SUBMISSION TO

PRODUCTIVITY COMMISSION ENQUIRY

ON DIRECTOR AND EXECUTIVE REMUNERATION

IN AUSTRALIA

September 2009

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Preface

Egan Associates, while not able to meet the initial deadline for submissions to the Productivity Commission, believed from the outset that they should make a contribution to the discussion given the long experience of their Principals, particularly that of John Egan, the group's Chairman, who has been active in the provision of advice on remuneration matters over four decades. Client commitments also prevented us from providing a comprehensive perspective of issues which we believe represent a relevant foundation for the Commission's deliberations.

Given the submissions prepared by others and initiatives sponsored by the Federal Government in parallel with the work asked of the Commission, our focus has been primarily on strategic and policy issues and not technical issues. In this context, however, as there has been limited comment on the outcomes from executive participation in long term incentive plans and the adoption of equity valuation instruments drawing upon Black-Scoles or derivatives thereof, we have prepared a market based analysis of the outcome of executive participation in these plans and the problematic nature of the manner in which Boards endeavour to adjudicate on equity allocations in order to align management rewards with their pay policy and shareholders.

Our report has been provided in two documents, this document and a confidential document. The second document contains a considerable amount of proprietary material derived from information collected by the company and John Egan over an extended engagement in consulting.

Unlike the majority of other submissions and with the benefit of reading a number, we have taken a long-term perspective dating back more than four decades and commenting on changes to executive remuneration and the factors which sponsored those changes, including the response to market influences by Chief Executives and their Boards.

About Egan Associates and John Egan

Egan Associates are a highly regarded consultancy advising the leading companies of Australia and New Zealand on executive and board remuneration. We offer experience and expertise on CEO, senior executive and director reward. We advise boards on governance and in responding to market comment on remuneration policies and practice. Our services are underpinned by comprehensive collections of market data reflecting more than two decades of trends analysis.

This document has been substantially written by John Egan whose early engagement in the field of remuneration analysis commenced with primary accountability for research at Cullen Egan Dell in the late 60s. John established that group's Quarterly Salary Review which continues to be a widely distributed and significant document forty years after its establishment, and many of the other industry and specialised surveys of that group, including their regular client forums.

Egan Associates have maintained a significant commitment to research and have built up comprehensive databases on the market since its establishment twenty years ago. While leading the consulting practice John continues to oversight the research function, while retaining his project leadership on major consulting assignments.

Reflective of the practice's engagement in innovation John has served as an Adjunct Professor in the Faculty of Economics and Business at the University of Sydney for a number of years and for the past nine years has chaired the Faculty's Board of Advice. In 2009 he was made an Honorary Fellow of the University of Sydney.

Acknowledgements

I would like to acknowledge the significant support of the Principals at Egan Associates and the research team in assisting assemble archival material, and data sets developed by the company over the past twenty years and developing graphics , metrics and other tables to illustrate perspectives offered in this report. I would particularly like to acknowledge the assistance of Lianne Hooper in providing material for the submission and reviewing the research. Millicent Chalmers assisted in the editing of both documents. I would also wish to acknowledge the contribution made of the research team and the secretarial team who have been engaged in reassembling data in a variety of formats and typing numerous drafts of this manuscript.

Introduction

In parallel with their request of the Productivity Commission (Commission) to consider trends in director and executive remuneration, the Government also requested that the Commission explore the relationship between executive remuneration and corporate performance.

Concurrently with directives to the Commission the Government specifically flagged employee and executive participation in equity based incentive plans as a further issue of concern with the primary focus on tax and shortfalls in Government revenue. In this context it is our assessment that the Government's engagement has two distinct points of focus, one addressing governance and community views and the other regulatory deficiencies and potential shortfalls in its revenue.

We note that the enquiry in relation to share plans following the Budget in May 2009 was directed to the Treasury. We observe that subsequent to initial consultation that the Senate of the National Parliament decided to conduct its own enquiry and at the same time the Government issued draft legislation as a continuing part of the consultation process and requested advice from the Board of Taxation on technical issues and a more comprehensive review by the Board on more substantive issues, notably:

- how to best determine the market value of employee share scheme benefits; and
- whether shares and rights under an employee share scheme at a start-up, R&D or speculative focused company should have separate tax deferral arrangements.

While acknowledging there are clear links between the nature of these enquiries, in our judgement they are distinct and different, one being capable of being addressed with the Government reviewing its existing legislative and regulatory framework and the administration of those frameworks, the other enquiring into the role of the participants in the setting of executive remuneration and the reasonableness in the context of yet to be developed frameworks of those remuneration arrangements.

We observe that a number of submissions to the Commission have been concerned with the taxation of executive remuneration. While we acknowledge that the Government have placed focused emphasis on taxation, principally in the context of employee share plans, on reading the Commission's terms of reference we note that it is not their primary focus of enquiry other than to the extent that the Government initiatives need to ensure that appropriate tax is levied, revenues are collected and tax avoidance minimised. We note at the time of submitting this report that the Rudd Government are considering the appointment of external tax experts to assist in the preparation of the Government's 2010 Budget in order to avoid taxing initiatives which prove to be inappropriate.

It is our understanding that the international concern expressed by governments prompting their current review was the quantum of reward not how it was taxed.

We have also observed that a number of others have commented on corporations law. In this context we have endeavoured not to replicate technical submissions made by knowledgeable others in specific areas relevant to the Commission's enquiry.

Accordingly, our submission primarily deals with the governance issues rather than the technical issues associated with managing the Government's revenue collection which is readily achievable through modification to the existing regulations. It is our view in principle that the levy of taxation should be even-handed, with all citizens being treated equally, that is that all reward arising from employment should be taxed in accordance with straightforward principles, the fundamental principle being neutrality of treatment or equivalence of the tax treatment on all elements of remuneration. It is acknowledged in this context that employers, including the Government, will provide certain facilities to employees which may be of indirect benefit to them but are essentially provided to ensure their effectiveness in their role as an employee.

We acknowledge that provisions may need to be made in order to accommodate innovation and entrepreneurship in start-up, R&D or speculative focused entities and these should be given appropriate consideration by those advising the Government.

Egan Associates' research over an extended period of time has found that concerns about disclosed remuneration have no broad foundation and that most of the quoted examples of excess are outliers, not representative of the broader market. Our experience over several decades has highlighted the fact that executive pay is determined by the relevant marketplace, be it national, regional or international, and/or sector specific (for example mining, financial services or the government sector), as well as by economic factors including prevailing personal and corporate taxation provisions.

The hydraulics of executive pay will be varied by these factors, the scale of enterprises and their prosperity, as well as an executive's position criticality. In contemporary corporate society with widespread community shareholding in leading companies, the investor community look increasingly to the Board of Directors to ensure integrity in the pay setting regime and transparency in shareholder communications which clearly set out policy and practice. Misalignment between any of these elements is seen as the fault of the Board in the stewardship of shareholder interest.

In this context Egan Associates do consider that Boards should be rigorous in their oversight of executive remuneration levels and in particular of incentive plans (disclosed and undisclosed) and have a deep appreciation of the foundation leading to payments or benefits under these plans organisation-wide, ensuring that while payments reflect performance in respect of defined periods they are adjusted for risk and account for sustainability of shareholder wealth and investment value.

Egan Associates have provided the Commission with a confidential document referred to throughout this submission which provides further comprehensive statistical analysis drawn from our client research over an extended period of time. These research papers are referred to in bold by page number and chart number. Note that no specific client information is made available in this submission.

Overview

There are many factors which influence the level and structure of executive remuneration in Australia. Up until the late 80s remuneration was relatively uncomplicated. A significant number of organisations had a reliance upon internal equity or the relative gap between layers in the organisation, with executive reward being aligned to positions of comparable scale having primary regard to work value principles.

With the growing internationalisation of Australian enterprises and rapid growth, boards and management increasingly focused on external market pricing, including differential pricing of positions considered comparable in internal rank having regard to specific market and commercial considerations. This influenced the level of fixed annual remuneration, annual incentive opportunity and participation in equity based reward.

In parallel with these circumstances, the late 80s saw the introduction of fringe benefits tax and the creation of a composite concept of base remuneration from a previous unbundled approach of salary plus benefits, including superannuation. This was strongly influenced by the then tax regime. The Consumer Price Index, level of unemployment and average weekly ordinary time earnings had a diminishing influence by the 90s and virtually no influence today.

During the 80s and 90s the tenure of senior executives changed and the expectation was that there would be turnover on a three to five year cycle, in part influenced by organisation needs and in part executive career aspirations and reward expectations which differed between industries and by concentration of ownership.

While over the last fifteen years base remuneration has continued to increase, reflecting the above factors and others, the level of performance aligned reward has increased dramatically. The opportunity for annual cash based incentives has more than doubled and the benefits arising from executive participation in equity (share) based long term incentives has taken on a proportion not anticipated in the early 90s, arising from an extended bull market and an increasing proportion of executive reward being delivered by way of equity.

By the commencement of the 21st century, companies had embraced institutional and broad community shareholder requirements for the introduction of performance hurdles which led to a circumstance where approximately two-thirds of equity based awards would vest and the balance would not vest. Awards became annual, shifting from a triennial or infrequent allocation process, and the level of allocation increased significantly, in part sponsored by global market influences and the adoption of risk adjusted values applied under the new accounting standards in the 2003/2004/2005 period.

During an extended period up to the present day the community has not objected to the wealth or earnings of athletes, film stars or entertainers and will meet the tariff of senior lawyers and medical practitioners to stay out of gaol or trouble or stay alive. Their reward is clearly set by the marketplace and their patronage influenced by their performance.

There is a general perception, whether valid or otherwise, that CEOs and senior executives continue to receive increased reward, albeit that their performance does not continuously deliver an acceptable or expected return to shareholders. CEOs and senior executives clearly retain their positions at the discretion of the Board who are elected by shareholders to represent their interest. Executive remuneration is determined by the Board having regard to the marketplace in which they compete for talent. Criticism appears to be substantially focused on bonus payments, severance benefits and substantial windfalls arising from participation in equity based incentive plans.

The International Marketplace

It is our observation that the remuneration of Australian executives has not outstripped those of their counterparts in North America or Europe, particularly in the United Kingdom. The basis of reward is different and Australian executives are not subject to the US$1,000,000 deductible limitation introduced during the Clinton administration in the 90s in the United States of America (US). This has distorted the hydraulics of pay in the US, though not the absolute outcome or level of annual reward. Executives leading Australia's top companies might by comparison with the US appear to be highly paid in relation to their fixed annual remuneration (given an exchange rate of 0.8+), though their bonus opportunities do not represent a multiple of base, nor do their equity grants represent many multiples of base, a change which has occurred in the US in response to the artificial cap on base remuneration.

International pay rates or structures are not a dominant feature of the pay of resident Australian executives in significant leadership roles across Australia's top 200 companies. It is true that from time to time international appointments in high profile companies have attracted comment and to some extent created an artificial view of local executive reward.

Given there are approximately 1,500 named executives across Australia's top 200 companies, it would be our judgement that less than 10% of this group of executives are international assignees sourced predominantly from either Europe or North America. To suggest that 10% of an executive population is a significant or dominant influence, in our judgement, represents a substantial overstatement of the facts.

Notwithstanding, Boards representing shareholder interests, particularly on companies with a significant international footprint, need to inform themselves on a regular basis on the extent to which international reward trends are proving to be a detriment to their ability to either attract or retain top talent. It is our observation that Boards fulfil that obligation well.

2009 – the Setting

Preliminary scanning of reported results for the 2009 financial year ending June reveals a general increase in fixed pay of senior executives (we note in respect of the mid year reviews of 2009 that many leading companies have frozen base remuneration levels at those prevailing throughout the 2009 financial year), a general reduction in annual incentive payments, though continuing payments in recognition of meeting a proportion of performance expectations, and a general pause or marginal increase in total annual cash compensation. Also revealed over the past six months in particular has been a significant elevation in new capital raised to support the impact of the global financial crisis and an impairment of balance sheets in excess of $50 billion, leading to an end financial year position where shareholders' investments have been diluted, the value of their prior holdings reduced and their dividends either reduced or remaining steady.

Decisions made by Boards on the recommendation of management and/or advisers in relation to the 2009 reporting of fixed remuneration would have generally been made in the period of May to August 2008 at a time when the depth of decline in the value of the Australian capital markets was not foreshadowed. In the context of reward outcomes shareholders clearly will be seeking a more comprehensive and transparent explanation on what factors have contributed to incentive payments in this, the most challenging financial year for more than two decades.

Research

Research looking back over the recent past has revealed a poor correlation between incentive payments and profit growth which had led Egan Associates to two perspectives. The first is that group profit does not have the significance in driving incentive payments that might be assumed and secondly, Boards are responding to a diversity of factors which in their judgement are value creating but where there is likely to be a lag effect on shareholder returns.

If base remuneration has increased in the 2009 financial year generally, this would suggest that the primary bases for adjustment is not growth in profitability or in market capitalisation or in the current level of profitability, but rather other factors such as revenue and assets under management without acknowledgement on a deferred basis of the significant impairment to assets over the past twelve to eighteen months. If talent shortage has been an impediment to recruitment this would also be a factor.

If incentive payments have remained in a steady state from the 2007 and 2008 financial years then it would be generally evident that the broad executive community are not receiving incentives on the basis of profit, though a legitimate case could be put by CEOs and Boards that the relative effectiveness of management during the economic downturn by their management team was exemplary and as a result they deserved recognition and reward.

Also during the reporting period there is evidence that some companies have prospered, profits are up, revenues are up, asset impairment is minimal and additional capital raising has not been required. One would expect in these enterprises a response to performance which is superior to the majority.

Remuneration Terminology

Executive remuneration comprises a combination of elements. The following terms have been used to identify the various elements.

Base Remuneration – before the advent of Fringe Benefits Tax (FBT) base remuneration comprised taxable cash salary only. Following the introduction of FBT the construct of base remuneration incorporated all guaranteed elements of reward (TEC).

TEC – Total Employment Cost – the annual fixed remuneration package which includes salary plus the value of benefits accessed eg motor vehicle, including the associated Fringe Benefits Tax. TEC also includes superannuation contributions. This would be referred to variously by employers as TEC, fixed annual remuneration (FAR), total remuneration package (TRP).

STI – Short Term Incentive – The annual bonus.

Total Annual Cash Reward – The combination of TEC plus STI. Also referred to as Total Annual Remuneration.

LTI – Long Term Incentive – the dominant form of 'at risk' equity based incentive deferred for a defined period.

Total Reward – The combination of all elements TEC plus STI and LTI.

Retention – In addition to the above a small proportion of organisations offer a select group of employees retention awards which are payable subject to the executive agreeing to remain with the organisation for a fixed period of time or until the completion of a project. These would form part of an executive's total reward opportunity.

Unlatching – Other benefits of a similar nature, though associated with the recruitment of an executive from another organisation, embrace what is commonly known as an unlatching payment which is providing the executive with a payment, in part at the time of appointment and progressively over the first two or three years of appointment, to meet foregone benefits primarily associated with long term incentive benefits forfeited through prematurely leaving their prior employer.

Term of Reference 1. Trends in remuneration

Consider trends in 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.

TOR 1

In order to avoid a short-term focus and a primary alignment with the global financial crisis, in our judgement it is important to consider the levels and structure of remuneration in the extended context of the last fifty years of remuneration practice.

1.1 Fifty years of change in executive pay structures in Australia

1.1.1 Overview

The structure and level of executive remuneration today is a product of a series of sequential influences, including:

- In the 50s and 60s salary and superannuation was assessed having principal regard to internal relativities and adjusted on the basis of CPI movements.
- Perquisites in addition to salary became a significant source of reward outside the income tax structure during the 70s and 80s following unprecedented wage growth as major corporates endeavoured to contain cost while addressing 'net income' internal relativity. Participation in defined benefit superannuation plans remained an increasingly valuable element of CEO and executive remuneration.
- Fringe Benefits Tax (FBT) introduced in 1986 required the total value of cash and benefits (excluding defined benefit superannuation) to be quantified and costed. Executive remuneration progressively became expressed as a composite of salary plus the cost of providing benefits and FBT.
- Remuneration disclosure by bands introduced (late 1980s). The individual benefit value of participation in defined benefit superannuation plans was not captured.
- Remuneration Report disclosures informed the market on individual executive remuneration with varying accuracy.
- Increasing geographic spread of Australian business and the free movement of talent between national markets. Use of equity in dot com businesses during the IT boom brought equity based incentives into sharp focus (1990s).
- Defined benefit superannuation plans replaced by defined contribution plans.
- AASB2 valuation and disclosure requirements assign a cost to equity based incentives (2005^{+}).

To set the changes in context, an analysis of the economic environment over the period has been set out in the confidential document supplied to the Commission (Document 2) on ***Pages 1 to 10***.

With regulatory and legislative change paralleling the significant internationalisation of many of the nation's leading corporations, the design of executive reward became more sophisticated and to some extent customised to reflect the commercial challenges facing enterprises across all sectors and of differing scale. Remuneration arrangements were disclosed and by the mid 90s equity plans had clearly become the new value opportunity, particularly when performance hurdles were not commonplace and equity was not valued in a consistent way as a component of executive reward.

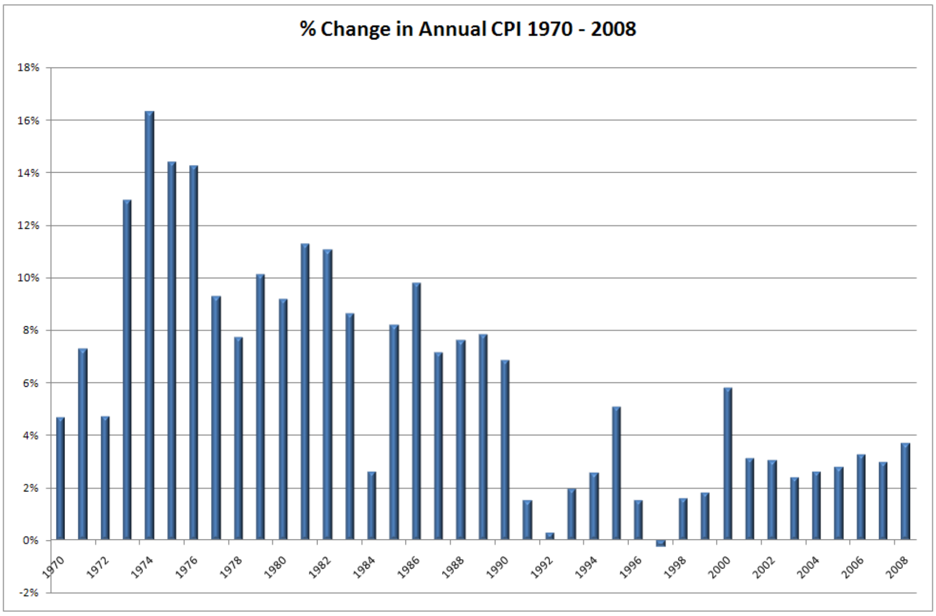
By 2004 accounting standards had been introduced to address the value of employee equity, that value being ascribed to individual CEO and executive remuneration disclosures. CFOs and their advisers increasingly adopted accounting values of equity instruments as the basis for equity allocation under long term incentive plans. The realised value of vested securities during the sustained share market boom substantially exceeded the remuneration intent and the expectation of all stakeholders.

In the 90s and early years of the current decade base remuneration adjustments, while beyond the CPI, were generally contained to single digits. Growth in cash based remuneration arose from a significant uplift in annual bonus opportunities and benefits arising from equity plan participation.

Throughout the past fifty years, and in particular the last twenty-five years, remuneration has proven to be hydraulic in nature, ie pressure exerted in one area of reward always elicits a compensating response in another area as the market adjusts to addressing their sense of competitive pay equity.

Prior to the global financial crisis and stress in the capital markets substantial wealth was created for many executives through their participation in equity plans. In parallel with the crisis the Australian Government found itself facing a near term shortfall in their revenue collections and as a result increased their scrutiny on tax avoidance and/or minimisation arising from employee and executive participation in these plans. Today, while the Australian Government has not been required to invest capital in the nation's leading companies, they have (in collaboration with their G20 partners) chosen to focus the spotlight on executive remuneration and its impact on all relevant stakeholders, including themselves in respect of their revenue collections.

The graphs below highlight the volatility in economic indicators influencing executive pay decisions over the past forty years.



