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TRANSCRIPT OF PROCEEDINGS

PRODUCTIVITY COMMISSION

INQUIRY INTO REGULATION OF DIRECTOR AND EXECUTIVE REMUNERATION IN AUSTRALIA

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

TRANSCRIPT OF PROCEEDINGS

AT SYDNEY ON MONDAY, 9 NOVEMBER 2009, AT 2.06 PM

Continued from Melbourne on 27/10/09

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MR BANKS: Good afternoon, ladies and gentlemen. Welcome to the second round of public hearings to receive feedback on the Productivity Commission's discussion draft for its national inquiry into executive and director remuneration in Australia. I'm Gary Banks. I'm chairman of the Productivity Commission and presiding on the inquiry. On my left is Robert Fitzgerald, who is a full-time commissioner, and on my right is Allan Fels, who was appointed as a part-time associate commissioner specifically to this inquiry.

As you'd be aware, the inquiry commenced in March when we received terms of reference from the government. We've conducted wide-ranging consultations in the first round of hearings, leading up to our preparation and release of the discussion draft at the end of September. As you know, the draft has received a lot of publicity and has engendered considerable debate. Some of the recommendations, notably the two strikes one, have received more attention than others, but it would seem that the majority have had quite broad support.

In all cases, we welcome feedback on the discussion draft and I emphasise that it is only a draft report and it's open to change in the light of feedback we receive and the further research that we do. We encourage those who have views about the recommendations and their likely effects to place their views on the public record through its submission which is then available for wider public scrutiny; it's an important part of the process. It is the purpose of these hearings to give participants an opportunity to do just that as well as affording the opportunity for discussion. This will in turn help the commission identify key issues warranting further thought and the various considerations that we need to take into account.

After these hearings in Sydney, we'll be holding a further day of hearings in Melbourne on 13 November, Friday the 13th, and then we will proceed to do any further work needed to refine the analysis and come up with bottom lines for our final report to government which is due by 19 December.

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

I should add for the record that participants need not feel constrained to making a single submission. For example, participants may wish to make submissions in response to the submissions of others and we will continue to accept submissions after these public hearings, although the deadline of mid-November is looming.

Finally, to comply with the requirements of the Commonwealth occupational health and safety legislation, I need to advise you that in the unlikely event of an emergency requiring evacuation of the building, exits are located out there and to the right. Staff are here to assist you if necessary, and indeed will assist on any other matter. So with those formalities out of the way, I have great pleasure in welcoming the first participants here in Sydney, KPMG. Welcome to the hearings. Could I ask you please to give your names and positions.

MR MORROW (KPMG): Thank you, Gary. My name is Martin Morrow. I am the lead partner of the equity compensation practice with KPMG. I have with me Ben Travers. Ben Travers is a director in our practice.

MR BANKS: Good. Thank you very much for attending. You were an active participant in the first round and we appreciated your input. We may not have had time to see all the arguments that you put to us in response to the discussion draft, so we're happy to give you the opportunity to lay those out for us.

MR MORROW (KPMG): Thank you, Gary. We've focused on five of the Commission's draft recommendations and I'd like to just go through those briefly and then leave it open to you gentlemen, if you have questions for us. I will specifically talk on recommendation 8 and 9 and then Ben will talk on recommendations 11, 13 and 15.

MR BANKS: Thank you.

MR MORROW (KPMG): So if I can, in recommendation 8, the Commission recommends a plain English summary would include the readability of remuneration reports. It refers to actual levels of remuneration received by executives and total company shareholdings of the individuals named in the report to be included. We support the principle of having remuneration reports in a format that's readily understood and articulates clearly the remuneration policies of the company.

However, one of the difficulties at present is that companies are currently required to comply with the Corporations Act; the ASX corporate governance principles on an if not why not basis; the accounting standards; in the near future, certain companies will be required to comply with APRA guidelines and if the Commission's recommendation is adopted by government, then there would be a further requirement to include a plain English summary.

Whilst I think it's commendable that there is a focus on getting it towards a plain English and more readily understood report, a further requirement like that can only add to that complexity in our view. So what we'd like to recommend is that the Commission put forward a recommendation that there should be a consolidation of all of these requirements at present and they be all brought under the one umbrella, rather than having accounting standards, corporate governance principles, investor association guidelines and even further, a plain English summary, but that there actually be a recommendation by the Commission to the government to rewrite the Corporations Act, specifically section 300A, with a view to picking up any principles that are in all of these other guidelines. Given that Australian companies' disclosing entities are required to follow Australian accounting standards and in turn follow international reporting standards, I think that's got to be the starting premise of the rewrite, but there does need to be just one set of principles put forward that companies be required to follow, rather than all these different requirements.

I think in pursuing that consolidation, it's probably a very good idea to bring together interested stakeholders like investor associations, Treasury, the ASX, the Corporate Governance Council and other interested parties that have input into that process, but of itself, it should lead to just one set of guidelines, then that could follow on. Those guidelines themselves should be principles based, with a stronger focus to the plain English to enable them to be readily understood. I'll just talk about the next couple of recommendations unless you wish to explore each of them.

MR BANKS: Maybe it's better for you to go through and then we'll come back to each of them.

MR MORROW (KPMG): The Commission also recommends the reporting of actual levels of remuneration. We submit that the nature and extent of cash-based remuneration should be disclosed but in addition, in relation to equity components for remuneration, what we do recommend or believe is that the company should be required to disclose the specific details of what equity components and equity instruments have been provided to the executives. By that, we mean the number of equity instruments that form part of the remuneration in that year, the underlying share price of the instrument, any exercised price payable, the vesting period or the performance period, the performance hurdles, and finally how the outcomes of the performance hurdles have effect or will effect the number of equity instruments to which the individual is entitled. You will note that we haven't referred to values because that is part of the problem that currently is in remuneration reports. What we are saying is if you provide the specific detail, investors and users are able to draw their own conclusion of the value, that you are providing all the values.

The Commission's recommendation 9 talks about that 300A should be amended to reflect that individual remuneration disclosures be confined to the key management personnel and that the additional requirement for the disclosure of the top five executives should be removed. We support the recommendation to remove the requirement to disclose the top five. You also did seek our views on further disclosure around other personnel. We do reiterate our earlier submission that in our experience investors are most significantly interested in the remuneration and the detail of the remuneration of the directors, and specifically the CEO and managing director, and it really is that information that should be provided in detail and enable the investor to fully understand the remuneration policy.

That is not to say that detailed information shouldn't be provided in relation to other executives but that information not be specifically detailed as is currently required but be provided in a format that enables the investor to understand the policy behind the remuneration, the total of the equity pool, how it has been determined and to which key management personnel are involved in it, rather than a detailed description in relation to each. Ben, can I ask you to cover the next three recommendations.

MR TRAVERS (KPMG): Yes. I also want to touch on recommendation 11 regarding the remuneration adviser and the naming of the remuneration adviser. The Productivity Commission's recommendation 10 regarding appointing and instructing and agreeing terms of reference is something KPMG firmly agrees with. In respect of recommendation 11 on the actual naming of the remuneration adviser, in our experience, boards when they seek advice will tend to seek advice on specific aspects of remuneration and that's more in line with anything they will do. It tends to be on specific aspects, and you may in fact have one, two, three or more advisers that are actually engaged.

When that advice is given to the board, the board then takes that advice and makes its determination as to what it will do with the advice, whether it follows some, all or none of the advice, and the board remains ultimately responsible for then implementing whatever the advice is and dictating the remuneration policy. The advice that is given by the remuneration adviser may or may not be followed in full and I guess our concern would be that if you go naming remuneration advisers there is potential for investors to be misled, that if a remuneration adviser is named the remuneration adviser has actually advised on either the whole of the report and/or agrees with the contents of the report.

A concern there is certainly just in terms of what is done with the advice by the board because the board will remain responsible for it. We certainly recognise there is a lot of debate around whether remuneration advisers should be named. In the event that the Productivity Commission does decide that remuneration advisers should be named then we would certainly recommend that it also provides a form of wording to include in the remuneration report that just outlines exactly that the board remains responsible for the remuneration of the company and it may have adopted some, none or all of the advice that it actually took.

Recommendation 13 regarding the cessation of employment taxation trigger, we certainly agree with the Productivity Commission recommending that no taxation event should occur at the cessation of employment. The proposed rules that have been introduced in respect of the taxation of employee share schemes do still have a taxation trigger that will arise at cessation of employment. Australia remains the only country that does tax on the cessation of employment. What it can lead to is actually tax dictating the design of certain remuneration policies to ensure that you may not have executives who have these things being worse off as a result of ceasing employment. So tax starts dictating the policy as opposed to good corporate governance.

We have certainly the G20, the FSF, many investor associations calling for remuneration to be deferred until the performance can adequately be measured and sustained performance can be shown. This will inevitably be after the cessation of employment for a number of individuals. Given that we want to keep having the long-term growth aligned with what's being paid out to executives, it's important that we don't have an early taxing point that might lead to policies that actually allow an early vesting, for example. We agree with the Commission in that regard.

Recommendation 15, as noted by Gary, has probably been one that has had substantial debate. Certainly the first aspect of where a 25 per cent no vote is recorded in respect of the remuneration report, the board being required to report back in the following AGM as to what it has done to address those concerns and if not, why not, KPMG agrees with that aspect of draft recommendation 15 and think that it provides an effective framework for dialogue between shareholders and the company.

The two strikes aspect of the recommendation would lead to the whole board remaining responsible for the remuneration policy. While the remuneration committee might do a lot of the analysis and a lot of the work in actually formulating the strategy, it is the board who remains responsible for setting the executive remuneration. In addition, the measure is likely to mean that the concerns of shareholders, in particular, significant numbers of minority shareholders, are given the attention of the whole board. What the two strikes policy may lead to though is the potential for unintended consequences. I certainly have read within the papers many arguments going back and forth: the increased power of minority shareholders, notwithstanding a majority of shareholders may vote in favour of the remuneration report; a minority of shareholders voting against may lead to a spill of the board.

We recognise the Commission has expressly not given any guidance as to what that second level of vote may need to be in order for there to be a full board re-election. We think that given the opportunity for feedback, many companies will certainly have that, as well as investor associations. The other issues that can arise with the two strikes policy, there's certainly a potential for increased cost and risk to shareholder value; the requirement for a full re-election of the board; could be a costly and destabilising process, particularly if directors were being turned over at a higher rate the company may suffer strategic damage to do with lack of continuity at board level. There is also the potential costs and strategic damage that can arise in respect of full board re-election that may actually result in shareholders being less inclined to vote "no" because they don't want that re-election to occur.

There is the impact that the two strikes policy could have in the remuneration policy design itself. It could lead to boards adopting remuneration practices that meet tick a box requirements of corporate governance and proxy advisers and they may not be the most effective for that particular business. There's also the time spent on remuneration. It is well recognised that boards are there to provide strategic direction of the company; oversee and authorise significant transactions and decisions; the increased focus on executive remuneration and, in particular, where there was a two strikes policy is likely to result in directors spending a significantly increased amount of time on remuneration issues.

