on?

MR HILLS: Absolutely. I mean I've got no question with that particularly. It's just that when you look at the Corporations Act here and also its corresponding legislation overseas its primary responsibility - any employee's responsibility is to make profit for the company, make profit for the shareholders, return a capital investment to the shareholders. That's its primary existence within a legal framework.

So then in order to stop that organisation from going rampant in the marketplace you then have to tack on trade practices, environmental protection, all these other things the community expects the organisation to comply with. So my reasoning is why don't you embed that into the DNA and into the organisation to start with so it has those things. If you look at remuneration, I suppose, and bonuses, when you're rewarding people for a specific thing, be it a KPI, be it share market

value, the behaviour of that executive is skewed to that remuneration bonus above and beyond often everything else because it's big bucks.

So the problem with that is you end up skewing that CEO's behaviour away from the general good of the organisation, the general good of the company, the general good of employees towards achieving high share growth. I know a number of companies that are marginally profitable but the focus is on the share price. I have seen - completely gut entire organisations: sell off capital, reduce the capital structure of the organisation; not because it's efficient but because it actually creates share market value and not particularly profit. So I don't necessarily believe that performance bonuses in their own right are necessarily a good thing unless they are across the board and you're measuring people against environmental outcomes, employee outcomes and things like that. So the bonus shouldn't be just how well the share price is doing.

MR FITZGERALD: Just another point. You're linking directors' fees - in this inquiry so far I have to say whilst our terms of reference deal with directors' fees we have received almost no comment about them and when we have people seem to say, "Oh yes, so long as your shareholders can in fact vote on the pool of funds available for the remuneration of directors that's about it." So you're one of the very few participants that have actually made any comment about the directors' fees. So again, following on from Gary's point of view, why should we be concerned about the current directors' fees arrangements?

MR HILLS: I suppose because the directors' fees in most organisations are fairly arbitrarily determined. I suppose what I'm trying to get to is that the directors, the CEO, the officers of the organisation, the employees, should all be part of one whole team, that the whole organisation should be doing one thing or whatever it's supposed to do as a whole team. The more you divide that up into separate individual parts where you've got - the directors are remunerated differently to the CEO who is remunerated differently to the senior executives all the way down the chain you end up with this mishmash of different priorities. They may say they're all going in the same direction, they may say they're all committed to the same vision, but they're all quietly pulling in different directions a lot of the time.

So the idea of tying the directors' fees to the CEO's fees is the same idea of tying the CEO's fees to the employees' fees as well too; so you have, I suppose, a continuation of remuneration which you can then add bonuses to if you want to incentivise particular areas. But you have a fairly straight and linear progression, I suppose, of pay, which makes logical sense to anybody who starts to look at it and doesn't require a whole heap of regulatory compliance and shareholders' meetings every time you want to basically raise the pay limit or reduce the pay limit or do something else like that.

PROF FELS: If they're all linked are there conflicts of interest along the way?

MR HILLS: I haven't been able to work out what they might be. I mean there's a potential there but I can't think of that would be.

PROF FELS: If say directors are setting executive pay and their pay is linked to that, would they not have an interest in inflating it?

MR HILLS: I suppose that's why I put the original caveat of having the CEO's pay directly linked to the lowest paid employee, so you don't have that situation where you have one group trying to inflate its remuneration at the expense of somebody else. It sort of flies in the face of a lot of comments I've heard from other people about how pay should be structured but to me it makes sure that the whole organisation is doing the same thing.

PROF FELS: Wouldn't you be careful to get one really low paid employee in the company and then - - -

MR HILLS: Well, I looked at the option of using the average Australian wage and that unfortunately if you're in a high-tech industry where your average employee is earning $150,000 as a qualified chemical engineer or whatever it happens to be - would basically pull a CEO's salary down to nothing. It wouldn't be down to nothing but it would be out of kilter with the rate of pay for that particular industry. But by the same token you don't want somebody who is earning $32 million a year currently when their average employee is only earning $20,000, $30,000. I think that disparity is grossly wrong from a community perspective and, as you know from the community backlash, is out of step with what the community expects.

MR BANKS: Okay. Thank you very much.

MR HILLS: Thanks very much.

MR BANKS: We'll just break for a moment before our final participant before lunch, thank you.

MR BANKS: So our next participant is Maxumise Consulting Pty Ltd. Welcome to the hearings. Could I ask you please to give your name and position?

MR UNDERHILL (MC): Yes, it's Max Underhill. I'm director of Maxumise Consulting Pty Ltd.

MR BANKS: Good, thank you. Well, thanks for taking the time to attend today and also for the submission which you put in. I'll give you the opportunity to speak to it and I may have some questions.

MR UNDERHILL (MC): Thank you very much. Maxumise Consulting is part of a group we call Maxumise with interests here in Australia, Fiji and also a group of companies called HRmonise which are in Australia and Fiji and representation in the UK. I'm both a Certified Professional of the Australian Human Resource Institute and also a Chartered Professional Engineer. Having spent 26 years in civil engineering, the lack of management tools for the most important resource, which was our people, drove me into the HR field, first of all, setting up my business as a consultant. That business was purchased by Towers Perrin, the actuarial company, in 1990 and I left that business to pursue our own business again in 1996.

As I'm sure your research will indicate, this period around the mid-90s was one of massive CEO salary increases in Australia, and a period I'm not proud to have been associated with. The Maxumise submission doesn't refer to a specific component of the terms of reference but is largely based around terms of reference 4, which is the mechanism of establishing the remuneration levels. This term of reference 4 we see as the driver of executive remuneration; until the mechanism to establish a fair and equitable remuneration package is establish then there is no reference point to engage the other components of the terms of reference.

While our submission addresses the mechanism there are some details that are pertinent points which we'd like to just emphasise from our submission. First of all, the base salary for a role, when it's established or designed, is not the base salary of the successful executive or other employee. We need to make that distinction between what is a role and what is the value of the executive placed in that role. An organisation needs to specify what they want and establish the value of that before you go hunting for the product to fit that specification. We talk about designing the chair before looking for someone to fit into it. The applicant's worth against the base salary has to be calculated using the same system you use to calculate the value of the chair. This is likely to be different, and sometimes significantly different.

In modern HCM methodology it is possible to manage human assets as well as any other asset, if not better. This includes the calculation of the worth of the role and the worth of the executive or the employee. Salary packages contain basically

four elements. These are: base salary, which is extremely important because it's the value of the contribution to the organisation. It is what that asset is worth to the organisation and what it contributes to that organisation. Adjustments to the base salary, and when that's added to the base salary it is the total cash component. We are in a competitive marketplace and sometimes we do have to make adjustments. Benefits are the third component, and comprise of statutory, which we don't have a lot of control over, and other benefits which can give a company a competitive edge for people over another company.

The fourth component is the performance pay, which is the potential based on a sound performance management system. It is established as a measure of base salary as this relates to the contribution to the organisation. The base salary is the value of that asset, the performance pay is how well that asset actually performs.

Performance management systems drive the pay at risk component of the package and must be set up so that it can be measured quantitatively, the executive always knows how they are performing, it is not something that pops up at the end of the year. It has a return on investment for the organisation, and as a guide, which has been used for quite some time in this country, it needs to be a minimum of three times. So if I get paid $100,000 then I need to have contributed $300,000 to the organisation. $100,000 goes to me, another $100,000 is for overheads and the other $100,000 is for the organisations bottomline. Partnerships have been running on that concept for many years and it is still a good foundation for establishing the quantitative component of performance pay.

The last point regarding performance pay, it should comprise both short-term, or annual, performance as well as the long term, or contract period pay. The financial implications of these are both the same. So if I have a three year contract and there is a performance pay at the end of that there still has to be that return on the performance pay. For performance pay it's quite simple. If there is a not a quantitative performance management system in place there should not be performance pay. Some contracts here in Australia are written along those lines, no performance management system, no performance pay.

A performance management system using today's technology will be some form of envelope system, ideally with three components: target, which tells you what a competent CEO or executive should be able to perform at, no performance pay for target performance; a high stretch, a point at which the organisation is prepared to pay full performance pay and receive the return on that performance pay. Envelope systems that we like to see in place have a low point, a point at which an organisation is in danger and requires serious intervention. If it is a CEO it is the board that has to intervene. If it's the board that is not performing it's the shareholder that intervenes.

A number of the issues in the terms of reference relate to recent executive salary performance payout. While this is not an area we want to make direct comment, it does reflect a lack of long-term targets and concrete performance measure with a true return on performance pay. Organisations that don't understand what they're likely structure will be in three to five years will be unable to develop their executives in line with the company growth and changes. If this asset appreciation is not in place it is possible the executive will be performing a similar role at the end of their contract to the one they started with, and that is unlikely to reflect the organisation's need.

We note that a number of submissions to this inquiry still treat human resources as the soft, waffly science that it was in the 1970s. This is no longer the case, and we would conclude by reiterating it is essential that today's organisations utilise modern human capital management methodologies and systems to manage human assets as well as, if not better than, other assets, whether financial, plant and equipment, inventory, buildings, etc. This includes specification for and valuation of a human asset's contribution to the organisation. Simple corporate measures can be measured that are as meaningful as accountants' return on assets. For example, return on investment in people is a total employment cost including performance pay divided by total base salary, a very simple measure that gives you the true value of th human capital return.

MR BANKS: As you know, probably the focus of this inquiry is primarily on directors and senior executive, and particularly CEOs. But just a comment from you as to the extent to which you see this as applying to that upper echelon of the executive market.

MR UNDERHILL (MC): Your performance management system has to start with your CEO, if not your directors. I noted your question of the previous submission, an executive, a CEO or a senior executive can be profiled and valued, a board can actually be profiled as well and valued. But for the valuation, it's absolutely essential that it starts at the top, it starts at the CEO. That's where your strategic plan is, that's where your performance framework is. The performance framework is your contract between your board and the CEO. So it must start at the top. The same principle can go down to a delivery boy.

PROF FELS: What's your assessment of the reality? Are those approaches applied evenly at different levels of the organisation or does it seem a bit below the top level, or not at all, or what?

MR UNDERHILL (MC): If it doesn't start at your top level you can't cascade it down to the rest of the organisation.

PROF FELS: What's the actual practice that you've observed? Do you think it

always starts at the top and goes down, or it starts halfway down, or what?

MR UNDERHILL (MC): Obviously some of the performance pay or performance bonuses that have received a lot of publicity in the last little while - obviously it is not applying at the top levels in a fair and equitable way. I guess that was something that started to break down in the mid-90s. As a consultant I was paid $34,000 to double a CEO's salary, it was very easy, and that was the 90s. That's why I left employment with my last employer. In 1990 $34,000 was a lot of money to do a submission to a board to get a CEO's salary doubled, but that was easy. That was an hour's work.

But the concepts of performance pay and performance management system, from our experience, is not followed very well in Australia. I'll go back to my comment that human resource management in Australia is not treated as a science, it's more of a soft – science. I come from an engineering background and human resources can be managed better than any other asset because they appreciate, they don't depreciate. When you buy an asset, a piece of equipment, you buy a Mercedes-Benz rather than a Holden car and if the Holden car is what you need the accountants will let you depreciate your Mercedes-Benz. With human resources you put on the books what that human resource is worth and you maintain it to develop it, so you've got to get that base salary component correct as it drives the performance pay component. In some of the smaller economies of scale outside Australia it's essential that they get their performance management right or they will not survive.

In human assets management we know what we need in three years' time, five' years time so we can actually say that, "That's the CEO we want today, that's the CEO we want in five years' time." Now, it's not going to be the same. We interviewed a CEO from a state government department just recently. The CEO hadn't been developed since the early 70s, had been through no training had come through an engineering background and then, "There you are you're now the commissioner." It wasn't "commissioner" but I'll use that term.

MR FITZGERALD: They're equally untrained, I have to tell you, so it's all right.

MR BANKS: I sort of got the impression reading this, and it's probably wrong, but that it was very much a kind of demand-side vehicle in the sense that it was about the firm and its needs and the value that should be attributed for certain attributes in connection with that firm. But isn't the reality of the market that there's a supply side as well and the person you want at the price you want may not be willing to come?

MR UNDERHILL (MC): Yes, commissioner, the second component of my salary package that I referred to was a market adjustment. I probably shouldn't go to lower levels but I can use IT as an example. Four years ago, five years ago, IT people would have been paid base salaries of $125,000 plus. Today, or a couple of years

ago, those people were worth about $65,000 to $70,000 in the market. What has happened? The value to the organisation never changed. Those were always $65,000 assets. But because markets forced us up to say that we've got to pay $125,000 to get them, we turned around and said, "Oh, the base salary, the value to the organisation, must be $125,000." That was rubbish. They were still worth 65,000 to the organisation. We had to pay adjustment of another $60,000 to get them. Three years later, we didn't have to any adjustment.

So the market pressures are there but don't mix that up with what the asset value is worth. If you wanted to go out and get a vehicle to go from A to B, a Holden would do. If you go out and buy a Mercedes Benz that's your business choice. The asset value to get from A to B is still $34,000 it's not $120,000. That was a business decision that you made to buy that additional asset. In people, yes, you want the best person. So I might pay an additional $20,000, $60,000 or $100,000. At an executive level I might pay another $400,000. We bring Australian and overseas expats into small countries. We sometimes double the cash. We don't double the base salary, it's still a $100,000 base salary. It's an additional $100,000 market adjustment to get that person to come to that country. When we work out the performance pay we don't pay performance pay on the total cash, we still pay performance pay on the base salary, because that's the asset value.

MR FITZGERALD: What's the role of remuneration consultants in all of this, then? We have a substantial number, most large companies have remuneration consultants. Allegedly they're experts in this particular area of remuneration. If there is in fact a disconnect between the value to the firm of the role and what we're actually paying, why do you think that's occurring? Is it simply market adjustment, as you say, or are there - is there a fundamental problem with the way in which remuneration experts are advising boards?

MR UNDERHILL (MC): I think that your question has answered itself. There should not be such a thing as a remuneration consultant. Remuneration is just part of that human resource management component. The people that come in and look and say, "I'm a remuneration expert," well, how does that fit with organisational structure, how does that fit with meeting the organisation's objectives? When I was with actuarial company my interest was purely superannuation. If I could double someone's base salary I got double my superannuation fees. That was easy. So a remuneration or any other expert in the areas of HR has to take the full picture.