% Change in Annual CPI 1970 - 2008
18%
16%
14%
12%
10%
8%
6%
4%
2%
0%
-2%
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
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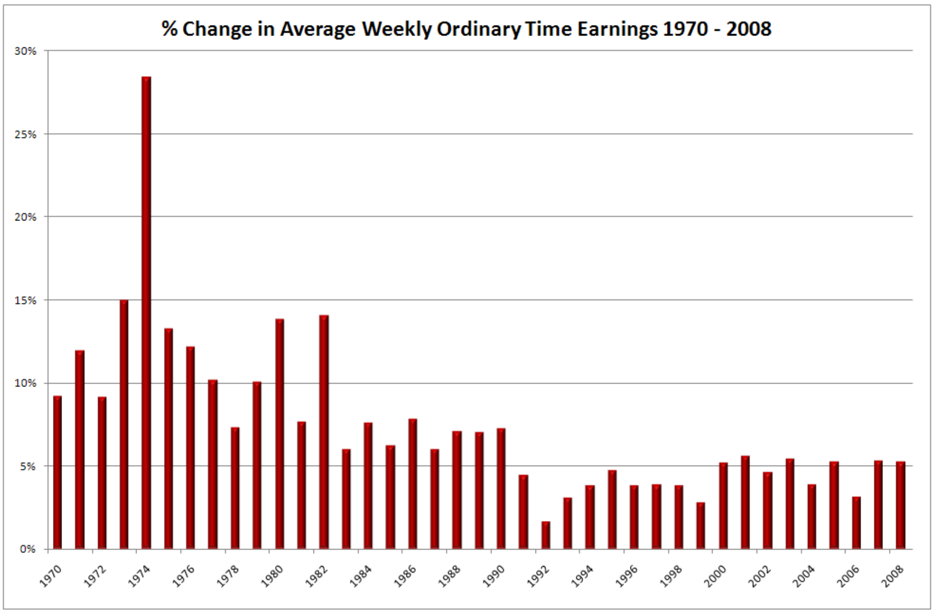
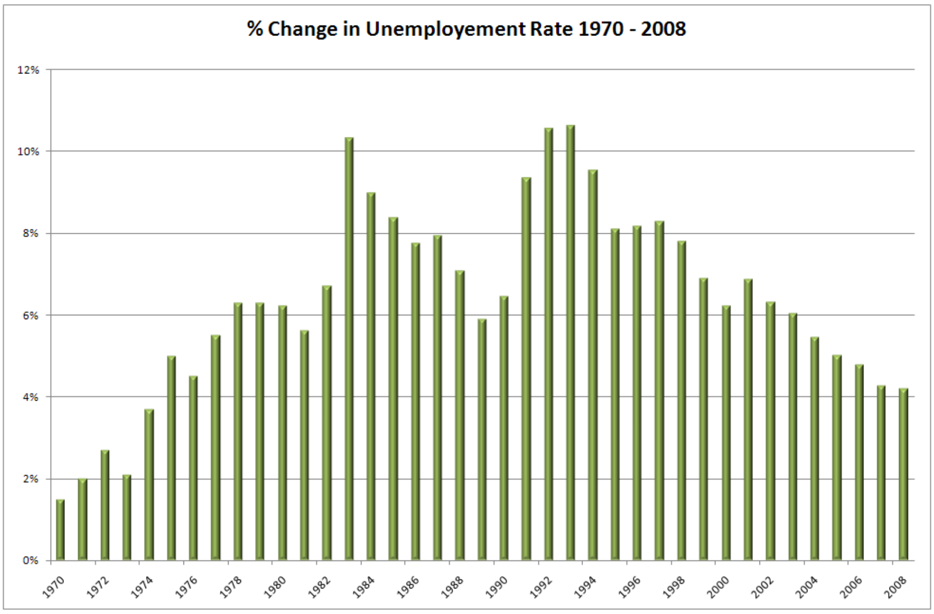
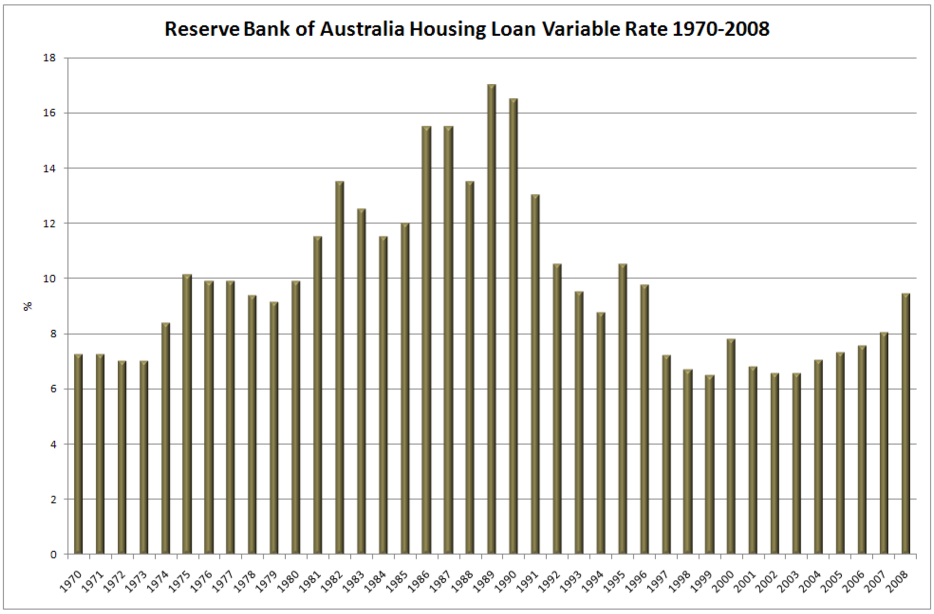
1996
1998
2000
2002
2004
2006
2008



% Change in Average Weekly Ordinary Time Earnings 1970 - 2008
30%
25%
20%
15%
10%
5%
0%
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008



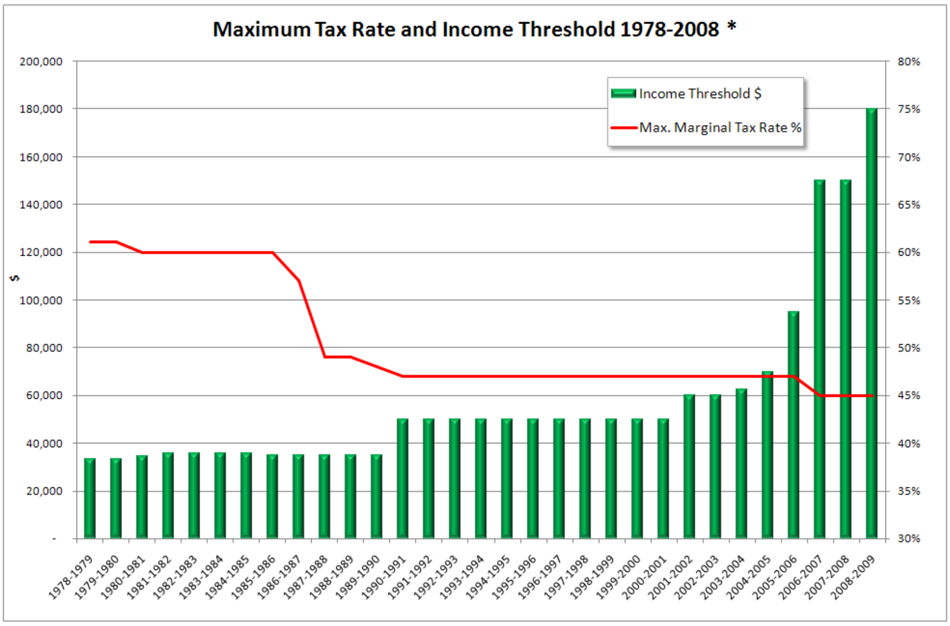
% Change in Unemployement Rate 1970 - 2008
12%
10%
8%
6%
4%
2%
0%
1970
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008



1.1.2 Tax and Government policy initiatives

In Australia over the period, with rising wage levels, particularly in the 70s, governments were forced to reduce both the level at which the maximum marginal rate of tax applied and the level of tax, an approach which has been consistently applied, though not always on a regular basis, for the last quarter of a century. From time to time, arising from rapid wage rates and enterprises' engagement in cost mitigation, there has been an observation by the government that there was a leakage of revenue to the Commonwealth, the most prominent initiatives in this regard being the introduction of fringe benefits tax in 1986 and more recently, in a period of declining Commonwealth revenues, the expression of concern in relation to the leakage of tax and the adequacy of regulations surrounding taxation on employees' participation in share plans.

The table below illustrates the changes in the maximum marginal rate of tax, excluding the Medicare levy, and the remuneration level at which the maximum marginal tax rate applies.



* Excludes the impact of the Medicare levy introduced in November 1986

1.1.3 The mid 70s to the mid 80s

Trends in executive remuneration

From the early 50s until the 80s there was greater focus on internal pay relativity rather than external pay relativity. In that era, issues of criticality were the cost of living (CPI), movement in average earnings and award rates, unemployment levels, interest rates, tax rates and associated employment cost mitigation. External factors influencing pay decisions related to relative company growth (revenue) together with expenditure, being key measures of executive accountability in work value assessment.

CEOs and their Boards managed to contain executive employment costs during the 60s, 70s and 80s, with marginal tax rates averaging above 60%, periods of CPI growth and average weekly earnings growth above 10%, the latter reaching 28% following the metal trades decision in 1974.

The issue of pay relativity and annual adjustment, both economic and merit, was severely jolted in the 70s by the metal trades award decision which led to underlying annual salary adjustments traditionally aligned to the CPI more than doubling on an annual basis in the latter half of the 70s as the level of competition for talent and a shift toward external market relativity and away from internal relativity gathered pace. The latter was a derivative of sophisticated job classification and evaluation systems, principally adopted by multinationals.

With the introduction of numerous benefits and the commencement by employers to highlight the value of benefits, as noted, including entertainment allowances, spouse allowances, payment for club memberships (both sporting and business), defined benefit superannuation, selective educational and recreation benefits, including use of holiday facilities, attending conferences (both internationally and domestically), companies were able to provide free cash flow or net income benefits through significant tax mitigation. From the mid 70s to the mid 80s, at the time of the introduction of fringe benefits tax and the emergence of pay disclosures, the tax regime was considered by many to be punitive and led to a flight to benefits.

In the early 80s, with salary levels having increased over the prior half dozen years quite significantly (average weekly earnings increased by 28% in 1974), pay levels for leading executives had broken the $100,000 barrier. In larger companies in the early 80s there was growing evidence of Chief Executives receiving salaries upward of $200,000, with an increasing flow of benefits, including the provision of more than one car, club memberships, entertainment and spouse allowances, attractive defined benefit superannuation contributions, with growing international travel accompanied by spouse.

There were two significant opportunities for the establishment of wealth by the business executive in the early 80s. One was through participation in company share plans and the other significant uplifts in base remuneration to reflect both the growing presence of Australian public companies with an increasing international footprint and in recognition of many leading executives' entrepreneurial flair. The fastest way to achieve wealth creation through share ownership was through the creation of the partly paid share paid to 1 cent, with dividends being minimal and the issue of bonus shares being more frequent among the entrepreneurial companies.

The adoption and rapid growth of the partly paid share and loan backed share survived for a decade from the early 80s through to the economic decline in the early 90s, with options by the end of the 80s taking on an increasing presence in Australia. This was reflective primarily of growing trends in North America and the observation that with significant growth in share prices it represented a meaningful opportunity for the creation of wealth –

more than ten Australian companies had a market capitalisation above $1 billion in the early 80s, reaching twenty-four by 1988.

This era was typified by the growth in the entrepreneurial class, the most notable Australian entrepreneurs and astute businessmen including John Elliott and Robert Holmes à Court and, in New Zealand, Ron Brierley. These individuals with growing public profiles, together with the Chief Executives of local public companies, increasingly engaged in complex and significant financial transactions requiring talented team members throughout the 80s.

The 80s saw the beginning of a more sophisticated and internationally aligned approach to executive remuneration structuring and planning with the requirement to report remuneration, though organise it in the most efficient form.

In parallel with these changes, incentive plans, both cash based and equity based, received greater attention from Boards and CEOs and progressively greater prominence as a proportion of total reward opportunity in the next decade.

Tax reform, pay disclosure and FBT

The decade 1978 to 1988 commenced with the maximum marginal rate of tax at 62.9% and finished with the maximum tax rate at 49%, though the reform of tax levels in relation to earned income had a sting in its tail, with the introduction of FBT. The Hawke Government of the day and Treasurer Keating were also observant of the emerging structure of reward, much of which, while benefiting executives, escaped the *'employee tax net'* and led to the introduction of fringe benefits tax legislation in June 1986 in parallel with a shift in the executive class away from managing internal relativity to addressing external competitiveness in a market under-resourced for talent, particularly young executives with international work experience and training. This market sensitivity increased further with the introduction of mandatory pay disclosure in the 1987 and 1988 financial years.

1.1.4 1988 – 1998

Trends in executive remuneration

Given John Egan's engagement in providing remuneration advice through the 70s, 80s and 90s to the present day, Egan Associates' research archives have documented many of the drivers of growth in executive remuneration, not the least of which has been the expanding international footprint of Australia's leading listed companies.

With these changes over the period of the mid 80s through to 1990, the shift in thinking about reward had moved from salary plus benefits to a construct of total employment cost and a recognition by the early 90s that market comparisons needed to address total employment cost, not just salary.

The 1987 and 1988 financial years saw the introduction of a requirement for remuneration disclosure within pay bands which operated in parallel with these changes in reward. Without doubt, prior to the economic downturn in the 1991/92/93 period, disclosure had led to a significant realignment of reward arrangements for executives and CEOs in the Australian marketplace.

Initial disclosures were highly variable in relation to what companies and their advisers incorporated in their disclosed pay bands. Holding company size relatively constant, the gap in the disclosure of the highest paid executive or CEO between the 90th percentile and the market median was quite extraordinary, in many instances the market median represented less than a third of the 90th percentile and a modest proportion of the 75th percentile among the largest companies.

The variation and alignment over time of remuneration as disclosed is illustrated on ***Pages 11 to 13*** of the Confidential Document ***(Document 2)***.

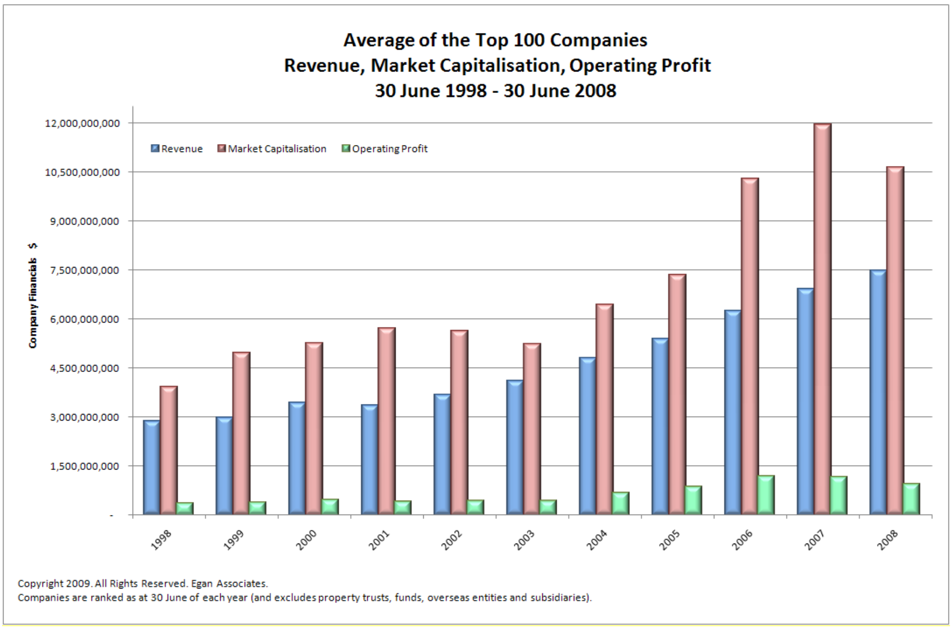
We observe in our research ***(Page 12 - Charts 1 and 2)***, that the growth in senior executive reward over the decade from 1988 to 1997 reflected a virtual doubling of reward, though given the initial gap between CEO pay and their direct reports the actual rate of increase over the period for CEO's direct reports outstripped the CEO. Annual remuneration among the top 100 company CEOs increased from around $460,000 to $900,000, whereas their direct reports on average increased from around $200,000 to $450,000.

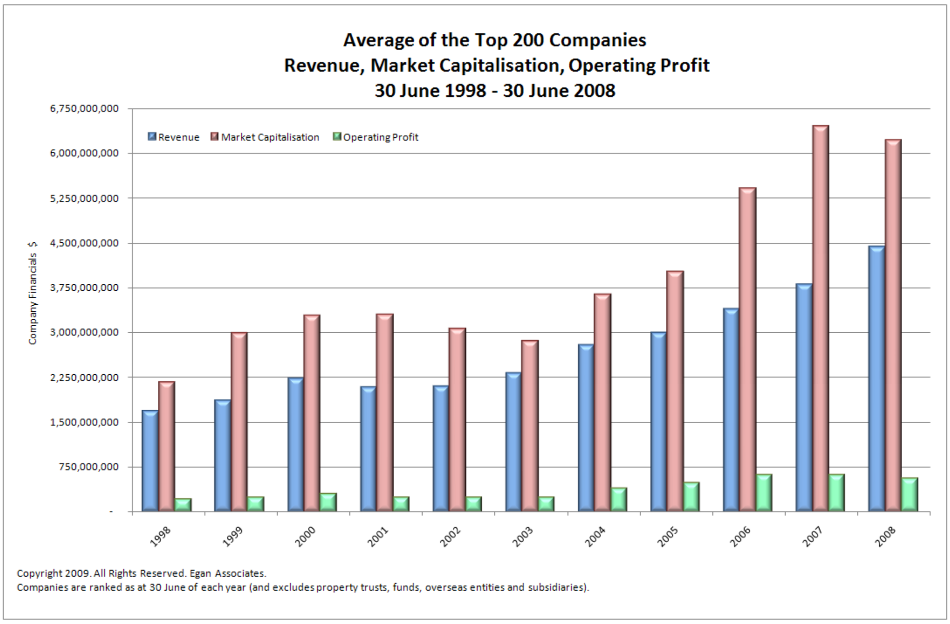
1.1.5 1998 – 2008

The Corporate Environment

The most significant rate of growth in the decade was in assets under management (funded by significant debt) in Australia's top 100 companies where the value of those assets grew three-fold on average from marginally in excess of $12 billion to in excess of $36 billion.

In the 1998 financial year the average revenues of Australia's top 50 ASX listed companies were marginally in excess of $5 billion. By the end of the decade the ASX 50's average revenues approached $12 billion. Among the top 100 companies the respective figures were $2.8 billion and $7.5 billion. The average market capitalisation of Australia's top 50 and top 100 companies in 1998 stood at $7 billion and $3.9 billion respectively. By the end of the decade the market value of companies in the above ASX indices stood at $17.9 billion and $10.6 billion respectively (at 30/6/2007 the figures were $19.7 billion and $11.9 billion). This represented a decade of growth in the order of 250% in respect of both annual revenues and market capitalisation.





Trends in executive remuneration

The period from the mid 90s until the present day has also been one reflecting a significant decline in defined benefit superannuation plans toward a defined contribution plan and in many instances compliance with the maximum contribution required under the superannuation guarantee legislation.

During this period there has been a significant focus of executives on securing future wealth through participation in equity-based long-term incentive plans, with an influential proportion of senior executives in leading companies investing their personal funds in acquiring shares in their employer as well as holding a proportion of the securities earned under the long term incentive plan for a period well beyond the vesting period.

Our research ***(Page 13 - Charts 3 and 4)*** reveals a decline in senior executive total annual cash reward (fixed annual remuneration plus annual bonus payments) in the 2008 calendar year, reflecting the decline in the annual incentive component clearly responsive to the economic conditions prevailing during the calendar year, paralleling the decline in profitability and market capitalisation of a number of Australia's leading companies. The data, however, reveals an increase in annual reward opportunity over the decade 1998 to 2007 through both an adjustment to fixed annual remuneration and the receipt of annual incentives in the order of 180% (which represents a compound annual rate of increase marginally less than 11%), representing a significant uplift in the rate of increase of the prior decade, though the data also reveals a sharp decline in earnings in the 2008 calendar year with a relative fall between 20% and 25%. On the basis of preliminary research in relation to the 2009 financial year ending 30 June, we anticipate a further decline in aggregate earnings across the S&P/ASX 200, with the most noticeable decline being awards made under annual incentive programs during a period when expected corporate returns will be mixed.

