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13 November 2009

Inquiry into Executive Remuneration
Productivity Commission
Locked Bag 2, Collins St East
Melbourne VIC 8003

Via email: exec-remuneration@pc.gov.au

Executive Remuneration in Australia – Discussion Draft

On behalf of the Board of Directors of Macquarie Group (Macquarie), I would like to take this opportunity to thank the Productivity Commission (the Commission) for the opportunity to make a further submission on the proposals contained in the Discussion Draft released on 30 September 2009.

In our previous submission to the Commission we encouraged the use of a principles-based approach to remuneration that encourages robust governance processes, while allowing Boards of Directors to respond flexibly to the challenges of remunerating executives in a way that encourages their attraction and retention.

The Commission is to be commended for the thoroughness of its report and the consideration it has given to the wide range of submissions received, in addition to its intention to further test its proposals by way of further consultation with business.

Macquarie welcomes the Commission's recognition that salary caps and specific prescriptive regulation are not the solution to tackling certain concerns relating to executive remuneration. In particular, it is encouraging that the Commission has recognised the central role played by the Board in setting executive remuneration. Macquarie strongly supports the Commission's view that a binding vote on the Remuneration Report would be unworkable and erode the capacity and authority of the Board to negotiate with executives.

Macquarie also endorses the Commission's recommendation that the cessation of employment trigger for taxation for equity-based payments be removed. Partial vesting of an amount to cover taxation obligations of the employee reduces alignment with shareholders.

Macquarie's submission on certain of the recommendations made by the Commission in its Discussion Draft is attached. Macquarie is concerned that if certain recommendations were implemented a number of unintended consequences may result. These concerns are outlined in our submission.

Please do not hesitate to contact Dr Helen Nugent, Chairman of the Macquarie Board Remuneration Committee, or Mrs Nicole Sorbara if the Commission wishes to discuss the submission in more detail.

Yours sincerely

David S Clarke AO
Chairman
Macquarie Group Limited

Att.

Productivity Commission Discussion Draft
Executive Remuneration in Australia

Macquarie Group Limited - Submission

Recommendation 1

The Corporations Act 2001 (Cth)[1] should specify that only a general meeting of shareholders can set the maximum number of directors who may hold office at any time (within the limits to the company's constitution).

- It is not clear from the report or the specific discussion what, if any, direct relationship there may be between executive remuneration and board size/composition. Macquarie submits there is no direct relationship. Nor is it clear what outcome relating to remuneration may be achieved by the proposal.

  In terms of comparable jurisdictions, there is no equivalent provision in the United Kingdom, Canada or the United States.

- Macquarie notes that the Commission acknowledges (page 303) there is little and/or indeterminate evidence in relation to matters such as "over-boarding" and lack of diversity on boards, other than possible underrepresentation of women.[2]

- The primary concern expressed by the Commission is that of a possible "barrier to entry" for appropriately qualified candidates, based on the contention of some participants that the composition of some boards may contribute to poor decision-making. We note there is no evidence given of appropriately qualified candidates being unable to secure board positions.

- The appropriate size for a specific board is a matter in which a wide range of factors must be taken into account including the ability of board members to work together and the ideal number of directors in the context of the company's business and needs. Identification and appointment of suitable candidates is a complex process that takes considerable time and resources in order for the Board to reach a considered decision. Shareholders do not have the same information or resources to make such a determination.

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[1] References to the Corporations Act in this submission are references to the Corporations Act 2001 (Cth). References to the Listing Rules are references to the ASX Listing Rules.

[2] The number of entities listed on the Australian market is large relative both to the general population, and the available pool of appropriately qualified directors. Australia is also at a geographic disadvantage in that it is less able to "tap" qualified directors from other regions (compare for example UK/Europe or the United States).

Macquarie position

- **Macquarie considers the Board to be best placed to accurately assess the optimum board size at any given time.**
- **When combined with Recommendation 15 the compound effect could be destabilising for listed companies.**

Recommendation 4

The Corporations Act should specify that company executives identified as key management personnel (KMP) and all directors (and their associates) be prohibited from voting their shares on Remuneration Reports and any other remuneration-related matters.

