

...from the office of the National President

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Executive Remuneration Inquiry
Productivity Commission
Locked Bag 2, Collins Street East
MELBOURNE 8003

Re: Submission to the Executive Remuneration Inquiry

I have pleasure in attaching the accompanying contribution to the Inquiry into Executive Remuneration being conducted by the Productivity Commission.

In due course I also look forward to speaking to the submission at the public hearing in Sydney as arranged with your office.

Yours sincerely,



Peter Wilson AM
National President

Regulation of Director and Executive Remuneration in Australia - A Productivity Commission Inquiry

Submission from the Australian Human Resources Institute

1. Introduction

The Australian Human Resources Institute (AHRI) is pleased to make a submission to the Productivity Commission Inquiry into Executive Remuneration.

AHRI is the principal national professional association of human resource practitioners within Australia, and has approximately 15,000 members. The ABS reports in the order of 33,000 HR managers at work today in the Australian economy.

HR practitioners bring a singular perspective to the issue of executive remuneration as they are the ones ultimately charged with advising employers on remuneration and overseeing the policies and practices of business in this field.

AHRI has drawn the content for this submission from three sources:

- An April 2009 survey of AHRI members on executive remuneration who have expertise with remuneration in general, and executive remuneration in particular. The published report of the findings from the AHRI survey is provided to the Commission as Attachment 1.
- Focus group interviews and workshops that AHRI National President Peter Wilson has conducted with senior HR directors from 20 leading ASX companies, that constitute AHRI's National President's Forum – Amcor, AMP, ANZ, Bluescope Steel, CBA, Coca Cola Amatil, GE, IBM, Lion Nathan, Macquarie, Metcash, NAB, Qantas, Telstra, Stockland, Woodside, Wesfarmers, Westfield, Westpac, and Woolworths.

Although it is important to note the AHRI has no formally delegated mandate to submit views directly on behalf of these 20 companies, we have taken close account of their views in formulating our position. Because there is a disparity of perspectives among the 20 forum members, no view attributed to that source in this submission can be taken as the view of any particular member of the forum.

- The professional experiences of the AHRI National President, who was the Group HR Director at ANZ and Amcor for a period occupying eight of the last 13 years.

AHRI is pleased that the Commission is the government agency that has been charged with the responsibility to inquire into and report on this matter. As an institution, the Commission has a proud record of basing its findings on fundamental economic and industry research, and tends to look at how markets can be improved in the way they function, rather than producing knee-jerk regulatory responses to anomalies and imperfections when and wherever they are encountered. AHRI believes these principles

will be required in this Inquiry in order to produce positive and durable recommendations for both government policy and commercial practice.

AHRI acknowledges this is an Inquiry into executive remuneration within the Australian workforce. From another perspective, however, AHRI sees the Commission undertaking an inquiry into how prices are determined within the global labour market for senior executives. AHRI also believes Australia is an integrated part of that global labour exchange, and that it is not operating within a trade sheltered field where extensive regulatory intervention is desirable, necessary or likely to have any lasting positive impact in the national interest.

Notwithstanding that global context, AHRI believes there are a number of areas where improvements to practice and policy can be made.

2. Background and Current Context

There has been much concern in the community over the last few years about senior executive pay, some of it based on some high profile and now somewhat infamous individual examples that have tested reason and shown scant regard for fundamental standards of fairness and equity. It is fair to say that the most outrageous cases have occurred overseas, and have been the cause in some instances of massive falls in shareholder value within certain foreign corporations, some of which are either no longer with us or have been the subject of nationalisation initiatives. There is no denying, however, that the knock-on effects in the developed world have touched all countries, including Australia.

There have been few such examples in Australia, however, of the flagrant executive pay and casino-style shareholder value behaviour that typified the US and UK financial sectors. The origins of the current world economic recession are undoubtedly within the sub-prime mortgage market of the US, and the subsequent and widespread trading of CDOs in secondary markets, some of which were picked up in the balance sheets of certain Australian banks. The resulting lack of trust and confidence within world wholesale banking markets has affected everyone through the impairments to flows of funds within both primary and secondary debt, and equity markets, followed by the sudden and extraordinary downturn in real GDP across the world. Australia has fared far better than almost all others except India and China, for the following reasons:

- There was very little sub-prime mortgage business written here because of better prudential regulation of our financial institutions and better governance within our banks
- Federal and state governments within Australia had stronger fiscal positions than other OECD or G20 countries at the outset, and have demonstrated an immediate desire to use them responsibly through positive stimulatory measures
- We still have four of the world's strongest AA rated banks
- Our economic structure and exposure to the new giants in India and China provided some reasonable buffer to the world recession.

