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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 THURSDAY, 25 JUNE 2009, AT 9.18 AM

Continued from 24/6/09

INDEX

	<u>Page</u>
AUSTRALIAN COUNCIL OF SUPERANNUATION INVESTORS:	
ANNE BYRNE	294-322
PHILLIP SPATHIS	
ROSALIND McKAY	
DEBORAH GILSHAN	
MERCER:	
YOLANDE FOORD	323-342
GRAHAM O'NEILL	
CHRISTINE DEVENEY	
FINANCIAL SECTOR UNION:	
LEON CARTER	343-354
ROD MASSON	
JAMES BENNETT	
RISKMETRICS GROUP:	
MARTIN LAWRENCE	355-382
DEAN PAATSCH	
KPMG:	
MARTIN MORROW	383-398
ANDY HUTT	
NORMAN GESCHKE	399-402

MR BANKS: Welcome, ladies and gentlemen, to the second day of hearings here in Melbourne. As I explained yesterday we had a couple of days in Sydney last week and we'll have some further hearings in Brisbane to complete this part of the process before we then go on to prepare our draft report. So without further ado I welcome the first participants this morning, the Australian Council of Superannuation Investors. Welcome to the hearings. Could I ask you please to give your names and your positions?

MR SPATHIS (ACSI): Phillip Spathis, the manager of strategy and engagement.

MS BYRNE (ACSI): Ann Byrne, CEO.

MS McKAY (ACSI): Rosalind McKay, manager of research governance.

MS GILSHAN (ACSI): Deborah Gilshan, from Railpen Investments. We're one of - active international members.

MR BANKS: Thank you. Thank you very much for taking the time to attend and also for the submission, which we have read, and we will obviously have some questions on it. Thank you also for a very informative early meeting, this process just started. So, as indicated, I'll give you the opportunity to raise the main points.

MS BYRNE (ACSI): Okay, thank you. I'm going to make some points about our submission and then of course we are happy to answer any questions or engage in any discussion about executive remuneration. So I'm the CEO of ACSI. On my left of course is Phil Spathis who is our manager, strategy and engagement; Rosalind McKay, our manager, research governance; but I would particularly like to introduce Deborah Gilshan who is the governance counsel at Railpen, which is one of the UK's largest occupational pension funds, and as a member of ACSI. As she is here in Australia for a couple of weeks we thought it would be interesting to bring her along. She might, if it's appropriate and during the questioning - for her to make some comments about a perspective from the UK.

MR BANKS: Good, thank you.

MS BYRNE (ACSI): ACSI, as you know, represents the interests of 42 superannuation funds that manage about 250 billion of Australia's retirement savings. We provide our members with advice and information on the impact of corporate governance, environmental and social issues on the long-term performance of companies. Our interest in this really is the interest in the equity market. Australian superannuation funds have a large proportion of their funds and assets invested in the Australian equity market and we welcome this inquiry.

At the outset our interest is as long-term investors and in that we have two cornerstone considerations. The first one is that we support highly skilled and independently minded company boards to discharge a key responsibility of managing the remuneration issues. We are very strong advocates of the primacy of boards to formulate and implement executive remuneration policy that motivates executives for long-term performance in the interest of shareholders. Shareholders don't have the same access to information as boards do, so therefore we don't support shareholders micromanaging remuneration issues. We have also concerns about suggestions that it should be a one size fits all. Each company is different and so therefore we think each company should be able to manage their remuneration to suit their long-term requirements.

We also see remuneration policy as one of the very few visible proxies for shareholders to check that boards in fact are managing their executives and have effective control over the corporate governance framework of the company. We are not privy to those behind closed door discussions but remuneration reports do give us some insight into what happens. So we think the boards should be properly empowered to discharge their responsibilities in terms of remuneration. We also think that they need to be genuinely accountable to shareholders and that shareholders should be able to scrutinise the remuneration arrangements. So we come from those two investor perspectives.

We noted that the commission asked for consideration as to why there has been a growth in pay. We provided in our report information about a longitudinal study that we have done from 2001 to 2007. There have been considerable increases in pay. It is fairly difficult to say why. Some of the suggestions that have been put in other submissions are increased market capitalisation of companies, growth in share prices, increases in job complexities, competitive employment, comparison pressures and a whole range of issues. I think it's difficult to say why there has been but clearly there has been considerable increase in pay. However, it's also our view that executives and boards should have access to remuneration data from remuneration consultants and they should in fact engage remuneration consultants themselves. There has also been a view that it might in fact be disclosure that has in fact been one of the reasons for increases in executive pay. We don't agree with that. We think there has always been such data in the market and whether or not there has been disclosure requirements and also the non-binding vote is not the reason that there have been increases in pay.

Prior to the downturn in the share market shares of listed companies would privately indicate to us that local and global competition was one of the explanations for driving up executive pay. We looked at the area of that and in our submission we did research on factual data disclosed in annual reports of listed companies and other company announcements about appointments and departures at the 50 largest

Australian ASX listed companies between 2003 and 2007. In summary, our research found that few companies lose their CEOs to overseas rivals with a greater likelihood of CEOs leaving a company because they have been sacked or retired rather than being headhunted by a foreign company. We know that that's not a definitive answer about there being competition for talent overseas and that's the reason for increasing executive remuneration, but neither does that research show that it is the justification for increases in executives. We're not sure that there is in fact the global war on talent.

What the research did show that there is a key implication about the importance of effective succession planning within a company with respect to executives and the ability for reasonable remuneration arrangements being applied to attract and retain these executives. One of the issues you've asked people to comment on is non-executive director pay. We agree with a number of submissions that the pay of non-executive directors should be treated differently from executives. Essentially that is because the structure and form of the remuneration of non-executive directors reflects a lesser emphasis on a reward for risk but much greater recognition of their governance and oversight responsibilities.

Let us then briefly discuss the relationship between remuneration and corporate performance. Because executives influence the direction of companies this affects, ultimately, shareholder return. So therefore we support remuneration structures that encourage and promote superior long-term performance of companies. We don't think executives should derive significant remuneration benefits unless there has been a direct contribution to long-term performance. ACSI has in fact supported the vast majority of remuneration related resolutions and reports as long as they show to us that they are about long-term incentive schemes that are underpinned by stretching hurdles.

Some of the times we have in fact voted against, and the highest level of dissent in the remuneration reports has been when there are short vesting periods for long-term incentives, that is, less than three years; there's been insufficiently demanding hurdles without any link to long-term performance; hurdles have been undisclosed; and increased prevalence of short-term or retention payments in lieu of long-term arrangements. That is, many times it seems to us there has been a de-risking of pay. Also, we've voted against excessive termination pay.

It is not entirely clear that higher executive payout comes with an improved profitability and share price growth in companies. We cannot necessarily say that and neither can our members. We also recognise there's limitations to the range of measures that trigger incentive payments, in particular long-term incentives, for example, relative and absolute measures of performance such as total shareholder return or earnings per share. For this reason we actually caution against a one size

fits all and think that each company should in fact select what are the most appropriate stretching hurdles for themselves. We actually think that most of the remuneration practices of the top ASX 200 companies are generally reasonably set. We have given some examples in our submission of remuneration practices which were not properly explained and we would be happy to talk about those later.

In this economic environment where some incentive plans are underwater for executives, we do have a concern though. We remain concerned with attempts to seek to placate executives by offering more accessible short-term incentives with no clear nexus to performance considerations. While executive retention is an important consideration for a board, such arrangements where poorly handled are often perceived to be a slap in the face for investors who have in fact in these circumstances absorbed the brunt of economic impact of the decreases in the share price and in fact the executives have not.

As I mentioned before, we support boards that are properly equipped to be effective stewards across a range of governance functions including remuneration policy. We think it's an ongoing challenge for boards to be encouraged to effectively deal with their own succession planning and make sure they have highly skilled and committed persons on their board. We also note there's a perception of clubbiness of boards, particularly given the propensity of boards to recruit from their ranks. In our longitudinal report we found that last year alone 70 per cent of new directors of the ASX 100 boards were directors of companies of ASX 100 boards. Furthermore, we note that women comprised but 9 per cent of directors on boards. We think there does need to be a range of skills on boards and we often have discussions with boards ensuring that that's what they're doing. As I mentioned before, we do think boards should seek expert opinions and we think they're justified in doing that and get information about their opinions on remuneration.

Another issue we'd like to raise is we're not convinced the complicated approach to fixing pay and short-term incentives and other relationships are not necessarily driven by boards but may in fact be driven by remuneration consultants not necessarily looking for the best outcome for the stakeholders. We encourage boards to embrace clear objectives that ultimately are effectively communicated to shareholders. We encourage boards to engage with shareholders. They should have a genuine exchange, in fact, before they come up to their particular meetings. We also encourage them to stress test their remuneration models to make sure that they in fact are effective.

We think remuneration committees play a strong role and they should be encouraged to also get their independent advice. We welcome and agree with the AICD statement in their executive remuneration guidelines for listed company boards that good practice would ordinarily for a board to engage different advisers

and consultants than those engaged by executives. There is also no current requirement for companies to disclose the identity of their remuneration advisers, and we think they should; some companies do, such as BHP, Iluka and Woodside, just to name a few. So in the interests of transparency we recommend that companies should include in their annual reports information about remuneration consultants to the company. Those details should be: who has been appointed, who appointed them and the types of services they provide.

Let me briefly talk a little about disclosure. In our opinion the disclosure requirements in the act with respect to remuneration is not overly onerous. Company disclosures and remuneration tend to be more complicated as a consequence of the design and nature of the arrangements rather than in fact the disclosure requirements. If you have a complicated design we recognise that it's quite challenging to provide a plain English version but we encourage companies to in fact have a narrative about how their pay is structured. We caution against the introduction of a regime that seeks to simplify explanations at the potential cost of properly and comprehensively explaining relevant details in reports. There are also a number of companies who have been able to give technical explanations and a useful narrative for investors and we, as I said before, encourage boards to do that. What we are discouraged by is a legalistic boilerplate disclosure in remuneration reports rather than a narrative for a company.

I'll now talk about the non-binding votes on remuneration. In our experience the introduction of the non-binding vote has been the single biggest catalyst for improved levels of engagement between institutional shareholders and directors. We believe that engagement between company has been a debate on pay rather than an adversarial discussion and it has led to some very good discussions about remuneration. There is a risk that if the vote on remuneration reports was binding that companies may revert to a more compliance based approach to disclosure rather than actually looking at what is the needs of their particular companies.

It's noteworthy that where remuneration reports have attracted a high no vote from shareholders or a majority vote against, most companies in the following year have used that as a basis to better understand what their shareholders think and in most cases have in fact improved their disclosure at the next point and also improved their remuneration practices; so ACSI does not support the notion of a binding vote on remuneration.

We do believe though that there need to be change to, I suppose, the voting constituency. We have concerns that at present all shareholders including directors and executives who are beneficiaries of the remuneration arrangements are able to participate in the non-binding shareholder vote. Directors and executives who are the beneficiaries of remuneration arrangements in our view are conflicted on such

matters since they can approve their own remuneration arrangements, thereby resulting in a higher approval rate on the remuneration report than might otherwise be the case. Therefore the non-binding vote may not be a true litmus test of shareholders' views. So therefore we recommend that in fact that they should be excluded from the vote. There was an example, I think, in this most recent or last year's remuneration and it was because of the holding of one chief executive that in fact the remuneration report was passed where if that vote hadn't been carried out the remuneration report would not have been passed.

We then want to talk about just the Corporations Act and the ASX listing rules. We believe that the combination of the Corporations Act, the ASX Listing Rules and the Corporate Governance Council provide a reasonable balance of technical and principle based requirements. We believe they're a sufficient springboard for shareholders to enter into constructive dialogues with companies. However, it's not these legal requirements alone that create an environment for companies and shareholders to engage and have constructive dialogue. What brings them together is the mutual care for the reputation and long-term prospects of the company.

The strength of the approach emanating from the corporate governance principles of the ASX brings together 21 diverse groups, business, shareholder, stakeholder organisations. The if not, why not model it seems to us has been a very productive approach in Australia. However, we are attracted by aspects of the Australian Stock Exchange submission for the referral of some remuneration-related matters currently the subject of the listing rules to be relocated to the Corporations Act. We recognise that this could enhance the breadth of enforcement options that are available under the Corporations Act.

We believe that the overall interaction though between the Corporations Act and the ASX Listing Rules do promote constructive shareholder participation. We do think though that there should be some greater enforcement of existing provisions. There are some companies that do not disclose the performance conditions attached to short-term incentives despite the Corporations Act's requirement to do so. We're aware that they think that this is because of commercial sensitivities. We also see that a number of companies are able to get over that hurdle of providing explanations without giving away any commercial confidentiality.

There is another loophole that we'd like to have closed and that is ASX Listing Rule 10.14. The listing rule was amended in October 2005 prior to the introduction of the non-binding vote. Companies are therefore no longer required to seek approval of shareholders to grant shares as part of a director's remuneration package where they are purchased on market. Our concern is in fact about the impact of this provision. The change was made so that salary sacrifice arrangements could be made without in fact shareholder approval. We are aware that a number of

companies voluntarily provide shareholders with the right to approve such grants. We think that the listing rule should be amended to just cover genuine salary sacrifice arrangements.

MR BANKS: Just on that, what happened? How did it get extended from salary sacrifice provision and logic to a broader, more encompassing - - -

MR SPATHIS (ACSI): It was really by interpretation and application by companies, by issuers, and as a consequence of that, more and more companies over a period of time since 2005 have been utilising that on-market loophole to be able to not seek I guess any specific approval from shareholders.

MR BANKS: But the specific reference to salary sacrifice was removed, wasn't it?

MR SPATHIS (ACSI): That's correct.

MR BANKS: So it was reasonable that they would interpret it more widely.

MR SPATHIS (ACSI): That's right. It just opened up a floodgate. I think the point that Ann is making is that there are a number of companies who, whilst recognising the loophole, have still gone out voluntarily in the name of good governance to seek approval from shareholders on this issue because the effective point is that if a company is making the point that there is a link between the share incentive and performance but not allowing any scrutiny in relation to that, then that is pretty much counterintuitive.

MR BANKS: Okay, thanks.

MS BYRNE (ACSI): I will now make a comment about termination payments. We support legislative reform that would provide shareholders with a greater say on termination benefit payments. This change will properly require companies to explain their rationale for seeking additional shareholder capital to pay for termination benefits in excess of 12 months' base salary. It doesn't automatically follow that considerations in excess of 12 months would be rejected; however, there is a greater onus on companies to provide a cogent argument supporting such arrangements. It also doesn't stop a company coming to shareholders earlier than at the point of termination so therefore they in fact can have that discussion with shareholders, and if shareholders think appropriate, pass those termination requirements.

There has been a number of instances where termination payments have been seen to shareholders to not be necessarily termination payments or have been excessive in their payments. There are examples where public announcements of a

departure have characterised those as resignations or retirements. However, the type of pay that has been there has in fact looked like a departure. It's often been the case that departures that would characterise therefore as voluntary have been accompanied by a termination payment, so it's no wonder that there's been a community backlash in these instances or circumstances where payment appears to be a reward for failure.

In this context, ACSI strongly supports the approach adopted by Macquarie Bank that allows for deferred remuneration to be clawed back on retirement or termination where it becomes apparent over time that the executive have acted in a way that damaged the company or its reputation. ACSI's overriding belief is that super fund interests are best served by trustees who are properly equipped to monitor and address governance issues in companies they invest in without seeking to micromanage those companies. ACSI members, the funds themselves and their trustees and staff have developed the ACSI governance guidelines as a supplement to the existing regulations and industry standards, and you have copies of those. We update those guidelines every two years and we provide companies with a clear statement therefore about the practices that our members believe that they should follow in the conduct of their business. They also provide trustees of super funds with a benchmark to assess companies practices, in particular when exercising their voting rights. It's a clear attempt by superannuation trustees to transparently discharge their fiduciary duties on these matters particularly, as I said before, when voting their shares.

Proxy advisers often provide an analysis against such standards. However, final decisions on voting outcomes are made in fact by super funds or their fund managers. As a consequence of this robust approach to governance, there's been an increase in the voting participation in Australia from about 35 per cent some five years ago to now over 55 per cent.

Can I just make a comment on the effect of hedging. In 2006 ACSI was very surprised to learn the existence and use of hedging instruments to limit the downside associated with long-term incentives. Hedging, as you know, is the use of financial products to remove the risk associated with long-term incentives before they exist. Allowing executives to hedge their incentives prior to vesting makes a mockery of the aim of these incentives to align the interests of executives and shareholders. So ACSI would encourage further disclosure with regard to the hedging of unvested incentives.

So in conclusion, we think that companies should include in their annual reports information about remuneration consultants. We think that there should be greater enforcement of compliance with the Corporations Act on disclosure, particularly section 300A(1)(ba)(i). We think that the ASX Listing Rule 10.14

should be revised to require shareholder approval of any acquisition of securities by a director outside the general salary sacrifice arrangements. We think that companies should properly utilise requirements for shareholder approval where they seek termination benefits in excess of 12 months' base salary. We think there should be greater alignment between the reasons for executives' departure and the ensuing termination payments. We encourage companies to include a plain English summary of their approach to remuneration as part of their disclosure requirements but this should not be at the exclusion of more comprehensive explanations. Institutional investors require comprehensive explanations.

We think the Corporations Act should be amended to exclude associates from voting on a remuneration report and we also think the Corporations Act should be amended to prohibit hedging of unvested incentives and to require more contemporary disclosure where vested incentives are hedged. We are happy to answer any of your questions, questions about other people's reports or our reports and to provide you with as much information as we can.

MR BANKS: Okay, thank you very much for that. I think you've covered a whole range of issues that we'll probably want to go back to. Towards the end you were talking about voting participation and how that's increased. We're still getting I think from a number of participants some concern that institutional shareholders are still not being active enough in relation to voting, on remuneration reports in particular. I'll give you an opportunity to talk about that. Indeed, the point has been made beyond that or supplementary to that, that given the central role of boards, including in relation to remuneration where there's been dissatisfaction with remuneration reports, nevertheless the reappointment of directors responsible for remuneration arrangements has just sailed through with a 96 per cent vote in favour. Would you like to comment on those things?

MS BYRNE (ACSI): I'll firstly comment about the voting. ACSI members, we encourage them to vote and it's our view that most of them are in fact voting their shares where possible. Some superannuation funds though are still in pooled funds so therefore they rely on their investment managers to vote those shares. Our members encourage those investment managers to do so and we believe that they do.

It is though an evolutionary process in terms of the development of a superannuation fund and as it gets larger, it takes on much greater responsibilities and is able therefore to ensure that its votes are exercised. So we think that the number of people voting will in fact continue to increase.

If I could make a comment and then I'll turn to Phil about directors and if there has been a vote against the remuneration, why there hasn't then been a vote. It's our experience that when there has been either a majority vote against or a significant

dissent vote against a remuneration report that that is a clear signal to the board that they need to have a look at their remuneration practices. What then occurs within the next year is in fact discussion with their institutional shareholders about what in fact has occurred, and we in the vast majority of cases have no significant improvement in the remuneration structures and the remuneration reporting.

We think it's a very blunt instrument just in the very instance therefore to vote against a director. We would prefer to actually see that there is improvement over time or at least improvement in the next year. That's not to say that if there was not improvement over a period of time that we would not recommend to our members that they vote against directors in those circumstances.

MR SPATHIS (ACSI): Just on that first question, Gary, the superannuation trustees take their fiduciary duty very seriously in this regard with respect to the consideration of exercising their vote attached to a shareholding. In our view, they have got an obligation at least to consider whether or not to vote, depending on I guess the materiality and the importance of the issue. Having said that, with respect to our 42 members, we encourage all of them to exercise their vote of all their shares all the time to the extent that they can if they are direct shareholders, and if they are part of a pooled fund, they have at least some very clear monitoring of their managers as to how a vote is exercised in the interest of that pooled investment.

So we have I think as a consequence of increased superannuation fund involvement lifted I guess the participation of voting from the low of about 35 per cent to about 55 per cent today. But let's put it in context: superannuation funds, whether they are industry funds, public sector funds, master trusts and so forth, probably represent about 25 to 30 per cent of the overall market, so there are many other I guess investors, whether they be mums and dads, governments, other institutions that also form part of that mix and may explain why the other 45 per cent of the vote is not actually exercised.

Let's also put into context that in other jurisdictions such as the US, there are requirements such as the Department of Labor Interpretive Bulletin that requirement public sector funds and other like funds to exercise their vote and so you have a higher level of voting at about 75 to 80 per cent. But the concern then becomes does that then create box ticking on the part of some institutions without really thinking about the full impact of voting?

MR BANKS: Has that been the experience overseas where it's been the requirement to vote?

MR SPATHIS (ACSI): Not in many jurisdictions but in some parts, as I understand it, of the United States, there is a requirement to vote.

MR BANKS: So has box ticking been an observed outcome?

MR SPATHIS (ACSI): In some instances it has, especially where there may appear to be an inflexible application of policies and guidelines.

MS BYRNE (ACSI): Can I make a comment. There has been some concern raised by institutional investors, particularly in the US, about what's called brokers, who actually hold the shares and therefore the votes and there's evidence to suggest that they always vote in favour of management.

MR BANKS: When you say there's evidence, what about disclosure of voting? Some have argued that there should be a requirement (a) not only that there should be voting but (b) how institutions vote should also be transparent.

MS BYRNE (ACSI): Part of our charter with our members is to encourage them to disclose their voting and the vast majority do and disclose how they vote on their web sites to their members and to the public.

PROF FELS: Yesterday we had someone who said that there should be a requirement to disclose voting, that's one point, and along similar lines to Gary's comment, about a reaction to the comment about ticking the box, there is an expression of concern that we have the opposite phenomenon with people sending in their proxies, that that automatically sets up the situation where there will be a large vote held by the chairman of the company and the suggestion that, first of all, that's a matter of concern and secondly that maybe something could be done about it to set a higher hurdle before the chair holding all the proxies could exercise that vote in a particular fashion. Do you have any reactions to that?

MR SPATHIS (ACSI): It is a concern that that discretion does stand with the chair and it does create some perverse sort of outcomes. From our perspective, we strongly encourage our member super funds to not sit on the fence, as they say, but to actually properly exercise a view through the vote and for that reason, we go back to having developed our own view of the world that complements the regulatory regime through the ACSI corporate governance guidelines. That I guess is a tool that we use in order to make it very clear to companies as to what our views and aspirations are as to what constitutes best practice and to avoid those sort of scenarios where effectively the discretion is left to the chair to more or less cherry pick votes usually in favour of - - -

MR FITZGERALD: Pursuing that then, given that governance is at the heart of this particular issue, and many of your recommendations go to that, and empowering shareholders is part of that without actually changing the balance such that the

companies become dysfunctional or unworkable, why would you not support a recommendation or would you support a recommendation that simply says that non-director proxies in relation to the voting on remuneration reports and the election of directors would in fact not be counted? So it forces shareholders either to direct the proxy, or in those two areas which go to the central issue of governance and the central issue of the remuneration report, undirected proxies would simply not be counted. You may want to think about it but in some senses if there is a concern that the balance in favour of the chair of the board of directors or the directors themselves is in fact out of whack, then this seems to me a proposal that might have merit. On the other hand, it may have some perverse and unintended consequences.

MR SPATHIS (ACSI): The intention may be right but I think we've just got to think about all the positive and perverse consequences of that. But I think the principle of it is actually akin to what Ann had said in the opening statement, that in respect to associates voting their own shares in relation to remuneration reports, you don't actually get a true litmus test in that regard with a remuneration report when an associate who could have five, 10, 15, 20 per cent holding or a bundle of that is able to exercise a view and a position that directly impacts on their own remuneration arrangements. It's counterintuitive.

MR FITZGERALD: Could I ask this question in relation to that which is a proposal that's been put by a number of others, that associates are not able to in fact vote, what would be the kickback to that? In other words, what would be the arguments against adopting your recommendation? Are there consequences of adopting your recommendation that we should be aware of?

MR SPATHIS (ACSI): I'm not sure, but I think the federal government, for example, has taken this approach in the Termination Bill where they have actually precluded associates, directors, executives from voting on their own termination benefits. So I think it's logical to expand that sort of principle with respect to the front end of remuneration, not just the termination part. If there are disadvantages, I can't think of any right now but I think that it would be more transparent and provide a truer litmus test in the best interests of corporate governance, as you say.

Can I just go back to your second question very quickly. I really want to emphasise the issue that Ann made that it is a blunt instrument to vote a director off, if, for example, we are unhappy with the remuneration report. We do want to build up trust with the company and hence in circumstances where there's been a high no vote in relation a remuneration report or where there's been a vote against, we give companies the benefit of the doubt, so look at the nature of their disclosure, whether there's any substantive issues that are at play that need to be resolved, and we have taken the view that if a company is not responsive in its engagement or in its approach or response to shareholders after such a high no vote or an against vote,

then we would consider using a blunt instrument to be able to vote against their election or re-election, but to date, most companies have been responsive and that's to their credit.

MR BANKS: I'm just wondering how blunt it was. There's that famous Samuel Johnson comment about nothing concentrating the mind like the prospect of a hanging. Has there ever been a situation that you're aware of where your members have voted against a director in circumstances where there hasn't been an adequate response to a significant no vote?

MR SPATHIS (ACSI): Not to date. We've had recommendations against directors for poor performances on a range of other boards or because of the inadequate structure of a board where it's not comprised of a majority of independent non-executive directors, but we haven't been put in that position where we are recommending against as a consequence of non-responsiveness to facilitating improvements to the substance and the disclosure of a remuneration report. We've come close, but there have been some substantial improvements.

MS GILSHAN (ACSI): It's fair to say as well that having that tool of directors in elections and the ability to vote against, just their ability to do that is often an effective way to hold companies to account. For example, in the US, you don't have the ability to vote against directors. Most companies don't have majority voting so you don't need to get the majority of the vote to get re-elected which I think sometimes boards of companies here in Australia - you have that ability to do, but often forces are better at forcing an accountability between shareholders and directors.

MR BANKS: What about in the UK then, do you see institutional shareholders being more active in relation to board appointments or reappointments?

MS GILSHAN (ACSI): It's fair to say that I think we would rarely vote against directors in extremis but we do, as a tool that we use, and certainly in terms of remuneration arrangements where there haven't been improvements, we would consider voting against members of remuneration committees. Certainly in the UK in this proxy season which we're just coming to the end of, there has been a spike in opposition to remuneration reports being defeated and also shareholders are more willing to vote against directors but it really is in extreme circumstances.