- Macquarie supports in principle the proposal that KMPs be excluded from voting on remuneration matters, where there is a direct conflict of interest.
- Macquarie does not support a wider exclusion to encompass all directors and their associates, as in the majority of cases there is no direct or indirect conflict of interest. Where there is a conflict of interest, the person would be excluded from voting under the Listing Rules.
- A person should not be excluded from voting on a resolution merely by virtue of an involvement or connection with the resolution, or matters that are dealt with in the resolution. In the case of directors, the widest extension of this logic would mean that directors would be excluded from voting on any resolution put to shareholders, as they recommend those resolutions to shareholders. It cannot be said that this represents a conflict of interest. The fact that a person holds a position does not necessarily mean that a conflict of interest will arise.
- The key question is: what is an interest, and what is a conflict of interest? It is only in the latter case – where a person will directly and materially benefit from the outcome of a resolution - that a shareholder should be excluded from voting. This is most likely to occur in the case of executives who will benefit from a resolution relating to their remuneration.
- Macquarie is concerned that such a wide net is being cast, which would effectively displace a basic shareholder right and create a separate class of shareholder.
- The Commission notes that a number of participants raised concern about the dilution of voting power arising from equity grants to directors under listing rule 10.14 and states that if the recommendation were adopted this concern would not arise. The ambit and policy basis of listing rule 10.14 relates to *dilution* of shareholder capital and related party transactions. That is, where a person is in a position of influence, a listed entity should not be permitted to issue shares to that person without the approval of shareholders. The rule complements the provisions contained in Chapter 7 of the Listing Rules that deal with issues of capital more generally.

Where a director or executive is permitted to salary sacrifice in order to purchase shares on-market, there is no dilution because the shares purchased have already been issued. There is no difference between that and a scenario where a director is given a car as part of a salary package. Similarly, a director or executive could be given cash and then purchase shares on-market.

Macquarie Position

- **Macquarie supports the proposal that KMPs be excluded from voting on remuneration matters, but only where the KMP has a direct interest in the outcome of the resolution**
- **Macquarie does not support a wider exclusion that encompasses directors and their associates, other than where a director has a direct interest in the outcome of the resolution.**
- **Macquarie notes that voting exclusions where there is a conflict of interest are already adequately dealt with in the Listing Rules and Corporations Act.**

Recommendation 6

That the Corporations Act and relevant ASX Listing Rules be amended to prohibit executives identified as Key Management Personnel (KMP) and all directors (and their associates) from voting undirected proxies on remuneration matters

- Macquarie does not support Recommendation 6 as it will have the effect of disenfranchising a specific proportion of voting shareholders – in this case retail shareholders. Macquarie does not consider there is any demonstrable benefit to the proposal and more importantly, it conflicts with the principle of encouraging shareholder participation/engagement.
- The right to vote at a general meeting is one of the most fundamental rights of a shareholder. The proposal to prevent the voting of undirected proxies by KMPs and directors on remuneration matters displaces that right, where there is no sound basis to do so.
- Where a shareholder chooses to give an undirected proxy to another party, they are exercising a choice in relation to their vote. In this sense, it is irrelevant to whom that vote is given. A shareholder should not be disenfranchised because they appoint a person to vote on their behalf.
- If the proposal were implemented, it would need to be made clear on any notice of meeting and voting form what the consequences would be should a shareholder give an undirected proxy to a person who cannot exercise that vote.

- ASX listing rule 14.2.3 requires that where a shareholder gives an undirected proxy to the Chair, they must tick the box on the voting form indicating they acknowledge that the Chair may vote those shares even where he has an interest in the outcome of the resolution and any votes cast by the Chair other than as a proxy holder will be disregarded.

