

# Newsletter December 2018



## **The Changing Role of the Remuneration Adviser**

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## **The Role of the Board – A Perspective from the Hayne Royal Commission**

Questioning by Counsel at the Hayne Royal Commission of Board Chairmen, CEOs and accountable executives has revealed an expectation of the level of stewardship and scrutiny which shareholders and customers might anticipate rests with the Board or the CEO in communicating strategy, financial results and breaches of company policy.



## **A Review of Proxy Advisors and Institutional Investor Guidelines on Executive Remuneration**

When it comes to executive remuneration, there are multiple stakeholder commentators including company executives, Boards, government bodies such as ASIC and APRA, universities and think-tanks, remuneration consultants, proxy advisors, retail and institutional investors to name a few.



## **Strikes Against the Remuneration Report – 2018 AGM Season**

There has been a significant increase in the number of ASX 300 companies receiving a strike against their remuneration report in the 2018 AGM season.

# The Changing Role of the Remuneration Adviser

The forensic examination of documents by the Hayne Royal Commission is likely to lead to additional demands being placed upon Remuneration Consultants and Board Remuneration Committees. New requirements may include the provision of detailed evidence which the consultant has drawn upon in providing information or advice to a Company or in preparing a recommendation.



This level of disclosure is not universal. Further, criteria used by the remuneration consultant for providing appropriate comparative information to a Board Remuneration Committee can also vary.

The Board's specification for selection of a peer group for **benchmarking** purposes will also require the consultant to be provided with a comprehensive brief. In looking, for example, at the position of a Chief Executive Officer, the following questions emerge.

- Does the Board explore remuneration paid to chief executives among organisations ranked 10, 20, 30 either side of the company's current ASX rank?
- Outside market capitalisation, does the company consider organisations with comparable revenues, assets and levels of profitability?
- As an example, in choosing companies ranked 20 either side of a candidate company ranked 50 on the ASX with a market cap of around \$8 billion, does the company consider including companies ranked 30 with a market cap of around \$12.5 billion and those ranked at 70 with a market cap of \$5.5 billion? Or does the company consider companies between half and twice the scale, which would be those with a market capitalisation of \$16 billion through to those with a market cap of \$4 billion?
- Is the spread influenced by the company's maturity and growth profile? Is it further influenced by industry factors or the internal/external talent pool? Are certain industry sectors excluded?
- Does the Board seek information on the policy settings of the comparator organisations rather than the prevailing value underlying awards under a long-term incentive plan or the parameters under an annual incentive plan, be that the target incentive is 50% of the executive's fixed remuneration and the maximum 100%?
- In looking at long-term incentives, does the company look at the grant value? Is the grant value the fair value or face value of the securities issued at the time of the award or the statutory accounting value?
- Will data alone be sufficient?
- Should the Board also seek information on the tenure of the counterpart executives?

- Should the Board seek information from an organisation with a highly credible database, though seek advice with that information in hand from a consultant who is highly knowledgeable of the industry sector in which the company competes for talent?
- Should the Board seek a second opinion?
- Should the Chair of the Remuneration Committee have a series of meetings following the briefing with the consultant once the information/advice has been submitted?
- Should the remuneration consultant meet with all members of the remuneration committee or the entire Board in order to answer questions and provide appropriate background in relation to the company's reward practices, the market's reward practices, the alignment between the company's practices and those of the market?
- Should the Board primarily rely upon information obtained by management as distinct from a consultant's recommendation? What influence in adjudicating on remuneration data will the individual's performance, level of experience, promotability, attractiveness to competitors, current performance and potential have upon the decision?
- In reviewing a KMP population of half-a-dozen executives, how much time would be expected for a Remuneration Committee to devote to preparing their recommendation in respect of each individual KMP, and how much time would be devoted at Board level in reviewing their recommendations?
- How does the Board ensure that all members of the Board, and particularly those on the Remuneration Committee, are well informed on market practices and have become highly engaged with management in exploring alternate incentive structures, both equity-based and cash-based?