1.1.6 Performance pay

Pay for improved performance has changed not only in quantum but in complexity, requiring considerably more sophisticated analysis and understanding.

Executive performance awards in the 60s and 70s through to the early 80s reflected more of a modest profit share than the outcome of a multi-factor formal incentive program. Progressively from the mid 80s there was an increasing emphasis on profitability and growth in a company's market value. Growth in executive remuneration reflected an increased emphasis on annual performance awards and an increased focus on equity awards in relation to sustainable or longer term performance. Over the period from the 80s to the present day the relative importance of base remuneration compared to total reward opportunity progressively diminished and while salaries continued to increase, the growth in reward opportunity was a derivative of executive participation in enhanced annual incentive plans and long term equity based incentive plans, both performance tensioned. Our research ***(Page 14 - Chart 1)*** highlights the diminishing proportion of fixed annual remuneration in executive pay since the 80s. This change is highly relevant in the context of the current proposals to limit termination settlements without shareholder approval to twelve months' salary, which represents around 40% of total annual reward.

There was a progressive shift from the early 80s through to the mid 90s and into the 21st century to a more balanced approach to the determination of total annual reward, particularly under annual incentive plans, with multi-faceted performance aligned reward programs embracing consideration of earnings (profitability), other financial return measures and cash flow, as well as strategic, tactical, operational and leadership factors, with the relative importance of those factors changing from year to year and increasing by level within an organisation as the proportion of the management workforce participating in these programs grew.

Following the economic downturn in the early 90s there was a progressive emphasis on equity-based, long-term incentives and the meeting of performance hurdles, initially related to share price and then progressively total shareholder return and earnings per share, until the second half of the current decade when an increasing number of organisations' Boards believed there was an inappropriate lottery effect in meeting the hurdles being demanded by proxy advisers and institutional investors, primarily representing superannuants. Implicit in those demands were that half the companies in which executives participated in these programs would not benefit. This became even more obvious when there was broad market opposition to *'retesting'*.

By the mid 90s the dominance of the partly paid share plan and loan backed plan of the prior decade had shifted to option plans, though many major companies moved away from options to rights at the beginning of the present decade in managing unexpected gains in the bull market while containing the allocation of securities.

With a relatively prosperous period of growth in executive remuneration after the economic downturn of the 91/93 era, considerable focus on incentive and at risk reward had commenced to emerge. There was an increasing emphasis placed on equity based incentives, the proportion of those incentives growing from less than 15% of total reward opportunity for executives in leading companies to one where fixed annual remuneration (TEC: total employment cost) was commencing to diminish from being above half the reward opportunity to less than half the reward opportunity, with the most significant growth being in equity based long term incentive plans, predominantly in the form of options. By the end of the decade share rights or performance shares had commenced to overtake options as the favoured equity vehicle under long term incentive plans, as noted above.

At the conclusion of the 90s target annual incentives on average for senior executives were typically in the range of 20% to 35% of base remuneration, with reward for out-performance being pitched at a premium of 150% of the target award. As we approach the end of the first decade of the 21st century annual incentive potential, while not necessarily fully realised in the 2008 and 2009 financial years, particularly among Australia's largest companies, has continued to rise.

While the predominant global comment in relation to cash incentives has focused on annual payments representing many multiples of base remuneration in the global financial community, particularly investment banks, shareholders do have an expectation that directors have a thorough appreciation of at risk performance aligned payments throughout the organisations on whose Boards they serve.

While concern has been expressed with 40% to 50% of profits being distributed to executives in leading investment banking organisations following a traditional Wall Street model, it may well be that shareholders will in future demand a clear statement in the Remuneration Report of the proportion of either pre tax or post tax profit that is being distributed organisation-wide to all staff reflecting at risk performance awards, not simply a statement of the policy applying to the most senior executives without having an understanding of the value of bonus/incentive awards across the companies in which they invest. This information might reasonably be divided into cash based awards, deferred cash based awards and share based awards.

We believe Board Remuneration Committees will increasingly devote their attention to ensuring that substantial bonuses are not being paid for suboptimal performance and when paid have regard to the underlying risk in the achievement of annual results, with increasing consideration being given to the deferral of bonuses determined annually, subject to the achievement of continuing growth and sustainability or improvement in shareholder value.

Given APRA's statement of principles, which substantially replicate observations in relation to executive remuneration by the Financial Stability Forum and our own observations of published Remuneration Reports of the ASX 300 and shareholder comment, it is our perspective that many companies have fallen short of meeting their obligations under Section 300A(1)(ba) of the Corporations Act which requires clear disclosure by way of a detailed summary of the performance criteria which Boards have used in annual incentive plans and the manner in which they have assessed the company's performance which has led to the disclosed executive emoluments. We note that this area of company disclosure has been considered poor by the Securities Exchange Commission in the US and by equivalent authorities in the UK and in Europe. In part, it would be our observation that legal provisions have generally been in place, though have not been strongly enforced.

While it remains our view that directors and their advisers are in the best position to improve this area of reporting, it is our judgement that the Productivity Commission should address these deficiencies which are likely to influence two out of three reporting companies in the interest of transparency and completeness of disclosure. We acknowledge in this context, as noted in the submissions by others, that their disclosure can be transparent and comprehensive though not reveal strategic initiatives which are commercial and in confidence.

We note in APRA's discussion paper of proposed extensions to governance requirements for APRA regulated institutions nine principles for sound compensation practices. While there may be a number of responses to this paper, particularly in relation to Remuneration Committee membership, the source and independence of advice, we anticipate that there may well be responses from regulated entities and their advisers in relation to the identification and measurement of risk and requests for further clarification in relation to APRA's approach to the certification of compliance, whether that certification is required to be provided by a company's auditors or legal advisers. We note that the FSA in the UK have established evidential requirements which, if embraced and adjusted by APRA to reflect local circumstance, may clarify some of the outstanding issues arising in the consultation process.

Notwithstanding the challenges of a principles based approach, which we strongly endorse, it is our view that APRA's approach is clearly in the right direction.

1.1.7 Correlates of executive annual reward

The complexity of reward structures has not transparently revealed that performance aligned awards reflect incremental and sustainable shareholder value creation.

It will be seen from the graphs in section 1.1.5 in relation to the scale of Australia's top 100 and 200 companies that revenue over the decade steadily increased. Our research in respect of the 2006, 2007 and 2008 financial years, indicates that annual company revenue is the strongest correlate of an executive's fixed annual remuneration, with the exception of the 2006 financial year in respect of CEOs when it was market capitalisation.

The correlation between company revenue and market capitalisation for the top 50, 100 and 300 companies averages above 0.8, and the correlation between market capitalisation and operating profit is higher over the 2006, 2007 and 2008 financial years. Revenue and market capitalisation are also highly correlated with assets, as is a Chief Executive's fixed annual remuneration.

What is revealed in our research, given the alignment and high correlation between revenue, market capitalisation, operating profit and net assets, is the relatively poor relationship between annual bonuses and operating profits or market capitalisation. Annual bonuses are more highly correlated with revenue than either operating profit or market capitalisation. The correlation between market capitalisation and operating profit with annual bonus payments in the 2008, 2007 and 2006 financial years averages less than 0.3 or approximately half the correlation between fixed annual remuneration with both revenue and market capitalisation.

Total annual remuneration, which is the combination of fixed annual remuneration and annual incentive payments or bonuses, had the highest correlation with the company's annual revenue, though an aggregate correlation of less than 0.5 with both market capitalisation and operating profit.

Our research ***(Pages 15 and 16)*** reveals virtually no correlation between improvement in a company's profit or market capitalisation and the reported remuneration of either a Chief Executive Officer or Chief Financial Officer.

This research, which in principle confirms the work undertaken by a number of proxy advisers, ASIC, ASCI and academics highlights a key accountability for Board Remuneration Committees and Board Chairmen in relation to ensuring the integrity of annual incentive plans and clarity in respect of the value drivers considered by the Board as critical in delivering shareholder returns. We note in this context that a reasonable proportion of named executives in Annual Reports are receiving annual incentives on the basis of business group, divisional or regional performance outcomes, not the corporate result which is adequately captured under long term incentive plans where performance hurdles embrace either or both total shareholder return and earnings per share growth.

A key question which arises from this research which broadly reflects the conclusions of a number of academic studies, though has not adopted comparable comprehensive statistic analyses, is whether Boards in determining the performance requirements of a company's executives are weighting the factors considered in research studies, which primarily reflect upon levels of profitability, growth in revenue and market capitalisation in respect of both the year in which data is reported and on a look back basis, as distinct from a number of other measures which are expected to flow through to shareholder returns. These factors might include a Board's assessment, at either a corporate or business group level, of business sustainability, the accomplishment of strategic objectives and the effective management of tactical initiatives in meeting competition, both on a domestic and global footing.

A concern which we have is that measures of profitability or market capitalisation may well not represent the key value drivers on an annual basis where there is often a lag in reporting of outcomes and those considered critical by a Board which should have an intimate understanding of not only the key value drivers for an organisation but also the extent to which management is achieving the performance hurdles set for them.

We note that for example the highest correlation in the three years charted exists between total assets and annual incentives (2008), demonstrating that annual incentives may be triggered by strategic and other initiatives and incentives paid regardless of movement in profitability.

A key challenge in this context will be the structure of annual incentive plans and the relative weighting of financial returns compared to strategic and operational objectives that might be set for Chief Executives and their direct reports and the prevalence of substantial awards (say between 50% and 75% of target bonus) being payable at threshold, which in many instances falls 10% or more below budgeted levels of performance.

Equally, in a significant proportion of annual incentive plans, having regard to the achievement of strategic objectives or financial objectives, there has been limited regard to the embedded or underlying risk in pursuing growth. This may prove particularly sensitive of where companies have achieved substantial growth in revenue, though in parallel assumed significant increases in debt. In recent times we have observed that in some disclosures the value of assets acquired to secure growth have been marked to market at a substantially reduced value from acquisition cost.

1.1.8 Shareholder and community engagement

One of the issues which have been flagged in comment by the media, proxy advisers, institutional investors and others has been the recent growth in CEO pay which substantially parallels growth in enterprise value and the gap between the CEO's reward and that of other reported executives ***(Pages 17, 18 and 19)***.

Over many years shareholders and the community have reflected on the rise and rise of executive remuneration. Warren Buffett has shamelessly referred to the mythical remuneration advisory firm of Ratchet, Ratchet & Bingo. In recent years the focus on improved governance led to the Australian Securities Exchange establishing a Corporate Governance Council and the publication in 2003 of its *'Principles of Good Corporate Governance and Best Practice Recommendations'*.

Over the past two decades academics have progressively commented on the relationship between pay and company performance using a variety of metrics, and more recently on the relationship between Board independence and governance in relation to executive pay.

Egan Associates' own research has confirmed the poor relationship between annual bonus payments and company performance in the context of profit, revenue and share price growth, as well as the absolute level of reward aligned to those three corporate metrics.

Research undertaken by Jensen and Murphy in 1990, examining the period 1969 to 1983, revealed that US CEO wealth increased by US$3.25 for every US$1 increase in shareholder wealth, while CEOs lost 24.4 cents for every US$1,000 lost by shareholders. Australian academic research, including work by Associate Dean Professor John Shields at the University of Sydney, has generally confirmed the US research.

In a setting of volatile and declining share prices in the latter half of 2008, increased concern was voiced during the 2008 annual reporting season, these concerns being exacerbated by the growing international impact of the global financial crisis.

TOR 1

1.2 Long term incentive plans

Equity based long term incentive plans, while not universally permeating the reward of an entire workforce, have a critical place in executive remuneration. Over the past three decades equity based long term incentive plans have played an increasingly important role in the reward of senior executives in creating shareholder wealth. The plans have taken varying forms over that period from those which involve the issuance of partly paid shares paid to 1 cent to those involving the provision of loans to enable executives and employees to acquire shares in their employer, those loans generally being non-recourse, to option plans, performance shares or rights plans and in a limited number of cases the issuance of restricted shares.

In the majority of settings the benefits arising under these plans were subject to employee service for a period of time, initially in the order of five years and in the current and contemporary environment typically three years. In the last two decades there has been an increased incidence of the incorporation of performance hurdles in these plans whereby employee entitlements are dependent upon growth in shareholder value, company earnings and/or related financial benefit to shareholders.

1.2.1 The emergence of performance hurdles

It will be noted from ***Page 22 Chart 1*** that in the late 90s total shareholder return and share price growth were the dominant performance hurdles. Earnings per share was embraced by only five companies in the top 100 at that stage, with varying measures of profit being adopted by one in twenty-five companies. Board discretion or no hurdle at all applied in approximately 30% of organisations. This was the beginning of the era when institutional investors were focusing on the need for performance hurdles as more critical than relying on Board discretion to determine whether or not executives benefited from equity grants made as part of their total remuneration arrangements.

Increasingly, long-term equity-based incentive plans have required either fixed rates of growth in return or relative or absolute growth in total shareholder return, where performance equivalent to a market index represents a threshold and superior performance at the base of the top quartile of the market is the position at which all equity would vest.

A decade on, while Boards reserve the right to exercise discretion, performance hurdles among Australia's leading companies are universal ***(Pages 22 and 23)***. Share price growth as a reference point has diminished in importance, with earnings per share growth and total shareholder return being the dominant performance hurdle considerations. In the second half of the current decade an increasing number of long term incentive plans adopted more than one performance hurdle, dividing grants into two or more tranches, each tranche subject to a different performance hurdle. In the 80s the vesting period was typically five years, as the 90s progressed the minimum vesting period was typically three years.

With increasing demand for performance hurdles to be met, in the mid 90s a significant proportion of companies reduced their minimum vesting period from four or five years to three years and introduced retesting as a provision if rigorous and demanding performance hurdles were not met by the initial vesting date. This has recently been opposed by a number of institutional investors, the Australian Shareholders' Association and proxy advisers. In our assessment this has arisen primarily from the fact that the frequency of grants in the 80s and early 90s was every two or three years and not annual, as has become more common practice in the second half of the current decade.

Egan Associates do not endorse the opposition to retesting as executives only benefit from achieving cumulative performance hurdles approved by shareholders, retesting is for a limited period and a benefit will only arise to the participating executive if shareholder-approved performance hurdles are met on a cumulative basis. We also observe that the performance criteria can change from year to year, as have the performance requirements, particularly those requiring the meeting of high levels of relative total shareholder return, which in recent years (prior to the global financial crisis and its effect on capital markets) to achieve a median result have in many instances required a cumulative annual rate of return exceeding 20%.

1.2.2 Share valuation for equity plans

It can be demonstrated that there are serious flaws in the application of share valuation methods currently being applied. Review of this is very welcome.

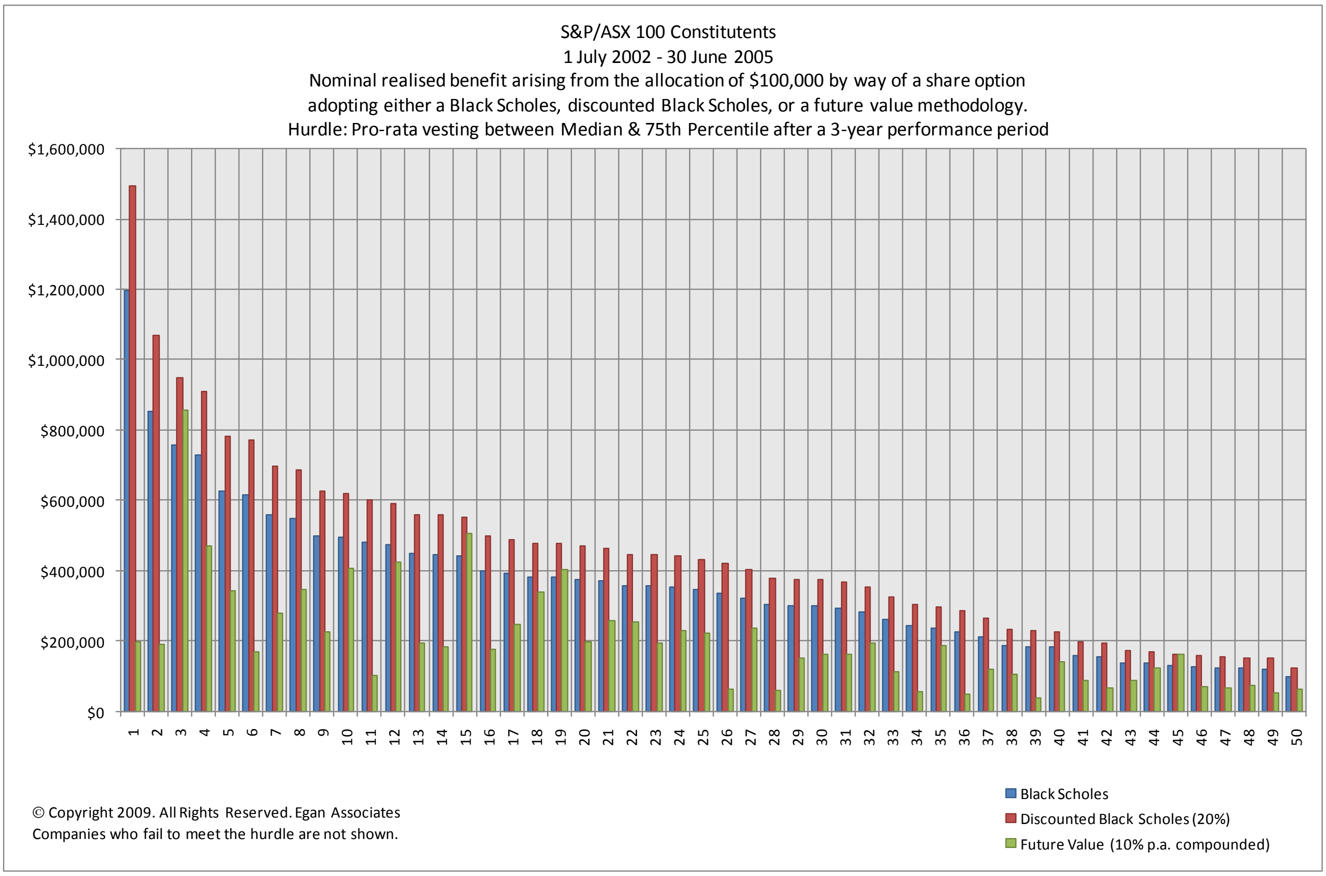
A serious flaw in the regulation of share plan administration is in the provisions in regard to valuation and recording of plans under the Accounting Standards. We support the review of the valuation methods to be used to establish the value of the granted benefit. While-ever there are two or even three methods of valuation being recommended or required for different purposes in commercial activities there will be potential problems and injustices. Valuations may be as provided by the taxation legislation, or as required by the various disclosure provisions of the local and international accounting standards. This requirement is clearly a regulated aspect of disclosure and in accounting for equity grants in a company's annual accounts.

