

Office of the Chairman

BHP Billiton Limited
BHP Billiton Centre 180 Lonsdale Street
Melbourne Victoria 3000 Australia
GPO Box 86
Melbourne Victoria 3001 Australia
Tel +61 3 9609 3891 Fax +61 3 9609 3588
www.bhpbilliton.com

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Executive Remuneration Enquiry
Productivity Commission
Locked Bag 2
Collins Street East
Melbourne Vic 8003

Dear Sir

Please find attached a submission from BHP Billiton to the Productivity Commission in relation to your current enquiry into Executive Remuneration in Australia.

I trust you find our submission of assistance in your deliberations.

Yours sincerely



D R Argus
Chairman

Attach (1)

SUBMISSION TO THE PRODUCTIVITY COMMISSION'S INQUIRY INTO REGULATION OF DIRECTOR AND EXECUTIVE REMUNERATION IN AUSTRALIA

We believe Australia's regulatory framework for director and executive remuneration is robust and not in need of significant change. There is one factor in particular that supports this contention. The non-binding shareholder vote on the Remuneration Report is a regulatory tool the significance of which has only recently become apparent. The requirement for ASX-listed companies to include an advisory vote on the Remuneration Report on the AGM agenda was introduced by an amendment to the Corporations Act in 2004. Since that time, the use of the non-binding vote by shareholders has evolved to the point where it functions as a front-line regulator of "excessive" remuneration practices. There are now many examples of companies changing their remuneration practices either following a high "Against" vote on the Remuneration Report, or even prior to the vote – in recognition of shareholder and governance advisor concerns voiced in the lead-up to the AGM. It has been a catalyst in prompting greater consultation by companies and significantly enhanced engagement by shareholders.

The non-binding vote is a regulatory tool particularly well-suited to the issue of director and executive remuneration, for several reasons:

- ASX-listed companies range in size very significantly, they operate in a wide range of different industries, and they have plants and offices in many different countries. The optimal remuneration arrangements for their executives will, therefore, vary. The non-binding vote provides a vehicle for the shareholders of each particular company to consider and express – through their vote – a view on the remuneration arrangements adopted at *that* company.
- Remuneration is a complex issue, with a considerable amount of information needed in order to understand the mechanics and purpose of a typical listed company's remuneration arrangements. Shareholders cast their non-binding vote several weeks after the release of the Remuneration Report for the year, thus expressing their view, through their vote, based on an updated suite of pay information.
- The *non-binding* nature of the vote appears not to have limited the vote's effectiveness. As stated above, there is no shortage of examples of Australian companies that have responded to a substantial "Against" vote, by making changes to their remuneration practices. And, in the event that a board is seen to be unresponsive, shareholders retain the option of a (binding) vote against the re-election of directors, including those who serve on the Remuneration Committee.

Significantly, the non-binding vote has not been a feature of the United States' corporate regulatory framework – although it is likely to become one in the future. Critical analysis of remuneration practices (particularly in the finance sector) in the United States over recent years should take into account the lack of a shareholder vote on the Remuneration Report.

Another feature of Australia's regulatory framework that we support in the strongest terms is the central role of the Board in relation to senior executive remuneration. One of the most important functions of a Board is to hire, monitor and where necessary replace the CEO. Giving the Board the responsibility, and holding it accountable, for senior executive remuneration is a logical extension of that primary function.¹

For the remainder of our submission, we follow the structure of the Issues Paper.

¹ In making this comment, we do not seek to detract from the role of the Remuneration Committee. We support the existing Australian market practice in relation to the Remuneration Committee, under which the Committee's "responsibilities ... should include a review of **and recommendation to the board** on: the company's remuneration, recruitment, retention and termination policies and procedures for senior executives; senior executives' remuneration and incentives; superannuation arrangements; and the remuneration framework for directors": ASX Corporate Governance Council, Corporate Governance Principles and Recommendations, page 35. Earlier on the same page, the Council states: "Ultimate responsibility for a company's remuneration policy rests with the full board, whether or not a separate remuneration committee exists."

Definitions and scope

What is an appropriate definition of ‘remuneration’? What aspects or elements of remuneration should be included?

A definition is a means to an end, rather than an end in itself. The appropriate definition of “remuneration” depends on the context in which the term is used.