MR BANKS: I suppose one element of bluntness might be that the next opportunity in relation to a reappointment of a director may not coincide with the remuneration committee membership or something.

MS GILSHAN (ACSI): That's right.

MR BANKS: Some have argued that where there's a significant no vote, put it that way, against a remuneration report, that there should be a requirement for either the chair of the remuneration committee or other members of the remuneration committee to stand for re-election at the next meeting.

MR SPATHIS (ACSI): We saw that. That was the ASA submission, if I'm not mistaken.

MR BANKS: Yes.

MR SPATHIS (ACSI): I think what they proposed was basically having the director up for re-election and a 75 per cent special majority threshold. We understand the sentiments behind that but we don't think we have the acute or extreme situation as it stands for there to be I guess those two regimes introduced. However, if, for example, for one reason or the other the approach did deteriorate over time, then that may be something we may come back with. Let's not underestimate the importance of trust and the importance I think that we put in our dialogue on an engagement with the companies and to be quite frank, both privately and publicly, a lot of directors are actually making the point themselves, "If you're not happy with us, vote us off," and more shareholders in this environment, in circumstances where extreme examples of pay, egregious behaviour, adventurism and so forth, may well result in higher recommendations of voting against in relation to directors' elections.

PROF FELS: I seem to remember in 1902 or something like that, that was the attitude to a lot of business behaviour like competition. In most areas of business behaviour, if there's a problem, sanctions are introduced, generally used wisely but a trust model occasionally works.

MR SPATHIS (ACSI): Occasionally, that's right.

MS BYRNE (ACSI): Don't underestimate the seriousness with which directors do take a dissenting vote. I think from our discussions with them, they take it very seriously, extraordinarily seriously, and do try and make sure they have it correct for the next year.

PROF FELS: I suppose if the community wanted to send a signal, they could pass some legislation which would get the signals working and then the blunt instruments might change behaviour further. On another aspect altogether, you have talked about the sharp rise in executive pay; you've done that, starting at something like a 96 per cent increase - - -

MS BYRNE (ACSI): In fixed pay.

PROF FELS: Yes, in fixed pay and then also I think in general pay, total pay, it went up by similar as against wages. Then you mentioned this morning that it's a bit hard to determine the causes but I just wondered which causes could be taken out of the mix. I take it from your submission that you are somewhat sceptical about the justification for the rise based on international trends; I thought I read that into your submission. Another one I wanted to ask you about is if pay is related to performance hurdles which you have emphasised, then if it were so, then you would not expect pay to go up by the same amount as the share market has gone up I think because if they're performance hurdles, they're not generally related to share performance generally, but to performance of the shares versus other shares or to specific performance targets and so on. So this was another explanation that could be factored into the story of why executive pay has gone up. It's not necessarily the case, so that's closely linked to international factors. Then if there had been good performance tests through the period, you would be surprised if pay went up in line with or by more than the share market went up. So still looking for reasons as to why pay has gone up by so much during that period, was there some dramatic change in supply and demand conditions that caused a 96 per cent jump? I'm not so sure. I don't know. I'm wondering about whether this sum is a supply and demand factor that causes the dramatic increase. So you start working through the explanations and then you come back to the question of did it just get out of hand generally if the other explanations don't fit terribly well? I wonder if you have any further thoughts on causes or to put it negatively, what are not causes of the rather dramatic increase.

MS BYRNE (ACSI): I'll make comment on the international - not international trends, our comments was on international competition for executives and that was put to us that that was often the reason for increases in pay. So our research was about the factual research disclosed about was that competition happening, and from that research it did not appear to us to be the case.

MR BANKS: Which part of the research do you think most demonstrates that?

MR SPATHIS (ACSI): Can I give you some of the statistics to back it up?

MR BANKS: Yes.

MR SPATHIS (ACSI): If we look at between 2003 and 2007, we looked at basically the top ASX S and P 50 companies and we found in relation to the departures in those companies that the majority left the company because of retirement, termination or resignation. That was about 69 per cent. 13 per cent had left to go to other Australian companies and only 4.3 per cent had gone overseas.

If you look more specifically to chief executive officers in terms of their own departures, what we found was that 57.1 per cent of CEO departures, and there were 26 of them, were through retirement; 28.6 per cent were terminations and 7 per cent were to join another employer and a smaller percentage went overseas. The conclusions that we reached in relation to that was that larger companies tend to lose executives due to retirement or termination. It's also telling at the time too because during that period, it was the private equity boom and there were all these sort of pressures that were put on all of us to suggest that all this movement towards corporate governance and disclosure and so forth are going to press executives to pack up their bags and leave and go to private equity, but our statistics only found that out of 230 departures, only two executives went into private equity.

MS BYRNE (ACSI): Neither though were there people coming into companies from overseas.

MR SPATHIS (ACSI): That's right.

MS BYRNE (ACSI): So the research showed that there wasn't people coming from overseas into executive positions in Australia.

MR SPATHIS (ACSI): Specially 57 per cent came from internal appointments.

MR BANKS: To CEO positions?

MR SPATHIS (ACSI): That's correct. 14.3 per cent came from other Australian employers; 7.1 per cent came from acquisitions and about 17 per cent came from overseas.

MR BANKS: So nearly a fifth of CEO appointments were foreigners. That's, I would have thought, a significant proportion. You often see in markets that the margin can drive the average, and the fact that you had a significant proportion like that could be indicative. It's the glass half-full or half-empty kind of approach.

MS BYRNE (ACSI): Yes. So our conclusion was it wasn't giving us evidence either way that there was in fact a war on talent, that it was a little inconclusive that we couldn't see that what was being said to us that there was this war on talent, neither could we say that there wasn't some. So I think this was the first factual police of data that has been done in this particular area about the changes.

MR FITZGERALD: It's also true of course that if you look at the top 50 - and I understand why you might do that, because they represent such a significant share of the capitalisation of the market, nevertheless this inquiry is about all disclosing entities of which there are many more; in fact I think there's 2000 companies on the

ASX register. Not all of those may be disclosing entities because you've got to have a hundred investors. One of the dangers in this is we seem to have a debate that is in relation to the foreign market really saying the top 10, top 20, top 30 have that international component, but in fact this inquiry into several hundreds if not thousands of companies, if we looked at that, the international market is a tiny influence in it. So I was wondering whether you could give us some guidance about dealing with this because at the moment it seems that so much of the conversation is really only about the elite level. Whilst that's very important and I understand why the attention is there, our concern is much broader. In other words, should we have a different sort of set of criteria for the top 50 as distinct from the rest? Are the issues of concern different for the top 50 than from the other 1950? I know you invest largely in the top 200, almost exclusively so, but can you give us some guidance about how we should treat the vast majority of disclosing entities that are not in the top 50 part of the register?

MR SPATHIS (ACSI): Whilst we are primarily investors in the ASX S and P 200, we are still concerned about the corporate governance standards that apply in the 300 and beyond because again, depending on market conditions and so forth, many of those companies may well enter into that investment universe. We'd actually like to see I guess a responsible approach on corporate governance as companies do become more capitalised. Again, trying to marry some of the points that Allan had put together and the issues that you do raise, I guess the pressure points and the reasons why we are here may come from a mosaic of reasons, a number of pieces and reasons. You do get to the top end of town that size and complexity of business has a very big impact on potentially overall quantum and perhaps design of the pay regime. That may then therefore influence both the size and the nature of the mix between fixed pay and performance-related pay which then could well vary as we get into smaller companies, start-up companies, where perhaps there's a greater risk on the part of the associates themselves.

Going back to our earlier principle, a one size fits all doesn't fit and a one size fits all explanation doesn't perhaps fit either and it may well be a cause for further research into the links between pay, performance and quantum outcome. I think to date - and I take the point that Gideon Haigh made in one of the more recent monthlies - there hasn't been a rational date about quantum in this country and I think there is an opportunity to be able to find through some comprehensive research about the - - -

MS BYRNE (ACSI): Sorry, can I make a comment about that smaller end. It was a practical experience I had some years ago when I was in a different position. The fund I was working at at the time was introducing the ACSI corporate governance guidelines and asking all of our managers to vote, including our small cap managers. When we started to talk with the small cap managers, there was quite a bit of

resistance that this in fact would be too difficult, too hard, across the very small end of the market. Six months later that manager came back to us and said to the fund at the time that this was in fact one of the better things they had done because it had meant that they had better discussions across the small end of the market, they had been able to really talk to them about how they were managing the company, how they were looking at governance. They had started to talk a bit to them about succession planning and a whole range of things that they hadn't been able to before and had felt now that many of the companies that they had in their portfolio would in fact be better performing because they had started to introduce some greater governance and disclosure. So it can be a catalyst for change and one would hope that some of those companies are going to come up into the top end of the market and that they shouldn't find it too big a shock when they get there.

MS McKAY (ACSI): I think what this emphasises is the importance of companies explaining why pay arrangements are appropriate in terms of management's performance, the company's performance and where they're sitting in the market. If you apply that sort of approach and companies explain on that basis, it won't matter what size or where they sit in the index.

PROF FELS: Just going back to the comments about the quantum, first of all, I probably sound ungrateful because you have actually been the ones who have done the research and have published some very interesting figures on trends and so on and you have also correctly said that one size fits all shouldn't be the explanation. On the other hand, the layperson looking at it would still be rather surprised to see such a massive increase in executive pay, as disclosed by your figures, and maybe have a bit of trouble with some of the explanations we've heard about it. Should it be linked to the stock market or to relative performance? So your data is open to more than one interpretation. What we haven't heard from you - I haven't heard the words fall from your lips - as a possible explanation is that the whole thing got quite out of control for a period of years. Boards didn't do their job and may have been tightening up in recent times; that is another interpretation which I would have thought could be put on those numbers. Do you have any reactions? Do you entertain that as a possibility or don't you even want to mention it? I don't think I've heard it mentioned today.

MS BYRNE (ACSI): It is difficult in vastly rising share markets for people to get the attention of boards and to talk to them about these issues because they see everything rising. It is also difficult sometimes for investors to look at these issues because they are also involved in the fast-rising share market, so when that occurs, remuneration is not seen to be as important an issue in comparison to a share market as it currently is; that's a declining share market or a share market that's much more volatile. So I would think that yes, that probably is the case, that during that time of the share market going up, things did get slightly out of control. It's also I think for

boards probably to actually talk to executives about their pay in those circumstances where their share price might have gone through the roof, but we all know that share markets rise for a whole range of reasons that are not often related to actually what is happening within the company. It can be simply because of the momentum in the market or there's other things happening overseas or certain other things happening in the economy, so yes.

MR BANKS: Just following on a little bit, if we talk about boards and their governance and their performance, would you say there's a deterioration in the governance and effectiveness of boards in that period that coincides with the rise in executive pay?

MR SPATHIS (ACSI): No.

MS BYRNE (ACSI): I would think there was an increase because of the introduction of the corporate governance guidelines of the ASX and other changes that had been made.

MR BANKS: So boards didn't get slacker in that period, but maybe the stresses on them got greater.

MR SPATHIS (ACSI): We haven't had the egregious examples that we've seen in the US and I think a lot of that has to do with oversight, the fact that share incentives, for example, are also underpinned by reasonably stretchy sort of performance hurdles, irrespective of whether you think the right mechanism would be a relative or an absolute TSR or an EPS or whatever, there have been I guess some specific requirements put in place that have set some very important milestones. I would only amplify the point that these issues become I guess of more interest in a market such as this, despite the fact that we have for a number of years been calling for I guess improvements to links between pay and performance and in circumstances where there are terminations, for example, that they are not excessive and for years we have been calling for the threshold of the Corporations Act to be amended and we welcome the government's response on that because it did smack, in the community, of a situation where significant payouts seem to be like a reward not just for mediocrity but for failure. At the fringes, there have been examples of that. At least with the introduction of the new provisions, if companies wish to pay more than they need to explain, why that should be justified.

PROF FELS: Another interpretation of it though is that boards were doing their job in conventional fashion, neither better nor worse. We've heard it said to us in this inquiry that what happened is there was a kind of new philosophy and approach to the pay set eight or 10, 12 years ago, and there was talk about making the agent relationship more effective by aligning incentives and so on which had a broad

conceptual appeal, to where a kind of new approach to executive pay was adopted but it was managed quite poorly by boards. They were not used to this new thing. There may be a dozen reasons for it. The general standard of boards, management, may have been the same as ever but this new phenomenon was handled in a way that didn't build in enough safeguards, given the new approach. Now we're starting to learn some of the lessons; that's another interpretation of where the situation - - -

MR SPATHIS (ACSI): In those circumstances we would recommend a vote against where we came across examples where there have been undisclosed reasons for base pay increases where there have been negligible to no hurdles attached to share incentives, where there have been moves from long-term to short-term incentives. In fact over the last few years, our overall recommendations against remuneration-related resolutions has been about 15 per cent. The majority, 85 per cent of companies, we thought, were approaching this issue in a best practice, good practice sort of way but there have been companies where there have been issues. During the peak or boom times, maybe because the community was mesmerised by increased share prices, maybe because of a whole range of other reasons, it fell on deaf ears. But I think in this environment, we've found that the levels of voting against or actual majority votes against have peaked because there is a more acute interest in this area.

MS GILSHAN (ACSI): I think as well it's not just the debate about quantum, you have to look at how incentives packages actually make executives act and work and the actions that they take. In the UK we've seen quite a few executives coming out and talking about incentivisation and the most I suppose significant one was the chief executive of Royal Dutch Shell who is actually moving to be a non-executive at the end of this month. Royal Dutch Shell had its remuneration report resoundly defeated by 60 per cent of its shareholders at its annual general meeting last month. The chief executive said about executive incentivisation that, "You have to realise that if I'd been paid 50 per cent more, I would not have done it any better and if I'd been paid 50 per cent less, I would not have done it any worse." I think that is actually quite insightful as to the whole nature of incentivisation and whether executives actually react to the incentive packages that are in place.

MR FITZGERALD: Does that actually support the proposition which many people have put to us that the quantum has almost no relationship to performance but the way in which the package is designed can? In other words, it seems to me that quantum may have something to do with size and it may have something to do with recruitment and retention. There's little evidence at all that quantum has anything to do with performance. What does seem to be the case is that the way you design the incentive schemes in fact matters a great deal and your statistics you have just said would prove that. That's not to say that quantum is unimportant because in fact that's part of the competitive pressures we talked about, nor is it unimportant in retaining

people, but the quantum doesn't seem to be the driver of the performance but the design features are. That seems to be a consistent message. Is that a reasonable interpretation?

MS GILSHAN (ACSI): I think that's why it's important as well that shareholders do have a vote on remuneration because they're able to vote on the incentive packages and the structure of them. We are often told that chief executives aren't incentivised by money but whether you believe that or not remains to be seen.

MR FITZGERALD: Can I put another proposition to you, and it goes directly to your clients: in the absence of the government deciding to in any way cap quantum or to deal with those issues other than through the governance arrangements, some of those of which you've made recommendations about, it is possible to put the proposition that the community, who are in fact the members of your members, the members of the superannuation fund, will in a way use superannuation funds as a proxy to in fact constrain what they might see as excessive or egregious behaviour, in other words through the voting that you recommend to your members? Are there any structural problems in the way in which your members, the superannuation funds themselves, operate that would in fact reduce confidence by the superannuation members in the ability of or the willingness of those superannuation funds to exercise that role; eg, the disclosure regimes that exist within superannuation funds that the CEOs pay themselves, are they disclosed? Are they keeping place with the market or are they differential? Are the same concerns about how remuneration of executives in superannuation funds the same as or totally different from those that have been exhibited in public traded companies?

In other words, I'm just asking a question which is a difficult one, that it's already clear that people expect more and more of their superannuation funds over and above a good return. Is there anything in the way in which the superannuation funds operate that would be of concern or could be moderated to ensure that they can more actively undertake the task we're talking about today?

MR SPATHIS (ACSI): I think there have been moves by a number of super funds to try and improve their own transparency and make sure that they are not throwing rocks from glass towers. Let me make the point, like the corporate sector, the superannuation sector is subject to a lot of heavy regulation, and so it should be, and subject to a number of reviews, including the announcement of the more recent review of the Cooper's inquiry into the whole structure and approach of superannuation in this country. I think it is a serious proposition to put that if you're asking or asserting for improved disclosure from the corporate sector in relation to CEO or director pay that super funds themselves need to ensure that they are also very transparent in terms of their own disclosure.

Let me make the further point though, if you were to compare - and this is no excuse for no disclosure, I'm just making the point that you'd have to drop a few zeros if you were going to compare executive remuneration in the listed sector with at least the executives and the directors of the super funds that belong to the industry funds and the public sector funds.

PROF FELS: So if I was a member say of UniSuper or something like that or you've got industry, public service, corporate super funds, can I look up the report and see what the salaries are or what the remuneration is?

MR SPATHIS (ACSI): Correct.

MS BYRNE (ACSI): If you were to look up the annual report of UniSuper which is their more detailed annual report, you would find the salary of the directors but you'd also find the salaries of the executives across bands and you'd also find the rationale for why people are paid those particularly. You would also see that in other public sector funds. Not all funds disclose their executive remuneration but the vast majority disclose the amount of money, if it's paid for trustees on those superannuation funds. So it has in fact been an opting-in process.

PROF FELS: To the extent that it's possible to generalise, I suppose there's a fair bit of incentive payment factors built into this on their own salary arrangements?

MS BYRNE (ACSI): I can make a very general comment. I think some funds do pay incentive and others do not, so not every fund would have an incentive payment, no. I couldn't say all of them but I would say quite a few of them do not.

MR BANKS: Just a couple of other questions: you talked about remuneration consultants and the role that they play and you think that information about remuneration consultants should be disclosed. I just might get you to elaborate on how you think that could help. Some have argued that it's a bit of a two-edged sword because it's not always clear to what extent the advice of a consultant has been taken, so they could be implicated in a decision that they weren't actually in the end very influential about. So maybe just any comments on that and then, secondly, the question of independence of remuneration consultants and how important that is to you.

MS BYRNE (ACSI): I'll make the first comment. We're asking that the remuneration consultant that is used by the remuneration committee or the board be disclosed and what they've actually been asked to do. We think that that consultant should be different from the remuneration consultant that is in fact engaged by the CEO or other people. If they are the same, we think there is potentially a conflict of interest and an ability to influence. We're not necessarily asking them to disclose

their reports or anything like that. We recognise that some boards will look at that report and take certain parts of it and use it for their reports but we do think that they should be disclosed and that they shouldn't be the same consultant that's used by the senior executives and the CEO.

MR SPATHIS (ACSI): I think you've summed it up. But in terms of the second question about the independence of remuneration consultants, in light of all those settings being in place and appropriate disclosure, I think the cornerstone of the system still remains with the board, so yes, they are entitled to get expert opinions and they play a very important role in that regard but by having a remuneration consultant is not an excuse for the board and the committee of the board to equip themselves with the appropriate skills to actually challenge some of the recommendations and the judgments that are put forward by remuneration consultants. So yes, remuneration consultants play a very important role but the most important role I think still remains with the board in terms of understanding the structure, the philosophy and the approach in relation to these issues.

MS McKAY (ACSI): I was just going to reiterate a point that Ann made at the beginning in her introductory comments, that we support the AICD's statement in their executive remuneration guidelines for listed companies which really sets out the issue there in relation to remuneration consultants, that good practice would ordinarily be for the board to engage different advisers and consultants for those engaged by executives and while that may seem overly strict, they are necessary to ensure the confidentiality and integrity of the processes and the proper functioning of the board, and to avoid conflicts of interest.

MR BANKS: What about where you're dealing with an organisation which has one arm of remuneration consultants, another consulting arm, an auditing role that has pretty extensive dealings with the company concerned and therefore the management on those issues, would that potentially be a source of conflict?

MR SPATHIS (ACSI): These are issues that we've dealt with CLERP 9 process and the conflicts of interest that you could have in relation to audit and non-audit functions by consulting firms, and the law has come down very clearly in relation to some of those aspects. I'm not sure that you can necessarily compare that issue, for example, with remuneration consultants, but it still hovers above us as to whether or not a consultant, if they doing a range of other non-rem consulting services and the ratio of those non-rem consulting services was greater that they would do anything other than placate or appease the executives or boards and provide the advice that they really want. What you want from rem consultants, like any other adviser, is to provide good, fearless and factual advice. But again the responsibility rests on the board to deal with these conflicts of interest, I would have thought, and at least with a more clear disclosure regime, at least that then brings the shareholders into the fray

and questions can be raised by shareholders in any engagement, if there are any concerns that we do pick up, taking into account a range of services provided by remuneration consultants in one area and the provision of advice on remuneration in another. It's simply about asking the question. Really, that's the very basis for that recommendation.

MS BYRNE (ACSI): It does remind me though - this is not to do with remuneration consultants but the process that is gone through when you're using the data that remuneration consultants may have collected or you might have collected others - if you think about it, and it goes back to your comments, Allan, about did it all just get away from us, is that when you think about that process, you get the data and you see your CEO or executives, what quartile they are in for the data set and for the companies that you've chosen, and I think it's very difficult for a board to say, "Well, our CEO and executives, we want them repaid in the bottom quartile." You want to think that you've got a really good CEO, a good executive team, so you're always going to pay above the median. If every board thinks that, the median just keeps going up and up and up, so that might in fact be one of the things to think about in terms of the increasing pay, the median itself, because of that process.

MR FITZGERALD: You're absolutely right and everyone has said that. There isn't a single company in Australia that recommends anybody below the median. By nature, that has to ratchet it up; it never ceases. So given that quantum is difficult, there's one thing that's absolutely certain and that is that the quantum keeps rising, if every company recommends above the median, but I haven't heard any suggestions yet as to how to address that issue. Maybe somebody today will do that but I have not heard one suggestion as to how to overcome that issue. It's self-evident that if that's the practice, it just keeps going up.

MR SPATHIS (ACSI): The federal government dealt with legislation and the Industrial Relations Commission's principles of comparative wage justice many, many years ago, but it seems that the only part of the economy that still applies comparative wage justice principles is this sector. Again, it's a very difficult issue.

MR BANKS: On that though, you have discounted any role for increased disclosure in that process. Do you think it's as black and white as that? We've had others tell us that increased disclosure has heightened that process considerably and in particular has increased the third party knowledge effects whereby executives know that not only do they know about the relativities but third parties know about that, so issues of reputation and perceptions of worth et cetera come into it. You don't think any of those things are relevant?

MS BYRNE (ACSI): No, we do think they are relevant but if that is how your reputation only is based on how much you get paid, that's what you will in fact focus on, but if you feel your reputation is on a broader view of yourself, you may not. But

I do think that there is a greater awareness, yes, of what people get paid and how much they get paid, so it does have an effect. We don't think it is the only effect. People are saying it is the only thing, but it's not the only thing.

MR BANKS: I suppose when you're thinking at what's almost a discontinuity in the trends in relation to executive remuneration, it's interesting to have a look around about the discontinuity point when salaries started to take off. One of them, as Allan was saying, is what's happened in the stock market and we need to look at that. Others might be regulatory changes or changes in practice and we've observed a number of those. So I guess it's just one way of looking at any explanation and trying to find an explanation.

MS GILSHAN (ACSI): I wanted as well to go back to Robert's point because a lot of shareholders do actually look at the percentage of say long-term incentives that are based on median performance and if half of the incentives are available for median performance, that's probably quite a worrying structure to remuneration plans. So there are ways in which shareholders can try and influence that.

MR SPATHIS (ACSI): Just to go to the quantum issue, there are some potted examples more recently, whether it be Macquarie or Telstra, who have been perceived to have reined in some aspects of this executive remuneration. I guess our challenge as a community is to ensure that we have long memories and that we don't apply a more modest approach just during these trying times, that we think about when the upswing does come about that we don't put in place arrangements that make it easy for executives to be in the money. I'm not sure of the exact statistics but it's no coincidence, for example, that the zero-exercised price options, the ZEPOs, as we say, that have negligible performance hurdles in place have become more significant, the performance hurdle being attached to the share price over the last three years. So you've got to really question the issue of the design of the hurdle and how stretchy that hurdle is in the context of the environment in which the company operates.

PROF FELS: I wondered if one of the hurdles that come in at - not exactly after the horse has bolted but there was a period when there wasn't that much exercise of control, when they're able to come in - - -

MR SPATHIS (ACSI): It was much simpler many years ago. It was a base pay and a bonus. When I think these incentives came about, there may have been an expectation that the base pay may have actually become a bit smaller to accommodate the at-risk payments but that didn't happen. The actual base pay increased and the bonuses have increased and the quantum attached to long-term incentives have also increased. So there's been an overall movement, let's say, across all aspects.

PROF FELS: Could I just take one step further something Robert was raising about things and this is the fact that there's been some discussion in this inquiry about some people about codes and one line of comment was that the codes and so on of behaviour in respect to executive remuneration are fairly process oriented and so on. They don't have a lot to say on quantum questions. So the AHRI, the Human Resources Institute, they think the codes have not quite addressed quantum concerns and some other concerns. They have talked about a slightly more ambitious code that goes a bit beyond process approaches. They have also suggested that maybe this inquiry should come up with some code recommendations. They have also raised another issue which is kind of related that they would share your reservations about having binding votes and so on in terms of the current context of things, but they suggested in fact that companies should put broad pay plans, I suppose, or codes or criteria to annual general meetings from time to time and have them approved, not really quantitative things saying that, "We'll limit it to X per cent," but going a bit more into criteria for setting pay and then companies having to report against those criteria. It's possibly a hard one to put to you without much warning but there was a rather detailed proposal to have a code that goes further than at the present time and I wondered if you would give it some thought.

MS BYRNE (ACSI): We'll give it some thought.

MR SPATHIS (ACSI): We'll give it some further thought but don't underestimate the importance and positive interrelationship between the hard law provisions as they currently stand, the Corporations Act and the ASX Listing Rule principles and the ASX Corporate Governance Council principles, the if not, why not regime, and then I guess what you might call the soft law or code principle approach that is taken by key stakeholders, whether it be the Superannuation Funds Act, whether it be the ASA, whether it be IFSA, and I think the hard and soft law regime and these principles sort of do complement one other. I take the point that they may not go to issues of quantum in any severe sort of way but I think as Deborah also suggested, by dealing in more substance with that process and the issue of the linkage to pay and performance and the various hurdles of design, I think you deal with a lot of the substantial issues that arise in this regard.

