Response to the Productivity Commission on its inquiry into the regulation of director and executive remuneration in Australia

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Contents

Introduction and key remuneration and governance aspects

PricewaterhouseCoopers' (PwC) welcomes the opportunity to provide the Productivity Commission (PC) with our comments on director and executive remuneration. In our submission, we have focused on the core aspects of remuneration and its governance that we believe could be improved, as well as highlighting some areas that we believe are currently working effectively and do not require amendment. Unless otherwise stated, our comments are based primarily on our experience in working with ASX 100 organisations.

We believe that if the inquiry were to conclude the following outcomes, Australian executive remuneration and governance practices would be sound and appropriate for the future.

1. **The board should continue to have ultimate accountability for director and executive remuneration:** Imposing greater regulation will lead to less board accountability and is likely to lead to unintended negative consequences. Regulation will constrain the board's ability to tailor remuneration packages to suit their specific organisation's needs for the benefit of shareholders. For the board to appropriately execute on this responsibility, the Remuneration Committee needs to possess appropriate expertise. We recommend that guidance be given around what skills and experience a Remuneration Committee should possess.

2. **The non-binding vote on the remuneration report should not be strengthened as it is currently working as intended:** The vast majority of companies that do receive a significant "no" vote undertake a review of their remuneration strategy and seek to rectify contentious areas. There is no need to "strengthen" the remuneration report vote or make this more binding.

3. **The current disclosure requirements in respect of executive remuneration should be simplified to promote greater transparency and accountability:** Current complexity has led to remuneration reports that now contain so much information that remuneration policies, structures and levels have become difficult for many users to understand. A particular example of this is the disclosure of equity-based payments in the remuneration table. The value disclosed is an accounting charge. It does not reflect the value of the remuneration in the hands of individuals in the current and future years. One alternative methodology is for the disclosed value to reflect the value of the equity award at the time of vesting, however this also has some challenges.

   Many shareholders often get lost in the detail of remuneration reports. To avoid this, and to create enhanced transparency and accountability, we suggest that the legislation only prescribe disclosure in respect of the core remuneration areas that investors are most interested in, namely:

   - the remuneration policy and associated reward governance;
   - levels of director and executive "key management personnel" remuneration on an individual basis; and
   - the structure of incentive plans and how these incentive plans align to company / business unit / individual performance.

4. **Governance guidelines should be consolidated:** Boards also find the multitude of different governance guidelines overwhelming. Any additional disclosures that are considered to be "best-practice" should be contained in **one** set of succinct guidelines and complied with on an "if not, why not" basis.

5. **The role of remuneration consultants should not change:** We do not believe consultants are conflicted when appointed by the board. In dealing with boards and remuneration committees, consultants typically provide market data, market insights, and assistance in determining appropriate remuneration structures and metrics. Boards set remuneration levels based on market data and other factors such as company performance and the executive's experience, skills, capability, performance and future potential. Boards often seek input from multiple advisors. We therefore do not believe that consultants have a conflict of interest.

6. **Taxation should not drive remuneration plan design:** It is important that taxation legislation supports the government's objectives, being to enable companies to align executive interests with those of shareholders through equity deferral and to build an employee ownership culture whilst ensuring tax concessions are appropriately targeted. The use of taxation law to try to limit the quantum of executive pay is fraught with danger and is likely to produce negative unintended consequences.

Terms of Reference 1: Trends in remuneration

Executive fixed remuneration is determined based on internal factors (eg skills, experience, performance) and external factors (eg peer remuneration levels).

Considerations when determining executive remuneration levels

ASX 100 Remuneration Committees typically consider both internal and external factors when determining executive remuneration levels.

Relevant internal factors (predominantly in relation to the determination of fixed remuneration) are:

- the performance and potential of the executive;
- the skills, experience, knowledge, capability and retention risk of the executive;
- the desired pay positioning for executives within the organisation (eg at the median against peer roles); and
- the size and complexity of the organisation and role.

Relevant external factors are:

- remuneration levels paid to executives in comparable roles; and
- forecast economic and inflationary / deflationary pressures on pay.

In addition, it is important that pay levels are competitive so that the larger companies can attract and retain the very best executives in a global context.

Process adopted

In the case of the CEO, the remuneration committee considers holistically the information in relation to both the internal and external factors.

Internal information is sourced directly by the remuneration committee. Remuneration consultants are typically engaged to provide input on the external factors, specifically market data and market trends. Management typically do not provide input into the benchmarking process to ensure that the provision of market data remains independent.

Based on all the information, the remuneration committee then makes a decision on the target remuneration level for the coming year for the CEO. This recommendation is then taken to the full board for approval. A similar process is adopted for direct reports to the CEO.

For executives below this level, it is often the CEO who will lead the process of internal data gathering for his / her team. Remuneration consultants will provide market data. In some instances the CEO will make recommendations to the remuneration committee (supported by analyses) for its consideration.