- The Commission states that given concerns about conflicts of interest have resulted in directors being prohibited from voting on certain resolutions, it seems contradictory to then allow the Chair to vote undirected proxies on those same resolutions. Macquarie submits that it is not contradictory for a person to vote undirected proxies when they are themselves excluded from voting. Where a shareholder chooses to give an undirected proxy to that party, they are exercising a choice in relation to their vote. The notice of meeting and proxy form that must be completed by the shareholder contain very specific information that enables the shareholder to give the necessary acknowledgement demonstrating their choice.

  We note that the text contained in listing rule 14.2.3B provides that if the shareholder does not mark the box and therefore does not provide the necessary acknowledgement, the relevant votes will be excluded.

- Of more general concern is that if such a measure were implemented, it would disenfranchise those shareholders who choose to vote by undirected proxy. As noted in our comments in relation to Recommendation 4, this would create another class of shareholder. Of more general concern is that it is primarily retail shareholders who elect to give undirected proxies.

- The Commission also states that taking into account that boards generally give their recommendations on the proxy form, a shareholder can then readily issue a directed proxy instead. Practice indicates that a segment of the shareholder base chooses to cast their votes in the form of undirected proxies, which is what the law provides for. The fact that a shareholder exercises their right to lodge a vote in this way should not mean that their vote is then excluded. Refer also to our comments below in relation to directed proxies.

Macquarie Position

- **Macquarie does not support the recommendation that KMPs and directors be prohibited from voting undirected proxies on remuneration**

- **A prohibition on voting of undirected proxies by specified persons will disenfranchise a specific sector of shareholders, who are primarily retail**

- **Macquarie suggests that a suitable measure to deal with any concerns regarding the voting of undirected proxies would be to amend the acknowledgement contained in ASX listing rule 14.2.3B to extend to other persons appointed as proxies, not just the Chair of the meeting. In this way, shareholders will be able to give an undirected proxy while indicating that they are exercising an informed choice.**

Recommendation 7

The Corporations Act be amended to require proxy holders to cast all of their directed proxies on Remuneration Reports and any other remuneration-related resolutions.

- Macquarie supports the voting of all directed proxies on all resolutions, not just remuneration related resolutions. We do not consider that remuneration related resolutions should be treated any differently to any other resolution.

- Macquarie also notes that this recommendation contradicts the recommendation that any undirected proxies held by directors or KMP should not be voted on remuneration matters. An undirected proxy is effectively an instruction from the shareholder to the proxy to cast a vote. An undirected proxy is essentially a direction.

- If the Commission believes all directed proxies should be voted, the same considerations apply to all undirected proxies on any resolution. It should not be restricted to Remuneration Report matters.

Macquarie Position

- **Macquarie supports the voting of all directed proxies**

- **If it is accepted that all directed proxies should be voted, the same considerations apply to undirected proxies, on any resolution.**

Recommendation 8

Section 300A of the Corporations Act should be amended to specify that Remuneration Reports should also 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.

- Macquarie supports the recommendation in principle.

- "Actual levels of remuneration received" requires further definition as to whether this means cash received in a financial year or realised value. This could include equity/options that have vested in the current year but which are granted in prior years and therefore have no linkage to current year performance. Similarly this would exclude current year profit share which is retained and deferred to future years. This needs to be carefully defined to ensure that there are no unintended consequences of reporting actual pay.

Recommendation 10

The ASX Listing Rules should require that where an ASX300 company's remuneration committee (or board) makes use of expert advisers, those advisers be commissioned by, and their advice provided directly to, the remuneration committee or board, independent of management.

- Macquarie fully supports the recommendation in principle.

- A provision in relation to the independence of remuneration advisers does not properly belong in the Listing Rules. The ASX Listing Rules deal with a range of matters – most specifically, disclosure, rights attaching to shares, how information is presented, related party transactions and significant transactions. The Listing Rules do not generally deal with matters such as remuneration or expert advisers used by an entity.

