

M O R R O W
S O D A L I

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**2017 Australian AGM Season
Preview**

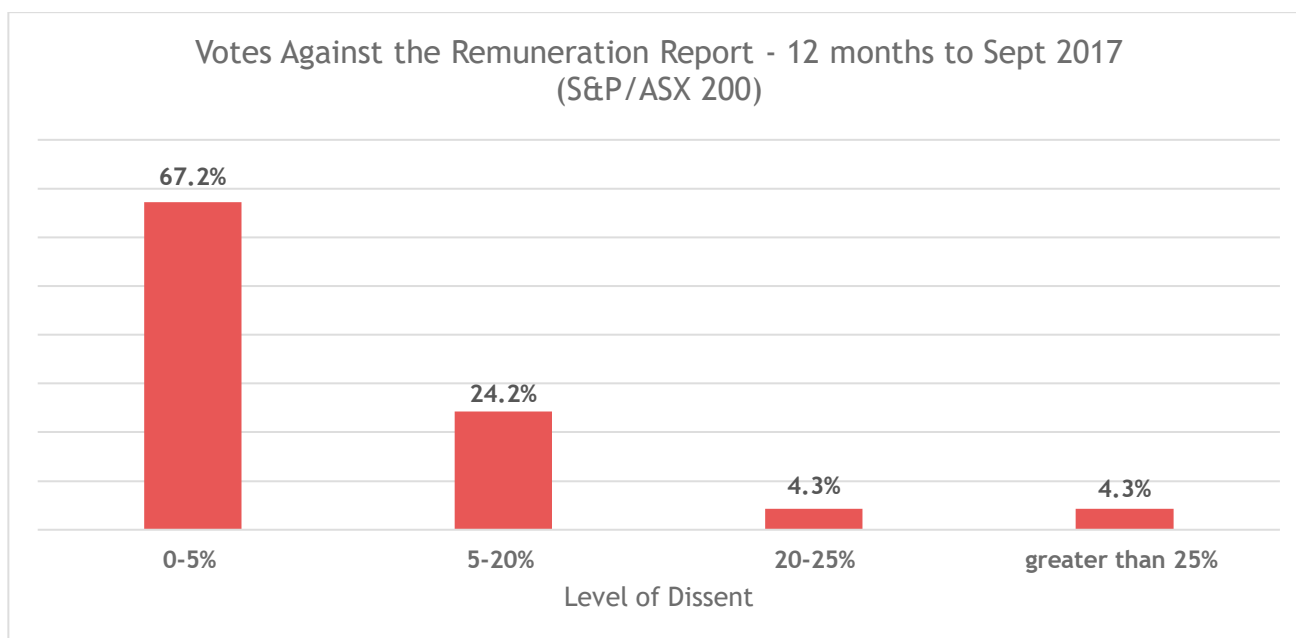
In this year's 2017 Australian AGM Season Preview, Morrow Sodali provides governance insights and trends as it relates to the following topics:

- Remuneration Report Voting
- Retention Payments
- Hybrid Remuneration Frameworks
- Non-Executive Director Elections
- Non-Executive Director Overboarding
- Gender Diversity
- Sustainability Reporting

Remuneration Report Voting Trends

Morrow Sodali has conducted a review of the voting outcomes and proxy advisor recommendations related to resolutions seeking the approval of the remuneration report over the 12-month period to September 2017. This review covers listed entities that were constituents of the S&P/ASX 200 index as at 01/09/2017, excluding stapled entities and companies incorporated in New Zealand, Papua New Guinea and other jurisdictions that would not require them to submit a remuneration report to shareholders for approval.

Based on the voting outcomes for the period under review, the majority of S&P/ASX 200 companies received 95% or more of votes cast in favour of the remuneration report. Approximately 24% of companies faced some level of dissent (between 5-20%), whilst 4.3% of companies were close to receiving a strike and an equal proportion of companies did incur a remuneration strike.



