S&C

SPARK AND CANNON

TRANSCRIPT
OF PROCEEDINGS

Telephone:

Adelaide	(08) 8110 8999
Hobart	(03) 6220 3000
Melbourne	(03) 9248 5678
Perth	(08) 6210 9999
Sydney	(02) 9217 0999

PRODUCTIVITY COMMISSION

INQUIRY INTO REGULATION OF EXECUTIVE AND DIRECTOR REMUNERATION IN AUSTRALIA

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

TRANSCRIPT OF PROCEEDINGS

AT MELBOURNE ON WEDNESDAY, 24 JUNE 2009, AT 11.08 AM

Continued from 17/6/09 in Sydney

INDEX

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

As you will be aware, the commission's inquiry started with a reference from the government in March. We've already talked to a wide range of organisations and individuals and submissions have been coming in to the inquiry. We are nearly at a hundred now, I think. The purpose of the hearings is to give interested parties the opportunity to discuss their views and their submissions on the public record. It's to help the Productivity Commission's task of understanding the drivers and trends of executive remuneration and any systemic problem warranting changes in regulation and government's frameworks.

We had a first set of hearings in Sydney last week. We have two days here in Melbourne this week and we will complete our hearings in Brisbane in July. We will then be working towards completing a draft report for public scrutiny in late September and we will hold another round of hearings in November when people have had the chance to respond to that report. That feedback will be taken into account in producing a final report which is to be submitted to the government by Christmas. Copies of the draft report and indeed the final report will be circulated to all those who have made submissions or have appeared at hearings or registered an interest in the inquiry.

The hearings are conducted as informally as possible, although a transcript is made to provide a record of discussions. There's no formal oath taking required but the Productivity Commission Act does require participants to be truthful in their remarks. Transcripts of the hearings and the submissions themselves are public documents and can be obtained from the commission's web site. Copies can also be purchased and I think order forms are available from staff here today or by contacting the commission.

Our first participant this morning in Melbourne is Jacoby Consulting Group Pty Ltd. Welcome to the hearings. Could I ask you please to give your name and your position.

DR JACOBY (JCG): My name is Jack Jacoby. I'm the managing director of Jacoby Consulting Group.

MR BANKS: Good. Thanks very much for attending and thank you also for your indulgence, given the delayed opening of these hearings this morning. We appreciate that. As discussed, we will give you the opportunity to make some of the main points in your submission and then we will have some discussion.

DR JACOBY (JCG): Thank you, Mr Chairman and gentlemen. Thank you for the opportunity to address the commission. My submission is very much focused on term of reference 4 which is the relationship between the corporation, its directors and management and the shareholders. I don't know if I need to go over my background because that's appended to the submissions so I won't bore you with that, but having consulted to corporations for over 25, nearly 30 years, I have had the opportunity of gaining some valuable and pointed insights from shareholders' perspective, from board perspectives, from executive and executive team perspectives.

In a nutshell, I'm pretty appalled at what I've seen, and let me say at the outset that my observation is that management and boards generally attempt to do the right thing by the organisation and by their shareholders. Having said that, I have had the honour or otherwise of coming across many managers who, despite their good intent, have not been good managers. I have experienced the same with directors, and the directions that some corporations have taken have not served shareholders well.

What has astounded me has been really the power of managerial subjectivity, not only in the way that it dictates the outcomes of corporations and it dictates the way corporations perform, but in the way that they understand their brief and the way they attempt to align corporate outcomes with shareholder expectations.

Another conclusion is that generally speaking, shareholders are fairly powerless to affect their investment and anybody who is an observer of corporations would probably come to a similar conclusion. Generally speaking, it is my view that management, particularly middle level management where a lot of important decisions are made, are oblivious to shareholder issues. They are certainly oblivious to what shareholders of their own corporations require and therefore their operational decisions are not focused on those sorts of expectations or requirements. If one has a look at the financial collapses of the 1980s and 1990s, certainly underscored by the current situation, one would recognise that there are some fundamental issues that exist between the corporation and its shareholders and they need to be rectified.

It is for those reasons that I took an interest in the area and felt was there a better way to align the corporation to shareholder expectations and hence my research. If one was to surmise that research, one would have to say that the issue of executive remuneration, as important as it is, and it is important, is merely a symptom of a much bigger problem and the problem is the way the corporation aligns to its shareholders. If executive remuneration is seen as costing shareholders maybe tens of millions of dollars, maybe hundreds of millions of dollars, then the poor performances that I've observed over the years must have cost shareholders hundreds of billions of dollars and if you factor in the current situation, maybe even more.

It's my view that unless you rectify the core problem, executive remuneration changes will never achieve much to protect shareholder interests. That's why I've focused on term of reference 4 which interestingly was also the topic of my doctoral research. As long as directors and managers are free to define the outcome of the organisation they manage, then shareholders will nearly always come off second or third or fourth best. Managers decide the projects, the initiatives, the markets, the philosophies and the core remuneration policy and these decisions commit the organisation to costs and to very significant risk and it's cost and risk that is inevitably borne by the shareholders and not the managers who incur the cost or incur the risk. More relevant still in my opinion is that managers determine the performance criteria against which they are assessed and by which they are rewarded. This pretty much stems from the philosophy that because of the legal status of the corporation that says that the corporation is a separate entity from its owners and therefore managers have the right and duty, as they perceive, it to dictate the direction and the outcomes of that corporation, which creates some problems. These problems relate to managers being affected by their subjectivity, determining outcomes for the organisation, not that the shareholders deserve but which they, the managers, can achieve. And that's a problem.

Instead, directors and managers must understand that despite the legal status of the corporation, they are nevertheless agents of the owners and they're not the owners themselves. They have to ensure that the effort toward optimisation of shareholder objectives is their job and that's what they are paid to do, and that's the fundamental purpose of the corporation. Only by knowing its shareholder objectives - and when I say that, I mean its metrics, on the criteria of value, benefit, growth and risk - can an organisation align its activities towards their fulfilment. Corporations currently make assumptions about their shareholder objectives which, my research has shown, are demonstrably, logically and intuitively wrong.

These assumptions form the basis of performance management and therefore the basis of remuneration. To give you some examples of some of these erroneous assumptions, the research found that all shareholders do not have the same objectives. A shareholder may have different objectives for different investments. Institutions are not a proxy for small investors. If you ask shareholders about the criteria of value, benefit, growth and risk, you get a distribution; it may be skewed to the right, it may be skewed to the left, it may be peaked or it may be flat, but it's a distribution and that is real and it exists. The problem is that management assumes it knows what those shareholders want and they act on those assumptions but they don't know without asking. My research has demonstrated that no-one asks.

A great example was the chairman of a bank, which I won't name, which was part of the research - as you know, I research the banking industry - I asked him, "What do your shareholders want?" and he said, "Our shareholders only want dividend." I said, "What do the shareholders of your competition want?" "Everybody in this industry only wants dividend." I showed him the metrics that came out of the research. He immediately sent me to his CFO and the CFO said, "This is all very interesting but we've just determined the metrics that we're chasing." I asked, "What's that?" and he said, "EVA." I asked, "Who determined EVA?" "Management." I can tell you now, no shareholder is interested in EVA *per se*. They're interested in the benefits that EVA may deliver. That raises the issue of corporations who chase the enabler instead of chasing the outcome, the core objective.

Another key finding of the research was that really, shareholders can't run the corporations that they invest in but they can and should define its outcomes. That is a board-interpreted shareholding metric based on value, benefit, growth and risk and those metrics become the corporation's mission. When that happens, all of a sudden you have a set of performance metrics that management can be assessed against and can be rewarded for if they achieve them.

If one rejects this “Social Entity” view of corporations, the alternative is the “Property view”. The property view is that the corporation is owned by its owners and everything that the corporation does must deliver that which the owners want. That's got implications for things like stakeholder theory and the relationship of the corporation to the community, staff and everybody else for that matter which I'll get to a little later. But some of the benefits that a property view had is that it enables a rational reward system to be embedded in a corporation that doesn't generate conflict between agents of the owners and the owners. It means that a staff member, an executive member, an executive manager or a CEO will be rewarded for delivering shareholder satisfaction as distinct from chasing some enablers, whatever they may be, that may conflict with what the owners of the corporation want.

So that brings me to the two core recommendations of the research. The first one is that all listed companies should publish their shareholder metrics in their annual reports. Secondly that the government should facilitate or encourage the establishment of a Shareholder or Owner Accreditation certification that would see listed companies seek accreditation against four sequential levels. The first level would acknowledge that they have understood their shareholder metrics. The second level would acknowledge that they have embedded those metrics in the corporate mission as interpreted by the board. That's really important.

The third level would ensure that the corporation has embedded those metrics in the planning methodology. If I do anything in corporations, it's corporate planning, visioning and so on and so forth and the number of corporations who have a flawed planning methodology which has been extensively outlined in the submission, and that flawed methodology dictates the outcomes of the corporation or misdirects those outcomes is astounding, absolutely astounding. Fundamentally, an owner-accredited planning methodology would be top down, not bottom up, a fundamental difference to a lot of what goes on at the moment.

The fourth level of accreditation would attest that the corporation has actually delivered the shareholder metrics. An organisation that is fully certified offers existing shareholders greater certainty, potential investors and bankers lower risk, and it also provides management with clarity and eliminates ambiguity regarding shareholder satisfaction. It therefore makes the management process much easier. It also has other spin-off benefits. It improves the planning system. If something that has been proposed doesn't contribute to core metrics, stop doing it, simple. It provides a significant control over managerial subjectivity. It encourages a rational performance management system that's based on shareholder metrics, not based on subjective managerial judgment.

One of the issues here - take the banking industry, any other industry for that matter - the performance of a corporation is often assessed by a group of metrics and where one corporation is compared to another in the industry. So, for example, let's say in a particular industry ROI was the metric, so it's considered that the corporation with the best ROI is the best corporation in that industry and the CEO and the executive are the best CEO and executive. But what happens if that ROI was achieved on high risk and high gearing when its shareholders were risk averse? Is that CEO still the best CEO? I would put to you no. I would put to you that in light of the research findings that the shareholder metrics for every corporation is pivotal and the only way to measure the performance of a corporation is its ability to deliver its shareholder metrics. Otherwise you're assessing, as an example, a corporation with low growth potential when in fact it's trying to maximise dividend because that's what its shareholders want. That's not a legitimate evaluation of that company's performance.

A property view also improves resource management because it saves resources and costs that are misapplied to things that don't matter. It facilitates the rejection of a whole lot of guru theories, eg the TQM, sustain competitive advantage, we need to be the biggest, we need to be the best, we need to innovate, all of those things as tools and techniques are legitimate in context. Out of context, they can harm shareholders. Lastly, it helps contextualise stakeholder issues.

It's my view that no corporation exists for its stakeholders, it exists for its shareholders. However, its stakeholders need to be managed. It is like comparing a sedan and a log-carrying truck. Both are legitimate vehicles that are fit for purpose but you can't change the purpose. You can't carry logs in a sedan and you can't carry lot of passengers in a semi. They are fit for purpose. A corporation is a wealth-generating entity and the moment you ask it to change its focus to something else such as, "We are here to improve society," not that I'm against improving society or "We are here to be the vanguards of environmentalism," not that I am against environmentalism, "We're here to change society," then you've got a problem. You're changing the fundamental essence of the corporation from that which it was established to deliver to something else. The losers will be both, the society who it's meant to help because it's not focused for that, and shareholders who invest their funds in good faith for the generation of wealth.

So it's my view that if society wishes that corporations take on a change agent responsibility in society, okay, legislate for it; make every corporation play on a level playing field. Because, if you don't, then managerial subjectivity will hurt shareholders. Put it on a level playing field, that's fine, whatever it has to be. But if you don't legislate, don't impede corporations doing that which they are established to do. In relation to remuneration, and the challenge I suppose for this commission, is that remuneration rewards must be fair and reasonable for the effort applied to achieve required outcomes and shouldn't, within reason, stifle personal ambition, motivation or free enterprise. And that's the challenge, I suppose.

Provided the organisation is aligned to its shareholders and shareholders have approved the remuneration policy and structure, then the board should be able to pay executives whatever it takes, within reason, to deliver the required outcomes. But the board must be held accountable to its shareholders for those decisions. Furthermore, any major attempt to interfere with the free market has got the potential to cause major corporate disruption, anomalies, distortions and manipulations. I am very sympathetic to some of the submissions that have suggested executive remuneration should be limited to a multiple of average, or the lowest, or whatever it is.

You can't help but sympathise with that. But what is going to happen? Firstly, one has to recognise that context dictates value. So if shareholders consider the job harder to deliver their objectives, they're going to be prepared to pay more. If the corporation is in a position where the turnaround, the improvement or the attainment of outcomes is more difficult in context, the shareholders are prepared to pay more. If you limit to a multiple, then you've really constrained the organisation from doing what it needs to do.

From what I have seen, notwithstanding my opening comments that generally the vast numbers directors and managers attempt to do the right thing, if you limit the corporation to a particular multiple, then what is going to happen; managers will restructure the corporations. So if you've got a diversified corporation where the lowest division will determine the remuneration of the top end, then they'll just divest the low end off. It will still be 100 per cent owned by the corporation and it will change the algorithm, and the shareholders may suffer in the interim. So it's not a particularly effective way to control remuneration.

In relation to bonuses, reasonable bonuses to reward executives for exceptional performance are okay, in my view, provided the organisation is aligned to the shareholders' benefit and the bonus is only based on exceeding shareholder metrics and not for any other measure, particularly any management-derived goal or indicator or enabler, such as, "Did we get TQM or innovation?" or some product concoction that we see rife in the financial industry. It's all about the difference between pursuing the KPO versus pursuing the KPI, pursuing the objective instead of pursuing the enabler; and particularly fraught in that is when the enabler is defined by management themselves, and that's what happens, nobody else defines it.

The role of directors is to interpret its shareholder metrics, and to set corporate objectives, that is the corporation's mission; therefore, to set performance criteria against which management will be rewarded. It is not practical or reasonable for shareholders to approve executive remuneration except through the approval of a remuneration structure or philosophy that is applied and enforced by the board and for which the board is held responsible.

In relation to corporation governance disciplines, they're not going to ensure shareholder satisfaction, in the same way the quality accreditation won't stop a disastrous product from being developed. Both are important, but both are merely processes and don't affect the core issue, which is – what is the outcome that is required of the corporation. The corporation’s board must be able to modify remuneration arrangements under certain circumstances, and those circumstances or the triggers for such reviews should be identified and embedded in all employment agreements; and such things might be major economic change, natural calamity, acquisitions, divestitures , takeovers, and so on.

In relation to golden parachutes, they should be constrained, if not totally banned. If a parachute blocks an initiative that benefits shareholders, such as sale or divestiture, then the parachute should be deemed as voided. Shareholders should not be constrained from dealing their asset, providing it's legal and it's within regulation. Finally, in relation to bonuses, or the holding of bonuses; if a corporation is aligned to its shareholders metrics and the bonuses have been earned in exceeding those metrics, then bonuses shouldn't be held. On the other hand, if the corporation is not aligned to its shareholder metrics - that is, it's not owner-accredited - then holding bonuses in trust for a period is a really good idea and should be considered. If an executive really wants immediate gains, then he has to align to a shareholder-centric view of the corporation and help deliver those benefits; therefore, it's a win-win.

So finally, gentlemen, in summary, if one doesn't fix and realign the relationship between the corporation and its shareholders, in my view, then tweaking executive remuneration will make little difference to business owners in the long run and may even harm them. Thank you.

MR BANKS: Good. Thank you very much for that. I think there's plenty of food for thought in there. We have had a number of participants talking about this question of alignment and what constitutes a shareholder, and indeed the heterogeneity of the shareholder group, and I think you have referred to that yourself. So you have some shareholders which are big institution shareholders, others retail, some take a long view, some take a short view, indeed some may decide to sell their shares after a few months, and so on. So how, in your schema, does management ensure that its metrics are aligned appropriately with the shareholder group, given that diversity and given that that's a changing group over time?

DR JACOBY (JCG): That's absolutely true, and you will find that the extent of change isn't as great as maybe the 5 or 10 per cent that may trade the stock for short-term gain. My view is that 10 or 20 or slightly more per cent of those who trade the stock for short-term gain does not invalidate the requirements of the organisation to deliver to its shareholder that which they want. The short-term traders will be represented in the distribution, the shareholder metrics distribution; you get a bell-shaped curve.

It is up to the board to interpret that curve in the context of the corporation, its industry, its strengths, its financial position, its competitors, its supply lines, its distribution structure. That there's a distribution curve is fact, that's what represents that diversity of shareholders, that's real. The problem that occurs is that management makes a decision oblivious to what that curve is, oblivious to how many shareholders it will satisfy and how many it will disenfranchise.

What it argues is that, because there's a diversity in interest, it means we don't have to ask the shareholders. It means that what they want out of their investment is invalidated for the sake of what we're prepared to give them. I reject that. There's no reason why a corporation can't ask its shareholders. Let me add, they do ask shareholders, but they only ask institutions, and they assume that the institutions are a legitimate proxy for everybody. My research shows that's false; they aren't. So I don't see that as a problem. It is a reality, and it's a reality that exists at the moment.

MR BANKS: So management looks at bell curve and makes some judgments, presumably that are pretty close to the top of the bell, or the average. How then does it legitimate those metrics that it has come to a judgment about, based on these surveys? Does it have to go back and then see a vote from shareholders generally?

DR JACOBY (JCG): No. That's what you pay the directors to do. You get a bell-shaped distribution, and it's not necessarily the peak that will drive the corporation, it's the context as determined by the Board. A great example I think was the last 80s when the market was paying 20-odd per cent interest, or whatever the number was, and shareholders had an expectation in the 20 per cent range. That was the expectation, it doesn't mean that it was rooted in the realities of industry at the time, because industry, after they had come off that interest curve, were living a different reality. So it raises a few issues.

If shareholders have an unrealistic expectation, let's say on dividend, then doesn't the corporation have a job of communication to explain to the shareholders what their context is? The flipside is that when you have a set of metrics that represent a corporation's shareholders, then intending investors have a better idea of what the corporation is chasing, so I, as an investor, am going to look for those metrics that best reflect my objectives. So if a corporation has a set of metrics that skew toward long-term return and my personal agenda is short-term return, then I'm going to stay away from those portfolios that are focused and the corporations accredited to deliver long-term return, because it doesn't serve me.

So the bell-shaped curve, the fundamental metrics of the corporation, are really important. The emphasis here is knowing what the shareholders want but paying boards and management to interpret those objectives, in terms of their context, and deliver the metrics as best they can. At the moment they deliver the metrics that they think they want to deliver. Sometimes that's delivered by industry ratios. Sometimes when they don't take their bearing from industries, they do it, because that's what they feel like doing.

If you have a look at bottom-up planning methodologies, the bottom-up planning methodology, "You're going to get whatever we're able to give you," and that's based on a mainly resource-based view of a corporation, "We can give you that which is a product of our resources, our plant, or equipment, our staff. So we'll give you what we can, and you have to be happy with that." If you do a top-down, it's the board that says, "Well, these are the metrics. The organisation can only deliver a part of that. How else or what else do we need to do to bridge the gap?" That's the responsibility of the board and that's not what happens at the moment.

MR BANKS: But trying to narrow it back to the remuneration issue, why do you not believe that the non-binding vote is a signal by shareholders of whether they are satisfied or otherwise. I mean, you make the point that the large investor shareholders dominate, but in fact if you take a property rights view of it, which you have, the majority should in fact hold sway, because it's an equal entitlement; those that hold most shares should have the most say, and that would be fundamental to that right.

But more importantly, some would say the non-binding vote is in fact a way by which shareholders can signal their satisfaction or dissatisfaction, not only with the remuneration package but as almost a proxy for the governance of the organisation generally, together with the ability, albeit limited, to be able to remove directors, and so on. So the non-binding vote, which is just about to be introduced into America, may in fact achieve much of what you're trying to do by a much more complex method.