If the commission does decide that it wants to implement a two strikes policy and make that recommendation, then we certainly feel that any threshold should not be set below the 50 per cent that would be required to remove a director at an AGM. We also think that consideration needs to be given to whether that will be based on votes actually cast on the remuneration report or whether it's going to be total votable shares.

MR MORROW (KPMG):   Thank you, gentlemen. That summarises, if you like, the five recommendations that we think are the most significant or that we want to provide input into at this time. We are happy to answer any questions.

MR BANKS: Thank you very much for that. Maybe we will go back in the order that you have outlined them. In the first one, in relation in particular to the potential rewrite of 300A, there have been other participants who have also raised this concern. I just wanted to get you to elaborate a little bit. In moving to principles based, are there components of the existing requirements that you think are redundant or inappropriate or are you just saying that the principle based approach would encompass them but in a way that gave it more flexibility?

MR MORROW (KPMG):   I think there's no question that there are aspects of the current requirements that are redundant and I think they are summarised and probably well captured in the first report. They came in various and different submissions. Without going into any specific range of information that's currently required that's not necessary, you can go through much of it and find that it's not providing a clear understanding to the reader as to the total effect and manner in which the remuneration policies are meant to operate. I'd certainly be happy to put a further submission to you and highlight the particular detail.

For example, one of the things that comes to mind is the value of options that have lapsed is currently required to be disclosed and I'm not sure how that provides a lot of useful information, yet there's further information in there that just compounds the total.

MR BANKS: How easy do you think it would be to get agreement among all the parties that you've talked about on a set of principles that would solve everybody's problem?

MR MORROW (KPMG): I didn't envisage it would be an easy process, but nevertheless we currently have, as mentioned, something like three at a minimum and five, six and seven different sets of guidelines, either guidelines or statutory rules, that are required to be followed. So by definition, that creates the confusion and the complexity. It's probably an exercise well worth spending time on to have the various stakeholders and parties together over a period of time to identify the issues that are the required issues; that is, the information that will help the reader understand without necessarily confusing. It's probably not a lot different to the process that the Commission has been going through.

MR BANKS: We've had some people say to us that a lot of companies are still on a learning curve and they're probably looking at what other companies are doing and you're getting an evolution towards best practice occurring naturally. Some companies have brought out very concise, very clear remuneration reports; they get away with that in a sense, and others may well want to emulate. But do you have any views about whether there might be a natural evolution of a solution here?

MR MORROW (KPMG): There's no question that remuneration reports have been changing over the last five years or so and some are getting better than others but that again is a question of who is the reader, what policies they have in place, what's the nature of the company. It can vary. It can be a lot easier for some companies and the nature of their workforce and the nature of the company itself as to how complex its policies may be compared to a different company. I think if the process continues to evolve or allowed to evolve in the same way, we will still end up in the next five years with three, four, five and six different sets of statutory or non-statutory guidelines that companies are grappling to comply with. APRA has got its prudential guidelines which come into effect from next April. If the Productivity Commission's recommendation is adopted, that is, there's a further plain English summary of policies adopted or put forward by the government and further, the Productivity Commission's recommendation of the check list is picked up, then we have further requirements, that companies would be seeking to capture that information, capture the information required by the standards, capture the information required by section 300A and then reconcile the whole lot. I think the Commission itself recognised that some companies already capture everything that they're required to in one part of the report and in other parts, they seek to distil it down to a more readable form. It's just not efficient.

MR BANKS: So you don't have a problem with plain English per se.

MR MORROW (KPMG): No, not at all.

MR BANKS: But rather that the plain English summary would add to the length. I can't see how it would add to the complexity.

MR MORROW (KPMG): It would add to the complexity, in that companies would be seeking to put in plain English what's already there in another form, that is, meeting the requirements, and reconciling the information that's there in such a plain English format that it's easily understood and is not against or does not reconcile with the statutory requirements. That of itself is important. Plain English to me might be different to someone else's plain English.

PROF FELS: I can see your point. I've got an open mind on whether that can be easily solved or not. I could imagine that you would say, "The general principle we've adopted is X. For the complications, see the detailed accounts," kind of thing, rather than trying to get down to the plain English complexities. That's one view of it, but the other view is maybe you're slightly more to the other answer where you can't quite get away with such a plain, short guide because it leaves out the critical elements of the complexities.

MR MORROW (KPMG): The difficulty for the preparer of that plain English report is ensuring that what they do in plain English is not leaving them open to further attack, albeit that the information might be somewhere else in the report, that doesn't necessarily mean the user does go looking for it. They'll go straight to the plain English. If we think about what we're talking about, the requirements, there are different requirements to be met. If that could all be consolidated into one, following the plain English principle, along with a principles based and maybe some specific detail, but all of that could be captured in one area, it does make it a lot easier for the preparers of this information to focus on what they need to deliver.

MR BANKS: I share your wish to have a principles based approach, but if we think about some other areas of legislation like the FSRA, for example, which was principles based and you ended up with very, very lengthy disclosure documents, again because there wasn't enough detail in the legislation, and financial institutions felt they had to cover all the bases, is there at all a danger in this area that you could get that effect?

MR MORROW (KPMG): Yes, there can be a danger, but nevertheless one would hope that in the formulation of that rewrite that much time could be given to trying to eliminate that and maybe the lessons of the FSRA can help in understanding what created the problem before in overcoming it now.

MR FITZGERALD: To what extent has ASIC failed to properly administer this particular section of the act? It seems to me that everyone is unhappy with the way this section has been applied. There is a regulator and yet, unusually, nobody talks about the regulator in this case. It's almost as if it's silent or a non-participant. Is there a role for ASIC to take a greater role in ensuring that its regulations, which is the Corporations Act, are more properly applied?

MR MORROW (KPMG): I think the answer to that probably lies in the fact that many aspects of 300A are currently being disclosed. There may be aspects that aren't, and then the question becomes to what extent are those aspects that aren't disclosed highly critical? One comes to mind and that is performance hurdles and short-term performance hurdles. There would be reasons for that. As to how active ASIC has been in that respect, I can't answer that question. That's a question better put to ASIC.

When you say that everyone is unhappy or there is much unhappiness with the remuneration report, I think we probably need to understand from which perspective because the preparers certainly do have problems putting it all together because there's much to be put together, and the Commission rightly notes that there are 20-page reports and 15-page reports and the like. The users may have difficulty in understanding it but nevertheless the information is there. It becomes a question of them being able to understand it, and as to the nature of the information itself, it is trying to teach all about remuneration perhaps in 20 pages. It's probably not that easy.

MR FITZGERALD: But even if you were to recast the Corporations Act into a principles based act, I'm trying to understand how do we stop - exactly what Gary has indicated - where you have a principles based legislation which still becomes unworkable. Where does that responsibility sit? Is it with the regulator? Is it with the actual corporations themselves? What's the balance? Again, the financial one is an interesting one where I think everybody thought with goodwill that it would serve the purpose of creating greater, understandable disclosure to consumers of financial services, but that was well recognised not to have been the case.

MR MORROW (KPMG): Certainly if it's sitting in the Corporations Act it's ASIC's responsibility. In the development of the principles I think there will be certain aspects of it that would need to be specific and detailed, but in the nature of remuneration itself, to specifically define or require the way it needs to be made up is actually going to then bring all remuneration across all companies back to the one format and probably work away from what investors do require; that is, variable remuneration that's only paid out on performance of certain targets or achievements. I can't answer the question as to how to get the principles correct but I think there can be probably learnings from the FSR.

MR FITZGERALD: I mean, you can come up with certainly good principles. The question is, how do you stop them becoming inappropriately complex or unintelligible over time. But can I link that to your next recommendation which was endorsing our approach towards using only key management personnel, but I do want to talk about narrowing the detailed reporting to the CEO and other directors. Initially I think some of us have been attracted to the notion of further narrowing the detailed disclosure in relation to only the truly key executives, as distinct from what's meant by this. But I suppose there's a caution in doing that, so I was wondering whether you could tell me what the pluses and minuses would be, from a shareholder's point of view or anybody else's point of view, if we were to restrict further the detailed reporting to the CEO and other directors and not this wider group of management personnel.

MR MORROW (KPMG): I think the reason for the citation of the key management personnel currently at present is to identify the points of conflict of interest, those who are in a position of conflict of interest over their own pay and various decisions, and those who are in charge or have responsibility for the performance of the company and the underlying risks within the company. At the end of the day it really is the CEO, and potentially the CFO, are the two main positions and like positions across all companies. As you start to go beyond those two you probably need to question how much detail in relation to others is helpful in the investment decision or at least understanding the conflicts that can arise with each of those particular executives and their performance when, if you have the information which should be supplied about the remuneration setting process, the remuneration policies and the pool of executives around that, without the detail relating to each executive, there should be enough information to identify whether executive number 4 is in a position of conflict or not; executive number 5 does manage the company's risk committee and the like and is also involved in the remunerations process or something of this nature, would be a question, the extent to which the additional information at present does more fully inform the investment decision.

MR BANKS: You are comfortable though with the notion that it should be a KMP or a subset of, rather than the doubling or the double requirement that also the top five - - -

MR MORROW (KPMG): Yes, yes.

MR BANKS: Some have, as you would expect, differed on that and felt that shareholders would still like to know if there was somebody who was earning more than the KMP and there are some kind of businesses where that can happen. What would be your response to that?

MR MORROW (KPMG): Again the question becomes if they're earning more than the CEO and the like, the reason why that might be performance based in a particular area of the business but they're unlikely to be managing the business or impacting the whole of the business, and that person's performance would be subject to the remuneration setting process which is independent, or should be independent, of that person. Again with the Commission's recommendations, and APRA's, which is more firmly pushing the remuneration process to the way of the board and trying to have a board more fully responsible, then I don't see a concern with a more highly paid individual that's outside the key management area having to be disclosed.

MR BANKS: As you know, some have argued that the origins of the financial crisis lay in inappropriate remuneration and not necessarily at the top but sometimes at the trading floor and that if that information had been more transparently available it might have been a bit of a red light to some observers.

MR MORROW (KPMG): It might be that or it might be more the remuneration process itself, and that is actually who owned the process, whether it's the board or the remuneration committee, and what procedures were in place in terms of setting it. That comes back to aspects that have already been identified by the Commission, or certainly by APRA, are the performance hurdles being risk adjusted for those areas of the business.

MR BANKS: Okay.

MR MORROW (KPMG): I think the cause of the global financial crisis is probably a whole lot wider than simply the remuneration of various individuals.

MR BANKS: I think that's right. Should we go on to this question of disclosure of expert advisers?

MR FITZGERALD: Okay.

MR BANKS: I mean, I take it you're happy with the notion of our recommendation that advisers report to the board and be contracted by the board?

MR MORROW (KPMG): Certainly, and it may be that advisers are advising and working with management but that the board may have a different set of advisers, but certainly if an adviser is working for the board or for the company, and if it's only one set of advisers in the company then it should be engaged by the board or the remuneration committee.