Nevertheless the crunch has arrived in Australia, and the regrettable flow from real GDP reduction into the higher economic and social cost of unemployment is only just beginning.

3. AHRI's Response to the Commission's Terms of Reference (TOR)

For ease of reference, AHRI has structured its submission in keeping with the Commission's terms of reference.

TOR1. *Consider trends in director and executive remuneration in Australia and internationally, including among other things, the growth in levels of remuneration, the types of remuneration being paid, including salary, short-term, long-term and equity-based payments and termination benefits and the relationship between remuneration packages and corporate performance*

The design of senior executive remuneration went through major changes from the early to mid 1990s. AHRI's National President wrote a widely quoted article on these changes published in both the *Melbourne Age* and the *Sydney Morning Herald* during April this year, by drawing on his own experiences in moving from the public to the private sector in 1990. A copy of that article is provided as Attachment 2. The kernel of the argument in the article is that private sector pay has moved beyond that of comparable public sector senior executive pay during the last 15 years, a development that has reflected the considerable growth in shareholder value of private sector employers compounded also by the pressure of excess demand for senior executives in the global marketplace.

AHRI understands the Commission has put together time-series-based executive remuneration data from listed company annual reports, and we have not attempted to replicate that. However AHRI has available current cross-sectional data from a member survey conducted in April this year, and I commend the findings of that survey to the Commission (see Attachment 1).

For more than 10 years the design of senior executive remuneration has comprised three components: fixed remuneration; short-term incentives (STIs) – usually comprising cash or shares, inclusive of deferral characteristics; and long-term incentives (LTIs) – usually comprising shares and options.

While the composition, mix and drivers of these three remuneration components have changed moderately over time, this structure has been fairly durable. AHRI's recent remuneration survey results from specialist practitioners reveal the following findings:.

- 96% of respondents – companies offer salary and super within fixed; 80% of them add in other expenses like cars clubs, health cover
- 73% - offer basic statutory super; another 20% offer up to 15% salary as super
- 35% - have a defined benefit scheme - covers up to 10% of employees for half of those reporting defined benefit schemes
- 85% report that their company has cash-only short-term incentives, with the remainder including a shares component
- 26% report that short-term incentives in their company have increased relative to long-term incentives in recent years
- 93% of respondents report that short-term incentives are linked to internally set KPIs and 13% to external comparators
- 77% of respondents report that long-term incentives are linked to internally set KPIs and 37% to external comparators.

AHRI Recommendation 1

AHRI recommends the Commission deems the current three-part structure for executive remuneration operating in Australia to be appropriate, and encourages the Commission to endorse that in its findings.

AHRI's rationale is that the three-part structure enables organisations to reward its most senior professionals for their performance and behaviour that acknowledges:

- the skill and experience they bring to bear in a current role (fixed remuneration)
- the effort they make to change performance and culture in the short term (STI)
- the results of actions they initiate to improve longer term results and organisational performance that boosts shareholder value (LTI), and therefore aligns executives with the interests of shareholders.

AHRI has serious concerns that some of the policy pronouncements and directions announced by the Federal Government are likely to move executive remuneration back towards a simple fixed and STI cash-only structure which is precisely the structure that dominated executive behaviour in the US during the sub-prime era and led to the economic malaise we are now experiencing. Such a policy shift would therefore be a counter intuitive response as it would encourage poor executive behaviour into the future and all in the interests of short-term tax revenue maximisation. In AHRI's view, policy choices in this area need to be carefully crafted if there is to be a balance in the decisions executives take to build longer term value in companies compared to simply striving for short-term profits. A policy push back to a 'cash and cash bonus' only structure would lead to potentially higher GDP and tax volatility in the longer term.