For the purposes of disclosure of remuneration in the Remuneration Report, the definition is contained in Australian Accounting Standard AASB 124 (where the term “compensation” is used rather than “remuneration”). The AASB 124 definition also applies for the purposes of section 300A of the Corporations Act (under section 9 of the Corporations Act and Regulation 2M.3.03 of the Corporations Regulations).

The AASB definition reflects international accounting practice, as Australia’s accounting standards are based on International Financial Reporting Standards (IFRS).

The remuneration (or “compensation”) that is required to be disclosed in the Remuneration Report is then subject to a non-binding vote by shareholders at the AGM.

What is an appropriate definition of ‘executive’? Does the remuneration report required under the Corporations Act and its coverage of key management personnel provide a suitable definition? Should the Commission’s coverage of executives go beyond this, and if so, why?

Australia’s rules governing disclosure of director and executive remuneration are a product of a two-track disclosure regime, and accordingly suffer from some confusion and lack of clarity.

Since section 300A was introduced into the Corporations Act in 1998, there have been two sources of remuneration disclosure rules:

- Section 300A and regulations supporting it; and
- Accounting standards.

Changes have been made over the years designed to reduce the overlap that two sources of rules can produce. However, one issue that remains, and is worthy of attention, is the divergence in whose remuneration is required to be disclosed. The accounting standards (AASB 124) apply to the remuneration of “key management personnel”, while parts of section 300A apply not only to key management personnel but also to “the 5 named relevant *group* executives who receive the highest remuneration for that year”, and “the 5 named *company* executives who receive the highest remuneration for that year”.

We believe there is no sound basis for section 300A continuing to refer to the 5 highest-paid executives of the group and of the company. This aspect of section 300A derives from its introduction more than a decade ago, at which time there was no coherent interaction between section 300A and accounting standards. That is no longer the case, and for reasons of clarity and consistency with international disclosure standards, we believe section 300A should be aligned with AASB 124 and require disclosure only in relation to the key management personnel.

“Key management personnel” is defined as follows:

“those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity.”

This definition covers the most relevant individuals from a remuneration-disclosure perspective, because it ensures:

- All directors, executive and non-executive, will always have their remuneration disclosed; and
- Those executives who have the capacity to make managerial decisions impacting shareholder value also have their remuneration disclosed.

A more modest change to section 300A would involve removing the reference to “the 5 named *company* executives who receive the highest remuneration for that year”. “Company” here refers to the parent entity of the corporate group. Given that a group’s most senior executives could be employed by subsidiaries, rather than by the parent company, there is no obvious value in retaining the requirement to disclose the 5 most-highly paid executives of the parent company, where the other limb of section 300A already requires disclosure in relation to the 5 most-highly paid executives in the entire group.

How should ‘corporate performance’ and ‘individual performance’ be defined? Is it possible to define them in general terms that are applicable across most businesses? Or is transparency in performance hurdles for incentive payments the more important issue? To what extent do external performance indicators ‘net out’ underlying market growth factors from entrepreneurial and managerial performance?

It is not clear that there is any need to define “corporate performance” and “individual performance”. Transparency of performance hurdles and their linkage to corporate objectives are the key issues.

Both section 300A and AASB 124 currently refer to “performance condition”, in the context of requiring disclosure of the details of performance hurdles for those aspects of remuneration that are contingent on the satisfaction of one or more performance hurdles. There are no obvious shortcomings with this framework.

TOR 1: Trends in remuneration

How are levels of director and executive remuneration determined? What constraints exist, and what is the market’s role in determining remuneration levels? What are the major drivers of negotiated outcomes? Have they changed over time?

For BHP Billiton, the key determinant of director and executive remuneration is the competitive market for talented directors and executives. As a company that has global operations, the market for our purposes is a global market. This is reflected in the first of the key principles of our remuneration policy: “provide competitive rewards to attract, motivate and retain highly skilled executives willing to work around the world.” The supply and demand for suitably qualified executives will ultimately be the determinant of executive remuneration.

While the market is important, we nevertheless also believe that a high percentage of senior executives’ remuneration should be at-risk, and a significant proportion should be deferred. For the year ended 30 June 2008, approximately 73 per cent of our CEO’s remuneration was at-risk. Only 28% of the at-risk remuneration was paid in the form of a cash bonus, with the remainder deferred for period ranging from 2- 5 years.