**Egan Associates have been leaders in the field of remuneration advice to Boards, Government and senior executives for more than three decades. Call us now on (02) 9225 3225 to talk through any issues you are experiencing or for a "health check" of your remuneration structures and policies for 2019.**

[Back to Title Page](#)

# The Role of the Board – A Perspective from the Hayne Royal Commission

Questioning by Counsel at the Hayne Royal Commission of Board Chairmen, CEOs and accountable executives has revealed the market's expectation of the level of stewardship and scrutiny which shareholders and customers in particular might anticipate rests with the Board or the CEO in communicating strategy, financial results and breaches of company policy.



APRA's Review of CBA's governance highlighted the need for more rigorous Board oversight of non-financial risk (in particular operational, compliance and conduct risks) and the importance of a Board's impact on risk culture.

APRA's findings in relation to the role of the CBA Board identified core deficiencies, including:

- 1. Insufficient rigour and attitude of urgency**
- 2. Diminished trust and elevated complacency**
- 3. Insufficient challenge from Board to executive management**
- 4. Weakness in reporting**
- 5. A lack of accountability which led to an inability to identify who is accountable when things go wrong.**

The Review extended its comments in relation to "insufficient rigour and urgency" and "weakness in reporting" to the Board Audit Committee and Board Risk Committee revealing that,

*"most global financial institutions, in the light of experience, have developed a sense of 'chronic unease' about the potential threats to their financial and reputational standing from non-financial risks, and their risk culture and risk management frameworks have evolved in line. In contrast, the review observed that CBA, led by their Board Risk Committee exhibited an inappropriate level of comfort for too long."*

APRA also indicated that other shortcomings included the CBA Board's reliance on key individuals (i.e. Chief Risk Officer), inadequate communication between Board committees, over-confidence in the operations of both committees and a lack of rigorous Board benchmarking.

Counsel's questioning of Board members implied an expectation that a Director's level of understanding of issues relevant to the welfare of customers and shareholders required more engagement and commitment of their time.

That being the case, is it possible that Directors serving on an ASX Top 50 Board will need to increase their time commitment to, say, double their present level? Or for the next 50, say, 1.5 times their current commitment? And for the next 100, say, a 25% to 50% uplift?

What are the implications, then, for the number of Boards on which Directors may serve and the number of leading ASX Boards which Directors may Chair?

To what extent do current revelations reveal the necessity for the Board to have an **Office of the Board**, reporting to the Chair, independent of management, undertaking detailed investigations internally on matters considered important by the Board?

This would not lead to a situation where management are not accountable to the Board or do not report fully and transparently to the Board. Rather, the Board could have an independent office, separated from the internal auditor and the external auditor, investigating matters of specific interest primarily addressing issues relevant to shareholders, the customer, the organisation's culture, its reputation and the broad parameters of risk and management reporting.

In reviewing **Board Charters** of the top 50 ASX listed companies, the vast majority set out the core obligations of the Board and formal Committees together with the accountability of the CEO and key management. The latter generally indicate that authority is delegated to the CEO and the organisation's leadership team to:

- implement the approved strategy;
- meet Board-approved financial plans and report regularly on progress toward the achievement of those plans;
- oversee the implementation of Board-approved policies and the management of relationships with customers, suppliers, shareholders and other stakeholders including regulators in a manner which upholds the organisation's code of conduct and the delivery of its products and services in accordance with specifications and understandings presented in formal company documents to the relevant stakeholders.

In the context of most statements of Board accountabilities, the language predominantly reflects an overview of what the Board is responsible for overseeing and what management have delegated authority to implement and accountability to achieve.

Without dwelling on the potential of semantics, management is seen as accountable and the Board are perceived as having clear responsibilities to review and approve a significant array of policies and practices with clear delegations to management.

***It is evident from the language that the Board review, consider and approve policies, products and services, operational parameters, the strategic plan, the organisation structure, acquisition and divestment initiatives, and capital management and have a prime obligation to set performance criteria in order to appropriately evaluate the effectiveness of the CEO's stewardship of the organisation.***

The Board have oversight of risk management and approval of the organisation's risk appetite. They delegate accountability to management to deal with regulators, though generally reveal their availability to meet with regulators at their request. Their role is primarily to review and approve and then monitor management's performance.

In order to meet their responsibilities as defined, the **Board have significant dependence upon the integrity and knowledge of the CEO and the leadership team** and in that context will potentially define their relationship with the CEO and the CEO's reporting to the Board as one of ensuring that the CEO reports systematically with openness on the progress being made by the company towards achieving its corporate purpose.