MR BANKS: Yes. You've made points about the fact that multiple advisers are used and issues would arise as to what extent any individual adviser was involved. You take those points and acknowledge them. I suppose from the wider shareholder's point of view there's also the issue of getting a bit of a window on whether there's a potential for conflict of interest and I think your response in your submission was, "Well, that can be handled through procedures," but how does that necessarily reassure shareholders - and in particular we thought that one bit of information that might be quite relevant would be the business of what an adviser may be doing separate from the executive remuneration area for the same company. How would those kinds of issues be dealt with?

MR MORROW (KPMG): I think if you look at the audit disclosures at present, there are systems and procedures in place for audit firms and potential for conflicts there. In relation to things like a remuneration adviser, the same sort of systems and principles or conflict management principles, could equally be put in place. One of the concerns that we expressed by naming the adviser was such that it can be more along the lines of, "Well, yes, adviser X has given advice and adviser X is well known in the business to advise us," so therefore that of itself says that policy is being followed and it's what the company is doing, but that just may not be the case. If it's not the case, it leaves it open for the reader, the user, to be misled as to what principles have been followed by the board, picking up on the adviser's advice or not.

I think it's a difficult one to say how do you manage the potential for conflicts of interest, but if the adviser is engaged by the board and the board is ultimately responsible, then the board should of itself be managing any conflicts.

MR BANKS: Yes, I agree with that in principle. The context for this inquiry obviously is shareholders wanting reassurance and transparency around things that they think potentially might be going on. They may not be going on but there's a concern which is then reflected in a loss of confidence in the system. That's one area where we thought some transparency could be reassuring. You're raising some potential downsides from that which we obviously need to think about.

MR MORROW (KPMG): Again it can be appropriate to name the adviser, in which case it is important and has been said in our submission that there be particular wording or a particular form of disclosure so that users do recognise and fully understand that adviser A, adviser B and adviser C have been used, or just adviser A has been used, but it's recognised by the user but they're provided advice and yet the board has still ultimately determined the remuneration policy themselves.

MR BANKS: Okay. Was it the two strikes that was the next one?

MR FITZGERALD: No, the tax issue. Can I just clarify your position on 13. In our recommendation I think we have indicated that we agree that tax should not be payable on termination but the original proposal by the government also included a seven-year period. Do you have a problem with the seven-year period?

MR MORROW (KPMG): I think that's a matter of government policy, and government decides.

MR FITZGERALD: So that's not the problem?

MR MORROW (KPMG): No.

MR FITZGERALD: Okay. That's fine.

MR MORROW (KPMG): The government has brought the longest time of deferral from 10 years back to seven years, so that's government policy.

MR FITZGERALD: What do you think the reason is why the government may be persisting with this view that a tax should be payable on termination, and what is your response to that, because the government seems committed to this view and I was wondering why that might be the case, and what's the risk to government if it changed its position?

MR MORROW (KPMG): It's not clear to me, Robert. The government has indicated in the July policy statement or one of those earlier statements that there was a concern that employees or executives on termination of employment can go offshore. Now, that risk or that concern really should no longer exist, given that the government has introduced an employer reporting and potential withholding mechanism. That previously didn't exist. Outside of that concern the only other concern would potentially be a further deferral of revenue, that is tax revenue, but again I don't see that as either being materially significant, nor actually likely to happen because essentially the way in which the law now works is that employers will provide schemes - employee share schemes and employee option schemes - such that the employee pays tax when they no longer have a risk of forfeiture.

Now, if that's three years later or five years later, that's the time at which they're intended to pay tax and that's the time government is doing its forward estimates. I just can't see having termination of employment brings forward any tax revenue. Again, as has been pointed out, to my knowledge - I have done significant research in the past on it - we remain the only country in the world where termination of employment is a taxing point. Companies will not put in place arrangements that have their employee being taxed before they're in a position to realise the equity or that the tax they're paying will be a different amount to what they ultimately may realise. Therefore they will end up selling equity at the time of termination of employment in order to meet the tax bill. That's against all good forms of remuneration design.

MR FITZGERALD: Can I just ask, what's the practical consequence if the government's position remains unaltered and it becomes law; will it be that in order to continue to meet shareholder demands for longer deferred equity entitlements that remuneration arrangements will now allow for a percentage to be sold on termination, or are you suggesting that in fact the entire deferral will be at risk and brought forward to the point in termination?

MR MORROW (KPMG): I think it's the former, that is a part of the equity will be released to meet the tax liabilities and there will be other aspects looked at. There won't be the deferral put in place that's currently being called for, such that the deferral or the forfeiture remain now two, three and four years until the prior performance can be measured. That just won't be put in place. Companies won't put their employees in that position.

PROF FELS: There has long been a heated debate in tax policy about whether you pay now or later, and if you pay later you get a benefit. Tax deferral is a benefit, assuming there's no interest charge for the deferral. The standard rate textbooks on this all say you should be taxed if a number is getting the benefit and then actually the politics of the situation, together with some of the technicalities, has led to lots of tax deferrals. Usually if you were at the higher end of the scale and then this one somehow or other got caught in the other approach, I wondered if that's what was going on myself.

MR MORROW (KPMG): Sir, I haven't fully followed. If you're saying that we shouldn't have deferrals - - -

PROF FELS: Say I got $100 in cash and I'm taxed, I get $100 of shares and I'm not taxed, then I've got a benefit.

MR MORROW (KPMG): But you may have. I think the point is, Allan, that you may never get $100 of shares.

PROF FELS: That's right, it may be 120 or it may be 80.

MR MORROW (KPMG): Or zero.

PROF FELS: Or zero, or 500. I accept there's uncertainty, that complicates it, but if at the end of the day I get my 500 then I've had a very substantial benefit from deferral, and there's no interest on that deferral.

MR MORROW (KPMG): The first question to ask is, is it deferral, because you've not got anything until the end and that's when you have been given something. What you were given at grant is the promise of something at the end. When we talk about deferral, deferral might be - if I can put that in inverted commas - - -

PROF FELS: Sure. But say I gave you $100 worth of BHP Billiton shares today, you would be better off, wouldn't you?

MR MORROW (KPMG): Most definitely.

PROF FELS: That's the normal definition of income. You would be better off, so you've got a benefit - - -

MR MORROW (KPMG): Are you going to let me keep it, the $100 of BHP shares?

PROF FELS: Yes. You can have all my BHP shares today.

MR MORROW (KPMG): I'm not going to lose them though.

PROF FELS: In a sense you've got a benefit today.

MR MORROW (KPMG): Yes.

PROF FELS: Your borrowing power goes up. For example, you could borrow a lot more against that, whereas if you're paid a hundred in cash, you're taxed on the spot for that benefit. You might also say a hundred dollars in share and might convert that to a single number, the expected value of it in today's terms, that would be conventional. If someone gave me a hundred dollars' worth of share, I would in my head turn that into a current value based on an estimate of the future. It's a bit hard to measure it all but I would know if I was better off.

MR MORROW (KPMG): If someone gave you a right to a hundred dollars cash in three years, would you expect to have the cash in three years - - -

PROF FELS: Yes, that's right, I would discount it slightly.

MR MORROW (KPMG): - - - and the right to shares in three years?

PROF FELS: Yes, that's right, I'd do a bit of discounting. The difference is the share is definite. I could go to the bank, as I said, and borrow against that straightaway. If the bank were to regard me as wealthier - - -

MR MORROW (KPMG): So the question is, Allan?

PROF FELS: So normally if you get an asset and it's of value, then on most principles of equity, you should be taxed at the time of receiving the benefit. That's one view.

MR MORROW (KPMG): Okay, I see your point. If I can just explore that for a moment.

PROF FELS: Yes.

MR MORROW (KPMG): So if I've got something today, if I got the $100 cash today and I pay tax of 50 today, accept that.

PROF FELS: Yes.

MR MORROW (KPMG): If I'm given the $100 of BHP shares today and they're mine to keep, I pay tax on that today or it goes into my tax return.

PROF FELS: That's one argument, yes,

MR MORROW (KPMG): Unless I'm at risk at forfeiting that. If the company can - - -

PROF FELS: Forfeiting, that's a different question. That changes it.

MR MORROW (KPMG): Yes, because I don't really have it.

PROF FELS: If there's a forfeiture risk that changes everything.

MR MORROW (KPMG): Which is the same with that termination of employment.

PROF FELS: Yes. Okay, so the forfeiture principle is quite an important element in it because the notion of uncertainty suddenly goes up.

MR MORROW (KPMG): If I have no forfeiture under the new rules, if I'm not at risk of forfeiting that option or that share, then I do pay tax at the same time.

PROF FELS: Yes.

MR MORROW (KPMG): That is at the same time as cash, I pay it now.

PROF FELS: Yes.

MR BANKS: Just drawing on that a little bit further, just your comments on the difference between the vesting point and the realising point. Under current arrangements there's the vesting point where the tax obligation would be incurred and some have argued that it should be the point of realisation of those assets.

MR MORROW (KPMG): Correct.

MR BANKS: Would you like to comment on that?

MR MORROW (KPMG): That discussion or consultation with government is now over because they've introduced the proposed legislation. Prior to the budget the old rules were that you would pay tax at the point of realisation, that is, when you exercise the option if that was the case. Under the new rules you pay tax at the time of vesting, that is when it's freed up and it's yours. It may have no value because if it's an option it may be out of the money. Now, many of us have continued to say to government and Treasury that that's inappropriate and doesn't typically happen around the world and for the very good example, such as termination of employment, you may be taxed at that time on a value, something will have a value because it has another two or three years of life, but I may never get to realise it because we may never come into the money or might forfeit it for some other reason.

But the rules that we have under the proposed employee share scheme rules are that people are going to be taxed when they are able to realise something, notwithstanding that they may get no actual value, but there may be a notional value or a market value and many of us would say that's not an appropriate taxing point, but that discussion has been had with government.

MR BANKS: In that case then the difference is between whether the person concerned chooses to realise that on day 1 or day 10, isn't it, and what you're saying is, well, it's only if they decide to realise at day 10 or day 8 that they should pay tax, even though they had the capacity to realise it on day 1.

MR MORROW (KPMG): Again, I can recognise the policy behind what the government has put in, that is, they're saying, "Well, that's when you're able to realise it. If you choose not to, we're still going to tax it." The best example is something that has a $1 exercise price and an 80 cent share price. Would I realise it at that point? No, I wouldn't because I would have a 20 cent loss. But that still, nevertheless, would have a value under the principles of valuation so under the proposed rules I will pay tax on that value.

MR BANKS: Okay.

PROF FELS: That has clarified some of this.

MR BANKS: Just another point and I'm sure we're going to have lots of discussions about the two strikes and I'm going to specialise a bit with different participants. But one you raised there was the disruption cost et cetera from having effectively a board spill for re-election. I just wanted to ask you about that, to comment a bit more about that. My understanding is that some companies, particularly the UK and even more so in the US, have annual re-elections of their boards. That's my understanding - it may or may not be correct - and you can comment on that. Secondly, if it was so costly to do it, why would there be a move in that direction?

MR MORROW (KPMG): I'm not in a position - I'm not informed enough to comment on that.

