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Guerdon Associates
Equity and Executive Pay

2 November 2009

Mr. Gary Banks
Chairman
Productivity Commission
Locked Bag 2, Collins St. East,
Melbourne, VIC 8003

Dear Mr. Banks

Re: Executive Remuneration Inquiry - Submission on the Commission's draft report

This letter provides feedback on the Productivity Commission's "Executive Remuneration In Australia" draft report. A summary of our submission, information about our firm, detailed comments on the draft report, and concluding remarks are made under the headings below.

Summary

Guerdon Associates commends the Commission on an outstanding analysis of executive remuneration issues and broadly supports most of the Commission's draft recommendations.

In particular Guerdon Associates fully supports the elimination of cessation of employment as a taxing point for equity rewards (Draft Recommendation 13). The current taxation of employee share schemes, including deferred equity, at termination discourages the use of these instruments as executives and other key employees approach retirement. The unintended consequence is that there are fewer controls to ensure management and key employees of Australia's enterprises manage risk for sustainable long-term returns over time.

A major concern with the draft report is that some recommendations have the somewhat perverse effect of over-emphasising the importance of executive remuneration relative to other director responsibilities. For example the "two strikes and election" recommendation may be reasonable in regard to the non-binding vote on remuneration, but does not have an equivalent for more material issues of valid concern to shareholders. This imbalance may distort director priorities and contribute to an inefficient capital market in a broader sense.

While fully agreeing with the Commission that board quality is key to sensible executive remuneration, we are concerned that there is no recommendation addressing the supply side of the problem. In fact, more regulation reduces supply, putting additional pressure on director pay and indirectly contributing to executive pay inefficiencies by reducing the supply of directors competent in these matters. We suggest board

capability is a broad need that may be beyond the narrow confines of the Commission's terms of reference.

The denial of the right to vote on matters where directors have no direct pecuniary interest is at odds with their role as fiduciaries. Further, extending this to include the undirected proxies they hold effectively disenfranchises the shareholders who have trust in their directors on these fiduciary matters. Lastly, if implemented, companies may face the anomaly that the shareholders who caused a spill of the board for an election will not be the same group of shareholders whose votes are counted in the subsequent election.

Guerdon Associates' suggestions also include:

- Ensuring fair value and realisable value of key management personnel remuneration is reported
- That the wording of "top key management personnel" be clarified to mean executive directors in regard to prescribed individual disclosure requirements
- Disclosure compliance be addressed more fully, given the extent of non-compliance noted by many of the initial submissions
- Refinements be made to disclosure of external adviser requirements, including the requirement for disclosure of company policy in regard to management contracting external advice on their own remuneration

About Guerdon Associates

Guerdon Associates is Australia's largest independent consulting firm specialising in board and executive remuneration matters.

Clients are mainly board remuneration committees of listed and unlisted Australian companies. These include a significant proportion of Australia's largest ASX-listed companies.

Our website is at http://www.guerdonassociates.com.

Introduction

Our general approach in this submission has been to comment on recommendations where we have suggestions for amendment, but are otherwise supportive, or where we have reservations. Guerdon Associates fully supports the Commission's recommendations on which we have made no comment in this submission.

Our comments are made under headings and subheadings below.

Market efficiency

The Commission identifies that market efficiency may be impeded by:

- Loss of public confidence in corporate sector remuneration setting that could result in lower investment, or political solutions that mitigate against market efficiency; and
- Poor remuneration design that is short term in perspective and results in risk taking that has perverse economic impacts, especially in the finance sector

A potential inefficiency in the executive remuneration market not referred to by the Commission is that supply may be constrained by otherwise suitable executives shunning publicly listed corporate roles in favour of positions in foreign multinationals, private companies or partnerships where remuneration details and processes remain private and unrestrained. Likewise, the supply of potential NEDs for boards of listed companies may be constrained by the disproportionate focus on executive remuneration (versus arguably more material matters), and the associated higher compliance burden compared with that for private or foreign companies.

