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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 MELBOURNE ON FRIDAY, 13 NOVEMBER 2009, AT 8.33 AM

Continued from 10/11/09 in Sydney

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MR BANKS: Good morning, ladies and gentlemen. Welcome to this final day 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, chairman of the Productivity Commission and presiding on the inquiry. On my left is Robert Fitzgerald who is a full-time commissioner with the Productivity Commission and on my right, Allan Fels, who has been appointed as a part-time associate commissioner to this inquiry.

As everyone would be aware, the inquiry commenced in March when we received terms of reference. We released our discussion draft at the end of September and we've already had hearings both here in Melbourne earlier and then earlier this week in Sydney. After the hearings we will proceed to complete our report to government which is due by 19 December. I remind you for the record that the hearings are conducted as informally as possible but a transcript is made to provide a public record of discussion. There's no formal oath taking but the Productivity Commission Act does require participants to be truthful in their remarks. Transcripts of the hearings and submissions themselves are public documents and can be obtained from the Commission's web site. Copies can also be purchased and there are order forms available to do that.

To comply with the requirements of the Commonwealth occupational health and safety legislation, I need to advise that in the unlikely event of an emergency requiring evacuation of the building, exits are located outside in that direction and staff will assist you if necessary and indeed staff are here to assist on any other matter that may arise.

Our first participants this morning are from Ernst and Young. Welcome to the hearings. Could I ask you please to give your names and positions.

MR CECCHINI (EY): Bruno Cecchini, I'm a partner and leader of the Melbourne performance and reward practice in Ernst and Young.

MR SADLER (EY): James Sadler, senior manager within the performance and reward practice of Ernst and Young.

MR BANKS: Good. Thank you very much for attending this morning bright and early. I also thank you for your submission, indeed for the two submissions that you've provided, and we've had some earlier discussion as well which has all been very helpful. So as indicated, I will give you the opportunity to go through the main points.

MR CECCHINI (EY): Thank you. Just to start with, I'd just like to compliment the Commission on a thorough and very balanced draft paper and recommendations. It's refreshing to see the amount of work and practicality of the recommendations.

What we thought we'd do is maybe just give you a bit of an oversight of a couple of areas that we think you could consider a little bit further. We've reflected upon the draft recommendations in our earlier submission and we note that many of our earlier suggestions have been included within the draft recommendations, so it's probably just around the edges that we've got some comments.

MR BANKS: Thank you.

MR CECCHINI (EY): The first one is around the reporting and disclosures required for shareholders and the public. We note that many of the draft recommendations are actually to increase the level of disclosure and transparency and we agree that there needs to be greater transparency and it needs to be in simpler language. But we do feel that the length of reports are getting quite lengthy, getting quite confusing, and many of the suggestions that have been made around making it plain English, some companies have attempted that in the last round of AGMs, as we're facing at the moment, and to some extent that has almost confused shareholders further, by having elements which talk about the policy in a plain English format, portray values ascribed to individuals on a value or cash basis, and then you've got the accounting treatment of the rem report sitting there and you've got more confusion arising from that.

What we have done is just make some suggestions around being able to simplify the rem report. We think in essence it could be brought back to about eight pages, focusing on the key elements that we see and we note that many shareholders focus on. So it's building on the recommendations of the Commission but just trying to simplify it.

MR BANKS: Could I ask there: when you said about eight pages, we heard of one company at one of the roundtables we had where they felt they had done very well and produced a remuneration report in five or six pages. Are there other precedents for short, concise, well-structured remuneration reports along the lines that you've set out in your submission?

MR CECCHINI (EY): There are, but they obviously get to a lot more than the five or six pages. To contain a report to five or six pages, it means you're doing just purely compliance aspects of it. You'd be running the letter of the law through it and providing minimal explanation and rationale around not so much what the intent of the policy is but why decisions have been made in the way that they have. So like I said, some of the companies have attempted to do that this year by providing almost an introductory piece into their rem reports in plain English and really focusing around their communication to their executives, how the package is actually portrayed to them, and then leading into, "Well, this is how it plays out now," in terms of the year.

There are some very good reports around that but they are still quite lengthy and that's why we thought we'll step back from it all. There are elements of it that are really there for an input into the financial statements. That can be retained within the financial statements. That can be referenced obviously within the overarching rem report where the real value add tends to be around what's the offer that is made to an executive, what's the intent of that offer, what are the performance conditions, and then how is that played out for the year, and that's really where the focus we think should be.

MR BANKS: Thank you.

MR CECCHINI (EY): The other couple of aspects, one of them is around facilitating effective use of the rem advisers, and again we're fully supportive of the intent of the recommendations, that there should be greater disclosure of the rem advisers and also that there should be greater transparency and guidelines in terms of how rem advisers should be used by the board and by management.

A couple of minor points: one is that we think that where the rem adviser has been disclosed in the rem report, it should only be disclosed when the board of the company has actually relied upon the advice. As you would have noted through your process, the nature of advice that is provided to organisations varies considerably from virtually information to quite specific advice around a legal matter or a tax matter and aspects like that. So actually being a little bit clearer around the nature of the advice and whether it's actually been used would be quite helpful there.

The other aspect is around the use of advisers, and we have a particular view around independence which we think balances practicality with the true independence of the board and to take a stronger hold around executive matters. Where we do note that there's issues in the marketplace around this is when management is actually instructing advisers, getting the advice and effectively the adviser has an inability to interact with the board. So around particularly KMP type of advice, we do believe that should come from the board, but without being able to work with management, you are limited in your ability to provide comprehensive advice and you do end up duplicating costs and potentially getting conflicting advice. That's why you see many boards actually trying to retain some focus around a group of individuals to help them through that process, even though they may allow them to work with management on particular things. So below the KMP, that tends to be pretty open, in the sense that there is not a lot of conflict there, as long as the board is actually signing off on the principles and the overarching frameworks, so again to go back to the board for final sign-off on that.

We do note and you would have seen that there's also probably a need to get a little bit more structure around or a bit more guidance on how rem advisers should actually operate and you will have noticed that the FSA through the Walker review did set out a set of recommendations around a code of conduct for remuneration advisers. We think that is quite practical and useful and could be adopted within this market as well in that form of advice. We're quite happy with that sort of structure.

The final couple of points, one of them was around remuneration report voting and consistent with our earlier submission, we do not believe that in fact we need to have a binding outcome of the rem report. Our own analysis and our own anecdotal evidence with organisations tells us that the boards take it very seriously and do act on it and in most of the circumstances where we've had votes of 25 per cent or more year on year, many of those have been for quite different reasons and as we know, the vote is quite a blunt instrument across the whole report and it is quite difficult to get an understanding of where the pressure points are at any point in time. In fact you get conflicting pressure points from different investors and shareholders around the rem report, particularly as we continue to get greater involvement of international institutional shareholders that have fairly firm house views around what they like to see and don't like to see around executive pay, so over time, we have the potential to see those "no" votes just increasing because of conflicting views around what should be underpinning executive pay. So to use a low threshold like 25 per cent rather than a majority we think will lead to unintended consequences and in fact could lead to greater turbulence around those reports or the voting on those reports in future years.

I guess the final point is probably around the termination payments and we note that the legislation has not received royal assent as yet, so it's still working its way through, but we do make some comments in regards to the legislation as it currently stood at the time. There are a couple of areas in there that we think require greater clarity. One of those is around the definition of "base salary". There is an inclusion at the moment around share based payments which are unhurdled. We do understand that the intent of government around that is to not disadvantage individuals that have salary sacrifice arrangements but including all share based payments as unhurdled could have unintended consequences. So you could end up with retention programs, as an example, which might just be time based, don't have any hurdles, being included for the purposes of a salary definition when that's not really the intent of it. So for some clarity around that or amendments to that would be welcome.

MR BANKS: Sorry, on that, how do you see that clarity best being achieved?

MR CECCHINI (EY): The current legislation, which has not received royal assent around share plans, really does specify two exemptions and that is the $1000-type plan, the general employee exemption, and a true salary sacrifice plan which is capped at $5000, so we actually have quite discrete language around that within the legislation, assuming that it goes through, that could be referenced for those purposes and everything else effectively could sit outside of that, so we can make it quite simple if we need to.

The other one that's creating a bit of the delay around getting that legislation through is the definition of the payment itself and lack of clarity or understanding or transparency around what the definition actually is, what is included and excluded within the definition. It is obviously quite difficult around that to try to keep it at a principles level so it can capture the variations around that, but the lack of specificity at the moment is creating a bit of confusion and is delaying the process. That will continue to be the case unless there is a little bit more guidance on what will actually be included and excluded within those definitions. We've found that challenge just with dealing with the whole range of different advisers in the marketplace as well. We're getting slightly conflicting views and interpretations in amongst the legal fraternity and amongst the remuneration consultants around that definition, so even the experts are struggling a little bit with that in certain circumstances.

The other one is that we do understand that one of the key principles of that termination payment legislation is that it wants to capture within the definition of "termination" any payments which are accelerated. So, for example, long-term incentive plans at date of termination are accelerated and the payment is made at that point in time, but that should be included for the purpose of determining whether someone has breached the cap or not. We do think that that probably needs to be looked at in a little bit more detail in terms of what is the real intent. We think that a pro-rataing approach to that, excluding pro-rataed amounts, is more aligned to the intent of the termination payments, rather than capturing all payments that are made through long-term incentives or short-term deferral incentives at that point. We believe the intent is one of ensuring that any payments over and above a pro rata amount should actually be captured for the purpose of a termination payment cap rather than all payments all together. That would be more consistent with the global approach conducted for those termination payments in determining whether they're reasonable or unreasonable and fairly consistent with what we see as best practice around the globe in that area.

The final one is around the valuation of the payments themselves and consistent with the disclosure recommendations that that should be done on a cash basis or an intrinsic basis at that point in time, rather than relying on the accounting treatment. As we know, the accounting treatment has caused confusion in the marketplace to date and to some extent, if we're looking at termination payments and determining whether they're reasonable or unreasonable, we should look at what the individual actually receives, rather than what an accounting cost of those payments may in fact be at that point in time. So they're the main points I guess that we thought that the Commission may wish to consider in determining its final recommendations.

MR BANKS: Good. Thanks very much. We'll certainly look at those issues. I guess in some respects it's surprising that there's so much uncertainty around the parameters of this legislation at this stage, given how much discussion there's been and so on. I'd be interested in your view, if you've got your druthers, as they say, and you got the definitions that you think are appropriate, how would that then accord with recent practice in terms of the 1 to 1 ratio et cetera? Would it capture most of the action anyway? The other way of putting it is would there be many outliers from what's being proposed if it was structured in the way you think is appropriate?

MR CECCHINI (EY): There wouldn't be many at all. If we look at the typical approach in what you might see to be boards exercising a balanced view around a payment, it tends to include the proportion of the notice period that the individual won't work, so there's a contractual entitlement around the notice period, and a determination in most cases of the board taking into account the time that the individual has actually been through that performance period, as well as performance conditions themselves around pro-rataing of short-term incentives and for good leavers, potentially long-term incentives. Boards do exercise discretion and in most cases exercise it in a very appropriate manner. That is quite balanced and if the pro-rataing was built into the definition, then that would capture pretty much most of the executives. There are a range that have existing contracts which may be over and above that, so some individuals do have 18 months or 24 months sitting in there as a notice period, so if they were let go without having to work their notice, then potentially they would be breaching that cap. There's not as many in the system any more around that and that's probably consistent with global practices. I do note that in some jurisdictions, 12 months is not the common notice period that is provided and although there are exclusions for where there's regulatory requirements or legislative requirements in certain jurisdictions for larger payments to be made, that it doesn't necessarily capture the alignment to local practices. So for global companies and recruiting executives in particular jurisdictions, having a 12-month notice period may actually cause them some problems around actually negotiating that, and all that does is put pressure on other elements of the package when they're in negotiation.

MR FITZGERALD: Firstly, thanks very much for providing the ideal remuneration report and I sincerely say thanks very much for actually going to the trouble of doing so. We have been long waiting for someone to come back to us in the way that you have to describe how the report could be simplified, so we're very grateful for that.

MR CECCHINI (EY): Good.

MR FITZGERALD: Just a couple of things: let's assume for a moment this ideal report, as you describe it, or this proposal had merit. What is the mechanism by which this could be implemented? In other words, we came up with a plain English version simply because we were unable to work out how to simplify the remuneration report.

MR CECCHINI (EY): Okay.

MR FITZGERALD: So assuming that what you've put to us is widely accepted as being reasonable, what is the way forward? Is it that ASIC should develop a model remuneration report which simply serves as a guide? Should it be developed by the ASX Corporate Governance Council? How do you actually take your proposal and ensure that it is used? The second point is some of your model requires changes to the Corporations Act and other governing rules, so I just would like some clarification or guidance as to how you would develop such a framework.

MR CECCHINI (EY): Sure. I will start off by saying we're not lawyers, so nothing we're providing is legal advice in that regard. But one of the ways that we have found as being quite useful is through the governance council type of approach in the past around these elements. That certainly has worked quite well with the directors' report in providing some level of consistency around that, so some guidelines for directors around the directors' report and that's really where we're still saying that it should sit, within a directors' report, rather than sitting within financial statements anyway, so it's just elaborating on those to some extent. Changes to the Corporations Act will be required and we've made some suggestions around where we think they might be. Again, I will state that I'm not a lawyer, so I'm not trying to say that's how they need to be drafted but just where the areas of change could occur to simplify that. That would also to an extent limit the requirement for the rem report to be audited. Certainly as you would appreciate, all auditors do get concerned about trying to audit very qualitative-type disclosures and it can get quite tricky in trying to substantiate a lot of those elements, so that will remove that ambiguity about what is audited. That will sit within the financial statements and maybe references to some numbers in there. Like, we do have concerns around fixed remuneration. All organisations have a slightly different view and definition of fixed remuneration, so we do think there's still liberty in using the accounting standard for the purposes of that, but that's probably about all that is required, we think, to simplify it.

MR FITZGERALD: So just clarifying in relation to the audit function, the auditors would be required to assess the valuation methods, the accounting values and the fair values which appear in your proposal in the financial statements.

MR CECCHINI (EY): Correct.

MR FITZGERALD: But would not be required to audit the actual remuneration reports. Is that what you're proposing?

MR CECCHINI (EY): Yes, correct, assuming that the guidelines are very clear around how cash is disclosed. So if that is the intrinsic value of either what the individual has received or what is vested to him to be drawn in that year, then it's fairly straightforward and doesn't require anything further than that. If we do put other valuation methodologies into play, then we might need to review that and have that audited.

MR FITZGERALD: Just one query: we obviously favour moving certain material, valuation methodologies, into the financial statements so it's only reported on once. Some participants have indicated to us that that means that you wouldn't necessarily be able to get the individual allocation or the individual's valuation of their equity may in fact be lost in doing that. But as I understand it, what goes into the financial statement is the methodology and the aggregate figures, but you could still disclose in the remuneration report the individual's equity grants and the assigned fair value or whatever the right valuation is to that.

MR CECCHINI (EY): What we're suggesting is that at an individual level within the rem report, they actually disclosed what has been granted to an individual. We don't think we need to ascribe the fair value to it because the fair value methodology is actually sitting in the financial statement, so that is being disclosed in terms of what value is ascribed to each instrument. Any reader could quickly just multiply a number of instruments by that fair value if they wanted to see the accounting cost at an individual level.

MR FITZGERALD: So if Gary Banks is the executive officer and he's granted shares going forward several years, what appears in the rem report next to his name?

MR CECCHINI (EY): For the current year, it would basically say, "Gary Banks has received 100,000 instruments," and it will describe the nature of those instruments. Then separately it will say, "What has Mr Gary Banks received during the year? What has vested to Gary Banks during the year and it will basically describe it in there. The tables that actually have the details around that will sit within the financial statements because that's required under the financial statements requirements, so we still keep it quite simple for the reader, to basically say, "What is it that is being provided to the executive in the year?" and then, "What has the executive actually received that year?" In true intrinsic terms, what has he or she actually taken home?

MR FITZGERALD: Just pushing that further, if I want to know exactly what the future value of the instruments that have been granted in this year, I could find that out by referencing the financial statement?

MR CECCHINI (EY): Correct. So the valuation is still sitting in the financial statements, so the fair value is sitting there, and I can quickly just calculate that through if I need to. The interpretation of fair value is, in the main, in the general public, that's what the individual has received. So when they look at a table, they tend to interpret a granting of 100,000 instruments at a fair value of $500,000 that the individual has received $500,000 and what we're suggesting is that we break out what the individual has been granted versus what the individual has received in the year and make that quite transparent to the readers.

MR BANKS: Okay. Just coming back to the earlier point, if you had any advice to us about remuneration reports that you thought were pretty close to best practice - you made a comment along those lines earlier - we'd be interested to get that information. We're not expecting you to give it now, but if you could get back to us.

MR CECCHINI (EY): Yes.

MR BANKS: As I say, we have seen a few. The requirement to have remuneration reports isn't of a very long duration; it's five years or so. Do you think there's a learning curve that's heading in the right direction currently or in the wrong direction? In other words, are we seeing best practice starting to predominate or are we seeing it spiralling in the other direction, becoming more complex and more legalistic?

MR CECCHINI (EY): I think the move has been right around moving away from the pure compliance aspect of just the numbers to actually trying to provide some rationale around the intent and that has been welcomed by the shareholders that we've been working with over the years. I think the practicalities of the volatility in the marketplace has highlighted the disconnect between how the average reader looks at those reports versus what's actually been ascribed to individuals and that's probably highlighted just that disconnect that is occurring between a face value versus a real value.

We think there's more that could be done around demonstrating the link between performance and reward and some companies are doing a very good job of that, but it's still a little bit patchy in some areas and again that's why we've suggested that there's a section that actually just talks about what's vested and talks about what the performance has been and tracking that over a period of time, so doing that over a five-year period so the readers can see a very clear and transparent historical view just around the alignment that's occurring between the executive outcomes, particularly around variable pay relative to performance during that period.

So I think we're going in the right direction, it's just that due to the inherent confusion that the report has actually produced at the moment are starting to provide greater and greater disclosure which is making them very difficult to read. We spend our lives effectively reading those reports and it's not an easy job, even for us, so I'm not sure how the average reader gets through them.

PROF FELS: But they do contain information that is used, I think. That is what we pick up, the professionals go through and indeed, in a sense from a disclosure point of view you would only find out what is happening if you have these detailed reports. There's a small submarket which make it very widely known when there's unusual deals and so on. If you, for example, just had the plain English and nothing else, then people would miss a lot of things. So there's an inherent dilemma in this situation.

MR CECCHINI (EY): Yes, we agree and that's why some of the elements, we were just saying, should be reflected back in the financial statements because the sort of readers that you're talking about have the level of sophistication to be able to interpret financial statements and that's what they do, it's their job in most cases. As long as the references are back in there and they know where to pick up those elements - I'm not saying we're changing the accounting standards around that, the accounting standards still stay, it's just trying to simplify a report which has the intention of actually providing some transparency around the deal that is being done between management and the board and the shareholders, describing that in a way that is easy to understand.

MR BANKS: Allan's comment obviously relates in part to the proxy advisers and the role they have, I guess the specialists in that area. I'll be interested in any comments you want to make on their role in relation to the remuneration report and voting on it and so on. You made a comment earlier that in relation to the two-strikes threshold issue that you could see a "turbulence", I think was the term you used, where it is very hard for boards to understand what the position is of different parties when there's a "no" vote. Another view that could be put is that a lot of those parties have been informed by one or two proxy advisers who can be pretty readily talked to and so on. Do you have any thoughts in that area?

MR CECCHINI (EY): I accept that in many cases the companies could, and many do, engage with those advisers in a productive sense. The timing can be difficult for them because they do start to run out of time. Unfortunately, we do have a very compressed period over which reports are reviewed and analysed and when boards are actually meeting and making decisions on things, you can't pre-empt a board's decision around something and therefore you run out of time, in a sense, in the practical sense of actually being able to organise an appropriate time with all your shareholders and proxy advisers. Those that do, tend to get a better outcome from it, and it informs them around what the shareholder expectations are which helps them around their structures, but also on the flipside, better informs the shareholders around the intent of what's actually being provided.

I still do believe that as the sophistication and maturity of the marketplace continues to evolve, not just in Australia but globally, we are continuing to see greater and greater differentiation around house views on this and that will continue to provide dilemma and does provide a considerable amount of dilemma for boards at all times and it might just be that shareholding shifts during the year. All of a sudden, they've got a shareholder that's got 8 per cent of the stock, and it has a particular house view which is inconsistent with how they might be providing remuneration at this point in time. They can't change it during that period, they will wait until after that period to get to it, and all of a sudden get "no" votes up against it. So that volatility is there and will continue to increase. I accept that companies could do more with their proxy advisers; there's a couple in Australia. It's quite difficult to get to the overseas advisers, the big pension fund advisers in the UK and the US. There's quite a few of them, so that's straightforward.

MR BANKS: Okay. The only other thing, I was just going to ask you to comment a little bit more on the remuneration adviser code of conduct. I take it from what you've said here that you were probably supportive of the recommendations we had in our report that relate to disclosure of companies in relation to the advice they have received, but you see this as being complementary to that?

