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Mr John Kluver
Corporations and Markets Advisory Committee
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Dear Mr John Kluver

Executive Remuneration – Information Paper - July 2010

Macquarie Group Limited (Macquarie) would like to contribute to the review the Corporations and Markets Advisory Committee (CAMAC) is undertaking at the request of the Minister for Financial Services, Superannuation and Corporate Law, Mr Chris Bowen.

Macquarie's remuneration framework has delivered superior shareholder returns over many years by aligning the short and long-term interests of staff and shareholders, and by attracting and retaining high quality people. While the principles have remained, the framework has been amended and has evolved in line with market conditions over the years.

Macquarie supports the increased debate on reporting of remuneration. Australia is already well regarded in its remuneration disclosure practices.

To this end, Macquarie advocates:

- A principles-based approach
- Boards should have discretion to determine how executives should be remunerated
- Regulation should not dictate the type of incentive scheme a company should implement
- Simplification of the Remuneration Report needs to be considered against the backdrop of the requirements of all shareholders, some of whom want the detail
- The legislative architecture should support good remuneration practices

The supporting paper provides details to support these points.

We appreciate your consideration of this paper.

Please do not hesitate to contact me or Nicole Sorbara on 8237 5015 if you wish to discuss this letter in more detail.

Yours sincerely

Dr Helen Nugent AO
Chairman, Board Remuneration Committee
Macquarie Group Limited

Executive Summary

Macquarie supports the effort to reform Executive Remuneration advocated by the Productivity Commission, APRA and other regulatory bodies.

While there has been significant debate as to what will make remuneration reporting simpler and more transparent, varied views exist on items to be included/deleted and the nature of what is disclosed. This is to be expected given the different needs of different interest groups.

Macquarie considers that, subject to considerations of risk, regulation should not dictate the type of incentive scheme a company should implement, nor should it restrict or diminish the flexibility of companies to attract, retain and motivate employees to achieve improved company performance.

It is important that company Boards and remuneration committees develop incentive schemes which are appropriate to their circumstances having regard to risk and which are aimed at driving superior executive performance which in turn drives shareholder returns.

Macquarie advocates a principles-based approach to remuneration, with responsibility resting with Boards and remuneration committees to implement incentive schemes to suit their particular circumstances.

In turn, shareholders should be provided with sufficient information in the Remuneration Report to be able to evaluate a company's remuneration policy and remuneration outcomes in light of the company's performance.

Remuneration reporting should be useful, understandable and transparent. In this context Macquarie acknowledges that a fine line exists between report readability and length, with the need to balance transparency and simplicity.

However, a prescriptive approach to incentive schemes or remuneration reporting does not ensure that remuneration packages are appropriately structured nor does it simplify the process. Moreover, it might possibly result in perverse outcomes such as has occurred with overseas interventions.

Detailed Response

Macquarie has considered the Minister's request for advice and would like to present the following comments on the items identified by the Minister.

REMUNERATION REPORTING

Examine the existing reporting requirements contained in section 300A of the Corporations Act and related regulations and identify areas where the legislation could be revised in order to reduce its complexity and more effectively meet the needs of shareholders and companies.

Make recommendations on how best to revise the legislative architecture to reduce the complexity of remuneration reports.

- Macquarie does not consider that any significant changes are required to the existing reporting requirements for Remuneration Reports. However, there are some amendments which may be useful to meet the needs of shareholders. Each of these suggestions is outlined in further detail below.

Simplification needs to be considered against the backdrop of the requirements of all shareholders, including the needs of both retail and institutional shareholders.

- Macquarie supports the Government's efforts to make Remuneration Reports more concise, useful, readable and transparent.

- However, as acknowledged by the Productivity Commission, tension exists between report readability and length, with the need to balance transparency and simplicity.

- Different companies have different shareholder bases, with different types of shareholders having different needs. From Macquarie's perspective, there is a need to focus on the needs of both retail and institutional shareholders as well as regulators, investors and other stakeholders.

- Macquarie supports in principle the idea of including a plain English summary of a company's remuneration policies, primarily for the benefit of retail shareholders. At the same time the needs of institutional investors should be met through greater detail.

- Macquarie supports individual remuneration disclosures being limited to Key Management Personnel (KMPs).

- Macquarie does not take the view that the Remuneration Report should be radically reduced in scope. Our consultation with institutional shareholders would suggest they are supportive of the richness of data reported and disclosures made. Institutional shareholders continue to express greater interest in the detail behind remuneration arrangements, policies and the accounting quantum of remuneration.

- The government in its response to the recommendation in the Productivity Commission report has indicated that it will introduce various changes to simplify the disclosure requirements of the Remuneration Report. One foreshadowed change is the requirement to disclose *the actual levels of remuneration received* by the individuals named in the Remuneration Report. Macquarie does not consider it appropriate to mandate that actual pay *received* in the current year should be included in the Remuneration Report.

- Most organisations consider and structure executive remuneration to reward, motivate, and align the interests of shareholders and executives. One of the key aspects of the

Remuneration Report is the link between performance and reward. This is critical to shareholders to understand whether:

- the remuneration granted is fair in relation to the performance achieved;
- the Board is achieving its function in setting effective executive remuneration and;
- the remuneration structures and awards are aligned with the interests of shareholders.