Is there any relationship between director and executive remuneration, and the remuneration of other company employees? How important are relativities between executives and other employees? Are there flow-on effects from executives to other employees? Do big disparities serve to motivate or de-motivate other employees?

BHP Billiton's Remuneration Committee takes into account the increases in pay packages for the general employee population in a particular market in considering adjustments to the base salary of senior executives based in that market. However, the market for senior executives and for the employees is quite different and it is understandable that there are disparities in outcomes. Nevertheless the Committee starts with the premise that the same adjustment that applies to the general employee population (which is based on the cost of living increases in the region in which they work) applies to the executive population. The basis for adjustment beyond those must be made out on the grounds that the role has changed or the market rate for that role has shifted.

What relationship exists between levels of remuneration and individual and corporate performance? To what extent are remuneration levels required to generate an adequate supply of suitable directors and executives; that is, are they primarily aimed at hiring and retaining the right person, rather than influencing their performance?

At BHP Billiton, there are three main elements of executive remuneration: base salary, short-term incentive, and long-term incentive. For the year ended 30 June 2008, the split between these elements for our CEO was: base salary and other "fixed" components: 27 per cent; short-term incentive: 20 per cent; and long-term incentive: 53 per cent. The relationship between levels of remuneration and corporate performance derives principally from:

- Those Key Performance Indicators (KPIs) under the short-term incentive plan that relate to company performance. For example, the 2009 KPIs for BHP Billiton's most senior executives included metrics covering health and safety, earnings before interest and tax, and performance against cost and schedule of capital projects.
- The performance hurdle for the long-term incentive plan, which requires BHP Billiton to outperform a range of peer companies from the mining, and oil and gas, sectors. The performance measure is total shareholder return (TSR), measured over a five-year period. The length of the LTIP performance period – five years – is consistent with our Corporate Objective ("to create long-term value for shareholders through the discovery, development and conversion of natural resources and the provision of innovative customer and market-focused solutions") and the long-term nature of our business decision-making.

The relationship between levels of remuneration and individual performance derives from the individuals' contribution to the company's performance and from the "personal" KPIs under the short-term incentive plan.

In 2008, for BHP Billiton's most senior executives, 80 per cent of the short-term incentive plan KPIs were related to company performance and 20 per cent were personal.

Therefore, corporate performance is very much a key driver of remuneration levels at BHP Billiton. It directly impacts both short and long-term incentive outcomes. Medium and long-term incentives are based on BHP Billiton shares the value of which is driven by corporate performance. Entitlement to the shares under award is controlled by our relative Total Shareholder Return performance that captures corporate performance relative to peers.

Remuneration levels need to be competitive to ensure that we attract employees of the requisite capability to work in a large and complex organisation. Remuneration is only a single component of our reward proposition but it is key part that if misaligned can place the company at a competitive disadvantage.

Remuneration structures and incentives

What are the key drivers of performance for directors and executives? Are there factors other than remuneration that influence their performance?

Remuneration plays an important role in the performance of directors and executives. The role remuneration plays can be categorised into a number of areas:

- **Attraction:** to bring talent to the organisation it is necessary that the remuneration level and structure is competitive with our peers who are competing for the same talent;
- **Retention:** to retain talent in the organisation, remuneration needs to be maintained at a competitive level and structured so that a large proportion of remuneration is at risk of loss should an executive decide to leave the business. This is typically achieved through deferred bonuses and long term incentive awards that conditionally vest at future dates;
- **Motivation and reward:** a large element of remuneration is “at risk” and linked to the achievement of specified goals. The purpose of “at risk” reward is two-fold; to motivate executives achieve stretch goals in the interests of shareholders and reward them for their efforts; and to align the level of remuneration with the success of the business. The basis of determining annual performance bonuses is described in further detail below.

BHP Billiton reviews the performance of executives and other senior employees on an annual basis. For the most senior executives (members of the Group Management Committee), this review considers their contribution, engagement and interaction at Board level. The annual performance review process that we employ considers the performance of executives against a range of areas to capture both “what” is achieved and “how” it is achieved. All performance assessments of executives consider how effective they have been in undertaking their role; what they have achieved against their specified KPI’s; how they match up to the behaviours set down in our leadership model and how they align with the BHP Billiton Charter values. The assessment is therefore holistic and balances absolute achievement with the way performance has been delivered. Progression within the Company is driven equally the personal leadership behaviours and the capability to produce excellent results.