MR CECCHINI (EY):   Yes, complementary to it. We have no issues at all with disclosure of the consultants within it, it's just that with that should go whether the board has actually used the advice or not and whether it's helped them form their views. We provide advice a lot of times and in many cases the board would seek advice from multiple advisers on the same issue and for whatever reason will go with one advice and not the other. But there needs to be some level of clarity around how the information is being used or which information is being used or advice is being used.

MR BANKS: Some have said that you just have a sort of disclaimer indicating that no individual adviser is necessarily responsible for the outcome. I'm not sure how helpful that would be.

MR CECCHINI (EY):   No.

MR BANKS: But you're going further to say that if six advisers were used and the advice of three were disregarded and three in some form were taken on board that there should be a form of words indicating that the advice was - - -

MR CECCHINI (EY):   "These are the three advisers that the board has relied on to form its views around X."

MR BANKS: To some extent.

MR CECCHINI (EY):   Yes, to some extent around whatever it was that they were advising. With the complexities, particularly for global companies, the amount of complexity there is in implementing and having to restructure executive pay due to legal, tax, market practice changes around the globe is quite complex and will need a variety of advices, so we have those issues.

MR BANKS: Do you see those disclosure requirements that we've talked about, which I think are reasonably straightforward, but some have argued that they would add unduly to the complexity of the report? There's always a trade-off between information value and I suppose adding length and complexity.

MR CECCHINI (EY): I guess we broadly agree with that which is why we think they should be separated out because as we've noticed in this current year, it has added confusion to the marketplace rather than simplified it. So by people putting in a plain English version up-front, putting in intrinsic or cash values - they haven't been consistent in their methodologies but attempting to do that - alongside the accounting treatment has actually just confused readers rather than enhanced the readability of those reports. To some extent, it has created scepticism around, "Why are they doing it?" Are they doing it because the numbers at the moment look well up from a cash value, which typically would be the case in this market, and because it's not a requirement, will just fall out of the report when the market chain turns, so having that as a requirement, and it tends to be easier to read and more relevant to the purposes of what we're actually talking about, that we can actually just push most of those accounting values back into the financial statements.

MR BANKS: But what about the disclosure arrangements around advisers, do you see that in itself as adding unduly to complexity, because it's a sort of separable issue, isn't it?

MR CECCHINI (EY): Yes. I guess I'm almost conflicted in answering that. At a principles level, we have no concerns with it. I think it aids in demonstrating that the board has taken an active role in the decision-making and the design of the executive pay and that it's appropriately got advice externally when it's required. Obviously it would receive advice internally and it hopefully should do so but occasionally it might receive some external advice, so I think it aids in demonstrating that the board governance around executive pay is at the level that it needs to be. But you would want to be careful about it just being used to demonstrate that there is a due process that actually hasn't been taken into account and I guess that's what we're trying to balance and to some extent balance our reputational risk that goes with it.

MR BANKS: Okay. Thank you very much. That's been very helpful.

MR CECCHINI (EY): No problems. Thanks for the opportunity.

MR BANKS: We will just break for a moment before our next participants.

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

MS JOHNSON (HG): My name is Karyn Johnson. I am the state consulting manager for Victoria for Hay Group and I'm also an executive reward practitioner within our business.

MR BERRY (HG): I'm Allan Berry and I'm a consultant, specialising in the executive reward area of our business.

MR BANKS: Good. Thank you very much for the submission that you've provided and also you were very helpful to us, both through the submission but also through the data that you provided leading up into our discussion draft, so we're grateful for that assistance. As indicated, we'll give you the opportunity to go through the main points.

MS JOHNSON (HG): Thank you very much. We have reflected on the draft report that has been released and we want to commend the Commission for the completeness and thoroughness that they have taken and the balance that you've brought to the discussion. It is a complex area. There are a lot of things to balance and we were very impressed with that. In saying that, broadly speaking, the majority of the recommendations we thought were very sound and have indicated our support for those. We commented on all the recommendations in our submission but thought we would just concentrate on a small number for this discussion and then leave some time for questions after that, if that's okay.

MR BANKS: Yes, thank you.

MS JOHNSON (HG): So I might ask Allan to start going through some of those recommendations.

MR BERRY (HG): The first one we wanted to talk about was the draft recommendation to the strengthening of the remuneration committee structure for the top ASX300 companies. Our experience in working with boards and remuneration companies is that we see remuneration committees that have a strong sense of identity and ownership of the process generally making better decisions than committees that are less clear about the separation between management and the board's responsibility, so we see that as a very positive move. We think there are other criteria as well for good decisions and remuneration committees are well informed and have a clear sense of the philosophy that they're trying to achieve, which are also important criteria, but the strength of the committee is important and we think that that proposed structure drives an important signal to the community but also to the participants, both to the board itself and to management, about who owns what in this process. I think, again, where we have some difficulties with a few clients is where that separation between management and the board isn't clear and this is a way of really enforcing that or highlighting that.

MR FITZGERALD: Could I raise a question on that. When you deal with boards that haven't got that clarity, why is that the case, given that one would have thought, for example, that having executives on rem committees seem to us to be fairly conflictual, yet it still persists in a small number of the top companies? What is it that allows a company to believe that that's an appropriate way to operate as distinct from the majority that see that as a problem?

MR BERRY (HG): It's not always clear to us how they come to that view. We would certainly encourage them to not have executives members of the committee. I think in a lot of cases it's about history and personalities and that some organisations just haven't understood the change in the environment and haven't responded as positively as others.

MS JOHNSON (HG): Sometimes the remit of the committee includes the direct reports to the CEO, who often feels like they’ve a say in how that reward is structured so that they can get the best out of those direct reports, so I think sometimes there, that confusion, there's a sense that a CEO needs to be involved and has to have a say, but that doesn't necessarily mean membership of the committee; that could be achieved through other appropriate ways. So I think sometimes that may be a contributing factor to that decision-making process.

MR BERRY (HG): So the third recommendation which is extending that strengthening of the structure to all listed companies on the "comply or explain" basis again we strongly support. We think that for most of the smaller companies that can provide a structure without significant additional cost in terms of having a number of independent and non-executive directors, then we don't see any real reason why they wouldn't adopt that, but having it on the comply or explain basis gives the flexibility, particularly for the smaller companies, if that is going to be a challenge. We would expect that companies that could comply but chose not to would find it more difficult to explain than companies that had a clear question of, "We'd have to appoint another one or two directors in order to do this," then that would be an easier sell in terms of the explanation.

Recommendation 5 which is prohibiting executives from hedging unvested equity long-term incentives is kind of a no-brainer. We think that's so straightforward that it clearly should be strongly supported. We're not aware that that's a particularly big problem. We know that many of the larger companies in particular already ban that practice but because it is such an inappropriate activity, we think hitting it with the biggest hammer possible, such as putting it through the

Corporations Law, would be the appropriate thing to do.

MR BANKS: Some have argued to us that that's fine in principle but it might be hard to enforce in practice. Have you got any thoughts on that?

MR BERRY (HG): I think it potentially would be in terms of who knows and would it become public. It's a bit like I guess, in the same way, insider trading, that it may be difficult to enforce but it's still something that shouldn't go ahead and it should be made clear that it's not acceptable. I think that companies may have more difficulty with enforcing through company policy because they can really only enforce that if they find out about it prior to the transaction or prior to the instruments vesting, once that's happened and their sanctions are gone, whereas putting it through the Corporations Law would allow that sanction to live on.

MS JOHNSON (HG): And potentially required to make a statement that there are none in place also puts the onus on the company to make due inquiries and ask questions to make sure that nothing has happened. If there's a disclosure statement required, everybody tends to be very focused on what it is that they're making sure of.

MR BANKS: Yes, thank you.

MR BERRY (HG): Recommendation 8, which is the extending of the 300A disclosure requirements, again we support. We think the plain English approach is a worthwhile attempt to increase the quality of the debate. We're not overly optimistic that the debate will lift substantially, but we think this is one way of contributing to that process, and particularly for retail investors, providing a document that is more useful, more accessible than the current remuneration reports that are difficult. I guess we'd probably agree with the previous discussion, that transferring the detail into the financial statements - because the detail that is there is pretty much all useful and should be retained - but it's trying to get something that crystallises what is the board really trying to do with the remuneration and why have they made the decisions that they have made is often quite difficult to interpret.

MR FITZGERALD: Can I just flesh that out a little bit and I don't want to interrupt your flow, but in the last presentation, we've seen a number where the fair value and accounting values should be in the financial statements and at first glance, that seems reasonable to us. The question that I raised then and we've raised several times before is that that means that in order to find out the future value effectively of the shares that are granted to the executive, you've got to go through financial statements and all those sorts of things. Is that a significant problem or not? If you move the fair value and the accounting value methodologies out of it, is it a significant problem that emerges in disclosure? Some people say it's good to have it in the remuneration report, others say it actually confuses it, it's of no relevance really and if you wanted, you could find it out. Just your view on that?

MR BERRY (HG): I think basically we're talking about the long-term incentives and the valuation is an incredibly complex and difficult area. We have some reservations about - we think that the disclosure of the actual remuneration value is an idea whose time has come and it will happen. We think it does have some problems in that we think the - there is some discussion about the realised value, and we think that should be as at vesting date; that changes in the value beyond vesting are a function of the owner's activity as an investor rather than their activity as an employee, so we would trigger that at vesting.

However, we think that it will engage the community when the numbers are large. The evidence is that the community gets excited when there are large numbers disclosed. The value of the LTI is a function of basically three things: how many were allocated in the first place; how did you go against the performance hurdles, so many vested; and what has happened to the share price. That number that were allocated was a decision made three years ago, and for CEOs in particular was approved by the shareholders because the CEOs are basically always directors and therefore need shareholder approval. So the debate, when the number comes out, is going to be focused on those companies that have been successful because they will generate high numbers because a large proportion will vest and the share price will have gone up a lot and so the number will be big. The executives and CEOs that have been less successful, that didn't get any that vested because the share price hadn't increased will largely, I suspect, skate through relatively unscathed in this sort of debate.

So I think that we have a concern that it will focus discussion on the wrong issues and despite all the limitations of the fair value methodologies which are, by definition, imprecise and are judgments, we still take the view that that in fact is the best description of the value that has been granted to the executive, in that when you grant a share or an option subject to hurdles and all the other variables, it does have a value and what is actually realised is - the nature of the plan is to some extent at least in the hands of the executive to generate. So the fair value gives an indication at the time of granting of, "This is the value of the opportunity that we are giving you." What actually transpires will clearly be less or more but unrelated to remuneration. It's more related to those performance variables.

MR BANKS: What they do with their wealth.

MR BERRY (HG): Yes.

MS JOHNSON (HG): Yes. The actual value alone could lead to a different type of misunderstanding about the reward and when it relates to. So potentially it is a hybrid of a much more simplified use of the fair values for the purpose of the rem report; but the bulk of the detail back down in the accounts because the tables just are too lengthy and complex for general readers to understand at the moment. So it could - both numbers add meaning to different audiences and provide that counterbalance around fair value of allocation versus what's actually being realised up to vesting; so potentially there is a hybrid answer in there.

MR BERRY (HG): But having two will certainly increase the possibility for confusion.

MS JOHNSON (HG): Absolutely.

MR BERRY (HG): If they are both shown then there will be some readers who will add the two numbers together and say, "This is what the total value is." So there is potential for confusion.

MR FITZGERALD: Just to be a bit pedantic for a moment, taking the example that I used in the previous inquiry of Gary Banks as the CEO, he is granted an equity right. What appears in the rem report would be that he is being granted 100,000 shares subject to a particular performance hurdle. The actual valuation methodology sits in the financial statements. Do you suggest that next to Gary Banks's name in the remuneration report is actually an assigned value to those or do you simply leave that, as the former participants indicated, that if you really want to work that out you multiply 100,000 by the valuation that sits in the financial statement?

MS JOHNSON (HG): I would think it possibly should be next to the name for those limited number of executives because otherwise the breadth of possible calculations there are - they're probably even wider. Is it by the current share price, is it by some hypothetical future share price? A lot of the other issues that get involved in that calculation, the valuation, aren't there. But that is a much simpler approach than currently in terms of the length and breadth of that sort of - type of thing. But not being there provides a broader possible set of interpretations, possibly, than having it there and then people choosing to disregard it or not, as the case may be, would be my sense. I'd be interested in Allan's view.

MR BERRY (HG): Yes, we - the disclosure guidelines going back a few years did require that you disclose the number of instruments granted but it didn't have a value and people were very unhappy because it was very hard to interpret what that meant. So then the adoption of the accounting standard valuation was a vehicle for saying, "Well, at least we can put a value on it, imperfect as it may." We would still say that that's the best measure. Certainly when we're working with clients around how much should we be granting to an executive, it's that kind of valuation that we use to say, "Well, this is what is being granted in the community irrespective of the performance outcomes, and that's what you need to be looking at."

MR FITZGERALD: Okay, thanks.

MR BERRY (HG): The final point under recommendation 8 was the disclosure of total shareholdings in the company by the key management personnel. We again think that is a useful thing. It does give the readers a clear indication of how much skin the executives have in the game. I think with reward my experience tells me that there's always unintended consequences and the risk with this one is that if executives start to get beaten up in the press about, "They've already got a very large holding and therefore why are we paying them additional large income each year?" it may then become an incentive for executives to sell shares as quickly as they can rather than accumulate. But I think that is just a risk we've got to take.

MR BANKS: I mean shareholders should be reassured, shouldn't they?

MR BERRY (HG): Well, I would think so, yes.

MS JOHNSON (HG): You would think.

MR BERRY (HG): Yes, and institutions I think clearly will be. Some retail shareholders will probably not, based on what we have seen.

MR BANKS: Okay.

MR BERRY (HG): Recommendation 10 is one dear to our hearts about the requirement for external advisers to be commissioned by and report directly to the board for the top 300 companies. Again, we strongly support that. It goes back a little to the discussion we had earlier. It provides clarity for the parties as to who is the client and what it is that we are being asked to do. As the previous speaker has talked about there is a need usually to work with management around getting information about understanding their jobs, about a whole range of things, but it should be clear to all the parties that the reporting back relationship is between the consultant and the board or the remuneration committee.

I think it would also clarify for the board and it would force kind of a separation of management suggestions about what they think should happen and then an independent view from an external adviser either about those recommendations or about alternatives. I think it's appropriate for the board to have both but it should be clear what the separation is between those two. Occasionally - we don't experience it as a major problem but occasionally that does get a little blurry and requires a little bit of tact on our part to negotiate our way through that process.

MR BANKS: That's really what I was going to ask you, whether your response indicates that these things do get blurred occasionally, maybe occasionally in your case but more widely that that separation needs to be made clear.

MR BERRY (HG): Yes.

MS JOHNSON (HG): I think sometimes it comes down to the working practices between board and management and the - you know, them involving management for help and information and the sort of - the passing back of feedback and those sorts of things. It stems from how they tend to work with management but has the potential for a lack of clarity around, "This is direct advice to the board," versus something that management has been involved in. So the recommendation makes that much clearer and provides a framework for suggesting when those working relationships may be getting in the way of this recommendation. So rarely would we see it as an intentional activity but it's more something that has evolved through custom and practice rather than through any intent to do anything untoward, I would suggest. Allan, do you agree?

MR BERRY (HG): Yes, and it's been changing over the years in the time certainly I've been involved in this. The standards and the expectations around this have changed dramatically over the last 15, 20 years in terms of what was expected of the relationship between management and boards, where 20 years ago we had very little contact, if any, with the external advisers. Our role was to support management who then put up a proposal.

So similarly with recommendation 11 of extending that in a sense by requiring for listed companies to disclose the external advisers, we again strongly support that. We think it does add transparency. The issues of who appointed the adviser and to whom they reported I think are clearly important and relevant. We would feel that the disclosure should make clear that remuneration decisions were made by the company, that our role is not to decide. We make a variety of contributions from pure information to advice to suggestions to a range of alternatives. But ultimately the decision is with the company. Again, particularly for the way in which the report is read by retail shareholders, we think it's useful to have a disclaimer in there that just makes that clear.

Again, going back to the previous discussion with the last presenters, I think it will be difficult to separate out which advisers the board or the company has listened to and which they haven't because it's rare that, "Yes, we'll take all this advice," or, "Reject all of that." I think the board will take a range of advice and will come to a view. In practice if they are required to disclose which advisers they relied on, they were going to disclose everybody because they won't exactly remember who triggered what idea. So it's likely that they will end up saying, "We were advised by this group of people." I think it would be useful to have that disclosure of who has been involved but I think it's going to be hard to get much more detail and values below that.

MR FITZGERALD: I don't think our recommendation goes much beyond that.

MS JOHNSON (HG): No.

MR BANKS: No. Agree, yes.

MR FITZGERALD: I think it's interesting to reflect on the fact that if there are several advisers involved in these decisions they must be spending a fair bit of dough on getting advice. As a proportion of the pay it must be quite an interesting cost to executive pay ratio.

MS JOHNSON (HG): I think it's more the fact that if there's specific tax advice that's needed and specific legal advice, you can end up with more advisers in that way. It really depends what stage a company and a board is at in terms of the executive award strategy. Most good companies set one of those up and it runs for a period of two to three years and then they look to evolve it as a business strategy evolves because it's part of a business tool. So depending on where they're up to in those processes there may be more work on an LTI design that requires legal tax and other bits and pieces in maybe a straightforward year where they're just looking for an assessment of the market to make some decisions. The type and nature of advice and the breadth of advice can vary but it can be multiple different types of parties that will contribute something, depending upon the expertise they're looking for.

MR BANKS: Just on that to what extent do you get the impression when you're dealing with a company that they have thought through the way their remuneration fits in with their other corporate strategic objectives and so on and that the remuneration is integrated in the suite of strategic plans that the company has?

MS JOHNSON (HG): It varies. Certainly our beginning position when we start to work with clients is, "What is your business strategy? How can the decisions you're about to make underline and support that?" Some do it very well. The strategic information is all very carefully analysed. What are the drivers? What are the performance outcomes you need? Others, probably at the smaller end without the opportunity for the time investment there, we will come to a more practical outcome but many do use this quite rightly as a business tool to ensure that the right drivers and emphasis on performance that will deliver shareholder value are a part of this business process as much as any other business process.

MR BANKS: I asked that because some advisers have said that they have been astonished going into a company that they haven't actually thought those things through.

MS JOHNSON (HG): You do find them but then that's part of our role to help them see that trying to take stock of that and make sure those things don't work in opposite directions is important. Some clients very willingly take that on board; others aren't at that particular stage yet. You do work with the clients but you try and help them see that it's much more useful if it's supporting the creation of shareholder value at the end of the day.

MR BANKS: Just related to that, one of the criticisms that's been made about the Commission's recommendations in tipping the balance, I guess, more in favour of shareholders, and shareholders' say on pay, is that it could provoke a kind of vanillaisation syndrome within companies whereby in order to get the tick from the proxy adviser or whatever they will follow a kind of template approach which may not be well attuned to their strategic needs. Any comment on that?

MS JOHNSON (HG): I think it can be a risk but the key at the heart of that is actually the work the company has done in explaining why they're doing what they're doing. If they can use the description in the report and discussions with the proxy advisers to say, "This is what we're doing. It's not the standard vanilla approach and here are the reasons why," then mostly those companies do get non-vanilla plans implemented and approved without a whole lot of drama. When it comes back to why is the company doing it, and if a board and a company can invest in explaining to the benefit of shareholders, either via proxy advisers or directly to a remuneration report, then they should be able to move to that place. However, that takes time, money and effort and sometimes they will trade all that off and come back to a more middle ground position.

I think a year or so ago there was more coming to the middle and now there's a bit more of a mixed result. It will be interesting to see what follows next in terms of patterns of behaviour there. The same executive award strategy for every organisation does not make sense because every organisation does not have the same business strategy. There should be at least a, "Why does this make sense for this company?" discussion happening, and companies that explain why, tend to be able to get something that's not in the stock standard, vanilla category, understood and accepted.

MR BERRY (HG): Yes, we saw that particularly with hurdles for long-term incentives. The pressure came on basically to adopt relative total shareholder return to phase it in at a 25th percentile relative ranking up to 75th ranking, and an overwhelming number of companies - particularly larger companies - adopted that approach because it was seen as safe. The institutions would support it and you weren't going to get into trouble. Early in my career there was a saying that nobody ever got fired for buying IBM in IT and it was that kind of attitude. It would seem a growing concern about total shareholder return as being a very blunt instrument and not directly related to business strategy and we're seeing boards becoming more inclined to look at other alternatives that are more specific perhaps in conjunction with a TSR hurdle and splitting it into having two hurdles, but trying to be a bit more specific and more creative.

MR BANKS: When you say a TSR hurdle, you mean a relative TSR?

MR BERRY (HG): Yes.

MR BANKS: Okay. Good, thank you.