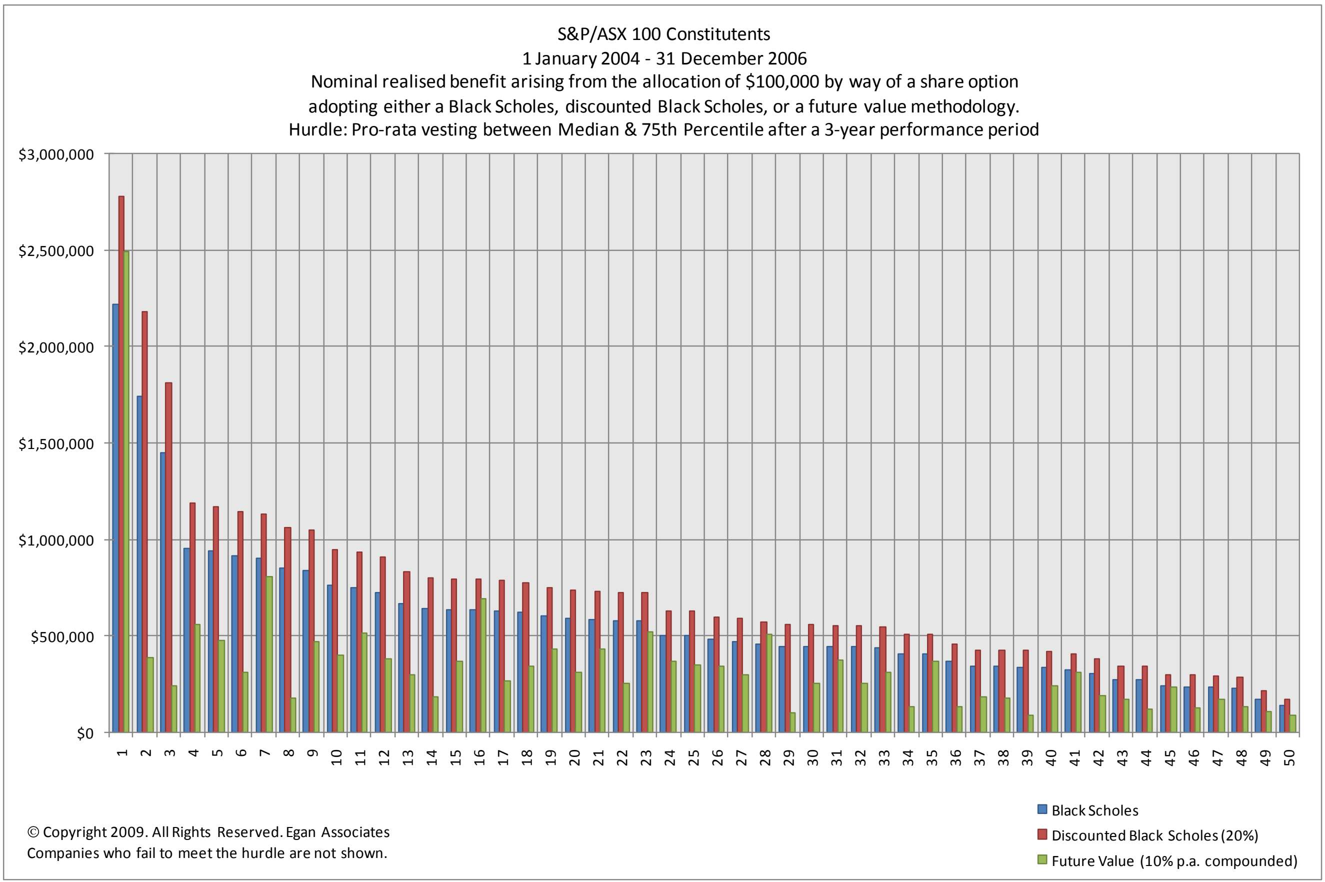
We also believe that the valuation provisions adopted by accounting standards (typically AASB 2) are inappropriate as a foundation for determining grants under employee share, option and rights plans. The valuation of grants under employee share, option and rights plans have led to significant distortions in the allocation of employee benefits under these plans and bear little relationship to future earned income which is the primary interest of both Governments, boards, shareholders and employees.

Prior to the introduction of the accounting standard AASB 2 the value proposition for the determination of allocated securities under a long term incentive plan was typically an estimate of future share price growth. This was aligned to a company's three year business plan outlook. The charts in the following several pages highlight the impact of various allocation scenarios over different three year periods and the impact of holding the July 2005 allocation until June 2009.

The first explores the three year period from 1 July 2002 to 30 June 2005 for the ASX top 100 companies at the time. The benefit reported is predicated on achieving a relative total shareholder return (TSR) having regard to the ASX 100 Accumulation Index with proportional vesting for performance levels from the median to the 75th percentile. The histograms reveal the value of the benefit arising from the allocation of options adopting a future value allocation, a standard Black-Scholes allocation and a 20% discount to the Black-Scholes allocation. The values represent the share price growth over the period which can be compared with the allocation value ($100,000 at the time of grant). The average benefit obtained by the executives in those companies meeting the TSR hurdle was $361,806 by Black Scholes, $452,258 by discounted Black Scholes, and $202,591 by future value methodology.

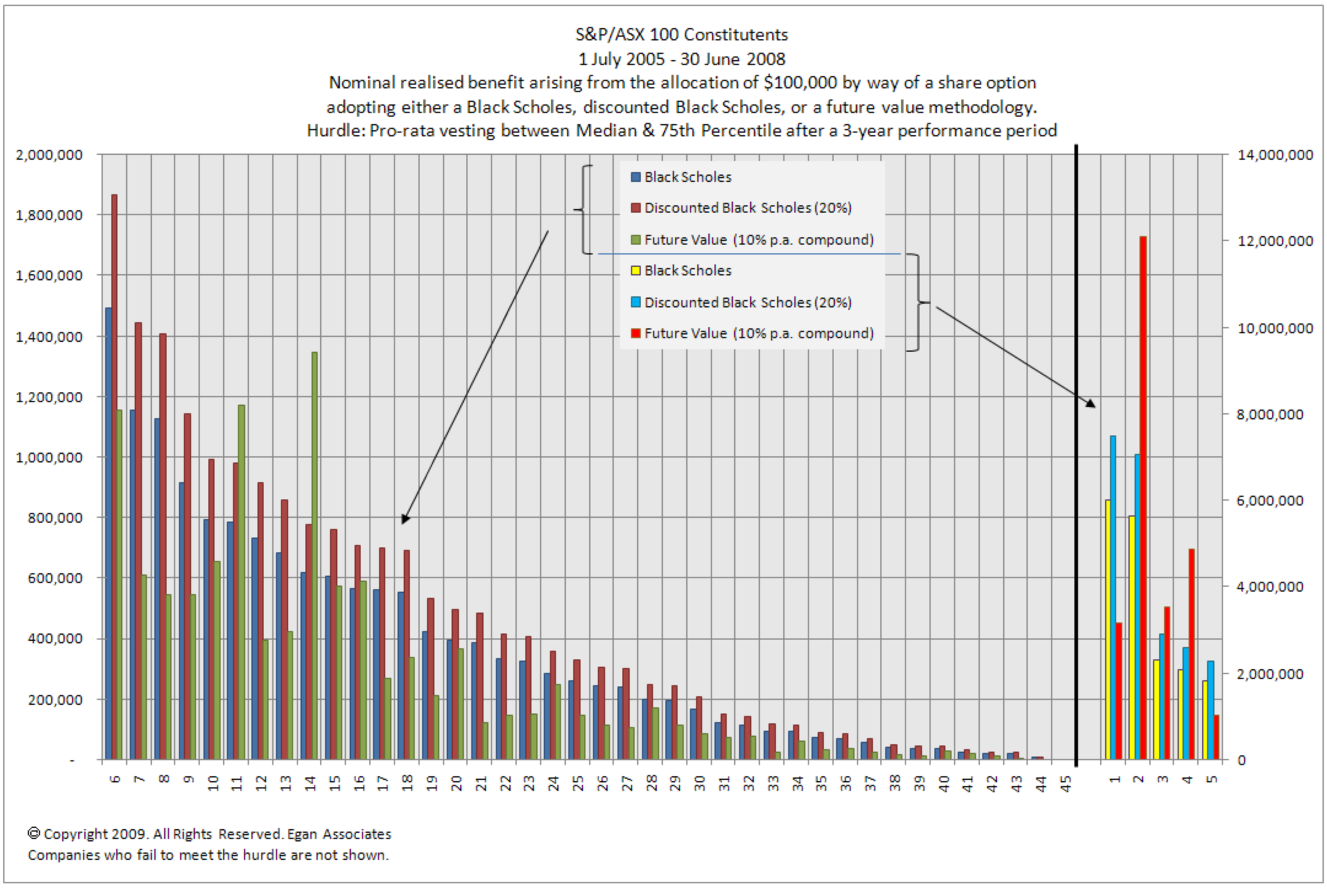
The second chart, adopting a similar total shareholder return performance hurdle, highlights benefits arising using similar allocation methods in the period 1 January 2004 to 31 December 2006 for the constituents of the ASX 100. The average benefit obtained by the executives in those companies meeting the TSR hurdle was $588,108 by Black Scholes, $735,135 by discounted Black Scholes, $349,441 by future value methodology.

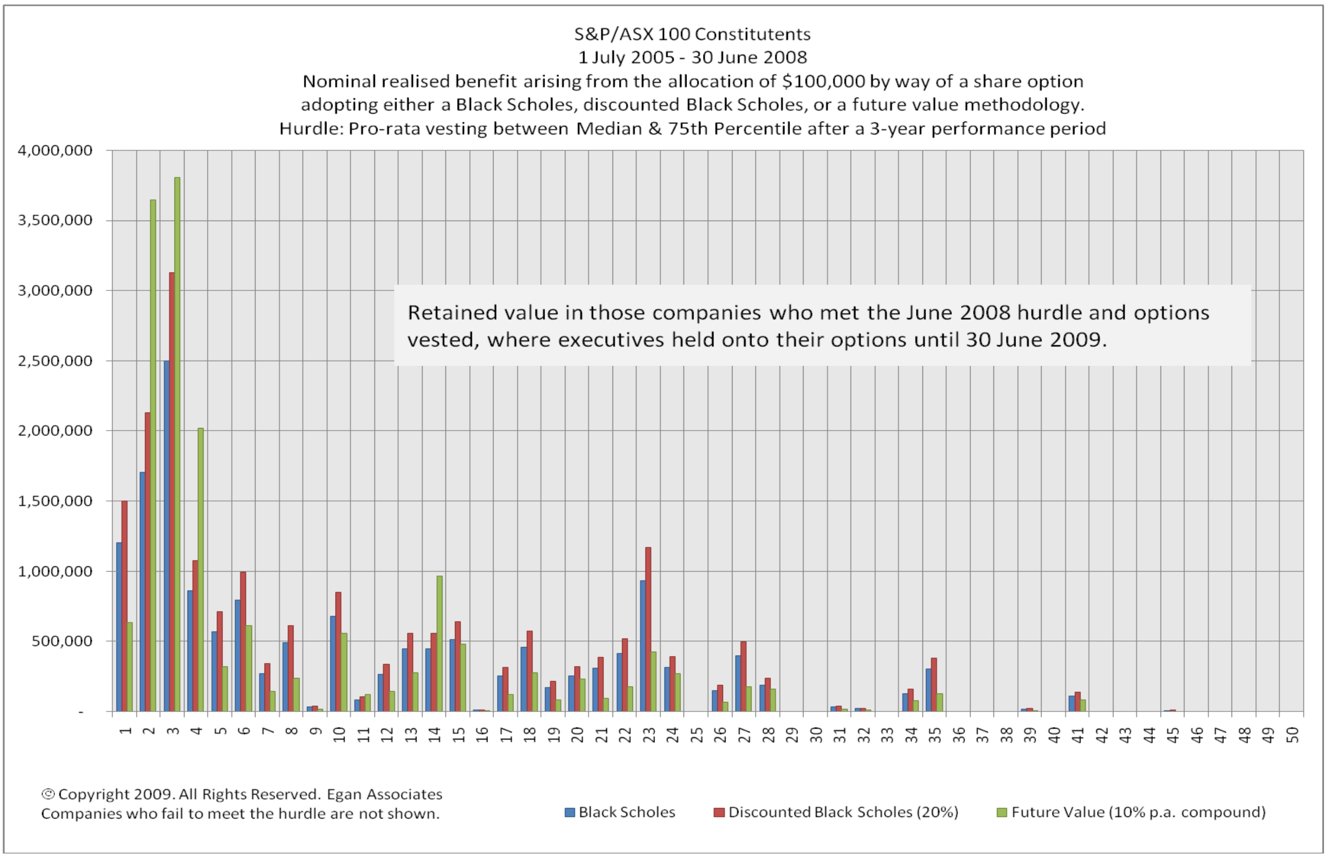




The first chart below applies a similar methodology for the period 1 July 2005 to 30 June 2008 for the constituents of the ASX 100. The average benefit obtained by the executives in those companies meeting the TSR hurdle was $727,941 by Black Scholes, $909,926 by discounted Black Scholes, $794,615 by future value.

Our research reveals quite variable values to participants over each three year cycle. Where securities which vested in June 2008 were retained until 30 June 2009, the current *'in the money'* value of options using the standard Black-Scholes valuation was $340,529, using the discounted Black-Scholes $425,661 and the future value allocation $365,769. It will be noted this represents a substantial decline on the value at the date of vesting (second chart below).





Given the nature of the nominated performance hurdle (relative total shareholder return) a significant number of employees (nominally 50%) did not benefit under the theoretical grant as their company's performance did not meet the hurdle rate of return. This arose in many circumstances where there was a significant increase in the company's share price – further, due to the nature of the TSR hurdle (the most common) less than 30% of companies met the stretch element of the hurdle. The figures reported above represent the realised value in accordance with each company's relative performance.

If there were an expectation that the valuation methodology adopted by Accounting Standard AASB 2 were to represent a reliable estimate of future value of securities obtained by employees under an equity based incentive plan, our results in the review of the application of a widely adopted performance hurdle and the adoption of three different approaches to valuing securities at the time of grant indicates a somewhat unsettling relationship between value ascribed and value realised.

In adopting a simplified performance hurdle of relative total shareholder return, 50% of participants would receive no benefit. Of those who do benefit the benefit is generally substantially above that expensed and purported to reflect an indicative remuneration value. Equally, for those companies whose participants fail to benefit using relative total shareholder return as the performance hurdle there is no relief in recovering the amortised expense of the issue of those securities.

Our basic research, reveals that the adoption of Accounting Standards for the purpose of providing shareholders with a meaningful appreciation of value of securities issued to executives is significantly flawed.

As the data reveals in the charts above, taxing a potential income benefit at the date of grant based on an existing valuation regime is at considerable variance to a mark to market outcome at the time of vesting. The illustration does not incorporate widespread market practice of smoothing returns or providing for retesting which we have endorsed based on our long experience, nor does it illustrate outcomes adopting different hurdles such as earnings per share growth or other measures.

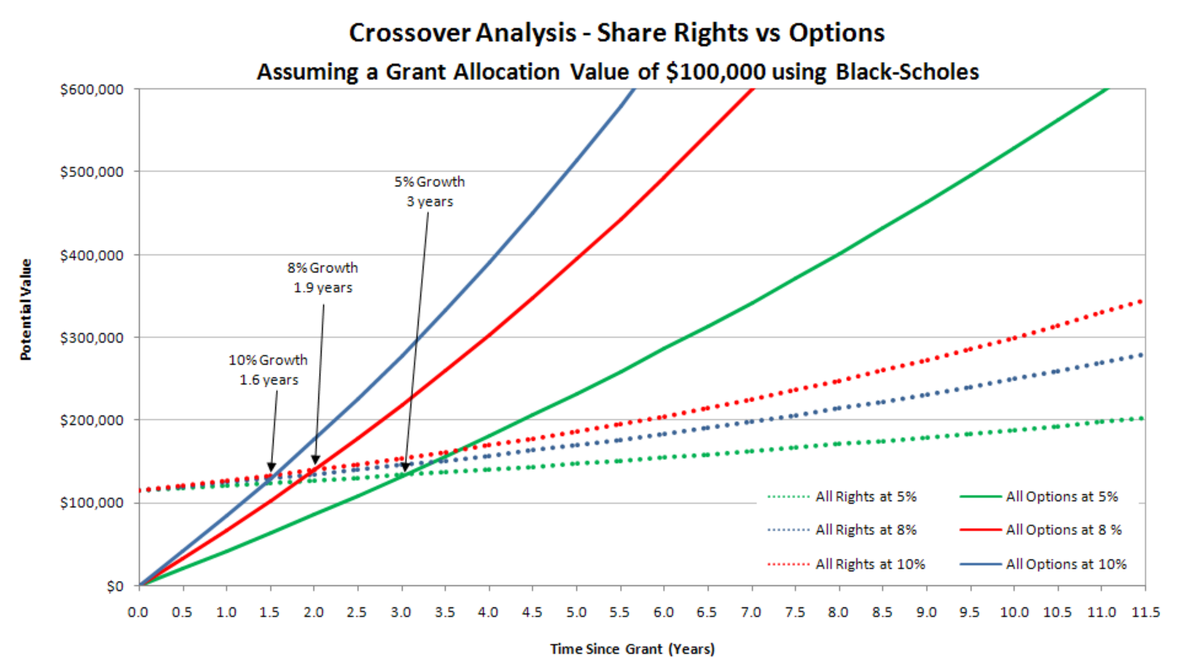
1.2.3 Valuation variance and allocation policy

In compliance with Accounting Standards and the requirement to expense equity grants under long term incentive plans companies will often seek a path which optimally mitigates the long term impact on their P&L, particularly as the issuance of securities, unless they are purchased on market, are a balance sheet item, not a P&L item, despite the involvement of international accounting bodies in resolving this foreshadowed governance challenge.

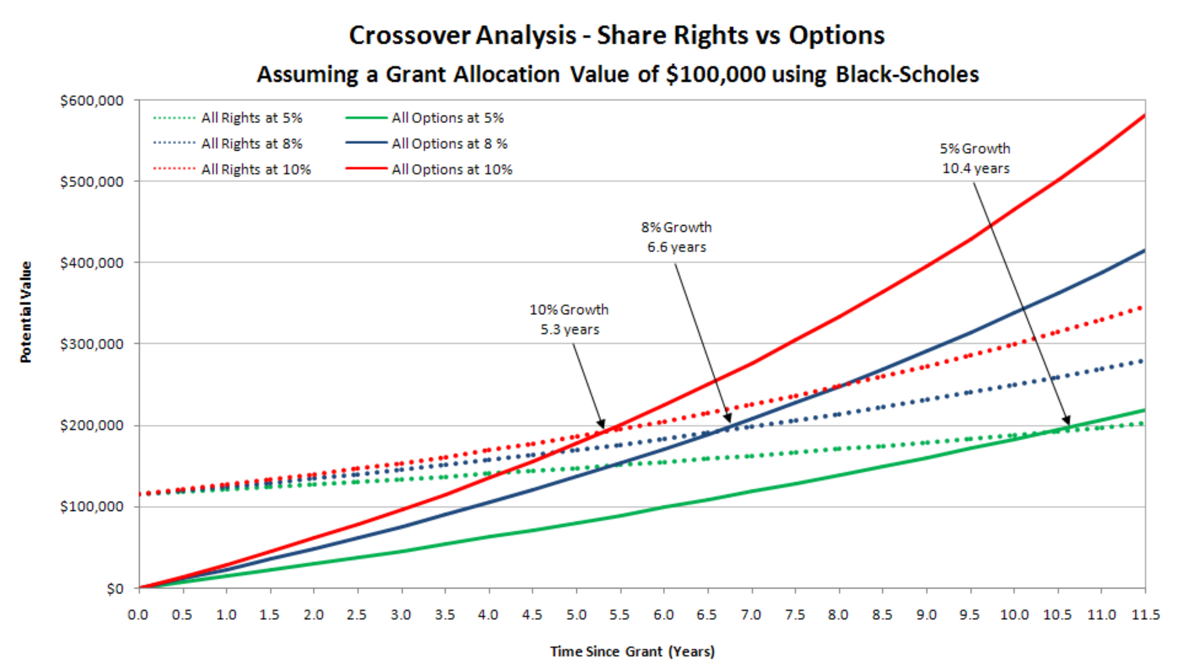
Arising from this juxtaposition of valuation and impact on the P&L many organisations, with advice, have discounted a straight Black-Scholes valuation to account for exogenous factors, including the meeting of performance hurdles demanded by investors. The two critical drivers of value are volatility and the life of the equity instrument under the long term incentive plan. Many companies would value the security over the period until vesting, others over the life of the security.

In the 2005/2007 period volatility of the leading indexes would have been in the order of 20% to 25%. Many companies are now experiencing volatility in the order of 60%, though might argue in a look forward context that their volatility for the purpose of determining expensing to the P&L should be reduced to 25% which will have a dramatic impact on the value of instruments issued and the appeal or otherwise in the current market of a share right compared to an option.

The illustration below sets out valuation variance without discount by varying the nominal vesting for an option or share right attached to a current share priced at $5 from three years to five years to seven years and its volatility from 20% to 60%. The graphic illustrations highlight the cross-over implications in respect of the choice of instrument under the long term incentive plan adopting various share price growth assumptions for the period ahead. These graphs also highlight a series of interesting dilemmas in relation to the disclosed intent of grants under long term incentive plans and probable outcomes in line with an organisation's business strategies and plans.