In relation to non-executive directors, the Board conducts regular evaluations of its performance, its Committees, the Chairman, individual directors and the governance processes that support Board work. The evaluation of the Board’s performance is conducted by focusing on individual directors in one year and the Board as a whole in the following year. In addition, the Board conducts evaluations of the performance of directors retiring and seeking re-election and uses the results of the evaluation when considering the re-election of directors. External independent advisers are engaged to assist these processes as necessary. The existence of these assessments, the criteria against which assessments are made and the outcomes are reported to shareholders.

What changes have taken place in the type and structure of remuneration over recent decades? What has driven these changes? Have changes to the structure of remuneration resulted in inappropriate risk-taking or other forms of director and executive behaviour inconsistent with the interests of the company? Are particular types of remuneration more likely to produce these outcomes? Has the experience differed across sectors (for example, the finance sector relative to other areas of business)? Who should determine what is an appropriate level of risk-taking or an appropriate corporate strategy, and how should this be done?

The proportion of BHP Billiton’s senior executives’ pay that is contingent on performance has grown significantly, and is now more than 70 per cent for the CEO (as indicated above). In comparison, in 1987 approximately 90 per cent of executive pay was fixed and only 10 per cent was at-risk, across a sample of large Australian companies.²

² Australian Human Resources Institute, Executive Remuneration Research Project: Executive Remuneration in Australia: An Overview of Trends and Issues (1999).

BHP Billiton's performance-related remuneration has been designed to motivate appropriate, rather than inappropriate, business risk taking. For example, rather than paying out all of the short-term incentive in cash at the end of the year, only half the award is delivered in cash and the other half is made as a grant of shares or options that are subject to a two-year vesting period. In addition, short term scorecards are carefully structured to ensure appropriate balance between the component measures of performance. The long-term incentive plan assesses performance relative to that of peer companies over a five-year period.

What relationship exists between the structure of remuneration and individual and corporate performance? What are the key drivers of performance for directors and executives? What arguments, for and against, are there for linking remuneration and the share price?

Please refer to comments above in relation to BHP Billiton's short-term and long-term incentive plans.

In relation to linking remuneration and the share price, BHP Billiton has (as have many other Australian companies) elected to focus on total shareholder return (TSR), rather than simply share price return, in our long-term incentive plan. Reflecting the position of medium to long term shareholders, TSR takes account not only of movements in the share price, but also of dividends paid.

BHP Billiton executives have a considerable amount of their remuneration linked to share price through the award of deferred shares (as part of the short-term incentive plan), awards of performance shares with TSR performance conditions (under the long-term incentive plan) and with requirements to maintain significant holdings of shares in the company.

TOR 2: Effectiveness of regulatory arrangements

Given that it is ultimately the responsibility of the board to engage a managing director and other key executives, including associated terms and conditions, what changes would assist the board in fulfilling this role, consistent with shareholder interests?

The current regulatory framework in Australia, we believe, strikes the right balance between board responsibility for appointing the CEO and determining his or her remuneration arrangements (with the assistance of a Remuneration Committee), and shareholder oversight – principally through the non-binding vote on the Remuneration Report, but also (as a secondary measure if necessary) through a binding vote on the re-election of directors.

We believe, therefore, that there is no need for regulatory changes to assist the board in fulfilling its role, but also that there is no need for regulatory changes that impose additional restrictions on boards and Remuneration Committees.

How effective are arrangements for director and executive remuneration under the Corporations Act and ASX listing rules and guidelines? Do arrangements provide sufficient transparency and accountability on remuneration arrangements and practices? How might transparency be increased, and what might be the impacts of this?

As we have indicated above, in our view the current regulatory framework in Australia strikes the right balance between board responsibility for appointing the CEO and determining his or her remuneration arrangements (with the assistance of a Remuneration Committee), and shareholder oversight, principally through the non-binding vote on the Remuneration Report.

In relation to transparency, we refer to our earlier comment: Australia's rules governing disclosure of director and executive remuneration are a product of a two-track disclosure regime, and accordingly suffer from some confusion and lack of clarity.

Are the current disclosure requirements in the remuneration report too complex? Is the coverage of executives in the remuneration report appropriate? Would shareholders benefit from access to readily accessible, consolidated information, on director and executive remuneration?

