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THE KMP REPORT

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AGM Reporting Season 2016

Proxy Advisor and Institutional Investor Views

Contents

We welcome your comments on the report and trust you will find it to be informative and thought provoking. For Board Advice, please call Egan Associates on 02 9225 3225 or **email us**.

Introduction

As the AGM season approaches and annual reports are avidly perused by proxy advisors and institutional investors alike, Directors will be engaging both proactively and reactively to explain their remuneration and corporate governance decisions.

In order to achieve the best results for their engagement, **Directors are best advised to understand their share register** - not only where the investments are coming from, but also whether the asset managers making those investments will be responsible for voting on resolutions at the AGM, or whether their vote will be taken by an overarching body or the owner of the funds being invested. It is Egan Associates' understanding that the asset manager will often not vote themselves, although their opinions will be taken into account by the voting entity. **Some international investors may default to decisions made by large international proxy organisations such as CGI Glass Lewis and ISS.**

Details on how the relevant organisations make voting decisions are found in their proxy voting policy. As in prior years, Egan Associates has summarised the views found in the policies and guidelines of select proxy organisations and institutional investors. This year we have broadened our remit to include a larger group of investors, considering the policies of top Australian and global organisations.

> **Boards deserve leeway to implement the best remuneration and governance systems for their company, yet this leeway only lasts as long as performance continues.**

The focus on this document is remuneration and board composition. It does not detail views on issues such as share buybacks, poison pills, shareholder rights, mergers and acquisitions etc, though the voting policies also deal with these issues.

2015-2016 AGM Focus

Egan Associates recently attended an event where key proxy organisations discussed their focus areas going into the AGM season.

Director performance and Board accountability was one key theme. If a company is not performing, voting organisations will consider whether the Board as a whole and the Directors as individuals deserve shareholders' trust to have stewardship of the company. In particular, organisations will be looking for **Board renewal**, including the appointment of Directors that enhance the Board's diversity as well as skill set. **Workload** is another key factor, as voting organisations consider whether Directors have the capacity to carry out their duties in a thorough manner.

In general, performance will have a significant effect on investor and advisor decisions. If things are going well with a company, proxy organisations are willing to be lenient if the company has not adopted what is considered to be best practice. Yet if companies are not producing the results expected, voting organisations will be critical of such divergence.

As always, voting organisations will be looking to see whether remuneration aligns with performance and **will come down heavily on "pay for failure".** Disclosure has also become very important, with many voting organisations considering that if they don't know what a company's practices are, they are unlikely to reflect good governance. In particular, a number of organisations will be monitoring **disclosure of performance metrics** this season. There will also be significant attention on **whether targets chosen are sufficiently demanding** and do not reward business as usual behaviour.

There appears to be increasing recognition that Boards deserve leeway to implement the best remuneration and governance systems for their company, yet this leeway only lasts as long as performance continues and remuneration outcomes follow a consistent, transparent process. Voting organisations prefer it if incentive plans are designed so they will in most cases be independent of Director Intervention, with **discretionary decisions likely to be inspected very carefully**.

In terms of engagement, generally voting organisations are happy to hear from companies that want to talk proactively about their remuneration and governance initiatives to ensure that there are no misunderstandings, especially if Boards believe there is an issue that could become a flash point. Some voting organisations, on the other hand, believe communications are best conducted in the public eye and that they would rather not be receiving information that the market does not.

Remuneration

After reading the voting policies of a number of organisations, it has become clear that although proxy organisations will have expectations and particular pressure points, **they are willing to accept non-standard remuneration structures** as long as these structures are accompanied with adequate explanation of the rationale behind them.

In the words of CGI Glass Lewis:

> *These guidelines are founded on the premise that institutional investors have no objection to rewarding highly successful executives, but take great exception to high levels of remuneration being paid for average or below average performance.*
>
> *Each listed company should design and apply specific remuneration policies and practices that are appropriate to the circumstances of the company and, in particular, will attract and retain competent executives and other staff and motivate them to grow the company's long-term shareholder value.*
>
> *Where those specific policies and practices are consistent with best practice, CGI Glass Lewis will support the company's approach without further explanation by the company. If those specific policies and practices depart materially from best practice, we will likely not support the company's approach unless the logic for those departures is transparently addressed and cogently explained in the remuneration report, notice of meeting leaflet or other relevant public disclosure.*

JP Morgan Asset Management states:

> *Policy in this area cannot easily be prescribed by any code or formula to cater for all circumstances and must depend on responsible and well-informed judgement on the part of remuneration committees.*

Important is that the necessary information is provided in order for investors and advisors to make their judgements, particularly when it comes to linking the company's performance with remuneration, as this will enable interested parties to determine whether incentive plans have been correctly chosen or are working as intended.

Companies should also recognise that **disclosure will not always be taken at face value**: a number of organisations such as CGI Glass Lewis and ISS will conduct their own calculations to decide whether payments have really been made for performance.