MR BERRY (HG): Recommendation 13 which is removing the cessation of employment as a trigger for tax on equity reward we really think is a brilliant recommendation and strongly support that. It certainly goes against the direction that the government has been moving and came out reinforced with the share plan legislation. But it really is a barrier to good design in terms of long-term incentives. It does make it difficult for rewarding executives that the company knows, or the executive knows, are approaching the end of their career or the end of their employment with that company, and suddenly the rewards that are going to trigger that tax before there's income available to support the tax do become a problem. We have generally supported the view that where executives are given a long-term incentive prior to leaving and where they leave for good reasons, that the program should run its course for the life of the LTI and still be subject to the same hurdle requirements and vest post-employment in order with that. But we have seen organisations that have gone with pro-rataing of LTI when people leave early, primarily, I think, driven by this tax and it really does act against trying to focus, particularly CEOs, on the long-term view, even if their personal horizon is a short one.

MR BANKS: Including the appointment of their successor.

MR BERRY (HG): Yes, indeed.

MS JOHNSON (HG): Yes, succession is an important thing for them to have supported so, yes.

MR BANKS: We had Regnan appear in Sydney arguing quite strongly that the duration for tax purposes should be 10 years rather than seven. Do you have any views on that?

MR BERRY (HG): I don't think there's any magic in either number. We were comfortable with 10 when the government talked about bringing it back to seven. We didn't feel unduly anxious. I think below that would be starting to be inappropriate. In practice what I've seen before I joined Hay was with a corporate as a remuneration manager. What we saw was that executives tended to exercise early in the early tranches that they got. So they tended to be driven by their own financial circumstances. So they would exercise and sell to pay off the mortgage, to buy the beach house or whatever but once those immediate needs were met, that they tended to hold for longer periods of time in the interests of having more skin in the game, that's a good thing. So artificially bringing that forward for no immediately apparent reason, I don't see why you would do that, it's not in the interests of the company and shareholder view.

Then finally recommendation 15 was the one that we didn't support. We see that in our view boards have been responding well to the current non-binding vote approach, that by and large boards that we deal are very conscious of what are the possible consequences of our proposals, what do we think shareholders - how will they react? If they do get a negative vote we've seen organisations by and large, not 100 per cent, but a pretty high proportion have gone back and revisited what it was that shareholders were unhappy with and responded to that. So we see it as being an unnecessary additional penalty. We think that there are potential for some adverse consequences to that approach in the way in which shareholders might use that mechanism.

If it was to apply, we would think that the second trigger should be 50 per cent rather than 25, that if you've got a majority of shareholders voting in favour of something, we think that that should not trigger a spill of the board, but if the board is spilt, we would suggest that there should be a compulsory EGM within three months rather than the potential to drag it on for a year to the next AGM at which point the whole issue may well be largely irrelevant and forgotten and other issues may well be taking pride of place.

MR BANKS: Is that in part for stability reasons as well or to have it sooner rather than later?

MR BERRY (HG): I think it would, I think there would be certainly questions about the board that could be seen as a lame duck. I doubt the board would see themselves as a lame duck in those circumstances but - - -

PROF FELS: Would the shareholders be a lame duck? That's a universal reaction out there in the community, if you don't - two votes and then a further meeting spread over a couple of years, the shareholders would be the lame duck in this situation.

MS JOHNSON (HG): This would actually compress the time because with waiting to the next meeting it is a two-year period, whereas there would be a vote one year, a vote 12 months later and then the situation would be resolved much more quickly.

PROF FELS: Over 15 months.

MS JOHNSON (HG): Yes. So it was actually thinking that having this issue drift on for two years with a company, if the issue started back here a faster resolution would be in the interests of shareholders.

PROF FELS: An argument for the extraordinary general meeting.

MR BANKS: You've said that the current arrangements are working quite well and if there's a significant vote that companies have gone back to shareholders. You might have been here when there was an earlier discussion about how easy is it for a company or its board to understand what the sources of discontent area. Would you like to comment on that?

MR BERRY (HG): I think that varies a lot on a case by case basis. I think in some cases it's been quite clear that there have been particular issues, often related to the CEO, some of the recent ones have been related to termination payments. In other cases I think it is less clear. I have certainly worked with clients that have gone to their institutional investors to float proposals and I've had one institutional shareholder say, "You ought to go north," and another institutional investor say, "You should go south," and they come to us and say, "What do we do?" and we wish them well.

So there is not a universal view on this. I think there is the risk that the non-binding vote can be a flag around which a range of issues can coalesce and it gives shareholders an opportunity to voice their displeasure in addition to the vote on re-election of directors but this seems to have become a more tangible mechanism for showing dissatisfaction. I think in some cases that may be unclear to the board exactly what it is that they're being asked to do. In other cases it may be that the board is very clear why they're doing what they're doing, feel they've solved it well, but a minority of shareholders have not accepted that view and at that point, "What do we do? If the majority are still supporting us - we still think it's the right thing to do, we should proceed."

MS JOHNSON (HG): It comes back to that communication piece, why and communicating that through to the proxy advisers through the remuneration report. The ones that do that tend to be not the ones that do end up with adverse votes, the small number that there have been. So it really comes back to if we're making a decision and implementing it for the benefit of shareholders, we need to explain why and how it works, why it is in their interests. So when they do that, I think it is possible - you may not please everybody because that's the nature of things but you should be able to explain to the majority of shareholders why this is a good outcome for the company and for them.

PROF FELS: Why is that all the witnesses are talking about what I'd call the second order behavioural questions and they're about minorities and takeovers and all this. I mean, isn't the primary likely effect of the changing of the rules to make boards more careful about executive pay? Wouldn't these rules make them a good deal more careful about their decision-making in executive pays and that's the primary possible consequence? Why is it that hardly any witnesses are mentioning that? All they're mentioning is complex stories about possible remote contingencies where under the following large number of assumptions you could get a situation where there actually is a vote on a board than the individual members - - -

MR BERRY (HG): I think we're saying that we think in fact boards are being more careful and that the existing approach with the non-binding vote has unquestionably lifted the focus of executive reward and the potential shareholder reactions to that has lifted that very much to front and centre for virtually all the boards that we deal with. I think there are some boards that have decided that, for whatever reasons, they were going to tough it out and have been burnt. I think almost all of those have reacted positively to that message and responded well in year 2. I mean our view is that recommendation 15 is not necessary because we think the existing structure is working well. If you were to adopt it then we would have those concerns that you have mentioned.

MR BANKS: That point is being made mainly about the second strike rather than the first one, in relation to reporting back?

MR BERRY (HG): Yes.

MR BANKS: Yes.

MR BERRY (HG): Yes.

MS JOHNSON: Yes, certainly.

MR BERRY (HG): Yes. No, I think the reporting back in terms of - - -

MS JOHNSON (HG): Absolutely.

MR BERRY (HG): - - - responding, again, most of the organisations that we have sort of - or at least that I'm aware of have responded pretty well to that already, but making it compulsory would be a good thing.

MR BANKS: Do I take it from what you're saying that one of the main sources of the problem of disconnect between boards and their shareholders is lack of communication? But a number of the recommendations we have made are about making the remuneration report a more communicative document, if I could put it that way. Certainly in our experience looking at the existing remuneration reports you could see why the board hadn't carried the day, particularly where they were arguing for something or putting something that was a bit innovative or reflected their particular circumstances. Do you think that is the problem, partly, anyway?

MR BERRY (HG): I think boards have not used the remuneration report as productively as they might. I think they've tended to - particularly in the early days. I think it's getting better but I think when the initial requirement for the remuneration report first came out there was a sense of, "The more we say the more trouble we might get into. Let's do this as quickly and easily as we can." I think the fact that there are so many people now with proxy advisers, the journalists and so on, paying attention to those reports I think boards are starting to see that there is real value in using it as a communication tool.

MR BANKS: Right.

MR BERRY (HG): But not all boards have bought into that, that's certainly clear. Again, I think the intent of the plain English approach and separating that from the mass of regulatory requirements that are in there now would help that process or should help that process, because the companies that do end up with 20-plus pages of largely impenetrable tables and text, it just is impossible for a retail shareholder to work their way through that.

MR FITZGERALD: Can I just ask this: where, if anywhere, will there be pressure to constrain executive remuneration going forward? One of the curious things - obviously we've not recommended caps but nevertheless one of the things that remains a curiosity at the end of all this process is there still seems to be almost no constraints, downward constraints, downward pressures, other than the market itself, which, you know, it always has some. But it's not a normal market - as Allan Fels has often indicated, nobody bids down the salary. Nobody says, "I'll do it cheaper for you than the next guy or woman." Are there any pressures at all, downward pressures, in this market into the future that you are seeing?

MR BERRY (HG): I think there are. I think that there are people bidding down pay, not in the sense of, "I'll do it cheaper," but the board is faced with, "Here's a candidate that we would like, and what they're looking or requiring is way in excess of what alternatives are and whether we would rather have candidate A we think candidate B is better value for money or is more acceptable value for money." So I think that there still is a competitive market. It is certainly a constrained market in that the impact of a CEO is so great or can be so great on the fortunes of the company that what you pay in terms of CEO pay for a large company, whether it's 5 million or 10 million, is fundamentally insignificant if you think you're going to get an extra 1 or 2 per cent of value from that person. So the trade-off is very highly weighted in terms of the benefit.

One of the things that we talked about for a strong remuneration committee is that philosophy of what it is that - our approach to pay. For a lot of boards it is a question of paying to get the quality of people that we want at no more than we have to pay. Ultimately that becomes the cap. The challenge is that, particularly when you're dealing with CEOs, it is a very limited market. If you've identified that we want Charlie then there is no market for Charlie; there is only one. What we have seen is that the power relationship between the CEO and the board depends a lot on the circumstances at the time. If the company is doing well, if the CEO has a really good public persona and is well regarded by the market, the last thing the board wants to do is to change horses. If the CEO at contract renewal says, "I want an extra $2 million," then it's tough for the board to call his bluff because the costs to the board are going to be a lot more than $2 million to do that. In other situations, sometimes with the same incumbents, the world turns and, you know, Charlie is on his way out in a relatively short period of time after that.

MS JOHNSON (HG): We also note that there are occasions though when a CEO is replaced that the remuneration does not necessarily start at the same point as the previous incumbent. So that's an example where boards take the opportunity to revisit and get that balance re-set so that they can then examine the performance of that CEO and make decisions subsequently. There have also been examples in the last 12 months where executive teams have taken pay cuts in relation to the economic circumstances as well. So they might not be enormous but there are some examples there of constraint to point to.

MR BANKS: I mean I think that's reflected in the latest AFR data that was published just recently.

PROF FELS: Are there flow-on effects down the line from pay decisions about, first of all, CEOs and second, about senior executives? Does the CEO decisions affect other executives and do all of them affect pay down the line?

MR BERRY: There is an effect, it may be indirect. The market for executives below the top level is broader, more populated, we have better data, we have more information points on what the market is for a head of legal or a head of finance or what have you below the very top levels where the number of data points is fewer. So it's easier to get a clearer picture of the market independent of our pay practice.

Where there is a problem tends to be if the CEO and executive is paid at a relatively low level. That will compress down what the company feels they can pay on other executives. Sometimes we have seen that impact, not so much in the ASX top 50 but certainly we see it a lot in not for profit organisations where they are really limited in terms of the quality of people they can attract lower down because of the low caps at the top. We would argue that is not a good model to feed back into our top 50 companies. But we haven't - I don't think I could see examples of a big gap between the top and the mid-tier sucking up the mid-tier levels. I don't think we have seen that happen.

MR BANKS: All right, that's fine. Okay, well, it has been very helpful. Thank you very much.

MS JOHNSON (HG): Thank you very much.

MR BERRY (HG): Thank you.

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

MR BANKS: We will get started again. Our next participant this morning is the Business Council of Australia. Welcome to the hearings. Could I ask you please to give your name and your position.

MS CILENTO (BCA): Melinda Cilento, and I'm the deputy chief executive at the Business Council of Australia.

MR BANKS: Good. Thank you very much. Thanks for attending today and also for the submission you've provided in response to the discussion draft and equally for the earlier submission you provided to us before we had prepared the draft which was very helpful. I will give you the opportunity to go through the key points in your response to the draft.

MS CILENTO (BCA): Thank you for that. I thought it would be useful just to make some brief introductory comments but then take your questions so that we can explore the issues where we may not have been quite as clear or get into a little bit more detail, if you like. First of all, I have to start by saying that the Business Council really welcomes the role of the Productivity Commission on this issue. I think it's been really important. The discussion draft I think has been very useful in increasing the understanding of the issues, presenting the facts, the data and the research around which there hasn't always been a wide knowledge or understanding, as well as presenting the different views and opinions of stakeholders on the two sides of the debate, so the Business Council is very appreciative of that and the ongoing role of the Productivity Commission on this issue, but more broadly.

The discussion draft we think reached some very strong conclusions that we support, including in particular the acknowledgment that there's a lack of a systemic problem and rejection of some of the more extreme suggestions that have been discussed, including arbitrary pay caps and a binding shareholder vote. As we outlined in our first submission and also this submission in response to the discussion draft, there's a range of starting points from our perspective, if you like, and I'll just very quickly run through those.

Really, from our perspective, the fact that a competitive and dynamic business sector is in the national interest, executives are globally mobile, Australian listed companies need to be able to compete on equal footing for skills and experience. There are some factors that we think are unique to Australia which increase the challenges for chief executives here and senior executives, including the challenges of location and scale. We drew attention to the relatively short tenure of chief executives here in Australia in our first submission and the fact that tenure was actually falling.

I think it's also important to say that from our perspective, we think that remuneration practices and governance is actually pretty good in Australia and I think your discussion draft also picked up on this. Whilst we recognise that there is broader community concern around executive remuneration, we think it's really important that any response is balanced in terms of remuneration relative to the other issues that boards and companies are dealing with and that serious consideration is given to any unintended consequences which, in the immediate term, can be detrimental to shareholders but also in the long term can be detrimental to the broader national interest through competitiveness and the ability of companies to continue to compete and grow.

Not surprisingly - you've read our submissions - we obviously think that the principles based approach has worked well in Australia and should guide the recommendations and any action in respect of executive remuneration. Really, we think that that's most likely to produce the most effective outcome in terms of cost, timeliness and also the quality of the outcome. The ASX Corporate Governance Council, for example, we think has been very successful and effective. It's a broad church through which compromises are reached from a wide range of stakeholders and we think it strikes a pretty good balance and has so far worked really well.

On the whole, as we noted in our submission, we support most of the recommendations that were put forward by the Productivity Commission, in some instances with some qualifications and different views about how you might implement the recommendation, but on the whole, the intention is supported by the Business Council.

By far and away, recommendation 15 in respect of the two strikes has attracted the most significant response from the membership in terms of the number of responses and the strength of the response which probably won't surprise you in the context of the public debate around that recommendation. The Business Council strongly opposes it. Our submission went into detail about the reasons underlying that, but perhaps if I could just take a step back and explain it from a higher level, I guess. The way we look at it is, for starters, the discussion draft concludes that there's not a systemic problem with regard to executive remuneration and governance. You then, through recommendation 15, effectively elevate remuneration to the most important issue that the board is considering by virtue of the recommendation. This is the point that was made by the prior speaker, that you've got remuneration which in the context of the overall business is relatively small, then all of a sudden that becomes more important than, say, a multi-year, multibillion-dollar investment or expanse in strategy.

PROF FELS: Can I ask you a question about that. The counter-argument here is that the key issue is in the principal-agent relationship, where we have the principal-agent situation, shareholders, boards and executives and there's clearly a big principal-agent issue which has to be handled. Then of all the problems there, the great one is excessive pay. There is big suspicion that things could go wrong in the principal-agent relationship there, and if you don't think there's a big suspicion, have a look at community attitudes, have a look at commentary and all that kind of thing. This is the spot where the principal-agent relationship could go wrong and ultimately undermine trust in corporate governance. That is why the issue has received attention from legislatures and so on, and a lot of people say, "Put a cut on executive pay." The Commission did not recommend that the first time round, but it does think there should be a very good, so to speak, architecture of choice in this matter, that is, that we leave it to boards and shareholders and the community does not interfere, but there should be strong arrangements to protect the interests of shareholders on this soft spot. What do you think of that?

MS CILENTO (BCA):   My question actually - and I apologise for answering a question with a question - but my question back would be how do you reconcile the first conclusion that there isn't a systemic problem with governance in respect of the executive remuneration with then a measure which seems to imply that there is?

PROF FELS: It's the behaviour of executive pay in the last few years around the world and there have been individual cases in Australia, and as we've said in the draft report, there have been periods when it's got out of hand generally and other periods when individuals have got out of hand, so there's a problem. That was the conclusion of the draft report.

MS CILENTO (BCA):   I guess what we're responding to is the conclusion in the draft report that there isn't a systemic problem, that boards have become more accountable to shareholders and also the recognition that in fact remuneration in the most recent period has responded to performance. So from my perspective, when you stack those three things up, I guess the point I'm trying to make is that it then seems a bit inconsistent to put in place a measure which, by its nature, actually runs counter to those very conclusions.

PROF FELS: If you read the report, you will see that it's pretty clear that the draft conclusion is that there have been periods of general excess of pay and there remain individual ones, and also one has to look to possible reoccurence in the future.

MS CILENTO (BCA):   I would say we actually support the conclusion that says boards have been more accountable. We certainly support an approach which reinforces and encourages boards to be clearer about and communicating how they are setting remuneration and what their strategies and approaches are and the outcomes that they are seeking from that. We actually think there's scope for that to happen already and scope for that to be encouraged in some ways in which the draft recommendations have outlined.

The notion of having a two-strike rule which spills the entire board on the basis of one issue is the one that we think is out of proportion to the issues as they're presented.

MR BANKS: If I can just pick up on your point about systemic. One of the points we made - and I guess it reflects what's quite obvious - is that this has become a big issue, as Allan said, over recent times and it's not too big a stretch that if it continued it could have a systemic effect in the sense of loss of confidence generally in equity markets and the public company model. Now, I'm not saying that we've got to that point but the fact that we're seeing a significant rise in "no" votes and a lot of agitation about that I think is symptomatic of a change of perspective that's going on. What we see - and as you would appreciate from our report - we're focusing on board governance and processes and institutions as ways of restoring confidence generally; I don't think the shareholders but for the wider public. Then there's a question of balance and you have competing considerations.

MS CILENTO (BCA): I think that's the point I'm trying to make in terms of reconciling the balance of the broad conclusions reached. I take your point. It's obvious that when you've had significant market turmoil and declining share market performance over all that you see a pick up in angst about remuneration. I think it's appropriate to respond but it needs to be a response that's consistent and in line with the problems that have been identified. The risk in responding to one or two cases is that you put in place measures which have unintended consequences that can drive wider outcomes which actually aren't what were intended.

In the first submission we supported the idea that the Commission look for ways in which boards could be encouraged to be more responsive to a "no" vote and to be clear about how they communicated with shareholders about what they were doing and what they're trying to achieve. We support that intention. The issue for us is the two-strikes approach and the potential for that to have significant and unintended consequences in terms of instability to the board, and also the capacity it creates for minority shareholders to potentially use it for reasons not related to remuneration.

MR BANKS: Just following on from that, I think you stand out as perhaps one of the few business representatives to raise concerns about even the first strike. I think you've argued that it would be better to have an if not, why not approach to that, rather than a more prescriptive one. Could you just elaborate on that?

MS CILENTO (BCA): Sure. I guess the point we were trying to make is there has been a lot of focus on what the second trigger is, but by virtue of the first trigger having been passed you actually create instability regarding what's going to happen next time. That was the concern that's been raised with us, that it's not just the case of once you've gone past the second trigger, but the first trigger in itself creates the potential for the board to be spilled and that can roll through for an extended period of time.

The uncertainty that that creates about the governance of the company is one that we think is a serious implication. I think the reality is that "no" votes against remuneration reports, one, there's not a lot of clarity about what the specific concerns are and, two, the feedback that we get is that those "no" votes are not always reflective of issues just of remuneration, that because the remuneration report is what can be voted on but it can be a broader protest vote reflecting a whole range of things and not necessarily remuneration.

MR FITZGERALD: There's a conundrum. There's several conundrums I think at the moment. The first point, just going back, is the non-binding vote was not introduced in a period of turbulence. I think there's a fiction occurring that this is only an issue brought out of the current financial turbulence. If that were the case we wouldn't have had legislation introduced under a conservative government forwarded on by a vote. Clearly this has been an issue of concern exacerbated, I fully appreciate, by the financial crisis.

The second thing is, it does seem to me that we've come to a conclusion that the central decision-making around remuneration rightly sits with the board. On that we're all in accord. But ours is not that simple. We're actually saying it's with the board but we have to a view that there should be greater influence by shareholders. We sought various mechanisms to achieve that. In the discussion with many of the senior directors of companies - and I can understand where they're coming from - it seems to me that a fundamental issue as to whether or not shareholders should have a greater influence or not is central.

The mechanism itself; I understand people have different concerns about it. But am I right to say that your own members actually don't necessarily - and I'm sure there's no uniformity - believe there is a need for greater influence by shareholders? Many of those opposed the non-binding vote years ago. But I get a sense that what is really at heart here is whether or not shareholders should have any greater influence than they currently have. Is that the central issue? The mechanism, yes, I'm happy to discuss the mechanism. That seems to me to be at heart, and I actually do want to go back and say this is not an issue just out of the current financial crisis.