Depending on the nature of the enterprise, there will be variable degrees of emphasis on the customer, the supplier, the management of risk incorporating the nature and diversity of risk, the resourcing of the organisation with capable individuals, their oversight of health, safety and the environment and their impact on the organisation's reputation and compliance with relevant regulation. Boards almost universally rely upon management to keep them informed of any breaches, challenges, changes to the regulatory environment, changes to the commercial environment which may lead to modification to their financial plans, their capital management, their acquisitive or divestment initiatives and their risk appetite.

The ***Corporations Act*** (s184) provides context to the decision-making power and accountability of Boards and executives. The *Act* stipulates criminal offences if a director or other officer of a corporation fails to exercise their powers and discharge their duties in good faith in the best interests of the corporation; or if they directly or indirectly gain an advantage for themselves, or someone else, or cause detriment to the corporation. Although the *Act* provides the definition of accountability, the assessment requires interpretation of the decisions made by the Board or executive from a retrospective perspective (that is, did the Board make the right decision based on the outcome).

In recent years, **remuneration** has become an area of focus. Shareholders could consider and vote against a company's Remuneration Report, potentially leading to a Board spill. There has been a closer engagement required of Boards to receive independent guidance and advice, though they retain authority to approve the executive remuneration framework, reward policy and outcomes, in relation to senior management including the CEO.

We also observe a more detailed focus on performance management frameworks and variable remuneration programs including employee equity programs and superannuation, with larger companies having oversight of the implementation of these programs in multiple jurisdictions.

Notwithstanding the criticality of this Remuneration Committee review role, a significant proportion of Australia's leading companies acknowledge that they do not seek or receive recommendations. Therefore, by implication, **Boards assume the principal accountability for the authorisation of remuneration levels and incentive payments involving cash and equity.**

The Hayne Royal Commission identified some shortcomings in this area in relation to the Board's depth of knowledge of remuneration programs throughout the organisations over which they have stewardship and a reliance upon management recommendations.

Arising from the findings of the Royal Commission to be published in February 2019, we anticipate that Board Charters might require amendment revealing that Board obligations will extend beyond reviewing, approving and monitoring the organisation's operations and financial stewardship for the purpose of ensuring that management meet their obligations in every respect for which Directors are accountable under the law.



Given the identification of shortcomings in either the information and the depth and quality of information provided by management, or the level of investigation by Directors, it would be our expectation (though we do not believe this will initially be well accepted) that a Board may need a small cadre of highly skilled individuals who are independent of management and have the authority of the Board to investigate all matters, assuring the Board that

- their approvals are being followed in every respect at all levels of the organisation;
- the nature and quality of reporting from the base of the organisation through the various layers of management provide the Board with the essential information to assure shareholders, customers, suppliers and regulators that the organisation is fully compliant;
- remuneration outcomes take full account of adherence to approved policies;
- and those employees who behave in a manner which is in breach of approved policies and practices are terminated, this process applying from the base of the organisation through to the level of CEO.

It would be a matter for further consideration to determine if such an outcome might be a step too far.

**The Hayne Royal Commission has shattered the old adage that *"all publicity is good publicity"*. Let Egan Associates help make your Board the best it can be. We can advise on your Board's composition, evaluate its effectiveness, benchmark governance and compliance, assist with succession planning and provide strategies to achieve your organisations objectives. Call John Egan on (02) 9225 3225 or email [jve@eganrem.com](mailto:jve@eganrem.com) for a confidential discussion.**

**[Back to Title Page](#)**

# A Review of Proxy Advisors and Institutional Investor Guidelines on Executive Remuneration

When it comes to executive remuneration there are multiple stakeholder commentators including government institutions such as ASIC and APRA, universities and think-tanks, remuneration consultants, proxy advisors, retail and institutional investors to name a few.



With the heat of the ongoing AGM season as well as the continuing impact of the Hayne Royal Commission, tension is building up not just for Boards and company executives, but for other stakeholders such as remuneration consultants, proxy advisors and large institutional shareholders.

