

# Understanding Proxy Advisors & Stakeholder Groups

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## INTRODUCTION

In the last 6 months GRG has been meeting with major proxy advisor and stakeholder groups (including Blackrock and the Australian Shareholders Association (ASA) in order to obtain a better understanding of the expectations of these groups, with regards to remuneration governance issues. Ownership Matters was the notable exception who refuses to meet with remuneration consultants. The proxy advisors we were able to meet with certainly recognised that both we and they, as well as all directors, have a shared interest in improving remuneration governance and disclosure for the benefit of the market. This article summarises the major themes that emerged from those discussions.

## WHICH COMPANIES NEED TO TAKE NOTE

Many Australian Securities Exchange (ASX) listed companies have the majority of their shares held by financial institutions such as funds' managers and superannuation funds. Many superannuation funds use specialist funds managers to invest the monies they hold on behalf of members and allow the funds' managers to vote the shares acquired with those funds. Some superannuation funds are now requiring funds managers to vote shares held on their behalf in accordance with their directions. Funds' managers and superannuation funds that are controlling the voting of shares held by funds managers generally subscribe to proxy advisor services so that they may be well informed when exercising those voting rights. The main proxy advisors seem to be CGI Glass Lewis, ISS and Ownership Matters with Regnan as a major ESG research and engagement provider for institutional investors.

It appears that the major funds managers and superannuation funds subscribe to proxy advisory services in relation to the companies that comprise the S&P/ASX300 as well as for specific additional companies in which they, at the relevant time, have significant investments. Thus, companies that fall outside the S&P/ASX300 may be on or off the radar of proxy advisors and superannuation funds depending upon the investments they (or their clients in the case of proxy advisors) hold at a point in time.

The ASA represents the interests of retail investors and therefore may take an interest in a wider range of companies than proxy advisors. However, given the ASA's limited resources it is understood that they tend to also focus mainly on those companies in the S&P/ASX300.

Companies that fall outside the S&P/ASX300 often have a significant percentage (often more than 25%) of their issued shares held by a small group of shareholders (typically less than 6). Ensuring that this group of shareholders recognises that the company is adopting reasonable and appropriately performance focussed KMP remuneration practices is essential to avoiding a "strike".

Accordingly, all ASX listed companies should ensure that they observe soundly based KMP remuneration practices and fully explain such practices in their Remuneration Reports to limit the possibility of a “strike” against the adoption of the reports.

## TELL US THE STORY

Contrary to popular belief the proxy advisors we met with were not prescriptive in their approach to remuneration issues. While most do have guidelines that are intended to be used internally to guide recommendations and externally to sense check practices, there did not appear to be a pervasive “box-ticking” culture. What they seem to be asking for is a transparent explanation of KMP remuneration policies and logic, particularly for incentive elements of remuneration and their linkages to company performance, as part of the Remuneration Report component of the Directors’ Report. This is a perspective with which GRG strongly agrees having observed a number of cases where clients had received and accepted advice on urgent changes that needed to be made, and had failed to disclose the proposed changes in their Remuneration Reports. In these cases proxy advisors have little choice but to recommend against the Remuneration Report which often leads to a “strike” being recorded against the company.

The proxy advisors and stakeholder groups that we met with accepted that boards, and in particular non-executive directors, were in the best position to make the right choices for companies and their shareholders. There was no assertion that they knew better but rather that they could only make voting recommendation decisions based on the limited information provided. Therefore what they appear to be seeking is additional information on the rationale, logic and considerations behind why the remuneration practices outlined in the report are appropriate to the circumstances of the company. Statutory disclosure does not require this if read narrowly, and therefore, in order to equip stakeholder groups with sufficient information with which to judge the appropriateness of practices, disclosures should go beyond the basic requirements.

As long as there is a rational and clear explanation in the remuneration report that illuminates remuneration practices as being reasonable, most of the groups we spoke with preferred to be supportive rather than opposing remuneration resolutions. This requires some narrative around the circumstances of the business, the current and future drivers of performance and the journey to link these effectively with remuneration in current and future years.

This echoes Blackrock’s 2012 paper on incentives which suggested that each company should examine the drivers of performance under the particular circumstances they find themselves in, and design incentives that are aligned with those circumstances and the required future performance. This comment arose from the observation that the vast majority of ASX listed companies use similar LTI vesting conditions being EPS growth and relative TSR.

## INCENTIVE PERFORMANCE CONDITIONS

While it has been said for some time that only relative TSR and EPS growth will have the support of the proxy advisors and other stakeholder groups as LTI vesting conditions, with the exception of Ownership Matters we were able to confirm that this is not the case. In fact there was a strong preference for consideration of other measures should these be seen by the board to have a stronger link with company performance under the particular circumstances of the company. However boards remain reluctant to do anything different that may be seen as unusual, creative or cutting edge on the assumption that departing from accepted practices will attract push-back from these stakeholder groups. At the same time the deficiencies of relative

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TSR and EPS growth are well understood and accepted by boards; it is impossible to identify a robust group of direct comparators that is sufficiently large to be statistically meaningful to a relative TSR assessment, leading to lottery-like outcomes (largely due to a broad range of betas.) In the case of EPS growth there is no recognition of the cost of capital or shareholders' expectations of returns and therefore sub-optimal investment decisions are motivated (growth in profit alone does not mean growth in value or in returns to shareholders).