On quantum, you will find across many of these principles that there is a view that companies need to explain why there have been increases in executive pay. One of the reasons why in the past we have had problems with remuneration reports or various problems is because there have been unexplained increases in executive pay. There have been retention benefits paid without much explanation. I think one of the submissions actually described bonuses as fixed pay in drag. There are all these sort of concerns that we do have, but I wouldn't tinker too much with the existing regime as it currently interrelates but I still think there needs to be some mechanism to

debate this issue of quantum.

MS McKAY (ACSI): Just to add to what Phil said, what we've seen is examples of fixed pay going up with very brief explanations along the lines of, "We have received advice from consultants which says that the CEO's pay is not in line with others," their peers and so forth, but without any explanation about: why is it appropriate for the company, why is it appropriate for the executive and why is it appropriate, given these circumstances, in that period of time? I guess what we would expect is intuitively companies would, when they're setting executives' pay, think about what they need to do to motivate them but the impact I guess of those pay arrangements on employees, others below that person, so they have got to strike that balance between encouraging the CEO, allocating profits to CEOs and to shareholders and then I guess the motivation of those under them. So there's a juggling act going on there and you would expect that all those things would happen and that's the sorts of conversations we have with companies around those types of issues.

MR FITZGERALD: I'm aware that we're well out of time now but your issues about disclosure, one of the things that is perplexing at the moment is improving the disclosure regime, and your point there is that there is room to in fact have a shorter, more comprehensible report without losing the detail. I don't think we need to go into it now but it is an issue that we'll probably come back to and talk about because it's clear to us that the disclosure regime is trying to achieve a number of different objectives for different stakeholders but not necessarily doing that in a very effective way. So we take on board the disclosure, but in part it goes to your point that can the disclosure document be reshaped in a way that gives greater explanation, and perhaps the technical detail sits somewhere else, that allows people like yourself to be able to do that analysis, because it doesn't seem to be achieving what people would like on them, so we're very keen to have a more detailed discussion about what that might actually look like.

MS BYRNE (ACSI): Okay.

MR BANKS: The only other comment I would make, and it picks up on the submission by the AICD which had a survey of executive search companies and so on in terms of what they do. They showed pretty high numbers for the degree to which search occurs globally rather than just in Australia, but I'm just interested in your perspective on that. Would you be comfortable with major corporations restricting themselves to the local searches for CEOs? Would you think that would be appropriate?

MS BYRNE (ACSI): No, I think they should actually try and find whoever is the most appropriate and best person for their position.

MR BANKS: But what you were saying earlier is that that person would be available in Australia, so why bother looking offshore?

MS BYRNE (ACSI): No, we say the evidence suggests that what's happened is that they're not appointing the people from overseas. They might be searching but they're not appointing them.

MR BANKS: No, but you were talking about departures.

MS BYRNE (ACSI): Departures, yes, and they're not going overseas.

MR BANKS: One in five are being appointed from overseas.

MS BYRNE (ACSI): Yes.

PROF FELS: I suppose if they looked a bit harder internationally, they would find some bargains. I keep hearing it's a competitive market and people are putting forward attractive price and salary offers.

MR BANKS: We find the bargains in the UK.

MS BYRNE (ACSI): There are quite a number of people who are coming back from the UK, so you never know.

MR SPATHIS (ACSI): There's a significant pool of talent of executives in this country. This is a foray that we probably wouldn't want to get involved in because it's micromanagement and that's not our role.

MR BANKS: Yes, okay. Thank you very much and it's been great to have participation from somebody with a UK perspective. We'll just break for a moment now before the next participants.

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

MS FOORD (M): I am Yolande Foord. I am the leader of our remuneration consulting business for Australia and New Zealand.

MR BANKS: Good, thank you.

MS FOORD (M): I have two senior colleagues with me, Graham O'Neill and Christine Deveney.

MR BANKS: Thank you very much for taking the time to attend today and also for the submission which came in on time and we've had time to digest it and have some questions for you, but we'll give you the opportunity to outline the main points.

MS FOORD (M): Thank you very much. I would like to commence our brief presentation just by thanking you for giving us the opportunity to present our submission to this inquiry and that we're really delighted to be able to participate in an informed discussion about executive pay. As I mentioned, I am the leader for our remuneration consulting business in Australia and New Zealand but I've also had the opportunity to work in other Mercer geographies, including the US, UK and Ireland. My other senior colleagues here today with me also have diverse experience in the area of executive remuneration and we've worked together jointly to prepare the submission and as such I've asked them to join us for this presentation.

The issue of executive pay is under increased scrutiny, lots of media attention and public outcry which is one of the reasons why this commission was formed. But I think the outcry has really focused on a specific number of companies where the pay is deemed excessive and I think it's important to stress that our view is that in most and the majority of companies, they have robust governance and pay programs in place.

The underlying dilemma for boards is that it's very difficult to determine what the right amount is to pay executives and CEOs. Whatever they decide needs to meet the requirements of a number of shareholders. It's also important to note that in many cases it's not the board's decision, there is actually a negotiation process that follows through with the preferred candidate that they're recruiting or promoting from within. So whatever they decide needs to be fair and equitable to that candidate or CEO. It also needs to meet the requirements of the shareholders and be considered reasonable under the Corporations Act.

Our submission which we will go through briefly covered five perspectives on

executive pay. Firstly, we've provided some context around the characteristics of the Australian CEO and executive pay market. Secondly, we reference some research findings that outlined the directors' perspective on executive pay determination and especially some of the challenges that they face. We then highlight Mercer's perspective on executive pay determination and especially the difference between the Australian and US and Europe markets. Fourthly, we outline what outcome we hope can be achieved by this review and comment on some of the questions raised by the commission. Lastly, I will outline our perspective on the role of the remuneration consultant and Mercer's approach to executive remuneration engagements. I will ask Graham to start off with the first two perspectives.

MR BANKS: Thank you.

MR O'NEILL (M): Thank you, Yolande. I want to address two issues; one is an overview of the nature of the Australian CEO pay market and then secondly I would like to draw from the research findings to illustrate some of the issues that remuneration committee members, non-executive directors face in making a determination of CEO pay.

The traditional economic view of the labour market is a market I think which has three major characteristics. Firstly, it has a broad range of employment opportunities; secondly, it has a large number of simultaneous and independent transactions going on and thirdly, no one transaction can affect the market as a whole, so in the whole traditional sense of an economic market, it's a supply and demand curve.

I think there are three features of the CEO pay market in general and I think they are highlighted in the Australian context because of the smallness of the market. These features distinguish it from the traditional economic description of a labour market. Firstly, the CEO pay market is a small market and it has relatively few transactions. Secondly, it is what economists would call a closed market, in that the available opportunities are indeed restricted to a narrow set of candidates who would be perceived as being eligible on the basis of the capabilities, the experience and other things which would make them legitimately candidates for the role of CEO, particularly with regard to large and medium-sized corporations. Thirdly, and given the requirements for disclosure, the CEO pay market is increasingly an informationally efficient market. The data is out there. In that sense, individual transactions can impact on the market itself.

I'd like to make that point by way of introducing the research findings. The research is based on a series of in-depth semi-structured interviews with some 15 non-executive directors who comprise board chairs, remuneration committee chairs and remuneration committee members; in other words, the interviews were

with the principal actors involved in a determination of CEO pay.

There are five key points which emerged from the interview data. The first of course is that the ready availability of CEO remuneration data acts as what I would describe as a proxy for a centralised pricing mechanism for remuneration committees to reference in formulating their recommendations on the level and structure of CEO pay. Now, given my early description of the uniqueness of the CEO pay market, each of the interviewees were unanimous in their reliance on market data as a basic reference point for determining both the level and structure of the pay of their respective CEOs. Together with the need to recruit and retain what was generally described as the right person for the CEO role, reliance on the market data was the most consistent finding from the research interviews.

MR BANKS: Just on that, you've talked about the nature of the market and the fact that there are only a relatively small number of potential candidates for these positions. Does that also mean that there's a relatively small sample of comparators when you're being a price determinator?

MR O'NEILL (M): Am I providing advice to a committee?

MR BANKS: Yes.

MR O'NEILL (M): Typically in providing advice or recommendations to a remuneration committee, we would in fact look at a peer group which would be derived from a similar industry set and a similar size of the organisation. So it's trying to match the characteristics of the focal company that we're looking at in terms of its comparator group.

MR BANKS: Would that comparator group be domestic or international or would that depend on the nature of the firm?

MR O'NEILL (M): The latter - and Yolande can talk more about this later - that in terms of framing our recommendations, we take section 211 of the Corporations Act which is the notion of reasonableness in terms of the circumstances of the individual and the circumstances of the company. So in that sense there, the comparative group would reflect the nature of the organisation and, if you like, its labour market.

MS FOORD (M): I'd just add that it would be very unreasonable to look at an international peer group or a very domestic locally operating company and we wouldn't recommend that.

MR O'NEILL (M): The third point I want to make about the interview data is the impact, if you like, of globalisation - I'm sorry, the things which the directors saw as

driving that market, and it comprised three or four things. First of all, the recruitment of US and UK CEOs, the incoming CEOs, was seen as having a major influence on that market and that I think is a very good illustration of the point that I was making before about the fact that any one transaction or any few transactions can influence the market overall, so there's the recruitment of particularly US and UK CEOs; the growing internationalisation of Australian business, and by that I'm talking here about the number of firms which would derive 50 per cent or more of their revenue from offshore operations therefore exposes them to an internationalisation of their business operations; there is then of course the overall mobility of Australian executives. From the director's point of view, those who participated in the interview, these were the sort of issues which they see as adding pressure to the ratcheting-up effect of CEO remuneration.

If I could just go back to the question you were asking before about was there a point when all this happened, you will note that in our submission, we referred to an article that I wrote with a colleague of mine at the time who is here, Allan Berry, published in the Asia Pacific Journal of Human Resources and in that article, Allan and I reviewed available CEO and senior executive remuneration data from the period 1987 to 2000. The reason we chose that period was it was during the 1990s that we actually did have an influx of CEOs recruited from the US, Bob Joss, George Trumble, Paul Anderson and there's one or two others in there as well. What we found when we looked at the data that we had, and I will quote from our submission here:

The median percentage of the long-term incentive component of a benchmark of Australian CEO remuneration packages increased from 6.3 per cent of the total remuneration to 32 per cent over that period and the total performance component of pay, that is, the short and long-term incentives (short and long-term incentives) rose from 9.5 per cent to 47 per cent.

I would argue as we did in that paper that what we had there was the immediate impact of a US style of pay and of course it was the time when options became a newly introduced form of remuneration to Australian CEOs.

MR BANKS: Was it in a sense through those executives who came in and you said had a disproportionate impact on the market because of the nature of the market and then was it both the quantum to some extent and the structure of remuneration that was affected, that we imported to some extent from the US?

MR O'NEILL (M): I think initially it was the structure rather than the quantum, but then altering the structure by increasing the short-term incentive and by bringing in options automatically increased the quantum as well. But what happened at that

stage was I think that the fixed pay tended to stay the same, so the initial short-term incentive and the long-term incentive became an additional component, so it was added on top of that. It wasn't to replace the short-term incentive.

Just by way of an aside, at the time in 1994 I had the role of global remuneration policy for a major Australian company and at the time I took that role up in 1994 there were three executive directors and each of those three executive directors had what these days would be titled an extremely modest grant of options and they were the only people in fact to have any share component reward at all. By the end of that decade I think we had something like the top 350 or so executives introduced into an option based long-term incentive plan and that's the rapidity with which I think that particular wave swept through the market.

I was talking about the findings. The last two points I'd like to make, the remuneration committee members clearly expressed a belief that there was a shortage of talented executives who had the requisite breadth and capabilities required to lead a major Australian public company. They do actually see it as a talent shortage.

What the research shows overall is that the determination of CEO pay by remuneration committees and boards is very much a judgmental process that has to balance a variety of views; firstly, the needs of the company to secure the best available CEO, and in doing so to provide an outcome which is credible, defensible and seen as legitimate by the major stakeholders which would of course include major institutional investors, the institutional advisers and those other organisations that form part of that matrix of what we would see as the institutionalised framework around corporate governance.

One of the major conclusions that I drew from the research findings is that there's an expectations gap between what the community expects that boards can achieve with regard to CEO pay and what boards can actually achieve, given the nature of the pay market, the ready availability of pay data and the impact of globalisation on so much of Australian business.

MR BANKS: Thank you.

MS FOORD (M): We'll move on to Christine next.

MS DEVENEY (M): As we know as we've been talking about, the whole concept of excessive risk taking and short-termism by executives, which is caused by disproportionate focus on a bonus payment, has been identified as one of the contributors to the economic crisis. In our submission we outlined what we think are two major differences with the structure of executive pay between the US and Australia that's lessened the impact here, one of those being the prevalence of the

dual CEO/chair role in the US which could be seen to result in undue influence by the CEO over the board. The second one is the higher leverage to at-risk pay in the US in the form of options, and incentives that are linked to tenure rather than future organisational performance, and that can be seen to lead to more risky behaviours.

So while Graham has outlined the influence that CEOs from overseas have had on executive pay in Australia, we do think this impact has been moderated by Australia's existing regulatory framework. So, for example, as Graham talked about, we have section 211 of the Corporations Act which talks about reasonableness and in our experience, boards take that responsibility very seriously and they undertake a number of actions to determine what is reasonable, so this includes sourcing market data for competitive roles, it includes engaging technical advisers and exercising their personal judgment based on their experience and the experience of the company.

We also have the non-binding vote which we have been hearing a lot about and that's allowed shareholders to express their view on executive pay policies and levels. We think companies and boards are very sensitive to this feedback and they do seek to design remuneration frameworks that are not only reasonable and competitive but are also acceptable to shareholders. We've seen numerous examples of companies that have taken that feedback from the vote on the remuneration report and modified their policies accordingly.

Another example is the requirement for shareholders to vote on the grant of equity to directors, so this allows them to have a say in the way equity based incentives are structured and we think has resulted in a more robust program that's linked to better performance outcomes.

As we mention in our submission, Mercer supports a principle based approach for addressing the question of executive pay and we've supported an approach in line with the recommendations by the G-20 working group and the Financial Stability Forum which were followed by APRA in its recommended guidelines. We think this approach has wider application than just financial services. I think ACSI was also talking about a one size fits all approach and we agree that the remuneration policy needs to be structured so that it's appropriate to that particular organisation's size, complexity, strategic objectives and operating environment. We think it's important that Australian companies be allowed a level of flexibility and innovation to be able to continue to recruit and retain the necessary talent they need to be competitive.

We are concerned that prescriptive legislation that seeks to mandate limits or prescribe a specific formula for determining the level of pay will limit the ability of boards to be able to develop these remuneration structures that align with their business requirements. We do think it may result in unintended consequences, so the

one example being the limit on the tax deductibility of fixed pay in the US and the impact that had in the increase in at-risk pay in highly leveraged vehicles. So as we said, we do agree with many of the principles recommended by the G-20 working group in the FSF, for example, compensation frameworks that are consistent with long-term goals and prudent risk taking, avoiding compensation schemes that reward short-term or excessive risk taking and payout schedules that reflect time horizons of risk and sustained performance and we would welcome those principles in the Productivity Commission's recommendations.

Mercer uses what we call our four-quadrant framework when we provide executive remuneration advice to our clients, so that includes remuneration performance, regulation and governance and we recommend a balanced approach that balances the various fixed, short-term and long-term components with the non-financial elements. Being a broader human capital adviser we do encourage boards to focus on those non-financial elements such as talent management, career development and succession planning which we think is very important, to some extent limiting the ratcheting up of pay by recruiting overseas executives.

We have noticed since the onset of the global financial crisis we are more and more being asked to work with boards to help them implement this balanced approach and we're encouraged that this increased level of attention to executive pay has moved boards to take a broader view than just having the remuneration committee responsible for setting market based pay levels. We think this illustrates the self-regulating nature of the Australian system and the fact that boards are sensitive to shareholders' concerns and respond to them.

So taking all of this into account, we think that a principle based framework in line with the G-20 and FSF principles is appropriate. We do agree with many of the submissions that talk about modifications to the disclosure requirements to better reflect executives' take-home pay would be valuable and we also think it's important that there is consistency between the legislation and rate of structure and taxation of various remuneration elements being consistent with the Productivity Commission's findings.

MR BANKS: Good, thank you.

MS DEVENEY (M): Yolande will spend a little bit of time just talking about the role of the remuneration consultant before we wrap up.

MS FOORD (M): Thanks, Christine. Lastly, I just wanted to touch on the issue of the role of the remuneration consultant and outline our perspective on it and the approach that we take to executive remuneration consulting engagements. As we alluded, we provide advice on the design and structure and level of executive pay

programs but we also provide broader human resource consulting advice. But central to our work on the executive remuneration area is the need that we and the companies have to align the executive performance with the company's business strategy and shareholders' interest. To that end and to address the issue of managing any potential conflicts of interest, Mercer developed a global standard approach that governs all our consulting arrangements and regulates how we operate with management and the board.

Firstly, we set clear standards for how we manage the relationship, whether it's with management or the board. We clearly outline the roles and reporting relationship at the onset of an assignment and that is just documented in our letter of engagement. We ensure the quality of our advice by always requiring a senior principal that is experienced in executive remuneration to lead executive remuneration assignments and we have a robust peer review process in place to ensure the accuracy and quality of our advice.

MR BANKS: Could you just comment on the peer review process that you have.

MS FOORD (M): The peer review process, it basically says that as an engagement leader for an executive remuneration assignment, you will have whatever recommendation and report you prepare peer reviewed by another senior specialist in executive remuneration before sending to the client. We also structured our business so that our executive remuneration consulting business do not report any other part of our business because we are a global business and we also provide broader resource consulting advice than just executive remuneration. We have introduced the four-quadrant model that Christine alluded to earlier which governs how we approach assignments so that we look at broader than just remuneration levels but also to the performance, regulatory environment and appropriate governance systems for each assignment. Lastly, we've also introduced a minimum analytical standard procedure for all our assignments which guides consultants on the appropriate selection of peer groups for assignments and data analysis - because as you all know, if you look at data in a number of different ways, you can get a different answer - to make sure that what advice we give to clients can stand up to external scrutiny. I think that summarises it.

MR BANKS: Just following on from that, who would normally employ you? Would you be working directly to the board or to the remuneration committee of the board?

MS FOORD (M): It varies from assignment to assignment. In my experience in the US, there was a lot clearer delineation between whether we were engaged by management or engaged by the board. I find that in an Australian environment, we do find in a number of cases the board would say to the HR department to find a

remuneration consultant, get them to provide us with data, and it actually flows through the management, even though it was a request from the board. We see that as still that we're engaged by management and not by the board, even though they have instructed it to do so. For us to really be advisers to the board, we demand unfettered access, so a direct link to the board and remuneration committee.

MR FITZGERALD: So how do you respond to some of the suggestions where there should be a requirement that remuneration consultants who advise in relation to senior executive pay should only be allowed to be engaged by the board and not in fact do other work for the company beyond that particular task? How do you handle that? As you know, there's been a long debate about auditors in this country trying to reduce the conflicts of interest that were self-evident some years ago, so how do you respond to that recommendation that companies like your own have to choose? You either work for the executives and do broad based work or you're appointed only by the board and only do that work for them?

MS FOORD (M): Because we're a global consulting firm and this issue has been very prominent in the US for a number of years already, Mercer has taken the approach that because we feel that our competitive advantage is that as a consulting firm, we can address all the broad issues, we can look at pay not just at the top level but throughout the organisation to ensure that there's alignment to business strategy. We can also address the leadership development issues and then we do work on the superannuation and everything else. Our position is that we would refuse an assignment where we can only work for the board and prefer to work at that - - -

MR FITZGERALD: Sure, but do you believe the issue of a conflict of interest is significant and if it is, how do you directly address that particular issue which is at the heart of that? It's not the issues about the knowledge, it's about is there a fundamental conflict of interest and how do you address it which is in some ways similar to the debate about the way in which auditors are also consultants and general accountants have been discussed?

MS FOORD (M): We believe that there is no conflict of interest because of the way that we structure our assignments. If we're reporting to the board and another division is doing some other work for management, in some cases the level that they report to would be at a completely different level from the CEO or direct reports. So we took steps five years ago when we introduced these global business standards to make sure that we set our assignments up so that we feel that we protect that conflict of interest. If the question comes that the board feels that they need an independent adviser and they don't want us to do work for the rest of the business, we have stepped away from those assignments.

MR O'NEILL (M): Could I just add a little bit to that. This is an area which has

very, very little academic research behind it. The only paper I'm aware of on this area was published by Martin Conn, a UK-based researcher who has been publishing in the area of executive remuneration for some two decades. He was looking at the conflict of interest issue in an instance where you have a consultant who is working for a firm that provides other sorts of services. Amongst his findings was there was no evidence of the conflict of interest being an issue in terms of remuneration consulting in the sample of companies that he looked at. That, as far as I know, is the only publication that looks at this issue.

MS FOORD (M): It's difficult to determine, as we mentioned in a previous session as well, as the advice of remuneration consultants is not always adopted by the board, so if you are doing a study that tries to measure whether there was conflict of interest and if that increased the level of pay, it will be inconclusive until you can clearly determine that that advice led to the difference.

MR FITZGERALD: Relating specifically to that, another set of proposals people have put is that the remuneration consultant should be detailed in the remuneration report. Some have gone beyond that to actually say there should be some sort of description as to what was required of that remuneration consultant. Do you have a particular view about that?

MS FOORD (M): We'd support that. We've already been doing that in the US, where that type of disclosure is standard. We require our clients to run past whatever they're disclosing beforehand and we would push for the board acknowledging where we've provided advice but they've actually not adopted it or made a decision that was contrary to it.

MR BANKS: Could I ask, given the obvious expertise about what's happened in the US, some have put to us that to the extent that there's been an unwarranted take-off in executive remuneration in Australia, it's been to some extent a contagion effect from the USA. I think you indicated earlier that in the USA, incentive-based remuneration has been linked more to tenure than to other performance hurdles. I might just get you to comment on why that happened, whether the structure of remuneration in the US also changed significantly in the lead-up to that period and what might have driven that.

MS DEVENEY (M): I think to some extent it was tax driven. I'm a US and an Australian CPA who worked on cross-border taxation for many years within the US and in Australia. In many ways, US remuneration structures were tax driven. They introduced section 162M which limited the deduction of fixed pay but it did not limit the deduction of variable pay. Many companies then implemented structures that basically made up what they wanted to pay in fixed pay and variable pay. Those tax rules then did allow for certain deferrals of taxation around the at-risk pay and equity

plans. But I think what happened in the US, because it was tax rather than remuneration or performance driven, they implemented purely service based hurdles. There's a term that our US firm uses for the grants that they would make to executives, and executives could then just put their feet up on the desk and wait for those to vest and it wasn't based on performance. So the thinking behind it I think wasn't around making it a robust performance based framework, I think it was in some ways getting around certain tax legislation and that's what we mean about the unintended consequences.

MS FOORD (M): If I can add to that, what multiplied the focus on the tenure based options was that under the accounting regime, options were seen to be not an accounting cost. That only changed in 2004 with the introduction of the new share based payments accounting across the world, while performance based equity received mark to market accounting, so US companies much more prefer to use options because there was no accounting charge that got outside of 162M and that's where we saw the rapid increase in large non-performance based option grants.

MR BANKS: There have been some changes in the US in more recent times. Do you see this having an impact? It's of interest in Australia obviously to the extent that people believe in Australia that what happens in the US to some extent sets the broader perspective on what will happen in Australia.

MS DEVENEY (M): I think what's happened is it's bringing in the broader perspective of the shareholder view and making boards accountable, so the evolution of that is that it's less tax driven and more in response to community concerns which is going to be I think the real driver of the changes rather than the legislation they're trying to implement.

PROF FELS: Just one general question about the features of the paid market, the three features in the market and other points you mentioned, one thing that strikes me about this market is that in many, if not just about all markets there are clear cost constraints at work. Take the determination of ordinary pay in a big corporation and it's a pretty large cost factor, so there's quite a strong market pressure in those situations to keep pay down. Executive pay generally, particularly at CEO level, is a really small part of overall pay and I seem to remember when I studied labour economics that one of the determinants of pay demand and supply was how big an impact on costs there was. In this case, executive pay, particularly at the top level, it doesn't seem to be much of a cost factor and I wondered if that differentiated it as a market, that is, that if you want to restraint it, it's not going to be natural concerns about costs, it's going to be other things. You have a fairly high pressure then on the board to do its job. I wonder if you have any comment on that since you've talked about it as a market.

MR O'NEILL (M): Allan, I'd agree with that. I think it's not a cost constraint; in fact if you go to almost any listed company and express the CEO's pay as a percentage of revenue or whatever it might be, it's a minuscule amount in that comparison. But I think the very important issue about the CEO pay market, particularly in Australia - but it mirrors the CEO pay market in other jurisdictions as well - is that I think it's more driven by social factors such as the need to get legitimacy from stakeholders such as the business press, the institutional investors, and those other sort of groups that are part of that governance framework, so this is seen as a legitimate sort of person to have as a CEO and this is a legitimate sort of price to be paying for that. That's what I think drives two things: one is the closed nature of the market, that is, who will be seen as legitimate within that institutional community, and the other thing I think is the absolute reliance as expressed by the interviewees on the CEO pay market data, so that the various expressions that we use for things like guidelines, road maps, defensibility, et cetera, it all comes down to those sort of issues. So I think it's more driven by the need for perceived legitimacy around the outcome in a governance framework than it is about the actual cost to the company.

PROF FELS: That then raises the interesting question of what the legitimacy levels were and have been and I wonder if there's been a change in the view of what's legitimate in recent times, but maybe it lagged a little bit behind what happened. In other words, there's a bit of a catch-up, but the public outrage factor is another variable that we read about in the literature. There's a bit of a lag. The pay took off and at that time, the outrage factor was not as strong as it is now, and it was a factor that let that pay go up quite sharply, and now there's much closer scrutiny here and in the US. I wonder if there's anything in that.

MR O'NEILL (M): Let me comment in two ways on that. Number 1, if I go back to the interview data, I remember two or three instances given by committee members; one was described - and this description fits the three instances that were given - the interviewee said along the lines of - although he actually used the term "B-grade candidate" - that the board was aware that they were risking the appointment of a B-grade candidate but they were unwilling to pay the amount that was required for some of the other people that the search had presented to them.