TOR2. *Consider the effectiveness of the existing framework for the oversight, accountability and transparency of director and executive remuneration practices in Australia including:*

- *the role, structure and content of remuneration disclosure and reporting*
- *the scope of who should be the subject of remuneration disclosure, reporting and approval the role of boards and board committees in developing and approving remuneration packages*
- *the role of executives in considering and approving remuneration packages*
- *the role of other stakeholders, including shareholders, in the remuneration process*
- *the role of, and regulatory regime governing, remuneration consultants, including any possible conflicts of interest.*

AHRI focus groups of senior executives within listed companies have expressed considerable dissatisfaction with the current content requirements for listed ASX company Remuneration Reports (RRs). Their concerns can be summarised as follows:

- RR's have become excessively technical reports, to the extent that they defy comprehension by many shareholders who struggle to come to terms with the setting out of concepts, values and entries in multiple tables for the same executive group.
- RR's are primarily driven by the imperative to measure remuneration by the accounting cost to the organisation, rather than the value of the remuneration to the individual executive. While a number of Board Remuneration Committee chairs have in recent times addressed AGMs giving simpler expositions of the concepts

behind the reports, the requirements relating to the RRs themselves lead to outcomes that make understanding difficult.

- Cumbersome formats that now burden the RRs with numerous vintages of different LTI schemes, many of which are these days shown with a positive accounting cost, are so far out of the money as to be questionable in terms of their meaningfulness, or are misleading in terms of remuneration value to the executive.
- The time required to prepare RRs in the absence of a sensible or agreed template has led one senior HR executive to describe writing an RR as akin to “fishing in the dark”.

The views within the HR profession as to the number and titles of executives that should be the subject of disclosure in the RR are mixed. Some favor boards publishing a fuller list of critical executives together with the criteria and market data used to reach decisions. Others have observed that this development would over-reach the mark as it would infringe privacy, and also encourage more upwards leveraging of pay levels by paving the way for executive search firms and competitors to pick off key and critical talent from within an organisation.

AHRI supports the current level of disclosure, namely the appropriate details relating to the CEO and the senior group critical to an organisation. It is our view that overall remuneration trends and structure in a company are normally set by the remuneration of that group. Such an approach provides shareholders with what they need to know, and is an appropriate balance taking into account privacy considerations.

In terms of decision making on executive remuneration, the AHRI survey results show the following:

Responses from the full sample group of 394 reveal the following beliefs:

- 80% of respondents - HR should be the main source of advice to the CEO
- 63% - HR should be the main source of advice to the board
- 96% - External consultants should not be the exclusive source of advice to the board
- 78% - HR advice drawing on external expertise is the best model
- 92% - Boards should take a holistic view, not rely on specialist reports alone

Responses about current practice from the specialist sample group of 150:

- 64% - HR is the main source of advice to CEO
- 43% - HR is the main source of advice to board
- 93% - HR is ‘a’ source of advice to CEO
- 75% - HR is ‘a’ source of advice to board
- 21% - External consultant is the main source to CEO
- 27% - External consultant is the main source to board
- 71% - Boards get external advice via HR and an accepted framework

AHRI Recommendation 2

AHRI recommends the optimal model for the determination of senior remuneration should consist of the following characteristics:

1. At least a ‘two level away’ rule should prevail for approval of remuneration, with the recommendation coming from ‘one level away’.

2. Specifically, the Board Remuneration Committee should recommend the CEO's pay for approval by the full Board.
3. The Board Remuneration Committee (or Board itself) should approve the pay levels of the CEO direct reports, on the CEO's recommendation.
4. And so on through the organisation using the 'one – two level' away approach
5. All share and share option schemes for anyone in the company should be approved by the board.
6. The board should approve overall remuneration guidelines for all executives.
7. The board should approve the structures and relationships for STI and LTI schemes for all executives.
8. In the case of very senior executives, the board should seek outside advice and data, but have that data quality assured and integrated by the HR director into the prior approved remuneration context and philosophies of the company. Both external advisers and HR should be at the board table to clarify director's questions.
9. In the case of share schemes, the board should receive independent legal advice on their construction and drafting, and further be prepared to publish that advice for the information of shareholders.
10. It would be possible to extend these principles into a Code of Remuneration Practice that could be prepared by a self-regulating industry body, or possibly as an Australian Standard. AHRI does not favour this happening by legislation, regulation or the deliberations of a publicly funded agency.
11. Shareholder votes on Remuneration Reports are currently non-binding.
 - The results from AHRI's survey, on the one hand, and senior HR focus groups on the other, are mixed as to whether they should be made binding or left as is.
 - If they are to be made binding, there should be no element of retrospective disqualification of a legitimate and contractually committed executive remuneration outcome, such as has been mooted in the press. The inevitable legal battles would likely be both inefficient and ineffective.
 - A compromise position would be as follows:
 - A binding vote on a company's prospective remuneration plans and programs for say the next five years including a transparent alignment of the former to a Remuneration Code of Practice as suggested above.
 - In subsequent years a non-binding vote on the annual outcomes of the shareholder approved plan as set out each year in subsequent RRs, which could also be the subject of a quality assurance audit certificate that such plans are being pursued fairly and diligently.
 - A qualified audit certificate could be the basis of a relevant remuneration matter going to a binding vote of shareholders.
 - If a remuneration matter is the subject of a qualified audit, the amounts so affected should be reserved by the company from the executive until the result of the binding shareholder vote is known

