Productivity Commission
Executive Remuneration Inquiry
Submission by Charles Macek, May 2009

Introduction

I am making this submission in my capacity as the non-executive Chairman (since 2002) of the independent research group, Sustainable Investment Research Institute (SIRIS).SIRIS is the largest, dedicated Asian research provider of sustainability and governance (ESG) investment research and analysis, undertaken through a multi-disciplinary and multi-lingual research team based in Melbourne. SIRIS' research is provided to enhance and assist investment risk assessment and opportunity analysis. It does not provide advocacy services.

During my executive career in financial services, principally in investment management, I was Chairman of the Australian Investment Manager's Association (AIMA) 1995-98, which in 1998 merged with two other industry associations to establish the Investment and Financial Services Association (IFSA). In 1996 AIMA launched the first corporate governance guidelines issued in Australia. The so-called Blue Book, was created for the benefit of its members, which were all institutional investment organisations, to encourage and facilitate proxy voting. In 2004 I was a member of a sub-committee of the Australian Institute of Company Directors (AICD), the Remuneration Task Force, which developed remuneration guidelines for both executive and non-executive Directors. I also provided input to the review of these guidelines in 2008.

Since 2001 I have been a director of both Wesfarmers Ltd. and Telstra Corporation Ltd. and, since 2005 I have been Chairman of the Telstra Board Remuneration Committee. I have been a member of the Investment Committee of Unisuper Ltd. since 2003. In 2008 I was appointed a member of the Global Research Advisory Council of Glass, Lewis & Co. LLC, a leading proxy advisory firm and owned by the Ontario Teachers Pension Plan. In 2008 I was appointed a member of the Australian Advisory Board of MMC Inc. which incorporates Mercer a leading superannuation, human capital and remuneration consultant.

This experience gives me a broad and deep perspective on what is a complex, and often highly emotive issue.

Overview

This Inquiry is being conducted against the background of the global financial crisis (GFC) which has served to heighten community concern about the level and structure of executive remuneration. Further, it is contended by some that inappropriate remuneration structures within financial services encouraged excessive risk-taking which has culminated in the GFC. Meanwhile, those charged with the responsibility of setting executive remuneration, namely non-executive Directors feel constrained by the "market place" in making their judgements about executive pay in the best interests of shareholders.

If the market is efficient then it can be argued that the level of executive remuneration is appropriate. However, even in this event, if remuneration levels move beyond the bounds of community tolerance it will be deemed to be excessive. The establishment of this Inquiry suggests that this point has been reached. Thus, any examination of current practices, and any improvements can be made to deal with these issues, should incorporate an

understanding of the market "eco-system", its evolution and the role of various agents. It is here that I begin my submission.

The Market Eco-system

By market eco-system I am referring to the capital markets and all its participants. This includes investors, large and small, and, the various agents that are involved and influence the processes by which household savings become invested in a security or asset and the governance framework which applies. This includes: investment managers, asset consultants, ratings agencies, retail research companies, financial planners and investment advisers, proxy advisers, investment banks, commercial banks, trustees of superannuation funds, company directors and regulators.

The 40 years which I have spent working within the capital markets have been characterised by de-regulation which has resulted in the "institutionalisation of savings". It has also been a period of explosive growth in the size of investment funds, largely driven by compulsory contributions to superannuation and supplemented by voluntary contributions. During this period we have moved from a marketplace where financial products lacked transparency, were expensive and consumers had little choice to - increased transparency, lower cost and greater, perhaps even too much choice and complexity.

With the decline of Defined Benefit superannuation plans investment risk has transferred from employers to individuals who are less able to bear this risk and usually lack the necessary expertise to make investment decisions without the involvement of third parties such as financial planners. The plethora of agents that have sprung up to meet this need, being rational in their pursuit of self-interest, have managed their business risk rather than their clients' investment risks. This principal-agency conflict is well understood by economists.

The main consequence of this structural change has been a focus on relative rather than absolute risk and performance and, a shortening of time horizons. Through this process of "short termism" the market has become less efficient in the allocation of capital. The GFC is simply a manifestation of this reality.

Does this represent "market failure" and, if so, what should be done? The root causes of the systemic issues which have spread from the US to the rest of the world can be found in policy and regulatory failure in the US. These include: the Community Reinvestment Act which encouraged lending for housing to people who were credit-unworthy; the Gramm-Leach-Biley Act which repealed Glass Steagall; the removal by the SEC in 2004 of capital reserve requirements for US (global) investment banks which enabled them to effectively become glorified hedge funds by leveraging their capital by 20, 30 even 40 times to engage in "proprietary trading" or, speculation; the fragmentation of regulatory oversight and, in particular allowing Freddie Mae and Fannie Mac having their own separate regulator capable of being captured by effective lobbying; excessively loose monetary policy by the Greenspan Fed; deficit funding by the US Federal Government especially through off balance sheet liabilities despite the warning of the former Comptroller-General, David Walker.

