10 minutes on...

2016 Annual General Meeting season – In whom do we trust?

pwc

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Remuneration report voting: it's not just about pay…

This AGM season has seen an increased number of companies receiving strikes; and a slightly higher percentage of votes against the remuneration report. While many strikes can be attributed to particular remuneration practices and decisions, in 2016, more than ever, the remuneration vote appears to have been used as a 'lightning rod' to express broader dissatisfaction with company performance (including alignment with remuneration outcomes) and decisions.

Remuneration is increasingly a crowded domain, with a varied set of stakeholders including management, Boards, shareholders, proxy advisors, regulators, remuneration consultants and government. With increasingly disparate views emerging as to exactly what is 'good' remuneration practice, there is growing distrust developing within this broad set of remuneration stakeholders. And societal discontent on issues such as growing income inequality and the concept of "fairness" is further fueling the remuneration debate. While some may view the current sentiment related to executive pay as a blip, our view is that this will continue to be an ongoing focus until the nature of the conversation changes regarding remuneration, and trust is rebuilt amongst key stakeholder groups.

Trust is a necessary foundation for Boards and Remuneration Committees to be able to make remuneration decisions that are right and just for their particular company, and to design specific and different reward structures that best align to their respective challenges and strategic objectives. Boards should be able to expect that all parties engage openly and constructively in the debate to collaboratively achieve a positive outcome - with all parties taking accountability for their decisions and the supporting engagement. This means, Boards need to treat the engagement process with respect - not just a validation exercise - and similarly should expect accessibility and transparency in return from external parties on whether they support the views of the company or not (surprises tend to breakdown trust).

Are the number of strikes increasing?

		2016	2015
ASX100	% receiving a strike	8%	4%
	Average % vote against rem report	8%	7%
ASX200	% receiving a strike	8%	5%
	Average % vote against rem report	7%	6%

There has been a marked increase this reporting season in the number of strikes against remuneration reports across the ASX200, with a more pronounced increase in the ASX100. There has also been an increase in the percentage of votes against remuneration reports, albeit not as significant. We anticipate that there will be continued greater focus on remuneration decisions given the current environment. This places greater onus on all the players in the broader executive pay ecosystem to engage in constructive conversations as it relates to executive remuneration, and on how this reflects on Australian business more broadly.

What can we learn from this AGM season?

Notwithstanding an increase in the proportion of votes cast against remuneration reports, simply reducing the 'no vote' is not an end to itself. The overarching aim must always be having the right remuneration approach for your company's strategy and success - the same remuneration structure will not deliver success across all companies as there is no single 'best practice' remuneration solution.

The questions companies should be contemplating in relation to remuneration are now much broader:

- **"Why?"** have we made decisions or set pay in this way and how transparent are our decisions and the rationale for those decisions?
- **"How?"** tough are targets and performance assessment (really) and do they genuinely encourage long-term value?
- **"What else?"** should we take into account in making decisions, outside of any mechanistic remuneration framework and how should we apply our judgement?
- **"Who?"** should we speak to and **"When?"**, with greater emphasis on early and open engagement.
- And finally **"Will this decision enhance or erode trust in our business?"**

We have observed more 'no' votes - strikes and proportion voting against remuneration reports.

Same, same but different?

Last year we flagged that companies received poor voting outcomes from three key areas:

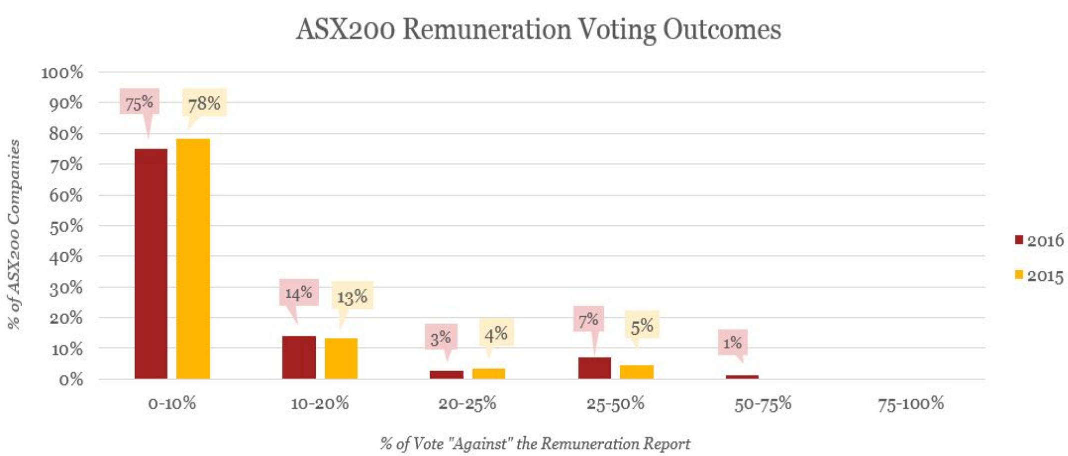
- Poor STI disclosures
- Selection of performance hurdles and reasonableness of stretch in targets
- Pay and performance relationship including adjustments / discretion / significant quantum / one-off payments.