We refer to our earlier comments about the interrelationship between section 300A of the Corporations Act and Accounting Standard AASB 124. In particular:

We believe there is no sound basis for section 300A continuing to refer to the 5 highest-paid executives of the group and of the company. This aspect of section 300A derives from its introduction more than a decade ago, at which time there was no coherent interaction between section 300A and accounting standards. That is no longer the case, and for reasons of clarity and consistency with international disclosure standards, we believe section 300A should be aligned with AASB 124 and require disclosure only in relation to the key management personnel.

The level and quality of disclosure has improved considerably over the past few years. However, there is a danger that additional requirements, if proposed, may prove counter-productive in either making reports longer, more complex and therefore difficult to understand, or potentially causing unintended consequences.

Is there an appropriate balance between legislated requirements and voluntary guidelines? What is the role of voluntary guidelines in governance of director and executive remuneration?

We believe that the balance between legislated requirements and voluntary guidelines is appropriate. The two primary legislated requirements are (1) disclosure of the remuneration of key management personnel and (2) the requirement for a non-binding shareholder vote on the Remuneration Report. Guidelines, particularly those of major institutional investors and their representative bodies such as the Australian Council of Superannuation Investors, serve a valuable function in terms of conveying investor expectations to boards and Remuneration Committees. Voluntary guidelines provide companies with scope to interpret dependant upon their specific industry requirements. This results in better outcomes for both the company and shareholders.

Are there any voluntary, good practice guidelines or codes applying internationally that may be of interest in an Australian context? Should Australia consider the adoption of a code of practice?

The large differences in size, industry and geography of operation of ASX-listed companies indicate to us that it would be difficult to craft a code of practice that was meaningful across the entire listed company community. The current system, under which companies receive input and opinions from shareholders and their governance advisers, ensures that practices that are widely considered sub-optimal are identified. As stated previously, existing voluntary guidelines serve shareholders and companies very effectively.

To what extent have remuneration committees been used in Australia? What effect have these had on the linkages between remuneration levels and individual and corporate performance?

BHP Billiton's Remuneration Committee, currently consisting of five independent non-executive directors, has played a significant role in recent years in formulating and pro-actively refining the group's remuneration policy. Two examples of the Remuneration Committee's focus on performance, described in greater detail above, are the 80/20 split between corporate and personal KPIs under the short-term incentive plan in 2008, and the use of a five-year relative TSR performance hurdle for the long-term incentive plan.

Do conflicts of interest arise in the arrangements by which remuneration consultants advise on director and executive remuneration? If so, how significant are they and how might they be addressed?

BHP Billiton's Remuneration Committee receives specialist advice from an external firm. The Adviser is directly accountable to the Remuneration Committee, and does not provide any other services to the company.

TOR 3: The role of institutional and retail shareholders

What degree of influence should shareholders have in their own right in determining remuneration practices? Do current regulatory arrangements enable shareholders to be adequately involved? If not, why?

As we have indicated above, we believe the role shareholders play through casting a non-binding vote on the Remuneration Report is an important – and effective – attribute of Australia's current regulatory framework.

Does the current non-binding vote require strengthening? Is it appropriate for directors and executives that are named in the remuneration report, and who hold shares in the company, to be able to participate in the non-binding vote?

In our view the non-binding vote has evolved in Australia to the point where it is now functioning very effectively, and does not need strengthening. In the majority of companies where shares are widely held by investors, there would not be a material impact in restricting the ability of Directors to vote on the resolution to approve the Remuneration Report.

To what extent have large institutional investors used their voting rights to influence remuneration practices and other areas where they have voting powers? Are there areas where their rights should be strengthened? Does institutional voting typically align with the broader interests of shareholders?

Proposals for changes to remuneration components or structures are subject to consultation with large institutional shareholders who use their expertise to influence outcomes in the broader interests of all shareholders.

In what aspects of remuneration practices and setting remuneration levels would it be appropriate to increase shareholder involvement? How would this be best achieved — without, for example, diluting the intended function of the board in engaging the managing director/chief executive officer?

We believe the current framework embodies an appropriate balance between shareholder and board involvement.

TOR 4: Aligning interests

To what extent do current taxation arrangements influence the level and structure of executive remuneration? To what extent should bonuses be an allowable tax deduction for companies? Should bonuses be subject to special/higher taxation rates?