- Boards generally consider the actual pay *awarded* in relation to the individual's performance, financial results and other factors, when setting levels of executive remuneration for a given individual in any given year.

- Macquarie's view is that the actual pay *awarded* in the current year should be included in the Remuneration Report. This will enable shareholders to see how the remuneration awarded is aligned with the current year's performance.

- Actual pay awarded would include any remuneration approved by the Board for an individual's performance in a given year. This would show fixed remuneration, variable/and or performance based remuneration, equity awards and any other incentives granted in the year.

- The conditions, restrictions, vesting and other relevant factors should continue to be disclosed in their relevant sections of the Remuneration Report.

- Macquarie does not consider that it is appropriate to mandate that actual pay *received* in the current year should be included in the Remuneration Report.

- While many companies consider performance-based incentives in two broad categories: Short term incentives (STIs) and Long term incentives (LTIs), this is not universally the case. For an organisation like Macquarie, the main form of performance-based remuneration is profit share, of which, a significant portion is deferred and vests over seven years. As a result, actual pay *received* may include current year fixed and short term performance-based remuneration as well as remuneration deferred from the previous seven years.

- The actual pay *received*, being broadly cash received and awards vested in the current year (in relation to remuneration awarded in prior years), is not the main focus of Board decision making regarding remuneration.

- For deferred remuneration, a number of factors may change during the vesting period, for example the economic climate, market conditions and the composition of the Board. The actual pay *received* approach will include deferred awards when they vest. Therefore, there is no alignment between current year company performance and remuneration.

- It is worth noting that remuneration reporting in the United States has recently shifted to reporting actual remuneration *awarded* and approved by the Board. This would include the total value of fixed, short and long term incentives awarded in that year. The structure, delivery, performance hurdles and vesting would be detailed in supporting schedules.

- Appendix 1 includes a summary of suggested items for inclusion in the Remuneration Report.

Accounting values of remuneration should be reported in the financial statements section of the annual report.

- Accounting values of remuneration continue to be an important element in the requirements of institutional shareholders. Thus, it is Macquarie's view that this information should be included in the Financial Report of the Annual Report on an individual basis, for KMP's.

- This may reduce confusion for some shareholders attempting to understand complex accounting concepts, while still providing the data to those shareholders interested in the statutory values required to perform analysis on the financial statements.

REMUNERATION ARRANGEMENTS

Examine where the existing remuneration setting framework could be revised in order to provide advice on simplifying the incentive components of executive remuneration arrangements.

Make recommendations on how best to revise the legislative architecture to reduce the complexity of remuneration reports and simplify the incentive components of executive remuneration arrangements.

Macquarie considers that a principles-based approach with Board discretion is the best approach. No significant changes are required to the legislative architecture to simplify remuneration reports or executive incentives. Further detail is outlined below.

Adopt a principles based approach to executive remuneration.

- In recent years, executive remuneration practices have come under close scrutiny from governance groups, regulators, governments, politicians and the broader community due to the significant changes in global financial markets.

- Numerous initiatives have been launched globally with a number of common themes as to what constitutes a good principles-based remuneration framework including:

  - Incentive arrangements should align with shareholder interests.
  - Incentive arrangements should align with prudent risk taking and should not reward excessive risk taking.
  - A significant portion of performance-based remuneration should be deferred and remain at risk.
  - Termination benefits should not reward poor performance.
  - Companies should have a formal, written remuneration policy approved by the Board.
  - Companies should have an independent Remuneration Committee which is responsible for ensuring that remuneration policy is appropriate.
  - A separate remuneration policy for non-executive directors and executive directors should be in place.

- A principles-based approach allows organisations flexibility to respond to a global and domestic marketplace and their individual company circumstances, while recognising and managing risk.

- A prescriptive approach will not simplify remuneration arrangements and in fact may have unintended consequences such as curtailing a company's ability to respond to changing market factors. Perversely, it may also drive up remuneration levels.

- A principles-based approach is consistent with guidance from financial services regulators such as APRA and the Financial Stability Board, following the Global Financial Crisis.

- Generally, regulators are concerned with the risks created by the structure of remuneration arrangements, not with the absolute amounts of remuneration or specific instruments, which remain a matter for remuneration committees and Boards.

- Prescriptive regulation may make Australian companies less globally competitive for talented executives.

- Macquarie considers that adopting a principles-based approach would enhance the remuneration framework, provide greater transparency and strengthen the relationship between the interests of a company's executives and the interests of shareholders.

Boards should have discretion to determine how executives should be remunerated.

- A one size fits all approach to incentive arrangements is not appropriate. For example, even the simple short-term incentive, long-term incentive approach does not work equally well across all industries. Different industries have different time horizons. At Macquarie, a significant portion of what may classically be described as STI - the annual profit share allocation - is deferred for up to 7 years. In other words, the supposed STI has the characteristics of an LTI.