MR BANKS: Maybe I'll keep that for the AICD.

MR MORROW (KPMG): Yes. I probably don't see that aspect as one of the biggest issues but I think some of the other points we note are of greater concern and in particular, the amount of time that the board would start focusing on remuneration as an issue if a mandatory two-strikes policy came in place, that there would be a lot more time devoted to the remuneration which may be out of proportion to some of their other more strategic and bigger issues that they should be focused on, quite simply because that one has a fatal outcome. The outcome of the other decisions are not as quickly fatal.

MR BANKS: Then some would say they've made analogies about probabilities of being struck by lightning et cetera. How fatal would it be perceived to be, you know, the need to re-present for re-election at an AGM or a special general meeting given the record of voting patterns and so on.

MR MORROW (KPMG): I think we've seen just the past two months, certainly the media has been making it very clear that there would be concerns around some of the voting. I mean, we already saw a number of weeks ago about the focus of some organisations on remuneration and remuneration only. I would not like to say that it would not be an issue. I think it would be a significant issue.

MR TRAVERS (KPMG): I think the other aspect that is worth noting, the remuneration report itself has a number elements. You've got your remuneration mix, STI, LTI, all these different elements. Now, a no vote may be a vote against one very specific element of the remuneration report. Another investor may be voting no for another element. So you actually often have no votes going against a specific as opposed to all the other aspects. You could agree with nine things in that remuneration report and have one you disagree with and that may lead to a no vote. So I just think when a remuneration report is voted no, it may not actually mean that the remuneration mix is no good or the quantum is no good. It might be a very specific element, it may be something from three or four years ago.

MR MORROW (KPMG): Importantly I think what Ben highlights is currently the non-binding vote is around a whole range of things and yet if you have 25 per cent in year 1, and let's call it 50 per cent in year 2, across those two spans those voting can be voting against a whole range of different aspects of the remuneration report and not a consistent aspect.

MR FITZGERALD: But in that scenario if you had a 25 and 50 and you had votes above those two, surely it is an indication that the shareholders are in fact dissatisfied, all with certain issues.

MR MORROW (KPMG): Well, I was just going to throw it back, Robert. Against which issue? Might it be the quantum? Might it be the performance hurdles? Might it be the actual reward mix, or might the whole strategy structure of the remuneration be appropriate in all aspects except for one particular aspect?

MR FITZGERALD: But that leads you to a very dangerous outcome, doesn't it? If we were not able to make the two strikes work, it would strike me that we are forced then back into some binding votes again in which case you might then have to break up the remuneration report into several components and vote on those, because one thing is clear - and we've acknowledged it - that we do believe the shareholders should be able to have greater influence. Now, it's very unlikely we're going to change that position. The question then is what is the best mechanism. If the two strikes is fatally flawed then, of course, the alternative would be, it seems to me, you have to go back to some form of binding votes on various aspects of the remuneration report. We have said we don't want to do that and we've indicated that there are reasons for it.

MR MORROW (KPMG): We would support that.

MR FITZGERALD: But part of the reason for not going for a binding vote is its unworkability. Having said that, if you actually start to break it up into different components, as messy as that would be, it becomes more workable because you're actually voting on bits and pieces. So there's a danger in your position that if you do believe that shareholders should have greater influence you are in fact forced back into looking at those sorts of issues.

MR MORROW (KPMG): Could I put it back to you that shareholders have had significantly more influence over the last five years with a non-binding vote and are increasingly so, both in terms of shareholder participation in voting and the way in which companies and boards have been taking that on board and addressing their policies. I think you mentioned earlier, Gary, there has been both an evolution of remuneration report preparation and, similarly, there has been an evolution of listening to and understanding what the meaning of a binding vote is. Then ultimately, if it's not listened to, shareholders still do have the ultimate of holding directors accountable on re-election in any event.

MR BANKS: Just coming back from a slightly different angle to Robert, I mean you were saying that the board wouldn't really know what was wrong with the remuneration policy because some investors might just like one bit and some might another. But surely - particularly under the 50 per cent threshold you're talking about - you've got some pretty big institutions that are unhappy. After the first strike presumably there would be some pretty intensive discussion going on between the board and the institutions.

MR MORROW (KPMG): The danger would be certainly if you had a threshold that was lower than 50 per cent that would be, you know - if you had a 25 per cent, for instance, for that re-election that would be more dangerous with different elements coming through. 50 per cent certainly reduces that risk.

PROF FELS: I suppose coming at it from another angle, not so different from what Robert is saying, that it seems to me that the two strikes is giving a lot to boards. In business if you make a mistake you're normally out. Now, the boards, under the two strikes proposal they get two warnings and then after that there's an election. That could be two or three years before anything happens. That's not a bad deal, the two strikes, but then if you add to that, the second one is 50 per cent, well, we're hearing from many people this emasculates them. It will have no impact. It's about as likely as a lightning strike, according to one of the submissions.

Aren't we, under the two strikes - with the second one being 50 - making it just too easy for boards? Why not just have a one strike 50? Wouldn't that make sense? People would know what they're doing. You can go straight to it instead of this huge delay and frequent votes and uncertainty that we're hearing about, going on and on and on. Give them a 50 per cent vote once up-front.

MR MORROW (KPMG): We wouldn't agree that that would be appropriate at all on an issue of this nature.

PROF FELS: Well, that's another point. You're saying that it shouldn't be overemphasised, the importance of remuneration, but you've also mentioned that there have been a lot of votes latterly about it. The shareholders think it's important; boards may not. Shareholders seem to think it is quite important. Should there not be some acknowledgment that even if boards think there are other things more important, they're going to get a consistent knowledge from all non-shareholders that a remuneration soft spot and the principal agent relationship does deserve special attention, and we're hearing from the community, determining that's one of the reasons why obviously there's a reference to the Productivity Commission. So should we be dismissing so quickly the idea that remuneration is not as important as being made out?

MR MORROW (KPMG): I don't think anyone is dismissing it quickly, Allan, given the time that many of us have put into the Productivity Commission's hearings. I think the point I was making earlier, if I can just reiterate, is that boards have taken on board very seriously the voting of shareholders and remuneration policies have been changing and I think we will continue to see them changing, particularly as we go forward. Much of what we have seen in the recent round of voting, of course, was remuneration decisions that were set before July 2008. That's only being reported on now. As we go forward to the 2010 reporting season we'll see the decisions of boards that have been now and that's reported on then. I think we will continue to see that evolvement of the impact or the import of the non-binding vote and how we always have been listening.

MR BANKS: Thank you very much for that. We appreciate it. We will just break for a moment before our next participants.

MR BANKS: We will resume now, and our next participant this afternoon is Regnan. Welcome to the hearings. Can I ask you please for the record to give your names and positions.

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

MR BRISCHETTO (RGRE): Nicholas Brischetto, manager, corporate governance.

MR BANKS: Good. Thank you very much for attending these hearings and equally you were strong participants in the first part of the process for which we thank you as well and we give you the opportunity to make some of the main points you want to make.

MR MATHER (RGRE): Thank you for the opportunity to revisit the issue and for the consideration of the points of view put forward. There are really only four very brief points before discussion. We support the position you've taken on the no vacancy rule, as a matter of fundamental principle, and we strongly support the recommendation to remove cessation of employment as a trigger on tax. We support that with a qualification that we don't agree with the position of seven years in relation to the maximum term. We believe that's acting against the interests of long-termism and fetters the ability of directors to asset liability match as they award remuneration - thinking of long-term projects, such as mining projects. Shareholders may be exposed to a risk of performance that may take much more than 10 years to appear and so seven seems to be an arbitrary number when viewed through that lens. Finally, on the two strikes rule we support the rule, and in terms of your consultation our response on the second arm is that the materiality of causing a spill of the board ought to be a 50 per cent threshold with one caveat: we regard the managing director is appointed by the directors and therefore should not be subject to that particular aspect.

There's one other curiosity and that is that our understanding is that in the normal course of meetings of companies is that the board will re-elect the directors first as a matter of course and then, second, receive a remuneration report. You might have the result in some companies where the directors are reappointed, then you have the second arm being triggered and therefore which board is going to be up for re-election under the second arm - the board who has just been re-elected or the board who were presiding at the time when the remuneration was delivered, that is the subject to the report.

PROF FELS: Can you see any way of getting around that problem?

MR MATHER (RGRE): Perhaps it would be better to have the remuneration report received first and then an election of directors subsequently.

PROF FELS: Yes.

MR MATHER (RGRE): Those are our brief opening comments.

MR BANKS: Thank you for that. One of the recommendations you actually supported and didn't mention then but it was the end of the no vacancy rule. It is one where we have had some opposition from others. I don't know whether you might want to comment on that. Some have argued that the practical consequence of it would defeat the purpose in the sense that you would have pre-emptive action by the board in one way or another that would see the latitude for elected directors that weren't endorsed by the board being diminished. Have you got any thoughts in that area?

MR MATHER (RGRE): We recognise that it's open to abuse that the board keeps changing the rules in relation to these things as a matter of practice or amends its constitution et cetera. The main thing from our perspective or from a shareowner's perspective is that at all times the board must go back to the shareowners and seek their consent in order to act and that's what our understanding is of the proposal that you've put forward. We can understand why some people would be unhappy about that because there would be full transparency in relation to the process and there would be consultation with the shareowners.

The fact of the matter is that it has been used conveniently in some perhaps limited number of circumstances, but where that no vacancy rule has been used in order to make it more difficult for candidates to present themselves to the board with the prospect of being elected, then that is a very serious issue. The serious antidote to a serious issue is to take it back to the shareowners to ensure that they're informed. If the shareowners consent to the board behaving in a manner that would be inconsistent with sound governance then the shareowners only have themselves to blame.

MR BANKS: Another point that has been made as a practical point, I guess, is the very low threshold in Australia compared to other countries for nominating oneself to the board. Some have argued that if you had something like this to stop frivolous or vexatious nominations that you would want to raise the hurdle perhaps to 5 per cent of shareholding or some other threshold like that. Do you have a comment on that?

MR MATHER (RGRE): I don't think we have the data in front of us - I mean, there is the hundred shareholder rule or 5 per cent - and we're not aware that boards have been inundated with all sorts of vexatious and radical proposals. If there were some that did occur there is no evidence to suggest, as a matter of economic ruin, that a ridiculous proposal from time to time is going to result in ridiculous outcomes. Shareholders have demonstrated for quite some time that they are very conservative and quite reasonable in considering proposals that are put forward to them.

In terms of whether the no vacancy rule is going to open up a floodgate of stupidity in terms of nominations, we see no evidence for that. The other thing is that we're very confident that institutional shareowners would not tolerate that in their voting processes and the issue would sort itself out pretty quickly.

PROF FELS: On the two strikes conservative attitudes, it may be that every director is up for election after a second vote of whatever size but it would be a single vote for each director. Is that correct? You wouldn't have a vote on whether the board as a whole goes after the second vote. You would then proceed to an election where each individual position is up for vote. You might say, "Well, actually I am a member of the board and I would like this person and this person to have an opportunity," or vice-versa. We're hearing that it would be destabilising but would it necessarily be destabilising as long as the votes are on each individual person?

