

DRAFT

10 March 2013

Mr Scott Rogers
Manager
Corporate Governance and Reporting Unit
Corporations and Capital Markets Division
The Treasury, Australian Government
Langton Crescent
Parkes ACT 2600

Submission Regarding Proposed Amendments to the Corporations Act Relating to Remuneration Disclosures and Other Measures

Dear Sir,

Following are our firm's submissions in relation to some of the proposed amendments to the Corporations Act. All of our submissions relate to those proposed amendments that affect key management personnel (KMP).

1 Improving Disclosure Requirements in the Remuneration Report

1.1 Disclosure of KMP Remuneration

1.1.1 Introduction

In relation to this amendment three (3) types of remuneration will need to be disclosed:

a) The amount that was granted and paid during the financial year.	In this submission these two types of remuneration are referred to as " realised pay ".
b) The amount of remuneration granted before the financial year and paid during the financial year.	
c) The amount that was granted but not yet paid during the financial year.	In this submission this type of remuneration is referred to as " deferred pay ".

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1.1.2 Remuneration Paid in Year

1.1.2.1 Realised Pay

Realised pay seems to be referring to remuneration that has been paid during the relevant year. According to the Online Legal Dictionary, “payment” means the “fulfilment of a promise; the performance of an agreement. A delivery of money, or its equivalent in either specific property or services, by a debtor to a creditor.” Thus, it appears that the proposed legislation is requiring disclosure of the value delivered to KMP at the date that payment occurs. For salary and incentives that are paid in cash the date and value of payments are easily determined. For payments in kind the date and value of payments is more challenging to determine and clarification of the legislative requirements is needed. Many payments in kind to KMP will arise from grants of equity (shares, rights and options). As discussed below the time of payment can vary and would appear to be typically either on vesting or on cessation of dealing restrictions following vesting. As also discussed below it would seem reasonable to adopt the taxing point as the time of payment and the taxable value as the value of the payment. Whether this approach or an alternative is used it will be critical for the legislative intent to be made clear.

Attachment A illustrates the reporting of realised pay. It also provides guidelines as to the completion of the statement based on assumptions we have made about the timing and value of equity grants. Amounts that would fall into this category typically would include:

1. Fixed annual remuneration (FAR) (salary, superannuation contributions, other benefits and fringe benefits tax (FBT)) that was due and paid during the financial year) and FAR amounts deferred from a previous year,
2. Short term incentive (STI) that was paid during the financial year – usually will relate to the prior year’s performance, and
3. Long term incentive (LTI) that was taxable under the employee share scheme (ESS) taxing provisions during the financial year, (some ESS benefits are taxed as fringe benefits and not under the income tax provisions, therefore it will be important to clarify whether such ESS benefits are to be reported as realised pay)
4. Sign-on payments paid during the financial year, and
5. Termination payments made during the financial year.

In relation to LTIs it is common practice for equity to be granted to KMP and for there to be a vesting period for each grant which is followed by a period when dealing in the equity is restricted. It is only when the dealing restrictions cease to apply that the KMP may realise, through sale of the equity, any benefit that has accrued in the equity. However, being able to realise a benefit does not equate to realising it, if the person has a choice to delay the timing of the realisation. These comments are intended to emphasise the need to define the term ‘realised’ pay.

Dealing restrictions are applied to ensure that KMP retain ownership of the equity for a minimum period, being the term of the restrictions. They will also defer the taxing point (if applied at the time of grant) for the period of the restriction; but the taxing point cannot be deferred beyond the earlier of the elapse of seven (7) years from the grant and termination of the employment. Unless the taxing point is also deferred by the dealing restrictions companies would be unlikely to apply dealing restrictions as it would be grossly unfair to preclude KMP from selling equity to fund their tax liability when it arises. If equity is not sold at the taxing point then KMP may be taxable on accrued benefits that may not be realised if the share price should fall before the equity may be sold. Other reasons for imposing dealing restrictions are that KMP are often precluded by the insider provisions of the Corporations Act from selling equity and even when that may sell equity

they feel that they should not do so as it may give the market the wrong impression as to their views of the current state and prospects of the company.