At this stage, executive remuneration in Australia cannot be regarded as ‘heavily regulated’ despite the impact of the Corporations Act, ASX Corporate Governance Principles and the recent restrictions imposed by BEAR upon financial services. In addition to these rules, guidelines published by proxy advisors and large institutional shareholders are closely followed by Boards and shareholders of many “large cap” companies.

Proxy advisors’ views on executive remuneration have gained more significance over time in line with the increase in company ownership institutional investors both globally and in Australia.

*“Between 1950 and 2000, institutional ownership of total U.S. equity outstanding increased from approximately 6% to approximately 50% where it has since remained”.*

According to a research paper published in [RBA’s Bulletin in September 2010](#), “prior to the financial crisis, institutional investors were the largest single class of investor, owning almost half of listed Australian equities”. Although this has changed in favour of foreign investors and retail investors following the financial crisis, institutional investors made up approximately 40% of the total Australian equity outstanding in 2010.

Traditionally, institutional investors relied heavily on advice from proxy advisors as they did not have the resources to thoroughly consider the thousands of resolutions that required their vote. However, over the years institutional investors have increased their direct involvement in the area of executive pay. Some of the largest institutional investors also have their internal corporate governance teams tasked with making voting decisions and ensuring consistent voting across investment vehicles. In this regard, BlackRock, Vanguard and State Street, the three largest global asset managers, provide their own guidelines in relation to ‘preferred’ executive remuneration practices.

This article aims to provide a review of proxy advisors’ and large institutional shareholders’ published views on executive remuneration. A review of the Australian (and New Zealand where combined) remuneration report guidelines of the [Australian Shareholders Association \(ASA\)](#), [Ownership Matters](#), [ISS](#), [CGI Glass Lewis](#), [State Street](#), [BlackRock](#) and [Vanguard](#) have indicated that, in essence, there are more areas where they concur than those where they diverge.



Essentially, each of these organisations emphasises the importance of establishing a clear link between variable pay and company performance as reflected in returns to shareholders. Other areas of consensus include avoiding re-testing of LTI hurdles, minimum shareholding requirements for CEOs and executives, avoidance of cliff vesting and the requirement for cogent explanation in those cases where Boards make decisions and use their discretion for all remuneration related outcomes including LTIs and STIs. Use of claw back and malus clauses are also regarded as good market practice.

Whilst non-financial KPIs are not preferred LTI hurdles, ASA indicate that they should be limited to a small portion of the LTI award. They are better suited for STIs and should be measurable.

Other executive pay design criteria which are treated unfavourably by the majority of proxy advisors and large institutional shareholders include the use of face value rather than fair value. ISS guidelines indicate that disclosure of incentives should include the potential value of awards to individual scheme participants on full vesting, expressed by reference to the face value of shares and expressed as a multiple of base salary. However, BlackRock support the use of fair value as per their 2015 voting guidelines.

### **Which LTI Hurdle?**

Absolute share price hurdles are generally not supported as share price could be more influenced by market forces than the contribution of the executives as well as the potential disconnect between company performance and share price increase. Use of multiple LTI hurdles is usually regarded as good practice. Whilst EPS, TSR (absolute or relative) and return hurdles constitute the most commonly used LTI hurdles by ASX listed companies, proxy advisors and institutional shareholders appear to have different views in relation to their relevance and impact on company outperformance.

Commonly cited shortcomings in relation to a relative TSR measure include difficulty in selection of a robust peer group and insufficient relationship between relative TSR and company outperformance. ASA guidelines emphasise the importance of setting an appropriate sliding scale according to which an LTI award starts to vest above the median of a peer group and 100% vests if the company performs above 85th percentile. CGI Glass Lewis state that the use of a relative TSR measure neither drives outperformance nor incentivises behaviour based on their previous research.

Other observations include the potential disconnect between growth in EPS and the share price increase; the use of underlying or normalised profit instead of statutory profit when calculating EPS are cited as a potential shortcoming of an EPS measure by proxy advisors. Also noted is that the LTI security (option, right or share) is a crucial factor when selecting the right LTI hurdle as are industry and company specific factors. Analyst forecasts are also considered crucial when setting threshold, target and maximum performance levels for LTI hurdles.

