Feature

TWO STRIKES AND...

A number of companies faced their first protest vote on executive remuneration last year. The onus is on companies to address this issue before the 2018 AGM season.

By Ben Power

After relatively few strikes in 2017, companies appeared to be improving disclosure, pay structure and engagement. But 2018 was a horror year for strikes.

Major companies, including AMP, Harvey Norman, National Australia Bank, Telstra and Westpac, suffered strikes – in which more than 25 per cent of the share register voted against their remuneration reports. Time will tell if companies suffer a similar fate this year.

The two-strikes rule was introduced in 2011. Under the rule, if shareholders vote down a company's executive remuneration package two years in a row, the board may be voted out of office.

Proxy adviser ISS Australia's latest *Proxy Season Review 2018* saw a record 26 companies in the S&P ASX 300 index record a strike, a significant increase on the 11 companies that received a strike in 2017 and the 18 companies that got a strike in 2016. There were also a high number of near misses, that is, votes against remuneration reports of between 20 per cent and 25 per cent. Within the ASX 100, strikes spiked from just two in 2017 to 11 in 2018, although strikes were reasonably high in 2016 as well. For many companies, the 2018 strike was their first.

"Last year was definitely an aberration in the context of the proxy seasons we have seen so far," says Morrow Sodali's director of corporate governance, Jana Jevcakova. "But there's a chance this will become the new norm."

Companies are keen to avoid another shareholder pay backlash in 2019. That will require a complex juggling act to balance shareholder and regulatory concerns. To placate shareholders, they will need to avoid excessive payments after poor performance and pay structures that are overly focused on the short-term.

Issues management

Two factors helped drive the 2018 pay backlash. The first was companies' determination to award bonus payments, despite shocking governance failures and under-performance.

Banks were among those that suffered the largest number of votes against their remuneration reports amid the fallout from The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

ANZ, National Australia Bank and Westpac each recorded strikes after they awarded bonuses despite Hayne's revelations. A total of 88.42 per cent of NAB shareholders voted against its remuneration report – the largest no vote ever.

"We have been pretty public about our disappointment with the three banks – ANZ, NAB and Westpac – awarding very significant bonuses to their CEOs last year, given the year that had transpired and all that had come out in the royal commission," says ACSI chief executive officer, Louise Davidson.

"We were disappointed boards didn't exercise a stronger level of discretion on bonuses, which indicated boards were out of step with community and shareholder expectations. You saw that reflected in the magnitude of the votes."

AMP, one of the worst-hit companies from the Hayne royal commission, and QBE also received strikes.

But it wasn't just governance failures and underperformance that angered shareholders. They also objected to the emergence of new pay structures that amalgamated short-term and long-term incentive plans.

As ISS noted, 2018 saw an unexpectedly large number of companies propose combined incentive plans, which allowed all bonuses to be awarded on one-year outcomes.

Morrow Sodali's Jevcakova agrees this was a major contributor to strikes and high no votes against the likes of AMP, JB HiFi, NAB and QBE. In total 21.7 per cent of JB HiFi's shareholders voted against its remuneration package, which did not constitute a strike.

"A problem is deferred equity that is no longer subject to long-term performance," Jevcakova says. "Those that had combined incentives, where there's no long-term hurdles, typically received a strike or high vote against," she adds.

Meeting the market's concerns

Many companies have moved to address governance failures that helped drive the remuneration backlash, largely through board and management renewal.

Following Hayne's revelations, AMP's chief executive Craig Meller, and chairman Catherine Brenner, along with three directors, left the company. NAB's chairman, Ken Henry, and its CEO, Andrew Thorburn, also departed. Companies are also moving on bonuses.

NAB has said it is looking at how to revamp its pay structure to improve culture. NAB's chief customer officer of consumer banking, and former NSW premier, Mike Baird, recently said the bank had to respond because the pay structure had led to poor outcomes.

AMP has also announced it has scrapped short-term bonuses and cut directors fees to avoid a second strike, after chairman David Murray recognised 2018's strike was a vote against the company's misdeeds but also how the company awarded pay.

Shareholders still want more action around pay structures, including combined incentives.

"I would expect more strikes if the status quo remains and companies don't do anything to the structures we currently have," Jevcakova says.

General manager of proxy advisory firm CGI Glass Lewis, Daniel Smith, says the combined incentive schemes are an interesting innovation, but there's a risk they could encourage a short-term focus.

"Shareholders should be looking for evidence short-term targets are sufficiently stretching, there is an appropriate haircut in opportunity, and whether a material portion of awards are subject to rigorous longer-term performance metrics," he says.

Jevcakova says combined incentive plans are the root of the problem. Those with traditional incentive schemes face a discrepancy in how investors and companies view bonuses or short-term incentives.

Investors view awards as something to be paid for out-performance or superior performance. "But if you look at some remuneration reports and talk to some companies, that's not how they see it," Jevcakova says, adding some companies are awarding bonuses for simply getting the job done. In some cases, annual target incentives are being reduced if they weren't set in line with expectations.

"That's one of the reasons why companies are getting high votes against," Jevcakova adds. "There is a perception on the investor side bonuses are pretty much a guaranteed variable remuneration rather than at-risk remuneration."