MR MATHER (RGRE): It's difficult to understand the argument that that process is going to be destabilising if you look at the transaction in its entirety that the board has already faced a 25 per cent no vote knowing beforehand the consequence of these issues. Then they have had 12 months to come back to the shareholders, and having failed to satisfy the shareholders have then faced a 50 per cent threshold and then they have to go through the process of having a further election. This idea that all of a sudden you wake up one day and you have this incredibly destabilising event in our view is a very difficult one to agree with.

What we would see is that the process is a destabilising one, but the wonderful thing about what you've proposed in our view is that in fact the boards of companies are given an enormous number of opportunities to rectify their shareowner dissatisfaction with what they have proposed. I think that those last words "with what the board has proposed" are very pertinent. It's only a few years ago when we also had "the sky was going to fall down" because we were going to have this non-binding vote and corporate Australia was going to be brought to its knees and it was going to be enormously difficult and it in fact has not turned out to be the case. The non-binding vote has engendered a lot of positive engagement and boards have been very responsive to shareowners' needs, not as responsive as some might have been, but a number have been improving their behaviour at engaging and they have learned, and they have learned because there have been increasing consequences for not behaving in that way, so the discipline has worked. We would see it would work in the same way.

PROF FELS: Just on this theme, we have heard so many comments about this rule.

I mean, the first reaction which is kind of, I think, what you were saying but just to say it in other words, the first behavioural response - it's not destabilisation for the votes - is that presumably it will be more careful about setting pay. That was the big behavioural response. You might then go and say, "Well, if they're not more careful about pay it might trigger a second vote. It might even trigger a spill with some people on the board losing their position." Even in the extreme there might be a lightning strike and the whole board - but I assume the first behavioural response to note is there would be more caution about executive pay. You have sort of said that.

MR MATHER (RGRE): And communication. Sometimes in our experience boards do things for quite sound reasons but unfortunately they can be rather ineffective in their communication as to those reasons. Sometimes they assume knowledge; that is, "We thought you knew we were doing that" type concept. In a lot of cases we find that the board explaining things to us through an engagement process is very helpful to understanding the reasons behind the facts. So all we see is the process you've proposed will further that behaviour and it should become the norm rather than the exception, and we would put to you that today it's the exception.

MR FITZGERALD: One of the comments that was made by the previous participants KPMG - and has been relayed to us in other fora - is that there is a risk of boards spending too much time on remuneration. It has been put to us - and it's in the submission put this afternoon - that our two strikes proposal, even with a 50 per cent threshold, will in fact inappropriately distort the amount of time that boards are spending on this particular issue. As I said it has been raised by a number of people to us already and I'm sure it will come through in other submissions. How do you respond to that particular point?

MR MATHER (RGRE): Again our response would be that it's a curious observation because it seems to assume that the issue of remuneration is not the focus of some considered attention and has been for some years. Every board is aware that this is a concern and would have to be through the non-binding vote. To say that all of a sudden this is going to impose a great deal of cost is very difficult to understand given where we're already at. What we do see is that it provides a mechanism for the shareowners to be more active in response to widespread satisfaction, as opposed to narrow views on remuneration, and to do something about it, and I think that's the key issue. Therefore, the fact that shareowners now actually have a greater means by which they could do something about it, is probably the real reason for which there is opposition to the proposal.

MR FITZGERALD: The second related point that was made again this afternoon - but it has been raised previously and I'm sure it will be again tomorrow - is this issue that the vote is a binary vote, it's a "yes/no" vote. So if you're putting at risk potentially the whole board or significant portions of the board one is unable to actually work out what is the concern by shareholders. You might get a 50 per cent or a 25 per cent vote but they will be voting on different aspects. One of the reasons people have been cautious or if not opposed to our proposal is that you actually don't know what the area of concern might be and therefore it's a very blunt instrument.

MR MATHER (RGRE): Is this in relation to the two strikes rule?

MR FITZGERALD: Yes, the two strikes rule.

MR MATHER (RGRE): Again the proposition that's put forward is one that we struggle to understand because it seems to assume that for three years there will be no process of communication; for three years there will be no discussion and sounding out; for three years nobody will have a clue what anybody else is thinking about, and roll up to a meeting and all of a sudden cast your vote with your eyes shut and your fingers crossed. The world does not work that way. What happens in practice is that when there is a vote or even a concern in relation to remuneration - and many, many chairs of usually the better boards do have a practice of sounding out the major institutions in advance of their thinking about, "Well, should we construct our remuneration in this way or that way?" and that process usually identifies - certainly chairs and remuneration committee chairs relay this to us - areas of concerns in advance and they are either taken into account or a board will implement a particular strategy in the face of that consultation, but oftentimes they will explain their reasoning in a more effective manner.

So the proposition that has been put forward to you would seem to us to assume that what happens on a day-to-day basis today would not happen going forward, and we find that a very difficult proposition.

MR FITZGERALD: Just on the third aspect, you've chosen the 50 per cent threshold for the second strike as distinct from a lower percentage. Can you explain to me why you think that's the appropriate threshold for the second vote?

MR MATHER (RGRE): The 50 per cent threshold in the second vote is really just recognising the materiality of what's being put forward which is a vote in relation to a spill of the board and therefore given that you're going to require a 50 per cent vote in order to remove or to re-elect a particular director, then we believe that it's appropriate to have that aligned, as opposed to a lesser threshold. Again it reflects a sensible and conservative approach by shareowners, as opposed to some sort of radicalism or a remuneration jihad which is not what shareowners are looking for at all. All shareowners are looking for is a sensible mechanism - and the 50 per cent majority means that it's far less open to any particular abuse which is the fear that many obviously put forward to you.

MR BANKS: Would it still nevertheless up the ante for directors or boards to think that you've had that second strike even with a threshold of 50 per cent?

MR MATHER (RGRE): There's no doubt that boards are going to get the message and it's going to provide a tool, and certainly a tool in order to exercise shareholder concern. What has been put forward to us with some concern is the behaviour of the institutional investors as a species that a lesser threshold might in fact engender an inappropriate level of conservatism; that is, "I am concerned but I don't want to be the tipping point because it's such a low threshold." On the balance of those issues again we would favour the 50 per cent rather than a lesser threshold that somehow had a perverse effect of preventing or dissuading people, investors, from casting their vote.

PROF FELS: As we were discussing with the previous witnesses, that's making it easy for the board. The common reaction is really the second 50 per cent emasculated the whole thing. I mean, that's a pretty wide view that you air. As to tactical behaviour and so on, you hear a million stories about what a board can do when there's a 50 per cent threshold. It can block anything with that. So it makes credibility. Really the board is better off - more bites of the cherry, you know. There's the first vote and then there's a second vote and then there's an election.

Shouldn't the proposal, if it's to have an impact, have a bit more to it than you jump over one hurdle and another and still there has to be a 50 per cent vote, and then after that there's an election of each single director. There seems to be an enormous number of safeguards in it. Maybe the medicine should be a bit stronger, either a lower threshold on the last vote or just one vote of 50 per cent and that triggers an election. This is a pretty common reaction that people have to this proposal.

MR MATHER (RGRE): We would agree with you that it's a very reasonable and measured proposition and hardly one that is radical or unfair, but we would be of the view that that accords with what shareowners are looking for. They're not looking for an execution style retribution of company directors, they're looking for a means by which when they really are dissatisfied there is a process that they can pursue and that also there's a strong safeguard to ensure that it not be dominated by one particular small interest.

From that perspective it's difficult to see how this is a threat to any organisation other than an organisation who really chooses to thumb its nose at shareholder interests, despite very clear signals from shareholders, and a board that has behaved in that way is probably likely to get that 50 per cent threshold and therefore be put up for election. That would be our support for that and again what you have proposed is a very measured approach and one that's difficult to see significant consequences to fear unless you are a board who not only has, one, a poor remuneration governance process but, secondly, is unable or unwilling to communicate your governance or change your governance and, thirdly, chooses to ignore the consequences of steps 1 and 2.

MR BANKS: I think you indicated in relation to our draft recommendation 2 about rem committees having at least three members, all of whom are non-executive directors, and that was for the ASX 300 as an ASX listing rule, but that might be cutting too deep and it should be brought back. I wondered whether you might just want to elaborate a bit on that.

MR MATHER (RGRE): It's a good question because when the implementation review group at the ASX Corporate Governance Council looked at the issue of audit independence it chose the 300 threshold because that was the typical cut-off for institutional indices, a point at which typically a company would have automatic purchasing of its shares and therefore a significant benefit by having automatic purchasing of stock.

The issue there was the auditor is appointed by the shareholders and reports to the shareholders, whereas the issue of the remuneration is perhaps not necessarily of the same order of magnitude. We've had feedback as well that some of the committees might be difficult to achieve. Certainly it's not an issue that we would die in the ditch in relation to, but from a commercial perspective the observation that we bring forward is that perhaps it might be better to have 200 as the threshold and then an if not, why not beyond that.

MR BRISCHETTO (RGRE): I think particularly the concern in that 200 to 300 band is where you've got quite small companies and for a prospective miner, for example, you might have a board of three directors in total, not all of those who would be independent. So in those sort of circumstances that's where we saw difficulties in actually implementing a majority independent remuneration committee.

MR BANKS: On this question of independence, there's been questioning about a threshold for that and it's not set in concrete obviously but we propose using the definition of the ASX Corporate Governance Council. I just wonder whether you had any comments on that in relation to the specific matter of remuneration, what you would see as the most important features of independence for that purpose. You might want to take that on notice, but it's obviously an issue, it's one of the details that we have to think a bit more about.

MR MATHER (RGRE): We might take that on notice. Independence is notoriously difficult. It's the independence of the minds, not the independence of the form that is critical. But we might take that on notice and respond if we could.

MR BANKS: That would be helpful. That leads in one sense to this issue about the rem report and who it should apply to. We, as you know, have recommended that it apply to key management personnel. The question for us is whether or not - and we may have even raised this in the first round of hearings prior to the draft - whether or not that should be further narrowed in terms of detailed reporting. There has been a number of propositions put to us that shareholders really are only concerned around the CEO, perhaps the CFO and another managers that are directors, but beyond that they really have no interest. I just want to get your sense as to whether or not when one could in fact restrict the detailed information to a smaller group of key management personnel and still achieve what shareholders need to know or whether there is a requirement to maintain the detailed level of reporting in relation to the whole of the key management personnel.

MR MATHER (RGRE): Do you have in your mind what that narrowing might be?

MR FITZGERALD: There is a proposition that in fact in relation to all but the CEO and the CFO you would talk about them as a composite group and that only the CFO and the CEO would be individually detailed in terms of their actual performance hurdles and the arrangement. Their view is that the only people that are really of interest to shareholders should be those that have the most significant management roles and that's the CEO and, at a push, the CFO.