In other instance, a board chair indicated during the interview that he had instructed the search firm that they were using to find a replacement CEO to restrict the search to the UK, South Africa, Australia and New Zealand but not to touch the US market because the board were not interested in paying that level of pay. So I think there is a sensitivity factor around that. I think the outrage issue is uniquely US, in the sense that since the 1980s there has been this I guess stream of community concern with where CEO pay was going and in that respect. I don't think we've had the same outrage issue here with one exception, and I think that exception was the

initial pay for failure-type approach where we had high-profile examples of CEOs who did not succeed. The problem there was that they were contractual conditions that were entered into prior to the current government's regime and were either negotiated to be pay out so you could just exit the person, because some of those high-profile ones were just really quite sensitive issues.

One of the comments from the interviewees about the disclosure requirements, apart from the fact that it underlies what they saw as a direct contributor to the ongoing sort of ratcheting up of the market was that it did clean up the whole issue of the contractual requirements and the termination payments and those sort of things, that pay for failure issue.

MR FITZGERALD: Could I just follow up on that. In the presentation you've used terms which we've heard many times. You used the term "fair and equitable", you used the term "fair and reasonable" and the Corporations Act talks about "reasonable pay". In your market analysis, there's a comparator to a particular segment of the market. You will have seen a number of submissions who have a concern about the increasing disparity or relativity between CEO and senior executive pay and average works. Do you believe that there is any place at all when looking at remuneration to look at the relativities between the pay to senior executives and the pay to average workers or is it simply a misplaced notion?

The other point I'd make is that the relativity gap has become much greater. Research indicates that back in the late 1980s it was something like 19 times the average and some people say that it's gone up to about 60 times the average in Australia. That's for an average CEO. Making some assumptions, you will see that continue to grow. So whilst the outrage hasn't been high, except as you say in relation to the pay for failure, is that an assumption that will hold water if the relativity gap continues to grow, although right at the moment it's likely to take a dip?

MR O'NEILL (M): There's a couple of issues you raise in that question. Let me answer the first one and that's this notion of a multiple of average weekly ordinary time earnings or whatever. We just fail to see the logic in coming up with an arbitrary figure to say it's going to be 10 times, 20 times, 30 times or whatever it's going to be. There just seems to be no logic there. I think also that apart from the apparent lack of logic in it, which I think is really different by a sort of populist view about, "This is the only way to contain it," it would require some sort of process which, as Christine was talking about, would put a cap on pay in that sense, and the only thing to put a cap on of course is the fixed component of pay which may lead back to what happened in the US. But the other thing I think that's important to notice here is there is a fundamental principle within the corporate governance regime that there will be some alignment of CEO pay with shareholder value. Now,

if you then started putting these things in place, the whole notion of our shareholder value approach to governance would seem to be kind of discarded.

The other thing can I just say too, one of the things - and in Yolande's introduction she mentioned this forum's contribution to an informed debate - I guess there are a couple of things that I find popularly thrown around but totally misleading would be for anyone to talk about the pay of an average CEO. There are close on 2000 companies listed on the Australian Stock Exchange. If you look at the highest paid and then go down to say about company number 1000, which I did a month or two ago, I think at that time it was a resources company which was paid something like \$350,000 total remuneration, and we've still got another thousand companies to go to get to the end of the roll there. There's no such things as an average CEO. One can only talk about in terms of some relative stance or cohort within that.

Therefore, I think when we hear about things like 600 times or 200 times or 40 times, whatever, it's a bit of a suspect piece of information. But nevertheless, if we did do it accurately - and I've done this in the past in certain publications - I used to take, for example, the median pay rather than the average of a cohort and compare that to the average wage, you actually do come up with figures such as you've mentioned, but then of course as you traverse further into those 2000 CEOs, you're not getting very high multiples. In fact if someone contained it to 10 times average weekly ordinary time earnings, some of those CEOs might be quite happy.

MR FITZGERALD: But your starting premise is that the relativity is in fact not a logical way of entering this discussion; as a consequence of that, then any measures to try to link any government policy to relativities would in fact be misguided.

MR O'NEILL (M): There is an absence of logic in terms of picking a multiple; that's the first point. I would say, and Yolande and Christine might want to comment, that any process which came at this whole issue of CEO pay, such as the Clinton tax bill in 1993, is going to have a problem. It will be unintended consequences.

PROF FELS: I'm aware of the fact that of course some people have been saying that there should be a multiple and so on and I've heard a fair number of criticisms of it, but I've mentally translated into something slightly different, that if it exceeds a certain multiple, then there should be some kind of referral off to general meetings or something of that sort. But just putting aside the mechanics of it, what would happen if companies had to go off to general meetings to get kind of an in-principle approval, but if there's a gap that kept them going up, would it be binding and they just had to report against that criterion to their meetings?

MS FOORD (M): Firstly, depending on whether that was a good year for the

company or a bad year for the company, you'd get a different result from the shareholders because shareholders would feel in the years that there was a good return and the company was performing well that their interests have been met, so they wouldn't care about the multiple. In other years, it fed the multiple a couple of years, but because that was a particularly bad year, they would want to vote against it. I think you are then asking shareholders to vote on something that - what the multiple is said to do is actually to address the public and community outcry, so the shareholders might not be the real people that have that interest.

PROF FELS: Okay. I'll go on to another point; forget that for the moment. What we are being asked to accept by at least the people who are not critics of the pay rises and so on and putting aside various sophisticated remarks is that in some way the sharp rise in executive pay compared to other forms of pay has been the result of normal market supply and demand driven factors, presumably the competitors' market, so relativity has sharply gone up because of some difference in the supply and demand factors of a competitive kind affecting the executive market from other markets. I wonder if you have any thoughts or even preliminary information about what happens now with the reversal of the supply-demand balance. There's a supply-demand imbalance that pushed up executive pay many, many times. If all of that seems to have collapsed, are we going to see a counterpart fall? We have had one witness who ventured the thought that there could be a 10 per cent fall in executive pay if we're not careful, or are we going to see equally dramatic downsides or is it too hard to judge?

MS FOORD (M): I think we concede just in the media that a number of companies have announced that they are not increasing executive pay this year. There's a couple of companies that announced they're actually cutting it, and based on the share market performance of the long-term incentive equity that they had, it's worth a lot less or even the unvested portions are worth less or might not pay out at all, so there's definitely already been a contraction of pay levels. It might not reverse at the same level but it's definitely going to slow down the increase in the next couple of years while the market returns.

PROF FELS: What about pay practices and criteria, for example, performance hurdles? I may be wrong but I have wondered whether at the start of this era where we're talking 2000 or so or even earlier, there was a smaller number of performance hurdles and a more general set of bonuses and incentives just related to share stock market value and whether we've seen a tightening up of that, I wonder if that's happened. Also, what are the implications of that on the downward track, in other words, will it turn out to be kind of convenient for people who copped the benefit on the way up and are now rather happy to have their pay set on the basis of the performance of their company versus other companies rather than in relation to the share market. I wonder if you've noticed any tendencies there.

MS FOORD (M): I think a lot of companies are not making changes now because of the concern that they have that the market will react negatively to the fact that they are now changing the barriers and the hurdles so that it is easier for them, but I actually think that part of the institutional framework had driven companies to adopt a very standardised approach. Nearly 70 per cent of Australian listed companies use a relative TSR hurdle, so everybody is using the same hurdle. They might be referencing different peer groups but it was pretty much a standard approach, so it didn't really take into account individuals' financial performance of the company. It really took into account their share price. In some ways it was good because in the upswing of the market, you would still have to have a higher effect than other peer companies before you would pay out, but in the downturn it means that shareholder value is going down but it's going down less than other companies that you're benchmarking in and those plans would still be paying out.

Our experience in the US where total shareholder return is not the most predominant measure, that is one of the main reasons why it hasn't been adopted as an industry standard as the main measure of performance because of shareholders' concern of paying out when there is actually no shareholder value being created.

MR FITZGERALD: I'm conscious of the time but just one thing: I just want to ask specifically about share options. You're right, that post the Clinton change, there seems to have been this great push to use not only share rights but share options and we inherited that. In talking to companies, both CEOs and directors, the one issue that keeps coming up is an ambivalence to or an antagonism to or a concern about share options. I'm not suggesting one should ban the use of them. At the moment, executives are saying, "It's not a problem because we're not going to use them." That's largely because they have gone, as you say, under water. But is there a particular issue, either in terms of complexity or other that surrounds share options as distinct from share rights or what have you? It seems to be a constant force.

Secondly, it seems to be - and I might be wrong on this - that the greatest area of complexity in the remuneration report is trying to ascertain the value of share options which is a complicated and technical task. Whether or not that needs to be disclosed is another issue or where it needs to be disclosed, but I get a recurring thing that of all the elements at the moment, share options pose the greatest difficulty, especially for non-start-up companies. There's an argument that share options for start-up or establishment phase companies has logic. That logic seems to disappear once you get into more mature companies. I just want your view about share options if I can.

MS FOORD (M): I think it's interesting that it's still such a controversial vehicle. In some ways the prevalence of share options in Australia has reduced dramatically

and in our latest study on the top 150 companies, you would find that only about 20 per cent still use stock options and the highest number - I don't have the numbers to hand - the 60 per cent or so is in full value shares, whether it's share rights or other related vehicles. The interesting thing as well is that even the stock options in the Australian market, they are still linked to performance hurdles, where in the US, that's not the case. In the US, we have the reverse. Everything is in stock options and a lot of them are still tenure based options. Part of that is just they are so institutionalised. Executives expect options. It's part of it, so companies have introduced other vehicles but options still make up a part of that package. So in some ways I don't think we have that much of a problem in Australia because it's a small part of it.

MR BANKS: Can I just draw that out then. Is there the problem then options per se or is it the conditions attached to vesting - you know, the performance hurdles and so on that have been the problem because as Robert said, clearly there's a role for options, particularly for small start-ups that don't have a lot of cash. They can motivate people with the prospect of company growth and so on. We've seen some repositioning of them but I'd just be interested in your view on that, on options as an instrument as opposed to the conditions surrounding them.

MS FOORD (M): I think they're appropriate vehicles for companies that are in a high growth phase where it's a legitimate vehicle to reward executives for growing the company. In many cases in immature companies, it would seem that there are other vehicles that would more achieve that incentive objective and if you tie it to the right performance hurdles that clearly align with shareholder interests, there should be both - a number of long-term incentive vehicles would be - - -

MR FITZGERALD: Could you just briefly explain to me why there's been this dramatic shift to, as I think you said, about 20 per cent of that 150 companies using it? What is the fundamental driver of that change?

MS FOORD (M): I could talk about a number of reasons but I think market practice in general and the fact that a number of companies have realised that with the introduction of the performance hurdles, you're already reducing the probability of those vehicles vesting, with the share price being another measure. It actually makes more sense to use full value shares because there's a higher probability of actually receiving a payout.

MR FITZGERALD: Thank you very much.

MS DEVENEY (M): I think too the point of the executive remuneration is very much an evolutionary process at the moment. We've now seen a couple of cycles to see how those types of vehicles actually work in practice and ACSI was talking

about stress testing because I think a lot of companies did not anticipate how highly they might pay out. Options were very prevalent because they came about in the IT boom in the US and then everybody thought, "This is a great idea," and adopted them and that had a flow-on effect to Australia, but with time, I think a lot of organisations have been able to come up with other vehicles that are much more suitable.

I think the other thing to your point about performance measures and also the engagement that executives have with equity that they're granted, that's an evolutionary process as well, so for many years, Australian companies just automatically implemented TSR. It was being done overseas. It had been introduced in Australia. It seemed to be a great idea. We've now seen what happens in a couple of cycles. One thing that we are spending a lot of time on with boards is helping them really examine the performance hurdles that they use and how they're appropriate for their organisation and how they can achieve a better line of sight with executives to performance, and that changes the thinking. We have received feedback from senior management after working with some of these redesign engagements where they said, "This is so much more meaningful to us. We really understand how we can influence the outcomes. We understand what we have to do," and it really does change the thinking about equity.

MR BANKS: Some people would argue if you have an equity component and maybe some rules around how long you have to keep that and so on, that that's probably enough to align incentives without all the extra paraphernalia that tends to go on to those and indeed some would go further - and this will sound slightly provocative - and say it's the remuneration consultants who have assisted this increasing complexity because it's obviously so complex that you need advice to guide your way through it and it would be nice to go back and keep it simple stupid, as the old saying went. Can I get you to comment on that? In other words, have we turned something that is a potential instrument for alignment into something that's so unwieldy and complex that even boards don't understand?

MS DEVENEY (M): I think, and again coming from a tax background, you're absolutely right. I know when I worked in the chartered environment, sometimes the structuring around the tax rules made things very, very complex and you lost that visibility to what the outcome was meant to achieve. I think going back to purely a discretionary based bonus type of arrangement is probably not possible in this environment because we have so much more transparency than we did and boards would have to be held accountable for those decisions that they made without the parameters around them.

MR O'NEILL (M): I think the very notion of suggesting a specialty bonus in this governance environment would send all sorts of shockwaves all over the place.

There is I guess a reminiscence certainly by some of the board chairs that that's what they'd really like to do anyway.

MR BANKS: Again, I'm still thinking of it as a long-term incentive, but one that perhaps wasn't as complicated, that had what they call "skin in the game" but for a fixed period of time and significantly so but perhaps had less emphasis on all the performance hurdle arrangements and so on. We've discussed with some others to what extent those additional hurdles are actually driving performance anyway and certainly having a significant equity holding as a proportion of one's wealth presumably would be quite a good motivator, providing you couldn't just sell it in the short term, that you were obliged to keep it for some significant period of time.

MS DEVENEY (M): I think Shearson Lehman had one of the highest executive ownership ratios in a US corporation which I think from the equity base was largely to be erased.

MR BANKS: But they could vest those at any time, couldn't they?

MS DEVENEY (M): Yes.

MR BANKS: They weren't locked in to holding those for five or six years or something. The only other thing is that you've talked about and made an owner, which is always dangerous, but you've talked about the effectiveness of the existing framework under that heading for overseeing accountability and transparency and there's been no requirement for companies to provide detailed on-target incentives and actually incentives vested. This was on page 8 of your submission that you encourage us to include that requirement in the disclosure rules and you'd be happy to provide further detail. I think you refer there to developments in the US, and this might come back to what you were saying earlier, but I guess to take up your offer, if you had any further advice for us as to how that could be done better, and certainly we have had a number of participants say that having information on actual incentives vested or realised, remuneration would be quite a step forward and it seems like a simple thing to do and one might wonder why it didn't happen before, but there's probably more incentive for it to happen now, I think.

MS FOORD (M): I think the presentation before us alluded to that as well, that if there's a bit more of a central control on the disclosure requirements right now, they're contained in various aspects of the regulatory framework and they're actually - not very onerous is the quote from the previous one which is true, but a lot of companies have gone out of their way and added additional disclosure which is really good and very informative for their shareholders but when you start trying to do a comparison across companies, that doesn't help the average shareholder when they want to make decisions because there's no consistency. So if we have a framework

that gives specific guidelines on a minimum level of disclosure, then those comparisons are easier to do.

An example that we mention from the US is that they have a requirement not just for the compensation table but for a number of other tables, some of them that actually require the targets for incentives, the threshold target and maximum level to be disclosed and to the level that they actually met at the end of the year for annual incentives because by the time you have the disclosures, the performance had already been met, and you can then comment on the degree of difficulty and what was influential in making those targets. So there's a number of features that could be quite useful if it's applied consistently.

A number of other submissions also mentioned the requirement to explain or the board to provide more detail about why the structure that they have implemented is appropriate and that's actually also a requirement from the US disclosure requirements where they have a compensation discussion and analysis report that talks about the rationale for why the structure is the way that it is and what has been implemented and what the company is trying to achieve by that. Now, it does place an additional onus on the company to provide and could become quite lengthy if it's not contained but it's more not describing the structure but the rationale for it.

MR BANKS: I guess the goal would not be to make it more lengthy and so on but rather the contrary, to make it more meaningful and digestible, particularly by shareholders.

MS FOORD (M): In some ways having a greater level of prescription might actually make it less lengthy because companies know exactly what is required rather than putting in more to try and explain what they're doing.

MR BANKS: Thank you. If you have any more information that you could make available to us in that area, we'd be happy to receive it. We don't have any more questions, I don't think, so thank you again for participating.

MS FOORD (M): Thank you.

MR BANKS: We'll just break for a moment before our final participants this morning.

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

MR CARTER (FSU): Leon Carter, national secretary.

MR MASSON (FSU): Rod Masson, director of policy.

MR BENNETT (FSU): James Bennett, senior policy research officer.

MR BANKS: Good, thank you. Thank you very much for attending today and also for the submission which we've read. It's a good submission. We've got a few questions for you but we'll give you the opportunity to make the main points first.

MR CARTER (FSU): Thank you. Can I just say we do appreciate the opportunity to make the submission and to actually appear in person. We appreciate the opportunity that you've provided to us. We won't speak to the submission. We're happy to answer any questions and elaborate on any points that you'd like us to. But I think what we would like to do just by way of an initial sort of statement is just to highlight a couple of particular points that are of particular concern, just sort of following on from the previous participants, whilst we wouldn't want to necessarily be accused of just being populist, we're happy to provide a bit of a different perspective, but we do understand the perspective that often is the focus of our attention which is representing the members who pay us to represent them and join the FSU. It does come from a particular focus around employment and how much they get paid, their conditions, and sometimes those issues aren't at the forefront of some of these inquiries, so we do understand that it's not your role to - you know, it's not offshoring within the industry. But I think what we would say is that the rem systems within finance - and we're not just having a global bash at rem systems, we're talking about the ones that apply particularly within the finance industry in this country - are completely driven by excessive amounts of pay and rewards and share schemes, whole structures. It's not, we would say, illogical to at least pare them back to what ordinary workers get paid and we have seen a growing gap between what an ordinary bank worker gets paid what the CEOs get paid. It has grown not only at the extremes but in all of the sorts of ways in terms of rem and rewards and all of the structures, notwithstanding some of the employee share schemes.

We have seen in our industry a complete fixation with short-term thinking and short-term reward, predominantly delivered through rem systems that reward and encourage short-term thinking and it's about how they can maximise profits in the short term. We think if we had one particular message for this inquiry, it is that the short-term incentives schemes with our industry cause bad behaviour.

MR BANKS: Can we just pause there because I think we've had a lot of people tell us that the regulatory governance and indeed practice itself in Australia within your sector has been far superior to what we know it to be in the States and that you seem to be going against that view. Do you have any examples of that?

MR CARTER (FSU): There is no doubt that the regulatory system in Australia is much better and I think this is where we say regulation is good. It has stopped the worst excesses that have got America and the UK particularly into all sorts of trouble on rem finance. But it continues to be the case that the bulk of home loan lenders and workers in our industry, pay is now completely structured around sales and meeting stretch targets, so it's not about does the customer genuinely need that level of a mortgage or a loan, it's how much can you sell in a credit sense to that person and the more you sell, the more you get paid, and that entire structure starts at the top. So what we see within our industry is that where it starts with the CEO and the senior executives, this notion of sales and short-term reward then is driven down to every single layer within the organisation. So each subsequent manager's target is often based on making sure that the person below them meets their target. So it is about driving that risky behaviour.

The fact that we haven't had the worst ravages of the financial crisis is because of the government regulation. We would absolutely say it is not because anybody in the big four banks decided that that behaviour was too much of a stretch and morally or ethically wrong. It is only that regulation that has stopped it. They have pushed that envelope right up to its edge, particularly around the short-term target and reward schemes in terms of the rem.

The other side that we see it delivered on in terms of short-term thinking is cost reductions, so it's not about, "How do I as a CEO or a senior executive maximise my bonus or pay?" it's about, "How many costs have I taken out of the organisation?" That is what is driving offshoring in our industry. It is what drove the bank closure regime previously. It's what drives the number of jobs that are lost in our industry. It's about short-term thinking in an industry that can afford short-term thinking the least. We've seen what it can do to whole countries' economies and it's really important that this short-term incentive-driven rem structure be replaced with long-term incentives rather than short term.

MR FITZGERALD: Can I unpack this just a little bit. The first thing, when you're talking about short term, there's two aspects to it; one is the performance criteria itself, in other words, some of what you've indicated is self-evidently problematic. For example, simply linking performance to sales for a senior manager as distinct from a salesman has always been known to be problematic. That it exists is surprising. So you've got performance hurdles which are in fact wrongly defined. The second component is once you've reached whatever those hurdles are, it's the

nature of the actual remuneration. I notice some of your suggestions go to holding shares for a longer period, so I just want to unpack those two things because they are different.

Your concern, is it largely with the fact that the performance hurdles have in fact been wrongly calculated, wrongly set, and they in fact are driving short-term behaviour, as distinct from people being able to access shares to soon after that performance hurdle, in other words, vesting? So could you just unpack it a little bit more.

MR CARTER (FSU): I think our primary concern would be the first one in terms of where those hurdles are being set and the culture that that drives, but clearly the vesting issue within our industry is really important, but clearly our major concern is around the first one.

MR FITZGERALD: What you're really saying however is that the directors who set these performance criteria either fail to understand the long-term nature of their own business or themselves are somehow misaligned in their thinking because every director we've even spoken to will say, "We're about the long-term sustainability of the company or increasing shareholder wealth over time." They're words. What you're saying is in practice, you don't think that's the case.

MR CARTER (FSU): Yes, I think that's exactly what we're saying. What we're saying is that the focus at the moment is about the short-term return. Now, of course they don't want to do anything that in the longer term is going to run their business into the ground or do anything that's going to close the doors but that is not where their mentality sits at the moment. The mentality is about: what do we do in the next quarter - you know, whether they call them stretch targets, whatever language they want to use - how do we push the envelope to deliver maximum return at the top level in terms of remuneration strategies, around targets?

MR BANKS: We have had ACSI here this morning representing the super funds. One explanation which often comes from corporations is that they are being driven in that direction by short-termist attitudes by super funds and other institutional investors.

MR MASSON (FSU): I think that's right. I think they are under enormous pressure from the institutional shareholders, investors and even mum and dad investors to try and get quick and significant returns and that's part of the problem. I think they also go a long way to try and build that expectation too though and they need to be better managers in turning around those expectations and talking about sustainable practices that are about the long term and are about the social responsibilities that are evident within the operations, particularly in the finance

sector.

MR CARTER (FSU): We do think that the banks in this country obviously have a privileged position, particularly with what's happened to the world. The previous participants talked about is there any logical reason to link pay or to do certain things. We would say that there needs to be a moral society element to this sort of behaviour and how remuneration structures are enacted, particularly within banks. They set the benchmark in all sorts of different ways around their behaviour. We've seen the gap in our industry grow for a teller - a CEO on average, taking out some of their short-term incentives, gets paid 200 times what a teller gets paid in our industry. Over the last 10 years a teller's wages probably has gone up - factoring in all sorts of different things - around 35 per cent, but CEOs' pays have gone up around 400 per cent, so there is a real disparity. What we are seeing more and more is that the money has been sucked up into the top end, particularly around short-term incentives and rewards and the people who are paying for it are the people at much lower levels who don't even get access to across-the-board pay increases any more.

MR FITZGERALD: I will come back to relativity in a minute, but just in terms of the short term, a number of the investor groups that have both presented and we've met with privately have got this sort of notion that an ideal structure is somewhere around 60 per cent is base pay and the rest is split between long term and short term. Now, the figures are not important but all of the investor groups have said that they actually do want a component of short-term incentives. So your proposition which would appear to be a little draconian, that is, you want them abolished - I'm not quite sure whether you actually think that would happen - but there seems to be that the investors actually don't mind 25 per cent, 30 per cent, whatever the magic figure is, for short-term investment. Your proposition seems to be out of kilter with what the technical owners of the companies are saying to us.

MR CARTER (FSU): From our point of view of course we'd like them abolished too. Do we think that is a realistic outcome? Probably not. If we could come up with a scenario where the percentage that is around short-term incentive is minimised, particularly within our industry, that would be a welcome step forward from where it sits at the moment, where the short-term incentive is almost the driver of the behaviours at the moment.

MR MASSON (FSU): I think just to supplement that, APRA are going to have a look at this process within the finance industry, as well they should, and we would be arguing to them similarly that they should try and lower the short-term incentive around the remuneration structures and certainly any of the performance hurdles within that short-term framework should remove the idea of risk taking which is again fundamentally part of the problem that we see that cascades throughout the culture and ends up with the salespeople being forced to have to sell in a volume

sense rather than in a consumer need sense and that will lead ultimately to difficulties for the whole of the industry.

PROF FELS: Have you any views on the APRA work in this area?

MR MASSON (FSU): Any views?

PROF FELS: On what they've been saying about exact rem and all that stuff.

MR MASSON (FSU): I think the fact that they are looking now to set up a purely independent process of review of remuneration we think is welcome. From what we understand, the issue of considering risk and risk elements within remuneration in the finance sector and seeking to have a look at whether they are appropriate is welcome. As yet, we're not sure where they will actually land in terms of percentages or how that will actually work but we think it's overdue and we certainly think that alongside the regulatory regime that exists in Australia that has assisted us in avoiding the US subprime crisis and financial meltdown crisis to some extent, that will be a welcome process that will ensure a longer-term sustainability of our industry.

MR CARTER (FSU): As Rod said, we are really encouraged and we hope that they actually do go forward with this notion of introducing risk into the rem strategy that the boards have got to consider, that it needs to be an element when a board of a bank and finance institution is looking at its rem, whether that is a driver of risky behaviour is an important thing that they should be thinking about and we really do support their notion of that being an independent process as opposed to the bank or the insurance company's management coming up with the rem system. So we would encourage - hopefully APRA go down that path and do talk about some independence around those rem experts like the auditors.

MR FITZGERALD: Could I just push again: one of the most important duties of a director of a profit or non-profit organisation is to manage risk. That's why boards assist; it's central to its function. Why have we got to a situation where APRA needs to address that issue? In other words, what I'm trying to get to the point of is why do you believe that the current system of appointment and retention of directors is not delivering an appropriate risk management strategy which reflects itself in the rem or is that overstating your position?

MR CARTER (FSU): I'm not sure it's overstating it but obviously being in the room when they talk about these issues, I think that they are focusing on the return and their performance and their profitability and those other things that they are looking at first and foremost. To be honest, I'm not sure that they would be aware of how the notion of their short-term incentives are cascading down to the lower level. Obviously the members of the FSU who talk to us about, "One of my jobs is to sell

home loans," I don't think they would be aware of just how much pressure it is to say, "You need to sell six home loans this week regardless of me. If you have an opportunity to increase the amount that that person borrows, then increase that amount." I don't think they're aware of just how much pressure and in some ways bullying is pushed out at that level. If you're not aware of it - and maybe they're not asking the right questions - but certainly in the representations we make to the senior management and to the government, you hear the view about how that risk is managed at the boardroom table, we tell you how it actually occurs on the ground and often the two are very, very different.