The one constant in market behaviour is human nature. We are social creatures comforted by herd like behaviour and mood swings from optimism (greed) to pessimism (fear). We make mistakes based on emotion, rational beliefs, imperfect knowledge and cognitive dissonance. In the depths of a business and market cycle when confidence is lost and behaviour is driven by fear there is inevitably a call for increased regulation.

However, such a response implies we are capable of recalibrating human nature. This would require genetic modification!

The inevitability of cycle's demands regulation, as unconstrained markets left to their own device would result in worse outcomes. The challenge is how best to make the market work. Not perfectly but efficiently, and thereby avoid regulatory failure. This requires a forward looking approach rather than reactivity. Moreover it is people and behaviour, not systems and processes which cause problems, so this where the focus should be. Understanding the role of various agents, their connectivity and relationship, especially where conflicts exist and, their incentive structures is a critical first step in determining the appropriate regulatory settings.

In the management of the community's savings there are three groups that are regulated explicitly as fiduciaries: trustees of super funds, investment managers as responsible entities and company directors. However, there are other agents that do have significant and, in some circumstances, greater influence over the outcomes experienced by investors than these regulated fiduciaries, yet they are frequently not subject to regulatory scrutiny or are only lightly regulated, usually through a licensing regime. For instance, historically asset consultants have had a greater impact on the total investment return achieved by members of super funds than the Trustees or investment managers, yet from a regulatory perspective, their role was initially dismissed as merely that of a service provider.

Various research houses that rate investment products and agencies that rate credit have a similarly powerful role. With respect to remuneration and other governance matters, proxy advisers are influential and in many cases have become de-facto fiduciaries.

Understanding the incentive arrangements and, in particular, the existence of conflicts is fundamental to ensuring that the market operates transparently and efficiently. The conflict created by credit rating agencies receiving payment from the product providers is now perceived as having contributed to inappropriate risk labelling of certain products.

The other dimension of evaluating the role of such agents is the degree of expertise and experience their services require. In determining the appropriate expertise and experience required one needs to understand the fundamental driver for acquiring their services: Is it to add value such as engaging an asset consultant to select an investment manager?; or, Is it to "protect" the agent contracting for their services? e.g. Trustees employing an asset consultant; financial planners relying on a research rating; or, an investment manager relying on a proxy adviser to determine how to vote.

The Evolution of Executive Remuneration Practices (TOR 1)

With the growth of globalisation over the last two decades global influences have increasingly impacted on executive remuneration practices in Australia. In particular, trends in the US have influenced both the structure and to a lesser extent the quantum of remuneration. However, differences in tax arrangements, accounting standards and culture have moderated this impact. It is probably a fair observation that it is only since the 1990's that remuneration practices have evolved and led to outcomes which are the cause of community concern.

Some of this concern can be dismissed as envy. However, there are outcomes which have little, if any, theoretical or economic justification. Examples of this include the widening gap between CEO compensation and that of their direct reports or compared to the average of their employees. Whilst the Australian experience has not been as excessive as the US we have followed US trends. This is well documented beginning with a NSW Labour Council research earlier this decade. The fallacy of the implicit assumption of the celebrity status of the CEO, which might justify such divergence in pay, was the subject of an excellent contribution by Gideon Haigh in the Quarterly Essay in 2004.

It is instructive to understand some of the forces which have contributed to current remuneration outcomes as this road has been paved with good intentions. Transparency through disclosure is a fundamental principle underpinning confidence in the behaviour of fiduciaries and agents. However, there is no doubt that, whilst it is not the principal cause, disclosure of remuneration has contributed to the escalation of pay. This reflects the reality of human nature that we make judgements based on relativities. In this respect, pay relativities are regarded as a form or expression of recognition; no one wants to be below average, yet the pursuit of above average remuneration creates an automatic upward ratcheting effect.

In 1993, in response to a similar heightened community concern about executive compensation, the US Congress capped the tax deductibility of salaries to a limit of $1 million. This unleashed a surge in equity based compensation. This principally was in the form of zero exercise priced options which were effectively encouraged by USGAAP under which there was no accounting charge for the issue of such instruments. Thus it was rational for Boards to enter into such arrangements and it was applauded by shareholders as a mechanism to align management and shareholder interests. It is important to note that institutional shareholders have been the key drivers of accepted market practice. They operate in an industry where substantial bonus or equity like payments are made, especially to the super stars and extrapolate the appropriateness of such arrangements to the companies in which they invest regardless of the industry's characteristics. However, the subsequent "bull market" delivered returns to executives that were many multiples of their fixed remuneration – tens and even hundreds of millions of dollars. Such outcomes became entrenched in the global market for executives.