MR BRISCHETTO (RGRE): I just want to offer an observation; Erik can probably answer this better. When we assess the corporate governance structure and remuneration of company, one of the things that we often gain value out of is seeing the differences between how the CEO is paid and how other key management personnel, so both in terms of pay levels and the kind of hurdles that are put in place around the incentives. So I think if we were to lose that ability to compare CEO's pay structure relative to other key management personnel then from a corporate governance perspective we may not be in the same position to gauge the strength of governance and just exactly what kind of remuneration plan they have in place.

MR MATHER (RGRE): I think, speaking candidly on this issue at the moment, there are not sufficient boards who - I think institutional shareowners, particularly the super funds that we work with, would feel that the boards have earned the trust to have that anonymity and that that trust would not necessarily be abused. I think that is the real issue at this point time. As Nicholas has pointed out, that perspective that you can gain from seeing multiple measurement points is quite helpful. My personal opinion is that that would be a helpful thing at some time in the future, that at the moment corporate Australia has not really done enough to earn the right to have that mechanism you're talking about. As much as there is all the ratcheting effect and everything else put forward to us, certainly our take is that institutional shareowners would be unhappy to lose that granularity at this time.

If you did choose to go down that path, then we've previously submitted a model that we think would solve 80 per cent of that particular problem through the use of equity as the main form of alignment because then it wouldn't matter what anyone is paid, they're going to go up and down like the rest of us as shareowners.

MR FITZGERALD: Thanks. One of the other issues that's emerged again, I suppose, to some degree is whether or not we need to develop a code of some description, we being somebody, not the Commission itself, that would be applied universally to give guidance in relation to the way in which remuneration is set. Currently, a number of bodies have different codes and guidance. People are still urging us to look at whether or not there should be a code developed, either through Standards Australia such as the standards they've actually developed for risk and so on, or through some other process. I was just wondering what's your view about the benefit or otherwise of that.

All we've done in our report is provided a checklist of things that boards should give consideration to in the establishment of remuneration packages. But is there a need to go beyond that to some sort of code, largely developed by the various key players, but some people have suggested through like, for example, Standards Australia or another mechanism.

MR MATHER (RGRE): I don't think we have a particular view in relation to that aspect. Our remit is ASX-200 companies as an institutionally owned organisation and that's the universe of our clients that we look at and therefore the ASX Corporate Governance Council principles are the ones that we rely upon. We would certainly not oppose the granularity that you're talking about which is principles based really, the sorts of things that you think ought to be considered and in our view there is quite an overlap with the ASX Corporate Governance Council already.

Companies are yet to come to grips with the idea of a commonsense approach to explaining their governance as opposed to a compliance-driven formulaic approach so this would all be helpful. Where you do it, don't have a strong view but it certainly would be encouraged.

MR FITZGERALD: The ASX governance arrangements themselves, I was just wondering, in some of our recommendations we've indicated that our proposals should be embedded in the Corporations Law, some in ASX Listing Rules and some with the ASX Governance Council. At this stage obviously we have no clear view from ASX or ASX Governance Council as to whether they agree with any of our proposals. In the event that the ASX Governance Council were not to agree to these proposals, what's the best mechanism to deal with that, do you think, going forward?

MR MATHER (RGRE): If you didn't have the support of the corporate governance council, then the Corporations Act would be the quickest and easiest way to ensure that these issues that you're looking for - for example, even your code that, "Each company should report on these following issues as a minimum," would therefore require that to occur. It would just take a little bit longer than working through, for example, the council perhaps.

MR BANKS: I suppose the only one - and you've obviously been advocating it strongly and just to give you the opportunity to talk a little bit more about and that is the seven years versus 10 years and just how much difference it would make in practice and whether in a way your primary recommendation relates to the taxation of employee share schemes as well, where you've got the seven-year time frame that we've essentially hitched our own recommendation to for consistency there. So it may be arbitrary, but it's an arbitrary peg that already exists in a sense. But do you want to just comment a bit more on that?

MR MATHER (RGRE): Yes. We are of the view that given what we have been seeing post the global financial crisis, one of the ways that shareowners can address the problems that have emerged is through a better alignment of reward and given the significant investment that's made by superannuation funds every day into Australian companies for the long term, the greater the long-term alignment with corporate executives in the long-term skin in the game, the less will be the concern with remuneration. It's not a perfect device but it's a lot better than the status quo where even your own report identifies that three years is the typical long term, and for young people like us, superannuation is a 20, 25-year proposition, so therefore paying in these three-year segments has been recognised as suboptimal.

Talking privately to companies, often that observation is made, that in terms of asset liability matching, a company strategy will rarely pay off. If it's a decent strategy, rather than just an opportunistic moment or a bit of luck, quite frankly, it's really going to pay off in the next 12, 24 months. A lot of these things take years to build through. We give the example of mining as an example, whereby it can take a significant number of years before something comes on stream. The risk of that, if an executive is paid significant bonuses because of the idea as opposed to the delivery, then all the reward goes to the executive and all the risk is borne by the shareholders, as we've explained to you previously. So given what we've seen and with lending practices in the financial services sector, but more overseas than here, with a mismatch between risk and consequence, then the notion that we should in this environment be moving to constrain to the shorter end the period over which remuneration should occur seems counterintuitive. If ever there were a time when we should be putting skin in the game for the long term, including post-departure, now is our opportunity. We do feel rather passionately that we seem to be coming headlong out of the GFC and the only thing that's going to have occurred is that we will have successfully moved more short term than long term.

I understand that you're seeking to align with the existing policy but in the independence of the Commission, if the existing policy promotes a shorter-term consequence, then we struggle to agree with that. In fact our view would be that boards should be unconstrained in terms of the period over which they should align, and they should align based on asset liability matching with their corporate strategy, but if they did feel the need to be constrained, then at least go for something closer to 10 years, rather than the seven.

MR BANKS: If we think about post-termination, I suppose there's a couple of considerations. One is, as you say, some investigations might take up to a decade for you to know really whether they've been judiciously entered into or not, so that would argue in favour of a long period; on the other, a CEO who leaves his fate in the hands of the successor within a 10-year period could find all sorts of decisions being made that impacted on the value of the shares, if that's the skin that's left in the game.

MR MATHER (RGRE): You mean so that they would be in the same way as a superannuation fund who is also exposed over those 10 years?

MR BANKS: That's exactly right.

MR MATHER (RGRE): Sorry, I'm not trying to be cheeky but it is farcical that there is a reverse burden of proof; that all of a sudden, the share-owning community, bankrolled by the superannuation funds of Australia, who are every week putting in a significant amount - I mean, the latest calculation was about $33 every week every working Australian puts into the Australian top 200 listed company shares - that all of a sudden the sky is going to fall down because the chief executive is going to depart and it would be unreasonable to expose them to the same risk, and all these people who have been benevolently buying his or her shares day in, day out, and supporting, on our calculation, in the last four years of the bull market, 20 per cent of the growth in market capitalisation. So having these people sweat on the future of the company in the same way as we do we think is a wonderful thing and if they think that's problematic, then we would say, "Well, welcome to our world," because that's the reality.

Now, despite being passionate, we are also very reasonable people and in the same way as in corporation transactions you have change of control provisions in contracts, there are all sorts of ways where a board could reasonably contract for contingencies that could occur. I just draw your attention again to if we do not act in this particular way, then organisations like Regnan and other shareowners will be forced to go out and tap on the door of every single one of the chairs of Australian companies and say, "We're not happy with what you're doing and regardless of the cessation of employment, we demand that you put in place a remuneration system that has serious risk of forfeiture and then you're going to have to trail off to the Tax Office and you're going to have to get a public tax ruling in relation to the remuneration system and you're going to have to do it one by one, and the government is going to have to reinforce the policy-makers at the Tax Office because we're going to encourage that they be snowed under with applications," because our understanding is BHP Billiton has done that and done that successfully and Chip Goodyear, as is our most recent understanding, has still not received his final bonus because the five-year total shareholder return has not yet been calculated. He's out there with the same skin in the game as I have in my superannuation fund and most people have in their superannuation fund and we think that should become what everyone is doing, with limited exception on merit base, rather than the exception that thankfully the board has put in place a good long-term system and that board has the complete discretion to remove any bonuses for a unilateral discretion exercise by the board.

MR BANKS: We agree on the principle and it comes down to the seven versus the 10 in sort of practical terms going forward. That's really where the consideration lies with - - -

MR MATHER (RGRE): We understand that the issue may or may not relate to revenue and that requires all sorts of sophisticated modelling. If you balance all of these sorts of issues, and if we're really interested in driving an economy that's going to perform over the long term - and, I might add, giving executives an incentive to invest in pay-off periods that are going to be 10 years or beyond - then it would make sense to not put a seven-year impediment just to grab some near-term cash, remembering that for the company that's successful in all of this, the executive is investing future tax payments that will grow in an equity environment as opposed to consumption, where the government may own a little bit of GST but it does nothing to align long-term shareowners, and we are closer to revisiting the misalignment of risk than the other case, whereby we've created a longer-term platform. So whether it's seven or 10 years, we think it should be longer, not shorter, and we see that it's a perverse outcome, given the whole reason for this inquiry, that we're in a situation where we're facing a shorter limit to rewarding and aligning over time than what we started with.

MR FITZGERALD: I've just got a couple of questions. Just in relation to the current reporting season, we hear that the current reporting season will not be reflected again next year. In other words, we're seeing a consequence of remuneration packages that were developed almost pre the global financial crisis and that next year we'll actually see that companies have taken on board the concerns of shareholders and it will be a different picture. Of course we have not yet got a clear understanding of what's happened in the financial year just ended, we're waiting to see that, from organisations like yourself and others. But I'm just wondering what is your take on the current reporting season and what we're seeing in executive remuneration this year and what it's likely to be next year, not in terms of dollars but just in behaviours.

MR MATHER (RGRE): Our observation would be that the fact that you're seeing this slow, very lagged change in behaviour is testament to the fact that the entire remuneration system is wrong, and the reason it's wrong is that the system of reward is not adjusting in line with the cycle. What's happening is that boards are sitting there listening for the outrage factor and when the outrage factor reaches a certain arbitrary level, then there's an adjustment to deny bonuses or whatever it might be and the only report that we have seen whereby the system delivered much lower reward because the shareowners had a much lower reward because the profitability was much lower was in fact Macquarie Bank, whereby they reported results, and next year, based on what we understand of the Macquarie Bank model, we will see the executives at Macquarie Bank earning a lot more, and so they should. The share price that we all earned in our superannuation funds was 15, 16 dollars earlier this year. It's now a significant multiple of that. Therefore, the value has been restored to some degree, compared to what it was previously. But we don't agree with this arbitrary, cut the remuneration by 5 per cent or 10 per cent or whatever it might be as an ad hoc response after the event. What will it be next year, who knows?

Certainly it seems that we're going back to the good old days very, very quickly, and again it will be an opportunity lost if we don't build in a systematic approach to providing the alignment. Again the opportunity for directors is still before them to do that.

MR FITZGERALD: The second thing relates directly to advisers. It has been put to me in the last few weeks in presenting and briefing people on these findings that there have been some directors in particular that have voiced concerns about the behaviour of proxy advisers themselves and whether or not there needs to be some constraints on their own behaviour. Now, this always arises with consultants and advisers and some people suggest there needs to be some sort of codes that governs this space.