Rights and options valuation using Black scholes option valuation methodology.
Analysis assumes a thereotical option and right grant value of $100,000; both rights and options are allocated in equal proportions.
The issue price and exercise price is assumed to be $5. Volatility is assumed to be 20%, dividend yield and risk free rate are assumed to be 5%.
Both rights and options have a term of 3 years.



Rights and options valuation using Black scholes option valuation methodology.
Analysis assumes a thereotical option and right grant value of $100,000; both rights and options are allocated in equal proportions.
The issue price and exercise price is assumed to be $5. Volatility is assumed to be 60%, dividend yield and risk free rate are assumed to be 5%.
Both rights and options have a term of 3 years.

Included in our confidential document is further graphic illustration indicating the points in time when options will outperform share rights at 5%, 8% and 10% growth in share price. The graphs above indicate the total value of the option or right over a twelve month period.

Material set out at ***Page 24*** further illustrates the growth rates over time required for options to outperform rights.

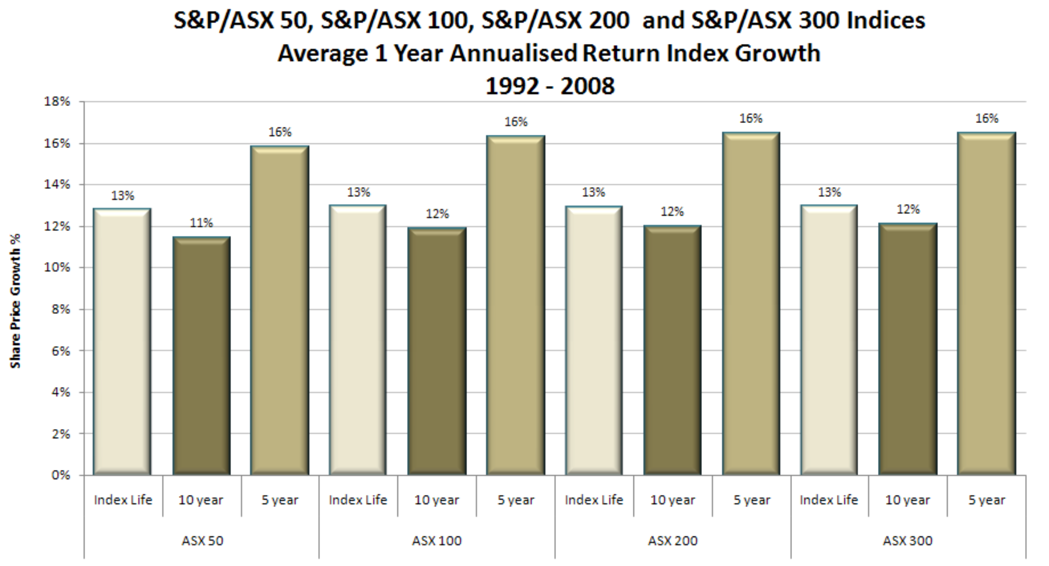
The value of options and share rights have been determined using a Black-Scholes Valuation methodology - assuming a share price at the time of grant of $5, the exercise price of an option at $5 and the exercise price for a share right at zero, volatility is assumed to be 20% or 60%, dividend yield and the risk free rate to be 5%, and a 3-year term for both options and rights.

Volatility has a direct relationship with the price of the option, such that the higher the volatility, the higher the value of the option.

1.2.4 Choice of performance measures and hurdle structure

While the above illustrates the equity allocation challenges for a company reporting a remuneration intent in their Directors' Report, the following information portrays the further issue of accurate and transparent reporting of outcomes on the one hand and the level of performance required to meet hurdles, predominantly imposed after pressure from institutional fund managers and proxy advisers.

Prior to the current decade of the mandatory stretch hurdle boards and shareholders appeared at ease with year on year 10% growth in shareholder returns, with 15% seen as exemplary. Risk mitigation was an underlying consideration, while growth was seen as key to sustainability. The table and graphs below highlight the level of return required to meet a nominated index's long term total shareholder return over five and ten years for the ASX 50, ASX 100, ASX 200 and ASX 300 indices, as well as the performance gap between the median and 75th percentile for the ASX 200 over varying periods.



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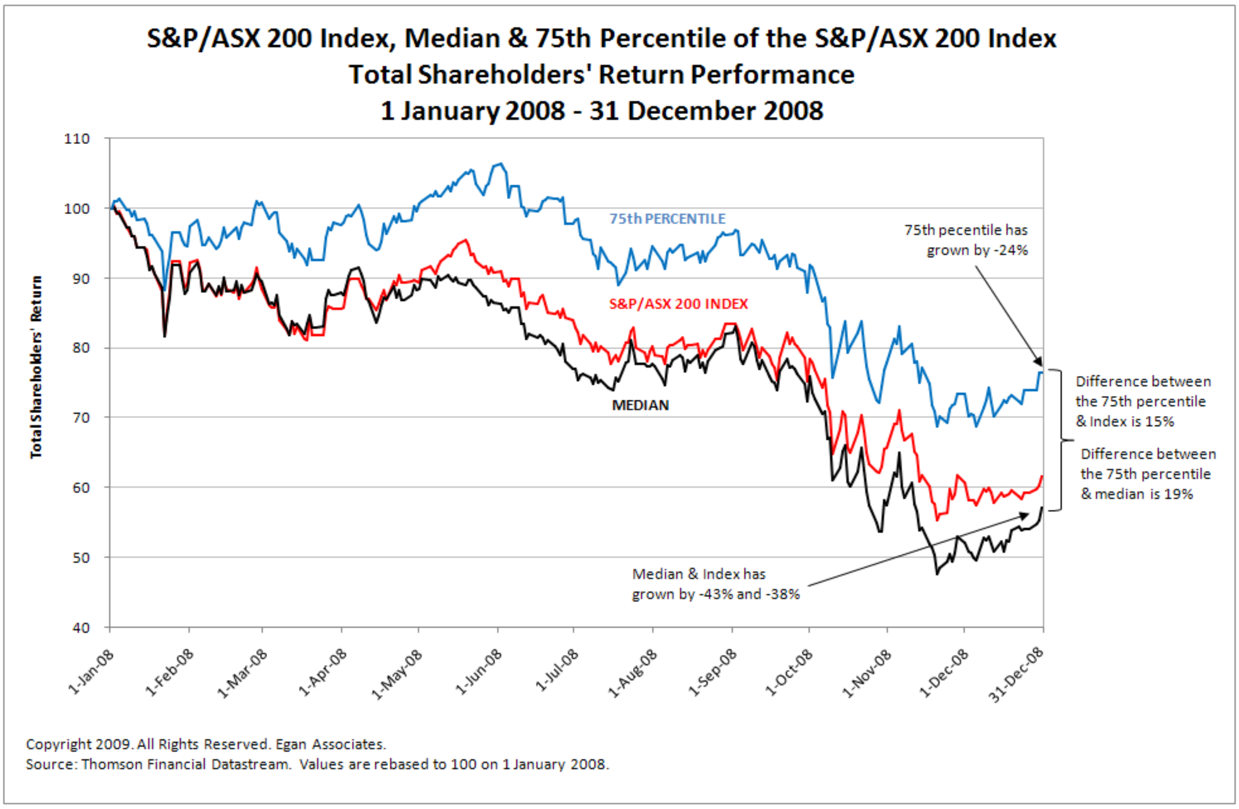
Source: Thomson Financial Datastream
S&P/ASX 50, 100, 200 and 300 Indices were first created on 29 May 1992.
10 year period is calculated from 1 January 1999 to 31 December 2008; 5 year period is calculated from 1 January 2004 to 31 December 2008.


S&P/ASX 200 Index, Median & 75th Percentile of the S&P/ASX 200 Index
Total Shareholders' Return Performance
1 January 2008 - 31 December 2008
Total Shareholders' Return
75th PERCENTILE
S&P/ASX 200 INDEX
MEDIAN
75th pecentile has grown by -24%
Difference between the 75th percentile & Index is 15%
Difference between the 75th percentile & median is 19%
Median & Index has grown by -43% and -38%
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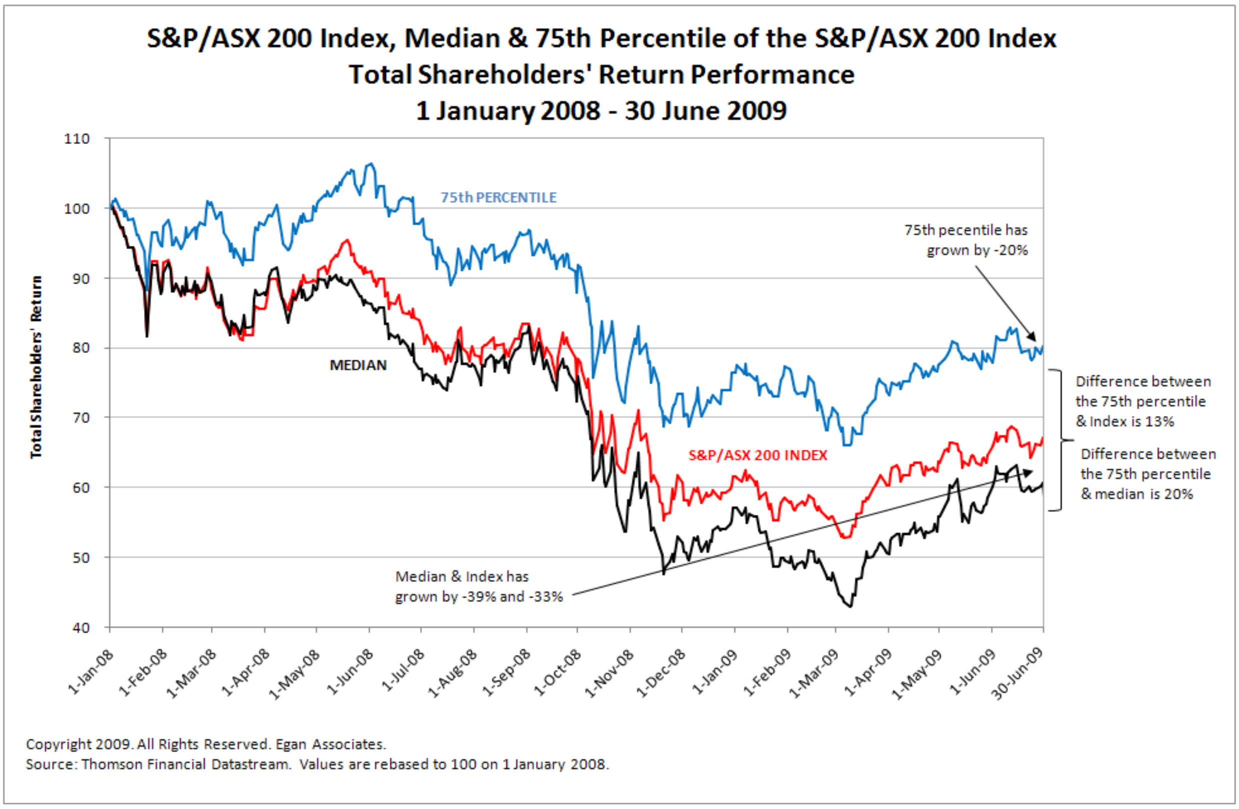
Source: Thomson Financial Datastream. Values are rebased to 100 on 1 January 2008.


S&P/ASX 200 Index, Median & 75th Percentile of the S&P/ASX 200 Index
Total Shareholders' Return Performance
1 January 2008 - 30 June 2009
Total Shareholders' Return
75th PERCENTILE
MEDIAN
S&P/ASX 200 INDEX
75th pecentile has grown by -20%
Difference between the 75th percentile & Index is 13%
Difference between the 75th percentile & median is 20%
Median & Index has grown by -39% and -33%
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Source: Thomson Financial Datastream. Values are rebased to 100 on 1 January 2008.

The lottery effect of the market and the probability of performance hurdles being met has not engendered wise planning or an appropriate forensic engagement or understanding by boards in relation to equity outcomes and the embedded risk in those outcomes. Solid performance in many instances has delivered no value to executives because their industry sector or circumstance under-performed the balance of the market.

Given that a key consideration globally as a core problem with executive remuneration has been underlying risk, one observation may well be that shareholders' or their representatives' demands for significant year on year compound growth in total shareholder return exceeding a median and achieving a 75th percentile has in fact been a core ingredient in sponsoring management taking increased risk in order to achieve returns demanded.

There has also been regular discussion in relation to the appropriateness of total shareholder return as a measure of company performance, particularly for the majority of executives participating in these plans. On the other hand, proxy advisers have criticised absolute earnings per share growth hurdles because they have almost universally been met.

It would be our assessment that the current structure of performance hurdles for long term incentive plans are not working for either shareholders or executives. Sound performance, particularly having regard to underlying risk, by management teams in many instances has not been rewarded, whereas in others the endless pursuit of growth associated with significant increases in debt has in recent years delivered substantial out-performance, though in the current challenging period the price of debt funding has increased and the value of assets acquired in a bull market are being revalued in the current economic downturn.

It is not clear to many shareholders, particularly those investing in funds, whether the performance requirements considered appropriate by institutions managing monies primarily on behalf of superannuants, led to significant performance payments to the executives of those institutions. These matters are not disclosed, but in our view as part of the global improvement of transparency in governance should be disclosed such that fund managers who receive performance fees should have the details of their executive incentive structures disclosed. In this context it is our understanding that there is no universal reward strategy for funds managers. Some would be rewarded on the achievement of an absolute return, others would have regard to their funds' relative performance with institutions adopting comparable investment philosophies or of a comparable scale, others a combination.

A challenging issue for directors of the major institutional fund managers, one which has existed for some time, is whether bonuses should be paid to investment specialists where they out-perform a market, though lose money. Similar questions have validity in relation to executive earnings under long term incentive plans where the company may have out-performed the market, though during the period of the long term incentive plan the value of shareholders' investments have declined. This represents a governance challenge for board Remuneration Committees.

The philosophical intent of a long term incentive is to reward sustainability of performance at levels acceptable to boards and shareholders. The philosophical imperative of an annual bonus or incentive plan is to reward management for delivering on the business plan and budget of that year and key strategic and operational objectives agreed by the board as aligned to both the business's sustainability, near term growth and prosperity. Under annual incentive plans key drivers are weighted between financial, strategic and operational objectives, with reward triggered on the basis of the extent to which management achieve or over-achieve targets or objectives established.

A further issue in relation to the lottery effect and the claimed remuneration intent of securities allocated under equity plans is whether in fact all securities offered under these plans should be conditional securities with no automatic right for those securities to vest irrespective of performance accomplishments. In this context if a fully effective performance is intended to deliver 50% of an executive's fixed annual remuneration, then should the number of rights or options capable of vesting be aligned with that remuneration intent or should the executive in the immediate past bull market environment for an adequate performance be entitled to receive three or four times the remuneration intent, simply as a result of a rising market? Should there be a cap on remuneration outcomes associated with the original reward intent such that achieving a market average or 50th percentile performance, or indeed a budgeted or planned performance, would deliver the outcome expected, with a superior performance delivering twice that outcome and an exemplary performance say three times that outcome?

Awards would therefore be conditional and benefits would be allocated to executives in accordance with a discipline embracing the construct of reasonable reward, though not one which has the lottery effect of relative total shareholder return or one which pursues rapid growth without due regard to risk and sustainability of acceptable returns to shareholders. This might relate to a construct of reward for the future.

A question arises as to how this links in with good governance. The construct clearly needs further development. It will require careful consideration in relation to tax, though if awards are conditional this should be less evident. Boards would be required to indicate what they expect to deliver to executives who achieve specific outcomes. Outcomes might be required to be sustainable over extended periods and issues in relation to shareholders' rights to trade and their flexibility should be considered quite separate from those of executives who are receiving remuneration arising from their employment, not a return arising from their investment other than the extent to which executives may be required to invest their earnings in shares during their period of employment.

Given the challenges associated with the performance hurdles now demanded by shareholders, primarily represented by institutional investors and proxy advisers, it may well be in the shareholder's interest and the executive's interest for awards of equity, whether options or rights, to be delivered as conditional awards aligned to a company's annual performance and an executive's contribution to that performance, those securities vesting over a three to five year period subject to the continuing employment of the executive, with gateways reflecting sustainability of a company's earnings and sustainability of an executive's performance at a level which reflects their continuing effectiveness.

It is acknowledged that this approach would also have challenges and place significant pressure on CEOs and boards in relation to the integrity of establishing sustainable performance gateways and assessing the ongoing effectiveness of an executive's performance. One would assume in this context in respect of executives that if their performance was not at the effective level they would be terminated and forfeit the potential benefit arising from their past participation.

1.2.5 Expensing of grants to profit and loss account

We do not support the current requirement to expense the issue of equity to employees to a company's profit and loss account. The issue of equity is normally a diminution of the shareholders' proportion of ownership in the company. It is not an opportunity foregone to receive funds for those shares as the company on the employees' behalf are not in the vast majority of cases purchasers in the market for the shares. Where shares are purchased on market to meet obligations under employee equity based plans they need to be expensed as they represent a cash cost in meeting obligations under an employee incentive plan.

1.2.6 Vesting and exercise

When a performance hurdle is satisfied, the share right, option or share is said to vest in the participant. Vesting means that the participant cannot be divested of their equity entitlement. However , there are at least three kinds of circumstance possible at this stage:

- the participant may receive the shares unencumbered, or be able immediately to sell the shares or rights;
- the participant may be required under the rules of the plan or the grant to hold the equity for a further period before dealing with it (exercise or sale) is allowed; or
- an executive may have limited windows in which to trade under the company's governance protocols and share trading rules.

When decisions are being made on the timing of the imposition of tax on grants, the access to funds to pay the tax where securities are restricted from dealing must be addressed. There are often further complications with equity rights in multinationals and private companies.

1.2.7 Concluding observations

Egan Associates are of the view that the wide use of accounting standards for the purpose of valuing equity grants to executives has no merit. The practice of adjusting the allocation value of the award to reflect the probability of risk of forfeiture or failure is in no way aligned to the disclosed intent of an equity based long term incentive plan.

The insistence by major shareholder groups, proxy advisers and institutional investors that demanding performance hurdles, principally relative total shareholder return, be adopted has led to an increasing focus on pursuing growth, often with inadequate attention being given to the underlying risk associated with these initiatives.

Traditionally and appropriately, executive participation in long term incentive plans has been designed primarily to align their interests with the sustainability of enterprise value for the benefit of shareholders. Meeting relative performance hurdles over a decade or more of bull market conditions, in our judgement, has placed undue pressure on company boards and executives to grow their enterprises at a rapid rate beyond measures considered to be reasonable and sustainable. In this context from a shareholder viewpoint, many being superannuants, steady rates of return in the range of 10% to 15% were considered admirable and today would be highly regarded. In contrast, the graphic illustration on page 29 above reveals the return requirements to meet the share price index over the past five and ten years for the ASX 50, 100, 200 and 300.

General indexes are meaningless in the majority of instances as companies' prosperity is reflective of their industry sector, their positioning in a life cycle in relation to growth and business sustainability.

TOR 1

1.3 Executive pay excess – Does it really exist?

Statistics reveal that executive remuneration in Australia is not excessive. There are examples of excess but the main flaws in market practice are in the structure of incentive plans, both annual and longer term.

While there is a significant focus on substantial rewards paid to senior executives in major corporates, statistics reveal that outside the top 100 companies only a small percentage of senior executives, including Chief Executives, receive salaries plus annual incentives to a combined value of $1,000,000.

Egan Associates' research based on published data for companies with financial years ending in the 2008 calendar year revealed that while the ASX top 100 companies retain a significant proportion of their CEOs with fixed annual remuneration in excess of $1,000,000, outside the S&P/ASX 100 the number diminishes dramatically.

Our research also revealed that it was principally among the top 50 companies that direct reports to the CEO received annual cash compensation in excess of $1,000,000, with very few in the next 350 companies.

The tables below set out the percentages of companies with CEOs receiving fixed annual remuneration in excess of $1,000,000 ranked according to the S&P/ASX top 400, as well as their top 5 reported executives, together with the number of companies reporting total annual cash compensation, that is fixed annual remuneration and annual cash bonus, exceeding $1,000,000.

While in the top 50 companies the proportion of CEOs receiving over $1,000,000 in nominal annual salary approaches 90%, in the next 50 it is 60%, in the next 100 less than 20% and in the next 200 companies less than 5%.