Increasing shareholder activism has also had a perverse effect through its emphasis on "alignment", which has led to an increasing at-risk component linked to performance criteria in the form of both short term (STI) and long term incentives (LTI). This process has dramatically increased the total remuneration potentially earned by senior executives. However, given strong share price performance prior to the current downturn the quantum was not generally regarded as a matter of concern.

Prior to this market evolution the more common practice was to pay a bonus, based on the company's performance and an individual's contribution thereto. This bonus was usually only a percentage of the base pay.

The use of options as the instrument for performance based rewards are well suited to the US environment where dividend payout ratios are low and the corporate and investor focus is on capital growth. They are also an ideal instrument for venture capital, immature and developing businesses with a need to conserve cash flow but requiring to attract quality directors and executives. Not surprisingly it was Silicon Valley which most strongly resisted the introduction of an accounting cost for share based compensation resulting from convergence between USGAAP and IFRS.

In Australia the use of options as a performance –based reward have been more limited, and have generally involved an exercise price which requires the recipient executive to pay for shares if the performance hurdles

are achieved. There is also greater leverage embedded in an option which will increase executive rewards in rising markets but lead to a loss of remuneration in falling markets. In Australia performance shares and rights have been more commonly used for share-based compensation. These instruments have the advantage for the recipient executives in that, once they have vested, they will continue to have some value, albeit still reflecting market fluctuations, unlike vested options where all value to the executive can be lost if the share price falls below the exercise price. Other than for small venture capital type companies in high risk sectors such as biotechnology and mineral exploration the granting and vesting of share- based remuneration is at risk and subject to performance hurdles.

The increasing complexity of remuneration arrangements has resulted in the establishment of Board remuneration committees and increased the need to engage remuneration consultants. This has increased the expertise available to boards in their deliberation on remuneration matters but has also increased the potential for management to drive the outcome.

The role and perceived influence of remuneration consultants is frequently overstated. Their major contribution is the provision of market data on remuneration. Independent market data is an important board safeguard against management seeking to push up their remuneration.

Contrary to some criticism the use of remuneration consultants does not drive the upward ratcheting of compensation. This is primarily attributable to boards and shareholders wanting the company to employ executives that are perceived to be better than average. It is the mathematics of this implementation that creates upward movement in executive pay. The consultant's knowledge of the pros and cons of different instruments and their tax and accounting implications is invaluable. Historically they have been appointed by management, which in the eyes of some creates a potential conflict. However, this risk is over stated and, in any case, best practice is resulting in such appointments increasingly being made by the remuneration committee. This is particularly the case with respect to a review of the CEO's arrangements. Moreover it is boards that determine the remuneration philosophy rather than consultants. Boards, supported by market data and the CEO's recommendations, typically are the arbiter in respect of the senior executives. In the case of negotiations with the CEO, Boards will determine the parameters within which they will exhibit flexibility.

As remuneration levels have risen in response to the global forces and practices outlined above the validity of the quantum has come sharply into focus, especially in the current climate. A frequent query is: why do executives need such large incentive payments in order to perform? Remuneration arrangements are primarily aimed at attracting and retaining the best people. Potentially high incentives largely reflect the evolution of the market.

There is much academic support for the proposition that remuneration is not the dominant motivator driving performance. Indeed a survey I undertook for a thesis that I prepared as part of my M.Admin course at Monash University in 1975, titled "Job Satisfaction in the Life Assurance Industry", found that recognition and scope for personal growth, development and promotion rated above remuneration in importance. However, relative remuneration is viewed as a measure of recognition and value.

It are forces such as public policy, including demands for increased disclosure, accounting and tax frameworks having unintended consequences, together with the acquiesance of institutional investors to arrangements appropriate to their industry but not necessarily all others, that have largely driven the quantum. The explosion in US investment banking profits, driven by proprietary trading, subsequent to the relaxation of capital reserve

requirements, added further impetus to market determined remuneration levels. Globalisation has ensured the spread of these practices.

Governance Framework (TOR 2 and TOR 3)

I will make little comment on the arrangements for non-executive directors as they are effectively prescribed by the Corporations Act and, for listed entities, by the listing rules and corporate governance guidelines. Proxy advisers have expressed the view that they would have no issue with NED's receiving higher pay providing they devoted the necessary time to discharge their duties.