Issues that will be examined when considering a vote on the remuneration report include:

- Financial performance and alignment of remuneration with shareholder returns over the long term
- Link between performance and pay, and whether there has been pay for "failure"
- Whether performance pay is for business as usual or for outperformance
- Total quantum of remuneration
- Proportion of remuneration that is in cash
- Base salary increases and quantum relative to peers and the workforce
- Peer selection and benchmarking
- Choice of appropriate, demanding STI hurdles and adequate disclosure of those hurdles
- Choice of appropriate, demanding LTI hurdles and adequate disclosure of those hurdles
- Performance hurdles that are contrary to the long term best interests of shareholders
- Retrospective changes to performance hurdles and/or start dates
- Retesting
- Allocation using Fair Value
- Board discretion
- Retention and Sign on payments
- Excessive Termination Benefits
- Executive and Director Minimum shareholdings
- Incentive payments to NEDs
- Whether grants to Directors have been brought to a shareholder vote
- Excessive complexity of remuneration structures that would fail to motivate executives
- Independence and effectiveness of the remuneration committee
- Ignoring remuneration concerns that were communicated following the prior season
- Adequacy, quality and readability of disclosure

The following sections will discuss these issues in more detail.

Fixed Remuneration

Investors and proxy organisations acknowledge that executives are **entitled to a basic salary that is set with reference to the market**, within reason. Blackrock uses the median of the company's market cap peer group as a guide. If remuneration is significantly higher than peers without a cogent and disclosed reason, CGI Glass Lewis considers this a red flag.

Vanguard Investments expects that the Board should rationalise the selection of peer companies based on relevant business metrics, particularly when including firms in other industries.

> **There is awareness ... that any increases to fixed remuneration will entail an overall lift in remuneration.**

JP Morgan Asset Management likes to **reference the remuneration of the company's workforce and the annual**

increases to the workforce's remuneration in its decisions as to whether an executive's remuneration is reasonable. It doesn't believe that large fixed remuneration increases should be utilised as a retention mechanism and expects that any substantial increases, for example in the case of a promotion, should be justified to shareholders. ISS will also be watching for retention-driven fixed pay increases. The Australian Council of Superannuation Investors (ACSI) opposes fixed pay increases which simply represent a 'catch up' for executives following a pay freeze or that purely reflect an increase in the market capitalisation of the company.

Credit Suisse, which does not recommend voting positions, but raises red flags for investors using a traffic light system, will flag increases to **fixed remuneration that are over 5%**, which are currently above inflation and the increases received by the average worker. It is also sceptical of companies that benchmark themselves against companies of higher market capitalisation due to perceived complexity in the business, companies that pay their executives above the 50th percentile of their peer group, and companies that increase fixed or performance pay due to their operation in particular overseas markets. Credit Suisse is concerned that the latter practice leads to increases among the whole peer group, since it is unusual for companies to remove other companies from their peer group that have international operations.

There is awareness across investors and proxy organisations that **any increases to fixed remuneration will entail an overall lift in remuneration**, as bonuses and long term incentives are generally linked via a multiple to fixed remuneration and any large increase to the latter will significantly boost total remuneration.

In its report on its voting record of the last season, AMP Capital revealed that it is concerned about the total quantum of CEO pay. **It does not believe that CEOs deserve double to triple the remuneration of their reports**. It believes that global benchmarking and peer comparison has created a persistent cycle of high pay, whether or not the executive's role or the value they have added warrants it. AMP Capital encouraged Boards to truly consider the value executives will provide and not be afraid to award an incoming CEO with a lower total reward than their predecessor.

Similarly, Vanguard Investments notes:

> *Executive pay, no matter how it is designed to reward performance, should always be reasonable on an absolute basis and should not duly dilute public shareholders' interests.*

In order to be better able to understand the total quantum of executive pay, CGI Glass Lewis is in favour of having the "actual" or realised pay disclosed, even though this is not a requirement in either legislation or the ASX Corporate Governance Principles and Recommendations.

Bonuses

A common thread between proxy advisor and institutional investors is that they **disapprove when a bonus is paid and performance is poor**, unless cogent explanation is provided.

Some organisations will raise a red flag if there is a **lack of variability in bonus outcomes** over time and across executives. Unless there has been exceptional performance, the consistent payment of "above target" bonuses over many years raises the possibility that incentives are not at risk.

Disclosure is also important – Most organisations want to know what level of performance was achieved and what the performance targets were. If hurdles are not disclosed in the year to which the performance relates (preferred), it is expected that the hurdles will be disclosed retrospectively. If there is no disclosure, at the very least a reason for the lack is expected. Egan Associates understands that under disclosure of metrics for STI is one of ISS' flashpoints for this season.

Hurdle choice will go under the microscope. Credit Suisse dislikes hurdles based on revenues, as they may reward sales over profitability. AMP Capital has concerns with performance conditions (for annual bonuses or long term incentives) that reward actions such as acquisitions that may accrue debt but not necessarily deliver value, a view that is shared by ACSI and Credit Suisse. Although the Australian Shareholders' Association (ASA) doesn't believe executives should receive STI at all, preferring a mix of cash and LTI, if there is STI it **prefers the majority of the award to be based on financial performance metrics rather than non-financial metrics**. This is a common preference among voting organisations, as non-financial hurdles are often difficult to measure and disclose.

> **Unless there has been exceptional performance, the consistent payment of "above target" bonuses over many years raises the possibility that incentives are not at risk.**

In terms of quantum, Vanguard Investments stated that it likes the maximum level of a bonus to be expressed in dollars. It then judges whether the bonus is excessive relative to peers and in absolute terms. JP Morgan Asset Management prefers that the STI have a maximum rather than be uncapped. This is the case for most large Australian companies, with only a very small number providing an uncapped opportunity.