Jevcakova says another focus in 2019 will be on the outcomes remuneration structures generate. "Structure itself is very important," she says. "But most investors will be scrutinising the outcomes these structures generate for executives. If investors are not satisfied these outcomes are very clearly and closely aligned to what the company has achieved during the year, but also the longer-term, then they're more likely to vote against it."

Illustrations by Angelo Vlachoulis

Over and above shareholder concerns, companies, particularly the banks, are facing further complexity amid the fallout from the royal commission and a push by regulator the Australian Prudential Regulation Authority (APRA) to influence remuneration structures.

Act now

All listed companies must review their remuneration structures in light of the royal commission.

"Most recommendations from the royal commission can be broadly applied," says Davidson. "All sectors should be looking at what they can learn."

One emerging issue is the inclusion of non-financial issues, or soft targets, which Hayne recommended, but which are opposed by big investors who want a focus on shareholder returns.

APRA has now weighed into the debate, with chairman Wayne Byres telling media bank remuneration should be based on a, "genuine and even balance of financial and non-financial considerations." He says less than 25 per cent of executive pay should by driven by shareholder returns so management is more focused on customer service.

In its proxy season review, ISS Australia agrees non-financial targets are looming as a major issue for directors setting remuneration in the wake of Hayne. It notes that, in response to the royal commission, some directors have suggested boards, "eliminate or substantially reduce the weighting of financial targets as a determinant of the bonus pool."

But ISS Australia says that is impractical and inconsistent. Shareholders, instead, may expect a two-step bonus structure as an appropriate response to the royal commission. This would involve a requirement to achieve financial targets and objectives and, "that appropriate risk management, compliance, conduct and governance objectives must be assessed by the board to have been met."

Smith says given the difficulty of measuring many non-financing metrics, a prudent approach may be for boards to use their discretion to determine performance in these areas, but only to dial down pay outcomes.

There's no certainty that creating the right remuneration structure will prevent strikes in a climate in which investors are becoming more activist and using the two-strikes rule to punish companies.

"The two-strikes rule was supposed to be a way of focusing boards on being accountable for executive pay," says law firm MinterEllison's head of remuneration governance, Jonathan Finlay. "But it's being used by institutional shareholders to send a message they have issues with performance or strategy – for any reason at all."

Davidson says her organisation doesn't use remuneration reports to protest. "We vote on the remuneration," she says. "But you have to understand, if it's a year when a company's performance has been poor, and remuneration outcomes for the key executives don't reflect that, we will vote against [the remuneration report]."

Activist investor Sandon Capital's founder and MD Gabriel Radzyminki says his fund does use remuneration reports to lodge protests.

"That's part and parcel of being a listed company. It's our way of expressing displeasure about things the company has been doing. We definitely use it for that. It manifests itself as, yeah, we think remuneration is at odds with what the company should be doing. Sometimes it can be issues of strategy."

Investors' use of the two-strikes rule as a protest vote is likely to continue in 2019, although Morrow Sodali's Jevcakova says she is noticing a change. "What we're starting to see is investors changing their focus from remuneration to directors," she says. "If they're not satisfied with any aspect of company performance, they are more likely to go against individual directors who are up for re-election rather than vote against the remuneration report."

Amid this complexity, companies must actively engage with shareholders to navigate a path forward.

"Companies that want to improve their remuneration report voting outcomes are engaging with institutional shareholders, especially those who voted against [the remuneration report], discussing the issues and genuinely taking on board constructive feedback. Simple as that," Finlay says. "On the company side the engagement needs to be by appropriate board members and, on the investor side, it should be those who cast the votes. Not those who buy the shares."

Fortunately, the two-strikes rule has led most large companies to boost engagement between market participants.

"The two-strikes rule has been clunky," Smith says. "But it has demonstrated a benefit in that it has encouraged more engagement and interaction between investors and companies, especially boards. Those discussions aren't limited to remuneration, although the topic of remuneration may be the focus. That board accessibility to shareholders is quite valuable."

Smith, however, warns engagement is not a panacea. "Better engagement can reduce the risk of surprises and miscommunication, but sometimes shareholders have a fundamental disagreement with the course the company has charted, and no amount of dialogue will rectify that."

The major banks are already actively engaging with shareholders ahead of this year's proxy season.

"They're contacting top shareholders and their proxy advisers to gauge the appropriate way forward," Smith says, adding these are initial discussions at this point. He says it is too early to tell exactly how banks will react in terms of pay structure.

"We don't want to dictate how the banks run their business," Smith adds. "What we encourage them to do is have constructive dialogue with shareholders who are in a better position to influence them on any changes that should be made."

Smith says symbolism is important. He notes of the major banks, only CBA avoided a strike in 2018.

He says CBA was the only big four bank that slashed its CEO bonus to zero, and it showed a remarkable amount of public contrition during the royal commission and around it.

"The lesson learned for directors is the importance of symbolism," Smith says. "Executive remuneration is just as much a signalling device to the market as it is a motivator or retention tool."

ASX companies are encouraged to keep this in mind as AGM season draws near.