Taxation arrangements that apply to remuneration are largely similar across the industrialised countries. Remuneration package structures for senior executives follow a similar pattern across the United Kingdom, United States and Australia regardless of subtle differences in tax treatment.

In our view, an appropriately structured short-term incentive (bonus) plan is a critical component of a senior executive remuneration package. There is no obvious case why differential tax rules (either disallowing a tax deduction, or imposing a higher taxation rate) should apply. Experience in the United States of limiting tax deductibility to try and limit compensation levels was arguably a factor in some of the extremely large equity based incentives that have been criticised by commentators. Engagement of shareholders and transparency of practice are likely to be more effective levers than changes to tax rules.

The global financial crisis has highlighted that there were some aspects of bonus arrangements, particularly in the finance sector, that at least had the potential to unduly influence behaviours and distort incentives. The use of requirements such as the non-binding vote mechanism, not currently in place in the United States, is preferable to use of the taxation system to shape remuneration practices.

What types of performance measures/hurdles could be used to accurately measure performance and align interests of executives and shareholders?

Consistent with our earlier comments, we believe that the significant diversity in types and sizes of listed companies means that the performance measures that make sense for any one company will not necessarily be optimal for another. A key attribute of the non-binding shareholder vote is that the share owners of each company can consider, and cast their vote, on whether they believe the measures chosen by the board and Remuneration Committee make sense for *that* company.

How can opportunities for executives to ‘game’ incentives be minimised?

The role of the Remuneration Committee is critical in assessing whether incentive outcomes properly reflect corporate performance. The Remuneration Committee at BHP Billiton takes an active role, utilising a wealth of commercial experience, in determining fair outcomes of incentive plans and ensuring that they align to true business performance.

Are boards properly exercising their functions on behalf of shareholders? Are they being unduly influenced by chief executive officers? If so, why?

We believe the “comply or explain” model, under which ASX-listed companies must either comply with the ASX Corporate Governance Council’s good practice guidelines, or explain why not in the annual report to shareholders, is an important mechanism for minimising the risk of boards being unduly influenced by CEOs. The good practice guidelines contain a number of provisions directed at ensuring a balance of power inside the company, such that no one individual has disproportionate influence.

Are some forms of remuneration more likely than others to promote a misalignment between the interests of boards and executives and those of shareholders and the wider community?

The range of remuneration tools available to corporations ensures that the most suitable choice can be applied in individual circumstances. All forms of remuneration have a place and the issue is the application not the type of remuneration itself. An example is executive share options which are often criticised but can be a useful tool to align shareholder interests with executives. Design can overcome the issues often quoted such as simply increasing in value with the market – for example, by attaching TSR type performance hurdles.

Are taxation considerations, either from the company's or executive's perspective, driving the design of remuneration packages? If so, what changes are required? How should bonuses be treated for taxation purposes — should they be an allowable tax deduction for companies? Should bonuses be subject to special/higher taxation rates?

These questions are asked in a slightly different way above. Please refer to the comments above.

If current mechanisms are not serving to align the interests of the board and executives to those of shareholders and the wider community, how could regulatory arrangements and remuneration practices better secure this? For example:

- *should shareholder votes on remuneration reports be (more) binding?*
- *are the current approval processes for equity-based remuneration appropriate?*
- *what effect does hedging have on aligning interests, and should this practice be permitted?*
- *is the current regulation of non-recourse loans appropriate?*
- *what is the role of remuneration consultants and what has been their influence on remuneration practices, including levels, growth and structures of remuneration? Do any conflicts of interest exist?*
- *should government have a greater role in regulating remuneration?*

Please refer to our earlier comments. We believe the current regulatory framework in Australia strikes an appropriate balance.

What are the costs and benefits of any options/mechanisms to more closely align the interest of boards and executives with those of shareholders and the wider community? What could be some unintended consequences of limiting or more closely regulating executive remuneration in Australia?

Please refer to our earlier comments. We believe the current regulatory framework in Australia strikes an appropriate balance.

TOR 5: International developments

Are there any international approaches particularly applicable to Australia?

As we have noted, it is important to bear in mind that shareholders in the United States have not had a vote on companies' Remuneration Reports. We believe this is an important point of divergence between the US and Australia, and should be borne in mind when assessing regulatory responses being taken, or considered, in the United States.