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Regulation of Director and Executive Remuneration in Australia

Submission to the Productivity Commission

5 June 2009

Submitted jointly by CGI Glass Lewis and Guerdon Associates

Contents

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1. Summary of Conclusions & Recommendations

We set out below a condensed version of our conclusions and recommendations in relation to the Productivity Commission's inquiry on the regulation of director and executive remuneration in Australia.

These conclusions and recommendations are made in the context of entities that are publicly listed in Australia.

1.1. Conclusions

1.1.1. Key management personnel (*KMP*) levels of pay

- Are correlated with market capitalisation;
- From an international perspective, are lower quartile for OECD countries
- Are less than management in equivalent private companies;
- Are equal to the management of foreign subsidiaries of equivalent size but less accountability, liability and complexity; and
- Are not dissimilar to the levels of pay for top entertainers and sports people.

1.1.2. Rates of pay increase

- Have been significantly higher than average weekly earnings increases during periods of high economic growth;
- Are related to the growth in market value of companies managed;
- But are vulnerable to a ratchet effect through the injudicious acceptance of disclosure comparisons with only those who are more highly paid; and
- Should, if boards hold the line and do not change the rules, decline and become negative as market value and earnings decrease due to the significant proportion of pay that is now performance based. The extent of decline should also be exacerbated by high levels of company share ownership among CEOs.

1.1.3. Constraints on excessive or inappropriate pay

- The key constraint is market efficiency;
- A diligent and independent board with the right mix of skills and experience for the company's businesses assisted by a competent remuneration committee (where those exist), relevant disclosure and the non binding vote assist efficiency, allowing cost benefit comparisons to be made and communicated;
- Constraints are facilitated by proxy adviser and governance group advice to institutional and other investors;
- Constraints will be more effective if boards receive unconflicted advice; and
- Constraints will be more effective with better institutional investor voting and engagement.

1.1.4. Disclosures

- Do not cover the full extent of the executive market by exempting foreign companies;
- Have improved since CLERP 9, and are continuing to improve;
- Do not mandate disclosure of remuneration in the form that is widely understood and used for comparative and management purposes;
- Do not mandate disclosure of the realised value of all remuneration benefits received in the financial year;
- Do not comply with current disclosure requirements under section 300A of the Corporations Act 2001 (*Cth*) (***Corporations Act***), especially in regard to performance requirements for short term incentives (***STIs***); and
- Are subject to regulation that is not enforced by the Australian Securities and Exchange Commission (***ASIC***).

1.1.5. Regulation

- Has, in its current form, been instrumental in the rapid improvement of remuneration management and the greater engagement of boards with their investors BUT;
- Has, in its current form, weaknesses that can and should be improved (see Recommendations);
- Cannot eliminate instances of poor judgement evidenced in all manner of agency/stewardship decisions (e.g. mergers and acquisitions, CEO recruitment, debt financing, capital expenditure etc., as well as executive remuneration);
- Comprises "hard" law compliance, "soft" law comply or explain ("if not, why not?") and guidelines applied by proxy adviser, governance and other stakeholder groups;
- Hard law compliance (mainly disclosure requirements) is not enforced;
- Soft law comply or explain is flexible, more easily changed to reflect evolving best practice but again is not enforced for the instances of non compliance, especially in small listed companies; and
- Guidelines from different agencies may conflict and suffer from low levels of stakeholder resourcing.

1.1.6. Taxation

- Based on US experience, has had unintended and, on the whole, negative consequences if used as a method to limit forms of remuneration; and
- The proposed limit and method on share plan taxation will have similar consequences.

1.1.7. Alignment and performance

- Performance contingent pay is an essential ingredient to ensure pay symmetry, i.e. pay increases as performance increases, while pay decreases if performance decreases;

- Performance measurement is a required board function in order to assess the executive;
- But can be better applied for determining pay outcomes by using a mix of market based and cash based measures of performance, taking into account capital requirements and risk as appropriate; and
- Alignment of executive interests with those of shareholders can be better achieved with a mix of equity vehicles to encourage an appropriate level of risk taking that will vary with each company's circumstances.

1.1.8. Overall conclusion

Ultimately, effective management of executive remuneration requires and is a consequence of diligent and independent boards with the right mix of skills and experience for the company's businesses, assisted by a competent remuneration committee to do the necessary nitty gritty on complex remuneration issues.

It is not possible to prescribe (create) such boards by regulation; ultimately, that is the role and responsibility of the owners (shareholders), and especially institutional shareholders, as the key activity in their monitoring of their agents (board and management) through voting and engagement.

From a comparative international perspective, Australia has a well balanced governance infrastructure, which, in the field of executive pay, allows the board to make operational decisions on pay matters to best meet their fiduciary duties while still remaining directly accountable to shareholders. In particular, there are good tools for shareholders to exercise constraint through non binding votes on annual remuneration reports and director elections or removal.

But the system can and should be improved (see below).

1.2. Recommendations

1.2.1. Disclosure

- Should be confined to KMP who have a material impact on shareholder value;
- There is no utility in the disclosure of the top 5 remunerated persons as a separate requirement (that may include non-KMPs) and this should be removed;
- Require the disclosure of pay in the terms of fixed remuneration, STI, long term incentive (***LTI***) and total remuneration terms used to manage and compare pay, but in a strictly prescribed format and according to consistent definitions for ease of comparison;
- Require disclosure of the realised value of all remuneration benefits received in the financial year;
- Maintain the current requirement for disclosure of KMP pay;
- Require boards to explicitly address the issue of risk in the formulation of pay policy;

- Require boards to disclose all sources of advice to the board on remuneration matters, with an opinion on the adviser's conflicts of interest and independence;
- Enforce disclosure requirements; and
- Reduce and simplify aspects of disclosure that are not required to judge the effectiveness of board governance of remuneration matters.

We will draft a suggested amendment of section 300A to address/implement some of the above.

1.2.2. Constraints

- As per the above, require disclosure of board advisers and an opinion on their independence; and
- Require boards to receive independent advice via soft law.

1.2.3. Alignment

- Amend soft law to encourage long term executive equity holdings, including holdings beyond their departure time to promote sound legacies;
- Change tax regulation to promote these outcomes; and
- Do not impose tax or regulatory inhibitions to boards applying equity vehicles and/or incentive payments to achieve optimal shareholder alignment.

1.2.4. Taxation

- Align taxation to be levied when a benefit is received.

2. Preamble

Prior to embarking on the detail of this joint submission, including specific responses to the diverse questions posed in the Productivity Commission Issues Paper, Guerdon Associates and CGI Glass Lewis believe they should record some overarching principles that apply to the modern business corporation and its governance.

2.1. Historical basis of the modern business corporation

Prior to the industrial revolution, business was owned, conducted and equity funded by sole proprietors or, in the case of larger businesses, by a combination of proprietors acting in partnership. In both these types, the fundamental concept was one of unlimited liability (joint and several in the case of partnerships). That was acceptable to the principals because they were intimately involved in the conduct of the business and, thereby, were aware of and could control their risk.

The modern business corporation arose out of the inadequacy of the (former) partnership model to accommodate the vastly bigger business vehicle demanded by the industrial revolution. That new vehicle required, inter alia, large and complex production processes, economies of scale and specialised management expertise and other workers. In turn, that required the pooling of capital to fund the new business monsters beyond the capacity of traditional sources of equity capital.

The oil that lubricated the resulting and necessary separation of the ownership (by the scattered providers of the equity capital needed to fund) and conduct (by management and workers) of these businesses was the principle of limited liability. That limited the liability of the owners to the amount of the capital they had agreed to contribute to the business (being any amount not fully paid up on the shares in the business they had agreed to buy).

Partly in return for this limited liability of their risk but also because they did not, as owners of the capital, manage or work in the business and, therefore, had neither the expertise nor the requisite intimate knowledge of the business to make competent business decisions, those owners had no authority or power under the constitution of the business to make such business decisions.

Instead, those owners were, under the constitution of the business, limited to two different but complementary authorities and powers.

The first was to elect, proportionately to their capital contributions and on a defined regular or other basis, a defined group of persons (the board) to direct the business. That direction by the board included controlling the key business decisions and the hiring, monitoring and, where considered necessary by the board, firing of the people who managed and worked in the business through a practical chain of command. If those owners were dissatisfied with the board's direction (performance), they could elect different directors on that defined

regular or other basis or, in between times, convene a meeting of owners to consider making changes to the board, again with any such decision to be made proportionately to their capital contributions. Those owners could not, however, otherwise interfere in the direction of the business.

The second was to make other limited decisions affecting their primarily equity capital based interests in the business, either as set out under the constitution of the business or, in some instances, under the body of corporate law that developed over a period in relation to those business vehicles. A good example of the latter is the body of law that overrides certain aspects of the constitutions of businesses to impose minimum standards considered appropriate.

For completeness, it should also be mentioned that the body of corporate law also developed in other areas of protection of owner (shareholder) interests. A good example of the latter is the body of law that has developed, part common and part statutory law, in relation to the fiduciary duties of the board in exercising its authorities and powers.

Essentially, however, the above separation of authority and power between the board and the owners remains a central principle of the structure of today's modern business corporation. It has stood the practical test of time and changing it in any respect needs to be most carefully considered and implemented.

2.2. Application to remuneration issues

Consistent with the foregoing, and as part and practical parcel of its direction – and, thereby, inside knowledge - of the business, the board's authority and power includes hiring, by and on behalf of the business, key management. By definition, that includes the contractual setting and from time to time reviewing and changing the remuneration of key management.

Any such change, however, needs to be in accordance with those contracts or with the agreement of the executive or pursuant to some provision of the law that overrides those contracts. Otherwise, any change by the business will be in breach of those contracts and the executive will be entitled to a remedy for breach not to mention possible broader implications for staff or other important relationships within the business.

Again, consistent with the foregoing, the owner (shareholder) not only has no authority or power to interfere in the above aspect of the board's direction but also, equally importantly, does not have the board's inside knowledge of the business to be able to do so competently.

2.3. Remuneration and governance

In governance terms, the board and management are the agents of the owners (shareholders) for the direction and conduct of the business and, as with any agency, the interests of the principal and the agent are actually or potentially in conflict. Consequently, it is in the interests of the owners (shareholders) to

monitor the actions of the board and management in the direction and conduct of the business to ensure that the interests of the owners (shareholders) are promoted and protected and are not subverted by or postponed to the interests of the board and management. As indicated above, the owners' ultimate sanction, if they consider that the business is being conducted inappropriately, is to procure change in that direction and conduct, by changing or threatening to change the board.

Remuneration is a key area of such actual or potential conflict because it is how the spoils of the business are carved up between those who work in the business (and especially the board and management who substantially set their own remuneration) and those who own the business. It is, therefore, not surprising that CGI Glass Lewis has observed in practice that how well boards handle that conflict in the exercise of their authority and powers in the area of remuneration is often a good litmus test for how well boards handle other conflicts of interest in the exercise of their authority and powers in other governance areas in the interests of the owners (shareholders).

Because those conflicts are not always well handled, it is in the interests of the owners (shareholders) to monitor the policies and practices of the board in setting their own and management's remuneration.

A number of governance tools have been developed to assist the owners (shareholders) in the monitoring of the board and management in the direction and conduct of the business, including in the area of remuneration. In that area, one such tool is the establishment of a remuneration committee of the board controlled by independent directors to deal with the nitty gritty of the business's remuneration policies and practices and thereby both assist the board to handle those important governance matters competently and to provide a focal point for the owners' (shareholders) monitoring of those issues.

2.4. The remuneration report and its associated non-binding vote

The introduction of the obligation of listed companies to produce an annual remuneration report and to submit that to (non-binding) shareholder vote at the Annual General Meeting (***AGM***) is a further such tool. First introduced in the UK in 2002, the obligation has since been imported into other jurisdictions, including Australia in 2005.

The purpose of this tool is to apply further pressure on listed boards, first, to disclose information relevant to the monitoring by the owners (shareholders) of the remuneration policies and practices of the business (***Disclosure***) and, second, where necessary, to improve those policies and practices in a way that the owners (shareholders) can support (***Structure***).

The sanction for either Disclosure or Structure (or both) that an owner (shareholder) considers to be inadequate is a vote against approval of the remuneration report. It is, in effect, a vote of confidence (or non-confidence in the case of a vote against the report) in the board's handling of its remit in the area of remuneration. If sufficient owners (shareholders) vote against a

particular remuneration report, that sends a strong message to the board that its handling of that remit is considered to be sub-par.

That is why directors of listed entities are highly sensitive not just to a report that is "voted down" (by a majority vote against the report, which is very rare) but also to a significant "protest" vote against the report (by even a quite small percentage of votes).

The reason for this sensitivity is twofold. The first is a reputational issue; directors of listed entities are very sensitive to their reputations in the public domain and sufficient disapproval of a remuneration report is not good for a director's reputation. The parties to this submission know this from their experience, including communication with the entities and the director community.

The second is the prospect that a potential further consequence of sufficient disapproval of a remuneration report is a binding vote against the re-election of the director when next up for election, which is an even more serious issue for the director. CGI Glass Lewis, for example, applies a policy of recommending against the re-election of a director who is the chairman of a remuneration committee that puts out a remuneration report that CGI Glass Lewis regards as seriously sub-par.

As this submission demonstrates, the non-binding vote is working in Australia to achieve the purpose for which it is designed. In general, the standards of remuneration reports have been raised and there is evidence that boards are handling with increasing competence their remit in the area of remuneration. Of course, there are high profile exceptions and there is still work to be done in many cases. But the central message from this submission is to allow the existing process to continue to work through.

There have been suggestions from political and other sources that voting on remuneration reports should be made binding. That misunderstands the purpose and effect of the current regime, including the non-binding vote, described above. A binding vote on a remuneration report would also be meaningless and incapable of implementation without additional legislation setting out the legal consequences of such a vote.

2.5. The remuneration landscape

The potential candidates for executive roles are fewer for larger organisations because there are fewer of these organisations in which to obtain the requisite executive knowledge and experience. The rapid growth in company size over two decades has outstripped the growth in executive supply. Hence, the growth in company size over almost two decades explains much of the relatively high rates of remuneration increase.

But now remuneration is comprised of a high proportion of performance based pay. This indicates that there should be reasonable symmetry between value created and executive pay. That is, the level of pay will most likely reduce in line with the reduction in shareholder value during the economic downturn.

However, the extent will not be known until the 31 December 2009 and 30 June 2010 disclosures.

The key to assessing and moderating executive remuneration is to ensure that it functions as part of an efficient market, whereby pay is just enough to generate optimal returns. Internationally, Australian executive pay levels are relatively modest, while the structure is more performance focussed than most, with relatively more orientation to longer term returns. This has contributed to higher shareholder returns for lower risk than economies elsewhere. So, despite a shallow pool for domestic supply, it appears that the Australian market for competent executive resources functions relatively efficiently.

While there are no major systemic flaws with Australian executive remuneration, there have been examples of poor practice. In some cases these have been identified as indicators of poor governance resulting eventually in company failure. In others, shareholders have expressed sufficient dissatisfaction through the non-binding remuneration vote to see remedial action in place the following year.

Governance and regulatory factors that have been identified as contributing to Australia's relatively good management of executive remuneration, include:

- Principle based law requiring directors to exercise diligence, care and judgement to meet their fiduciary obligations to shareholders;
- Majorities of independent directors on boards;
- A good balance between legally enforceable disclosure and voting requirements and voluntary principle prescriptions on an "if not, why not basis";
- The separation of independent non-executive chairmen and executive roles;
- Director nomination and election by shareholders;
- Shareholder non-binding votes on remuneration reports; and
- A good standard of remuneration disclosure.

But there are problems with:

- Boards receiving advice only from sources that have conflicts of interest;
- Non compliance with existing disclosure requirements that make shareholder assessment of board competence and remuneration fairness difficult;
- Disclosure requirement redundancy, complexity and opacity; and
- Poor regulatory enforcement.

2.6. Remuneration, regulation and behaviour in context

Whilst it is trite to say, it is important to bear in mind, that the regulation of remuneration involves the regulation of human behaviour. Accordingly, there are natural and appropriate limits in the extent of that regulation, especially in a free market economy like ours.

As discussed in this submission, we are aware of poor remuneration practices, poor disclosure in remuneration reports and individual egregious pay examples. That said, we are also aware of a range of other failures by companies in the form of marketing failures, executive recruitment failures, business acquisition and disposal failures, risk management failures, business strategy and implementation failures, company reputation failures and legal compliance failures. These failures also result from human behaviour. Not all problems and failures can be avoided just by increasing regulatory requirements.

Whilst some of these other failures may have been encouraged by poor remuneration policies, we submit that the vast majority of them are not caused by those policies. In fact, we believe that most of them are caused by poor governance systems, rather than by poor remuneration policies, and it is often the case that poor remuneration policies are the result of poor governance, not vice versa.

Clearly, remuneration is an important issue, as it is a driver of behaviour (along with ego/reputation, corporate and person values, skills, expertise and professionalism, amongst others). Accordingly, we believe it is critical that the settings within which remuneration policies are established and remuneration decisions made are appropriate, sufficient and practical. However, we do not regard remuneration as an issue that is so much more important than, for example, regulatory compliance, good governance, managing conflicts of interest, respect for shareholders, creditors, customers and other stakeholders, recruitment policies, occupational health and safety compliance. All of these issues need to be managed properly by directors and executives, in the regular running of a company.

Further, if the regulatory regime is too proscriptive, it will not be practical day-to-day or in the long term. If the regime is too lax, there will be insufficient checks and balances on the decision making process.

The framework within which these decisions are made needs to be sensible - that is, the policies should be set by an independent and relevantly experienced board, perhaps with the benefit of independent advice, and the policies and decisions need to be regularly explained to shareholders through appropriate disclosure. The policies themselves need to pay regard to all of the key drivers in the business that are relevant to each specific executive or class of executive. As such, each policy will need to be tailored for each company. There is no 'one size fits all' policy. (APRA has acknowledged this in its recent reports on remuneration, with its adoption of a principles based approach.) The policies and their implementation are not, however, capable of being established and made by shareholders. They need to be made by those close to the operations of the company, the executive team and the day-to-day performance of the company and the team.

Having reviewed the Australian regulatory landscape, in the context of a free market economy, we believe that the settings in which remuneration decisions

are currently made is generally appropriate. Refinements to that system can and should be made. In particular, by:

- ASIC ensuring better compliance with disclosure requirements under the Corporations Act;
- Simplifying the disclosure requirements of remuneration reports to encourage compliance and to provide more meaningful and comprehensible disclosure;
- Encouraging the use by companies of better performance principles in the design of remuneration systems, through disclosure of those principles; and
- Encouraging companies to adopt remuneration policies which inherently encourage long term thinking by the important executives.

3. Introduction

This is a joint submission from CGI Glass Lewis and Guerdon Associates to the Productivity Commission's inquiry into director and executive remuneration.

The submission responds to the Commission's questions. Major sections include an upfront summary of conclusions and recommendations pertinent to that section.

Specific Commission questions are highlighted in blue prior to specific text responding to the question.

4. Organisations making the submission

4.1. CGI Glass Lewis

CGI Glass Lewis is Australia's most experienced and independent proxy advisory firm, established since 1993. It is a member of the San Francisco based Glass Lewis group, which covers more than 17,000 companies in over 80 countries and now provides services to institutions that collectively manage more than US$15 trillion in both hemispheres.

CGI Glass Lewis has special responsibility for reporting to group clients inside and outside Australia on entities listed on the Australian and New Zealand stock exchanges.

4.2. Guerdon Associates

Guerdon Associates is Australia's largest independent[1] consulting firm specialising in executive and director remuneration. Its consulting operations are concentrated in its Melbourne and Sydney offices, while support staff are located in Chennai (data centre) and San Francisco (technology).

[1] Independence in this instance means to be as far as possible free from conflicts of interest. Guerdon Associates only provides board advice on executive and director remuneration, and does not provide broad based services covering other specialities that are, or could, be commissioned by management.

5. Why make a joint submission?

There is a wide degree of consensus among the two organisations making this submission with respect to executive and director remuneration matters. Also, because of the diversity of specialisation and perspective, a comprehensive review of all aspects of executive and director remuneration matters is probably beyond the scope of any one organisation.

This submission brings together the skills, experience and interests of diverse experts. It reflects largely consistent views and we believe recommends an outcome that is in the best interests of all stakeholders.

6. Definitions and scope

6.1. Definitions and scope summary of conclusions and recommendations

Our detailed analysis on the appropriateness of definitions of 'remuneration', 'executive' and 'performance' are set out in Appendix B.

Our conclusions on definitions and scope are as follows:

- Prescribed remuneration disclosures do not require disclosure of remuneration in common usage terms used to understand, communicate and manage remuneration;
- The Corporations Act has too many overlapping concepts applying to 'executives'. For example, section 300A refers to the following definitions and concepts (or includes them in composite definitions): 'key management personnel', 'company executive', 'group executive', 'relevant group executive', 'director', 'secretary', and 'senior manager'. This does not enhance practical outcomes;
- Disclosure of information on performance and remuneration is inadequate and does not allow transparency and adequate judgments to be made;
- Compliance with remuneration report disclosure obligations is difficult and time consuming;
- Compliance with the disclosure requirements is not enforced by ASIC;
- Absolute market based measures of performance reflect market growth outcomes, rather than performance attributable to the company or executives;
- Relative market based performance measures do not result in reward that is a function of overall market growth, but these have their problems;
- Market growth factors can be ignored using fundamental non-market based measures suited to long term value creation;
- However, agency theory would indicate that some exposure to market growth factors is necessary for shareholder alignment; and
- Shareholder alignment and reduction of agency costs can be achieved with a mix of remuneration vehicles and a mix of market related and non-market measures of performance.

We recommend that section 300A of the Corporations Act be amended so that:

- Remuneration reports disclose remuneration in prescribed terms that reflect common usage (fixed remuneration, STI, LTI and total remuneration);
- Individual remuneration disclosures be limited to (for a corporate group) KMP only;
- Remove the separate requirement for the disclosure of the top 5 remunerated persons (that may apply to non-KMPs);

We are currently drafting an alternative version of section 300A to assist the Productivity Commission. We anticipate providing this when the second round of submissions are due, or earlier if the Productivity Commission requests.

6.2. Remuneration

What is an appropriate definition of 'remuneration'?

What aspects or elements of remuneration should be included?

The definition of 'remuneration' as set out in Australian Accounting Standards Board (***AASB***) 124 is an appropriate definition for use in accounting standards and financial reports of the company. The term is less useful or relevant when disclosing director and executive remuneration.

The most useful and common remuneration terms:

- Are not formally defined in regulation;
- Have various meanings that are confusing and misleading;
- Are not required to be formally disclosed; and yet
- Provide the foundation for board decisions on executive and director pay matters.

The terms most often used throughout this submission are those used by boards, management, board and management advisers, investors, proxy advisory firms and the media. They are:

- Fixed remuneration;
- STI;
- LTI; and
- Total remuneration.

The component parts of remuneration in common usage today rely on accounting value definitions. This has caused confusion and frustration among boards, executives, investors, proxy firms, governance groups and other stakeholders because they do not provide a guide as to what the executive actually received "in the hand" in a form that he/she could save or spend, nor the current "real" value of remuneration if it could all be realised immediately. To this end, we have defined two further measures of remuneration for consideration, namely "realised remuneration" and "total compensation".

Definitions of these terms are in Appendix B.

6.3. Executive and director

'Executive' is not defined in the Corporations Act. Whilst the existing definitions are relevant in more than one area under the Corporations Act, our submissions focuses on the appropriateness of the definition of 'executive' and other terms used with respect to personnel for the purposes of the remuneration report under section 300A of the Corporations Act.

Disclosures of remuneration should be confined to individuals occupying positions that have a conflict of interest and have a material impact on shareholder value.

The persons that have a conflict of interest are those that have, or could have, a significant input into the setting or framing of remuneration policy or the performance standards that may impact their own remuneration outcomes. [These people are usually directors but may include senior managers.]

The persons who can have an effect on the overall performance and standing of a corporation are its directors and the persons who:

- make, or participate in making, decisions that affect the whole, or a substantial part, of the business of the corporation (for a group, on a consolidated basis); and
- have the capacity to affect significantly the corporation's financial standing (for a group, taken on a consolidated basis).

This is equivalent to directors plus those who meet the definition of 'senior managers' under the Corporations Act (but taken on a consolidated basis for groups and including secretaries if they meet the other requirements).

This concept of 'senior manager' is preferred to that of 'key management personnel' in the Corporations Act. Key management personnel are those that have overall responsibility for planning, directing and controlling. This definition does not accommodate any concept of the person's ability to expose the entity to risk. A person holding the position of credit controller may have the capacity to significantly affect a corporation's financial standing, but that person may not have a role planning, directing and controlling the activities of the entity. Senior managers (as described above) are relevant for the remuneration report as their responsibilities can have an effect on the overall performance and standing of the company.

Should other high paid personnel be included in disclosures?

It is possible that other individuals who are not directors or senior managers receive relatively high remuneration. This is an outcome of policy and decisions by directors and senior managers. The other highly remunerated individual(s) should not, as a principle, have their privacy compromised by the decisions of those persons making remuneration decisions that result in their high pay.

However, this does not preclude disclosure of policy and decisions and governance processes by directors and senior managers that resulted in this outcome. That is:

- Has the board reviewed remuneration outcomes for non-senior manager/ director personnel that resulted in high pay outcomes?[2]

[2] This could be defined as pay that exceeds the reported total remuneration of the lowest paid director or senior manager employed for the full financial year (see section 6.3 for more detail).

- Is the board satisfied that remuneration policy and frameworks resulting in this outcome are satisfactory?
- Why?

6.4. Performance and transparency

Performance requirements for performance contingent payments are inadequately or, in the case of most short term incentive plans, not disclosed. This is contrary to compliance requirements under section 300A of the Corporations Act.

In Appendix B we suggest a reporting framework that could be prescribed in the Act that includes, for each performance contingent payment:

- Who is eligible;
- The period or periods over which performance is measured;
- The service requirement before a payment vests;
- The nature of the performance measure;
- The threshold level of performance required before a payment is granted;
- The payment for attaining this threshold;
- The way in which a payment may increase above the payment for threshold performance (i.e. the formula);
- If there is a maximum or capped payment and, if so, what this could be; and
- The payment vehicle/s.

We note that while there is a requirement to disclose performance conditions under the current Act, there is no recognition in the Act that disclosure need not be provided if there is the prospect of material harm[3].

We address performance condition disclosure more fully in Section 8.

6.5. Compliance will aid performance requirement transparency

The Act requires companies to disclose performance conditions. Currently most listed companies do not comply, especially in regard to short term incentive plans.

This is not difficult to rectify. See Section 8.

6.6. Should there be a nexus between shareholder outcomes and executive reward? The agency problem

[3] Given that the remuneration report requires disclosure of performance conditions for payment that applied to the prior fiscal year, there would be very few instances where non-disclosure could be justified on this basis.

To what extent do external performance indicators 'net out' underlying market growth factors from entrepreneurial and managerial performance?

The aphorism "a rising tide lifts all boats" is associated with the idea that improvements in the general economy will benefit all participants in that economy. This applies to all employees, and not just executives. However, executives in receipt of equity vehicles will experience this more directly than employees who do not receive equity. So, by extension, an ebbing tide will lower all boats and thus, the effective reward received by executives.