This year, the same issues have been raised again; and with a seemingly heightened focus on non-financial metrics, quantum and one-off payments.

Second, third strikes?

A strike at successive AGMs triggers a vote on a Board spill where all Board members may be replaced. A spill resolution is passed if at least 50% of shareholders vote in favour.

- There have been no second strikes in the ASX200 this reporting season
- A number of companies outside the ASX200 received a third successive strike (e.g. UGL, Mortgage Choice, Reckon); however this is equivalent to a 'first' strike as the count is reset after a spill resolution is presented to shareholders.



Company (ASX 200)	*% vote against*
carsales.com Limited	55%
Commonwealth Bank of Australia	51%
Mineral Resources Limited	49%
Goodman Group	39%
AGL Energy Limited	37%
Spotless Group Holdings Limited	36%
Spark Infrastructure Group	34%
Sims Metal Management Limited	32%
Metcash Limited	30%
Woodside Petroleum Limited	28%
Bellamy's Australia Limited	28%
CSL Limited	26%
Boral Limited	26%

Concerns on transparency and the pay and performance link continue, with increased scrutiny on non-financial metrics, quantum, and one off payments.

	Shareholder / Proxy Adviser concerns	*Our view; and what companies should consider*
Clarity and transparency of disclosures	• Lack of transparency in disclosures for external stakeholders to independently validate whether executives have been 'paid for performance'. • Insufficient disclosures, particularly relating to performance measures, weightings, thresholds, targets and multipliers of STI. • Lack of rationale behind payments contributes to increasing cynicism of appropriate assessment of performance.	• The divergence between how executives, Boards, and external stakeholders define performance is exacerbated where there are opaque disclosures. • Improvements in transparency should mainly focus on the linkages between strategic drivers, company performance, and remuneration outcomes. • Irrespective of disclosure, a clear rationale is needed for the use of incentives and how 'performance' is defined that is company specific. • Transparent and detailed disclosure of the expected and actual performance allows companies to address cynicism of the stretch in incentives. • Where details can be disclosed without breaching commercial sensitivity, a higher level of transparency is encouraged.
Perception of inappropriate outcomes	• Increases to fixed remuneration, including where new CEOs are paid higher than predecessors, and where increases appear misaligned to company performance. • Bonuses that have been paid at or above target, despite a view that the company has performed poorly (i.e. decline in profit or share price), or even just a lack of variability in line with minor variations in performance. • Use of underlying measures particularly where this creates a divergent experience from shareholders - sometimes suspected as being used to "shield" executives from the real costs borne by shareholders. • The grant of equity seen to offset the gap between Australian and international markets, or to compensate executives for losses due to dilution around a capital raising.	• Demonstrate pay restraint in response to stakeholders' concerns such as: - minimal or no increases to executives' fixed pay and / or non-executive director fee - showing accountability over taking a holistic view on pay for performance (e.g. foregoing the payment of STIs to executives following a write-down of assets, despite achievement of a number of other KPIs). • Provide clear rationale for any fixed remuneration (or total remuneration) increases that is company specific, not generalised to market movements. • Clearly articulate upfront (i.e. before the fact) how performance is defined - especially if this differs from statutory or shareholder expectations. • Demonstrate variability in reward outcomes especially as it relates to STI payments. • Where implementing equity-based plans which are different to the current market norm, the Board needs to consider the appropriateness of any model on a case-by-case basis - with consideration of company, industry and circumstances - and provide clear rationale and an explanation of quantum to give stakeholders comfort that this is in the best interests of the company.

Concerns on transparency and the pay and performance link continue, with increased scrutiny on non-financial metrics, quantum, and one off payments (cont'd).

