10 Shelley Street
Sydney NSW 2000

PO Box H67
Australia Square 1213
Australia

ABN: 51 194 660 183
Telephone: +61 2 9335 7000
Facsimile: +61 2 9335 7001
DX: 1056 Sydney
www.kpmg.com.au

The Secretary
Senate Economics Legislation Committee
Parliament House
Canberra ACT 2600

Our ref 8023134 Senate Econ Legislation Ltr re Corporation's Act - Exec Remuneration Reform 090717
Contact Andy Hutt 02 9335 8655

17 July 2009

Dear Sir

Executive termination payments reform - comments for Senate inquiry

We refer to the Senate inquiry into the *Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009* ("the Bill") announced on 25 June 2009 and herewith make our submission to this inquiry.

This Bill, by way of its interaction with the Government's proposal for the taxation of employee share schemes, produces outcomes which are likely to diminish the alignment of executive pay with the long term returns for shareholders.

In our view, the Bill as currently drafted will also have unintended consequences for certain employees of listed companies who serve as directors on subsidiary boards.

For these reasons we recommend the following amendments to the Bill.

Summary of recommendations to the inquiry

A cohesive approach to executive remuneration reform

The treatment of employee share scheme ("ESS") income at termination in both the Bill and the Government's proposed amendments to the taxation of ESS income should be consistent with other Government initiatives (for example, the APRA and Productivity Commission reviews) that are seeking to better align executive pay with long term shareholder wealth creation. There are two alternatives available to achieve this consistency:

- The Bill is amended to remove accelerated vesting of ESS income at termination from the definition of "termination benefit"; or
- Amend the draft ESS taxation proposals to remove termination of employment as a taxing point.

Please see Appendix 1 for further details.

KPMG, an Australian partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International, a Swiss cooperative.

Liability limited by a scheme approved under Professional Standards Legislation.

Please see Appendix 1 for further details.

Termination payments to directors of listed company subsidiaries

Application of the Bill should be limited to executives who hold a "managerial or executive office" of the listed consolidated entity.

Termination payments paid to directors of non-listed subsidiary companies of listed entities should not be subject to shareholder approval, unless the employee holds a "managerial or executive office" of the listed consolidated entity.

Please see Appendix 2 for further details.

Deferred bonus arrangements

Further clarification should be provided to enable stakeholders to determine in what circumstances a "deferred bonus" arrangement is not a termination benefit.

Please see Appendix 3 for further details.

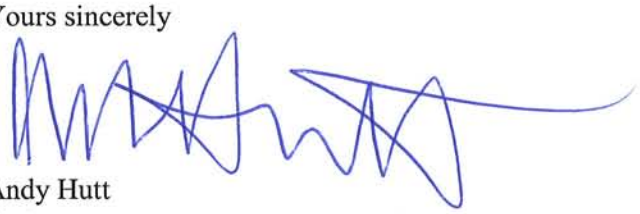
Clarification of the impact on superannuation payments

Draft regulation 2D2.01(1) has caused considerable confusion for employers, in particular those with employer-maintained defined contribution funds. The regulation should be amended to make clear that lawful payments from complying superannuation funds are excluded from being termination benefits.

* * * * *

We would be pleased to further discuss our recommendations with the Committee if required.

Yours sincerely



Andy Hutt
Partner

Appendix 1

A cohesive approach to executive remuneration reform

Introduction

The Australian Prudential Regulation Authority ("APRA") and Productivity Commission ("PC") are currently reviewing the governance framework of executive remuneration. APRA has already published draft standards to apply from 1 January 2010.

In addition, the Government has commenced legislative reform of executive remuneration through the Bill and the proposed amendments to the taxation of ESS income.

Each review and legislative amendment has been carried out with respect to its own individual objectives. The Government needs to co-ordinate a cohesive and holistic approach to the corporate governance and taxation issues of executive remuneration to ensure its desired outcomes are achieved.

Views on the treatment of executive remuneration on termination of employment

The Corporations Amendment (Improving Accountability on Termination Payments) Bill 2009 ("the Bill")

The Bill will require shareholder approval for any "termination benefits" to be paid to a covered executive that exceed one year's base pay.

Under the Bill, the value of ESS entitlements that have been subject to accelerated vesting at termination is included in the definition of a "termination benefit" that is subject to the cap.

Amendments to the taxation of ESS income

Under proposed (and current) taxation law, termination of employment is a deferred taxing point for unvested stock and options held by an executive at the date of termination of employment, regardless of any vesting conditions or disposal restrictions that will continue to apply post termination.

The amount subject to tax will be the tax market value of the share or option on the date that employment terminates.

Importantly, under the proposed legislation to apply from 1 July 2009, termination would only be a taxing point where the shares or options were still subject to a real risk of forfeiture or a genuine restriction preventing disposal. Shares or options that are not subject to these conditions would already have been taxed.

The APRA review

The APRA guidelines recommend that performance thresholds and targets for an employee's variable reward are established prior to the start of the performance period. The measurement period for that performance should be sufficient for the sustainability of the results to be assessed, extending beyond cessation of employment where appropriate.

APRA indicates that any 'payment' under the plan should not be accelerated simply because an employee is terminating employment.