Some have suggested this is a fair and reasonable outcome. But its impact on executive behaviour may not be in the best interests of shareholders.

Executives are agents of shareholders. As much economic research concludes, this has costs[4]. While this cannot be eliminated[5], various attempts to overcome the agency problem have been made with executive reward. The most common involve the vehicle of reward and performance requirements on which reward is contingent.

Reward vehicles to overcome agency problems have been forms of equity, including shares, options, share rights, share appreciation rights and shadow shares, among others. While they are better at limiting the extent of agency costs, rewarding with these vehicles does not resolve agency issues. For example:

- Options encourage risk taking. Option holders do not experience the downside risk regular shareholders have;
- Share rights, now the most common form of equity reward in Australia, have downside risk, because as the share price drops, so does the reward value. But rewarding with share rights, requiring these to be held for the term of employment, and the lack of liquidity at senior executive level because of trading blackouts and insider trading laws[6] in effect makes the executive more risk averse than most long term shareholders[7], who have minimised their risk with investment diversification;
- Options and rights do not encourage executives to adopt capital management strategies that may increase dividends, because executives do not benefit from this;
- Shares do of course have dividends attached. But their use as a reward vehicle is not common because of regulations requiring expensively

[4] Examples of this research can be referenced HERE.

[5] Unless the employee and owner are one and the same.

[6] This can be overcome when an Australian government gets around to implementing CAMAC recommendations – see Guerdon Associates commentary HERE.

[7] That is, the major method used by institutional superannuation funds investing in equities. While methods vary, no complying superannuation funds would be allowed to have all their investments in one stock. So requiring executives to have much of their wealth held in only their own company can be problematic in getting optimal returns, over a portfolio of companies where the risk is diversified.

administered and inflexible trusts to be established. As with share rights, concentrating reward in the form of shares increases risk aversion; and

- Share appreciation rights and shadow shares are common in other countries, but hardly used in Australia because they involve cash payments and ASIC is of the view that using them requires an exemption from licensing and disclosing document obligations under the Corporations Act. They share agency issues with options and shares respectively.

In most instances it is probably better to provide reward in a mix of cash, share rights, share options and shares to overcome much of the agency costs. But there is no "right" mix. It will depend on the company's strategy, opportunity, cash flow, capital structure and requirements, and its stage of maturity. The implication is that over time the "right" mix will change.

In short, the mix is somewhat of an art requiring business judgment of the stage that the organisation is at. Given the complexities, the board is in the best place to exercise this judgment because it has the requisite inside knowledge of the business.

6.7. Should uncontrollable market outcomes be reflected in executive performance requirements? The case for and against share price indicators of performance

In the discussion above we have identified some of the ways the reward vehicle mix can be applied to resolve some of the agency problems.

But performance requirements can be more contentious than the reward mix.

The most common requirement since the UK Cadbury report[8] has been the use of relative Total Shareholder Return (***TSR***) for LTIs. This requires comparing the company's performance against the TSR of comparator companies over time.

The implication of this is that executives can still receive a reward if shareholders have lost money, but their loss has not been quite as much as shareholders of other companies. In effect the ebbing tide that lowers all boats will not apply to executives with this requirement.[9]

This aspect of the reward has received negative press with the economic downturn. However, in our view it is still a viable reward outcome[10] because, through good management, shareholder capital has been better preserved than in peer companies.

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[8] Committee on the Financial Aspects of Corporate Governance (1992) *Report with Code of Best Practice,* [Cadbury Report], London: Gee Publishing.

[9] Unless their reward is locked away in company shares.

[10] Providing certain other criteria are met.

Interestingly, the Financial Services Authority (***FSA***) in the UK recently released its "remuneration principles" (see the FSA draft code on remuneration practices HERE and a Guerdon Associates article relating to it HERE) that effectively advocate alternatives to relative TSR, indicating that relative TSR induces risk taking. Guerdon Associates made this point some time ago (see a 2006 Guerdon Associates article HERE), but also suggested that there are solutions.

More problematic for Australian listed companies is the absence of viable comparator companies. Without a viable comparator group, a performance requirement based on relative TSR is not motivating, as executives have no influence over outcomes. Yet all relative TSR incentives incur an expense whether the performance condition is met or not. In these cases, requiring reward to be contingent on relative TSR is a wasted expense (see Guerdon Associates commentary HERE and HERE).

Other market-based measures used are share price or a company's absolute TSR. These have close to perfect alignment with shareholder outcomes. But to use them is in most cases inappropriate. A typical Australian Australian Securities Exchange (***ASX***) 200 company's share price (and TSR) varies more or less in accord with the market. Statistically, over 60% of a listed company's share price will fluctuate with market sentiment. It is hard to justify reward based on general market movement[11].

6.8. Focus on controllable performance factors

The alternatives to market based measures are, of course, non-market related measures. In recent years governance groups, investors and proxy firms have adjusted their guidelines to either "allow" non-market based measures, or encourage non-market based measures in addition to market-based measures. Typically, these non-market based measures are over aspects that executives can exert more direct influence, so meeting one of the very basic requirements for motivation (see the discussion of the expectancy theory of motivation HERE for example). The key to effective non-market related measures is to select the measures that are best correlated to long term value creation, and yet meet the requirements for effective motivation.

Non market factors result in reward outcomes that are divorced from short term share market volatility.

The most common non market based measure for executive LTIs is earnings per share (***EPS***) growth. While there is some intuitive sense in this measure, it is not necessarily highly correlated with long term shareholder value creation. In addition, as various investigations into the financial credit crisis have demonstrated, it can encourage excessive risk taking[12] (again FSA draft code

[11] Unfortunately, this method is still predominant in the USA and Canada.

[12] For example, a company can take on more debt relative to its equity to achieve more earnings growth, but at the expense of putting the company more at risk in the event of an economic downturn.

on remuneration practices, refer to this HERE, and related commentary). Other common measures include net profit after tax (***NPAT***) growth or earnings before interest and tax (***EBIT***) growth.

Less common, but probably better oriented to the creation of long term shareholder value in capital intensive companies are cash flow measures that take into account the risk adjusted cost of capital. This is sometimes referred to as cash flow return on investment, economic profit, risk adjusted return on capital, or economic value added. They are less common because they are complex and difficult to understand, expensive to administer, require discretionary judgment, difficult to audit for fair assessment, and not well suited to less capital intensive companies.

Non market based measures can, and do, often result in executive rewards that do not appear to correlate with shareholder returns. Often this is the result of an inappropriate measure (e.g. risky EPS growth, or NPAT with no reference to capital usage) and/or inappropriate time frame (i.e. too short a time frame).

Few non market based measures are used (outside of Australia's financial services sector) that take adequate account of risk.

7. Trends in remuneration

7.1. Trends summary, conclusions and recommendations

In summary, executive reward has undergone major transformation over four decades, including structures that ensure outcomes are more variable with performance, mixes of equity vehicles to overcome agency costs, and better discipline and coherence. But levels have increased more in line with market growth than inflation or average weekly earnings. Disclosure also played a part in pay ratcheting. But, with the downturn and greater proportion of pay exposed to economic outcomes, there is likely to be a decrease in realised executive pay.

Our conclusions are as follows:

- The basis of setting executive pay levels in most companies does not differ from the process for other employees;
- A primary question of justification, fairness and equity is whether the market that determines rates of pay is efficient;
- An indication of Australian market efficiency is pay for Australian domiciled executives relative to others. On this basis the level of pay is less than other developed countries, and about the median for major developed and developing countries;
- A further indication of relative efficiency is the returns and risk delivered by Australian domiciled executives relative to other markets. On this basis Australian listed company performance is superior to that of the UK and USA;
- A valuable input in ensuring executive pay levels are optimised for the performance achieved, and constraining managerial power, is the "outrage constraint", exercised through shareholder voting;
- Optimising the cost-benefit balance for executive pay could be improved with better compliance with disclosure requirements for the basis for payment of STIs;
- Executive pay increase rates correspond with productivity, measured directly by increases or decreases in market valuation;
- Executive remuneration is reasonably symmetrical, although not perfect. It goes up when measures of value produced go up, and goes down when measures of economic value go down;
- The extent of executive pay symmetry is a function of the proportion of pay at risk and contingent on performance; and
- There is no evidence of wholesale inappropriate risk taking in Australia attributable to remuneration.

Our recommendations are as follows:

- The optimisation of executive pay levels to give the greatest value could be improved by enforcing better disclosure of STI performance requirements specified in current regulation (see Section 8);

- Australian companies should be encouraged to link bonus outcomes to a 'profit pooling' concept which sums all employee bonuses payable at 'target performance'; and
- The responsibility for determining the appropriate level of risk taking should remain with the board.

How are levels of director and executive remuneration determined?

7.2. Board sets policy and framework

Company board remuneration committees are responsible for setting non-executive and CEO remuneration levels, and the CEO's remuneration mix (fixed, STI and LTI), performance measures, thresholds and maximum performance requirements, and performance payment calibration.

For other executives, the board approves:

- The remuneration framework in terms of fixed remuneration, STI and LTI mix;
- Payment vehicles (e.g. cash, cars, options or performance rights); and
- LTI performance measures, thresholds and calibration.

The CEO generally recommends the remuneration for his/her direct reports, subject to board approval.

As a result of the global financial crisis financial regulators (such as the Australian Prudential Regulation Authority (***APRA***)) will probably require company boards to be actively engaged in setting the policy, approving the framework, and monitoring outcomes for all front line employees selling, marketing or developing product that may involve risk. This requirement is expected to permeate non-financial services companies over time.

7.3. Fixed Remuneration

Fixed remuneration comprises salary, superannuation, non-monetary benefits (e.g. company cars) and equity payments that are not performance contingent[13].

Currently there is no requirement to disclose fixed remuneration as defined above. However, most companies frame their policies around this concept and, to varying degrees, disclose some aspects of their fixed remuneration policy, albeit inconsistently.

Executive fixed remuneration is reviewed annually, as it is for other employees.

Executive fixed remuneration is determined by reference to the market. In determining an appropriate level, jobs are matched as closely as possible to similar jobs in other companies. But, as companies vary in size the level of

[13] See Appendix B for further definitions.

responsibility[14] is also a key factor (market capitalisation, assets, revenue etc). Market capitalisation is the primary factor that determines the level of fixed remuneration among jobs that otherwise match in terms of job description.

Statistically, market capitalisation explains about 45% of the variation in fixed remuneration for ASX100 companies, as illustrated in figure 1. Other factors are also mainly size related (e.g. revenues and assets)[15].

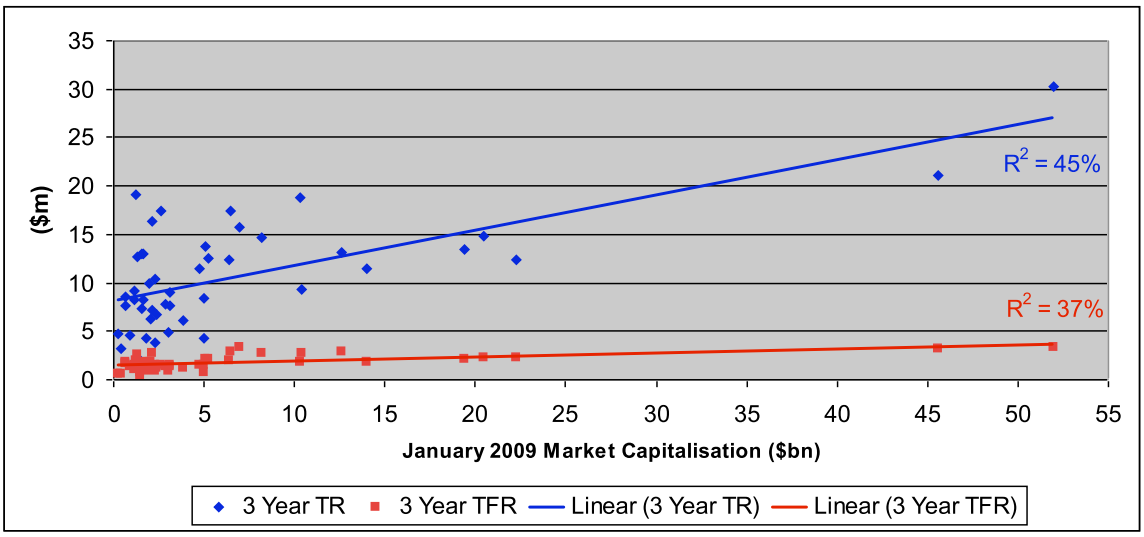

Figure 1: ASX100 CEO same incumbent 3 year fixed and total remuneration

A consequence of the known relationship between fixed remuneration and market capitalisation is motivation to grow the size of the company. The fastest way to achieve this is by acquisition. But these have high failure rates[16]. The nature of many acquisitions is such that the realisation that it has failed may not surface until the relatively short tenure of the CEO[17] has already ended, or is drawing to an end.

While we know that executives are aware that their remuneration is largely driven by their organisation size (i.e. market capitalisation) there is no direct evidence that this has featured as a primary driver of growth by acquisition. Nevertheless, it heightens the importance of having boards comprised of experienced, knowledgeable and independent directors. In addition, other pay

[14] Several large companies apply a "job sizing" method to rank jobs and determine fixed remuneration. This is known as "job evaluation". Jobs are ranked on various factors and allocated points. These points are correlated with market rates of pay. The most heavily weighted factor in all these various systems is the "responsibility" factor, which at executive level is the size of the organisation managed. The public service in Australia applies the same methodologies.

[15] There is also circumstantial evidence that executive tenure is a contributing factor. Unfortunately the Australian listed company market is too shallow, the number of longer serving executives too few, and the remuneration disclosures history is too short for robust statistical analysis.

[16] E.g. see Straub, Thomas (2007). *Reasons for frequent failure in Mergers and Acquisitions: A comprehensive analysis*. Wiesbaden: Deutscher Universitätsverlag.

[17] E.g. see Guerdon Associates article "High CEO turnover – outside CEO recruits deliver less than insiders" HERE.

methods can be applied to defer reward until the success of acquisition results are known (see Guerdon Associates commentary HERE).

Most organisations aim to provide fixed (guaranteed) remuneration at around the median[18] of the market. This is considered by most boards (and their advisers) to be fair to both shareholders and executives. In addition, equity theory and research[19] has indicated that employees paid at the median will be satisfied enough not to seek employment elsewhere[20].

There are valid exceptions to policies paying at the median:

1. A board may require the CEO and/or other executives to accept less than median market fixed remuneration rates in return for much more highly leveraged incentive pay; and
2. A company which has inherited a poor reputation and legacy issues weighing heavily on performance may need to provide higher fixed remuneration to attract a new management team.

A minority of companies practice these alternatives.

Therefore, with the bias to establishing or maintaining policies that pay at the median, it follows that there could be a ratcheting effect. The median is the pay of the middle paying company in a sample. That is, as poorer paying companies adjust their policies upwards towards paying at the median, the median may move upwards. However, those companies paying higher rates, while they rarely adjust pay downwards for the same incumbent[21], may slow down his/her rate of increase so that over time pay moves towards the median.

Alternatively, as companies move towards the median in pay there could be a "normalisation" effect. That is, a tighter distribution of pay around the middle of the market, with fewer extreme examples. There is some evidence of this observed by Guerdon Associates' longer term practitioners after two decades of statistically analysing executive pay distributions.

7.4. Short term incentive remuneration

An STI is a payment contingent on performance measured over a period of 12 months (or less)[22]. The most common payment vehicle is cash, although deferred shares are becoming more common for retention, shareholder alignment and risk management purposes.

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[18] The median is that pay level at which 50% of companies pay more and 50% pay less.

[19] Adams, J.S. 1965. Inequity in social exchange. *Adv. Exp. Soc. Psychol.* 62:335-343.

[20] Herzberg, F. 1968, "One more time: how do you motivate employees?", *Harvard Business Review*, vol. 46, iss. 1, pp. 53–62.

[21] This is, however, happening during the current economic downturn.

[22] See definitions in Appendix B.

For most organisations, incentive remuneration is determined by reference to fixed remuneration. That is, the threshold, target and maximum incentive remuneration is expressed as a percentage of fixed remuneration. Hence fixed remuneration is a driver of incentive pay.

Too few Australian companies link bonus outcomes to a profit pool concept. That is, bonuses are sourced from a pool of funds that vary with the company's capacity to pay[23]. So anomalies occur whereby bonuses based on achievement of personal goals can be paid when company profitability plunges. A major issue for CGI Glass Lewis in reviewing the 2008 remuneration reports of some companies was the unexplained or inadequately explained award of substantial STI pay for the 2008 financial year to the CEO and other KMP despite flat or declining company profitability.

The most common way a profit pool works is to sum all employee bonuses payable at "target" performance, and divide this by the budgeted or expected profit. As company profit exceeds or fails to achieve expectations, so does the bonus opportunity for each employee, including executives. In addition, there may be a threshold requirement before any bonuses are paid, usually related to capital efficiency (e.g. return on capital employed). If below an acceptable level, no bonuses are paid.

Because a profit pool is a finite amount, one employee group cannot be favoured over another, otherwise the resulting dissatisfaction will result in unwanted turnover. All employees gain or lose on company wide as well as individual performance outcomes.

Profit pooling is a common method in US, Canadian, Nordic and German companies.

STIs form a larger proportion of remuneration for larger organisations than they do for smaller ones.

7.5. Long term incentives

An LTI is a payment contingent on performance measured over a period of greater than 12 months[24]. The most common form of payment is performance rights, although options and shares are also provided. Cash is currently provided by a handful of companies, although this proportion may grow depending on the outcomes of the budget review of share plan taxation.

Various media reports have indicated that STIs have increased disproportionately relative to LTIs, and that this compounds the overemphasis on short term results. There is no evidence of this. On the contrary, Guerdon Associates research indicates that LTIs as a proportion of executive pay have increased (e.g. see Guerdon Associates research and analysis HERE and HERE).

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[23] Capacity to pay and profit, in these contexts, should refer to cash generation. For example, Enron and Babcock and Brown had profit based bonus plans where the measure was accounting rather than cash profit.

[24] See definitions in Appendix B.

Among ASX 200 companies, levels of LTI are usually determined by reference to a set percentage of fixed remuneration.

Once the board has approved this policy, the likely fair value of the share option or share right is calculated by reference to a standard options model such as the Black Scholes Merton model (see the article on the work of Black, Merton and Scholes HERE), sometimes adjusted for a Monte Carlo simulation (see the commentary on the Monte Carlo methods for option pricing HERE). Less sophisticated approaches assume that a share right[25] (the most common form of LTI payment vehicle) has the same value as a share[26]. The number of share rights or options granted to an executive is a percentage of fixed remuneration multiplied by the amount of fixed remuneration, divided by the calculated fair value of the share right or option.

The reported value in disclosures is the fair value calculated in accordance with AASB 2 (see AASB 2 HERE), which prescribes methods similar to the Monte Carlo and Black Scholes methods described above.

The criticism of these disclosures is that they do not show what the executive actually received as a final benefit. This is addressed in Section 8.11.

7.6. Executive pay structures, levels and symmetry with shareholder outcomes

As indicated in the previous three sections, executive pay is comprised of fixed remuneration, STI and LTI. The level of fixed remuneration is the primary driver of incentive pay levels. But fixed remuneration is also largely driven by reference to the company size (e.g. market capitalisation).

So, what happens when there is a market downturn and company size drops?

For regular employees remuneration is "sticky". That is, during economic downturns an individual's pay does not tend to be reduced[27]. This asymmetry of regular employee pay contributes to unemployment, as laying off staff is one of the few ways to reduce labour costs.

While layers of executives may also be subject to redundancy, total remuneration is structured to be more flexible in response to downturns. STIs reduce, while the realised value of LTIs (which is currently not clearly disclosed) also reduces. In some cases the fixed pay level is frozen or reduced (unlike the fixed remuneration for non-executive positions).

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[25] A share right is an option to acquire a share at a zero exercise price (otherwise known as a ZEPO).

[26] This is not actually the case in most circumstances, as a share price includes an allowance for the net present value of dividends, which are not received by ZEPOs. Interestingly, this incorrect valuation method should be picked up during a standard auditing process. It surprises us that it is not, and indicates that audit competence in this area is poor.

[27] An exception would be award covered employees that receive significant overtime during good economic times.

The net effect is usually a drop in realised total remuneration. The extent of reduction increases with the extent that total remuneration is comprised of incentive payments. This is addressed in Sections 7.15 and 10.2.

7.7. Non-executive director pay

Non-executive director (***NED***) remuneration is usually comprised of fixed remuneration in the form of a NED's fee, with a shareholder approved cap on aggregate NEDs' fees. Incentive NED pay is contrary to the ASX Corporate Governance Council's Principles and Recommendations (***ASX Governance Principles***), Australian Institute of Company Directors (***AICD***) guidelines, and the guidelines of all other governance stakeholders.

NED pay is usually cash, but an increasing proportion of NEDs are also receiving pay in shares (see Guerdon Associates commentary HERE[28]). No relationship has been found between receiving pay in this form and company performance (see Guerdon Associates commentary on Chairman share ownership HERE), although a recent study indicated that paying NEDs in equity might restrain CEO cash remuneration[29].

Remuneration of NEDs outside ASX 300 listed entities tends to change in nature from cash based fees to a combination of cash based fees, market price options and, in some cases, performance based remuneration. It is not uncommon for smaller listed entities in the development phase to issue options in lieu of cash as a method of preserving cash. We have no objection to this practice so long as the nature and terms of the option grant do not prejudice the independence of the NED.

That is why we believe any option grant to a NED should not be on the same terms and conditions as options granted to management, as that would tend to align the interests of the NED with the interests of management whose strategy and performance NEDs are supposed to monitor for shareholders. It is also why we believe that NEDs should not receive performance based remuneration as this, again, risks confusing the role of the NED with that of executives. Further, any options granted to a NED in lieu of cash should vest immediately to ensure that the NED shoes not have an incentive to remain on the board to enable his or her options to vest at some future point and is thereby inhibited from exercising the NED's ultimate sanction (and warning signal to investors) of resigning from the board.

CGI Glass Lewis has also noted that there are cases where the value of options granted to NEDs has resulted in the remuneration of NEDs far exceeding the level of NED remuneration in ASX 200 listed entities. An extreme example of this is Poseidon Nickel Limited, where in 2008 the non-executive chairman,

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[28] It is also common for small start up companies and private equity owned companies for NEDs to receive pay in share options as, among other things, this conserves cash.

[29] "The influence of Non-Executive Director Control and rewards on CEO Remuneration: Australian Evidence", Robert Evans and John Evans, draft working paper available via SSRN.

Andrew Forrest, received options valued at A$277 million plus shares worth A $8.7 million with his total remuneration for the year totalling A$235.7 million.

NED remuneration is reviewed and adjusted less often than the remuneration of executives. Adjustments in NED pay were made about every three years. However, NED pay reviews are now about every two years, partly as a result of increased time demands being made on NEDs.

NED remuneration is determined with reference to the external market. As with executive pay, the size of the company in terms of market capitalisation is the primary determinant of NED remuneration levels. Whether a company is APRA regulated or not is also an important factor, reflected more directly in workload variables (e.g. the number of meetings).

To date we have not observed the correlation of NED pay to market capitalisation as an influence on board decisions relating to merger or acquisition, despite the conflict of interest apparent in this relationship.

An individual NED's remuneration is also impacted by workload. For example, a NED's basic fees may be determined with reference to fees paid by other similar companies, but the additional fees for committee membership or chairmanship may be determined based on the workload of that committee, relative to other board committees.

Broad based studies of NED pay and relative workload have indicated that workload[30] did not seem to impact NED remuneration (see Guerdon Associates articles HERE and HERE). However, more recent client commissioned studies provide conclusive evidence that workload is a significant director remuneration factor for APRA regulated companies[31].

7.8. Pay equity

Pay equity has been cited as a consideration in setting pay levels.

Most large Australian companies have a "job sizing" process linked to market levels of pay for all award free employees. Because only a few jobs can be commonly matched to jobs in the external labour market, these job sizing approaches provide linkages between these matched jobs and unmatched jobs to ensure equitable payment. The pay percent differences between these different jobs tend not to have varied in decades[32]. This also applies equally to executive level jobs that fit in this hierarchy. (See Guerdon Associates commentary on executive pay equity HERE).

[30] E.g. the number of meetings and the size of the board, whereby a smaller board requires more of individual directors.

[31] Client confidentiality constraints prevent Guerdon Associates from publishing these analyses.

[32] Controlling for occasional job specific supply and demand variations over time.

What constraints exist, and what is the market's role in determining remuneration levels?

7.9. Market efficiency in theory and practice

Executive pay constraints can be understood in a market context. That is, in a perfect market, resources are allocated such that demand equals supply in the most efficient manner.

For the executive market, this means that executives with the most appropriate knowledge, skills, experience, prior results and highest probability of success are sourced, retained and motivated to focus on value building strategies for the least cost. Further, the best executives are placed in jobs that create the most economic benefit.

In practice, various constraints apply to an efficient functioning of this market:

- Transparency is limited to the listed company market. It does not cover markets that could also be attractive to this resource pool, such as the non-listed companies (e.g. foreign multinationals and privately owned companies), or the professions (e.g. law and accounting);
- Transparency is limited by current listed company disclosure requirements, which do not require the explicit disclosure of realised remuneration value (i.e. actually received remuneration at intrinsic value, rather than accounting value), relating this to the service period it was earned, and the company performance during this period (see Section 6.4);
- Transparency is limited by non-compliance with current disclosure requirements, primarily relating to the STI performance measures, calibration and outcome. In addition, there is also non-compliance with the requirement to report on the relationship between pay and performance[33] (see Sections 6.4 and 8.7);
- The absence of resources among investors to analyse, and/or evaluate and/or exercise votes on remuneration matters (see Section 7.11.4);
- Conflicts of interest among some investors that do not encourage vote exercise on remuneration matters;
- Conflicts of interest between fund managers paid on short term outcomes, exercising votes aligned with these outcomes, and beneficial owners who require stable long term performance (see the *Business Spectator* article commenting on design flaws in the global funds management industry HERE and Section 7.11.3);
- Conflicts of interest among the advisers to boards on pay matters (see Guerdon Associates article on relevant US Congressional Committee findings HERE and Section 7.12);
- The absence of expertise and experience on remuneration matters at board level (see Section 10.7);
- Unintended consequences of pay and tax regulation (see Guerdon Associates commentary HERE and Section 10);
- The shallowness of the Australian equity market, resulting in few local individuals capable of managing public enterprises who could be

[33] For example, see "The practice of director and executive remuneration disclosure by Australian firms", Nigel Finch, MGSM Working Papers In Management, via SSRN.

approached for any vacancy that may arise[34]. Hence, the local market is dependent to an extent on the "migrant" executives, and, hence, the market imperfections associated with overseas executive remuneration (see Section 2.5);

- The short tenure of executives in jobs that always require "out performance" of market expectations[35], leading to burnout or dismissal[36] (see Sections 7.3 and 7.19.7); and
- Factors other than remuneration impacting supply and demand. Among these must be included a preference for privacy, inducing executives to work for private or foreign owned companies where specific compensation details are not typically public (see Section 6.3).