- Boards are best placed to assess both the level of remuneration that needs to be paid to attract and retain executives, and how remuneration should be structured to recognise risk and ensure returns to shareholders are sustainable over the long term.

- Boards also need to have the ability to respond to both individual company circumstances and the environment in which the company operates.

- A prescriptive approach may restrict the Board's ability to adapt their remuneration arrangements to suit their particular circumstances (lifecycle, growth plans, environmental factors, market conditions and risk profile), i.e. a company in a growth phase may have different remuneration arrangements to a well established company.

No significant changes are required to the legislative architecture.

- The legislative architecture should support incentive arrangements that comply with the general principles advocated by the various governance groups and regulatory bodies as set out above.

- The legislative architecture that governs remuneration arrangements is broad and covers employment law, tax law and corporation and securities law, as these all influence how incentive arrangements are designed.

- Macquarie would like to draw attention to areas where the legislative architecture is not aligned with the remuneration framework or areas where best practice remuneration incentives place an additional administrative burden on companies.

The taxation of employee share schemes on termination of employment

- Under the tax legislation covering employee share schemes, termination of employment triggers a tax event for employees, even in circumstance where vesting is deferred beyond termination of employment.

- Like many global financial services regulators, shareholders consider that good governance practice requires companies to retain profit share amounts post termination to maintain alignment and ensure that executives consider the long-term consequences and implications of transactions post employment.

- To avoid placing employees in an adverse cash-flow position, both APRA and the Government's Consultation Paper, released subsequent to the Budget legislation, suggest that companies allow partial vesting of shares to enable realisation of funds to pay that tax on cessation of employment.

- This suggestion is flawed because it will reduce alignment with shareholders during the vesting period post termination as alignment would be on a post-tax rather than pre-tax basis.

- In addition, there could be circumstances where a determination is subsequently made not to vest amounts post termination, yet the employee will already have received some shares to cover tax liabilities. For example, at Macquarie, during a period of up to 2 years post termination, a determination can be made not to vest shares if it is found that the employee has committed a disqualifying event (e.g. fraud). If some shares have already been released, it will be difficult and expensive to recoup these funds. This is not in the best interests of shareholders.

Corporations and Securities laws

- ASIC provides limited exemptions from some of the regulatory burdens that can otherwise complicate the offering of company shares to staff (Class Order 03/184). For example, ASIC gives relief from the obligation to make certain share scheme offers under a prospectus or product disclosure statement, and relief from provisions of the Australian Financial Services licensing and disclosure regime.

- One of the conditions of this relief is that no more than 5% of the company's shares are issued under the ASIC Class Order 03/184. This cap was set in 1994 to balance the encouragement of staff share offers against the risk that staff plans would be used for fundraising. The cap has for some time presented difficulties for listed companies with a large workforce or strong staff equity alignment principles.

- With the increased regulatory emphasis on delivering remuneration in the form of equity, this very low cap should be increased to ensure the relief offered by Class Order 03/184 is not eroded. Other outstanding technical issues under Class Order 03/184 should also be clarified or resolved through this review.

- ASIC also provides relief from the Corporations Act prohibition against subsidiaries acquiring parent company shares. This relief is critical for funds management businesses which need to acquire shares in their listed parent as part of normal trading by the business' funds (e.g. index funds).

- One of the standard conditions of this relief is that the aggregate interest in shares of a listed company held by its subsidiaries does not exceed 5% of the company's total issued share capital.

- One aspect of all staff share schemes is that they are deemed to give the parent company a "relevant interest" in its own shares through its ability control disposal of shares (e.g. where shares are forfeited). As a result, this cap will increasingly create difficulties for listed companies as they deliver more remuneration in the form of shares. We submit that this cap should be increased with adequate market protection provided through normal substantial holder disclosure disclosures.

Appendix 1

Suggested inclusions in Remuneration Report

- **Executive summary**
- **Remuneration Framework/Policy**
  Description of the remuneration framework, including the key elements, the underlying principles and evolution over time.
- **Remuneration Governance**
  Description of governance framework managing and monitoring executive remuneration, description the Board oversight process, the function and responsibilities of the Board Remuneration Committee, and details of the remuneration approval framework.
- **Remuneration strategy**
  Description of the goals of the remuneration policy and the remuneration arrangements implemented to achieve them.
- **Performance and pay link**
  Description of how performance goals and remuneration strategy are aligned, description of alignment to shareholder goals and discussion of remuneration components and tools used to achieve this. Explanation of how remuneration arrangement are delivering performance outcomes including relevant benchmarking against peers
- **Incentives**
  Discussion of remuneration incentives, structures including
  - fixed remuneration,
  - variable performance based remuneration,
  - delivery and retention of performance based remuneration
  - investment of retained amounts
  - vesting schedules
  - performance hurdles
  - minimum shareholding requirements and
  - significant contractual termination arrangements.
- **Remuneration outcomes**
  Remuneration table for KMPs outlining remuneration *awarded*, including fixed salary, total performance based incentives split by category, for the current and previous year.
- **Non-executive director policy and outcomes**
  Description of the non-executive remuneration policy, details of current and previous year fees and shareholding requirements.