DR JACOBY (JCG): There are a few issues in that. The fact that it's a non-binding vote says something in itself. The other thing is, what are they voting on. They are voting on a remuneration that has occurred and been applied - that is, executives are being paid on the basis of assumptions that are ill-founded; that has not changed, not for a second. If you realign the corporation with what the shareholders want and the shareholders agree the remuneration strategy and policy and principles, then its up to the board to deliver it. You won't need that sort of vote, except as a result of an independent audit, which currently exists, that the remuneration policy has been adhered to.

PROF FELS: First of all, just on the metrics, I just wondered if you could give us a more specific idea of what a metric might be, take a bank, or something like that, what kind of metric do you think might emerge? What would be the variables in it?

DR JACOBY (JCG): Well, again it's value, benefit, growth and risk. How do the shareholders determine value? What is it that they value? Is it share price? Is it market cap? Share price is a produce of market cap of course. Or is it some other measure? Benefit, how do they want to get their benefit? A great example was the Coles shareholder discount scheme and the furore that occurred when they withdrew it. A lot of those shareholders became shareholders by virtue of the way the benefit was going to be delivered.

So if shareholders say that - "We want our benefit in the form of dividend," or "We want a capital benefit through share price," who is the organisation to say that that's not the way that they should deliver? Shouldn't the organisation know that if they make a policy decision in one direction that it's actually going to disenfranchise a significant number, if not most, of the shareholders. The knowledge is the issue. Growth, what it is it that the shareholders want to see grow? A growth in market cap, asset-backing, is different to a growth in dividend. They're different strategies, different policies, different corporate decisions, different ways that you align your resources, different tools you use. They're fundamental issues.

As a consultant, I see it every day. My question to the boards that I deal with is, "Well, okay, you've got a mission statement that says X, Y and Z. You want to be a quality organisation. Do you really want to be the best in the world or do you want to get the benefits of being the best in the world? What is it that you're pursuing? You know the old adage, you engender the behaviour you measure. Well, measure the shareholder metrics, because, if you don't, you're going to get something else." My research demonstrates it, to me anyway, and to a few others, that the assumptions upon which governance is undertaken at the moment, the assumptions upon which operational decisions are made by corporations, are ill-founded; not all of them, but a lot of them.

PROF FELS: Look, the only other question I had was about your proposed independent owner accreditation body that certifies corporations. Do you want to just talk a little bit about that; I mean, how it would be constituted and how it would be assessing the corporations, at what level.

DR JACOBY (JCG): It really depends on what role government would like to take, if any. I see it as an independent body. I see it much aligned and very similar to quality accreditation, where corporations would see an advantage in being accredited because of the attractiveness for investors, and it would provide a lower cost of capital because banks would see an accredited corporation as one offering lower risk. The accreditation body might undertake accreditation services to corporations directly on a fee-for-service basis or it may licence the Peat Marwicks of the world and Ernst and Youngs of the world to do exactly that. To accredit it, they take consulting revenues, the corporation gets accredited, and then re-accredited after a number of years; it's a very simple model.

But really I think it needs to be underpinned by the message that says that the property view prevails. The social entity view is a real problem and it's why a lot of the issues relating to regulation need to be instituted, because of the social entity view, because you can't allow a corporation to determine its own entity while it uses shareholder funds. If it was a private organisation, go for your life. But it's not a private organisation, they're using investor funds; and the social entity view has got too many problems with it to allow it go around unfettered, that's why you've got regulation. The property view is much less complicated.

PROF FELS: Okay. That's not a bad note to end on. So thanks very much. We will just break for a moment before our next participants. Thank you.

DR JACOBY (JCG): Thanks very much.

MR BANKS: The next participant this morning is Ian Hundley. Welcome to the hearings. Could you perhaps just indicate the capacity in which you're here today, please.

MR HUNDLEY: I'm here in a private capacity, making a submission on my own behalf, Mr Chairman. I've been an observer of labour markets for a few years.

MR BANKS: Good. Well, you're very welcome, and thank you for the submission that you've made and taking the time to appear today. As discussed, why don't you make your main points and we will have some questions after that.

MR HUNDLEY: Thanks very much, Mr Chairman. I just want to expand on a few of the points that I made in my written submission. It appears that the blow-out in executive remuneration was most significant in the finance sector, however, it clearly came to affect all corporate sectors and the non-corporate world as well, not least for its contribution to the global financial crash. It may be that some of these effects are not that well understood. As I noted in my earlier submission the concept of comparative wage justice has been squeezed from wage fixation for most Australian workers. However, it appears to be alive and still in good health for higher income groups, including corporate executives.

As a chief executive, it will not do to get paid significantly less, even if very generously, compared with the chief executive of another company and unlike most other workers these days; as a senior executive it appears that you have been able to do something about satisfying this sense of grievance. There are self-evidently issues of market failure at work here in the setting of executive remuneration. It will be no easy task for this inquiry to work out what to do about it. People with accumulated privileges in this society are often successful in protecting them. However, the potential cost of not doing something effective is likely to be fairly high. What strikes me about the pay arrangements for senior corporate executives is their contrite complexity with base pay, short-term and long-term performance pay and incomprehensible but frequently extravagant severance payments. This confected complexity actually provides legitimacy for these arrangements that they would not otherwise enjoy.

Before I came here today I looked more or less at random at annual reports of three listed public companies, 11 and a half pages of the CSL 2008 report were devoted to the remuneration report of senior executives. Two pages covered the other 9000 employees and only 10 pages reported on the business. 18 pages of the 2008 NAB annual report were devoted to executive remuneration and 16 pages in the Origin Energy annual report and similarly reletively sparse reporting on the businesses themselves. Whatever this inquiry recommends, simplicity of approach in the setting of remuneration should be the essence. For all the good that they do, I would recommend that these reporting requirements be abolished and that they be replaced by a single chart which shows the income distribution for all wage and salary earners in the company. Individualised or merit based performance pay systems were relatively unknown in Australian workplace practice until relatively recently but they were at the centre in the setting of executive remuneration.

There can be only one underlying justification for performance pay systems. They should result in superior organisational performance. However, there is little evidence to support the contention in my view. There are, however, many things that we know for certain about the negative aspects of performance pay systems, these include: they are expensive to run and they thrive on political gamesmanship, they create fear in the workplace and they underwrite and undermine intrinsic rewards to be gained from workforce participation. Performance assessment can be viewed as an important part of the employment relationship but when remuneration outcomes are attached to it the results are often too toxic for it to be worthwhile for the organisation.

It has been argued that giving shareholders a more direct say in decisions on senior executive appointments and remuneration would help a lot. I don't see that myself. This makes no more sense than stockholders negotiating the salary package of other employees or the introduction of a new computer system or the supply of paper. It is important, however, that the onus be put on directors to behave responsibly and in an highly informed manner. I agree that we should be considering how to properly incentivise performance through performance management systems. However, we should be getting individualised performance pay out of the system altogether and replacing it with a simple rate for the job subject to review from time to time.

There are many adverse knock-on effects from performance pay systems for executives which have become more fashionable over the years. The most obvious of these relate to the organisation itself. Whilst the complexity of performance pay systems masks the self-serving exploitation which has often been the lot of the senior executive, it is often used at the other end of the labour market to at best extract compliance and, in other cases, to knock employees around. Emerging evidence of low employee commitment and the increased incidence of workplace bullying are relevant measures.

Firms are supposed to be greater than the sum of their parts, that is why production is organised through firms. Teamwork is the key and in a world in which people are more alike than unalike, artificial efforts to ascribe substantial differentials in individual performance where they do not really exist, inevitably affect the performance of the business as a whole.

Performance based systems have also spread like a virus through the public sector in Australia, Commonwealth, state and local. There is no evidence it has contributed to improved organisational performance, nor for that matter is it obvious that those organisations perform so much worse than their corporate counterparts because their senior managements are paid so much less. However, in an environment where measures of output are relatively nebulous, not being measurable in terms of profitability or even realistically measurable at all in some cases, individualised performance process can lead even more readily to dysfunctional behaviour in most public sector organisations. Things have reached such a silly stage that some state educational agencies are contemplating the introduction of performance based systems for teachers. It would be good if the Commission had something to say about that.

It is interesting to also consider how there might be knock-on effects from the executive remuneration rollercoaster among other professional groups who both believe that they are the social equals of corporate executives and also able to exercise discretion in what they charge for their labour. High level legal practitioners, accountants and medical practitioners would be in this group. The fact that many in these professions derive their income either directly or indirectly from the public purse suggests that the breadth of influence of this inquiry could actually be quite wide.

Pattern bargaining, as normally understood, involves a union winning a superior deal from one employer and then campaigning for the matching of these conditions by other employers. In recent years governments have placed barriers in the way of pattern bargaining for most of the workforce. The inquiry might consider recommending a form of what I call reverse pattern bargaining for senior executives. Accordingly, employers would be required to demonstrate that they have attracted a substantial field of potential candidates for senior appointment and to have exercised downward pressure on the remuneration package as a consequence.

The institutional arrangements for executive search which have been established over several years are based on the proposition that a third party knows better than the business itself what it is looking for in a senior executive and how much it should pay. This is an unlikely proposition. I can only suggest that firms have been willing captives of these processes because they give them somewhere to hide if things go awry. It provides an alibi because everyone else is doing it. It also provides the conditions for successful rent seeking by appointed executives.

In conclusion I hope that we have just about got to the end of this particular or peculiar managerial culture and that it will very soon implode. In a few years we might be able to look back upon the current arrangements for setting executive remuneration as an unfortunate fad which took hold and caused significant damage. It would be good if this inquiry gave it a hefty nudge over the edge. Thank you, Mr Chairman.

MR BANKS: Thank you for that. I guess the main thrust of your submission relates to performance pay. Is your concern primarily about the incentives or what it's doing to incentives or about the quantum that it's delivered and, therefore, if you had a system in which one way or another performance pay was excised from the system, what would that mean for the quantum?

MR HUNDLEY: I think as a starting point, Mr Chairman, I would argue that regular performance pay assessments that are quite typical now are unnecessary to actually attract the performance that businesses are actually requiring. I don't think they make any difference. There may in fact be dysfunctional aspects to it which has been reflected in the literature in relation to short-term behaviour, for example.

MR BANKS: So you could remove short-term incentives, long-term incentives and go back to the base pays. That would be a two-thirds reduction in remuneration and it would have no effect?

MR HUNDLEY: I'm not particularly talking about the quantum reduction, I am talking about the way the pay package is structured. In my view if it was basically based on a figure which was adjusted from time to time by the company based on regular performance reviews perhaps rather than a regular assessment of bonuses, both short term and long term. It would be certainly a much simpler approach and I think one that wouldn't have the dysfunction built into it that the current system has.

PROF FELS: So you are saying systems of bonuses and so on do have behavioural effects, it's just that they're bad behavioural effects or they're not worth having?

MR HUNDLEY: Broadly, yes, they're negative effects. My general view would be that senior executive performance hasn't been elevated as a consequence of the introduction of these systems. If anything it would be the opposite. I take that as being the case across the workforce generally and not just for senior executives and directors.

MR BANKS: There are cases where the incentives - and obviously people respond to incentives - have encouraged the wrong behaviour. What evidence do you have to suggest that that is the norm rather than being an aberration?

MR HUNDLEY: I guess I make a general observation that company performance hasn't really improved all that much since the introduction of these sorts of systems.

PROF FELS: The argument is that there is a correlation between the two for most of the last nine or 10 years. We are constantly hearing that from submitters. Whether we accept that or not, do you have a view on that? Company profits until recently rose sharply, executive pay rose sharply. Is there a connection or not and which way does the connection go?

MR HUNDLEY: It may be a correlation but it may not be cause and effect. It appears to me that most have risen in the last 10 years up until, say, 18 months ago on a good range of measures, some of which have probably got relatively little to do with the actual performance of people within firms, stock market price rises, for example, I think is a particularly inappropriate way of assessing the performance of firms when everything is going up. But my general view is that there is a substantial amount of rent seeking going on here, as I said at the outset, and the general level of senior executive remuneration could be brought much further back to the field without any adverse effect on performance. In fact it arguably could be improved, effects on performance, given the knock-on effects for the rest of the organisation and more broadly for society as a whole.

MR FITZGERALD: One of the issues, however, is that investor groups particularly have been encouraging both in their guidelines and in their submissions to this inquiry to in fact ensure that the base rate of pay is not as high a percentage and that in fact their view, as investors, as owners is that more needs to be put into the long-term incentive area. Yours go contrary to that entirely. So when the shareholders, the alleged owners of the companies want in fact greater long-term incentives your proposal would in fact go contrary to their wishes as put during this inquiry.

MR HUNDLEY: I think that's precisely right, I do have a contrary view. I have that view not only in relation to executives, but for most workforce participants. I don't really make all that much of a distinction for what drives executives in that regard than I do for general workforce participation.

MR BANKS: Thank you very much for making your submission and attending today. We will just break for a moment before our next participant. Thank you.

MR BANKS: Our next participant today is Stephen Mayne. Welcome to the hearings. Could I ask you just to indicate the capacity in which you are here today.

MR MAYNE: I'm a shareholder activist.

MR BANKS: That sounds quite relevant to our proceedings. So, as indicated, we will give you the opportunity to go through the main points you want to make.

MR MAYNE: As you know, you've got my little two-pager which I submitted. I've got a two-page supplementary I would like to take you through for a couple of key points responding to some of the submissions. The executives who keep on complaining that the estimates of their share-based pay is overstated in the current market, that may be correct but for most of the last three to five years it was understated to the tune of several hundred million dollars at any point in time and the one specific example I would like to draw you to, which was also the one occasion I raised at valuation of equity incentives at an AGM, was the 2006 Babcock and Brown AGM where the auditor and the board had valued 800,000 $5 options - and this is on page 3 of your supplementary, I have actually extracted the Babcock and Brown annual report - at 1.17 million when at the time the share price was north of $20 and the valuation should have been closer to 10 or 15 million.

So rather than the CEO, Phil Green, having his pay estimated in 2005 at 12.3 million, it should have been around 25 million if you had been doing an appraisal of the valuation based on the current market price. Given that Babcock, I think, is the largest disaster in Australian corporate history with more than 10 billion lost, including all their listed funds, the executives hoofed out the door with a couple of hundred million in cash, it's just an example - now these options are valueless, now, but at the time that particular annual report it was understated 10 to 15 million. I got up and asked the auditor and said, "Isn't this fundamentally inaccurate?" and he just said, "It applies with accounting standards," and blah blah blah.

So I agree with the argument we should go with received value from incentives and we should update it each year. So we should say, "Over the years we've said this, but now based on the current share price the actual incentives received over the years are this," and it just gives you a more accurate figure. I was at dinner last night with a former chair of a top 150 company remuneration committee who said, "I still don't understand Black-Schole." I don't understand it, I rarely take the valuations of the incentives to be meaningful. Poor old Sol Trujillo, his pay wasn't 13 million last year, it was eight million. He didn't get five million because the long-term incentives were worthless and he got zero. So it does distort the public debate because the figures are a snapshot in time, the accounting process Black-Schole is contentious and the market movements render the figures meaningless in short periods of time.

My second supplementary claims that proxy advisers have too much power, particularly Charles Macek's recommendation, the chairman of the Telstra remuneration committee, that proxy advisers be banned on voting on remuneration reports. I think that is frankly self-serving pap, Telstra having had their rem report voted down courtesy of proxy advisers recommending against it. As a whole I think proxy advisers have been a force for good in Australia but I also think that they do have extraordinary power. RiskMetrics in particular does seem to have quite a donkey vote where if they say, "Vote this way," the institutions tend to do that. The best example of that is that I have run for 35 public company boards, my average vote is 15 per cent in favour, the one time RiskMetrics recommended in favour of me was Centro Retail last year and suddenly I got 70 per cent of the non-Centro vote in favour and I was the same candidate who was only worth 15 per cent everywhere else. The only difference was RiskMetrics' recommendation, and the institutions did tend to slavishly follow that recommendation.

My opinion is it's okay if overall I think they're getting it right, but it is an enormous amount of power given the donkey vote that follows that. I sometimes criticise them such as the recent Westfield remuneration report where RiskMetrics, in my view, had delivered the against votes at Boral, Transurban and Wesfarmers, which were three of the most noticeable defeats last year. We get to Westfield this year, Frank Lowy's salary has gone from 15.8 million to 16.2 million over the odds. Everyone else is cutting back. Macquarie's CEO down from 28 million to 300,000. RiskMetrics said, "We support voting in favour of the Westfield remuneration report," 93 per cent in favour. So I just felt they lost their spine on that one but overall they tend to get it right and it is an incredible donkey vote that the institutions tend to follow their advice.

Remuneration consultants, I agree when they're hired directly by CEOs, certainly is a conflict of interest and I still remember back to the press conference when AMP demutualised and the chairman, Ian Burgess said, "I'll let George Trumbull explain his remuneration package," and then George got up, the CEO, and explained why a million free shares for him was fine and that was worth 15, 20 million at the time and the remuneration consultant concerned who said this was just fine was John Egan. 10 years later he is still the most prominent, often used remuneration consultant. I still sort of say, "Where is the accountability?" Most of the AMP directors have gone from that whole disaster and debacle with George Trumbull, the rem consultant who endorsed the most outrageous gift of shares I have ever seen, still is the number 1 rem consultant in Australia today.

My key message is that at the end of the day the most important thing for governance and for controlling and monitoring executive pay in Australia is the appointment of directors. The directors will set the policies and should be accountable. We are seeing the system work well in terms of remuneration reporting and voting against remuneration reports but the system is not working well in terms of voting against directors. On page 2 of my update today, I have listed the 13 times since 2006 that a remuneration report of an ASX 200 company has achieved an against vote of more than 40 per cent and I've ranked them from the top. So it starts with Valad, 76 per cent against, and I've contrasted that with, at the same AGM, what was the least most popular director's vote. So if the shareholders have got a problem with the remuneration report, they should also in my view have a problem with the directors because they accept the remuneration policies which they are so unhappy about. If you go through it, there is not a correlation.

If you look at Boral, 58 per cent against the remuneration report; least popular director, Paul Rayner, 99.5 per cent in favour. Wesfarmers, 50 per cent against remuneration report, least popular director, new chairman, Bob Avery, 99.5 per cent in favour, and on it goes. So the directors averaged 96 per cent and the system is not dealing with voting against directors. I think it's directors who let pay get out of hand, knew that they would be voted off the board or something could happen to them; it would strengthen their arm in terms of negotiating with greedy CEOs to say, "Hang on, mate, I can't give you a $10 million bonus because I'll lose my seat next year if I do that," but at the moment; very, very rare for directors to be voted against.

In terms of fixing up corporate voting, there's a couple of sort of key rorts in the director election system which I would like to draw your attention to. The first one is called the no-vacancy rort, which is where a board in their constitution can declare that any number they like is the maximum number of directors. So a good example is West Australian Newspapers. I ran for their board in 2007. They only had four directors. It was the smallest board in the ASX 100. But they came out and still said, "Sorry, Mr Mayne, there's no vacancy," because their constitution says they can pick any number they like. It says, "Minimum 3; maximum 11, or any number we like." So they always do that. The effect of that is that to get elected, a simple majority of 50 per cent is not good enough. You have to knock off one of the incumbent directors to get elected.

Now, when your average incumbent director gets 96 per cent of the vote, it makes it pretty difficult for a challenger to knock off an incumbent director. Then when you twin that with the other major rort of the corporate voting system known as the undirected proxies, which is where someone who just signs the form and sends it back automatically defaults their vote to the chairman. The equivalent of this in political terms would be someone walking in to the federal election and saying, "Yes, I'm on the roll," and putting an empty ballot in the ballot box. That's an automatic vote for John Howard because he's the incumbent. That would be the equivalent. In politics it would be an outrage; it is an outrage in corporate elections. It averages about 10 per cent of the vote.