This view raises some issues. Firstly, if NED's spend excessive time on an individual company they risk intruding on management's responsibilities, losing their independence and limiting their effectiveness. Secondly, this view begs the question as to how best to spend their time. It is my contention, shared by many NED's, that a disproportionate allotment of time is spent on compliance issues rather than strategic and risk oversight. Remuneration is a microcosm or manifestation of this. For most large companies the quantum involved in the remuneration contracts for which the Board has clear responsibility is quite small in terms of the overall business and, other contracts which commit a much larger expenditure of shareholder's capital may receive less scrutiny. Thirdly, NED remuneration, even more so than for executives, is not the principal attractor or detractor of this profession. It is the ability to be involved in stimulating activity, make a meaningful contribution and an assessment of the risk-reward, particularly legal liability, which are the main determinants of this personal judgement to pursue this vocation.

Disclosure and the non-binding vote on the Remuneration Report are the main mechanisms for external oversight of this element of Board responsibility. This increased transparency is a principle which is soundly based as it contributes meaningfully to engendering trust. However, it is not without its unintended consequences as mentioned in the previous section i.e. the means to expose remuneration to market forces.

The non-binding vote increases the importance of good disclosure of remuneration policies and outcomes. For disclosure of remuneration arrangements to represent effective communication it must be comprehensive, accurate and understandable. Yet a frequent criticism of Remuneration Reports is that they are far too long yet incomplete, complex, opaque, and incomprehensible.
Thus there is a need to improve the legibility of Remuneration Reports. In part they are an amalgam reflecting accounting standards, corporate law and governance guidelines. In meeting these compliance requirements they often fail to answer the two questions that they must which are: What are the executives actually paid?; and, What is the cost to the shareholders? These should be a matter of fact. A third question of interest and relevance, but which is subjective, is: Has remuneration been deserved based on performance?
A more encouraging observation is that companies are making greater effort to improve the presentation of their Remuneration Report, within the limitations imposed by legal and compliance requirements, as they gain more experience of the new environment. In Australia it is company law rather than accounting standards which detract from the Report's effectiveness.
Despite limitations which I will outline below, in my view, the non-binding vote has been a success, with the biggest benefit flowing from its introduction being the increased engagement between Boards, typically the Chairman and/or the Chair of the Remuneration Committee, and the company's shareholders. Within the confines of continuous disclosure obligations,this interaction provides valuable feedback to the Board, and not just on remuneration, to the Board and, simultaneously an opportunity for the Board to provide shareholders with a better understanding of their philosophy and approach to various issues.

The vote on the Remuneration Report should not be made binding despite the limitations of the non-binding vote. A major weakness of the current framework is that the vote is binary and applies to the entire report. Thus, concern about only one issue can lead to an investor voting against the entire report. This can be done knowing that there will be no consequences from that vote – other than potentially adverse publicity for the Board. Moreover, whilst the concern over that issue may be legitimate, the analysis may be faulty or the view may reflect an ideological bias, for instance the use of a measure other than Total Shareholder Return (TSR) as the performance criteria for an LTI plan. Equally, but conversely, a shareholder may support the report despite concern over an issue.

If the vote were made binding it may, in many instances, lower the negative vote as to protest over a single issue might have unfortunate and unintended consequences and a negative vote would require more careful consideration, whereas at present it is a relatively safe way to register a protest. However, by binding the company it would effectively put shareholders in a position where they are micro managing the Board and impose an impractical constraint on the Board's ability to negotiate and employ the best candidate as CEO or other senior role. It is pleasing and worth noting that, to the best of my knowledge, no segment of the shareholder community is calling for this change.

Thus the key issue is, How to improve the current system? Improving the presentation of the Remuneration Report would be a good start and progress is occurring on this front. Maintaining effective communication between Boards and their respective shareholders should continue to be encouraged. The media has a role to play in enabling the community to have greater confidence in the market and its practices. Too often its coverage trivialises the issue, highlights the negatives, focuses on personalities and is based on superficial and unbalanced analysis rather than providing a deep understanding of complex issues. The better journalists already attempt to objectively inform their readers on such complex issues but in any event this is outside the remit of this Inquiry.

Much is made of shareholder rights. However, rights also carry obligations and responsibilities. I have spent much of the last two decades working for what can best be called "responsible investing", whether by encouraging voting or by incorporating ESG risks into the investment process. It is my contention that the best regulator of investment markets is an educated and informed investor who is actively engaged with their companies.

In the previous section I highlighted that the markets have become less efficient through their focus on short term, relative performance and current and often speculative transactions. Principals will often have a different view of risk, performance and time horizon than their agents. With a few notable exceptions, for too long, institutions failed in the governance of the portfolios entrusted to them through failing to exercise their fiduciary responsibility to vote. That they are doing so today is credit to the trustees of super funds, particularly industry funds and their representatives such as the Australian Council of Superannuation Investors (ACSI).