Guerdon Associates suggests that the Commission specifically acknowledge and address these matters.

Improving board capacities

The Commission recognised that executive remuneration is as much art as science, and requires nuanced business judgement that varies with the circumstances of the company, its stage of maturity, capital structure, product profile, customers, competitors, and its executives. Board candidates with the requisite skills are already in short supply. The aging baby boomer demographic is starting to limit the pool of available directors. Growing time pressures resulting from additional director regulatory imposts[1] and liabilities[2] plus increased shareholder expectations, engagement and scrutiny are forcing existing NEDs to reduce the number of board directorships they take on.

While the low board representation of women indicates that current board demographics are not representative of the broader community, or even the executive community, removal of the no vacancy rule will not resolve the supply side problem. What is required is an attack on the plethora of regulations and liabilities across state and federal boundaries that discourages otherwise qualified people from considering NED positions.

Given the Commission's narrow brief, it is understandable that this has not been tackled head on. However, a fuller review of these impediments, including delays in current COAG red tape reviews and implementing the

[1] E.g. APRA remuneration regulations
[2] E.g. criminal sanctions for non compliance with recently amended Corporations Act requirements for executive termination pay

recommendations of reviews already completed would assist, if acted upon, in increasing the supply of competent board candidates.

We note that in most cases where there have been "excess" nominations for board vacancies in the past, resolutions following board recommendations are carried. So, on balance, we accept the Commission's Draft Recommendation 1 to terminate the "no vacancy" rule.

Improving board capability and diversity may be achieved with a greater focus on the board nomination committee. This "sleepy hollow" of board function is arguably one of the most important. Should it be required to report on the factors considered for director recruitment and selection? What director development activities did it sponsor (e.g. in executive remuneration knowledge and skills)? Guerdon Associates suggests this may be a more fertile and less risky focus of attention.

The Commission has identified board diversity and the broader issue of board capability as key factors in ensuring robust executive remuneration governance. Given that board capability is at the heart of our system for raising and investing capital, and critical to Australia's future, the Commission may suggest it be worthy of more in depth government consideration than allowed for in the Commission's terms of reference.

Reducing conflicts of interest

Directors and executives voting on remuneration

Draft Recommendation 4 requires that all directors and other key management personnel be prohibited from voting on remuneration reports, while Draft Recommendation 6 would prohibit directors voting undirected proxies. Guerdon Associates does not think these are appropriate recommendations for directors, given that:

a. The Corporations Act does not allow directors and related parties to exercise votes on resolutions where they have a pecuniary conflict of interest
b. Directors have a legally binding fiduciary obligation
c. Directors are not required to withhold votes on any other matter that does not conflict with "a" above
d. Shareholders currently provide undirected proxies to individuals that they trust. Inability to exercise would nullify and disenfranchise these investors' votes
e. In situations where there is a board election required under Draft Recommendation 15 there will arise the anomalous situation where the election of directors would be based on a shareholder population that differs from the population that elicited the board spill in the first place.

Improving relevant disclosure

Plain English, but not plain compliance

As the Commission has noted, the *Corporations Act* requires a detailed summary of the performance conditions for payment of performance contingent pay. However, we disagree with the Commission's assessment that companies appear to be complying with the letter but not the spirit of the law. Regulation 2M.3.03 is very specific, and requires disclosure of sufficient detail to provide an understanding of "how the amount of compensation in the current reporting period was determined". Judging from the submissions made to the Commission to date, current disclosure practice has clearly not met this objective.

While the Commission recommends, "plain English reporting" we suggest that the Commission consider:

a. The "plain English" requirement, and the current specifics in 2M.3.03, be amended such that a "reasonable person" can, given the details of the inputs prescribed, work out with little effort the level of bonus or number of equity instruments that could be awarded.
b. Given the existing 2M.3.03 requires enough explanation for understanding how the current compensation was determined, encourage ASIC to enforce the current disclosure requirements.
c. Consider introducing an "out" for companies not to comply if such disclosure will result in material commercial harm. This is allowed in the US, but is actively monitored and usually disallowed by that country's SEC. It would be difficult for a company to argue that such information is commercial in confidence as it pertains to a past fiscal period.