TOR3. *Consider, in light of the presence of large local institutional shareholders in Australia, such as superannuation funds, and the prevalence of retail shareholders, the role of such investors in the development, setting, reporting and consideration of remuneration practices.*

As with democracy in its broadest meaning, shareholder democracy precludes anyone presuming to make a judgement on the quality of votes cast. One share should be one vote. Yet the last ten years have seen somewhat of a divide emerge between institutional and retail shareholders, and the representatives of the latter.

Institutional shareholders usually hold the majority of shares held in a company, and have considerable resources within their grasp to do the technical analysis and reach

objective views on the value of more detailed remuneration issues – especially share based incentives. They also understand the risk and complexity of the top jobs and don't usually display alarm at what top people are paid in a global world because picking cheap executives is perceived as a material risk to shareholder value. Hence, for that and other reasons relating to the complexity of notice papers that need to be assembled for an AGM, institutional shareholders can tend to give a lower priority to analysis of remuneration material in the papers before they cast millions of share votes, often across many companies for the different AGMs occurring in a single week.

Retail shareholders are often middle Australians who have worked at or proximately above average weekly earnings for most of their lives, and so can find the salaries that top executives are paid to be well beyond their comprehension. Accordingly, advisory bodies have sprung up to represent their interests, but with mixed results.

AHRI does not expect this to change, and we believe our AHRI recommendation 2 covers the point. A consistent structure, well vested with independent advice, and with powers for all shareholders to buy in to plans where remuneration intent, philosophy, and where those plans are consistent with an accepted standard, and shaped in consultation with all shareholders into a workable system. A system with these characteristics would reflect a fair balance of responsibilities.

The shareholders' role should be to elect directors to run the company. The divided public opinion on what is fair and reasonable with respect to executive remuneration provides grounds for requiring directors to display greater transparency about their actions as a way to regain public and shareholder confidence.

AHRI recommendation 2 suggests an environment whereby a Code of Practice sets overall standards, with binding votes providing for the endorsement of broad plans and strategies, in addition to audited qualifications or exceptions to practice. This is a reasonable parallel to the situation that prevails with public statutory accounts.

On average, however, there seems to be a bias in the power institutional shareholders exercise in securing passage of votes at company AGMs, especially on matters requiring a simple majority. It is therefore worth contemplating the range of matters in which a majority greater than a simple majority may be desirable.

One such set of circumstances is included within AHRI recommendation 4 below.

TOR4. *Consider any mechanisms that would better align the interests of boards and executives with those of shareholders and the wider community, including but not limited to:*

- *the role of equity-based payments and incentive schemes*
- *the source and approval processes for equity-based payments*
- *the role played by the tax treatment of equity-based remuneration*
- *the role of accelerated equity vesting arrangements*
- *the use of hedging over incentive remuneration.*

AHRI's general position on the broad structure of remuneration, the role of equity based incentives and tax treatment, is set out in AHRI recommendations 2 and 3.

As to the drivers of remuneration, it is worth reviewing the following specialist practitioner reports from the AHRI survey findings of April 2009:

- 83% of respondents - use firms like Hay, Mercer or John Egan
- 75% - benchmark to market annually; 15% every 2 years
- 65% - link effective executives to market median fixed remuneration
- 14% - link effective executives to Q3 fixed remuneration
- 52% - link effective executives to market median total remuneration
- 27% - link effective executives to Q3 total remuneration

