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6 November 2009

Mr Gary Banks AO
Chairman
Australian Productivity Commission

By e-mail: exec_remuneration@pc.gov.au

Subject: Executive Remuneration in Australia:
Submission on Productivity Commission Discussion Draft

Dear Mr Banks,

This submission is in response to the Productivity Commission's invitation to comment on the Discussion Draft released on 30 September 2009. In presenting Mercer's comments for consideration, we acknowledge the ongoing consultative process the Commission has used in conducting this inquiry and the resulting context in which the Commission has needed to balance a series of diverse and often opposing views.

Mercer is a global company providing human resources and related financial advice, products, and services. These services include consulting to corporations, boards of directors and board remuneration committees concerning the pay of executives and directors. Mercer is a wholly-owned subsidiary of Marsh & McLennan Companies Inc. The comments and recommendations expressed in this letter are the views of Mercer (Australia) ("Mercer") and do not necessarily represent the views of Marsh & McLennan Companies Inc. or its affiliated companies, or the views of our clients.

Our objective in this submission is to address only those recommendations we believe directly link to enhancing the integrity of the processes surrounding the determination of executive pay. While Mercer is generally supportive of the direction taken in the Discussion Draft, we are opposed to recommendations 6 and 15. We are also opposed to recommendations 8 and 11 in their current form. We believe that recommendation 8 requires further detail to achieve the potential benefits stated in the Draft Discussion. Similarly, we believe recommendation 11 requires further clarification, particularly with reference to overseas experience regarding the disclosure of remuneration advisers.

In the following sections of this submission, we list the detail of the recommendations relevant to this submission and the reasons why we support or oppose the respective recommendation.

I take this opportunity to thank the Commission for the opportunity to present Mercer's perspective on these significant governance issues surrounding executive pay.

Yours sincerely

Yolande Foord
Principal

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Reducing conflicts of interest

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.

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.*

Mercer submission:
Mercer supports draft recommendations 2 and 3 as a means of increasing the independence of remuneration committees and thus reducing the potential for conflicts of interest. We note that the introduction of committees composed of independent directors has been a major plank in international governance reform for over a decade.

The Commission asks for comments on whether draft recommendation 2 should be extended to all listed companies if recommendation 3 is not adopted. We are not best placed to provide such comment beyond a view that the boards of smaller listed companies may find it difficult to comply given fewer members than ASX 300 companies.

DRAFT RECOMMENDATION 4

The Corporation 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.

Mercer submission:
Mercer supports draft recommendation 4 in that it addresses an issue which poses a clear conflict of interest for the parties concerned.

DRAFT RECOMMENDATION 5

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

Mercer submission:
Mercer supports draft recommendation 5 on the basis that hedging unvested equity deliberately dilutes the intent of performance-based pay and the purpose behind providing executives access to equity as a means of alignment with shareholder interests.

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.

Mercer submission:
Mercer opposes draft recommendation 6 on the basis that an undirected proxy implies a shareholder's intention to vote in favour of a board proposal. To prevent a shareholder from exercising this intention takes away the right to have their vote counted. Given the potentially significant impact of a 25 percent 'no' vote, as proposed in recommendation 15, Mercer believes that recommendation 6 will further add to the likelihood of a minority 'no' vote having a disproportionate influence over a significant majority in favour of a remuneration proposal.

Having expressed our opposition to this recommendation, if it does form part of the Commission's final recommendations to Government we look forward to less undirected proxies being used by shareholders.

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.

Mercer submission:
Mercer supports Draft Recommendation 7 on the basis that shareholders who have appropriately identified a voting intention to a proxy, have a fundamental right to have their vote counted. There is no apparent logic in limiting the stipulation to cast directed proxies to Board Chairs.

Improving relevant disclosure

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.

Mercer supports the Commission's objective to improve the information content and accessibility of remuneration reports through enhanced disclosure. The stated potential benefits include 'better informed shareholders and community' and that it will 'reduce scope for confusion about incentive pay structures.'

In our initial submission to the Commission, we stated our concern that current disclosure requirements do not represent the actual remuneration received by executives and that there is no consistent framework or oversight authority regarding disclosure. However, we do not believe that recommendation 8 in its current form will achieve the target objectives; instead, this recommendation may create additional confusion.