MS CILENTO (BCA): On that point can I say I completely agree with that and was very aware of the fact that this has been an ongoing issue, and released a paper I think in 2004 regarding executive remuneration at that point. It came out of the last round of concerns around corporate governance. We've certainly given it consideration for some time. The perspective of the membership is - as I started off saying - think about the balance of issues and their relative importance in terms of the outcomes and performance of the company and what that delivers to shareholders and, secondly, I think there is a view that the current arrangements there is a scope for shareholders to exercise their rights appropriately through being able to vote the board and that is an appropriate balance of influence.

MR FITZGERALD: Why is it therefore that the shareholder groups by and large - they have different views about our mechanisms as well - have a contrary view to that of the directors, because it's clear if you look at the submissions that the majority that represents shareholder groups - both small, large, institutional and mum and dads - don't have that same view. They don't believe that the mechanisms in place adequately meet their needs, so there is a disconnect occurring between the custodians of the business, the directors, and the shareholders.

MS CILENTO (BCA): To be honest, I can't really comment on that, and the views of the shareholders. I'm trying to put the view that we're here for the membership and the chairmen of our company's boards, that they feel the current system does provide adequate provisions, and the feed back that we also get is that they are in consultation with their shareholders on a regular basis and seeking to respond in a way which reflects the concerns of shareholders, but also the appropriate balance of control over the company.

MR BANKS: Has the requirement for a remuneration report facilitated that extra increased communication?

MS CILENTO (BCA): I suspect it has, and I think the focus on the if not, why not has probably really enhanced it across the board, in terms of governance and given more attention to how effectively you communicate the way in which the company has been governed.

PROF FELS: You've listed a very, very large number of possible consequences - I think there are eight of them in here somewhere. The most obvious consequence I would have thought isn't mentioned and that is that boards would be more careful about executive pay if all these diabolical consequences result. It would make them a bit more careful about executive pay. But you haven't mentioned that, nor has anyone actually that I've noticed.

MS CILENTO (BCA): With all due respects, I think boards are careful about pay.

PROF FELS: So it wouldn't change their behaviour. They already give the optimum amount of attention to it and all of these extra possible consequences which sound so frightening that really wouldn't change the treatment of executive pay. Is that what you're saying?

MS CILENTO (BCA): Well, I go back to my opening comments. I think our starting point is that the system is working well, that there is appropriate governance that boards are paying to consideration to this issue. That's reflected in the outcomes that, on the whole, we've seen and some of the comments that were made in the discussion draft as well about the characteristics of pay structures in Australia and the like, which actually compare really favourably to other countries. My starting point is that boards are actually paying due consideration to this. The question is if you elevate it in the way that we have outlined whether that produces an outcome which is actually in the long term best interests of the company and the shareholders. Now, your presumption is it's clearly yes but what I'm saying is I actually think that boards are very focused on delivering a remuneration structure and strategy that appropriately motivates the chief executive and its senior executives whilst having regard to the interests of the shareholders and long term company performance. I don't actually think that boards are dismissive of paying CEOs too much. I think that they have a very strong interest in making sure that they are clearly aligning CEO performance with what their expectations are and there is no desire for them to pay more than they need to.

PROF FELS: The second kind of behavioural thing which is put to me by many people, I think, and - for example, I think on the ABC program, Inside Business, the first thing was, well, you know, if you don't have - you know, if you had 50 per cent votes all the way through or nothing further, that would emasculate the possible outcome. In other words there would be no consequences from your recommendations if it were two 50s or even if it stayed at non-binding. Indeed it would turn out quite - simpler if the recommendations, whatever they prove to be, were not adopted at this stage. So I'll just ask you, that's a second possible behavioural thing. It would be a pretty clear signal that the law is not really going to have much impact if it's reduced to fifty-fifty. I realise you're not even in favour of having any kind of votes on this situation.

MS CILENTO (BCA): I'm sorry to be somewhat boring on this but I keep coming back to our starting point, which is we actually think the system is working reasonably well or working well. We support your conclusion in the report that there isn't a systemic problem, that there are already appropriate avenues for concerns to be conveyed and that we would support the intention of encouraging boards to be more responsive to that. We certainly support efforts to focus the attention on the board and to ensure that the board owns remuneration outcomes and strategies and that they do all that they can to clearly communicate those and to be responsive to shareholder concerns.

The issue for us is trying to ensure that that is done in a way which reflects the company's specific circumstances and in way which doesn't carry with it the risk of significant unintended consequences. Now, we have spelt out the concerns that we have regarding the scope for minority shareholders to use the rem report for reasons not related to remuneration and the potential risk that that carries as well as just pointing out some of the issues that relate to, you know, what happens if this actually comes into play. I think it is fairly ironic that if the full board is spilled because of concerns about executive remuneration then in fact the group that takes over responsibility for running the company are the very executives that are supposedly over-remunerated. There is a significant period of instability until such time as you replace the board. I think that is not to the benefit of shareholders and I think there is a very real concern about what happens when any new board is re-elected. The reality is that most directors who are on the board will be seriously disenfranchised and I think in all likelihood unlikely to put themselves up for re-election. Then again, you know, my question is what are the implications of that in terms of governance of the company, the skills and experience that are lost?

MR BANKS: Well, the prospects of the whole board not being re-elected - I mean they have an opportunity individually and you could imagine, you know, shareholders taking the opportunity perhaps to express displeasure with particular individuals, I guess. But I mean how likely is it that a whole board in those circumstances would be removed?

MS CILENTO (BCA): Well, the whole board is spilled, was my understanding of the - - -

MR BANKS: That's right, but they're not standing as a block, are they?

MS CILENTO (BCA): Well, again - - -

MR BANKS: Sorry, can I just clarify?

MS CILENTO (BCA): Yes.

MR FITZGERALD: Our recommendation is not that they suddenly disappear, that they are required to individually stand for re-election either at an AGM or later. So each director is subject to re-election - - -

MS CILENTO (BCA): Yes, so my question is - - -

MR FITZGERALD: - - - and he or she either gets the 50 plus one or doesn't.

MS CILENTO (BCA): Yes, sure, but they've been spilled. They've been asked to stand for re-election because the shareholders are dissatisfied with board performance.

MR FITZGERALD: Yes, but some business people have misinterpreted that to say that suddenly there's no board, and that's not the case. They have to stand for re-election. In other words one by one they get re-elected or they don't.

MS CILENTO (BCA): When?

MR FITZGERALD: At the next meeting.

MR BANKS: At the following meeting.

MS CILENTO (BCA): My point is that for a period of time then there are no directors. Is that - - -

MR FITZGERALD: No, that's not correct.

MR BANKS: No.

PROF FELS: No. Let's say there are the two negative votes. The board continues in place then there's a meeting after - the following year.

MS CILENTO (BCA): The following year?

PROF FELS: Either the following year or - we gave two options: either the following year or following annual general meeting. It would be know that there would be a vote, or alternatively an extraordinary general meeting is called quite soon, within a month or two. The board would continue in place during that period, just as the government continues in place during an election, and then on the day there would be a vote. I would assume that it would have an immediate effect and so at the meeting, by the end of the meeting, if there's a change there would be new directors installed. They would be immediately in charge, otherwise there wouldn't be a caretaker period like there is in politics.

MR FITZGERALD: There's not a black hole, in other words. But you're pointing out the disruption. Can I just make the comment: all regulation, all good regulation, is designed to bring about behavioural change. Good regulation is not designed to capture people but good regulation also does capture the outliers, the rogues, the ones that don't take notice. We fully appreciate that the vast majority of companies seem to be responding to shareholder concerns. That's why you might get a high first vote and a low second vote. We see that quite often. But then there are examples which you'd acknowledge, even amongst your own members, where that doesn't seem to be the case, that the second vote is in fact much higher than the first vote. Whether it's 50 per cent or not it's rare.

It was put to me that, "Oh, what would happen if one of those went over, you know, let's say 50 per cent threshold?" My response is, "Well, maybe there should be a consequence." If it's one out of 2000 every year, or two out of 2000 every year, or three out of 2000 every year, that's what regulation does. It takes the outlier, it takes the ones that don't listen, that don't respond. So these measures are clearly designed to what Allan indicates, a behavioural change; if you believe that is necessary, and obviously your members don't believe that is necessary. But the second thing is it is only meant to capture those that don't follow the normal patterns, don't respond and don't act.

So if it is - because business is arguing two cases. On the one hand they're saying that the measure could have great instability. On the other hand the same people are saying, "Oh, but it will never be used." Now frankly, I don't mind if it is never used if it brings about a behavioural change, if you believe that's - if that is necessary, which is clearly a point of contention.

MS CILENTO (BCA): Well, I guess - I mean I'm not saying there is not behavioural change. I'm saying that I think companies are listening. I think companies - and I think that is evidenced by some of the recent statistics that came out about where executive remuneration has gone. I think companies have listened in terms of the way they structure their remuneration as evidenced by the data presented in the draft discussion paper and the shift towards longer-term incentives and more performance-linked incentives.

My point is that there has been a response. The point about the two strikes is - I take your point about capturing the outliers. The message that I am trying to convey from the members is that there is the scope for this to be used in ways not related to remuneration and in ways which are intentionally destabilising. That's the point about the first strike as well, that by virtue of the first strike being crossed that you have that leverage, if you like. Now, if you assume that everyone is only ever going to use that for remuneration, that's fine. Well, it's perhaps less of a concern. But there is scope for that to be used in ways which don't relate to remuneration and which does give minority shareholders significant influence.

MR FITZGERALD: let's assume that the community concern remains and shareholder concern remains, which is probably more significant. Do you not face the prospect of introducing - in order to reduce the lack of confusion about what the vote is that you actually end up looking at multiple binding votes? So that another way forward on this is to break down the remuneration, don't vote on the report per se but vote down on certain component parts. Shareholders could be very explicit what is concerning them. So prospectively if nothing were to occur in that community but more importantly, shareholder concern remain, it seems almost inevitable that somebody would put forward the view that shareholders should be very explicit about what their concerns are.

That would mean multiple votes with a potential, I suspect, that some of those could end up being binding votes. That seems to me to be, from our point of view, a problematic position; (1) we don't like the notion of binding votes and secondly, that would probably add even greater confusion. But if the business community says, "We don't really know why they're voting," and I accept to some degree that's possible. You then end up with another scenario which seems to me to be potentially more difficult and more dangerous.

MS CILENTO (BCA): The concern that I have is that we seem to be anticipating problems.

MR FITZGERALD: Or identified trends that are already very clearly present.

MS CILENTO (BCA): As we said earlier when we were discussing this, concerns about executive remuneration are not new. There have been issues that have been discussed for some time in a way that have resulted in us putting out papers in recent years. I go back to my point: I think the boards have responded and I think they will continue to respond and I think they will continue to respond positively on the whole. They will be looking at what the Productivity Commission's discussion draft is saying. They will look at the direction of community concerns and they will respond to it. To put in place a range of measures that anticipate a range of problems that might occur with the scope for unintended consequences is something that we have a concern with.

PROF FELS: The same comment might be made about your comment about unintended consequences.

MS CILENTO (BCA): I'm sorry, could you - - -

PROF FELS: The same comment might be made about your expressed concerns about possible unintended consequences. There was the question about how probable those outcomes that you talked about would be.

MS CILENTO (BCA): I take that point, but we're looking at a specific recommendation that you've put and looking at how we think that could operate in practice on the basis of what's been articulated. I don't think we're looking forward and extrapolating where we think community attitudes are going to go, irrespective of ongoing behavioural change and responsiveness of boards.

PROF FELS: If you were trying to destabilise a board, wouldn't you invoke the 5 per cent rule? That's a much easier way; we've never heard any complaints about that. Has it ever been used to destabilise a board, the 5 per cent rule?

MS CILENTO (BCA): I'm not sure, to be honest, but - - -

PROF FELS: I'm not aware of cases. There may have been - - -

MS CILENTO (BCA): - - - there are circumstances that - - -

PROF FELS: I mean, if 5 per cent isn't used to destabilise it, why would a 25 plus 25 or 30 or 40 or 50 be - how probable is that when there's a much easier mechanism and quicker mechanisms to destabilise the board?

MS CILENTO (BCA): We can dispute that. I guess the other point I'd make is that there was perhaps a lack of clarity about how the vote would be measured and whether it was a proportion of votes cast or total shares on issue and I think it's very important to note that if consideration is given to the two strikes that it should be very clearly on the basis of shares on issue.

MR BANKS: The other area where I think you have most concern about our recommendations is the first recommendation, the no-vacancy rule. We'll perhaps give you an opportunity to talk about that but perhaps also raise any suggestions you might have for addressing one of the objectives there, which was to I suppose remove a perceived impediment to the refreshing of boards or greater diversity within boards or indeed just greater capabilities within boards.

MS CILENTO (BCA): Can I just make the observation at the outset that this is the one recommendation that people rang up, wanting to know what it referred to.

MR BANKS: Those who weren't invoking it?

MS CILENTO (BCA): It didn't seem to be common terminology, so there was a little bit of having to talk to people about what was being discussed. The first point that we've made is what's the relationship between the no-vacancy rule to better remuneration; that's the first point. Secondly, you've raised the issue of diversity. It's not clear to me - and I think we said this pretty clearly in the discussion draft - that there is already a high degree of transparency around the lack of diversity on boards and a tremendous degree of reporting around that and pressure for this to change and it hasn't changed, and it hasn't changed even though there are board positions available.

The biggest concern I have with the suggestion around the no-vacancy rule is that in practice, it is very important for boards to have flexibility in terms of how they appoint people and having the scope to appoint additional candidates, if necessary, to reflect changing business developments, changing skill needs. The recommendation, as it's currently put, does not seem to reflect - well, in talking about the need to get rid of the no-vacancy rule, it talks about appropriate skill sets but it doesn't seem to be reflected that that's actually what's happening at the moment and one of the reasons why boards like to have the scope to have some capacity to appoint additional people on to the board to reflect changing skill needs, so I think that's a really important point.

It's not clear to me that abolishing the so-called no-vacancy rule is actually going to have an impact on diversity, and again, in relationship to that, better remuneration is one that needs to perhaps be more clearly articulated. I think the risk is that the perverse outcome will be that boards that want to be able to ensure they have got the right skill mix and who have an eye to how the board functions and the good working relationship of the board. What you will end up seeing is actually a reduction in the number of board positions and a formal reduction with the cost that there will be less flexibility in terms of how those appointments are made.

The issue of diversity is one that's obviously received a lot of attention at the moment and I don't know that there is a simple solution to that. The point I would make, because I think there seems to be a tremendous degree of momentum at the moment behind driving real change there but I actually don't think that the no-vacancy rule in and of itself is going to - - -

MR FITZGERALD: I take on board a number of your comments and we're reflecting on all of these recommendations, including this one at the moment, but just one thing: where the no-vacancy rule is most egregious, where it's used, you're right, most companies don't actually use it, but those that do, they only use it for one purpose and that is to exclude a potential candidate that they don't want basically. Whilst I understand the theoretical arguments about the boards being able to set the numbers and all that, I don't disagree with any of those. The truth of the matter is that in the limited number of occasions, what generally happens is at some stage prior to the AGM, there's suddenly a decision that all positions are filled. That's the way the no-vacancy rule works basically, and normally that occurs when there is a likelihood of somebody being nominated - although I might say no likelihood they're actually going to be elected - withstanding. So in a sense, the no-vacancy rule, I can understand why most boards don't pay much attention to it, but where it's used, it's used as a clear device to stop non-director nominated new directors, even though all the evidence indicates they wouldn't get the 50.1 per cent anyway, so is that not the truth of the matter?

MS CILENTO (BCA): There seems to be a presumption that that person has got the required skills and expertise to be on the board, that there's not a functioning board - - -

MR FITZGERALD: But what I don't understand with this is, it's as if the directors can't trust the shareholders. There's a fundamental problem that I've got here. On the one hand, we say that the directors are custodians on behalf of the shareholders, broadly speaking, yet every time you put a proposition that the shareholders might put forward somebody, notwithstanding they've got to get 50.1 up, there's this terrible reluctance, and I suppose I'm struggling with this, that in the end, is it that the directors really don't trust the judgment of the shareholders? That judgment might in fact be absolutely, as you say, completely flawed. They might put up me and I'd be hopeless. But it just seems to me the no-vacancy rule as it is currently applied is a device used to stop the shareholders having even the possibility of putting up somebody. As I said, on all the evidence, they're not going to get up anyway. That's where this comes from, doesn't it? It's not about the size of the board or the expense of the board and all that, all of which is true about board setting. The no vacancy is actually a device.

MS CILENTO (BCA): But if the board responds by just formalising the number of positions, you're not actually going to get a change, but you run the risk of limiting flexibility.

MR FITZGERALD: I agree.

MS CILENTO (BCA): My point is that for boards that you believe are misusing this, I think the abolition of it isn't going to change their behaviour. My view is that the vast majority of boards are not misusing it. The cost to them, if they feel the need to respond to it, is going to be to actually achieve exactly the outcome you don't want. So that's the key issue for me.

MR FITZGERALD: I take that point on board.

MS CILENTO (BCA): I just don't - when we were looking at the recommendations we did really try to look at what the intention of it was and whether or not we thought what was being put forward was likely to actually achieve the desired intent and then whether or not it was actually likely to do it in the most effective way. That was sort of our starting point. This one, I think, really stands out as one that it just doesn't seem to stack up in terms of actually having the desired outcome.

MR BANKS: Well, we're glad you did that because that's exactly the purpose of a discussion draft, to get people to tell us what some of the consequences would be. But just to come back to your threshold one, I suppose reassure you that there was a logic in there that related this to remuneration. I guess in broad terms it gets back to that earlier point about perceptions that shareholders or the wider community have about whether things are being done appropriately, and in particular perceptions that boards are effectively clubs.

Now, we looked at that, including empirically, and indeed didn't find a lot of evidence, for example, in the top 100 that there was a lot of overlapping board memberships and things like that. But there is a sort of strong perception. So rather than impose quotas and affirmative action type regimes which people were recommending, we then looked to see whether there would be some barriers to entry that could be addressed that would have a perception value apart from anything else.

MS CILENTO (BCA): Yes, and again I mean I don't disagree with that desire and nor do the Business Council. I think anything - measures that can increase the pool of people that have the skill set and the expertise and the experience we would be supportive of. I think raising the issue and getting boards to consider the issue and to think how they can look - the broadest possible pool of candidates who are going to bring the experience and the skills that they need, by all means. But I think in all of these things it's not - if they were straightforward I suspect that they would already be in place. So the issue that - - -

MR BANKS: Not necessarily. As a woman I guess you'd probably have some perspectives on that. I mean if you look at the gender balance, for example, it's actually going backwards and it's hard to explain that because the education level of women, their experience in business et cetera et cetera is going the other way.

MS CILENTO (BCA): Yes, and I think there does need to be a discussion about ways in which workplaces become more flexible to accommodate greater diversity. But I think it is a more structural challenge there. I guess the point I was trying to make is that if I thought it was just because there was a no-vacancy rule that was being used to maintain the club in some ways that would be nice because we could just say, "Yes, fine, we'll get rid of that," and then it's all resolved.

My point is that there is scope to appoint more people to the boards. It's not by virtue of the fact that there is - you're talking about the no-vacancy rule but we haven't seen that diversity. I think what needs to happen is that people need to actually focus more on where there are positive outcomes and how you can encourage that diversity and encourage people who are actually really committed to it and who are focusing their attentions on it who have managed to achieve greater diversity, how they've managed to achieve that, and try to get a bit more momentum behind following the actions of people who are setting the example.

MR FITZGERALD: Is there any mechanism in public policy terms, which is what this inquiry is about, that can in fact do what you and Gary have just been talking about? I mean what is the mechanism by which this occurs? I understand cultural change is difficult. Occasionally public policy has a role in that, sometimes it doesn't. Clearly the mechanism - a mechanism we put forward is - even if it were adopted is inadequate to achieve that goal. But I'm lost as to knowing what other mechanisms that need - well, more specific: are there any mechanisms that can be explored or in fact recommended to bring greater diversity - both the gender and the gene pool - which on any analysis is at best, you know, fairly constrained at the top level of the business world.

MS CILENTO (BCA): I mean the first comment I'd make is that - I mean I think there's lots of things happening at the moment through consideration of the EO legislation and - where I think consideration is being given to that. I mean to be honest I'd like to see a little bit of what comes out of that because I know there's a lot of thought and consideration being given to this issue specifically. I do think that the reporting side of it and the requirement to have greater disclosure around that has been helpful, and I know it has not manifested itself in a trend improvement and in fact things don't appear to be doing all that well. But I do think what you're saying now is more attention being paid to it, and there will be greater scrutiny and greater focus on that and that there will be questions raised of boards about their diversity. I actually have to say I think it's also very helpful that the diversity debate has broadened out beyond just gender but also to other ranges of diversity because I think the evidence does show that diversity in decision-making leads to better decisions.

MR FITZGERALD: That is the link, I guess, back into the remuneration issue because - but I'll just get you to comment on one other thing, I suppose, because you mentioned earlier that remuneration in a sense was small, certainly in the total valuation of the company et cetera but I don't think you were saying it's a small issue, because we have had other people tell us that how a company remunerates its executives, its top people, actually is an important driver of the success of the company itself. Do you want to clarify that?