So when you combined those two rorts, the first being the no-vacancy rate, the second being the 10 per cent average undirected proxies that finish up in the back pocket of the chairman, I've listed for you there on page 1 of the supplementary the 17 times in my board tilts - and I've run for 35 - 17 times where 100 per cent of the directed proxies in favour of me would not have been enough to succeed because the size of the undirected proxies that the chairman would then use against you in a poll was big enough to reduce your vote down to below what the least popular director got. What I've listed there for you is the AGM, the year and what my vote would have been with 100 per cent of directed proxies in favour, offset by the chairman voting the undirected proxies against. The fact that on 17 occasions 100 per cent of directed proxies in favour would not be enough to succeed says you have a gerrymandered system which is tilted in favour of the incumbents and that directly takes away from shareholders being able to hold directors to account and remove directors who are not performing.

PROF FELS: So on your first example, NRMA, the 45.07 refers to - - -

MR MAYNE: What happened there was Nick Whitlam said, "Don't vote in favour of all four candidates because your vote will be invalid. Only vote in favour of three candidates," so most of the shareholders voted in favour of three and left mine blank. Nick then grabbed them and said, "I'll take those as undirected proxies," so he managed to come up with 55 per cent of the total vote as undirected proxies in his hand and so even if I got a hundred per cent in favour, he would have used 55 per cent of all votes as undirecteds and he would have got me down to 45 per cent and I would have lost by the length of the straight because the least popular director was 95, 96 per cent that year.

MR BANKS: Have you recommended a solution to that because you've also got a recommendation about CEOs facing elections as well.

MR MAYNE: Being up for election. I think a simple solution would be - it's either the listing rules or the Corporations Law which says that a public company must have a minimum of three directors. I think you could just extend that by saying it must have a minimum of three and a maximum of 15 or pick some figure and then you don't allow constitutions to say "or any figure the board wants". Board size is a matter for the shareholders. If the shareholders want to add one, two or three new directors, they should be able to do that. To Telstra's credit, under the Howard government, every time there was a contested election at Telstra - and I've run three times, you've had Melbourne Cup fields there - they always allow the vacancies to go up to the cap in the constitution which is I think 15. So they say there's 12 candidates, three of them are incumbents, there's six vacancies - because that would take us up to the cap in the constitution - and after that there's no vacancy.

Big companies likes Telstra actually do do the right thing here and so I think just something which - the basic problem is you can't allow a board to decide how many vacancies there after they have seen who have nominated. In any political election you declare this is how many positions there are and then however many nominate then that's it. So it's just removing that ability to retrospectively decide how many vacancies there are would be a very, very important reform. In terms of the undirected proxies, you just fix that with an electronic system of direct voting. Why do you need to have a cumbersome manual system that requires the chairman to formally lodge all proxies for, against and undirecteds? Just move to a straight direct voting system and if you really want to give a proxy to the chairman, you have to tick the box because at the moment it just defaults to the chairman if you send the form back in the reply-paid envelope. So removing the system that defaults the undirected proxies would be the other element of that reform.

On the bottom of page 2 under that list of the biggest protest votes I have said a few other things just to fix up voting. A very important one in my view is that executives can't vote on their own remuneration reports. I think in terms of concrete things that you can actually come out with from this inquiry that would be in my top three or four that you can actually recommend that Frank Lowy can't vote his 10 per cent stake in favour of his $16 million salary package which is now the highest salary package in Australia and six weeks ago at the AGM he just did that. He did precisely that, he voted his 170 million shares in favour. I think the argument goes that if you are listed in the top five or top 10 paid executives, then you should not be allowed to vote your shares in favour of the remuneration report. At Toll Holdings last year Paul Little owned 10 per cent, big controversy over ridiculous payouts and he voted his 10 per cent in favour and it would have been line ball if he hadn't voted.

So I just think there is a fundamental conflict in allowing major CEO shareholders to vote their stakes in favour of remuneration reports and because it's non-binding I don't think there is any harm, there is no real disenfranchisement because it's a non-binding vote. They should be able to vote on their own election and things like that. But just to get a true sign to strip out the conflicts of interest voting on your own remuneration report I think would be one very concrete thing that you can deliver.

Another very important one is the disclosure of how institutions vote. We have no visibility in Australia about how specific institutions vote in their stock. We have a system of conscripted superannuation funds. No other system in the world where people's moneys are conscripted away from them and we have a trillion dollars of super. Voting is a key asset of that trillion dollars and there is no visibility. You see the best funds, such as AMP and AXA, releasing regular reports saying, "We voted against 25 per cent of remuneration reports, we voted against 15 per cent of directors," but you never know on which ones. So it really is a secret fund manager's business as to who voted against what. In the US by law the big mutuals have to release on their web sites how they have voted on specific resolutions and this did deliver a lot of accountability.

When Enron collapsed, people were able to go back and say, "Fidelity in Boston, you voted in favour of every single dodgy pay resolution at Enron," and they were held to account. There were press discussions, the Teamster's Union even picketed Fidelity in Boston because of vast amounts of their super funds lost in Enron and they were able to go back and say, "Who backed all these dodgy schemes?" In Australia I think it would be terrific if you could say, "AMP supported Frank Lowy's pay this year," and I would go to the AGM and I'd say, "AMP you're doing a really good job overall on voting, but why are you backing Frank on 16 million a year?" It would be a terrific level of visibility.

I would love to see compulsory voting for institutions. If you compulsorily conscript people's superannuations away and then you give them to all these huge funds, I think they should disclose how they vote and they should be compelled to vote. If we have a system of compulsory voting in political elections because the turnout is often 30, 35 per cent. All the assets of Ausminerals was sold off two weeks ago to the Chinese government and the turnout was 35 per cent. 65 per cent of the shareholders on a key vote, selling off $1.7 billion worth of major mines to the Chinese government, no visibility as to who voted, no visibility who didn't vote and a terribly low turnout of 35 per cent.

So compulsory voting for little boutique funds might be difficult, but if you are of a certain size and scale, you are a big fund, you should be able to manage a system where you vote on the top 300 stocks and, like the US funds do, on your web sites you reveal precisely how you voted and then I can say to them - an example of a controversial vote, Transurban's AGM last year, Australia's biggest toll road company. The chairman is David Ryan who was the chairman of ABC Learning and for the previous five years was the chairman of the ABC Learning audit committee. I got up and I said, "David, I think it's time you retired. You've blown 3 billion down there at ABC Learning, it's not a good look, on you go." No, the shareholders gave him another three years on $450,00 a year and I don't know who were the 66 per cent of shareholders who voted in favour. Don't know. Was it the Canadian pension plan fund with 15 per cent? Don't know. No visibility. No transparency.

To fix director election voting, a lot more transparency around who is voting and how. Take away the undirected proxies rort, take away the no vacancy rort, have an auditable trail. At the moment there is no electronic audit trail on corporate voting in Australia. So Computershare don't even give you a receipt to say, "We've received your vote." AMP have released lots of reports saying how votes have gone missing and I think there needs to be a fully transparent electronic auditable system of corporate voting. I have run numerous times in political elections, I have run against Peter Costello, Jeff Kennett's old seat, I'm allowed to scrutineer. I'm allowed to appoint scrutineers who have exactly the same access to the voting results as Peter Costello's did in Higgins in 2007. In corporate elections I have run 35 times. I have never, ever seen the votes come in. But the CEO and the chairman have an electronic system where they can dial into the Computershare system and they can see precisely what the current voting is at any point in time. But the outside candidate who is challenging gets nothing, no visibility and often they will try and charge me five grand just to give you a copy of the share register. Political elections you automatically get the electoral roll for free.

So I think it would be terrific to have a look at the principles of how political elections are handled in Australia and we're very proud of our system of compulsory voting and very transparently scrutineered, independent watchdog. Who counts the votes? There's no independent Australian Electoral Commission for corporate voting. It's all countered by the agent Computershare appointed by the company. I had a meeting with the Computershare the other week and he said, "Yes, look, at the end of the day we work for the companies, the issuers. They ring up and say, 'We we want to know how this person voted, that voted,' and we can. We give them running totals. We tell them who is on the register. We help them solicit, we do all that stuff." The outside candidate; nothing. Very, very tilted, unlevel playing field.

We can talk all we like about valuations of options and these sort of things but I think for me the most important thing is cleaning up the director election voting system. The last two comments I make, bottom of page 2 of the supplementary, to fix up voting on directors I think we have a fundamental problem in Australia which is the evolution of financial supermarkets. We are the only country in the world where the big domestic banks also dominate in funds management. So the Commonwealth Bank was simultaneously a lender of a billion dollars to Centro and the larger shareholder with 7 per cent of Centro. So they smoked 600 million of their superannuation moneys whilst putting Centro basically under as a banker. From my experience the big banks don't vote against directors nearly as much as independent fund managers or an AMP or a 452 capital or offshore funds. The offshore funds particularly are the donkey voters with the likes of RiskMetrics.

So I am not aware of National Australia Bank, Australia's second biggest manager, Colonial ever taking a big stand on a director election and voting against. They don't release reports like AMP, they're not very transparent. I think part of the problem is that they are financial conglomerates that have multi-layered relationships with these companies. So if you're a lender to BHP, you're running their super fund, you're their transaction bank, can your bank-controlled fund manager really come along and vote against the chairman of BHP at the AGM? I think you can't. I know this would be a massive structural reform but I would love to see almost a Glassed Eagle-type thing where an unbundling of who is controlling equity in the Australian economy and who is controlling the votes and who is controlling debt because I think there is a fundamental conflict between debt and equity.

We have seen that with the collapse of Centro where the one player was simultaneously big lender and big equity player and I think it plays out in corporate voting, that the club, the relationships. If you go and track who is on the boards of the big four banks, you can basically track what other companies they're on, they're always on the big the companies as well. I don't know how the club works, but from my experience you don't see the big banks exercising their votes like you see other more independent boutiques or the AMPs of the world. So I think the way to fix that would be first to put some visibility on it and say, "Let's see how Colonial is voting. Let's see how MLC is voting for NAB and we can prove this," but at the moment it's just speculation because there is no transparency about how they're voting. But I've never seen them in the press. I have never seen any evidence of big banks actively voting against directors and I think that would be a good reform.

The reason I run for boards is because it's too difficult in Australia to put up a shareholder resolution. Boards effectively have a monopoly over what shareholders vote on AGMs because under Australian law you need 100 wet signatures from shareholders to get up a resolution for the AGM or to call an EGM or you need to own 5 per cent of the stock. There has only been about 25 per cent times that 100 shareholders' signatures have been successfully gathered by a retail interest and that has been only green groups, unions and the Australian Shareholders Association. 25 times in 20 years.

In America Exxon will get a dozen every year. They will have hundreds and hundreds a year because in America you can get up a shareholder resolution if you have owned US$2000 worth of stock for the previous 12 months. That completely lowers the barrier to shareholder resolutions. It's too easy to nominate for a board. I need one signature from a shareholder. I can nominate for a board in five minutes. It's too easy. If you want to run for a federal seat of parliament, you need 50 signatures from people who are in the seat. So there should be some sort of higher barrier to running for a board, but because it's such a low barrier that's why I do it because it's the easiest way to put pressure on. But I would far rather put up shareholder resolutions.

I could knock out all those dodgy constitutions which say the board can choose any figure they want to be the maximum because the investors don't like it, the proxy houses don't like it. So I could just routinely go, "Woolworths, remove this clause from your constitution," and it would get up. But how do I get 100 wet signatures? I haven't got two weeks to around, drive around to people's houses, etcetera. It's too hard.

So if you lowered the barrier to shareholder resolutions I could have knocked off, for instance, all those director retirement schemes that were running particularly through the 1990s. They've mostly all gone now, there are a few of them that are grandfathered. But they basically work like good behaviour bonds, where the size of your balloon payment at the end of being an executive director rose over time the longer you served. So you want your non-executive directors to be able to walk the plank on a matter of principle. But they won't do that if they're sitting there going, "Once I get to 15 years I get five times my final average salary as a balloon payment."

Now, they've mostly all gone but during the 90s I would have put that up. I would have said, "Cancellation of director retirement scheme, compensating increase in up-front cash payment." All would have been voted by the shareholders, would have been fixed far earlier and is far better governance. But the mechanism to do it, the mechanism for a small shareholder to put up a shareholder resolution is very high with the 100 signatures. So if you were to recommend one thing to make life as a shareholder activist easier and end me needing to do frivolous board tilts when I really just want to put up a resolution, lower that and you get us a lot more accountability for boards very, very quickly with that very small reform.

MR BANKS: Just on that last one, if you would have got support for such a resolution why isn't the resolution coming from another quarter?

MR MAYNE: I'm not aware of an Australian institution with 5 per cent ever putting up a resolution.

MR BANKS: Why is that then?

MR MAYNE: They don't want to rock the boat. A primary interest of fund managers is not improving governance of companies. So if something comes up and they have to vote on it, they've outsourced the research on how they vote to the proxy houses and they will vote. But in terms of actually creating something to vote on, that is a major step, like putting up a resolution to remove a director, calling an EGM. Putting up a resolution for anything is a major step for an institution, and I'm not aware of it ever happening, which is an example of chronic passivity in Australia. My basic beef, getting into this space, is a lack of culture of shareholder pressure in Australia.

PROF FELS: Can I just ask you one very general question. Obviously this inquiry is about executive rem. You are saying many of the problems would be better addressed if there was a change in corporate governance arrangements generally, which would have all sorts of implications for other dimensions of corporations than just executive pay. So I just wanted to say this is an obvious issue that arises: how far does this inquiry get into that, and if it does does that call for a kind of general examination? I can see, just listening to you, what the implications are for votes on executive rem. I'm not quite sure what the other implications are for things that are a bit beyond the inquiry in some ways. Do you want to comment on that?

MR MAYNE: I think it's just all one and the same, and that one of the most important roles that a board does is to hire and fire the executive talent to run the company and to pay them appropriately. So I think the idea of having a separate vote on remuneration is almost not relevant. If the system was working better you would always be having that vote every time you voted on a director. So just see it as one and the same. I simply say, in terms of getting outcomes, which I think would be more accountability and more appropriate pay, rather than coming up with something prescriptive, you can't earn more than your average worker works or something like that, I just think the system would work best if you step back, get to the basic principle-agent issue. Look at the voting records and identify the major problem in Australia as an inability of shareholders to vote against directors, 96 per cent average. If you accept that is the key problem then I think you fix that, you fix executive pay.

So I am asking you to take a slightly bigger picture, but I'm simply saying that I think it is all one and the same. Where will we get a debate started to improve the fairness and transparency of corporate voting? I think some PC commentary coming out of this would be a great place to start. Obviously it is not the key focus of it, but I have noticed some other submissions, the RiskMetrics submission talks about the problem of the no-vacancy rort. I think it also mentions about directors voting on their own pay. So it does, in my view, come back to the shareholders own the company, the directors are their agents. In any system you need an ability to change your agents based on good, reliable information. At the moment we don't have good, reliable information on how the principals are voting in the appointment and reappointment of their agents. You fix that and I think you fix a lot of it.

I think, personally, that the biggest single problem in America in terms of why their executive pay is so out of control is the inability of American shareholders to vote against directors. All they can do is withhold votes. If Obama introduces that you can vote against directors and you can remove them, and he decouples chairs and CEOs, removes poison pills, I think that would have a profound effect on executive pay in America, because boards that approve ridiculous packages would be voted out.

PROF FELS: Could I ask you just to go on from that and talk about how you would see that then affecting Australia in turn, if the US got its house in order? There's an implication in your submission, I think, that you see that as being an important factor.

MR MAYNE: You always hear companies talk about the global war for talent, and the American market is where it's most out of control. So we in Australia have a propensity to hire expat CEOs in our top 10 companies more than any other developed market in the world. At the moment, seven of our top 10 companies are run by CEOs who are born overseas. We almost have a bit of a cultural cringe in Australia about appointing Australian-based CEOs. The last five BHP CEOs have been expats. In terms of what you have to pay them, particularly when you're recruiting from the American market, blows out because the American market is so out of control.

The Ahmed Fahour example was the one I gave you in my submission, where he was paid $13.3 million in compensation benefits for what he was leaving on the table at CitiGroup. CitiGroup is a nationalised bank, it's gone broke, and what he left on the table would be diddly squat if he was still at Citi. But the National Australia Bank shareholders here in Melbourne have had to pay $13 million. That's why the former CEO of NAB got up at the AGM the next year and said, "Why have you paid this guy more in his first 35 days than I got in 35 years as the CEO of NAB?" It's all because the American pay system was completely out of control. So you bring the roof down there, it improves things globally.

MR BANKS: Getting back to the directors, you've got a couple of other suggestions, one of which is that CEOs who are managing directors or directors should in fact be required to stand for re-election. What are the perverse outcomes of that? If you were to do that, two things could happen. First is CEOs could say, "The risk has just one up and therefore I want to be compensated even more than I am now," because one of the reasons for the golden parachutes that we see and that have been put to us is in fact that the risk of losing your contract is relatively high. The second thing is you would suddenly have CEOs no longer being directors but they would simply just be CEOs. So I just want to understand what you think would be the perverse or unintended consequences of requiring CEOs to stand for election.

MR MAYNE: I don't think there would be any unintended consequences because they would simply join the 96 per cent club. I mean, no CEO would ever be voted out of office. The voting record for CEOs is even higher than the typical non-executive director, so they would get the usual 98, 99 per cent. But it would just be an extra accountability mechanism. Why is one specific group of directors given a job for life on the board? There's no other situation I'm aware of in board voting where one director gets a job for life. The best example is Rupert Murdoch went for decades without being elected to the News Corp board even though he was the executive chairman.

So the loophole in the law doesn't just say the CEO. The loophole allowed Rupert Murdoch as the executive chairman to never face the shareholders to be voted on the board. The only other executive chairman who was doing that was John Gay at Gunns. Rupert Murdoch and John Gay at Gunns, two companies with shocking governance. You leave the gate open and they will walk through it and they will say, "I won't submit myself to the shareholders even though I'm the executive chairman." I simply say, "Close the gate." Even if it's every three years, that's fine. Why should Sol Trujillo have never been elected to the board? If you don't want to be a director, you don't be a director and you don't face the vote. If you're a director, you're up every three years.

I just cannot understand why there is an exemption for CEOs. If you want accountability for CEOs let the shareholders vote on them every year, in my view, because at the moment the two most unregulated things in the executive pay debate are the fact that a company can pay an unlimited amount of cash to the CEO and the CEO can't even be voted off the board because the CEO is appointed for life until they leave. So I think, poor old non-executive directors, they face an electoral cycle every three years and they've got to go cap in hand to the shareholders to say, "What's the overall cash cap that you can give us each year?"

PROF FELS: What about the view that in the case of the CEO it's almost that kind of ex officio role on the board?

MR MAYNE: Well, that may be so but I'm not aware of any CEO in the top 100 who is not actually a formal voting director.

PROF FELS: Yes.

MR MAYNE: So you get a vote. I mean I think it would be fine to not have - I think it would probably be a better system to have them ex officio. But if you want to give them a vote then you want to have them as a formal director with all the fiduciary responsibilities that comes with that then you should be subjected to the vote. Again, it's one of these little concrete things. I think it's in my top five of concrete things you could specifically change, not particularly earth shattering but just as important in governance and shareholder rights, because no-one in the community even realises that a CEO is there for life and it's a voluntary issue. So Ziggy Switkowski put himself up, Sol Trujillo said, "Why should I? The government might vote against me. I won't even have an election."