The current disclosure framework is based on the ASX Corporate Governance Principles and Recommendations (Principle 8 – Remunerate fairly and responsibly), the Corporations Act (Section 300A and associated Regulation 2M.3.03) and the accounting standards. The general intent of this framework is to enable investors to understand the costs of executive remuneration policies and the link between the remuneration paid to key executives and the financial performance of the company. However, in practice, companies have different opinions on what are the most important elements to include and there is no consistency in the actual information disclosed from one company to another: consequently, it is difficult for shareholders to make meaningful comparisons.

Mercer believes there is benefit in learning from steps taken globally to centralize the rules for disclosure and clearly define information to be included. For example, the US requires detailed tabular disclosure of short and long term incentive plan targets and actual amounts paid or vested. Furthermore, the Compensation Discussion and Analysis (CD&A) section requires an overview of the company's compensation program; and although it follows a principles-based approach, is based on a detailed guide to specific information to be included.

In our opinion, clearer disclosure requirements will result in more meaningful information and more concise Remuneration Reports. We also recommend disclosure of both actual amounts and potential fair values.

Attachment A outlines current global disclosure requirements and those we suggest should be considered in Australia. While Mercer may not support all aspects of the current US, Canadian or UK disclosure rules, lessons can be learned from the effects these requirements on the level of understanding of the respective national pay practices.

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.

Mercer submission:
Mercer supports limiting individual remuneration disclosure to key management personnel. We believe that those executives nominated as key management personnel would, by reason of their seniority and roles, participate in the overall planning of the corporation's strategic objectives and operating priorities and exert significant influence on the performance of the company.

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.

Mercer submission:
Mercer supports draft recommendation 10 on the basis that it minimises the scope for executives to directly or indirectly influence the design of their own remuneration.

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.

Mercer submission:
As demonstrated by our support for recommendations 2, 3, 4 and 10, Mercer supports the Commission's objective to avoid conflicts of interest with regard to executives influencing their own pay outcomes. In this respect, we also support draft recommendation 10 requiring remuneration advisers be commissioned by, and report directly to, the remuneration committee. However, in our opinion, draft recommendation 11 falls short of this objective.

The role of remuneration consultants is not always understood by shareholders. Contrary to a view often presented in the general press, we do not tell remuneration committees or management what to do, nor do we negotiate employment or pay arrangements, set remuneration philosophies, determine pay levels, equity awards or incentive plan payouts. We do provide objective information, insights and advice to clients (boards, remuneration committees and management) to help them make informed decisions on executive pay. We also adhere rigorously to the 'one up' principle such that we never provide data or advice to a CEO or other executive on their individual pay: we deal exclusively with the directors or executive responsible for determining that person's remuneration.

As acknowledged in your Discussion Draft, committees have the primary responsibility for determining executive remuneration. However, they do not always follow our advice and may use a range of advisers to inform their decisions.

We do not oppose the requirement that advisers on remuneration matters be disclosed but recommend the Commission use its final report to clarify the following issues:

- disclosure is required for **all advisers** (not just remuneration consultants); and that
- disclosure is only required when advising **the remuneration committee.**

We also believe more information is required to assess the role of the advisor, particularly with regard to the **specific aspects of remuneration** (e.g. fixed pay, short- and long-term incentive design) on which the remuneration committee received advice.

In its present form, we oppose recommendation 11 for two primary reasons. First, the requirement to disclose the 'nature of other work' will require the provision of potentially misleading information that will not enable shareholders to assess potential conflicts. Instead, it **creates a presumption that if other work is being performed there is a conflict**. Second, such disclosure creates a de facto standard that a conflict exists whenever

a multiservice firm is used to provide services. The disclosure is therefore anticompetitive because it **favours single service boutique consulting firms over multiservice consulting firms**.

Our comments are based primarily on the premise that remuneration committees, rather than shareholders, are better positioned to determine whether they are making decisions that are appropriately considered and not influenced by potential conflicts of interest. Remuneration committees should be able to rely on protocols adopted by multiservice consulting firms to mitigate any potential conflicts. For example, our formal letters of engagement to clients now disclose the nature of other, non-executive remuneration services, provided to clients. We elaborate on these points in Attachment B.

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.