- 85% - have 'cash only' STI; the rest have a shares component
- 73% - STI is up to 50% of fixed; 10% up to 75% of fixed; 10% up to 100% of fixed
- 26% - STI has increased relative to LTI in recent years
- 42% - have excluded options from LTI in recent years
- Overall remuneration is linked to:
 - organisation performance - 68%
 - individual performance - 42%
 - organisation culture contribution - 52%
 - short-term KPIs – 84%
 - progress towards long-term KPIs – 78%
- STI – 93% linked to internally set KPIs; 13% to external comparators
- LTI – 77% linked to internal KPIs; 37% to external comparators

- 51% - apply retention payments to critical staff
- Of those:
 - 60% use them for 5% of staff
 - 23% use them for 10% of staff
- 63% believe use of retention payments will not decrease in next 12 months

- 31% have expatriate executives on salaries in currency other than AUD
- 6% of executives receive recourse loans
- 2% of executives receive non-recourse loans

- 92% - have 12 months fixed pay or less on termination for CEO
- 98% - have 12 months fixed pay or less on termination for general executives
- 75% - report PM's cap has no material effect on their capacity to compete
- Nearly half found PM's statement on executive termination pay confusing

Some particularly interesting features of these results are:

- Nearly 2 out of every 5 respondents have given up on options programs; probing the results shows reasons to be past frustration with vicariously applied Total Shareholder Return (TSR) comparator groups, and vesting criteria forced on to them by shareholder concerns at around the 75th percentile of TSR – which effectively means 3 out of 4 participating executives overall are bound to get nothing from what have become extraordinarily costly schemes to administer.
- As a corollary, 3 out of 5 respondents wish to retain options as a motivator to focus the executive on upside share performance, combined with the presence of some part of LTI going into deferred shares to also give such schemes a good mix of positive and defensive characteristics. AHRI believes this majority view remains the appropriate approach to LTI remuneration design.
- Retention payments are still in use – in other words critical skill gaps remain an issue for many firms, notwithstanding the general rise in unemployment.

- A majority of drivers for both STI and LTI are moving to be ‘internal to the firm’. Focus group discussion of this phenomenon indicates a number of companies have endeavored to gain control of the direction of remuneration outcomes, rather than be exposed to TSR style lotteries, yielded to in the past, to pacify retail shareholders and activist groups.
- The move by more than a quarter of firms to increase the share of STI relative to LTI also reflects a move to regain some ground in the control boards exercise in overall remuneration outcomes to senior executives, for similar reasons to the previous dot point.
- Of those likely to be affected by the Prime Minister’s proposed termination-pay cap, in indicating they would comply (“of course, if it were law”), they also make the point that it will be necessary to find some other way of spreading the present value of the foregone benefit into other remuneration elements either pre- or post-termination. Most companies have a present value income and also payment expectations when dealing with senior executives. Therefore if a regulation forbids them from operating within a certain part of the employee cost and payment curve, rational behaviour will drive them to find another delivery instrument. So the PM’s termination cap is likely only to solve the political perception of high termination payments at the point of termination.
- Many employers and boards have become sensitive to shareholder criticisms of executives taking the gain up front and leaving the shareholders with the subsequent wreckages from bad management decisions. So focus groups have indicated that more companies are now looking at ways to defer STI and LTI outcomes over time by:
 - The company banking the majority of payouts in trust against sustained future performance and conduct by the executive, together with a requirement for value generated to be sustainable over time
 - Building in tougher forfeiture conditions for such deferred bonuses
 - Swapping part or all of any such banked value into (deferred) shares so there is a longer term painshare/gainshare alignment with general shareholders.

AHRI believes these findings are rational and appropriate to the current economic environment and, by and large, produce sensible outcomes with executive pay.

Accordingly no recommendations for change accompany this TOR

TOR5. *Consider the effectiveness of the international responses to remuneration issues arising from the global financial crisis, and their potential applicability to Australian circumstances.*

For reasons stated above, AHRI believes the outrageous executive remuneration behaviour has mainly occurred offshore, and so the extreme regulatory proposals being considered in other places are not necessarily relevant in this country. Those that AHRI believes are relevant have been considered within our discussion and recommendations under other TOR.

TOR6. *Liaise with the Australia's Future Tax System Review and the Australian Prudential Regulation Authority in relation to, respectively, any taxation and financial sector remuneration issues arising out of this Review.*

In the recent Federal Budget, the Government showed its hand with respect to short and longer term taxation of share based instruments. AHRI has very significant concerns on that matter and it is worth contrasting the tax treatment for shares of senior executives with the widely distributed \$1000 employee share scheme.