MS CILENTO (BCA): I guess the point I'm trying to make is that yes, I think it's an absolutely important driver and I think - as I said, I think companies by and large are doing it very, very well. But it is only - I think there is an issue - it's a fundamental decision that there's very, very important - to me it's as much about the structures of what you're trying to do as much as the quantum and the way in which you're remunerating. I think there's a lot of focus on the quantum. I guess that was the point I was trying to make, is that a lot of the angst around this in the community is just about the size of pay packages. So there's the issue of the quantum and there's the issue of how it's structured and yes, I think structure is very important in terms of how you align the interests of shareholders and the company and performance.

The other point I would make is that I think that implicit in a lot of this is a perception that the CEOs aren't actually there doing the right thing and hard working and dedicated to the company. Yes, all people look for the best remuneration they can. They want to make sure that they're remunerated in line with their peers and all the rest of it. But my experience with our member CEOs is that they have the best interests of the company and the shareholders in mind. So I think it's just - to make that point as well. But I think - there's a focus on quantum. The quantum of remuneration relative to everything else that gets done in the business needs to be kept in perspective. I think it's the structure as much as anything else. Somewhat perversely, over time in a way the efforts to align the structure with shareholder interests have been the aspect that have attracted the most attention.

MR FITZGERALD: One of the issues that I think going forward will get more attention is whether or not the discrepancy or the gap between CEO salaries and the workers within the organisation is in fact a material issue - is interesting. I noticed even recently a couple of German companies, one in particular, has now put a - has itself imposed a cap on a CEO for 17 times the average earnings of its employees. So I think there's an interesting story about whether the relativities within organisations is unimportant or important, but that's for another day, I think.

MS CILENTO (BCA): But I think they are two - I mean these are issues that companies consider.

MR FITZGERALD: Yes.

MS CILENTO (BCA): I mean I think companies look at the totality of their workforce. They look at how they motivate all of their staff. They look at both the quantum and the structure of that and it's an issue that boards and senior executives have to deal with all the time and there is clarity around - through the reporting requirements already about what senior executives are getting. So, you know, people within the organisations are aware of that. I'm sorry to keep coming back to this but I think those evidences of new practices overseas - people will be watching those, and particularly the leading companies. They will absolutely be looking at what practice is overseas, not least of which because they're going to have to keep pace with it. So I think - my point is you will get that evolution where it is relevant to the company.

MR BANKS: One of the ways in which you helped us in your submission, I guess, is by addressing the question of degree of blackness, if I could put it that way, black lettered-letteredness - in any regulatory outcomes or proposals. There's always the issue of whether you make something a black letter law within the legislation or listing rules or go for the if not, why not. We're looking at that and, indeed, the ASX in a helpful submission has indicated some of the criteria that you might use for putting rules in different boxes.

MS CILENTO (BCA): Yes.

MR BANKS: One that I just wanted to get you to talk a little bit about related to the recommendations 10 and 11 relating to remuneration consultants where, in particular, we thought in draft recommendation 10 that the listing rules was the place to have a rule about the reporting of expert advisers to the board, rather than to management. But the BCA thought it would be better to do that on an if not, why not basis which sort of implied - and then you go on to say the advantage of that is that companies would then have to explain why they weren't doing it. But that in turn implied that you thought there would be some good reasons why you wouldn't want to have remuneration consultants providing advice separately from management or not through management.

MS CILENTO (BCA): Let me very clear about this: we support the principle of what you're trying to achieve and in fact many companies already have this in place where the remuneration committees are fully able to go and source independent advice. I guess what we were trying to do was to say that there may be circumstances where against a legal requirement a board might say, "The remuneration consultants have reported into us," but there may be issues in which they're dealing with management. The issue was how clear is that and if it's prescriptive in law are you going to get the information that is really helpful in terms of how that's actually being done. That was really the point we were trying to make.

MR BANKS: I'm still not entirely sure about that because this rule wouldn't preclude the same advisers or certainly the same firm providing advice to management or the company but again that would have to be made transparent which we thought was a good thing.

MS CILENTO (BCA): Yes. As I say, we agree with the objective of what you're trying to achieve. Our leaning is more to the ASX Corporate Governance Council principles but I don't want to split hairs in terms of saying we don't think it's not good practice.

MR BANKS: Okay.

MS CILENTO (BCA): In all of these things I think our approach is to say we actually think where you have flexibility about how you do this and you can provide more information about what you're doing and why you're doing it, that that's actually more helpful in most instances.

MR FITZGERALD: I'm not sure it's canvassed in my submission - or you may even have not thought about it - but some people have been talking to us about codes of conduct or advisers. Clearly there are proxy advisers, they're just remuneration advisers, and what have you. Some submissions have indicated there should be a code that surrounds their behaviour or conduct. We're not sure about all that. There wasn't a recommendation in the draft report. Did your members express any views about that issue or advisers more generally?

MS CILENTO (BCA): The key point that's been made to me is that where advisers have been used it's interesting to understand where their thinking is at and what's driven that thinking and to have a bit more clarity and transparency around that in some circumstances. We certainly haven't discussed a code per se. I'm happy to take it on notice and talk to people.

MR FITZGERALD: It has just come up on a few occasions. The other one about the codes is whether or not we can come up with a code or a standard in relation to remuneration packages themselves, not a prescription about what should be in it but this notion that in fact there needs to be much greater guidance about how you actually design remuneration packages. Some have suggested a code or a standard or something like that.

MS CILENTO (BCA): I struggle with that a little bit just because I find it hard to imagine what you would do that's meaningful. A lot of companies do obviously get advice and they get advice from a range of consultants. They do that to understand a number of things: (1) where remuneration is at generally which is not always straightforward and (2) to understand what the different practices are in setting the structures of remuneration and the like, and it's not clear to me what you would put in a code that's going to go further than some of the things that we've already talked about and some of the best practice principles. For me the fundamental issue is encouraging boards to do all that they can to explain what they're doing and why.

That's the issue for me, the intention of remuneration and I think, if anything, if we could encourage greater differentiation in how remuneration is structured so that it does target directly the objective amount that boards are seeking that that would actually be a good outcome, rather than an expectation that certain structures are the best way to go.

MR FITZGERALD: Thank you.

MR BANKS: With some of them you've agreed in principle and you've raised a number of practical concerns and that again was very helpful to us. One area is in relation to draft recommendation 8, section 300A requirements and so on where we talked about actual levels of remuneration and so on. I just clarify there that you're not opposed to the objectives there or even perhaps pursuing those avenues - - -

MS CILENTO (BCA): No.

MR BANKS: - - - but you're raising issues about implementation and - - -

MS CILENTO (BCA): I think again it really was from a perspective of trying to get a meaningful outcome because if we are going to have changes - you know, rather than having to come back and revisit these things I think it would be good to try and put in place a structure that is capable of getting the best outcome but also is able to adapt and respond to circumstances and to innovation. The point we made in respect of the reporting back on the "no" vote, you can require it by law and that's great but in a sense if you could create an environment in which boards are encouraged to do this in a way which is effective from the perspective of their shareholders, that that's actually ultimately the better outcome.

If I could ask one question: in recommendation 8 the suggestion to report the total company shareholdings of individuals named in the report. What was the purpose of that?

MR BANKS: Just to bring that forward into the remuneration report and provide an indication in one place of what the shareholding was. It has, I think, a useful information value in a number of respects, particularly given the notion that skin in the game is a positive thing. We saw it as being relevant to shareholders understanding the motivation or position of executives in their company. As someone said, "It could backfire in a sense and it could lead to a negative reaction that certain executives have got so many shares, why should we be paying them as well?" or something like that.

MS CILENTO (BCA): It's not a major point, but to the extent that you want skin in the game I think that's the way you set up your long-term incentives and how that's structured and that's addressed elsewhere. If an individual wants to buy more shares in the company in their own right I would have thought that's a good thing. It's not clear to me that the requirement to report your total shareholdings, if they have acquired them on their own, whether that's actually the right thing to do. As regards what the company is paying them - - -

MR BANKS: You're saying it's okay for the flow but not for the stock? It's okay for the remuneration but not for the wealth component of the same thing?

MS CILENTO (BCA): I guess the issue that we were getting at was to the extent an individual has gone off and purchased their own, what's the information content there. That was the only issue from our perspective. If they have gone off and individually done this in their own right - anyway, we were just trying to get to the bottom of - - -

MR FITZGERALD: I think the answer was much simpler than that. It was simply, as you say, you've got skin in the game and it's how much skin in the game, I suppose. It just basically indicates that.

MS CILENTO (BCA): Yes.

MR FITZGERALD: But we can take on board those comments.

MR BANKS: Of course, if executives are voluntarily putting skin in the game, that's quite a positive thing, you would think, for shareholders to know that the senior people in the company have got such confidence in the company that they are quite highly weighted in the company shares.

MS CILENTO (BCA): It was just a small point.

MR BANKS: Maybe slightly related to where you're coming from on that, you expressed concern I think in relation to recommendation 12 about requiring institutional investors to disclose how they had voted - well, "requiring" is probably not the right word because we saw it as a self-regulatory thing and indeed IFSA's Blue Book recommends that for members of IFSA. But one of the issues you raised there was privacy, which I thought I should get you to elaborate on. It seemed a little bit of a stretch.

MS CILENTO (BCA): Well, I guess again the sort of question for us was if it institutional - I guess who is it you're trying to inform? Institutional investors have their own clients. Surely if they want to know what their own investors are doing it's for them to dictate to their investors what they want to know.

MR BANKS: So I suppose one of the points of clarification is institutions and institutions and they vary enormously - - -

MS CILENTO (BCA): Yes.

MR BANKS: - - - from small ones with boutique clientele et cetera. But I supposed what we had in mind was the super funds that have lots of members who are, under law, obliged to be putting their savings into these, and therefore enhancing the accountability back. But as we said, you know, we saw this as something that institutions could - - -

MS CILENTO (BCA): Well, see the question - I guess when I was looking at it it's like, well, which - it's accountability back to their investors, which they should be - that, to me, seems like a separate issue; is one comment. The second comment is that all the companies that I speak to actually talk to their institutional investors and they tend to deal with these issues. So in responding to what the concerns of the institutional investors are, from a practical perspective - I mean I also, to be honest, questioned - if you do this, what is the behaviour of the institutional investors? Is it going to encourage them to vote their shares more or not? It seems to me - - -

MR BANKS: You would think so.

MS CILENTO (BCA): Well, I'm not sure. I guess that is also a fundamental question I have. If they're disclosing does it encourage them to vote more or not? I mean I think I've mentioned to you before just in a very practical sense having worked on that side of the business if you were overweight, a company in your portfolio, I find it almost impossible to imagine that you would actually vote your shares against the remuneration package. I think there is a whole bunch of issues there in terms of how you then explain that to your own clients about having a concern on the issue but still being overweight. So I guess it's just - again, it's - what do you think the genuine effect and impact of this is going to be and what are you actually really trying to achieve and is it the best way to go about it?

MR BANKS: I guess we'd be somewhat reassured by the fact that IFSA had seen it as best practice and the sky hasn't fallen in - - -

MS CILENTO (BCA): No, no. But I think the issue there is that it's the same in terms of the relationship between the institutional investor and their clients.

MR BANKS: Sorry, is that a question?

MS CILENTO (BCA): No, I'm just - - -

MR BANKS: No. Yes, okay. All right. I'm not sure whether we have any more questions and we have kept you in the hot seat for a while.

MS CILENTO: No, that's okay.

PROF FELS: We always take the Business Council very seriously.

MS CILENTO (BCA): Allan, I can't resist coming back to you and saying that we have explained in detail where we think we have concerns but we were taking that that's what you were looking for us to do on the basis of your discussion draft.

PROF FELS: Absolutely.

MR BANKS: Absolutely, and we had that word "discussion" on the cover and we've had a good discussion today. We do thank you for - - -

MS CILENTO (BCA): I'm sorry, Gary, the one other point that I did want to make, and we have made it in the submission, but I think the other thing that does need to happen, and this specifically relates to recommendation 4 in respect of the associates.

MR BANKS: Yes, we've picked up on that and in fact that was probably an oversight in terms of - - -

MR FITZGERALD: Well, not an oversight. The problem is really trying to define it.

MS CILENTO (BCA): Yes.

MR FITZGERALD: There are several definitions of associates and we have to be - if we choose to continue with that we have to be very clear about who we're trying to capture. It may be in fact too difficult to capture.

MS CILENTO (BCA): Yes.

MR FITZGERALD: But we're conscious of that, that term has problems.

MS CILENTO (BCA): Yes.

MR FITZGERALD: We've asked people to come back to us but I think at the end of the day we'll just have to do an analysis of who we really want to capture. But I think yours is a broader point about whether you should or shouldn't.

MS CILENTO (BCA): Well, I think the issue too is just how these things interact.

MR FITZGERALD: Yes, that's right.

MS CILENTO (BCA): How the different recommendations in totality interact with one another and making sure that when you stack them all up you're actually getting - - -

MR FITZGERALD: The one thing I can assure you, it was never intended to capture a situation where a director, for example, is appointed by a major shareholder and suddenly that shareholder pulls out, Shell or BP or whoever it might be can't exercise their vote.

MS CILENTO (BCA): Yes.

MR FITZGERALD: That was never intended.

MS CILENTO (BCA): Yes.

MR FITZGERALD: We're conscious that some people have read that but that was never intended. But we agree that the word itself is problematic.

MS CILENTO (BCA): Yes, okay.

MR FITZGERALD: We have to be careful with it.

MS CILENTO (BCA): All right, great.

MR FITZGERALD: Good.

MR BANKS: Okay, thank you very much. Thanks again. Break now for morning tea.

MR BANKS: Okay, our next participants this morning are the Australian Council of Super Investors. Welcome to the hearings.

MS BYRNE (ACSI): Thank you.

MR BANKS: Could I ask you please to give your names and positions?

MS BYRNE (ACSI): Anne Byrne, chief executive officer.

MR O'SULLIVAN (ACSI): Michael O'Sullivan, president.

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

MR BANKS: Good, thank you. Well, I think you were sitting in those same seats not so long ago in the lead-up.

MS BYRNE (ACSI): Michael wasn't here last time, that's right.

MR BANKS: Maybe not Michael.

MR O'SULLIVAN (ACSI): That is correct.

MR BANKS: We do appreciate the input you've made into the inquiry in the first round and now the submission that you've made in response to our discussion draft. So we'll give you the opportunity to cover the main points.

MS BYRNE (ACSI): Okay, we're going to make some very brief comments. I'm going to make some and then I'll pass on to Michael. Then we think that - we're open for, as Allan said before, as many questions or I think a grilling, he might have suggested. So we'll be happy for that.

So we thank you very much for your report and the analysis and the draft recommendations. So you know who is appearing with us today. We believe the draft recommendations lift the standard of debate on remuneration issues in this country and the Commission's draft proposals present, we think, very constructive reforms. We note there's two key objectives of the Commission: to give shareholders more say on pay and to reduce the likelihood of remuneration outcomes in the future that shareholders would find objectionable. We note that your draft recommendations have supported these objectives and we have provided, as you know, written submission, comment, on each of the recommendations and we would happily take questions on that today.

However, we are concerned that one opportunity to achieve the Commission's objectives has been missed and we think requires further consideration. The issue I'm talking about is in relation to the ASX listing rule 10.14. We feel that the current function of 10.14 reduces shareholders' say on pay and potentially increases the likelihood of remuneration outcomes which shareholders will in fact find objectionable. So I'm just going to hand over to Michael who is going to go into that in a bit more detail.

MR O'SULLIVAN (ACSI): Thank you. Thanks, Anne. Yes, we would like to have another go, if we can, at persuading you that you've made a small error in relation to 10.14. We accept what you say in your report about the history of it. It's true that before 2005 it was as you said it was and its amendment was intended to get rid of a problem that every grant of equity to a director had to be voted on by shareholders when they were mainly part of what we would call salary sacrifice plans or employee share ownership plans or plans of that kind.

What we are seeking, really, is to return to the position as it applied before that amendment so that 10.14 does the work that it was supposed to do in the first place and not some new work which it is starting to do because we say now that it's a loophole. It's able to be utilised in ways that weren't intended by the drafters of the listing rule or even those who have defended it to you who say that it's - it's defence is that it's dilutive so it doesn't matter. But we're saying that's not the issue at all.

The issue now for us is that in respect of looking at and approving of long-term incentive plans we think that grants of equity, whether on market by the creation of new shares or by the creation of options for new shares, should be treated equally. In the other two cases you need a binding vote. If you're going to issue new shares to somebody as part of a long-term incentive plan you have to bring it to a vote. When you bring it to a binding vote then the shareholders exercising that vote have the opportunity to look at the quantum that you're proposing to give the person, the terms on which you're going to give it to the person, and the vesting arrangements. So you have a really sharp opportunity to vote on something that you've had for very many years and which to a large extent can be avoided by buying the shares on market.

PROF FELS: So you're saying, just to get it clear, that at the moment there's a non-binding vote but you don't even get a non-binding vote on this one. That's what's you're driving at.

MR O'SULLIVAN (ACSI): Effectively.

PROF FELS: Then if the consequences are escalated, that is, that the vote starts to have some consequences, you won't get any consequences if companies go down that, therefore you want that picked up in voting in one way or the other. Is that what is - - -

MR O'SULLIVAN (ACSI): We want it to be treated - it being submitted to a binding vote in the same way that new shares would have to be submitted to a binding vote and options have to be submitted to a binding vote, irrespective of the non-binding vote which takes a retrospective look at the way in which the remuneration policy has been applied by the company and sometimes a prospective vote but not very often. Frequently you're looking backwards on what they have done and approving it or not approving it in a non-binding way. That's a different issue. We're superannuation funds, we're long-term investors. We want to encourage long-term value creation and any long-term incentive plan we would like to have the maximum opportunity to scrutinise the quantum, the terms and the vesting arrangements. Now, we have that with options, we have it with new shares but we don't have it if they buy the shares on market.

MR BANKS: You would have it through the remuneration report, but retrospectively, for those who are covered by the remuneration report - - -

MR O'SULLIVAN (ACSI): Only non-binding.

MR BANKS: Only non-binding, but with the binding element in the other case, it relates to dilution and therefore potential disadvantage to shareholders. I have argued since the report came out that in a sense you could argue there's only upside for shareholders in on-market purchases of shares for executives because if anything, it will serve to push up the price for shareholders, and provided there's transparency about that, it's transparency about something which, as you say, is actually aligning the interests of executives with shareholders. So that's why I guess when we approached it from, "What's the objective here?" in terms of having a binding requirement, we thought there was an asymmetry between those two.

MR O'SULLIVAN (ACSI): If it were always done as the AMP did it, which is the example that you cite, that they did it very transparently and with a full explanation, then it would be less of a problem but if they do it in the way that Downer did it or Wesfarmers did it and others have done it, then it's not satisfactory. Wesfarmers gave Mr Goyder 100,000 shares on terms that nobody knows about. Nobody knows what he has to do. Downer gave even more shares twice to their CEO on terms that nobody knew, and with apparently a hidden power vested in the board to waive the terms anyway, so they kept lowering the hurdle till he could jump it.

MR BANKS: But the alternative might be cash, for example.

MR O'SULLIVAN (ACSI): Yes, I saw that too, a reference in your report that somebody had said, "If you deny us the opportunity of buying shares on market, we'll just pay them in cash," but that opportunity exists now in relation to any part of remuneration, but I think one message that's got through, if any have got through at all, is that people want alignment and long-term alignment of interest between shareholders and boards and management. Everybody now has the opportunity to pay solely in cash if they want to, but they don't. Overwhelmingly people go to their shareholders and ask for a binding vote to give out options or to give out new shares and in many cases they put these to the cases. We've indicated in our submission a number of people, even though they're not obliged to put it to the vote, have. What we're asking for is the closing of the loophole so that those who use it as an avoidance mechanism are blocked from doing it.

MR SPATHIS (ACSI): Michael, can I just interrupt for one moment and just amplify the point in the context of a real example.

MR O'SULLIVAN (ACSI): Yes, certainly.

MR SPATHIS (ACSI): The Financial Review today talks about Shareholder Protests Mount Over Payout, and one of the companies that's referred to is Downer EDI and the 59 per cent vote against. You raised the issue of the remuneration report and the fact that there is a vote, albeit retrospectively, but what you've got in these circumstances is that the horse has already bolted when it comes to the implications of a grant of $1.6 million to the CEO in 2008 and a further 500,000 shares granted to him in 2009. Approval wasn't sought in relation to any of those.

MR BANKS: These were on-market purchases.

MR SPATHIS (ACSI): That's correct. Basically in 2009 the company disclosed that it had retrospectively changed the vesting criteria for the 2008 grants. The company introduced a retest in response to a decline in the company's share price in late 2008. Now, had the company sought approval from shareholders in relation to the 2008 grant to the CEO, the terms on which it sought approval would have had to specify unequivocally that the board reserves the right to change the vesting criteria. But all we've got now at the moment is yes, there's been a 59 per cent vote against and that's all well and good, but the grant still stands. The horse has bolted.