Now, if a remuneration is coming in and telling you what’s the best way of putting the package together for income tax, all of those things, that's fine. But we would not and we do not even call ourselves human resource consultants. We're human capital management, which are strategy consultants. We're as closely related to finance, to property, to anything else than we are to HR. If you don't get your business right and your capabilities right and understand your performance

framework, don't touch HR because you don't know what you're buying the asset for. Would you go and buy a building without knowing what you wanted that building to do precisely - how many square feet, where you wanted it located say near a railway stations. It's exactly the same with getting a person. So if you just come in as a remuneration consultant then how is that going to fit the big picture?

PROF FELS: If practices are a bit deficient in Australia, what is the role of the government?

MR UNDERHILL (MC): I think the role of the government is really to educate people and to explain how the process should work, I guess. It's ultimately up to the shareholders of companies. I'll keep away from government policy but obviously both State and Federal government has got some very serious issues in the productivity, the efficiency issues in government departments and the correlation with salaries. But from intervention into pay structures I really don't know. There's the benefit side of it, where organisations have been hit with fringe benefits tax and we would see that companies can use benefits from an incentives perspective, but I think it's more of an education process in educating businesses on what is involved in proper remuneration. You still hear large companies - I think it was Telstra recently - still talking about KPIs and KRAs and terms like bonuses. They were terms that we used back in the 50s and earlier. We are really backward in the area of human capital management in Australia. Strategic planning: pick up the strategic plans from some of these large organisations and they are very, very vague on where that organisation is going to be in two years' time, let alone five years' time. We've done a lot of work in the media sector, for example, and if you're going from analog to digital, you will have a totally different structure in 3 to 5 years time and that's going to take you three years to develop or change your people within that organisation to get there and that includes your CEO. You mentioned directors, what I'm saying here about CEOs, you can also profile and value what directors contribute to the organisation. Performance measures for the CEO and the performance measures for the directors are not the same. They are quite different. If they're the same, then why do we have a CEO and why do we have directors? Directors' outcomes and contribution is at a different level to that CEO. If you're going to measure them with the same measures, then why have you got two?

MR BANKS: Good. Thank you very much for that. We appreciate it. We'll break now for lunch. I think we're resuming at 2 o'clock.

(Luncheon adjournment)

MR BANKS: Our next participant today is Freehills. Welcome to the hearings. Could I ask you please to give your names and your positions.

MR DIGBY (F): Quentin Digby. I'm a partner with Freehills here in Sydney.

MS PUGSLEY (F): And Caroline Pugsley. I'm a senior associate also with Freehills in Sydney.

MR BANKS: Good, thank you. Thank you for attending today and also for the submission which we've read and we have some questions but I'll give you the opportunity to outline the main points first.

MR DIGBY (F): Terrific. What I was going to do was just speak very briefly about a concern implicit in the submission but I think is more easily vocalised, which is around the concerns on any additional regulation, understanding the political constraints, and then Caroline will touch on a couple of the points in the submission.

I guess from my perspective what I'm hoping - and there might be some interaction after this - is that the first term of reference is sufficiently broad to pick up a bit of an analysis of the impact of regulation historically on remuneration and executive remuneration levels. We have a concern, having looked at what has happened in the area over the last decade, that actually regulation, well intended, has more often than not been counterproductive, both from the perspective of impeding natural market forces but also in all likelihood increasing the acceleration in executive remuneration. Our concern is that the current process, not with this commission which is fortunate - we're actually pleased that there is at least one arm of the administration that's taking the time to consider it properly - but in the current process, where the issue is highly politicised, decisions are being made almost on a kneejerk basis and they are actually, dare I say it, tripping over themselves.

A classic example from our perspective is at the very time when APRA has been looking at how executive remuneration can be structured to ensure that there isn't an incentive for high risk at the expense of prudential and solvency adequacy, they have come up with an underlying theme that incentive payments have a capacity to extend over a longer-term period, including post-termination, so that if there's a risk that in fact the conduct of management is actually undermining the long-term prudential position of the company, that remuneration will be deferred until a time when in fact that would come back to roost and be taken into account.

At the same time as you had APRA heading in that direction, we had a tax proposal in the budget. I know it's been stepped back from, but the idea that taxing of that very sort of instrument where it's equity based at the time of grant, rather than allowing deferral at least until vesting, which is now proposed, or on a longer-term basis in line with the APRA suggestions, completely undermine the proposal. Now,

I know APRA was able to defer the release of their paper. They did come up with a compromise which is to allow partial vesting at the time of termination to enable the executives to get sufficient funding to pay any tax impost, but at the very same time we've got this termination benefits legislation which will probably undermine that solution because for the company to provide a benefit which is accelerated vesting of LTI instruments will inevitably be a termination benefit, especially if there's a board exercise of discretion around it which in all likelihood, for governance reasons, you would want.

So the difficulty we've got is almost without fail, every bit of regulation that we have seen introduced in this area, well intended, has actually proved counterproductive and in that, I would include - I know it's now a given and we can't step back from the level of disclosure - but even the disclosure around executive remuneration in respect of listed companies has actually contributed in a number of ways to an increase in remuneration levels.

I just wanted to touch on one other thing too which we haven't covered in the submission but was in the terms of reference and that's around the role of remuneration consultants. It's interesting actually if you step back and look at why remuneration consultants are behaving the way they are and are used by boards in the way they are, there's two things: one is at the end of the day, their key contribution is around benchmarking which is feeding off the disclosure and the reason the boards are using them is because of yet another provision in the Corporations Act which is Australian specific and that is the related party benefits provision, that if you're paying a financial benefit to a director - so we're talking executive directors here - it must be reasonable remuneration, otherwise the board is at risk. What do they do to protect themselves? They will go to the remuneration consultant.

Now, it's not an abrogation of their responsibility but yet again it's actually regulation that is driving them in that way. I think our general submission would be there is actually already a pretty sound system of corporate governance that does apply at the director level. The directors by and large in our experience do take the issue seriously. They are not just trying to dish out as much as they possibly can and they're subject to directors' duties. To overlay the levels of regulation we have actually muddies the water and has created many of the difficulties that we're now looking at today. If we can get back to the market forces more and have less, dare I say it, intervening regulation, that would be better.

I do understand - and Robert, you've expressed it before - that ideally there is a political drive to come up with a solution or some workable compromise. That would be great. I'm concerned that Australia not try to come up with an Australian solution. The one bit of regulation that from our perspective probably has been effective is the advisory vote on remuneration. That does seem to work. It is not an Australian solution. We picked it up after it was tried and tested across in the UK.

To the extent we can, we urge caution. Wait, let's see what is plied on the international scale, let's not put ourselves at a disadvantage, and piggyback off that. But Caroline might touch on just a couple of things.

MS PUGSLEY (F): Flowing on from where Quentin has got to, assuming that we do come out with some form of further regulation out of this process, in terms of what we'd like to see, obviously following on from what Quentin said, it's not anything that's either going to be piecemeal, or too specific in its application, or legislative in form. Certainly we would prefer anything that comes out of this process to be more in the nature of the if not, why not type of guidelines that really do provide the flexibility for companies to adopt structures that are suitable for them but by reference to a benchmark or guiding principles as to what is expected. Best practice is the term that is typically used in government circles.

We've found that dealing with companies in the context of the ASX corporate governance principles as they exist at the moment, certainly the majority of companies have found that that has been an effective way to get understanding at the board level as to what expectations are in terms of governance and to really make the company step back and think about the practices that they are adopting, and to judge their practices by reference to those principles, but not just to blindly adopt them, because there are legitimate situations in which it is not appropriate or in the best interests of a company to follow those principles.

That really seems to have been embraced by shareholders and by investors in that companies making legitimate departure from those kind of if not, why not principles haven't been unfairly criticised or subject to push back by shareholders. On the flip side, companies that have made no effort to actually report against the principles or adopt structures that in any way kind of marry up with those principles have actually been subject to that level of scrutiny that you'd expect, having that kind of framework in place. That style of thing is consistent with what APRA has come out with in its preliminary recommendations. That is certainly the type of thing that we would prefer in terms of an additional outcome.

In terms of how it applies, our concern is for clarity and consistency, I guess. Whilst at the moment there certainly is a governance framework in place that we would argue is operating effectively in most cases, certainly there are a lot of sources. So there are these ASX corporate governance guidelines, you then have your governance bodies like the AICD and the Australian Council of Superannuation Investors that come out with their own guidelines. Then below that you have informal guidelines that are the views of the proxy advisers that actually influence institutional shareholders' voting patterns, and they're the kind of unwritten guidelines.

So the difficulty for companies is actually making sure that they stay across all

of those areas because at the moment there isn't that level of consistency where they're all necessarily saying the same thing or they're all in tune. Adding an extra layer of framework on top of that, depending on the response that comes from those types of bodies and whether they support it, but assuming we can get something where things generally come into line I think that could be beneficial. The danger is creating an extra layer then actually adds to the cost of monitoring and compliance from the company's perspective, because there's been another layer of framework and governance that they need to be keeping in touch with.

I think in terms of existing areas of regulation we would strongly encourage be revisited, the remuneration report disclosure requirements is the big one from our perspective, dealing with companies quite frequently on these issues. Initially these requirements came in as part of the CLERP reforms to the Corporations Act. It was very much at that stage a list of requirements that were put forward as the type of things that would enable shareholders to access the information they needed about executive remuneration and that would enable them to be fully informed and therefore empowered to actually hold boards accountable and companies accountable for their remuneration practices.

As those reform came in in 2005, and we've now had five years of remuneration reporting, it's become clear that in many cases not only are shareholders struggling to extract that meaningful information from the reports but companies themselves often have a lot of difficulty coming to grips with exactly what it is that they're being required to disclose and why. So what is the driver underpinning this disclosure in terms of what shareholders are actually going to take out of it?

There certainly is scope to revisit those requirements, which were initially put in place where there wasn't that understanding of what shareholders actually wanted from this type of reporting, now that shareholders have become a lot more savvy in reviewing these kind of document and actually bring it into line with the type of information that shareholders are really finding meaningful. I think that would actually result in a shorter form remuneration report that is both easier for companies to produce and does provide more meaningful information to shareholders that they can use to question the board and the directors on the types of remuneration practices that have been adopted.

MR DIGBY (F): Are there any aspects of the - - -

MR BANKS: You ended up on that question of a shorter form, which sidetracked me. Why do you think the remuneration report has turned into the beast that it's turned into, given the initial objective was a reasonable one?

MR DIGBY (F): I think we'll both have a go at that one. It's interesting, if you

look at the remuneration methodology in terms of the values, and everybody goes straight to the table, cash, that's easy. Everybody understands that. But often that's not a sizeable component in the total column. It's when you get to the value of particularly the equity components, they're done on fair value at the time of grant, and there's reasons for that. But one of the suggestions Caroline and others have made in the submission is whether that's appropriate in the remuneration report or should be in the financial statements, and in the remuneration report more reporting around what the actual value delivered is.

I think the Sol Trujillo example is a classic one. At the time of the grant a value is provided in relation to long-term incentives that may have been earned. They were subject to a positive TSR return or nothing was provided. Ultimately, he received nothing. But every year over that vesting period a substantial amount was included in the remuneration report as his remuneration. Is that meaningful disclosure? Dubious. Certainly from the board's perspective it paints them as having provided this incredibly generous package when in fact if you look through as to what was actually delivered that was never delivered. So I think "blame the accountants" isn't quite the right expression. I know why they had the fair value, and it does make sense if you're going to expense these things, which is now done, for accounting reasons to make sure you're doing it at the time of grant, because otherwise how do you start running into your financial statements values that are attributable to events entirely outside of the control of the board members at the time?

MS PUGSLEY (F): It is appropriate to provide - - -

MR DIGBY (F): Correct.

MS PUGSLEY (F): - - - what you estimate as at the grant date to be the likely value over the course of the grant, recognising that 99 cases out of 100 that won't end up being the actual value. But it is reasonable for shareholders to expect that when you do grant these equity instruments you will provide an estimate; but more meaningful to them is, "Well, you gave me the estimate at the start. What did they actually get?"

MR DIGBY (F): See, part of our concern there is that is one part of the report that people may look at and think is very clear: you get to a dollar figure that can be picked up and it's headed Total Remuneration. In our view it actually is potentially misleading. It's accurate because of the methodologies used but does it really convey the key message? Not so sure. Then you get into a whole series of minutiae around options, which ones are vested, which haven't vested, which flow out of the regulations; which even the companies still struggle to understand what they're picking up.

MS PUGSLEY (F): And the flow-on issues that creates where the legislation clearly refers to options. We treat it, in terms of the advice that we give, as equally applying to rights. But you have a whole range of equity instruments that are offered and some of them are very difficult to classify in terms of the rights and entitlements that they actually have attached to what is granted, as to whether it's a share or a right or an option or something in between. You end up in a situation in which some companies, because what they grant is clearly an option or a right, are providing a whole extra layer of disclosure on top of a company that just grants shares straight out who aren't required to make those levels of disclosures even though the same basic principles apply in that you're granting an equity instrument that is in effect at risk depending on satisfaction of performance and/or service hurdle. So that creates difficulties because you get the two different styles of reporting.

MR DIGBY (F): If you take it back to basics at the end of the day what that rem report ought to do, in my view anyway, especially with the advisory vote in place, is provide all of the information that is material to a decision of a shareholder whether or not to vote in favour of the rem report. I'm not sure that if you applied that test you would need anywhere near the prescription of disclosure that is required in section 300A and the regulations.

MR BANKS: But would you need more of the why as opposed to the what; some have argued.

MR DIGBY (F): It certainly wouldn't hurt. If you look at prospectuses - some sort of, dare I say, a MD and A, management discussion and analysis, absolutely; but a lot of the good rem reports do include that now. So there's scope to do that. You could have - and to be frank, section 300A actually does mandate that already. It's not that that creates the problem. It's the level of prescribed detail beyond that.