MR BANKS: Why is that? Where is the disconnect between perhaps a more balanced approach at the board level in trying to work out incentive arrangements for its senior executives that get that - - -

MR CARTER (FSU): We would say part of that disconnect comes from this culture that it's just about, "Have you met the targets?" so it is such a fixation on the outcome as opposed to what Rod talked about, for instance, "Have you met the consumer's need? Have we pushed too far?" They genuinely do have quite good credit regulatory systems internally but we know at the ground level they're being pushed. Why they're not being reported through, I don't know. Whether it's each subsequent layer of management saying, "Yes, but I've met my target," and that's really the first thing that they want to hear about.

MR BANKS: In your view with this kind of short-term sales-driven approach at the bottom end, where is that impacting most? Is it in the home loan area?

MR CARTER (FSU): Home loans and credit cards predominantly, personal loans more and more nowadays. It's always been a problem but I think just how fragile many households' economies are at the moment in terms of how stretched they are, we're seeing more and more people become unemployed, whereas predominantly they were lending at a hundred per cent of the value of the house, sometimes even more, they're now starting to bring that back to 90 or 95 per cent of what you're trying to borrow, but predominantly it's house lending and credit cards where the real stress is.

MR MASSON (FSU): But it can go beyond that into things like retirement savings - - -

MR CARTER (FSU): Yes, absolutely.

MR MASSON (FSU): - - - where it's commission based, for example, so people may be directed to products that are not necessarily in their best interests. They will be eaten up by fees and by trailing commissions and the like. It can go to insurance,

the selling of insurance and the type of products that people may choose. So the culture of a focus on volumes of sales as compared to consumer need can create some pretty spectacular issues for our industry and for the broader community.

MR CARTER (FSU): In some ways we think we've got a different credit bubble problem in this country. It's just kept going up and it's going to burst one day. We don't have the subprime concerns thankfully, and again because of the regulations, but household indebtedness, it's growing. What the government might be hoping is that it's being spent in the stimulation package - some of it is going down to pay debt - but the fact that the Harvey Normans of the world advertise recession-busting deals the same day that the payments have come out means that people are still going into debt. We all need credit, we're not saying that people shouldn't lend money - it's an integral part of what we all probably do to buy a house and all sorts of other things - but if it's about short-term incentives to get paid more, then that is risky behaviour.

MR FITZGERALD: Going back to short term and long term, why are you relatively modest in your recommendation that equity payments should be held for at least two years? We've heard propositions of at least three, we've heard five, we've got some schemes which graduate the vesting up to 10 years. Your proposal is a very modest one compared to some of those, so I'm just wondering why you've chosen a figure of two years.

MR MASSON (FSU): As good unions, with some things we'll stretch an ambit and on others - no, look, in the main we've picked up the issue - as I understand it, it was from some others that were arguing that maybe that's a rough figure. I suppose it's a bit arbitrary whether it's two, whether it's four; the point being I guess that you would like to see how the decisions that executives are making play out over time and to see that there is a sustainable outcome being delivered. I have no logic for the two years, I suppose is what we're saying, other than we've seen it bandied somewhere else.

MR FITZGERALD: I just thought there may have been a particular reason why in your sector you thought that was more appropriate than a longer stretch, but that's fine.

MR BANKS: You also make a recommendation in relation to disclosure of pay relativities which you see as assisting investors making an informed vote on a remuneration report but you haven't gone further into specifying some kind of particular relativity or cap or whatever. Do you want to just comment on that?

MR CARTER (FSU): It is one of the ones that we do struggle with a little bit. The relativities we think are really important, particularly with what's happened with them over the last 10 years. But we don't think it's an easy thing then to just come up with a multiplier that says a CEO should only get paid X times what a teller gets, so

it is a complicated approach. From our point of view what we think should at the very least happen is there needs to be a relativity in the sense that if the CEO and the senior executives are getting adjustments to their rem each and every year through whatever process, shareholders or their own sort of rem strategies, then it's at least got to cascade through the place. It doesn't need to be dollar for dollar - it'd be fantastic if it was - but at the very least - we've had situations in the last five or six years where the CEOs and the senior executives are getting double-digit increases and at the same time saying zero outcomes for the people who work for them.

So there's lots of theories around the camp, whether you can apply a multiplier, and when we talk to our members about it, their strongest rhetoric comes back to not how much they get paid, to be honest. There's no particular remedy. I think like most people they would think they get paid too much at a bank CEO level, but it's not, "I want that money," with that sort of envy, the system has to deliver real wage outcomes right across the board, rather than it being concentrated at the CEO end. So I don't think we have a particular view that says it should be a 20 multiplier or a 20 times cap, but some sort of relativity, that if there is a system that delivers at the top end, it's got to deliver throughout the system.

MR MASSON (FSU): Can I just add I think it also goes back to the morality argument, so even if you're not prescribing a particular multiplier, you are at least making it out there and known when shareholders are making decisions. When we go to annual general meetings and address those meetings and talk to shareholders about the issues for workers within those environments, they are quite surprised. They are genuinely surprised about the level of pay that those people receive, about the fact that the management won't agree to vary very constrained pay outcomes and at the same time they're voting to increase CEO or executive salaries by huge amounts. So it comes back to just being open and transparent about that sort of stuff and better informing the people who in the end pass some sort of decision about accepting remuneration reports or not.

MR BANKS: I think Allan has made the comment that at the top end, I guess one factor in the dynamic is that typically, and it probably would apply to a bank, the executive remuneration of the top group is a very, very small proportion of the total size of the bank, whereas obviously the rest of the employees are a fairly large group and there's going to be an effect on the overall cost structure of the corporation.

MR MASSON (FSU): And we're not suggesting that everyone within the organisation should be paid \$8 million. You're just not going to have a sustainable business. But equally, if the CEO and the top executives are going to pick up an average of 14 per cent every year and in the same breath talk about the need for constraint in terms of wages and costs throughout the organisation, then that's fairly

hypocritical, so there's a need for some sort of balance within that debate.

MR FITZGERALD: But in this case, there's not necessarily an alignment between shareholders and employees because we've seen the stock market react where they have cut costs, shaved salaries or constrained them and got rid of your members. I note you've put it in the terms of, "The disclosure of pay relativities would actually assist investors." I can understand how it might assist employees in their negotiations or you can do the calculations already. Is it really true to say that investors are concerned about what takes place with employees in these organisations or is that a wishfulness on your part?

MR CARTER (FSU): We've been going to AGMs for at least five years now and I would say that over that period of time we've had a much greater take-up. Often we put out a note beforehand saying, "Give us your proxies so we can attend the meeting," and that take-up has been increasing each year that we go along. We get contacted by many, many more shareholders now to say that actually we do care. It's a strange relationship. I'm not talking on behalf of the institutional investors but the mums and dads that turn up to the AGMs, they care about the people who serve them. They really do have an ownership of the bank and they want the bank to run particularly well and often tell stories about the particular branch that they do their banking in. So is it as high as what we would like it to be? Is it a fundamental concern that they put it in place of their return? Probably not at the moment, but certainly from our point of view, the discussions we have had with shareholder groups, it is becoming a much bigger issue for them. Whether it's part of this whole sort of corporate social responsibility push, I don't know, but certainly the contact we have with shareholders, it's much more front of their mind than it used to be.

MR MASSON (FSU): I think you open up a whole debate about whether institutional investors or funds managers should be compelled to vote on matters like this or whether they just pass proxies to the board which is a whole other argument around the Corporations Act. We do get support from superannuation investors, for example, but I don't think we'll get support from JP Morgan, if that's the question, who are the biggest shareholders in the banks in Australia, because they are institutional investors and, you're right, probably would like to see costs reduced and profits maximised. If that means sacking people, then they do.

MR CARTER (FSU): At the St George AGM that decided that it merged with Westpac, we sort of won the vote on the floor and had over a million votes, and at the end, the institutional investors of course swamped that amount. But I think there is more concern in that room now about the people who work for the institution than there used to be.

MR FITZGERALD: Your vote there, do you think, notwithstanding that it wasn't

the majority vote, did it influence any behavioural response by St George, because what we're hearing is that as long as you get a sufficient enough no vote to a remuneration package, corporations for any number of reasons will want to react to that. There are examples where that is clearly the case. So in a practical sense, do you think that your block of one million votes made a difference?

MR CARTER (FSU): I think the way it made a difference is in two ways: firstly, as part of the engagement we have with the federal government about what conditions should be placed on that merger. For the first time ever in this industry, we referred specifically as one of the conditions that the employment issues that have been raised by the FSU have to be addressed by Westpac, so I think that is a direct correlation to the fact that we had a block of votes behind us. I think Westpac is one of the organisations who, whilst they didn't go down the complete WorkChoices route under the previous government, are now talking about entering into a collective agreement that looks at issues like pay. So there is no doubt that it does have a direct correlation to behaviours of the big corporates. They don't like their big day spoiled.

PROF FELS: How well do you think ACSI represents what would be the views of your members, including those investing in industry funds? For example, I think ACSI had quite a number of specific suggestions about how the system might be improved but I don't think I heard them expressing any concern about the quantum of pay increases. I wonder if most of your members think they get on the high side.

MR CARTER (FSU): Is that ACSI or ACSP?

PROF FELS: The Australian Council of Superannuation Investors.

MR CARTER (FSU): Yes. We have regular dialogue with them as we do with others. I think we would agree with most of their submissions around corporate government and a whole range of other things but at the end of the day we don't see them as the group who represents I guess our members' views about it. I think on a number of issues, our views and their views would align but we wouldn't have expected them to turn up here particularly running an argument around the pay outcomes and those sorts of issues. But it's one of the bodies that we engage with every time we go to an AGM. We have an open dialogue with them but they don't really represent our views would be my assessment of it.

MR BANKS: The last question I had really just related to how you would see your various recommendations being implemented, whether you would see them coming through guidelines, through the ASX governance rules, the if not, why not kind of approach, or black letter regulation, the Corporations Act or something like that. Have you thought that next step?

MR CARTER (FSU): Rod and James are much better placed to answer the specifics of that than I am, but can I just say it's from very bitter experience we do prefer the black letter regulation, but I don't know if we've got a particular view about implementation.

MR MASSON (FSU): It's not hard and fast. I think Leon's point is right, where we don't have black letter regulation, we don't get the desired outcome. That's the reality. Yes, we can continue to put the moral and other forms of pressure on these organisations to behave much better, but that's a very long road to hoe and often the damage is well and truly done by the time you actually get them to start making any sort of considerations or concessions about those sort of things. So we think there's probably elements of the Corporations Law that we might be able to look at and talk through what can come about in APRA and their review. Clearly there's going to be further regulatory outcomes that they will deliver that will have to be lived up to, but I think overall, left to their own devices - - -

MR CARTER (FSU): They don't change.

MR MASSON (FSU): - - - they won't change, and we need to see some change about the type of culture they're creating there, these organisations.

MR BENNETT (FSU): It's on a slight tangent but it is relevant I think to this discussion that we welcome, as you're probably aware, the regulation of credit being transferred to the Commonwealth and within that, there's the whole context of responsible lending being mandated which effectively says the product must be suitable and the consumer must have a proper capacity to pay. Now, we are optimistic about that, in that if you make the selling of credit more and more about its suitability and about the consumer, then it starts to decouple or remove the sort of role that sales targets can play. Obviously whether that is the effect, we'll have to wait and see. We are also hopeful that with the new responsible lending provisions, our reading of it and our discussions with Treasury suggest that the provisions would mandate actually disclosing of sales targets, so in a selling environment, the teller or whoever is selling the actual product would have to say, "I stand to gain possibly X, Y and Z outcomes from this," which is quite established in other areas of financial services. So hopefully that disclosure, coupled with suitability and capacity, will actually start to make the sale more about what is suitable and what the consumer needs, rather than what the teller has to try and sell to the particular person. That obviously has a way to run until implementation but just in terms of regulatory developments, we're reasonably hopeful that will be a positive one.

MR FITZGERALD: It's an interesting case study because as you're well aware, we were one of the bodies that did the inquiry that recommended that - sorry, recommended the transfer to the Commonwealth, the financial services but not

necessarily that provision. But prior to that of course the banks all had the responsible lending codes and approaches, so I suppose in a sense it's an interesting example. Can I just deal with one issue only and that is you have a couple of areas where you've said there should be an absolute prohibition. One of those is in relation to non-recourse loans and hedging. Can you just explain why you believe an absolute prohibition on that is necessary?

MR BENNETT (FSU): I think it's probably just a lot simpler because if you have some sort of halfway house, I guess unfortunately in our experience that will provide wiggle room to change arrangements such to avoid the intention of it. We note I think also in the submission that Westpac off its own bat have an absolute prohibition on hedging, in terms of remuneration, so I don't see why other banks could argue that that's not possible in that sense.

MR FITZGERALD: Are there any perverse or unintended outcomes from doing that? Others have put the suggestion also, I think yours is a bit stronger, but from our point of view, are there any consequences of such a prohibition that we should be aware of?

MR CARTER (FSU): Nothing that occurs to us.

MR BENNETT (FSU): You've had arguments saying hedging is somehow good?

MR FITZGERALD: No, when somebody recommends prohibition, our immediate response is does that have consequences which may be perverse or unintended, I suppose, so it's an automatic reaction.

MR MASSON (FSU): Maybe the answer is there would be other methods by which presumably access to moneys to take up equity could be provided other than non-recourse loans and so forth, so we don't necessarily see it as being prohibitive to people actually being able to access the equity holding.

MR BANKS: Good. All right, gentlemen, thank you very much.

MR CARTER (FSU): Thank you.

MR BANKS: We'll break now for lunch, resuming at 1.30. Thank you.

(Luncheon adjournment)

MR BANKS: Welcome back, ladies and gentlemen. Our next participants are from RiskMetrics Group. Welcome to the hearings. Could I ask you please to give your names and positions.

LAWRENCE (RMG): Martin Lawrence, head of research for Australia and New Zealand.

MR PAATSCH (RMG): Dean Paatsch, director.

MR BANKS: Good, thank you. Welcome and thanks very much for participating and thank you for the submission. It's a substantial submission and we've read it. We've got some questions on it but we'll give you the opportunity to make some introductory remarks.

MR LAWRENCE (RM): Thank you very much. Thank you for the opportunity to appear before the Productivity Commission. I would like to make a brief opening statement covering some of the points raised in our submission and a couple of other submissions that we've viewed that have been lodged with the inquiry and then happy to take any questions.

Just by way of background, for those who don't know who RiskMetrics is, we're a government advisory firm to institutional shareholders. It's a worldwide company, headquartered in New York. More details are actually in our submission, I think.

Our starting position is that there is no question that executive pay is set within a market. There is also no question that it is, like almost all markets in the real world, imperfect. So we should not be surprised that there is evidence of aberrant behaviours and misallocation of resources. This leads to the big question about executive pay, the extent to which it aligns with performance. We think the commission with its reputation for evidence based policy-making would be ideally suited to examine the extent to which Australian executive pay reflects performance using a wide range of measures, including share price, dividends, return on capital et cetera.

We have suggested in our submission a framework that we like to try and assess the extent to which executive pay matches productivity improvements. We would encourage the commission to do similar work and would like to point out that as far as we're aware, this inquiry is the most significant allocation of research resources to the issue of executive pay in Australia that there's been.

More generally, we think Australia's regulatory framework as it applies to

listed companies and executive pay is generally sound because of the primacy of boards and the institutional mechanisms that make them responsive to shareholders. Our submission suggests a series of small improvements in response to evidence of market imperfections. Some of these are improvements to existing accountability mechanisms that enable shareholders to better protect their property.

The key changes we think are necessary are restore the ability of shareholders to approve in advance any transfer of shares using company resources to directors and extend this to other members of key management personnel. We also note the submission of the ASX in this regard, that the remuneration-related provisions of the listing rules, including the requirement for shareholder approval for the issue of shares to directors be transferred to the Corporations Act and we endorse that proposal.

We support the proposed legislation currently before the parliament to lower the threshold of termination payments without shareholder approval. We also think there should be a series of small but necessary changes to the system by which votes in listed companies are cast to minimise the potential for votes to go missing, and also changes that would reduce the ability of boards to frustrate the election of non-board endorsed candidates.

We do not think there is a need to substantially change the remuneration disclosure framework. The remuneration report is still a relatively immature disclosure mechanism. There is a sense that companies don't quite know still what to do with it but it's certainly improving. One area where existing practice could be improved without regulatory change is to enforce the existing law as it relates to the disclosure of termination entitlements and the requirement to provide a detailed summary of performance conditions applying to the pay of members of key management personnel.

We would also like to take this opportunity to respond to points raised by other submissions. In brief, several submissions have explained executive pay in the context of Australian executives selling their labour in a globally competitive market. Empirical evidence for this proposition is mixed. Work that we have done on behalf of ACSI, which I believe the commission has seen, found top 50 Australian companies were as likely to lose an Australian based senior executive to death as to an overseas employer between 2003 and 2007. On the available empirical evidence, if there is a war for talent, we are winning it.

Some submissions have suggested present disclosure requirements for share based payments overstate executive pay. Our own empirical work provided to the commission suggests prior to 2007 that share based payment disclosure requirements actually minimised executive pay. We also note that cash paid doubled in the top 100

companies and cash bonuses quadrupled between 2001 and 2007.

We would briefly like to respond to some commentary from the commission on the issue of the role of shareholders in being the chief body external to the board involved in an executive remuneration setting. Alternative views reduce shareholders to one of a range of parties with no special claims on the company. The risk of a stakeholder argument, as attractive as it is, given the environment in which companies operate, is that directors and management end up being accountable to everyone and therefore accountable to nobody.

Finally, several submissions have, instead of engaging with the issues raised by the discussion paper, questioned the competence of proxy advisers or suggested we have irreconcilable conflicts or a moral hazard. We would simply observe the following in regards to proxy advisory firms such as ourselves: there is no compulsion for Australian shareholders to vote their shares, there is no compulsion to buy our service, there is no compulsion to follow our advice. There are almost no barriers to entry into our business and on that basis, we are relevant only insofar as our clients think we are useful, which is exactly how it should be. With that, we're happy to take any and all questions.

MR BANKS: Good, thank you. That was short and sweet. We have a range of questions. I guess maybe one place to start was the commentary by Stephen Mayne yesterday in relation to your influence. I guess he was saying on the one hand that you have a lot of influence; on the other, it's of the nature of a donkey vote in terms of the extent to which that some shareholders are slavishly following the recommendations that you make. Do you want to just comment on your role in the bigger picture and what influence you have?

MR PAATSCH (RMG): Yes, we're participants in a free market for information, so as we finished in Martin's opening statement, there's no compulsion to buy our service, there is no compulsion at all to follow our advice and frankly, it's ridiculous to suggest that in some way, our very sophisticated clients would donkey vote off the back of our recommendations. It is true though that we have influence and we have influence only insofar as we can back up what our recommendations are. I think we're living in a situation where the disconnect between pay and performance has never been more apparent and it's unsurprising that if we are good - we are the market leader - at identifying those disconnections, then people might agree with us, but Stephen particularly overstates our influence.

MR BANKS: Okay. Martin raised the question of commentary about competence and moral hazard and so on. Maybe if I just put to you one way it's been put to us and that is that typically, proxy advisers are spread quite thinly in terms of the range of companies they are covering and that inevitably restricts or constrains the depth of

insight they can bring to any particular company's performance and remuneration report of valuation. What do you say about that?

MR PAATSCH (RMG): If we weren't providing value, our clients would not employ us.

MR BANKS: So you have a well-informed purchaser of your services?

MR PAATSCH (RMG): We have incredibly sophisticated purchasers of our service and to suggest that in any way they are obliged to either follow our advice or purchase our advice is patently ridiculous. Some of the people who have advanced those arguments, I question their motivations for doing so. Basically, as Martin said, it's a free market. We're participants in the market for information and we have pretty efficient systems, we have global resources at our behest. Sure, we'd like to have more resources but more isn't necessarily better and in fact I'd put a lot of our people up against the supposed sophistication of remuneration consultants any day of the week.

MR BANKS: Okay. The only other thing that has been raised in that connection is also the extent to which you get involved in a dialogue with companies. Clearly you're pretty close to your clients but what about the corporate world?

MR PAATSCH (RMG): In what sense? Can you just expand on that?

MR BANKS: Just in terms of understanding what lies behind the decisions that they have made and may be reflected in the remuneration report and so on.

MR PAATSCH (RMG): Yes, we have a very disciplined process in contrast to some of our competitors whereby we contact the company in most material instances where we're proposing to recommend against, primarily for that motivation to tell the company's story about the commercial context in which remuneration is set and I think we do that better than anyone else in the market in each year. So in the Australian office we would cover something like 360 Australian companies. We meet with more than half of those companies generally at a senior board level. We provide ample opportunity for companies to comment. We will provide copies of our report. Our recommendation is our recommendation, it's ours, it's independent, it's not available for sale, but we do put the company's side of the story. We think that's our obligation to do that.

MR BANKS: You've not recommended to us that we should in turn recommend a binding vote on the remuneration report which implies I think that you think the non-binding vote is doing a fair bit of work.

MR PAATSCH (RMG): It is. That's not to say that there isn't scope for improvement but our position is that a binding vote doesn't really add anything. There is already a binding vote and that involves getting rid of dud directors who put in place dodgy pay arrangements. The non-binding vote I guess has a disadvantage in the sense that they may not be an immediate consequence but the price of shame sometimes actually does get company directors to respond and that's certainly something that we've observed. There's a great word in Spanish which is called "sinvergüenza", someone who acts without shame. Of course you run the risk in a non-binding environment that you will encounter boards or individuals without shame for whom there is no remedy.

We're not really seeing that today to be honest; in fact we've seen most companies respond to significant negative votes. I think there is some attraction in considering whether, as I think has been advanced in the UK, that in the event that there's a significant against vote on a rem report that the following year, the chairperson of the remuneration committee has submitted themselves to a vote. There's some attraction in that idea but I think it warrants further consideration to see whether there might be some consequences.

PROF FELS: In terms of the recent history in regard to non-binding votes and things of that sort and remuneration packages more generally, can you identify any trends in the last five or seven years - of course there's been increases and then it's stabilised somewhat - but in terms of practice, one of the theories is that executive pay got out of hand for a while and then in a more recent period, there has been a number of things that have started to restrain it. The shame factor has increased sharply, but only in the last year or two. The more close linking of pay to performance has stepped up sharply in the last two or three years but there was a period when that wasn't so present. I just wondered if you had observed any trends or would your generalisations apply right across the last 10 or 15 years? Has there been any evolution of some of the - - -

MR LAWRENCE (RMG): There's definitely been evolution. I suppose we can go back as far as 1998 because that's when you started getting told what was going on, in Australia anyway. In Australia, what we've seen is that certainly around long-term incentives, so equity that vests over several years, the hurdles around that have got a lot tougher. Typically 10 years ago, a long-term incentive was an option with no hurdle of an exercised price and remaining employed. That has really changed. It started to change around 2000-2001. The change accelerated about 2004-2005. I guess that change came in at two levels. There was the first one which was, "We'll just buy something that we know is acceptable. We'll just get something that we know is acceptable and doesn't cause us any problems." What we've seen in the last two or three years is boards actually sitting down and trying to work out what kind of hurdles will really drive their business and are acceptable to shareholders but

also aligned with their strategy and that's a positive development.

One suspicion I have, and it's hard to I guess nail down why this is so, but at the same time as we've seen that greater attention on long-term incentives by shareholders and also by boards, we've seen base pay double effectively at the top end in terms of cash and we've seen short-term incentives because not only much more prevalent but also much larger. So the medium short-term incentive bonus in 2001 was about \$350,000 and in 2007 it was about \$1.3 million. We don't have the data yet for 2008. I know that the firm PricewaterhouseCoopers did a study at the beginning of this year and they found that 94 per cent of the top 100 companies' senior executives got more than half of the target bonus in 2008. That's an astonishing finding if you think that a bonus is a genuinely at-risk mechanism and part of the problem with bonuses and trying to work out what's driving them is that you just don't have enough information in most cases. You don't actually see what's driving them. You get very vague general disclosure.

PROF FELS: In the same vein and acknowledging your point that we don't have very good recent data anyway, have you picked up any impact of the global economic recession, not only the levels but also in practices and so on?

MR LAWRENCE (RMG): Pay, for instance, there's been a lot of companies announcing base pay freezes for senior executives. In some cases those people will say, "But hang on, your base pay went up this year." It's usually because for a company with a 30 June year end, base pay actually increased in, say, July, so when they're announcing a freeze, it's for the coming 12 months. The freeze has been the most common. In a couple of isolated cases, we've actually seen cuts, not substantial but meaningful, 5, 10 per cent. Bonuses we haven't yet really seen. The general movement, I haven't seen many companies, in the companies that reported to 31 December 2008 which we do have the data for, where bonuses increased. We are also seeing a move - and this was happening anyway - but we are seeing a move to more deferral of bonuses to payment in shares rather than just in cash up front. That's largely in response to - I guess clawback mechanisms, as some people are talking about overseas, are all very well but it's much easier to give them shares and have them move in accordance with the ongoing performance rather than to try and get the cash back out of the bank account.

MR PAATSCH (RMG): The other thing to say is that I think with maximum observations that the legitimacy of the outrage constraint is probably sharper now or the effectiveness of the outrage constraints are probably sharper now. Look no further than Pacific Brands where I think that sent a signal to a lot of boards that your brand may actually be at risk where you are mismanaging - okay, she was treated quite unfairly actually - perceptions around executive pay.

PROF FELS: Acknowledging this is slightly speculative but I can at least put the hypothesis to you: when the history of this comes to be written, is there any possibility that it will be said that on the way up, there were not so many performance constraints that really stopped pay going up quite sharply, partly with the market, partly for other reasons, and then almost at the time that the cycle turned, the criteria were tightened up and it was more closely linked, for example, to your performance versus your competitors and that has cushioned the fall?