### **Dilution Limits**

Dilutionary impact of equity plans are another area of scrutiny by proxy advisors and institutional investors. BlackRock and CGI Glass Lewis support a 5% annual cap on ordinary issued capital for newly issued shares and options under all employee and executive incentive schemes whereas this cap could be stretched to 10% for developing companies. ISS guidelines indicate an overall cap of 10%.

## Combined plans

According to their March 2018 Guidelines for ASX200 companies, ASA does not regard combined plans as “true LTIs” if the number of shares or performance rights are determined by the company’s performance over a one-year period with no further performance hurdles to be met until vesting.

CGI Glass Lewis indicate that while they assess all combined plans on a case-by-case basis, their expectations from those plans include a minimum vesting and post vesting period of five years.

**Whether you’re a private entity or a Government department, Egan Associates can help you ensure your incentive structures are comprehensive and resilient. Call Zoe Lockyer now on (02) 9225 3225 for a confidential discussion or email [zlockyer@eganrem.com](mailto:zlockyer@eganrem.com).**

[Back to Title Page](#)

# Strikes Against the Remuneration Report – 2018 AGM Season

There has been a significant increase in the number of ASX 300 companies receiving a strike against their remuneration report in the 2018 AGM season, with 19 companies overall receiving strikes compared with six in 2017.

Below is a summary of the disclosed commentary on those companies that received a strike at their recent Annual General Meeting as at mid-December 2018.



## 1. National Australian Bank Limited

- [The company had 88.43% of shareholders voted against](#) the remuneration report. Chairman Ken Henry said to shareholders, "We tried, but we got it wrong. We are listening to you."
- Shareholders also voted against CEO Andrew Thorburn's awarded shares. Ken Henry indicated that shareholders were unhappy that the bank changed its remuneration scheme.

## 2. Westpac Bank

- Shareholders voted [64.16% against the remuneration report](#). The Chairman Lindsay Maxsted knew that more than half of the votes would go against the remuneration resolution. He said in his opening speech,

*"This means we will incur a first strike. This sends a strong message to the board...In assessing short-term variable reward performance, outcomes were below target for economic performance and for customer and service-related areas of the annual scorecard. As a result, this year's short-term variable reward for the CEO and group executives in Australia were, on average, 25% lower than last year. The largest individual year-on-year reduction was 50%".*

## 3. Mineral Resources Limited

- [63.63% of shareholders voted against](#) the executive remuneration report. It is the company's third strike in a row.
- Last year the company received its second strike, causing a board spill motion. They received a vote of 41.48% against the remuneration report and, in 2016, it was 49.18%.
- The board spill motion was not carried through due to shareholders voting for the retention of the board and existing management.

## 4. Karoon Gas Australia Limited

- Shareholders voted 62.95% against the remuneration report.

#### 5. Telstra Corporation Limited

- 61.98% of shareholders voted against the remuneration report. The Chairman, [John Mullen](#), admitted that there is merit with replacing the complex remuneration calculations,  
*"maybe there is a case for doing away entirely with all these complex schemes and just go back to a fixed salary commensurate with the difficulty of the role."*

#### 6. Havilah Resources

- Shareholders voted 60.15% against the remuneration report.

#### 7. Harvey Norman Holdings Limited

- 50.63% of shareholders overall voted against the remuneration report. This was partly due to the [company losing \\$40.5 million over the failed Coomboona dairy farm](#) acquisition. Additionally, shares in Harvey Norman were up 2.49% to \$3.085 at 1415 AEDT on Tuesday, which is 35% lower than the 20-month high of \$4.51 in March.

#### 8. NRW Holdings Limited

- Shareholders voted 49.05% against the remuneration report.

#### 9. Goodman Group

- The remuneration report was 45.46% voted against by shareholders. The shareholder votes were mostly against the remuneration report and the [performance rights issued for their executives](#).

#### 10. Jupiter Mines Limited

- 44.84% of shareholders voted against the remuneration report.

#### 11. Tabcorp Holdings Limited

- Shareholders voted 40.40% against the remuneration report.
- Shareholders have been concerned with the pay packets of executives, however [Chairman Paula Dwyer](#) stated in the meeting that the awards being paid their executives would change due to their merger with Tatts.

#### 12. Myer Holdings Limited

- 37.54% of shareholders voted against the remuneration report however a potential board spill was prevented as 63% of proxies opposed a spill motion.
- This is the company's second strike.
- In 2017 during their AGM season, the company received 29.41% against their remuneration report.