Source: Proxy Insight, Morrow Sodali analysis

Of the companies within the S&P/ASX 200 that have received a strike over the past 12-month period, **all of these companies received an against recommendation from at least one proxy advisor and in some instances by all three proxy advisors.** The companies that received a strike during this period were scrutinised over their remuneration and general governance practices, with a particular focus on:

- **Significant executive fixed pay increases** that were not linked to material changes in the business or the role and responsibilities of those executives;
- **Retention-related cash allocations** that did not facilitate alignment between executive remuneration outcomes, financial performance and shareholder returns;
- The award of **equity grants with no performance hurdles attached**;
- Vesting of incentive awards for **below median performance**;
- Applying **underlying STI and LTI financial measures** that did not sufficiently capture the downward impact of statutory financial performance; and
- The provision of **high bonus payouts** at times of poor financial and/or operational performance.

It is worth mentioning that the **Australian Council of Superannuation Investors (ACSI)** has noted that approximately 30% of S&P/ASX 100 CEOs received bonus outcomes equal to at least 80% of their potential maximum bonus payout, which is consistent with shareholders’ concerns over persistently high bonus payouts, which is an issue that many of the companies that received a strike faced.

As we head into the 2017 AGM season we note that proxy advisors continue to focus on issues such as fixed pay increases, pay-for-performance alignment, the use of appropriate performance measures under STI and LTI plans, and transparency around the disclosure of variable pay frameworks and outcomes.

Morrow Sodali has undertaken a review of proxy advisor policies and their approach in relation to executive remuneration topics such as fixed pay increases, STI and LTI structures and outcomes, retention payments and the recent adoption of combined (hybrid) incentive plans. The purpose of this review is to provide companies with insights as to the key areas of focus for proxy advisors, their approach to key remuneration issues and whether there have been any significant changes in their policies since the last AGM season.

	INSTITUTIONAL SHAREHOLDER SERVICES (ISS)	CGI GLASS LEWIS (CGI GL)	OWNERSHIP MATTERS (OM)
Increases in executive fixed remuneration/Non-Executive Directors’ (NED) fees	ISS’ position on executive fixed pay/NED fee increases remains largely unchanged. In general, given the absence of positive financial performance outcomes, it would often take a negative stance on ascending base remuneration adjustments (including non-monetary benefits), particularly if regarded to be above median against the comparative market capitalisation peers (for NEDs), or sector peers (for executives).	CGI GL continues to view different fixed pay arrangements on a case-by-case basis.	OM is of the view that remuneration adjustments should be quantitatively aligned to financial performance outcomes. Additionally, OM continues to “audit” the quantum and disclosure of non-monetary benefits and ex-gratia remuneration components (from an accounting perspective).
Non-financial STI & LTI performance hurdles	ISS continues to express its view that the increase in the proportion of non-financial targets doesn’t always align with shareholder value creation. Targets related to	CGI GL supports the use of non-financial performance measures, and views favourably upon the adoption of a mix of performance	Given sufficient disclosure of the rationale and the level of alignment to the shareholder experience, OM would generally