MR FITZGERALD: You will have seen in some of the submissions that people have tried to deal with this issue in a different way. For example, some submissions have said that if the shareholder vote against a remuneration package rises to about 25 per cent then in the next year either all directors stand down or all those that are on the remuneration committee stand down. They're not part of your recommendations, you've got a broader set of strategies, but I wonder whether you have a view about those sorts of propositions that link up the directors having to stand with a significant or material vote against a remuneration package?

MR MAYNE: I think that anything that automatically caused the removal of the director would be wrong, because the thing I most like about the non-binding vote is it removes the fear factor and allows people to vote against it and send a message because it has got no consequences, there are no adverse consequences, it's just a signal. So I think maybe the system would be - I like the idea that automatically the chairman of the remuneration committee is up for election at the next AGM if the rem report vote is more than 10 per cent against.

For instance, the reason I think that Macquarie Bank wilted in sticking with their pay package - I mean I came up with the nickname, "millionaires factory", 10 years ago. I've been to their last seven AGMs, run for their board. I've heard all their debates. They are the most highly paid people in the country. Now, at the 05 AGM, Macquarie, the pay packets were getting up north of 20 million. The proxy advisers recommended in favour and they got 97 per cent. It was massive; despite huge pay packets, it was massive. I think it was in 06 that the RiskMetrics changed its tune and said, "We recommend a vote against." Massive campaign by Macquarie, they were strongarming the institutions; big, big campaign. 21 and a half per cent against, and this was substantial.

After a big battle I saw that as a shot across the bows at Macquarie Bank. They then folded and they changed their policy when they changed their CEO and now a majority of the bonus is not short-term cash, it's in shares. I think one of the key reasons that that happened was because Helen Nugent, the chairman of the remuneration committee, was up for election at the next AGM. She knew that if Macquarie brazenly ploughed on with the massive short-term cash bonuses - yes, it was the same system for 30 years but times have changed. If they had ploughed on she would have got an against recommendation as the chairman of the remuneration committee from RiskMetrics and she would have been in danger of being voted off the board.

I cite Telstra and Macquarie, the changes they did to their remuneration, as the two best examples of the system working really well. Non-binding protest vote, sends a message, change policy. That's what you want.

PROF FELS: What about the extra step, making it binding?

MR MAYNE: No, I think then you would be breaking contracts and people would be less likely to vote against because it would cause uncertainty. I like the system. I just think it needs to be coupled with follow-through voting against directors rather than beefing up the consequences of - I mean executive pay votes is one of the best things Costello did in government. The system is working well, much more transparency and market discussion, much more disclosure about pay practices, shareholders voting against, message has been taken, policy is changing. Don't change it. The system is working really well.

MR FITZGERALD: Sorry, but I just need to clarify. Are you saying that the system works well insofar as the binding vote but are you supportive of, for example, the head of the remuneration committee, the director, being required to stand at the next election?

MR MAYNE: Yes.

MR FITZGERALD: You're in favour of that consequence, not an automatic removal?

MR MAYNE: Yes, correct, that's right. So that would be terrific. Over 10 per cent, you're up for election at the next year even if you're not on the three-yearly cycle. It's not removing them but it then just says, "Hey, you've got 12 months to heed the vote," or the Macquarie situation: you've got 12 months to heed the vote or you can test your support. That would really focus the chair of the remuneration committee. You might struggle to get directors volunteering to be the chair of the remuneration committee and you'd probably get a big explosion in pay for the extra amount to chair the rem committee because of the risk associated with being removed. So there might be some unintended consequences there but it would be a good accountability mechanism.

MR BANKS: Which would have to be voted anyway, to the extent that the pool for directors was inadequate to achieve that.

MR MAYNE: Correct, yes. It's amazing how highly regulated the cash payments to NEDs is and how it's being controlled. I think the NEDs are underpaid. It's primarily, in my view, because they have to go to the shareholders for approval to increase the cap, yet the CEO can be given 100 million cash with no reference to shareholders. I think it's fundamentally inconsistent. The directors should be saying, "Deregulate board pay. Why should we seek an approval for our overall pay when it's completely unregulated for the management and the CEO when it comes to their cash?

MR FITZGERALD: One of the other issues we're looking at in this inquiry is whether or not the current range of senior executives that are covered by the disclosure regime or the remuneration report is appropriate. There is some view that the only people that shareholders should be interested in is the CEO and the CFO. In other words, to reduce the number that are captured by the current disclosure regimes. It would reduce complexity in the reports and so on and so forth. Others, of course, might hold the view that you need to capture more. I was wondering whether you have a view about who shouldn't be subject to the current disclosure regime or any other disclosure regime that's introduced?

MR MAYNE: I have a very firm view on that: all directors, so if the CFO is on the board then automatically that's disclosed; and then only the five or 10 or whatever the figure is most highly remunerated employees. So I've mentioned in number 8 on my formal submission, "Better disclose fund manager pay and close the Alan Jones loophole." Of course the Alan Jones loophole is that Macquarie Radio, public company, he is paid $5 million a year yet he is not included in the top five executives because he is not technically an executive, he is just an employee. Yet the shareholders are told that the 2CH programming director, Ian Holland, earns 123,000 a year. Now, talk about meaningless disclosures. How can one employee hoof out the door with five million a year and the shareholders are not told yet they are told someone is earning a fraction of that. It was the same with Eddie McGuire at Channel 9. He was on five million a year as an on-air talent. It was only when he became CEO this was disclosed.

The biggest reward of all is fund managers. Fund managers are not technically deemed executives. So you have all these multi-millionaire fund managers voting on everyone else's pay when their pay is not disclosed even though they are the most highly remunerated people at the company. John Sevior, head of Perpetual Equities, is earning three, four, five million a year yet the company discloses in the annual report that the company secretary is on 400,000. This would be again in my top five of very simple, small reforms that would be very positive, would be change the disclosure to all directors and the five most highly paid people. If that is some guy on commission in China who happens to make seven million in commission selling zinc to the Chinese for OZ Minerals, so be it, shareholders should know.

MR FITZGERALD: But can I ask what is your rationale for that? Why do you want to know simply what non-executive employees earn? In a sense, there's a bit of a view that there's a right to know. But that may be insufficient. So why do you actually want to know what the head of a particular division is earning, even if they are the highest paid, if they don't have, technically, an executive role?

MR MAYNE: I have a view that sunlight is the best disinfectant, and that you wouldn't have had the amazing perks scandal that has bedevilled British politics if you'd had sunlight, if you'd had disclosure of the guy claiming the cleaning of his moat. So if you are disclosing that there is some guy in China getting seven million a year it won't happen. So the most important thing for shareholders to be told is, "Who is taking the most of your cash each year?" That is far more meaningful, and particularly with fund managers.

I mean, Greg Perry, we all remember Chris Cuff pay issue when the Commonwealth Bank took over Colonial. He was the CEO of Colonial First State, he got 33 million. Greg Perry, who was the head of equities, got something similar. They were B1 and B2 at Colonial. The 30 million that he got has never been disclosed, because he wasn't technically an executive. He was just a humble, ordinary, garden-variety fund manager with no executive powers.

What the definition of an executive is is also an important issue. I would argue that someone who is the head of equities, managing a large team of fund managers, is an executive. But no fund manager appears in these top five. So I often go to the

AGMs of the likes of Bell Financial Group and Perpetual and say, "This isn't your top five most highly paid, is it? It would be very different," and they go, "Yes, it would be very, very different if it was the five most highly paid people. But I'm not going to tell you what my bloke on commission in Perth is making, stockbroking firms." I think it would far more meaningful.

PROF FELS: I just want to pursue this a bit further. I think I can see your point that in some ways the present system doesn't capture quite what is intended. I'd like to test some of the arguments against. One of them is one of the reasons why we want executive pay disclosure is there is a concern that they in some way directly have an input into the setting of their own pay so you want maximum disclosure. On the other hand, a person in China who gets seven million for doing something is probably not involved in determining their pay, so there's a slightly different approach to that one.

Just another obvious thing, there is also some kind of people who are a bit intermediate; that is, they're not executives, they're not way out there just getting a lot of money but having no real role in determining it. There are probably a number of intermediate cases which the present system picks up. So that was just a thought about the different categories. If you're going to have the five highest paid, would it be the five highest paid plus the five highest executives?

MR MAYNE: You've nailed it in one. I think you'd say, "Identify your five most senior executives and reveal what they're paid. Then, identify your five next most highly paid employees," and that way you cover the lot. Imagine the negotiating power a CEO would have if you say, "Mate, if I sign this contract you're in the top 10, you're in the annual report." Beautiful negotiating power to stop secret multimillion dollar packages going to non-executives. There would be hundreds of pay packets that are not being disclosed that are of a significantly larger quantum than what is being disclosed. It's all about quantum.

MR BANKS: Are you ruling out that some of these people may actually be delivering more value for the company than the management group?

MR MAYNE: If the bloke in China has landed a massive contract with the Chinese government I'd say you should have given him 10 million, but at least tell us you've given him seven because that's a huge amount of my money which you're giving him and previously you're not disclosing it.

MR BANKS: Might that disinfectant be so strong that really talented individuals who could be really valuable to the company and therefore to shareholders are not stepping forward into roles that would expose them to that kind of scrutiny?

MR MAYNE: I think that's an argument for not disclosing any pay to anyone. I accept that the executive pay has ratcheted up with disclosure, but that's a price that I'm very happy to pay for transparency and accountability. So be it; disclose it all. If you accept disclosing executive pay then I think you should accept that it be done comprehensively, and it bring in the top executives, the directors and the next five most highly remunerated employees.

PROF FELS: Just going back to something I kind of half mentioned anyway, I think the principle reason why you want executive pay disclosure is their own role in setting it or influencing it. The guy in China, who let's say it's a pure case where that person has no real role in determining their pay and having a vote or an influence on it, then your rationale is just when someone gets paid a huge amount of money it should be made known to everyone. It's a slightly different principle.

MR MAYNE: I agree it's a slightly different principle, but at the end of the day, the person who has negotiated the contract in China has influenced the contract because they have negotiated that contract for themselves. So anyone who can negotiate themselves a contract which extracts millions of dollars of shareholders' funds - - -

PROF FELS: They've got a bit of bargaining power.

MR MAYNE: Clearly they have some influence they're obviously delivering - often these commission-type things, like the real estate agent who flogs $100 million worth of property in Toorak, or the car dealer, the lawyer at Slater and Gordon who is down in Gippsland doing asbestos claims, you would see a lot of unusual people pop up, and then that would be needed to be explained. So, "Mr Slater and Gordon, why is your bloke in Gippsland on two million?" "Well, he's extracted $100 million of asbestos settlements." "Great, well done. Good to see it disclosed." But sunlight is the best disinfectant.

I don't care what the station director of 2CH is getting, it's not meaningful. I would happily accept a system which says you don't have to disclose any figure under $500,000. So if you want to reduce disclosure you'd say, "Anyone over 500,000, the top five executives and the top five next highly paid." So get rid of the $100,000 packages, it's irrelevant. So if you're worried about too much disclosure, put a threshold which says anything under a certain amount we don't need to know. It's the seven figure balloon payments that are secret that I think need to be disclosed.

MR BANKS: Perhaps that station manager needs a pay rise.

MR MAYNE: I think he does, yeah.

MR BANKS: The only other thing I was going to ask you, you talked a bit about proxy advisers. You haven't said much about the remuneration consultants, and just any thoughts you had on that and how it's operating currently. We've had a number of participants talk about the lack of independence in relation to at least some remuneration consultants, given that they're also getting their own remuneration from management as well as reporting to the board, depending on the range of activities they are involved in.

MR MAYNE: I absolutely believe it shouldn't be the CEO appointing the remuneration consultant. It should be the boards seeking independent advice from someone who's remuneration is not in any way influenced by the people he or she is recommending on. My problem with remuneration consultants is the same issue with auditors who rarely qualify the accounts, or independent experts in takeover deals who always come up with a valuation that suits. Whoever pays the piper, whatever that saying is, gets the tune they want to hear. From my experience, I guess there is no visibility over a remuneration consultant who says, "This is outrageous, this is over the top."

The only one I'm aware of is when the NRMA was in the middle of their Keating versus Whitlam factional fights. Eric Dodd, the CEO back in 2000 was getting a big options package, and Nick Whitlam wanted to get a similar big options package as the non-executive chairman. Keating called in John Eagan - the John Eagan who said it's fine to give George Trumbull 20 million dollars-worth of free shares - who said, "No, we shouldn't give any options to the non-executive chairman." That's the only instance I'm aware of of a rem consultant rolling a chairman, and it was coming from a rival faction on the board, so it's a unique situation.

I must admit I know a lot more about the proxy advisers than I do about the rem consultants. It's a very, very undisclosed world. My gut feeling, but not particularly informed, is that it's a lot of conflicts of interest and the pay has been getting out of control. The consultants, they always say, "We got an independent firm of consultants in to recommend it." But often when the boards are saying that defending the increase in board fees, they're right. The non-executive directors are not getting overpaid and the consultants are recommending modest increases in the pool cap.

So for me, there is nothing wrong - NEDs are underpaid and consultants should be recommending higher pay for NEDs. CEOs is where it's out of control. Those figures I give you, Frank Lowy, 16 million in 2008 at Westfield, the entire board, 2.28; ridiculous. Macquarie, 24.8 million, Allan Moss; entire board, 2.65. Why aren't the consultants saying, "Less for the CEO, more for the board"? That is the biggest change that should happen, is the relative pay between NEDs and CEOs. I think, frankly, the rule of thumb should be no CEO should get more than his entire board. So whatever the fee cap is for the board is the fee cap for the CEO. That would be an amazing reform.

MR FITZGERALD: It would be a significant reform. I'm aware that we're out of time but I just want to understand one thing. One of the consistent themes in all of the submissions is that disclosure might be good but the disclosure regime we have at the moment is not working effectively. We constantly hear about annual reports that have more than a third devoted to remuneration reports and so on. If you extend the number of people that are captured, that would increase that. Have you got a particular view as to how you in fact make the disclosure regime work more effectively than it currently appears to be?

MR MAYNE: I have the biggest stash of annual reports at home than anyone, because I'm a shareholder in 690 companies and I get deluged with annual reports. I have never read a full remuneration report. I find them to be 50 pages of excess information. The only thing I'm interested in in the annual report is - and all the separate tables valuing options and short-term incentives, all I'm interested in is the actual total pay packet of the directors and the top executives broken down into cash, STI, LTI, super, other benefits and the comparator with the previous year. So that's the one table I'm interested in.

From my point of view you could get rid of all of the rest and that would be fine. The one thing you would add is the historical assessment of all pay deals for - particularly the CEO. So it would say, "Frank Cicutto joined National Australia Bank in 1960. He was paid a regular teller's wage," whatever. "He became executive director in 1990 when he was on 300,000 a year and received his first options issue of this many options. He sold this many shares in 1995. We then issued him these options in 96, these options in 98. He then sold these shares here. His pay went up to here," so an accurate historical assessment of the CEO's overall remuneration relationship with the company; because every time we go to have a vote on new options or something, we never know how many other options he has been issued earlier, whether he has dumped some shares when they were $35. It's a snapshot in time on a one specific isolated component, an incremental component to their pay, presented in a way which is completely out of context with all that has happened before.

So for me you can get rid of it all except for the actual data and then I would just love a really succinct summary of the pay relationship with those key people since they joined. You would get five-page rem reports which for me I would read ever word of it. It would be really, really valuable and it would save a lot of trees.

PROF FELS: What about the argument that you kind of need both? In other words to get to the bottom of some things you need the details, there needs to be - even if you can't read them all there will be a few people who will go through it.

MR MAYNE: Look, I know the proxy advisers go through them in detail and value them. The Westfield and the Macquarie rem reports are very good. The disclosure is very detailed. I guess I personally just find it too much. I accept the argument that there are some people who look at the detail. I think when RiskMetrics and the others present that's really a good question for them: at the end of the day you are delivering the votes for and against rem reports. What information do you use of the detail and what information do you not need and what additional information do you need? It is a very detailed area. The experts are looking at it in detail.

I sort of rely on the proxy advisers. I'll get to an AGM and I'll say, "Can you show us the proxies please on the remuneration report?" They will say, "Right, 30 per cent against." I will say, "Right, there's an issue, what is it?" because I can't read all the - and I get the chairman to explain what the issue is and I say, "Well, are you going to change it?" He says, "Well, you know, maybe," or whatever and this and stuff. But often it will be, "Put the proxies up." "98 per cent in favour." "Okay, chair, I'm in favour as well. The instos are obviously happy, the proxy advisers are happy, I'm happy, no issue. Let's move on to something else." That's the way I work. I've outsourced that research, if you like, to the proxy advisers and how the proxies come in. Then I leap on it. Whenever there's a protest from the instos I leap at it and say, "Right, what is it and what are you changing?" Then for me I just look at the pay figures and say, "Mr CEO, you're up three million from last year. You're getting a bit greedy here. Do you really need these options? You've already got 10 million options." A little debate around that without, "your KPI says," "your hurdles," and, "you're in the first quartile". All that stuff is just too much.

PROF FELS: Only for the CEO?

MR MAYNE: Primarily for the CEO, yes. The history, yes, that would be great, CEO history.

PROF FELS: On another issue there are various codes of kind of good practice now that we see from AICD, from the ASX and so on. Have you looked and have you any views on those codes about value or - - -

MR MAYNE: The corporate governance principles?

PROF FELS: Yes, in regard to exec - - -

MR MAYNE: On exec pay? I must admit I haven't spent a lot of time on the detail.

PROF FELS: Yes. Do you have - you've talked a lot about process. Now, just on actual substantive outcomes, do you have a general view on executive rem and do you want to say it or you're not going down that track? Has it been excessive in general? Has it risen excessively? Is that how you'd see it? Others say, "Oh, not too bad but some exceptions." We've had the full range of views, as you can imagine.

MR MAYNE: I think it is very much company specific. I have no problems with Frank O'Halloran, who I probably regard as probably the best CEO, pound for pound in Australia, getting five million a year at QBE. He has been the finance director since 1978. He has created one of the 10 biggest insurance companies in the world. The stock has done fantastically well. Five million sounds a lot. No problems at all for me with that.

I think your typical big four bank CEO in the last 10 years, or particularly if you stopped at two years ago, retired worth between 30 and 50 million. That was basically because the cartel was out there. They were all getting paid piles of cash and then they all got their options and it went through the roof. For mine - that was just - it was greedy. The CEO of ANZ who was paid only in shares. He was getting $15 a year in cash, $15 or something. It was tiny. The rest was in shares. He was gaming the tax concessions on the shares. Share price is going up. He is worth 30 to 50 million. For me that was - at the end of the day banks are like a licensed utility - licensed by the government, should be a utility. I think that the fact that Australia has the world's most expensive banking system was because the CEOs got all their huge options plays on and then just milked the system as far as the regulators would allow. Howard government did nothing, sat back. Australian consumers suffered the world's most expensive banking system. Brutal banks driven by equity incentive schemes which delivered the big four CEOs 30 to 50 million. I think they were the perverse incentives in our financial system. It wasn't taken risk in subprime, it was abusing our cartel and gouging the consumer and delivering Australians the world's most expensive banking system.

The last one I would say is any CEO who gets lucky on the commodities boom, Greg Gailey, current chairman of the Business Council left Zinifex with a $12 million payout which was just basically, "You can have all your incentive shares." He didn't triple the zinc price, China did that. I would love to see incentives that focused on what you can deliver, what you can actually deliver and curtails it if it's just the zinc price triples; you don't just get some massive windfall. So I think some of those mining CEOs did get out of whack with variables they had absolutely no influence over. You could pick another company where someone has done a huge amount of heavy lifting in a difficult situation and got nothing because they've saved the company, salvaged huge value, but the company share price has still gone down; tough industry. I should try to think of someone. You need to focus it on deliverables that you can influence, and sometimes that does include bonuses for stopping your company going broke, risk management, and not just a one-dimensional upside based on share price. Particularly in a commodities focused nation like ours, you get windfall CEOs who happen to be in the right place at the right time.