In item 3 above it has been assumed that paid means the equity has vested and any dealing restrictions have ceased to apply, which is the employee share scheme (ESS) taxing point. This approach seems to be reinforced by comments in the Explanatory Memorandum such as: “pay that has been received due to past pay being crystallised” (para 2.31) and “will now report what is realised pay” (para 2.32). It means that the same value that is taxed as income of KMP from equity grants will also generally be the value that is disclosed. Of course, many KMP retain some or all of the shares acquired from LTI equity which is one of the reasons for providing LTIs in the form of equity. Thus, the LTI benefit that is available at the ESS taxing point may not be realised if shares are retained and the share price falls. At best it represents pay that could be realised at the first opportunity to do so. Clarification of whether our assumed approach is what the legislation intends should be considered. Whether use of the term “realised” is appropriate should be reviewed.

It would also be helpful if it could be clarified how indeterminate rights which vest subsequent to a termination of employment are to be treated. Under the income tax law if an indeterminate right is settled in cash then it is taxable in the year the indeterminate right vests and the cash payment is made. If the indeterminate right is settled in shares, then the value of the shares at the date of termination of employment is taxed in the year the termination of employment occurred even if the indeterminate right vests several years after the termination of employment. This requires an amendment of the KMP’s tax return for the year in which the termination of employment occurred. For purposes of disclosure of realised pay it would seem more appropriate for the value at the date when vesting has occurred and dealing restrictions have ceased to apply to be the value that is disclosed and for it to be disclosed in the year when that occurs rather than in the year of termination of employment. If it is to be disclosed in the year of the termination of employment then companies will need to prepare and lodge amended Remuneration Reports possibly each year for typically up to three years after the year in which the termination of employment occurred. Such a requirement would seem to be overly onerous and would confuse rather than add to clarity of what remuneration has been realised by KMP.

1.1.2.2 Earned Pay

An alternative to the foregoing approach would be to require disclosure of the value of equity grants at the time that they vest irrespective of whether or not they are subject to disposal restrictions. Given that it may not be realisable it may need a different term such as earned pay.

This approach has the advantage of not overly delaying the recognition and report of equity remuneration. Again if this approach is preferred then it should be made clear in the legislation or the Explanatory Memorandum.

1.1.3 Deferred Pay

Attachment B illustrates the reporting of deferred remuneration opportunities that were granted during the financial year but will not be paid, if paid at all, until a subsequent financial year. It also provides guidelines as to the completion of the statement.

1.1.3.1 Short Term Incentives (STIs)

In relation to STIs it is our understanding that many companies do not have threshold, target and stretch levels of STI. Some have a target or stretch only whereas others have a relationship

between performance such as profit and the amount that may be earned from the STI e.g. STI is x% of profit above a minimum profit level. If threshold, target and stretch were to be defined then most companies should be able to quantify the values associated with these levels of performance. Example definitions follow for your consideration:

Threshold	The minimum level of performance that would be seen as warranting a minimal level of STI award.
Target	The STI award that may be earned when a challenging but achievable level of performance is achieved.
Stretch	The amount of STI award that may be earned when performance achieves a level that is considered to be outstanding and unlikely to be achieved other than rarely. It may be the maximum STI award.

If concepts such as these are not required to be disclosed then it will be more difficult for shareholders to understand the STI award opportunity. These aspects could be covered in the Explanatory Memorandum that accompanies the legislation when it is submitted to Parliament.

1.1.3.2 Long Term Incentives (LTIs)

Most LTI plans in Australia are based on grants of equity that may vest after a period of service if specified vesting conditions are satisfied. Where equity is granted the value at grant should be the value that is disclosed. It would be the undiscounted market value of the shares, rights or options less the amount, if any, payable for the equity unit.

While the accounting approaches to the valuation of equity grants and amortisation of that value over the vesting period have merit the amortisation approach does not recognise that **remuneration in the form of an equity grant is remuneration for the year of the grant** and not remuneration for subsequent years even if it may vest only after subsequent years have elapsed. The amortised value of equity grants that are currently reported as LTI income of KMP is not appropriate and should not be used in the proposed new disclosure statements.