PwC Point of View

We believe there is a reasonable amount of community misunderstanding about how executive remuneration is determined. Based on our experience in working with ASX 100 companies, we do not believe that the process for determining executive remuneration is fundamentally flawed. However, the success of this process in practice depends upon the skills and capability of the board to interpret market information for their company and to exercise the requisite professional judgement. Accordingly, we do not believe that this process should be regulated. Instead, we recommend that guidance is given around the appropriate skills and expertise that the Chairperson and members of the Remuneration Committee should possess to enable them to consistently make appropriate remuneration decisions.

Terms of Reference 1: Trends in remuneration (cont'd)

The introduction of "total target annual remuneration" and pre-agreed performance hurdles have been the two major changes in executive remuneration structure over the past decade.

Changes in the executive remuneration structure over the past decade

Remuneration structures have changed significantly over the past decade. The two key changes that we have seen are:

- ***the introduction of the concept of "total target annual remuneration":*** Going back ten years, remuneration was typically communicated as base salary only. This was usually supplemented with a discretionary bonus and often an ad-hoc award of equity (typically options with no performance hurdles other than the exercise price).

  Now, common practice is for executives to be aware of their total target annual remuneration. This consists of their fixed remuneration (base salary plus benefits including superannuation), target short-term incentive (STI) and target long-term incentive (LTI). It is essentially the remuneration that the executive could receive if they achieve their performance metrics. This total target remuneration is generally based on a reward mix, eg 50% fixed remuneration, 30% STI, 20% LTI.

- ***the introduction of pre-agreed performance hurdles at the start of the performance period:*** As stated above, historical market practice was for bonuses to be discretionary and options to be issued with no additional performance hurdles. Now common market practice is for STI and LTI metrics to be agreed at the start of the performance period and for awards only to be paid if these metrics are achieved. There is also a greater focus on ensuring that the metrics are aligned with the overall remuneration strategy which is aligned to the business strategy and drivers of value.

  In the past, metrics also used to be based purely on financial metrics whereas now there is a greater focus on non-financial metrics (such as customer satisfaction, employee engagement, sustainability etc) which are aligned to long-term value creation. That said, financial metrics typically still have a higher weighting on the overall performance scorecard.

PwC Point of View

Recent trends in establishing variable remuneration have supported alignment of executive pay with performance. Boards should continue to have the flexibility to structure variable remuneration in a manner best suited to achieving their business objectives. Enhancement of the linkage between pay and performance should also be encouraged.

Boards are ultimately best placed to determine the appropriate mechanisms for ensuring this alignment, however, as stated earlier, they need to have the skills and capability to be able to do this effectively. In this regard, we believe that guidance on appropriate levels of expertise would be useful.

Terms of Reference 1: Trends in remuneration (cont'd)

Non-Executive Director fees have been sufficiently governed by shareholder approval of aggregate fee pools.

The determination of Non-Executive Director (NED) fees

NED fees are determined based on different considerations to those of executives. A key difference is that all NEDs on the same company board generally receive the same base fee. This base fee is supplemented by fees for additional roles that they may have (eg Chairman of Board or Chair / Member of a sub-committee).

NED's individual skills and experience do not generally influence their fee, instead the fee tends to be based on the company's characteristics. Characteristics that are typically considered by the Board when setting NED pay are:

- the geographical diversity of the organisation;
- the complexity of the company's operations;
- the market capitalisation / size of the organisation; and
- the number of directors on the board and the impact that this has on time commitment.

NED pay is also influenced and constrained by shareholder approval. Shareholders approve the aggregate amount that can be paid to NEDs. The Board must then ensure that the fees paid to individual directors are reasonable and do not exceed this cap.

We believe it is important for NEDs not to receive performance-based pay because of the necessity for them to be independent. That said, we do believe that fee-sacrifice arrangements into shares for NEDs work well because this practice aligns a portion of their pay with the company's shareholders. For this reason, we believe such arrangements should be encouraged. We note that the proposed employee share scheme taxation legislation does not encourage this practice as NEDs would be taxed up-front on any shares purchased. Accordingly, fee-sacrifice plans are no longer going to be feasible.

Process adopted

It would be typical practice for the remuneration committee to instruct external advisers to independently benchmark the company's NED fee levels against a comparable peer group.

The committee would then consider the analyses and make a recommendation to the full board for any proposed fee changes.

It may initially appear inappropriate for board members to determine their own fees. However, the requirements to disclose fee levels and the need to seek shareholder approval for aggregate fee pools means that boards must, and generally do, act responsibly.

PwC Point of View

The current requirements for disclosure and shareholder approval for NED fees should continue. To date they have been effective in moderating NED fee levels.

We recommend that NED fee-sacrifice plans continue as a way of aligning NEDs interests with those of shareholders. For this to be the case, changes in the proposed employee share scheme tax legislation need to occur.

Terms of Reference 2: Effectiveness of regulatory arrangements

Regulatory and governance arrangements are currently too complex and can be unified and simplified to increase transparency.

Complexity of current regulatory and governance arrangements

Regulatory and governance arrangements in respect of director and executive remuneration have become too complex. Companies are required to comply with the Corporations Act, AASB 124 "Related Party Disclosures" and the ASX Listing Rules. They also need to comply on an "if not, why not" basis with the ASX Corporate Governance Principles.