The \$1000 tax exempt share scheme

Under the current regime, most large employers provide a \$1000 worth of tax exempt shares to employees. The plans require a restriction period of 3 years (during which the employees cannot access the shares).

Under the budget changes, the tax exemption would now not be available for employees with a taxable income of more than \$60,000, and the share income would need to be included in their next tax return.

For a person earning \$65,000, and receiving such shares in the 2008/2009 tax year, that would mean a tax bill of \$315 for the \$1000 worth of shares in 2008/2009, even though they will not be able to access their shares until the 2011/2012 tax year. This does not take into consideration the impact of capital gains tax, which would potentially result in less revenue for the Government by the end of the 3 years.

Over 600,000 Australian employees at most top 200 ASX listed companies would be affected, including NAB, Commonwealth Bank, Westpac, ANZ, Transfield, Computershare, Fosters, Orica, BHP, Telstra, Lendlease, Qantas, Wesfarmers and Boral.

In AHRI's experience, these schemes are widely recognised and valued by ordinary Australians working in our largest companies, whatever their role. Staff surveys consistently show they are effective in aligning all employees, giving them an active interest in the affairs and performance of the company, and as a collective reward for valued individual performances. Long serving employees who are never able or likely to reach the level of an executive and qualify for STI or LTI are particularly strong supporters of such schemes.

Clearly the Federal Government has the right to take tax expenditures away. However this scheme is highly valued by the mums, dads and young people working today, and the scheme is seen as important in producing a better level of corporate performance that leads to higher corporate and income taxation. It also produces the sort of alignment that will be positive in producing a more speedy economic recovery. In short AHRI sees this budget measure as bad economics and bad politics.

Taxing all executive share schemes up front

The companies referred to above also increasingly provide shares to their more senior employees under programs for retention or performance-assurance purposes (i.e. guarding against excessive risk-taking behaviour by employees). The shares may have forfeiture conditions and milestone hurdles attached – for example, they may only become accessible by the employees after a key project is completed. Employees would have to pay tax on the shares in the year of allocation, even if they can't access the shares for some time. Further, if the shares are forfeited because the project is not completed, the employee loses the shares but still has the tax liability (and cannot seek any refund of the tax paid).

So this issue does offer the opportunity for significant reform, but also a rethink by the Federal Government of its budget position.

AHRI Recommendation 3

Given the 2009 Federal Budget changes are likely to have these unintended consequences, AHRI recommends that a better approach would be the following:

- Maintain the taxation of employee shares and rights at the time the employee is able to sell the shares (i.e. to tax equity on the same basis as the tax on cash, being when it is received).
- Remove any ability to defer tax beyond the initial restriction/forfeiture period.
- Abolish the ability for employees to elect to pay tax 'upfront' in the year of allocation (removing the perceived ability for high-net-worth individuals to achieve a better tax outcome than the ordinary person).
- Require the employer to report equity allocations to the ATO annually to allow them to match to individual employee tax returns and therefore to increase the rate of tax collection.

These proposals achieve what AHRI believes the Government's objectives are – i.e. to increase tax receipts in the short term and improve tax compliance, while decreasing the costs of doing so and to eliminate any preferential tax treatment for high-income earners.

Benefits to the government of this AHRI recommendation are as follows. It will:

- maintain the taxing point at the same time as it would be if employers move to deferred cash instead of equity
- bring forward tax receipts to the end of the primary forfeiture/restriction period
- increase the rate of tax collection/capture – and decrease compliance costs
- avoid a decrease in company tax receipts in the current year due to the move to cash (as cash is expensed in full in the current performance year, but equity expense is spread over the vesting period)
- remove the ability for high earners to defer or minimise their tax
- maintain the ability for low/middle income earners to participate in employee share ownership
- maintain the alignment between employees and shareholders
- avoid a decrease in earnings in the current year which would result from the move to cash (as explained above)
- simplify communications and understanding of equity programs, and make equity much more user friendly (e.g. not requiring tax election on a \$1000 program. The \$1000 plan currently requires the making of a tax election to receive the exemption, but it would be a simple matter to remove this requirement and make the \$1000 program tax exempt on the basis that it meets the prescribed requirements (e.g. 3-year restriction, broad applicability etc).

