Inquiry into Executive Remuneration in Australia
Productivity Commission
Locked Bag 2
Collins Street East
Melbourne VIC 8003

Via email: exec_remuneration@pc.gov.au

Discussion Draft

This submission on the Discussion Draft is to be construed as a private individual's input although it is informed by both the context, and contact, that arises from my work as the Chief Investment Officer of a large superannuation fund.

The nature of the material contained in the Discussion Draft dated September 2009, and the subsequent public discussions either via newspapers or through public forum such as that convened by CGI Glass Lewis and Guerdon Associates in Sydney on 19th October 2009 have been particularly useful in allowing various proponents to outline the reasons for their positions.

At a fundamental level, the nature of the Inquiry being referred to the Productivity Commission was designed to address the public policy issues which flowed from the last few years' collective economic experiences:

> "The current global financial crisis has highlighted the importance of ensuring that remuneration packages are appropriately structured and do not reward excessive risk taking or promote corporate greed."[1]

While it is necessary to restrict Inquiry recommendations to areas which are controllable via the Corporations Act, or by reference to other "soft law" or "advisory guideline" groupings, the Inquiry should also have identified that some egregious remuneration practices which have received publicity over the last few years occur within legal entities which are not captured under the rubric of publicly listed companies.

The public policy issue is solely one of "fairness". This terminology has been invoked by the proponents who argue against the Commission's draft recommendations on the so-called "two-strike rule" when they have argued that the concept of a 50% majority is fair.

Equally, however, the invocation of "fairness" applies strongly to the arguments advanced by the proponents of pay caps. To the general public, the concept of the best paid executives being paid some defined maximum multiple of Average Weekly Earnings is eminently fair.

Public disquiet at excessive remuneration undermines faith in the quality and the ethics of the Directors/executives involved, engendering the full range of emotions from anger

[1] Background, Terms of Reference, discussion draft p.IV

to jealousy. The lingering danger is that unthwarted "greed" encourages the next participant to equally pursue greed.

Thus, Chairman Bank's comment, at the Sydney forum on 19th October 2009 identified the Inquiry as being more about "how the sausage machine works, rather than the sausage" may be interpreted as "let's get the framework right".

An equally correct narrative would be that if you let the sausage machine turn out a poisonous, adulterated sausage, then you may well be encouraging a community perception that such market failures are acceptable, because they happen infrequently. My belief would be that the purpose behind the framework should be to stop poor community outcomes from emerging, so as to act as a deterrent to more dangerous mutations in future circumstances. The historical brouhaha about Chris Cuffe's contract payment at Commonwealth Bank/Colonial First State should be an illustrative example in this regard. [No amount of executive talent was able to be brought to bear to stop this outlandish contract-induced overpayment – paid for by shareholders, whilst not being able to be over-sighted by them.]

The draft recommendation of the shareholder engagement in relation to the 25% trigger should be totally supported, with the 50% fairness argument being restricted on public policy grounds.

Where the Inquiry may need to revisit issues are:

(i) "Unintended consequence" is frequently cited as an outcome to be avoided in the introduction of policy. If so, then the Inquiry may well be creating the unintended consequence of enshrining a role for remuneration consultants in excess of their current role, and over which shareholders have no pre-appointment control. - Draft Recommendations 10 and 11

    Just as credit-ratings agencies are non-elected/generally faceless influencers of outcomes (and a major "contributor" to recent financial distress), we should be careful not to create a similar role for remuneration consultants. The case at this stage has not been proven that they are able to define "fairness" correctly.

(ii) Unintended consequences will arise where a number of employment arrangements will be re-configured to avoid public disclosure. Unless some policy context is set to review/oversight non-public listed companies, then remuneration transparency is only likely to decline. Therefore, the policy prescriptions applied to listed companies should at least be worded in such a way as to equally apply to unlisted/partnerships for their moral suasion to have more impact.

(iii) The 25% rule should be encouraged, but there will need to be an increased use of independent "returning officers" for ballots both in terms of scrutineering and in monitoring. It is not unusual for votes to "disappear" if they are too heavily biased against management's desires, and such practices would need to be stopped.

(iv) From a pragmatic point of view; can we dispense with the spurious argument about the true wealth generated by executives. Market Capitalisation statistics are inherently flawed, because they are priced by the "marginal" stock exchange price. By way of example: if a company has 1 billion shares on issue, but trades reasonably infrequently, then the share price (and therefore total market capitalization) is set by the last traded share, e.g. if 100 shares trades at a 10% rise from the last price, then the whole of the market cap is assumed to rise by 10%. For executives to state that they have presided over a multi-million dollar increase in market cap is disingenuous at best, and deliberately misleading at worst.

As a matter of process, it would also help if the Commission more firmly indicates why it has subscribed to the employment contract/rule of law philosophy. In general, contracts between Boards/CEO tend to be private/unknown. The true nature of the agreement is usually only discovered by shareholders at separation/termination.

While it may be appropriate to conclude that proper corporate governance should not require the oversight of contract negotiations by outsiders, in truth employment contracts tend not to be contestable – at least not in a true economic /competition sense – and their negotiation seems to have a bias against shareholders/owners. Unless we wish to move to an environment where shareholders pre-approve contracts, then a more formal reporting process should be required. This argument alone supports the 25% rule, and should not be deterred by those opponents who will, no doubt contend, that it is commercial – in – confidence [and too sensitive to be known until inflicted upon shareholders].

- Once the payment is made, the transfer of the "unearned" surplus to the Executive has already occurred. Unless the shareholder can seek restitution, it is always too late after the event.

Thanking you for your consideration.

Yours sincerely,

Mark Sainsbury