Ownership Matters will watch the amount of executive pay that is delivered as cash, stating that **cash insulates the executive from the risks borne by shareholders**. Deferral of bonuses into restricted shares is generally seen favourably (with 50% deferred for two years preferred by some organisations), as is malus or clawback, although not all organisations express the belief that these features must exist.

Long Term Incentive Plans

Most institutional investors and proxy organisations provide companies with flexibility as to how they structure their long term incentive plans, holding the view that Directors generally know their companies best.

Vanguard Investments has a succinct explanation of what it expects:

> *Incentives should be structured to reward relative outperformance, as opposed to a general rise in equities prices or other market-wide trends, over the course of a business or product cycle that is relevant to the company.*

Detailed information on expectations is contained in the following subsections, which if applicable should each be addressed in annual disclosure.

Plan vehicle

While cash long term incentives can be poorly regarded since equity is considered to better align executives with shareholders, there is not much discussion in proxy guidelines on which incentive vehicles are preferred. The terms of loan backed share plans may receive scrutiny. For these, CGI Glass Lewis expects loans to be interest free and non-recourse.

Vesting Term

Currently, most leading Australian companies have **three-year vesting terms** for long term incentives. Most institutional investors and proxy organisations expect the vesting term to **match the natural business cycle of the company**; however, short vesting terms that are less than three years can be regarded in a negative light. JP Morgan Asset Management prefers vesting terms that reach five years and the Australian Shareholder Association also prefers five-year vesting terms, but expects at least four.

> **There is an expectation held by many organisations that below median performance should not lead to any vesting of reward.**

Blackrock notes that it is acceptable for companies operating in the retail sector to have a performance period of less than three years, since fast turnover of stock is essential. In cases where a performance period for a long term incentive is less than three years it expects a companies to provide a clear explanation for the short performance period and how it fits with long term strategy.

The Australian Council of Superannuation Investors, among others, prefers **equity awards to be made on an annual basis** and in tranches, rather than occasionally and in a single batch.

Vesting schedule

Cliff vesting is not well regarded, with a sliding scale vesting schedule preferred. There is an expectation held by many organisations that **below median performance should not lead to any vesting of reward**. JP Morgan Asset Management goes further to say that rewards for at-median performance should be modest. Previously, it was normal for companies to have 50% of a long term incentive award vest when median performance has been reached, but there are now companies that are choosing a lower level of vesting for median performance, such as 20% or 30%.

Restriction after vesting

Vanguard Investments prefers shares gained through the exercise of options to be held for a period. Fidelity International and JP Morgan Asset Management also prefers share to be mandatorily retained after vesting. The ASA requires deferral of some part of any LTI award for two years after the shares have vested. ISS prefers restrictions on vesting if the performance period is less than three years.

Performance hurdles

A lack of performance hurdles on long term incentive plans is generally regarded poorly. Some voting organisations, such as ACSI even take issue where there are no performance hurdles for options grants that have a premium exercise price. Exceptions can be made for smaller companies that are in exploration or development stages.

Over the last couple of years, there has been a perception among Boards that investors and proxy advisors expect them to follow a formula on long term incentive performance hurdles, with those who do not follow the formula likely to suffer an adverse vote against incentive grants or the remuneration report. While this may have been and may still be the case for some voting organisations, **there has been increasing recognition from investors and advisors that companies benefit most from having hurdles that suit their situation.**

The Australian Council of Superannuation Investors, for example, adopted into its most recent guidelines this sentiment:

> *Rather than adopting what is seen as an 'acceptable' measure, Boards should always aim to select the most appropriate hurdles for the company – be they market-based measures or internal returns-based performance metrics.*

CGI Glass Lewis similarly states:

> *CGI Glass Lewis expects performance hurdles to be consistent with the nature, maturity or strategy of the company.*

Notwithstanding this, **each voting organisation will always have certain performance measures that will raise a red flag** unless the rationale for their adoption has been adequately explained.

Credit Suisse believes performance hurdles should not reward outcomes that are outside the executives' control. AMP Capital and the ASA prefer hurdles that measure the company's performance against a group of peers. Fidelity International expresses a similar view, stating that hurdles should incorporate a combination of absolute and relative return targets and have a direct linkage with share price performance. The ASA goes further to note that it prefers two hurdles, one of which should be relative total shareholder return.

Relative Total shareholder return has been very popular in recent years, due to the view that it is an objective measure that aligns executives' benefits with shareholder returns. Its popularity has suffered more recently for a number of reasons. One issue is that **it can reward executives when their company has outperformed its peer group despite the absolute total shareholder return being negative over the performance period** – this is a red flag for the ASA, which expects that no incentive should be paid if shareholders experience negative TSR in nominal terms of the performance period. Another issue has been concern over its efficacy as a motivator. CGI Glass Lewis and Macquarie Securities released research in 2015 that found the use of relative TSR neither drives outperformance nor incentivises behaviour, undermining its utility other than to facilitate alignment with shareholder outcomes. Measures such as ROE or EPS performed better in the research. CGI Glass Lewis therefore expects companies to explain the rationale behind using a relative total shareholder return hurdle and any mechanisms that will be used to prevent excessive vesting in years of poor shareholder experience.

