Table of Contents

Introduction 3
Draft Recommendation 1 4
Draft Recommendation 2 4
Draft Recommendation 3 5
Draft Recommendation 4 5
Draft Recommendation 5 5
Draft Recommendation 6 6
Draft Recommendation 7 6
Draft Recommendation 8 7
Draft Recommendation 9 8
Draft Recommendation 10 9
Draft Recommendation 11 9
Draft Recommendation 12 10
Draft Finding 1 10
Draft Recommendation 13 11
Draft Recommendation 14 11
Draft Recommendation 15 11

For more information please contact:

Trevor Warden
Executive Reward Practice Leader Pacific
t. +61 3 9667 2628
e. trevor_warden@haygroup.com

For general enquires and more information about Hay Group
please contact **1800 150 124** or log onto **www.haygroup.com.au**

Introduction

About Hay Group

Hay Group is a global management consulting firm that works with leaders to transform strategy into reality. We develop talent, organise people to be more effective and motivate them to perform at their best. Our focus is on making change happen and helping people and organisations realise their potential. We have over 2500 employees working in 86 offices in 47 countries.

Locally, we operate out of seven offices across Australia and New Zealand with over 100 employees. We consult to listed, private and public sector organisations as well as the not-for-profit sector.

We provide advice to and work with leaders and their teams in the areas of:

- Building effective organisations
- Leadership and Talent
- Reward

In the reward area we focus on helping organisations:

- Develop a strategic approach to remuneration
- Design reward plans and programs that support the business strategy
- Understand the real responsibilities and value of jobs in a consistent and objective way
- Develop Executive Reward policies and practices that are consistent with the long term needs of the organisation
- Understand the competitive remuneration environment by providing valid and reliable market data on current pay practice

Hay Group interest in the Productivity Commission enquiry into Executive Remuneration

Hay Group's participation in the Productivity Commission inquiry stems from our belief that we will add value to the process as we:

- have proven expertise locally and globally in executive remuneration based on vast experience
- have deep insight into the issues that impact on executive remuneration
- maintain a significant database of executive remuneration globally, including many of the publicly listed companies on the world's major stock exchanges
- believe that reward is a powerful tool for company boards to use to improve company performance to the benefit of all in an economy.

In Australia our remuneration information is used by many of the top ASX listed organisations and we also advise Boards and management on director, executive and management remuneration in a number of ASX listed organisations.

Our approach to this submission

Hay Group is supportive of the general direction the Commission has taken with its draft findings and recommendations. We commend the members of the Inquiry for their insight into the range of issues affecting executive remuneration and the practical and balanced suite of recommendations in the Draft Report.

We have made comments on all the findings and recommendations but have provided more detailed comments on those where we feel we have specific expertise in remuneration strategy and practice and particular value to add. There are some recommendations we strongly support, some we support with reservations and one recommendation we do not support.

Subject to our reservations discussed below, we trust that the various regulators will accept and implement the recommendations.

Draft Recommendation 1

The Corporations Act 2001 should specify that only a general meeting of shareholders can set the maximum number of directors who may hold office at any time (within the limits in a company's constitution).

We support this recommendation.

It may discourage unnecessary barriers to Board diversity. We have some reservations that it may lead to larger Boards and reduce the flexibility of Boards to manage renewal and replacement of specialist skills. The negative consequences for some companies could be greater than the benefits.

Draft Recommendation 2

A new ASX listing rule should specify that all ASX300 companies have a remuneration committee of at least three members, all of whom are non-executive directors, with the chair and a majority of members being independent.

We strongly support this recommendation.

This has been accepted by most sections of the market for the past few years as good practice and most of our larger listed company clients have already adopted this model. We see the structure of the Remuneration Committee as important in not only supporting the independence and power of the Remuneration Committee, but also as a signal to all parties about where the ownership of the company remuneration philosophy and executive pay administration belongs.

Although the Board "owns" executive remuneration, it is important that the CEO has a voice in company remuneration strategy and policies, plan designs, performance targets and actual pay levels for subordinate employees. These are key tools to be used in the management of the enterprise and the CEO should have influence over how they can be used. This can be achieved by having management provide input and proposals to the Committee but ensuring the decisions are made by independent directors.

ASX 100 companies should be able to provide a Remuneration Committee in accordance with these requirements at minimal, if any, additional cost.

Draft Recommendation 3

The ASX Corporate Governance Council's current suggestion on the composition of remuneration committees should be elevated to a 'comply or explain' recommendation which specifies that remuneration committees:

- *have at least three members*
- *be comprised of a majority of independent directors*
- *be chaired by an independent director.*

We strongly support this recommendation.