In addition, there are numerous guidelines released by various stakeholder bodies. Such stakeholder bodies include, among others, the Australian Institute of Company Directors, the Australian Shareholders Association, the Australian Council of Super Investors, Corporate Governance International, IFSA and Risk Metrics. Some of these bodies such as the proxy advisors are not covered by regulation. Their business model includes earning income from their clients by reviewing companies' remuneration practices for compliance with their own guidelines. Further, the sheer volume of different, and sometimes conflicting, guidelines severely complicate board decision making.

These numerous requirements have resulted in remuneration reports that have become lengthy and complex and are now very difficult for the typical investor to understand.

Disclosure of share-based payments

One disclosure area that causes a lot of confusion to shareholders is the requirement to value employee equity under AASB 2 "Share-based Payment" and to disclose the amortised value in the executive remuneration table. Many shareholders believe that this disclosed amount reflects the value of equity that the executive realised during the year (similar to other disclosed components such as cash salary, non-monetary benefits, superannuation, cash bonus etc). This is not the case because the disclosed value is an accounting charge based on the fair value of equity at the grant date. The equity grant may fully vest, partially vest or not vest at all.

For these reasons, the grant date method used in accounting can cause significant issues for a company. In order to understand the remuneration report, you need to understand this accounting methodology which is designed to reflect the cost to the company rather than reward outcomes to the executive.

An alternative manner of disclosure for share-based payments is not easily determined. For this reason, we suggest that a working group be established to determine a feasible solution. One potential alternative for consideration is for the disclosed value to reflect the value of the equity award at the time of vesting, however, this is not without its own set of challenges.

A vesting date basis for disclosure may still not align with the ultimate "realised value" but may reflect the amount of remuneration the executive could receive if they chose to sell their shares or exercise their options / rights at the time that they were able to. We believe this treatment is more appropriate than requiring the "realised" value to be disclosed because this will require greater administration as executives sell / exercise their equity at different points in time. In addition, some executives may hold their equity for significant amounts of time post vesting and therefore the disclosure of equity may be deferred for a very long period of time, or never be disclosed if the executive sells their equity after they terminate employment.

In the current environment, a vesting date basis may appear more appropriate than the current disclosure requirement which reflects the cost to the company rather than reward outcomes for individuals, however, the consequences of adopting such a treatment need to be fully explored.

Terms of Reference 2: Effectiveness of regulatory arrangements (cont'd)

The proposed threshold at which termination payments must be approved by shareholders is too low.

Purpose of the remuneration report

The purpose of the remuneration report should not be to convey accounting information, but to provide a framework for disclosing sufficient details on the remuneration practices which will enable the reader to understand:

- the remuneration policy and associated reward governance;
- levels of director and executive "key management personnel" remuneration on an individual basis; and
- the structure of incentive plans and how these incentive plans align to company / business unit / individual performance.

The focus should be on the quality / usability of the information provided, and based on reward concepts, not necessarily accounting values. That said, under any basis of measurement, we still support the number of equity instruments granted in the current financial year being disclosed along with their fair value in the notes to the financial statements. This is so investors can understand the amount of remuneration granted that may be realised in future years. This amount also reflects the P&L charge which is relevant for shareholders.

Coverage of directors and executives in the remuneration report

PwC believes that the current coverage of directors and executives in the remuneration report is appropriate. Current legislation requires the disclosure of all directors, the five highest paid company / group executives and the key management personnel. Collectively, these capture all those directors and executives that have strategic influence over the organisation, which we believe is the correct approach.

It is our view that the above disclosure requirement has placed upward pressure on remuneration in recent years because of the increased transparency of pay levels. This is clearly an unintended consequence that has resulted from increased regulation. That said, the public disclosure of remuneration may prove to constrain executive pay in times when company profits and share prices are down.

The proposed threshold at which termination payments must be approved by shareholders is too low

We believe the proposed threshold for termination payments of one year's base salary is too low. This is because of the wide definition of a "termination benefit" which includes notice periods (which are often 12 months for CEOs and very senior executives of larger companies) and STI payments which are based on performance and pro-rated for the period of time the executive served in the performance year. The combination of just these two benefits would often exceed the threshold and we do not believe shareholder approval is required in these circumstances. This is because shareholders would already be aware of the notice period and the target STI.

We believe that notice periods should be limited to 12 months fixed remuneration (not base salary) and that there needs to be some buffer in the termination payments threshold.

We understand the government's rationale in requiring the shareholder vote to be held after the director or executive has departed from the office or position, however we do not believe this process will practically work. It will impede contract negotiations as companies will not be able to give executives a guarantee around key contract terms, such as notice periods and the treatment of incentive plans upon termination, as these will be subject to shareholder approval after termination if the threshold is exceeded.

Our view is that the threshold is set too low and that shareholder approval should be able to be sought as close as possible to the time of contract negotiation.

Terms of Reference 2: Effectiveness of regulatory arrangements (cont'd)

Remuneration consultants and advisors do not have a conflict of interest.