ISS, on the other hand, states that generally a relative total shareholder return hurdle is preferable to absolute share price hurdles or accounting measures of performance such as EPS. It notes that **absolute share price hurdles can reward executives in a rising market even if their company does relatively poorly**. Also, if the grant has a long life, even if the share price hurdle is set at a significantly higher level than the prevailing share price, it may not be particularly stretching. ISS' concern with accounting hurdles is that they **do not necessarily improve shareholder value before the incentive vests.** It noted, for example, that growth in EPS may, but does not always, translate into a material increase in share price and dividends over the medium to long term. ISS is more supportive of

Hurdle quick guide

Relative TSR

- Aligns executives with shareholders
- Can reward companies for relative performance even if the absolute TSR is negative
- May not motivate executives as effectively as earnings hurdles

Absolute TSR

- Only pay out when shareholders have received value
- May reward executives for a rising market

EPS Growth

- Good line of sight for executives
- May not lead to an increase in shareholder value before vesting
- Can be manipulated
- Statutory rather than underlying results preferred

Non-financial Targets

- Can provide guidance on company direction
- Concerns about transparency. Disclosure is important
- Some non-financial hurdles may be considered as what is expected in "business as usual."

EPS hurdles if they are applied to options rather than performance rights, since options will have an inbuilt share price hurdle.

Blackrock prefers companies to avoid EBITDA hurdles, since EBITDA can be increased in the medium term through acquisitions that ignore debt and quality of acquisitions.

When considering earnings hurdles, institutional Investors and proxy advisors are **very sceptical of companies using underlying results** to calculate their performance measures, believing that they ignore real costs to shareholders. Statutory results are preferred, although Blackrock believes underlying measures are appropriate where there is an element of revenue or expense which may be outside the influence of management. **There is also recognition that accounting based measures such as EPS can be manipulated**, which puts certain executive behaviours under the spotlight when these measures are implemented.

Some organisations, such as ISS, can be **wary of non-financial targets**, holding the view that certain non-financial targets, such as safety or diversity, should be part of doing the job correctly. Strategic targets, on the other hand, can provide valuable information about a company's direction. However, there is concern that for such targets disclosure is often poor.

Operational hurdles such as discovery of mining reserves or production targets are more readily supported by ISS if they are applied to options to provide more alignment with a tangible increase in shareholder value.

Peer Group

When using relative performance hurdles, the choice of peer group is important. **Cherry-picked peer groups are not well regarded and peer groups that are too broad (such as the ASX 200) may also attract censure**, as the company will be measured against others which have differing business cycles and risk profiles.

Target setting

It is a general expectation that performance conditions be sufficiently challenging. Credit Suisse and Blackrock consider consensus estimates to determine whether hurdles are demanding enough. AMP Capital will view negatively plans that vest well below earnings guidance.

When considering whether EPS targets are challenging, ISS considers whether there has been a substantial cumulative growth rate in EPS. (This is not necessarily delivered if relying on the CAGR formula to calculate EPS growth as noted in a recent Egan Associates article.) In its considerations, ISS will consider EPS forecasts published by analysts and any earnings guidance provided by management. It specifies that a significant proportion of the incentive is only to vest for EPS performance that exceeds consensus analyst forecasts.

Retesting

Most institutional investors and proxy organisations oppose retesting without a good reason for doing so. ISS prefers there is no retesting, but makes a distinction between fixed base retesting and rolling retesting. Fixed base retesting means the performance condition is retested over an ever increasing period, while rolling retesting has a rolling start date. The former is considered preferable to the latter. Enabling one retest is also less problematic than allowing two or more.

Discretion

Discretion is earmarked by a number of proxy organisations and institutional investors for scrutiny, especially when a majority of vesting is reliant on the Board's discretion or discretion leads to awards vesting that would not have due to poor performance.

The concern has been expressed to Egan Associates that Directors in many companies do not have the necessary knowledge of remuneration issues to be able to make discretionary adjustments in a considered fashion that will lead to positive outcomes for shareholders. This concern is heightened where Directors serve on a large number of Boards.

> **Discretion is in Egan Associates' opinion a necessary check to ensure that long term incentive plans provide intended outcomes under a variety of situations.**

However, **discretion is in Egan Associates' opinion a necessary check to ensure that long term incentive plans provide intended outcomes under a variety of situations**. For example, Blackrock notes that it expects Boards to use discretion to adjust long term incentive vesting where there has been failure to manage key risks such as safety or the implementation and maintenance of information technology systems.

Discretionary adjustments to performance conditions, start dates or the exercise price of options after grant will be heavily scrutinised by most voting organisations, as well the backdating of awards. Changes need to be identified, explained and justified and will not be well received if they are perceived to be compensating executives for a lack of prior vesting due to poor company performance or providing value to employees yet no value to shareholders.

There is a certain level of understanding where adjustments are being made due to serious concerns about executive retention or significant company transformation, but they must be well explained.

Exercise Price of Options

The grant of "in the money" options is poorly regarded. ISS expects the methodology for determining the exercise price to be disclosed.

Dividends

Generally, **it is not well regarded when dividends accrue on unvested equity**, although deferred STI that is vested but restricted can accrue dividends without censure.