This provides the benefits of the previous recommendation but allows smaller companies to plead their case if they believe they have special circumstances. We would expect the market to accept explanations based on the cost implications of appointing additional directors to allow compliance but not respond positively where the Board could readily comply but chooses not to.

We expect the ASX Corporate Governance Council will adopt the proposal but, in the event they did not, we would not encourage extending Recommendation 2 to all listed companies. The ASX could incorporate this "comply or explain" requirement in the listing rules in a similar way that they require "comply or explain" for the Governance Council guidelines.

Draft Recommendation 4

The Corporations Act 2001 should specify that company executives identified as key management personnel and all directors (and their associates) be prohibited from voting their shares on remuneration reports and any other remuneration-related resolutions.

We strongly support this recommendation.

The impact is likely to be very small for large listed companies but could be significant in some cases for smaller companies. We share the Commission's view that the disenfranchising of key management personnel and directors on these issues is outweighed by the benefit of a vote that will have greater credibility as the voice of independent shareholders.

Draft Recommendation 5

The Corporations Act 2001 should prohibit all company executives from hedging unvested equity remuneration and vested equity remuneration that is subject to holding locks.

We strongly support this recommendation.

Although we are not aware of this issue being a common problem, the objectives of incentive plans linked to the company share price are severely compromised if the executives are able to transfer the share price risk to a third party. Many of our clients already have policy and/or plan rule prohibitions against the use of hedging however they have limited enforcement capacity unless they become aware of the hedging before vesting. The Corporations Act will provide a more rigorous level of sanction.

Draft Recommendation 6

The Corporations Act 2001 and relevant ASX listing rules should be amended to prohibit company executives identified as key management personnel and all directors (and their associates) from voting undirected proxies on remuneration reports and any other remuneration-related resolutions.

We support this recommendation.

We think it is reasonable to argue that shareholders who give undirected proxies to directors or key management personnel have confidence in the judgement of those directors/executives and they should be free to exercise that judgement on behalf of the shareholders. On the other hand the perception of the integrity of a vote on remuneration will be enhanced if directors and key management personnel do not vote on these issues no matter whose shares are being voted. We think this latter view is a slightly more powerful argument.

It seems likely that shareholders who might give undirected proxies to the Chair will be encouraged to direct their proxies in line with the Board recommendations or vote them directly if electronic voting facilities are provided.

Draft Recommendation 7

The Corporations Act 2001 should be amended to require proxy holders to cast all of their directed proxies on remuneration reports and any other remuneration-related resolutions.

We strongly support this recommendation.

Shareholders who give directed proxies would expect that those votes will be voted in line with their expressed wishes. The concept of directed proxies is somewhat outdated and electronic voting provides a more direct mechanism for shareholders to express their views on company meeting resolutions. While directed proxies are supported as a voting mechanism they should be exercised.

We share the Commission's view that appropriate provisions could be framed that would legitimise a failure to vote in specific circumstances when the proxy holder was acting in good faith.

Draft Recommendation 8

Section 300A of the Corporations Act 2001 should be amended to specify that remuneration reports should additionally include:

- *a plain English summary statement of companies' remuneration policies*
- *actual levels of remuneration received by executives*
- *total company shareholdings of the individuals named in the report.*
  Corporations should be permitted to only disclose fair valuation methodologies of equity rights for executives in the financial statements, while continuing to disclose the actual fair value for each executive in the remuneration report.

We generally support this recommendation with a reservation explained below.

Plain English Summary of Remuneration Policies
Requiring a clearer explanation of the remuneration philosophy and policies will encourage Boards to be more specific and rigorous in considering the remuneration objectives for their particular company and this in turn will facilitate more soundly based policies and plan designs. The effective communication of this to stakeholders is challenging but the benefits of doing so are becoming increasingly apparent to most directors.

Disclosure of Actual Levels of Remuneration Received
Fixed pay and Short Term Incentives are generally easily valued in current dollars. Equity based Long Term Incentives (LTIs) are much more problematic. Recording the realised value of shares acquired as a consequence of employment has the apparent advantage of showing a "real" dollar value but has the potential to add confusion to the general public's understanding of executive pay.

We suggest that the actual realised value at the point of selling the shares is not relevant for remuneration purposes as the sale may be deferred for many years. The most logical point to value the "realisable" value is at the point where the shares are vested and free of any holding restrictions (vesting value). At this point the executive has the capacity to convert the shares into cash at an objectively determined value. Any variation in value from this point is a consequence of the executive's activities as an investor, not related to their contribution to the company or their reward as an employee.