I might say I don't think any of us are wedded to the notion of codes for advisers or consultants, largely on the basis they're impractical, even if you can work out what to put in them. But is there a risk in this advice that advisers themselves become part of a problem in this whole remuneration area, either in distorting the voting patterns of shareholders, using them for proxies for other purposes other than real concern about remuneration? I just put that to you.

MR MATHER (RGRE): First of all, we do not do proxy voting as a matter of course and we have no business plans to go down that path. We do subscribe to proxy voting advice and I have to say as a user of a service if I was corporate Australia I would be backing the proxy voting advisers because the stuff that we see we oftentimes do not agree and we feel that they are very measured and conservative in relation to their behaviour. The other thing is that none of our clients that we are aware of will automatically buy the advice of the adviser. We have conversations with our clients in relation to contentious issues where they will say, "Look, have you got a view?" but they make their own mind up, and I'm not aware of any of them ever advising us either of what their intention is. I think that's where that's at.

Again, I'm not aware where a board has a reasonably argued position and has communicated that effectively. You've only got to make two telephone calls to the major proxy voting advisers, or two proxy voting advisers and then a council of super investors and in three calls you can canvass pretty much the whole market. Given that that's so easy it's very difficult to understand that it would be impossible to find out what their views are and impossible to engage. In our experience they have all been very reasonable and will always take a conversation on the issues. I don't think a code would achieve very much.

MR BANKS: Thank you, gentlemen. We will break for a moment before our next participants.

MR BANKS: Our next participants today are the Institute of Chartered Accountants of Australia. Welcome to the hearings. Could I ask you please to give your names and positions.

MS HICKS (ICAA): Kerry Hicks, head of reporting.

MR EL-ANSARY (ICAA): Yasser El-Ansary, tax counsel.

MR BANKS: Thank you very much for participating and for providing the submission which we have just got - we may not have fully absorbed - and we'll give you an opportunity to raise the key points.

MR EL-ANSARY (ICAA): Sure, thank you. Thanks, chairman. By way of an opening statement, if I may, firstly, I'd like to start by thanking the Productivity Commission for the opportunity to appear at this afternoon's public hearings. In this brief opening statement I would like to describe the role of the institute and walk the commissioners through some of the high level points that we have set out in our submission dated 6 November.

Both Kerry and I are, of course, happy to answer questions during our appearance this afternoon on the points that we make in our submission. Turning now to some brief background information about our organisation, the Institute of Chartered Accountants in Australia is the professional body that represents chartered accountants. We represent over 50,000 chartered accountants, predominantly based in Australia. The institute is also a member of the ASX Corporate Governance Council. Our members work in diverse roles throughout the economy, spanning public practice, commerce, academia, government and the non-profit sector.

The diversity of our membership means that the institute is well credentialled to be able to offer independent and expert advice to key stakeholders on a range of matters of public policy and importance. Today the intersection between accounting disclosures, governance and taxation policy represents a great illustration of how organisations such as ours can bring together a mix of skills and expertise to make a valuable contribution to the furtherance of this debate.

At the outset, it is worth noting for the record that the institute is generally supportive of the direction adopted by the Commission in its September 2009 draft report. It goes without saying, of course, that the key issues that are the subject of this inquiry are of vital importance to not only corporate Australia but also to senior management personnel who make significant contributions to those businesses, sometimes with great personal sacrifice; the shareholders to whom they are accountable and, of course, the community at large.

It is therefore important that decisions made as part of this inquiry are taken with the benefit of having access to all relevant information pertinent to the debate. The advent of the global financial crisis has certainly highlighted the importance of transparency in business dealings. In a free and open market economy, such as the one we enjoy here in Australia, information and knowledge are the foundations upon which important decisions are made.

The recent economic downturn and the consequential loss of employment for many thousands of workers across Australia further highlights the gravity of these decisions and the difficulties and challenges within which some businesses must operate in order to merely survive and fight another day. That said, the institute believes it is also appropriate to acknowledge that even though there has been much doom and gloom commentary and significant public debate about matters, such as executive remuneration, fundamentally the structure of executive remuneration in Australia is not broken. Had the executive remuneration framework in place in this country been significantly different, the current state of our economy may well have been very different indeed.

As with all regulatory regimes, improvements should always be welcome. However, in the case of executive remuneration the institute's members support changes that can be directly attributed to enhancing the understandability of disclosures and which best aligns best practice, corporate governance standards with taxation policy outcomes. Symmetry between governance standards and tax policy settings whilst logical has to date been somewhat of a mirage. It is now time for that aspiration to be met head-on.

Central to a debate, such as this, is the need to ensure that any new regulatory requirements are measured with equal doses of practicality, acceptable compliance costs and usefulness. In an economy, such as Australia's, striking the right balance between interventionist policies and complete free market economics is a perennial challenge, and over the coming months and years this challenge is likely to be greater than ever. Against that backdrop it is pleasing to see that the Commission has to this point taken a considered and measured approach to the recommendations contained in the draft report. Whilst other organisations, I'm sure, who will appear before this Commission during these public hearings will provide other expert advice on certain other aspects of the draft recommendations, the institute commends the work of the Commission insofar as it relates to remuneration report disclosures and taxation policy.

I would like to turn now to two key topics that are the subject of the institute's 6 November submission in response to the draft report. Firstly, our submission highlights the institute's view of where further opportunities exist for the Commission to address the very real policy concerns we have identified with the proposed new tax laws that will apply to employee share schemes from 1 July this year. As the Commission will undoubtedly be aware, the institute has been a leading adviser to the federal government and public debate over recent months during the course of this long-running dilemma.

Whilst the government has adopted some of the institute's key recommendations over the past few months, others have not yet been adopted as part of the new laws currently before parliament. Whilst the institute is considerably more comfortable with the proposed new tax laws than was the case on the night of the 12 May budget announcement, two residual areas of concern remain in relation to the current tax policy settings. Further discussion of these two points will follow shortly.

Secondly, our 6 November submission to this inquiry has put forward some suggestions for how improved remuneration report disclosures could be achieved in the future. We believe the proposals set out in our submission strike the right balance between delivering better and more comprehensible information to shareholders and other stakeholders, whilst keeping a tight rein on compliance costs. Again, further discussion of these ideas will be led by Kerry shortly.

Finally, in summing up the opening statement, it goes without saying of course that the institute is committed to doing everything within its power to see through the implementation of the Commission's recommendations in the areas of disclosure and taxation policy once of course the federal government's response has been provided. The institute's role in educating our members and through them the wider business community will form a central plank in disseminating information and ultimately delivering better outcomes for shareholders, regulators and the community at large.

MR BANKS: Thank you very much for that. Did you want to make any further comment?

MR EL-ANSARY (ICAA):   No.

MR BANKS: Thank you. I guess one of the issues I just wanted to ask you about, and we may well have previously discussed this with the institute, but the tax integrity issues that come into play and have been invoked in relation to deferral of the taxing point beyond termination, would you like to comment on those?

MR EL-ANSARY (ICAA):   Sure. This goes, chairman, to the recommendation that's already been made in the PC's draft report. Is that right?

MR BANKS: Yes.

MR EL-ANSARY (ICAA):   Certainly I would agree with the direction that's been adopted on that particular issue. To go back a couple of steps, the government's

1 July 2009 policy announcement about employee share schemes which is the most recent policy announcement of the three that were made consecutively from the night of Budget night to 1 July, whilst fundamentally the government's 1 July announcement is a positive step compared to where we were on Budget night, there were in the institute's view three residual issues of policy concern that we identified at that point. The first of those was the cessation of employment trigger point for deferred taxation. The second of the residual areas of concern relates to the triggering of the taxation point at the time of vesting options and the third residual area of concern related to the $5000 per annum salary sacrifice limit that is proposed to apply to certain share schemes.

So clearly of those three issues the one recommendation centred around tax policy that the Commission has identified in its draft report accords entirely with one of our three residual areas of concern, that being that we have held a longstanding view that cessation of employment was not an appropriate point at which to trigger a taxation liability and that the integrity concerns identified by both the Tax Office and the government to justify the deferred taxing point at cessation of employment in our view were outweighed by the benefits that could be derived to both Australian companies, their shareholders and the community at large by ensuring that executives retained a stake in their previous employer for as long a period as possible.

MR FITZGERALD: I was just going to raise that. Why do you think therefore that the government has persisted with this particular policy? In other words, you say that you believe the benefits of removing termination as a trigger point outweigh the costs. What I suppose I'm struggling with is what are the costs? In other words, what is the issue that's been presented to you by government of concern that's led them to maintain their current position?

MR EL-ANSARY (ICAA): Commissioner, I guess I can only operate on the basis of publicly available information that we have access to in respect of the policy justification, if you like, or the policy objective and as best as I am able to understand, the one justification that has been evident in the government's explanations of that integrity measure centre around the suspicion - and I'll call it a suspicion because I don't have any actual data in front of me to rely on to back this conclusion up - but the suspicion that if tax were not collected at the point in time that an employee or a senior executive left a company's employment, that that executive may well leave Australia altogether and therefore it would pose an integrity challenge for the Tax Office in being able to collect the taxation that is due at some point down the track post their employment. So insofar as I'm best able to understand, that is the only policy justification objective I've been informed of as to why that policy setting in the government's view is the appropriate position to take.

MR FITZGERALD: But your principle goes beyond that, doesn't it? Your underlying principle is that the tax shouldn't be applied until the benefit has actually been realised, so your second point or I suppose really your starting point is the overarching principle is tax should be applied when the benefit is realised, not when the benefit is available to be realised.

MR EL-ANSARY (ICAA): Absolutely. One of the fundamental tenets of Australia's taxation system insofar as it applies to individuals is that the principle of tax after cash holds true in just about every facet of the tax system and this does apply only to individual taxation, not to the taxation of businesses or corporates generally which operate under a different regime. But the principle of tax after cash, as the saying goes, I guess, is based on the fact that an individual should be liable to pay an amount of tax only at the point in time at which they have derived some cash gain. Indeed, if you look at almost every other aspect of the individual tax system, whether it's salary and wages, whether it's the taxation of capital gains, whether it's the taxation of income from activities such as rental properties, all of those instances give you a result where taxation is levied after the point in time at which the cash is actually generated and received, not at a point in time when the cash has not been received but there is some legal entitlement or equitable entitlement to receive cash.

It's a fundamental policy principle. It's important for a variety of reasons but the key reason however is that imposing tax at that point in time just makes sense. If an individual has received a cash gain or has received cash remuneration, then they have the cash, therefore ipso facto they can pay the tax. If they don't pay the tax, then obviously they should be subject to the normal collection and debt rules that would apply under the tax rules in order for them to pay that tax liability. But at no other point in the individual tax system is there an expectation that an individual will be required to fund tax liability, and I might add potentially a considerable tax liability as well, depending on the value of the remuneration provided. In no other part of the income tax system is an individual required to pay tax at a point before they have received that cash benefit.