However, there is a systemic weakness in the manner of dealing with the vote on remuneration. There are two dimensions to this: one is the effective abrogation of their fiduciary responsibility of some investors by effectively delegating this function to an external service provider, namely a proxy advisory firm. Secondly, there is the issue of What expertise should be properly applied in exercising their judgement about the appropriateness of remuneration arrangements?

When the non-binding vote was introduced it added an additional item to the AGM agenda upon which shareholders could vote. Increasingly as institutions were encouraged, or even mandated, to exercise their proxy vote, they contracted with independent, external proxy advisers. The expertise historically required of such advisers related to matters that were strictly confined to corporate governance, in particular, the composition, structure and operations of Boards and their committees. This was a role they fulfilled in a diligent and competent manner. However, establishing an appropriate remuneration framework and negotiating successfully with senior executives in a competitive global market which underpins some of those arrangements and, upon which they were now required to make judgements, requires additional expertise which proxy advisers lacked. Senior executive and Board experience together with financial modelling skills are now critical if proxy advisers are to provide insightful analysis and meaningful advice. Such skills are expensive to acquire and the proxy adviser business model cannot accommodate such expense. It is interesting to note that the largest proxy advisor in the US allegedly earns the vast majority of its income from advising companies on processes and outcomes to improve their governance rating whilst also continuing to provide such ratings and advice to investors. Apart from the obvious conflict of interest, which is not dissimilar to that observed within credit rating agencies, it is a reflection of the fine margins to be earned from providing proxy and governance advice to investors.

My own organisation, SIRIS, realised the inherent weaknesses and anomalies in this industry structure and business model some years ago when we exited proxy advice but not the provision of governance research. Within our organisation, at least at Board level, we had practical experience of a former CEO who had experience of developing an appropriate remuneration framework and negotiating with potential employees in a competitive market and also current Board and remuneration committee experience. Despite this, and even with substantial disclosure such as is found in the Remuneration Report, we concluded that it is often impossible for anyone or party outside an organisation, to form a soundly based judgement about the appropriateness of that organisations' remuneration arrangements generally and specifically . At best, we could make comment about its conformance with various guidelines and the approach taken by other companies, and general observations about framework.

It is not possible to adopt a one-size-fits-all template to this consideration. What may be appropriate for one industry or even company may not be appropriate for others. Moreover what may be appropriate today may not be appropriate in three or four year's time. Prior to exiting proxy advice SIRIS sought to highlight variations from accepted practice or guidelines, emphasise matters for shareholder consideration and, frequently not make any voting recommendation believing that judgement was the responsibility of the shareholders, seeking instead to equip shareholders with the necessary and appropriate information, including benchmark data to make a considered decision.

There is also an inherent conflict between providing objective research that shareholders can use in considering how to vote and advocacy. This is reinforced by a moral hazard which is created by the desire to demonstrate value from a low margin service i.e. proxy advice. This can be done by emphasising "bad" practice and exaggerating its prevalence, rather than highlighting good practice. Colourful language, disparaging the director community is readily seized upon by the media and helps raise the profile of individuals promoting their own "activist" agenda. It also serves to undermine confidence the high governance standards in Australia, which are largely adopted by the over whelming majority of companies. These have served Australia well, noting we have avoided the worst of the scandals that have bedevilled some overseas jurisdictions.

I believe that the absence of any industry association which promotes an appropriate code of conduct or ethical standards for proxy advisors is a structural weakness which, given their influence, needs to be addressed. A starting point could be a licensing regime that requires governance research and advisory firms to be independent and not permitted to engage in advocacy, but through the provision of their services, enable their clients – the investors – to be effective and informed activists in their engagement with companies.

An issue briefly touched upon which deserves more focus is that of institutional investors effectively delegating their fiduciary responsibility to a proxy adviser. This is motivated by minimising the risk of criticism or even litigation by claiming that independent, expert advice is sought in exercising the proxy voting function. However, where this process amounts to nothing more than "ticking the boxes", in the manner advised, it is effectively an abrogation of fiduciary responsibility. In my capacity as the Chairman of a Board Remuneration Committee I have received verbal and even written confirmation by some investors that they follow or, in some cases, are required to follow the recommendations of a specific proxy adviser. Interestingly, Unisuper which is at the leading edge of promoting good ESG practices and is a signatory to the UN Principles for Responsible Investing mandates voting, requiring consideration of but not mandating rigid adherence to specific guidelines.

I should state that it is my experience that the majority of institutional investors do take their proxy voting as a serious responsibility. In some cases they have invested in significant internal expertise to review and assess external input which complements their own analysis before determining their position. However, this independence of thought is most pronounced with respect to proxy advisers recommendations on the election of individual directors and is less evident, but not necessarily absent, with regard to the Remuneration Report. A simple solution to this unacceptable situation would be to limit proxy advisers to providing research, data and observations but prohibit making a voting recommendation on the Remuneration Report. This would place the fiduciary responsibility clearly where it belongs – with the fiduciary.