PROF FELS: From that perspective, those people who say the pay rise, I think we had a 96 per cent increase over six years against 30 per cent for wages or something like that, is justified because the stock market went up by almost that much. What do you think of that as a class of argument?

MR MAYNE: I think it was out of whack, not hugely, and I accept pay all around the world was going up. But I think that quantum was out of whack. You could wind it back 20 to 30 per cent on where it got to and I think it would be about right. I've got no problems with a CEO earning 3 to 5 million a year. I love saying to James Packer at the AGM every year, "Well done for working for free," because he doesn't draw a salary. I always go to Frank Lowy and Rupert Murdoch and say, "Why can't you do a Packer and work for free? Frank Lowy, you're getting 190 million a year in dividends from your stake in Westfield. You don't need 15 million a year in cash. You are double-dipping."

I still can't believe RiskMetrics recommended in favour. So that's an example where I think it is out of whack. Frank should be working for free, like Kerry Stokes, a lot of the owner shareholders. Gerry Harvey, what's he on, half a million? Kerry Stokes just takes a regular director fee, 100,000 a year, even though he's executive chairman. So it's all uneven. Rupert Murdoch, 32 million a year when the share price has gone nowhere since 1998; that's just an outrageous example of American benchmarking. Shares have gone down from 28 to 12 or something, he's still hoofing it with 32 million a year and lecturing everyone else through his newspapers about some public servant getting a 10 per cent pay rise.

MR BANKS: I think we were ambitious allowing 30 minutes, but it's been very useful, that discussion, so thank you for that. I was trying to keep count of your top five reforms, and I think we might have blown out to 10. But they are all concrete suggestions and we'll clearly look at those as we're thinking our way through this process to the draft report. So thanks a lot.

MR MAYNE: Thank you.

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

(Luncheon adjournment)

MR BANKS: Welcome back, ladies and gentlemen. We'll recommence this afternoon with the Joint Accounting Bodies, namely CPA Australia Ltd, the Institute of Chartered Accounts and the National Institute of Accounts. Welcome, individually and severally. Can I ask you please to give your names and the capacities in which you are here today.

MR PURCELL (JAB): I'm John Purcell. I'm the policy adviser, corporate regulation, with CPA Australia.

MS HICKS (JAB): I'm Kerry Hicks, head of reporting at the Institute of Chartered Accounts Australia.

MR RAVLIC (JAB): I'm Tom Ravlic. I'm the policy adviser responsible for technical activities and professional development at the National Institute of Accountants.

MR BANKS: Thank you very much for attending, and again apologies that we've started a bit later than scheduled. Thank you also for the submission, which we found very interesting. We have a few questions for you on it, but we'll give you the opportunity to address the main points first.

MR PURCELL (JAB): I have four opening remarks, if I could. The joint accountant bodies which are made up of CPA Australia, the Institute of Chartered Accountants, the National Institute of Accountants represents 180,000 professional accountants in Australia. Our members work in diverse roles across public practice, commerce, industry, government, academia, and are located throughout Australia and internationally. We support the Productivity Commission's inquiry into director and executive remuneration, and thank the commission for the opportunity to present here in public hearings.

As a tripartite submission, the joint accounting bodies are represented here today by Kerry Hicks from the Institute, Tom Ravlic from the NIA and myself, John Purcell from CPA Australia. Whilst acknowledging the breadth of the terms of reference contained in the issues paper, our written response is focused on those areas where accounting practice is most relevant to the issue of director and executive remuneration, these being the attributes of disclosure and corporate governance. As such, key parts of our submission consider the operation and intend of section 300A of the Corporations Act.

Kerry will present preliminary views on the scope of the section, the definitions of executive and key management personnel, and related issues of disclosure of share-based payments. I will then provide remarks on the relationship between remuneration policy and company performance, member non-binding votes in relation to the remuneration report, and the use of non-recourse loans as a source of funding equity components of remuneration. Our introductory remarks will conclude with comment on particular aspects of executive remuneration. I'd like to hand over to Kerry.

MS HICKS (JAB): Just some introductory comments on the scope, we're happy with the scope, in it covering those directors and executives that fall within section 300A. The big point I wanted to highlight today is there is confusion by users of remuneration reports about the remuneration of executives. I just wanted to point out some of those areas of confusion and just indicate how we thought that they could be resolved and simplified to just make things less complex to an everyday investor in a company.

The first one was on the definitions. Currently we have in the act a definition of a company executive, a group executive, and we also have this KMP, key management personnel, which comes from the accounting standards. There are disclosure requirements around KMPs, there are also disclosure requirements around top five company executives and group executives. It is very confusing to look at all the definitions and to work out who fits in what, even for an accountant who is used to looking at this on a regular basis. We believe to help users it would be better just to rely on one definition to determine who should be disclosed. The one definition we thought was all-encompassing was the key management personnel definition, which is a definition contained in the accounting standards. If there was one definition it would just cut out some of the confusion. So that was one area I wanted to highlight.

The second area that, again, is causing a great deal of confusion, is the disclosure of what we call in the accounting profession share-based payment arrangements: option disclosures, performance right disclosures, things like that. The accounting requirements around share-based payments are very confusing, again, even for accountants, let alone investors who are trying to read and understand the information. The accounting standard, if an entity has one of these type of schemes there are extensive disclosures about these schemes already in the financial reports, usually comprising many pages.

The confusion in accounting arises because the values that are put on these things are all done at grant date, even though the executive or director to whom it relates may not actually receive anything until five years, 10 years down the track. The companies put an estimate on these things on day one, and there is then a vesting period which could take, as I said, many years. Invariably, the estimate on day one will be quite different to the value to the executive at the end of the vesting period, which may be five or 10 years or any length of time. The amount that is put in the remuneration is the amount determined per the accounting standards. But as I said, it's not necessarily going to be the same value at the end of the vesting period.

So there is great confusion around, "Well, if the accounting standard says it's this value, and if I end up 10 years' worth of that value, that should be the value to the executive in their hands." In the current circumstances we have today, where share prices have crashed, the value in the executive's hands if something is vested today it is highly unlikely to be reflective of anything that is sitting in the books of the company.

MR BANKS: So they would overstate what would be happening today.

MS HICKS (JAB): Yes. In today's economic conditions it would be overstated. If we were in the opposite, where prices were skyrocketing, the figure in the accounts might be understated. Estimates are put on to try to predict these sort of things, but some market movements, as we've seen, are beyond prediction.

MR BANKS: So unanticipated share price movement, is that the major source of disparity, would you say?

MS HICKS (JAB): Yes. These estimates on day one are based on models and different proven valuation methodologies. So to be showing people what's going through the accounting records, and they often are the numbers that get picked up by the media and strewn through papers, it's not necessarily reflecting the true position. We think that to cut the confusion there is scope to look more at the type of information the shareholders really want and put it in a context that is reflecting the value to the executive at the date where the executive is able to do something with those options or to do something with those shares.

We're not saying take away the accounting information. The accounting information is all there, fully disclosed in the financial report. We're just saying that there is a piece missing. The piece missing is a really important piece, which is the value to the executive at the date where they can actually do something, at what's called the vesting date, the date they've actually got control of that option or share, whatever it may be.

MR FITZGERALD: Can you just explain to me how that might look. We're fully cognisant of the fact that the process for which you have to account in the financial statements is at that heart of the problem in the remuneration report. We understand that. Are you saying, firstly, that you can leave the financial accounting as it is and change the remuneration report in a different way? I presume that's what you're saying. If so, how would you make that change? In other words, when you say you would reflect the true value to the executive, assuming it doesn't vest for two or three years, at the date of grant, year one, about something that may or may not vest in year three, how would you now deal with that in a remuneration report? If I could just get a layman's understanding of what that would now look like if we accepted your proposal.

MS HICKS (JAB): I think the remuneration report needs to fully disclose by individual KMP what's been granted, how many of these things have been granted. Whether you put the accounting value in there or not is debatable, but certainly the number, the type of arrangement, the type of structure it's under. John will go into how it might impact performance. But at the vesting date - - -

MR FITZGERALD: So the first year it says he's been granted 10,000 shares, and today's market value is $10, if you want.

MS HICKS (JAB): If you want, yes.

MR FITZGERALD: Which gives a value, but it's an artificial value.

MS HICKS (JAB): An arbitrary value.

MR FITZGERALD: Three years on it vests.

MS HICKS (JAB): It vests, and there needs to be some sort of disclosure there about the value that has vested to the executive.

MR FITZGERALD: So in the third year report, when it's vested, we show that the executive received 10,000 at $5, if that's the current value.

MS HICKS (JAB): Yes.

MR BANKS: So a combination of realised remuneration and the accounting stylised version in advance of what's vested.

MS HICKS (JAB): Yes. But the distinction needs to be made extremely clear so people don't look at it and add the two numbers together and think there's two lots. So it's got to be done in a very clear fashion.

MR BANKS: What you say is very attractive with one qualification; in the first year what will emerge is 10,000 shares at $10, that will be the figure that will emerge. That's an even less accurate figure as to what they're going to receive than the accounting figure, isn't it? Because you discount and use a particular formula. So in terms of public perception, that year one figure will look even higher than it does now and it bears no relationship to what will happen in three years. But it would be easier to read, I might say.

MS HICKS (JAB): It would be easier to read, but if you're going to put the market value of the shares at that point in time part of your consideration should be should you put next to that the accounting value? So should you put the market value, the accounting value, and then a vesting value or is that going to be too confusing for the average shareholder?

MR BANKS: Or would you prefer a situation where you simply say that in the year one you've been granted 10,000 which will vest at a subsequent date and in that report not put a market value? The market value in year one is completely irrelevant to what it will be worth in three years.

MS HICKS (JAB): I agree. I'm not sure I have a definitive answer. I would obviously warn on having too many values sitting there because then it will get too confusing. So you're approach may be a compromise in order to not show too many numbers, because I agree with you, to show the market value without the accounting value would be confusing.

MR BANKS: The key thing that you were saying, and others have also suggested, is being required to include the realised value would be an important step forward.

MS HICKS (JAB): Because from an executive's perspective, when they have the ability to do something with those shares, whether it be hold them, sell them, transfer them to someone else, is the point in time when it becomes valuable from their perspective.

MR BANKS: Just to understand this a little bit further, if you were to take that approach, is there anything lost by not having the methodology that sits behind the accounting value in the remuneration report? Am I right in understanding that you're saying that methodology is already in the financial statements?

MS HICKS (JAB): Yes, that's right.

MR BANKS: So all we're doing at the moment is extracting information and putting it into another format, increasing the size of the annual report and, frankly, for many of us reducing its readability anyway. But am I right in saying that in fact nothing is lost, or is there something lost in that process? In other words, is there information that even proxy advisers might want that would not now be available if you took that approach?

MS HICKS (JAB): My view is that everything is covered in the financial report and there is no need for duplication between the two.

PROF FELS: It's explicit in the financial report?

MS HICKS (JAB): Yes. It's not by individual person. The financial report will have aggregate amounts for each arrangement. So say the entity has got four different types of arrangements, it will have disclosures for each of those four different types of arrangements. It won't go down to individual names. The individual names area is what's in - but if the remuneration report is identifying this director has got this many options and is part of this particular plan, and that particular plan is then fully disclosed and expanded on in the financial report. It depends if you believe more information is needed on a methodology - - -

MR FITZGERALD: But just taking Allan's point, if in the remuneration report you put the five directors by name, you said this is the amount of shares, you might or might not put the current market value, you could in fact put the accounting value for that individual executive in the remuneration report. But the actual methodology is back in the Financial Services, where you describe the methodology for that basket or that set of arrangements as distinct from the individual. So you've achieved both. You've got the actual methodology in one path and you still have an individual allocated accounting value if you so want it.

MS HICKS (JAB): If you wanted to. Otherwise you say, well, this has been - the grant was done as part of this particular scheme and in the financial report it will be laid out by scheme. For each scheme and each grant it will have the fair value. So one can track the information. If one really wants the accounting value they will be able to find it in the financial report. It just depends how important you think it's - you need to have that up in the remuneration report or if you think people are going to actually sift through the pages to locate it, if they really want it.

PROF FELS: Why not just say it?

MS HICKS (JAB): Yes, you could say it.

PROF FELS: Instead of making people make do the - you're saying they have to do the maths?

MS HICKS (JAB): No, I wouldn't - - -

PROF FELS: Not exactly the maths.

MS HICKS (JAB): No, they just have to click pages, that's all.

PROF FELS: Yes, okay.

MS HICKS (JAB): Yes.

MR FITZGERALD: Sorry, I just want to clarify . They'd have the number. If they wanted further detail as to the methodology behind the number they'd go to the financial statement.

MS HICKS (JAB): Yes.

MR FITZGERALD: What we already know is the vast majority of investors want an understanding of sort of the total package, in a sense, but some need a much more detailed knowledge and you could facilitate that, potentially?

MS HICKS (JAB): So you wouldn't need to do any mathematics to work anything out. It would be clear. You might just put in your annual report, "The details of these arrangements are contained on page," whatever of the financial report to make it easier for people, if that's how you wanted it to work.

MR BANKS: Okay, good, thank you.

MS HICKS (JAB): Over to John.

MR PURCELL (JAB): Whatever discussion about section 300A which was introduced into the act as part of the CLERP line forms in 2004, the wording of the section requires directors in their report to provide a discussion of the relationship between remuneration policy, the company's performance - with particular emphasis on the consequences for shareholder wealth. I want to focus in on this idea of shareholder wealth and whether it drives a notion of short-termism as such. The accounting bodies suggest that what are largely qualitative disclosures should be considered in the context of the commission's reference to suggestion that the structure of remuneration can, in some instances, encourage a short-term approach to decision-making and undue risk taking.

There is some research that indicates that executive remuneration is often more strongly correlated with the size and complexity of the company rather than linked to company performance. Similarly, the notion of a long-term view of the company and its sharehold interest is widely accepted in many aspects of corporate law. As such, the wording of section 300A subsections (1AA) may not in fact reflect the wider scope of directors' and officers' general duties against which their obligations to the company are governed. As such we would recommend, perhaps, that the commission consider - make a recommendation for the amendment of the wording of subsection (1AA) to reflect the acknowledged broader scope of directors' and officers' duties against which an individual's performance should be measured.

The notion which exists under the general duties of directors which extend to officers is one of taking the interest of the company as a whole. It has been widely interpreted as not the short-term immediate interest of existing shareholders but rather the interest of the shareholders on a long-term basis. As such, the focus on section 300A around shareholder wealth may tend towards a short-term approach.

MR BANKS: So again, you're saying the company nevertheless being defined broadly in terms of the collective shareholder group but over a long period rather than the current - - -

MR PURCELL (JAB): Yes. There's detailed academic commentary, strong judicial opinion, around particularly how section 181, the duty of good faith, operates. The idea of good faith and loyalty here is that it is found on the interests of the corporation, and it's the corporation's interests on a long-term basis. What you have here in the disclosure is something which focuses on short-term shareholder wealth. Obviously shareholders are critically concerned with performance of directors in relation to the generation of wealth. Viewing more in terms of the quality of disclosures and shareholders-investors' capacity to understand the behaviour of a corporation on a long-term basis, we believe that shareholder wealth needs to also include reference to the wider long-term interests of the corporation.

MR FITZGERALD: If I were to use the term "shareholder wealth" generically, does it have any particular meaning in the accounting area? When I say that, does it automatically mean in your minds that it's short-term? Clearly, it's contextual but does "shareholder wealth" from an accounting profession's point of view have any specificity at all? Does it mean anything or is it totally reliant on the context within which it's used? What leads you therefore to the conclusion that the section necessarily means short-term wealth?

MR PURCELL (JAB): Accounting numbers, typically historically based, enables calculation of such thing as earnings per share. The interest, however, of a shareholder - what we're trying to see is reconciling the behaviour of the director, the performance of the director. Clearly it is reflected in notions of shareholder wealth. Accounting measurement will give a clear understanding of what shareholder wealth - it is contained within the accounting numbers.

If we are trying to move both behaviour of directors and executives and the uses of corporate disclosures to understand the overall performance of the company and its directors and officers, there is an overlaying of the long-term interests. So there is an interest which is reflected in shareholder wealth as well as an interest reflected in the long-term interests of the corporation which manifests also in the long-term capacity of the corporation to generate wealth to the shareholder.

MR FITZGERALD: Some shareholder groups would already say that they're concerned about a lack of alignment between their view of shareholder wealth and the decisions of executives and directors. Would it be a plausible argument for them to say that if you make the amendment that you're suggesting that that could potentially reduce the attention to their interests, their version of shareholder wealth, and it actually might be a negative towards the shareholders; recognising that shareholders are not the same, they're all different with different motivations and incentives.

MR PURCELL (JAB): I will concede that there is that residual risk. I would, however, argue that quality of disclosure, which covers both the immediate term issues and the long-term future of the corporation is something which different types, classes, of shareholders will have an appetite for and a capacity to understand. A lot of the criticism around executive remuneration, some of the issues which have been addressed by APRA, is how to better align executive decision-making with management of risk.

In these issues there's pros and cons. At one level there is elements of the Corporation Law which encourages, promotes, reasonable risk taking by directors and corporations. But on the other hand we now have a pressure which is trying to move away from excessive risk taking. When it comes to disclosure of remuneration I would suggest that there is an appetite amongst shareholders, institutional investors and such, to both deal - understand both the long-term interests of the corporation as well as the capacity to generate wealth within the short-term. It doesn't necessarily translate to negative behaviour on behalf of executives and officers.

MR PURCELL (JAB): I'm just going to make some general observations with respect to tax, but before I do we should know at this stage that none of the panel present before you today are taxation experts in their own right. So I'll outline just a couple of issues in relation to tax and there is an additional point with respect to risk and director's performance that we need to raise as well, particularly in the audit context.

As you will note from our submission, which we take of course as read, we would like the commission to work in concert with the current review that is being spearheaded by Dr Ken Henry in relation to taxation. We don't really see tax arrangements at this point in time as having a great influence on the way in which remuneration is structured, although we note there are a range of things that do go on from salary packaging and salary sacrifice which happens throughout the full spectrum of employees. We also do note that there is an opportunity to perhaps improve the way in which shares and other similar arrangements are disclosed to the ATO. I guess the final point is we believe that bonus should continue to be an allowable tax deduction.

The additional point on risk management, however, given my colleague's discussion with respect to risk management and my other colleague's discussion in relation to financial reporting, deals with the behaviour of executives and how auditors may be called upon to look at a range of issues in preparing and planning for the audit. Auditors are required to examine a range of risks that could impact on the financial statements of an entity. These can be anything from the general economic environment, the industry environment in which an entity operates, whether it's the automobile industry, whether be clothing, whether it be services, information technology.

It could also be, which is of greater interest to this committee, the nature of the various contracts that executives and directors have in place for performance. Why would that be relevant? If in those contracts there is a key performance indicator or a performance measure that is tied in some way to a financial result there can be the potential - we're not saying it is in every case - for people to manage earnings; that is, they tend to use accounting requirements in a way that leads them to meet that particular hurdle and as a consequence get the gain that flows from it. That is what the accounting academics refer to as earnings management, of course. Auditors are required to assess risk. They are required to get to know their client, the client's environment, the management, those in charge of governance, and understand the environment in which those financial statements are being prepared. That may be something the commission may wish to consider as it develops its draft report in the next few months.

MR BANKS: Thank you. Were there any other introductory remarks?

MR PURCELL (JAB): I wanted to cover off on both non-binding vote and also non-recourse loans.

MR BANKS: Perhaps while we're just on the tax thing, Allan, did you want to - - -

PROF FELS: Could you elaborate on the impact or non-impact of the tax arrangements on the structure of executive remuneration. Are you saying they don't have much impact?