TOR7. *Make recommendations as to how the existing framework governing remuneration practices in Australia could be improved*

AHRI's three sets of recommendations above are held to be potentially valuable components of a new and fresh policy and practice mix for executive remuneration. However there is some risk that they may in combination be only necessary conditions for satisfactory reforms.

We would like to raise two other issues for the Commission's consideration:

AHRI has been concerned that some remedies suggested – e.g. the PM's termination pay cap - are akin to catching a drop down a waterfall, rather than dealing with the headwaters of the problem. In the May 2009 issue of *hrmonthly*, AHRI strongly advocated that directors of Australian boards need standards set, appropriate training, and some disclosure of all this to ordinary shareholders. The article is provided as attachment 3 and complemented an article by AHRI National President Peter Wilson that appeared in *The Age* on March 5 2009. ('Self-examination of chaps is no standard' (see Attachment 4) The 14 recommendations set out in the *hrmonthly* article are commended to the Commission. Furthermore discussion of remuneration and general corporate governance issues since that time has led to the development of additional recommendations.

It is widely known that directors of ASX listed companies are usually re-elected with votes of 95%+ unless extraordinary circumstances prevail, regardless of shareholder dissenting votes on Remuneration Reports. It is also true that boards rely heavily on their experienced directors for direction and leadership – e.g. they usually constitute Company Chair and Committee Chair roles. In AHRI's view the tendency of institutional shareholder reluctance to disturb things can lead to board inertia that leads in turn to bad calls within the board, but for which no consequence may be invoked. Dissenting retail shareholders can often comprise the majority of 'no' voters to director re-elections, but their numbers are too small to influence the final outcome. Nevertheless, the final accountability for executive remuneration rests with the board and AHRI contends that is how it should be. However AHRI also believes board accountability needs to be sharpened in the field of executive remuneration, and other critical board performance areas.

In terms of board accountability and decision making the following AHRI results set out in Attachment 1 are a basis for some significant concerns with the status quo. HR practitioners surveyed in April 2009 believe as follows:

- 73% of survey respondents - board members have difficulty understanding technical complexity of executive remuneration
- 69% - boards have direct financial interest in executive remuneration
- 27% - external consultant is the main source of advice to the board
- 63% - boards should publish market data and rationale on executive remuneration decisions
- 69% - boards take the responsibility for drafting CEO contracts, with 83% reporting their board seeks independent advice and 73% reporting their board consults with HR.

The AHRI survey found that nearly three quarters of respondents have observed board members experiencing difficulties understanding the technical complexity of remuneration advice given to them, combined with a quarter of boards relying on outside advice primarily, and a lesser number deciding on key issues alone with respect to CEO contracting. This does not necessarily represent a healthy environment for decision making. However boards do have a right to decide these issues as a matter of responsible corporate governance, but they should also be held to an appropriate level of accountability over time if the accumulation of their decisions is seen to be inappropriate or irresponsible. Accordingly AHRI recommends as follows:

AHRI Recommendation 4

AHRI recommends that:

- The Commission considers and endorses the value of AHRI's 14 recommendations for director reform set out in Attachment 3
- The Commission recommends to Government that ASX listed directors:
 - Be elected initially to their board positions on the basis of a simple shareholder majority
 - Subsequent re-elections of directors to the same board be subject to a requirement to achieve at least three quarters of all votes cast in support.

Finally, an area of reform that remains open is the possibility of rogue behaviour whereby a board of directors sanctions large rises to CEO &/or executive remuneration pay that is well above the standards acceptable among commercial peers or to the community generally.

While this phenomenon may encourage an urge to regulate piecemeal each type of remuneration causing offence. Action of that order would unduly harm those who are behaving reasonably and responsibly with respect to management pay levels and where the outcomes within a company reasonably approximate a normal distribution of what is happening in the market with salaries for comparable job weights.

AHRI Recommendation 5

AHRI recommends as follows:

- Provision be made for Remuneration Reports to include statistical data of executive remuneration levels, for given job weight bands and total target remuneration levels exceeding say \$400,000, that inform shareholders as to whether that company's distribution of pay reflects the broader market for comparable roles, or is positively or negatively biased with respect to that, and explanations be provided thereafter by the company, based on material differences inherent from heavily skewed distributions.

AHRI thanks the Commission for the opportunity to present to its Inquiry on Executive Remuneration. We are pleased and able to attend Commission hearings to provide any further elaboration or clarification.

**Australian Human Resources Institute
National Office
Melbourne**

29 May, 2009