PROF FELS: There's hardly a word that I would disagree with in what you've said as an accurate statement of the way the law works on personal tax. It's also true, isn't it, that under that system, the individual gets a benefit from the deferral of tax and that a fair system would maybe conceptually include some tax on the benefit they have achieved by deferral or the detriment if it goes the other way.

MR EL-ANSARY (ICAA): The issue, commissioner, of is there a benefit or is the deferral regime properly referred to as a concession is something that we've certainly grappled with at length over the last few months. Certainly there have been many commentators who have suggested that deferral is a form of concession and therefore a winding back of a concession such as what was proposed on Budget night ought not be met with the sort of resistance that it was met with post the announcement. However, after considering this for a long time and taking a lot of different opinion and advice on this, my conclusion is that the deferral systems is in fact not a concession but it is in fact the most logical and the most practical way in which to impose tax on the remuneration benefit in relation to which there's a degree of uncertainty about its materialisation. So I think it makes a lot of sense above all else to tax benefits in the form of non-cash remuneration in this way because to tax them any other way would bring you back to the debate we just focused on which is around: should an individual be put in a position where they have to pay tax, not only at a point in time before they have the cash means with which to pay the tax, but also at a point in time when there exists a degree of uncertainty as to whether they'll ever receive a cash benefit down the track or not.

So I think ultimately the deferral regime should properly be referred to and should be considered, not so much a concession or a benefit in some way, but as in fact the most logical and practical way to impose tax on this form of non-cash remuneration. Indeed, in many other OECD jurisdictions around the world, a comparable method of taxation applies and it's clear to me that the other jurisdictions impose tax in the same way that we do largely here for precisely the same reason, that it's not a concession, it's not a benefit, it is the most logical way to tax this type of remuneration.

MR FITZGERALD: Can I just move onto the disclosure, if I can, just for a moment. Just a couple of things, the remuneration report itself, you've put forward a recommendation in relation to the way in which actual and realised levels could be dealt but you've also endorsed, I think, what KPMG in their submission this afternoon put forward, that the accounting standard needs to be in fact changed. Can you just explain a little bit further your proposal.

MS HICKS (ICAA): Currently all of our accounting standards in Australia are based on international standards, including the related party standard. Currently the related party standard has the international standard, but attached to the back of it it has these things called AUS paragraphs which are Australian requirements that have been put in, I guess, because historically the law required those type of disclosures and I noticed that one of your recommendations pulled out the recommendation relating to disclosure of individual equity holdings. That's actually in the accounting standard currently and it's proposing to put them up in the remuneration report. Excellent suggestion, however, it just raises the same old question of why do we have all these disclosures in the accounting standard which rightly many of them law requirements, not accounting standard requirements so they should be in the law not the accounting standards.

So the last thing we want to see is duplication between the law and the accounting standards. I suspect that if the accounting standard board was approached that they would be very happy to wipe all of those AUS paragraphs and it's just a matter of the lawmakers working with the Accounting Standards Centre in order to get the right result which is, "Let's make it not complex, not complicated, let's remove duplication and simplify it."

MR FITZGERALD: So just as a layman can you explain to me what's in the remuneration report and what's left in the financial statements if you do that, in brief terms just so I can understand that.

MS HICKS (ICAA): So your remuneration report would be more centred around the components relating to the individuals that you've required to be identified. But as far as - I think you've also mentioned in regards to the share based payment option-type disclosures, all that methodology is all needed for the accounting. That shouldn't clutter up the remuneration report. That's a requirement in a different accounting standard to the one of share based payments. So they should be left in the financial statements, the remuneration report would predominantly be the disclosures related to individual people. So there should be no requirement to put in the accounting standard anything relating to individual executives.

MR FITZGERALD: Right.

MS HICKS (ICAA): So that's how I would try to dissect the two. So the non-duplication is a really good issue and I think it's something that the Commission could perhaps go further - - -

MR FITZGERALD: If we were to say in our recommendations there should be non-duplication, to use your expression, what is the means by which that is achieved? Who in fact achieves this? In other words, who are we making the recommendation to?

MS HICKS (ICAA): You're basically making it to Treasury who determine what's in the Corporations Act and the Accounting Standards Centre who determine what's in the accounting standards to talk to each other to determine a way forward to achieve non-duplication. The Accounting Standards Centre is under the strategic direction of the Financial Reporting Council who reports to the minister, the same minister - - -

MR FITZGERALD: Which is the treasurer.

MS HICKS (ICAA): Yes.

MR FITZGERALD: We're all for non-duplication, if you can tell us how to get there we're be very happy. That's good, thanks. The other comment you have is in relation to remuneration committees. You've made a comment that we should be consistent between recommendations 2 - which deals with effectively independent directors being on the remuneration committee - and recommendation 3. Just explain to me what's the consistency. In recommendation 2 we're trying to get the ASX300 companies only and we're saying that in that group there should be no executives in that committee.

MS HICKS (ICAA): Yes, that's the difference. Whereas in recommendation 3 that refers to the Corporate Governance Council's principles, they don't say there's no executives in the committee, it's a majority of independent directors.

MR FITZGERALD: Yes, correct.

MS HICKS (ICAA): So we believe that the listing rule requirement should use the same language as the council requirement and have the majority.

MR FITZGERALD: Let me just clarify because we may be at cross-purposes. We're trying to say for the top 300 companies that executives should not be on the remuneration committees, end of story. We recognise for the next group down that that may not be practical and so we've actually tried to carve out the top 300 and specifically say: (1) there should be an independent chair; (2) there should be the majority of independent directors; (3) there should be no executives on the remuneration committee. We want to be clear about that. You're not supportive of that?

MS HICKS (ICAA): We're not supportive of that.

MR FITZGERALD: Why is that?

MS HICKS (ICAA): Because even in the 300 there could be difficulties in - especially for companies 200 to 300, whatever cut-off you choose, whether it's 300 or 200, for entities that might be on the cusp and, therefore, go into the 300 one year and might come out another year, we don't think it's practical to suddenly have to change the composition of a remuneration committee because - - -

MR FITZGERALD: If you have any threshold and you may have heard Regnan has suggested that it should be ASX200, not 300. But putting that aside, there's a threshold issue no matter what you do, so you are going to have to have a situation where if you believe there should be a difference - which we do - that you are going to always have a company having to change to meet that threshold. But the real point about our one is simply that the executives can't be on it. Do you believe that that's appropriate for the top 200, that executives should not be on the remuneration committees?

MS HICKS (ICAA): No, we don't support that. There are many areas that a remuneration committee will be involved in, other than just determining a CEO's remuneration or a CFO's remuneration. So there are many areas that that committee will be making decisions on and executives could provide a very valuable input to that process.

MR FITZGERALD: Why do they have to be on the committee? Why can't they just provide the advice? There is a difference, I know it's subtle and I don't think we want to be too pedantic about this, but there is a difference between having an executive on a committee as distinct from executives providing advice to a committee. It seems to me that if you want to avoid both the direct and indirect conflicts of interests, having the executives on the committee poses a problem, especially if you want to take the top end of town groups.

MS HICKS (ICAA): Really we would not oppose an executive being on that committee as long as they weren't in a majority perspective. So we support the majority of independents. We just feel if they're on the committee they will be able to have a better input into the process.

MR BANKS: I guess it's the difference between input and influence that's exercising our minds in this kind of recommendation. It's useful to get your feedback because many others have seen this as appropriate, it's just a question of where the threshold - your concern is partly in principle, partly in practice, whether this would be workable.

MS HICKS (ICAA): That's right, yes.

MR FITZGERALD: The last one we have asked participants, and that's in relation to who should have detailed remuneration disclosure, and we are keen to explore this. Can you clarify your position. As I read it in your letter very briefly, you're saying we should be cautious about restricting down further to the CEO or the CFO in terms of detailed reporting. Why are you cautious about moving to that position, which we haven't yet recommended, I might say.

MS HICKS (ICAA): Yes. We're very supportive of the removal of the top five. It was in our previous submission. The reference to key management personnel, which is an area that the accounting profession has got used to since we've had IFRS since 2005. I noticed your recommendation was either CEO, CFO or something like top key management personnel, whatever you want to call that. As Regnan said earlier, these disclosures are important and any subset of a requirement that has already been adopted as far as accounting standards is liable to create confusion, especially to use a term like "top". CEO and CFO might be a bit clearer, but if you use a term like "top", confusion as to who is a "top", what does that mean? I would strongly advise against those sort of words.

If you were just going to say CEO, I think for the Commission to recommend a substantial reduction in disclosure in that area coming out of this call for increased transparency for organisations as a result of the GFC, I don't think it would be best placed. I think shareholders, investors are interested in that information. They use that information. I think the information lost by not having it would be far too great.

MR BANKS: There have been differences of view. Some have said that the shareholders are not interested in the information below directors and CEO and CFO perhaps. I think your other point, in practical terms, whether you could pull back on something that's already there in terms of the transparency at the moment would be difficult. For each of these things we're trying to take a long view in saying what is appropriate on the merits one way or the other. Anyway, it all adds to the richness of the debate, so thank you for that.

MR FITZGERALD: I want to clarify one thing. I think you've done it before. The terminology "key management personnel" is sufficiently definable to be a reasonable categorisation. Most people have agreed with that but I just want to be absolutely certain going forward that all companies would understand who should be covered by that expression because the accounting standards already require that. Is that the case?

MS HICKS (ICAA): The accounting standards have required it since 2005. The first year or two, like anything new, people were coming to grips with it. We're now 2009, we've applied it for a number of years, so people are very clear who ends up in that disclosure and who doesn't. I guess using terminology and principles that already exist is much more preferable to creating new terminology.

Could I make one point in relation to that. You have proposed to adopt the recommendation regarding disclosure of actual or realised remuneration which is really good to see. I notice in some of the submissions you've already got, there's different ways - because you haven't defined that term - of perhaps getting that term. May I suggest again not to propose something new; to propose something that already exists. The approach we've put in our submission is it should be the value assessed to taxation in the hands of the executive, would be an acceptable methodology. Companies will already have to do that for taxation purposes, so it's not an additional exercise for companies because we're very conscious of not increasing compliance costs in this area.

MR FITZGERALD: I think that's very sensible, thanks for that.

MR BANKS: I'm not sure I found that in your submission.

MS HICKS (ICAA): It's in the second paragraph under Remuneration Report Disclosures.

MR BANKS: Okay.

MR FITZGERALD: I did notice that. I thought that was quite helpful, so thank you for that. We have a few other definitions we might come back to you on, trying to work out what terms we should be using in the final report.

MS HICKS (ICAA): Yes. We would be happy to help you if you want to clarify anything prior to your final report.

MR FITZGERALD: Thank you very much.

MR BANKS: Thank you. That's been very helpful and again we appreciate your contribution to the inquiry.

MR EL-ANSARY (ICAA): Thank you very much.

MR BANKS: That concludes our proceedings for today and we resume tomorrow morning at 9 o'clock.

AT 4.45 PM THE INQUIRY WAS ADJOURNED UNTIL
TUESDAY, 10 NOVEMBER 2009