Blackrock holds an alternate view, stating that dividends should be taken into account for unvested equity as executives may otherwise be incentivised to not pay dividends during the performance period. It suggests that where an equity-based remuneration vehicle has been used, dividends paid during the performance period should be held in trust until the equity vests and paid to executives on a pro rata basis in accordance with the equity that vests. The value of dividends should be disclosed as a component of remuneration.

Clawbacks

Some voting organisations expect clawback measures to be in place, while others appreciate the adoption of such measures but do not expect it.

Valuation and allocation of equity

Many voting organisations will regard it negatively if organisations use a fair value that takes into account the likelihood that the incentive will not vest to calculate the number of performance rights to be granted to executives.

CGI Glass Lewis will use the face value of any awards when completing its pay for performance calculations, regardless of whether the company has utilised fair or face value for allocation. ISS expects the full cost of the equity to the company to be disclosed, as well as any discount applied to account for the probability of equity incentives not vesting. It expects the maximum opportunity should be consistent with comparable schemes operating in similar companies.

Fair Value

Egan Associates has been of the opinion for some time that while accounting values of equity are entirely appropriate for use in the profit and loss statement, equity should be granted without any discount applied for the likelihood that incentives will not vest. For further information, our views can be found on our website.

Blackrock prefers performance-based equity grants to KMPs to be valued and granted immediately after the AGM as it believes information both regarding the prior year results and released as part of the AGM should be embedded in the share price immediately after the AGM.

Dilution

Dilution appears front of mind for a number of asset managers. Potential dilution is the number one reason why Vanguard Investments will vote against incentives or plans. State Street Global Advisors expects disclosure on the amount of dilution a plan will cause. ISS states that the aggregate number of shares and options issued under all employee and incentive plans should not exceed 10% of issued capital. Blackrock prefers a limit of 5%, or 10% for companies in development or exploration stages.

Approval

A number of voting organisations consider it inappropriate when companies do not seek shareholder approval for grants of equity to Directors because the relevant shares were purchased on market rather than issued.

Change of Control Provisions

Automatic vesting of incentives in the case of a change of control is a red flag for a number of organisations. Pro rata vesting based on the amount of the performance period that has been completed is accepted.

Blackrock notes that the remuneration committee should have discretion in relation to change of control provisions as the circumstances that may result in a change of control are varied and cannot be determined at the time contracts are entered into.

Sign-on, Retention and other one off bonuses

There is a **significant amount of scepticism about the granting of these bonuses** and the matter is one of Credit Suisse's focus points. Disclosure and rationale is key if grants are to be approved.

JP Morgan Asset Management prefers that sign-on payments are limited to the value of awards foregone and that they are granted on equivalent terms. ACSI considers whether there is evidence of a bona fide negotiation to secure the executive, the weighting of the grant to long term performance-based components, and the quantum of the grant. Blackrock prefers awards to have an equity component and at be at least partially subject to performance hurdles.

Termination payments

Vanguard Investments believes "*Executives should be paid well when they perform well, not when they're asked to leave*".

When considering whether to approve termination payments above the statutory maximum of 12 months' base pay, Ownership Matters considers:

- The period of time for which the exclusion from the statutory cap is sought;
- The proposed treatment of equity incentives on termination;
- The past practices of the company and its directors in awarding executive termination payments.

ISS generally votes against resolutions seeking approval of termination payments to executives in excess of the statutory maximum of 12 months' base pay, unless there is "clear evidence" that the termination payment would **provide a benefit to shareholders**. Where approval is sought for an amount in excess of the statutory under an equity plan, it will vote for the resolution if approval is sought for three years or less and there is **no vesting of awards without satisfaction of "sufficiently demanding" performance hurdles**.

CGI Glass Lewis prefers unvested incentives to **vest pro rata on termination** based on time elapsed in the performance period and performance achieved. Blackrock prefers incentives to remain live for the originally intended performance period.

AMP will vote against termination payments above the statutory limit considering the same issues that Ownership Matters does but also if Boards have unlimited discretion to allow incentives to vest upon a CEO's termination.

Contracts

Although contracts may have an initial longer term, many proxy organisations expect contracts to be **renewed each year** to minimise post-employment payments. As an example of the detail expected when disclosing contracts to the market, Blackrock expects the following terms to be made clear in contracts:

- Period of the contract;
- Quantum of fixed remuneration;
- Structure of any performance based remuneration;
- Notice period and termination provisions;
- Sign-on remuneration;
- Retention provisions;
- Post-employment restrictions on trade and consideration paid;
- Post-employment consulting or advisory relationships;
- Post-employment vesting of payments granted during employment;
- Contractual provisions for conflicts of interest, including acceptance of payments from shareholders, employees, suppliers, customers and others with a pecuniary interest in company activities;
- Change on control provision and the impact on variable remuneration;
- Any other material issues which will assist shareholders to fully understand the terms.

Executive and NED Shareholdings

There is general consensus among institutional investors and proxy organisations that **both executives and Directors should over a reasonable time acquire a "meaningful" shareholding in the company**, expressed as a multiple of salary. According to Fidelity International, the aim is for dividend income to become a meaningful component of the individual's remuneration. JP Morgan Asset Management, the ASA and Blackrock specify a shareholding of one year's fees for Directors of large companies. JP Morgan Asset Management and Blackrock also suggest a shareholding worth two years' salary for CEOs.