MR RAVLIC (JAB): As I said earlier, we'd probably prefer to take the question on notice and provide you with a written response.

MR BANKS: You do say in the submission that you don't think tax has been a driver, by and large, for the design of remuneration. However, you do say that changes in taxation could have a significant impact. I was just trying to understand that asymmetry. One interpretation is you think everything is fine now, and if you change it would destabilise or cause distortions. Is that, in general terms, the way you're approaching it or is there another interpretation?

MS HICKS (JAB): What might be useful is, we haven't done a joint submission on that but some of us individually have done submissions in respect of the taxation changes that were announced as part of the budget process, and that's been dealt with as a separate issue because there's a separate proposal going on at this point in time. But what we have gone out publicly and said on behalf of the accounting profession is that the proposed budget changes will have a significant impact for remuneration arrangements.

Since then, we've already done two submissions commenting on those proposals and trying to recommend where the government might go with these type of things. We have heard and we've read it in the media that potential share based payment type arrangements under the budget proposals may no longer exist. If the commission is looking at doing more linkage between performance and long-term type performance measures, etcetera, as John was getting at, if the taxation arrangements aren't supporting that then it's not going to go in the direction that you would like it to go. So we can certainly provide you with those submissions that have gone direct to Treasury.

MR BANKS: This is a process now of refining or changing or amending the original proposal. I guess once you've seen that if you've got anything further to say to us then feel free to do that. You may wish to have, in other words, an up-to-date commentary rather than one that precedes the decision.

MS HICKS (JAB): Yes.

PROF FELS: The principle of should there be any special tax deal for share based arrangements or should the same principles of tax apply across all increments to a person's worth, whether stemming from income or shares or whatever, I don't know whether you would have an opinion on that in this response?

MS HICKS (JAB): Not in this response.

PROF FELS: No, I'm asking the question, you may or may not want to address or get back to us.

MR PURCELL (JAB): It may be something that we would need to collectively confer with our taxation colleagues on and we'd be quite happy to provide you with a written response in due course.

PROF FELS: Thank you.

MR FITZGERALD: Just in that, it intrigues me, some people would say that the complexity of the arrangements we now see in part is driven by tax in terms of trying to maximise the beneficial tax position for executives. But I get a sense from what you're saying and the caution you have is that you may not necessarily think that is true. In other words, very simply, to what extent are the complex arrangements we have driven by tax planning? Or is tax planning simply an element in the complexity but not necessarily a driver of it?

We know that tax always complicates everything, and we know that tax planning makes that even more difficult. But there is something very odd about the complexity of the arrangements we now have, and I suppose in one sense trying to understand why it is so complex is part of our challenge. I'm just wondering whether you have a view as to whether tax planning plays a dominant role in the current complex arrangements we have or is it only an ancillary part of the whole issue. Again, you may not have a view.

MR RAVLIC (JAB): If I can comment on an analogous situation, it's not quite remuneration but it is something that I'm a bit more au fait with and it might assist in understanding the general principle that we're putting across. From time to time in the corporate environment people engage in setting up corporate structures, special purpose vehicles for transactions. There are times that people are accused of wanting to push things off balance sheets, there are times people are accused of wanting to minimise tax, and other times the contrary view is taken, these things are done for the right economic reasons for an entity. I guess it really does depend on how close you are to what an entity is doing, what the arrangements are, and understanding more carefully the individual circumstances of the various individuals and all the parties involved.

In the case I mentioned of setting up of corporate structures, it has been said from time to time that entities deliberately seek to avoid reflecting things on balance sheet when in fact the accounting standards may end up with something being off balance sheet but for economic purposes that may be the best outcome for the entity in terms of outcome they're seeking from the point of view of the shareholders and the directors. It all depends on who's looking at the problem and what bias or prejudice they're coming to the table with.

MR PURCELL (JAB): Could we address now some of the issues with a bit of controversy, around the member non-binding in relation to the remuneration report. When you put it into the context of historically shareholders' relative positions in terms of their oversight capacity in some instances to approve director remuneration, director fees, as opposed to their capacity to have oversight involvement in decisions around executive remuneration, the traditional view has been that executive remuneration, appointment of executives, is within the realm of the director's powers of management. So on the one hand you have historically a fairly strong situation with shareholders in relation to directors' fees and remuneration as to a relatively weak situation in capacity to challenge management in relation to its decisions around appointment of executives and their remuneration. So in this context, the non-binding vote operates as a means of encouraging enhanced disclosure to shareholders so they can understand the rational of directors and executives in terms of the setting of executive remuneration.

The Joint Accounting Bodies support the retention of the non-binding vote in its current form. As to the practicalities of ending up in a situation where there is some right of veto through the voting process in relation to the remuneration report we see that as problematic. It poses questions about what is a clear division between corporate powers between directors and those of the powers of shareholders in general meeting. It also leaves very open some questions about what follows on once there is a vote to reject the remuneration report if it becomes of a binding nature. What then is the process for the company and the general meeting itself to then create a decision to move forward?

Similarly, there are issues around the voting itself: attendance at the annual general meeting at which the vote is put; how representative is the vote itself; and do those voting in rejection of the remuneration report have a full, detailed understanding of what is behind the remuneration structure, its intent, and the disclosure itself. The view that the accounting bodies would take is that this issue requires a little bit more time to resolve, particularly in the current climate of shifting executive remuneration based on changes in market circumstances. To put the binding vote forward may ultimately be an over-reaction and may actually, as we see it, have negative consequences.

MR RAVLIC (JAB): It may well be worthwhile noting, given that we've been talking a lot about disclosure and clarity of disclosure, during the last 48 hours the International Accounting Standards Board have released a proposed non-mandatory guidance document for comment on management commentary, and the commission may wish to consider that, management commentary more generally, discussion and analysis, but it incorporates all the notions of transparency and the provision of clear information to stakeholders. That document is freshly released by the IASB the other day and we'd be quite happy to forward a copy of it to the commission staff if you'd like.

MR FITZGERALD: Thank you. One of the issues you've raised in your submissions around non-recourse loans, you've indicated that you don't think it represents best practice. In fact, you're negative about it. But as I understand, and correct me if I'm wrong, you've fallen short of wanting to ban it.

MR PURCELL (JAB): Yes.

MR FITZGERALD: So can you explain to me in simple terms the rationale for your position.

MR PURCELL (JAB): Firstly, in terms of it not being best practice, I think in some ways you can draw a parallel with the approach towards termination payments. There is about both a risk of transference of corporate resources, corporate wealth, away from the corporation by both these types of practices. With the government's approach to termination payments, there the approach has been taken to lower the thresholds at which shareholders approval is required and to increase the type of payment which is subject to shareholders' approval. A more appropriate point we'd see around non-recourse loans is actually to quarantine that and perhaps make that as an element which is subject to shareholder direct approval, given the risk it does carry with it of transference of corporate wealth.

The other element about it, the actual practice of non-recourse loans, not only is applied, as we understand it, to directors and executives but also to part of structuring employee share participation. Employees themselves are not in a significant position to directly affect corporate wealth in the manner of a director or an executive. So we see here the approach of not only proper disclosure but actually potentially allowing greater shareholder oversight through approval of those loans.

MR FITZGERALD: In what circumstance do you think a non-recourse loan as part of a remuneration package for executives would be appropriate? Why shouldn't you just ban it? In other words, are there circumstances that would ever really warrant its use?

MR PURCELL (JAB): In terms of whose decision it should be, it doesn't represent best practice. So it's a question of who decides whether its use is correct and right. I concede it could be prohibited outright through a legislative approach, but the parties which are potentially subject to detriment through the practice are in fact the shareholders. So we would believe that bringing the shareholders into the decision-making process through a capacity to veto achieves the same sort of outcome.

MR FITZGERALD: Sometimes the right response is to allow people to understand what is happening and for them to be able to vote on it or veto it.

MR PURCELL (JAB): Yes.

MR FITZGERALD: Sometimes it's a much easier response, subject to the unintended consequences of adverse effects is simply to stop the practice.

MR PURCELL (JAB): Yes.

MR FITZGERALD: We use all of those instruments variously.

MR PURCELL (JAB): Yes.

MR FITZGERALD: I suppose I'm trying to understand why you shouldn't just stop the practice. I'm not advocating that. I just want to understand why that might not be a simpler response than another disclosure voting regime.

MR PURCELL: Potentially simple, but I think the approach we would like to take is to actually identify where the power is within the organisation and the party who is actually adversely affected by the practice, and that is the shareholder themselves. I think as a first measure it will be appropriate to put it in the realm of shareholder decision-making.

MR FITZGERALD: Thanks.

MR BANKS: You made reference to the link or lack of it between executive remuneration and company performance, and the much closer link that has been statistically or empirically verified between remuneration and size and complexity of the company. Do I take it from what you are saying that you don't see that someone who is in charge of a very large and highly complex company should be earning any more than someone who is in charge of a small, relatively simple, let me put it that way, company. In other words, that you wouldn't see the CEO of BHP earning more because of the scale and reach of BHP relative to someone who was running an operation that was making shoes or something?

MR PURCELL (JAB):   The relativities potentially draw into consideration elements of subjectivity. So in some realms you can rationalise remuneration by scale, the organisation, and potentially even capacity to pay. But also there's issues around the questions as to the market of chief executives, their capacity to actually demand from boards of companies what is perceived to be the market rate. All these, when stacked up against issues as to whether scale and complexity likewise is a better indicator of executive performance, still (indistinct) bring us until the realms of uncertainty without drawing conclusions as to what the correct measure an executive or a director's worth is. We would prefer to see these matters dealt with by improved disclosure.

Improved disclosure not only informs those who are directly affected by the decisions about the scale of remuneration but also actually feed back into the organisation as a control, and I think that's the purpose very much which underlies section 300A, to not only inform shareholders in the market but actually also to influence the behaviour of those who decide what executive remuneration is set at and how it is rationalised in the disclosure.

MR BANKS: Is what you're partly getting at the difference between the level of remuneration and the rate of change in remuneration if linked to performance?

MR PURCELL ((JAB):   Yes.

MR BANKS: Okay. Good. Thank you. Are there any other

MS HICKS (JAB):   Can I just make a final comment from our perspective? I would encourage the condition to really have a good look at what is going on overseas in this space, because the accounting profession in Australia would not like to see proposals for directors and executives here more stringent than those overseas, because the last thing that we would like is good executives leaving our shore because of stringent remuneration proposals; that's not good for Australia.

MR BANKS: Are there any areas already where you think there's a danger of that happening?

MS HICKS (JAB): We have identified certain areas in our submission, but I did notice as I went through there are a number of other submissions that actually go through what is going on overseas, in overseas jurisdictions, and sort of gives current updates on those. So I'd sort of I guess encourage you to take a good strong look at those. Again, it's a bit of moving feast at the moment because jurisdictions are looking at this all over the world.

MR BANKS: That's true.

MS HICKS (JAB): So just to keep it in line, not saying copy, you know, it doesn't mean Australia can't have best practice, but keep in mind that we don't want it to detriment Australian executives and see them all going offshore because of what executives might see as adverse recommendations coming out of the commission.

MR FITZGERALD: Could I go back to an issue raised very early in the piece, which I didn't raise at the time, and that was your proposal to move to a key management personnel definition. Just in a practical sense, one of the issues in the terms of reference is to look at who should be covered by - well, anything, but particularly the disclosure regime.

If you use the definition that you've proposed, what do you think the practical effect of that will be? In other words, some people have actually said to us we should restrict the personnel just to the CEO or the CFO and executive directors, others want a broader category, and you may or may not have heard Stephen Mayne before talking about that group plus the five highest-paid people in the company. I just want to get a sense, if I can, as to your definition. In a practical sense, what is likely to happen? Will we shrink or increase, or is that impossible to tell?

MS HICKS (JAB): It's pretty much impossible to tell. It will depend on the company. A complex-type organisation, you may end up increasing. So you may not just have five, you may end up with 10 or 15. A simple organisation or a type of organisation where you have a very hands-on, shall I say, managing director, executive director, who gets involved in every single major decision with that organisation, you may end up with less than five. So it's really going to be very dependent on the type of organisation that you're talking about.

MR FITZGERALD: You're satisfied that the accounting standards around that use of term gets clarity, so in any particular circumstances one is able to ascertain with some certainty who is in, or are there elements of greyness and boundary issues that beset that definition?

MS HICKS (JAB): The definition is clear. I guess the areas of confusion come when someone is comparing that definition with the definitions of the law and whether these people covered in this or that , et cetera. So we see it as that the confusion is lying there, not in the definition under the accounting standards.

MR BANKS: I just have one last question, just a proposition to get your response to, and that is I understand that under the accounting standards some equity based payments have to be expensed by the company when they're granted, but the expense to the company can't be recouped if the payments don't vest; for example, because the hurdle is not met. Is that correct?

MS HICKS (JAB): That is correct, yes. The accounting standard is very complex, full of funny rules like that. But if the only condition in a share-based payment arrangement is you have to do so many years, so a service condition, even if it does not vest at the end of the day, it gets expensed, it does not get reversed. However, if the only condition in an arrangement is, as you said, some sort of a performance-type condition, a performance hurdle, if it's ascertained that that hurdle will not get met, then it is possible that you will get some situations. So maybe it's a five-year type arrangement and after three years you've actually determined that that hurdle won't be met, for the first three years you will be putting an expense through, anticipating it will be met; after three years, if you've decided it's clear that it's not going to be met, you can actually, as you said, reverse or put a credit against the expense that has been recognised in the past, to take that out. So that's another confusion.

MR BANKS: So it effectively can be neutralised, if I can use that term, in certain situations but not in others?

MS HICKS (JAB): Yes, and the distinction between those situations is not always clear.

MR BANKS: Right. All right.

MR FITZGERALD: Only if I were a masochist would I ask you why; but I won't.

MS HICKS (JAB): No, don't. I can spend a couple of hours on that.

MR BANKS: Thank you. Well, we gratefully appreciate your time and the submission, and indeed there may be other issues that arise that are in your realm, and if you'd like to get back to us on some of those, we'll appreciate it.

MS HICKS (JAB): We will.

MR BANKS: So thank you very much.

MS HICKS: Thank you.

MR PURCELL (JAB): Thank you.

MR BANKS: We will just break now for a little while, please, before our new participants.

MR BANKS: Our next participant is the Remuneration Strategies Group. Welcome to the hearings. Could I ask you, please, to give your names and the capacity in which you're here.

MR DAY (RSG): My name is John Day. I'm a director of the Remuneration Strategies Group.

MR FITTON (RSG): I'm Gary Fitton, and I'm also a director of Remuneration Strategies Group.

MR BANKS: Good. Thank you very much for taking the time to attend today and also for the submission, which we have read. We have some questions for you, but give you the opportunity first to outline the key points you want to make.

MR DAY (RSG): Again, thank you to the commission for allowing RSG - if we make call ourselves RSG - to submit. By way of background, our company had a contract with the Department of Workplace Relations with the ESO unit, and the objective of that particular contract was to increase employee participation from the then 4 per cent to 11 per cent in Australia. So we have been around employee participation plans for some time. Our submission basically - and I might just read from it, if I may - is that basically there is a direct link between employee equity plans, human capital management and a company's financial performance.

International experience demonstrates that long-term incentive equity plans assists in the attraction, motivation and retention of employees. Furthermore, employees, human capital management, manifests in increasing assets to the company and with employees. Our experience is that the optimum method of design, implementation and administration of effective employee long-term incentive plans is for all stakeholders, which includes employee shareholders through employer equity plans. That's basically our submission. We will speak to some of the comments made on termination payments, if requested.

But basically our main submission is to enhance the ability for all employees of all types of organisations, be they public companies, private companies, joint venture, partnerships, trusts, to have some form of employer equity participation plan, which is easily implemented, easily administrated, and that those plans do not have to have unnecessary regulatory constraints, that there's a sort of a clear pathway for all types of employees, being little private companies to large public companies, because the way the legislation is placed at the moment, although it's under review, it is that there is some clear definition for employees of public companies to have employee participation plans. There is very little clear path for employees to participate in plans in other than public companies.

MR FITTON (RSG): I think our particular focus, although John has stated, the tax focus, has been mainly on listed companies. We're one of the few organisations that has a specialisation in providing share plans for unlisted organisations. The first thing that we learnt with the Dewr project was that most new organisations, most new employers, are in fact not even companies, apart from being private companies, and they're very often not even companies, and they have devised certain methodologies for delivering a share of what we call surplus value or the actual value of the organisation and the growth in that value of the organisation to deliver these long-term incentives, and that's it, the optimal methodology for doing it.

At the moment I think the level of employee equity shareholding is around 5.9 per cent to 6 per cent, so the target was 11 per cent by 2009, and that hasn't been met. But the main concentration for employee shareholding is certainly listed organisations, about 90 per cent of listed organisations have employee share plans, but it's only .9 per cent of unlisted organisations have employee share plans; as compared with the United States, it's 90 per cent and 90 per cent, so in the United States 90 per cent of unlisted companies actually have employee share plans, and that's a big discrepancy with international practice, which we are endeavouring to rectify.

MR DAY (RSG): As best we can.

MR BANKS: Can we explain it first?

MR FITTON (RSG): Of course.

MR BANKS: Yes, so why the huge disparity then?

MR DAY (RSG): The research has shown that particularly in the UK, because the UK has large participation percentages as well, it has been the regulations, and both of those, including taxation regulation, is a lot clearer and a lot more supportive of non-public companies implementing. That's the research; that's not a personal view, that's just what the research points out.

MR BANKS: So there's more tax inducement, if I could put it that way?

MR DAY (RSG): Well, for example, the IRD, as it was once known, in the UK instigated template plans for private companies, they took the initiative of developing different types of plans for different types of employers, recognising that not all employees work for public companies. That was the initiative. I think it's called something else, but it was called the IRD at the time.

MR FITZGERALD: Just expanding a little bit on that. If the benefits of having a reasonable employee shareholding are as strong as you indicate from the studies and your submission, why would we not have already seen a very strong movement by companies, both private and public, to embrace it? If it's such a self-evidence good, why have we been so slow to - - -

MR DAY (RSG): I think there's significant constraints, particularly for private companies. That arise out of the existing legislation, which basically says that to offer what was then called a discounted plan - it might change during the current situation - an employee or an employer could not have more than 5 per cent of the share equity. So if you're a private company, you'd like to be a private owner and own more than 5 per cent after you have employees participate; you are unable to participate (indistinct) offer that plan.

There's also significant corporate law that makes it different or hard for private companies and their advisers to understand and to advise on the ability for a private company to offer shares to their employees. Do they need an AFSL licence or don't they? Does their trustee have to have an AFSL licence? Do they need a prospectus or don't they need a prospectus? Are they considered to be share hawking? These are significant legal issues that certainly the large legal firms have the capacity to advise on. But if you're running a 30-person company, you don't have perhaps the legal team behind you or the ability to fund that sort of advice. It's just very unclear.

So two things. One is, the public company legislation is clear. There's exemptions under the corporate code in relation to a prospectus for a public company, for example. Those sorts of exemptions do not exist for other than public companies. The law is very difficult for other than public companies to implement employee participation plans, and that would be one of the reasons why we get the percentage we do.

MR FITTON (RSG): I think that the big difference between those figures concerning the United States is the proliferation in the United States of what is called ESOPs, a means of capital-raising and capital injection for the unlisted corporate sector. It's a very nascent practice here, but in the United States it's very, very prevalent. But it means that you don't have to list to actually effectively raise new capital for the company, so it's fulfilling a joint function, both as an employee equity participation program plus also as a means of injecting external capital into the company without having to go to a stock market to capital raise from the stock market.

