

TWO STRIKE RULE: WHO REALLY DETERMINES REMUNERATION RESOLUTIONS?

Boards at 100 listed companies, including 23 ranked in the ASX 300, face the possibility of ‘spill resolution’ at their 2012 Annual General Meeting if shareholders deliver a 2nd annual ‘strike’ against executive remuneration.

This is not news, of course, for any company that received its first ‘strike’ at their AGM last year. It will have been the focus of intense discussion at board meetings, legal advice and governance reviews. “What went wrong, why did this happen and how do we fix it?” would be some of the obvious questions asked and finding the answers is an important pre-requisite to avoiding the second strike.

An important part of the process will be for Chairmen and key directors to engage with shareholders. Anecdotal evidence is that the number of companies seeking to engage with their shareholders has almost tripled since the two strike rule was introduced.

However, the more important question that needs to be asked at this time is “Who exactly should the Chairman be talking to – is it the proxy adviser, the fund manager, the industry superfund or all three?” Which of these three wields the greatest influence over the actual votes?

Who determines remuneration resolutions?

Whilst the focus on remuneration practices is one of the outcomes of increased attention in recent years to corporate governance, another is the increased number of institutional owners⁽¹⁾ who actively exercise their voting entitlements on shareholder resolutions, rather than leaving this function to the fund manager who selects and manages their investment in equities.

Votes of institutional (beneficial) owners are critical to the determination of remuneration resolutions as:

1. they will exercise their votes;
2. their voting entitlements are often material; and
3. their vote is typically sensitive to any adverse perceptions on remuneration best practice.

Our research into institutional voting patterns has identified that around two-thirds of Australia’s major industry super funds actively exercise their voting entitlements (or direct their fund managers how to vote) for their investments in ASX 200 companies.

Whilst the comparative figure for ASX companies outside the ASX 200 is less, at around 40% of local institutional beneficial owners, we estimate that these same “actively voting” institutions account for over 60% of total domestic institutional investment in ASX companies outside the top 200.

Proxy Voting/Corporate Governance advisers

Conventional wisdom is understandably that proxy advisers have a substantial influence over the voting habits of the overwhelming majority of Australian institutions (and their fund managers) who subscribe to these corporate governance advisory services.

However, our research and first-hand experience suggests that the influence of proxy advisers, on the ultimate voting decisions of institutional owners, can easily be overstated and should not be assumed.

¹ Institutional owners/institutions in this article refers to the beneficial owners of shares, as distinct from the fund managers who invest on their behalf.

TWO STRIKE RULE: WHO REALLY DETERMINES REMUNERATION RESOLUTIONS?

CONTINUED

Many institutional owners in Australia are open to meeting 'one-on-one' to listen to the case put by a company, especially where the institution is considering voting against the remuneration report. They will take into account alternate views to an adverse recommendation by a proxy adviser, in particular the view of the fund manager(s) responsible for their investment in the company.

Managing the Process

Companies concerned by risk of a 'strike' or a 'spill resolution' should **start planning now** for a programme of structured engagement with proxy advisers and key institutional owners and fund managers.

1. Engaging with institutions who actively vote

Directors and senior management of many companies listed on the ASX have historically not been required to be overly familiar with the company's institutional owners; the quantum of their voting entitlement; or whether the institutional owner exercises its vote, or delegates that function to its fund manager(s).

For the majority of the year a company focuses its efforts almost exclusively on the fund managers who are contracted to make the investment decisions on the super funds' behalf. However, when it comes to the AGM or any Meeting requiring a vote, a different lens must be applied. A separate layer of analysis is required which, in addition to key fund managers and retail investors, specifically identifies:

- the company's key institutional owners;
- which institutional owners actively vote;
- their voting entitlement; and
- which proxy advisers advise them.

2. Early engagement with key voters and advisors

The compressed nature of Australia's spring AGM season means early engagement is essential if a company wishes to ensure it has adequate access to key proxy advisers, active institutional voters and fund managers. Access to proxy advisers in particular is far more practical outside the AGM season.

For a company with a June balance date this means that preliminary conversations with key voters conclude by September. The company can then use feedback from such discussions when finalising the remuneration report or considering how best to communicate its recommendation, before the remuneration report is 'locked in' by the despatch of the Notice of Meeting.

In our experience, some issues relating to contested remuneration reports could have been avoided by better communication both prior to the meeting and in the documentation mailed to shareholders.

3. Contested remuneration resolutions

The large majority vote required to avoid a strike against the remuneration report, at 75% of votes cast, is akin to a special resolution. Assuming the board has met with shareholders and outlined the rationale for its remuneration report, possible scenarios include:

- Lack of support is known in advance but there is nothing that can be done to change key (and potentially blocking) shareholders' views;
- Shareholders do not share their voting intentions and lack of support is not known until proxies are lodged in the days prior to the Meeting.

Where there is sufficient advance notice of dissatisfaction, the most positive action a company can take is to ensure that its broader communications to shareholders, including retail investors, reflect cases both for and against the remuneration report. The viewpoint of one particular shareholder may not be shared by others. Elevating the importance of voting, particularly where a second strike is a possibility, becomes an important exercise in investor relations.

This might take the form of calling retail investors directly to ascertain if they have any questions requiring clarification, posting a Q&A page on the website which addresses commonly asked questions relating to the remuneration report or including a summary of various objections raised by shareholders and the board's response to those. Measures taken to address adverse perceptions leading to a first strike at the previous AGM would be highlighted.

Caution should be exercised in spending company funds on pro-active vote solicitation campaigns which may risk perception of unduly influencing the outcome of the resolution on the remuneration report. Such expenditure might arguably be an improper exercise of directors' powers or misuse of their position.

Where a board is caught unawares with little time to respond to a negative vote, the exercise then becomes one of detailed attention to management of the Meeting including potential interest from the media.

Of course it is possible that the remuneration report and the two strike rule lends itself to exploitation by disgruntled shareholders seeking to either 'put the board on notice' or destabilise the board for reasons unrelated to genuine concerns over remuneration. Under such circumstances the need for communication remains the same, but understanding the agenda and being alive to the endgame of particular shareholders, can change completely the rules of engagement.