In relation to the top 5 reported executives, other than the Chief Executive Officer, in the top 100 companies there were fewer than 75 executives on fixed annual remuneration in excess of $1,000,000 and in the next 300 companies fewer than 10.

In respect of total annual cash compensation, in the top 100 companies more than 85% received annual cash compensation in excess of $1,000,000, in the next 100 companies around 35% and in the next 200 companies 10%.

Among the top 5 executives, in the top 100 companies there were more than 200 executives other than CEOs receiving total annual cash compensation in excess of $1,000,000, though in the next 300 ranked companies there were less than 5% in the same category.

Our research reveals that while the media focus on the very substantial companies that have significant market prominence, pay levels in terms of fixed annual remuneration and the value of annual incentives diminished dramatically outside the top 100 companies, to become almost indistinguishable as a proportion of the senior executive cohort.

Million $ CEOs

S&P/ASX Rank	Fixed Annual Remuneration	Total Annual Cash Remuneration
1 – 50	88%	96%
51 – 100	60%	80%
101 – 200	17%	35%
201 – 400	6%	10%

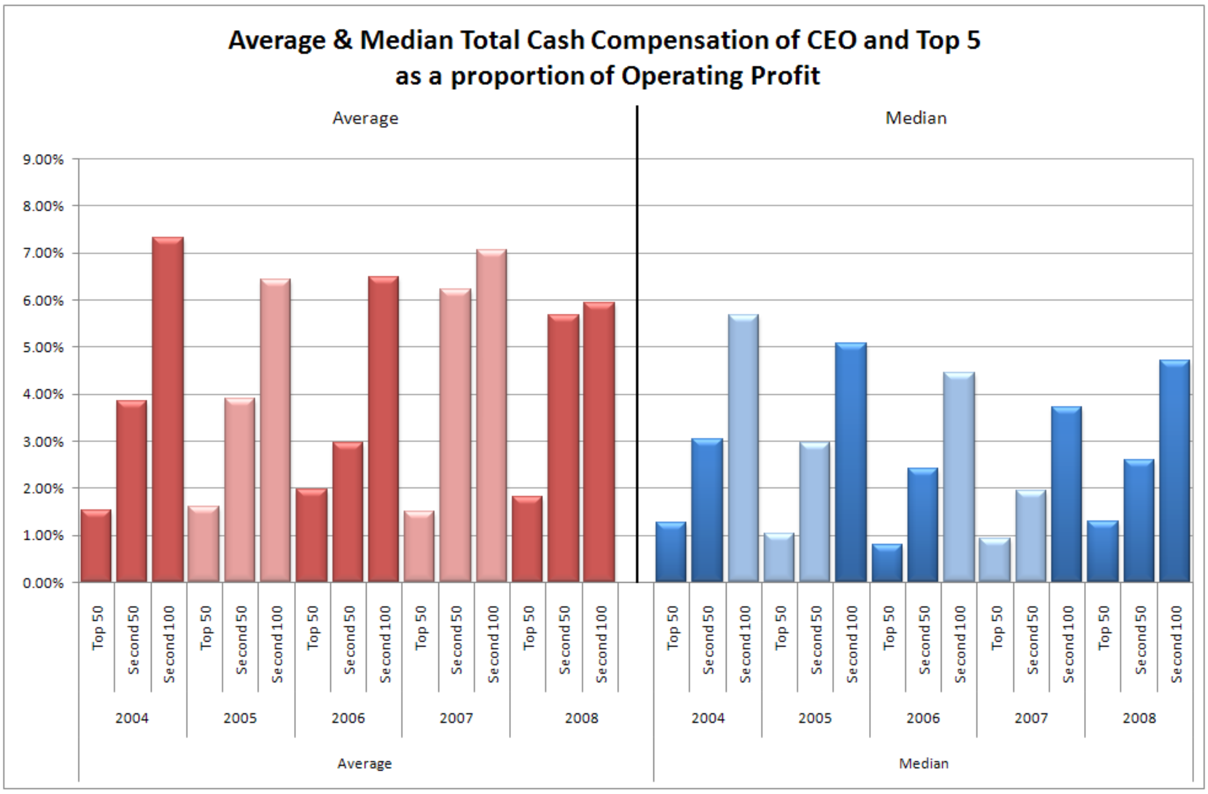
Million $ Executives

S&P/ASX Rank	Fixed Annual Remuneration	Total Annual Cash Remuneration
1 – 50	26%	68%
51 – 100	4%	20%
101 – 200	<1%	<5%
201 – 400	<1%	<5%

1.3.1 Top executive pay as a proportion of net and operating profit

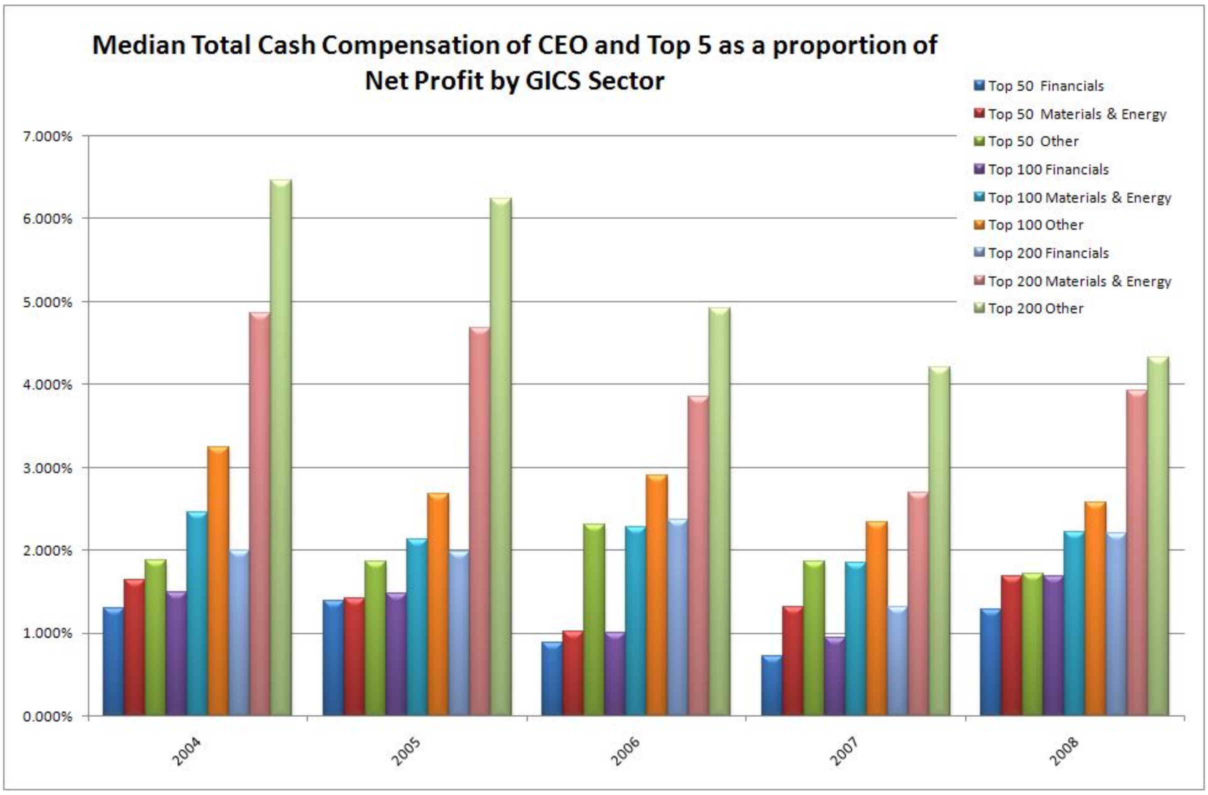
The illustrations below reflect the proportion which the aggregate of the CEO and top 5 executives receive in total annual cash remuneration of their respective company's pre-tax operating profit. The first chart reveals the skew in data arising from substantial payments in those organisations pitching their total annual reward opportunity toward or above the market 75th percentile. This is clearly illustrated by the difference in the median share of profit compared to the average.

Excluded from our analysis in each year were those companies which did not report a profit.



The chart above also reveals the skew in the data arising from substantial payments in those organisations pitching their total reward opportunity toward or above the market 75th percentile.

On an industry sector basis there is little difference between the top 50 companies, though the top 100 and top 200 industrial companies generally reward their executives on average and at the median with a far higher proportion of profit than financial services companies.



It needs to be pointed out that the top 50 companies are incorporated in the top 100, which are in turn incorporated in the top 200 analysis. This indicates that companies with lower profits and lower levels of market capitalisation reward their senior executives significantly more highly in terms of a proportion of both net and operating profit than is the case of executives among Australia's leading companies, which are the subject of most comment.

In the second 100 of the top 200 companies the size of the executive population would be far less and a more substantial proportion of those companies would be in the hands of the CEO and the top five executives than would be the case among the top 50 companies.

It should be noted that the data in the illustrations above does not incorporate benefits arising from participation in equity-based plans generally approved by shareholders.

Our research in relation to benefits arising from equity plan participation does indicate, however, that the value of CEO participation in these plans, generally over a three to four year period, can be substantial. If they were allocated equity to a value in the range of 50% to 100% of their fixed annual remuneration, which would average in excess of $1,000,000 among the top 50 companies, for those executives benefiting under these plans (nominally two-thirds) then in the three year period up until June 2008 their annualised benefit on average is likely to be equivalent to twice their base remuneration. For the one-third of executives whose companies fail to meet performance hurdles their benefit would either be zero or negligible.

TOR 1

1.4 Reward in substantial private companies

Any increase in government regulation of reward should make provision for the needs of private companies run largely by the proprietors which tend to rely on lower annual remuneration.

1.4.1 Introduction

Our experience over an extended period of offering advice is that large private companies reward proprietors in terms of fixed annual remuneration modestly, though if led by executives independent of family ownership reward executives at highly competitive levels.

The nature of reward in family companies is often at variance from that in listed public companies, in that proprietors, while willing to pay broadly competitive salaries at around the market average, will often (for long-serving and highly effective executives) provide motor vehicles that are beyond the norm, high quality vehicles for their leading executive's spouse, sponsor overseas holidays, support for the acquisition of high quality accommodation and variable, though generous, bonuses when their profits substantially exceed expectation.

Proprietors will generally have the personal assets associated with extended ownership of successful enterprises. It is not uncommon, in our observation, to observe a proprietor CEO of a company with annual revenues substantially in excess of $100 million to receive base remuneration of less than $300,000, though annual dividends substantially above $3,000,000. This circumstance may differ when only some family members are active executives in the company. In these circumstances their annual remuneration will often reflect market practice and dividends will reflect reduced profitability arising from this circumstance.

A key difference between the proprietor and the listed public company executive, both with a significant length of service, is that the proprietor does not sell shares but holds the equity and adds to it by further investment in the company, and when successful is the recipient of substantial annual earnings and growth in personal wealth as a result of a quarter of a century or more commitment to an enterprise.

No more was this in stark evidence than at the time the Government offered a limited window for significant superannuation and termination settlements in 2007/8, when arms length termination arrangements were sought by a number of proprietors in their 60s or indeed 70s. While annual drawings were modest, as described above, on an arms length basis a retirement allowance up to seven times reasonable remuneration would amount to more than twenty times their annual salary, though a modest proportion of their annual drawings which included dividends.

1.4.2 Investment banking and private equity firms

Executive remuneration over the past decade in investment banking and private equity firms is also at variance with the traditional listed public company and in many respects is more aligned to proprietor reward in significant private companies. The transaction cycle in private equity is normally not less than three years and often between five and seven years between the acquisition of a business and its on-sale back into the market, either by way of a trade sale or public listing. In investment banking, given the diversity of engagement in market transactions, organisations reward executives on the efficient and profitable manner in which they manage capital at their disposal.

Leading investment banks and private equity firms operating in Australia have traditionally followed remuneration practices in North America and Europe. Those practices have generally been transparently disclosed to shareholders and investors in funds set up for the purpose of acquiring under-valued assets. The majority of these companies have unashamedly indicated that their remuneration practices are aligned to a global market reflecting the cost of top talent.

A significant difference in these companies' reward practices from the typical industrial company is that executives co-invest along with other investors in the funds or business interests of the organisation from the outset and will often defer incentive entitlements to further increase their investment exposure and alignment with key stakeholders. When successful their rewards are substantial and their incentives will often represent several multiples of their base salary. The nature of the incentives of executives retained by private equity companies are fully disclosed should their investments be offered to ordinary shareholders by way of an initial public offering and listing on the Securities Exchange. Executives in private equity firms also invest their own personal funds and will often borrow capital to increase their equity participation, those borrowings being full recourse to them personally. In this context the nature of their investment risk is different from executives in listed public companies, excluding investment banks.

The earnings of senior executives in investment banks have been widely commented upon, both in Australia and internationally, during the recent difficulties in the global capital markets. It would not be our judgement that practices in private equity or investment banks would readily translate into other industry sectors. The banking sector in particular has been subject to close government scrutiny and increasing regulation on an international footing.

While absolute levels of reward have been the subject of considerable review and discussion, a primary focus of enquiry has been the relationship between executive reward arising from financial transactions and the long-tail shareholder risk associated with those transactions, with the primary endeavour being one of increasing alignment between executive reward, risk and shareholder return. A further primary difference between the investment banking arena rewarding key staff on the Wall Street model is that they would normally distribute up to 50% of their profit to staff annually, albeit that a proportion is invested in the bank's shares or satellite fund shares or deferred in cash.

TOR 1

1.5 Non-executive directors

The remuneration of non-executive directors has changed radically over the last forty years to respond to the change in the complexity of business, increased regulation and a major expansion of the expected involvement and expertise of members of the Board. It will be important to ensure that remuneration continues to reflect the increased risk and responsibility of the role.

1.5.1 Changing role and pay profile

The role of non-executive directors over the last quarter of a century has changed dramatically arising from the sheer scale of the leading companies on whose Boards directors serve, the international engagement of those companies, the demands imposed by various standards and the Corporations Act and the emergence of directors' engagement in specialised work of the board through committees, including but not limited to Audit, Risk Management & Compliance, Remuneration & Nominations, Occupational Health & Safety and the Environment.

In the 60s and 70s, while directors had clear accountabilities, a key aspect of their role was to provide an alternate viewpoint in relation to the conduct of the company's business interests and to be a further, though independent, source of reference in relation to issues relevant to shareholders and/or in networking across key stakeholder communities, including governments, international and domestic industry bodies, professional associations and service providers.

The median and average fee for a Chairman of a top 50 company in 1988 was less than $60,000 per annum. For a director the fee was indicatively in the range of $25,000 to $30,000 per annum. At the time, the top 100 companies represented the major diversified industrial groups, resource companies, financial services, retail, transport, construction, property development and media enterprises, not distinctly different from today, though the relative weighting of the industry sectors was at variance with today's corporations, particularly the top 50 companies.

At the time, while the median or indicative value of a director's shareholding in the company on whose board they served among the top 50 companies was less than $30,000, the average was a significant multiple of that figure. Directors serving on significantly smaller companies, that is those with revenues of less than $50 million in 1988, on average had shareholdings with a then market value in excess of $1,000,000, reflecting significant shareholder vendor representation on boards.

With the significant growth in major companies has come an increased level of demand on non-executive directors, both in serving as a member of the Board but also participating at a far more intimate level through committee work of the Board, particularly in audit, risk management, remuneration and more recently safety and environment issues. With this increased engagement has come a substantial uplift in a director's time commitment and growth in fee levels required to attract suitably qualified non-executive directors.

While in the 70s and 80s directors on many leading companies received shares or options as part of their emoluments, by the late 90s as a practice this had been restricted to small market cap companies and recently listed companies. In recent years, however, Egan Associates have observed an increase in the commitment of non-executive directors to acquiring shares by way of fee sacrifice, an initiative widely endorsed by shareholders, reflecting a commitment of directors to align a proportion of their emoluments to ordinary shareholder returns.

In the early part of the 21st century activist shareholder initiatives, in parallel with the introduction of the superannuation guarantee charge legislation, persuaded the majority of leading companies to close their long established defined benefit retirement plans for non-executive directors. At the time these provisions were not as transparently disclosed as is the case today and Board service was not expected to be in the order of ten to fifteen years but rather between two and three terms of three years.

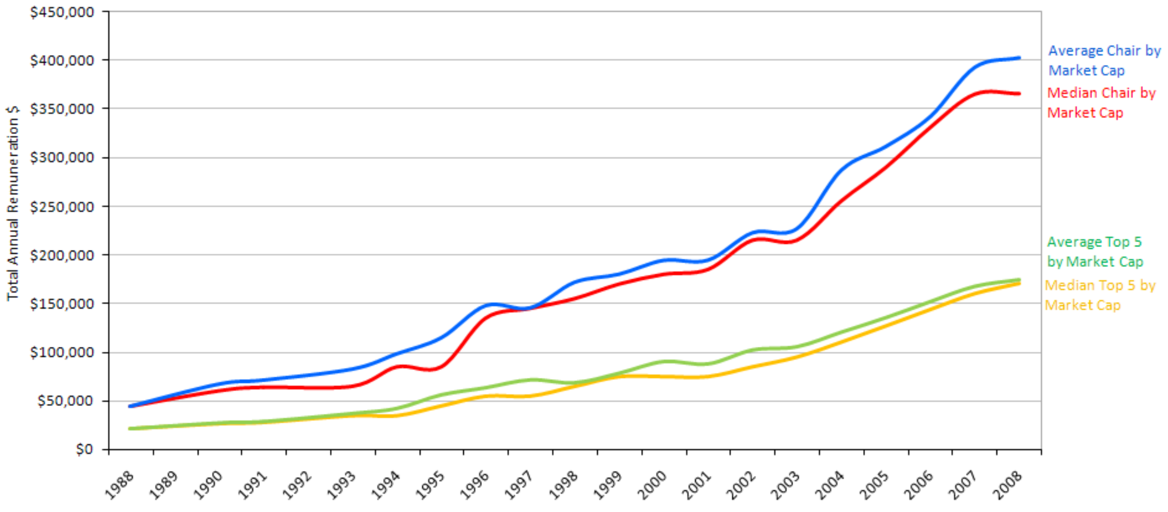
While the Corporations Law had provided for non-executive directors to receive a retirement allowance up to three times their final year's fees, it was noted by shareholders at the time that many plans provided for benefits (with shareholder approval) up to five, or in a very limited number of cases six, times a director's final year's fees after long service. The underlying cost of providing these defined benefit retirement programs were in the range of 30% to 50% of a director's annual fees. Among Australia's leading companies a significant majority of these defined benefit plans were closed and the benefits crystallised, predominantly in the 2003 to 2006 financial years. Arising from these initiatives directors' emoluments were adjusted to reflect the loss of retirement benefit, though also to more appropriately reflect their significantly increased time commitment. Accordingly, fee pools approved for distribution among directors were substantially increased during that period.

Subsequent to the above changes companies have been required to comply with the superannuation guarantee charge legislation and directors have either received an aggregate fee within which they comply with that legislation or a base fee with additional contributions being made by the employing company to meet the obligations under the legislation or comply with the spirit of those obligations.

In this context, while an increasing proportion of directors receive a contribution toward their superannuation in accordance with the limits of the legislation, a proportion of companies apply a superannuation contribution equivalent to 9% of the aggregate fees of the non-executive director. In the vast majority of cases these contributions sit within the shareholder approved fee cap, though in a small minority of companies contributions in accordance with the company's compliance with the superannuation guarantee legislation stand outside the approved fee cap.