Mercer submission:
Mercer supports draft recommendation 12 regarding disclosure by institutional investors on how they have voted. However, we believe that such disclosure should also provide that in the case of a 'no' vote, investors are required to provide an explanation of why they cast a negative vote. The additional requirement for investors to provide an explanation provides a basis for companies to address the concerns raised by investors.

We believe that the implementation of the intent of recommendation 12 be a voluntary code promoted and co-ordinated by key industry associations such as the Australian Council of Superannuation Investors and the Investment and Financial Services Association.

Well-conceived remuneration policies

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.

Mercer submission:
Mercer supports draft recommendation 13 for the following reasons.

The use of equity-based rewards is encouraged within the governance frameworks of all Anglo-American jurisdictions as a key element in aligning executives' interests with those of the company and shareholders on a longer-term basis, including post-employment. Retaining equity post-employment means executives have a vested interest in future company performance and are therefore motivated to carry out their executive duties responsibly throughout the end of their tenure.

Removing the point of taxation from the cessation of employment is consistent with the intent of the federal government's proposed legislation to reduce the level of termination payments requiring shareholder approval. Retaining shares or options post employment acts as an inherent performance hurdle as increase in value is linked to future share price performance, therefore maintaining alignment with shareholder interests.

Australia is one of the few OECD countries to tax equity on termination of employment. We believe it important that Australia's taxation treatment of executive remuneration is generally aligned with international taxation arrangements and does not disadvantage the competitiveness of Australian companies.

Finally, there seems to be no necessity to maintain the taxing point at the termination of employment as the new legislation allows that unvested equity would still be subject to a risk of forfeiture even after ceasing employment.

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 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.*

Mercer submission:

Mercer does not support recommendation 15 for three reasons. First, the 25 percent threshold is so low that it will almost inevitably allow a situation where a minority view is favoured over a significant majority, thus impinging on the principle shareholder democracy. Second, the voting process is leads to an' all or nothing' outcome. For example, it is entirely feasible that one element of an otherwise acceptable remuneration proposal may be considered controversial. Thus, not only causing the report to be voted down, but also the disruption of an entire board election. Third, given the initial low threshold, and even allowing for a more substantial' 'no' vote threshold on the consecutive report, we believe that this recommendation will be instrumental in promoting an homogenised approach to the structure of executive remuneration. Such an institutionalised outcome may limit the extent to which boards feel free to design executive remuneration programmes to suit the specific needs of their respective enterprises.

Attachment A:
Supporting Arguments Regarding Recommendation 8

In this attachment to our submission we recommend the Productivity Commission consider aspects of the experience of the US under its compensation disclosure rules adopted by the Securities and Exchange Commission (SEC) in 2006, of Canada under its rules adopted by the Canadian Securities Administrators (CSA) in 2008 and of the United Kingdom under the requirements of the Directors' Remuneration Report Regulations 2002. Although Mercer may not support all aspects of the current US, Canadian or UK disclosure rules, there are lessons from the effects these requirements have had on the level of understanding of US, Canadian and UK executive pay practices. The material presented below is organised under the following headings: 'Disclosure Framework', 'Compensation and Discussion Analysis', 'Summary Compensation Table', 'Incentive Compensation Plans' and 'Termination Pay and Benefits'.

1. Disclosure Framework

As a first point of reference, US rules include the disclosure items for the company's CEO, CFO and three other most highly compensated individuals or: 'Named Executive Officers' (NEOs)

- The Compensation Discussion and Analysis (CD&A) presents an overview of a company's compensation program for its NEOs, including the program's objectives and implementation. The CD&A takes a principles-based disclosure approach to explaining the compensation program's objectives and policies, what it is designed to reward and the various pay elements used to meet these objectives.
- The Summary Compensation Table (SCT) covers three years and, for each year, includes a total compensation figure for each NEO. In addition, there are columns for salary and bonus (generally discretionary payments), accounting cost of share awards and share options[1], non-equity incentive plans (generally annual and long-term performance-based cash plans), change in pension value and above-market nonqualified deferred compensation earnings, and all other compensation elements.
- The Grants of Plan-based Awards Table contains detailed information about performance-based and service-based cash and equity award grants (short- and long-term incentives including share options) to each NEO during the last completed fiscal year in the SCT.
- The Outstanding Equity Awards at Fiscal Year-End Table allows readers to calculate, the amount of each NEO's unrealized appreciation or value in all share options and other share-based incentives outstanding as of the end of the last fiscal year.