NED Fees

ISS opposes the provision of **fringe benefits** to NEDs such as additional travel time fees that are provided in addition to Board fees. It also regards poorly post-employment benefits that may represent an entitlement per year of service on the Board, since they incentivise longevity on the Board, which could jeopardise succession planning. Fidelity International expects any **ex-gratia payments** to Directors to be put to a shareholder vote.

When considering whether fee pool increases are appropriate, institutional investors and proxy advisors consider:

- The quantum of the increase and the explanation for the increase;
- The level of fees compared to peers;
- The size, complexity, geographic spread and skills requirements of a Board;
- Whether the company has discontinued retirement benefits;
- Director shareholding policies;
- The company's performance;
- Board renewal plans;
- Board composition (skills, independence and size);
- Board turnover;
- Disclosure.

If the company's performance has been poor and Board membership is largely the same, ISS will generally vote against a fee pool increase unless the increase is earmarked for Board renewal. When considering company performance to vote on Board fee increases, ISS considers the last three years' data on share price, earnings per share, and return on capital employed.

> **Shareholders should exercise control over NED fees by keeping a tight margin between the cap and fees actually required.**

CGI Glass Lewis prefers frequent small increases to the Directors' fee cap rather than larger infrequent increases, believing that **shareholders should exercise control over NED fees by keeping a tight margin between the cap and fees actually required**. It looks unfavourably upon requests for increases to create "flexibility" to increase fees or the number of NEDs "if appropriate", noting that it expects better justification for any increase.

CGI Glass Lewis will generally support a proposed increase in the NEDs' fee cap where the gap between the proposed new cap and estimated total annual NEDs' fees (being the higher of the actual NEDs fees or the average fees of the market index) does not exceed the equivalent of two annual NEDs' fees.

Many voting organisations will vote against increases of fee pools for companies still providing **retirement plans** to Directors.

Equity Remuneration for NEDs

It is acceptable and even desirable for NEDs to receive shares in lieu of fees in order to build a shareholding, however, there **should not be performance conditions attached**.

Most voting organisations **do not support the granting of options to NEDs** since these instruments have a different risk profile to shares and could incentivise Directors to neglect their fiduciary duty to shareholders.

An exception is where options are granted to Directors of smaller companies or companies in a development or exploration stage where there may not be a significant profit and grants may be in lieu of cash. CGI Glass Lewis prefers such grants to vest immediately and expects NEDs except the Chairman to be granted the same number of options.

Spills

Although most proxy organisations appear **keen to avoid a Board spill** due to their concerns about the disruption such an action would cause, they will occasionally vote for a spill based on:

- Company performance and the performance of the Board and management
- Plans for Board Renewal
- Whether remuneration issues are material
- Whether the company has tried to address shareholder concerns
- The potential consequences for shareholders of a Board spill meeting

Some voting organisations will provide companies with a number of chances before considering a spill. For example, CGI Glass Lewis only votes for a spill motion as an option of last resort after making three consecutive recommendations against a company's remuneration report in which all Directors have stood for election or re-election.

Board Composition

Director Elections

When proxy organisations vote to elect or re-elect Directors they consider a number of factors including:

- The overall composition of the Board and committees (including independence considerations);
- Performance of the company under the incumbent Board and its engagement with shareholders on material governance issues;
- Oversight of management and whether appropriate remuneration arrangements and succession plans are in place;
- Whether the Board has been acting in the best interests of all shareholders;
- Skills of the individual Directors and whether they fit well into the Board skills matrix;
- Director tenure;
- Attendance Records for Board and committee meetings;
- Director capacity and workload;
- Director Performance on other Boards;
- Evidence of the exercise of independent judgement;
- Any relevant, publicly-known conduct of individual directors.

This season, the performance of the Board will be particularly under the spotlight. When a company is not performing, voting organisations will be asking whether the current Board is the correct one for the company going forward and whether the company contravenes any governance best practice.

> **It is imperative that independent NEDs are capable of holding executives to account.**

Integrity and transparency are expected. Material failures of governance, stewardship of risk or fiduciary responsibilities may lead to adverse re-election votes, as may the failure to replace management as appropriate. Boards are expected to thoroughly probe information provided to them by management or experts instead of accepting the information or advice on face value – it is **imperative that independent NEDs are capable of holding executives to account**.

There is also significant focus on Directors actions on other Boards, both current and former, as well as their behaviour during executive roles. Significant involvement in failed companies or egregious actions will be weighed seriously. A regulatory or court finding against a Director regarding their fiduciary standards or capabilities would be a red flag.

More detail on factors that may lead to adverse votes against Directors is provided on the following pages.

Disclosure

Companies are expected to provide **adequate disclosure on Director attributes** in order proxy advisors and institutional investors to make informed judgements about their suitability.

The ASA suggests that companies provide the following information for each Director on their website and in the formal notice of meeting when the Director is up for election:

- Professional background;
- Qualifications;
- Age;
- Date of appointment to board;
- When last elected;
- City of residence;
- Any committee positions;
- All other directorships held;
- Past directorships of ASX listed companies;
- The size of any shareholding.