In this regard the nature of the vesting conditions affects the valuation for accounting purposes of the LTI equity grants. Market related vesting conditions are taken into account in valuing the equity units giving rise to a discounted value whereas non-market vesting conditions are not taken into account giving rise to a non-discounted value. Irrespective of the type of vesting conditions the equity grants should be valued consistently and the stretch value should be the full value of the equity granted at the grant date.

1.1.3.3 STI Deferred into Equity

It should be noted that when an STI award is partly satisfied with a deferred grant of equity i.e. equity that does not vest until a latter year, there is no disclosure of that grant of equity under the proposed amendments. This is because:

- a) the STI grant occurred at the beginning of the measurement period when award opportunities disclosed in **Attachment B** were agreed, and
- b) the payment of the deferred part of the STI will not occur until the equity vests (and any dealing restrictions cease to apply) and it is then disclosed as indicated in **Attachment A**.

It would be appreciated if this aspect could be clarified in the Explanatory Memorandum that accompanies the legislation when it is submitted to Parliament.

1.2 Changing Lapsed Options Disclosure from Value to Number

This is an area of disclosure that needs to be extended to cover all forms of equity and not just options. The term 'option' refers to a specific form of right. It does not include shares or equity units generally referred to as 'rights' which are used by the majority of ASX listed companies. For this aspect of disclosure to be truly helpful for shareholders and other stakeholders it needs to cover all forms of equity and expand the information provided. This need will become more critical when disclosure of 'realised pay' is implemented. While 'realised pay' is of interest the company's remuneration policy is more important. This may be deduced from the 'deferred pay' and equity disclosure tables if equity is more fully disclosed as suggested in **Attachment C**.

Attachment C provides a suggested disclosure format for all forms of equity whether granted on a salary sacrifice basis or as a deferred STI or as an LTI. A more complete disclosure as illustrated in **Attachment C** is a necessary adjunct to the disclosures of Realised and Deferred Pay as discussed earlier in this submission. When the three (3) tables are analysed by various stakeholders they will be able to assess the extent to which variable pay has been then aligned with company performance and shareholder expectations.

1.3 Disclosure of all payments made to KMP on Retirement from a Company

We do not have any comments on this aspect other than to point out that three aspects of KMP remuneration that relate to service prior to the termination of employment should not be treated as termination benefits. These are:

- a) Pro-rata STI payment in respect of the part of the year worked prior to the termination of employment,
- b) LTI grants made in years prior to the year in which the termination of employment occurred, and
- c) Pro-rata LTI grants made in the year of the termination of employment in respect of the part of the year worked prior to the termination of employment.

In our view these payments and grants are similar to pro-rata salary paid up to the date of the termination of employment.

1.4 Description of Remuneration Governance Framework

We do not have any comments on this aspect.

1.5 Clawback of Over Paid Remuneration

While this has not been an area on which we have any statistics as to the frequency or extent of material misstatement and omissions in the accounts of ASX listed companies our impression is that this would occur very rarely. Further, if it did occur and KMP were responsible for the material misstatement or omission then it is likely that it would be matter that the company would pursue through the courts. In these circumstances there seems to be little need, if any, for a clawback provision.

Usually the Explanatory Memorandum reflects the proposed legislation and explains its intent however Chapter 3 of the Explanatory Memorandum seems to be somewhat disconnected from the proposed legislation. The Explanatory Memorandum repeatedly refers to "a disclosure requirement for a company's clawback policy," whereas the proposed amendments require:

- a) *if a material misstatement or omission has occurred in the company's accounts for any of the prior three years, and*
- b) *if there has been an overpayment of remuneration to key management personnel (KMP) as a result of the material misstatement or omission,*

then the company must disclose in its Remuneration Report for the year in which it became aware of the material misstatement or omission,

- c) *whether any overpayment to Key Management Personnel [KMP] has been or will be clawed back, or*
- d) *if no remuneration is to be clawed back then an explanation.*

Clearly the proposed requirements fall well short of a requirement to disclose the company's clawback policy or even details of the amounts clawed back either individually or collectively from KMP. This aspect needs to be clarified before the legislation and Explanatory Memorandum are finalised.