7.10. The "outrage" constraint

The managerial power thesis of Lucien Bebchuk and Jesse Fried argues that outrage is perhaps the only effective constraint on executive remuneration, and the absence of channels to express outrage has contributed to excessive US executive compensation (see Guerdon Associates article on US executive pay governance HERE).

Unlike the US, the UK and Australia do have more effective channels for shareholders to express outrage. In the UK, this is via a non-binding vote on the remuneration report. In Australia, this is via the non-binding vote on the remuneration report (section 250R(2) of the Corporations Act) and the binding vote on the issue of securities to directors (ASX Listing Rules 10.14).

Our own observations have been that this has been effective in achieving change and constraining the extent of poor remuneration practice. Recent research in the UK and Australia has found these voting channels to be very effective[37] at constraining executive pay.

7.11. Market participants and the "outrage" constraint

Any analysis of the Australian executive remuneration market must include an understanding of the major participants in the market setting process. These include:

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[34] Most listed companies are part of market oligopolies. So for some vacancies there could only be a "market" of 2 to 6 experienced executives.

[35] It is not well understood that a company's share price has already factored in the market's expectations of earnings growth and return. To improve on this requires constant out performance in a market environment where material information is required to be disclosed on a continuous basis. A public company executive's life has been likened to the ability to continuously drink from a fire hose.

[36] The rate of public company change in a hot house of market competition means most executives have a use-by date, where their expertise is no longer sufficient for the company that has evolved from the one they joined not so long ago.

[37] "Is the outrage constraint an effective constraint on executive remuneration? Evidence from the UK and preliminary results from Australia", Kym Sheehan, via SSRN.

- Executives;
- The board;
- Institutional investors;
- Proxy advisers;
- Governance groups; and
- Regulators.

Each of these is described more fully below.

7.11.1. Executives

The supply of competent executives is a key element in executive pay constraint.

The larger the company the less the available supply of executives with knowledge and experience in both the industry and the complexity associated with company size.

Supply constraints are influenced by:

- The extent that boards have managed the internal succession process;
- Boards have the flexibility to engage with external candidates both domestically and internationally;
- Taxation regulation impacting the absolute and net level of remuneration; and
- Boards have the flexibility to negotiate the proportions of fixed and variable remuneration; current and deferred remuneration; cash, pension and equity remuneration; remuneration on termination; non-competition post termination remuneration[38]; equity hedging policy; equity ownership policy; insider trading policy; and remuneration on change in control; performance pay requirements; notice periods; relocation arrangements, and many other details.

Other supply constraints include the availability and relative attractiveness of non listed company and off shore career opportunities.

Several of these supply and demand aspects are addressed in Section 7.21.3.

7.11.2. The board

The three most important board aspects constraining executive remuneration are:

- The knowledge and experience of the board;
- The extent of its independence; and
- The source of its advice.

[38] In Australia these are governed in the main by restraint of trade laws.

Specific industry and specialist knowledge and high level experience are necessary to balance the "expert" power of knowledgeable and experienced executives. This is addressed in Section 10.7.

It is no accident that companies that have the most egregious examples of executive pay are the least independent. The absence of independence usually (but not always) stems from the dominant shareholding blocks. Interestingly while media attention usually addresses bad examples of executive remuneration in larger companies, the highest frequency of poor pay practices are in smaller companies where in terms of scale, the level of remuneration is relatively lower. In most cases this is the result of low levels of board independence[39]. This is addressed in Section 10.

Lastly, a key element in being able to exercise constraint is the board's access to and source of advice.

Many smaller company boards feel constrained in the type and extent of independent advice by cost considerations[40]. This is addressed in Section 8.16.

7.11.3. Institutional investors

Institutional investors hold the major proportion by value of Australian equities.

Any discussion of institutional investors must recognise that there are several types that, for the purposes of this submission, we have condensed into:

- Fund managers; and
- Superannuation funds.[41]

Superannuation funds have a longer term investment horizon. They would tend to support remuneration approaches that focus on longer term performance outcomes. The investment horizon of fund manager varies depending on their style and mandates.

In most cases, voting on issues submitted for shareholder approval, including remuneration issues is delegated to the fund manager as part of its investment management mandate and responsibility and the client super fund monitors the manager's voting performance. This monitoring is usually via a reporting mechanism provided by the manager "after the event" but sometimes, particularly in proposals that are deemed "controversial", this involves the super fund's participation in the voting decision. Alternatively, some super funds have directly retained the voting decision but require their managers to

[39] That is, the proportion of board members who are independent.

[40] This is also often evident in larger companies too. However, in the context of other expenses the costs involved are immaterial, and compared with the cost also commissioned and received by management on remuneration matters, small.

[41] An example of other institutional fund may be insurance funds, which comprise long tail (i.e. long term) life insurance and shorter term (e.g. car and property insurance). The term horizon influences investment strategy and choice of fund managers, and hence the behavioural focus required of executives.

provide them with the manager's analysis and voting recommendation as input to the fund's voting decision.

7.11.4. Proxy advisers

It is generally accepted that institutional investors have a fiduciary duty to vote in the interests of their clients or beneficiaries on resolutions submitted to shareholder vote at AGMs or other general meetings. This is because, in many cases, the proposal to be voted on involves an actual or potential conflict between interests of the owners (shareholders) and their agents (board or management) promoting the proposal – which is why regulation prescribes a shareholder vote to approve the proposal. But voting requirements are seasonal with annual general meeting cycles (generally between August and October and February to April). During these seasons, large institutional investors will need to review the thousands of pages of complex annual reports and voting resolution papers in order to exercise these votes.

Few maintain the in-house resources to analyse this information fully in the time available[42]. So, to assist them in their review of and decision making on those resolutions and associated governance issues in the company, they contract with proxy advisor firms to provide them with the firm's analysis of and voting recommendations on those matters.

There are two of these firms in Australia advising both fund managers and the fund managers' main clients, the large super funds:

- CGI Glass Lewis; and
- RiskMetrics.

These two firms produce reports with voting recommendations for ASX 300 and many other smaller listed companies for their clients according to their published guidelines.

They are often criticised by boards as being too powerful an influence on vote outcomes.

In practice, however, institutional clients of the proxy advisors use the analysis and voting recommendations of one or both proxy firms as part of their input into reaching their own final voting decision. This is borne out from CGI Glass Lewis's experience and review of actual voting results (in comparison with the CGI GL voting recommendations). It is also not unexpected since there will be other matters that the institutional investor will rightly take into account in each particular case beyond the best practice principles or guidelines used by the proxy firm in its analysis.

The Australian Council of Superannuation Investors (***ACSI*** – see further below) also provides a voting alert service for the ASX 200, which it markets to its member base of, predominantly, industry super funds.

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[42] Although many have developed and apply their own proxy voting guidelines.

7.11.5. Governance groups

Governance groups are a generic term that covers investor groups that influence proxy vote outcomes. The main ones include the:

- Australian Shareholders' Association (***ASA***) representing retail shareholders;
- Australian Council of Superannuation Investors (***ACSI***) representing, predominantly, industry superannuation funds;
- Investment and Financial Services Association (***IFSA***) representing retail and wholesale fund managers; and
- Regnan, an environmental, social and governance (***ESG***) researcher owned by superannuation and funds management organisations representing 5% of value invested in Australian equities.

Each of these to varying degrees exercises influence over voting outcomes and remuneration practices. Some have guidelines that are publicly available (see Guerdon Associates articles on the ACSI ASX 100 executive pay study HERE and on ASA position and guidelines on executive remuneration HERE for example).

None dominate[43]. Their guidelines vary and can conflict.

7.11.6. Regulators

Regulators include the:

- ASIC;
- APRA;
- ASX; and
- Australian Tax Office.

The extent of their influence is a function of the regulations they are required to enforce and the effectiveness of their enforcement.

We suggest in Section 8.7 that ASIC has potential to influence executive remuneration compliance if it starts to enforce disclosure requirements.

Outside of this, it is likely that APRA's new prudential guidelines, which the organisations submitting this joint submission support, will have a significant influence even outside of the deposit taking or policy holding financial services companies in their purview (see Guerdon Associates commentary on the APRA consultation HERE).

What are the major drivers of negotiated outcomes?

Have they changed over time?

[43] Unlike the UK's Association of British Insurers (***ABI***) for the FTSE market.

7.12. Negotiated outcomes

As with any market, supply and demand is a driver of negotiated outcomes. Internal promotions result in outcomes with lower executive pay than external appointments. The internal appointee is a better known quantity in terms of track record, strengths and weaknesses. In addition, supply of individuals at the internal appointee's level is considerably more than the number of CEOs already occupying roles they would be promoted to (the ratio would be about 8:1). So negotiating power is slanted towards the board.

An external appointee is often at the CEO level already (i.e. an eighth of the number of candidates who would be considered for promotion). Supply is far more constrained. Among ASX 200 companies there would typically be fewer than 5 viable external potentials. Few of these would be willing to move into a role where the prospects are more uncertain than the role they occupy unless the prospective reward is significantly greater. The situation is exacerbated if the most ideal candidate is based offshore. Offshore markets tend to pay more (see Section 7.15). In addition, remuneration negotiations are impacted by the candidate's perception of higher risk associated with a new culture and business environment, the need to relocate family, and taxation[44].

Information on the external candidate is less, particularly in regard to shortcomings. Boards that seek external appointees usually represent companies where there are issues to be resolved beyond that of the current management team. Boards, having whittled down the most likely candidates to one or two, lack the negotiating power of the external prospect. Remuneration cost is considered relatively minor compared with the need to appoint a resource believed capable of resolving the company's issues.

Therefore internal appointees tend to minimise executive pay levels increases, while external appointees tend to maximise pay levels increases.

About 30% of the ASX 200's CEOs are externally appointed. Given that a premium is required to obtain an external appointee, it can be said that external appointees tend to increase market rates.

Intervening in the recruitment process may be a search consultant. They are paid a commission based on the remuneration of the appointee. Therein lies a conflict of interest.

Because of the sensitive nature of the process, few boards seek independent verification from a remuneration consultant of the negotiated remuneration for reasonableness.

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[44] Australia amended tax laws to make it easier to import foreign executives (see Guerdon Associates commentary HERE). Unfortunately the amendments do not make it easier to recruit offshore recruits most likely to succeed – expatriate Australian executives.

Beyond the initial appointment the negotiation power tends to revert to the board if they have sought external data or advice from an informed remuneration professional. The advice or data is used to arrive at a fair rate of pay relative to other companies. In addition, ongoing pay reviews at board level are better informed by an assessment of the executive's performance and potential.

However, according to a recent ProNed survey, (see survey HERE) 33% of ASX 200 company boards receive remuneration advice on what to pay management from management. Therein lies another source of conflict.

On occasion, an executive may refer to disclosed data for a peer in a competitor as a lever to use in the annual remuneration review. This method sometimes is successful in achieving an unwarranted increase[45], and so contributes to an executive pay ratchet effect.

What growth in the level of director and executive remuneration has taken place over recent decades, both within Australia and internationally?

What factors contributed to this growth?

7.13. Historical changes

Data for historical statistical analyses on a like-for-like basis cannot be assembled in time for this submission. So the commentary on historical data relies on the collective memory of those engaged in remuneration management and consulting from the early 1980s.

During the stagflation era from the mid 1970s to 1984, average worker rates of pay increase were higher than executive pay increases. The differences were exacerbated in the early 1980s, as executives and boards, following exhortations by the Fraser government, froze pay to set an example for their companies' other employees.

During the Hawke government era from the mid 1980s, executive remuneration increased at a faster rate than those of other employees. These increases were in concert with shareholder value increases, while the dismantling of the nexus between inflation and award level employees' pay increases exacerbated the difference.

In the late 1980s unacceptable instances of executive pay occurred as a result of poor governance, and executive pay began to escalate, fuelled by high share market and asset valuations. This escalation was arrested markedly with the stock market crash of 1987. Executive and employee wage increases became more aligned.

[45] Based on more robust statistical approaches.

The economic downturn of 1990-92 witnessed an effective freeze in employee wages[46], while executive pay declined overall. This decline was a result of fixed pay reduction and freezes, and lower bonuses.

In 1998 better executive pay disclosure assisted in the "normalisation" of executive pay, assisted by the pay consulting industry's data collation. That is, there were less instances of what would now be considered unacceptable pay as a result of more transparency, better data and the beginnings of a formal advice industry[47]. However, also coincident from this time was a rapid increase in the use of share options[48] as an LTI[49]. The use of share options stemmed from their rapid increase in the USA from 1993 as a result of restriction on the tax deductibility of salary above a certain level. The trend spread to Canada, the UK, and France, and Australia followed soon after. Because these option grants were not costed, the actual rate of increase during this period on top of increases in fixed pay and bonus was probably very marked relative to average employee pay.

Executive pay slowed following the brief economic slowdown of 2001, mainly via reduced bonus payments. Also, from 1996 performance hurdles were introduced on options and (becoming more common) share plans. Tax deferral on options and rights encouraged broader participation in these plans. Disclosure rules were enhanced, showing remuneration for the top 5 executives and the board and senior management team (fixed pay and bonus – disclosure of share plans came later). To an extent, this additional disclosure contributed to some ratcheting.

Rates of increase in executive remuneration have generally reflected a pattern evident in other OECD countries, although there are indications that the rates of increase in Australia have been less volatile.

7.14. Recent changes: based on ASX 300 company disclosures

The current (CLERP 9) disclosure regime was introduced from 2005[50], disclosing the cost of all elements of executive pay. This allowed data records to be maintained and compared. In addition, it also allowed shareholders to compare pay against performance, and express the extent of approval through a vote.

CEO fixed remuneration has increased by a median of 11% over the past three years. Total remuneration has increased somewhat faster at 10%, 17% and

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[46] On a same job basis. Overall, average wages fell and the workforce restructured to replace permanent employees with casuals and part timers. The workforce restructuring continued for the next decade.

[47] Assisted by new Corporations Act requirements that remuneration be "reasonable".

[48] For a period, part paid shares were also popular due to quirks in various regulations.

[49] These options were granted and not subject to performance hurdles, similar to the US model.

[50] The investigation into the HIH failure and its executive remuneration practices featured in the report that eventually resulted in CLERP 9 (see an excerpt of the HIH Royal Commission Final Report HERE).

15% for 2006, 2007, and 2008 respectively (for Guerdon Associates summaries see HERE (2006), HERE (2007) and HERE (2008)).

The incentive component of CEO remuneration tended to increase more than the fixed pay component (see Guerdon Associates analysis HERE). In addition, the pay increase tended to reflect performance (see the analysis HERE).

However, rates of increase were not uniform (for example see Guerdon Associates commentary HERE). In any one year during these good economic times between 20% and 30 % of CEOs' remuneration decreased. Most commonly this was the result of a decrease in performance contingent pay.

NED pay did not increase as much as executive pay, despite steep changes in workload on NEDs (for example see Guerdon Associates discussion of NED pay trends HERE).

7.15. Remuneration movement factors

What factors contributed to this growth?

Have increases over recent years been justified?

Statistically, the two factors that correlate most strongly with the increase in executive pay are growth in market capitalisation and EPS growth. However, this is not on a direct linear basis. That is, executive pay has not gone up at the rate that market capitalisation has increased[51].

Theoretically, growth in market capitalisation would, to an extent, reflect additional company size and complexity, making it more difficult to source qualified executives. However, market capitalisation can be volatile, implying that, if the correlation was to hold true, executive pay should be decreasing as market capitalisation decreases during the global financial crisis. The extent that this holds true will not be known before the December 31 2009 and June 30 2010 disclosures. However, based on historical evidence and experience, plus anecdotal knowledge from Guerdon Associates' current client work, there are likely to be decreases in executive remuneration.

As Australian disclosures are not required to show "realised remuneration" (see Appendix B for a definition), the true extent of remuneration symmetry with economic returns is hard to fathom. But LTI plans based on EPS growth are unlikely to vest, as would plans based on absolute share price or TSR growth. Any share options that vest are likely to be "underwater", with a large proportion probably lapsing as the market price languishes below the exercise price. About 50% of plans that have a relative performance requirement will deliver value.

While perfect symmetry has never been evident, we have a reasonable degree of confidence that executive pay will reduce, but perhaps not to the extent that

[51] Quid pro quo, nor is it likely to go down as much.

market capitalisation will decrease. This is in accord with the rate of increase in prior periods (i.e. pay did not increase at the rate the stock market went up).

The variability and symmetry of executive pay reflects its structure. At CEO level on average 50% of total remuneration is variable with performance. As 50% of pay is fixed, there will not be a one for one correlation between company performance and pay.

Offshore rates of executive remuneration increase/decrease reflect the Australian experience, to varying degrees and for often different reasons (see Section 7.12).

Has the experience differed across different industries or sectors of the economy?

Guerdon Associates research (cited earlier) has indicated the rates of increase differ with industry. The research indicates this variation is a function of:

- The extent that executive remuneration structures vary with performance (this varies by industry); and
- The economic health of the industry and returns delivered to shareholders in these sectors.

7.16. Relationship between director, executive and other employee remuneration

Is there any relationship between director and executive remuneration, and the remuneration of other company employees?

A relationship exists between CEO remuneration and executives reporting to the role (see Guerdon Associates commentary HERE). This relationship has remained constant for three decades.

A similar constancy in relationship over three decades holds for the relativity of pay of chairmen and NEDs (although the pay of both has increased significantly in recent years and probably still has further to go in line with the increased workload and responsibilities of NEDs). A recent Guerdon Associates analysis of this relationship can be found HERE.

There is some evidence to indicate that the ratio of CEO to chairman remuneration has increased (it is now about 6:1). This is attributable to the growth in the proportion of performance based pay at executive levels. In contrast, the ratio between CEO fixed remuneration and chairman pay has not changed much over time (at about 4:1).

We would not expect a relationship to exist between executive remuneration and employees at the lowest reporting levels. We would expect, for example, that bank tellers would be paid similarly regardless of the size of the bank because the skill set is very similar. However, we would expect the

remuneration of the CEO of a large diversified bank would be considerably higher than that of a small regional bank.

How important are relativities between executives and other employees?

Research on internal pay equity reveals that the most important factor for employee satisfaction is an assessment of pay relativity with co-workers of the same level, and secondly themselves relative to their supervisor (see an excerpt of the reference *Managing People in Today's Law Firm – The Human Resources Approach to Surviving Change* HERE for example).

However, the issue of pay equity between the lowest paid and the highest has been a significant issue in most OECD countries. The UK has recently introduced legislation requiring companies to explain policy in this regard (see Guerdon Associates summary HERE). A few US companies volunteer a policy in their disclosures, although this is usually expressed as the CEO's pay relative to the executive cadre in the same company[52].

Another consideration is risk. Moody's debt ratings take into account the difference between the CEO pay level and the next report. Too large a difference raises several risk factors (see Guerdon Associates commentary HERE). CGI Glass Lewis also regards a huge disparity between the CEO and the next highest paid executive as a potential warning sign that the board may not be on top of key issues within the Company, including but not limited to remuneration.

Are there flow-on effects from the executives to other employees?

7.17. Flow on effects to other employees

Changes in pay rates tend to be most closely related to employees in the immediate hierarchy and in the same job family. This reflects the supply and demand variables impacting remuneration. Even within the executive group, there are variations reflecting supply and demand variables. During the mining boom, heads of exploration increased at a higher rate than for other employees. In the current environment, CFOs with experience are in demand, so some are receiving remuneration increases while other executives have had their pay frozen.

7.18. Internal equity considerations

Do big disparities serve to motivate or de-motivate other employees?

Disparities with co-workers and peers motivate employees to seek remedial action with their supervisor. If this fails they leave. Disparities with their supervisor encourage employees to seek promotion and engage in self development to achieve this end. Disparities between employees with

[52] Examples include GE, Intel and DuPont.

significant layers of hierarchy between them do not have an observable impact on trends for development, performance or turnover.[53]

7.19. Justification

Are current director and executive remuneration levels justified?

Have increases in recent years been justified?

7.19.1. Justification factors

Justification can be assessed by reference to:

- The Australian market rates for similar jobs in listed companies;
- The Australian market for similar jobs across all companies;
- The Australian market for dissimilar jobs representing a proportion of a working population with a similar statistical reference point;
- The global market for executive positions;
- Impact on economic wealth; and
- Productivity.

7.19.2. The Australian market rates for similar jobs in listed companies

Most executive pay levels can be justified with reference to market benchmarks, but there are exceptions.

There is an opportunity for shareholders to express dissatisfaction with these instances via the remuneration report vote. If significant (generally a "no" vote of 10% or more is considered significant), a board takes action to remedy the situation in the next year. This has been referred to previously as the "outrage" constraint.

7.19.3. The Australian market for similar jobs across all companies

This market includes foreign multinationals and private companies.

Pay data for these organisations is not publicly available and is often difficult to obtain for comparative purposes. Our comments are generalisations from privately commissioned surveys not available to the Productivity Commission, and supplemented with anecdotal information.

The executive roles in subsidiaries of foreign multinationals are not as complex nor carry the same legal liabilities as those in Australian listed companies. For example, complex capital decisions are undertaken by the parent company. Despite this, these executives are a source of labour for listed companies. Generally speaking, OECD multinationals pay 20% to 40% more than Australian companies for similar roles in similar companies (US multinationals

[53] Carrell, M.R., and Dittrich, J.E. (1978). "Equity Theory" The Recent Literature Methodological Considerations, and New Directions" *The Academy of Management Review*. 3;2: 202-210.

pay 150% more). So the executives in their subsidiaries, even though they are in less onerous roles, are paid about the same as executives in Australian listed companies.

Private family companies are generally smaller than Australian listed companies. But non-family executive pay levels within a private company of a similar size are generally higher than those in listed companies. For family members the effective pay (salary plus dividends) is substantially more than those received by listed company executives.

7.19.4. The Australian market for the top leaders in a vocation

CEOs of Australian listed companies represent 0.0018% of the full time Australian working population. They also represent .0145% of what the ABS classifies as the managerial and administrator population (see ABS data HERE). These proportions cannot be replicated for fulltime media entertainers or sports people, because the populations of these groups are considerably smaller. However, the top 10 of each of these would receive remuneration in excess of the median ASX 200 CEO total remuneration of $2.34 million.[54]

That is, the average pay of the top 10 Australian sports earners was $9 million, while the median was $8 million (see article HERE). The average pay of the top 10 Australian entertainers was $21.9 million. The median was $16 million (see article HERE).

The heads of the top legal and accounting firms earn between $3 million and $4 million.

In contrast, while comparing the highest levels of a population in a field, we acknowledge that Australia's top public servants earn about $400,000.

While it is common to point out the divergence of pay between top entertainers and top executives and what they contribute to economic well being, it has just as much relevance to compare top executive pay with top public servant pay. We do not see particular merit in these comparisons for justification purposes, acknowledging that these are, indeed, different markets. There is little cross over, and at the elite level, incomparable competency sets.

7.19.5. The global market for executive positions

International data from 2006 indicates that the pay of an Australian CEO for a $500 million company ranked 13 out of 16 OECD countries and 12 out of 26 developed and developing countries[55] as per the graphs below.

[54] GuerdonData®.

[55] Towers Perrin, Managing Global Pay and Benefits, 2005–2006 Worldwide Total Remuneration.

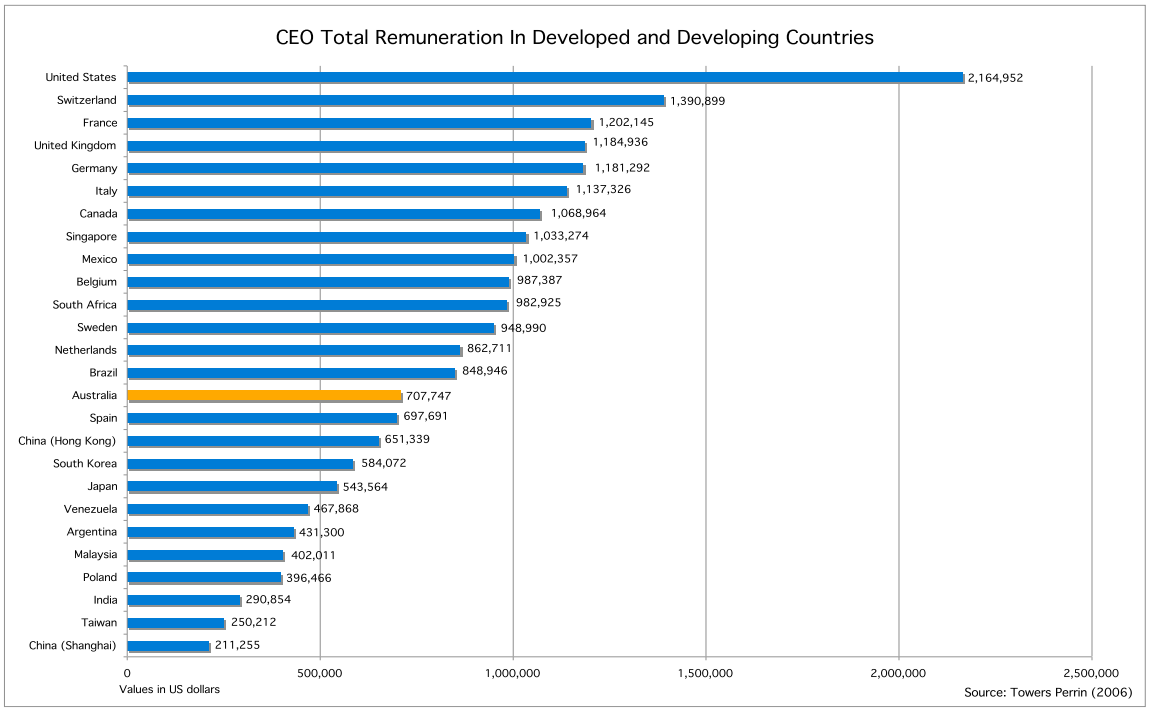

Figure 2: CEO remuneration in a sample of developed and developing countries

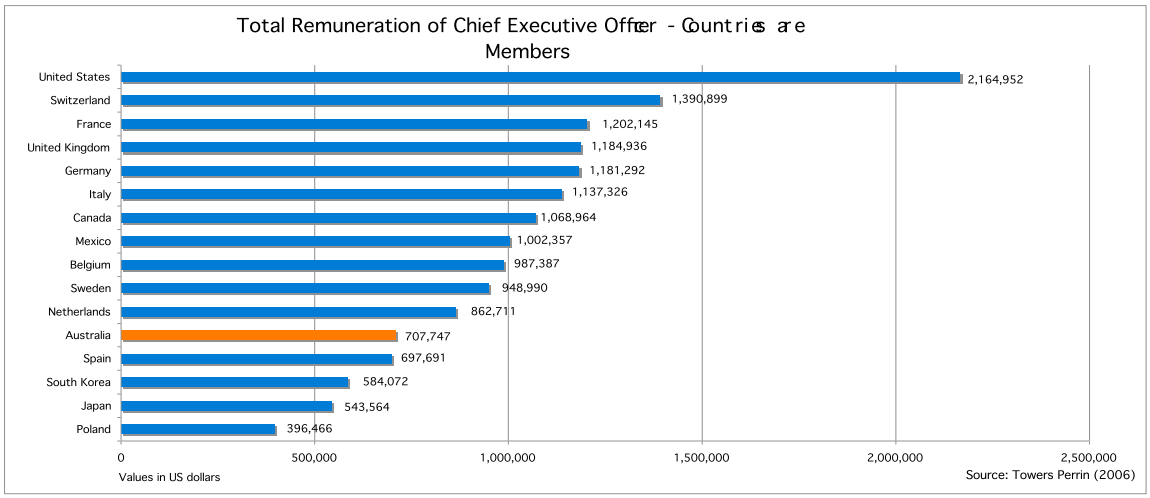

Figure 3: CEO remuneration in OECD countries

In Section 10.1.1 we provide data to support that Australian executives deliver higher returns for less risk than their counterparts in the USA or UK.

