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Inquiry into Executive Remuneration
Productivity Commission
Locked Bag 2, Collins Street East
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6 November 2009

Dear Commissioners

Executive Remuneration

We appreciate the opportunity to make this submission to the Productivity Commission's Inquiry into Executive Remuneration.

We have limited our submission to five of the Commission's fifteen Draft Recommendations as follows:

- Draft Recommendation 8
- Draft Recommendation 9
- Draft Recommendation 11
- Draft Recommendation 13
- Draft Recommendation 15

We set out in the following pages our submission to the Inquiry, organised by relevance to the Draft Recommendations.

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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.

KPMG supports the principle of having remuneration reports that are readily understood by investors and clearly articulate the policies applied by a Board in determining how to remunerate, and the nature and extent of remuneration provided to executives.

However, increasing the current requirement to satisfy the various ASX Corporate Governance Principles, *Corporations Act 2001* obligations and the Australian accounting standards along with the proposed APRA guidelines with the addition of any potential Productivity Commission recommendations will increase the length and complexity of the remuneration report, add to the cost of producing the report, and yet probably detract from its ability to be readily understood by investors.

Plain-English summary

The inclusion of a plain-English summary of remuneration policies is unlikely to address the issues of complexity and ability to be readily understood by investors. Rather, it is likely to increase the overall length of the remuneration report, add to compliance costs and lead to unnecessary further debate where investors seek to reconcile points of detail in the statutory report with the general comments in the plain-English section. In addition, what is considered plain-English is subjective and likely to differ between readers. This is recognised by the Productivity Commission that concludes *"mandating plain-English explanations might provide a useful signal even if it were impractical to fully enforce in practice*."[1]

We note that the Commission considers that *"there could be merit in representative (including investor) bodies developing a best practice guide."*[2] Further development of best practice guides will again increase the multitude of requirements a company is required to satisfy when producing its remuneration report.

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[1] Page 224 Draft Discussion Paper
[2] Page 224 Draft Discussion Paper

We consider the most effective way to improve the readability of the remuneration report is to consolidate the multitude of requirements that must currently be taken into account.

Reporting entities in Australia that are compiling remunerations reports are required to prepare their remuneration reports in accordance with:

- the statutory requirements of *Corporations Act 2001*; and
- Australian Accounting Standards set by the Australian Accounting Standards Board ("AASB") which follow, and add to, International Financial Reporting Standards ("IFRS") set by the International Accounting Standards Board ("IASB").

The various investor association guidelines, ASX Corporate Governance guidelines, proxy advisor guidelines and similar are neither statutory nor obligatory but nevertheless are sought to be followed by reporting entities.

KPMG considers that the Productivity Commission should recommend there should only be one statutory set of requirements over remuneration reports. As part of this, we also consider that the Productivity Commission should determine the types of entities these requirements should apply to: listed companies (as previously required), all disclosing entities that are companies (as is currently required) or all disclosing entities (including non-companies such as registered managed investment companies). The AASB should also be directed to remove any specific remuneration disclosures from Australian accounting standards, as this type of disclosure should be a public policy decision.

If the statutory requirements are expanded to cover non-company disclosing entities, then the information needs of users of those financial reports need to be considered. The remuneration structures are different in practice and so disclosures that are appropriate for a corporate entity are not likely to be appropriate for an entity that has a responsible entity.

KPMG also considers that the Productivity Commission should recommend a complete re-write of section 300A of the *Corporations Act 2001*. The disclosure requirement should be principle-based, with the objective of disclosing to shareholders the principles and policies applied by the entity in setting remuneration for key management personnel, and the nature and extent of remuneration transactions that have occurred in the reporting period. The starting point for such a re-write should be the guidelines in AASB 124 and should involve the input of Treasury, the ASX Corporate Governance Council and investor associations such that there is one comprehensive set of requirements that fulfil the information needs of users so they can make appropriate investment decisions.

This would ensure that the myriad of overlapping recommendations and requirements directors must have regard for when preparing remuneration reports are distilled into a clear and concise set of principle-based requirements. This is likely to make remuneration reports more consise and more useful for the end user, as well as reduce the administrative effort of producing the report.