MS PUGSLEY (F): And the difficulty companies face, first off, in understanding themselves exactly what is it they're meant to be disclosing and providing. Then to the extent that they don't think for various reasons that that's necessarily representative they then have to go into long-winded explanations as to why they don't think it's representative and the fact that this is a notional equity value that has been put on it and in fact there are all these performance hurdles and it may not vest.

We find in certain cases companies are being so keen to distance themselves from the information that they have been required to put in that they legitimately don't think is reflective of what they have granted that you end up with pages and pages of what looks like kind of self-serving statements from the company's perspective. Shareholders will look at that and you end up with a very lengthy report. The criticism that then comes back to the company that in many cases has acted with very good intentions is, "You're hiding the meaningful information. You've given us 40 pages. What are we going to do with 40 pages? We only want

three."

MR BANKS: So why wouldn't the company put in realised pay then, because that would solve the problem, wouldn't it?

MR DIGBY (F): Look, to be honest I'm not entirely sure that it would. I mean some companies do. For instance in our most rem manual one of the things we suggested was a two-page summary at the start where you could actually provide an actual remuneration snapshot. The difficulty with that is if they are still mandated to include in the rem report, as opposed to in the financial statements, all the full detail on fair value, the two are diametrically opposed. So then they have got to go and try and explain well, why is it this one that we presented to you is actually the more meaningful and better guide. You get to the very situation Carolyn is just flagging where it looks like the company is tripping over itself to distance itself from the information which is mandated.

MR FITZGERALD: There's a couple of strategies. I mean in the financial services disclosure - which has the same problem. As you would be well aware, the commission has released a report on consumer policy which was highly critical, as everyone is, of the financial disclosure regime. There have been a couple of approaches. One is to simply reduce the requirements and therefore simplify the actual information provided. Another view is that you should have a short form which is publicly available which links to a much more detailed analysis who only those that have a very keen interest would ever read and look at. So you achieve dual purposes there. One is to protect the company, which the lawyers really want, and the second is to actually inform consumers, which was the intent of the law.

But in relation to the rem report a third way forward is to have a short form but to actually get the auditors to say that the short form reflects the true position; because what might happen here is people may not trust the short form. They probably don't understand the long form but they may not trust the short form. I'm not saying that they would. So how do you in fact, to ensure that the information that is provided is in a comprehensible form, a principle which most of us would readily endorse, but also to ensure that it is an accurate reflection of the more complicated package that sits behind it?

MR DIGBY (F): Well, that's interesting because if it's the auditor signing off, and they do sign off on the current form of rem report, it is going to be difficult for them to depart from the fair value at the time of grant because that's going to the very heart. We would say, to be honest, that's probably one of the key issues that is leading people off in the wrong direction. We reform prospectus laws by getting away with a lot of the detail and just saying anything material to a decision by an investor whether or not to invest in the company". It didn't result in shonky prospectuses. It did result, I think, in clearer. Now, there was the same level of due

diligence because the responsibility was still there. I am still of the view that that's probably a better standard. Then do you need the auditor to sign off? You've just got to question whether or not that's going to work.

MR FITZGERALD: Yes, and that's why I'm raising it. I'm not sure whether (a) it complicates, duplicates effort. I have no idea but it's just - - -

MR DIGBY (F): Well, the auditor has only been signing off for a couple of years. I don't think it has aided and sometimes it has actually taken the auditors awhile to get up to speed with what the requirements are.

MR FITZGERALD: The second thing, I suppose, that underlies it. There is the disclosure issue which a number of participants have raised. One yesterday morning indicated they're going to try to have a rewrite of section 300A, and we would be very interested to see any submissions that do that. But I suppose it begs the question, which is a more fundamental question: if the disclosure is so complex does it actually say something about the packages and the arrangements themselves? The packages and arrangements got to a point where their complexity is part of the problem. I understand the disclosure is difficult but if it is so complex why have we created this very difficult set of arrangements? If the directors are having difficulty presenting it do they actually understand what they're signing off in the package itself, which is a fundamental question.

MR DIGBY (F): You know, it's an interesting question, a good question. I would say the directors certainly understand the break-up. So they know that there's base, there's short-term incentive, there's long-term incentive and they understand the stress testing, what should be delivered under various scenarios. At the end of the day the rest of the - the complexity is coming in in primarily the long-term incentive.

he driver for it - now coming back to my starting point, I'd say if you go right back as to why long-term incentive has become such a significant part of executive rem, you only need to go back to a US decision to impose a 1 million tax deductibility limit on base salary, which then spark an immediate work around, they're going to - in my view, it's probably the starting point of regulation, actually intervening in executive remuneration.

The other complexities in LTI come through the taxation system. So whether it is a performance right, a deferred share, often that is around structuring to ensure that it is compliant with the tax deferral rules as they were. It was otherwise structures not to provide hidden benefits, not to complicate the position, but to provide a tax effective result for the executive. Then we have the hurdles, and the hurdles add complexity.

You could simplify it by, as some people have suggested, just using TSR as a

standard hurdle, but often for companies it's not an appropriate measure. So you've got the three layers: the structuring for tax reasons; the emphasis on the long-term incentive, which is meant to bring parallels between performance and reward; and the efforts to structure performance hurdles that really will drive behaviour. So I don't think it's a lack of understanding on the part of directors, nor do I think it's an attempt to muddy the water and hide the extent of the value that's really been given. There are logical, rational processes that have led to that.

PROF FELS: So on the disclosure, the question is the alternatives to the present system, apart from some tinkering. Am I hearing you say your alternative is that it has to be your disclosure regime would be prone to disclose that which is materially relevant to investment decisions, a general principle? Is that - - -

MR DIGBY (F): It's not going to be investments decisions for - - -

PROF FELS: Sorry.

MR DIGBY (F): What I'm suggesting is you'd link it to the advisory vote and you'd say all information that is material to the decision whether or not to approve the remuneration report.

MS PUGSLEY (F): I would think it would be helpful to still have underlying guidance as to the types of things which would typically be regarded as material. So as ASIC do in their class orders that support the prospectus disclosure regimes, to me, as Quentin said, the critical ones would be actual values of remuneration delivered, the policies and structures that you've adopted and what you're actually setting out to achieve. Then the third element, which I think companies are really starting to understand is the key from the shareholders' perspective, do 1 and 2 actually marry up in practice? So you've said what your policies and structures are and what you're intending to achieve. Give us actual value figures and then explain, if these two don't marry up tell us why not, and if you don't have a good reason then that's the push to change.

MR DIGBY (F): We would question whether or not it is necessary to breakdown individual by individual across all KMPs for that analysis. I'm not sure that it is, I would have thought a global figure. We are very aware of senior people - I won't call them executives for a particular reason - who actually are very, very concerned about any possibility of their becoming KMP, not because of the responsibilities involved, not because of the liabilities as an officer, but actually around the level of intrusive disclosure. They're happy to work for the company but they do not want to be key management personnel for that reason alone. I don't think that's a good thing, from the company's perspective, from the executive's perspective.

PROF FELS: You've been firing quite a few shots at various regulations and so on,

but just standing back, what has brought about this regulation? A reaction to community attitudes, perhaps?

MR DIGBY (F): I think the two have fed on each other. For instance, when disclosure was brought in community attitudes weren't as hostile as they are now. I don't think that that's purely a result of people all of a sudden finding out what executives are earning, because we've had the discussion when people find out what sports people are earning, they're market driven, they earn what they get, but you haven't had this real reaction to it.

PROF FELS: Many of them have been subsidised by the taxpayer at the Australian Institute of Sport.

MR DIGBY (F): They have, yes.

PROF FELS: We need to bring in a HECS for - - -

MR DIGBY (F): Although the tax office is suggesting that executives have been too.

PROF FELS: Education has been subsidised.

MR DIGBY (F): I think there has been a vicious circle, and the greater the regulation, particularly around disclosure, it has actually increased the politicisation and has proved counterproductive. You only need to look at the example of the Senate vote last night where a decision has been made based on a refusal to apply a salary cap to the executives involved. Why has it got to that? It is not because of the excess of salaries, in my view, that have been paid to CEOs. It is because the degree to which this has become politicised.

PROF FELS: You can put it in half a dozen different ways. It's because of a perception by some politicians that the situation has not been well handled and so we could go and ask them what's behind that, and is the corporate sector going to suffer further detriments like that? Presumably that was a detriment to the corporate sector through this perception. What's to be done about that?

MR DIGBY (F): Absolutely. So what I'm hoping is you three wise men will actually be able to introduce a - - -

MR BANKS: Sorry, I just wanted to ask one question. We had Australia Human Resources Institutes this morning making a number of suggestions, which you might actually want to have a look at. One of them was that while they supported the notion of a non-binding vote they thought that there would be scope for the policy or the remuneration plan at some higher level of parameters going forward be subjected

to a binding vote. In other words, what is the firm's policy around executive remuneration in broad terms, the principles that are applied. They were also talking about a code, etcetera, that it would need to be consistent with. I just thought I'd give you the opportunity - you might want to have a look at that and take it on notice and get back to us.

MR DIGBY (F): One of the reasons why we feel that the advisory vote is working is actually because it is non-binding. The institutions have been willing to exercise the protest vote in the context of a vote which is not going to damage the company through breach of contract or whatever. The fact that it is advisory has actually, if anything, empowered the institutions in a way that they would not consider themselves similarly empowered if it were binding. If it were a binding plan going forward, other than maybe Regnan or some of the index fund manager proxy advisers, the other institutions who at the end of the day are around the turns will be concerned at limitations on flexibility to get the right people and to adjust as times require. So my gut reaction is I wouldn't be particularly enamoured to it.

MS PUGSLEY (F): One of the suggestions that we considered and put forward as an alternative to actually strengthening the force in any way of the vote is to actually require a follow-up disclosure when you do get a certain level of vote against your remuneration report in the next year's report as to what actual steps you've taken. So proactively require reporting of what you've done to address the vote. In our experience, in most circumstances they take it very seriously and there are certainly strong choices made on the back of having got a very significant negative vote. In most cases companies would not only be happy to make that disclosure but would want to be making that disclosure, and that shareholders would then get a level of comfort or some level of understanding as to what impact their vote has had, directly.

MR DIGBY (F): Even the companies that have initially come out in the face of a significant no vote and said, "Well, in reality they go behind closed doors and they try to work out how to swing it around." If you track it, there have been some pretty significant changes flowing out of that.

MR BANKS: What would be the threshold to trigger such a provision, do you think?

MR DIGBY (F): In terms of a - - -

MS PUGSLEY (F): No percentage vote. I would say 20 per cent or more would be regarded as significant against.

MR DIGBY (F): We'd prefer to reserve on that because I'm probably more in the realm of 40 plus. It doesn't necessarily work in all cases. Some of the best kept companies have a cornerstone or parent shareholder that guarantees you anything up

to 50, 60 per cent of the vote. It's probably more again around the philosophy of addressing prior expressed concerns.

MR FITZGERALD: If I can pick up on of the other comments you made earlier, there seems to be general agreement that some form of code or codes is appropriate or practice guidance is appropriate. You mentioned in your opening comments, Carolyn, that there are a number of them and we're aware of those and to some extent we'll be looking at all of those codes to see, as I have said many times, where there is commonality, where there is divergence, why that might be the case. But participants might say the time has actually come to try to consolidate, to the extent that it's possible, into one code. Is that the thrust of your submission as well? We acknowledge that codes have different purposes for different players, we understand that. But 99 per cent of them perhaps are in fact trying to deal with the same issues and there would be some variation depending on the actual association.

MS PUGSLEY (F): I think that's right because certainly there are certain codes that some companies will consider more relevant to them than others, depending on their institutional shareholding base or depending on the sector that they operate in. Our expectation is whilst, for example, the APRA guidelines will obviously apply directly to financial sector companies, to the extent that they represent a significant proportion of the ASX 20 companies, that may well become a default governance code for the rest of the ASX 20 and so there are the flow-on impacts and to the extent that you can have something that is at least a starting point, "Here are some consistent points across the scale," I think it would be helpful but the difficulty, as you've identified, is actually getting there in that you obviously can't prevent these organisations from going out and having their own guidelines and requirements that are out there.

It's just the difficulty in actually, for a company, staying across what all of those are and making sure that they take into account all of the relevant ones when they are making decisions regarding remuneration practices. We find it difficult just trying to pull them into our documents for guidance so certainly the companies would find it a real challenge.

MR BANKS: What would be your favoured institution as a vehicle for this consolidation? Where would you see it happening best?

MR DIGBY (F): There are some codes you're not going to be able to consolidate and so the proxy advisers who are actually often operating off international guidelines will inevitably come up with their consolidation. But to be honest, the code that we have see work the best is actually the ASX Corporate Governance Council. It is not perfect and it's starting to get into a level of detail that has become problematic so that the more basic principle and guideline from our perspective the better. But that is the one that has resonated and the companies do try and adhere to.

MR FITZGERALD: Precision was put by Australian Human Resources Institute this morning that one of the problems with that particular code is that it is still too high order. Their view is in fact it lacks the sharpness that it needs and I think their position is that many of the codes are in fact now too principle based. The second part of that would be - I don't think they were saying they should be regulated but that if you make them sharper but them have the if not, why not provision it doesn't become mandatory. But they were very clear that their view is that most of the codes in fact the greatest weakness is the lack of - I think their term this morning was sharpness in it; one, there needed to be a consolidation but, secondly, you needed to go down another level on the proviso that you have to explain if you don't beat it rather than as a penalty.

MR DIGBY (F): As long as we're just talking disclosure because to be honest I don't think any code logically is going to be able to come up with a one size fits all for executive remuneration and nor should it because you are not dealing with apples and apples, they're apples and oranges even within industries and the listed companies are competing for talent with the private equity players and the international multinationals and to impose a code that regulates the actual structuring of executive remuneration comes right back to my concern at the outset. That would be disastrous.

MS PUGSLEY (F): The other thing that I just wanted to add about those ASX Corporate Governance principles and recommendations is whilst you are only required to report against the recommendations, there is a significant amount of guidance that sits below each recommendation, suggestions as to content and policies and charter that most of the companies that we would be dealing with would treat as though that is an actual recommendation in itself and whilst they're not required to report specifically against it, they certainly treat that on the same basis as though that were actually part of the broader framework.