While the legislation focuses on overpaid remuneration it ignores the possibility that KMP may have been underpaid remuneration as a result of material misstatements or omissions. In the experience of the writer most companies would not seek to make good underpaid remuneration in these circumstances. By not also covering underpaid KMP remuneration the proposed amendments are unbalanced and clearly biased. Such a stance may be reasonable for legislation designed to protect shareholder interests.

Overpaid remuneration will generally only arise in relation to incentive remuneration. This will mean that the clawback provisions will generally not apply to non-executive directors as the remuneration of non-executive director must be a "fixed sum" as required under ASX Listing Rule 10.17.2. Thus, the clawback provisions are mainly aimed at executive KMP.

Incentive remuneration for executive KMP generally consists of two elements being STI and LTI. STIs usually consider individual performance, business unit performance and company performance. Individual performance generally does not focus on financial results and therefore this aspect would not be subject to clawback. Of course, if a financial gate were to apply to an STI plan then it could bring within the ambit of clawback all aspects of the STI. Business and company performance generally includes financial measures as well as other measures such as production and health, safety and environment. Again the non-financial measures would not be subject to clawback. Thus it would only be incentives that arose from financial measures that would be subject to clawback. Could this lead to the undesirable consequence of STI and LTI plans using less financial measures?

Once an STI is earned it is common practice for part of it to be deferred into shares or rights that vest based on completion of a period of service. Even if the deferred STI was not related to financial measures the value of the deferred amount will vary in line with movements in the company's share price which may be influenced by material misstatements or omissions. As the company would not incur any cost to increase the value of the shares as that is a market influence it may be argued that the company would have no right to recover any overpaid remuneration that arose in such circumstances. Is the role of a clawback policy to recover costs incurred by the company that should not have been incurred or is it to penalise KMP by removing any benefits derived as a result of material misstatements or omissions? Similar situations may arise in relation to LTI plans. This aspect needs to be clarified.

An impact of the clawback amendment will most likely be that companies will seek to quarantine part of STI and/or LTI benefits for up to three (3) years after they have been earned so that they are available to be clawed back. This will require dealing restrictions to be placed on earned incentives.

By delaying KMP access to incentives that have been earned the effectiveness of the incentives will be severely diminished. Studies have shown that incentives with long earning or deferral periods tend to be heavily discounted in the minds of executives and therefore have less motivational impact. A likely company response may be to increase the value of the incentives on offer to counter this perceived discounting effect.

Given that clawbacks would only be required in a small minority of cases it seems excessive to introduce legislation that may seriously undermine the effectiveness of incentive plans. Our view is that this proposal should not be implemented.

It is trusted that the foregoing comments are of assistance. If you have any questions in relation to this matter please feel free to give me a call.

Yours sincerely,



Denis Godfrey

Managing Director

2 Attachment A – Realised Pay

Realised Remuneration												
Role	Name	Year Ending	FAR Due and Paid for the Year	FAR Due in a Prior Year and Paid this Year	Realised STI (paid value of equity is its benefit value at vesting which may differ from the amount that is realised by the executive)			Realised LTI (paid value of equity is its benefit value at vesting which may differ from the amount that is realised by the executive)			Realised Total Remuneration	
					Performance Year	Form of Payment	Amount	Performance Period	Form of Payment	Amount		
MD&CEO	Mr J. Young				2013	Cash	\$200,000	1/7/2010 to 30/6/2013	Rights	\$400,000		
					2012	Shares	\$100,000	1/7/2010 to 30/6/2013	Cash	\$1,000		
					2011	Shares	\$70,000					
		2014	\$1,000,000				\$370,000			\$401,000	\$1,771,000	
					2012	Cash	\$150,000	1/7/2009 to 30/6/2012	Rights	\$300,000		
					2011	Shares	\$75,000	1/7/2009 to 30/6/2012	Cash	\$1,000		
					2010	Shares	\$50,000					
		2013	\$900,000			\$275,000			\$301,000	\$1,476,000		