Many other submissions to the inquiry have called for ASIC to improve its enforcement of the disclosure requirements. This has not been sufficiently addressed in the Commission's report.

Realisable pay, fair value and accounting value

We welcome the Commission's recommendation that "actual levels of remuneration received by executives" be disclosed. However, we suggest that the Commission better define what this means. We suggest that this be defined as the value of all remuneration that vests to the employee in the fiscal period. This would include cash, contributions to superannuation, fringe benefits, the market value of shares, and the realisable value of options. The realisable value is the intrinsic value, i.e. the difference between the market price and the exercise price on the day a benefit vests to the executive.

The Commission also suggests in the same draft recommendation that the reporting of an individual's remuneration fair value continue to be reported in the remuneration report, while the details on fair valuation

methods be set out in the financial report. This wording may create some confusion, and so needs clarification.

Currently key management personnel remuneration details are reported as accounting values only. Fair value is an arms length objective assessment of the potential market price of a compensation item in the year of grant. Accounting value includes the fair value of compensation, but amortises it over the period of service to which that item of compensation pertains.

Fair value details are more appropriate than accounting details because fair value is a better reflection of a company's practical application of its pay policy. Fair value will tell you that a company paid a total bonus of, say, $100,000, even if it was comprised of immediate cash and shares deferred for 2 years. Fair value will tell you that a company granted a $100,000 LTI, even if it was comprised of share rights that vest in 2, 3 and 4 years, plus options that vest equally in years 2 and 4. So if the individual's fixed pay was $300,000, you can easily ascertain that the company paid a bonus equal to a third of fixed pay and a long term incentive equal to a third of fixed pay. This cannot be ascertained from current remuneration report requirements. That is, it is impossible to discern what the company paid the executive in the fiscal year from the currently required accounting values, which would tell you only the amortised value of the components described above applying to the current year, mixed in with portions of grants from prior years.

Implementation of fair value reporting will bring Australia into line with Canada, while we note that the US SEC already has drafted the regulation requiring this in its overhaul of executive remuneration disclosures post the GFC. Both these countries have wrestled with the lack of transparency associated with using accounting values in reporting top executive remuneration, and both have opted for reporting of fair value instead.

Hence Guerdon Associates recommends that:

- Accounting values be confined to the financial report
- The remuneration report discloses individual key management remuneration details in terms of both fair value and the actual vested value
- That the Commission clarify its wording and recommendations accordingly

Equity holdings

In Recommendation 8 the Commission suggests that remuneration reports include "total company shareholdings of individuals named in the report". These holdings are required to be disclosed under AASB 124 Aus25.7.4 in the notes to the financial report, although many companies place this table in the remuneration report, and refer readers of the financial notes to it. Given that this table is already required, it would be duplicative to have it repeated in both reports. Hence the

recommendation should be modified to suggest that this table be in the remuneration report and not be duplicated in the financial notes[3].

KMP disclosures

In seeking feedback on Draft Recommendation 9, the Commission implies that disclosure should be confined to the CEO and "other top KMP". We assume that "other top KMP" refers to other executive directors, so that detailed disclosure would approach the UK standard on levels of disclosure rather than the US standard.

We suggest that the Commission clarify its recommendation to note that detailed individual disclosure be confined to directors, including executive directors.

External advisers

Draft Recommendation 10 requires ASX 300 remuneration committees' expert advisers be independent of management. The recommendation makes no reference to disclosure. As an ASX listing rule, it appears difficult to monitor and enforce (especially if there is no required disclosure). Lastly, while it refers to ASX 300 companies, it does not require ASX 300 companies to use external advisers. So the easiest method for ASX 300 company compliance is not to use an external adviser, relying on management as the principal source of advice.