Even though credit rating agencies have been criticised for their role in contributing to the GFC and their conflicts of interest have been highlighted, they provide an interesting contrast with governance rating and proxy advisory firms. Credit rating agencies demonstrably employ people with the necessary skills to undertake their role, namely financial analysis. More importantly their process is totally transparent. The measures which they monitor and the thresholds applied for determining an appropriate rating are known in advance and are based on sound finance principles. There is also a high level of consistency in the ratings by different agencies. Companies can make informed decisions about their balance sheet ratios and capital management plans with a high degree of certainty about the impact on their credit rating and the consequence of this on their cost of borrowing. This is valuable information and a valuable service. This type of feedback is not automatically embedded in the vote on remuneration. There is a demonstrable correlation between credit ratings and company insolvency .Academic studies from respected institutions such as Stanford University demonstrate little, and indeed almost an inverse relationship between governance ratings and company performance.

Case Study – Example

To paraphrase one prominent company Chairman who has not experienced a negative vote on a Remuneration Report speaking at a semi-private forum; "I do not know what I would do if my company received a negative vote on its Remuneration Report". As the Chairman of the Remuneration Committee of a company, Telstra, which has received such a negative vote – in 2007 -I can relate to those sentiments. In that instance both leading proxy advisers recommended against the report. However, their reasons, with only limited overlap, were different. Presumably by changing the design features advocated by one adviser to gain their support the other

adviser would have still had a different view. The most common concern expressed generally with that plan was the non disclosure of the performance metrics for the specified criteria driving the LTI allocation of equity (options). The reasoning given by the Company for its decision was that a majority of the hurdles applicable at that time were regarded as commercially sensitive, for instance the target date for the completion of the "Next G mobile network" which was expected to provide significant competitive advantage to the company, and proved to be the case. To have pursued popularity i.e. the support of shareholders in order to avoid embarrassment would not have been in the best interests of shareholders.

However, the Company recognised that cynical scepticism was likely to result from non disclosure of hurdles for specific criteria. Consequently, in its public commentary, including at the investor briefing on the day of announcing the annual results and the release of the Director's Report and Remuneration Report, the Company gave an outline of the total shareholder returns necessary to earn their target, stretch and maximum incentive payments. This disclosure of the outcome of the detailed modelling which was an integral part of the process of framing the remuneration plan is not commonly made available by companies yet is extremely important information. That plan included a shareholder safeguard, namely a gateway minimum TSR of 11.5% p.a. compound growth over 4 years which shareholders needed to receive before any LTI options would be allocated to management , regardless of what should vest based on the performance achieved against their accountabilities. This indicated that in excess of $25 billion of shareholder value had to be created for any options, which vest on the basis of achievement of management's accountabilities, could be allotted. This made the criticism made by some investors that there was an inadequate link between management's incentive payments and shareholder's interests difficult to fathom.

However, it should be noted that the experience in Australia with companies that receive a large negative vote is that they do respond and make changes that improve shareholder support in the subsequent financial year. This was certainly Telstra's experience with a 95.5 % vote supporting the Remuneration Report in 2008. Such outcomes are generally the result of enhanced communication and dialogue with institutional shareholders and influential groups representing a shareholder base such as ACSI and the Australian Shareholders Association which represents many thousands of small investors.

A major frustration experienced by Boards in dealing with proxy advisers and some investment organisations is their tendency to adopt a one-size-fits-all approach in considering governance matters. This is best illustrated by the issue Warren Buffett faced as a Director of Coca-Cola some years ago, which is documented in Alice Schroeder's biography of Buffett, "The Snowball".(Pages 778-785). A leading proxy adviser, ISS, and supported by CaLPERS, the California Public Employees' Retirement System, a prominent activist shareholder, advocated voting against Buffett's re-election to the Coca-Cola Board, on the grounds that his membership on the Company's Audit Committee was compromised because of related party transactions. The amount involved, some $102 million, paled into insignificance compared with the $billions Berkshire Hathaway held in Coca-Cola stock. *"The rules of ISS …were based on a check-list, with no leeway whatsoever for common sense." "CaLPERS's actions show the stupidity of corporate governance run amok." "The Financial Times referred to ISS as the Darth Vader of corporate governance, citing a position that smacked of dogma".*
"The bigger problem was that ISS was not just giving advice. Because so many investors had simply delegated their voting rights to it, ISS was more like a single behemoth that controlled as much as twenty percent of all the board votes for major corporations in the United States. The securities laws had not anticipated that a situation could arise in which one, unregulated, magisterial "shareholder" held so much power over American business."