MR FITZGERALD: So you can just explain it in brief? What are the specific recommendations - and given our inquiry is largely about public companies, publicly traded companies, what's the specific recommendations that you think governments should implement, or we should recommend to governments that would enhance the employee share ownership in publicly-traded companies?

MR DAY (RSG): I'm unaware that this inquiry is only about public companies.

MR FITZGERALD: No, it's predominantly about that group.

MR FITTON (RSG): But public companies aren't necessarily listed companies if it's quite a large - - -

MR FITZGERALD: No, but I want to just deal with them in segment if I can.

MR FITTON (RSG): Sure.

MR FITZGERALD: In relation to publicly listed and traded companies, are there particular recommendations that you think need to be made to governments that would enhance your objective of increasing the level of employee share ownership?

MR DAY (RSG): I certainly think the current review that's occurring in relation to division 13A, I think, personally - and though we've discussed private companies, we also advise a lot of public companies. But our passion, I guess, is in the private company sector, so offsets become evident to you. But I would suggest - whether this is formal or not - but I suggest that division 13A be left alone until the completion of this inquiry, to allow public companies the ability to have confidence in the share plans they currently have in place, and for those share plans they'd like to put in place. I think to answer that one question, leave division 13A alone, allow this commission to complete its inquiries, to make its recommendations for the government to consider those recommendations, and then make a sensible and considered and intelligent decision about how they go forward for division 13A. Whether that's the new division 83A or 83A gets varied, I don't know, but at the moment there is a huge amount of uncertainty amongst directors of public companies.

We're in contact with these directors on a daily basis. They do not know what to do, and even an announcement by Mr Sherry, I don't think will make any difference to that. You could possibly see a situation that for up to 12 months to 18 months you've got a void in equity participation, to answer your public company question. You may have up to 12 to 18 months of a lack of confidence in the ability to implement an employee share plan for a public company, and that could have devastating effects on all sorts of areas, not just on the employees themselves, which is the most important part. It's their families. It obviously goes against any revenue that might have been raised during this initiative of the government's. You don't need us to tell you that. It's in the papers every day of the week.

MR FITTON (RSG): The problem is that the tax conditions impose upon remuneration design conditions. So once they set, you know, "It's got to be subject to genuine risk of forfeiture," it's not just restrictions on disposal, it's not just any forfeiture condition, but this genuine risk that takes out a range of applications for share plans in terms of a bonus delivery or salary sacrifice facilities, which are now defunct. It means that the design of employee share plans is now driven by tax considerations and short-term tax considerations, because ultimately if there's a tax trigger, the only way that employees can pay that tax trigger is to sell their shares and realise the cash return. Once they do that, it tends to dissipate the equity within the share plans. So you have to start the process again. But it's a very short term and cash driven focus, which we believe undermines genuine design considerations.

MR FITZGERALD: Your premise for this proposal is - can I just unpack it a little bit? Is your basic premise that you believe that a more significant employee shareholder will drive corporate performance generally, and as such, there's an inherent good in having employees as shareholders for corporate performance, because most of this inquiry has heard about linking shareholder or equity arrangements in order to drive individual performance, or to reflect that in some way. So people are talking about long-term incentives in order that CEOs or senior executives have their eye on the long term. But can I just unpack. Yours seems to be a more general position, that in fact overall increased employee shareholding is in and of itself going to be beneficial to the company. Is that right?

MR DAY (RSG):   It's beneficial to all the stakeholders, including government. Obviously the ability to link the wealth creation process between an employee/executive - but we mean employees as well, of course - and the shareholders obviously is inherently good for the company. Too often, some remuneration strategies have been designed which - it's like you're driving a car and you've got a certain map to get a certain direction. Your remuneration design determines consciously or subconsciously people's behaviour. It's like a GPS. Whether they mean or don't know, they are driven by that REM strategy. So our suggestion is you design remuneration strategies, including long-term incentives, which are for the long term good of all stakeholders, which includes employees, the shareholders, and the nation, because our research goes to the fact that increased participation also increases wealth for the nation as well, in terms of national savings. Who was it did the study? Dr Fitzgerald did the study - - -

MR FITTON (RSG):   Dr Fitzgerald found that it was actual - the tax deferral created ultimately more tax take than if employees had paid the tax up front. So it was actually over the long term much better tax revenue result than having them pay the tax up front.

MR FITZGERALD: Dr Fitzgerald was there.

MR FITTON (RSG):   Vince Fitzgerald, the ex-treasury chap who was - he's up at Exhibition Street.

MR FITZGERALD: Allen Consulting Group.

MR FITTON (RSG): Yes, that's right.

MR DAY (RSG): This increase in employee wealth and increase in share wealth is obviously through evidence, but it's also actually being inside these businesses and seeing the attitude of the employees and how it changes dramatically, and how their sense of self-worth improves, how it reinforces and builds culture within an organisation, and that culture creates the long-term asset of any business, whether it's a public company or private company. The ability for an employer to, with some sort of ease or simplicity, to have an employee participation plan is, as we are putting to you, best for everybody. It's not just about the money. It's about the respect. Money isn't what motivates people. It comes out fifth or sixth. What motivates people at the top is showing respect, and if you implement an employee share plan, you are showing that employee, "You are important enough to be part of our wealth creation process. We respect you." That might be a bit airy fairy stuff, but we see this.

MR FITTON (RSG): But I think there's a general perspective or perception, especially amongst the unlisted market of employee share plans are too hard and can't be done. At the listed market, it certainly become much more prevalent. There may have been some tax issues in terms of compliance, which we thought could have easily been rectified. Indeed, in 1995, when we lobbied against the then Labour government's original proposal of $500 tax exempt and maximum, $1500 taxed a third, that they should impose a compliance regime whereby those allocations were subject to up-front reporting, similarly to the PAYG system. But it was never taken up by neither the government, treasury or the tax office, and that has been a major flaw with how the tax system for employee share plans has been administered.

So it's long overdue. We've got no problem with that. But we think that the regulations imposed or proposed are extremely short term, cash-driven and will cut back a lot of genuine employee share plan participation. Actually, the proposed changes to the tax system for some reason - and I don't understand this - seems specifically focused on the listed corporate market. In fact, most of the share plans we do for the unlisted market is unaffected by these tax changes. These tax changes hit squarely the listed market, which if the problem were simply non-disclosure or non-compliance, that should have been rectified 15 years ago. It was not rectified. If that's the problem, that needs to be sorted out. But the other elements are quite negative.

MR BANKS: When you say it's focused on the listed market, would that be because of a concern with senior executives who may have been - - -

MR DAY (RSG): We don't know where that thought came from but I would imagine that would be the case. We don't know.

MR FITZGERALD: A participant last week in Sydney put the proposition that if you had employee share ownership at an increased level it might act in some way as a restraint on what they viewed as excessive remuneration at the CEO and senior executive level. They weren't disputing the fact that they thought they should have shares as well but they felt that once employees have a vested interest in the organisation that that directly or indirectly might have an effect on the way in which senior management is in fact remunerated. I suspect what is behind that is the notion of relativities, which we continue to see become greater. I was just wondering whether you have a view on that?

MR DAY (RSG): No, I would support that view. But quite frankly I think at the moment most boards of directors are so concerned about governance issues - in this environment boards are very concerned about the governance issues and they are very concerned not to be having remuneration policies which are deemed to be excessive, because there are a lot of people looking at them.

MR FITZGERALD: If they are excessive, what are the constraints on them at the moment that you think can be better utilised, I suppose? In other words, if there is a view, if there a perception that CEO and other executive salaries are in fact excessive, what are the tools or the levers that exist for directors to moderate that or, more importantly, the incentives for them to do so apart from public pressure.

MR DAY (RSG): I think your point about increased employee participation would certainly have that relative effect. I think the disclosure requirements in the end reports at the moment I think are sufficient; my point of view, that's - - -

MR FITTON (RSG): I think extending the vesting conditions beyond a limited period, which means that they don't have this focus on short-term cashing out for short-term return, I think this is a problem, also having them automatically cashed out on termination. I mean some part of that long-term incentive should extend beyond that termination period to ensure that they have not taken short-term decisions for short-term return. Sometimes accounting practice can bring profits forward to short-term and realise the so-called key performance indicators, KPIs, and just return short-term cash return. That is a problem with how especially option plans have operated in past years.

MR DAY (RSG): We think that our initiative for that where the vesting conditions can go past termination date is a good idea.

MR FITZGERALD: Can I ask you just specifically about that. Do you have a view as to what's reasonable? Let me put that in context. In discussions with actual CEOs of substantial publicly listed companies there is a general view that going beyond termination might be acceptable. When you ask the question, "What might be reasonable?" one or two years is the sort of figure. Some proponents, some participants, have put the view that it should be three years, five years. You may have seen Regnan in the Sydney inquiry had a view that they go up to 10 years.

MR DAY (RSG): Yes.

MR FITZGERALD: Do you think there is a reasonable or other reasonable period post-termination where a senior executive should be required to hold the shares or in fact have the shares not even vest?

MR DAY (RSG): It goes back to the design phase. So when you're designing long-term incentive you're not doing so with a view that the person is going to leave. So that period of time after termination is actually determined when you're doing the design. So typically for most companies it's three years. We think three years is fine; in some cases five years, depends on where their business is in its cycle. If it's at the very beginning of its cycle, it's a start-up, you might have five or more. But if it's a mature company with mature cash flows and a mature profit and balance sheet, we think three years.

MR FITZGERALD: Post-termination?

MR DAY (RSG): No, three years from the LTI.

MR FITZGERALD: Post-grant?

MR DAY (RSG): Yes, from the acceptance of the offer post the grant.

MR FITZGERALD: Yes, the grant.

MR DAY (RSG): So if the person leaves one and a half years into that three-year cycle, well, it's already locked away. It's a contract that's legal. They wouldn't be allowed to sell their shares, if that's what it is, or exercise options till one and a half years after that. So going backwards is a bit academic, going forwards is what real life is. You've got to sit down, negotiate this with the executive. They have to agree to it. It is commonly that three years - and we did the same thing with private companies, put three-year vesting conditions in as well.

MR FITTON (RSG): It also depends on the type of organisation. If you're looking at long-term bank, established bank, well perhaps five, seven years is quite appropriate. But if you're looking at some start-up situation - and we do a lot of start-ups because frankly shares fulfil a very, very important role in constituting a part of how you pay people because many people in the mining industry or high-tech start-up companies are staggering from one capital raising to the next capital raising.

They will reduce their base fixed cash pay as much as they can and top up with shares, so deliver their short-term incentives plus their long-term incentives in the form of shares. So it's a trend to have those shares but break them up so that the shares will fulfil an effective role as a short-term incentive delivery mechanism plus a long-term incentive delivery mechanism.

We have seen a change in the way that incentives have been delivered recently in terms of the market uncertainty by getting a break-up of long-term incentives into a retention component and a true incentive component. The retention component might be delivered as full value zero exercise price or what is called performance rights, with the short-term as more growth only type option structures.

MR DAY (RSG):   What is quite bewildering at the moment is where you have a situation where we're taxing long-term incentives up front in an environment where we're trying to keep our fixed base pay down. If you start taxing or adversely impairing a long-term incentive one way or another, inevitably that is going to lead to pressure to increase base. So base salary is a fixed cost. Accountants would prefer that you try and keep your fixed costs down in this day and age. So it's bewildering as to the timing of these purported changes by the budget. It seems to lack any logic at all.

Secondly, if I may, if there's any suggestion that termination payments should be a multiple of base pay only, that is also bewildering because base pay isn't - a total remuneration package of an employee could be made up of base pay, short-term and long-term incentives, what we call total employment costs. If there's any discussion to occur as to how a termination payment is to be calculated it must be done - we believe anyway it should be done on the total employment cost, not on the base pay, particularly in this economy environment where we're trying to keep our fixed costs down.

MR BANKS: There have been people who probably provided a contrary perspective to you in terms of concern about the use of equity and executive remuneration in terms of it being a significant part of the problem in either the escalation in remuneration or lack of transparency or whatever was associated with the fact that it was equity based. Some have made recommendations following on from that. Some have argued that equity is a good motivator if properly structured but it would be good - you know, that old KISS principle, Keep It Simple, Stupid. Is that feasible in this area? Do you have any views in response to those sort of concerns?

MR DAY (RSG):   We think the KISS principle is a wonderful principle. If you can't explain something in five minutes it can be difficult to understand it. If people can't understand they don't trust it. So we think - our experience with our clients that come to us, the so-called abuse of option plans is more out of ignorance and lack of knowledge than any sort of conspiracy to defraud the government of any tax. A lot of the executives had no idea how the option plan works. They didn't know they were to do a 139E election. The handbooks that they had had no detail as to that. They trod off to their accountant in the suburbs, the accountant had no idea what a 139E election was. So this so-called abuse was more out of lack of knowledge, ignorance or advice. They then lodged their tax returns and claimed a capital gain for something that should have been declared as income. They didn't know any better. It wasn't explained to them. So we actually think that abuse had occurred but it's not as prevalent as it was made out to be.

MR FITTON (RSG): We also applaud the accounting standards of the valuation of equity and share-based payments, the Accounting Standard AASB 2, it has brought some logic, it has brought some accurate calculation of option and share benefits so that since 1 January 2005 we now have a methodology for actually calculating accurately the level of short-term incentive which the equity is delivering plus calculations of the long-term incentive. Generally speaking we have found those valuation principles very, very good, very advantageous. They have logic plus we have proper ceilings now for the allocations of options and shares.

We have had a few issues with the recent market fall. As you know there was a dramatic market decline in October-November last year which have put a lot of especially growth-only type option plans, what is called underwater and basically useless. It would have been good just to have had those cancelled and brought back as equity, but that is not how the accounting standards work. But generally speaking the accounting standards have worked very, very well.

MR DAY (RSG): So to go to your question, if they're well designed you shouldn't have that problem. It's about designing the long-term incentive for all stakeholders' benefit, not just for the executives; to go to your question.

MR BANKS: Just in relation to the comment about them being underwater, I mean wouldn't that be a poor design feature if you could reverse or change the nature of it so that when markets fell there wasn't a bit of pain coming through that?

MR DAY (RSG): No, we - Gary is referring more to how they're treated for accounting purposes on the P and L. As the lady before spoke about having to expense for the third, fourth and fifth year there would be some logic to say you have to expense for the first two then they're under the water and cancelled; and the lady used the word "credit". There would be some logic to credit it. Our suggestion there is you have rolling offers. You have rolling offers of equity every year. So the dollar cost average - you can call it what you might. There will be some years - and that goes back to aligning the executive long-term incentive with that of the shareholders. They're in there for year after year after year, why shouldn't the executives? But the notion of issuing a equity plan and not doing anything for three years we don't think makes much sense. But if you're offering every year you're going to have situations where they're going to be under the water and over the water. That's just linking the executives to the shareholders, as they should do.

MR BANKS: Yes. We had one leader of a union - we asked him about share plans. Probably fair to say he was lukewarm in his support of them. We heard nevertheless the ACTU I think was concerned about the mooted changes and tax arrangements and so on. Has the union position changed over time in relation to these share plans?

MR DAY (RSG): I'll answer from an overseas perspective and Gary answer from a local perspective. Overseas in America and the UK the unions are actually the ones that advocate these plans. It's just a little odd to us as to why the unions don't take the same view, because ultimately it's sharing wealth. If you have an all-employee share plan you're sharing wealth with your members. We don't understand why they're not - but certainly overseas the unions are much more - it might be another reason why there's more participation in overseas countries but the unions are much more supportive of share plans overseas. Gary will talk to Australia.

MR FITTON (RSG): We have actually done quite a lot of work with the ACTU and with the unions. We recently presented at Brisbane at the triennial conference on employee share plans. It's fair to say that the view within the ACTU and indeed unions can be varied but certain unions are very strongly supportive of employee share plans, especially such as the Finance Sector Union; APESMA is very supportive, the AWU is very supportive. Many are supportive, some fear that it may undermine the role of the union and the traditional division between labour and capital. We view that and indeed many other union members view that as a good thing that there's less artificial divide between labour and capital, and it actually gives labour a fair share of its investment that it's putting into the process.

MR BANKS: All right, well, thank you very much for that. We'll break now for a moment, please, before our next participants.

MR BANKS: Our last participants today are Andrew Donovan and Peter Tunjic. Welcome to the hearings. Could I ask you please just to indicate the capacity in which you're here today, thanks.

MR DONOVAN: I'll give a quick introduction as to who we are and then Peter will talk about our submission. We promise not to read it out, as I understand some participants have. We are coming as individuals because we have multiple roles. I've been a company director in publicly listed companies for the last 18 years and I advise about half a dozen Australian companies not in remuneration but in governance issues. Peter is a commercial lawyer and together we also provide advice in that area. But we're also the trainer and authors of several Australian Institute of Company Directors' courses in governance as well as I'm a fellow of the institute and quite actively involved. But because of those multiple interests we are here as individuals rather than any particular organisation.

MR BANKS: Thank you.

MR TUNJIC: Thank you. If it pleases the commission, today we're going to introduce a couple of concepts regarding executive remuneration that we think have been potentially missed, in the terms of reference and the main assumptions underly the terms of reference. We want to talk to those insofar as creating an argument that stems from the definition of performance. So we start with the definition of performance because I understand that's one of the key questions of the Commission and how performance is related to executive remuneration.

We define performance as the manner in which the company achieves its objectives, being making and keeping the best possible promises it can, given its assets and opportunities. We define that as performance. It's not about a KPI, it's not about a profit margin, it's about the promises that a company makes and its ability to deliver those, because if it can't, it has failed. It has failed to deliver on its performance objective.

MR BANKS: Promises to its shareholders?

MR TUNJIC: We'll go into that in the sense that there are three potential classes of promises to which a company makes: its capital promises, they are the promises to the shareholder and we'll address those briefly; the promises which we will call corporate promises, the Executive and director contracts of employment would fit within those and we'll talk to those; and then what we'll call regulatory promises. They're the promises that a company must make to maintain its registration as a company and to comply with the law. Each of those classes of promises must be maintained. They form a nexus of contracts, if you want, of which each is interdependent. In order for the company to perform each of those must be delivered upon, to the best of the company’s ability. That becomes a qualitative issue and subjective issue which we will talk to briefly.

If we go then to the first class of promises, the capital promise to the shareholder. I think there is a general view that somehow that promise by the directors to the shareholders has somehow been breached by what is classed as excessive remuneration. We come to this asking, "Okay, where does that promise stem from? Why are you complaining about excessive remuneration" on what grounds that when it has always been open to the shareholders to specify in their constitution the principles or arrangements in relation to executive director remuneration. That they've failed to do so doesn't then mean that the government should stand in and effectively rewrite the contract in their favour when they can unilaterally, with 75 per cent, enshrine those principles in their constitution.

So one of the questions we ask of the commission in our submission is to ask - before the government intervenes why have the shareholders not intervened and enshrined the principles of remuneration that they think are in alignment with their interests? We think there is a secondary point to that is then how do you encourage them to do so? If this is an issue that they think that there had been a breach of an implied promise, would make sense to express it so that the board can make a decision - and directors can make a decision, "Do I want to be on this board?" rather than have a situation where I accept employment on the conditions of the constitution but I'm being second-guessed constantly by the state, and I mean that with respect, and shareholders and the community at large.

So we would encourage that inquiry to go on to consider this. For example, one element or area in which a positive step could be taken in that regard is for the board to form what we call a constitutional committee, that is asked to be formed by shareholder representatives and members of the board, where this specific and other questions are addressed, so that there's a freedom to contract. We allow the marketplace then to allow shareholders to say, "Well, I'll invest in this company over this company because it has enshrined these principles," and we can get a differentiation of principles rather than a situation where there could be a prescription, a generic prescription, which may or may not apply to a company’s circumstances and that doesn't enshrine the freedom to contract.