Reporting actual levels of remuneration

KPMG submits that the nature and extent of cash-based remuneration should be disclosed in the remuneration report.

In addition, for all types of equity instruments granted to executives, the remuneration report should include the following specific details:

- the number of equity instruments that form part of remuneration in the year;
- the underlying share price of the company on the date of grant;
- any exercise price payable by the key management person;
- the vesting period(s) for those equity instruments;
- any performance hurdles; and
- how the outcomes of performance hurdles have affected the number of equity instruments to which the individual is entitled.

This will enable companies to clearly communicate to users how they have used share-based payments and other forms of remuneration to reward the key management personnel.

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.

KPMG supports the recommendation to remove the requirement to disclose the top five executives' remuneration for the reasons outlined in the Productivity Commission's Draft Discussion paper.

The Productivity Commission has also sought views on whether remuneration reports would be improved by confining detailed individual disclosure to the CEO and the top key management personnel, with remuneration for other key management personnel reported collectively in bands.

Based on feedback we have received from business, we consider there is some support for confining detailed remuneration disclosure to the CEO and all other directors. In our experience, Boards receive by far the most questions regarding the remuneration packages of the CEO and various Board members. In addition, while a CEO/Managing Director's ultimate responsibility for the whole business is comparable from company to company, the roles of other key management personnel are often more difficult to compare. This is because certain

responsibilities of these other key management personnel may be shared, delegated, or amalgamated depending on the particular structure of the entity.

This therefore brings into question the utility of providing the individual remuneration details of each key management personnel without providing a full job description for each manager instead of only a job title. Providing this level of detail is impractical not only from an administrative point of view, but also from a commercial point of view.

We consider it is important for investors to be provided with an overview of the remuneration of key management personnel other than the CEO and directors. Such detail should include the total pool of remuneration provided to key management personnel, the extent to which the pay of key management personnel is fixed, or variable based on short or long-term performance, as well as the total pool of equity instruments provided to key management personnel. It is equally important to provide a brief description of the terms of such equity instruments.

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.

KPMG endorses the Productivity Commission's recommendation that where a company's remuneration committee (or Board) makes use of expert advisers, those advisers be commissioned by, and their advice be provided directly to, the remuneration committee or board, independent of management.

However, in our experience, the Board may seek advice on specific components of a company's remuneration practices only, and will adopt all, some or none of an expert adviser's advice and recommendations.

Therefore, the naming of a remuneration advisor who has advised on a specific aspect of remuneration, and whose advice may or may not have been reflected in the remuneration arrangements that were ultimately entered into, may mislead investors into concluding that the Board has sought advice on the entire remuneration report and that the Board has followed all recommendations of the advisor.

In addition, given it is the Board that is ultimately responsible for the remuneration practices of the company (rather than the remuneration adviser), it is unclear as to how the naming of the remuneration adviser would enhance the remuneration practices of a company.

In the event that the Commission recommends remuneration advisers be named in the remuneration report, it is submitted that the Commission should also develop standard wording to be included in the remuneration report that alerts investors that the remuneration adviser may have been engaged to look at specific aspects of a report only, the Board may have adopted all,

some, or none of the advice, and it is the Board that remains responsible for the remuneration practices of the company.

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.

KPMG supports this recommendation regarding the removal of termination of employment as a taxing point. We consider it is in the shareholders' best interests to ensure that an executive's remuneration remains subject to disposal restrictions after termination of employment.

This is consistent with APRA and multiple investor associations that consider termination of employment should not trigger a taxing event and that equity compensation should not vest in an executive until such time as the Board can be satisfied that the performance on which the compensation was awarded has been sustained.

We note that the recent *Tax Laws Amendment (2009 Budget Measures No. 2) Bill* introduced into Parliament on 21 October 2009 continues to tax equity remuneration on termination of employment. KPMG views the taxation trigger at termination of employment as being out of step with principles of good corporate governance.