Use of the vesting value in the remuneration report will be objective but has limitations for remuneration purposes. The value cannot be shown until well after the LTI has been granted and approved, if necessary, by shareholders. This will then involve the Board justifying the outcome of decisions made in good faith three years ago. Potentially those decisions were made in different circumstances by a differently constituted Board. They will now be judged by commentators enjoying the benefits of hindsight.

It is clear that a lot of the public debate centres on the absolute dollar value of executive reward. Large numbers often attract condemnation irrespective of the circumstances and rationale. The vesting value of LTIs will reflect the outcomes of performance hurdles and movements in the share price. This will generate low or zero values for unsuccessful executives and high values for successful ones.

While Boards will be able to put their case for the dollar outcomes they will, in practice, only have to defend in cases of success. The greater the success, the more difficult the communication challenge will be.

The vesting value is largely irrelevant for use in setting LTI allocation levels. The data reported for vesting values will reflect remuneration decisions of the past modified by company performance against hurdle criteria and share price movements. It will be virtually impossible to determine what level of allocation is required to meet the current competitive market based on reported vesting values. This will not stop the press and other commentators from drawing dangerous and unfair comparisons.

The theoretical fair value determined under the global accounting standard is clearly less than perfect. It does however represent the best available estimate of the LTI reward opportunity provided to LTI recipients in the last year. Executives who receive an LTI allocation have received a valuable entitlement even if the hurdles are not met and no value is ever realised. This LTI opportunity should be considered when comparing the executive with the external remuneration market.

The fair value numbers will vary between companies but our experience is that they are within an acceptable range of comparability. The fair value provides a best available approach to recognising that LTIs have a different value depending on the degree of difficulty of the performance hurdles, the nature of the company share price (expected volatility) and other factors built into the valuation formulae.

In addressing the value received by executives the Board should be able to explain the difference between the fair value at grant and the realisable vesting value by reference to company performance over the vesting period.

We believe that vesting values will be very attractive to the financial press but appeal primarily to the public interest in individual personal wealth. Fair value is much more useful as a measure of comparable remuneration and informed remuneration debate.

We accept the required disclosure of realisable equity value at vesting in addition to the fair value figures but suspect it will add more heat than light to the public debate.

Disclosed Levels of Company Shareholding.
A clear statement of the total shareholding of the directors and key management personnel would be a useful indication of the financial exposure of the individuals to the share price and alignment of interests. This would be a more useful indicator than the current detailed disclosure of equity transactions.

Draft Recommendation 9

Section 300A of the Corporations Act 2001 should be amended to reflect that individual remuneration disclosures be confined to the key management personnel. The additional requirement for the disclosure of the top five executives should be removed.

We strongly support this recommendation.

The current dual criteria for disclosure is confusing and unnecessary. The important governance issue is related to the remuneration of those executives actually running the company – the key management personnel. They will typically be among the highest paid but there are occasionally specialist staff who are also very highly paid but not in the key managerial roles. Disclosing remuneration for these other employees is about public fascination rather than governance.

Draft Recommendation 10

The ASX listing rules should require that, where an ASX300 company's remuneration committee (or board) makes use of expert advisers, those advisers be commissioned by, and their advice provided directly to, the remuneration committee or board, independent of management.

We strongly support this recommendation.

Ensuring the Board has access to independent advice on remuneration is an important way to support the capacity of the Remuneration Committee and Board to make strong and appropriate decisions on executive pay. The Hay Group philosophy is that we work only for companies and not individuals. We therefore always consider our advice on executive pay from the point of view of the Board and not that of management. For some time we have had a policy that we will only provide information and advice on CEO pay directly to the Board. We prefer to have our assignment initiated by the Board but it is quite common for the Board to ask the CEO or HR Manager to commission us.

The proposed listing rule requirement for the ASX 300 would make it clear to all parties that in these cases the client is the Board and the advisor's responsibility is to meet their needs, not management's.

It will also clarify for the Board when the advice they receive is from the external advisor and when it is a management proposal, even if management has had external input.

Draft Recommendation 11

The ASX Corporate Governance Council should make a recommendation that companies disclose the expert advisers they have used in relation to remuneration matters, who appointed them, who they reported to and the nature of other work undertaken for the company by those advisers.

We strongly support this recommendation.

It is appropriate that the market should be aware of the range of input a company has received in formulating its remuneration structures. The listing of advisors should be kept as simple as possible to avoid this becoming an additional incomprehensible section of the Remuneration Report. A listing of advisors working for and reporting directly to the Board and a separate listing of advisors who have worked with management would provide this general indication.

We have reservations about detailed statements about the nature of the work as our experience is that we may provide access to market information, general remuneration

policy advice, specific remuneration proposals or a combination of all three for several different assignments over a year. It is also common and absolutely appropriate that Boards and/or management may accept all, some or none of our advice. The listing should not imply that the advisors support the contents of the Remuneration Report.