Therefore, in an international context, Australia appears to get relatively good value from its executives.

7.19.6. Impact on economic wealth

ASX 200 CEOs are collectively accountable for $1.2 trillion of market value primarily owned directly, or indirectly, via superannuation funds and, by Australian residents, and for 2 million direct employees.

7.19.7. Productivity

On appointment to the CEO position the market has priced the company's shares on the basis of expectations of future earnings, taking into account the operational, strategic and market risk that these cash flows can be achieved. Hence, to achieve share price growth the CEO must continually exceed market expectations. This is what the board requires. A CEO who maintains value, and meets expectations, will not move share price. This explains why the tenure of ASX 200 CEOs is relatively short (at approximately 5 years). The job can be likened to "drinking from a fire hose". That is, there is continuous pressure to exceed expectations, while the board oversees activity to constrain excessive risk.

Hence, if there is share market growth, the implication is that CEOs are achieving productivity gains, and that pay moves in accord with productivity growth.

While imperfect, the correlation of executive pay with market capitalisation supports this point.

7.20. Justification tests

How should the Commission determine what is 'justified' – what tests should be applied?

The key test of justification is the extent that the market is efficient at allocating resources.

7.21. Levels of remuneration and performance

7.21.1. Relationships between performance and the structures and levels of remuneration

What relationship exists between levels of remuneration and individual and corporate performance?

What relationship exists between the structure of remuneration and individual and corporate performance?

There is little agreement among various studies analysing the relationship between pay and performance. The methodological issues are complex, and data sets are incomplete.

Guerdon Associates has conducted several studies into this relationship, and is very aware of the methodological issues. In one of their later studies they

identified relationships between company performance (typically measured by TSR so that they can be applied across industries) and CEO pay (see Guerdon Associates commentary HERE). The validity of this relationship varies with company size and industry. This is because smaller companies have less incentive pay in the remuneration structure, so their remuneration outcomes vary less with performance.

Guerdon Associates has also established relationships between share ownership and company performance for both CEOs and NEDs.

In 2006 they found no significant relationship between chairman shareholding and company performance (see Guerdon Associates commentary HERE). However this was in contrast to CEO shareholding and company performance (see Guerdon Associates commentary HERE). This has since been verified by privately commissioned Guerdon Associates research in various sectors[56].

There is also evidence that the relationship of CEO pay relative to company performance has improved with new disclosure requirements implemented in 2005 (see Guerdon Associates commentary HERE). Guerdon Associates expects this trend to be more pronounced as greater proportions of pay become dependent on performance (see Guerdon Associates study on CFO pay for example, HERE).

7.21.2. Relationships between performance and remuneration governance

Not specifically addressed in the Productivity Commission questions, but of specific relevance, is the relationship between company performance and remuneration governance. In this regard, there is an excellent long term research by Australia's largest and longest running "governance" fund.

Goldman Sachs J. B. Were has undertaken research on corporate governance data, collected since 2001. These ratings are heavily influenced by specific remuneration governance ratings. In turn, the overall assessment of remuneration governance is the most significant indicator of good corporate governance and predictor of long term company performance (see Guerdon Associates commentary HERE).

[56] Confidentiality considerations prevent Guerdon Associates from publishing this research.

7.21.3. Supply and demand

To what extent are remuneration levels required to generate an adequate supply of suitable directors and executives; that is, are they primarily aimed at hiring and retaining the right person, rather than influencing their performance?

Many factors go into the dynamics of attraction, retention and performance. In regards to remuneration:

- Fixed remuneration is a key component of attraction;
- Given the risk associated with the present value of career earnings associated with taking on an executive, and more particularly, a CEO role, termination provisions are also key to attraction;
- Deferred remuneration is important for retention. Typically this includes pay earned from performance, but retained for an additional service period. In future we expect that these deferred payments will be subject to additional requirements, such as performance sustainability and risk management via a clawback; and
- Performance pay is important for both retention and performance. If based on performance requirements that have good line of sight, and are considered to be reasonably attainable, the executive will remain to see out the performance period. Likewise, good line of sight and a reasonable probability of attainment will focus employees on attaining these performance requirements[57].

7.21.4. Drivers of performance

What are the key drivers of performance for directors and executives?

The drivers of individual performance include:

- Known and articulated goals;
- A method to measure goal achievement and progress;
- Ability to impact outcomes to achieve the goal;
- Feedback during the process of progress towards the goal;
- An assessment of the achievability of the goal (the more achievable the more motivating); and
- A reward commensurate with the effort, and greater than the reward for competing goals.

These are basic criteria that must be met for effective motivation (see commentary on Expectancy Theory HERE).

[57] The influences on behaviour are described in various theories of motivation – see commentary on Expectancy Theory HERE.

Some common performance requirements, such as relative TSR, fail to be effective as drivers of performance because they do not meet all the criteria above.

Are there factors other than remuneration that influence performance?

What relationship exists between the structure of remuneration and individual and corporate performance?

Yes – see previous answer. Additionally, the global economic situation, regulations, natural disasters etc can all impact corporate performance.

7.22. Remuneration structures and incentives

7.22.1. Changes in structures over time

What changes have taken place in the type and structure of remuneration over recent decades?

What has driven these changes?

- Pre 1980: Primarily base pay and an annual bonus, with bonus being purely discretionary and not formulaic. Share grants were made, but were ad hoc. Wide variation in pay levels set by reference to other company payments known among board members;
- 1980s: Bonus as a proportion increased markedly to about 30% of base pay for a CEO. Performance requirements became more formalised. More regular share and option grants, influenced by US multinational practices in their Australian subsidiaries. More use of formal survey results of senior executive pay among large companies via a private survey "club" of the largest companies that met in Canberra annually;
- Early to mid 1990s: Significant option grants, influenced by US practice in the US and in their Australian subsidiaries. Disclosure improves, resulting in more publicly available surveys;
- Mid 1990s to mid 2000s: Performance requirements specified for option and share grants where none had been required before. Influenced primarily by UK practices as a result of the Cadbury[58] and Greenbury[59] reports, and governance guidelines issued by the ABI (see 'Executive Remuneration – ABI Guidelines On Policies And Practices' HERE) and the National Association of Pension Funds. Dual listed Rio Tinto introduced first relative TSR performance requirement under advice from both UK and Australian consultants. Westpac appointed US executives with US style compensation modified later to a framework more in line with UK requirements; and

[58] Committee on the Financial Aspects of Corporate Governance (1992) *Report with Code of Best Practice,* [Cadbury Report], London: Gee Publishing.

[59] Directors' Remuneration, Study Group chaired by Sir Richard Greenbury, Confederation of British Industry, 15 July 1995

- Mid 2000s to present: "Normalising" of pay such that there is less variation in levels for similarly sized companies as a result of better remuneration disclosures required by the Corporations Act. Better alignment of pay with performance as a result of the non-binding vote on remuneration.

7.22.2. Risk and structure

Have changes to the structure of remuneration resulted in inappropriate risk-taking or other forms of director and executive behaviour inconsistent with the interests of the company?

Are particular types of remuneration more likely to produce these outcomes?

Has the experience differed across sectors (for example, the finance sector relative to other areas of business)?

No, there is no evidence of wholesale inappropriate risk taking in Australia attributable to remuneration.

This is in contrast with evidence from the US, which indicates that significant option grants (valued at 5 to 10 times salary at grant date) that are not contingent on specific performance requirements encouraged significant risk taking.

This absence of excessive risk taking can be attributed to:

- A governance framework requiring independent chairmen and directors, and providing shareholders with the facility to elect directors;
- Payment vehicles that comprise a mix of share rights and options, rather than a concentration of options;
- Board controls to not repeat lessons from the over leveraged 1980s; and
- A sound financial sector governance framework regulated by APRA.

There is evidence that use of options is correlated with risk taking. However, this should not preclude the use of share options as a reward vehicle (see Guerdon Associates commentary HERE). The excess use of any individual payment vehicles will create changes in behaviour.

Start up company founders and its first professional executives often are rewarded with options to conserve cash flow and provide reward commensurate with the risk taken with their own personal wealth and/or foregone career earnings. This "risky" remuneration framework is matched to investor risk expectations. Few start-ups succeed. Those that do, typically return the value of their investment several fold. Seed investors, private equity, and venture capitalists diversify risk by providing capital to a portfolio of start-ups, with the expectation that the few survivors will provide returns commensurate with the portfolio investment. In the US, options are the preferred reward vehicle of

Silicon Valley technology companies. In Australia the same can be said of smaller resources companies.

In order to obtain shareholder alignment and negate agency (see Section 6.6) costs, a mix of reward vehicles needs to be considered and matched to the riskiness shareholders expect. Shares and share rights increase risk aversion, and so are better applied to high dividend yield utility type of companies. Options are better applied to higher risk ventures, such as exploration companies and biotechnology. Other companies have risk profiles between these extremes. It follows that all else being equal, some mix of share rights, shares and options is appropriate to overcome agency cost and align risk taking with shareholder expectations.

The Financial Stability Forum (***FSF***) remuneration guidelines accepted by the G20 leaders recently provide excellent commentary on the risk factors to consider for deposit taking institutions (see Guerdon Associates commentary HERE and the FSF Principles for Sound Compensation Practices HERE).

What relationship exists between the structure of remuneration and individual and corporate performance?

While Australia is relatively well positioned in regard to structuring executive remuneration to be reasonably symmetrical with performance, the structures also need to take into account executive expectations of tenure.

Given the stresses and expectations of performance for executives in public companies, most executives would realistically assess their likely tenure as 5 years. Such expectations would typically focus executives on short term results to maximise STIs, rather than LTI outcomes (see research HERE).

We recommend that holding unvested LTI post departure will alleviate this bias. APRA agrees with us, based on their recently released draft regulatory guidelines. However, the current plans to tax all equity at grant date, or even revert to the old approach of taxing at termination date, will discourage use of tis approach.

7.22.3. Appropriate risk taking

Who should determine what is an appropriate level of risk-taking or an appropriate corporate strategy, and how should this be done?

Responsibility for determining an appropriate level of risk taking or an appropriate corporate strategy is for the board. As discussed at Section 2.2, shareholders not only have no authority or power to interfere in the above aspect of the board's discretion, but also, equally importantly, do not have the board's inside knowledge of the business to be able to do so competently.

Why and/or when are the dealings between shareholders and companies on remuneration issues a matter of public interest?

Excessive executive remuneration becomes a public issue when executive classes are paid on a disproportionate basis than the working classes. Just when that disproportionate level occurs will always be a matter of opinion and the arbiter of the issue is time and society. Boards should be mindful of society's views with respect to executive remuneration.

What arguments, for and against, are there for linking remuneration and the share price?

For:

- Aligns shareholder interest (excluding yield) with executive interest (remuneration).

Against:

- Guerdon Associates volatility analyses indicate that about 60% of share price movements are attributable to general market movements, on average. That is, share prices move independently (up and down) of company performance;
- Shareholder interest can be better linked to executive interest through share ownership. That is, the wealth created from remuneration can be linked to the sustainable performance of the business for better alignment;
- Share price can be influenced in the very short term by the nature and timing of material information released to the ASX. Therefore, a linkage to share price may encourage inappropriate behaviour; and
- Some companies' share price can be significantly impacted by external factors over which the executive has no control (e.g. oil price shocks to the airline industry, commodity prices for resources stocks).

On balance, we believe there is little justification for linking remuneration directly with share price for most companies. There may, however, be exceptions. These exceptions include start up companies and perhaps companies in terminal decline and due for major transformation. These companies have share prices that do not vary in accord with general share market sentiment.

7.23. Examples of poor remuneration structures and policies

The analysis in this section 7 would not be complete without acknowledging that there have been a number of examples where remuneration structures and policies have been poorly disclosed and/or remuneration outcomes have been poorly handled by the board. Some of these examples, which include, prima facie, excessive short term payments and excessive termination payments, have been identified by CGI Glass Lewis in Appendix D. A key feature of the structures is the cash component, which provides an immediate reward to the executive.

One way to deal with these incentives is to settle the incentive by way of equity, which has a holding lock over the long term.

There have been a number of examples of significant cash termination payments, which, prima facie, given the particular circumstances, appear not to have been justified and to represent an inappropriate transfer of shareholders' funds. We, therefore, support the tightening of termination payments unless they are approved by shareholders (to a multiple lower than the current 7 times) but it is also important that the level not be too low as to promote unintended consequences such as an increase in base pay, sign on fees or other types of discretionary bonuses.

Shareholders need to make boards more accountable and change the board where necessary by voting against the directors responsible for egregious remuneration outcomes. The investor community needs to see this starting to happen.

8. Effectiveness of regulatory arrangements

8.1. Regulatory arrangements summary, conclusions and recommendations

Current arrangements comprise a combination of "hard law" (i.e. legislative prescription), "soft law" (i.e. "if not, why not?"), and guidelines maintained and promoted by various stakeholders.

The legislated requirements for disclosure and the shareholder non-binding vote have had a marked impact on improving standards. However, the prescriptions for tabular information could be improved, while other aspects can be rationalised. Other legislated requirements, particularly in relation to taxation, can have significant and detrimental consequences.

Soft law has been useful and has improved remuneration disclosure and structures.

Guidelines are fluid and evolving, and represent a range of sometimes conflicting requirements.

Our conclusions are as follows:

- Hard law needs to be made and exercised with caution, and may result in unintended consequences;
- Soft law is more flexible, allows variation and has further potential to improve remuneration disclosure and structures;
- Guidelines reflect the resourcing and sophistication of their constituents, and have some way to go to be as influential as guidelines in the UK;
- The non-binding vote on remuneration reports is working and there has been a significant improvement in both disclosure and structures. Shareholders have expressed in the past their displeasure regarding a significant number of remuneration reports that had poor disclosure and/ or structures;
- Dialogue between listed entities and investors has increased and continues to increase;
- Shareholders have the ability to vote against directors where they believe that they are not fulfilling their role appropriately, including on remuneration matters;
- ASIC has powers to require an explanation or levy a fine on a non-complying company but rarely exercises these powers;
- Current accounting standards provide confusing information relating to actual remuneration received;
- Readily accessible information on executive remuneration will encourage a more efficient allocation of resources;
- Guidelines represent the consensus of best practice and should be allowed to develop with changing circumstances, experience and views;
- The sources of advice to ASX 200 boards are many and varied but the primary source of advice is management;

- Most external advisers will have conflicts of interest; and
- There is strong international evidence to indicate that executive pay is higher when external board advisers also provide advice to management.

Our recommendations are as follows:

- All entities listed on the ASX should have to follow the same requirements for disclosure and reporting on executive remuneration, including production of an annual remuneration report and submission of the report to non-binding shareholder vote at the AGM;
- Disclosure of remuneration to shareholders should include:
  - The fair value of remuneration; and
  - The realised value of remuneration received.
- To achieve better consolidated data in the remuneration report there should be a prescribed, inflexible, tabular format of information and a requirement that companies file this information in a common format;
- Additional legislated or regulated requirements should remain confined to disclosure;
- Section 300A of the Corporations Act needs to be re-written so that the required information disclosures are informative and relevant for shareholders and include a disclosure on how risk management has been addressed in the remuneration policies;
- ASIC should exercise its powers to ensure compliance with the current regulatory system;
- Require the board remuneration committee to be comprised of only independent directors;
- Require disclosure of all advisers to the board with an opinion by the board on the adviser's independence and the reasons for that opinion; and
- An ASX Governance Principle should be introduced that all remuneration advisers to a company only advise the board, or management, and not both, with an "if not, why not" explanation.

8.2. The Australian Governance Landscape[60]

8.2.1. Investor Protection in Australia

In Australia, the rights and protection of public investors are contained partly in the constitution of the listed entity, partly in the Listing Rules of the ASX and partly in the Corporations Act. For example, the obligation of a listed company to provide an annual remuneration report and to submit the report to non-binding shareholder vote at the annual meeting is contained in the Corporations Act.

The ASX Listing Rules apply to (must be observed by) all ASX listed entities. The Corporations Act applies to (must be observed by) companies incorporated under that Act – i.e. Australian incorporated companies.

[60] This section 8.2 is taken from the CGI Glass Lewis Proxy Voting Policy Guidelines for the 2008/2009 year.

The content and enforcement of (including granting of waivers from compliance with) the ASX Listing Rules are decided and administered by the ASX. The content of the Corporations Act is decided by Parliament; enforcement of (including any permissible granting of exceptions from compliance with) the Act is administered by ASIC.

The powers of the ASX, if an ASX listed entity breaches its Listing Rules, are essentially limited to suspension from listing or delisting of the entity. Compliance with the ASX Listing Rules is, however, an obligation of Australian incorporated ASX listed companies under the Corporations Act and ASIC has an independent right of enforcement of the ASX Listing Rules in the case of such companies through that provision. This is an important parallel power in the case of such companies because ASIC, unlike the ASX, can impose monetary penalties and other remedial orders on such companies and has done so in a number of cases, particularly in connection with the ASX Listing Rule 3.1 requiring Continuous Disclosure of material information.

The great majority of ASX listed entities are companies incorporated in Australia and, thereby, governed by both the ASX Listing Rules and the mandates of the Corporations Act.

Some ASX listed entities are not companies and so are not governed by the mandates of the Corporations Act, which apply to companies incorporated under that Act. These entities mainly comprise some members of the listed property and other trusts sector (other than where management is internalised in a stapled entity). Also, a small number of ASX listed companies are incorporated outside Australia. Depending on the non-Australian jurisdiction concerned, the rights and protection of public investors in those companies may be weaker than they would have been if the company had been incorporated under the Australian Corporations Act.

8.2.2. Election and Removal of Directors

Shareholders of ASX listed companies get to vote on their board representatives, individually, at least every three years. Under ASX Listing Rule 14.4, each director, other than the managing director, must retire by rotation at the first AGM of shareholders after each three years of board service, but may seek re-election by shareholders. Additionally, any director, other than the managing director, appointed by the board subsequent to the last AGM must stand for election by shareholders at the next AGM.

Shareholders of Australian incorporated ASX listed companies have the additional power to nominate, appoint and remove directors of those companies. The Corporations Act provides a mechanism that enables shareholders to appoint a director to, and/or to remove a director from, the board of an Australian incorporated listed company. That mechanism entitles one of more shareholders representing five per cent or more of the voting equity (or 100 shareholders holding voting equity) to convene a special meeting of shareholders or to add an agenda item to a forthcoming meeting of

shareholders, including for the appointment of a new director to, or the removal of an existing director from, the board.

The election or appointment of a director to, and/or the removal of a director from, the board is by ordinary resolution (simple majority of votes cast). In the case of removal of a director, the Corporations Act enables the director to have a statement by the director circulated to shareholders by the company before the meeting and to speak at the meeting but, ultimately, a simple majority of votes cast decides whether the director is removed.

8.2.3. Binding Nature of Shareholder Votes

In general, decisions made by shareholders of Australian incorporated ASX listed companies by resolution in a duly convened general meeting are binding on the company. The decision must be one that shareholders are competent to make but, as indicated above, it certainly includes the nomination, appointment and removal of individual directors.

There is, however, one type of shareholder decision that is not binding—the shareholder vote on the annual remuneration report. That vote is advisory only.

Given that it is ultimately the responsibility of the board to engage a managing director and other key executives, including associated terms and conditions, what changes would assist the board in fulfilling this role, consistent with shareholder interests?

8.3. Engaging a managing director and other key executives

Key elements necessary for facilitating board success in employing the managing director and other executives include:

- A majority of independent directors;
- Independent directors with expert industry knowledge and experience;
- Active board engagement on succession planning;
- Executive equity "hold through retirement" policies (see Guerdon Associates commentary HERE and HERE) to ensure their engagement on grooming and selection of successors; and
- Primarily remuneration "soft law" via "if not, why not?" principles that allow remuneration levels and frameworks to be adapted for ensuring the most capable resource is recruited, even if this person is from offshore.

How effective are arrangements for director and executive remuneration under the Corporations Act and ASX listing rules and guidelines?

Do arrangements provide sufficient transparency and accountability on remuneration arrangements and practices?

8.4. Board and shareholder inputs to pay decisions and the implications

The board is ultimately responsible for the sound and prudent management of a listed entity. Accordingly, it is important that the responsibility of appointing the CEO and other senior executives, and setting the terms and conditions of their employment, remain with the board. Further, boards must not only focus on remuneration structures but also on the operation of remuneration systems.

The non binding vote on remuneration reports has provided a mechanism for all shareholders to express their views on a listed entity's remuneration disclosure and policies.

The non-binding vote on remuneration reports was first introduced in the United Kingdom in 2002.[61] The rationale behind its introduction was to provide a mechanism to put pressure on boards that were complacent in respect of the structure and reporting of their remuneration practices. Since the introduction of the nonbinding vote on remuneration reports in Australia in 2005, there is evidence that institutional investors have required better standards through an increase in the level of votes against remuneration reports.

NEDs are sensitive to these issues primarily in terms of reputation risk. If a company's response to a negative vote on its remuneration report is not adequate, the next step in the process for shareholders who continue to be dissatisfied with remuneration reports is to vote against directors when they come up for re-election.

Australia is in the advantageous position of having an ASX Listing Rule requirement that obliges directors to put themselves forward for reelection every three years and their re-election requires a majority of votes to be cast For their re-election. It is also possible for shareholders to remove a director by a similar simple majority vote.

These opportunities give vent to the "outrage" constraint noted in Section 7.10.

The role of the directors is broad and varied. The elements of their work go well beyond overseeing remuneration policies and practices. Therefore, shareholders may be pleased or unhappy with their directors over many matters. The power of the shareholders to elect and remove directors should not be linked to any specific issue but left at large for shareholders to assess performance as a whole.

Over the last 3 years amongst ASX 200 entities 5 remuneration reports have received against votes above 50%, and 22 remuneration reports have received negative voting levels in excess of 20%. While these numbers may not appear to be significant, as indicated elsewhere in this submission there has been a significant increase in dialogue between institutional investors and boards as a consequence of increased levels of voting against remuneration reports. In this

[61] The Directors' Remuneration Report Regulations 2002 (UK) (see the Regulations HERE).

regard the average level in a consistent sample[62] of against votes has almost doubled from 6.0% to 10.2% between 2006 to 2008.

8.5. Positive outcome of Remuneration Report

CGI Glass Lewis has experienced a significant increase in dialogue instigated by NEDs on remuneration issues since the non-binding vote was introduced. The experience of CGI Glass Lewis is that ten years ago engagement by listed entities with their key institutional shareholders was minimal. Currently, CGI Glass Lewis would have regular engagement with over 35% of ASX 200 entities on remuneration as well as broader corporate governance issues.

This increased dialogue by companies with their institutional shareholders, and proxy advisors is a positive outcome of the non binding vote on remuneration reports.

With increased director dialogue with shareholders, it has also become an increasing practice for Australian listed entities to disclose full details of a newly appointed CEO at the appointment date rather than leaving such disclosure until the publication of the annual report.

A very recent and potent example of this increased dialogue is the conciliatory response of the board of Austar United Communications Limited to a significant protest vote against its 2009 remuneration report at its AGM on May 29, 2009. Notwithstanding that the votes of Austar's 55% US parent company, Liberty Global, ensured that the remuneration report was technically approved by shareholders, the Austar board has publicly acknowledged the concern of institutional and other public shareholders on two particular issues, the quantum and structure of executive remuneration, and has undertaken to address those issues going forward. See, for example, the article "Shareholder outrage pressurises Austar to review executive pay rises" by Jane Schulze on the front page of the Business Section of The Australian of 30 May 2009.

A further very recent and potent example of the sensitivity of directors of listed entities to criticism of the board's handling of remuneration or other key issues is evident from the AGM notice flyer distributed to shareholders by the board of OZ Minerals Limited (formerly known as Oxiana) Limited for its AGM on 11 June 2009. The board's decision to award the former Oxiana managing director, Owen Hegarty, an $8.35 million retirement payment despite the merged (Oxiana and Zinifex becoming OZ Minerals) company's severe debt refinancing difficulties and share price meltdown has been repeatedly and trenchantly criticised.

Mr. Hegarty, who was to have remained on the merged board as a NED, has already left the board. Further, in the flyer for the pending AGM, the board has advised that it has reviewed the board's composition going forward in the

[62] Voting statistics relate to a sample "widely held companies" ie companies that do not have a director related shareholder controlling more than 20% of issued shares that were part of the ASX 200 for each of the three years 2006, 2007 and 2008.

envisaged much smaller company following the anticipated shareholder approval of the sale of the bulk of its assets to the Chinese Minmetals company to fund its debt repayments. The proposal is to reduce the size of the board to six, comprising the proposed new managing director (just announced) and five independent directors.

To that end, two existing independents will have gone from the board following the AGM and two more, comprising the independent board chairman and the independent combined nomination and remuneration committee chairman, will leave within a maximum further 12 months and two fresh independents will be appointed to replace them. That will leave only three remaining independents as survivors to carry forward corporate memory from the original Oxiana and Zinifex businesses and merged board.

The board's above plan means that it has prescribed for itself the medicine that CGI Glass Lewis would otherwise have recommended that institutional shareholders should seek to administer to the company. Overall, while this particular case is borne out of a disaster for shareholders, it is evidence of increasing accountability on the part of boards and a strong precedent for the future.

8.6. Changes to assist boards

While the developments described above are seen as a positive outcome in the remuneration debate, there have been consistent complaints by both NEDs and institutional shareholders of the complexity and disclosure requirements of section 300A of the Corporations Act.

How might transparency be increased, and what might be the impacts of this?

8.7. Disclosure and non-compliance

The extent that listed companies systematically and explicitly assess their executive performance requirements, judge outcomes and have reward contingent on the use of these measurement disciplines varies significantly[63]. The best examples are seen in proxy explanations where there is a shareholder resolution required to grant equity to an executive director under an incentive plan.

The worst examples are evident in remuneration reports that are required to describe the basis for STI rewards delivered in the fiscal year.

This requirement under section 300A(1)(ba) of the Corporations Act is for

[63] In some cases it is not possible. Start up companies are often unable to assess product demand in the 1st year, or market environments in the current financial credit crisis which are difficult to ascertain. In these cases discipline can still be applied to determine some elements, such as the measure of performance, while the extent of reward, if any, can be applied after the fact on a discretionary judgment of outcomes given the context in which they were achieved.

companies to provide:

(i) a detailed summary of the performance condition;

(ii) an explanation of why the performance condition was chosen;

(iii) a summary of the methods used in assessing whether the performance condition is satisfied and an explanation of why those methods were chosen; and

(iv) if the performance condition involves a comparison with factors external to the company:

(A) a summary of the factors to be used in making the comparison; and

(B) if any of the factors relates to the performance of another company, of 2 or more other companies or of an index in which the securities of a company or companies are included—the identity of that company, of each of those companies or of the index.