PwC Point of View

There is significant scope to simplify and unify remuneration regulation and governance and subsequently enhance transparency, by focusing on the core remuneration aspects that are most important for an investor to understand, namely:

- the remuneration policy and associated reward governance;
- levels of director and executive "key management personnel" remuneration on an individual basis; and
- the structure of incentive plans and how these incentive plans align to company / business unit / individual performance.

Any additional disclosures or guidelines that are considered to be "best practice" should be contained in **one** set of succinct guidelines that are required to be complied with on an "if not, why not" basis. In this way, there is clarity and consensus on what is required.

We recommend that a working group is established to determine the most appropriate way to disclose share-based payments in the remuneration table as the current disclosure method is currently causing a lot of confusion.

We believe that the current coverage of directors and executives in the remuneration report is appropriate and does not require change.

We believe that the proposed termination payments threshold is too low and that shareholder approval should be able to be sought as close as possible to the time of contract negotiation.

The role of the remuneration consultant

We believe there may be some confusion in relation to the role that external advisors play in individual executive remuneration decisions. Our role as remuneration consultants typically involves:

- providing market data (sourced from audited remuneration reports) to boards and remuneration committees on comparable roles to assist them understand peer remuneration levels for the CEO and executive team;
- providing market insights on executive remuneration trends so boards and remuneration committees can determine remuneration structures that are in line with current / evolving market practice, taking into account the specific circumstances of their company; and
- assisting boards and remuneration committees to determine appropriate remuneration structures and metrics to incentivise executives to achieve company strategic objectives and key financial metrics.

In terms of our working relationship, we are engaged by both the board and management, however this is typically in different capacities. We are often instructed directly by the board on matters relating to the remuneration strategy and CEO remuneration levels, whereas we often work with management on implementation and operational matters.

The main area where there is commonly an overlap between consultants working with both the board and management is when incentive plan structures are being designed. This is necessary to produce optimal outcomes. Liaising with executives enables the advisor to gain a thorough understanding of the business drivers which subsequently enables determination of the most appropriate incentive metrics. In addition, this enables strategic and performance alignment as management can then appropriately cascade metrics down to lower-level employees.

Terms of Reference 2: Effectiveness of regulatory arrangements (cont'd)

The entire board is ultimately responsible and accountable for decisions taken on remuneration matters.

Advisors do not make the final decisions on pay because any advice provided on remuneration levels is always considered by the committee or board in conjunction with other factors as previously outlined. It is the board who makes the ultimate decision on executive pay levels.

Boards and remuneration committees typically receive advice and information from more than one remuneration consultant as well as a number of other advisors such as data providers, strategists, governance specialists, lawyers and tax specialists. Due to this, the influence of a single remuneration consultant is diluted as the board is typically receiving advice from a broad range of parties.

Remuneration advisers very rarely, if at all, act on behalf of the individual executive. Typically, the executive seeks advice on a recruitment / appointment package from recruitment firms or lawyers. In the event that PwC were to advise the company / board, we would not advise an individual executive due to the obvious conflict.

Australia has a handful of large firms, supplemented by a few boutiques, providing specialist remuneration advice. In the event that a company's access to these advisers were restrained in an attempt to address a perceived conflict, there is a likelihood of unintended consequences. Boards may be forced to rely on those less qualified to provide the advice or those with "a true conflict" such as recruitment agents, whose fees are often dependent on the candidates pay.

PwC Point of View

Remuneration Committees and / or boards should have unfettered access to advisers. Consistent with the proposed APRA Prudential Standard, where the committee or board engages expert advisers, the advice should be commissioned by and provided directly to the committee or board.

Advisers should be able to work with both the board and management, but not to act on behalf of any individual executive whilst advising the committee or board.

Prevalence and role of Remuneration Committees

Remuneration Committees typically exist in most large-cap companies. They are less prevalent in smaller companies where remuneration decisions are likely to be considered by the full board in the first instance.

It is difficult to quantify the effect that remuneration committees have had on the linkages between remuneration levels and individual and corporate performance. However, based on our knowledge of the operation of remuneration committees in large cap companies, we believe that they strive to achieve a rigourous link between pay and performance and ensure that pay levels are reasonable yet competitive. The ultimate objective is to structure executive pay in a way that leads to the creation of shareholder value.

There are existing guidelines, such as the ASX Corporate Governance Principles, that specify the requirements for construct, role and operation of remuneration committees. This guidance is intended to ensure executives are not placed in a position of actual or perceived conflict of interest when their remuneration is determined. We believe this objective is achieved through the operations of the remuneration committee. In addition, the Board retains the broader responsibility for remuneration given its wider fiduciary duty to protect shareholder interests.

PwC Point of View

The current ASX Corporate Governance Principles sufficiently specify the requirements for remuneration committees. There may be opportunities for the Productivity Commission to consider further monitoring areas of non-compliance (accepting the Principles are currently "comply or explain").

Terms of Reference 3: The role of institutional and retail shareholders

The "non-binding" vote on the remuneration report is already encouraging improved transparency and rigourous remuneration practices.