Draft Recommendation 12

Institutional investors should disclose, at least on an annual basis, how they have voted on remuneration reports and any other remuneration-related issues. How this requirement is met should be at the discretion of institutions.

We support this recommendation.

The increased transparency that this recommendation will encourage is desirable in understanding the role of individual institutions in the governance arena. Unfortunately, we think it likely that institutions will be even more likely to outsource the PR risk by following proxy advisor suggestions.

Draft Finding 1

Remuneration structures are company and context-specific and a matter for boards to resolve rather than being amenable to prescriptive direction. That said, there are some key dimensions that often warrant being explained clearly to shareholders, and, where appropriate, could usefully be addressed in companies' treatment of their remuneration polices in the remuneration report:

- *how the remuneration policy aligns with the company's strategic directions, its desired risk profile and with shareholder interests*
- *how the mix of base pay and incentives relates to the remuneration policy*
- *how comparator groups for benchmarking executive remuneration and setting performance hurdles and metrics were selected*
- *how incentive pay arrangements were subjected to sensitivity analysis to determine the impact of unexpected changes (for example, in the share price)*
- *whether any 'incentive-compatible' constraints or caps to guard against extreme outcomes from formula-based contractual obligations apply*
- *whether alternatives to incentives linked to complex hurdles have been considered (for example, short-term incentives delivered as equity subject to holding locks)*
- *whether employment contracts have been designed to the degree allowable by law, to inoculate against the possibility of having to 'buy out' poorly performing executives in order to avoid litigation*
- *whether post-remuneration evaluations have been conducted to assess outcomes, their relationship to the remuneration policy and the integrity of any initial sensitivity analysis.*

We generally support these findings.

While the check list is a useful starting point for Boards to consider we have some concern that these issues could just be added to a "boiler plate" template. Many of the issues in the check list are difficult and involve balancing a variety of competing interests and pressures.

Explaining this in plain English and beyond the level of "motherhood" statements will add considerably to the length and complexity of the Remuneration Report.

Draft Recommendation 13

The cessation of employment trigger for taxation for equity-based payments should be removed, with the taxing point for equity or rights that qualify for deferral being at the earliest of: where ownership of, and free title to, the shares or rights is transferred to the employee, or seven years after the employee acquires the shares.

We strongly support this recommendation.

Hay Group has a strong position, when working with clients, that remuneration design should be driven by business strategy and objectives and not by tax rule leverage. It is clear however that tax rules do have an influence on remuneration structures. The US experience over recent years with punitive tax treatment for fixed pay over $1 million and for option plans with performance hurdles is a good case study of how tax provisions can distort remuneration policy.

The current Australian tax rule that equity remuneration may become taxable on cessation of employment has created disincentives for plans that extend beyond termination. This creates problems for providing a long term focus for executives nearing retirement.

The removal of this tax trigger point will facilitate plans that better align with APRA suggestions and reduce the risks of short term gaming by retiring executives.

Draft Recommendation 14

The Australian Securities and Investments Commission should issue a public confirmation to companies that electronic voting is legally permissible without the need for constitutional amendments — as recommended in 2008 by the Parliamentary Joint Committee on Corporations and Financial Services.

We support this recommendation.

This would assist in upgrading the integrity and convenience of shareholder voting.

Draft Recommendation 15

The Corporations Act 2001 should be amended to require that where a company's remuneration report receives a 'no' vote of 25 per cent or higher, the board be required to report back to shareholders in the subsequent remuneration report explaining how shareholder concerns were addressed and, if they have not been addressed, the reasons why.
If the company's subsequent remuneration report receives a 'no' vote above a prescribed threshold, all elected board members be required to submit for re-election (a 'two strikes' test) at either:

- *an extraordinary general meeting or*
- *the next annual general meeting.*

We do not support this recommendation.

Since the introduction of the non-binding vote on the Remuneration Report, Australian Boards have been very responsive to strong negative votes. Boards have almost universally taken the concern of shareholders very seriously and ensured that the next Report addressed the areas of shareholder dissatisfaction.

We do not see a significant need to strengthen the power of the current non-binding vote.

Notwithstanding that we do not see the need for the "two strikes" approach, if the proposed 2 strikes model was adopted we would advocate that the trigger for a Board spill in the second year should be in excess of 50%. It is democratically unacceptable for a majority of shareholders to be overruled by a minority.

If this approach is implemented we suggest that the election of directors should be at an Extraordinary General Meeting of the Company to be held within three months of the triggering AGM. Deferring the election for a full year would make the penalty too remote from the offence.