So it does, I think, strike a nice balance between having the actual recommendations which you are required to report against but also having that underlying guidance there that whilst you might not directly be required to say, "Yes, we do," or, "We don't," you do have your charters out there and someone can go and pull up your charter on your web site and actually compare the content against what's suggested in that commentary underlying the guidelines and see if you have all the requirements. So that certainly is taken quite seriously.

MR FITZGERALD: Can I ask a very specific question. Just in relation to the scope and coverage of the requirements, the disclosure and what have you, you've mentioned before an increasing reluctance by some employees to fall within the ambit of that disclosure.

MR DIGBY (F): Yes.

MR FITZGERALD: Some have put to us that irrespective of the requirements, those requirements should only apply to a more limited group of executives, CEOs, CFOs et cetera and executive directors. Do you have a view about that? I know on the termination it seems to have grown rather than shrunk, but - - -

MR DIGBY (F): That's a different issue.

MR FITZGERALD: - - - is there a case to argue that there should be a narrow form?

MR DIGBY (F): I think a very good, strong case. Actually I think CGI Glass Lewis came out with that. They would be aware of some of the issues that are arising and I think their point was around, "Look, focus on the disclosure, on those people who really have a meaningful ability to affect shareholder value." I think it does make sense, to the extent that you're going into individual disclosure you leave it at the very top level; query though again if what we're trying to do is assess the degree to which the board has managed to equate remuneration with performance, do you even need to get down to that level of disclosure? Directors probably, because that's again well beyond. But for the non-board members - although I don't want to encourage CEOs to try and stay off boards which some may if they feel that has a big impact on the disclosure. In short, yes, absolutely, Robert, I think that is a good idea.

MR BANKS: You mentioned as part of an interesting discussion about the interlocking effects of knee-jerk regulatory responses et cetera the question of the tax initiative in relation to share schemes and so on. I think when you wrote your submission it was before the more recent draft discussion paper. Could I get you just to make a more up-to-date comment on whether you think the proposed revisions get us there or not because they do address - - -

MR DIGBY (F): A lot better than the announcement on Budget night. What they do do which I think gives them a tick is they actually do at least line up with one international standard and that is the US, only allows deferral until vesting and there is some logic to allowing deferral until vesting, but when the remuneration has actually been earned and effectively is guaranteed on delivery, then you have it. So there is logic to it. Our concern, however - and it comes back to the termination benefits. We are concerned about that termination benefits legislation. It looks simple. It actually has the potential to create a lot of difficulties and in the context of the tax treatment and accelerated vesting, it is going to be something that will always be considered at the time of termination for good leaders which might be someone that the company is actually - even though they have performed, they are redundant or whatever - encouraging to move along. Your capacity to address that tax position - and this was an issue before but through an arrangement at the time of termination -

is going to be constrained. So I think there's still issues with the new position. It's a lot better than had been proposed but I think the termination benefits cap is still going to create problems.

MR BANKS: So is the problem now, with those things interacting, more the problem of the termination provisions.

MS PUGSLEY (F): The one with the tax is still how it sits with the broader push towards carrying on equity instruments post-termination and the fact that termination will still be the vesting point because on the one hand, that's very much a new push and not just an Australian push, it's international, to try and have equity instruments that do carry on post-termination and having termination as a definite trigger point in all circumstances, rather than it being the later of - when it actually vests or termination, it's the earlier of - so termination will always be the trigger.

MR DIGBY (F): Although that was an issue under the old legislation.

MS PUGSLEY (F): Correct, but the push for more deferred equity is new. Previously, termination was just a point at which you assessed whether they vested or whether they lapsed.

MR BANKS: So is that going to significantly inhibit the potential to have vesting occurring some years after an executive leaves?

MR DIGBY (F): Absolutely, because from an executive's perspective, you will have a tax obligation in the year of either vesting or even under the existing provisions in the year of termination, but unless you're able to, given the values that are involved, realise some of that to meet the tax obligation. You're in a difficult position. Even in respect of the US, you will have Australian companies with operations in the US where at the moment, to try and ensure that their incentive systems work properly, they have to fund the US-based executives for that tax liability on the basis that when it would have been paid, he or she will repay it, so it does inhibit it.

MR FITZGERALD: Just on the termination pay which was a separate issue itself, most of the participants so far have said they are not opposed to a shareholder vote and they are not opposed to it being at a particular time. Someone said 12 months was okay, someone said two years was okay.

MR DIGBY (F): Particular times, I don't - we're very concerned that in fact a vote cannot occur until after termination which in our view just means you will never go for it.

MR FITZGERALD: Sure. But that's a problem you've already got too.

MR DIGBY (F): No.

MR FITZGERALD: It's seven years.

MR DIGBY (F): But under the current provisions - - -

MS PUGSLEY (F): That's the capped limit. The problem that doesn't exist at the moment that will exist is that you can actually get the approval in advance of that person actually ceasing employment under the current arrangements and that previously used to be relatively common for people to actually get approval around or close to appointment, when the contract arrangements are actually set out as to what that will be. The difficulty now is that there is that requirement built into the draft legislation that you are not able to seek shareholder approval under after termination and our view on that is that in practice, there is no incentive, even for a good performer, to approve a termination payment after they have actually left. Our proposal on that front is that you be able to seek the shareholder approval in advance, potentially subject to a maximum amount, that you seek approval from shareholders at that point and if you then down the track propose to exceed that maximum, you would actually have to go back again and get a fresh approval, but it would at least enable companies to do that and get certainty for the executive.

MR BANKS: I think we've just about used up our time, I think. I was going to talk a little bit about directors but since we've got the AICD coming, I think I will ask it of them. So thanks very much. We appreciate the time you've taken and the submission. Thank you for that.

MR DIGBY (F): Thank you.

MS PUGSLEY (F): Thank you.

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

MR BANKS: Our next participant today is the Australian Institute of Company Directors. Welcome to the hearings. Could I ask you please to give your names and your positions.

MR STORY (AICD): John Story, I'm chairman of the board of AICD.

MR COLVIN (AICD): John Colvin, I'm the chief executive of the AICD. With us, we have Dr Mark Blair, who is a senior policy adviser.

MR BANKS: Good, thank you. Thank you for attending today and also for a voluminous submission which is also full of substance, so we thank you for that. Obviously we've got a bunch of questions to ask you but give you the opportunity to go through the main points.

MR STORY (AICD): Thank you, chairman. Maybe if I could briefly lead in just with a short introduction of who we are. John is the CEO of AICD. His background was as a senior partner with Freehills for many years; in that capacity he was very much involved in employment law. I think he thought he had escaped executive remuneration when he left Freehills but in his time at AICD, he's been very much intimately involved with it. My own background is my first career was as a corporate lawyer. For the past 15 years or so, I've been very much involved in company directorships. I'm currently chairman of Suncorp and Tabcorp and a director of CSR. I've certainly been intimately involved in remuneration decisions over the years. I like to think most I got right; a few of them with hindsight, I might have done otherwise. What I'd like to do is ask John to speak to our submission and then I'll make a couple of remarks after that. I think at the earliest opportunity we'd be delighted to go wherever you'd like to take us.

MR BANKS: Good, thank you very much.

MR COLVIN (AICD): Thank you very much. Just to set the scene about who the Australian Institute of Company Directors is, because I think that's important, it's Australia's pre-eminent organisation for directors, dedicated to making a difference in the quality of governance and directorship. We strive to make a positive impact on the economy in society by providing leadership on director issues and excellence in governance and we deliver education, information and advocacy to enrich the capability of directors, influence the corporate governance environment of Australia and promote understanding of and respect for the role of directors.

You may not know, AICD is the second largest member-based director organisation in the world and it has been acknowledged as providing world class education, if not the best. Other people come out to have a look at us. AICD membership includes directors from a diverse range; it includes directors from ASX

listed companies, the ones which we will mainly be talking about today, I assume, but we also have members in proprietary companies, in the not-for-profit organisations and the public sector bodies. Why that becomes important we'll go through later on, but mainly because many of the laws - and we'll get to one of them later on in the submission - deal with companies and they don't actually distinguish between these sorts of companies.

It's important to distinguish between the non-executive director and executive director. We would argue that there doesn't seem to be really much controversy about non-executive roles and remuneration. One of the reasons for that is there's an available pool which is voted on by shareholders and it is also far less complicated. Normally directors fees are paid in cash or sometimes there's a cash and share component. Sometimes it's salary sacrifice or sometimes it's part of the package. There were some changes to that when the severance payments went out of favour and there was an increase in pay around about that time to, if you like, factor that in. However, one of the issues which I think is a very important issue and which should come up is the directors', if you like, risk reward equation, and that non-executive directors face particularly. One of the things we would be putting forward which we have in our submission is there are over 650 state laws making directors liable and these have mushroomed over the years. Probably the more worrying aspect about some of these state laws is that they trammel the rule of law and democratic principles and simply say positional liability is the one that we're aiming at. The second thing is that the normal, if you like, human rights, such as innocent until proven guilty, the right to remain silent, these types of, if you like, basic human rights have been taken away in many cases.

One of the real problems we've canvassed is some of the new draft law that's just coming out, with the “usual provisions” and the usual provisions are taking away fundamental civil rights. We are taking that to civil rights people at the moment to discuss but that is another issue. We're happy to talk about that. The issue there is, what is the risk reward for being a non-executive director or director and is that appropriate in these circumstances?

I might suggest also, just talking about the appointment of a CEO and it being a core function of the board. We would argue, and I don't think there is much debate about it, that the appointment of a CEO in the remuneration is a core function of the board. It's really nowhere else and in terms of legal theory and also in practice that's where it should remain. We can go and discuss that at length, if you like, if that's an issue but we will come back to that. We would say that the evidence shows that Australian boards have performed relatively well on a world stage. There have been mistakes but often those are with hindsight and looking at economic situations with a rear-vision mirror. One of the problems has generally been and the grappling which will continue to go on in the future is linking performance and pay and what is the right structure to do that. There are many, many models and we hope there will be

many, many more to come and there will be more and more innovation.

Will somebody get it "right"? I don't think this is really possible because you can't get it right for any particular company at any particular time in any circumstances. So that's another issue which we will come to. The long-term incentives component seems to be the difficult one because you're aligning interests using company related proxies, often shares and what markets do, versus what companies can control. That's one of the areas where there's also different views by some people but there is a coming together in the sense that the investors want executives or directors sometimes aligned with themselves, namely with shares, but shares go up and down on markets and sometimes they can be totally at odds with how the company is performing, travelling or even against a strategic plan which has already been agreed to.

Boards have also, we would argue, done a reasonably good job internationally again. They have acted in the best interests of the company and with the best motives. International comparison of Australian boards and governance rate Australia at the very top of the tree. 2007 GovernanceMetrics International ranked Australia first in the world out of 38. In 2008 Australia is ranked equal fourth in the world out of 39. So we are regarded as having one of the best sets of corporate governance and boards in the world. Also there is the latest survey on corporate boards undertaken by Prof Andrew Kakabadse, which you might know, who found that Australian businesses are the best in the world at selecting board members and that was an international survey.

We would argue that heavy-handed regulation on executive remuneration is not the way forward. Even light-handed regulation has some real difficulties. We would argue it would make matters worse and we have demonstrably been shown that in other countries and even in Australia. In Australia you've got to remember we do have quite a vast array of regulatory controls already in place. As you know there's a reasonable benefits test which executive directors and related parties have to comply with. That law is available for people to use if they want to. It hasn't been used but it's there - it hasn't been used much, that is.

Statutory limits on termination payments, we have a bit more to say about that later on. You have already heard Freehills talk about some of the issues, remembering that requirements already exist in sections 200A to 200J of the Corporations Act, and have been, if you like, tightened and increased over the years. There are extensive disclosure rules which you have also heard about, there is an advisory shareholder vote, there are listing rule requirements and there is a general legal duty of directors to act in the best interests of the company. We also point in our submission to the fact that when the US has tried to regulate in this area it has actually been counterproductive, or at least had an effect of making it worse and we referred you in our submission to 1984, the US Congress passed a law eliminating

tax deductibility of golden parachutes and to 1993 when the US Congress said only $1 million salary could get a tax deduction and there's pretty good evidence to show that it then had, if you like, a squeezing of the balloon effect which was "no deductions above this level", so it moved into options and share space schemes which you can argue misaligned, if you like, some of the executive remuneration practices.

We similarly believe that attempts to try and find what is the best practice could also be counterproductive because there is no one size fits all. You take a small start-up company, say, in the mining industry and you compare that to a BHP, even in the same industry. Alternatively, you take a start-up biotech which relies nearly solely on issuing shares to executive to try and keep them or develop them versus paying cash, versus a well-established bio company. So we think attempts to try and define what is best practice are probably misconceived because they don't allow for the flexibility and they don't allow for the innovation which is required in remuneration to make companies successful.

In the context of the recent bill, Improving Accountability on Termination Bill 2009, we have serious and deep reservations about this type of legislation. You might know that this draft legislation came out with no consultation, it just was announced and we say it is going to be not only counterproductive, it's going to actually cause some real damage if it goes ahead in its current form. We would be asking the Productivity Commission to perhaps look at this issue and make some recommendations.

As you know, it's a one-year base pay threshold for having to go to shareholders for approval before you can have it approved and then that's coming down from current threshold of seven times remuneration - and remuneration is defined in 200A to 200J as being really total remuneration. So it's going from total remuneration seven times maximum to one times base. My mathematics is pretty poor, that's why I did law, but I understand that would be a decrease of something like 93 per cent if you assume that base pay is, say, half of total remuneration. So we say that a reduction of 93 per cent is just too drastic and interferes with the structure of remuneration and is not warranted nor is there evidence really, we would argue, of any system fault and why you would need to do it.

Another aspect about that is that what will happen in practice? So if you can't have a termination payment? Let me give you an example. For example, let's say when Bob Joss was really needed to help Westpac. I have no idea what his contract was but let's say in the negotiations he said, "Look, I'm happy to come to Australia and I'm happy to give up my job at Wells Fargo where I was going to become the CEO. But there has to be a huge risk for me coming to Australia to a new culture to a new board in a company which may have been under some threat at that stage. So I want some protection that if I have a political problem and I'm terminated in that

first year, I would like the payment of, say, two years of termination payment. After that I'm quite happy to bring it down, so at the end of five years I might even be happy to have no termination." This legislation will stop that.