We can use another example with respect to QBE. QBE in 2008 received a 30 per cent vote against conditional rights and options to the CEO under a deferred compensation plan. Shareholders, and a significant number of shareholders, 30 per cent of votes counted, believed that the hurdles were not forward-looking enough and they were measured by a return on equity measurement over one year. The following year in 2009, QBE used the Listing Rule 10.14 to say that it did not seek approval for the equity grant to the CEO and their remuneration report stated that this was "because the remuneration committee considers that this is no longer appropriate" based on the "approach of many other listed companies". Now, it was only a significant engagement that came about from shareholders in the lead-up to the 2009 AGM which led to QBE going out on the record and announcing that it would put grants to its CEO under its equity incentive schemes in the future year.

What this is effectively doing for us is like we're almost feeling like we're putting out spot fires all over the place. We have to be vigilant. In fact, between ourselves and RiskMetrics, we're basically putting out spot fires across different parts of the ASX, S and P universe and trying to deal with I guess this issue in a very practical sort of way. When we do go about explaining to companies who have somehow utilised these sort of provisions and expressed our concerns about the most extreme sort of impacts that they can have, thankfully many of these companies which are very responsible companies do accept and come to the table in addressing this issue as was the case with QBE, but we cannot guarantee that for many other companies.

MR O'SULLIVAN (ACSI): I don't know whether what we're saying is clear. It's an old listing rule, amended in 2005, now being, we would say, misappropriated for a use for which it was not intended and that use ought to be stopped. We're not suggesting the listing rule be withdrawn or that the proper purpose be withdrawn, simply that the loophole be closed. Phil is reminding me that we're absolutely comfortable about it being used to preserve salary sacrifice but this is not salary sacrifice, this is avoiding a vote, which others have been, as you've indicated in your own report, very happy to submit themselves to. Even though they bought the shares on market, they still take it to a vote, because the other things about the LTI are just as important as where the shares originate, whether they're on market or off market. The real thing about the LTI that we want to be comfortable about is that there is a long-term measurement and there is going to be long-term wealth creation and there is an alignment of interest with our people.

MR BANKS: Okay. As I said earlier with early participants, this is a discussion draft and we're open to feedback on a lot of those recommendations, so thanks for that.

MR O'SULLIVAN (ACSI): Thank you. So really, it's up to you. If you have issues on any other part or our second submission - - -

MS BYRNE (ACSI): We were going to answer questions rather than actually go through our submission.

MR BANKS: Fine.

MR FITZGERALD: Could I just start with the no-vacancy rule. In the scheme of things, it's probably not the most significant of our recommendations, but universally, business groups have asked us to not proceed with that recommendation. A couple of people have in fact, such as yourself, I think endorsed it. Given that the arguments against it have been put so strongly, I am just wondering why you believe that we should continue with that recommendation. The first point that most business groups would say is that it's not used very often; secondly, the unintended consequences of abolishing it may be to constrain the ability of boards to optimally set the board size and so on and so forth. You would have seen all of those comments. So in light of those comments, I was just wondering whether you have any particular additional views you want to put in relation to that.

MS BYRNE (ACSI): Those people who are saying that it will in fact give them unmanageable boards because they in fact won't be the group that say that they have the particular size I think are forgetting that overwhelmingly, shareholders are very responsible, and to get on to a board, you have to get more than 50 per cent of the vote. We are encouraging of anything that we believe provides the opportunity for greater diversity on boards and whilst we are not convinced that this will absolutely provide that diversity, it does give some opportunity and we think that is something that needs to happen. It is very clear that boards are not taking the opportunity of having a diverse skill base on their boards.

MR SPATHIS (ACSI): I'm actually pretty surprised that there has been the reaction that we've seen in relation to this recommendation. We work off first principles. Essentially the number of board seats that are made available for a company are clearly prescribed at the moment, as a maximum, in the company's constitution. So under Corporations Law, you have essentially shareholders who have the paramount position as to determine the maximum number of board seats that should be made available. I have some real difficulty as to why we cannot still have a manageable mechanism in place to require company boards who believe that that maximum might be a bit too big or too cumbersome, given the situation or circumstances of the company, why they couldn't go about either utilising the mechanism that you've referred to on page 145 of your report or whether they've also utilised the special resolution provisions to alter the constitution; therefore, require the boards to make a recommendation and explain their position to shareholders, and I would say in more cases than not, you would have a situation where shareholders would endorse that.

I think we've also probably seen in the last few weeks an excellent example in the context of Fairfax, where you had a company that didn't use the no-vacancy provision when it could have and allowed for some, I guess, more robust debate and allowed for essentially non-board-endorsed candidates to stand for the Fairfax board and to actually engage with the incumbent board on issues to do with succession planning and strategy, so I think we've got a very good example of how that actually manifests itself.

To go to the issue of the proposal supporting mechanisms to bring about greater diversity, it may well do, I'm not sure, but it could not do any harm in that regard. Companies really have to step up to the plate to deal with the whole issue of skills, succession planning and diversity. I think the more that we ask the question about what they are doing in this area, the more I guess engaged they will be in this sphere of improving diversity because there's a long way to go in relation to this issue.

MR BANKS: Are there any - maybe I will get you to elaborate on them - alternative mechanisms to pursue greater diversity and what we would call "capability" more broadly, that there's a gender element to it but there's also a range of other dimensions to it? Do you have any thoughts on that area?

MR O'SULLIVAN (ACSI): We've had, even quite recently, a substantial discussion with the Institute of Directors and a number of their senior members about diversity, particularly gender diversity. I guess the argument that comes from business is that there are insufficient women surviving in their careers long enough to have CEO, CFO, COO experience in order to qualify themselves for the board. We don't really believe that that's true or not so true as to make the figures that you see now a natural consequence of that. The only measures that I'm aware of, and there may be others, are a position that was taken, as you probably know, in Norway was to fix quotas on boards, that they must have a certain number of women by a certain date. They say it's worked extremely well but Norway has a very different culture I think about all sorts of matters to ours, and whether such a proposition would be acceptable here, we doubt, so we're not at present advocating quota systems. But certainly there is need for some kind of a circuit-breaker, and I don't think we've found the answer, to deal with the gender issue.

The other issue about having only lawyers, accountants and so on on boards is really much more a matter I think for the way in which boards search and the way in which they evaluate their own skill deficiencies. But they tend to see the need to be reflected by the person who's just left, whatever he or she was and it's, "We need another one of them."

MS BYRNE (ACSI): Also, it seems to be in our discussions that boards really need to look at their skills and use some sort of matrix to work out what their skills are and they're very specific skills - and we talk to them - that people are in fact asking for. Are they being made so specific - and inadvertently they might be excluding the skills that might be held by a different group. You might recall that we do research each year on the composition of boards and if you are a woman on a board, there is a much higher chance that you are in fact going to be the chair of a committee, so therefore it seems to us that to get on to a board as a woman, you have to be higher skilled because they're expecting you to be the chair of the committee. Why isn't that the same for men? So why should women have to be at that higher skill level? I think boards need to really start to think about how they develop that process of their skill mix. We have had discussions with companies about their skill mix and we've also seen from Canada some disclosure to shareholders about their board skill matrix and therefore how they put together their boards. So something like that may in fact encourage, but I think "encourage" is something that needs to be a bit stronger. It's not happening, and in fact the number of females particularly has decreased slightly over the time.

PROF FELS: Can I ask a question. Apart from the issue of females and also apart from the question of a narrow representation on boards that has been confined to members of the club or to particular professions with particular skills, are there any other issues about board diversity? This is the era of corporate social responsibility. Are boards reflecting that in appointments? Do you have any concerns about that?

MR O'SULLIVAN (ACSI): I don't think it's reflected in boards but that's not said in necessarily a disparaging way because I think a number of good boards have made managerial arrangements to deal with those issues in a far more thorough and sophisticated way than they would have, say, 10 years ago. Some of them are really admirable. Others have got to catch up to that. But there are standards set by good companies that others can be held now to account to follow. What a defence might be is that there are very many people serving on boards for business reasons who also have substantial lives in the not-for-profit, philanthropic or other activities which fits them to understand better the contribution that business can make to corporate social responsibility, as distinct from environmental, social and governance-type issues which we distinguish as meaning risk management and other things. If you mean by corporate social responsibility contributions to the wellbeing of the society in which you operate, your social licence to operate stuff, then I think there's fair evidence that good companies are doing better with that. There's less evidence that they're handling their environmental and social risks as well as they might and certainly not giving investors good information to make judgments about whether they are or not in many cases.

MR BANKS: I was going to get you to perhaps elaborate a bit on your response to our celebrated recommendation 15(a) and (b) and I think you created a 15(c).

MS BYRNE (ACSI): Phil did that, but we thought you needed some alternatives for a discussion.

MR SPATHIS (ACSI): I think based on our broad experience, and let me just put the caveat that we've been providing advice to our members on the ASX S and P 200 - that's been our universe - I generally think that the majority of companies would find that this proposal if it did get up, it would actually be irrelevant to them. I think in the main, most companies, if there was a first trigger, would then seek out and find out what the problems were in relation to a remuneration report. More likely than not, they would probably already know what the problems were. But if it's an issue relating to standards of disclosure or issues of substance, more often than not and our experience has been such that companies, well before the AGM season, at an early phase, at the contemplative phase, may well have talked to us and other key groups and there's evidence of that and examples of that even more recently. There's a lot of news about companies that didn't quite step up to the plate but there are examples of companies like Toll Holding and Boral, who dealt with I guess substantial votes against in the first year and actually wanted to get to the heart of why there was such a reaction from shareholders, and to their credit - and I'll put that on record - they were prepared to deal with some real issues of substance.

So if we go to the first trigger, you need a reasonable sort of trigger to at least make aware the recalcitrants, and I would say that the recalcitrant companies do exist, they do exist in the marketplace, who do not get on the phone and want to find out what the substance of their problems were or the issues or why there was a high vote against. So at least it creates I think a first trigger, at least a sort of amber light that lets companies know that there could be consequences for any inaction.

MS BYRNE (ACSI): So that's the 25 per cent.

MR SPATHIS (ACSI): That's the 25 per cent. We note that the Productivity Commission left the second trigger open and we do have some concerns that if there was to be a consequential spill of the board as a consequence of a second trigger, we think it really should reflect a strongly held and widely held view of shareholders that a trigger like that should be effected, hence why we have settled on a 50 per cent trigger in that regard.

The third tier that you've referred to really relates to a situation where let's imagine in the first situation, the first trigger itself attracted a "no" vote of above 50 per cent. There must be something substantially wrong with a remuneration report for it to attract in excess of 50 per cent of the vote against, and in that regard hence why we wanted to somehow lift the threshold of support that should perhaps be considered in those sort of circumstances because it would still be pretty untenable if, in the first year, you get a 55, 60 per cent vote against and then in the second year you get a 51 per cent vote for. 49 per cent of your shareholding, a substantial amount, still have concerns with that.

MS BYRNE (ACSI): Or you get 49 per cent.

MR SPATHIS (ACSI): That's right, or the other way around.

MS BYRNE (ACSI): So therefore there isn't a consequence.

MR SPATHIS (ACSI): So the 75 per cent figure is not a magical figure. It's a special resolution-type mechanism and it just seeks to sort of lift the threshold in that regard.

MS BYRNE (ACSI): I think it seeks to clean up, so therefore there isn't having to be this continuous discussion about, "We've got to get this right." It gives the imperative for companies - they get a 50 per cent vote against, they've got to get it right next time, and that in fact would then just allow us to very quickly get on to what is most important to shareholders, in fact for companies to look at their long-term value creation, not to have to spend years and years trying to sort out their remuneration.

MR FITZGERALD: Whatever the thresholds are, you've heard that most of the corporates have in fact opposed the notion of a two strike and then some of them have come back about alternative thresholds. But one of the things they say is that in fact people are now using remuneration votes for a whole range of other purposes and some would say that remuneration in and of itself is insufficient to warrant this action but the second thing they would say is even if it were around the remuneration issues, companies can't be sure as to what the real issues are, and the third thing, they're used as a stalking horse for other issues. So if you go beyond the non-binding vote that we currently have, allow shareholders must greater influence but that influence is either not about remuneration or if it is, they're unable to discern what the key issues are, people are voting on it. I'm just wondering how you deal with those sorts of responses, irrespective of the actual thresholds.

MR O'SULLIVAN (ACSI): We're conscious of the allegation anyway, that these numbers can be gamed and that people with other ambitions about the control of the company can use them in order to advance their position in one way or another which is why we think the figures should be pretty high, that the first possible vote should be a majority vote and the second vote should be even higher.

PROF FELS: Could I ask a question on this gaming. Could someone in the wide world give me an example of where someone have used a much easier threshold of 5 per cent, but to have all these high-reaching gaming consequences to destabilise a company, to change the board and to have adverse consequences, have there been any cases?

MR O'SULLIVAN (ACSI): The most recent example that people quote when they're talking about this has been I think Western Australian News. I'm not sure if that's the only example but it's an example which I know has been used in discussions of your report as an example of what would be done with substantially less than a majority holding.

PROF FELS: Was that such a bad thing?

MR O'SULLIVAN (ACSI): That's a matter of judgment really, but ultimately the other shareholders approved it.

PROF FELS: I didn't think it was such a bad thing myself.

MR O'SULLIVAN (ACSI): At the end of the day it was still subject to the same - - -

PROF FELS: If you take out narrow Productivity Commission views on the market, you would have no concerns at all.

MR O'SULLIVAN (ACSI): We don't really hold those concerns ourselves but we understand that they may be persuasive and if they are likely to be persuasive, we think they can be met by having reasonably high targets. In effect to achieve 50 per cent plus 1 is a very substantial target and 75 is an even more substantial one when you're trying to do something controversial in a company.

MS BYRNE (ACSI): But we also haven't seen any evidence that people voting against remuneration reports are voting against for some other reason. People are voting against those because in fact they're unhappy with what's in fact in the remuneration report.

MR BANKS: I suppose at the moment others would say at the moment no consequences follows from that.

MS BYRNE (ACSI): Yes, so therefore that would increase. I think shareholders are generally very responsible. I think in fact institutional shareholders are very responsible in the way that they deal with all of their dealings with the companies that they invest in. I don't think people go off on - it's not for your benefit as a long-term shareholder to actually be involved in that sort of gaming and - - -

MR BANKS: Unless you want to take control of the company, of course.

MS BYRNE (ACSI): But you've got to own a lot of shares to be able to do that, don't you.

MR BANKS: That's true.

MS BYRNE (ACSI): A very, very substantial shareholding, yes.

MR BANKS: I suppose the question is raised, such as that a shareholder currently can do that on the 5 per cent rule. Now, what people have then said to us in turn is that that would be far more transparent and it would be clear to the wider shareholder group what the purpose was there, whereas what they're saying to us is that under the two-strikes approach, really 10 could be disguised and you've got the board on the back foot because they're seen to be having done wrong. I don't know. Any comment?

PROF FELS: This is the argument that people wouldn't notice that there was a takeover occurring.

MR O'SULLIVAN (ACSI): I was going to say it sort of beggars belief that somebody would - - -

PROF FELS: That's the argument, isn't it, that they wouldn't notice the company is being taken over.

MS BYRNE (ACSI): Taken over, that's right.

MR O'SULLIVAN (ACSI): You'd think somebody would notice it.

MS BYRNE (ACSI): They wouldn't notice it - or the directors that have been put up are from a particular group - - -

MR O'SULLIVAN (ACSI): It's even conceivable that a journalist might publish something about it which of course would be very unfortunate for the brilliant strategy.

MR FITZGERALD: All right. You don't - - -

MR O'SULLIVAN (ACSI): Our answer is we don't think it's real but our defence against it is if anybody else does, they would use higher figures - anyway, the higher figures are probably just in their own right.

MR FITZGERALD: Just taking Gary's point, the other part of the argument is that you don't need this because shareholders can already exercise at least some sort of influence with the 5 per cent, the ability to call a meeting, the ability to put a resolution. So the other argument is if shareholders were so concerned, they've got the power now and why do you need to actually go to this extent. We have reasons why we've put the no strike in, but on the other hand if the shareholders are left with only 5 per cent why should we give them something else?

MR O'SULLIVAN (ACSI): I think the answer to that really is the non-binding vote has a very brief history and before that the only recourse was to - I don't know whether it ever happened. It certainly didn't happen in our business memory, and others would know whether it happened in the distant past. Now that you have the non-binding vote I think your suggestions have focused a way of taking real dissent and doing something constructive with it; putting people to the jump really if they don't satisfy their shareholders. So I don't think there's a correlation between the two. If you took it away, well, I guess we would have to go back to the 5 per cent, and we might be more prepared to do that now than our learned predecessors were because, frankly speaking, for the superannuation funds they weren't sufficiently organised or influential to do it in the past.

MR SPATHIS (ACSI): If those same groups, who incidentally were actually against the introduction of the non-binding vote four years ago, are really concerned and want to focus on remuneration, well, why don't we amend 10.14 and focus on a remuneration so it doesn't have any further consequences and flow-on effects and just deals with whether or not a proposal relating to an executive should stand or not. I mean, it's counter-intuitive, you can't have it both ways.

MR FITZGERALD: Just finishing off the arguments - I'm sure there are lots you have seen - but the other one is a slightly more tricky one, and that is, in a sense, by elevating remuneration to this status, not only in terms of the two strikes but a number of our other proposals in relation to the restrictions on who can vote and proxies, that we actually do a disservice to shareholders and companies that are focusing attention away from what everyone would agree are very significant other issues, so that all of what we're doing collectively ramps up remuneration to a level that is unwarranted and potentially unhelpful to your own clients.

MR O'SULLIVAN (ACSI): It's a function of your remit from the government that you focused on one part of corporate behaviour at the expense of all the others, but our expectation would be that we're certain your recommendations, whatever they turn out to be, will be very powerful with the government, but we're not absolutely confident that there would be the political will to put some of these more difficult things into place anyway. But assuming that there is and they do go into place they will eventually settle back into their proper proportion as a part of the whole of the corporate countryside. They won't any longer be the only skyscraper in town, there will be others.

There are always other issues, but it just happens because of the GFC and the impression that people were paid excessive salaries and bonuses in circumstances based on losing a lot of shareholder money that you were given the opportunity of dealing with it which is a snapshot in history really. I think we only get one shot at it, and if this shot passes we won't get another for many years.

PROF FELS: Can I ask you, just on the 50-70, have I got it right that in effect you're proposing two alternative tracks: one is that if this time there is a vote of more than 25 per cent of less than 50 per cent, if there was then a further vote at the next meeting you would require a 50 per cent or more votes to trigger an election; but if at the first level there was a 50 per cent or more vote, then at the second meeting you would require a 25 per cent negative vote to trigger an election. Is that correct?

MR SPATHIS (ACSI): You would need a 75 per cent endorsement.

MS BYRNE (ACSI): Yes, or 25.

PROF FELS: Or 25 per cent.

MS BYRNE (ACSI): Yes. So the following year then - - -

PROF FELS: Yes.

MS BYRNE (ACSI): Clearly in that first year they have had the majority saying, "Your remuneration is not okay, so therefore the hurdle is higher," because they already know that.

PROF FELS: Okay. Well, I won't pursue that, but that needs a little bit of thought because it seems to contradict your idea that it's very serious to call an election of the board, that you'd want 50 per cent of people doing it. I mean, I can see the thinking behind it is not illogical or that but it's sort of paradoxical in a sense and it is perhaps addressing a view that many put that if you have a 50 per cent second hurdle that that would emasculate the force of the two-strike recommendation and people would look for other routes - let's just say they were getting the 5 per cent - would be an easier way of doing it.

MR FITZGERALD: We'll have a look at that. Can I ask a question about another issue and that is about our recommendation 12, I think it is, about institutional investors disclosing how they voted. I just want to talk about operationalising that, and correct me if I'm wrong, I understand that you're supportive of that but the actual way it operates should be left to the individual investor to determine how that might be implemented. The question is, who should be caught by this term "institutional investors"? In fact the term is very loose in our recommendation. It is only the superannuation funds that should be required to disclose?

The second thing is if it is, are there requirements that we should put in place to actually mandate it through legislation, even if the way in which you disclose is left up to yourself. At the moment we've asked the question but nobody has come back to us as to how do we actually operationalise this particular recommendation. So with superannuation funds it's probably easy. There is probably an act you can amend, but what is the way you operationalise this, giving you support and its general thrust?

MS BYRNE (ACSI): It's a very interesting question, what's an institutional investor, but we don't think this should cover just superannuation funds, we think it should cover the mutual fund industry, managed investment funds, all funds.

MR FITZGERALD: So it may be equally described, in other words. Clearly the term has to be defined but I suppose really the question is, who should be in it.

MR SPATHIS (ACSI): You could define it and then bring together various pieces of legislation that already existed to find that sort of organisations that Anne is referring to. Whether it be superannuation funds, managed funds - - -

MS BYRNE (ACSI): Insurance companies.

MR SPATHIS (ACSI): Fund managers.

MS BYRNE (ACSI): We would be happy to think about that to try and come up with a definition.

MR FITZGERALD: That would be helpful, yes. I mean, the purpose was really, I suppose, to pick up those investors that represent a large stakeholder universe. We're not trying to pick up everybody, we're trying to pick up that theme. How would you operationalise this? Is it just a guideline and if so who is the guideline coming from, or does it require legislative reform? Again you might want to think about that.