We suggest Recommendation 10 be modified to:

a. Be in the form of an ASX Governance Council Principle
b. Be applicable to all ASX listed companies on a comply or explain basis
c. Require the remuneration committee to appoint, seek and receive direct advice from independent external advisers on remuneration matters[4]
d. Disclose the adviser/s, method of appointment, advice sought, and extent of adviser independence, and any board policy pertaining to management's use of advisers for their own remuneration

Draft Recommendation 11 requires the ASX Governance Council require companies to disclose "expert" adviser details. This has been rolled into the suggestions for Recommendation 10 above.

In the event that the ASX Governance Council does not accept this recommendation, item d above should be considered for inclusion in the Corporations Act and its regulations.

[3] We note that this part of the AASB 124 accounting standard is not part of IAS 24
[4] There may be several levels of independence that may be acceptable to the board and shareholders, such as an adviser providing no services to management, or where services are provided directly to management with the board's full knowledge and consent.

In reviewing the Commission's discussion of conflicts of interest and external advice we note an important omission. We know that some companies' management use company resources to receive advice on their own remuneration, which is subsequently forwarded to the board. In the US, where the issue of independent advice has been debated for longer than in Australia[5], it is not unusual for management to hire advisers as advocates for their own remuneration to "balance" the advice being independently received by the board. Clearly this is a conflict of interest. For this reason we suggest including a requirement for companies to disclose policy (if any) in regard to management contracting its own external advice in relation to their remuneration, if any, in item d above.

Institutional investor securities lending

The Commission has also asked for feedback on securities lending for the transfer of voting rights on remuneration matters. While recognising the complexity of the issue, we draw to the Commission's attention the existence in the deeper UK and US markets of hedge funds that specialise in governance improvement opportunities. While many of their strategies concern cleaning up board membership, they have not been averse to other governance improvement methods, including focusing on remuneration voting issues. Securities lending has been an important modus operandi for these hedge funds. While the Australian market has not yet witnessed this evolution, we suggest that any action should not preclude it from developing and contributing to a more efficient market.

Well conceived remuneration policies and their impediments

Incentive deferral is an essential ingredient to ensure fairer outcomes and better risk management. APRA has advocated this in its draft prudential standards. However, unlike almost all other countries, Australia's tax system impedes progress towards the adoption of incentive plans that ensure alignment of reward with results that are the legacy of management's decisions if those individuals have left the company.

Therefore Guerdon Associates fully supports the elimination of cessation of employment as a taxing point for equity rewards (Draft Recommendation 13). The current taxation of employee share schemes, including deferred equity, at termination discourages the use of these instruments as executives and other key employees approach retirement. The unintended consequence is that there are fewer controls to ensure management and key employees of Australia's enterprises manage risk for sustainable long-term returns over time. That is, on their departure from an enterprise, there is no method to maintain tax neutral pecuniary interests in outcomes from decisions and actions made by them while in employment. One of the key responses to the global financial crisis has been encouragement for the introduction of such controls.

[5] A direct result of the US Congressional House Oversight and Government Reform Committee inquiry on remuneration advisers chaired by Henry Waxman in 2007.

Our only issue is that the wording of the PC draft recommendation means that taxation is levied at vesting date, rather than realisation date. Guerdon Associates, as well as many others, have raised many concerns[6] associated with this approach's complexity, fairness, consistency with the tax systems of other countries, administrative costs, uncertainty, and economic efficiency (especially in relation to start up and higher risk ventures). In addition, it will simplify the convoluted legislation now going through parliament, and hence encourage companies to use equity as a payment vehicle. Use of equity as a payment vehicle to executives should be encouraged, given that this will bring closer alignment between shareholder outcomes and executive pay outcomes.