MR LAWRENCE (RMG): Hard to say. Specifically the way that your performance is indexed to your competitors, the relative TSR measure of the long-term incentive, that does have the potentially perverse outcome that your share price can halve, but because everyone's falls by 75 per cent, you get paid. One observation that I would make though is that relative TSR is becoming a progressively less important part of long-term incentives, so around 2005-2006, that was the one that everyone shifted to because they knew that it was acceptable. Then a variety of things happened; one is a lot of companies put in place a relative TSR scheme that assessed performance against the S and P ASX 200. For example, if you were a manufacturing company and you put in place that scheme in 2005, the resources sector just killed you. It wouldn't matter how you did. So they either tried to narrow the scope or they turned to other types of measures and the most common type of measure people turned to was earnings per share which had an uncanny propensity to vest. I actually think we might see a renewed appeal of relative TSR because earnings per share targets that were supposedly linked to individual executive performance probably had a lot more to do with growth in GDP.

MR FITZGERALD: In your submission you've dealt with a whole host of potential changes, recommendations and analysis, so in the time we've got we'll only look at a few of them. Central to this whole issue has been the issue of governance. Consistent in the last three and a half days of hearings has been the governance of boards, the role of shareholders. I just want to unpack some of the recommendations in that. I'm going to start with the shareholders. You've indicated that the non-binding vote is effective and a binding vote would not be, although you said that there could be some linkage to a director or the chair of the remuneration going down. What are the other areas in terms of shareholder rights or entitlements do you think need to be strengthened, if at all, that would have an impact in this particular area?

MR LAWRENCE (RMG): I'll take a particular part and then I guess we can talk about mechanisms that are accountability mechanisms generally. I'd start off by saying that a client of ours actually said that they thought that the say on pay legislation that's been talked about in the United States will not work in the United States unless you ally it to majority voting for directors, so unless directors actually know that they can be removed. Not many directors are actually removed by

shareholders but the knowledge of it is a powerful incentive. One area - and this specific to pay - until October 2005, Listing Rule 10.14 said that if you wanted to give an equity security, so an option or a share or whatever you call it to a director, you needed to get prior shareholder approval. That rule has since been changed to say that if you use the company's money to buy it on market, you don't need approval.

The problem with that is that it's been expressed that there's no dilution. Well, the entire risk of dilution is that you actually transfer control over the company, the rights of the company's cash flows, voting entitlements, to related parties by issuing new shares. You do exactly the same thing by using the company's money to buy those shares and transfer them to people. Now, at the top end of the market there hasn't been much sign of I guess what you'd call "abuse". There might have been schemes put in place that shareholders didn't agree with and wouldn't have voted for, but not wholesale transferring of assets. It's an accident waiting to happen though because if you look at some of the funny things that sometimes go on at the smaller end of the market, the only reason this loophole hasn't been used by them is they don't know it's there. There would be nothing to stop them, say, doing a placement for general working capital purposes and then using some of that placement to buy shares on behalf of the directors, because it involves equity securities. So voting rights, claims to dividends; we think that's an area where there is a real compelling interest for shareholders to have the right to approve insiders dealing with those securities in a way that other shareholders can't. Of course if insiders want to use their own money to buy shares in the company, let them do it.

MR PAATSCH (RMG): This is where I think the ASX's submission which is effectively arguing for ceding its powers over executive remuneration to the Corporations Act is very worthy of your attention because - - -

MR FITZGERALD: Why is it worthy of our attention?

MR PAATSCH (RMG): Because I think if you go back to the history, and we've given you the detail around the way in which Listing Rule 10.14 has changed to enable that loophole to close, it's very difficult for the ASX to manage that conflict.

MR FITZGERALD: Sorry, why is it difficult for the ASX to manage it, whereas if we move to the Corporations Law, that would have a better outcome?

MR PAATSCH (RMG): Parliament is a very good forum for resolving all sorts of claims and the ASX might find it very difficult to (a) have the expertise but necessarily have the constituency. It may be offending the very constituency on which its listing fees depend. But the proposal to cede the listing rules dealing with executive pay has come from the ASX. It is quite significant and worthy of your

attention.

In terms of the other issues that you've spoken about, shareholder mechanisms, we've made a number of suggestions there. I guess what we're concerned with here is the infrastructure through which boards can be made accountable. Make no mistake that the sole reason for aberrant outcomes on executive pay are boards, wheat boards and boards who should be able to be removed and replaced. We're concerned about aspects of the government's infrastructure that would make that difficult, the no-vacancy rule, for example. We've suggested a solution to that. We've also made a number of observations in relation to the way that the proxy voting mechanism itself operates. In particular it would be shocking to most people to realise how porous the system is and also the fact that it's not just a matter of undirected proxies that can be voted by the chairman in favour of these things but the very fact that a chairman, according to the Jervois Mining decision earlier this year, can change their mind on the floor of the meeting and be subject to no fiduciary duty to vote in accordance with what they had declared prior to the meeting. So we draw those to your attention. They may be technical things but the establishment of I guess an auditable, workable system for voting rights of shareholders, the property rights - - -

MR FITZGERALD: Just in relation to non-directed proxies, the proposition is that in relation to both remuneration reports and the election of directors that undirected proxies would simply not count. We asked our participants this morning are there any unintended consequences of such a proposal.

MR PAATSCH (RMG): Potentially. The counter-argument, Robert, is that there is effectively no such thing as an undirected proxy because the board has told you that they intend to vote it for or against a particular proposal. That's the counter-argument. However, the Jervois Mining decision tells you that that's worth nothing.

PROF FELS: It's kind of more like a donkey vote type thing, is it?

MR PAATSCH (RMG): You're effectively giving it to the complete discretion of the chairperson to do with it what they will, so in a scheme of arrangements, voted for or against. I think we're agnostic on that point.

MR LAWRENCE (RMG): The other thing about undirected proxies is that someone has taken the trouble to fill out the proxy form and send it back undirected. Quite why they just haven't ticked the box saying yes, I don't know, but many people don't take that trouble, so it's an odd thing.

MR PAATSCH (RMG): I think a bigger problem is missing votes or a complete

lack of an audit trail and I could bore everyone in the room with dozens of instances where votes have simply gone missing, significant bunches of votes of our clients, with no explanation whatsoever on remuneration issues, but more the disaster scenario here is on a scheme of arrangement or change of control. To repeat the phrase we used earlier about 10.14, an accident waiting to happen.

MR FITZGERALD: Pushing on that same area, we heard propositions or recommendations that associates - that's mainly executive directors and executives that have shares - would not be able to vote in relation to remuneration reports.

MR PAATSCH (RMG): Yes. They're excluded from voting on the issuance of equity.

MR LAWRENCE (RMG): Or director fee caps, they're excluded.

MR PAATSCH (RMG): Or director fee caps, that sort of thing. By extension, you would say the same sort of voting exclusion should apply to rem reports.

MR LAWRENCE (RMG): Interestingly, there is one company I know of that has voluntarily done it. It's Transpacific Industries, I think, and their executive chairman, who owns a big chunk of it, voluntarily abstains on the rem report because he doesn't think it's appropriate to vote on it.

MR PAATSCH (RMG): It's just a way of making the outrage constraint more efficiently.

MR LAWRENCE (RMG): What would be really interesting would be if executives actually voted their shares against it. That would be quite interesting.

MR BANKS: At the beginning of your submission, you talked about an increased willingness on the part of shareholders, especially institutional shareholders, to vote against remuneration resolutions and we heard that this morning also. To what extent do you see this as demonstrating to some extent that there's a bit of self-correction going on here, that perhaps in the heady times there wasn't the incentive but what's happened since then has concentrated a few minds and therefore we've seen a break that, looking forward, will actually change the way shareholders think about remuneration and remuneration reports and that they will therefore be more active and therefore more disciplined on what happens.

MR PAATSCH (RMG): Yes, I think the commission heard this morning elsewhere that the participation rate has doubled effectively. It's gone up from 30 per cent actually to roughly 60 per cent of listed capital. That's almost entirely been driven by institutions, so they get it. There is a large cohort of people who

aren't voting through passivity but also through not being entitled. So we draw the commission's attention to the fact that the fastest growing form of retail shareholding is through wraps. Most wraps in Australia do not offer the ability to proxy vote. I won't name names but if you're owning through a wrap service, it's very difficult for you to actually cast your vote and offering that facility. I'm aware of a very big provider in Sydney who sends truckloads of proxy forms straight to landfill or recycling, whatever they do with it. That is one aspect, so there's a lack of entitlement there.

I think the interesting thing if you think of it in terms of does the punter know, so the providers of capital - super funds are collections or mutual funds are collections of other people's money - do they know which manager or which super fund is a better manager of governance things generally and at the moment they don't. They're just reasonably haphazard. There are some super funds who I guess might see a competitive advantage in showing how they vote or showing how they manage - because not every pay issue is up for a vote - governance issues in general.

MR LAWRENCE (RMG): Some funds managers too.

MR FITZGERALD: You would have heard me ask the question this morning of the peak investor body, whether or not they needed to be structured or other changes in relation to the way in which superannuation funds operate. Your comments there lead to a view that there may be a variable performance in relation to voting and other things. So again the same question: are there things in the investor market, particularly the superannuation funds, that would aid or assist a greater alignment between the views and interests of the members of those funds and how they voted right through into the remuneration reports?

MR PAATSCH (RMG): I don't want to appear self-serving by saying that obviously it would be good for our business were people to disclose what they do. It's certainly the case in the States that that's the case. The real question you've got to ask yourself is would it make any difference? I don't know.

MR LAWRENCE (RMG): One thing I would say, in the States there is a mandatory disclosure requirement of how fiduciary duty money is voted, and I'd say partly it reflects that I think Australian institutions, through no compulsion actually, have been quite active, relative to other institutions around the world in governance debates. In the US, one of the things that a few watchdog-type bodies do every year is do a list of who has voted with management most this year and it's uncanny actually to see how it improves the following year - it depends which way you look at it - but how the percentage in favour falls at those firms. I'd say you'd find Australian institutions probably have a greater propensity to vote against, because most of them have taken a considered decision to vote. There's not that legal

requirement that you have to do it.

MR PAATSCH (RMG): And they are responsible to their super fund clients, so that's very true, although I do have a personal story with a particular transaction. A fund manager I had an engagement with had the swing vote and had roughly 7 per cent. It wasn't on a remuneration issue, it was on a major corporate restructure. Having said to their superannuation fund clients that they intended to vote against this resolution, it was subsequently revealed that they had changed their mind. When I asked them, they said, "Look, they're good blokes. They're good blokes so we voted for them." It happened to be Babcock and Brown taking over Prime Infrastructure, but it turned out to be an absolute disaster for shareholders.

MR LAWRENCE (RMG): It depends which shareholders you're talking about. It was a pretty good deal for Babcock's shareholders.

MR PAATSCH (RMG): The reason why you would encourage disclosure would be to say that you would remove some sort of conflict, that there would be some quid pro quo that's associated. Really, on the remuneration issue which is the subject of your inquiry, the numbers are immaterial.

MR BANKS: We talked earlier about the question of a binding vote and you weren't agreeing with that but you thought one possible reform might be to extend the binding vote on directors' remuneration pool to include executives as well. I just thought I'd give you the opportunity to talk a little bit about that and indeed how workable it would be. You could imagine directors are a discrete group and you've got information to compare it with in relation to the CEO's pay et cetera. How workable would it be for a larger cohort?

MR LAWRENCE (RMG): It's interesting, I guess we sort of threw that out not so much as something that we necessarily agree with but just in the sense that these mechanisms do exist elsewhere in the world. Specifically with Pools Korea, for example, you have to approve the aggregate amount and you have to approve it in advance. They don't tell you anything at all basically about how it's split up but you do have to approve the aggregate amount.

MR BANKS: How low does that go in terms of the executive group?

MR LAWRENCE (RMG): It's every director and in Korea there's a tradition of a lot more executive directors.

MR BANKS: So it's the board again.

MR LAWRENCE (RMG): Yes, and the board might have 11 people and five are

executives. Australia is relatively unusual in having quite a small number of executive directors on boards. Even in the UK there tends to be a lot more executive directors on boards. We did also raise in that section that again, one area if you wanted to give shareholders a great deal of power over setting total executive pay or director pay levels, it would be through existing mechanisms in the Corporations Act that to date just don't work; section 211, the reasonable remuneration exemption. Our understanding of how that works at the moment is if you're a board and if you're worried about it, you get somebody from an external firm to sign a letter saying, "This constitutes reasonable remuneration based on our expert opinion," and you've covered your base. It's a dead letter at the moment. You could make it a lie by giving more guidance around it but it probably would just open an enormous shemozzle.

MR PAATSCH (RMG): Our proposition would be to say use it or lose it; get rid of it.

MR LAWRENCE (RMG): The courts have dealt with the issue of executive and director remuneration under the arm's length terms provisions in the Corporations Act, but the reasonable remuneration one, it's difficult to see in what circumstances a court would actually countermand the judgment of a board so long as it wasn't involving members of the board's family or something like that.

MR FITZGERALD: One of the recurring things that we've heard in relation to the actual quantum area has been that the accounting values that we attribute to the share based payments is not in fact a good reflection of what actually occurs. Everyone would agree. But I just wanted to get your assessment as an objective observer of this. The story we tend to get is that more often than not that they overstate, the accounting value overstates what executives get, yet in the last few days we've seen a whole lot of tables from different sources from different people which on the surface would in fact present a very different picture. So I just want to understand - and I understand that we don't have the data for the current year and so on - what is the overall picture of the accounting values vis-a-vis the actuals that you see, what is actually happening there?

MR PAATSCH (RMG): We provided you with evidence from 2003 through to 2006.

MR LAWRENCE (RMG): August 2006.

MR PAATSCH (RMG): August 2006, that for every million dollars in equity granted, their value at grant date, it was worth three and a half million to the top hundred executives across the board, so it's significantly, on a factor of 1 to 3.5, understated. The reason why it's understating is because there's significant flexibility

within the accounting standard to discount back for the probability of a vesting hurdle being achieved. There was no science behind that discount. It can be 90 per cent discount that's applied to the fair value or it can be 1 per cent discount but with no explanation. In fact actually in one fabulous instance last year, there was a hundred per cent discount that we noted and had been signed off by the auditor. But on the flipside, you're just as likely in changed market conditions to get it wrong. These things come from the accounting standards, international, so there's very little we can do. We've got to live with it for the time being, but we do like this idea about the running total, the intrinsic value. That's useful. It's useful about the whole question of quantum, what is the value of these things. We are often dispirited when we talk to boards that clearly don't understand the value. Not every board does that but they don't understand the accounting value and actually what the fair value actually is. Frequently it's the instances where boards say, "I'm going to give you a million dollars' worth of long-term incentives," and they haven't really put the detail into working out how those long-term incentives are actually valued. There's one chairman of a top 100 company who said to me once, "Dean, what do you want that value to be? I can make it be whatever you want it to be."

MR FITZGERALD: Some might say that of the whole financial statement.

MR PAATSCH (RMG): Exactly right.

PROF FELS: You've set out issues about discounting and that thought of running reports and so on. Have you got preferred approaches on this?

MR PAATSCH (RMG): The finance maths behind it are actually really tough. We're not purporting to reinvent the wheel. There's different valuation techniques that you can do. You're effectively relying on boards to get that balance right and they're not expert financial mathematicians either. I like the commonsense approach and that is, what's the intrinsic value? So what's the value going backwards? How much money, options or performance rights have they got in the past, because it helps you identify just how reasonable it is going forward. I should add actually that this is all related to tax - you do realise that - because the commission's attention should be drawn to the fact that all pay is not tax neutral, it's moving in that direction, and there is a distorting effect. Part of the remuneration consulting industry's expertise is in designing packages to be tax efficient and so that means stuffing more into equity because it will mean more in after-tax value for the executives concerned. That's a big concern to us because that gives a distorting effect on that part of the labour market. It gives more of an incentive for you to doctor the numbers to make sure that your equity vests if you're getting twice the amount.

It's an open secret that under the old regime applying to employee share

schemes that you would pay no more than 26 per cent tax on the realised value of your equity. In fact the Treasury tax estimate suggests that not even that huge discount was enough and that people weren't even bothering with the income component, they were just trying to convert everything into the - get the concessional capital gains tax. From a taxation point of view, think about a zero-exercised price option. Why should an executive, who's risked no capital whatsoever, they've risked only their labour, enjoyed the benefits of the CGT concession - isn't that a distorting effect? They haven't risked any capital whatsoever, they've just risked their labour. Where else do we allow people to salary sacrifice into concessionally taxed capital? Should we allow them to salary sacrifice into yachts or objects of art and get the CGT concession?

MR BANKS: When you say "concessionally taxed", you're referring to the differential between capital gains tax and the income tax, but if an executive board's shares in year 1 out of after-tax income - - -

MR PAATSCH (RMG): No problem at all.

MR BANKS: But in this case they're paying tax nevertheless at the marginal rate on the market value of the shares they receive in year 1, aren't they? The difference is that - - -

MR PAATSCH (RMG): No, they're not.

MR BANKS: They're not. Could you explain that then?

MR PAATSCH (RMG): Under the old regime, these things were fluid, a work in progress, but effectively there was an option under section 139 for you to prepay tax at a scheduled rate. The schedule was frankly a joke. You were prepaying tax as a fixed proportion of the exercised price which was termed a discount. So once you had done that, that was all the income tax that you paid.

MR BANKS: But the rate of tax was not the marginal rate, it was a prescribed rate, are you saying?

MR PAATSCH (RMG): No, the amount that you included - - -

MR BANKS: No, that's different.

MR PAATSCH (RMG): The amount that was included was a fictitious value, so the maximum was that you were to include 18.6 per cent of the market-exercised price if it was a market-exercised price option, then you were paying tax at the marginal rate.

MR BANKS: On a proportion of the - - -

MR LAWRENCE (RMG): Yes, so if you options with a cumulative exercised price value of \$1 million and they fit into this schedule at 18.6, you would declare income in the year of grant of \$186,000, you would pay 46 and a half cents in the dollar tax on that. If you then got four and a half million dollars on selling those shares after waiting 12 months, after exercise, you would pay - - -

MR PAATSCH (RMG): You would pay the capital gains tax or you would cancel the option frankly, which was more tax efficient for you to do so and you got the capital gains tax concession on the cancellation of the options, so you'd risk none of your capital in doing that. ZEPOs are also tax efficient as well because whilst you pay the full rate of income tax on the discount, which is the total value of the share at the time, you immediately enter the capital gains tax regime.

MR FITZGERALD: Just say for a moment, whatever you do, you ended up where you remove the tax attractiveness on equity to a neutral position, if you can ever do that. What do you think would then happen to the scheme arrangements because directors and CEOs have been telling us how important it is to reach alignment with shareholders, that the way you do that is through equity. So at one level, if you took that at face value, they would say, "We would continue to have the ratios of fixed pay, short-term incentives and long-term incentives largely through equity," or are you saying that once you change the tax arrangements, in fact the attractiveness of equity starts to minimise, and really some of this alignment is a fiction?

MR LAWRENCE (RMG): It will be interesting to see what happened. I guess it would be revealing. At the moment the ordinary shareholder in the street, if they want to buy shares, they have to buy it out of post-tax dollars, so as a matter of fact, making it tax neutral would actually provide true alignment. If boards responded by shifting things to cash, as a result (1) that would be surprising because there wouldn't really be an incentive to do it. It would be taxed exactly the same way, so there really wouldn't be an explanation of why they would do that. The alignment mechanism is still there because once you've paid cash, whatever value it has is whatever value the executive does with it, whereas equity will continue to move.

MR PAATSCH (RMG): We stridently oppose tax gross-ups, so we don't think it's the role of boards to manage the after-tax position of executives.

MR LAWRENCE (RMG): There's some isolated examples or a few examples we've seen where that is happening.

MR PAATSCH (RMG): Absolutely the case. Certainly if the marginal tax rate

changed, you wouldn't go back and renegotiate with the rest of your workforce to keep them in the same after-tax position. You shouldn't do it for the senior executive group. It doesn't make any sense whatsoever.

MR LAWRENCE (RMG): It's one of the more odious parts of the US system, the tax gross-up, a complicated algorithm that ensures the executive will get X dollars.

MR FITZGERALD: The related issue, in relation to the equity, we've seen this very significant decline in the use of share options. According to the participant, Mercer, this morning, in fact I think of the 150 companies they have surveyed, only 20 per cent now use share options, a huge shift. We asked them what was behind that. I don't know if you agree with their figures but if it is true, what is behind the shift away from share options as distinct from fully paid shares?

MR LAWRENCE (RMG): There's probably a variety of reasons for it. One was that options got a dreadful name in about 2002 or 2003. They became synonymous with everything that was wrong with executive pay. The problem was that what the anguish I guess should have been or was probably harnessed towards was options that rewarded people for a rising share price in a rising market. In a rising tide, it lifts all boats. So one of the things that companies did was say, "People hate options, so we'll create something called a share award, a performance award, a performance share or restricted stock unit," and the joke is it's a zero-exercised price option instead, "and that means that people won't be angry with us." Partly I suspect it also was due to the fact that when people started getting very angry about options in 2002 or 2003, we were in the middle of a bear market and an option is not as attractive an instrument in a bear market as a ZEPO is because a ZEPO always has some value.

I should add that for some of our clients, and our clients don't have a unified position on this, actually for that reason think ZEPOs are more attractive as an alignment mechanism because if you think about it, if you're managing a company and you have options of \$10 and the share price is 7, you will try to make sure the thing gets back over 10, and that could be disastrous. But if you've got a ZEPO, you're aligned all the way down, so 7 is better than 6 and 6 is better than 5. It's probably been a variety of factors and probably also partly I think some boards actually felt that they had a better handle on potential remuneration outcomes if they were dealing with ZEPOs rather than options because options has a huge leverage element.

MR BANKS: So ZEPOs are presumably a bit simpler too. What's the problem with them then, if they had a vesting period that was sufficiently long, because in a sense, you're putting executives' skin in the game, they've got their shares which they've got some incentive to ensure that the value of that holding increases over time.

MR LAWRENCE (RMG): The biggest issue is when you use that kind of instrument where the hurdle is linked to an accounting mechanism. We're I guess largely agnostic between ZEPOs and options. We're interested in the hurdles, what you've got to do to get them. But if you're granting, let's say, a million shares, ZEPOs, whatever you'd like to call them, and you've got an earnings per share hurdle, that earnings per share has to be 10 per cent per annum for three years. One of the quickest ways to meet that hurdle, and most earnings per share hurdle don't exclusively take account of this, is do a share buyback because it'll certainly increase earnings per share or a debt-funded acquisition, particularly if you can structure it so the debt repayments ratchet up later in life for the acquisition. Then you get it, and the market might look at this and go, "Yes," and with a ZEPO, it will still have a value, quite a substantial value, and the share price might fall from \$10 to \$5, whereas with an option, if the market has worked out what you're doing, it's not going to be worth anything to you, so there's no point trying to manipulate the hurdle.

MR PAATSCH (RMG): Can I just go back to the taxation. If there's differential taxation treatments between ZEPOs and options, you will end up with a distorting effect and that's why we made that statement.

MR BANKS: So putting that to one side, what you're saying is the hurdles have to be really well calibrated and designed to avoid having perverse effects. That's been a big part of the problem I think that we've been experiencing.

MR PAATSCH (RMG): Yes.

MR BANKS: But how critical are the hurdles in driving differential executive performance over simply having exposure to the stock over a significant period of time?

MR LAWRENCE (RMG): That's a good question. One of the things our companies tell us when they talk to us is, "Our executives don't value our long-term incentive program, they think it's worthless." That's particularly a complaint made around relative total shareholder return hurdles. Institutional investors are very comfortable with relative total shareholder return because it's they get ranked, so they're comfortable with what they know. If you believe that markets are in the long run good at working out good use as a capital, then relative total shareholder return certainly has some attraction. It's very hard to manipulate as well.

You're seeing a move towards ensuring executives have skin in the game on top of programs and often the way it works is through the combination of a mandatory shareholding requirement and a deferred bonus mechanism. So the way it

will work is you are required to sacrifice 50 per cent of your bonus into equity and you're required to do that until such time as you have one year or two years or three years, however much, worth of salary in shares. Some companies actually leave open the question of the value, so actually they require an executive in a falling market to put their hand in their pocket and buy more shares because the value of their shares will have fallen; others say the value at the date of acquisition. That's a positive trend because that means they're actually paying for it out of their own money and that's true alignment.

Incentive structures, certainly you're seeing boards being more willing to structure incentives around to deliver specific projects. The Commonwealth Bank is a classic case, where a couple of years ago they extensively redesigned their long-term incentive scheme for senior management because clearly they decided that they delayed it on customer service and this was going to hurt their business.

MR PAATSCH (RMG): You frequently see it in the resources industry around safety, where there have been clawbacks which affects a company's licence to operate. If someone gets seriously hurt or killed, your mine will shut down. Qantas have a very interesting scheme where on the short-term incentive arrangements, they have a specific component for a 5 per cent improvement in their safety targets, so it's horses for courses. It's not one size fits all by any stretch.

MR BANKS: Are there any examples you can think of in relation to the scheme you were just talking about, a mandatory requirement to hold a certain quantity of stock purchased out of post-tax income?

MR LAWRENCE (RMG): Post-tax, most of them don't distinguish between how you purchase it. They might operate the mandatory bonus deferral and at the moment, the equity granted in the bonus deferral would probably be through some kind of equity scheme.

MR BANKS: So it wouldn't be a post-tax - - -

MR LAWRENCE (RMG): But they have drawn no distinction. Non-executive directors are quite often in that position. A lot of companies have non-executive director planning. The expectation is you get to one year's worth of fees in five years. I've always wondered how you'd enforce it as a minimum shareholding guideline; if someone doesn't need it, you fire them. Some companies are quite cunning, in that they make your ability to actually exercise vested instruments is dependent on having a minimum shareholding requirement. They're quite common, particularly amongst companies that have significant UK exposure. BHP is a minimum shareholding requirement, Rio has a minimum shareholding requirement. I think Telstra does for its senior executive team. Again, most of them - I know in

the case of Telstra it was through a bonus deferral mechanism - but they don't actually care so much how you get there. If you want to put your hand in your pocket and write the cheque and have the bonus in your hand from that point on, you can do it.

MR BANKS: Okay.

PROF FELS: On another dimension, on this international comparison to everything, you've done some research on that and also ACSI commented on the global war for talent. They were tending to suggest that there wasn't a very definitive answer from the evidence, but on the whole it was negative. I noticed in a couple of articles you've written, you have mentioned this question of labour mobility and whether you search in the pub for what's on offer or do you look a bit further afield, if I remember rightly. Do you have any comments on the international impact on pay? Has it been a really important driver, should it be and so on?