MR O'SULLIVAN (ACSI): We have a policy approach amongst our own members which are not all superannuation funds, only the not-for-profit and only a majority of them, that it is desirable for them to report how they vote, and the means by which they do it is on the web site, and the occasion on which they would do it would be perhaps quarterly or half-yearly. Retrospectively we don't favour, as some Americans are now talking about, doing it before. It is in effect canvassing for support from other institutional investors by putting up the way you intend to vote and why. I don't say that it's wrong but we think at the moment that's a step too far for us to expect our people to take, or whether it's necessarily wise in all circumstances anyway to do that. So retrospectively perhaps, quarterly, half-yearly, a web site for our kind of people, but we really have no mandate to speak for anybody else but we could write to you about a definition.

MR FITZGERALD: We would be very grateful about the definition, and you might think about the operational process.

MS BYRNE (ACSI): Some of our members if they wanted to report, as this is the voting season at the end of each month, it's okay. They can do it, whichever they want, but we encourage them all to - - -

MR FITZGERALD: Sure.

MR O'SULLIVAN (ACSI): Those who use our guidelines we provide them with the way in which we recommend it so pretty much they follow it so they've got a ready-made report. The difficulty is how much information you want to put up about why you voted against something.

MR FITZGERALD: Well, that's up to you.

MR O'SULLIVAN (ACSI): The beneficiaries of superannuation funds don't have necessarily information to make any kind of a judgment about the reasons why you voted about Billy Smith or Harry Jones.

MS BYRNE (ACSI): Then your question goes to whether it should be legislation or regulation or whatever.

MR FITZGERALD: What's the best way, as I say, to operationalise this recommendation. If you could have some thought about that, that would be helpful - quickly, I might say.

MS BYRNE (ACSI): Okay. We hadn't actually thought about that so we will quickly try and think about that.

MR BANKS: I don't think we have any other questions. It just remains to thank you again for your participation. That's very helpful. Thank you very much.

MR BANKS: We will resume and our final participants this morning - and indeed for this round of hearings - come from RiskMetrics. Welcome to the hearings. Could I ask you please to give your names and positions.

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

MR PAATSCH (RMG): Dean Paatsch, director.

MR BANKS: Thank you. We've just been reflecting that people have been sitting in the same spots, but a bit of time has gone by and we've produced a discussion draft, so we look forward to your reactions to that and indeed the written submission which I think is coming next week. I'll hand over to you to make the main points you want to make.

MR LAWRENCE (RMG): Thank you. Thank you very much for the opportunity to appear. Your initial set of recommendations very correctly asserted board primacy basically and, I guess, the bit of board primacy that boards are not necessarily all that comfortable talking about which is the shareholders' rights to appoint and remove directors. That is their fundamental right in a listed company and you very correctly identified that as the nub of the issue.

We have always said - and for this reason we support many of your recommendations - that the system as it stands is fundamentally sound; not that it works perfectly or that it works in every instance, but really what it's in need of is some tweaks rather than wholesale surgery. Specifically, a number of what you would call your less high profile recommendations that deal with - and this is in a non-pejorative sense - the plumbing are really important, very necessary and long overdue. The chief among those we would put no vacancy. It kind of beggars belief why somebody on a board which has the capacity to have new appointments, as set under its constitution, who receives a majority of the votes cast on their election should not be elected. I guess that is the nub of the issue. That is the shareholders' rights.

If a dissident candidate can support 50 per cent plus one of the shareholders voting in favour of their election, why shouldn't they be elected. Under your proposal of saying that it is the shareholders who fix the number of directors, a board would still be able to protect itself from some dreadful, as yet almost unheard of, event where you had turmoil and the potential for unmanageable board by going to a meeting where there were dissident candidates and putting up as the first resolution that, "We declare there to be no vacancy and that this position is endorsed by shareholders," and if 50 per cent plus one of their shareholders endorse that, they're fine.

Some of the other issues around the plumbing which just touch on electronic voting - the voting exclusions issue - to rebut some of the arguments that have been made against voting exclusions on remuneration. There are voting exclusions for interested persons, shareholders, directors, associates already in law. It's kind of hard to see why it will be the end of capitalism if they're required here. Directed proxies - they might seem small and boring but they're important and so we commend you for those.

What we see as the glaring omission in your initial recommendations is one that has already been touched on by ACSI and that is listing rule 10.14 and the jurisdictional problem generally with the listing rules. The arguments that have been put to you in favour of the status quo on listing rule 10.14 show a fairly limited understanding of the concept of dilution. Listing rule 10 - the whole listing rule as it stands - embodies the principle when it comes to listed companies that prevention is better than cure. It exists to protect shareholders of the company from having their company taken away on unfair terms by insiders in privileged positions. That's what it exists to do. This can happen through the issue of new shares on terms that are not available to any other shareholder to a director, or through the company spending its own money to buy shares for a director and then transferring it to them for nothing.

Either way, voting and dividend rights pass to insiders on terms that are unavailable to anyone else. It's analogous to a selective buyback and it's worth noting that a selective buyback under the Corporations Act requires a special resolution of shareholders. The gaping loophole in 10.14 illustrates to us why the Productivity Commission should reconsider the ASX's invitation in its original submission to advise the government to remove the ASX's jurisdiction over pay and reserve it to the parliament. This is reinforced by the potential for competing exchanges and the need to avoid a regulatory race to the bottom. The results and the potential outcomes of that are all too apparent if you look at the United States and the pernicious effect that Delaware has had on US corporate governance. The second thing that we would like to comment on - - -

PROF FELS: Some of what you said is a repetition of the dilution point and some of it is just that it's not disclosed. The dilution and the removal of shareholder voting rights and so on, isn't that pretty trivial in most cases? I mean, the impact on shareholder votes, even at very generous amounts - is minimal, isn't it?

MR PAATSCH (RMG): Can I insist through the chairman's prerogative that we actually come back to that, Allan. I just want to sort of set it up because we haven't actually made a submission as yet. I just want to set it up and then we can come back and maybe take up the dilution in more detail.

PROF FELS: You want to do the whole thing?

MR PAATSCH (RMG): Yes.

PROF FELS: Okay.

MR PAATSCH (RMG): It will be very, very quick and then I want to set it out in the very limited time that we have what our issues are that you can then grill us on in detail.

MR BANKS: Yes, okay.

MR LAWRENCE (RMG): One of your recommendations that has got by far the most publicity, two strikes. The two-strikes recommendation to us looks like a solution in search of a problem. It's not something that we support. I'd like to make clear that unlike the somewhat hysterical opposition from parts of the business world to your proposal that, frankly, we find mystifying in terms of some of the arguments that have been put, that have suggested that it will be the end of capitalism if this is put in place and, as one of the prior speakers alluded to, the same suggestions were made around the disclosure of executive pay when that came in as a non-binding vote.

Our opposition comes to something that was mentioned in the question and answer section in the last section which is that shareholders already have these rights. 5 per cent of shareholders already have the right to requisition a general meeting and sack the entire board if they want to. 5 per cent of shareholders already have the right to put a resolution to an annual general meeting being held by the company to seek the removal of any director, and they have their fundamental right to every three years vote against a director who is up for re-election. Conflating the feedback mechanism of the non-binding remuneration report vote, which by and large has worked quite well, with a director removal potential, it actually has the potential to make people too scared to use the feedback mechanism. That feedback mechanism will not work because boards and their advisers will say, "Well, you wouldn't want to recommend against this because there are terrible consequences. The board could be spilled."

The interesting thing as an aside, I guess, about some of the arguments that have been put about this prospect of a board spill, you would think that incumbent directors in Australia survive by the narrowest of electoral margins, that they get back every time by 20 votes in every director election. The average vote - just to put the stat out there again - in favour of an incumbent director of an ASX top 200 company is 96 per cent. So if there is a board spill they're going to be re-elected unless their shareholders are really unhappy about a whole bunch of other stuff. With that, we're in your hands.

MR BANKS: Thank you.

PROF FELS: Can I just ask you on the evolution of your thinking on this matter and where you are now. On the two strikes are you saying this would be nothing more than the non-binding? What is your position?

MR PAATSCH (RMG): The two strikes we don't support at all.

PROF FELS: So you just want to stay with the non-binding vote?

MR PAATSCH (RMG): No, we want the shareholders' pre-existing rights to approve all forms of equity pay under listing rule 10.14 restated.

PROF FELS: That's it?

MR PAATSCH (RMG): Prevention is much better than cure.

PROF FELS: Okay, and that's it?

MR LAWRENCE (RMG): Fundamentally. I mean, there's a couple of other things that we might put in a long shopping list but those are the two fundamentals.

PROF FELS: I had thought when the report came out you had actually supported the two strikes. You'd supported some aspects of the two strikes.

MR PAATSCH (RMG): No, in commentary the next day I was rather premature in suggesting that it can do no harm. We never supported it. We were being polite.

PROF FELS: In the original submission you never supported anything?

MR PAATSCH (RMG): No.

PROF FELS: You never went beyond a non-binding vote?

MR LAWRENCE (RMG): Except on the restoration of a binding vote on equity pay.

MR PAATSCH (RMG): A binding vote on equity pay, and we wanted the binding vote on all forms of equity pay extended to all key management personnel.

PROF FELS: Okay.

MR PAATSCH (RMG): The reason why I regret saying that it can do no harm is that I hadn't really thought through the extent to which incumbent boards will lobby their shareholders to change their votes to avoid that embarrassment. If you want a good example of that have a look at Transurban where the two Canadian pension funds withdrew their votes that had already been lodged, and lodged them from the floor of the meeting in order to avoid that embarrassment.

MR FITZGERALD: But they did that with a non-binding vote.

MR PAATSCH (RMG): Correct.

MR FITZGERALD: Why would they do that?

MR PAATSCH (RMG): You'd have to ask them but the idea is - - -

MR FITZGERALD: That whole voting thing seems perverse. A non-binding vote - - -

MR PAATSCH (RMG): By conflating the two issues, a board spill with that feedback mechanism, you are opening the way to pervert the feedback mechanism.

MR LAWRENCE (RMG): Shareholders don't vote against rem reports lightly now; certainly not institutional shareholders. You see that. Most of the votes, when they do happen, they are in response to real concerns about pay. This straw man argument that you don't know what people are voting on about the rem report I think is a rather self-serving one to save a board from saying that they don't really understand what they're talking about anyway.

MR PAATSCH (RMG): In the spirit of honesty, it's a distraction and it's not the issue, particularly when you have many, many instances of shareholders' property being given to company executives through using the loophole in listing rule 10.14 with no recourse whatsoever.

MR BANKS: But how can you say it's shareholders' property? I mean, they have been paid for it.

MR PAATSCH (RMG): No, they haven't.

MR BANKS: It was bought on market.

MR LAWRENCE (RMG): It's company money, it's not their money.

MR PAATSCH (RMG): It's a selected buyback for one person. The only person in Wesfarmers - - -

MR LAWRENCE (RMG): Two people. There's two executive directors.

MR PAATSCH (RMG): There's two executive directors - who receives shares that are bought on market are the two directors. Why?

MR LAWRENCE (RMG): They have decided it's in the best interests of the company to issue new shares for the use of their long-term incentive scheme in all but those two instances.

MR PAATSCH (RMG): Gary, you mentioned that there was only upside to a selected buyback for - - -

MR BANKS: On the market price?

MR PAATSCH (RMG): Yes. What about when the share price falls? It costs a company money.

MR LAWRENCE (RMG): It's a very expensive way of doing it.

MR PAATSCH (RMG): It's a very, very expensive way for you to do this. There are many examples where companies have spent shareholders' money buying shares on the market for a ZEPO. The share prices falls. You've bought the shares for $10 million, put them in some sort of, like, treasury to hold them in trust. The share prices fall to $5 or whatever it is and you're left with this.

MR BANKS: It depends what the counterfactual is because if you've given them cash - I mean, if you compare it to cash, for example, there's no difference.

MR PAATSCH (RMG): They can give them cash.

MR LAWRENCE (RMG): On the subject of cash there's a couple of things. One is, cash has no voting rights and no dividend rights, and also if the board had wanted to - there's been a few boards or a few management teams who have decided, "We want to be paid entirely in cash," over time they have got beaten up fairly badly by their shareholders over it. Shareholders can protect themselves for that. Let them try.

PROF FELS: The voting rights, isn't it pretty trivial? I mean the voting rights is minimal - - -

MR LAWRENCE (RMG): In the case of Downer EDI that was mentioned it's about a per cent of the company - 1 per cent - which is not trivial. I guess the other thing we would say - and if you talk to some companies, particularly the larger companies in the mining sector - when you put this to them they start to see our point which is the big companies by and large it's not going to be material but if you go down to the smaller end, the only reason there hasn't been wholesale theft in some of the smaller companies where there isn't a great deal of scrutiny - and disclosure is poor and the rules on disclosure aren't enforced and the rules on accounts aren't enforced - is because those companies haven't worked this out yet. That's the only reason it hasn't happened.

MR PAATSCH (RMG): It's a disaster waiting to happen.

PROF FELS: Isn't that just a tad exaggerated?

MR LAWRENCE (RMG): No, it's not. Having covered something like 200 small resources companies in the past month, no.

MR PAATSCH (RMG): Gary, we do this for a living. We know what we're looking at.

MR LAWRENCE (RMG): We know who we're dealing with.

MR PAATSCH (RMG): We've seen so many examples of insiders using a privileged position for the benefit of their own pocket in the absence of any enforcement. I saw an example during the week where a small mining company board of three people - two of the directors - agreed to underwrite a non-renounceable share issue. The effective underwriting through the grant of in-the-money options was 20.25 per cent, but here's the joke: 57 per cent discount; here's the joke: they underwrote $4 million worth of share entitlements. Six months later the in-the-money options are now worth $4.8 million. They have exceeded the value of the shares that they had agreed to underwrite. It's the principle that isn't - - -

MR LAWRENCE (RMG): That's why listing rule 10.14 exists.

PROF FELS: Can we just identify the different issues here: one is the voting rights and there's transparency. Well, let's talk about the transparency, if you like.

MR PAATSCH (RMG): Contemporaneous disclosure is an issue.

MR LAWRENCE (RMG): There is no disclosure with this. To actually go back and work it out, like, what it has been brought out at, what price, it's really only if the company chooses to tell you. It's not like a buyback where there is a daily announcement of, "This is the amount of shares we've bought back. This is the price and we're going to cancel them." There is no disclosure, and so you have no idea what they're being bought back at, when they're being bought back, and are they actually doing it wisely or are they blowing up a lot of shareholders' cash in the process. You just have no idea.

MR PAATSCH (RMG): There is very material information that is out there in the market on the particular performance hurdles associated with the senior executive pay. A good example of that is Wesfarmers where they didn't tell you what the ROE hurdle was. In the first year they did and subsequent years. Just recently McMahon Holdings revealed to us a couple of days ago what the ROE targets were. That's really material information. Having two sets of companies: one where that information will be out in the public domain; and another through the requirement to get approval, and another where they don't because they use the loophole.

PROF FELS: I think I know the answer to this question but are you in that respect just making an argument for disclosure? Why is the situation not handled by disclosure?

MR LAWRENCE (RMG): Certainly disclosure would be a lot better if you were required every single day that you were buying shares for an employee share trust to make an announcement to the exchange, "We bought this many shares and spent this money," that would be absolutely better than the existing circumstance, but just because no-one has yet taken advantage of 10.14 to grant - I'm not sure exactly how much you could be on market for an individual director and give it to them. It would be at least 4.99 per cent of a company without any approval whatsoever. Just because that hasn't happened doesn't mean it won't.

MR PAATSCH (RMG): I actually believe if you are agnostic, if you continue to be agnostic on the 10.14 loophole, then you should positively argue to the government that they should change the existing binding vote on the issuance of shares because effectively, economically, there is no difference.

MR LAWRENCE (RMG): There's no difference if the shareholders' funds are taken to buy shares on market that are transferred to insiders, versus issuing part of the company to insiders. You end up in exactly the same place which is why the dilution argument is a non-starter. Also the idea that shareholders will willy-nilly reject equity grants. If the argument is that if shareholders were given a chance on the giving away of their property that they vote against it, well, that's a pretty good argument actually because it's their property. The second one is that shareholders by and large - if you have a look, how many option grants or equity grants have been defeated? Newscorp - and that was only because Rupert couldn't vote because he was getting - - -

MR PAATSCH (RMG): Quite a number of the smaller companies - - -

MR LAWRENCE (RMG): Have had some.

MR PAATSCH (RMG): - - - they just withdraw, but this is a good thing, this is owners asserting their rights.

MR LAWRENCE (RMG): It's shareholder power.

MR PAATSCH (RMG): Rarely is executive pay material in the context of total company expenditure, but it can be extremely material in terms of the incentives and behaviours that they induce by the management. It is important to reduce the agency problem.

MR LAWRENCE (RMG): Which is, I suspect, a large part of the reason for your remit from the government and why people around the world have been obsessing about this because of the idea that bad incentives can produce appalling results.

PROF FELS: Again just picking up the story, the incentive for executives - say there was full disclosure and everything - so what are the other incentives? Are there two? One is, is it a tax advantage?

MR PAATSCH (RMG): No, not any more.

PROF FELS: Then, what, it encourages behaviour to distort share values?

MR LAWRENCE (RMG): Are we talking about, sorry, 10.14 specifically?

PROF FELS: Yes.

MR PAATSCH (RMG): No, what it is is - - -

MR LAWRENCE (RMG): Companies seem to be really bad at timing buying on market - they're certainly not buying on inside information. Where you can work it out, they tend to - - -

MR PAATSCH (RMG): It's simply a contradiction really that - look, if I was to state it in very simple terms, prevention is better than cure. Roughly a third of all executive pay - the bit you really want to know about is the alignment, and you see that most through equity pay. You see that absolutely the most.

MR LAWRENCE (RMG): That's the only rationale for giving executives equity pay. Otherwise do what Gary says: pay in cash. Why do we bother? Why do we bother with the pretence? So if you don't know the hurdles, if you don't get the chance to actually say, "Yes, that works," or, "We're prepared for you to use the company's money or for us to share our property with you through an issue," why bother?

MR FITZGERALD: So why do you think corporate Australia is so keen not to address this loophole?

MR LAWRENCE (RMG): If you had the ability to get a lot of stuff for free with voting and dividend rights with no-one being able to say no, would you want it addressed, to be brutally honest?

MR PAATSCH (RMG): I think there are a number of schools of thought. It's frequently put to us where we say, "Why aren't you seeking approval?" and they say, "It's within our rights. We're doing no more than the law requires."

MR LAWRENCE (RMG): The best argument I've heard for why they do it is - I was speaking to a very large top 10 resources company and I said, "Why don't you seek approval?" and they said, "Why would you?" Why would you put your CEO through the potential of, God forbid, the shareholders saying that they don't think that this is in their interests?

MR PAATSCH (RMG): Many of the companies that have had problems with non-binding votes, many, and this is a guess - I can give you an exact number, if you like - more than 50 per cent buy on market. They use the 10.14 loophole. You don't find out about what ridiculously low hurdles they have put in place or how perverse they are until after the event. You don't find out until - like Downer EDI and others, that the board retains the discretion to lower the hurdles. If those grants had been subject to shareholder approval, the board would not have been able to do it.

MR LAWRENCE (RMG): Unless they had specifically said, "We reserve the right to alter the hurdle." There is one company in Australia that actually does that, to their great credit. The chairman of that company I don't think will ever do it, having done it once before.

PROF FELS: Are you able to give us a bit more evidential backup for this which would have to go on our web site and - - -

MR LAWRENCE (RMG): In terms of the - - -

PROF FELS: You mentioned all these small companies earlier, the mining companies and all of that seemed like you were claiming it's a rampant practice and so on - - -

MR LAWRENCE (RMG): We're saying that given the kind of things that go on there already - I'll give you an example. This actually happened and this was only caught because this company did not know about the loophole. [Withheld] released a notice of meeting, as many small resources companies do, to the exchange, saying, "We seek to grant options at 31 and a half cents, exercised price." This is all public. The share price at the time was 27. No-one really blinked an eyelid. It was a small resources company; a meeting to be held in a month to approve the options.

The next day they announced they had found the world's largest copper deposit. Their share price went to $11. That was insider trading, absolutely, there is no doubt. ASIC actually intervened and said, "You must reissue your notice of meeting and spell out exactly how much these options are worth, given what has happened." The ASX got involved and starting looking at it. But the only reason it happened was because they didn't know that if they had just done a quiet little placement of 2 per cent of the company to some mates in a broking firm and raised the cash, they could have bought those shares on market, given it to them, announced the world's largest copper deposit and no-one would have ever known.

MR BANKS: There is insider trading, but isn't there insider trading laws et cetera - you can imagine that there's an instrument for that. But in relation to these on-market purchases - - -

MR PAATSCH (RMG): But there's also preventative things, Gary.

MR BANKS: Yes, but let's think about what we're trying to prevent. You might educate me about the way in which those shares are used. My understanding was that these would be on-market purchases that would be effectively a grant of remuneration and it may have a holding lock that you have to keep those shares for two or three years. But can you tell me what the typical arrangement is from your perspective?