Guerdon Associates' best estimates are that fewer than 20% of listed ASX 300 companies comply with this requirement (for example see Guerdon Associates commentary HERE).

Given that remuneration reports are subject to audit this may seem surprising. The main area of non-compliance is in the full reporting of performance requirements, mainly for the annual STI payment.

Australia is not alone. The US requires similar reporting. In 2006 the SEC (equivalent to ASIC) embarked on a 2 year campaign to ensure companies report more transparently (see Guerdon Associates commentary HERE and HERE) and report performance requirements. They argued that because it was past performance being reported, there would be few instances where disclosure could result in material harm. They sent confidential "explain or comply" letters to the boards of the top 300 US companies failing to report this information (see Guerdon Associates commentary HERE).

ASIC has similar powers, but has chosen not to exercise them. This may be related to a staff and budget shortage. But this need not be the case.

ASIC can levy fines. It has powers not dissimilar to the SEC. A non-compliant company can be required to explain its actions. If this is unsatisfactory a fine can be levied. Given the extent of non-compliance this police activity could be self funding.

Some entities do not disclose or use certain types of performance hurdles on the grounds that such information is "commercial in confidence". While we accept that performance hurdles such a budgets, EPS targets, performance against milestones may contain commercial in confidence information, it is important that entities not be discouraged from using such performance

hurdles if they are in the best interests of shareholders. There are no reasons why retrospective disclosure of performance against such hurdles could not be made.

8.8. The importance of plain English and comparable disclosure

Currently remuneration reports are very difficult to read and understand for those shareholders who are not financially literate (see Guerdon Associates commentary HERE). Australia does not have a requirement to make these reports "understandable". However, examples of such supporting legislation include Article 22(1) of the Listing and Reporting Directive of the European Union and Rule 421(d) of the United States Securities Act of 1933. Both pieces of legislation indicate the importance of the understandability and analysability of the information disclosed by the directors and the company as a whole. The USA's SEC undertook a campaign to improve the readability of that country's required "compensation discussion and analysis" disclosures, with positive results (see Guerdon Associates commentary HERE).

In our view, in order to assist both listed entities and investors, section 300A needs to be re-written so that the required information disclosures are "clear, concise and effective" so that they are informative and relevant for all shareholders.

Our next submission will propose an alternative version of section 300A of the Corporations Act.

8.9. Foreign companies

The current requirement for disclosure and accounting for remuneration are contained in the Corporations Act which only applies to Australian incorporated companies. As a result, foreign listed companies (as at the date of this submission, 5 in ASX 200) are not compelled to make the same disclosures as Australian incorporated companies. This creates an issue for shareholders when comparing remuneration practices.

In our view, all entities listed on the ASX should have to follow the same requirements for disclosure on executive remuneration to ensure that the disclosure and reporting obligations for all entities are the same notwithstanding their place of incorporation. This can be incorporated by referencing the relevant provisions of the Corporations Act relating to executive remuneration in the ASX Listing Rules.

Are the current disclosure requirements in the remuneration report too complex?

8.10. Disclosure nonsense

As mentioned above, some of the current disclosure requirements of section 300A of the Corporations Act provide nonsensical and irrelevant requirements for disclosure of many aspects of executive remuneration.

A good example of such a requirement is section 300A(1)(e)(iv) of the Corporations Act which requires the disclosure of the value of options that have already lapsed:

> *"if options granted to the person as part of their remuneration lapse during the financial year because a condition required for the options to vest was not satisfied—the value of those options (worked out as at the time the options lapse, but assuming that the condition was satisfied)".*

8.11. The use of accounting standards for disclosure

To further complicate disclosure in remuneration reports, current accounting standards requirements provide confusing information relating to actual remuneration received. The value of equity based incentives is required to be amortised over the performance period, which may be up to five years. This means that in any given year, in the case of LTIs, the amount disclosed as LTI comprises amortisation charges relating to a number of past equity grants. The resulting figure will have no correlation to the executive's level of remuneration in the year under report.

Changes need to be made to the way remuneration received in any particular year is disclosed to shareholders to ensure its relevance.

Such changes would include disclosure of the realised value of remuneration received in the reporting year i.e. the value of remuneration received in the form of cash, non-monetary items plus the value of any securities (or other financial products) that have vested during the reporting year calculated on the date of receipt.

Disclosure of the realised benefit to executives will improve the transparency of remuneration policy and structure.

8.12. Coverage of executives in the remuneration report

Is the coverage of executives in the remuneration report appropriate?

The current disclosure requirements of section 300A rely on accounting standards. This creates an environment which is confusing for both preparers and users of remuneration reports. See more detailed discussion in Section 2.3 of Appendix B.

The current scope of executives subject to the disclosures required in the remuneration report is set by:

- The 'key management personnel', a concept set by the accounting standards which includes directors; and
- The 5 highest remunerated relevant group executives or company executives, which include senior managers and secretaries.

'Key management personnel' are those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.[64]

To some extent there will be complexity. But this should be confined to the description of performance hurdles. This is because running listed companies is complex, and performance hurdles will have different time perspectives and will vary across companies. Nevertheless, it is the job of directors to explain how these relate to value creation.

Other elements of remuneration should be straightforward to describe. See more detailed discussion above.

The new APRA regulation (see the draft Prudential Practice Guide HERE) requires boards to directly supervise the development and application of policy to employees who, collectively as well as individually, impact the organisation's operational riskiness. So, while not necessarily disclosed publicly (as this could impose operational risk of key person loss to competitors wanting to poach such people), these boards will need to demonstrate to APRA that the remuneration framework is justifiable.

Outside of APRA regulated organisations there is no such requirement yet. However, we believe that over time a trend will develop to require similar practices in non-APRA regulated organisations. This trend may be further encouraged by additional regulation on non-APRA companies as a result of publication of the International Organisation of Securities Commission's (***IOSCO***) report Task Force on Unregulated Financial Markets and Services (see Guerdon Associates commentary HERE), that suggested the remuneration of originators and sellers of non-regulated financial products may be needed (presumably by ASIC in Australia).

We note that the US SEC is considering requiring disclosure of remuneration policies for non-executive personnel and the extent that such policies could expose the company to risk.

Would shareholders benefit from access to readily accessible, consolidated information, on director and executive remuneration?

Are there other useful data sources on director and executive remuneration over time?

[64] AASB 124 Related Party Disclosures (see AASB 124 HERE).

Shareholders will benefit from access to readily accessible information on executive remuneration because readily accessible information will encourage the market to be more efficient in the allocation of resources. If this can be achieved, then shareholders and other users of financial information of Australian listed companies will have the ability to compare within and across industry sectors as well as across all entities.

Currently consolidated information is available, but at a cost. Guerdon Associates, for example, has Australia's only on-line executive and director database[65], although others, too, have databases created to service the needs of management and directors in listed companies. But collecting and maintaining the data is an expensive process. Guerdon Associates have 12 trained and dedicated employees with accountancy qualifications employed full time in Chennai to sift through PDF file disclosures to maintain almost 100 discrete data fields on remuneration elements. They utilise proprietary technology, including "artificial intelligence" software to assist comb text based documents for data elements. The technology required significant capital expenditure to develop. Human interpretation is also needed because companies do not use standard definitions in describing policy. Company data table disclosures are not presented in a prescribed format.

To achieve the desired outcome of better available consolidated data will require at least two changes:

1. A prescribed, inflexible, tabular format of information; and

2. A requirement that companies file this information with a new technology.

However, there is a danger that a prescribed format may not be adequate to describe the range of remuneration practices and outcomes. Even worse, it may channel boards away from remuneration solutions that do not fit the format, but are otherwise well suited to their particular strategic needs. Lastly, there is the danger that a prescribed format will have huge compliance costs. The USA, for example, has a prescribed format. The rules just covering the latest amendments to these formats total 494 pages[66]. This compares to the 9 pages of section 300A of the Corporations Act and 30 pages of AASB 124.

We have completed preliminary work on a prescribed format that may meet the data consistency requirement for somewhat less of the USA's compliance burden. If there is interest in our initial submission, we will work to complete this for a subsequent submission.

The other proposed requirement would be to impose a new technology submission method. This has already been well researched, and promises to

[65] GuerdonData® see HERE.

[66] SEC sections 402 and 404 amendments to Compensation Analysis and Disclosure requirements can be seen HERE and HERE.

contribute significantly to companies' ability to obtain optimum value in setting executive pay. In fact, it is arguable that there are considerably more material gains from overall market efficiency improvements if the format is applied more broadly to listed company financial information and to other securities. The technology submission method is known as XBRL. This technology has been mandated by the USA's SEC for future lodgements of financial disclosures, and is considered superior to the PDF lodgement format required by the ASX. In fact the SEC has examples for US compensation data allowing anyone to access and analyse data across any number of companies (see example website HERE).

Unfortunately, converting to and maintaining this technology will add to the cost burdens on business, the ASX and ASIC.

For many and perhaps most companies, the current costs incurred by purchasing data from data consolidators will be cheaper than this alternative. Hence, there is a trade-off between the cost of an improvement in transparency and market efficiency accessible to more stakeholders and the cost of maintaining the process of data access we have now. The decision will need to justify this cost to improve a governance system that is arguably better than most other countries' systems now.

8.13. Balancing guidelines and legislated requirements

Is there an appropriate balance between legislated requirements and voluntary guidelines?

What is the role of voluntary guidelines in governance of director and executive remuneration?

Current arrangements comprise a combination of legislative prescription ("hard" law), "soft law" (i.e. "if not, why not?"), and guidelines applied or promoted by various stakeholders.

The legislated requirements for disclosure and a non-binding vote have had a marked impact on improving standards. However, the prescriptions for tabular information could be improved, while other aspects can be rationalised. Other legislated requirements, particularly in relation to taxation, can have significant and detrimental consequences.

Soft law is best represented by the ASX Governance Principles. Companies are required to explain if they have applied these principles on an "if not, why not" basis. Soft law has been useful and flexible[67], and has more potential to improve disclosure and structures.

[67] They recognise, for example, that many smaller listed companies may not have the resources to implement many of the principles, and that the principles are not applicable to some companies (in start up situations, for example).

Guidelines are fluid and evolving, and represent a range of sometimes conflicting requirements. These tend to be provided by governance stakeholder groups and institutions. They vary with the interests, sophistication and resources of the organisation.

The role of guidelines in governance of director and executive remuneration is to provide a benchmark for both reporting entities and shareholders to be able to assess the appropriateness of remuneration structures. From the Australian listed entity perspective, guidelines are only that. Deviations from generally accepted guidelines should be accompanied by a cogent explanation. The ASX Corporate Governance Principles and Recommendations, for example, operate on this basis.

Directors should be free to design the best remuneration structure for their particular entity taking into account the specific business environment and the key value drivers of that entity. Different entities have different value drivers which in turn change over time. Directors are in the only position to determine this because only they have the inside information on the company to be able to decide the most appropriate performance hurdles to be used. Good decisions will be able to be readily explained.

Guidelines represent the consensus of best practice and should be allowed to develop with changing circumstances, experience and views. An example of this is the increasing support for departing CEOs to hold performance based equity instruments after their retirement/resignation date to encourage a focus on longer term and not just to retirement/resignation date. Previously, best practice thought that they should not hold beyond their time in office because their influence ceased with retirement. Now it is considered appropriate for executives to wear the consequences of their decisions post retirement by holding securities that are subject to both holding locks as well as performance hurdles. It has become evident in a number of cases that CEOs departed with large cash payments for short term performance and soon after their departure, shareholders have suffered significant loss in the value of their shares.

Therefore, we suggest that legislated or regulated requirements remain confined to disclosure. Guidelines may be more prescriptive in regard as to how executives should be paid, but allow deviation on an "if not, why not?" explanation.

8.14. Should we copy international practices?

Are there any voluntary, good practice guidelines or codes applying internationally that may be of interest in an Australian context?

Should Australia consider the adoption of a code of practice?

Is the case for regulation stronger where government is an active participant in company activities, for example through the use of

taxpayer funds to bailout companies in financial difficulty or through other ongoing support activities?

Most researchers in this area acknowledge that the regulations and governance systems that prevail tend to be specific to a cultural context, and are not transferable across borders[68].

The most cited reference to a legislated code of practice is the UK Combined Code (see HERE). This has been assessed as not meeting the UK's requirements, and is under review (for the third time in 3 years). However, Australia already has a code of practice enshrined in the ASX Governance Principles. The Australian industry bodies for major (mainly industry based) super funds and investment managers, ACSI and IFSA, also have published guidelines, which differ in relatively few respects from the ASX Governance Council's. In our opinion, all provide boards with flexibility to respond with governance measures suited to their situation, and disclosed to shareholders on an "if not, why not?" basis.

In our view, it is better to work with the current Australian codes and to allow them to develop in line with developments in generally accepted best practice than to allocate resources to try to introduce and obtain acceptance in the Australian market of yet another code.

If an appropriate environment can be created for both the structure and disclosure of remuneration, then it should not be necessary to have stronger regulation for any entities, including those that may receive tax payer financial support. That is, the standards present for investors to assess risk and returns should be adequate for all investors, including tax payers who, via the government, "invest" in company bailouts. Presumably such bailouts would not occur unless the government undertook a risk and return analysis.

There is a risk that stronger regulation may:

- Delay an entity seeking tax payer financial support; and
- Motivate an entity to extinguish taxpayer financial support prematurely, in order to relieve the entity of increased regulatory obligations.

In saying this, we acknowledge that APRA is a prudential regulator and is entitled to help shape the design of remuneration policies, to the extent that remuneration policies may be regarded as influencing corporate behaviour from a prudential perspective.

There is a risk with guidelines and codes of practices that reporting entities will focus too much on such guidelines in order to receive investor support rather than structuring remuneration policy according to the particular reporting entity's circumstances and reporting that policy to shareholders in the remuneration report.

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[68] See, for example, "International Executive Pay: Current Practices and Future Trends"Randall S.Thomas Vanderbilt University - School of Law, September 8, 2008, Vanderbilt Law and Economics Research Paper No. 08-26.

If the government used taxpayer funds to bail out companies there are various methods it could apply to influence executive remuneration if it wished, ranging from debt covenants to equity injections providing it with shareholder voting rights. The extent that the government exercises these rights depends on the situation.

8.15. Remuneration committees

To what extent have remuneration committees been used in Australia?

The ASX Governance Principles state in Recommendation 8.1 that the board should establish a remuneration committee (see ASX Governance Council's Principles HERE).

Yet only 68.92% of ASX 300 companies have a remuneration committee[69]. Of those that do not, the "if not, why not" explanation most often refers to the small size of the board, and that these matters are considered by the full board.

Of those listed companies that do have a remuneration committee we note that 22.5% include among their members an executive director.

The recently released APRA draft remuneration prudential practice guide requires the board to establish a remuneration committee[70].

What effects have remuneration committees had on the linkage between remuneration levels and individual and corporate performance?

There is a distinct difference in the consistency of remuneration outcomes for companies with remuneration committees compared with boards without remuneration committees. The table below indicates the extent that executive remuneration is correlated with market capitalisation. It can be seen that those with remuneration committees have executive remuneration more closely correlated with market capitalisation. While not ideal, market capitalisation is a reasonable proxy for both job complexity (and hence supply of candidates) and to a lesser extent, performance. This indicates a more disciplined and focussed approach to achieving consistent remuneration outcomes.

Table: Extent of CEO pay level correlation with market capitalisation

Correlation between CEO's remuneration and MCAP[1] for S&P/ASX 300 Index		
	Companies with remuneration committee	Companies without remuneration committee
TFR vs. MCAP	0.53	0.30
STI vs. MCAP	0.63	0.10

[69] As at 29 May 2009, data source – GuerdonData®.

[70] Prudential Practice Guide PPG-511 Remuneration, page 5, paragraph 4, 28 May 2009.

TFR+LTI vs. MCAP	0.58	0.41
TR vs. MCAP	0.59	0.30

[1]: MCAP as at financial year end

It is also worth noting that the presence of a remuneration committee is a significant factor in the governance ratings used by Goldman Sachs JB Were (see Guerdon Associates commentary HERE). In turn, the overall assessment of remuneration governance is the most significant indicator of good corporate governance and predictor of long term company performance (see Guerdon Associates commentary HERE).

In the experience of CGI Glass Lewis, well staffed remuneration committees usually result in superior remuneration disclosure and structures, including remuneration levels consistent with market cap peers, and those often, but not always, occur in well performing companies. Generally, the standards are higher in the bigger companies.

8.16. Remuneration advice

Do conflicts of interest arise in the arrangements by which remuneration consultants advise on director and executive remuneration?

If so, how significant are they and how might they be addressed?

A conflict of interest is a situation in which a person has a private or personal interest sufficient to appear to influence the objective exercise of his or her official duties. A conflict of interest exists even if no improper act results from it, and can create an appearance of impropriety that can undermine confidence in the conflicted individual or organisation.

In responding to this question it is worthwhile to review the sources of board advice. Currently, boards, or individual directors, may receive remuneration advice from:

- Management;
- Remuneration advisers;
- Law firms;
- Accounting and tax firms; and
- Search consultants.

They may also receive input, supportive or critical, from:

- Large investors;
- Proxy advisers; and
- Governance groups.

Any adviser that advises the board and either does or could advise management is conflicted. Clearly, under the definition, conflicts of interest can be present in any of these sources of advice.

It is interesting to note that the most significant and uniform source of remuneration advice used by all ASX 200 boards is management, who, by any form of measurement, must be the most conflicted source of advice possible. In fact, according to a ProNED survey, this is the only source of remuneration advice for over 33% of ASX 200 companies.

This practice is contrary to AICD guidelines that suggest boards seek independent external advice (see guidelines HERE).

The next major source of advice to boards of ASX 200 companies is accounting firms. The advisers tend to be remuneration or tax professionals. All the major firms locate the remuneration advisers in their tax divisions. However, most of the major and second tier accounting firms have conflicts of interest policies in place. These mainly revolve around the provision of audit services. For example, where an audit includes the remuneration report, the audit firm will not undertake any option valuation services for the company.

The US took a black letter law approach to potential conflicts within audit firms. As a result of the Enron scandal, the USA introduced the Sarbanes Oxley Act to, in part, resolve conflicts of interest among auditors. In effect, it bans auditors from providing advice on specific matters where conflicts may arise under section 201:

> *"It shall be "unlawful" for a registered public accounting firm to provide any non-audit service to an issuer contemporaneously with the audit, including: (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert services unrelated to the audit; (9) any other service that the Board determines, by regulation, is impermissible. The Board may, on a case-by-case basis, exempt from these prohibitions any person, issuer, public accounting firm, or transaction, subject to review by the Commission."*

As a result, the major accounting firms in the US do not provide remuneration consulting services. The extensive services they did provide were sold to other organisations.

Research by the US Congressional House Oversight and Government Reform Committee found that 113 of the Fortune 250 companies used consulting firms for pay guidance as well as other management services in 2006. Fees for compensation work averaged $220,000, while those for other projects averaged $2.3 million.

The survey of six leading and allegedly "conflicted" consulting firms showed that CEO median salaries at companies who hired them for the most work were 67 percent higher than the median pay of CEOs at companies that did not use "conflicted consultants" (see Guerdon Associates commentary HERE and US House of Representatives report HERE).

The converse is, of course, that unconflicted remuneration consulting firms kept a lid on CEO pay that was over 40% less than that of CEOs in companies receiving conflicted advice.

The House Committee defined conflict, in this case, as arising when firms provided services simultaneously to the board and to management. Therefore their definition does not include firms that do not provide simultaneous services to management and the board, but have the potential to.

Of all sources of remuneration advice in Australia there are probably only two specialist firms that fundamentally restrict their services to boards only[71].

There is no direct evidence that conflicted remuneration consultants contribute to high rates of executive pay increase and market inefficiency in Australia. Such research is made difficult because there is no requirement to disclose the source of board advice, although several companies volunteer this information. In the US and Canada this is a compliance requirement. In the UK it is a disclosure required under the Combined Code (see the Combined Code on Corporate Governance HERE).

We recommend actions to minimise conflicts of interest could include:

1. Requiring the board remuneration committee to be comprised of only independent directors;
2. Requiring disclosure of all advisers to the board with an opinion by the board on the adviser's independence and the reasons for that opinion; and
3. Incorporating in the ASX Governance Principles a principle that all remuneration advisers to a company only advise the board or management and not both with an "if not, why not" explanation.

[71] Guerdon Associates (see website HERE) and Egan Associates (see website HERE).

9. The role of institutional and retail investors

Our conclusions are as follows:

- It is important that the responsibility of appointing and setting the terms of employment of a CEO and other senior executives remains with the board;
- Shareholders should not be involved in the operational decision making process of listed entities;
- The current non-binding vote does not require strengthening; and
- It is inappropriate for directors and executives named in the remuneration report to participate in the non-binding vote.

Our recommendations are as follows:

- The broader interests of shareholders should remain the preserve of social policy initiatives independent of governance related to shareholder returns; and
- The responsibility of appointing the CEO and other senior directors, and setting the terms and conditions of their employment should remain with the board.

What degree of influence should shareholders have in their own right in determining remuneration practices?

Do current regulatory arrangements enable shareholders to be adequately involved? If not, why not?

As discussed at Section 8, it is important that the responsibility of appointing the CEO and other senior directors, and setting the terms and conditions of their employment, remain with the board. It is incumbent upon the board to communicate remuneration policies to shareholders in an informative and transparent manner.

Shareholders should not be involved in the operational decision making process of listed entities. Shareholders will continue to influence remuneration through guidelines from industry bodies such as ACSI and IFSA, governance advisory bodies such as Regnan, proxy advisors and the ASX Corporate Governance Council.

Apart from their influence on remuneration guidelines, the degree of influence that shareholders should have on an entity should be restricted to dialogue/ engagement, voting by all shareholders, who are not conflicted on the remuneration issues under the current regime, voting on dilutionary equity grants to directors and on director elections.

It should be noted that a number of ASX listed entities also, as a matter of good governance practice, seek shareholder approval on non-dilutionary equity grants to directors.

Does the current non-binding vote require strengthening?

As discussed at Section 8, the introduction of the non-binding vote on remuneration reports has improved the transparency of remuneration of listed entities and increased dialogue between those entities and their major shareowners. Legislating for boards to do their job competently is simply not possible. Nor is it possible to legislate for shareholders to vote competently. Therefore, in our view, the current non-binding vote does not require strengthening.

To make the voting on remuneration reports binding is impractical, as the report represents policies and remuneration structures that apply across the entity and the 'against' vote does not specify which parts of the remuneration policy shareholders find objectionable. The non-binding vote is a plebiscite for shareholders on a listed entity's remuneration policies, which may cover NEDs, executives and other employees.

Further, remuneration is an operational matter. Operational management matters have been delegated to the board by shareholders. The board should be in the best position to exercise judgment on what is in the best interests of shareholders. The sum total of their efforts on all operational matters enables them to fulfil their obligations to shareholders. The more shareholders re-appropriate the management of operational matters from the board the less they can be held accountable for overall results. Furthermore, shareholders are not best qualified to decide absolutely on remuneration policies and levels of executive remuneration. These are strategic decisions which should be taken by the directors. They are engaged in light of their expertise, experience, qualifications, and proximity to the business in this and other strategic areas. Certainly, shareholders should have a voice but the discretion and ultimate responsibility is and should be with the board.

There is also an additional, if indeterminable, economic cost. Institutions will need to add staff to better process and understand the issues and exercise judgment. Individual shareholders will need to spend more time on these matters. Generally, when shareholders are asked to resolve on a matter, they must be given the material information known to the company that is relevant to the decision.

This would create additional costs and complexity for companies. Boards would need to explain the factors relevant to determining remuneration policies and levels. The relevant law relating to executive remuneration may need to be explained, which is currently very technical and complex. Disclosures may include commercially sensitive, strategic information, such as the grounds for performance hurdles, characteristics of the market for executives in their field, etcetera. It may also be necessary to disclose expert remuneration reports. Making those reports public documents is likely to greatly increase the cost involved in obtaining them.

Even if all this information were presented to shareholders, they would still only be able to approve or veto one particular proposal. Remuneration policies and practices are complex and cannot be reduced to a yes/no vote.

Further, to compel institutional investors to vote on issues put to shareholders at meetings (including remuneration reports and election/re-election of directors) will increase the risk that institutions that do not put the time and resources into assessing these issues will not vote competently. The only way to get institutions to vote competently is through disclosure of their voting, which will allow their own beneficiaries to hold them accountable for their decisions. While such a move will involve cost on behalf of institutions, these costs may reduce overall agency costs for their beneficiaries (see Section 6.6).

An alternative would be to require superannuation funds and /or their managers to disclose publicly how they have voted on these issues. Such requirements will be costly as disclosure of such information is likely to generate interest from members, which will require superannuation funds to have the appropriate infrastructure in place to deal with these issues.

Is it appropriate for directors and executives that are named in the remuneration report, and who hold shares in the company, to be able to participate in the non-binding vote?

We are of the view that it is inappropriate for directors and executives named in the remuneration report and their associates to participate in the non-binding remuneration report vote. They are clearly conflicted as they may have a material interest in seeing the vote succeed, and their participation therefore risks a voting outcome inconsistent with the interests of public shareholders.

To what extent have large institutional investors used their voting rights to influence remuneration practices and other areas where they have voting powers?

As discussed at Section 8, proxy voting statistics show that institutional investors are using the non-binding remuneration report to send a message to boards about their overall displeasure with a number of remuneration reports.

Whether or not institutional voting is typically aligned with broader interests of shareholders will always be a matter for debate. However, institutional shareholders have an obligation to look after the interests of their beneficiaries and their votes represent such interests.

We suggest that the broader interests of shareholders remain the preserve of social policy initiatives independent of governance related to shareholder returns.

In what aspects of remuneration practices and setting remuneration levels would it be appropriate to increase shareholder involvement? Are there areas where their rights should be strengthened?

Does institutional voting typically align with the broader interests of shareholders?

How would this be best achieved – without, for example, diluting the intended function of the board in engaging the managing director/chief executive officer?

See Section 8.

10.Aligning interests

Our conclusions are as follows:

- Taxation of the employer and the employee is a major consideration in determining the form of remuneration, but not necessarily the quantum;
- Attempts to use taxation to influence executive remuneration in the international context have often had unintended consequences and have not been effective. That suggests that taxation policy should align with regulatory policy rather than being used to enforce remuneration policy;
- Taxation policy which does not align the time for taxation of executive remuneration with the executive's ability to pay is likely to push employers and employees to seek remuneration options where the tax outcomes do align, rather than affecting the quantum of the overall remuneration;
- In the main bonuses, with LTI rewards, have been critical for aligning pay outcomes with shareholder value, despite recent bad examples;
- Cash bonuses should be subject to marginal tax rates, not special rates;
- ESS:
    - The current tax regime does not distinguish between equity grants which have a substantial risk of forfeiture and those that have a remote risk of forfeiture in determining the time of taxation of the equity or the market value of the equity;
    - Where tax deferral is available (i.e. in respect of "qualifying shares" and "qualifying rights"[72]) an employee (who has not been taxed earlier) will be taxed on ceasing employment despite that the equity may not have vested and be subject to substantial risk of forfeiture;
    - In the case of shares, where an employee has been taxed on shares and subsequently forfeits the shares, there is currently no ability to recover the tax paid, instead the employee will have generally made a capital loss;
    - There is currently no reporting or withholding obligation on an employer with respect to ESSs;
- Termination Benefits may currently be taxed concessionally despite that the executive is on a short term contract which is analogous to a contractor who would not get concessionary treatment;
- An important factor contributing to misalignment is the lack of long term equity ownership by directors;
- To ensure that executives align their thinking for the longer term it is important that they wear the consequences of their decisions in the longer term. Appropriate performance hurdles and holding locks on awards will encourage long term thinking;
- The interests of shareholders and the wider community can sometimes be in conflict;
- Performance measures for reward should be one of several important indicators of board and individual director competence;

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72 See section 139CD.