	Shareholder / Proxy Adviser concerns	*Our view; and what companies should consider*
One-off payments	• One-off payments such as retention or sign-on bonuses are often seen as a way to supplement reward for executives. • A lack of transparency and disclosure of the latter has fueled concern.	• Only use one-off payments in rare circumstances, and clearly articulate the rationale. • Adopt a detailed policy underpinning the specific circumstances in which one-off payments could be made. • Hurdled equity is preferable to cash so that some performance element remains.
Non-financial measures	• Correlation to shareholder value is ambiguous and difficult to evaluate. • Some measures are perceived to be part of an executive's day job (e.g. engagement, succession planning, culture). • Lack of rigour and transparency of disclosures lead to a view that they are being used to underpin 'soft' performance or to bolster executive pay.	• Consider the difference between 'hard' and 'soft' non financial metrics (e.g. customer and safety measures can be key lead indicators of delivering shareholder value associated with quantifiable targets where stretch can be demonstrated vs. activities such as 'succession planning' that may be considered more part of the job). • Consider reducing the weighting on non-financial measures in the STI that are not critical to the strategy, or implementing financial gateways to prevent STI payments being made for achievement of non-financial KPIs despite unsatisfactory financial performance. • Where non-financial metrics are used: - Explain the rationale and how this is aligned with long-term shareholder value creation - "Over-communicate" their definition and measurement to enable transparency - Articulate the stretch in metrics - Be confident to apply upside and downside to associated performance assessment and outcomes.

With scrutiny of executive pay and pay inequality increasing the threat of further pay regulation abroad, the time for Australian companies to listen is now.

The UK state of play on pay regulation

A number of high profile UK FTSE100 companies garnered substantial 'no votes' against their remuneration reports at their 2016 AGMs.

However overall, there was only a small drop in support for remuneration policies across the FTSE100 in 2016 with, on average, 92% of votes cast in favour of remuneration policies (2015: 96%). The reasons for no votes were consistent with the themes seen for ASX companies, such as: misalignment between pay and performance; poor disclosure of targets on which pay outcomes were based; use of discretion to adjust vesting upwards; and perceived excessive quantum.

The 2016 UK AGM season occurred against the backdrop of executive pay and wealth inequality entering the political spotlight - with UK Prime Minister Theresa May announcing a raft of potential pay reforms in July.

These initial thoughts have since been watered down, with the UK Government's recent Green Paper excluding May's initial proposal that workers be given a seat in the boardroom, and only including a broad requirement that "all or some elements" of executive pay be subject to an annual binding vote (i.e. potentially limited to only variable pay)[1]. Other key executive pay reforms detailed in the Green Paper include introducing stronger consequences for companies losing the annual advisory vote, and requiring companies to set an upper threshold for total annual pay to trigger a binding vote.

Proxy advisor regulation in the US

Proxy advisors have been targeted by lawmakers in the US, with the US House Financial Services Committee introducing a draft bill in June 2016 - ***Proxy Advisory Reform Act of 2016*** - to tighten regulation of proxy advisory firms.

The principal aim of the draft legislation is "fostering accountability, transparency, responsiveness, and competition in the proxy advisory firm industry". Key provisions will require proxy advisors to:

- register with the Securities Exchange Commission and certify that the firm has adequate financial and managerial resources to provide services
- provide issuers with sufficient opportunity to review draft recommendations and present details to the individual responsible for the recommendation
- employ an ombudsman to receive and respond to complaints about the accuracy of voting information used in making recommendations.

The proposed legislation comes in the wake of recent criticisms of proxy advisors:

- the perception that some institutional investors (typically smaller investment funds) largely default their proxy voting decisions to advisors, instead of using their research as an input
- inaccuracies in proxy advisor research identified by companies
- apparent conflicts of interest where some proxy advisors also provide consulting services to issuers.

Implications for Australia

The threat of further pay regulation in the US and UK undoubtedly has implications for Australia, with 'fairness' of remuneration outcomes a topic increasingly being covered by our local media. Rebuilding trust and ensuring appropriate self-regulation across the broad set of executive remuneration stakeholders is paramount to minimise the risk of further pay regulation in Australia. We will watch these regulatory developments with interest.

In the meantime, we believe that trust can be enhanced by the following principles and actions:

- Stakeholder engagement is key - to be done early and with a mindset for all parties to genuinely listen whilst openly and constructively seeking to find solutions that work
- Companies have a responsibility to be transparent on the "why" of decisions on performance metrics, targets and assessments - the 'what' is insufficient to allow stakeholders to draw fair conclusions on the pay and performance link
- Complexity and ambiguity of remuneration frameworks is not helping to alleviate cynicism and mistrust - simplification of executive remuneration and the resulting greater understanding will help
- Executive shareholding is the best way to align executives and shareholders and can help rebuild trust via a shared experience
- Decisions on quantum need to be taken in light of broader company and market context (not just what the standard peer group is paying). Stakeholders are now asking - "how much is too much"? Pay restraint is the new norm and so decisions outside the norm need to be carefully considered, and well communicated.

1. Department for Business, Energy & Industrial Strategy, Corporate Governance Reform: Green Paper, November 2016

How can PwC help?

To have a deeper discussion about these issues, please contact:

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