MR LAWRENCE (RMG): We can give you an example of a large company. They say, "We are going to grant you the right" - and their type of instrument will vary. They all are, by and large, either an option with an exercise price or a ZEPO, one of the two. They've got different names for different reasons. They say, "We're going to grant these to you. These will vest to you conditional on you still being employed with us in three years, unless we decide otherwise and also if certain performance conditions are met. They can name any performance condition they like. It could be earnings per share, it could be painting the boardroom pink - that's unusual, but you can set any performance condition you like and that's appropriate. Then in three years' time, if those performance conditions are met, you get them.

In an on-market purchase, what will happen is that the company either will go out and buy an amount to satisfy that obligation or it will, because it hasn't had stuff vested in the past, have an employee share trust sitting there and that's got some spare capacity which they can then take those shares out and transfer them.

MR PAATSCH (RMG): I guess the other issue is there was a scandal in the US about options backdating. 10.14 actually provides in Australia the same opportunity because what company insiders can do is they can say, "What we've done is we've set aside those shares for those executives in advance of the good news coming to market." It's known in the trade as spring loading. You say, "Okay, we're just about to do a major acquisition and we think it's going to add a heap of value. Gary, you've been doing a fantastic job working on this acquisition, let's grant you a ZEPO and we'll go out into the market and we'll buy those in advance because it's going to be cheaper for the company." Unlike Martin, I won't actually name a particular company but I did encounter this about three years ago for a very small company which is now on the ASX200 where I spoke to the CFO actually and he absolutely acknowledged to me that the date was determined prior to the public announcement of a major joint venture. He said, "Well, we had to get some upside." So the opportunity for these things to happen in the dark is something that really should direct your mind to a preventative step.

MR FITZGERALD: Just explain this interplay with the remuneration report then. You've indicated several times that there's no requirement to disclose terms and conditions in performance hurdles in relation to these matters but my understanding was that in relation to long-term incentives, performance hurdles are being required to be disclosed in the remuneration report.

MR LAWRENCE (RMG): Retrospectively.

MR FITZGERALD: Yes. So isn't the argument that people put to us that eventually - not at the time but eventually - those performance hurdles are disclosed in the remuneration report on which the non-binding vote - are you saying that doesn't happen or it does happen and it doesn't matter?

MR LAWRENCE (RMG): There is a requirement under the Corporations Act, section 300A something, for a detailed summary of performance conditions attached to all parts of pay, short-term bonuses, long-term incentives. I read something like 400 rem reports a year and that is a part of the Corporations Act that is flaunted with gay abandon.

MR PAATSCH (RMG): There are less than five companies that comply with that rule.

MR FITZGERALD: Can I ask a specific question there: you can address the equity issue in the way you've described but just in relation to if the current law is not being complied with, is that an indication that ASIC itself is failing to do the job.

MR LAWRENCE (RMG): It probably has too much to do, I suspect.

MR FITZGERALD: Or is it just impractical to do it? In other words, the law that we currently have effectively - - -

MR PAATSCH (RMG): Why have it if it's not going to be enforced? There are three or four companies that take the trouble of actually telling you what the performance hurdles are.

MR LAWRENCE (RMG): Retrospectively. This is for annual bonuses.

MR PAATSCH (RMG): Yes, this is for the STI component. If this continues on - - -

MR LAWRENCE (RMG): Why would they keep doing that?

MR PAATSCH (RMG): - - - why are we bothering, frankly? I mean, it's just becoming a dead letter. There's civil disobedience - - -

MR LAWRENCE (RMG): On an unprecedented scale.

MR PAATSCH (RMG): - - - that really does demand the parliament's attention to say, "Well, look, obviously no-one cares."

MR BANKS: So say we went back to that situation, what proportion of the typical declared executive's remuneration would be covered by a binding vote?

MR LAWRENCE (RMG): About a third.

MR PAATSCH (RMG): You mean in aggregate?

MR BANKS: Yes, that's right.

MR PAATSCH (RMG): Yes. I think it would be something like 25 per cent of the top 100 companies would be using 10.14 now.

MR LAWRENCE (RMG): Yes, I think that's your point in terms of the proportion of the total remuneration.

MR PAATSCH (RMG): A third, a third, a third, yes.

MR LAWRENCE (RMG): It's roughly a third, a third, a third, and that's how most companies sort of - - -

MR BANKS: About a third of the executives' remuneration would be subject to a non-binding vote if you - - -

MR LAWRENCE (RMG): To a binding vote.

MR PAATSCH (RMG): To a binding vote.

MR BANKS: To a binding vote if this was back in - - -

MR LAWRENCE (RMG): Yes.

MR PAATSCH (RMG): Yes, that's exactly right.

MR LAWRENCE (RMG): It's actually quite helpful to look at the rationale that was advanced at the time they went to amend listing rule 10.14, which was a point the people from ACSI touched on. When they initially announced it they said, "What we're trying to do here is exempt the specific instance of the purchase by directors of shares in salary sacrifice schemes." Everyone said, "Well, yes, of course. Of course, that is absolutely - you shouldn't be caught." It came out with anything that's bought on market is open season. Go for you life.

MR PAATSCH (RMG): Yes, that's right. That's what happened. In any incentive scheme, not just - when we actually had a look at this at the time and we thought it was entirely agnostic and benign, because we thought it was about non-executive directors - - -

MR LAWRENCE (RMG): Which is specifically what the discussion document said.

MR PAATSCH (RMG): Something happened between the exposure draft and the others which created, quite frankly, the loophole.

MR LAWRENCE (RMG): Which, to be honest, was also a loophole that was in existence before, because there were waivers freely granted. It appears all you had to do was ask.

MR PAATSCH (RMG): That's correct.

MR BANKS: Would this have the perverse effect, at least from shareholders' perspective, that it might move remuneration packages away from equity?

MR PAATSCH (RMG): If there was a perverse effect we've had a very long history of study because listing rule 10.14 was only amended in this way in 2005.

MR LAWRENCE (RMG): Since then cash bonuses have increased by about 60 per cent.

MR PAATSCH (RMG): So all we're asking here, we're not asking for investors' pre-existing rights to be restored. I think it's a nice segue for us to revisit the invitation by the ASX for you to recommend that it cede its jurisdiction.

MR FITZGERALD: Yes, I want to come back to that. But to what extent does it cede? You're saying that it cedes its jurisdiction in relation to all remuneration matters, holus bolus.

MR PAATSCH (RMG): It's being very specific, actually. Yes, it's being very specific. It's really in relation to those five listing rules but effectively the parliament could decide the extent to which it should apply to corporations in general. But really, there are provisions within the Corporations Act to - - -

MR LAWRENCE (RMG): That already touch on specifically this issue.

MR PAATSCH (RMG): On listed companies themselves. The ones that I'm thinking of are issuance and buying of shares on market for executives, the total amendment of the non-executive director fee cap.

MR LAWRENCE (RMG): The never-enforced listing rule about you can't have your pay triggered by a change in control, which there are so many wonderful words used in contracts to get around that: "substantial diminution of responsibility" is my favourite.

MR PAATSCH (RMG): David Kirk's. And the termination benefits. So what we've done is - you know, we've picked out one of those, which is the termination benefit, and by and large got that right. We very much support the government's position on that with one - there's one tweak that they need, a very serious tweak that they need in relation to the pre-approval of the termination benefits. We saw it at Computershare's AGM a couple of days ago where the company sought shareholder approval to exempt any equity it was paid on termination from the - - -

MR LAWRENCE (RMG): One year cap.

MR PAATSCH (RMG): - - - requirements of the act. We think that the government has an opportunity to make sure that in the event that a similar proposal is put before shareholders that there is a dollar figure that is spelt out, otherwise you don't know what you're voting for. It will be very clear to us that we'd be recommending to our clients that they just vote against - - -

MR LAWRENCE (RMG): Anything that asks for a blank cheque like that.

MR PAATSCH (RMG): - - - anything that asks for a blank cheque like that. But the idea being that we just picked out one of those on its remuneration, just termination, popped it in the Corporations Act comprehensively. I think as we're entering into a period where there will be multiple exchanges that, you know, the parliament really should be counselled by a group like the Productivity Commission to say, "Well, all right, is this issue important enough or should we open the way to have a race to the bottom?"

MR FITZGERALD: Maybe I'll clarify this. My understanding, one of the concerns about moving stuff to the Corporations Law was how you pick up international or overseas companies. The ASX listing rules pick up those that are on the stock exchange - international, others - Corporations Law tends not to pick those up. We haven't looked at that technically but is there a problem with that or not?

MR LAWRENCE (RMG): There is a status of listing - I know vaguely the area, I'm not specifically across the detail, Malcolm Starr at the ASX is the person to actually tell you. But if you're a certain category of overseas issuer they basically say, "If you satisfy us that you're in compliance with the listing rules of your home exchange then we will recognise that you are complying with those rules and so you're fine." It depends on your size and the particular exchange. For example, if you had a listing on the Somalian exchange, if there is such a thing, then they might say, "Well, I'm sorry, we don't extend that way."

MR FITZGERALD: Do you think there's a means by which you - yes, they won't escape.

MR LAWRENCE (RMG): In New Zealand actually they have this thing that if you are listed on the New Zealand exchange and you are not actually subject to New Zealand law, you're a foreign company, they actually require you at the back of your annual report every year to say - these things aren't - and the ASX does this as well for a New Zealand-listed company on the ASX. You've got to put up the back, "We aren't subject to the Australian takeovers laws, we're subject to the New Zealand takeovers laws."

MR PAATSCH (RMG): Yes. I just want to follow up on the point that was made by the ASX when they made that invitation to - and that is that the enforcement. At the moment the enforcement of any ASX listing rule is entirely in the discretion of effectively the companies officer within the ASX without any wider scrutiny; and the sanction for which normally is removal from trading or improved disclosure. Well, perhaps there's a perverse effect of penalising shareholders for something that's a transgression of the rule. So, you know, I really do think that their invitation to you was not something that they took lightly.

MR FITZGERALD: No.

MR PAATSCH (RMG): As I read through the by and large very good recommendations I kept coming back. Every time you said, "Oh, the listing rule should be amended," I would shake my head saying, "The listing rules are never going to be amended," no matter how well-intentioned, no matter how compelling the case, because the listing rules are subject to the exchange's sphere so if they've come to you and said, "Put it in the parliament's jurisdiction if you want a result here," I invite you to take up their suggestion.

MR FITZGERALD: I don't want to get to the technicalities. One of the issues that raises is if you take the stuff that we've said could be the Corporations Law, the ASX listing, some of those we've restricted to the ASX 300 companies.

MR PAATSCH (RMG): Sure.

MR FITZGERALD: I suppose it raises a strange issue as to how you would define that group within the Corporations Law but - - -

MR LAWRENCE (RMG): The ones that are restricted to the 300 though are not actually remuneration issues. It's the composition of audit committees, which is absolutely appropriate for an exchange to impose that rule.

MR PAATSCH (RMG): We shouldn't make any - on the 10.14 example, we shouldn't make any distinction between if it's a - - -

MR LAWRENCE (RMG): No.

MR PAATSCH (RMG): You know, if it's number 2035 on the list.

MR LAWRENCE (RMG): Less of a distinction, I would suggest, actually.

MR PAATSCH (RMG): Yes, that's right. So I don't believe that that's - I did want to pick up one thing - it's just I know that we're very conscious of time - you asked about the, how would you operationalise the disclosure component.

MR FITZGERALD: For?

MR LAWRENCE (RMG): Institutional investors.

MR FITZGERALD: However that's defined, yes.

MR PAATSCH (RMG): We are again agnostic on disclosure. That's something that you have a view on. But if you wanted to do it there are two principal ways that you would do it. One, you could do it through amending the SIS Act. The best and most comprehensive way would be through the Australian Financial Services licence regime, because you could very clearly identify those. Your interest ought only be to improve disclosure to those people who are consumers of funds management services, and that's the nexus through which you could do that very easily. You asked the mechanism. In the US any registered mutual fund has to make what is called an NPX filing retrospectively once a year of how they've voted their proxies, and that's freely available, it's easy to search out. I'm happy to point that in your direction.

MR FITZGERALD: Yes.

MR PAATSCH (RMG):   You could do something very similar; very, very similar.

MR FITZGERALD: All right, thank you for that, and yes, we would be keen to get the details of that, absolutely.

MR PAATSCH (RMG):   Sure.

MR BANKS: Your concern about the two strikes, does that also rule out the first strike?

MR PAATSCH (RMG):   Do you think we should abandon the idea that we should - so we may have a different view of what the first strike is. Our view is that there is already a first strike and that is the 5 per cent.

MR BANKS: We were thinking more about just a requirement to - - -

MR LAWRENCE (RMG):   To report back, yes.

MR BANKS: - - - report back at the next AGM.

MR LAWRENCE (RMG):   It's probably helpful. I would hope that any company that suffers - they do anyway. If you have a look at Boral, I'd commend Boral's remuneration report to you this year. They had a 58 per cent against vote and this year they've got an opening statement in their rem report of, "This is what we have done to try and address your concerns." They clearly sat down and tried.

MR PAATSCH (RMG):   But it's quite an interesting thought to actually mandate that.

MR LAWRENCE (RMG):   Yes, have it as a mandatory discipline.

MR BANKS: Certainly what it would require is - there would more incentive to talk after the "no" vote.

MR PAATSCH (RMG):   We saw yesterday at Lend Lease, that the chairman of Lend Lease had suggested that it was all the proxy advisers' fault that this 43 per cent vote was against. We commonly see that.

MR BANKS: You get blamed for a lot in the course of these hearings. You will have to read the transcript.

MR PAATSCH (RMG): Yes. It's really obfuscating the issue, it really is. We don't control anyone's votes. We don't control anyone's thoughts. We don't control people. Our clients are free to purchase shares or to vote them.

MR LAWRENCE (RMG): It's a very pleasing and self-serving argument to be able to say, "If it wasn't for the evil proxy advisers, all our shareholders would love us."

MR PAATSCH (RMG): There was actually a comment by a chairman during the week which caused me no end of amusement where he said, "I liked it in the old days when people actually thought about voting before they did it." I'm sure that there are a lot of chairman who have been very happy to take undirected proxies from retail punters who obviously didn't exercise any thought whatsoever.

MR FITZGERALD: I think it is true, in relation to the two-strike principle, ignoring the mechanisms, a large number of directors who will admit in different fora, after they go through the set routine of what's the unintended consequence, the one thing that is often mentioned is the role of proxy advisers and it's mentioned endlessly as a genuine concern they have. We've raised with them, "Well, what do you think you should do about it?" but it certainly occupies the minds of a large number of the directors we've spoken to, reinforced by the fact that whatever mechanism we put in the report is subject to what they would regard as some sort of abuse.

MR PAATSCH (RMG): The standard of lobbying frankly and the rebuttal of the two strikes has been nothing short of appalling. It's less than undergraduate.

MR LAWRENCE (RMG): But then again if you have a look at the lobbying against the non-binding rem report vote of disclosure of executive pay or indeed any proposal to give shareholders any rights whatsoever, it's of a similar ilk, "This will be the end of capitalism. You can't trust shareholders to look after - - -"

MR PAATSCH (RMG): I mean, the classic for me is to argue that somehow this is a Trojan horse for the taking control of the company. I mean, save me.

PROF FELS: To spell that out, why are you sceptical of that?

MR PAATSCH (RMG): I'm just not sceptical, it's completely ridiculous and offensive. It's false. With 5 per cent of the shares, you could spill the board, 5 per cent. There's an exact example of that happening at the moment at a company called Redflex where a group of institutional shareholders were quite upset about a placement that was made to two parties. What have they done? They have called a general meeting to sack the board and to reappoint some others. Now, it does have control implications. They have done that with I think - - -

MR LAWRENCE (RMG): 31 per cent.

MR PAATSCH (RMG): - - - 31 per cent, but any of those investors could have done that. It's a preposterous suggestion and frankly it makes me very much more inclined to disregard other arguments that they are making about, for example, increasing the power of proxy advisers, to regard it with similar - - -

MR LAWRENCE (RMG): My favourite argument about "the proxy advisers control the votes" was said by the chairman - and I'll say it because he was the guy who said it - of what was formerly Babcock and Brown Capital and he's now at Eircom, he had two proposed resolutions relating to his CEO, one a grant of equity and one a termination payment rejected overwhelmingly by shareholders and he said, "It's just all the fault of the evil proxy advisers because fund managers just do whatever they tell them," which is insulting to fund managers. The really odd thing is we recommended against one of the two, the other we went "for", so I'm not quite sure what happened there, and I know the other proxy adviser who makes a lot of recommendations in Australia did a similar thing. It's a convenient fiction.

MR FITZGERALD: I know we're out of time but the last comment, and it's related to that, is it's been put to us that a number of the institutional funds are compelled to follow your advice. Some of the directors have said that some are required almost as policy to follow the rem consultant's advice, irrespective of what it is. Is that the case, and if it is the case, to what extent is it the case?

MR PAATSCH (RMG): Did these very erudite and respected people give you one name?

MR LAWRENCE (RMG): Any names?

MR FITZGERALD: No.

MR PAATSCH (RMG): Which institutional investor is required to follow our advice?

MR LAWRENCE (RMG): Because if you can produce one, I'm very happy to - - -

MR BANKS: So it's not correct?

MR LAWRENCE (RMG): It's false.

MR PAATSCH (RMG): It's completely incorrect, but it's a convenient untruth.

PROF FELS: Could I just mention something. We've been sitting now and we hear two lines of argument against the two-strikes proposal and all of that. We've been hearing time and time again it has dangerous consequences for firms, destabilising and all of that, that they have gone blue in the face arguing that. You have more than one reason for not supporting the two-strikes rule. One of your main reasons I think I heard you say was the opposite, that it had absolutely no effect and certain consequences from that. So I don't know if you have any comments on that. We have two very clear but completely opposite lines of thought on why the two-strikes rule is undesirable. That would seem to be a correct observation on the evidence that we're hearing.

MR LAWRENCE (RMG): Yes, it is a correct observation. I'd encourage you to go back and read some of the arguments that were put by those same parties arguing against two strikes - kidnapping, I think. We were going to have - - -

PROF FELS: Against - - -

MR LAWRENCE (RMG): No, actually against disclosure of executive pay, we were going to have executives and their families kidnapped and I don't think to date that has happened.

PROF FELS: Yes. I just wanted to point out - - -

MR PAATSCH (RMG): The reason why you shouldn't continue with two strikes really is not for all of the crazy arguments that have been put forward, it's simply because you will be conflating that feedback mechanism. You will be undermining that feedback mechanism which is actually working pretty well in practice right now because what will happen is that investors will pull their votes because they don't want to embarrass the board.

PROF FELS: That's your assumption. Do you really know that?

MR PAATSCH (RMG): Yes, I do.

PROF FELS: I question that.

MR PAATSCH (RMG): Okay.

PROF FELS: I think people's voting behaviour patterns are extremely hard to predict. I certainly find it difficult to accept that anyone, even with your vast knowledge, can predict how people will vote in that absolute fashion.

MR PAATSCH (RMG): But I'm observing it already, Allan.

PROF FELS: In what way?

MR PAATSCH (RMG): A large holder of Boral, for example, last year didn't cast their vote. They were going against the rem report and didn't cast their vote because that would have tipped it over into negative territory.

PROF FELS: Okay. There are lots of contrary examples, so therefore voting is hard to predict.

MR PAATSCH (RMG): Which contrary examples are you referring to?

PROF FELS: An example is people who have been prepared to support non-binding votes. You're saying some aren't prepared - - -

MR PAATSCH (RMG): They have been prepared to vote against a rem report?

PROF FELS: Yes, heaps of them.

MR PAATSCH (RMG): Why? To embarrass the board?

PROF FELS: I don't know, but they're voting against them.

MR PAATSCH (RMG): Yes.

PROF FELS: You're saying someone didn't vote because of this - fine, I can understand your point as a possible effect on earnings. I can also see that people may go the other way. That's commonsense actually.

MR PAATSCH (RMG): Keep it pure. It's a non-binding say on pay; if we make it a non-binding say on pay and spill the board, there will be some people who don't want, in the second go around, to spill the board.

PROF FELS: I can see that. I absolutely agree.

MR PAATSCH (RMG): And how can they then actually give that feedback?

PROF FELS: Well, there are quite a few ways, but what I'm troubled by is the idea that this would be the absolute determinant of voting, that that would be the sole driver of voting. That seems to be what you're saying.

MR PAATSCH (RMG): No.

MR BANKS: I think, as this last session - for which we thank you - has illustrated that there's great value in these public hearings because we get diverse perspectives on everything we've put forward and it's certainly met our expectations, this whole round, so I thank you, first of all, for the contribution you've continued to make. We look forward to your written submission. You've obviously provoked more thinking on our part. I should ask, for the record, if there are any other participants who want to appear at these hearings. Looking around the room, I think not. It remains for me to thank all participants through the course of this inquiry. I think there have been few inquiries that I've been on where the quality of submissions has been as high as this, so it's been very valuable to us.

We will use this second round of submissions and input to prepare a final report which is due to go to government by 19 December. It will then be up to the government to digest the report and release it and indeed make decisions on the basis of it when it sees fit, presumably next year some time. So again thank you to all who have participated, on behalf of my colleagues and myself, and we will conclude the hearings. Thank you.

AT 1.19 PM THE INQUIRY WAS ADJOURNED ACCORDINGLY