So if you're in negotiations - and I will stop, tell you why - because the provisions relating to shareholder approval are in such a state as drafted that nobody will want to use them. So it interferes with the structure of how you arrange and negotiate with executives. The second thing it does is it interferes with if you're trying to structure remuneration payment. One of the issues that will no doubt come up is, "This is the best thing for shareholders. This is the best thing for going forward," and then somebody will say, "Yes, but if you're terminated it will only be base pay, so we had better go back and look at the structure of the remuneration again," which is, I think, the wrong way around. Legislation driving remuneration outcomes is economically inefficient.

It should only also apply to public listed companies and this comes back to my point earlier on about who our members are and who we represent. So this legislation applies to companies, so let's take the charity that has a very long serving and well-respected CEO and the board notices or has knowledge that the CEO has virtually no superannuation and they decide to award an increase termination payment or a resignation or even a retirement - a modest one. That could easily breach the legislative provisions and under these provisions that would also give the directors personal liability and it would also be a strict liability.

The third aspect about this is, 200A to 200J, when I was practising, is one of the most complicated areas of law and has inherent inconsistencies and also has lots of vagaries about how it all works. If you then increase penalties in these circumstances and make them strict liability, the fundamental rule of law is if you're going to have strict liability, you must have a law which is absolutely and positively ascertainable so you know not to tread over it. That's not the case under 200A to 200J and this is an add-on to those pieces of legislation. So it's poor in terms of structure and in terms of drafting.

Lastly, we would say that the ability not to have a shareholder approval prior to entering into a negotiation or once it's done puts the negotiation process backwards. So if I'm negotiating with the CEO - and when I used to advise in this area it was common - you would have an agreement, you'd flesh out an agreement which was acceptable to the executive and to the company and if it needed to go to the shareholders, you would want to go straightaway. The reason you want to go straightaway is you cut away at some of the uncertainty and you made the certainty for the executive that they would get what they had bargained for. Under these provisions you can't do by calling a meeting and you've got to ask yourself, "Why would you have a provision which wouldn't allow the directors to say, 'This is in the fundamentally best interests of the company to call a meeting to fix this problem,'"

and you're prohibited from doing it. The rest of the Companies Act doesn't have provisions like that, it just allows the directors to call meetings if it's appropriate under certain circumstances.

Maybe a CEO's termination package may not be or rarely be a provision which might need it, but if it was, you're prohibited from doing it. So you've got to wait for up to maybe a year, if you'd just had the AGM, and then you've got to ask the question, "What happens if there's a takeover or major shareholding change between the period of time before you can have a meeting?" It could be very unfair on the executive who negotiated in good faith. Lastly, just from an economics perspective, if you were including a risk as to whether something could be given or can't be given at some stage, then that usually has to be priced in. If it's going to be priced in, it will have to be priced in somewhere else. So it will probably go back to base pay or one of the other areas. Also why would you put yourself through these sort of risks and have these, if you like, legal requirements when you might be able to do it another way and to do it another way might actually have the opposite effect of increasing one other part of the package.

So we have serious reservations about that draft bill and we have said publicly elsewhere that it really needs fundamental revision. We also have difficulties on the concept of binding vote on executive remuneration because of its impracticality for reasons which I can go into. I don't think that's an area where anybody is much in disagreement. I haven't heard any shareholder association, any proxy governance organisation thinking that this is a good idea. I've only heard one organisation that thinks this might be a good idea but I haven't heard anybody in the mainstream. I'm happy to go to that if you would like me to. It's in our submissions.

MR BANKS: We can take those arguments as given but we may well come back to it.

MR COLVIN (AICD): The next point, and it has been raised at our first meeting, is there a global market for senior executives? We would argue without doubt that it is global and in our submissions you will see that there are two letters: one from Korn/Ferry and on is from Russell Reynolds. Both well-respected, well-known search firms who do a lot of the work in this area. There are a lot of other search firms you probably could get letters from others but these are two of the very best. Surprisingly - because we asked them what their experience was and I had a figure in my mind from when I was practising in this area but I was surprised to find their - view is every CEO search is of an international dimension. In other words, you look at international candidates, you go searching for them all around the world. In Australia for that level you might have a very thin market or they might be basically already taken up so you look externally.

Also search companies want to go to the board with various options and the

boards may take a view that they would prefer to have an international CEO at this level with these capabilities as against a local one for good economics and very good reasons for the best interests of the shareholders. The figures you see in the submissions are that of the CEO searches for the top 100 companies it's 100 per cent international searches. For the next level which is CIOs, CFOs, COOs et cetera is also 100 per cent. The surprising thing to us was that when you get to the next level it's about 70 per cent. So if you go and have a look at whether there is an international market for the senior executives of the top 100 companies, for example, or maybe the top 200, we would argue that there definitely is an international market at this level. John might like to say something more about that later from his own experience.

MR BANKS: Just quickly while we're on that, and I have read those two letters, where is the drive from the 100 per cent coming from? Is it from the firms themselves or is it from the consultants who are in this business of search?

MR STORY (AICD): I think it would very much be from the boards. For a CEO's job you are obviously seeking the best person and it's a critical position and the market is thin in Australia particularly where there is domain experience required depending on the particular job, you will, I think, inevitably be going offshore for the very senior position. I am engaged in a search at the present time for a senior executive position and we are going offshore. So, obviously you're testing internally, you're testing the Australian market but you're then benchmarking it against what is offshore and the driver is to get the best possible person.

At the same time you're seeing considerable mobility amongst Australian executives moving offshore. I think you've seen a couple of appointments recently of Mike Pratt going up to Standard Chartered. You've seen Brian Hartzer going to Royal Bank of Scotland. It is a characteristic at the senior levels. It is a global world in this market.

MR COLVIN (AICD): I'm happy to go to some of the reasons why the levels of executive remuneration can be high from a community perspective versus an international CEO level or just move on.

MR BANKS: Again, you could probably take that as read and come back.

MR COLVIN (AICD): All right. We would just like to make a few comments about regulation. One is that Australia has a very high level of regulation in this area, as I have already said. It also has a high reputation for the regulatory aspects that we have. So one of the issues and concerns we have, like many organisations, is importing overseas solutions for non-existent problems in Australia. We would say that there are many non-existent problems in Australia where proposals have been forward to change where we say there is no either evidence for them or, secondly, if

there is, it's not systemic in any way. So we would be concerned about those areas and a subprime crisis, there are elements about all that in the United States which simply do not come into, we would argue, the Australian system.

For example, in remuneration Australia didn't have option backdating scandals. It hasn't had a lot of the issues that, say, the US has had in this area and the type of termination payments pale into insignificance when you compare them to, say, the US and some of the issues they have had there. There have been areas where termination payments may or may not have been - depending on your view of how the contracts are structured or what have you - considered excessive and there some of the ones that were put forward in the reasons for the termination payments legislation. We can come back to that if you want to have a discussion about that.

The other thing we need to keep in mind is that at the moment you have the executive remuneration probably starting to come down trend down in some areas. You have a number of companies cutting back on fixed pay and there has been a list of those which we can go to in discussion. You have incentive schemes under water. At the moment you have bonuses which are not being granted or being granted less of. We would say that you need to have a look at, going through this market, what is going to happen as a result of the downturn now as opposed to what happened, if you like, in the build-up to the boom. You'd have to actually see the down slope as well before you can work out the general trends. We say the market is the best place to work this out and it is working it out now. Some companies have already gone out of production or gone into liquidation already as a result of the economic downturn and that also has a factor on availability and supply of labour et cetera et cetera. We think it is unwise to draw conclusions about executive remuneration in terms of long term until we have really gone through this cycle.

The other aspect which I think is fundamental in this area is executive remuneration is a competitive advantage or disadvantage. So those companies that can get remuneration at least within certain tolerances and do that well motivate their staff, retain their staff and keep all that intact and do well and have their strategic plans implemented have a major strategic advantage. Those that don't have a major strategic disadvantage, an actual disadvantage and you can argue now that those companies which have had, if you like, queries and problems with their executive remuneration have had to spend a lot of time trying to deal with those issues rather than getting on with the rest of the business. So those that have good structures haven't had to worry about that, - they haven't devoted executive time, board time for those sorts of things. The competitive advantage of getting remuneration right also leads to innovation, leads to new structures, leads to learning from what are some of the downfalls, some of the contractual problems, some of the structures and gets the, if you like, system moving and hopefully innovating for the benefit for all of us and for the whole of the economy and for growth, for tax revenues et cetera.

I think I'd probably like to just finish it there on those high level areas. One of the last aspects I'd just like to leave you with is what is the issue involved here in remuneration and who are the parties really that are the major parties. If you say it's shareholders and boards are the ones that need to get this right, in 2009 we undertook some research into voting results for non-binding resolutions put to shareholders at AGMs in the previous 12 months by companies in the S & P ASX 200 index excluding entities such as trusts, foreign companies that do not have those resolutions and our findings that were notwithstanding the market downturn and the fact that this is meant to be one of the biggest downturns since the Second World War, of those directed proxy votes exercised by shareholders an average of almost 90 per cent were cast in favour of the remunerations reports and only nine companies had directed proxy votes of 50 per cent or more against the remuneration report.

In one of the biggest downturns the country has faced, they're pretty low figures, we would argue and they would go towards the argument we put earlier that there isn't a systemic nature in this, although there have been some outliers.

MR BANKS: Okay, thank you.

MR STORY (AICD): Can I just make a quick comment. I mentioned that I am currently engaged in a search which involves both within Australia and offshore. I've had a number of discussions with offshore candidates and obviously in those discussions remuneration is a factor. Their existing remuneration arrangements clearly are a factor and it is a competitive market, it is a genuine market and negotiations are undertaken in the context of the global market. That having been said, boards do not live in splendid isolation. We are not immune to the expectations of the market, of the institutional shareholders and the expectations of the community and in setting remuneration we have to have regard to what the general economic climate is and we have to have regard to what Australian market conditions are and we have to balance off that against our ability to successfully recruit from overseas if that is the right person. So there is a balancing act and frankly it is a very difficult balancing act but we accept that as part of the job. But there is a high level of complexity in it.

I have to say that in the discussions I have had it is rather embarrassing to explain to offshore candidates just where Australia is at the present time, the nature of the legislation that has come out in relation to terminations which is extraordinarily inept and heavy-handed; the muddle that we seem to have got into in relation to executive share schemes because obviously long-term incentive arrangements involving equity are a critical part of it and the confusion that currently prevails in that area does not help matters. I think we supported the submission or the referral to the Productivity Commission, we see that as an opportunity for a highly respected body to take a step back and give what is an area of community concern some considered support. We support that. We think that where APRA has

come from on a principles basis is a sensible approach and that did involve extensive consultation with the market and we were engaged in that and we appreciated that opportunity.

So we think that is heading in a sensible direction but we are certainly concerned with relation to the way in which the termination provision has been handed down and the way in which the share scheme proposals have been put forward. If there is a problem in enforcement, then the solution is enforcement. The solution isn't in further regulation.

MR BANKS: Thank you. Just on the point that you were making there about overseas search, could I get you to comment on the extent to which boards are doing their job domestically in Australia ensuring that there are good succession plans and training within the relevant corporations to ensure that you've got good internal candidates as well.

MR STORY (AICD): Chairman, succession is high on the list and it has to be high on the list. I'm not sure we've done it as well as we could have, but it depends on the size of the organisation and I think in BHP where you might have six divisions and you are trading people are used to command at senior levels because the size of the organisation facilitates that. It is not always the case in a smaller organisation that you can have first lieutenants within your organisation who are immediately available at a moment's notice to step up into the CEO position.

There are sometimes, in the life of an organisation, where new blood, fresh perspective is desirable. If every organisation in Australia promoted through internal succession it would be the vibrant, dynamic organisation that it is. External CEOs all the time may not be a good thing, but I think in any organisation external CEOs at various stages of development are a good think and I think external CEOs from outside the country are a good thing. I think the fresh perspective, new ideas, new approaches and new dynamism are good for every organisation.

MR BANKS: What about from outside the industry? In other words, I will just get you to comment on the record about the relative merits of having someone who has industry knowledge as opposed to someone who may have CEO experience or whatever but not specific - - -

MR STORY (AICD): That's a hoary old argument. I think I was probably more of the view that an experienced executive who came with a tool kit of appropriate management techniques - the standard employee engagement, corporate structures, customer service, you could apply those techniques to any business. Given a few battle scars after the impact of GFC, I'm starting to think that domain experience actually counts for a little bit more. I don't think there's a right answer here but I do think a number of organisations have been tested over the last two years and I think

those organisations which have been particularly tested have found that domain experience has sometimes been more valuable than a rounded manager.

PROF FELS: In Australia maybe, not internationally in the financial sector. Everyone thought - and maybe leaving Australia aside - people running the financial sector in the United States had done a really bad job.

MR STORY (AICD): There is no doubt within the senior banking environment, particularly in the so-called investments banks obviously there have been bad things happen and you have seen people who have believed that - I think Chuck Prince said that as long as the music keeps playing they will continue to dance. I think people were swept away by the euphoria of it so there has been bad judgment. There has been a view that the housing prices would continue to spiral upwards forever but in a management sense in what you're looking for in a CEO, in the range of skills and experience you're looking for good judgment, that's an essential part of it and I think in a number of organisations, particularly in the US, but obviously the UK has been challenged as well. Good judgment has been left behind.

PROF FELS: Sorry, I shouldn't have gone down that path too much but on a more general point, as I read your very thorough and well-presented submission you give quite a high mark to the Australian performance in regard to executive remuneration, let's say a nine out of 10. You recognise there have been some problems and so on but on the whole you give it a high mark. Do you think the community would give it a similar mark?