However, in acknowledging that termination of employment represents a taxing point for ESS remuneration, APRA has indicated that it would be acceptable for partial accelerated vesting to occur, to enable the employee to meet any tax liability arising. This produces the perverse outcome of tax rules adversely impacting governance objectives.

The PC review

The PC has not finalised its review of executive remuneration. However, the terms of reference (as provided by the Government) for the review require that it considers 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.

Effect of inconsistent treatment of ESS income at termination of employment

If the Bill and the proposed ESS taxation amendments are enacted as presently drafted, executives will not accept long-term share based incentives as there will be excessive financial risk arising from taxation of unvested shares and options at termination. Executives will seek alternative forms of remuneration which are not taxed until realised. They will not want to have their ability to pay tax on their shares and options be dependent on receiving shareholder approval for early vesting.

We would expect a move towards cash-based incentive plans. These do not align the interests of shareholders and executives to the same degree, as the executive does not hold shares as part of their incentive arrangements.

The choices available to prevent the inconsistencies

Alternative 1

The Bill is amended to remove accelerated vesting of ESS at termination from the definition of "termination benefit".

On termination of employment, this will allow sufficient ESS entitlement to vest so that an employee's tax liability arising at termination of employment can be funded without requiring shareholder approval.

Alternative 2

Amend the draft ESS taxation proposals to remove termination of employment as a taxing point.

Accelerated vesting would not therefore be required to fund an employee's tax burden arising at termination of employment, and performance would continue to be measured over the appropriate period.

The proposed mandatory employer reporting obligations will ensure that an employee's tax compliance obligations are met if and when they become entitled to their ESS income post employment.

Appendix 2

Termination payments to subsidiary directors

Many large listed organisations find it prudent for commercial reasons to run their operations through subsidiary companies. As each of these subsidiary companies is required to have directors, employees of the listed parent company commonly occupy directorships of the subsidiary entities.

In many cases, the directors of these entities do not receive remuneration from the subsidiary company as their directorship is a component of their employment with the parent company.

We have experience of large organisations who employ hundreds of employees who are not "managerial or executive office holders" of the listed consolidated entity, but are directors on subsidiary company boards.

The reduction in the threshold at which shareholder approval is required will cause a significant number of those employees to be subject to the new provisions, including many who are on the Boards of overseas subsidiaries.

Practical implications of the Bill

The combined effect of Subsection 200B(1) and Subsection 200E(1B) in the Bill will require approval by the shareholders of the listed parent company of termination benefits exceeding the cap to be paid to employees who are directors of the subsidiary entity.

If such an employee were to have a long period of service, any benefits to be paid on termination of employment under the company's normal redundancy policy could likely exceed one year's base pay.

There will be no material advantage achieved for shareholders and the wider community from voting on the termination benefits to be provided to such an employee.

The time and administrative costs for organisations of having to comply with these requirements will be significant. For example, the time spent in organising and distributing additional AGM papers would be onerous.

Further, these organisations could experience difficulty in getting employees to serve on the boards of subsidiary companies if this would cause their termination benefits to become subject to shareholder approval.

Recommendation

The Explanatory Memorandum explains that in part, the Bill's intention is to increase the *"range of personnel whose termination benefits can be subject to shareholder approval...to also include senior executives or key management personnel."*

However, the Bill's scope as currently drafted is extensive, as it applies to employees who are not "senior executives or key management personnel" of the listed consolidated entity, but are directors of subsidiary companies whose performance may not be material to overall group results.

The Bill should be amended to ensure that only termination benefits of the managerial or executive office holders of the listed consolidated entity are subject to approval by shareholders of the listed parent entity.

Appendix 3

Deferred bonus

The Bill provides for certain exclusions from the definition of a termination benefit to be outlined in the accompanying regulations. The draft regulations supporting the Bill state that a "deferred bonus" is such an exclusion.

Market understanding of deferred bonus arrangements

Many organisations will operate deferred bonus arrangements, whereby once employees meet specified performance criteria, they do not become entitled to receive payment unless employment continues for a further specified period of time. Such deferred bonus arrangements are commonly used to aid retention of key executives.

Generally, where an employee terminates their employment voluntarily prior to becoming entitled to the deferred bonus, they forfeit their bonus. However, where an employee is made redundant or terminates employment by reason of death or disability, the employee is typically paid the bonus in full or in part on their termination date.

Employees who are made redundant may also receive a bonus after termination (at the usual bonus payment date) that rewards them for performance up to the termination date.

We submit that the above scenarios are both appropriate to regard as "deferred bonuses" for the purpose of the regulations.

The above arrangements can be clearly distinguished from a payment that is received at the time of termination of employment, where performance hurdles for the bonus (over and above ongoing employment) had yet to be met at the time of termination.

Recommendation

Due to the variety of market practices, and the interchangeable use of terminology from one organisation to the next, further guidance should be provided in the extrinsic materials regarding the type of arrangements that would be considered a "deferred bonus" for the purposes of the Bill.

A deferred bonus should include a bonus for which all performance hurdles other than a minimum period of continued service have been met. It should also include a bonus determined after the termination date calculated on the performance of the employee up to the termination date and based on the bonus criteria agreed with the employee at the start of the relevant performance period.