[1] The SEC is currently considering amending the rule to use the full grant-date fair value in lieu of the accounting cost in the SCT and Director Compensation Table, as described under "Summary compensation table" below.

- The Option Exercises and Stock Vested Table covers the actual amounts realized by each NEO during the last fiscal year from the exercise of vested share options, share appreciation rights, and similar instruments and the vesting of restricted share, restricted share units, and other share-based awards.
- The Pension Benefits Table shows the actuarial present value of each NEO's accumulated benefit under each defined benefit plan (including tax-qualified defined benefit plans, supplemental employee retirement plans, and cash balance plans but excluding defined contribution 401(k) plans).
- The Nonqualified Deferred Compensation Table covers each NEO's contributions, company contributions, withdrawals, all earnings for the year and withdrawals, and the year-end balances of each executive's nonqualified deferred compensation arrangements.
- A narrative or tabular disclosure of amounts payable under different termination scenarios: resignation, severance, retirement, or other termination, such as a constructive discharge or a termination related to a change in job responsibilities or change in company control.

Canadian rules include similar requirements. However, the CSA rules differ from US rules in a few significant ways. For example, the Canadian approach uses the grant-date fair value for valuing equity awards in lieu of the accounting method, use only compensatory amounts in determining the value of pension benefits and require fewer details on individual equity grants, outstanding equity awards, option exercises and vested equity awards.

2. Compensation Discussion and Analysis

The CD&A is one of the most significant aspects of the new disclosure requirements in the US and Canada. The UK Directors' Remuneration Report Regulations similarly require a statement covering all aspects of current and future compensation policy.

The CD&A should provide an analysis of the company's rationale for its compensation decisions and the basis and context for granting different types and amounts of pay and the factors considered in approving each element of pay. A discussion of how benchmarking is used to set pay levels, details of the company's approach to the proposed market position of each compensation element and whether the Committee exercises discretion to deviate from benchmarking data should also be included.

In Canada and the UK, this section is also required to include a comparative Total Shareholder Return (TSR) performance chart of the company against a hypothetical holding in a suitable broad equity market index over the last five years. This performance chart is a useful inclusion which provides shareholders (and other stakeholders) with historic company performance which they can use to assess the company's compensation policy and practice. In the US, this performance graph is included in the annual report to shareholders.

Although initial CD&A reports of US companies were long and complex, they have improved each year since the rules were adopted as companies have become accustomed to the new requirement. Since Canada adopted a similar CD&A requirement in 2008, many Canadian companies learned from the US experience and were able to provide more streamlined disclosure in the first year of the new requirement.

Many US, Canadian and UK companies have succeeded in providing shareholders with plain English explanations of pay plans and decisions that are more readable and accessible documents than might result from more prescriptive rules. The best disclosure gives shareholders a 'roadmap' to understanding the tabular information on pay and a more robust understanding of compensation programs and decisions. Effective disclosure avoids reciting plan descriptions, and program mechanics and legal boilerplates: instead it is written in plain English, using tables and graphics where possible to enhance understanding. The requirement to provide a principles-based discussion of compensation programs and decisions has avoided some of the pitfalls of more prescriptive disclosure requirements, such as the reduction of disclosure to legal boilerplate.

We recommend the Productivity Commission adopt a principles-based disclosure requiring a narrative discussion of the company's remuneration policies and decisions. This gives investors an overview that explains the material elements of senior executive rewards and puts into context the remuneration information provided by the quantitative, tabular disclosure requirement. The narrative section should cover the objectives of the executive compensation program: what it is designed to recognise; each element of the package and why the company chooses to provide it; how the company determines the amount of pay; and how each element of pay fits into the company's overall pay program.

3. Summary compensation table

We believe that a Summary Compensation Table that gives investors an annualised total pay figure should be the centrepiece of the quantitative disclosure requirements. As executive remuneration packages have become more sophisticated, it has become increasingly difficult for investors to ascertain the potential size of these packages and to evaluate their individual components. A Summary Compensation Table provides investors with a concise and comprehensive overview of the total package. We believe that, to make the information in the Summary Compensation Table meaningful to investors, the various package elements reported in the table should be presented on a consistent basis or combined only with similar elements. This is of particular concern with respect to equity awards and pension plan values, as discussed below.