MR LAWRENCE (RMG): It's certainly had an influence. One of the things that my colleagues in RiskMetrics around the world will mutter about when we get together and give our US brethren a hard time is, "You blokes, you've just made it horrible for everybody else," because you've got the US and then everyone benchmarks themselves against the United States, although no other market has kind of gone that far. The international comparison measures, to the extent to which executives are globally mobile, is not proven. Yes, the odd executive does get poached, moves somewhere, but if you think of an Australian CEO, I can't name an Australian CEO, for example, who has been poached to run an offshore company and you would think, for example - to give you an example, I just happen to know the stats - Freeport-McMoRan two years ago, its executive chairman was being paid \$US70 million and the person running BHP, which was six times larger, was getting \$10 million, and half of that was actually an accounting value that was very hard to get. In a truly money-motivated - if that's the big driver of mobility, then he should be working for Freeport-McMoRan; either that or BHP has got a guy who is substantially worse. I think most people would agree that's not the case.

MR PAATSCH (RMG): There's no question there is labour substitution internationally, inward/outward. We didn't find a lot of evidence of outbound labour substitution. If you think about it - - -

MR BANKS: At the CEO level only or - - -

MR LAWRENCE (RMG): Or senior executive level.

MR PAATSCH (RMG): If you think about it, the justification is that, "We have to pay these higher rates because we will lose these people." We didn't see any

evidence of those outbound departures which there may be an explanation for - they're winning the war for talent. But we don't know, it's inconclusive, it really is.

MR LAWRENCE (RMG): Causality is hard to explain but I think the conclusion we actually reached was that the evidence is at least as good to suggest as Australian executives are not quite such hot property as used to suggest that they are hot property and boards are doing a wonderful job of keeping them.

MR PAATSCH (RMG): I think that's the danger and this is where the commission can really use its public funding to test some of these tropes that have arisen. My personal favourite is, "Disclosure made me do it." The reason why executive pay has increased is because there's more information in the public domain - rubbish. There are two sides to every bargain. The reason why executive pay would blow out to an inefficient level would be because a board has said yes to an intolerable arrangement. It's not through disclosure. That information was always available anyway. It's ridiculous. It's a preposterous suggestion which the only conclusion is that the discredited notion of pattern bargaining still exists in the executive suite; it's ridiculous.

MR BANKS: But are you saying that the change in the degree of disclosure made no difference on transparency because I'm sure there was intuitive knowledge about was going on and probably stories swapped at the Melbourne Club et cetera.

MR PAATSCH (RMG): It may have made an increase in demand but it didn't make you say yes.

MR FITZGERALD: Just taking that point, intuitively what you're saying is that there's a weakness in the boards, and I think you've made that comment earlier, and we heard that from a number of different sources and of course the boards would say that's not so and so on. I suppose the central question goes to the quantum. We understand the design issues, you've articulated those and we have other presenters this afternoon who will do the same. One of the struggles for the commission I think is absolutely the issue of quantum. The question is really simple: should we be concerned with it? Even if we were concerned with it, can you do anything about it and does it matter? In a sense, the public outrage is linked in part to the quantum and in part, particularly, the termination phase. I suppose we've asked a lot of participants this: should we be concerned about quantum in any way, shape or form and if so, what would you do about it anyway?

MR PAATSCH (RMG): No, you shouldn't be concerned about it, shareholders should be concerned about it, and if they don't like it, they should be able to toss the boards out and get new ones, new directors. That's it.

MR BANKS: So making it easier to toss boards out is obviously part of the solution.

MR PAATSCH (RMG): It assumes that there is a problem frankly. Your concern should be whether the market is working. As we said in our opening statement, this is a market like any other, it is imperfect. The question should be for the commission: is there any systemic impediment to the market righting itself? We don't believe that there's any systemic dysfunction. There's some tweaks that you can recommend that would help those imperfections persist for a little less longer than they might otherwise, but no, I don't think you can do anything about it to be perfectly frank.

PROF FELS: This commission is frequently dealing with the distorting effects on resource allocation of certain matters. Wouldn't there be some questions about whether, if the quantum is out of line, there are distorting effects? I think that might have even been mentioned when the treasurer and Minister for Superannuation announced the inquiry that if a price is out of line with what a competitive market would yield, then you're immediately drawn into possible distortions and inefficient resource allocation, rent seeking and a range of other things which are generally regarded as a public concern beyond shareholders. Shareholders have got a focus on whether too much is being paid and that kind of thing. I just wonder whether we're giving a special treatment to this price compared to other prices which we are constantly hearing of when they're out of line with the market and there's some kind of public issue.

MR LAWRENCE (RMG): It's always quite curious, some of the submissions made to the Productivity Commission; I know one of them from an employer organisation referred to putting any kind of reduction in the ability of boards toward termination payments would lead to massive distortions and dreadful things, which was odd because their own stated policy on industrial relations should be that termination payments should be made as small as possible. It's quite interesting, I guess, and it depends which group of employees you're talking about.

The issue around quantum as it relates to shareholders is: is it related to performance? There will be a certain point at which quantum is just too much, where someone is just taking far too much of the company. Defining what that is is probably left to shareholders because everyone has got a different view. If it's a society-wide issue about quantum, if there's an issue about executive pay and quantum in terms of the social contract from a society perspective, probably the tax system is the best way to deal with that. That's kind of beyond our remit. That's a social equity question. That's a really important question but it's kind of beyond our expertise.

MR PAATSCH (RMG): The exception would be where there is significant public investment such as in the banking system or in any other guarantees. Where I think the government and the commission should think about that is that - take the proposition that's been put forward by APRA and that is that there is a role for dialling up the reserve capital of a bank where it forms the view that remuneration arrangements are promoting excessive staking. That's an entirely judicious use of public policy where public resources are at stake. But I think it's very difficult to extend that argument beyond, because labour costs are very small.

MR BANKS: Just drawing out what you've been saying, what I read from that is the issue as you see it is what really lies behind the quantum and if the quantum is a consequence of an incentive structure that has perverse elements to it or whatever, then that is the worry, and I think again on your introductory page you talk about:

In some cases, based on recent experience in Australia and around the world, it appears that poorly designed incentive structures contributed to the demise of companies, illustrating that while executive remuneration may not be material as an expense, it may create materials risks.

I don't know whether you want to elaborate on that, but in particular, are there examples in the Australian context that come to mind?

MR LAWRENCE (RMG): One - and I am drawing on what's been reported here rather than stuff I absolutely know and no doubt the administrators and receivers will actually get to the bottom of this - the case of Babcock and Brown, for example, certainly there existed an internal whistleblower, and this was widely reported in the Sydney Morning Herald, I think, that Babcock and Brown said, "Our risk systems are really bad and we appeared to running a business based entirely on meeting return on equity targets that aren't sustainable, so the bonus pool will pay out." That was quite an unusual arrangement because it was a board which had quite a large number of executive directors and most of the bonus decisions were actually taken at executive committee level and then referred up to the board. The rem committee itself had five members and one was executive chairman and the other one was the CEO who were both major shareholders as well. I would undoubtedly think that the way that bonus structure and the bonus pool operated probably contributed to the kind of excessive risk taking that led to the demise.

MR PAATSCH (RMG): It's probably worth extending a little bit there, and that's to think about the role of government where it contracts for the private construction and operation of infrastructure. We do extend taxation concessions for private participation in infrastructure projects. There's obviously a social dividend that's there. There's been no question that the operators of infrastructure funds have had curious remuneration arrangements and perhaps there is a public interest that would

extend to the examination of their practices.

MR LAWRENCE (RMG): Particularly when they're owning critical pieces of monopoly infrastructure.

MR PAATSCH (RMG): So that's something that is worthy of reflection, where there may be a role for the invisible hand of government to at least establish whether they would be promoting excessive leverage or risk taking that would compromise significant assets that are used by the public but not owned by them.

MR LAWRENCE (RMG): And have also been extended to the private sector on the basis of an agreement with government under a contract usually.

MR FITZGERALD: Can I just round off that conversation. Some of the proposals have dealt with the issue of relativity to average wages or relativity to average wages within an organisation. I suspect I know your response, but I just want to flag that the Financial Services Union in the presentation before yours suggested that it should be disclosed, not that it should be a cap, but that somehow or other the disclosure of the relativity between the senior executives - and I think they were referring to the average worker within their particular organisation - might have an impact on the way in which shareholders deal with the issue. My comment was that sometimes it doesn't seem that the shareholders and employees have an alignment of interest anyway. But this whole issue about relativities, most groups have said relativities have almost no import but some have.

MR PAATSCH (RMG): I think it's just a matter of making the outrage constraint more efficient. I guess we're agnostic on that.

MR LAWRENCE (RMG): It may have a benefit from a kind of human capital management perspective. A company with a very large labour force where its employment costs across its labour force are very large, that could be quite interesting. I'm not sure it's something you could make matter. If some companies voluntarily disclosed that kind of information or say that, "Our CEO," or, "Our executives will get pay rises that are the average of the pay rise we give to our entire workforce" - I know Sims Group used to do that. I don't know if they've done that since the moved to the United States.

MR PAATSCH (RMG): I just do reiterate the point that shame is a very poor motivator of changes in behaviour where people don't suffer it.

PROF FELS: Just on the quantum matter and the shame matter, I guess a week ago or two weeks ago, with the discussion with the AICD, this question of quantum came up, along with some of the unions' submissions which have been back to back. Yet

one other factor that was mentioned was that maybe the shareholders look after these things, maybe they don't, but when there is perceived widely in the public to be an excess relative to what is justified by a competitive market outcome, if nothing is done about it, there is often a significant legislative overreaction. Of course one of the terms of reference requires us to have a look at the general question, if we can, of the reasonableness of pay. That's one interpretation that could be put on the terms of reference. There are so many areas of policy where certain things generate public feeling and then there's a response. Whether it's the job of the Productivity Commission to be worried about that, I'm far from sure. Its job is to come up with whatever the findings are and whatever the appropriate sensible policies are. I can already see legislative responses to the public feelings about excessive remuneration.

MR PAATSCH (RMG): If you accept that shareholder primacy is a way of controlling aberrant executive pay outcomes, I think there's a broken link there about most shareholdings are held through collective investment vehicles now and it's very difficult for you to allocate capital on the basis of the performance of the promoters of those collective investment vehicles who are acting as your agents. I don't know whether I'm being direct enough there but if I wanted to shift to a super fund who was doing a better job reining in executive pay, I should be able to do that, and yet there is not symmetric information on which I can make that decision at the moment.

MR FITZGERALD: Can I just conclude on remuneration consultants, given they're actually a part of the terms of reference explicitly. We've heard a whole range of different proposals and recommendations in relation to the engagement of remuneration consultants, specifically in relation to this issue of reducing conflict of interest; that is, remuneration consultants either have to be appointed by the board and only act in relation to remuneration advice for the senior executives and do no other work for the organisation, similar to the audit debate that's been had, and there's been other proposals in relation to the way in which remuneration consultants should be disclosed in the remuneration report and some want to go further than that. I just want to ask whether you have any particular recommendations or view about issues relating to remuneration consultants and any changes that you think could be worthwhile looking at.

MR LAWRENCE (RMG): Our general view is that to focus on remuneration consultants to a certain extent muddies the responsibility of the board. Ultimately the remuneration consultants are consultants. They don't make the decision. The board makes the decision. I guess our view is that if boards would like to refer to the advice of a remuneration consultant in justifying a decision, then they shouldn't be able to do, as one large company very prominently did two years ago, say, "Our pay framework has been reviewed by four remuneration consultants but we can't tell you who they are." But ultimately the board is responsible, so anything that muddies that line - and remuneration consultants I guess statutorily, legally, perform a very

different function to the role of the auditor.

MR BANKS: I had just one or two more; one was just to draw out a little bit further our earlier discussion about tax and get you to comment on the current state of play with employee share schemes and the government's amended policy there. Do you have any comment to offer?

MR PAATSCH (RMG): Its still a work in progress but it seems that the prepayment distortion to which I referred earlier will now disappear and to the extent that it's executive remuneration, that is a positive move towards tax neutrality, but there are still some loopholes which will take too much time to go into. Until we see the final legislation, we don't know. There still will be a tax advantage at the end. Precisely what the benefit of - - -

MR BANKS: What's the source of that tax advantage, simply the difference between the two rates?

MR PAATSCH (RMG): It will be the capital gains tax discount where persons risk no capital but only their labour. Effectively if the legislation is implemented as conceived and there aren't some loopholes there, there's a number of detailed things where there could be some - let's assume that that's the case and that the value of the grant will be taxed as income, where you've effectively been able to buy the shares at pre-tax rather than post-tax income, you'll still be able to get a capital gains tax discount, so there still will be a distorting from that point on.

MR BANKS: What do you think would be more appropriate, that they would pay the marginal tax rate at the time of taking over control of the shares or vesting or whatever?

MR PAATSCH (RMG): I'm not speaking as a sort of shareholder advocate here, I'm speaking as a taxpayer, and I fail to see any public benefit in any tax subsidy of executive pay.

MR BANKS: The last thing relates to a comment you made on page 16 where you're talking about the role of voluntary guidelines and you cross-referred to our issues paper where we indicated there are a number of guidelines and regulatory provisions et cetera and then you say:

Given the diversity of listed companies, it would not be appropriate to adopt a single code of practice on remuneration.

Could I ask you just to elaborate on that.

MR LAWRENCE (RMG): At the moment, most sets of guidelines I guess to a certain extent reflect the people who have drawn them up which is as it should be. Retail shareholders have a set of guidelines, the ASA, and they have a particular set of concerns. ACSI has a set of guidelines which reflects the views of their membership. IFSA, the funds managers, have a set of guidelines on pay which reflects the concerns of their membership. The Institute of Company Directors, for example, has a set of guidelines which is more I guess a how to manage the issue and manage the potential reputational issues document. That's as it should be. Let freedom reign. Let everyone be free to express the view.

To have a single set of guidelines would be to try and come up with a preferred way of doing remuneration structures and the way that remuneration should look from a mining company that has a prospective asset, very little cash flow and is living from one capital raising to the next to a large established manufacturing company, and those two businesses have very different needs, outlooks and remuneration incentive arrangements appropriate to those. So it might be appropriate to have a general set of commonly agreed principles which to a certain extent I think we do in the ASX Corporate Governance Council principles, but most principles as they apply to executive pay are motherhood statements: pay should be aligned with performance. Yes, but how?

MR FITZGERALD: The Institute of Human Resources or the peak body, if that's not its exact name, it took the view that the guidelines were reasonable, except they lacked a sharpness and a clarity. Their view was not to prescribe them but it was to say that they need to in fact be a bit more prescriptive, with this qualification: that is, it's an if not, why not. So if you want to deviate from them - and I don't think they were actually saying, "You've got to have these percentages," and all those sorts of things, but they were actually saying as practitioners, as human resource practitioners, that the guidelines lack the sort of clarity or, their word, sharpness, and if you had an if not, why not, which effectively is the regime that exists in the ASX governance, that would help without in fact hindering. I don't know. We'll look at that sort of approach. But they were actually saying that's part of the problem. You're right, ASX governance guidelines are very important because they impact on the very companies that we've been talking about more directly than any other set of guidelines.

MR LAWRENCE (RMG): Yes.

MR PAATSCH (RMG): I don't think we need more boilerplate disclosure. I think we made the comment earlier on that the disclosure in the rem reports is relatively new. In the first few years a lot of companies just outsourced it to their lawyers who gave us dross that we used to see bobbing up in other reports, the same terms, exactly the same paragraphs. In fact in one celebrated instance, the company just gave us

two years in a row of exactly the same things.

MR LAWRENCE (RMG): The page numbers were different.

MR PAATSCH (RMG): The page numbers were different. So I'd rather see it work through its phase. We're really seeing a maturing in the engagement between companies and their shareholders on pay. I'd be really reluctant to move down the if not, why not, on every element. It just doesn't really cut it for me, I'm afraid.

MR BANKS: All right. Thank you very much. We went over time but it was well worth it. It was a good discussion and we appreciate, again as I say, that submission but also the other assistance you've provided, the data, advice and so on, so thank you very much.

MR PAATSCH (RMG): Thank you.

MR LAWRENCE (RMG): Thank you.

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

MR BANKS: Our next participants are from KPMG. Welcome to the hearings. Could I ask you please to give your names and your positions.

MR MORROW (KPMG): Martin Morrow, I'm a partner with KPMG. I lead the equity based compensation practice and equity based compensation and executive remuneration.

MR HUTT (KPMG): Andy Hutt, I'm also a partner at KPMG in the equity based competition practice.

MR BANKS: Good, thank you. Thank you very much for taking the time to appear today and also for the submission which we've read. It's got a number of points in there that we want to discuss with you, but I'll give you the opportunity to summarise the key points first.

MR MORROW (KPMG): Thank you. Just to put our submission into a bit of context, gentlemen, KPMG is one of the big four advisory firms. We advise across audit, tax and financial advisory, including risk advisory. In that space, we do advise companies on all aspects of remuneration, all employee and executive remuneration, so that includes the taxation, the accounting, the behavioural valuations, basically all aspects except the legal, so our submission comes from that background. We have had a very good and thorough read of the paper and have been following the debate of course. We've sought to focus on just four significant areas basically; the effectiveness of the regulatory arrangements, the alignment or performance hurdles aspect, the taxation side of executive remuneration and the role of the remuneration adviser. I might ask Andy first to speak to the regulatory arrangements.

MR BANKS: Good, thank you.

MR HUTT (KPMG): Here we've really focused on the regulations and laws governing remuneration disclosure. What we hear constantly from the organisations that we work with in terms of the questions they receive from their shareholders or from analysts or other members of the public is that the high level of interest really is in the remuneration of the directors and the chief executive officer and that there is very little interest in terms of the amount of questions or analysis that they're required to provide in relation to other senior employees of the business whose remuneration might be reported under the current disclosure requirements. They indicate that that information - apparently in their eyes it doesn't generate a huge amount of interest among the stakeholder community - is causing certain unintended pressures for their organisations.

Previously we heard about the comments about, "Disclosure made me do it," in

terms of the amount of information that's out there contributing to inflationary pressures and in relation to executive remuneration. I agree that the board ultimately has to make the decision but certainly there's a perception that the amount of information that is available creates an element of "me too" that boards then have to find the capability to resist or sometimes accept because the amount of comparable information can be very great.

In a couple of isolated cases, there's been real concern from prospective candidates for positions that their remuneration would be disclosed in the reports. They might work for an Australian listed company but they might be resident in a country where risks around abduction or whatever are very real and it has been an inhibitor to getting the right candidate in those organisations' eyes. Thirdly, just the level of disclosure giving rise to more confusion than is necessary among readers of the annual report.

Our thoughts on a possible solution to that situation was that the remuneration of directors and the CEO should continue to be disclosed broadly with dollars in the form that it's currently disclosed in, but that for all other executives, it would be appropriate to show to shareholders the elements of their pay that were fixed in terms of percentage of total and the elements that were variable based on short and long-term performance and to state what those performance criteria were and that that would be sufficient information for shareholders to determine the actual risk loading and weighting of the remuneration of those executives.

The other element in relation to disclosure that we wanted to focus on was the actual expensing of share based remuneration in the accounts. Organisations are required to expense share based payments over the vesting period of those instruments in their accounts and by and large those organisations report the same amounts as remuneration of the key management personnel group of executives who are receiving those share option rewards. Our concern is that because those rights or shares or options are put through the remuneration report, in most cases based on grant date fair values and those values are based on expectations about likelihood of vesting in future at the time of grant, and in many cases there's no possibility to write back that element of remuneration if in fact it never vests, if the performance hurdles are based on, for example, relative market performance. But that disclosure really creates more confusion and consternation than is necessary amongst stakeholders and readers of the annual report.

Our view was that it would be a much better form of disclosure if, in the remuneration report, we could be stating the number of securities, the performance conditions attached to them, the term over which performance was required and to essentially leave people to form their own view as to how valuable or not the potential vesting of those shares or rights might be from time to time, rather than

have the vision impaired somewhat by having a number in the books that's still based on factors which were taken into consideration two years ago or three years ago when the instruments were granted.

MR BANKS: On that, what's your view about actually including in the remuneration report realised remuneration?

MR HUTT (KPMG): To some extent there already is disclosure of that, in that as part of the remuneration report, the company is required to show how many instruments vested in that particular executive and movements in their overall shareholdings, so to the extent that the share based payment actually does relate to the delivery of shares, that information is currently there, although it's not expressed in dollar terms generally, it's expressed in terms of the number of securities that have been transferred to the executive on vesting.

So I think if we're going to talk about disclosure of realised remuneration - then again we're looking at some elements of complexity in terms of when long-term incentive rights do vest and can be realised - that might be a big number because it relates to five years' worth of performance for the company and then that has to be explained in the year in which the remuneration was realised. So it's not a solution to the consternation in its own right because we still have a number in its own right; okay, it's a more real number maybe than sometimes what we see at the moment, but it still requires a lot of explanation to be put in a fair context.

MR FITZGERALD: Could I just clarify on two points. Yesterday we had a presentation by CPA Australia, the Institute of Chartered Accountants and the National Institute of Accountants and in both areas they made comment; can I just deal with the one that leads on from Gary. Their view was that the fair value method should remain as it is but it is already disclosed. The methodology is disclosed in the financial statements. Their view was that that methodology should stay for the purposes of the financial statements but be removed from the remuneration report. What they also said however is, a bit like yourself, that you would decrease the amount of information in the remuneration report and point to the number of shares that have been granted and later vested. But they were open to the view that you might still in that report actually put the accounting value in respect to that particular executive, but all the details, the stuff that takes the 20 pages in fact doesn't do that. So they weren't prescriptive about what it would look like, but am I correct in your submission that the accounting standards would still require you to assess the fair value to identify the methodology, and that still would be reported publicly?

MR HUTT (KPMG): Yes, for the purpose of the financial statements in terms of the hit to the organisation's profit and loss account in relation to those securities.

MR MORROW (KPMG): That fair valuation has to take place.

MR FITZGERALD: But if you're doing your methodology where you simply disclose the number of shares, a journalist would take three minutes to actually work out that they have 10,000 shares at \$10 and therefore the value is X. That value by necessity has to be much higher than the accounting value which has discount components into it. So in a public sense, you end up with even a higher figure than the current accounting value figure. I'm not saying you shouldn't do that, I'm just saying that it strikes me that if one of the concerns is the community fails to understand what executives are actually getting, which is the common catch-cry of CEOs and directors, you will simplify the report but you might in fact exacerbate that problem, only because the figure could in fact be quoted at a much higher rate than even the accounting value.

MR MORROW (KPMG): It is a very real issue and a lot of time and effort goes into that communication exercise to try and make it very clear. If there are 10,000 shares or 10,000 options at today's exercised price of \$10, you would still be subject to these performance hurdles and it may ultimately vest in nothing or it may be something else. Organisations do their best to communicate that as clearly as possible. You are just left with how it might be interpreted.

MR FITZGERALD: I think we're of the view that if we can make comprehensibility of the remuneration report better, that's a good thing, but whatever you do, it seems to have an unintended consequence. Can I just go to the other point that you raised. Yesterday, the same three accounting bodies put to us that they would like a common definition to be used in relation to the reporting of remuneration. Their view was that it should be - and correct me if I'm wrong - key managers?

MR MORROW (KPMG): Key management personnel.

MR FITZGERALD: Yes, key management personnel. They believed that that was a better definition. Again we asked them what would be the practical effect of that and I think - correct me if I'm wrong - they indicated that probably would actually capture potentially more personnel than currently, but it's a more consistent accounting notion and a more easily definable group. Other participants have actually said - I think what you're saying - we need to shrink the group to the executive directors, particularly the CEO, the CFO, and maybe one or two others.

MR MORROW (KPMG): I think the point we're making is really the community is really zeroing in on the most senior executives and the rest of that information can be used for the wrong purposes. It's not helpful to the investor if you do have a wider group; I think the escalation problem can continue and can continue much more

widely.

MR HUTT (KPMG): The wider and deeper you go within the organisation, the less external understanding of precisely what that person's role is; I think everyone understands the role of the CEO. The buck stops with them on just about everything and that's pretty transparent to everyone. Even if you go to the CFO, they might have a COO operating next to them or they might not which fundamentally changes the breadth of their responsibilities from organisation to organisation. So it's very hard to compare those numbers.

MR FITZGERALD: I thought you were saying that you needed more detailed accounting for the executive director level, CEO and what have you, but you could still capture a slightly larger group but it would be a much more minimal approach to the information disclosed. Am I reading your submission correctly?

MR HUTT (KPMG): Yes. I guess what we're saying is directors and CEOs, broadly the disclosure in terms of the dollar value of their remuneration, subject to the comments we have made about share based payments; for others, we see the key piece of information for readers is at the remuneration report we see and being able to understand how much of their pay is at risk and what they need to do to achieve payment for those at-risk amounts. Is the CFO on 20 per cent fixed pay and 80 per cent short-term variable and no long term? That's important information. Are they on 90 per cent fixed and only 10 per cent incentive? That's useful information. The dollar value of what that could potentially be I don't think is as important in terms of understanding the drivers for that particular individual as the weightings.

PROF FELS: By the way, just on that theme, yesterday we heard a submission that in fact it should not only be the five top executives but the five top paid people in the business. Do you have any comments on that one?

MR MORROW (KPMG): It's difficult to see the utility of that information for the investor. It really should be more around the remuneration policy, how it's designed. I think using that example would be more to understand if they're highly paid and they're in a particular part of the organisation, then is it risk adjusted? I think those issues could be better enunciated and that's more important than having number 1, 2, 3, 4 and 5 earning this much money and creating the escalation problem.

MR HUTT (KPMG): Some might say that if you were a financial services organisation, your top 5 earning people might be your top 5 traders for the year who don't actually have management or executive responsibility within the organisation. Their job is to trade and do the best for their clients and be rewarded accordingly and the more senior employees' managers job is to make sure that they do that within the required risk constraints and the risk constraints they put in place are appropriate and

that they are adhered to. So I don't think it's useful for the shareholders to know that the top 5 traders got heaps more money than the CFO. I think it's more important for them to know that the board and the senior executive team are putting appropriate risk management parameters in place, so if that guy earns 10 million bucks from trading, it's been done in a way that's within the boundaries that have been set.