MR COLVIN (AICD): In some areas the answer would be no, they would give it a low mark but if you take a view that what is, if you like, an appropriate salary from a community - if we're talking about people who are uneducated in terms of the business world then they would probably think a salary of a certain amount was incredibly high. I think there was one survey that said anything over $200,000 was too high or something, so there's that aspect. The next aspect is if you look at it from a standard of executive remuneration around the world, then you would give it a very high mark. But the question is from whose stance are you looking at and if you're looking at growing the economy and you're looking at growing tax revenue and you're looking at growing jobs you would also give it a very high mark.

The other aspect you would give it a very high mark on is that non-executive directors have been largely running the executive remuneration for executives in Australia which is different to most of the other countries in the world and one of the arguments as to why it's done reasonably well - maybe nine out of 10 is too high but maybe seven out of 10 - is that you've had the non-executive directors actually running the executive remuneration program unlike, say, the US where you have chairman and CEO in the one job. So I think if you say, "What is the community expectation?" you would also have to say, "The community expectation is also that

we have a very prosperous economy, that we have a high tax base for the country to run and that we have prosperous companies and jobs. So that community expectation would be as high as I would argue as also saying - it's a bit like that old joke, "What's the worst thing about a profitable bank?" and that's, "A very unprofitable bank." I think the community would have expectations along similar lines.

MR STORY (AICD): Could I just follow on from there. One of the difficulties and one of the frustrations which I think we as non-executive directors suffer from is the reporting. I think a lot of it is highly simplistic and a lot of it is highly inaccurate and it is not helped by the manner in which we are required to report executive remuneration. This often comes back to your long-term incentives and the long-term incentives are shares which may or may not vest and the vesting dependings - normally 100 per cent vesting of these shares will depend on outstanding performance and I have never seen any complaints from shareholders in a company where you have had 100 per cent vesting because it means that those shareholders have done extraordinarily well.

Our difficulty is that a lot of the reporting which we're required to set out in our remuneration reports and which is picked up by the press takes the gross amount and does not have regard to what is actually the benefit that is ultimately received by the shareholders and by the directors.

MR FITZGERALD: We have heard that many times and there is no doubt at all the disclosure regime is in need of some changes and we are looking forward to submissions that tell us what those changes could be. Having said that, you as a company are able to actually tell the shareholders what was paid to a CEO or a CFO at any time. So in a sense, and I've said this to other directors, it's a bit like having your cake and eating it at the same time; that is, if you don't disclose what in fact the executives did receive, why would you expect the public to understand it any differently? No company reports the actual. They're quite entitled to, there's no law prohibiting, you're absolutely entitled to it. So is it a bit rich to say the community has it wrong when in fact the companies don't disclose the difference between what was reported a couple of years ago and what was actually received? How would they know if you don't report it and we haven't spoken to one company yet that reports it.

Having said that, we understand the complexity of the disclosure regime and I take your point that it does need refinement absolutely but the companies have that ability.

MR STORY (AICD): I accept that. I don't think we have communicated that as well as we could have. It is certainly stated in the report that appears that this is the amortised cost. All those caveats appear to say this isn't what has actually been received. So companies do set that out within the remuneration report. That is

totally overlooked and ignored by the press and the various commentators who follow on from there. I think we could do a better job of it. Frankly, for most companies you are operating at a very short time frame, frankly you are more concerned with getting your accounts finalised and appropriately presented. The remuneration report is a complex document. Once you've met the formal requirements of the remuneration report as well as all of your other financial accounting responsibilities I think everyone has a bit of a sigh of relief and say, "We got there," and in hindsight we probably should. I think this year you will see companies being a lot more proactive in setting out the real position.

MR FITZGERALD: Can I just play the cynic for a moment. Is that because the results will have gone down and therefore it's in the interests of companies to disclose it whereas previously they have been going or is it going to be a continuing trend that we're going to see? In other words, what we see in this particular downturn, will it be the start of the new pattern? That is the question.

MR STORY (AICD): I don't think any company is ashamed to disclose the value of the equity remuneration when it vests. Frankly, if have been on the board of a company and we have hit the top quartile in a TSR and we have vested the shares, we are proud to disclose it. I don't have any reservation in disclosing it. But if I have the press going back over and looking at the theoretical grounds that a CEO might have received after his departure and the press reporting and other commentators taking it up thereafter to say, "That's the benefit he's received over a six-year period," when in fact he hasn't received it and will not receive it, that I find a bit frustrating.

We have gone back the press on that issue and the press chooses not to take it up. There is a very simplistic, populist - it is easy meat. There are any number of would-be experts who are very happy to stand up on the soap box and opine in this area, often with very little factual basis.

MR COLVIN (AICD): I'll just take that point also. At AICD we are encouraging many of our members and boards to think about doing that and we're discussing in our journals and things how this might be looked at and some of the boards are actually going out this year and putting in a small block saying, "This is what they got and this is how it's worked." No doubt they will be sitting with their lawyers saying, "Is this okay to say this under this report and under these regulations with the accountants and things?" and maybe they're going to have to qualify that and say, "This is not a proper report, this is simply a snapshot." They're trying to work out how they actually do it. So I would expect at least some of the boards to try and do that. Others I think will look at it and see how they go. I wouldn't be surprised if that becomes more prevalent and where they will end up going.

PROF FELS: During this afternoon, as opposed to yesterday at this time when we

hearing from the CFMEU and others who have a slightly different view of the world - - -

MR COLVIN (AICD): That's a surprise.

PROF FELS: But we've been hearing an unceasing attack on the regulation and I think it's been reminded that everyone was against even the pressing non-binding vote law that was passed when it was. I just wanted to put it to you that's what happened is not so illogical in terms of community attitudes. The community may - and I'm not sure of this but I put it to you, isn't it a problem that the community and they'd pass things on to politicians and apparently it's picked up in opinion surveys and so on - to feel that the boards have not done their job on executive pay and then that has created a little bit of pressure which has led not just to this inquiry but to the termination and intervention and various other things. It's almost created a situation, a vacuum, where nothing is done and then you start to get quite unwise decisions being made. For example, presumably the law last night that failed because of the green vote on remuneration is in a way a consequence of the community perception to some degree that not enough is being done about executive pay and therefore suddenly apparently the whole commercial property sector is at high risk because of this perception. There are a number of other things in the ether which are leading to quite strong wishes to get reasonable regulation in this situation. Do you have any reactions to that situation?

MR STORY (AICD): I think we support the reference to the Productivity Commission. We're looking for a respected body who can step above what we see as a populist kneejerk reaction. Now, at the end of the day, executive pay has not brought about the global financial crisis and similarly, the amount that footballers are paid or the amount that private businesses are paid. There are many, many businesses. There's private equity. There are innumerable corporate organisations where the remuneration levels far exceed that of the executives in listed companies. But because the listed company executives have their remuneration set forth, that is public and that attracts the kneejerk reaction. But there are many, many other - what are partners in professional firms paid. There are plenty of other economically critically important entities that are not public but do not receive this level of scrutiny. I can appreciate that the shareholders have a legitimately interest, but in terms of the community, whatever "the community" means, and often the community is represented by talkback radio, but it focuses on the remuneration of listed companies, that that is merely one sector. That's the sort of frustration I have with it and I suppose we are looking to you gentlemen to sort of take the step back and to look at it on an appropriately rational basis. But in terms of driving public opinion here, we can put forward the arguments but it is obviously a hard argument to run. All I can say is that as a public company director, I'm desperately trying to balance off the realities of a global market, and they are the realities, against the interests of the shareholders in setting forth an appropriate and balanced remuneration program.

We are not irresponsible people running amok. We are genuinely trying to do as good a job as we possibly can in pretty difficult circumstances.

MR BANKS: Could I just say, do you think that boards have done enough in terms of explaining to shareholders the "why" of executive remuneration? There's a perception in the sense that the media and the shareholders have got the wrong end of the stick. They've picked up the wrong numbers that are set out in the table and it's all their fault. Could boards have done more and companies have done more to explain what was going on?

MR STORY (AICD): Chairman, all I can say is that we do in the remuneration report certainly convey the underlying philosophy that we're approaching. Boards will often adopt a balanced scorecard. You will set out what the base is. You will set out what the STI and the LTI are. You will described what the balanced scorecard is, the fact that there is a financial component, there's non-financial components. All of those factors are taken into account in arriving at the balance. So all of that is in fact set out in the remuneration report. It is available for those who choose to read it. People will set this out at length to try and convey the underlying rationale and the underlying philosophy of what is undertaken. There's an awful lot of work that goes into the structuring of these things.

In the presentation of the remuneration report, chairmen will speak to that report and they will describe it at length. In the discussions in advance of the annual general meeting, I think these days most chairmen of the larger companies will visit the proxy firms, they will visit the major institutional shareholders. We're not disclosing anything that hasn't already been disclosed but we'll sit down face to face with the institutional shareholders and again will explain it. Obviously we have failed because we haven't got the message across, but can I simply say it has not been for want of trying. It's something which is exercising the minds of most boards very, very sharply.

MR BANKS: Thank you.

PROF FELS: We've heard all the opposites, equally passionate statements - - -

MR COLVIN (AICD): Yes, I think every time we talk about this, we acknowledge there's obviously community concern, otherwise we wouldn't be here now. We acknowledge that. One of the issues, I suppose - and it's one of the idiosyncrasies of economics and free markets I suppose - is that it's also strange to find that somebody might be earning $50 million or higher than that, an entertainer or whatever, and it goes on and on, but if you're running a business which has 50,000 employees and has a large share base and what have you, it seems to be a percentage of that sort - in other words, the elite of the business, we're talking about the top 100, - somehow there's a disconnect between elite, in terms of business, and elite in sport and elite in

entertainment and elite in a lot of other areas. So there is a disconnect there. That's part of our job, I suppose, and this is where the AICD tries - we try to get out to explain what's happening in journals and articles and briefings. I suppose I'd agree with you, there is an issue and we're trying to do the best we can in this area.

PROF FELS: I accept Mr Story's statement at the beginning that our job is to do an impartial analysis of the situation and you put up a serious paper about it all. I'm kind of straying a bit to the edges of a role, in a sense, talking about the community, it's just that as I sit here, it just seems to me that what you to some extent have is an ongoing perception by the community that there's something wrong with executive pay and then if you just say there should be minimum action about it, then there's kind of a political vacuum and someone will step in, the Greens will step in and possibly do huge harm for all I know to the commercial property sector. The government will step in as they did last time and bring in the termination payments, kneejerk without further consideration.

There's a number of other areas of law I could tell you about which I'm sure you know about where there's all this heavy pressure from the business community, "Don't touch regulation," and then you create the situation where the government comes in. Like I said, there was the famous Birdsville amendments to the Trade Practices Act and the classic recent action where because nothing was done by anyone you got a very, very undesirable outcome. So I just wondered if you had thought about that. In some ways it's a bit marginal and we should just say what we think is best.

MR COLVIN (AICD): I think it gets down to a couple of things. Let's take the termination legislation. We haven't been saying, as AICD, "Don't do it, don't do anything." We've been saying, "Had we had the opportunity to consult, here's some ways" - and you see in our paper - "we think we could have helped in advance and here are some ways we think we can help post draft legislation. So here's some possibilities. We are going to bring the threshold down from seven down to one" - you know, a seven as total, just to one - "perhaps you could revisit that and maybe have a system where you might have two or three years' total remuneration." You wouldn't have a provision where you couldn't actually vote on it; you'd do something which was structurally sound - in other words, seven came from the public sector final average salary, from the seven times final average salary pension schemes, the defined benefits scheme. That's why it was in the legislation and we've moved away, from this except in the public sector, as I understand it. That's why when that moved, there's a movement now to change that legislation. But it was probably right when it was introduced because a lot of the schemes were seven times final average salary, as I understand it; based on the average of the last three years remuneration. So that's why you have numbers like that in the legislation. That now having been restructured largely in the private sector, that's why you can move to another number. But, we would argue, would you move to one times base? It seems to me to be

counterproductive and it's going to cause more damage than it's worth.

We've put up some other proposals. I don't think we have been just totally negative about these aspects. We've put up ideas, and possible ways around it. I suppose the best way to put it is if you've got a stream, the best thing that governments can do is to make sure the levy banks don't fall down on either side so the water can go through clearly. The worst thing they can do is put a big boulder in it and divert the water and cause floods and mayhem and that's pretty similar in regulation.

MR FITZGERALD: We agree. Certainly, both in the discussions we've had with your organisation and in the very substantial submission you've put, we acknowledge that you've put forward constructive ways of dealing with some of those issues. I suppose there's just two things: one is, going back to the earlier discussion we had about the international marketplace, one of the dangers in the argument that you put, which may be absolutely legitimate, is that in some senses it says to the Australian people, "We're really at the mercy of what America does." We were at the mercy when America put in the inappropriate law of capping it at $1 million and the consequential flow-on that came here. We're at the mercy in a sense of what the international market does." If it does something on termination, almost the argument is, "We really can't control this."

One of the things people say to the commission all the time is never make recommendations based on the outlier, the rare events. Relative to the total number of CEOs in the 2000 ASX companies, the international issues are in fact relatively small, not to the individual companies that you chair but to the overall stock market, but if we just take that group, all the top 200 or the top 300 or top 500, wherever you bench it. So I suppose there is a disquiet or a concern that in a sense, if we take the approach that this is truly an international market from an elite group of CEOs and we almost have to compete exactly on terms, we are in fact almost abrogating the ability to do anything in relation to executive pay because we'll have to just respond to whatever the world does to us. Now, you haven't done that. We've got governance guidelines, we've got ASX listings, and we do in fact have black letter regulation quite different from America, much of which was opposed when it was introduced but now accepted.

So I just want to raise this issue, that we fully understand that in certain parts of the market, the international competition is very strong, you're absolutely right, but on the other hand, the question is does that in fact mean that we do nothing to in fact continue to improve governance and maintain our position as number 1 in the world as you have rightly indicated. I suppose what we're trying to say is having made a substantial change in governance, having recognise that we do it better than many other countries in the world, are there things we could now do which would further improve that without actually causing detriment to the companies? But the danger

with the argument about the international is that it almost says, "Well, we just have to keep responding to that." Now, in this area, that's also brought negatives. Some of the stuff in the executive remuneration is extraordinarily complex almost without reason, but we live with it.