We note that in a submission to the parliamentary Senate Economics Committee, Treasury provided no costing of deferring the tax point suggested in not only the Commission's recommendation, but also every submission (other than Treasury's) received by the Senate Economics Committee that addressed this point. The Productivity Commission suggests that there will be a cost, but that in the context of better economic outcomes, this will be both minor and preferable. Our own view is that the recommendation, if acted upon, will be cost neutral, and only result in tax deferral, with the time cost of the deferred tax already accounted for in the method of valuation.

Therefore, Guerdon Associates is fully supportive of the Commission's recommendation, and suggests that it reviews the report's paragraphs pertaining to the cost of the recommendation and amend the recommendation to levy tax on benefit realisation. As an additional minor point, we also suggest an alteration of the wording to insert "or rights" at the end of the recommendation.

Facilitating shareholder engagement

Consequences of a significant "no" vote on the remuneration report

Draft Recommendation 15 requires that the board respond to an initial "no" vote of 25% or higher with an explanation in the following remuneration report on the extent that shareholder concerns have been addressed, or the reasons why they have not been addressed.

Guerdon Associates supports this part of the recommendation.

Not addressed in the Commission's report is that this level of "no" vote probably understates a truer picture of shareholder dissatisfaction for many companies with significant institutional shareholders. These institutional shareholders use electronic voting platforms that, for various reasons, currently require lodgement of votes up to 10 days prior to the latest lodgement date. The record date for voting is usually 48 hours before the shareholder meeting. Meantime institutional investors trade

[6] For example, see Guerdon Associates' submission to the Senate Standing Committee on Economics "Inquiry into the reform of the taxation of employee share schemes" at https://senate.aph.gov.au/submissions/comittees/viewdocument.aspx?id=695edfe5-8c5d-4e14-8ae5-775fd7dba6e0

shares. Given the short period between the record and meeting dates there is usually very little time for communication between the company, custodian and institutional shareholder to reconcile the number of votes lodged with the number of shares held due to trading taking place after lodgement of votes and before the record date. Where discrepancies occur the company may disregard voting instructions from institutional investors. That is, institutional shareholder votes may not be counted in a "close run" voting process. The true extent of this practice is unknown, although AMP Capital has published an analysis in regard to its own votes[7].

While others will probably also raise this issue, we do not believe that it should change the 25% threshold suggested by the Commission. The reconciliation and validity of shareholder votes is separately resolvable, and should not impinge on thresholds considered otherwise reasonable for responding to shareholder concerns or (see below) a board election spill.

Draft Recommendation 15 also suggests that if a "prescribed threshold" of 25% of shareholders reject the subsequent remuneration report then all elected board members will be required to stand for re-election. This raises concerns.

A minority of shareholders should not impose their will over a majority.

But, in principle, Guerdon Associates would agree that if the proportion of "no" votes were 50% or greater then a majority of shareholders are expressing no confidence in directors and an election would be justified. Our concern, however, is with relative materiality. Should a busy board facing numerous material issues in a challenging year divert valuable time and attention from these more material issues to ensure a majority remuneration report vote? Would this requirement in these contexts be economically rational and efficient?

However, Guerdon Associates recognises community executive pay concerns, and that a recommendation of this nature goes some way to addressing these concerns. These concerns cannot be ignored. Given this, we accept the need for recommendations similar to Draft Recommendation 15, but suggest it be re-worked along the lines suggested below:

- Break the recommendation into 2 distinct parts
- The 1st part would require the remuneration report to explain the board's response to a prior year's negative vote of 25% or more
- The 2nd part would require board elections to be held in an extraordinary general meeting if there were two consecutive "no" votes on the remuneration report of 50% or greater

[7] AMP Capital Investors "Corporate Governance Report", May 2009

Concluding remarks

Guerdon Associates commends the Productivity Commission on its draft report and recommendations on executive remuneration. We have commented in this feedback on concerns with aspects of detail, or where the narrow focus of the inquiry encourages it to ignore the broader implication of otherwise sensible recommendations on overall market efficiencies and emphasis, particularly in director supply and broad board focus.

Yours sincerely

Michael Robinson
Director

Peter McAuley
Director