In addition, the taxation of equity compensation at termination of employment for revenue integrity reasons is unnecessary given the 'real risk of forfeiture' test included in the draft tax legislation means tax is only deferred on any instruments that are subject to real risk of forfeiture, and the proposed legislation requires employers to report details of equity compensation to the Australian Taxation Office in the year in which a taxing event occurs.

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.

KPMG recognises that this recommendation provides an effective framework for dialogue between shareholders and the company regarding the remuneration report.

While this may increase the length and cost of preparing the remuneration report for a company that has received a significant 'no' vote, this proposed measure would increase shareholder interaction and engagement and would allow the concerns of shareholders to be addressed.

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.***

This measure means that the whole Board remains responsible for the remuneration policy. While the Remuneration Committee may perform much of the analysis and do most of the work in formulating the remuneration strategy, the remuneration of executives remains the responsibility of the whole Board.

In addition, this measure is likely to mean the concerns of shareholders, and in particular, significant numbers of minority shareholders, are given the attention of the whole board.

However, KPMG has significant concerns with this recommendation because of the potential for unintended consequences.

Increased power of minority shareholders

Notwithstanding a majority of shareholders may vote in favour of the remuneration report, a minority of shareholders voting against the remuneration report can result in a full re-election of the Board. This places a disproportionate amount of power in the hands of a minority of shareholders.

This may also enable minority shareholder and proxy groups to gain significant leverage on other company-related issues, simply by threatening to vote 'no' at the AGM.

Cost and risk to shareholder value

The requirement for a full re-election of the Board could be a costly and de-stabilising process. If directors were being turned over at a high rate, a company may suffer significant strategic damage due to a lack of continuity at Board level. This could be felt through both the leakage of confidential business and strategic knowledge, and a lack of cohesive direction. It is not hard to see that such disruption could impact shareholder value.

The potential cost and strategic damage that can arise in respect of a full board re-election can also result in a real risk that shareholders may be less inclined to vote 'no' in respect of a remuneration report.

Impact on remuneration policies

The 'two-strikes' policy could potentially result in boards adopting remuneration practices that meet the 'tick-a-box' requirements of corporate governance and proxy advisers. These policies may not be effective for the particular business or executive and will not necessarily be the most appropriate policies to create shareholder value.

It is the boards that are best placed to determine the remuneration strategy of a business taking into account the nature of the business, its people, competing market forces and the key drivers of value creation.

Board time spent on remuneration

It is well recognised that the purpose of the Board is to provide the strategic direction of the company and to oversee and authorise significant transactions and decisions during the course of the year. The increased focus on executive remuneration, and in particular, the introduction of a two-strikes policy, is likely to result in directors spending a significantly increased amount of time on remuneration issues to the detriment of other strategic business matters.

Setting the threshold for a 'two-strikes' policy

In the event that the Commission decides to make a recommendation to introduce a "two-strikes" policy, KPMG's view is that any threshold that will result in a full re-election of the board should not be less than the 50 percent vote required to remove a director at an AGM. In addition, consideration should be given to whether the threshold should be based on the actual votes cast at an AGM or the total votable shares. For example, where only 55% of shares are voted at an AGM, a negative vote of 25% would equate to a total negative vote of 13.75% across all votable shares.

Setting the threshold at no less than the vote required to remove a director at an AGM would have the effect of:

- Ensuring a majority of shareholders need to be unhappy with the remuneration report before a total re-election is required.
- Allowing minority shareholders to still hold directors responsible for remuneration practices through the requirement for directors to report back to shareholders in the following remuneration report on how shareholder concerns were addressed in the event of a 'no' vote of 25 percent or more.
- Reducing the gap between the number of votes required to invoke the 'two strikes' trigger and the number of votes required to re-elect (or otherwise) a director, thus giving the 'two strikes' process more meaning.
- Reducing the likelihood of shareholders not voting on the remuneration report for fear of causing a costly and unnecessary Board re-election process.

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We look forward to presenting on these and responding to your questions at the Productivity Commission hearing in Sydney on 9 November 2009.

If you have any queries in the meantime, please feel free to contact me on 03 9838 4600.

Yours sincerely

Martin Morrow
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