- Australia's regulatory and governance system has served well in relation to gaming incentives relative to the experiences of other countries;
- Well structured boards with a majority of independent directors tend to properly exercise their functions on behalf of shareholders;
- The risk that the CEO or other member of management may unduly influence the board arises where there is not a well structured board and the independent directors lack core industry skills;
- The form of remuneration most likely to create misalignment is one with a mix that is comprised entirely of cash based fixed remuneration;
- A longer term focus may be encouraged by deferring bonus payments into equity; and
- Recent government plans to tax equity at "acquisition" date will negate our suggestions on alignment.

Our recommendations are as follows:

- Taxation policy should align with regulatory policy with respect to executive remuneration. For example, the time for taxation of an executive's remuneration should align with the executive's ability to pay (i.e. at the time cash is received or equity is practically able to be dealt with and is no longer subject to substantial risk of forfeiture);
- Bonuses should remain tax deductible to the employer to the extent that there is a cost incurred by the employer at the time that the cost is incurred;
- Cash bonuses should be subject to marginal tax rates, not special rates;
- In relation to ESS:
    - The time at which equity is taxed should be no earlier than when the equity is no longer subject to substantial risk of forfeiture (or, in the case of options, when the options are exercised). Substantial risk of forfeiture would include continued employment and would also include 'real' performance conditions;
    - If cessation of employment is retained as a taxing time, the ability to recover the tax where shares are forfeited (eg. by amending the appropriate tax return) should be included;
    - Employers should be required to report equity grants at the taxing time (without an obligation to withhold tax);
- Termination benefits should be taxed as remuneration income and subject to marginal tax rates;
- Disclosure requirements should be modified to simplify and indicate the intrinsic value of remuneration vested and received, and aligning this realised intrinsic value with the service period it applied to;
- Require the disclosure of all board advisers, with a board opinion on the extent of each adviser’s conflicts of interest;
- Review announced termination provisions to include a broader definition of remuneration and consider bringing the limit requiring shareholder approval more in line with international standards for attracting potential off shore executives;
- A certain proportion of reward should be deferred and payable in equity; and

- ASX Governance Principles requiring boards to seek independent advice on remuneration matters, disclosing this on an "if not, why not" basis.

10.1. Taxation

Are taxation considerations, either from the company's or executive's perspective, driving the design of remuneration packages?

If so, what changes are required?

To what extent do current taxation arrangements influence the level and structure of executive remuneration?

References in the following sections to the ***1936 Act*** and the ***1997 Act*** are to the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997.*

10.1.1. Background and international context

Taxation impacts the structure, level and effectiveness of remuneration. In Australia the tax concessions on equity (until recently) allowed companies to require executives and other employees to receive reward in equity. Without these tax deferral mechanisms, executives would not accept equity as a reward. Because of trading blackouts and windows, it is not liquid (see Guerdon Associates commentary HERE). The insider trading laws restrict them further. So the tax deferral is a necessary element to right the balance and obtain better shareholder alignment.

On the negative side, the taxation of equity at termination, even if it is still subject to performance requirements, is a disincentive, and results in inappropriate remuneration responses or behaviour (see Guerdon Associates commentary HERE).

Several countries' taxation systems provide examples of the impact on executive remuneration.

The USA has "led" the way on taxation imposts to influence executive pay.

The USA levies tax "penalties" on companies and individuals that provide executive termination pay in excess of 2.99 average base salary and bonus. The tax was brought in during 1987 in response to egregious examples of termination pay that were out of line with the poor returns experienced by shareholders during the economic downturn at that time. Prior to the changes, market practice on executive termination pay in the US ranged from 3 months to 6 months pay, usually contingent on a "non-competition" requirement.

Within 6 years the 2.99 times "maximum" enshrined in Internal Revenue tax regulations became the "sanctioned" minimum. The prevalent market standard has increased 700%. Further, base salaries and bonuses increased significantly during this period, providing further leverage.

Despite this experience, in 1993, the US introduced a "maximum" US$1 million base salary level beyond which pay was not tax deductible. This was in response to another economic downturn and examples of egregious executive salaries and termination payments based on these salaries. Exempted from the absence of tax deductibility beyond the US$ 1 million were performance based payments. Share options were included in the definition of performance based payments. At the time median Fortune 500 base salaries were US$420,000.

Within 6 years base salaries for the majority of Fortune 500 companies neared the tax "sanctioned" $1 million level. The maximum became a minimum. But of more importance was the significant escalation in option plans. If costed with today's accounting method, these option plans would be worth 5 times the salary level[73]. Moreover, being options, they encouraged risk taking. While risk taking is expected of management to a degree, the extent of risk taking expected would vary with the nature of the company. Utility companies with high dividend yields would not be expected to take much risk with shareholder funds. Enron was a utility company. Its management received option packages costed at 10 to 20 times their base salaries. Moreover, virtually all US companies rewarded their executives with large numbers of share options. The volatility and returns of the US market compared to the UK (less use of options) and Australian markets (least use of options) are shown below.

Table 1: Market Total Net Return (%)

	5 YEARS	10 YEARS
S&P/ASX200	6.63%	6.27%
FTSE100	3.55%	-0.18%
S&P500	-1.83%	-2.28%

Source: Bloomberg

Table 2: Market Volatility (%)

	5 YEARS	10 YEARS
S&P/ASX200	15.40	14.05
FTSE100	16.14	18.98
S&P500	16.09	18.90

Source: Bloomberg

It can be seen that the Australian market had less volatility and better returns over 5 and 10 years than the markets in the UK and USA.

The source of the global credit crisis was the US. Executive pay has been identified as one contributor. Various global financial regulators have released remuneration guidelines for banks that discourage use of options because it encouraged too much risk taking.

We believe this to be a good example of an unintended consequence of regulation and taxation directed at a single component of pay.

[73] That they were not required to be expensed under FAS 123 added to their appeal.

10.1.2. Australian context

In Australia the taxation treatment of different forms of remuneration (eg. cash, non-cash, equity etc) has been a major factor in determining the structure of an executive's remuneration as the extent and manner of taxation affects the actual cost to the employer and the actual value of remuneration, and its benefit, to the employee. In determining a remuneration package, an employer and employee balance consideration of tax deductions or tax concessions available to the employer and obligations imposed on the employer such as fringe benefits tax (***FBT***) and superannuation guarantee, State based taxes such as payroll tax, as well as the tax-impact, and timing of taxation, to the employee.

The tax law also includes numerous concessions for different forms of remuneration. It is common knowledge that the Government has implemented, or removed, such concessions to generally promote Government policy or public sentiment for supporting, or not, the use of particular forms of remuneration. Some of the most relevant concessions in this context are the (proposed historical) significant concessions afforded to shares and rights granted under ESSs[74], the concessional treatment of superannuation and employment termination payments and specific FBT exemptions or concessions (eg. cars, computers etc).

A striking example of the significant influence of taxation over remuneration practices has recently been evidenced by the significant corporate backlash against the measures announced in the Federal Budget to remove the tax concessions for the deferral of taxation on the grant of shares or rights under ESSs[75]. Media reports[76] within days of the announcement highlighted the extent of corporate ESSs which were 'put on hold' pending further response by Government and indicated a general view that ESSs might be shut down if there were no change. Further, rather than affecting the quantum of remuneration, the proposed changes were largely expected to affect the form of remuneration as it was expected employers and employees would largely fall back on cash alternatives.

Given the significant influence of taxation policy over remuneration practices, it is imperative that care be taken, and we would encourage the Government to consider aligning as closely as possible taxation measures with public policy on executive remuneration. For instance, it would be folly to expect or encourage corporate Australia to support long-term equity based remuneration (particularly being subject to performance and time criteria) where, as proposed by the Budget, an executive is unfairly exposed to fund a tax liability in the year of grant of the equity notwithstanding that they are unable to fund the tax liability with the grant at that time and, indeed, may never get the

[74] See Division 13A of the 1936 Act.

[75] See Budget Paper No. 2, Part 1, Treasury Measures and the Treasurer's Press Release No 65.

[76] For example see Australian Financial Review, 15 May 2009, pages 1 and 15.

benefit of the grant due to conditions which could result in forfeiture. In such instance, it would also be vastly unfair to regulate or require the provision of equity to the executive, so as to give rise to the tax liability and would significantly disadvantage Australia in competing globally for executives as compared to other OECD countries where the taxation of equity is aligned to the ability to pay (such as when the employee is able to sell at least some of the equity to fund the tax liability).

As discussed above, attempts to influence outcomes for executive pay using taxation laws in the international context have often had unintended consequences and have not been effective.

10.2. Bonuses and tax

How should bonuses be treated for taxation purposes?

To what extent should bonuses be an allowable tax deduction for companies?

The presence of bonuses in a remuneration structure allows that remuneration to be aligned with economic outcomes. This symmetry allows remuneration to increase when results are good and decrease when results are poor. To discourage bonuses will result in misaligned remuneration structures and outcomes.

Whether a bonus is provided as cash, non-cash or equity, it will generally represent a remuneration cost to the employer. In such circumstances, where there is a cost *incurred*[77] by the employer, an Australian employer would generally be entitled to a tax deduction in the year it is incurred[78]. We support the effect and application of the current law in this regard which recognises actual remuneration costs as an expense along with other expenses of the business of the employer.

We do not support the denial or limitation of a tax deduction in these circumstances which would inflate the real cost to the company, and hence the cost to shareholders. While the denial or limitation of a tax deduction might serve as a tool for curbing excessive remuneration practices, it would be difficult to legislate such a measure without adversely affecting employers with nonexcessive practices through not just potentially denying deductions (and consequently increasing the 'real' cost) but also increasing the burden of tax compliance. Further, if consideration were to be given to imposing caps on the level of deductions for remuneration, there would be inherent difficulties in determining the appropriate amount of the cap (or caps where different scales were adopted for different industries) and query how these would be kept at

[77] Section 8-1 of the 1997 Act. The provision requires that there be a cost incurred by the taxpayer employer so that a cash payment or cost would give rise to a deduction, whereas the issue of shares would generally not (though there are some limited circumstances in which a deduction might be obtained).

[78] An exception to this timing is the deferral of a tax deduction for costs for the provision of rights or shares under an ESS under section 139DB of the 1936 Act.

practical and reasonable levels going forward given the vast differences in the employment market between industries and globally?

There is no reason not to allow bonuses to be tax deductible and many reasons to retain tax deductibility:

- Data indicates that executive remuneration varies with performance. Most decreases in total remuneration are an outcome of lower bonus payments (see Guerdon Associates commentary HERE). Bonuses allow a company expense to vary with its capacity to pay, allowing it to remain liquid, and less prone to liquidity risk. In addition, it will allow a company to retain more of their workforce for longer, to be positioned better for any upturn. There are obvious economic benefits with retaining employees in employment;
- Bonuses focus employees on financial outcomes that are important for adding incremental shareholder value;
- To remove tax deductibility would most likely result in an increase in other pay components (probably base salary[79]);
- To remove tax deductibility would most likely result in the failure to attract well qualified candidates from offshore confident in their ability to meet high performance standards; and
- Bonuses can be a critical component of remuneration structures (see Guerdon Associates commentary HERE).

Should bonuses be subject to special/higher taxation rates?

We support a system for the taxation of executives which is equitable as compared with other high income earners. Executives should not be in a position in which they receive inequitable taxation benefits or suffer inequitable taxation outcomes in comparison with other high income earners. See further prior answers.

10.2.1. Cash bonus (including 'salary sacrifice')

Where a bonus is currently taken as cash it is taxed as remuneration income in the income year it is received and subject to marginal tax rates so that it is likely that the executive would be subject to the highest marginal tax rate on the bonus, currently 46.5% (including Medicare) on 2008/2009 rates. We submit that this is a reasonable and equitable outcome.

Generally, an executive may, in advance of earning the bonus, salary sacrifice all or part of that bonus to receive the value as non-cash benefits and the employer would include any FBT liability of the employer in determining the value salary sacrificed[80]. This current ability to salary sacrifice can provide significant tax advantages to executives where salary sacrificing is used to

[79] This is also likely to be the outcome of the termination pay limitations recently announced.

[80] FBT is currently levied at 46.5% in line with the highest marginal tax rate.

acquire non-cash benefits which have concessional FBT treatment. Two examples of this are superannuation and ESSs[81].

The ability to salary sacrifice into superannuation is currently limited by the Concessional Contributions Cap ($50,000 for the 2008/09 year and, proposed to reduce to $25,000 (indexed) from 2009/10 year onwards). Any concessional contributions in excess of the cap will generally give rise to a liability for the executive for excess concessional contributions tax which will, effectively, mean that the salary which is sacrificed would be subject to 46.5% tax as a contribution.

Unlike superannuation no cap is currently imposed on the ability to sacrifice into an ESS with the current tax deferral concession (other than that the executive cannot hold 5% or more of the company[82]). An executive can therefore salary sacrifice into an ESS (provided conditions are met) and potentially defer tax on the shares or rights acquired for up to 10 years with, generally, little risk of forfeiting the rights to those shares or rights and, often, continuing to be entitled to rights in respect of the shares (such as dividends) during that period.

Typically, this sacrifice alternative is open to all employees where it is also offered to the chief executive.

Long term investors prefer executives to hold company equity, as do many boards of these companies. Hence, many companies have mandatory holding requirements. This is supported by research that indicates that company performance is better where executives hold shares (see Guerdon Associates commentary HERE).

Given this, we see no reason to remove the bonus sacrifice alternative, providing other employees are offered an equal opportunity.

10.2.2. Equity bonuses

Where a bonus is paid as equity under a bona fide ESS it will generally be taxed under Division 13A of Part III of the 1936 Act. That division contains what might be described as a "code" for the taxation of shares, and rights to shares, provided under "employee share schemes" which fall within the definition set out in section 139C of that Division.

Importantly, schemes which would fall outside of the division include:

- Shares or rights which are not acquired at a discount to their Division 13A market value;

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[81] See definition of 'fringe benefit' in section 136(1) of the Fringe Benefits Tax Assessment Act paragraphs (ha) to (hc) of the definition, and paragraph (h) relating to similar benefits under section 26AAC, the EES provisions which Division 13A replaced.

[82] See section 139CD of the 1936 Act.

- Equity schemes which deliver cash benefits rather than shares (eg. phantom share plans); and

- As an integrity measure, schemes which are not 'true' ESSs in that they do not relate to any employment of the taxpayer.

Under the current provisions of Division 13A, significant tax concessions are provided to ESSs which evince an historical intention of Parliament to encourage and facilitate the operation of ESSs in Australia.

The division provides that an employee will generally be taxable in the year in which the share or right is "acquired". Importantly, the Division (currently) provides where the conditions of section 139CD are met (i.e. the shares are *qualifying shares*, or the rights are *qualifying rights*), the employee is given a choice to elect to be taxed on the shares or rights in the year of grant, or to defer taxation of the shares or rights until the "cessation time"[83], which effectively allows ESSs to be structured to allow tax to be deferred for a maximum of 10 years from the date of acquisition (unless the employee ceases employment earlier).

Contrary to the comments in the Treasurer's Press Release[84] that there is an 'inequity' between qualifying and non-qualifying schemes, the limitation of the concessions to qualifying schemes was primarily an integrity measure to ensure the concessions went to bona fide ESS schemes and to encourage the provision of benefits across a majority of the workforce (eg. the shares concerned must be ordinary shares, the shares must be in the employer or a holding company of the employer, 75% of permanent employees of the employer at the time of the grant must have been able to participate in ESSs, the employee must not hold more than 5% of the interests in the company etc).

Further, a critical element of division 13A is that an employee will 'acquire'[85] a share or right notwithstanding that the share or right may be subject to performance or employment conditions, or conditions which may result in forfeiture of the interest in shares or rights, and the market value which is used in calculating the amount on which the employee is taxed is determined irrespective of such conditions.

As we have stated above, we submit that the structure of taxation should be closely aligned to executive remuneration policy in order to support that policy and to prevent inequitable or unfair outcomes. If policy drives the use of long term equity incentives then we submit that taxation of those incentives should align with the time at which the equity benefits are able to be used by the executive, i.e. their ability to pay. To have an earlier time for taxation would not only be unfair for the executive, but would certainly discourage the use of such incentives which would ultimately defeat the policy intent.

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[83] As defined in sections 139CA and 139CB of the 1936 Act.

[84] Treasurers Press Release No 65, 12 May 2009.

[85] See section 139G of the 1936 Act.

For the above reason we support the use of tax deferral generally on equity incentives to achieve alignment, however we encourage the Productivity Commission and the Government to consider the appropriate conditions which should attach to the ability to access tax deferral which we think are a more appropriate means of achieving a publicly acceptable outcome, i.e. what should be 'qualifying schemes'? For instance, the requirement to offer shares to 75% of permanent employees of the employer is only applicable where shares are granted – the requirement does not apply in the case of the grant of rights. This disparity can encourage the use of options or rights schemes for executives without the consequent benefit to the broader workforce.

Similarly, as we have noted above, the acquisition time, and market value, of shares and rights are the same regardless of conditions attaching to the shares. We consider that this is appropriate where there is the ability to defer tax until the time at which the shares or rights are able to be used by the executive, but would be inequitable where taxation is applied at grant. Also, as conditions are not taken into account, there can be no distinction between shares or rights which are substantially 'at risk' through performance or vesting conditions, as compared to salary sacrifice arrangements where the risk of forfeiture is often remote. This is another area where consideration could be given to removing inequities.

Lastly, under the current tax regime, tax is generally payable when the employee is able to sell the shares (i.e. when forfeiture and disposal restrictions no longer apply), based on the market value of the shares at that time. However, curiously, cessation of employment is a taxing time for employee equity incentives, regardless of whether those incentives are vested or able to be sold at that time. That is, the employee is taxed on cessation of employment based on the market value of the shares at that time, disregarding the forfeiture and disposal restrictions that may continue to apply. This amount is subject to tax as remuneration income at the employee's marginal rate of tax in the year of leaving the employment.

Where the equity incentives are not, at that time, able to be sold to pay the tax due on those incentives on cessation of employment, the former employee is left in the difficult position of having to source alternative funds to pay this tax bill. This is notwithstanding that there may be no certainty at that time whether the incentives will vest and, if so, what the value of the incentives will be on vesting. This is a particular problem in the context of the developing best practice to impose holding locks and performance conditions significantly beyond the executive's departure from the company to promote behaviour by the executive during employment to leave a good legacy in terms of ongoing shareholder value.

The amount on which tax is payable on cessation of employment may vary significantly from the value of the shares at the later time when the former employee becomes entitled to sell the shares. This difference (whether an increase or decrease) is generally accounted for under the capital gains tax regime on the disposal of the shares. If the incentives are forfeited after

cessation of employment, a refund of the tax payable on cessation of employment is generally only available where the employee has not had dividend and voting rights on the shares before that forfeiture has occurred. Even where a refund of the tax paid on cessation of employment is available on a later forfeiture of the equity incentives, the former employee would still have had to source alternative funds to pay the tax bill until the refund of that amount occurs on the later forfeiture.

Australia may be considered 'unique' in seeking to tax equity incentives on cessation of employment where those incentives continue to be subject to substantial risk of forfeiture. It is hoped that the Productivity Commission will include recommendations to align Australia's tax treatment with other OECD countries by removing cessation of employment as the taxing time. Instead, taxation should occur no earlier than when the incentives are no longer subject to forfeiture, with consideration being given to the appropriate tax treatment which should apply where significant disposal restrictions continue to apply to vested awards after cessation of employment.

We suggest that from a risk management perspective, such provisions are not in the best interests of shareholders, and do not encourage boards to impose on executive a "hold through retirement" policy (see Guerdon Associates commentary HERE and HERE).

In addition to the structure of the tax scheme for ESSs, concern has recently been expressed by the Government as part of the Federal Budget ESS measures that there has been significant non-compliance in relation to ESSs. It is likely that this issue arises from the fact that there is currently no reporting or withholding obligation on an employer with respect to equity granted under an ESS. This concern could be better addressed by introducing a reporting obligation (such as through the annual Pay-As-You-Go Payment Summary issued by employers to employees) at the time that the tax liability arises.

The difficulty at present in relation to qualifying shares and rights is that employees may elect to be taxed in the year of grant or on a tax deferred basis and the employer is not privy to the election. This could be resolved by requiring the employee to notify the employer where an election is made to be taxed in the year of grant.

We do not consider that it would be appropriate to impose an obligation on the employer to withhold tax in the circumstances due to the fact that the employee may not wish the employer to sell the equity to pay the tax liability and the inherent difficulties which may arise where the tax liability is in excess of the employee's cash pay for the period.

10.2.3. Termination Benefits

Executive employment contracts most often include consideration of the benefits which will be received at the termination or end of that contract, whether as equity, cash or some other benefits.

Currently, Australia provides concessional taxation treatment to payments received on termination of employment know as 'employment termination payments[86]' and also further concessionary tax relief in the case of genuine 'bona fide redundancy' payments[87].

Executives may, depending on their circumstances, be eligible for concessionary treatment with respect to payments made under their contracts on the termination of employment. This is despite the fact that many executives may only be intended or expected to remain in office for a limited term (eg. 4 years) such as might be expected of a contractor/consultant rather than an 'employee'. We would encourage the Productivity Commission to consider whether concessionary taxation treatment is appropriate in all circumstances and whether limits should be applied to limit the circumstances in which concessionary treatment for termination payments should be available to executives. In this context, we do not consider that special or higher taxation rates would be appropriate but, rather, that the executive is simply taxed on the payment as remuneration income at marginal tax rates.

We note that our views on termination payments are consistent with those expressed in the submissions to the Treasury on the Corporations Amendment (improving accountability on termination payments) Bill 2009 made by Guerdon Associates (see Guerdon Associates' submission HERE) and Allens Arthur Robinson.[88]

10.3. Evidence of misalignment

What evidence or examples indicate that the interests of boards and executives may not be adequately aligned with those of shareholders and the wider community?

What factors have contributed to any misalignment?

There are a number of examples identified by CGI Glass Lewis[89] where high short-term profits led to generous bonus payments to employees without adequate regard to the longer-term risks they imposed on their entity. Accordingly shareholders lost significant value yet executives received immediate cash rewards for failed strategies.

An important factor contributing to the misalignment is the lack of long term equity ownership by the executives. Long term equity ownership would encourage executives to align their interests with those of shareholders and perform to their fullest capacity. Accordingly, we support the use of appropriate

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[86] See generally Division 82 of the 1997 Act.

[87] See subdivision 83-C of the 1997 Act.

[88] Allens Arthur Robinson's submission is to be published by the Treasury on their website (see Treasury website HERE).

[89] Eg. ABC Learning, Transurban, Oz Minerals, AGL Energy.

performance hurdles and to place holding locks on awards (even after the hurdles have been met), to encourage long-term thinking by executives.

What are the interests of the wider community in relation to director and executive remuneration within a company?

To what extent do the interests of shareholders and the wider community align?

In what circumstances will they not be aligned?

See Section 7.22.3.

The interests of shareholders and the wider community can sometimes be in conflict as shareholders are expecting returns on their investments which can potentially come at the expense of the community. However, for a listed entity to be sustainable in the long term it must avoid externalising costs on the wider community. A listed entity that does externalise costs increases its exposure to brand/reputational risk, which may potentially result in a loss of shareholder value.

Can cost cutting by companies, including by sacking workers, align with the public interest?

Is it reasonable to reward executives for actions that promote shareholder interests but which may not align with the public interest?

The greater good depends on an active and healthy economy. This has been achieved by a system that encourages competition between companies. This may entail actions in one company where individuals may suffer job loss. But the stronger company not only survives, it may grow, employing more people and generating surpluses that benefit workers with superannuation.

Of course, laying off workers presents social and reputational risks for the company. It needs to assess these in the context of other risks, including credit and liquidity risks if the layoffs did not take place.

In this context, it is not the role of management and boards to set social policy regarding safety nets for workers that are displaced. This is for government.

Listed entities which want to use a cost cutting strategy, involving the dismissal of workers, will have to weigh the wider community brand/reputational risk and potential impact on sales etc, against the potential increase in shareholder value via a lower cost base.

Cost cutting strategies which reward executives will generally have short term benefits (i.e. on immediate profitability) but if the externalising of such costs on the wider community is significant, the longer term impact of such a strategy may not be realised.

To ensure that executives align their thinking for the longer term it is important that they wear the consequences of their decisions in the longer term. Hence, delivering reward in equity, which has a retention element for the longer term, will encourage executives to consider the longer term consequences of decisions which may have short term positive implications for profitability and shareholder value but potentially negative longer term consequences.

What are the costs and benefits of any options/mechanisms to more closely align the interest of boards and executives with those of shareholders and the wider community?

See prior answers.

What could be some unintended consequences of limiting or more closely regulating executive remuneration in Australia?

Should government have a greater role in regulating remuneration?

The consequences of more closely regulating remuneration in Australia include:

- An inability of directors to fully exercise business judgment on operational matters that may be in the best interest of shareholders (see Section 9);
- Inflexible remuneration frameworks that do not cope with the great range of variability in business conditions and strategy alternatives (see Section 8.13);
- Unintended consequences that regulating components of remuneration may have on other components (see Section 10); and
- Less ability to attract migrants with executive skills and experience.

10.4. Performance measures

What types of performance measures/hurdles could be used to accurately measure performance and align interests of executives and shareholders?

It is difficult to generalise, as every company differs. In fact, one of the problems we see with executive remuneration has been the tendency of boards to approve long term performance incentive plans contingent on performance measures that are ineffective and inappropriate in some circumstances but which are utilised because they are prescribed by various governance and stakeholder groups. Relative TSR is the prime example (see Guerdon Associates commentary HERE and HERE). That relative TSR could induce risk taking received recent validation with the recently released APRA guidelines (see HERE).

In so many instances the expense could have been incurred for a LTI that

would have been more effective, i.e. that focused executives on outcomes over which they had good line of sight, and that would have directly impacted shareholder value. An example applicable to many capital intensive companies would be cash flow measures that take into account the risk adjusted cost of capital. But these sorts of measures would not be suitable for companies with primarily working capital, where simple cash earnings growth per share may be more appropriate.

The prescriptive requirements of various stakeholder groups, and held up as best practice, is one of the reasons why there tends to be more focus on short term incentives by executives than on LTIs. This can be (depending on the nature of the company) unhealthy (see Guerdon Associates commentary HERE).