The non-binding vote on the remuneration report

The non-binding vote has encouraged the following outcomes:

- Companies seek to structure their remuneration policies to align executive and shareholder interests. In doing this, they try to be transparent and to emphasise this link in order to minimise the likelihood of receiving a high "no" vote on the remuneration report. Even though the vote is non-binding, boards do not want to be faced with the reputational damage associated with a remuneration policy that is not accepted by shareholders and that receives adverse media and stakeholder reactions;
- Where companies have received a high "no" vote on the remuneration report, the vast majority of these would have undertaken a review of their remuneration policy, and subsequently amended the contentious areas of plan design. Accordingly, the current process is working as it is intended to;
- There are practical difficulties associated with making the remuneration report binding. The first is that in many cases the company has contractually committed to various entitlements and therefore the "binding nature" could only apply to remuneration plans going forward, not retrospectively.

In addition, shareholders vote on the remuneration report in its entirety, not on specific aspects. This means that although companies may understand the areas of concern of their key institutional shareholders and stakeholder bodies through engagement with these parties, they are unlikely to understand the remuneration concerns of all of their shareholders, particularly where there is a large retail base.

Appendix A provides statistics on the level of "no" votes in ASX 100 companies over the past three years.

In relation to international practice, there are examples of many countries that require shareholders to vote on employee share schemes (eg Denmark, Norway, Spain) and the remuneration of directors (eg Estonia, France, Germany), however to our knowledge only the Netherlands and Sweden require shareholders to have a binding vote on the remuneration policy. Even in these circumstances, we understand the detail provided in the remuneration policy is limited.

We understand that Korea is the only country where shareholders have a binding vote on remuneration including salary, bonuses and retirement allowances.

In addition to the non-binding vote on the remuneration report, shareholders have a binding vote on director appointments, the maximum aggregate level of Non-Executive Director pay and equity grants for directors where the equity grants are satisfied via the fresh issue of shares.

PwC Point of View

There is no need to strengthen the remuneration report vote or to make this "more binding". We are not aware of any international precedents of where there is a binding vote on the entire remuneration report.

To avoid perceived conflicts of interest, we believe that directors and executives should not be able to vote on their company's remuneration report. Further mechanisms to encourage shareholders to be more active in respect of setting director and executive pay are not necessary.

Terms of Reference 4: Aligning interests

There needs to be an appropriate process in place to ensure that the remuneration strategy is driving shareholder value.

Linking pay to performance – current performance hurdles used by ASX 100 organisations

Variable pay is typically delivered via short-term incentives and long-term incentives.

STIs are typically based on performance over a one year period. Metrics are typically a combination of company, divisional and individual measures and are a mix of both financial and non-financial metrics.

- Common financial metrics include earnings, revenue and expense management; and
- Common non-financial metrics include those relating to customer satisfaction, employee engagement, health and safety, sustainability, and general operations / milestones.

STI metrics tend to be customised to each organisation and therefore there is significant variability in the metrics used between organisations. The targets associated with such metrics are often commercially sensitive, making upfront disclosure difficult.

LTIs are typically measured over a three year period. Metrics are generally based on company-wide metrics such as:

- relative total shareholder return;
- earnings per share; and
- return on equity.

Accordingly, LTI metrics are relatively similar between companies. There is an argument that the relatively homogenous nature of LTI hurdles across the ASX100 has been, at least, caused by a desire to "comply" with stakeholder bodies' views of better practice LTI hurdles. This has potentially led to a lack of innovative and strategically-aligned LTI plans.

Ensuring there is a rigourous link between pay and performance

There is no one "right" way to establish a rigourous link between pay and performance. For this reason, we do not believe that the nature of incentive metrics, or the overall incentive structure itself, should be regulated.

Any attempt to regulate incentive plan design is likely to result in homogenous metrics which are not in the best interests of shareholders. Metrics need to be tailored to the organisation to incentivise executives to achieve metrics that are within their line of sight and that are aligned to the business-specific value drivers. It is important that the board is not constrained in setting these metrics.

The optimal way to do this is for the Board to set the metrics for the CEO and direct reports and for the CEO to be responsible for ensuring that these metrics are cascaded throughout the executive ranks. In doing this, appropriate performance alignment will be achieved.

PwC Point of View

Interventions that better assist shareholders understand the link between executive pay outcomes and performance would be invaluable. Clearer company reporting on this matter, which may include retrospective disclosure of commercially sensitive STI targets versus actual performance could easily be implemented. Attempts to specify or regulate incentive metrics, or the operation of incentive plans, should be avoided.

Terms of Reference 5: International developments

Australia, along with the UK, is leading the globe in relation to its regulatory / governance approach to remuneration.

Legislation

Across continental Europe a number of governments are in the process of either introducing or discussing legislation that aims to improve the regulation and corporate governance processes in the area of executive remuneration.