### **13. Austal Limited**

- The company had 37.24% of shareholders voted against the remuneration report.
- The strike was against the [shipbuilder's Board managing director David Singleton's](#) pay structure.

### **14. Australian and New Zealand Banking Group Limited**

- The company received a [33.76% vote against the remuneration report](#). The Chairman Mr. Gonski told shareholders that the board cut directors' fees by 20 per cent. He stated it was the "right thing to do given the impact the bank's failings had on share shareholders this year".

### **15. Computershare Limited**

- Shareholders voted 31.89% against the remuneration report. They had voted against the remuneration report over the [pay packet of its expat Chief Executive](#), even though the company gained high record earnings and Computershare's share price increased.

### **16. Healthscope Limited**

- The company received [29.29% votes against the remuneration report](#). Shareholders were against executive pay.

### **17. Brickworks Limited**

- Shareholders gave a 28% vote against the remuneration report.

### **18. Automotive Holdings Group Limited**

- The company received their first strike. Shareholders gave a 27.62% vote against the remuneration report.

### **19. Emeco Holdings Limited**

- The company received their first strike this year.
- Shareholders voted 26.03% against the remuneration report.
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In addition to the companies above, 17 companies were close to receiving a vote against their remuneration report during this AGM season as they received 'against' votes which ranged from 15% to slightly below 25%.

Companies Close to Strike	
1. APA Group	24.96%
2. Ramsay Health Care Limited	24.88%
3. MYOB Group Limited	24.40%
4. Accent Group Limited	23.69%
5. Regis Healthcare Limited	23.59%
6. Mesoblast Limited	23.36%
7. Challenger Limited	22.62%
8. JB Hi-Fi Limited	21.65%
9. Afterpay Touch Group Limited	20.30%
10. SEEK Limited	20.26%
11. Qube Holdings Limited	20.04%
12. AMA Group Limited	19.80%
13. Senex Energy Limited	19.49%
14. IOOF Holdings Ltd	19.23%
15. Aveo Group	16.24%
16. Australian Agricultural Company Limited	15.88%
17. Breville Group Limited	15.57%

Let Egan Associates help you achieve shareholder approval through benchmarking your organisations' roles and assessing how competitive your organisation is in its remuneration, incentives, commissions and other pay-based retention strategies. Call us now on (02) 9225 3225 to speak confidentially with one of our Consultants or email at [mail@eganrem.com](mailto:mail@eganrem.com)

[Back to Title Page](#)



# About 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 Board Directors, executives and key staff members, as well as performance management, corporate governance and Board effectiveness.

Our Services include:

- **Remuneration reviews and benchmarking:** for CEOs, executives, senior management and professional positions, including specialist roles
- **Annual incentive plan structures:** advice on performance criteria, target and maximum payment levels as well as deferral and clawback provisions
- **Long term incentive plan structures:** advice on participation, performance hurdles, equity instruments, valuation and allocation, as well as provision of performance monitoring services
- **Corporate transactions / IPOs:** assistance transitioning pre-IPO reward arrangements into the listed company environment (or any other corporate transformation) considering issues including escrow provisions
- **Government pay reviews:** assistance at federal, state and local level in administrative, policy and corporatised environments on reward for senior executives, professional and administrative staff, and governing Boards
- **Board fee reviews:** benchmarking Board fee levels, including Chairman and Director retainer fees, Committee Chairman and member fees and fees for adhoc engagements.
- **Board effectiveness:** assistance with Board reviews, Board skills matrices, scenario planning and Board documentation.
- **Workforce & Governance:** *Define and evaluate positions and analyse pay the easy way!* Our new cloud-based software captures more than 30 years' knowledge, learning and experience in organisation analysis and remuneration in a suite of products which operate either as powerful, stand-alone modules or as an integrated combination. Access more than 1,000 role templates and over 13,000 accountability statements or easily create your own PDs from scratch. Organisation charts are generated automatically. Powerful analytics give you pay and workforce insights in one click. And our intuitive, user-friendly job evaluation module is designed to bring your JE process into the 21<sup>st</sup> century. And because *Workforce* is designed and hosted in Australia by Egan Associates, you know you're in great hands!



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