Realised Remuneration											
Role	Name	Year	FAR		Realised STI			Realised LTI			Realised Total Remuneration
					Performance Period		Amount	Performance Period	Target Amount	Amount	
			Enter the total amount of salary benefits and FBT due and paid this year. If pre-payments of a prior year are recovered then the amount paid this year would be lower by the amount of the recovery.	Enter amount of FAR that were due and payable in a prior year but payment occurred in this year.	Enter the measurement period for the STI award	Enter the form of payment. If in equity it is the value at the date when both vesting and cessation of dealing restrictions have occurred. For example if Rights were granted to defer payment of STI awards then shares would be received when the Rights vest.	Enter the amount of gross cash payment or the benefit value at the time when both vesting and cessation of dealing restrictions have occurred if in the form of equity.	Enter the beginning and end of the measurement period.	Enter the form of equity which vested or other form of payment such as cash.	Enter the amount received or the benefit value of the equity.	Enter the total of FAR, realised STI and realised LTI.

3 Attachment B – Deferred Remuneration Opportunity

Deferred Remuneration Opportunity												
Role	Name	Year	STI				LTI (value at grant date)					
			Minimum	Threshold	Target	Maximum	Equity Type	Number	Minimum	Threshold	Target	Stretch
MD&CEO	Mr J. Young	2014					T1 Performance Rights (TSR)	100,000	\$0	\$0	\$200,000	\$400,000
						T2 Performance Rights (EPS)	100,000	\$0	\$100,000	\$200,000	\$400,000	
						T3 Performance Rights (milestones)	50,000	\$0	\$50,000	\$100,000	\$200,000	
						T4 Retention Rights	50,000	\$0	\$0	\$100,000	\$100,000	
			\$0	\$200,000	\$400,000	\$800,000		300,000	\$0	\$150,000	\$600,000	\$1,100,000
		2013					T1 Performance Rights (TSR)	80,000	\$0	\$0	\$120,000	\$240,000
						T2 Performance Rights (EPS)	80,000	\$0	\$60,000	\$120,000	\$240,000	
						T3 Performance Rights (milestones)	40,000	\$0	\$30,000	\$60,000	\$120,000	
						T4 Retention Rights	40,000	\$0	\$0	\$60,000	\$60,000	
			\$0	\$18,000	\$360,000	\$720,000		240,000	\$0	\$90,000	\$360,000	\$660,000

Deferred Remuneration Opportunity												
Role	Name	Year	STI				LTI					
			Minimum	Threshold	Target	Maximum	Equity Type	Number				Amount
			Enter the minimum amount that may be earned from the STI.	Enter the amount that may be earned from the STI when threshold performance is achieved.	Enter the amount that may be earned from the STI when target performance is achieved.	Enter the maximum amount that may be earned from the STI or the amount that may be earned when stretch performance is achieved.	Enter the types of equity LTI grants.	Enter the number of LTI equity units granted.	Enter the minimum value that may be earned from the LTI grant.	Enter the value at grant of the number of equity units that will vest when threshold performance is achieved.	Enter the value at grant of the number of equity units that will vest when target performance is achieved.	Enter the value at grant of the number of equity units that will vest when stretch performance is achieved.

4 Attachment C – Disclosure of Equity Holdings and Movements

Role	Incumbent	Year of Grant	Type of Equity Unit	Number Held at Beginning of the Year	Number Granted During Year	Value of Grant at Date of Grant	Adjustment to Numbers Held Due to Bonus Issue or Capital Reconstruction	Number that Lapsed During the Year	Number that Vested During the Year	Number Held at End of Year
MD&CEO	Mr J. Young	2014	Performance Rights	0	200,000	\$300,000	0	0	0	200,000
			Retention Rights							0
			MEPOs							0
			PEPOs							0
		2013	Performance Rights	180,000	0	\$252,000	0	0	0	180,000
			Retention Rights							0
			MEPOs							0
			PEPOs							0
		2012	Performance Rights	160,000	0	\$192,000	0	0	0	160,000
			Retention Rights							0
			MEPOs							0
			PEPOs							0
		2011	Performance Rights	150000	0	\$150,000	0	50000	100000	0
			Retention Rights							0
			MEPOs							0
			PEPOs							0