The following themes are emerging:

- Formation of remuneration committees composed of a majority of independent directors to oversee executive remuneration;
- In countries operating a two-tier board system, the supervisory board will be responsible for the remuneration of the management (or executive) board;
- Greater and improved transparency in the reporting of executive remuneration showing all elements of executive total remuneration and their value and costs to the company in a clear and concise format;
- Requirement for companies to demonstrate that their remuneration schemes and policies do not encourage risk taking and support their long term objectives and value creation; and
- Restrictions on golden parachutes and rewards for failure. This includes a prohibition on paying golden parachutes in the event of non-performance and limits on the amounts that can be deducted by companies for corporation tax purposes.

Appendix B sets out a summary of recent or proposed legislation relating to executive remuneration in a number of key locations.

Shareholder guidelines

Shareholder guidelines in the following countries have been established: Belgium, Canada, Ireland, Netherlands, Sweden, Switzerland and the UK.

Regulator Guidelines

Across Europe there is a strong consistency between regulator guidelines, partly influenced by best practice within the EU. Regulator guidelines provide a more prescriptive framework in countries where legislation governs executive remuneration. These guidelines operate under a "comply or explain" basis, encouraging self regulation. Regulation in UK, Netherlands, Belgium, Switzerland and Canada play a major role in remuneration of executives. Guidelines have recently been adopted in Austria, Hungary and Poland and further updates have been announced in France.

Outside of Europe, regulator intervention has been minimal with only Canada and the US proposing any updates. The anticipated new rules introduced in Canada are more concerned with reporting and disclosure of executive remuneration, with a focus on risk, including "say on pay" provisions allowing shareholders to voice approval or disapproval of executive remuneration. Similar sentiments have been echoed in the more recent updates announced in the US. This is in contrast to European regulation which tends to be more prescriptive in recommendations on remuneration mix and performance criteria.

At a global level, many regulators have made recent announcements regarding executive remuneration, recognising the need for global reform within the banking industry.

Appendix C provides more detailed commentary on regulator guidelines in particular locations.

PwC Point of View

There is limited evidence of overseas regulatory practices that could be imported to Australia and improve our current position. It is important to ensure that we do not place unnecessary compliance burdens on our corporations that hinder their ability to compete effectively in the global market.

Terms of Reference 6: Liaising with Australia's Future Tax System Review and APRA

The proposed employee share scheme tax legislation is likely to lead to the elimination of salary sacrifice share plans.

The influence of the taxation of remuneration in driving the structure of remuneration plans

To date, taxation considerations have not been a primary driver in the design of remuneration practices. Instead, remuneration practices have been designed to align the interests of executives and shareholders and to drive shareholder value through incentivising executives to achieve strategic and core financial metrics. Taxation implications have been considered as part of the plan design but only to ensure that there are no adverse tax consequences to either the company or the individual. This may or may not change depending upon how employee equity is taxed going forward.

The proposed changes to the taxation of employee equity announced in the Federal Budget on 12 May 2009 were punitive and as a result were strongly opposed by the business community and by other stakeholders. Consequently, the Government released a Consultation Paper on the taxation of employee equity which contains proposals that are a material improvement on those which had been announced in the Federal Budget, but still contain features which will result in the tax treatment of employee equity influencing remuneration design.

Salary sacrifice share plans

Currently, many companies operate salary sacrifice share plans ranging from broad-based plans where all employees are able to sacrifice salary on a regular basis to acquire shares from pre-tax monies, to deferred bonus plans where bonuses are deferred for a number of years and are settled in shares. The proposal in the Consultation Paper to allow tax deferral only in situations where there is a "genuine risk of forfeiture" will eliminate these types of plans which currently operate with "restrictions" on dealing with these shares, but not with forfeiture conditions. These types of plans do not provide a "genuine risk of forfeiture" because the employee has already derived the income which is being sacrificed in lieu of receiving shares at a later date. It is not practical to operate these types of plans with a "genuine risk of forfeiture" and employees will not participate in such plans if tax is payable immediately.

$1,000 exempt share plans

The imposition of a $150,000 income cap (as proposed in the consultation paper and increased from the $60,000 cap announced in the Federal Budget) to enable employees to access the $1,000 tax concession under exempt share plans is another example of how taxation may drive remuneration plan design post-1 July 2009. Pre-1 July 2009, many organisations used these plans as a mechanism to build an employee share ownership culture and therefore encourage employees to act more like owners of the business and be more engaged and aligned. Many employers will find it difficult to operate plans that have any sort of discriminatory cap, and as a result it is likely that these types of plans will simply not be made available in the future. We have recommended to Government that no threshold should be imposed on exempt share plans.

Bonuses

In relation to the taxation of bonuses, we strongly believe that bonuses should be an allowable tax deduction and that bonuses should not be subject to special / higher taxation rates. This is because companies use bonuses to incentivise executives to achieve short-term strategic and financial measures. They are a necessary component of the executive's total remuneration package which typically consists of fixed remuneration, short-term incentives (ie bonuses) and long-term incentives (typically share-based payments). Bonuses should be treated in the same way as salary is treated from a tax-deduction and tax-rate perspective.

Terms of Reference 6: Liaising with Australia's Future Tax System Review and APRA (cont'd)

It is critical that the government works with its regulatory bodies to ensure that all regulatory arrangements and governance principles are in alignment.