Equity award disclosure in Summary Compensation Table and Grants of Plan-based Awards Table: It is often difficult for shareholders to understand the true value of equity awards granted to executives. We recommend that, at a minimum, shareholders are provided with a Summary Compensation Table with a total package figure that includes the full grant date fair value of equity awards as a means of more accurately reflecting the true

value of equity grants received by executives. US rules currently require disclosure of the accounting cost of equity awards in the Summary Compensation Table, but not the full grant date fair value. It is noteworthy that after considering the US rules and experience, in adopting its disclosure rules in 2008, the CSA decided to require that the grant date fair value of equity awards and not the accounting cost be included in the Summary Compensation Table in Canadian company proxy circulars.

In the US, investors and companies alike have been disappointed that the disclosure of the accounting cost of equity awards in the Summary Compensation Table (and Director Compensation Table) does not adequately or accurately reflect the value executives and directors were meant to receive. This also has severely limited the value of the total compensation figure. As a result, a few companies provided “alternative” summary compensation tables showing the grant date fair value in lieu of the accounting cost. The SEC recently proposed amending this requirement to report the full grant date fair value. It is anticipated this change will be adopted since it has received support from both companies and shareholders.

UK regulations currently do not require the equity value to be disclosed in a summary compensation table. Information on equity and other long-term incentive plans is disclosed in separate tables where all the details used to calculate fair value at grant are disclosed.

The Productivity Commission may want to consider using two Total Remuneration columns in the Summary Compensation Table. The first, an Earned Remuneration column, would include the compensation that an executive has actually earned and received in the covered fiscal year. Thus, the amount disclosed in this column will reflect the total of the amounts of salary, bonus, and other components, such as perquisites and other benefits. Share awards that are granted and vest in the same fiscal year and share options that are granted and exercised in the same fiscal year would also be included in the Earned Remuneration column.

The second, a Contingent Remuneration column, would include the amounts that may change in value, or may never be realized, depending on the satisfaction of future contingencies. Thus, the amount disclosed in this column would reflect the total of the amounts of share awards, option awards, and non-share incentive plan remuneration. The advantage of this approach is that companies would not be required to aggregate disparate compensation elements into a single total, but would be permitted to combine like elements to produce separate total figures that acknowledge the differences in the presentation of these amounts in the Summary Compensation Table. Such an approach would not disadvantage investors who would be able to add these two columns together if they wished to produce a single total compensation figure.

Alternatively, the Productivity Commission could consider requiring two summary compensation tables, one that reports "realized" remuneration and another that reports "realizable" remuneration. The table of realized pay would include salary, annual bonus, value of vested restricted share, value of exercised share options, value of other long-term incentive plan (LTIP) payouts and cost of perquisites and other benefits. The table of realizable pay would include the base salary rate, target annual bonus, value of restricted share awards amortized over vesting period, grant date fair value of share options, target payouts for LTIP awards and expected cost of perquisites and other benefits. Each table would also include a total actual or total target remuneration figure. Although this type of table is not required under the US rules, some companies have included similar supplemental tables in their disclosure**.**

We also recommend supplemental equity tables similar to those required in the US that report annual grants of incentive awards, the value of outstanding equity awards, and option exercises and share vested to demonstrate the life cycle of an equity award and the accumulation of equity value. The UK and Canada also have similar tables - UK for annual grants of incentive awards, options exercised and vesting of incentive awards and Canada for outstanding awards and the vesting of incentive plan awards.

4. Incentive compensation plans

Incentive compensation plans are, in many ways, the most significant aspect of executive pay. This is in part because they make up a substantial portion of the total remuneration amount. Furthermore, incentive plans are the primary vehicle to align managements' interests with those of shareholders and to reward performance. However, they are also one of the most difficult aspects of remuneration to understand since, as noted by the Productivity Commission, there is no universal definition of corporate performance.

Potential payouts: Incentive plan disclosure, particularly the disclosure of potential payouts, is one of the most critical components of the remuneration report. Although we believe Australia's existing regulatory system provides an effective framework that has helped the country avoid some of the excesses in other markets, we are concerned that current disclosure requirements are not sufficient to elicit the actual remuneration received by executives. This is largely because there is no requirement for companies to provide details on target and actual incentive payments.