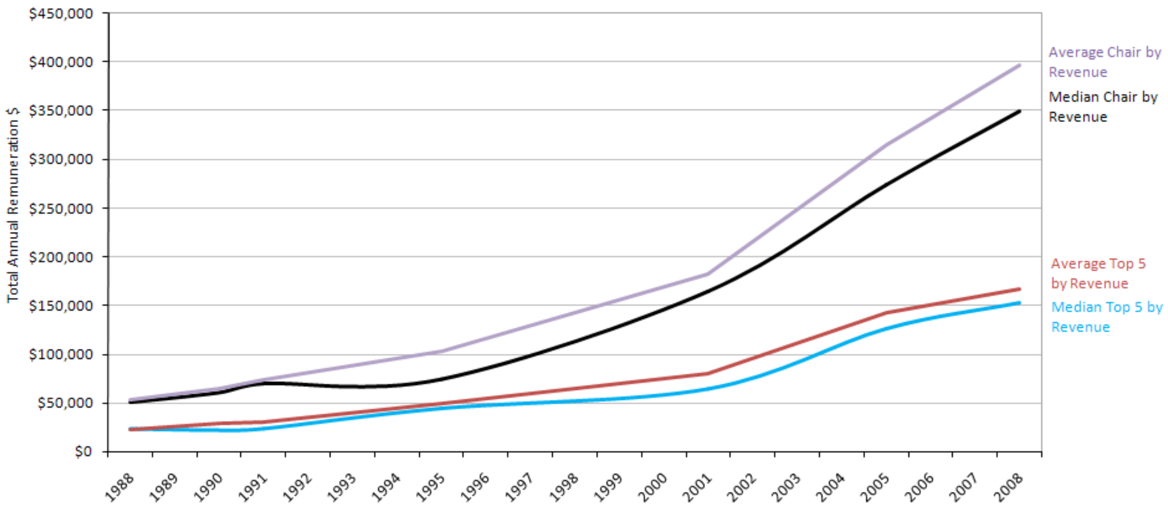
The charts below provide information on non-executive directors' fees on average and at the median for both Chairmen and the five highest paid non-executive directors over the period from 1988 to 2008 among Australia's top 100 companies by market capitalisation and annual revenue.

Annual Emoluments among the Top 100 Companies (by Market Capitalisation)
Non-Executive Chairmen and Top 5 Highest Paid Non-Executive Directors
1988 - 2008



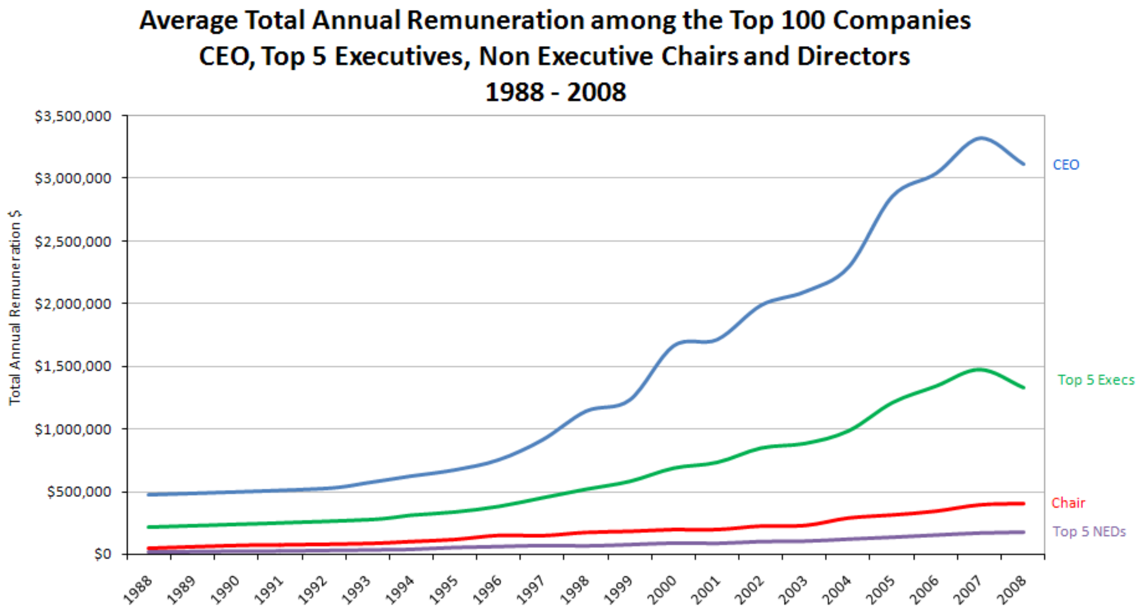
Prior to 2003, Non-Executive Directors' Remuneration Bands were used. From 2004 onwards, Non Executive Directors' Actual Total Annual Remuneration were used.
Companies are ranked by market capitalisation as at 30 June of each year (and excludes property trusts, funds, overseas entities and subsidiaries)

Annual Emoluments among the Top 100 Companies (by Revenue)
Non-Executive Chairmen and Top 5 Highest Paid Non-Executive Directors
1988 - 2008

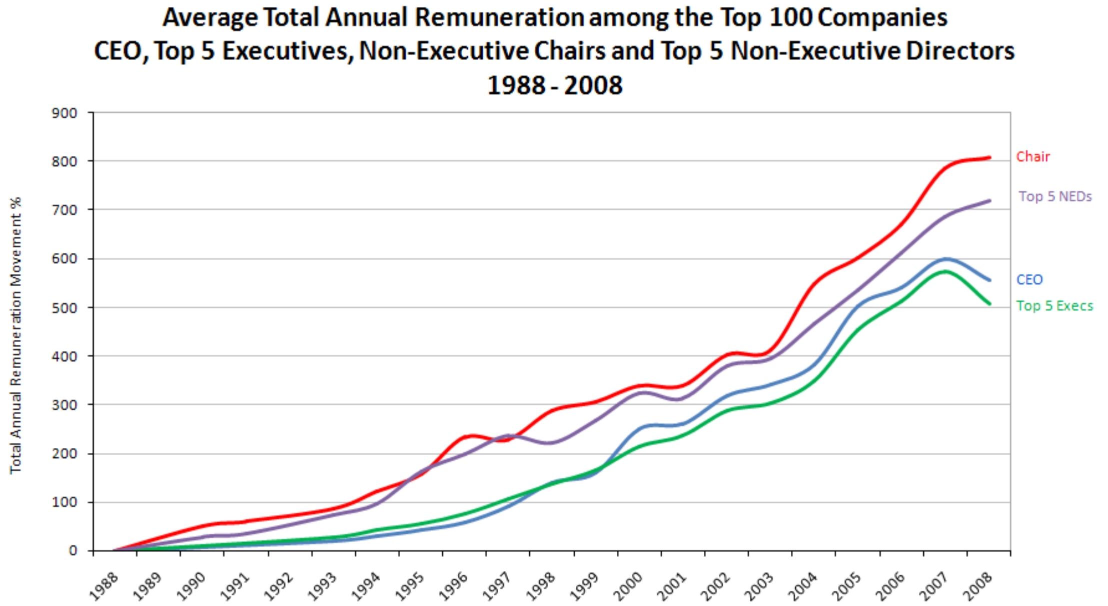


Prior to 2003, Non-Executive Directors' Remuneration Bands were used. From 2004 onwards, Non Executive Directors' Actual Total Annual Remuneration were used.
Companies are ranked by market capitalisation as at 30 June of each year (and excludes property trusts, funds, overseas entities and subsidiaries) and revenue.

The charts below highlight the actual level of total annual cash remuneration among Australia's top 100 companies by market capitalisation over the two decades since 1988, as well as the cumulative percentage increase in the annual remuneration of CEOs, the top 5 executive, non-executive Chairmen and non-executive directors.



Prior to 2003, Remuneration Bands were used. From 2004 onwards, actual Total Annual Remuneration were used.
Companies are ranked by market capitalisation as at 30 June of each year (and excludes property trusts, funds, overseas entities and subsidiaries)



 Values rebased to 0.
Prior to 2003, Remuneration Bands were used. From 2004 onwards, actual Total Annual Remuneration were used.
Companies are ranked by market capitalisation as at 30 June of each year (and excludes property trusts, funds, overseas entities and subsidiaries)

Of interest in relation to the top 50 companies and the top 100 companies ranked by market capitalisation is that today a Chairman's average and median fee level represents around 15% as a proportion of a Chief Executive's total annual cash compensation (fixed annual remuneration plus annual bonus) or between 20% and 25% of their base remuneration.

An issue which the Productivity Commission is to address is the allocation of options to the non-executive directors, particularly in start-up companies and companies with a modest market cap, usually in the technology and resources sector. A consequence of this practice, often embraced to preserve cash, is highly variable reward to non-executive directors from either a substantial windfall or a limited return.

Further issues which have been controversial over the past decade include the number of boards on which an individual should serve as a non-executive director and the importance of directors being shareholders in the company on the Boards on which they serve.

Egan Associates do not believe these are matters requiring review by the Productivity Commission. When they become important to shareholders we observe they are raised publicly at Annual General Meetings.

Over the past decade or more it would be our clear observation that non-executive directors have responded promptly to issues raised by shareholders in relation to their own remuneration. This is particularly evident in the closure of long established retirement plans and substitution of fully transparent emoluments, including an uplift in their cash compensation in substitution for the traditional defined benefit retirement arrangements.

Term of Reference 2. Effectiveness of regulatory arrangements

Consider the effectiveness of the existing framework for the oversight, accountability and transparency of 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.**

TOR 2

It will be important that any regulation contemplated recognises the complexity of modern commerce and the evolution of enterprises in Australia in response to the global market.

2.1 Australian Government regulation

With increasing concern about executive reward levels and their alignment to profit growth and share price performance being voiced during the 2008 annual reporting season and the growing international impact of the global financial crisis, governments chose to intervene in remuneration setting arrangements, both arising from shareholder concern and in a number of northern hemisphere countries arising from the government's forced investment in enterprises essential to the sustainability of their economies.

The initial engagement by the Australian Government was through the Australian Prudential Regulation Authority (APRA), which had a seat at the G20 Financial Stability Forum review of executive remuneration arrangements in the financial services sector (which were achieving notoriety on a global basis). Evidence revealed that Australia's leading financial institutions were far less vulnerable, more stable and better managed.

At the time of preparing this document the Australian Government had initiated four separate enquiries, one by the Australian Prudential Regulation Authority (APRA) into the financial services industry, the Productivity Commission addressing director and executive remuneration more broadly, as well as two specific initiatives, one relating to executive termination benefits and the other the taxation regime in regard to employee share plans.

2.1.2. Effectiveness of regulatory arrangements

The Term of Reference makes clear the present complexity of the various forms of regulation on levels of termination payment for executives. These arise from the Corporations Act and the ASX Listing Rules and Corporate Governance Guidelines. This is apart from the potential for complicated tax implications in termination payments which have been thoroughly addressed by tax specialists responding to the Commission's enquiry.

It may be that some of this complexity has been caused by a strong perception in the market that it is neither fair nor effective to regulate remuneration levels too rigidly given the wide range of company size, international engagement, commercial complexity and risk exposure.

The functioning of any market-driven organisation must be adapted continually to adjust to changes in the market, be it domestic or international. This applies to remuneration as well as operating characteristics.

TOR 2

2.2 Reform of the taxation of employee share schemes

Care is needed to ensure that the collection of tax is not used to manipulate the remuneration market in ways which lead to unintended results. Egan Associates supports the streamlining of the collection of tax provided that the sound commercial and social functions of employee share plans are protected and enhanced.

2.2.1 Introduction

Our observations are not so much in regard to the means by which the Government's regulation of the taxation of benefits arising from share plan participation is determined, but rather about the principles underlying that regulation. In accord with many countries in the developed world, Australia has an excellent record for successfully encouraging employees to take up shares in their employer companies, be they private companies, multinationals or publicly listed companies.

Recent Government findings reveal, however, that there are some employee participants who have either knowingly or carelessly avoided paying tax on some or all of the benefits arising from their participation in share plan programs. Most Australians would applaud steps to counter this. Our main concern is that a clear perception of the principles being addressed is maintained throughout.

2.2.2 The principles

2.2.2.1 Protection of the main stakeholders

The public response to the 2009 Federal Budget proposals has illustrated the wide range of stakeholders in employee share plans. These include:

- the shareholders in the employer companies who accept sharing some of the "corporate cake" to encourage improved morale and performance;
- the employees who are the key operator stakeholders who seek participation in the company's increasing prosperity to which they have contributed;
- the nation which is seeking the engagement of entrepreneurs and employees in enhancing the wealth and reputation of the nation;
- the representatives of the stakeholders who support the reasoned and equitable participation of all stakeholders; and
- the government having the responsibility to optimise tax collections to which they are entitled while at the same time supporting legitimate measures to improve the function and output of commercial enterprises.

The broad range of this list emphasises the need for a careful and efficient approach to the problem.

2.2.2.2 Government attitude

The basic employee share plan is designed to align the interests of employees with the shareholders so that the true community of interest in the success of the company is made clear to the employees. Any regulation should be carefully scrutinised to ensure that this primary function is protected.

The fact that some plans may have been designed for the benefit of a limited number of participants should not be made an excuse to prevent thousands of Australians from sharing in the benefits of their own hard work. This means that employers and their advisers will need:

- clarity and certainty as to the nature and timing of government action;
- better understanding on the part of government as to the nature of employee share plans and their function;
- a commitment by government to supporting ordinary Australian employers and protecting them from the abuse of these plans.

A symptom of a problem of attitude may be found in the nomenclature used in government regulation and literature in this area. Companies, advisers, participants and commentators call these arrangements “employee share plans”. The government material refers to them as “employee share schemes”. The word “scheme” may have quite innocent implications but it does have pejorative implications which are inappropriate for most plans and most participants.

2.2.2.3 Protection of Australian tax revenue

Australians are recognised round the world as working long hours and being careful and dedicated employers and employees. They expect that appropriate tax is collected from income earned (including the gross value of benefits arising from participation in employee share plans). As well, they expect that the government will be vigilant to close off loopholes where tax is being evaded or significantly reduced due to unintended consequences of legislation.

It is clear that there are several serious deficiencies in the collection of tax on benefits under share plans. This is mainly due to existing legislation and regulation. It is important that these shortcomings are removed as much to protect the rights of the majority of share plan participants as to collect the tax.

2.2.2.4 Tax exempt plan

Egan Associates’ view is that all employees, irrespective of their salary level, should be entitled to participate in the $1,000 concessional share plan. That is, there should be no cap on salary for the purpose of participation. We do, however, hold the view that those employees who choose to participate in the tax exempt plan not be eligible for participation in any other plan. This enables all employees, irrespective of their salary level, to have an engagement or participation in an equity plan. Many large companies may restrict participation in performance tensioned options, rights and other plans to senior management staff who may be in receipt of base salaries in excess of $200,000 or indeed $300,000 per annum. The imposition of an arbitrary cap at $180,000 disqualifies many employees from sharing in the prosperity of the companies for whom they work through employer sponsored plans. It would be our judgement that the loss of tax revenue from the above strategy would be far less than would arise from the careful management of ensuring that staff at all levels who participate in plans other than the tax exempt plan meet their tax obligations arising from any benefit through such participation on the basis that that benefit is treated as ordinary income.

2.2.2.5 Tax problems

We note that, after extensive consultation, the government has addressed several of the problems arising from the collection of tax on the proceeds of certain equity plans.

TOR 2

2.3 Termination

2.3.1 EA Statement

The treatment of termination payments, recognising the complex nature of their sources, means that requiring shareholders to undertake the required study and analysis of their sources is putting an unfair burden on the shareholders when it is the recognised role of the Board to manage these matters. We would support much clearer methods of disclosure in this area reducing the opportunities for uninformed and inflammatory comment.

2.3.2 Reasons for making termination payments

Termination payments to executives are made for a number of reasons. These can include:

- special provisions in their employment contracts arising from their recruitment such as unlatching costs deferred from recruitment to termination;
- special retention and service agreement provisions, the desired outcomes of which may be met early where contractual payments are due on termination, whether early or as scheduled;
- provisions in employment contracts in regard to illness or death;
- the delivery of deferred awards under incentive plans (STIs and LTIs);
- as compensation for early termination due to corporate restructure or merger;
- acknowledgement of dealing with special challenges; and/or
- entitlements under superannuation plans.

Some of them may not be included in the calculation of termination payments for the purpose of the restrictions in the Corporations Act but most are.

2.3.3 Problems with regulation of termination payments

Because of the wide variety of types of payment, regulation needs to be sophisticated. There needs to be a clear concept of why there are limitations and what they are designed to achieve.

It would appear that the current initiatives are partly a response to comments triggered by the global financial crisis, as well as the fact that a number of high-profile CEOs have departed recently taking with them the accumulated incentive and retention payments of years of service. It has not suited the press to explain these payments as accumulations from successful years from which shareholders have benefited as well.

Perceived excesses in some executives' termination payments can be the result of poor communication of the elements in the total but also can include an excess over the recognised market practice at the time. Because of the complexity of contemporary commerce, there can be no standard formula for executive remuneration. What is regarded as reasonable from time to time must be influenced or guided by the overall behaviour of the market, the nature, size and success of the employer organisation and the significance of the executive's position in the organisation.

For the same organisation, the levels of reasonable remuneration and termination payments will vary from time to time. The freezing of executive remuneration levels in many organisations in Australia during the current crisis is a clear illustration of this process. This does not mean that remuneration levels were all excessive or unreasonable, some obviously were, but rather that market forces and market sentiment are a strong influence on market practice.

2.3.4 Why do terminations occur?

Executive termination can arise for a number of reasons, many of which may be planned, others not. Directors need to have the flexibility to decide on timing and terms and execute quickly. Reasons for termination may include:

- early or planned retirement;
- corporate restructure, including mergers and divestment of businesses;
- contract term not renewed or fixed term contract expires;
- early implementation of planned succession;
- business failure;
- poor performance;
- ill health or incapacity due to injury or other cause;
- a family member's ill health (executive assuming a carer's responsibility);
- cause/dismissed for breach of a company's code of conduct or agreed terms of employment.

Boards have the knowledge and skills which shareholders do not possess in relation to the intimacy of issues requiring management on a day to day basis in representing shareholder interests. While democracy in many respects reflects positive features, democracy is not the manner in which major and complex organisations should be managed, nor is it a framework for challenging commercial negotiations.

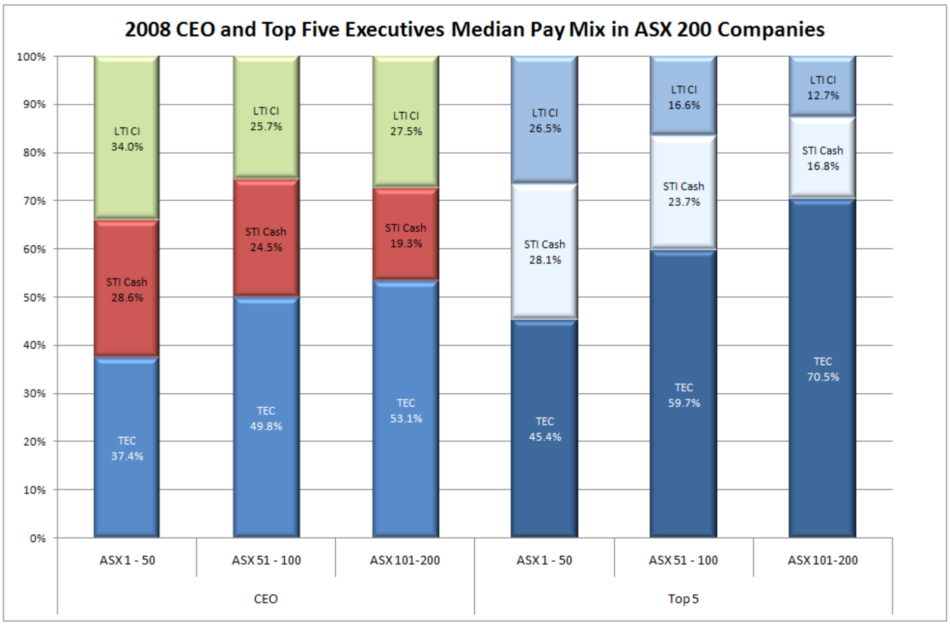
2.3.5 Asking for shareholder approval

We do not believe it is appropriate for shareholders to be asked to approve termination provisions, which require speedy execution in most instances. Nor do we believe that shareholder approval should be sought in relation to entering into contractual terms with a senior executive, including a Chief Executive Officer. As noted above, boards are in the best position to make commercial decisions in this regard.

If the Commission are of a view that clear guidelines should be established and boards' adherence to those guidelines confirmed, then it would be our judgement that a set of principles and guidelines should be prepared by the Commission as a result of its research and to the extent considered practicable those guidelines should be embraced by the ASX in an enhancement to the established best practice corporate governance guidelines.

The nature of executive reward, which is well documented in service agreements, letters of appointment or comprehensive deeds, does not constitute a focus on salary. While these documents are comprehensive, in a significant commercial negotiation without doubt the most important clause is the one dealing with how an executive will be dealt with if terminated.