Independence

Despite recent research on whether "independent" Directors create or destroy value, the consensus among proxy organisations and asset managers is that **a well governed Board is a majority independent Board**. Investor and proxy organisations will often vote against non-independent Directors or the chairman or members of the nomination committee if they are unhappy with the proportion of independent Directors. A no vote will often depend, however, on factors such as the size of the Board. State Street Global Advisors specifies that outside of ASX 300 companies, it only expects Boards to be one third independent.

> **Independence is determined predominantly by an individual's character and integrity.**

Also important is an independent Chairman, although there is acknowledgement that **executive Chairmen are suitable for certain companies**, for example, where a significant shareholder or founder is the Chairman. Where there is not an independent Chairman, there must be a lead Director who is able to lead certain meetings without the chairman present.

In terms of the independence of Directors on committees, generally it is preferred that all of the Directors on the audit committee are independent and that the chairmen of the other committees are also independent, with a majority of members being independent. Vanguard Investments goes as far to expect all members of Board committees to be independent.

The voting organisations' definitions of independence vary slightly but are all reasonably similar. The ASX Corporate Governance Principles and Recommendations are a reasonable baseline. Points that may vary include the length of Director tenure after which a Director is no longer considered independent, the value of a business relationship considered to be "material" and under what circumstances a Director who was previously an executive of the company may be considered independent (whether after a three-year period or only after a three-year break from the company between the executive and NED roles).

As noted by the ASCI, investors often also recognise that **independence is determined predominantly by an individual's character and integrity**, so that written guidelines will not always be sufficient to address particular circumstances. In such cases, companies are expected to provide disclosure of how potential conflicts or affiliations are mitigated by the board.

Tenure

The consideration of tenure varies for each voting organisation. Most have set a limit above which they no longer consider a Director to be independent, which **does not necessarily mean the Director no longer provides value**, but may detract from their desirability, especially if there is not a majority of independent Directors on the Board.

Board renewal is considered to be important, however, institutional investors and proxy organisations also recognise the **value of accumulated experience** in a company over a substantial period. The key, according to Credit Suisse, is to **keep renewal constant**. It has identified a sweet spot for average Director tenure on a Board of four to six years. If it is higher, Credit Suisse believes there is a risk of later knowledge loss when a sudden renewal of multiple Directors occurs.

The tenure limits for individual Directors above which voting organisations will increase scrutiny of those Directors and review their independence are (where disclosed):

- ASA: 12 Years
- Blackrock: 15 Years
- Credit Suisse: 10 Years
- CGI Glass Lewis: 15 Years
- ISS: 12 Years
- JP Morgan Asset Management: Three terms or 10 years in the same capacity
- Ownership Matters: 20 Years

Age

While Board tenure is an issue for most proxy organisations, age is not. ISS notes "*Age should not be the sole factor in determining a director's value to a company. Rather, each director's performance should be evaluated on the basis of his or her individual contribution and experience.*"

Director Workload

Proxy organisations do understand that Directors are often managing their duties adequately, even if they are sitting on a large number of Boards. However, their **concern is that if there is a crisis, Directors will not have the additional capacity to provide the extra time needed during that crisis**, especially if more than one of the companies they are sitting on experiences difficulty. In the current environment where there is volatility and significant disruption in a number of industries, they consider this issue to be particularly important.

> **[The] concern is that if there is a crisis, Directors will not have the additional capacity to provide the extra time needed during that crisis.**

Not all of the investors and proxy organisations have fixed limits on when they consider a Director to be overboarded, with some treating it on a case by case basis. CGI Glass Lewis considers NEDs that sit on more than six listed Boards to be overcommitted, although it may also recommend voting against Directors serving on more than five Boards depending on their workload and capacity. Five Boards is also ISS' and the ASA's limit. JP Morgan Asset Management sets the limit at no more than three "significant" Directorships. A chairman role is generally considered to be worth two ordinary NED Directorships.

Credit Suisse and ACSI are particularly concerned about the **capacity of Chairmen to perform in their role if they chair more than one Board** and one or more of those Boards experience an adverse situation. JP Morgan Asset Management agrees if the companies are major listed companies. CGI Glass Lewis makes a note where a Chairman serves on two ASX 100 Boards.

Another point of contention is when an **executive also holds a NED role**, which Credit Suisse, BlackRock and the ASA are sceptical is possible while providing sufficient attention to both roles, especially in a crisis. Generally, it is not considered good practice for executives to hold more than one external NED role. Some investors specify that additional NED roles should only be allowed if an executive is intending to retire and transition into a NED career. An exception is where NEDs are an executive of a substantial shareholder of the company and serve as a representative of that shareholder on the Board. Another exception is where a NED temporarily takes on a CEO role.

CGI Glass Lewis warns that it will recommend against an audit committee member if they sit on more than three public company audit committees, unless they are a financial expert, in which case the limit is four committees.

Skills

Voting organisations will do their own research based on Director biographies into whether the skills composition on the Board was appropriate and whether there were any gaps, with a particular focus on financial acumen.

If there are concerns that a Board has not achieved the **correct composition of skills, experience and independence** after issues were raised, voting organisations will consider voting against the chairman or members of the nomination committee.

The ASA notes that while each Director should bring a particular skill-set to a board, Boards should also have multiple directors with direct relevant industry experience.