- The Corporations Act currently contains provisions regarding audit independence (refer section 324CA and related provisions) and consistent with those provisions, Macquarie submits that any measures dealing with the independence of remuneration advisers should be effected by amendment of the Corporations Act.

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.

- Macquarie supports the recommendation of the Commission. The taxation of equity at the cessation of employment point discourages vesting of equity awards post-termination and runs counter to remuneration best practice, particularly for financial institutions.

- Under the proposed changes to the taxation of employee share schemes contained in the Tax Laws Amendment (2009 Budget Measures No. 2) Bill 2009, deferring taxation to a point after employment ceases does not put the collection of revenue at risk.

- The requirement for employers to report details of the equity award at the deferred taxing point will provide the Australian Taxation Office with sufficient information to ensure employee compliance with their tax obligations. Further, the condition that the taxation event for equity awards is deferred only where the equity is subject to a real risk of forfeiture and only for a maximum of 7 years, restricts the ability of employees to benefit from the deferral concession.

- Taxation of equity at the cessation of employment reduces alignment with shareholders during the vesting period post termination as alignment would be on a post-tax rather than pre-tax basis. This is not in the best interests of shareholders.

- As an example, an employee terminates with $100,000 of retained remuneration in shares subject to vesting post termination. If the company allows partial vesting to accommodate a tax liability triggered on termination, the company releases approximately $46,500 of shares to the employee so the employee can fund their tax liability. The remaining retained remuneration held by the company would be only $53,500. If vesting does not occur, the employee can claim a tax refund of $46,500. The company is left attempting to recoup the $46,500 from the ex-employee. If that does not occur, the company would be left with $53,500. A perverse outcome could be where an employee ends up receiving a benefit to which they are otherwise entitled and the company is out of pocket for the amount of the tax liability. Whereas if the full amount of $100,000 is retained, the amount of retained remuneration is truly "at risk" and is better aligned with shareholders over the vesting period. If forfeiture occurs, the company retains the $100,000 which could then be available for use by the company either for expenses, or for distribution to shareholders. This approach would be preferable from a shareholder and regulatory perspective.

Recommendation 14

The Australian Securities & Investments Commission should issue a public confirmation to companies that electronic voting is legally permissible without the need for constitutional amendments.

- Macquarie supports voting by electronic means, and actively encourages its shareholders to use its electronic voting facility. At its last annual general meeting held in July 2009 approximately 28% of shareholders voted online.

- While electronic voting should be promoted and it is hoped that the number of shareholders who use it will increase, the paper based system of voting should remain as an option. There will continue to be a substantial component of Australian shareholders who prefer to vote in this way, and they are largely represented by the retail element. This is particularly the case with certain large companies who have a strong retail shareholder component.

Recommendation 15

The Corporations Act be amended to require that where a company's Remuneration Report receives a "no" vote of 25% 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.

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 ("two-strikes" test) at either:

- **An extraordinary general meeting; or**
- **The next annual general meeting.**

- As a stand-alone measure, Macquarie would have no objections to a requirement for the Board to provide a formal explanation/response where there was a specific "no" vote of a specified high level in relation to the remuneration report.

- However, Macquarie considers a proposed threshold of 25%, is too low, noting that an ordinary resolution of shareholders must be passed by only a majority of shareholders (over 50%) and a special resolution must be passed by only 75% of the votes cast by members entitled to vote on the resolution. To set the trigger at a level which would only just stop a special resolution being carried seems incongruously low.

  The proposed level of 25% flips the accepted voting requirement on its head with the result that a minority of shareholders could trigger a certain chain of events that could have serious company-changing consequences.

  If a 25% level applied, those shareholders voting "no" are being given a disproportionate amount of influence relative to the total number of shareholders, as the 25% level would apply only to the number of shares voted. That is, up to 75% of shareholders would be disenfranchised.

  This is exacerbated when one considers the proportion of shareholders who choose not to vote, which is often a significant part of the register (typically in the case of Macquarie, in the range of 35 – 50%)[3]. It is reasonable to assume that those who do not vote are neutral about or supportive of the status quo, whereas those who are not will vote "no".