The graph below highlights the structure of remuneration among the ASX top 50, second 50 and second 100 companies for the position of CEO and top five executives excluding the CEO. It reveals that the indicative proportion which salary represents of an executive's reward is less than 60% and in the ASX top 50 companies typically less than half.



The above highlights the annualised value of reward, though excludes relevant data on deferred remuneration to which an executive would be generally entitled. It also excludes the carried interest on a marked to market basis of securities which are capable of vesting during a notice period and/or those which have vested but have been retained by the executive, either on a mandatory basis or at their choice aligned to their shareholder commitment.

The management of separation in these circumstances needs to be dealt with sensibly, reasonably and speedily. This cannot be done if boards require shareholder approval. The disclosure of termination settlements, where they are at variance with disclosed contract entitlements, in our judgement represent an appropriate item for disclosure after the event.

It needs to be recognised that these contractual arrangements represent significant commercial considerations for an enterprise and constitute material contracts which in many instances would represent a settlement of several million dollars. These settlements are not unreasonable if an executive has served an extensive period with the organisation and over that time accumulated substantial shareholdings and superannuation or other entitlements.

A board may of necessity seek an independent assessment as to whether the termination settlement which they are proposing is reasonable, though we can assure the Commission in this context that an independent consultant will place emphasis on both existing contractual entitlements and relevant commercial considerations at the time of termination. These commercial considerations can include disruption to the business, the likelihood of being sued and the costs associated with managing any litigation, both those incurred in retaining legal counsel and the loss of application to the ongoing management of the business by tying up executives in such matters.

Egan Associates accept that termination is not always straightforward. Our observation is that a substantial proportion of termination settlements are in accordance with disclosed agreements, though occasionally a board will exercise their discretion for purely commercial reasons. This is a critical role of the board in either managing the appointment or termination of a CEO or supporting a CEO in the appointment or termination of a senior executive.

Term of Reference 4. Aligning interests

Consider any mechanisms that would better align the interests of boards and executives with those of shareholders and the wider community

It is important that the work of the many ethical and concerned remuneration consultants is not ignored as a result of uninformed comment. The market has gradually become aware of the benefits that good remuneration advice can bring. This includes providing sophisticated and effective structures of remuneration which acknowledge the interests of the company's stakeholders, including the wider community.

4.1 The role of the remuneration consultant

4.1.1 The nature of their work

Remuneration consultants are asked to advise on a wide variety of issues relating to the way in which organisations reward their employees for the work that they do. As business and government become more complex arising from scale, global reach and breadth of jurisdictional influence, so the nature and structure of pay has become more complex. Remuneration advice now has the potential to involve intricate taxation, legal, accounting and commercial questions, as well as the traditional provision of strategic advice supported by comprehensive market data.

There are wide variations in the methods and range of advice sought from consultants and within this group there are specialists providing advice on different sectors and/or levels of corporate seniority. Consultants advising on reward issues are mostly drawn from the ranks of management consultants, human resource practitioners, lawyers, accountants, auditors and actuaries. Today there are very few independent consultants specialising solely in the provision of remuneration and related advice.

Those offering advice or providing information on executive remuneration may participate in a diverse array of assignments, including but not limited to:

- executive appointments:
    - advising on market competitive reward, including the balance between fixed annual remuneration, annual incentive and long term incentive payments;
    - advising on unlatching costs of prospective candidates by assessing foregone deferred payments and contract entitlements;
    - confirming estimates of a candidate's current remuneration;
    - advising on the reasonableness of unlatching strategies under consideration:
        i. cash/equity/timing of vesting/structure/performance conditions, if any;
        ii. structuring pay on appointment (fixed annual remuneration, annual and long term incentives, review processes (cash, type of equity, performance considerations));

iii. establishing a template for a service agreement, including addressing criticality of termination provisions (for cause, for convenience, for poor performance);

- acting in the capacity of an independent adviser to the Remuneration Committee;
- advising on termination settlement proposals and their reasonableness in the context of corporations law;
- conducting an annual review/market update on executive reward, both domestically and internationally;
- conduct of a review of annual incentive plans and/or the design new plans for the executive team and/or specialist staff groups;
- conduct of a review of long term equity based incentive plans and/or the design new plans for the executive team and/or specialist staff groups;
- offer independent advice in relation to executive entitlements under both annual and long term incentive plans by way of either conducting independent research or auditing proposals prepared by others;
- assist in the preparation of the Remuneration Report for inclusion in a company's Annual Report;
- assist in the preparation of Notice of Meeting/Explanatory Notes/Q&A for Annual General Meetings;
- attend Annual General Meetings and/or address shareholders as an expert in support of resolutions before an Annual General Meeting;
- assist clients respond to proxy advisers, major investors, Australian Securities Exchange or ASIC queries arising from either Annual Reports or Notices of Meeting;
- advise on remuneration aspects of takeovers, mergers, corporate reconstruction and major staff changes;
- advise on specialist staff reward strategies, including international assignees and secondees.

Less frequent, though important engagements for remuneration consultants also include:

- assessment of income loss;
- advice on arms length reward in private companies for retirement payment purposes and/or shareholder negotiations;
- advice in family law matters on market based remuneration in property and shareholding settlements.

The role of the remuneration consultant will be further influenced by other advisers which the board or the client company has commissioned to assist in any of the above issues. On occasions the remuneration consultant will review the work of others and provide an independent perspective, on some occasions work collaboratively with executive search consultants, independent tax advisers and legal counsel, and occasionally both parties on either side of an acquisition or divestment initiative in advising on a path forward to accommodate different interests or reward policy perspectives.

The nature of engagement will also be influenced by the scale of the organisation and its domestic or international scope which will often impact on jurisdictional challenges in relation to the application of Australian practices which may be less applicable in other jurisdictions. In this context the remuneration consulting practice may be offering what appears to be conflicting advice in relation to the relative apportionment of fixed annual remuneration, cash and equity based bonuses or the provision of employee benefits or other terms and conditions of executive employment.

The remuneration consultant can often fulfil the role as educator, information provider, sole adviser and collaborative adviser with other professional service organisations; and would occasionally find themselves in a position facilitating either employment, retention or termination negotiations, the latter clearly being influenced by the breadth of the consultant's experience, their intimacy of knowledge of the company and/or the participants to a transaction and their acknowledged skills.

Of critical importance in relation to the engagement of the remuneration consultant is whether management or the board seek data or information to inform their decisions or seek advice. In fulfilling their obligations the methodology which consultants use for providing information and/or advice also becomes critical.

- Do they simply choose organisations with comparable annual revenues?
- Do they include companies with comparable levels of profit, market capitalisation, net or total assets?
- Do they conduct an industry/sector specific review?
- Do they survey international comparators?
- Do they develop customised solutions or only adopt proprietary methods/processes?

A remuneration consultant would normally only address issues raised by a client – occasionally an established adviser to a client will identify related issues requiring consideration. The nature of a consulting brief may be classified in the following expanded terms:

A. Could you provide market data on the following? …..

B. A plus and advice on the most appropriate course of action for our company.

C. A plus B and can you also provide a view as to the likely acceptance of your proposals by major institutional investors and proxy advisers.

D. A plus B and assist with implementation, including preparing board papers, employee communications, tax and legal sign-off.

E. A plus B plus C and brief executives and, if requested, meet with key shareholders/stakeholders.

F. Any of the above, together with briefing the board and/or Remuneration Committee of the board and assist in the preparation of the Remuneration Report to be included in the Directors' Report of the company's Annual Report to shareholders.

G. Any of the above and attend the Annual General Meeting of shareholders and respond to shareholder questions if called upon to do so.

4.1.2 Independence

4.1.2.1 Enquiry by US Congress in 2007

On the basis of our understanding consultant independence was an issue raised in the United States House of Representatives by their Committee on Oversight and Government Reform. The committee's review considered lack of independence or conflict of interest could potentially arise when organisations providing remuneration consulting advice also provided other advice. In his report to Congress in December 2007 the Chairman of the committee, Henry Waxman, revealed broad conflict having regard to the measure of conflict, being both the amount and proportion of fees received by consulting organisations who were also key advisers on executive remuneration.

Given our observation that there are few leading specialist organisations offering executive and board remuneration advice in Australia, if the US Congress study is to be deemed as the appropriate measure of independence then it is highly probable that a similar conclusion would be reached in Australia where many participants in the remuneration consulting arena are part of a more broadly based advisory firm providing assistance to their clients, including superannuation benefit administration, broader human resource consulting services, actuarial services, audit and taxation services, strategic advisory services and legal services to name but a few.

While Egan Associates acknowledge that many of the participants in the marketplace offering remuneration advice offer other services, we also observe from time to time that some major companies prefer a diversity of services to be offered by the one firm, including remuneration advice, tax advice and legal advice. We have also observed that among major corporate entities the board become actively engaged in the review of additional consulting services sought from their external auditors, providing some checks and balances in this regard.

It is our view, having been a participant in the market for a considerable number of years, that while there might from time to time be a conflict of interest issue, the board should be in a position to assess the appropriateness of the remuneration consulting services offered by an advisory firm which may provide other advisory services.

Of greater concern to Egan Associates and others who may specialise primarily in the provision of executive remuneration advice would be the quality of advice being offered from time to time in the arena of strategic advice in relation to executive remuneration where their primary expertise is legal, tax, actuarial or broadly based business consulting. Our experience is that for a company to be in a position to provide strategic remuneration advice to a Chief Executive or a board the consultants deployed on such a project need to have a comprehensive understanding of the marketplace in order to provide cogent advice or offer accurate information.

This is not in any way to suggest that specialists who are called upon to contribute to the decision-making process across the spectrum of inputs to executive remuneration are not capable of doing so with the highest level of professionalism and independence, particularly where their advice might specifically involve an examination of the underpinning risk associated with incentive plans, follow a forensic investigation of a company's accounts and reporting of results in order to determine appropriate incentives, document the rules and notices associated with complex equity incentive plans or document legally binding agreements between executives and employer companies.

It would be our experience that the majority of organisations that specialise in executive and director remuneration do not provide a board with accounting, legal and tax sign-offs, where companies rightly seek the highest level of expertise available to them for that purpose.

Given the modest scale of the Australian market and the number of participants across the spectrum of services sought addressing executive remuneration, Egan Associates are of the view that the vast majority of advice tendered is not burdened by a conflict of interest or prejudiced by a lack of independence, though openly acknowledge that if the frame of reference embraced by Chairman Waxman were applied among Australia's top 200 companies many of his committee's findings would be replicated in Australia.

Egan Associates are of the view that comprehensive disclosure in relation to the advisory firms providing the company with either information or advice will suffice, although along with others we would be reluctant to be named in an Annual Report where we may have provided information or advice and that advice was not taken unless the board or management clearly stated in the Remuneration Report why the advice was not followed. Sometimes this can arise as a matter of timing between when advice was proffered and decisions in relation to that advice were taken. The recent turmoil in the global capital markets would clearly be an example where timing may influence a board's decisions quite appropriately.

A question of independence as distinct from conflict of interest also arises where a board is seeking an independent perspective in relation to an issue put to them by management. Here it becomes the responsibility of the directors to ensure that a consultant's advice is independent of management and that they are capable of providing objective and neutral advice to the committee to assist them in their consideration of matters before them.

In this context it would be Egan Associates' view that independence is a more critical issue than the question of a conflict of interest due to the breadth of services being offered to a client organisation and here it becomes important that the board have fully assured themselves of the expertise possessed by those consultants from which they have sought to seek advice.

While Egan Associates are independent and have no conflict of interest, John Egan, in reflecting upon circumstances which may have arisen as a result of his industry participation, holds the view that his independence of judgement would have been retained irrespective of the professional practice which he served. By way of illustration, in the early 80s a business of which John Egan was an owner, known as Cullen Egan Dell, was acquired by Hill Samuel which also owned the Noble Lowndes consulting, actuarial, financial planning and superannuation administration group. Shortly following the acquisition of Cullen Egan Dell the practices were merged, Hill Samuel was acquired by the Trustees Savings Bank and subsequently Lloyds in the UK. Subsequent to those transactions the Noble Lowndes Group, including Cullen Egan Dell, was on-sold to an insurance broking group with interests in employee benefits and in recent years became part of the Mercer Group worldwide which is owned by Marsh & McLennan.

This aggregation of professional services, in our judgement, could well make the pursuit of avoidance of conflict of interest one of limited merit, though always remaining of criticality will be the issue of independence of advice in its broadest context. We believe this is an area where board Remuneration Committees and management may need to separate their source of advice if in their judgement a single party is potentially compromised in providing what might be regarded as fearless and independent counsel.

Waxman's committee's findings revealed that remuneration consultants with the most significant conflicts of interest in relation to their practice engagement with a Fortune 250 company had rewarded their incumbent CEOs at almost twice the rate over a five year period as companies not so conflicted. The committee rightly indicate that the correlations between consultant conflict of interest and levels of CEO pay suggest, but clearly do not prove, a causal relationship.

The committee also observed that a significant number of leading US companies described their remuneration consultants as independent in circumstances where the firm had provided significant other services of far greater value. In this context independence was clearly not perceived by Congress in the same manner as the client company.

Further, the committee's research revealed that diversified advisory firms have established protocols to ensure that the quality of service that they offer their clients is not compromised. Notwithstanding, many significant professional firms have an engagement partner that oversights the entirety of their relationship with the client and further expect their partners or equivalents to cross-sell services for the benefit of the firm.

4.1.3 Role of the remuneration committee

In considering regulation of remuneration of executives, it is not feasible for specific regulation to be applied too far into the process. This has been acknowledged by the development of governance guidelines. With the increased complexity of commerce, it would be useful to remind Boards of some of the basic tenets which assist in the management of remuneration. One of these aspects of governance is the role of the Remuneration Committee.

The role of the Remuneration Committee is not to do the work of management but to work with management in ensuring that key issues are readily addressed and differing perspectives shared.

The role could be summarised as follows:

- assist the Board in establishing effective employment and remuneration policies;
- assess the underlying risk associated with the generation of income or profits where they represent drivers or triggers of remuneration payments, particularly short term incentives or annual bonuses;
- assess the P&L and balance sheet implications of remuneration programs under considerations;
- ensure the company are able to attract, retain and motivate effective executives;
- ensure that executives are rewarded fairly in the context of the financial environment, industry sector practice, competitive influences and corporate and personal performance;
- conduct audits of all remuneration disclosures including the Remuneration Report;
- ensure the equitable application of policies in numerous jurisdictions where the company has a significant presence;
- audit service agreements, particularly termination agreements of senior staff ensuring their appropriateness;
- monitor market trends and seek input from executive search firms or others in order to ensure that the company's practices are contemporary;
- review succession and talent issues in ensuring availability of senior management resources
- sign off on the framework of employment agreements of all senior executive hires;

- ensure compliance with the regulations and governance standards applying from time to time.

Approve employment policies, including remuneration policies applicable to specified levels of executives in the Company, including:

- quantum of fixed annual remuneration;
- short-term incentive plan parameters;
- long term incentive plan participation, including vesting and performance conditions;
- appointment conditions, including termination provisions and unlatching costs, if any;
- oversee compliance with disclosure requirements in light of:
    - government requirements;
    - stakeholder interests;
    - commercial and sectorial influences.
- Review the structure, compliance and effectiveness of the company's superannuation arrangements.
- Engage appropriate remuneration consultants to provide analysis, information and advice from time to time. Settle their terms of reference and basis of independence.

Egan Associates have been engaged to assist both management and Boards to address remuneration issues both jointly and independently of one another. Given the increasing complexity of stakeholder management Boards may well be more at ease with separate advisers.

Variations in the role of the committee
The list above is a broad outline of potential accountabilities. It is not exhaustive and does not include the broader obligation of some committees with an intimate involvement in broader human resource and organisation issues.

Boards need to design the role to suit the size, complexity, function and local or global footprint of the company. The clarity of the role and the general acceptance of that role across the organisation is vital to its effective functioning.

Term of Reference 5. International developments

We support careful scrutiny of international initiatives in any examination of potential Australian policy. This sharing of global perceptions and skills has the potential of improving market performance in many areas.

5.1 International responses

The global financial crisis, the impact of which emerged in late 2007, led to a variety of initiatives by governments, particularly in the United States of America and a number of European countries, including the United Kingdom. The initial focus was on major financial institutions embroiled by the global flow-on effects of asset revaluation and misaligned debt. These issues continued to be addressed by governments, including the G20, and over the 2008 calendar year the effects of the global financial crisis had clearly permeated many other industries and commenced to have a detrimental impact on the economic prosperity of many communities.

A new US President was elected in late 2007, taking office in January 2008 and in Australia the Rudd Government had just assumed office in late 2007. Many of the governments in Europe, particularly in the United Kingdom, as well as in the US had provided direct financial support to leading financial institutions and increasingly in other industry sectors vital for their economy's prosperity.

Following the G20 meeting in early 2009, a set of principles in relation to remuneration were determined with the participation of a number of G20 countries, including Australia. The Financial Stability Forum's (FSF) Principles for Sound Remuneration Practices were developed to ensure effective governance of remuneration and alignment of remuneration outcomes with prudent risk taking and effective supervisory oversight and broad stakeholder engagement . The view of the FSF was that sound remuneration practices will be achieved only if there is determined and coordinated action by national regulators facilitated, if necessary, by suitable legislative powers and supported by national governments. The principles which they espoused included:

- effective governance of remuneration:
    - the company's board of directors must actively oversee the remuneration system's design and operation;
    - the company's board of directors must monitor and review the remuneration system to ensure the system operates as intended;
    - staff engaged in financial and risk control must be independent, have appropriate authority and be remunerated in a manner that is independent of the business areas they oversee and commensurate with their key role in the company;
- effective alignment of remuneration with prudent risk taking:
    - remuneration must be aligned for all types of risk;
    - remuneration outcomes must be symmetric with risk outcomes;
    - remuneration payout schedules must be sensitive to the time horizon of risks;
    - the mix of cash, equity and other forms of remuneration must be consistent with risk alignment;
- effective supervisory oversight and engagement by stakeholders:
    - supervisory review of remuneration practices must be rigorous and sustained and efficiencies must be addressed promptly with supervisory action;
    - companies must disclose clear, comprehensive and timely information about their remuneration practices to facilitate constructive engagement by all stakeholders.

While these guidelines were principally focused on the major corporate entities across the G20 member countries they were perceived to have broader application and are being embraced within a variety of frameworks by parties considering the appropriateness of remuneration arrangements across G20 countries.

In their discussion paper of late May 2009, in proposing extensions to the governance requirements for APRA regulated institutions dealing with remuneration, the Australian regulator proposed to extend its existing governance standards to cover remuneration, these extensions requiring the board of each institution to have in place a remuneration policy that covers various matters, including alignment of remuneration arrangements with long term financial soundness of the regulated institution and its risk management framework and to establish a board Remuneration Committee comprised entirely of independent directors with the requisite skills and knowledge to perform its functions which, at a minimum, are to review the remuneration policy periodically and make recommendations to their board on policy and the remuneration of executives. The principles embraced by APRA set out elsewhere in this report very much adopt the proposal of the Financial Stability Forum.

In August 2009 the Financial Services Authority (FSA) in the UK set out a detailed framework for regulating the financial services sector remuneration structures, revealing that their new code will come into force in January 2010. While also adopting a principles based approach, the FSA in the UK have also set out clear guidelines in respect to evidential provisions which they would clearly monitor in relation to adoption of each of their articulated principles which again broadly follow those of the Financial Stability Forum. Critical evidential provisions relate to bonus payments, the calculation of bonus entitlements and provision for oversight by risk management and compliance functions, with a strong emphasis on longer term performance.

In relation to non-financial metrics they have clearly set about to ensure there is strict adherence to effective risk management and compliance with the regulatory system, both on a domestic and international footing, and in respect of equity based plans that those plans should be risk adjusted. Their principles also highlight a position that a significant proportion of any bonus be deferred and that the deferred component should be linked to the future performance of the financial institution, though could include a business unit or division of the institution.

In the US not only have the Government established guidelines broadly in alignment with those of the FSF but have also appointed a distinguished Washington lawyer Kenneth Feinberg the *pay tsar*, to overview the remuneration plans of leading financial institutions which have received substantial government funds to ensure their continued survival. The payment of bonuses in many of the leading US financial institutions have been the subject of extensive debate in both the Congress and the Senate and a number of practices considered contrary to earlier agreements entered into with the Government have found themselves before the courts.