The mantra of AIMA when it launched the Blue Book in 1996 was that governance should be about "performance not conformance". This is as valid today as it was then and applies equally to the governance of remuneration.

Remuneration is not a precise science. Employees come in job lots of one. This is especially true of senior executives and most especially CEO's. Sound principles for influencing behaviour such as incentivising greater performance suggest that rewards should be linked to individual accountabilities. This is perfectly demonstrated in commission based selling, albeit in this instance conflicts need to be well managed or avoided. However, this principle is harder to build in to the performance hurdles for executives when the shareholder community, whose support is required, often advocates various design measures that do not meet this test. For instance, TSR is highly favoured with a preference for relative rather than absolute measures. This works well if there is a statistically significant peer universe against which executives' performance can be compared. This is rarely the case in Australia which, because of its small market and the need for scale efficiency, has many industries which are oligarchic in structure. This encourages many companies to adopt a size based comparator universe e.g. the 20 largest listed companies for a company of that size. This has the unfortunate consequence that executives are being compared with executives who have different challenges due to operating in industries with different characteristics, market structures and regulatory frameworks e.g. comparing a banker with a retailer, with a miner, with a manufacturer, with a telecommunications or media executive etc. On the other hand setting an absolute TSR can create either a soft or a hard target depending upon the share market environment, which is influenced by many factors outside the executives' control, most particularly macro-economic forces.

Earnings based measures, which in the short term can be manipulated in the short term, introduce other hazards. This has been most evident in the US where quarterly reporting and profit guidance are normal. Changing the accounting treatment of certain items can produce the "targeted" outcome. Moreover inappropriately designed incentives can encourage excessive risk-taking. This has been most evident in the global investment banking sector. Performance needs to be adjusted for "normalised" balance sheet ratios to mitigate against excessive leverage driving profitability in good times but exposing the shareholders to increased risk of financial collapse in the bad times. "Locking up" earlier vested awards or incorporating a "claw back" element in designing incentive plans is one way of mitigating this risk. This is increasingly being recognised by prudential regulators as they review the forces contributing to the GFC and seek to strengthen the framework for regulated financial institutions.

However, such a plan incorporating deferred equity will need to be workable within our tax framework. Mooted changes in the 2009 Commonwealth Government Budget would prevent such an outcome. Income, in whatever form, should only be taxed when it is actually received or, when the asset subject to tax is capable of being converted into cash in order to pay the tax liability.

One failure in setting remuneration arrangements is the lack of a robust and approach for recognising the different characteristics of industries in terms of the driving forces which create shareholder value. For the sake of illustration it is clear that some companies require significant monetary capital to undertake their business activities while others create shareholder value through the application of intellectual capital. Manufacturing, mining and commercial banking would be examples of the former, whilst investment management, information and software companies such as Microsoft and Google would be examples of the latter. Clearly the remuneration framework should not be the same for such divergent businesses as the direct contribution of executives to creating shareholder value differs.

The complexity of remuneration, the biases of various shareholders and the need for governance oversight has led to a more formulaic approach in determining the compensation settings. This, in turn, has made the arrangements more complex, difficult to understand and therefore for those outside the company, to trust and, more challenging in terms of getting the settings "right" i.e. the alignment between management and shareholders in all circumstances. From my own practical experience, supported by many remuneration experts and endorsed by others with similar knowledge and experience, a pre determined bonus pool with board discretion for allocation is the simplest and fairest framework. Most recently, the retired and highly respected former CEO and Chairman of Wesfarmers, Trevor Eastwood advocated such a return to the past. In the eyes of many, the supposed alignment between management and shareholders in complex, equity based plans, has not delivered the "promised" outcomes.

However, such a back to the future approach requires trust. Today that trust of Boards by shareholders does not exist. Neither, I suspect, is there sufficient trust of Boards by management to exercise such discretion in an objective and fair manner.

The difficulties in designing appropriate incentive arrangements outlined above merely serves to highlight the complexity of developing remuneration arrangements to fit individual circumstances and, the need for relevant expertise amongst those who influence the outcomes i.e. Boards, shareholders and their advisers.

Conclusion

It is important to recognise that Australia has been well served by its existing regulatory framework. This is evidenced by the health of our banking system and the better relative performance of the national economy, compared with all other developed countries, as we navigate the challenges flowing from the GFC. Equally we have been well served by our corporate governance framework as we have avoided the abuses and excesses evidenced elsewhere, particularly in the US. Research from the Boston Consulting Group reveals that in the five years to December 2008 the top ASX 100 companies by market capitalisation achieved TSR that outperformed their peers in Europe by 6%, those in the US peers by 8% and Japanese companies by 9%. In short the system is not broken. However, it undoubtedly can be improved.