The way appears clear for boards to start to think more strategically and deeply about what incentives may best motivate the performance of their top teams and GRG strongly encourages clients to do so.

GRG was also surprised to note that not all groups require an absolute TSR positive vesting gate to be applied to LTI vesting conditions. While this gate ensures that no LTI will be payable if shareholders have lost over the measurement period, there was acceptance among some that we met with that a certain amount of incentives may be appropriately vested in these circumstances, for example if TSR were negative but TSR Alpha was positive (i.e. losses were not as great as expected and shareholders were protected from overall downward market movements to a greater extent than implied by the company's beta). It should be noted that the ASA in particular is strongly advocating positive TSR gate conditions for LTI. The ASA also appears to be supportive of components of fixed remuneration or STI being deferred into securities, which was also highlighted as a preferred practice by one proxy advisor. However it should be noted that Employee Share Scheme (ESS) securities are taxable on the day of grant unless a real risk of forfeiture (performance test) applies, which presents significant challenges for these types of structures.

### NED SECURITIES

Most of the groups we met with were generally sceptical of securities being offered to NEDs as part of remuneration, except in the cases of start-up companies and explorers/researchers where cash needed to be conserved and revenue generation was limited or nil. The reasons for this have been canvassed in other recent GRG Remuneration Insights (see RI 46 and 47) and will not be re-stated here. However, it was reaffirmed by several parties that there was no automatic "against" where securities are provided, but that the appropriateness of this practice to the circumstances of the company would need to be explained if it were to be supported by stakeholder groups. Paramount is the protection of the independence of directors and ensuring that they are free to make decisions in the best interests of shareholders without undue influence. However GRG believes that securities can be designed such that they will not create an inappropriate incentive to hold on to board positions beyond 12 months and would not be of sufficient magnitude to compromise independence. This has received conditional support from at least one of the proxy advisors who recognises that NED securities have the potential to create positive alignments between NEDs and other shareholders.

The ASA expressed a very different view to that of the proxy advisors. While they strongly oppose NEDs receiving the same equity incentive schemes as the executives, they encourage NEDs receiving part of their fees in ordinary equity in order to have "skin in the game". The ASA believes a NED should own shares worth more than a year's worth of cash fees and including shares as part of remuneration is one path to this outcome. The comment made was that NEDs should not be presiding over the demise of companies and the suffering of shareholders without such "skin in the game" to ensure that the work of the Board has the full attention of a NED -particularly under those circumstances.

## ENGAGE IN CONVERSATION

The stakeholder groups were much more willing to engage with companies that are the subject of their advice than may be broadly assumed. While for all there are periods related to reporting and AGM seasons where it may be challenging or impossible to find time to meet, they were all otherwise open to engaging in conversation with companies that are the subject of their advice. It was suggested this might be best done well ahead of reporting season and ideally at the point at which boards are weighing up alternatives to be implemented in the future. GRG often recommends that clients “road test” new remuneration structures with stakeholders before implementation to gauge support and to manage strike risks. This includes meeting with proxy advisors or any other stakeholder group that may have a significant influence upon AGM voting patterns. This was echoed by almost all of the groups we met with who indicated that they much preferred an opportunity to explain why they did not support particular arrangements in particular circumstances at a point where the situation could be remedied and a strike avoided, than to recommend a vote against the remuneration report after a plan has been implemented. This would appear to make good sense for all parties involved as making changes to remuneration structures can be expensive.

This engagement with stakeholder groups need not be time consuming or exhaustive. GRG has for a long time recommended that clients engage with shareholders more deeply on the issue of remuneration and that consideration be given to more open and complete disclosures as part of the annual report, (including writing to shareholders where major changes are being considered to gauge sentiment and explain how remuneration is to be used to greatest effect). We have seen a number of cases where strikes have been expected but avoided as a result of genuine efforts on behalf of clients to inform and engage with stakeholder groups on remuneration issues. These groups generally aren’t looking for an opportunity to dictate policy, but do like to be well informed, which is in everyone’s interest. After all, when a strike occurs any comments made at that AGM in relation to remuneration must be recorded and responded to as part of the next Remuneration Report disclosures under the Corporations Act. In GRG’s experience those comments tend to be made on the basis of a lack of clear understanding and it is much better to avoid those comments being publicly made, recorded, re-printed and drawing attention the next year.

### Key Management Personnel Remuneration Advice

GRG is a specialist advisor on remuneration for key management personnel (KMP) i.e. non-executive directors, executive directors and other top executives, meaning that we are truly independent.

To facilitate its advisory function GRG maintains Australia’s largest KMP remuneration database with over 1,000 companies and over 6,000 incumbents. The analysis this allows keeps GRG up to date with current trends and developments and enables us to produce specialist benchmarking as well as broad remuneration guides.

The increased focus being placed on KMP remuneration makes it more important than ever for Boards to be satisfied that they are adopting practices that are consistent with market practice and appropriate to their company’s circumstances, and to communicate remuneration decisions clearly and effectively.

If you would like an independent review of the market competitiveness of your company’s remuneration practices for KMP then GRG will be pleased to assist. We can also assist in communication strategies, drafting of Remuneration Report disclosures, resolutions related to remuneration, incentive plan rules and engaging with stakeholders to manage strike risks. Please call Denis Godfrey, James Bouchier or Mike Carroll on (02) 8923 5700 or Nicholas Jackson on (03) 9607 1318 for further information.