	<p>safety, diversity and compliance should be a “given” and does not warrant the provision of an additional (bonus) payment.</p> <p>However, ISS would not discourage the use of non-financial measures as STI and/or LTI gateways.</p>	<p>measures that incorporate both financial and non-financial targets.</p>	<p>support the adoption of non-financial performance measures.</p>
<p>Shift from Fair to Face value</p>	<p>Companies may use a “discounted fair value” calculation to determine the number of equity awards to be granted to executives. The “fair value” of equity awards under such accounting-based calculations represents a discount to the prevailing trading price of the company’s shares by factoring in the risk-free rate of return, the expected share price volatility, the non-tradeable nature of the equity award, the value any foregone dividends, the risk of the performance hurdles not being met and the time value of money over the vesting period, among other factors. The impact of this discount is that executives can receive a greater number of equity awards than they would have otherwise received if the number of awards was determined on the basis of the “face value” of the awards, often on the basis of the volume-weighted average price (“VWAP”) for the company’s shares over a defined trading period.</p> <p>It is therefore considered corporate governance best practice for companies to apply a face value methodology when determining the number of equity awards to be granted to an executive, rather than fair value. Consistent with this expectation, all three proxy advisors continue to support the shift from fair to face value. However, ISS has pointed out that some companies have subsequently adjusted the LTI maximum to offset the fair-to-face shift, which can be perceived as a governance concern.</p>		
<p>Use of underlying financial performance measures</p>	<p>All three proxy advisors continue to scrutinise the application of underlying or non-accounting based financial measures to STI and LTI performance criteria (most commonly observed as underlying EPS or underlying profit) in determining pay outcomes. Adjusting for non-cash or non-recurring items in executive incentive schemes is viewed to remove an element of executive accountability, particularly for long tenured executives that may have presided over acquisitions, investments or strategic initiatives that have not been value accretive to shareholders over the long term. The application of such measures is also regarded to be less transparent and potentially difficult for shareholders to reconcile with overall performance.</p> <p>It is worth emphasising that any STI or LTI plan that applies an underlying or non-statutory financial measure, and has resulted in a payment that would otherwise have not resulted on a statutory reporting basis, has received significant shareholder dissent and negative proxy advisor voting recommendations.</p>		

Source: CGI Glass Lewis, ISS, Ownership Matters, Morrow Sodali analysis

Retention Payments Remain in Focus

Having reviewed feedback from institutional shareholders and proxy advisors in recent cases where companies have provided retention-related payments, Morrow Sodali has observed that proxy advisors will refrain from supporting the application of retention benefits without a **clear, robust rationale**. In particular, proxy advisors will assess whether the rationale underpinning retention payments is both fully disclosed and considered to be sufficiently compelling.

Companies should note that **cash** retention awards are not viewed favourably by proxy advisors and institutional investors. In principle, retention payments provided in cash **do not provide sufficient alignment between executives and the interests of shareholders**. Morrow Sodali has observed that institutional investors, and particularly **US pension funds**, are often opposed to cash retention awards and have been seen to vote against remuneration reports solely based on the provision of such payments. The **quantum** of these types of payments is also reviewed by investors who have been seen to vote against remuneration reports that provided executives with excess retention payments.

Equity retention awards that are subject to performance hurdles are seen to be somewhat more acceptable and when such awards are provided, the rationale needs to be sufficiently disclosed. **LTI grants** that are time vesting, or vesting subject to continuous employment only, are not considered acceptable practice for companies within the S&P/ASX 300 and are generally not supported. In such instances, investors are seen to vote against the remuneration report or resolutions seeking the approval of LTI grants. Ownership Matters recently remarked to Morrow Sodali, “if an executive is genuinely sought after then another prospective employer will just buy out the retention award.”

Retention payments are **particularly scrutinised when the company is performing poorly** and therefore companies need to be **cautious** when deciding to provide such retention-related payments or grants.

Hybrid Remuneration Frameworks on the Horizon

All three proxy advisors have acknowledged the recent shift by some companies towards the adoption of hybrid variable remuneration plans (e.g. - QBE, Perpetual and Wesfarmers from 2017), and will assess these arrangements on a case-by-case basis. A hybrid variable remuneration plan is a combined incentive arrangement that incorporates elements from both STI and LTI frameworks.

An example of a company that recently adopted such a plan and has had it voted upon by shareholders is Seek Limited. Seek applies a hybrid variable pay model and decided to remove its STI plan in order to ensure that executives remain focused on long-term growth. Instead of a cash-based STI, Seek provides its executives with equity-based variable incentives only. For the LTI awards to vest, the company’s share price must exceed the historical growth of the ASX All Ordinaries over a period of 15 years. Seek is of the view that this increases the alignment between executive remuneration and shareholder wealth creation.