The lesson from this is not to be prescriptive. Leave more to the judgment of boards. The focus can then shift away from a micro issue, such as remuneration measures, to the bigger issue of board and individual director competence. Their selection of a performance measure for reward would be one of several important indicators of this.

10.5. Gaming incentives

How can opportunities for executives to 'game' incentives be minimised?

10.5.1. Considerations

There are three aspects to consider:

1. The robustness of the performance measure;
2. The performance level required; and
3. The competence and independence of NEDs.

10.5.2. Performance measure robustness

Many boards seek performance measures that are robust. For this reason it is not uncommon for boards to rely on accounting measures that are audited. EPS growth is a common example. However, there is a growing realisation that accounting measures are not necessarily the best measures to drive shareholder value. These measures more often involve cash generation, and judgments regarding the cost of capital.

These measures are not accounting measures. Therefore they are not subject to rigorous external audit. This is of concern to most boards. But of almost equal concern is the need to have measures that drive shareholder value. The better response, as many boards are now doing, is to have these results audited by internal audit/risk management functions of the company[90]. However, to avoid conflicts of interest, many boards require these employees to

[90] To avoid conflicts of interest these functions should report to the board and/or (as the APRA guidelines on remuneration suggest), have their own remuneration subject to different factors.

report directly to the board, and be subject to a different remuneration framework.

10.5.3. Performance level

The second aspect is the performance level required. Boards generally seek the input of management, as well as external advice. Management may "sandbag" to game an easy requirement.

On the whole, however, boards arrive at a judgment of the performance level they expect, and the level of performance that they, on behalf of shareholders, will pay for. If it is too low, they will receive an appropriate response from shareholders on the remuneration report. This is a good check on the effectiveness of the board to recognise gaming. It would be even more effective with better disclosure of STI performance requirements.

As an adviser, Guerdon Associates generally works back from the market's valuation of the company down to the impact assumption of what this means for minimum performance. For example, in simple companies the net present value of future earnings and dividends should approximate the share price. This provides the growth rate required to meet market expectations. Hence this forms the basis of the minimum performance requirement before any incentive payments can be made. This method is a good check against performance level gaming.

The method suggested above is implicit in ABI remuneration guidelines[91].

10.5.4. The competence and independence of NEDs

Of all considerations, this is probably the most important. Board members need knowledge, skill, and independence to arrive at a judgment of appropriate performance requirements. It is an essential prerequisite for one of their primary purposes – to appoint and dismiss management. Without knowledge of the performance required, NEDs will not be in a position to assess candidates, nor will they be in a position to dismiss incumbents. And along the way they need to communicate their expectations and then to deliver a fair reward for the outcomes achieved to motivate and retain incumbents capable of delivering results.

[91] The ABI is the UK's most significant influence on governance matters, and their remuneration guidelines can be found HERE.

10.6. Regulatory arrangements and alignment

If current mechanisms are not serving to align the interests of the board and executives to those of shareholders and the wider community, how could regulatory arrangements and remuneration practices better secure this?

Relative to the experiences of other countries, Australia's regulatory and governance system has served well. The attributes that have contributed to this include:

- Principle based law that allows directors to focus on their duties to shareholders, and not be compliance focussed[92];
- Reasonably transparent and comprehensive disclosures;
- A shareholder non-binding vote on remuneration reports;
- Considerable flexibility allowing boards to apply remuneration arrangements that in their judgment best meet the interests of shareholders;
- ASX Governance Principles that prescribe good practice, yet allow variation on an "if not, why not?" approach;
- Remuneration frameworks that include equity as a vehicle of payment for better alignment with shareholders;
- A reasonable supply of well qualified directors; and
- A reasonable supply of well qualified executives, supplemented as required by migration.

These mechanisms do not need radical surgery. However, they can be improved by:

- Modifying disclosure requirements to indicate the intrinsic value of remuneration vested and received, and aligning this realised intrinsic value with the service period it applied to;
- Modifying some aspects of disclosure for simplification;
- Implementing the outcomes of a review of the business judgment rule to maintain the supply of well qualified directors;
- Not overriding the application of business judgment with legally prescribed remuneration methods;

[92] In contrast to US company boards, which lead to the world for arguably overgenerous executive payment.

- Requiring the disclosure of all board advisers, with a board opinion on the extent of each adviser's conflicts of interest. Amend the ASX Governance Principles to require the board to seek independent advice on an "if not, why not?" basis;

- Incorporating in the ASX Governance Principles a principle that all remuneration for an executive in any given year above a board-determined threshold must take the form of common equity vesting over a period of five to ten years following the grant date, regardless of continued employment, with any dividends paid on equity during the holding lock period to be reinvested[93];

- Reviewing announced termination provisions to include a broader definition of remuneration to ensure there are no unintended consequences impacting particular components of pay, while also considering bringing the limit requiring shareholder approval more in line with international standards for attracting potential off shore executives. In addition, consider working with the ASX Governance Council to establish a principle for termination pay requiring a lesser maximum payment than the prescribed legal maximum on an "if not, why not?" basis;

- Reviewing recent budget intent to tax all equity payments on grant rather than on unfettered receipt of a property benefit to allow remuneration frameworks to incorporate equity for better alignment with shareholders' interests;

- Considering the costs and benefits of a XBRL disclosure format for prescribed remuneration and other financial data for a more transparent comparison of these matters (supporting market efficiency in optimising performance for pay); and

- Hedging – Where remuneration in the form of equity has been earned and is not subject to further performance conditions or holding locks, it is reasonable for an executive to hedge such equity in the same way as any other shareholder. Equity remuneration subject to performance conditions or holding locks should not be allowed to be hedged as the purpose of such equity is to encourage the long term sustainable growth of the listed entity. Where a particular person is under a legal obligation to disclose their holdings, either under section 205G or ASX Listing Rule 3.19A, any hedging or borrowing arrangements in respect of shares held should be disclosed.

Are boards properly exercising their functions on behalf of shareholders?

Are they being unduly influenced by chief executive officers? If so,

[93] Regnan Remuneration Reform Policy.

why?

10.7. Chief executive influence

Executives possess relative "expert" power[94] as a result of dealing with the day to day minutiae of managing the business. Hence executives are the primary source of information, opinion and advice in running the business. This may blind some NEDs to accept at face value advice on which there is clearly a conflict of interest. The extent that this is true is evidenced by the fact that the ProNed survey mentioned in Section 7.12 found that over 33% of boards received remuneration advice only from management.

This practice is contrary to the AICD guidelines to directors on executive remuneration matters (see Guerdon Associates commentary HERE).

On the basis of the ProNed research, it can be said that on executive remuneration matters a proportion of boards do not properly exercise their functions on behalf of shareholders.

There have been few cases which indicate that boards are not properly exercising their functions on behalf of shareholders.

A well structured board should have a majority of independent directors, and within that group a mix of skills, including core industry skills of the particular entity. Where core industry skills are entrenched in management and lacking amongst the independent directors, there is a risk that the CEO, as well as other members of management, may be able to unduly influence the board.

To counter this it is essential that the board be comprised of independent directors with relevant industry knowledge and experience, remuneration knowledge and experience, and access to a source of expert and independent external advice.

10.8. Remuneration and misalignment

Are some forms of remuneration more likely than others to promote a misalignment between the interests of boards and executives and those of shareholders and the wider community?

10.8.1. Fixed versus incentive remuneration, and equity payment vehicles

The form of remuneration most likely to create misalignment is one that is comprised entirely of cash based fixed remuneration. This will encourage behaviours focused primarily on job retention. That is, incumbents will minimise risk taking in case it results in job loss, i.e. what economists call

[94] French, J. P. R. Jr., and Raven, B. (1960). The bases of social power. In D. Cartwright and A. Zander (eds.), Group dynamics (pp. 607-623). New York: Harper and Row. See HERE for a summary.

"satisficing"[95]. This is an ingredient contributing to agency costs (see Section 6.6).

Satisficing and the resulting agency costs can be alleviated by introducing performance contingent incentive pay and payment in forms of equity (e.g. shares, share rights, options, or preferably a mix of these elements tailored to the risk expectations of investors). These forms of payment require taxation to be deferred until restrictions on trading these equities cease. This is contrary to recent government budget measures.

The extent that fixed remuneration can be reduced is constrained by the need to attract and retain suitably qualified candidates, and the need to provide fixed remuneration on the understanding that it is for all the requirements of managing a business to a "satisfactory" level not directly rewarded with performance contingent incentive payments.

10.8.2. The time focus of reward

Some forms of reward focuses on short term results (e.g. cash remuneration, fixed remuneration and STIs). The excessive focus on the short term is exacerbated by the tenure expectations of executives (see Guerdon Associates commentary HERE and HERE).

A way to encourage a longer term focus is to defer bonus payments into equity (see Guerdon Associates commentary HERE). This approach is recommended by the FSF's guidelines produced for the recent G20 summit (see Guerdon Associates commentary HERE).

If taxation laws were amended along the lines recommended by Guerdon Associates, the extent of long term equity deferral, and therefore alignment with long term shareholder outcomes, will increase.

Recent government budget plans to tax equity at "acquisition" date (see Guerdon Associates commentary HERE) will negate all of these suggestions (see Section 10.2.2).

[95] Satisficing (a portmanteau of "satisfy" and "suffice") is a decision-making strategy which attempts to meet criteria for adequacy, rather than to identify an optimal solution. A satisficing strategy may often be (near) optimal if the costs of the decision-making process itself, such as the cost of obtaining complete information, are considered in the outcome calculus. See Simon, H. A. (1978). Rationality as a process and product of thought. American Economic Review, 68, 1-16.

11.Financial Institutions

In summary we recommend that there be separate treatment of financial institutions because the consequences of the failure of a financial institution are far more damaging than for other types of reporting entities.

Is it appropriate that there be separate treatment of financial institutions? If so, why and in what way?

Are there any risks from such an approach?

Are there other sectors that would require a different approach?

If a financial institution (i.e. one under APRA supervision) fails, the consequences for the wider community are far more damaging than other types of reporting entities. Financial institutions have a systemic role to play in our financial system. This is why they alone are prudentially regulated. This was seen with the collapse in 2001 of insurance company HIH Limited and with the recent steps taken by the Australian and other governments to ensure the survival of major financial institutions. In HIH, many policyholders receiving long term insurance payouts were affected as was the domestic building industry with the collapse of domestic builders warranty insurance.

Personnel of financial institutions responsible for financial and risk control require special attention because of a potential conflict between their own interests and the interests of executives, on the one hand, and others whose financial and risk performance they are required to assess, on the other.

Financial and risk control personnel of a regulated institution play a vital role in ensuring the integrity of controls throughout the institution.

Given the importance of effective alignment of remuneration with prudent risk-taking, institutions need to rely on internal controls and proper measurement of performance. Financial and risk control personnel need remuneration arrangements that avoid compromising their role. Accordingly, the remuneration of financial and risk control personnel needs to be determined independently from the business areas they oversee and independently from any bonus arrangements associated with these business areas.

This logic could also be applied to executives of non-financial entities who are also responsible for risk and compliance issues.

These and other aspects associated with remuneration in financial regulated institutions have been assessed and reported on by others, in particular the FSF. The FSF's remuneration principles were supported by the G20 (see Guerdon Associates commentary HERE).

12.International developments

In summary we recommend that executive remuneration should not be regulated further in Australia in light of the example in the US where regulations have failed to effectively deal with issues surrounding executive remuneration.

Are there any international approaches particularly applicable to Australia?

Are there particular lessons for Australia from international approaches and experience — both successes and failures?

12.1. An example of what not to do

Probably what is most instructive are examples of regulation gone wrong. The most instructive, and in our collective opinion the source of all global problems associated with executive pay, is US regulation:

1. Boards are not nominated and elected by shareholders, and lack accountability;
2. There are no avenues, either through director nomination and election, or a vote on remuneration, that shareholders can indicate their views; and
3. Taxation has been used as a blunt instrument on components of pay, driving unintended consequences for termination payment practices, excessive use of options and excessive risk taking.

In contrast, Australia has been relatively unencumbered, until recently, with regulation on components of remuneration, and directors are directly accountable to shareholders via elections and voting requirements on remuneration reports and director new equity grants.

Where regulation has been present on components of remuneration, it has resulted in undesirable outcomes. For example, the taxation of equity at cessation of employment contributes to excessive risk taking as retirement approaches with no accountability for the consequences post employment.

The outcomes, in a relative sense, have been very good. Since the explosion of US executive pay in the US in the early 1990s:

- Australian shares have delivered above average returns for lower volatility;
- Australian executive pay is more performance focussed than most countries; and
- Australian absolute executive pay levels are among the most modest in the OECD, and about the median of global rates for developing and developed nations.

However, Australia is not immune from international developments. Until the USA gets its own house in order (see Guerdon Associates commentary HERE),

aspects of executive remuneration management will not be ideal.

Appendix A
List of Questions

No	Question	Section
	What is an appropriate definition of 'remuneration'?	6.2
	What aspects or elements of remuneration should be included?	6.2
	To what extent do external performance indicators 'net out' underlying market growth factors from entrepreneurial and managerial performance?	6.6
	How are levels of director and executive remuneration determined?	7.2
	What constraints exist, and what is the market's role in determining remuneration levels?	7.9
	What are the major drivers of negotiated outcomes?	7.12
	Have they changed over time?	7.12
	What growth in the level of director and executive remuneration has taken place over recent decades, both within Australia and internationally?	7.13
	What factors contributed to this growth?	7.15
	Have increases over recent years been justified?	7.15
	Has the experience differed across different industries or sectors of the economy?	7.15
	Is there any relationship between director and executive remuneration, and the remuneration of other company employees?	7.16
	How important are relativities between executives and other employees?	7.16
	Are there flow-on effects from executives to other employees?	7.17
	Do big disparities serve to motivate or de-motivate other employees?	7.18
	Are current director and executive remuneration levels justified?	7.19
	Have increases in recent years been justified?	7.19
	How should the Commission determine what is 'justified' – what tests should be applied?	7.20
	What relationship exists between levels of remuneration and individual and corporate performance?	7.21.1
	What relationship exists between the structure of remuneration and individual and corporate performance?	7.21.1
	To what extent are remuneration levels required to generate an adequate supply of suitable directors and executives; that is, are they primarily aimed at hiring and retaining the right person, rather than influencing their performance?	7.21.3
	What are the key drivers of performance for directors and executives?	7.21.4

No	Question	Section
	Are there factors other than remuneration that influence performance?	7.21.4
	What relationship exists between the structure of remuneration and individual and corporate performance?	7.21.4
	What changes have taken place in the type and structure of remuneration over recent decades?	7.22.1
	What has driven these changes?	7.22.1
	Have changes to the structure of remuneration resulted in inappropriate risk-taking or other forms of director and executive behaviour inconsistent with the interests of the company?	7.22.2
	Are particular types of remuneration more likely to produce these outcomes?	7.22.2
	Has the experience differed across sectors (for example, the finance sector relative to other areas of business)?	7.22.2
	What relationship exists between the structure of remuneration and individual and corporate performance?	7.22.2
	Who should determine what is an appropriate level of risk-taking or an appropriate corporate strategy, and how should this be done?	7.22.3
	Why and/or when are the dealings between shareholders and companies on remuneration issues a matter of public interest?	7.22.3
	What arguments, for and against, are there for linking remuneration and the share price?	7.22.3
	Given that it is ultimately the responsibility of the board to engage a managing director and other key executives, including associated terms and conditions, what changes would assist the board in fulfilling this role, consistent with shareholder interests?	8.3
	How effective are arrangements for director and executive remuneration under the Corporations Act and ASC listing rules and guidelines?	8.4
	Do arrangements provide sufficient transparency and accountability on remuneration arrangements and practices?	8.4
	How might transparency be increased, and what might be the impacts of this?	8.7
	Are the current disclosure requirements in the remuneration report too complex?	8.10
	Is the coverage of executives in the remuneration report appropriate?	8.12 and 2 of Appendix B
	Would shareholders benefit from access to readily accessible, consolidated information, on director and executive remuneration?	8.12

No	Question	Section
	Are there other useful data sources on director and executive remuneration over time?	8.12
	Is there an appropriate balance between legislated requirements and voluntary guidelines?	8.13
	What is the role of voluntary guidelines in governance of director and executive remuneration?	8.13
	Are there any voluntary, good practice guidelines or codes applying internationally that may be of interest in an Australian context?	8.14
	Should Australia consider the adoption of a code of practice?	8.14
	Is the case for regulation stronger where government is an active participant in company activities, for example through the use of taxpayer funds to bailout companies in financial difficulty or through other ongoing support activities?	8.14
	To what extent have remuneration committees been used in Australia?	8.15
	What effects have remuneration committees had on the linkage between remuneration levels and individual and corporate performance?	8.15
	Do conflicts of interest arise in the arrangements by which remuneration consultants advise on director and executive remuneration?	8.16
	If so, how significant are they and how might they be addressed?	8.16
	What degree of influence should shareholders have in their own right in determining remuneration practices?	9
	Do current regulatory arrangements enable shareholders to be adequately involved? If not, why not?	9
	Does the current non-binding vote require strengthening?	9
	Is it appropriate for directors and executives that are named in the remuneration report, and who hold shares in the company, to be able to participate in the non-binding vote?	9
	To what extent have large institutional investors used their voting rights to influence remuneration practices and other areas where they have voting powers?	9
	In what aspects of remuneration practices and setting remuneration levels would it be appropriate to increase shareholder involvement?	9
	Are there areas where their rights should be strengthened?	9
	Does institutional voting typically align with the broader interests of shareholders?	9
	How would this be best achieved – without, for example, diluting the intended function of the board in engaging the managing director/chief executive officer?	9

No	Question	Section
	Are taxation considerations, either from the company's or executive's perspective, driving the design of remuneration packages?	10.1
	If so, what changes are required?	10.1
	To what extent do current taxation arrangements influence the level and structure of executive remuneration?	10.1
	How should bonuses be treated for taxation purposes?	10.2
	To what extent should bonuses be an allowable tax deduction for companies?	10.2
	Should bonuses be subject to special/higher taxation rates?	10.2
	What evidence or examples indicate that the interests of boards and executives may not be adequately aligned with those of shareholders and the wider community?	10.3
	What factors have contributed to any misalignment?	10.3
	What are the interests of the wider community in relation to director and executive remuneration within a company?	10.3
	To what extent do the interests of shareholders and the wider community align?	10.3
	In what circumstances will they not be aligned?	10.3
	Can cost cutting by companies, including by sacking workers, align with the public interest?	10.3
	Is it reasonable to reward executives for actions that promote shareholder interests but which may not align with the public interest?	10.3
	What are the costs and benefits of any options/ mechanisms to more closely align the interest of boards and executives with those of shareholders and the wider community?	10.3
	What could be some unintended consequences of limiting or more closely regulating executive remuneration in Australia?	10.3
	What could be some unintended consequences of limiting or more closely regulating executive remuneration in Australia?	10.3 and 2.3 Appendix B
	Should government have a greater role in regulating remuneration?	10.3
	What types of performance measures/hurdles could be used to accurately measure performance and align interests of executives and shareholders?	10.4
	How can opportunities for executives to 'game' incentives be minimised?	10.5
	If current mechanisms are not serving to align the interests of the board and executives to those of shareholders and the wider community, how could regulatory arrangements and remuneration practices better secure this?	10.6

No	Question	Section
	Are boards properly exercising their functions on behalf of shareholders?	10.7
	Are they being unduly influenced by chief executive officers? If so, why?	10.7
	Are some forms of remuneration more likely than others to promote a misalignment between the interests of boards and executives and those of shareholders and the wider community?	10.8
	Is it appropriate that there be separate treatment of financial institutions?	11
	If so, why and in what way?	11
	Are there any risks from such an approach?	11
	Are there other sectors that would require a different approach?	11
	Are there any international approaches particularly applicable to Australia?	12
	Are there particular lessons for Australia from international approaches and experience — both successes and failures?	12
	What is an appropriate definition of 'executive'?	2 Appendix B
	Does the remuneration report required under the Corporations Act and its coverage of key management personnel provide a suitable definition?	2 Appendix B
	Should the Commission's coverage of executives go beyond this, and if so, why?	2 Appendix B
	How should 'corporate performance' and 'individual performance' be defined?	3 Appendix B
	Is it possible to define them in general terms that are applicable across most businesses?	3 Appendix B
	Or is transparency in performance hurdles for incentive payments the more important issue?	3 Appendix B

Appendix B
Definitions

13.Remuneration

Throughout this submission there are references to components of remuneration. These components do not feature in accounting or legal definitions. However, they are the most frequently used concepts applied in the management and review of remuneration in Australian companies.

These are defined below.

13.1. Fixed Remuneration

Refers to the sum of the annual cost of all elements of remuneration attributed to an employee that do not vary with performance.

Payment vehicles may include the cost of salary, fringe benefits and any associated FBT, shares, options, share rights, superannuation and other non-monetary benefits.

By cost we mean the expensed cost to the organisation under the Australian accounting standards, not the cash cost or the value as may be measured by the recipient.

13.2. Short term incentive

Refers to the sum of remuneration annual costs incurred that are attributed to an employee for performance measured over a period of one year. Payment vehicles may include cash, fringe benefits and the associated FBT, shares, options, share rights, superannuation and other non-monetary benefits.

The key aspect in determining whether a payment is an STI is a performance requirement covering a period of a year or less.

By cost we mean the expensed cost to the organisation under the Australian accounting standards.

13.3. Long term incentive

Refers to the sum of annual remuneration costs attributed to an employee for performance measured over a period of greater than one year.

Payment vehicles may include the cost of cash, fringe benefits and the associated FBT, shares, options, share rights, superannuation and other non-monetary benefits.

The most common forms of payment are share rights (often referred to as performance rights), options, shares and cash.

It is a common mistake to assume all forms of equity payment (e.g. share rights and options) are LTIs. This is not the case.

The key aspect in determining whether a payment is a LTI is a performance requirement covering a period greater than a year.

By cost we mean the expensed cost to the organisation under the Australian accounting standards.

13.4. Total Remuneration

The sum of the above elements (i.e. fixed remuneration, STI and LTI).

13.5. Total Compensation

Under Australian accounting standards, this is the total remuneration plus any special termination payments.

13.6. Realised Remuneration

Realised remuneration refers to all remuneration received that is an unrestricted benefit. This may include:

- Salary, fringe benefits, and superannuation;
- Cash bonus in the hand; and
- Vested equity.

The value of the vested equity component is its intrinsic value. That is, the difference between the market price that it could be sold for at the time of vesting and any payment owed by the executive to fully redeem this value (e.g. an exercise price on an option).

14.Executive

What is an appropriate definition of 'executive'?

Does the remuneration report required under the Corporations Act and its coverage of key management personnel provide a suitable definition?

Is the coverage of executives in the remuneration report appropriate?

Should the Commission's coverage of executives go beyond this, and if so, why?

14.1. Existing definitions

The Corporations Act contains a number of definitions relating to persons to whom the function of managing companies has been delegated. The following existing definitions are used[96]:

Definition	Where used
'**director**' which refers to the fiduciaries charged with managing a company on behalf of its shareholders.	• In the remuneration report provisions, included as part of the key management personnel. • Also used throughout the Corporations Act, including in Division 2 of Part 2D.2 (Termination Payments), Division 2 of Part 2D.3 (Remuneration of Directors) and Part 2D.5 (Public information about directors).
'**senior manager**', which for a company includes persons that make decisions that affect the whole, or a substantial part of the company's business, or have the capacity to significantly affect its financial standing. Directors and secretaries are not included.	In the remuneration report provisions, 'company executives' and 'relevant group executives' include senior managers and secretaries, but not directors.
'**company executive**' includes senior managers and secretaries.	This definition is used in determining disclosures in the remuneration report (the top five by remuneration must be disclosed if there is no group).
'**group executive**' (being directors, secretaries, and senior managers for entities in the group, with additional persons for partnerships and trusts) and '**relevant group executive**', which are group executives that are not directors of the parent preparing the report)	This definition is used in determining disclosures in the remuneration report (the top five by remuneration must be disclosed for the group).

[96] Another key definition under the Corporations Act is "officer". It is not used in the remuneration report and perhaps to reduce the number of definitions in the Corporations Act, consideration could be made to use this term in section 300A.

Definition	Where used
'**key management personnel**' which is a definition originating from AASB 124 and includes: *those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.*	This definition is used in determining disclosures in the remuneration report (all must be disclosed for the group).
'**secretary**' – the secretary is included in 'company executive' and 'group executive'.	The related definitions are used in determining disclosures in the remuneration report.

14.2. Current definitions are complex and confusing

There is significant complexity in the above definitions. While it is appropriate that different descriptions are used for different purposes, it seems to us that there are too many different definitions used which create confusion and complexity.

Complexity and variety make it more difficult to prepare remuneration reports, because those drafting them continually need to trace through who is to be included or excluded with respect to a particular matter when differing terms are used. It also makes understanding remuneration reports more difficult.

The current scope of executives subject to the disclosures required in the remuneration report is set by:

- the 'key management personnel', a concept set by the accounting standards which includes directors; and
- the 5 highest remunerated relevant group executives or company executives, which include senior managers and secretaries.

This draws on the legal concepts of directors and senior managers, while also drawing on the accounting standards concept of 'key management personnel'. It is not clear to us that the practical outcome is enhanced by referring to all these concepts.

We also query whether requiring disclosure by reference to a particular number of executives is helpful for investors. The vast difference in the nature and scale of companies suggest that an absolute number may not be appropriate.

For example, a small listed mining exploration company may have only 10 staff members, some of whom are technical experts and not strategic managers, and only two or three executives (such as the CEO, CFO and company secretary) who have strategic responsibilities. By contrast a large company with a complex business and several significant offices or business centres would be in a different position entirely.

While we are therefore calling for some change, we also note that the definitions used in section 300A have changed frequently in the relatively short history of the provision. It is not desirable for this area of the law to be in a constant state of flux. Such change causes real cost to those preparing reports and makes it very difficult for readers to compare the content in reports from year to year, even for the same company.

14.3. The use of accounting standards

What could be some unintended consequences of limiting or more closely regulating executive remuneration in Australia?

There is a fundamental issue as to whether the law should rely on accounting standards for setting boundaries for behaviour and disclosure beyond the area of financial reporting.

The recent move towards greater reliance on accounting standards is often explained in terms of convenience and consistency with financial reporting obligations. However, in effect this enlarges the de facto lawmaking function of the AASB. It makes the AASB responsible for any changes to the scope of the disclosure (and potentially other) obligations that stem from this definition. It also creates the potential for frequent changes in legal requirements as accounting standards change.

The accounting standards are set for the purposes of ensuring the integrity of financial information. Where legal definitions relate to the construction of financial matters it may well be entirely appropriate, at least in certain circumstances, to rely on accounting standards alone to define relevant concepts.

The remuneration report serves a different purpose to the financial report. There is overlap between the two concepts, in that both contain financial information. However, it seems to us that the primary purpose of the remuneration report is to disclose three different elements: remuneration policies, remuneration practices and certain identified payments (or other benefits) received by executives in performing their role. Only the last of these items is a financial question. Even in relation to the financial question, the purpose of the disclosure (to inform stakeholders) differs from the company's purpose in assessing financial information from its own perspective.

We submit that it is unlikely that the AASB is best placed to be the source of certain definitions, and to help determine the disclosure rules and limits. It is acknowledged that the financial integrity of the remuneration report is important, and the accounting standards may assist with that[97], but the question of scope of disclosure is quite different.