The US rules require companies to disclose in the Grants of Plan-based Awards Table the estimated future payouts under non-equity and equity incentive plans at threshold, target and maximum levels of performance on a grant-by-grant basis. This is designed to give shareholders an understanding of the potential payouts under incentive pay plans and the value of grants made during the year.

We recommend that the Productivity Commission require disclosure of the potential threshold, target and maximum payouts as well as the actual payouts in a table similar to the US Grants of Plan-based Awards Table. The Productivity Commission should also clarify whether the disclosure is required for the year the payouts were actually received or the year to which the performance relates.

Performance measures and targets: In the US, there has been considerable tension between investors' desire for greater transparency about the pay-for-performance relationship and companies' reluctance to disclose sensitive, confidential or proprietary information. One of the most controversial aspects of the US disclosure rules is the requirement to disclose performance metrics and targets if they are material to an understanding of remuneration policies and decisions. The rules require companies to disclose in the CD&A the specific performance metrics and targets considered in determining awards unless they have been kept confidential and disclosing them would result in "competitive harm" to the company. Canadian rules have a similar requirement that uses a "serious prejudice" standard in determining whether specific performance targets should be disclosed. Firms must also disclose whether the company or the executives achieved the prior-year performance targets and how the company determined awards paid under incentive plans; this includes the extent to which target or maximum performance goals were achieved and how achievement of various corporate performance objectives and individual goals resulted in specific payouts.

The UK rules require detailed disclosure about long-term incentive plans including specific performance conditions and whether performance conditions are measured on a relative basis and, if so, details of the peer groups used. Less detail is required on bonuses - only the total amount of bonus paid or received has to be disclosed. However, many UK companies, due to pressure from shareholders and advisory bodies, disclose bonus targets and maximum opportunities while a smaller number also disclose the specific performance metrics and targets required. Increasing pressure from stakeholders may result in UK companies being expected to at least disclose the specific performance objectives for the bonus paid in that fiscal year and the extent to which the objectives were achieved.

Initially, less than half of US companies disclosed the specific performance targets for their incentive pay plans. However, in years two and three under the new disclosure rules, more companies have disclosed the specific target levels and fewer have argued such disclosure would result in competitive harm. In the US, targets generally are disclosed for completed performance periods, but companies have successfully argued that future or current period targets should not be disclosed. For example, targets for multi-year plans may not need to be disclosed until the completion of the final performance period.

Over the past three years companies have become more accustomed to disclosing objective performance criteria, particularly where the measures are corporate and not business unit performance metrics. However, there also seems to be a trend away from objective criteria toward more subjective plans where the board exercises discretion in determining payouts under incentive pay plans. It is not clear if this is a result of the disclosure requirements pushing companies toward discretionary plans or the increased market volatility caused by the recent economic turmoil.

We do not recommend that the Productivity Commission require the disclosure of specific performance targets as this may require companies to disclose confidential or proprietary information. We believe that this may cause companies to move toward more generic performance measures that may not be consistent with their strategic business objectives, or rely on discretionary performance assessments that may not provide the most effective incentive for management to drive results.

5. Termination pay and benefits

Termination benefits would include severance, equity vesting, enhanced retirement benefits, continuation of health benefits and perquisites, payable in connection with any termination, including resignation, severance, retirement or constructive termination or a change in control of the company. The US rules do not require the value of termination benefits to be disclosed in a table but allow companies to provide this disclosure in narrative form outlining the amounts payable if termination occurred on the last day of the year. Because the US rules allow flexibility with respect to this disclosure, it is difficult for shareholders to compare termination benefits among companies. However, most US companies have decided to present this disclosure in a table or multiple tables, which is more transparent and easier to understand.

The UK rules require compensation for termination and benefits to be included in the summary compensation table for the fiscal year in which they are payable, similar to the current Australian requirement. Details on termination payments and benefits tend to be provided in the notes to the table with additional narrative on potential amounts for current executives payable on termination or a change in control of the company.

We recommend the Productivity Commission require disclosure of estimated termination payments in a table that includes a total figure. This will enhance investors' ability to access and understand potential amounts payable on termination of an executive under various circumstances.