MR STORY (AICD): I made the point earlier and I'd really like to emphasise it again: in an executive search, you will be looking at the international market. I think there is then a question as to whether you can afford the international market and I said that it is a balance of having regard to what is prevailing externally, but a good board will also balance off what are the Australian conditions and I think it is a very serious decision to take. It is a brave board that ignores Australian standards, Australian expectations and goes offshore and applies New York standards or former London standards. I think that is part of the equation and you have to compare the levels and bring it back to where you are in Australia. There may be circumstances that call for going offshore and applying those higher levels. I have recently had a situation in another company where we have gone offshore at probably a third layer down because we were wanting specific domain experience in particular circumstances and we have paid at US rates in a particular industry to get a particular expertise. That was done consciously because we believed we had the need for that specific domain experience. You would not normally do that. So we're not simply marching to the drum of international standards. It is not international accounting standards. We are not in that position. We accept the Australian standards and we respect those standards but it has to have the overlay of what is happening globally and we have to be able, in particular circumstances, to apply those standards to bring it back into Australia.

MR COLVIN (AICD): Can I do it from a high level economics point of view which is where we are because of international or global problems basically. You can go back - you guys know more about this than I do - but do you go back to China and the imbalances between China and the US or what? So some of these things, we can't sort of say we're not part of the global economy, and I think there are some choices we have to make. One issue is we can bring in regulations in Australia and we can do it at a level which we're all happy with. Maybe the community expectations have taken it to the level of somebody who is not involved in the area; we could do that. But then you would have to say what is the actual cost of doing that? Have we then moved ourselves out of the international market and are we moving towards a branch office as opposed to competing nationally? I think, as John said, like everybody else it's a balancing every time you have to make a decision, can we afford that? If we can't, what would it look like to our shareholders? How could we possibly justify that? Maybe sometimes the best candidate is not hired because of perceptions and issues. On other occasions you may not have that luxury if you want to survive.

So I suppose from the AICD's perspective, we wouldn't want to see our

companies disadvantaged internationally so that we don't have, if you like, a fair go. I suppose one of the problems with the termination legislation is that that puts us at a disadvantage. Europe have come out I think with two times, America has three times - we're talking about total remuneration levels - and the UK has a system which is if not, why not? You can argue that's a better system; it's not legislative but it actually makes you explain why you're doing something different. So you could explain my example say to Bob Joss and people would probably say, "That's very understandable and it's a good decision."

MR FITZGERALD: Just on the termination, if you've seen the submissions, you will see that there's a whole lot of variations on the theme that people have put forward. For example, yesterday we had a proposal that up to 12 months, you can do what you like; between 12 months and two years' worth, it's a please explain, and over two years it's a vote. But anyway, people are putting those suggestions forward. In relation to termination particularly, we will be looking at that issue and seeing what is the way forward. If the government doesn't lock it in - - -

MR COLVIN (AICD): In the meantime.

MR FITZGERALD: - - - in advance of our draft report. But just on that, one of the other suggestions that's come up is that - and you would have heard me put this to Freehills - the time maybe has come to try to get a consolidation of the various codes and practice to the extent that that's possible and as you would have also heard, there's been some view that some of the weakness in the codes is that whilst people don't want an overly prescriptive approach, the converse is also true that high-order principles can also be problematic and if you do have an if not, why not approach, you can afford to be a bit sharp or a bit more clearer about the sort of direction you want. Again, all the company has to do is explain why it deviates from that. Now, I'm not putting forward any particular proposals but that suggestion, given the good work you've done, given the good work that the ASX Governance Council does and everybody else is doing in codes, is it the time to try to consolidate to the extent that's possible?

MR COLVIN (AICD): I'll answer this. John might have a different view. But my view is it's not, and the reason it's not is because we're getting at this stage different views of how it should be developed. We're getting innovation. We're getting people coming out and saying - for example, I think Regnan will come out and say, "We would like to have long-term equity, and, if we can do that and put that over a long period of time, that is a really good idea." My experience in drafting these contracts is every time we come up with something which we think is going to be really first-class and solve the problem, it doesn't and it causes often another problem which we hadn't foreseen.

So I guess my argument would be, I'd like to see, quite frankly, no boundaries

put on people coming up with these ideas and these guidelines. There are many of them; if you look at them, you could probably get to maybe 60 per cent, maybe even 80 per cent, of pretty much round about the same place, particularly in the governance space. Hopefully our guidelines on this have led the way, and we think that there's pretty much general acceptance that boards are the right place to with remuneration matters. Good corporate governance says it's important to lay the right foundations. Once you've got the foundations right, you can start building on the models.

But these models are so complicated and so different that if we have a system in which we have, a guideline like APRA puts out, which is based on APRA-regulated organisations, and then we try and just apply that across the boards, we're probably in a worse situation, in terms of having one size fits all over again. So I think it's too early to develop. It may be that investors and shareholders and other people think that the one really to go with is this, particular example or a combination, and it might actually be, developed naturally along those lines. That would be my sort of take.

MR STORY (AICD): Maybe a specific example I mean, one of the biggest challenges, which I don't think we got an answer to, is what are the performance hurdles for long-term incentive arrangements. Probably the most common proxy for sustained outperformance is total shareholder return on a comparative basis. So you might compare TSR against the peers within the same industry or it may be within the top 100 or the top 200, whatever you think is appropriate. It has the benefits because it is a totally objective measure, and one of the risks of long-term incentive is that you start adjustment for the one-offs and you start bringing in a subjective assessment and the integrity of it in a long-term incentive arrangement can very quickly be damaged.

So TSR is a good objective proxy, but it's not by any means a perfect proxy. One of the difficulties at the present time is that there will be companies in the top quartile at a time of substantial underperformance. The idea of a long-term incentive is that when shareholders have done well, then the executives should similarly do well. Right now there are very few shareholders who are doing well and you should be asking, "Should any LTIs be vesting under the present circumstances." So TRS has its drawbacks, but it's a bit like democracy, it's probably the least bad system that currently we have come up with. That doesn't stop people searching for new and better ways of doing it.

Our hope is that people will continue to search and we might come up with a better proxy for sustained long-term performance. Once you start getting a sharper code you start homing in on what are the measures of what are the measures of long-term performance, that's where you start to head, and once you start to head into those nitty-gritty areas then I think you might start constraining and stopping the

creative minds coming up with newer and better ideas.

MR COLVIN (AICD): TSR wasn't used when I was drafting contracts 10, 15 years ago and there has been all sorts of developments in this area which have been coming through naturally, and if there was a silver bullet, I guess we wouldn't be sitting here.

MR STORY (AICD): You can look at earnings per share, you can look at return on equity and all sorts of internal measures, but the fact of the matter is they are susceptible to clever executives gaming the system, and that's what we're trying to avoid.

MR FITZGERALD: Irrespective of what codes or guidance or what have you are in place, the if not, why not is a preferable approach clearly - well, I presume it's a better approach, from your point of view, than a black letter law approach or a prescriptive regulation that has some sort of consequence.

MR COLVIN (AICD): I think we'd agree with that.

MR STORY (AICD): We do not shrink from the need to justify what we do. We may have not done a good job of justifying what we do in the past; and that's obviously an area where we have got to keep working it. But boards are genuinely trying to do the right thing here, and I think it is incumbent upon us to explain better why we do it, and the if not, why not is an obvious case for explaining why you have gone down a particular path.

PROF FELS: If you have more substantive code on the if not, why not basis, wouldn't that give you a wonderful reference point on this uphill task and leave you less exposed to other actions?

MR STORY (AICD): It depends on sort of how prescriptive the code becomes.

PROF FELS: It wouldn't be at all prescriptive; it would be entirely up to companies whether they followed it and they could justify it to the shareholders and so on.

MR COLVIN (AICD): We do that now under the ASX, the if not, why not rule.

PROF FELS: Yes.

MR COLVIN (AICD): Are you saying that it would apply to remuneration? I'm not quite following where that's going.

PROF FELS: We did have a proposal about this put up by the Australian Human

Resources Institute today that suggested that there should be - I think they thought the present guidelines didn't have a lot of content and - - -

MR COLVIN (AICD): The ASX guidelines or our guidelines?

PROF FELS: Both, in terms of the community concern about - - -

MR STORY (AICD): If it were a code that provided for cap on salaries, you know, a prescription along those lines, I would regard it as not a helpful document. But if it were a helpful, constructive code, certainly we would support it.

MR BANKS: It could be worth - I don't know whether you want it on notice - just maybe having a look at the submission by the AHRI, because they recommended a couple of things that would be of particular interest to you. So feel free to look at that, and if you wanted to send us a note in response to that, which we'd put on the web site, it gives you that opportunity.

MR COLVIN (AICD): We can do that.

MR BANKS: I was just going to look at - I assume you've still got a bit more of your time - if it's okay, clearly you and others see boards as being central in this whole game, and therefore the quality of boards, the incentives of the governance arrangements are also obviously very important. A lot of what we have been hearing is ways of perhaps enhancing the environment in which boards make decisions, if I could put it that way. You referred earlier in the introductory remarks to a problem of the risk reward ratio perhaps getting a bit out of kilter with the risk going up and perhaps the rewards not responding adequately to that. Is that having an impact on the quality of the people who are stepping forward for board positions?

We have had others say that it's already a club. If it's a club of diminishing quality, then we have got an even bigger problem. I notice that in your dos and don'ts in your most recent guidelines from February 2009, two of the don'ts, things not to do, don't have executives setting their own remuneration and don't overly rely on advisers. They would seem like pretty fundamental things, and the fact that you're having to give that kind of very basic advice perhaps for some would make them worry about the capacity of boards to be - - -

MR COLVIN (AICD): I think there's two answers to that. There are subtleties in some of that which, you know, need to be sort of teased out, which you can't do in a guideline, but we do in briefings and what have you. Then secondly, those guidelines are not just for the top 100, they do probably pretty well, those guidelines are for people who might only have one CEO, one finance person, one company secretary and a very small staff. So some of it, yes, I agree, could be a bit simplified. But then you get down to, "Well, how do you actually do some of these things," like,

you know, what role does the executive play in this.

So the HR director might have a role. What is the relationship between the board and the HR director at that time? The general counsel might also be looking at the contract, what is the relationship between the board and the general counsel at that time and how are those documents to be looked after and confidentiality, to avoid these things. That becomes a far more sophisticated issue, not just maybe an obvious statement. That's one of the aspects. They're the two. What was the other question, sorry?

MR BANKS (AICD): I suppose I'll just get you to comment on the quality of the gene pool, if you like, in that area.

MR COLVIN: I think there's a lot of good people coming forward. There's a lot of talent which is coming through. Experience of, you know, some of these very difficult issues, I think that's always going to be an issue, and training and educating and what have you, and that's probably one of the roles we're trying to develop now. So in this area, we're putting out new education aspects, new training, new in-boardroom training, new discussions to try and lift, if you like, this whole area.

I think that's one of our mandates and we hopefully will do that reasonably well over the next few years. That's one aspect of it. The other aspect I suppose, if you're talking about getting in to becoming one of the top directors in the BHP board and what have you, is it's a bit like getting in the Australian cricket team, I think you've actually got to be quite good at it; and if you take that as a club, you take that as a club.

PROF FELS: We know what you mean.

MR COLVIN (AICD): If you take that as a club, well, probably it is. There's a club to get into the cricket team, and all those sort of things. So there's that balancing issue. One of the concerns we have though is we did a survey with treasury, in that survey we did with Treasury, 18 December last year it came out. I remember that because it was my birthday. In that it had some figures which concerned us. I have just been handed them actually, which is very good.

In that survey, which is top 200, listed company directors, 87.6 per cent said that they had declined an offer of a company directorship because of liability issues. That's a very high figure. 63.9 per cent said they had retired from a position as a company director because they thought liabilities were too high. 75.3 per cent said they had resigned from a position as a company director; again resigned, as opposed to retiring, one of the issues that came into their list was liability.

One of the problems I sense is you have got 650 state laws making you liable,

positionally-liable. So not that you did anything wrong, it's because you are director that you are then liable. If you have a position where, say, in New South Wales, occupational health and safety laws is a good example, and environmental laws, even the new laws on trading and carbon emissions have come out saying, prima facie, liable; you have to prove yourself innocent, the defences are quite narrow, the right to remain silent is taken away from you, and you've got to say to yourself that if this type of liability continues then you are naturally going to discourage people from wanting to sit on boards in high-risk areas.

You can argue that people who may be the top 100 they have got the abilities and the resources to deal with some of these types of difficulties and the large number of laws making directors positionally-liable. The problem comes when you have smaller boards and you want to attract top board people on to areas which are dangerous, for example. So mining, manufacturing, some of those areas which have high risk; then trying to get some of the top board members on to some of these areas or the new innovative companies, the liability becomes a big issue, a really big issue, and you may not be able to attract people on to the sort of the start-ups or in the dangerous industries.

MR BANKS: What about liability under the Corporations Law? I mean, if we move from the broader thing of the risks I guess of becoming a director, to start to focus in a bit more in this area. Are there issues there within the Corporations Law itself that have created a problem?

MR COLVIN (AICD): Yes, there are. We have been advocating for a much better business judgment rule so that you aren't as a director liable for making a decision which you thought on the economics of the day and on the evidence was a very good decision but actually it turns out to be not as good because you have a GFC, that you shouldn't be either civilly or criminally liable for bad business judgment.

MR BANKS: As revealed.

MR COLVIN (AICD): Yes, as revealed. As lots of friends of mine have said, "You can be right for the wrong reasons, and wrong for the right reasons."

MR FITZGERALD: I'd be very interested to know how many successful actions there has been where that hasn't applied. I mean, the liability laws exist, but - - -

MR COLVIN (AICD): Let me just deal with the first point, when you say prosecutions. First of all, in New South Wales there have been a large number of prosecutions.

MR FITZGERALD: Under?

MR COLVIN (AICD): Under the occupational health and safety laws.

MR FITZGERALD: No, sorry, the Corporations Law. I thought we were specifically talking about that.