All three proxy advisors supported Seek’s 2016 remuneration report and noted that the company adequately aligns executive remuneration outcomes with company performance. However, CGI GL was somewhat concerned with the use of one performance measure stating that “a pure share price hurdle...may inappropriately reward (or penalise) the executive because of market conditions rather than contribution of the executive”.

Companies that are considering to adopt a similar remuneration structure should make sure that the details of the plan are transparent and clearly defined, including why such a structure would be regarded as ‘fit for purpose’ in context of the long-term strategy, the current operating environment and a company’s stage of growth.

Non-Executive Director Elections

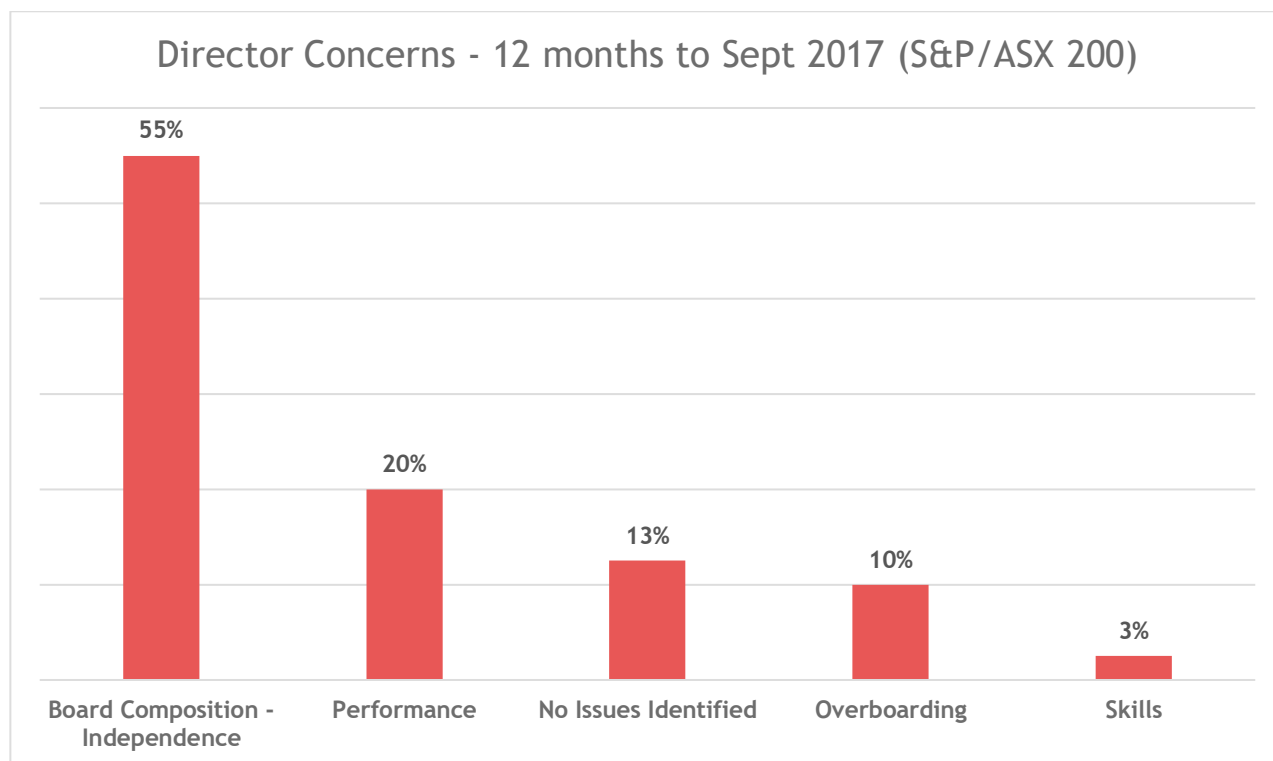
Morrow Sodali reviewed the voting outcomes and proxy advisor recommendations related to resolutions seeking the (re)election of directors for S&P/ASX 200 listed companies for the 12-month period to September 2017.