Attachment B:
Supporting Arguments Regarding Recommendation 11

1. Disclosure should only apply to advisers to the remuneration committee

We make three observations with regard to this recommendation. First, the use of the term 'advisers' in recommendation 11 the term 'advisers' appears to be broad in scope. For example:

- it extends to all the expert advisers used by the company in relation to remuneration matters;
- It would apply regardless of whether the remuneration advice was provided to management or the remuneration committee; and
- it would cover all remuneration matters regardless of the employee group.

We recommend the inclusion of other expert advisers in the disclosure requirement but more guidance may be required on 'remuneration matters'. In our opinion advice from accountants and law firms can significantly affect remuneration design and in particular the amounts payable in termination.

Our second observation may just be an oversight in the current draft. The current rationale for Recommendation 11 does not support extending disclosure requirement to services provided solely for management in relation to remuneration matters. There can be no conflict of interest, actual or potential, where management is the client. In these cases, the committee is well aware that materials presented by management or by management's consultants reflect management's recommandations. It is up to the committee to exercise judgment, being aware of the obvious potential for bias, in evaluating the quality and objectivity of such recommendations.

Third, the recommendation refers to advice on 'remuneration matters' and does not specify if it is limited to executives. However, even if it did companies define 'executives' in different ways; there is no consensus on who is an executive beyond the top tier of management.

We encourage the Commission to clarify that any work performed for the remuneration committee triggers disclosure. If the Commission also requires the disclosure of new advice prepared for management, then executive should be defined as 'Key Management Personnel.'

2. Executive pay levels are not influenced by perceived consultant conflicts of interest

We believe the recommendation is based on the false premise that remuneration consultants employed by multiservice firms, such as Mercer, do not provide objective advice to their remuneration committee clients and instead enhance management's remuneration levels in an effort to establish, preserve or enhance consulting fees from other engagements with management. The corollary premise, in our opinion, also false, is that single service boutique firms recommend lower pay for management and therefore, the use of such firms should escape shareholder or regulatory scrutiny.

There is no evidence that companies that use multiservice firms that perform other services for the company have higher CEO pay or that those who use single service boutiques have lower pay. In fact, at least three independent academic studies in the US have rigorously analysed the data and found no correlation between the consulting firm's business model and US CEO pay levels.

3. 'Nature of other work' disclosure is a poor proxy for assessing conflicts of interest

Even if one rejects the findings of the academic studies referenced earlier, the Commission's proposed disclosure on 'the nature of other work' is not a solution. We are aware that this issue has gained ground in the US and some groups have requested that other work and associated fees be disclosed because they believe it demonstrates that companies are receiving biased advice. We believe this is a flawed conclusion and the Commission is in effect lending credence to these arguments.

We note that only two of the 101 initial submissions to the Commission indicated that 'the disclosure of other services the consultant provided other than consulting to the board ***may be of some assistance***', the Australian Shareholder Association (sub.54, p. 15) and Oppeus (sub. 61).

In the majority of cases the submissions called for the disclosure of the remuneration consultant only if the board relied on that advice in setting an aspect of executive remuneration e.g. Risk Metrics (sub. 58, p. 8) and Ernst & Young (sub 92).

Kym Sheehan and CGI Glass Lewis and Guerdon Associates recommended the disclosure of all advisers (not just the remuneration advisers). CGI also suggested that the board provide an opinion on the independence of the adviser and the reason for that opinion.

The implication of the proposed disclosure is that the mere fact that other services are being performed indicates that the consulting advice was not objective. However, it does not highlight the potential conflict if a single service boutique firm receive a significant portion of their revenue from one client. The firm's financial stability may be threatened if it provides advice that a client does not want to hear and yet, since there is no other services to be disclosed there would be a presumption that there is no conflict.

4. The recommendation favours single service boutique firms

The recommendation to disclose "the nature of other work" would not effect single service boutique operations, which generally do not have the capability to provide services beyond remuneration consulting. Accordingly, only the clients of a handful of global, multiservice firms, such as Mercer, would be subject to this disclosure requirement.