Ensuring that regulatory arrangements and governance principles complement each other

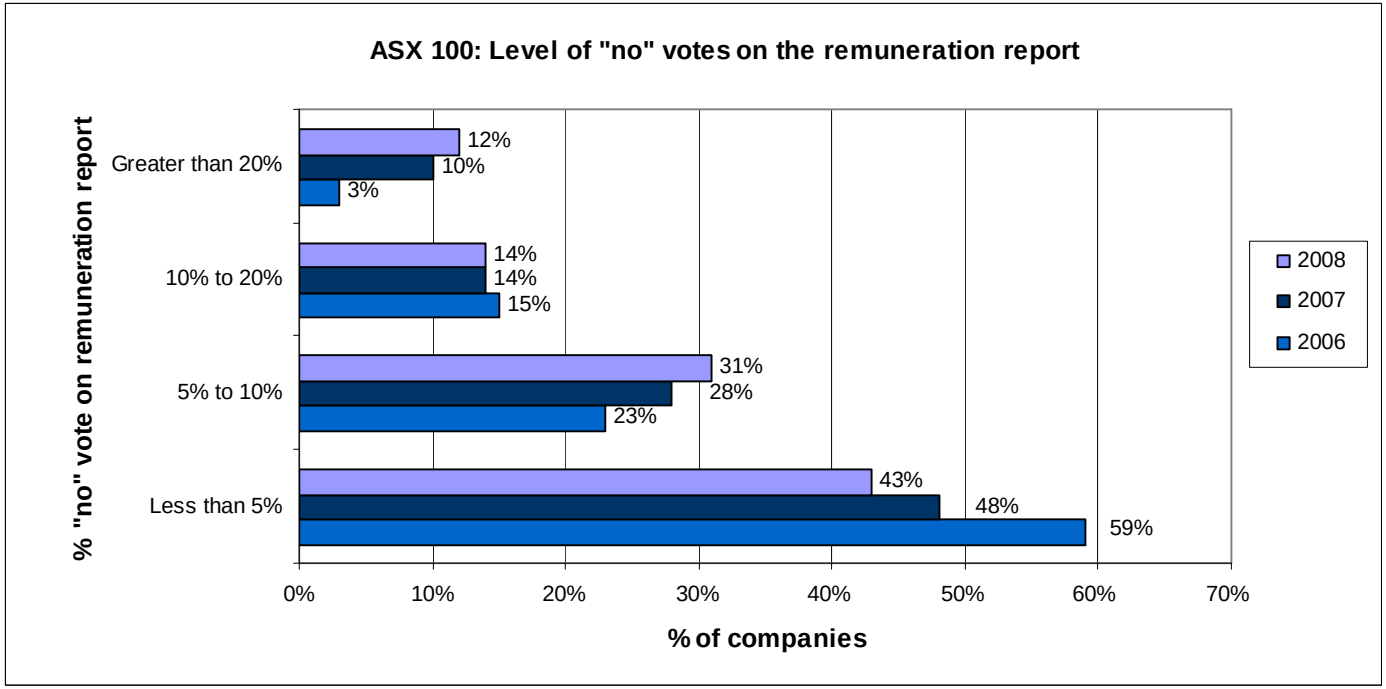
- In addition to complying with the regulations that are applicable to all corporates, APRA-regulated institutions are also required to comply with the APRA Prudential Standard on governance which contains both remuneration and governance requirements. It is critical that all regulatory and taxation arrangements and governance principles are in alignment.
- Some of the concepts outlined in the APRA Prudential Standard, such as the Remuneration Committee having accountability for the remuneration policy of executives and ensuring this Committee has appropriate levels of expertise, could also apply to non-APRA regulated companies.
- Any changes arising out of Australia's Future Tax System Review which is currently being undertaken by Dr Henry should also be in alignment with broader regulation to minimise disruption in implementation.

PwC Point of View

It is critical that the government works with its regulatory bodies to ensure that all regulatory and taxation arrangements and governance principles are in alignment.

Appendix A – Remuneration report “no” votes

The below diagram outlines the percentage of “no” votes on the remuneration report over the past three years:



As seen, the “no” vote on the remuneration report has been increasing in recent years. In 2008, 12% of ASX 100 companies received a “no” vote greater than 20% on their remuneration report compared to only 3% in 2006. This is a result of institutional investors and proxy advisors becoming more active and taking a less tolerant approach to remuneration practices that they do not believe are in the best interests of shareholders. The vast majority of companies that receive a significant “no” vote undertake a thorough review of their remuneration practices and seek to rectify any contentious areas. For this reason, we do not believe that the remuneration report vote needs to be strengthened in any way. It is currently working as intended.

Appendix B – Legislation and regulator guidelines

Outlined below is a summary of recent or proposed legislation relating to executive remuneration, as well as information on regulator guidelines in particular locations.