It is observed that approximately **7.5%** of directors that were up for (re)election faced **significant levels of dissent** defined as more than **10%** of votes cast against their (re)election, and with some directors even receiving approximately **40%** of votes cast against their (re)election.

Amongst those directors that faced significant levels of dissent, Morrow Sodali has noted that the main driver of negative votes and/or recommendations related to concerns over **board composition and levels of independence** as many shareholders are continuing to vote against the (re)election of non-independent directors on boards that are not

majority independent. In addition, shareholders are observed to be less inclined to support the election of non-independent directors that are also members of key committees, for example the audit committee.

The graph below highlights the primary consideration that have resulted in recent votes and recommendations against non-executive directors that have faced significant levels (more than 10% of votes cast against their (re)election to the board) of dissent.



Source: Proxy Insight, Morrow Sodali analysis

Non-executive director performance is one driver of negative director votes and recommendations. During the period under review, a significant number of directors faced scrutiny over their **poor attendance records**, their **companies' poor performance** or the **poor performance of other companies they were affiliated with**.

Morrow Sodali also notes that during the period under review, some shareholders chose to vote against directors at companies with no apparent governance failings. Under the category 'no issues identified', this represents instances where all proxy firms recommended in favour of the director nominees but a relatively high level of voting dissent is still observed.

It is also worth noting that some proxy advisors are seen to recommend, and some shareholders voted, against directors with skillsets that are not perceived to be complimentary or relevant to the board or the company strategy.

Shareholders are also observed expressing their concerns over the **workload of directors** that serve on a significant number of boards. Although the definition of 'overboarding' might vary amongst investors, the policies applied by proxy advisors on this issue are detailed further below.

Non-Executive Director Overboarding

ISS continues to apply a quantified approach to non-executive director overboarding, whereby overboarding occurs where one sits on more than a total of **five listed company boards**, and counting a board chair as two directorships. Even an impeccable attendance record is insufficient to offset overboarding concerns as ISS generally considers a director to be less capable in exercising their duties at all companies in the presence of a potential crisis or corporate action at one of their boards, and particularly if the director is a board chair of more than one public company.

Broadly consistent with ISS, **CGI GL** also applies a quantified approach and will generally vote against non-executive directors “who serve on **more than six major boards**”. Further, it will “make a note of directors’ private entity commitments, particularly those serving as senior executives or directors of large unlisted entities”.

OM will generally assess director over commitment on a **case-by-case basis**. In select instances, OM is observed to support certain director candidates that are regarded to be good performing directors or a good fit for a board but that would otherwise be considered overboarded by the other proxy firms.

Gender Diversity

The importance of gender diversity on ASX boards has been acknowledged by institutional investors, proxy advisors, ESG research providers and other governance stakeholders such as **ACSI**.

ACSI, which issues voting recommendations for its members, stated in an October 2016 press release that “**companies which have not taken steps to address their lack of female directors will find themselves facing votes against sitting directors in 2017**”.

ACSI has adopted a target for women to comprise 30% of all S&P/ASX 200 boards by the end of 2017. In its press release, ACSI further stated that the purpose of this new policy “**is [for companies] not to have just one woman on a board – it is for each board to have at least 30% women.**”

In August 2017, **Vanguard** published its Investment Stewardship 2017 Annual Report where it stated that “gender diversity has emerged as one dimension on which there is compelling support for positive effects on shareholder value” while **State Street Global Advisors (SSGA)** also stated that they intend to demonstrate their commitment to enhancing gender diversity by “**issuing new gender diversity guidance to the more than 3,500 companies we invest in across three major regions (US, UK and Australia), designed to increase the number of women on corporate boards**”. It is therefore evident that large global investors such as Vanguard and SSGA are expecting increased disclosure and performance against diversity objectives, which can also extend beyond gender to include different ethnic groups, ages and backgrounds.