MR BANKS: No doubt that's correct, but given what people have been saying in terms of where the systemic risks have their origin in relation to the financial crisis, they're often attributing that to what was going on on the trading floor rather than higher up and a bit of knowledge about the quantum that was being delivered might have been an early signal about more systemic problems and the incentives short term.

MR MORROW (KPMG): I think the knowledge about the quantum could equally be addressed and as we say, just the total numbers without necessarily pulling out a number for each individual, whether it be a total number over 10 people, that would certainly start indicating the quantum.

MR HUTT (KPMG): But on the other hand, if you were actually saying, "Our chief risk officer, here is their fixed, here is their variable and here is the basis on which they get rewarded on the variable," then if they're rewarded for their variable on various NPAT targets, things rather than, you know, a compliance scorecard or whatever, then that shows you what their drivers are going to be and that they might be different to what you would want them to be.

MR FITZGERALD: Just on the fair value, can you just clarify one thing for me. We heard yesterday the issue raised that if the value differs from what was recorded, you're not able to claim it back.

MR MORROW (KPMG): Reverse it.

MR FITZGERALD: Reverse it.

MR MORROW (KPMG): Can I clarify that?

MR FITZGERALD: Yes.

MR MORROW (KPMG): I was sitting in on that session yesterday and I think something was said along the lines of if someone - their reward does not vest because they are not there for the five years or the three years, then the fair value that has been expensed to the profit and loss account can't be reversed. That instance may not be correct. The ones that can't be reversed are when it's a market condition hurdle, so if it doesn't vest because there is a total shareholder return relative to a peer group or

relative to an index, then that expense can't be reversed. Most of the other types of performance hurdles, if they don't vest, if the person hasn't been there, that could be reversed or if there is an internal hurdle, what they call an on-market condition.

MR FITZGERALD: What happens in the year when the vesting occurs and the value of the shares are much higher than anticipated? So in other words, you've got the reverse. You've got an overstatement. Do you expense the difference in that year or is this a fixed formula and that's all that happens?

MR MORROW (KPMG): Yes.

MR HUTT (KPMG): If the ultimate reward is delivered in shares, then your valuation model is based on the work that was done at the grant of the instruments and if it was valued at five bucks a share and they all vest, then if they vest at 10 bucks a share, the accounting treatment is still based on five bucks a share.

MR MORROW (KPMG): So it won't go through the profit and loss.

MR BANKS: We interrupted your flow.

MR MORROW (KPMG): That's all right. We might cover off the second aspect - I think that's covered that quite well - and talk to the performance hurdles and the alignment of interest between the shareholders, the boards and the executives.

MR HUTT (KPMG): I guess our key point on the alignment of executives, shareholders and boards was that really that should be up to the board to determine. The board is responsible to shareholders for signing off on the company's business strategy and having signed off the business strategy, who is better to determine what the appropriate performance hurdles and indicators are in terms of whether the executive team is actually achieving that strategy and delivering on what the board wants it to do. Shareholders in the current situation pay a number of rights in terms of trying to make sure that the board is setting appropriate goals for the future. The shareholders ultimately to get to choose the directors for starters. They do have a non-binding vote on remuneration which were votes non-binding. The evidence is that companies do take it extremely seriously if the negative vote is into double digits as a percentage.

MR MORROW (KPMG): If I can just add, that has certainly shown to be very effective in the last four or five years with not a significant participation or not a significant negative vote in the first year of introduction and then an increasing range of negative votes over the next two and three years and in particular of course last year which have sent very strong signals to the boards and they have been listening.

MR HUTT (KPMG): And the shareholders also have the ability to vote on the issue of shares and options to directors and the chief executive under current rules. So there's quite a number of layers of shareholder potential for intervention or interaction with that performance hurdle process.

There were a couple of other questions raised in the issues paper around performance hurdles and levers in terms of making sure that targets are appropriate. One was around whether the tax system should be used to differentiate bonuses or long-term incentives from ordinary pay. I guess our concern with that kind of proposal was that if we put some kind of penalty tax rate on bonuses or long-term incentives, then we end up with a preference for delivering more in fixed pay as a percentage of the total potential remuneration and I don't think that's really serving alignment in terms of pay for performance.

The other observation we made was around the types of hurdles that companies use. We have seen that a lot of organisations are going with a relative total shareholder return kind of approach because really, they just think it will get a tick from the shareholders. It won't give them any problems with governments, advisers, and the measurement of it is able to be monitored by external parties, it's not based on internal measurements that might not be known outside and it's a generally accepted concept. So we've seen very much a trend towards these relative total shareholder return hurdles and perhaps not enough focus on what actually the right performance measures for the company at that particular stage of its development might be. I think a particular issue in Australia is that in many cases the real comparator group is just so small or so difficult to identify in a meaningful way that a lot of these performance hurdles really actually get perceived by the executives as being a bit of a lottery and that can't be good for the community and those organisations either.

MR MORROW (KPMG): That is a very unfortunate aspect of the relative total shareholder return in our market, in a market this size, because at the end of the day, we are talking about compensation, and compensation should be a reward for effort. I've seen plenty of examples where the business has performed very well in terms of basic - whether it be revenue, profit and other fundamentals for the business, yet the performance hurdle design, a relative total shareholder return, meant they didn't get in the market, they were being compared against an index and they didn't reach a certain percentile, so therefore they get nothing. On the other hand, you will get companies who will get it, again for reasons beyond the control of the executives. That's not a correct way in which to reward or compensate someone for their efforts.

MR BANKS: We had a discussion earlier with RiskMetrics as to whether those hurdles in the LTI component are really worth the trouble. In the short-term incentives, the bonuses, they're often very specific to hurdles that relate to the

short-term objectives of the corporation. One could argue that in the longer term, having skin in the game, exposure to the share market with a minimum holding of equity for a minimum period of time might generate sufficient longer-term incentive. How would you respond to that? It would be a lot simpler.

MR MORROW (KPMG): It certainly would be a lot simpler. I think again it's important to come back to the purpose of what the short-term incentive and long-term incentive are for. They are called that. It is variable pay, it's compensation and it really should be for effort. Below the very senior levels, a lot more will be attributable to the business unit effort and the individual effort. At the most senior levels, it's a combination of the whole company. But we do want it aligned - certainly we would say it should be aligned - to the corporation's objectives.

MR BANKS: But what you're saying is everyone is using relative total shareholder return. How meaningful is that?

MR MORROW (KPMG): We give an example amongst the big four banks; it's a very good peer group.

MR BANKS: It's maybe the exception.

MR MORROW (KPMG): Yes, in strata of the mining sector you can find good peer groups, junior explorers, midrange, but then as you get up the top, you're left with again a very small peer group. Outside of that in our market, they're just not a satisfactory peer group, so it's a distortion. So by default, companies will go and look to an index, an adjusted index, adding some in and taking some out to try and get an appropriate comparator. Again it's for those reasons, as Andy was explaining, that to go against it can cause a lot of difficulty for the organisation with government's advisers and shareholders who may not be fully understanding all the aspects of the business, the business goals, the strategies, their objectives and their people. That's why the board is there. So it's probably a long way to answer your question; I don't think it's just to have a short-term incentive or a long-term incentive with time served and - - -

MR BANKS: No, no-one would argue that for a short-term incentive but the question is what are you trying to achieve through the long-term incentive and is that the main vehicle for alignment or not and how much of that do you achieve through the exposure to the shares of the company, relative to the additional hurdles that are thrown into it? That's the proposition there. Some would mischievously say that complexity suits you guys because you then need advice to calibrate things to the nth degree and - - -

MR MORROW (KPMG): No, it's too hard.

MR HUTT (KPMG): There's no value for us and our client coming back 18 months later and saying, "Look, this isn't working because no-one understands it." That's a refrain that we do hear, "Help us produce something that is more transparent to our people as well as our shareholders," because if people aren't au fait with how it is working and they can't track it and it appears to be too far removed or too complex in terms of correlation with what they're doing, then it's not incentivising them and therefore it was all a waste of time.

MR MORROW (KPMG): And we won't be asked back.

MR BANKS: Could you reflect the observation that some have made that it got to the point where boards themselves can't properly understand the full implications of the packages that senior executives are earning. Have we gone past the tipping point and we have to come back?

MR MORROW (KPMG): It's a fair observation and I can speak to it now. We were going to speak in terms of the role of the remuneration adviser. You can't expect boards to be across all the different types of remuneration structures out there and what the remuneration consultant - whether it be across tax, accounting, valuations or the behavioural implications - is actually giving them advice on and seeking to inform the board; the board takes that information and then decides does it work or doesn't it work.

Just picking up on the last part of our discussion, there are numerous times when the executives and the board will hear the advice and just go a different way and that's still appropriate because again, the remuneration consultant won't be across all aspects of the business, but as they provide the information to the board, it's informing them and they're learning the principles and understanding the principles as they relate to their organisation. To have them understand that there's another 10 different ways to design that structure out there or that others use, no, you can't expect them to be across all of that detail, but you can expect or want them to understand what's appropriate for their organisation.

MR HUTT (KPMG): And to understand the one they signed off on.

MR BANKS: Okay.

MR FITZGERALD: You were going to talk about tax.

MR MORROW (KPMG): Tax, certainly. We'll raise tax and perhaps then follow on from the earlier session. There have been comments and discussion about whether the tax design creates a lot of these plans. Basically, employee share

scheme income, if there's equity awarded for meeting certain performance hurdles and the like, it's ordinary employment income. In the first instance, that's how it should be taxed, taxed at the executive's marginal rate of tax. No-one should have a problem with that and that's how our tax legislation has been designed.

The other aspect of the legislation has allowed for the employee, and it's any employee, to choose to actually pay an amount of tax at the time they get granted so that they then continue to hold the shares or options as capital assets. There was a comment earlier that even if someone under the proposed changes holds their shares through to deferral under they vest, they will still enjoy the capital gains tax discount. That's not correct. Under the proposed rules that the government is proposing, employees and executives will be paying tax at their marginal rate of tax at the time - well, when we find out what the final taxing time is, but at that time, and it will probably be when there's no longer a risk of forfeiture or when they vest; let's use that for the present, say, three years out. If the plan that is provided to the executives and the employees is not qualifying, doesn't meet certain conditions, then they will be taxed at the time that it's granted to them. Again, they will be taxed at their marginal rate.

MR BANKS: On the what, on the market value of - - -

MR MORROW (KPMG): On the value. I'll give an example: if the executive is given the right to be given 10,000 shares in three years' time for no consideration, at the time of grant he will pay tax on the full value of the shares. Compare that to if they were given options and they had an exercised price, using the example earlier, Robert, of \$10, the share price at the time of the grant and assuming a five-year life on those options, then under the current rules, they would pay tax on basically 11 and a half per cent of the share value at that point and would continue to hold them.

The government has flagged that and has said, "We'll look at the valuation rules," and that's one aspect that they're looking at, but even then, if those options vest in that person three years later and they exercise them at that point in time, they still need to hold the shares for 12 months and hold them at risk before they enjoy any capital gains tax discount. There are different permutations, but there's basically nothing fundamental wrong with the way the tax rules have been designed over the last 15 years or so. They are very similar to the taxation of employee shares and options around the world, with very little difference.

MR HUTT (KPMG): The government's proposal is fairly straightforward. Shares or options should be taxed as soon as you get them, unless they're subject to what they call a real risk of forfeiture, in which case you're taxed when those real risks of forfeiture cease to apply. No matter which point it is, you're paying tax on the value

of what you were getting as ordinary income and once you've got past that point, then just as if you paid for those things yourselves, it's a capital asset.

MR FITZGERALD: Yes. Your proposal - and correct me again, I may misunderstand you - the government is proposing what you've just said but you're not supportive of that. You're seeking a difference to the timing of that tax imposition, aren't you?

MR MORROW (KPMG): Essentially the rules that they've currently proposed and are considering are that the executives - and I'll talk executives alone, without talking about the broader employee population - will be taxed when they no longer have a risk of forfeiture. So to use the example that I gave of something vesting in three years' time and if it's an option, it may vest, the performance hurdles have been met and the proposed rules would say at that point in time, the person should pay tax.

MR FITZGERALD: Yes.

MR MORROW (KPMG): That executive may be under trading windows, so they're not able to trade, so they can't exercise. They may be in possession of sensitive information, inside information, so they certainly can't exercise; the options themselves may not even be in the money but yet still have another two years to run. So what we're saying and what we've said to the government as have others said, the appropriate taxing point is actually at the first time that they no longer are under any restriction, so that they actually can dispose of the share to meet the tax liability. Basically again that's what happens around the world.

MR FITZGERALD: What's the downside for government of that? Clearly the government has not acted capriciously, it's acted because the ATO has raised concerns and clearly, whatever people think about governments, they don't generally take action unless they have a concern or they're trying to meet a particular problem. So I'm just wondering, in your proposal, what would the government see as risk to it because basically that's what this is all about, risk to revenue.

MR MORROW (KPMG): The government has addressed what it's perceived as a problem with the existing legislation, and again using the example that I gave, that at the time that that person exercises those options and acquires the shares, then they are put under a restriction on sale, simply a restriction on sale, and that can extend for up to another seven years. So in total the government says, "Well, there's a deferral of tax for 10 years." That restriction on sale that they're looking at, in their consultation paper they have referred to it as artificial because it's easily lifted, so they're concerned about that. It's an appropriate concern. What they've said is that they want the tax earlier and that they have used the real risk of forfeiture. What we and others have said is, "Okay, fair enough, that's accepted," but have the tax at the

time that the person can actually realise it again, which may be, using my example, another six months out or one year out. It's not up to the seven years.

MR HUTT (KPMG): So you might refer to them as mandatory sale restrictions rather than elective ones, if you like.

MR FITZGERALD: The other point, I'm not quite sure what the government is proposing because I haven't seen it, but in one of the drafts that I saw, they were proposing that termination would trigger a taxing event. Is that their current draft proposal?

MR MORROW (KPMG): That's correct. Under the current rules - that is, the rules that we've had for the last 15 years - termination of employment is a taxing event and it has caused problems. Government has said in its consultation paper that they maintain that view, that termination of employment should continue to be a taxing event, and this is at a time when governance organisations, shareholders and many others, including APRA and perhaps yourselves at the end report, are saying, "Well, shares and options or equity should be held for an extended period of time," whether the employee terminates employment either voluntarily or involuntarily, that they go past that date. The problem with that of course is that it is a taxing point in time with no funds to meet that tax liability.

MR FITZGERALD: Why do you think the government - I don't want to pursue this much longer because it's quite detailed and we'll be looking at it - determined that termination should be a taxing event, given what you've just said about the general trend to deferral till post-termination?

MR MORROW (KPMG): The consultation paper refers to a concern that employees can be leaving and travel overseas; that's certainly the only statement there.

MR BANKS: And not come back.

MR MORROW (KPMG): I think those concerns actually are readily addressed in the government's other proposal which is to have employer reporting. We will have that. It's appropriate. It's a good thing and that will improve the compliance and the revenue take. Again, Australia is currently the only country that I'm aware of around the world that taxes on termination of employment. It's just out of sync.

MR BANKS: So you think it's the tax on - that's the main - - -

MR MORROW (KPMG): That seems to be the indication.

MR HUTT (KPMG): I think there's also been a notion that once you cease employment, then you're no longer deriving value out of these instruments in relation to your employment, so we should tax you on the employment income at that point and then from that point on, it can be your own personal capital adventure. That provision has been in the law for 15 years, you're taxed on termination, so it's not a new thing.

MR BANKS: I was just going to ask you - because this has come up with other submissions - about your views in relation to whether there should be a binding shareholder vote in relation to equity grants, regardless of how they're acquired, whether it's been equity or they're purchased on market.

MR MORROW (KPMG): No, I don't believe there should be a binding vote, if we're just talking in general terms. I do believe the non-binding vote has worked well. It certainly sends signals. It's the role of the board, as Andy was explaining earlier, to address this area and to communicate it to the shareholders, and if they're not adequately communicating it, then the tool is there for the shareholders.

MR BANKS: I'm just talking about the provision of equity to executives.

MR HUTT (KPMG): In terms of the different rules currently, whether - - -

MR FITZGERALD: Whether you buy the shares off market or on market, whatever the term is.

MR MORROW (KPMG): I'm going to venture and say I think certainly in relation to executives that most of the larger companies anyway take their remuneration plans to a shareholder vote in any event. I appreciate there's a difference between whether they're buying on market or off or issuing. I probably hadn't focused and given it enough thought. I wouldn't have a strong view one way or the other.

MR BANKS: Okay.

MR HUTT (KPMG): I don't think we can really see any reason to differentiate.

MR MORROW (KPMG): Because of the dilution.

MR HUTT (KPMG): Yes. If the focus is the value of the remuneration as opposed to the dilution, then there would be no reason to differentiate. Dilution is the reason why there's a differentiation currently but if you're looking at it from the remuneration perspective, why would you differentiate?

MR FITZGERALD: I just have one last set of questions and I think you have expressed a view in your submission in relation to the disclosure of the remuneration consultant in the rem report. There's been a fairly consistent view that that should be the case.

MR MORROW (KPMG): That there should be or shouldn't be?

MR FITZGERALD: That the consultants should be disclosed.

MR MORROW (KPMG): Right.

MR FITZGERALD: You've got a contrary position, as I understand that, so if you could explain your position.

MR MORROW (KPMG): It again would require I think some very careful disclosure rules. As I said earlier, the remuneration consultant is not unlike any other consultant or adviser to the company and to the board. The board will seek legal advice, engineering advice, building advice, it just goes on, and it raises the question whether they follow that advice or not follow that advice. In the simplest of terms, if I'm advising a client and given the advice and they don't take any of that advice, but they have been informed and they go another path and for whatever reason the shareholders actually didn't like the path that they finally decided on, I'd be very concerned to be named in the report as the adviser, without a qualification. If I extend that further and they were to say, "KPMG advised us but we didn't follow that advice," I think that's going to give them further problems.

Again, a lot of boards and companies will go to a lot of trouble to understand and get the information and as they get that information, that will inform them in terms of helping them form the final view. What we do say is important is that remuneration consultants actually should be appointed by the board and their terms of reference be dictated by the board.

MR FITZGERALD: I noticed that in there, but can I just go on further. Some people have said that should be the case. They have gone on to say that the remuneration consultants, if they're a firm such as your own, would be precluded from doing other work for the organisation or other work for the executives of that organisation. It's a bit like the old but very important arguments around the auditor issue. So I'm just wondering whether you have a view. This morning we had Mercer who have taken a corporate position that if they had to choose between working for the board or working for the executives, they're going to work for the executives, clearly because there's substantially more work involved in that area.

MR MORROW (KPMG): This probably goes back even further; the board will

often say to the executives, "Go out, engage someone and get some information," because the board of itself is not an operating function. They meet for one, two days a month and just don't have that capacity to be fully engaged along the way but it still remains the board's responsibility to control the issue. There's two questions in there and I think one is the conflict of interest and that certainly arises a lot for organisations like us under the current rules. We have procedures, clients have procedures to certainly understand because the last thing you want to do is end up in a conflict. Rules as such can and should be put in place for that reason, whether they be a Mercer or a KPMG, but they can all be addressed. If they're not appropriately addressed, they tend to problems and then it's determined.

MR FITZGERALD: Thank you.

MR BANKS: Good, thank you very much. We appreciate that.

MR MORROW (KPMG): Thanks very much for you time.

MR HUTT (KPMG): Thank you.

MR BANKS: We'll break just for a moment, please.

MR BANKS: Would you like just to indicate the capacity in which you're here today?

MR GESCHKE: I'm probably best described as a disgruntled shareholder because of losses I've incurred I believe through rather overpaid executives, company directors and others, who have often given misleading information. Having said that, I have to admit also as a shareholder that I've been totally responsible for a lot of the losses I have equally had through bad judgment on my part, so it's a bit of both. But what has concerned me a little bit is that the executives and directors, not only in the companies but also the information that is given out by them and which the investing public rely on buying shares and there's been I'd suggest disclosures or comments made which could be considered quite wilful and quite deceiving in withholding from people the true events of the company. Am I able to quote names?

I think of one, at an Australian Shareholders Association meeting, where the chief executive officer said, in answer to a query I raised to him as to why the market price of the shares was so different to what the company's value was, his words were, "I assure you that there's nothing wrong with the company. The market has got it wrong." Six weeks later, an administrator was appointed and the company's shares were valueless.

There's also just recently a case with Nufarm having a rights issue which initially closed last Tuesday. Three days before it was closed, the company announced not disastrous but very unsatisfactory earnings and a doubtful possible future. Now, most people had by then at that stage subscribed for their entitlement shares and this was rather late in the piece information to be given which should have been given much earlier and certainly before the issue went to press. However, I understand the company has extended the closing date, so in this case, the shareholders' entitlement offer will be based on the price of the shares five days before closing, but that's the sort of thing I'm concerned with.

With the extremes of remuneration benefits which seem to have been given irrespective of country performances, it's reached what I suggest is the unfair view that perhaps companies are run more for directors and executives than they are for shareholders or their employees. Some recent examples as to where the groundswell for review of remuneration paid to these executives has germinated, not only here but overseas, I've listened to the comments today and also to the views of your earlier meetings expressed in the paper, the Bankers Association, the Shareholders Association, and the issue seems to come down to be not that something shouldn't be done, but the question of over-regulation or under-regulation. With under-regulation we certainly get the problems of this credit crisis which I think was largely due to a complete under-regulation of the credit market in America and the regulation of what directors of some companies were doing. With over-regulation, we get other

problems with sometimes a denial of initiatives. The difficult thing in anything is to decide what is over and what is under-regulation.

Another example of under-regulation is where Tweed and his cohorts have been buying shares at very low prices for many years. In 1995 with the help of the Australian Securities and Investments Commission, I was able to get action which temporarily stopped him for a few years by requiring him to advise the value of the shares. The regulations were changed in 2001 and since then I've been arguing with the government that they had to have better regulation, like a market court or something else, but as at to date, under Hassle Free Investments and many others, the bottom feeders are still going. So under-regulation has quite serious defects; whether it can be balance or offset by over-regulation, I'm not sure.

But the one point I was hoping to make, Mr Chairman, is that it's very difficult to decide what is a correct regulation. From my experience of many years in consumer affairs and as ombudsman, I would say please don't ever allow self-regulation. I have never known that to work to provide justice for all parties engaged in a matter. That's all I wanted to say, and thank you very much for listening to me.

MR BANKS: I think it was very valuable and while it was unscheduled, it's good that you were able to listen to the others and give those reflections as an individual. I might just ask you, as a shareholder, any views you might have on at least the ability now as a shareholder to attend the AGM and observe the process of voting on a remuneration report.

MR GESCHKE: I perhaps should say I've been a shareholder for 70 years. From the age of 15, I went to work in a broker's office in Melbourne, A.T. Day, who is now long gone, and have had an interest in shares since that date and attending meetings and a member of the ASA and so forth. Now, I find that a lot of the powers of a shareholder are a bit illusory. What you can say is controlled by the meeting. You certainly now can have a vote on the remuneration package but it's not binding, and I'm not arguing whether it should be or not, but one can only put in a thing and perhaps can stand at a meeting. But these days, unless a meeting is held in your home state, it's very costly to attend a shareholders' meeting, especially those in Perth where you're not only up for air fares and accommodation overnight, because rarely can you do it in one day, so it is a bit illusory in that way. I have attended shareholder meetings. I recall on one occasion congratulating the board on its activities and saying I'd never known before how a company could lose 90 per cent of its capital in one year and the board should be congratulated on this and perhaps they would forgo their salaries to help those shareholders who don't appreciate what they've achieved for them, but it wasn't very successful. I do attend some meetings and have spoken. But a shareholder as an individual doesn't have much sway and it's

often said if you don't like the directors, you can not vote for them and nominate somebody else, but I cannot recall individual shareholders, even a group of them, being able to propose a director to a board. Usually management decides who they'll pick and you have the chance of vetoing them perhaps but never ever picking somebody and saying they should be there.

I can understand the mechanics of this because it's very difficult for individuals to collectively get together to decide on an issue, whereas institutions and associations are able to do that. I've felt myself a little bit restricted in what I could achieve. I find that in writing to a company, you always get a letter back from the shareholders' communication officer or something like that but it's not well researched and it's just a palliative to keep you quiet. If I could quote some examples, during the recent downfall in the market, I approached the Macquarie CountryWide consumer rep on a number of occasions to ask what was happening with the shares and saying, "You say this, but this is not the case," and each time I was told there was nothing really wrong, "It's just the market." This followed the share market down from 2.45 down to 10 cents which I could hardly believe the reasons would be unknown to Macquarie CountryWide.

The same thing with McMahon Resources, where they were doing quite well and suddenly also collapsed; I spoke there to their representative on two or three occasions and was assured, "There's nothing we know of that is causing the fall." Lo and behold, there was something; the contracts they had from mining companies were going and I think there should have been some indication given to the market that this was a possibility because an informed shareholder can only be informed if there is proper disclosure. I don't call proper disclosure after some event when a tragedy has occurred, because the course of those actions which would lead to a disclosure have been generating for months in advance and often this is not announced until the last moment.

MR FITZGERALD: Whilst that's not completely on remuneration in terms of disclosure, the continuous disclosure regime which has been introduced I suppose in part was meant to address your concern - - -

MR GESCHKE: It is.

MR FITZGERALD: - - - where there's a material change that the market needs to be aware of. I presume from what you're saying that either that regime doesn't work very effectively or determining what's material is in the eye of the beholder.

MR GESCHKE: I think you're right. I think there has been quite considerable advances and I think ASIC and the ASX to some degree do try and enforce it but of course regulations without adequate enforcement is not very often useful and they're

often just a bit of smoke and mirrors job. But it seems to me that where there has been a failure to disclose, it's not that the company should suffer but it should be the executives who are responsible for that non-disclosure who should suffer because all you're doing is having a double-whammy at the shareholders firstly not being told what is going on and secondly, for not being told till they're virtually fined by the costs levied against the company.

MR BANKS: Thank you very much for your contribution.

MR FITZGERALD: That's good, thank you.

MR GESCHKE: Thank you.

MR BANKS: We had a final participant, a Mr Allan Potter, and I don't know whether he's in the room or somewhere nearby. I think we have to assume at this stage, given he was scheduled for 4 o'clock and it's now 4.15, that he's not coming. So with that, I will adjourn the hearings. We resume in Brisbane on 10 July. Thank you very much.

AT 4.15 PM THE INQUIRY WAS ADJOURNED UNTIL
FRIDAY, 10 JULY 2009