Remuneration, at any level, is a highly emotive issue, particularly when involving a small universe of highly paid individuals who are very visible. In the current climate it is easy to pander to populist sentiment blaming executive greed for the crisis. Inappropriate compensation arrangements have undoubtedly contributed to excessive risk taking by some institutions. However, this is less the case in Australia than overseas. Corporate Australia should no more be blamed for the GFC than the Australian Government, which the community recognises is not responsible. However, in a democracy the so-called "licence to operate" is determined by community tolerance and support. In turn, the health of our economy and ultimately our society depends on the private sector to undertake investment, employment and create wealth. This system revolves around confidence and trust. When confidence is lacking and trust is absent everyone suffers. Trust in governance is fundamental to the efficacy of the market. Remuneration is the fulcrum point around which trust in boards and executives currently revolves.

It is critical to Australia's national interest that we remain an open and internationally competitive economy. The market for executives is global and the market sets their remuneration. We should not put in place taxation or regulatory changes that will reduce our international competitiveness, and which ultimately harm our

productivity and prosperity. However, whilst the market is not perfect it does work. There is significant scrutiny by the shareholder community, who are increasingly engaged with their investee companies, of companies and the performance of boards. Boards welcome and are sensitive to feedback from shareholders. However, directors are spending increasing amounts of their time on compliance to the detriment of oversight of strategic and business risk issues. This is evidenced by the workload of remuneration committee chairmen now approaching or even exceeding that of their counter part at the audit committee. The latter committee has oversight of all of the company's risks while the former is merely dealing with one set of contracts.

With the introduction of the non-binding vote on the Remuneration Report, our corporate governance system is working better than other jurisdictions. Some, such as the US, are yet to introduce this initiative. Already many companies, such as Wesfarmers Ltd., have introduced salary freezes for their Board and senior executives. That these are occurring on a voluntary basis reflects awareness of corporate social responsibility. Moreover, no matter how imperfect the existing remuneration arrangements for incentive payments is, due to the collapse of the share market executives have lost $billions of income value of equity grants, which have previously vested or have been earned by individual accountabilities. This is not recognised in the reporting of their remuneration as journalists continue to portray amortised accounting remuneration as being the same as "take home pay".

History is replete with examples of prescriptive regulation resulting in unintended consequences. This submission has provided some examples of such adverse impacts in respect of remuneration. Thus, improvements to the effectiveness of Australia's governance framework should be driven by a focus on "best practice" principles. Central to this is transparency through comprehensive and effective communication and engagement between boards and shareholders. The International Corporate Governance Network (www.ICGN.org) has developed many useful guidelines for areas such as *"Executive Remuneration Guidelines (2006)" and "Statement of Principles on Institutional Shareholder Responsibilities (2007)".* The exception to this approach is where there is a perceived excess in market practice, such as termination payments. However, even in this event unintended consequences need to be avoided. Another exception is where special Government assistance is provided to an industry such as banking or the automotive industry. In this event, where taxpayer funding support is involved, good governance dictates greater Government control over this expenditure.

The most effective outcome from this Inquiry would be establishment of measures that enhance "responsible investing", recognising the responsibilities that shareholders have: Rights come with responsibilities! It is in this area that the greatest scope for improvement exists. Proxy voting is merely the first step in this process and much progress has been achieved over the last decade.

There are two areas relating to proxy voting on remuneration which need to be improved and, which can be driven by principle-based regulation. These are related and reflected in the ICGN Statement of Principles on Institutional Shareholder Responsibilities.
Firstly, that a fiduciary cannot delegate their responsibility to an agent should be made explicit. This occurs where some institutional investors effectively outsource their voting decision to an external proxy adviser.

Secondly, and quoting directly from the ICGN Statement, *"decision makers along all parts of the investment chain should be appropriately resourced and meet standards of experience and skill in matters subject to deliberation".* This has occurred where boards have established remuneration committees and directly engaged external, independent experts with the requisite expertise to assist them in exercising their responsibility. It is yet to occur with respect to proxy advisers or the majority of institutional investors. It is my belief that the

appropriate place for such expertise to reside is within the advisory firms whose services are bought by institutional investors.

The first of these structural weaknesses in the current operation of the market is most easily encouraged and assured of compliance through prohibiting proxy advisers making a specific recommendation on the Remuneration Report. This is akin to the prohibition on certain non-audit services but not others which can be provided by a company's audit firm. This would still permit the provision of relevant data, analysis and commentary by proxy advisers.

This approach would also most likely drive the up-skilling of proxy advisers as it would not be economic for all investors to acquire the necessary skills to meet any licensing requirement demonstrating that they have the appropriate expertise to fulfil their responsibilities.

Ultimately the best regulator is an educated and informed shareholder actively engaged with companies in which they have investments.

Charles Macek,
29 May 2009