Sustainability Reporting Trends and the Increasing Demand for Enhanced Disclosure

Institutional investors are increasingly favouring companies that adopt widely accepted ESG reporting guidelines such as the **Global Reporting Initiative (GRI)** and **Integrated Reporting**. The most commonly used guidelines, in Australia and globally, are the GRI Standards and their use is encouraged by various governance stakeholders including **ACSI**. According to ACSI, the best ESG reporters in Australia use internationally recognised standards.

In July 2017, ACSI published a report entitled “Corporate Sustainability Reporting in Australia”, the purpose of which was to present the status of ESG reporting amongst Australian companies. **ACSI noted in its report that in 2016, 60 ASX200** companies (30%) used the **GRI** as a framework for reporting, compared to 21 (10.5%) in 2008.

In **June 2017**, the **Task Force for Climate-related Financial Disclosures (TCFD)**, a Financial Stability Board initiative, published its final recommendations that aim “to provide a foundation to improve investors’ and others’ ability to appropriately assess and price climate-related risk and opportunities”. **ACSI** has endorsed this new

framework and has also stated that “it is anticipated that the framework will be adopted by investors and companies as the ‘gold’ standard for disclosure.”

To date, **103 investors, stock exchanges and companies** have affirmed their commitment to support the voluntary recommendations of the TCFD, including **ANZ Banking Group, BHP Billiton and Cbus Super**.

These recommendations were also endorsed by Australian activist group **Market Forces**. Market Forces is a not-for-profit organisation and is associated with the group ‘Friends of the Earth’. Their focus is to enforce a proactive culture of climate risk reporting amongst Australian companies.

In a **June 2017** press release, **Market Forces** stated that “these recommendations are **sorely needed in Australia**, which was recently rated by S&P as being one of the highest carbon-exposed markets in the world” and adding that “particularly for insurers and super funds that are heavily exposed to carbon intensive industries, or real assets prone to the physical impacts of climate change, disclosure is absolutely necessary.” Market Forces expects ASX-listed companies to incorporate the TCFD recommendations into their 2017 sustainability reporting.

Market Forces is expected to be targeting some of the largest ASX-listed companies this AGM season with shareholder resolutions that are focused on increasing disclosure around climate change and its material impact on how companies are adapting.

This comes at a time when large asset owners have expressed their view that board members are expected to oversee and mitigate climate-related risks and that “it is important for boards to communicate how they oversee material climate change related risks.” For example, **SSGA** has stated that it expects that, at a minimum, companies (particularly in high-impact sectors) should “address how the board or its committees oversee climate risks.” Boards need to demonstrate that their directors have some knowledge or training on material sustainability or climate-related risks.

In its recently released proxy voting guidelines for 2017/2018, CGI GL also highlights the importance of director accountability in relation to ESG. In its policy, CGI GL states that: “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, we may recommend voting against certain members of the board** who, in our opinion, have had some influence over these practices (particularly those responsible for risk oversight in consideration of the nature of the risk and the potential effect on shareholder value)”.

In another recent development, 100 global investors with approximately US\$1.8 trillion in assets under management are demanding that large banks enhance their disclosures on ESG risks and opportunities with a focus on how these are managed by directors. This campaign is being led by UK responsible investment non-profit **ShareAction and Boston Common Asset Management** who urge banks to adopt the recently released TCFD recommendations. ShareAction states that: “There is a growing desire among asset owners and asset managers for more robust climate-related disclosures and risk management from the banking sector. The recent issuance of recommendations by the Financial Stability Board’s Task Force on Climate-related Financial Disclosures (TCFD) introduces new norms and expectations around disclosure in this space.”

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