MR BANKS: Could I ask you then to talk about the relationship between what you're proposing, a constitutional, fundamental kind of initiative, relative to the remuneration report and the non-binding vote on that, and some who would argument that you need to simply improve the remuneration report in terms of setting out the policy of the company in relation to remuneration, et cetera, including actual realised remuneration as well as the accounting complexity that is in those documents.

MR TUNJIC: That might lead me into the second aspect of the corporate promise. There we're talking about the promise between the executive or the director and the company to deliver something to the company that the company requires in order to meet all its other capital, corporate and regulatory promises. It's within that context I think that we've seen an element of what is described as uncommercial or excessive remuneration.

The question for me there is the focus tends to be on one side of the bargain, the bargain of what the executive is being paid. However, you can't understand or know the commerciality of a bargain until you know what you're [the company] is getting in return. So reading the terms of reference, the focus tends to be on the quantum or the terms of remuneration, not on the question of what you're getting.

Performance is not about what I pay someone, performance is about what I get in return that aligns those promises that have been made by the director or the executive with achieving the performance objective of meeting all my other promises. I think what we have at the moment are executive contracts, that fundamentally miss this aspects. They are made in hope and kept in fear. But we really don't know what we're getting for our money. Uncommerciality, the uncommercial nature of the contract, is not the quantum but the lack of specificity of what we get in return.

MR DONOVAN: I think we would argue, in going further, specifically to answer that question is that those changes wouldn't actually deliver the result, that it's actually a fundamental mismatch in the contractual negotiations. It may well be you may in your deliberations determine that there is a role for government in evening up those contract negotiations. Our view is the shareholders are pretty well empowered, it's not like an ACCC-type affair where there's an abuse of power or an imbalance of power there. But you may well find that there's some regulatory approach to even up the approach. It's just simply that shareholders and their boards, or the boards of the company because the board is of course not the shareholders' board, have not actually looked at this other side of the equation.

If you look at the majority of the contracts it is all about what we're giving away as directors, but we're not actually specifying particularly, except in some fairly loose, in general terms, I would argue, KRAs or KPIs. We're not actually specifically treating them more like service contracts or actually negotiating a service agreement. As directors, we would never let our executives enter into service level contracts with the same sort of quantum without the sort of specifications in them that we expect in any service contract, and yet we don't expect that in a CEO contract.

MR TUNJIC: To go then to your question about transparency, transparency only gives me a view of one half of the bargain, but it's meaningless. Potentially, for example, the proposition is put that shareholders could be given the vote on remuneration, it becomes even more uncommercial because you've got shareholders who aren't party to the transaction as a whole, and who do not know the value that I'm [the Company] is receiving from the executive director. It's for each company, each board to determine the value, because it's not just the sweat that they're delivering; it might be a brand name, it might be access to their networks. When we bargain it's a suite of assets that we're getting in return.

However, I think at the moment in terms of the relationship between executives and directors, directors have been outbargained. That's a question we ask; "Why is that? Why has the relationship become for some reason more of an agency relationship between management and the board? We don't see the strength of bargaining position within the board to be able to articulate a strong position and say, "Well, that's what the deal is," and being able to specify that this is what we expect in return, and if we don't get that there are consequences. I think that's when we can get to the other side of the bargain.

I was speaking to some lawyers this morning that negotiate contracts and we talked about what sort of other contract do you negotiate where you would see some of these exit payments. When do you try to incentivise a contractor to perform the contract? You don't enter into a contract on that basis of needing to incentivise. If we interpose a company rather than a CEO I would never in my mind think, "I have to incentivise this company to perform. I've articulated what I need in return and this is what I'll pay, knowing what I'm going to get." Come back to KISS. I think we've lost sight within the sophistication of remuneration that this is an essential bargain between company and an executive and a director that has to deliver something back to the company that leads to performance, which means keeping all the other promises.

MR FITZGERALD: Can I just take up Gary's point about the non-binding vote. Is it possible that the non-binding vote empowers directors or strengthens the directors' hands? Firstly, some people say the non-binding vote has been an important and beneficial advance, certainly over similar jurisdictions, particularly America, where they don't have this. But when you think about it, the directors in fact have another bargaining chip, and that is that if we in fact don't negotiate this appropriately, or "reasonably" is the words, then in fact there is an accountability back to shareholders.

So do you in any way see that the non-binding vote empowers or strengthens the hand of the directors, because it's no longer just a bargain between directors and CEOs and executives, there is in fact a third active player, namely the shareholders, and there is an instrument by which those shareholders can in fact express a view. If they chose not to that's a different issue.

MR TUNJIC: The shareholders are largely silent. If they have a role they have chosen not to exercise it, they've relied on the government to essentially rewrite a clause into their contract giving them a non-binding vote. I see it as a continuum. I agree it gives them a bargaining chip. The greater bargaining chip would be for the shareholders to say, "This is what we have determined and agreed as the remuneration strategy. If you want to contract with this company as an executive or director, I am bound by this," and therefore giving them [the Board] the ultimate hand.

I think at the moment there is no way of a board being able to respond to the competitive market aspect. If a director wants to work for a company, and the company has limitations on what it can pay, we eliminate some of the pressure on boards. That's a decision then for the shareholders who enshrines this to determine, "Is that in my best interests or not." So I guess what I'm saying is I agree with you, I think it does strengthen the hand, but I see that there's a continuum here that we need to explore, that continuum which at one point tips over and goes too far and the value and the performance drops, and the other way there's no limitation in giving the board a stronger hand.

MR DONOVAN: I'd be concerned also if directors felt they needed to have that strengthened hand. They have that already under corporations law and they have it by that. I think this is one of the problems, it is a failure of governance. We aren't arguing at all that there aren't some substantive issues that need to be addressed, and it is a failure of governance both at shareholder and at board level, and that indeed if they are given a non-binding vote on this issue, when the next issue emerges where boards are failing to deliver on their own promises to deliver as good directors then we'll have to introduce another non-binding vote on that issue and that issue.

That leads to this question of who actually should be the directors of both public companies, listed and unlisted, etcetera. There may well be a need to be considering the UK model, which hasn't actually developed all that well so we might look to another jurisdiction, but the licensed director or the chartered director. At the moment, we've basically got the accidental director. Largely, as you would know from the stats, a gentleman over 55 who is an ex-CEO, and those people have in many cases excellent experience to be able to be directors but in many cases they don't actually have the capabilities to deal with the complexity of some of these issues. I believe that that lack of diversity in the cohort and where they have come from has held them beholden to management in a number of issues, and this is one of them. In other areas they perform their role particularly well.

MR BANKS: Could I just get you to clarify there. Are you saying that ex-CEOs are not well suited or are you saying that some directors are not because of their background? Is it a reflection on being an ex-CEO in that role?

MR DONOVAN: I think it's like all things, you don't want a whole board full of ex-CEOs. Again, the demographics of our directors in the top 200 in Australia is around that, it is gentlemen over the age of 55 who are ex-CEOs. So I'm just simply saying as a cohort, and directors are a team, that in fact we don't have that pool of diversity. In fact, the fact that the cohort is a largely ex-CEO cohort makes them, if nothing else, compassionate and sympathetic to the CEOs in terms of negotiating this; they've been through this themselves. So I'm not arguing there aren't excellent CEOs who make good directors, but I don't know that we should be seeing that as our pool for the excellent director, and more looking at it as a profession, as a licensed profession, to actually deal with these issues. I would argue that a suitable professional director would not be negotiating some of these contracts that we're seeing.

MR TUNJIC: If I could just add to Andrew's comments, what we're trying to break, as I identified, is this concept of entrapment, that somehow management and board have become entrapped in a relationship and that makes them unable to make commercial decisions in relation to remuneration and contracts. I think we're saying that if we had certain different classes of director on board that entrapment might break. So for example, the dissident director, and we've seen that in a number of situations where you do have a dissident director who emerges or is put on and breaks that entrapment and realigns the board and realigns the bargaining position, and the board remembers what it's there to do again; that is, to keep it's promises. The question is, "How does paying this amount of money help us keep our promises?"

MR FITZGERALD: In your range of options you've talked about the German-style supervisory board. Last week in Sydney we had a similar proposal by another organisation where I think they called it a governance board, which would look at only two or three issues. One was remuneration, one was the appointment of auditors, and there are a couple of areas. Their basis for that was that they think there's an inherent conflict of interest in the board itself dealing with those issues, and I won't go into their explanation for that. If you were to move to this sort of notion of a supervisory board, or your constitutional committee, which I presume has a different function, could you explain to me what functions or roles those two bodies might perform.

MR DONOVAN: I think our preference is not necessarily the supervisory board, although I note that's in the BRW this week that David Gonsky is also canvassing exactly that sort of model. I suppose we've placed that as an option. Our preferred position would be the constitutional committee, so perhaps we'll talk to that.

MR FITZGERALD: Can you just explain what that would do then.

MR DONOVAN: So that would be more in relation to strengthening the role of the shareholders in active participation about the nature of the contract, and their contract with the directors is obviously through the constitution. At the moment that's largely set and forget. Indeed, in public commercial companies there isn't even a statement of objects, whereas of course in not-for-profit organisations there's extensive identification by the members as to what the purpose of this company is.

So there would be a range of things, such as establishment of objects by this constitutional committee - the issues of determining key policy areas at a very high order level, because we don't want micro-managing shareholders - such as remuneration principles that they may well chose to enshrine or they may chose to leave to the directors, and the third would be an active consideration of the nature of the governance structures of the organisation in terms of how they might want to go further in terms of determining sizes of boards or the various provisions in the constitution around governance.

So it's those three areas of the objects of the company, any high-order decision-making that the shareholders want to reserve to themselves, and then the governance structures. It would be in a very similar way that a good board should be establishing its terms of reference for itself and its delegations policies to management.

MR TUNJIC: That committee would report to the board. It would be a board committee that reports its recommendations to the board, which would then be incorporated into, for example, the annual general meeting, enshrining these principles.

MR FITZGERALD: Could I go back to your opening premise. You heard this morning, you're right, that very rarely do large institutional shareholders ever put up special resolutions or amendments to the constitution of the companies, in fact, almost never, and we were given some exposure to that. I suppose the fundamental question is if they don't exercise their current powers which they have why should we be interested? In the sense that it's their company, theoretically and legally, if they have no interest in changing the way the company operates through the resolution process why should be want to give them another vehicle when they can if they're so interested actually do something, as you rightly said right at the beginning. So I suppose it's a really simple layman's view of the world. If they're not interested why should we be bothered giving them another instrument? That's distinct from the governance board, which has a very different purpose, but this constitutional committee - - -

MR TUNJIC: But I see that as being an initiative of the board. The board at the moment is being undermined about assumptions about its role, assumptions about the relationship, the assumptions about what it can and can't do. Essentially, there's a bunch of implication which gives it no sort of certainty as to what its roles are. This committee would be a way of providing certainty to the board and certainty to shareholders of expectations.

MR DONOVAN: There is also the argument that good shareholders make for a good company as well, and that in fact we have been deskilling and deincentivising shareholders to be engaged in governance in general, in the English sort of common law corporate regime. It may well be to our benefit as communities and as companies to re-educate and re-engage shareholders by actually adding mechanisms, because the current mechanisms are ones that have largely been established since 1600. So I suppose it's a review of the avenues available to them. But that basic premises of course is right, that if they're not going to get involved - but I don't know that we actually have active shareholders other than a small retail group who are actually thinking at a more sophisticated sort of level.

Again, like directors, there's no requirement other than being 18 and not mad or bad or in other ways disqualified from being a director, there is no limitation on who can be a shareholders either, so there's no licensing of those. I suppose our general premise is that an active and educated shareholder group and an active and educated director group actually produces better outcomes, both in immediate terms of commercial outcomes, but also in wider terms, in terms of how they might contract for much wider purposes. The constitution and those objects can incorporate corporate social responsibility and other initiatives rather than those having to be regulated, if the shareholders so chose.

MR TUNJIC: If I could add also that the state has also walked away from the contract in a sense, walked away from the nature of the contract by removing the requirement, for example, for some companies to have a constitution, to remove the requirement of objectives and really say, "Okay, we have this contractual relationship here but we're going to deal with that contractual relationship not as contracting parties but through the Corporations Act or through the ASX or through other vehicles rather than coming back to the core document and the core relationship," if we look at the amount of decisions in relation to the constitution, they are minuscule, and contractual laws in relation to the organisation of the company are minuscule The laws and relationships between the board and shareholders insofar as the state is concerned is the Corporations Act.

I think there's an opportunity here, the relationship has become imbalanced, and we need to incentivise or encourage shareholders again to exercise their contractual rights and freedoms and then allow the market to develop as a process of that insofar as where people want to invest given the rules that they're investing into.

MR FITZGERALD: Even if we were to accept that proposition, a question that arose earlier today when Stephen Mayne put forward a number of significant recommendations around changes to the governance arrangements, and others have done so, I suppose the question is whether or not executive remuneration is a sufficient reason to bring about those changes. So even if you believe those changes might be appropriate, our entry point through the terms of reference is around executive remuneration and directors remuneration. So our fundamental question is that might be fine, but does executive remuneration in and of itself give you sufficient reasons why you would propose what some would regard as a radical reform?

MR DONOVAN: My personal view - we haven't discussed this - would be it's not sufficient reason but that it is one of many symptoms that have emerged over the last 10 years that would add to the need to actually have significant governance reform.

MR TUNJIC: It's commercial. We come back to it's about productivity and performance. Having a bunch of implied expectations of directors is not a good foundation on which to trade. It's simply second-guessing and having these kind of debates, which could have been resolved long ago had the shareholder and the board engaged proactively in this, aligning this again to performance - coming back to the question of performance - back with the corporation, back with how my relationship with the board enhances my corporate performance. That's been lost, I think.

MR BANKS: Just coming back again to the constitution, realistically, how prescriptive can the constitution be in these respects? The shareholder group itself will vary in its composition and inclinations and preferences over time, constitutions are fairly stable documents and need to be. How do you reconcile those two things?

MR DONOVAN: I'll speak to a couple of those points. They should be stable but they shouldn't be sort of dead. In that sense they have been dead, they either have never existed or they have actually not changed or have not dealt with some of these fundamental issues. I agree, I certainly wouldn't want to be a director of a company where my terms of reference are so prescribed that I have got no domain to - I wouldn't accept that appointment because in my mind there is actually a dignified role for directors to actually pursue good governance and to be good stewards of these companies. But at the same time I think directors can also benefit and I as a director would benefit from the shareholders prescribing at least at very high levels about how they'd like to see this company operate.

We're not talking about a constant renewal of the constitution every year, we're not talking about it necessarily every couple of years but at least over the period of a company, which can be decades long if not over a hundred years, that we should actually be considering some of the fundamentals that should go in here. What is the fundamental DNA of this company? Certainly issues that we have seen in the last 10 years around corporate social responsibility and the debates that happened - implied in the present in other places - rather than happening specifically and contractually; that whole issue around whether or not as directors we should pay donations after the tsunami. So again that becomes a general debate that we have to sort of try and wade through what we feel our shareholders might want rather than us having that specific conversation with them about, "How do you feel about us making contributions to our community, either in a broad sense to victims of something like the bush fires or the tsunami, or in more strategic senses around making our business more socially responsible?"

So I suppose that's simply an argument. But I would definitely, if that was the implication of your question, I wouldn't want to see it to be a constant changing process and I wouldn't want to see it to be too detailed, but certainly I think there's some role for it to be an iterative process over time.

MR TUNJIC: I would add that I think there is a competitive advantage to corporations not having the same pro forma relationship between them and the shareholders. I think there is an advantage for a corporation that can articulate those promises in a way that aligns itself with a greater number of shareholders or a group of shareholders that aren't interested in short-term. For example, if they're happy to invest given that without another cohort of shareholders saying, "Sorry, we want a short-term return because we're required to. We're a super fund. We're here to maximise shareholder value. It's in our Act." We've got organisations that have limited purpose and made clear what the purposes are, as Andrew says. I think we've got an opportunity here to enhance performance.

MR DONOVAN: One of the examples with that in Australia would be the cooperative structure that engages the shareholders in a much more active way. They have got some limitations around capital raising but it certainly - I've just stepped down as chairman in the dairy industry of a joint venture of all of Australia's dairy manufacturers, and several of them are cooperatives. Those constitutions define much more clearly what the expectations of those cooperative members are around the objects of the company and what the dividend returns might be and indeed potentially in some areas what the remuneration system might look like, because they are much more active shareholders with an engaged interest.

As I said, there are some limitations to that model as well in terms of capital raising but again, I think there are examples, even in Australia, both in the not-for-profit sector companies limited by guarantee and in the commercial cooperative sector where I think there's actually clear - without there being research that I know of - examples where you actually get better governance and you get better outcomes as a result of a more engaged and more prescriptive but not too detailed set of members or set of shareholders.

MR FITZGERALD: Although you would have to be careful of drawing that analogy too closely, whereas the members, as you say, have a very active interest in a cooperative, a trading cooperative, and in fact they exist for their own direct benefit. The shareholder obviously is there to also obtain a benefit, but it's a very different character. Whilst they both seek benefit that there is in fact a fundamental difference, isn't there, between the two. I'm not disagreeing with you that there are some elements in cooperatives and non-profit organisations which could in fact effectively translate into the commercial but one would have to be careful about going too far down that road.

MR DONOVAN: Of course. But I mean having said that, like they have two hats there, they're suppliers. They can't be arguing in an AGM or a special general meeting anything about changing the milk price, for example, in their supply contract. That's not the place. They've got a shareholder's hat then. I suppose I'm just indicating that there are active shareholders and members in the Australian community. How come it is that in the listed and even in the public unlisted environment our shareholders basically are asleep at the wheel and unfortunately in some cases us as directors have been as well.

MR TUNJIC: If I could add, it's about enshrining freedom of contract, because you're quite right, they aren't iterate but there is an assumption at the moment that every shareholder that comes into a public listed company is there to see its wealth maximised. That's an assumption. It's a domain assumption because it's not enshrined anywhere in a contract, it's not enshrined in any promise. It's an assumption. Whilst I think that would be - for most people that would be absurd, of course that's why they're there, well, why not write it? Why not write it and enshrine it? It's like buying a house and not mentioning the house in the contract. We shouldn't have an implied promise to maximise shareholder value.

MR FITZGERALD: There is one problem with that, as you know as a lawyer, once you write it in you have to define it. Once you define it you're constrained. So there is a danger in there, and that's relevant because we were talking to the accounting bodies previously about the notion of shareholder wealth and what meaning that has. They want to add another few concepts around that because they have a problem with the way that's expressed. So again, just the caution in that is that once you go too far down trying to define those sorts of concepts there is a absolute constraint that comes with that or a boundary.

MR DONOVAN: But even worse thing is you might actually have to deliver it as well.

MR TUNJIC: Sure, because that's what we want.

MR DONOVAN: As early as three weeks ago I was in a forum where I was articulating these ideas and a senior company director was deeply concerned and indeed quite angry about this notion of a promise because he said, "I don't want to have to be bound to deliver something to my shareholders." It was an interesting debate and discussion that he sees there's benefit in actually having this lack of clarity around things. But I think it has led then to a range of - and these are symptomatic. As you say, remuneration may in and of itself not be sufficient but I think it is one of many symptoms that there's actually a lack of sort of rigour in the sort of corporate health, if you like, or mental health around these issues. Of course the cautions need to be worked through and people such as yourselves will have a better capability to do that having heard a range of views.

MR BANKS: Good, okay.

MR FITZGERALD: Thank you, that's terrific.

MR BANKS: Any further comments? Thank you very much.

MR FITZGERALD: Good, thank you very much for that.

MR BANKS: Very useful. We will conclude the proceedings for today and adjourn until tomorrow morning at 9 am. Thank you.

AT 4.26 PM THE INQUIRY WAS ADJOURNED UNTIL
THURSDAY, 25 JUNE 2009