- The Commission states that it believes a level of 25% is appropriate to ensure that a significant shareholder rejection of the Remuneration Report delivers a response from the company concerned, and in particular that a higher hurdle may be too difficult for shareholders to reach. An analysis of voting results since the introduction of the non-binding vote indicates that this is not the case, with a substantial number of negative votes at levels well over 25% over the past several years.

  In the current AGM season negative votes of more than 40% (up to 59%) have been recorded in respect of the Remuneration Reports of a number of

[3] At the last Macquarie AGM in July 2009, 64.7% of shareholdings were voted, which means that holders of approximately 35% of issued shares elected not to vote.

listed companies. In 2008 among the top 200 companies, we believe there were eight "no" votes of more than 50% recorded and there were also a number of other significant votes against Remuneration Reports. In 2007 several companies recorded negative votes above 40%.

The non-binding vote is proving to be an effective mechanism that strikes an appropriate balance. Repeated rejections of Remuneration Reports are infrequent, and Macquarie considers this is evidence of a significantly more dialogue between non-executive directors, management and key shareholders on remuneration issues.

Macquarie believes that over time shareholders have become more familiar with the non-binding vote and their willingness to vote against a Remuneration Report has increased.

- Macquarie also notes that the recommendation does not take into account identification of the specific concerns that cause a "no" vote above a certain threshold. This would be essential if the Board were to provide a satisfactory explanation/response subsequent to an initial "no" vote. Remuneration reports are comprised of numerous elements and a "no" vote may be indicative of concerns regarding a variety of matters such as systemic issues, quantum, termination payments or lack of clarity in reporting. A vote against may be in response to a single element, a combination of elements or other permutations. Unless the issue or issues are clearly identified it would not be possible for the Board to provide the requisite response.

- Macquarie does not support the proposal that where there have been two subsequent "no" votes above a required threshold, that all elected board members be required to submit for re-election.

- The proposal would mean that the second vote on the Remuneration Report would effectively be a vote against the incumbent board, and this could be used on a wide range of issues that may or may not be related to remuneration. This would have a destabilising effect and would have serious consequences for business continuity, and could also be used as an avenue for board takeover.

- The measure would also have the consequence of the Board focussing disproportionately on remuneration issues when a much wider range of issues require the attention of the Board at any given time.

- The Commission states at page 321 that in considering any formal requirements it is important that they be proportionate to the problem. Macquarie is concerned that remuneration issues are being given undue emphasis/focus when other considerations relating to the operation of a company may have far more serious impact – e.g. capital management, risk management or a failed significant transaction. This is not to suggest that remuneration is not an issue of genuine and significant concern to shareholders, particularly in the wake of the global financial crisis. We question, however, why a single issue should trigger a re-election of the entire board of a listed company?

- Macquarie contends there are more important resolutions that can be passed by shareholders with just a majority vote, e.g. significant changes to activities

(where ASX requires it) or disposal of the main undertaking of the company under Chapter 11 of the Listing Rules. In those cases a 49.99% vote against the resolution does not trigger a Board spill. We question why two votes at much lower percentages should trigger a Board spill?

In fact, not even a 100% vote against any other resolution would trigger an automatic Board spill under the Corporations Act. It is not clear why remuneration should be singled out as the issue to trigger such an outcome.

Macquarie Position

- **Macquarie does not support the proposed "2 strikes" rule**
- **The proposed 25% threshold for the first strike is too low, and would mean a disproportionate amount of power would be given to a minority of shareholders**
- **If a threshold were to be implemented, specifically as a trigger for a formal explanation requirement, an appropriate level would be 50% of voting shareholders**
- **Macquarie does not support the proposal that in the event of two "no" votes, the entire board must stand for re-election**
- **The proposal could be destabilising, impact business continuity and serve as a de-facto takeover tool where the motivation may not be remuneration issues**