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[97] In addition, it is acknowledged that now many other OECD countries have remuneration disclosure reference to accounting standards to some degree, allowing international comparison. But there are important exceptions. For example, Canada departs from accounting standards in the reporting of equity grant value.

An example of the regulatory challenges raised by changes to accounting standards is the recent move from AASB 1046 (Director and Executive Disclosures by Disclosing Entities) to AASB 124 (Related Party Disclosures). In December 2005, the AASB revised accounting standards AASB 124 to include certain disclosure requirements previously contained in AASB 1046 and as a result, AASB 1046 has been withdrawn. The revised standards are applicable for annual reporting periods ending on or after 31 December 2005.

When AASB 1046 was replaced by AASB 124, Regulation 2M.6.04 and Schedule 5B to the Corporations Regulations (which allowed the transfer of remuneration information required by AASB 1046 into the director's report) ceased to be effective. As a result, listed companies were no longer able to combine the remuneration disclosures required by accounting standards with those already required to be included in the directors' report under section 300A of the Corporations Act and reduce the duplication of remuneration information between the directors' report and the financial report.

To remedy this, ASIC issued class order relief on an interim basis on similar terms to the above regulations to allow listed companies preparing financial reports to transfer remuneration information required to be disclosed in the financial report under accounting standard AASB 124 into the directors' report[98]. However, ASIC did not provide relief to allow remuneration under section 300A to be calculated in accordance with AASB 124 rather than AASB 1046. In declining to give that relief, ASIC noted that:

> *"AASB 124 contains substantially reduced requirements and guidance on calculating remuneration. Any ASIC relief could be inconsistent with the intent of Regulation 2M.3.03 in the absence of a new source of requirements or guidance on calculating remuneration."*[99]

ASIC considered that a substantive change in the law had been effected by the change in accounting standards, and did not consider it appropriate to change that law without input from the appropriate lawmaker.

The above example demonstrates that referring to accounting standards may cause unintended changes to the legal regime relating to executive remuneration. We do not think that accounting standards are useful in determining what disclosure investors require, and more broadly how executive remuneration is regulated as, by definition, the AASB is solely concerned with the accounting aspect of executive remuneration.

The reference to accounting standards may also impact the consistency of disclosure as changes to the standards may result in frequent changes to

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[98] ASIC Class Order 06/50 (Transfer of remuneration information into directors' report) (see Class Order HERE).

[99] ASIC Media Release IR-06-03 'ASIC Relief on Remuneration Disclosures (see release HERE).

disclosure year on year. It would be easier for shareholders to follow and compare disclosures if they tended to be consistent.

This issue is of some importance in connection with the proposed use of the accounting standard definitions for purposes that do not relate to financial disclosure under the draft Corporations Amendment (improving accountability on termination payments) Bill 2009.

In particular, we submit that it would not be appropriate to use accounting standards to define whose remuneration is regulated and to whom a cap should apply.

There is a significant risk that changes made by the AASB will give rise to unintended legal consequences even if they are appropriate for accounting purposes. By referring to the standards, standard setters may make entirely appropriate changes to financial disclosure, but have knock on consequences elsewhere. The AASB cannot be expected to consider those other consequences, as its task is dedicated to financial disclosure and the integrity of financial reports.

14.4. Comments on 'key management personnel'

The concept of 'key management personnel' (as set out in AASB 124) currently defines the persons about whom certain disclosures on remuneration must be made.

We can see merit in there being disclosure in the remuneration report around the remuneration policies that apply to the people that are responsible for the financial and operational performance and risk management of the organisation. Remuneration policies need to be balanced in rewarding good performance in each of those areas. Therefore, it is important for investors to understand how remuneration is set and the incentive and performance measures taken into account in judging performance.

15.Performance

How should 'corporate performance' and 'individual performance' be defined?

Is it possible to define them in general terms that are applicable across most businesses?

Or is transparency in performance hurdles for incentive payments the more important issue?

15.1. Defining performance

According to the Encarta® World English Dictionary[100], "performance" in an employee sense could mean:

1. The manner in which somebody functions, operates, or behaves;
2. The effectiveness of the way somebody does his or her job;
3. Something that is carried out or accomplished; and
4. The performing of something, for example, a task or action.

In an executive remuneration context, performance is generally assessed in terms of the 2nd and 3rd definition above. The evidence of performance for the 2nd definition is the measurement of outcomes in an absolute and/or relative sense over a specified period. That is, the change in earnings achieved over a year or the ranking of the company on TSR relative to other companies over 3 years.

The 1st definition rarely explicitly appears as an input into executive reward outcomes, although is frequently applied to other employees. For example, it is common for employees to be dismissed if they carry out their function in an unsafe manner in a hazardous industry. Nevertheless, it has been applied explicitly at executive level on some occasions.[101]

The extent that this definition is applied to determine executive reward is likely to increase as a result of recent APRA regulation. The regulation explicitly requires boards to exercise discretion to adjust reward outcomes if other performance outcomes were achieved in a manner that constituted unacceptable risk. This may mean not complying fully with risk policies or procedures.[102] This may also be applied "after the fact" to payment of reward under definitions 2 and 3 above if a component of the reward was deferred under a "clawback" policy.

We expect a growth trend in the extent of "negative discretion" clawback being applied to modify performance pay outcomes in non APRA regulated companies as governance and shareholder groups move to incorporate aspects of APRA regulation into their own guidelines.

15.2. Corporate and Individual Performance

Both corporate and individual performance can be defined using the same definitions.

16.Transparency

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[100] © 1999 Microsoft Corporation.

[101] Boeing Co. forced its chief executive to resign in March 2005 after an investigation uncovered that he had an affair with a female employee. See article HERE.

102 See a synopsis and links to the APRA documents HERE.

Is transparency in performance hurdles for incentive payments the more important issue?

16.1. The issue of measurement and the components of performance

While performance can be defined as per the above, the key points of contention in executive reward matters are the required:

- eligibility requirements;
- performance and service periods;
- measurement, measurement threshold for payment;
- measurement calibration; and
- payment vehicle.

These distinct requirements are often referred to separately or together as "performance hurdles". Typically, only a few of these elements are disclosed clearly and transparently. The remaining elements are not reported, or are reported in a manner that is opaque at best.

This is not helpful to shareholders required to vote on remuneration reports and equity grants to directors. More clarity is required.

Definitions of these elements are provided below.

16.2. Eligibility requirements

Many companies fail to disclose who is eligible for the performance payment.

16.3. Performance and service period

Performance is usually required over a specific period.[103] This is typically 1 year for a STI and 3, 4 or 5 years for a LTI.[104]

The service period before payment could differ from the performance period. This will become more common as APRA regulated companies defer payment until some time has elapsed after the end of the performance period to ensure

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[103] On rare occasions, it can be a period "up to" as opposed to "over". In Australia this is most commonly found in start up companies in biotech or mining, but may also be relevant to more established companies undergoing major transformation. For example, a reward may be contingent on a new mining company developing an ore deposit and receiving its first commercial payment for shipped ore. The sooner this is achieved for its subscribed capital, the better the return for investors. But after a certain prescribed time, the investment returns will be negative. The sooner it is shipped the bigger and sooner the reward. Hence the performance period is up to the point at which shareholders' returns are negative. See Guerdon Associates commentary HERE.

[104] There will be an increase (again as a result of APRA regulation) in "hybrid" plans with two performance periods. That is, a deferred payment for one year performance (a STI), with the payment of the deferred amount contingent on an assessment of the performance sustainability achieved in that year over subsequent periods. We would still label these plans STIs, because the driver of reward is the initial 1 year performance outcome.

that the outcome on which the payment was based does not change with experience.[105]

There may be circumstances where the service period is less than the performance period. This applies to executives subject to a performance period that extends beyond their termination of employment (usually through retirement). This allows the executive's final reward to reflect their accountability for decisions taken on their watch (see Guerdon Associates commentary HERE and HERE for a further explanation of this rationale).

It is important to understand the performance period over which reward is delivered. Arguably, rewards that are only contingent on an assessment of annual performance is inappropriate for an energy company executive who decides on capital expenditure based on a 30 year cash flow that it would generate. Likewise, a reward contingent on 3 year performance only would be inappropriate to an executive in a fashion retailer that can become insolvent through poor buying decisions for fashion wear with a three or 6 month cycle.

16.4. Measurement

Measurement refers to the standard adopted for assessing performance. Examples include the annual percentage growth in EBIT, the percentile rank of the company's TSR relative to a defined set of other companies over three years, or lost time injury frequency rate per hundred thousand workforce hours over a year.

It is important to understand the measure. Relative TSR is inappropriate for rewarding decisions when the comparison companies are not direct competitors. Annual EBIT growth is inappropriate as the only reward measure if it encourages acquisitions and does not take into account dilution of capital or sustainable debt levels.

16.5. Measurement threshold

The threshold for payment is the level on this measure to be attained before a reward is earned. Examples include 10% annual EBIT growth, the 50th percentile relative TSR, or 3 lost time injuries per hundred thousand hours in a year.

The threshold could be too easy if the executive receives a reward and shareholders lose value. Likewise it could be too hard, where it fails to motivate the executive to do anything but find a job elsewhere where the expectations are fairer and more reasonable.

[105] E.g. actual bad debts incurred compared to the allowance for bad debts in the accounts.

16.6. Measurement calibration

The calibration refers to the relationship between improvement above the threshold and the level of additional reward earned. An example may include $200,000 on attaining the threshold and pro-rated payment up to a maximum incentive reward of $400,000 for attaining or exceeding maximum performance under the scale.[106]

As with the prior example, the calibration can either be too easy or too difficult.

16.7. Payment vehicle

Payment vehicle refers to the form of payment. This is important because it may have secondary impacts on behaviour. Typical payment vehicles may include one or more of cash, shares, share rights, options, share appreciation rights or shadow shares.

[106] There are more complex variations and formula, depending on the priorities and strategies of the business.

Appendix C
Terms of Reference

The Productivity Commission (the Commission) is asked to undertake an inquiry into the current Australian regulatory framework around remuneration of directors and executives, as it applies to companies which are disclosing entities regulated under the *Corporations Act 2001* and report within nine months of the date of receipt of this reference.

This review is intended to complement the work already underway in relation to executive remuneration practices by regulated financial institutions. Last year, the Prime Minister announced that the Australian Prudential Regulation Authority would develop a template that links capital adequacy requirements to executive remuneration practices in order to limit excessive risk taking in financial institutions.

Background

The remuneration of company directors and executives is an issue which has attracted considerable interest from shareholders, business groups and the wider community. Concerns have been raised over excessive remuneration practices, particularly as we face almost unprecedented turmoil in global financial and equity markets.

The current global financial crisis has highlighted the importance of ensuring that remuneration packages are appropriately structured and do not reward excessive risk taking or promote corporate greed. The crisis has also highlighted the need to maintain a robust regulatory framework that promotes transparency and accountability on remuneration practices, and better aligns the interests of shareholders and the community with the performance and reward structures of Australia's corporate directors and executives.

It is also important to recognise that internationally competitive reward structures for company directors and executives continue to provide incentives for directors and executives to assume leadership responsibilities within corporations.

Internationally, remuneration practices have been raised by various forums as a contributing factor to the global financial crisis. The Group of Twenty (G-20) and the FSF are both examining remuneration issues to ensure effective governance and oversight of executive remuneration is part of their responses to the crisis. In addition, the United Kingdom and the United States have imposed conditions on remuneration for entities that have received the benefit of recent corporate bailouts and government assistance packages.

Scope of the Review

In undertaking the review the Commission should:

1. Consider trends in director and executive remuneration in Australia and internationally, including among other things, the growth in levels of remuneration, the types of remuneration being paid, including salary, short-term, long term and equity-based payments and termination benefits and the relationship between remuneration packages and corporate performance.

2. Consider the effectiveness of the existing framework for the oversight, accountability and transparency of director and executive remuneration practices in Australia including:

   - the role, structure and content of remuneration disclosure and reporting;
   - the scope of who should be the subject of remuneration disclosure, reporting and approval;
   - the role of boards and board committees in developing and approving remuneration packages;
   - the role of executives in considering and approving remuneration packages;
   - the role of other stakeholders, including shareholders, in the remuneration process;
   - the role of, and regulatory regime governing, termination benefits;
   - the role of, and regulatory regime governing, remuneration consultants, including any possible conflicts of interest;
   - the issue of non-recourse loans used as part of executive remuneration; and
   - the role of non-regulatory industry guidelines and codes of practice.

3. Consider, in light of the presence of large local institutional shareholders in Australia, such as superannuation funds, and the prevalence of retail shareholders, the role of such investors in the development, setting, reporting and consideration of remuneration practices.

4. Consider any mechanisms that would better align the interests of boards and executives with those of shareholders and the wider community, including but not limited to:

   - the role of equity-based payments and incentive schemes;
   - the source and approval processes for equity-based payments;
   - the role played by the tax treatment of equity-based remuneration;
   - the role of accelerated equity vesting arrangements; and
   - the use of hedging over incentive remuneration.

5. Consider the effectiveness of the international responses to remuneration issues arising from the global financial crisis, and their potential applicability to Australian circumstances.

6. Liaise with the Australia's Future Tax System Review and the Australian Prudential Regulation Authority in relation to, respectively, any taxation and financial sector remuneration issues arising out of this Review.

7. Make recommendations as to how the existing framework governing remuneration practices in Australia could be improved.

The Commission is to undertake an appropriate public consultation process including the invitation of public submissions.

Chris Bowen
Assistant Treasurer

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Appendix D
Examples of poor remuneration structures and policies

CGI Glass Lewis has identified the following examples of poor remuneration structures and policies.

17.Oxiana Limited

17.1. Background

Mr. Hegarty was appointed CEO of Oxiana Limited (the Company) in September, 1994. On 3 March 2008, the Company announced that Mr. Hegarty had agreed to stand aside as managing director and CEO and to become a non-executive director. This was to allow Andrew Michelmore to assume the role to facilitate the merger of the Company with Zinifex Limited (to create OZ Minerals Limited).

In July, 2008 the Company submitted for shareholder approval the following proposal with respect to Mr. Hegarty's termination benefits:

- Salary

  1. A$2.3 million cash to be paid out in full for the duration of the current contract of his employment (20 June, 2008 to 31 December, 2008);

- Short term incentive

  2. A$1.5 million cash short term incentive covering the period from 1 January, 2008 until the end of the contract at 31 December 2008. This payment was proposed on the basis that Mr. Hegarty would have met performance targets and objectives for that period.

- Retention payments

  3. A$0.16 million cash as a retention/transition payment in recognition of Mr. Hegarty agreeing to fill the role of chairman of the integration sub-committee of the board in accordance with the merger implementation agreement. The committee was expected to operate from June to December 2008.

  4. 250,000 shares to the value of A$0.765 million to vest on 18 July 2008 (originally to vest on 1 January, 2009)

  5. 250,000 shares to the value of A$0.753 million to vest on 18 July, 2008 (originally to vest on 1 January 2010)

- Long term incentive

6. The unvested options granted in accordance with Mr. Hegarty's contract of employment to be paid out in cash as follows:

    a. A$1.588 million being the estimated value of 2 million options granted on 2 May 2007, which were due to vest on 1 June 2010;

    b. A$1.71 million being the estimated value of 2 million options granted on 18 April, 2008, which were due to vest on 1 June 2011;

    c. A$1.93 million being the estimated value of 2 million options to be granted in April 2009 and due to vest in June 2012.

The entire termination package totaled A$10,660,600.

The Company's 2007 remuneration report, which was issued in April 2008 had stated:

> "On early termination by the employer the Managing Director would receive accrued entitlements up to the date of termination plus the value of the base salary and superannuation component for one month per year of completed service plus three months in lieu of notice."

The payments that shareholders were asked to approve, in July 2008 were well above the Company's stated termination policy. The explanatory notes for the termination payment did not provide a cogent explanation for the significant divergence from stated policy.

It is generally accepted practice for short and long term incentives to vest on a pro-rata basis based on time and performance conditions to the date of termination.

The explanatory notes stated "The cash payments recognized that in relinquishing his role, Mr. Hegarty has given up considerable value he would have reasonably expected to receive in the future by virtue of his continued employment as Managing Director and CEO of the Company".

We recognize that, as a NED, Mr. Hegarty would receive considerably less remuneration than if he remained as an executive.

In our view, however to assume that all options granted and those scheduled to be granted would vest is a very bold assumption. Further, to cash out the value of the options removes the risk that, if the strategy put forward by Mr. Hegarty, i.e. the merger of Oxiana Limited and Zinifex Limited, failed, Mr. Hegarty would not suffer as he would have received cash.

The directors withdrew the proposal before the general meeting. The following is from an announcement of July 18 2008, by the Company to the ASX:

"It was clear to the Board based on proxies which had been lodged prior to the meeting that shareholders would decline to support the payment to Mr. Hegarty of the termination payments set out in the Notice of General Meeting. The Board therefore decided after consultation with Mr. Hegarty, to withdraw the Resolution.

The Board of the Company will carefully consider feedback from shareholders and obtain further advice before deciding how best to proceed with respect to the payment of termination benefits to Mr. Hegarty.

The Board will act in the best interests of the Company and, consistent with that duty, will look to treat Mr. Hegarty fairly in the circumstances. The Company will keep shareholders informed as appropriate. "

17.2. Outcome

On 21 August, 2008 the Company (now the merged OZ Minerals Limited) announced that it had finalised the benefits and entitlements to be paid to Mr. Hegarty in connection with his retirement as CEO and Managing Director of Oxiana. The announcement stated:

"In accordance with his contractual arrangements, Mr Hegarty will receive a payment equal to 6 months' of his remuneration, together with all accrued and statutory entitlements.

Additionally, the Board has determined that it is appropriate to make an ex-gratia payment to Mr Hegarty of $8.35 million. The ex gratia payment recognises Mr Hegarty's outstanding contribution to Oxiana's growth and success over the fourteen years since 1994 and his salary compensation in recent years relative to his peers.

All of Mr Hegarty's unvested options under the Company's long term incentive program (amounting to approximately 4 million), lapse and are therefore of no value. Mr Hegarty will not receive any short term incentive payments or further equity grants in the form of retention shares. "

The announcement failed to disclose the basis of the calculation of the A$8.35 million ex gratia payment.

At the time of the merger, Mr. Hegarty held just under 1% of the issued shares of the newly merged entity.

At the time of the merger the share price of the newly merged entity was around A$1.75. Within six months the share price had fallen to around A$0.24 or 86%.

17.3. Key Issues

- The board failed to provide shareholders with a cogent explanation for the substantial cash termination benefit paid to Mr. Hegarty (particularly having regard to the significant deterioration in the share price).
- Further, the retirement benefit was not significantly below the amount mooted in July which had met with strong shareholder opposition.

18.Toll Holdings

18.1. Background

On 13 December, 2006, Toll Holdings (Toll) announced a restructuring initiative to separate Toll's transport infrastructure assets from its network and supply chain business. Toll proposed to establish two ASX listed entities, Toll and Asciana Limited (Asciano), with the goal of maximizing shareholder value and positioning each company for growth.

Toll held a general meeting in May, 2007 to seek shareholder approval for the demerger proposal. As part of the meeting there were a number of proposals seeking shareholder approval for termination benefits to be paid to Toll executive directors and executives as well as an Asciano executive director and executive.

The scheme booklet disclosed the following information:

> "If the Schemes are approved, Toll will pay to the senior executives, in lieu of the Options [not issued in respect of 2006], a deferred compensation payment (based on an independent valuation of the Options) which will become payable if the executive remains in the employment of Toll or Asciano (as the case may be) for a period of 12 months from the Effective Date [5 June 2007], or if the executive's employment terminates within that 12 month period other than by the executive's resignation or summary dismissal. The estimated amount of deferred compensation payments payable has been included in the estimated transaction costs identified in Section 5.3. As part of the Restructure, Asciano will assume the liability to pay the deferred compensation payments in relation to executives who transfer to Asciano; "

18.2. Outcome

The 2007 Toll annual report disclosed deferred compensation for the following executive directors:

- Paul Little A$8,857,000
- Mark Rowsthorn A$8,857,000
- Neil Chatfield A$5,197,000

18.3. Key Issues

- The 2007 annual report discloses that the executive directors have received deferred compensation as approved by shareholders at the 2007 general meeting and the amount received by each. The 2007 remuneration report fails to disclosure the rationale behind the quantum, in particular the component relating to the valuation of the options.
- Prima facie, the executives received cash payments based on assumptions made in early 2007 that had no bearing of the Company's performance since the strategy proposed by management was put to and approved by shareholders. The success of that strategy has also been questioned.

19.Asciano Limited

19.1. Background

The Company commenced trading as a separate listed entity from Toll in June 2007.

The 2008 remuneration report discloses that the short term incentive for 2008 was based primarily on earnings before interest, tax, depreciation and amortization (EBITDA) target set by the board. It was the board's view that EBITDA is one of Asciano's key financial metrics and, as such, plays a central role in determining bonus payments.

19.2. Outcome

The 2008 annual report discloses that the CEO, Mark Rowsthorn, received an STI of A$1.265 million, which was 70% of his maximum STI entitlement. EBITDA for the 2008 year was A$667 million versus the forecast in the scheme document of A$712 million. Further, it appeared that a significant item relating to management's decision to purchase a stake in the listed Brambles Limited, cost shareholders A$104 million, yet appears to have been ignored in determining Mr. Rowthorn's 2008 STI.

32% of shareholders who voted on the 2008 remuneration report voted against it. Only 56% of shareholders in total voted on the remuneration report.

19.3. Key Issues

- Too often executives appear to have received large short term incentives when prima facie Company performance has been poor and the remuneration report has failed to provide a logical explanation for such short term incentive payments. In the experience of CGI Glass Lewis, the lack of explanation of large STI cash payments was too often a feature of 2008 remuneration reports.
- Further, the use of EBITDA as a performance hurdle must be questioned when the Company has intangible assets which equate to 2.1 times shareholders' funds and debt which equates to 2.3 times shareholders' funds. Such a measure ignores deterioration in the value of intangible assets, which under normal circumstances are under the control of management and also the cost of the Entity's funding of debt i.e. interest costs, which in this case are substantial.

20.Transurban Limited

20.1. Background

In August 2007, the Entity announced that the board had approved a Strategic Mile Stone Incentive Plan (SMIP) for the outgoing CEO, Kim Edwards. The SMIP involved a bonus payment of up to A$5 million on departure, subject to achieving a series of agreed performance milestones. These included, among others:

1. Assistance to the board in the appointment of a new CEO;
2. Key results in delivering the corporatization, development and funding of the Entity's North American business; and
3. Successful integration of the Sydney Roads Group business including the achievement of targeted costs savings and synergies.

Upon departure, the CEO Kim Williams received total remuneration for his ten months of employment in the 2008 financial year of A$16,644,532.
The amount included three significant cash bonuses:

- An STI cash bonus of A$1 million (the Entity incurred a loss of A$140 million in financial year 2008);
- A cash payment of A$5 million pursuant to the SMIP described above;

- A cash payment of A$3.218 million pursuant to the Business Generation incentive Plan (BGIP).

20.2. Outcome

In his last ten months of service with the Company, Mr. Edwards received cash bonuses totaling A$9.218 million. This level of remuneration is significantly above the median of the Entity's market cap peers.

20.3. Key Issues

- The remuneration report failed to disclose details of the performance hurdles used to determine the A$1 million cash STI.
- Nowhere in the 2008 remuneration report, or any past remuneration reports, was there any mention of the SMIP. As discussed above, details of the SMIP were announced in August 2007. While three key parameters were disclosed in that announcement and are listed above, the remuneration report failed to disclose how Mr. Edwards performed in respect of parameters 2 and 3 above.
- It was unclear if the payment under the BGIP relates solely to Mr. Edward's final ten months with the Entity or also to past years. There was no disclosure in prior remuneration reports regarding any accrual to Mr. Edwards in respect of the BGIP. The remuneration report has basically failed to disclose exactly what Mr. Edwards achieved in order to receive the payment under the BGIP.
- The Entity's share price was around A$6.65 when Mr. Edwards departed with significant cash bonuses and is now around A$3.98, a fall of around 40%.

21.AGL Energy Limited

21.1. Background

In 2006 the (old) AGL infrastructure assets were merged with the (new) Alinta. The (new) AGL Energy Limited (AGK) was then separated off and began trading on the ASX on 12 October, 2006.

Paul Anthony who had been CEO for only 18 months departed on 22 October, 2007 under his new contract following the separation of the new AGK. In a release to the ASX, the Company stated that:

> "…the circumstances leading up to and surrounding the revised earnings guidance announced last week and other factors, have contributed to the Directors' view that now is the right time for a new management approach, with strengthened focus on our core operations…"

On joining the Company in May 2006, Mr. Anthony received a sign on payment of A$1,640,000, and long term incentives valued at A$6,364,046. On his departure in October 2007, Mr. Anthony received A$5,118,840 in termination payments, this was in addition to A$530,407 in fixed remuneration, A$214,607 in non monetary benefits paid and A$325,946 in performance rights.

21.2. Outcome

- In summary, Mr. Anthony received a cash payment of A$6,189,800 for less than four months service in the 2008 financial year.
- Within six months of Mr. Anthony's departure the Company's share price had fallen from A$15.98 to A$11.24 or 30%.

21.3. Key Issues

- The remuneration report failed to disclose a cogent explanation for the large cash termination payment to Mr. Anthony.

22.Valad Property Group

22.1. Background

On 26 August, 2008, the Valad Property Group (the Entity) reported a A$247 million write-down of goodwill of European business as a consequence of an operational review stated to have highlighted the need to re-align operations amid challenging market conditions. That contributed to a reported net loss of A$248 million for the 2008 financial year compared with a net profit of A$109 million in the previous year.

The ASX announcement reporting the write down/loss states that the Entity achieved a 123% rise in underlying profit to A$169.6 million, reflecting a solid performance in a very difficult environment.

Note 25 on pages 83 and 84 of the financial report deals with non-current intangible assets. Although not expressly disclosed in that note, it would appear from perusal of the Note that the whole of the A$247 million write-down of goodwill on the European business relates to Scarborough, which was acquired only during the 2008 year.

The then executive chairman, Stephen Day, received a short term incentive for 2008 of A$743,000, which was above the median of the Entity's market cap peers. Peter Hurley, the other long serving executive director and now managing director, received a short term incentive for 2008 of A$675,000 and other senior executives also received not insignificant short term incentives. Further, the executives were guaranteed 75% of their target short term incentives.

At the 2008 annual general meeting the Entity sought shareholder approval for the issue of a significant number of options and performance rights to the executive directors. Further, the 2008 remuneration report disclosed that the two executive directors would receive retention bonuses of two years base salary if they remain with the Entity until June 30, 2010.

22.2. Outcome

- The two executive directors received substantial cash bonus without a match in the Entity's performance.

22.3. Key Issues

- Large incentive payments have been paid without any correlation to performance, particularly when the value of a recently acquired investment saw A$247 million write down of shareholders' funds. The remuneration report failed to provide a cogent explanation of such payments given the Entity's 2008 results;
- The remuneration report failed to provide a cogent explanation for the guaranteeing of a significant portion of short term incentives;