MR COLVIN (AICD): Well, you're talking about impact on directors and on their psyche, that's one. The second one though is it's one thing to talk about prosecutions, but if you are a director and you get a letter of advice from lawyers regularly on a basis of, you know, what you need to do on a decision, the other party in this survey said that decisions were being made which were sub-optimal which were too conservative.

MR STORY (AICD): But the other answer is that we have gone through, or we are still going through, a challenging economic cycle.

MR FITZGERALD: Sure.

MR STORY (AICD): I think the new factors you are seeing at work at the present time are the entrepreneurially-funded litigation lawyers. I think it is a reasonable expectation that over the next couple of years you will be seeing not so much prosecutions but I certainly think you will be seeing opportunistic litigation being undertaken which will be sort of relying on the absolute liability provisions which do appear within the Corporations Law. The business judgment rule currently applies to the general duty of care but it doesn't apply to exercise of judgment, such as continuous disclosure or indeed insolvent trading.

MR FITZGERALD: Can I make the point, I'm not disputing the issue that liability is a significant issue in relation to boards. As a matter of fact, can I flesh out a couple of things. The first thing is, I just want to understand your approach to it. Is the approach to try to increase the reward or is it to reduce the risk? So the liability, in other words. Because when you talk about the risk/reward, you can do it in two ways, you can say "We will increase the remuneration pool to directors," or you can take the harder much more difficult approach of trying to actually roll back some of those more strict liability laws.

MR COLVIN (AICD): We are taking the more difficult approach.

MR FITZGERALD: Yes, I thought you might be.

MR COLVIN (AICD): We are visiting the politicians in all the states. We have written to them. We have explained this, if you like, ad nauseam, as to what the effect is. The surveyed the treasury have. The corporations ministers we have spoken to. We have said, "This is a serious concern and needs to be addressed. It would be better if it's addressed that way than people saying, 'This is too risky; I

want a higher reward.'"

MR BANKS: Sure. Is that survey available?

MR COLVIN (AICD): Yes, it is. We're happy to send it to you.

MR BANKS: Okay, that would be good. What about then how does that play out in relation to our main topic, which is executive remuneration? Are we seeing as a consequence of that a kind of risk, a version that may be leading boards to rely too much on consultants; you know, (a) to use consultants, and then (b) to sort of accept their advice, err in that way, accepting their advice?

MR STORY (AICD): Look, I don't think so. I think one of the strong points made in the AICD's paper is encouraging boards to make their own decisions. During the boom times I think some of the difficulties have arisen because boards have overly relied on the external advisers. I certainly think that in the current times, and also recognising the current community concern in relation to executive remuneration, it is undoubtedly an area where boards and remuneration committees are far more sharply focused and are conscious of the expectations of the market and the expectations of the community and are testing and probing the recommendations that have come forward from the consultants, which in previous times might have been accepted at face value.

MR BANKS: Just taking that point, but very specifically, and it may be in your submission. Some people have suggested that to section 202A of the Corporations Law needs to change. That's the one that actually talks about the fact that you only need to get shareholders vote if the pay is not reasonable. Some people have said that clause which talks about reasonableness and remuneration has in fact driven the use of remuneration consultants as a legitimate way of protecting the board and some have actually recommended the word "reasonable" be removed; and we haven't formed a view about that, obviously. But the premise was that it in fact has driven the excessive use in their minds of consultants. I was just wondering whether you have a view about that.

MR STORY (AICD): I will let John speak for the AICD. I mean, a personal view is I think a remuneration committee will and should get reputable external advice and I think it is part of your job to obtain that advice. But I think then it is incumbent on an experienced remuneration committee to exercise its own judgment, and I believe that if it has exercised its own judgment, consciously taking into account the right matters and it comes to a decision which is different from that recommended, then it's entitled to do so and I am not too concerned about whether it's the application of that particular provision. John?

MR COLVIN (AICD): It's along those lines. But I can well imagine people who

aren't legally trained or have these sort of backgrounds would say, "What do I need to do to make sure that if we are sued I've got some documents which actually protect me as a director." No doubt a lawyer would write to them and say, "Well, you'll need evidence to show that you actually have a reasonable belief in this," and if you're an inexperienced director you would probably be saying, "How do I get that sort of evidence?" and they would say, "You will need to get somebody to give it to you who has the expertise." So I think it gets down to horses for courses again. In the top end of town they have the ability to actually look at all this and they know what market they're in. When you get down to other companies which don't have expertise, don't have HR departments, don't have all those sort of things, then they need to find out what is the market and the best way they can do it is probably hire some of that in. They do a pretty valuable job, I think, in giving ranges and percentages and those sorts of things.

MR FITZGERALD: The whole area about risk is in issue. But my last comment is about this strict liability that applies to directors and you're right, I think many people would be concerned about the expansion of that strict liability law and obviously you're absolutely right, occupational health and safety, particularly in New South Wales, is of paramount concern.

MR COLVIN (AICD): The good news is that's hopefully been addressed in the harmonisation.

MR FITZGERALD: Sure. It could go the other way.

MR COLVIN (AICD): Harmonisation the other way wouldn't be such a good idea.

MR FITZGERALD: I was going to say there are two ways of harmonising.

MR BANKS: I think he said hopefully. I think the rules have headed south.

MR FITZGERALD: Given you're the peak body, I suppose I want to take up something that Allan said - - -

MR COLVIN (AICD): Just before you do that, investment decisions in this survey have actually been moved out of states that have these sort of laws into other states so there's a competitive issue there too.

MR FITZGERALD: There are a number of reasons why these sorts of laws emerge but can I just put it to you broadly as a peak body. Does it in any way reflect on a concern by governments generally that in fact directors have not demonstrated enough responsibility or duty of care in these areas. If you got to strictly liability you're basically saying, "We want to shop the blame right back to the vary top because we don't believe that unless you do that you're going to get the outcomes."

Safety is a particularly difficult one but, as you said, there's lots of other areas. You might look at it as an outsider and say, "Well, this is a general view, the government has informed me that somehow or another you have to compel the senior leadership of the organisation, that is the director, not just the CEO, although it applies to them as well." How do you respond to that?

MR COLVIN (AICD): I can respond to that pretty forcefully over the next five hours but I will try and keep it really short. (1) that sort of approach - and take out the word "director" and put any other community or ethnic group or anything else and you say you take away the same fundamental rights as anyone else has - would cause an outrange. (2) we live in hopefully a democracy with a rule of law, so why would you just simply trample something as fundamental as that without a massive amount of discussion in parliament and everywhere else. (3) you would expect that laws coming through which have really just trading-type events you wouldn't think would need it. My worry - and I'll put my worry because I'm not sure it's AICD's - but when I'm talking to people they said, "We're just putting the usual provisions." So I say, "Which one did you put in?" and they give it to me and the usual provisions have all those reverse onus of proofs, taking away the right to remain silent, all those sort of things and you say, "Are they the usual provisions?" and they say, "Well, I assume so."

So I think there is a breakdown in relation to control, if you like, either by parliament or by the drafting in this area of what is fundamentally human rights and when should they be broken. You say to me, "Do I apply that across the board?" the answer is I probably would. But that's probably a personal view about human rights and what have you. So I think that's the first issue. The next issue is trust is incredibly important and it's part of our duty as AICD to educate, to make sure that what we've been saying is that most of the directors are trying their very hardest to do the very best job they can do for their shareholders, retirees, make sure that it's profitable, that that works for the benefit of all of us and our standard of living goes up and so does our ability to do everything else, defence, et cetera et cetera.

There are always in a big church as big as that, there are always outliers and they always will cause problems. I would like to suggest they're probably not members of the AICD but I'm not sure whether that's true. But certainly in terms of educating, looking after issues like this, developing courses, making sure that at least we have some of the best trained directors - and I think we have - in the world making sure that we keep going with that and get it higher and higher, then I think you've got to put your faith in something in Australia and I think we've done a pretty good job, not necessarily just AICD but directors generally and I think we will do a much better job and we will be as competitive as the rest of the world. I suppose the issue for us is well summarised by Michael Kirby's article about 10 years ago which said the balance between over-regulation and killing the golden goose and at the same time making sure that there is a proper framework, I think that's exactly where

we are now and we don't want to kill the goose. We want to make sure it's rational, economically sound and well thought out law.

MR STORY (AICD): There was obviously a fundamental role for the board in occupational health and safety and it is a leadership role. In an organisation that is bereft of a safety culture and you are having workplace deaths or serious injuries and the board has demonstrably failed, then the board should be held accountable. We don't have a problem with it. All we're asking for is balance legislation that has the normal checks and balances that you expect to see and in the cases where the board has failed to ensure that there is in place appropriate processes and procedures, then I think boards should be accountable. The most difficult part in workplace health and safety is that an organisation has the most strict and intense safety culture and all of the processes and all of the procedures and, notwithstanding your very, very best, there are occasions where you unfortunately will get fatalities and liability shouldn't automatically flow in those circumstances which in New South Wales it potentially does.

MR BANKS: I have only one more question and it just keys off, John, your comment about the remuneration committee really having the obligation to seek expert advice in relation to remuneration. I suppose I would say that expert advice is a necessary but not necessarily sufficient condition for giving good advice and I just wanted you to comment on the extent to which that advice should also be independent, in particular independent of any conflict of interest it may obtain because of dealings of the adviser or consultant with the management of the company, as the same time as they're reporting on this matter to the board and some have argued that that is a very important area and indeed, it may be an area where you want to see some guidelines and an ASX if not, why not provision?

MR STORY (AICD): It is an interesting question and I'm not sure I've got the right answer. But in an organisation which has a good remuneration system you find that it is applied systematically across the company. So they may well work on a balanced scorecard which I will take into account, cultural values and all of these things and that will start here and then it will cascade up. So for STI you will see a pool allocated across lines of business depending upon their balance scorecard. So you cascade up and you've got your general executive or whoever reports directly to the CEO is working with his team in driving towards certain predetermined key performance indicators. So it's an organisation which is totally aligned, everybody knows where they are heading, they know what the objectives are, they know what is expected of them.

On any demonstrable view that is a good organisation. It's integrated, it has remuneration aligned to recognise objectives and those organisations are probably the ones who have sat down with the good external consultants and they have worked their way through, you've got an HR department that's taken external advice

and they've worked their way through. You theoretically can then bring in another expert to advice on the remuneration for the CEO and his reports. He may well have a different view of life. Whereas the better view is to have the same principle, the same philosophy, the same policy flowing all the way through to the CEO. I personally think that is a good outcome. But what I would do as chairman of the remuneration committee is I would want to be satisfied as to the integrity of the consultant you're using and ensure that you are sitting down with the senior person within that organisation and say, "Okay, you've looked at the troops, we're now looking at the heads of the lines of business and the CEO and now let's look at them and you're no longer reporting to the HR department, you're now reporting to the remuneration committee."

You have to ask, "Can they maintain their independence under those circumstances?" If you're not satisfied as to the integrity of the house, then you've probably got the wrong remuneration consultant. But I think it's possible to have the same external adviser advising holistically for the remuneration policy within the organisation. I have heard this argument, there are some people who would argue that the remuneration committee should be going out and getting somebody independent and there is force to that argument and it really comes back as to whether the judgment you as the remuneration committee make as to whether you can rely on that independence.

MR FITZGERALD: I just have one very last one, it is very specific to directors. We've had a number of submissions - not a huge number - that are suggesting that in order for an existing director to be re-elected the vote required should be 75 per cent as distinct from 50 per cent and there are a number of reasons put forward for that. You may not have a view on that at the present time but there seems to be a view at the moment that in relation to returning directors or directors that wish to be returned, there needs to be different threshold for new directors and it has been put a couple of times already and I am sure it will be put in Melbourne as well. I don't know whether you have any particular view about that but - - -

MR COLVIN (AICD): Are you talking about remuneration - - -

MR FITZGERALD: No, just general directors.

MR COLVIN (AICD): Off the cuff, without thinking about it, but I'll come back to you on this, I can't see why you wouldn't just have the normal voting at 50 per cent. I guess my question would be in reverse: what is broke why do we need to change the system that has worked reasonably well now?

MR FITZGERALD: I suspect it's part of the issue that Gary raised before, the club issue. There is a view by some shareholder groups that it is extremely difficult to actually get freshness of directors onto the board when that sort of closed shop

mentality exists and I suspect they believe that this might make a difference. Having said that, we've heard that returning directors generally get votes in excess of 90 per cent anyway so it would have very little effect. But I think it was this notion that part of the governance would be improved if you could signal that some change was - - -

MR COLVIN (AICD): Should we do that, public sector and politicians?

MR FITZGERALD: I think it would be a good idea.

MR COLVIN (AICD): Shall we just say you've got to get a 75 per cent majority next year to get re-elected into your seat because you're getting a bit stale? I'm yet to be convinced theoretically that that is such a good idea.

MR STORY (AICD): I suppose we would assume if the Productivity Commission was coming up with something like that you'd have some pretty good evidence to substantiate that there wasn't appropriate renewal on board and then secondly I'd be interested in the philosophical approach that says 25 per cent or 26 per cent is more important than 74 per cent. That is a funny view of democracy that you've got 76 per cent saying, "We want that person as our director," but 26 per cent are saying, "We don't want him." But that to me is disenfranchising a very substantial - - -

MR COLVIN (AICD): It's great for some of the takeover lawyers, isn't it, getting a blocker in there.

MR STORY (AICD): I think that's a very valid point. That could lead to some very serious disorder.

MR FITZGERALD: It just came up and seeing as you represent the directors I thought I would ask.

MR BANKS: One of the advantages of this process, as you're now aware, is the diversity of perspective that we can tap and you wouldn't be surprised to know that one advocate for that position would be the Australian Shareholders Association which would see perhaps greater leverage for its own membership relative to the big institutional shareholders. I think that's the context. Again, I should say you should feel free to scan other submissions that are making recommendations to us and if you think you could help us work our way through that and you have a point of view to put, feel free to do that. It doesn't have to be long, it can be in the form of a letter or something and we would value that kind of cross-fertilisation.

Thank you very much for your time, we appreciate it. We're going to adjourn the hearings now. We resume in Melbourne next week.

AT 4.46 PM THE INQUIRY WAS ADJOURNED UNTIL
WEDNESDAY, 24 JUNE 2009