In addition to being misleading, requiring other services to be disclosed may result in competitive or proprietary information being disclosed. For example, if Mercer is the investment consultant and the executive remuneration consultant, a description of the investment consulting services would be required. Competitors may use that information to gain insight on Mercer and could target its clients.

The current wording of Recommendation 11 does not specify if only the 'nature of other work' performed for the company by the specific adviser, the remuneration consulting firm or all affiliated entities of such firm, should be disclosed. In the case of a consultant such as Mercer, which is owned by MMC, the consultant's affiliates may have broad global reach across diverse sectors and affiliated companies have separate management. Executive remuneration consultants at Mercer are unlikely to know the nature and scope of services provided by these affiliated companies for clients around the world.

5. The Recommendation will reduce competition and choice

Companies would also be reluctant to disclose services involved with potential mergers and acquisitions or changing a subsidiary or a division's business strategy. The easiest path for companies to avoid these types of disclosure is to avoid using a multiservice firm for executive remuneration consulting. Or it may discourage companies from using multiservice firms such as Mercer in more than one capacity and therefore diminish the consulting resources available in the market.

This in turn will discourage multiservice firms from providing executive remuneration services. This outcome is contrary to the interests of shareholders who benefit from the breadth and depth of resources that large, global multiservice firms such as Mercer bring to the issues of executive and director remuneration. Furthermore, as previously stated, companies would likely turn to single service boutique consulting firms yet these firms may be influenced by the high percentage of revenues that a single client may represent.

The audit firm model is frequently cited as an example for remuneration consulting independence and disclosure. However, we believe the economics of the remuneration consulting business differ from the audit model. Audit fees for large companies can be very substantial (e.g. around $20 million a year) and the relationships last for multiple years because it is costly and onerous to change auditors. If an audit firm is precluded from performing other services for a given company, the audit fees still provide a healthy revenue stream from that company. On the other hand, executive remuneration consulting arrangements for committee's at large companies may be in the range of $200,000, while the revenue opportunity for human resourcing consulting services with a large company may be many millions. Further, while companies may not choose to go out to bid on remuneration consulting every year, the work is always at risk. It is not expensive or particularly burdensome to change consultants.

As a result of these economics, Mercer is generally unwilling to accept remuneration committee engagements that are conditioned upon agreeing that Mercer or its affiliates will be excluded from other opportunities with the company. We believe that the other multiservice firms are similarly positioned. Therefore, an independence requirement, whether mandated directly or done indirectly through disclosure, will reduce competition in the consulting industry and reduce client choice.

This diminished choice has adverse implications for executive remuneration program design. Only the large multiservice firms have global knowledge and presence, have the financial resources to invest in substantial databases and research, or the depth of talent to staff intensive projects such as a merger or acquisition. As companies are being asked to assess risk in their incentive plans, multiservice firms have the analytic tools and the business consulting expertise to assist them.

6. Remuneration committees should be able to rely upon protocols adopted by multiservice consulting firms to mitigate any potential conflicts

Many multiservice consulting firms have taken steps and set our protocols to mitigate potential conflicts of interest. For example, Mercer has adopted processes and procedures to minimise the potential for the firm's relationship with a client to exert inappropriate influence over executive remuneration advice.

- In addition to its overall Code of Conduct, Mercer has adopted **Global Business Standards** (copy attached) to manage any potential conflicts related to executive remuneration consulting. These are incorporated into our engagement letters, which are required for all client relationships.
- Specifically, we establish and document clear **reporting relationships** between the consultant and the committee, and rules regarding whether and how information and recommendations are shared with management team members.

- We **disclose** to our remuneration committee clients Mercer's relationship with the client organization, including fees and services.
- **Our incentive programs** for consultants also support objectivity. Consultants are not paid bonuses or commissions for sales of other services to clients. Consultants' remuneration does not depend on the programs they design.
- **Our reporting structure** also supports objectivity. Executive Remuneration Consultants do not report to client relationship managers or to consultants in other lines of business. They report through our human capital line of business, of which executive remuneration is one segment.
- Executive remuneration consultants are required to **report to our leadership** any effort on the part of management or another Mercer consultant to influence our executive remuneration advice.

We also work with our clients to establish any additional safeguards tailored to meet their specific needs or concerns. We believe that our Global Business Standards mitigate the potential for our remuneration committee consultants to be inappropriately influenced by management.