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Guerdon Associates
Equity and Executive Pay

20 November 2009

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

Dear Mr. Banks

Re: Executive Remuneration Inquiry – Addendum to submissions DD119 and 80

This letter is an addendum to submission DD119 (submitted on 2 November) and Submission 80 (made in association with CGI Glass Lewis) on 10 June. The reason for this addendum arose as a result of our discussion with commissioners at the hearing in Sydney on 10 November where we felt compelled to raise issues that, while covered in others' and our first submission, appeared to be lost in the noise of excess data, and yet may have a very significant impact on the efficient functioning of the executive remuneration market, and markets in Australia generally.

Information about our firm and our addendum remarks are made under the headings below.

About Guerdon Associates

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

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

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

Board capability

While Guerdon Associates does not object to the removal of the "no vacancy" rule, we made the point at the hearing that there is no evidence that this will improve board capability.

During the ensuing discussion, after reiterating the view in our submission DD119 that the Commission has not adequately addressed the supply of capable directors we were asked what would enhance supply and capability. While in our view Australia is well served at larger companies with directors with high level capabilities in finance, law, risk, and relevant industry expertise, we acknowledge that specific director expertise in remuneration matters is sparse. Further, with APRA prudential guidelines requiring remuneration committee members with remuneration expertise and knowledge, the requirement will grow.

However, instead of specifically seeking out new directors with this expertise, much could be achieved by structured learning programs to educate existing directors, as well as prospective new directors. While our own firm contributes to director education through our monthly newsletter, and through organisation and sponsorship of an annual director and investor remuneration forum[1], there is a dearth of other avenues whereby directors can acquire more knowledge (other than "on the job"). We understand that the Australian Institute of Company Directors, which also runs occasional and ad hoc director briefing sessions on remuneration matters, is considering a more formal and structured approach, which we would welcome.

With the field attracting more academic study, we suggest that the Productivity Commission consider ways of facilitating the process of director knowledge and expertise acquisition to improve overall board capability.

Taxation of options

We, as well as many others in their submissions, have commended the Commission for its draft recommendation to remove cessation of employment as an equity taxation event. However, while noted in our submission to Treasury in August[2], we believe the taxation of options at vesting date, even if the exercise price of the option is underwater, has been entirely missed in the Commission's draft report, with significant economic implications.

Prior to the government's budget night announcement regarding changes to employee share scheme taxation, Australian companies applied options in essentially the same way as other OECD and many developing countries. They were most prevalent, and appropriate, for start up and/or high growth potential companies that in most cases were cash poor. A company with a bright idea, limited capital and huge potential needs to attract expert management. These people are typically employed in large companies in Australia and overseas where they have received much of the knowledge and experience required by the small company. Without cash, but a lot of upside, these small companies entice this experience from the established organisations with large numbers of options despite salaries that are much lower. That is, options are provided in lieu of salary. They have no explicit performance hurdles and no forfeiture requirements.

The USA has been hugely successful in applying this method in developing

[1] In association with the proxy adviser CGI Glass Lewis and hosted at Allens Arthur Robinson.

[2] See "Submission for the reform of the taxation of employee share schemes", Guerdon Associates submission to Treasury 31 August 2009 at http://www.guerdonassociates.com/Files/Documents/ATltr090831%20-%20Share%20Scheme%20Taxation.pdf

advanced technology companies that have created trillions of dollars in economic value over the past 3 decades. Similarly, Australian small caps have applied this method not only in technology companies, but also where Australia has a comparative advantage, in mining and energy development.

The government's taxation of options at vesting will severely hamper Australia's ability to create sources of new growth.

The government has recognised this and asked the Board of Taxation to report how these problems could be overcome within the confines of its new tax regulations. Without incredible complexity, Guerdon Associates cannot see a suitable solution being proposed, other than a fundamental change in tax approach as suggested below.

Fundamentally, personal income tax should only be levied on income actually realised by an employee. Concepts of notional income, such as attributing a taxable value to an option that is underwater for the whole of the option exercise period, discourage equity plan usage in enterprises where they are otherwise most needed, are contrary to almost all other OECD countries' methods, and damage Australia's competitiveness and ability to attract and retain skilled professionals and executives.

The proposed arrangements are unfair to employees because they seek to impose personal income tax when an employee has not actually derived any income from an employee share scheme. The government's argument has been that whether an option is ever in the money reflects the investment risk the employee takes on when the option is granted. In practice, the employee has taken on the investment risk by accepting the option in lieu of cash remuneration. The employee wins if the option provides a reward and loses (the value of the foregone cash remuneration) if it does not. The rewards received by the employee should be taxed as income; but if there are no rewards received, there should be no tax liability.

A fair approach would be to apply income tax at the point at which the employee realises value under an employee share scheme. With options, this would be when the options are exercised, not when they become exercisable. This would be consistent with the Commission's draft recommendation that cessation of employment be removed as a taxation trigger.

The simplicity of this approach would assist companies and employees, who will be able to clearly understand the tax treatment of benefits received under employee share schemes and will be more easily able to meet their obligations to pay tax on those benefits. In the long-term, the impact on tax revenue from employee share scheme benefits should be positive. ATO administration of the taxation of employee share schemes would be greatly simplified.

Taxing the benefits actually realised under employee share schemes would also mean there would be no need to consider establishing different rules for start-up, research and development and speculative companies (i.e. the brief given to the Board of Taxation) – if option grants pay off, the rewards to employees will properly be subject to income tax. If the grants do not deliver any value, then there is nothing to tax.

Yours sincerely

Michael Robinson Director	Peter McAuley Director