Belgium

Belgium has two Corporate Governance Codes – the Lippens Code for listed companies and the Buysse Code for non-listed companies. Compliance with the regulatory codes is currently operated on a "comply or explain" basis. Following the financial crisis, the Belgian government is now expected to enact into law a number of the provisions of these codes, making it compulsory for companies to comply with these areas.

Provisions relating to executive remuneration that will become law are likely to include:

- Formation of a remuneration committee to oversee and regulate executive remuneration;
- New requirements to make the reporting of executive remuneration more transparent; and
- Restrictions on the amounts that can be paid to departing executives as golden parachutes.

Final legislation is expected shortly and, as a result, the Code is expected to be amended.

Canada

In 2005, the Canadian Coalition for Good Governance published Good Governance Guidelines for Principled Executive Compensation. Building on this work, in June 2009, it released further guidance based on six "pay for performance" principles.

France

Proposals to French law are expected to include rules to improve the transparency of reporting of all elements of executive remuneration. Changes have been enacted banning bonuses at organisations that are undergoing "large scale redundancies".

Updated guidelines have been issued in France which cover the remuneration paid in all banking organisations. These guidelines have the aim of encouraging "consistent behaviour" in employees, with particular emphasis placed on a company's risk profile. Specifically, these guidelines include:

- Updated guidance on how bonuses should be calculated, ie taking into account the real profit of an organisation rather than projected profits, and also taking into account all costs;
- Requirement for a significant element of remuneration to be deferred;
- Variable remuneration to be aligned with the long-term interests of organisations and clients; and
- Separation of performance criteria for back office and front office staff so that risk and control functions are not dependant on business profits.

Further improvement to guidelines is expected which will be operated on a "comply or explain" basis. Guidelines are likely to include:

- Prohibitions on termination payments in the event of poor company performance. Where termination payments are made, these will be restricted to two year's total remuneration; and
- Restrictions on the amount of pension benefits that can be paid from a employer funded pension scheme.

Appendix B – Legislation and regulator guidelines (cont'd)

Germany

The parliamentary working group has identified several areas for possible legislation with a decision expected in the near future. Key areas being proposed can be summarised as follows:

- All aspects of the Managing Board (Vorstand) remuneration to be subject to Supervisory Board (Aufsichtstart) approval;
- The Supervisory Board to review remuneration of executives in order to adjust for unreasonable remuneration;
- Executive remuneration must focus on long-term value creation and not short term incentives;
- Greater transparency in the reporting of executive remuneration particularly with respect to pension benefits; and
- Severance payments should not be paid in the event of poor company performance.

Italy

Proposals by the Bank of Italy include:

- Remuneration committee for larger banks;
- Remuneration policies to focus on long term objectives and should be risk adjusted;
- Variable pay to consider short and long term performance and adjusted for risk;
- Restrictions of equity based remuneration for non-executive directors and senior executives in control functions; and

Listed companies are also required to follow a Self Disciplinary Conduct Code.

Netherlands

The updated Dutch Corporate Governance Code was published in December 2008. The majority of amendments relate to executive remuneration, in particular focusing on the remuneration structure and the instruments available to the remuneration committee. In total there are 19 main areas for provisions to the code. In addition, the Dutch Central Bank has set out 12 principles for appropriate variable pay policy, focusing on:

- Governance;
- Performance measures; and
- Remuneration mix.

Switzerland

Legislation has been extended to include a requirement for a shareholder approved remuneration policy covering board of directors and claw back provisions.

The EBK has been working with a number of organisations to review and recommend changes in remuneration structures.

The Swiss Financial Market Supervisory Authority (FINMA) published for consultation a circular on remuneration systems in June 2009. It contains wide-ranging proposals regarding the structure of remuneration which will apply to all financial institutions supervised by FINMA. With regard to disclosure, FINMA proposals that institutions should be required to disclose their remuneration policies in a remuneration report and that there should be a summary of disclosure of the remuneration structure for all employees.

Appendix B – Legislation and regulator guidelines (cont'd)

United Kingdom

In the UK, the Financial Services Authority has reviewed executive remuneration policies for UK organisations and comparing these against their own good practice criteria, which include:

- How bonuses are calculated;
- Composition of total remuneration;
- Bonus deferral plans; and
- Control and management of remuneration policies.

Following their review, ten principles for executive remuneration have been published by the FSA which are:

Principle 1 – Role of bodies responsible for remuneration policies and their members

Principle 2 – Procedures and input of the risk and compliance functions

Principle 3 – Risk and compliance function remuneration

Principle 4 – Profit-based measurement and risk-adjustment

Principle 5 – Long-term performance measurement

Principle 6 – Non-financial performance metrics

Principle 7 – Measurement of performance for long-term incentive plans

Principle 8 – Fully flexible bonus policies

Principle 9 – Deferment of the majority of any significant bonus

Principle 10 – Linking deferred elements to the firm's future performance

United States

In June 2009, the US Treasury Secretary outlined a number of principles for compensation design and governance. These focused on the financial services sector, but the scope of the principles apply more broadly.

In essence a non-binding vote on the remuneration report ("say on pay") will be introduced as well as greater governance around the role and requirements of Remuneration Committees.

Contact details

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