Annual Board evaluations where the outcomes are disclosed are expected, with recognition also that the **occasional use of external facilitators can provide additional insight**. State Street Global Advisors notes that this evaluation process should highlight future succession and Board structure requirements to address emerging risks, changes to corporate strategy and diversification of operations and geographic footprint.

The requirement to disclose a Board Skills Matrix has not long been established. Most proxy organisations' view of the disclosure requirements regarding skills matrices is that it has mainly produced boilerplate disclosure. Where they believe it has been useful is that it generally makes the Board think about their skills composition. It is appreciated if companies provide Board Skills Matrices that are **more than laundry lists and highlight expectations over at least a five-year horizon**.

Diversity

Generally, organisations **expect a diversity policy** (not just including gender, but also other elements of diversity such as ethnicity and age) to be disclosed, and welcome **measurable objectives** for diversity and disclosure of progress against these objectives.

Many organisations would also like to see reporting on the percentage of the Board and senior management that is female.

Credit Suisse has stated an aim for companies to reach for **30% women on the Board**, as has the ACSI. ASA expects at least one female Director. CGI Glass Lewis will consider recommending a vote against the chairman of the nomination committee or equivalent if the Board has a poor record on Board diversity.

Board Size

JP Morgan believes that Boards with more than 15 directors are excessively large. CGI Glass Lewis believes this limit should be 14. It provides a rough guideline of 9-11 Directors for companies with market capitalisation over $11 billion and 6-8 Directors for smaller companies. BlackRock and CGI Glass Lewis consider **five Directors to be the smallest size for ASX 200 companies**. CGI Glass Lewis believes that companies beyond the ASX 200 should have a minimum of four Directors.

Attendance

When attendance at meetings for the Board or committees **falls below 75%** it is generally a red flag.

Committees

Audit, Remuneration, Nomination and Risk committees were favoured by a number of the voting organisations, although the committees' functions could be combined. BlackRock preferred that ASX 200 companies formed at least an audit and remuneration committee.

Organisations prefer the that the chairman of the Board does not chair Board committees. Executives are not well regarded on remuneration committees or the audit committee.

Poor audit or accounting-related practices could lead to an adverse vote against the audit committee chairman, poor nomination process to votes against the nomination committee chairman, poor remuneration practices to votes against the remuneration committee chairman and poor risk management or internal controls to votes against the risk committee chairman or the chairman of the committee responsible for risk oversight. A lack of financial expertise among committee members may also lead to votes against the audit committee chairman.

CGI Glass Lewis also recommends votes against the audit committee chairman if members of the committee were former partners or employees of the auditor and if the fees paid for audit or related services are less than 50% of fees paid to the audit firm, as this may affect the firm's independence.

ISS recommends adverse votes against members of the remuneration committee if there was a strike in the previous season, taking into consideration the company's ownership structure, whether the issues are isolated or recurring, whether there was sufficient engagement and response in addressing specific concerns, and whether the adverse vote exceeded 50%.

ESG

While CGI Glass Lewis recognises most environmental and social concerns are best addressed via avenues other than director elections or proxy proposals, when a substantial environmental or social risk has been ignored or inadequately addressed it may recommend voting against members of the Board who were perceived to have influence over these practices.

About us

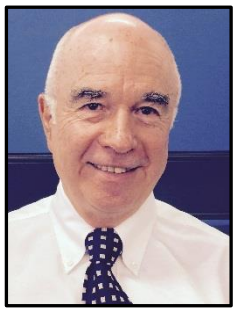
Egan Associates

For more than 25 years, Egan Associates has advised leading organisations and emerging enterprises in Australia and New Zealand on the remuneration of executives, Directors and key staff members, as well as performance management, work value, corporate governance and Board effectiveness.

Our Services include:

- **Remuneration reviews and benchmarking** for Boards, CEOs, executives, senior technical positions and specialist roles including governance and stakeholder engagement
- Advice on **annual incentive plan structures**, performance criteria, target and maximum payment levels including deferral and clawback provisions
- Advice on **long term incentive plan structures**, participants, performance hurdles, equity instruments, valuation and allocation, as well as monitoring
- **Corporate transactions / IPOs**: assistance transitioning pre-IPO reward arrangements into the listed company environment with considerations including escrow provisions
- **Government pay reviews**: assistance at both Federal and State level in administrative, policy and corporatised environments on reward for senior executives and independent Boards
- **Online human capital solutions :** online resources to assist organisations manage role accountability statements, work value, internal relativity and market competitiveness
- **Board effectiveness:** assistance with Board reviews, Board skills matrices, scenario planning and Board documentation.

John Egan



John's early career was with Cullen Egan Dell (now Mercer Human Capital), which he chaired from 1983 to 1989, when he formed Egan Associates. John has been an advisor to Boards and senior executives on organisation, governance and reward issues over many years. He has assisted a significant majority of Australia's top 200 companies as well as a myriad of entrepreneurial organisations and government entities across a wide range of industries.

John has been actively involved with Universities, chairing Sydney University's Board of Advice for its Faculty of Economics & Business (2001 – 2010). John is an Honorary Fellow of the University and an Adjunct Professor in the School of Business.

His personal interests are in cool climate gardens – www.thebraesgarden.com – and he served as a Trustee from May 2010 to June 2014 of the Sydney Royal Botanic Gardens & Domain Trust.