
Two Strikes and You're Not Out: A Study of Australia's Shareholder Say on Pay Regime

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I. Abstract

In 2011 Australia implemented legislation which attached consequences to the mandatory shareholder vote on the executive remuneration of a corporation, widely termed the 'two-strikes say on pay' rule. Under this rule, a corporation that attracts a vote of 25% or more against their resolution to approve the remuneration report in two consecutive years must allow shareholders to vote on a resolution requiring all board directors to stand for re-election. This thesis examines the development and implementation of the two-strikes regime and its operation over a four-year period from 2014. The research questions examine whether the operation of the two-strikes regime has realised the policy goals set out for the regime in its development process.

In order to identify how the two-strikes regime emerged and the policy goals of the regime, an examination of the legislative process, led by the Australian Productivity Commission, that established the regime is performed. Analysis of the published materials of the Productivity Commission inquiry, reveals that the commissioners intended for the regime to empower shareholders to hold board directors accountable for excessive executive remuneration, to strengthen shareholder engagement with corporate boards on their remuneration, as well as to provide a last resort option for dealing with unresponsive boards.

To assess the operation of the two-strikes regime in achieving those policy goals a sequential mixed methods approach is adopted. A regression analysis of voting strikes on the remuneration report is followed by a qualitative analysis of media reporting on executive remuneration to support the findings of the quantitative analysis. Using a sample of 704 shareholder votes on the remuneration report for large Australian corporations between 2014 and 2017, the analysis demonstrates that larger short-term benefits paid to the executives with the greatest total remuneration increase the likelihood of a voting strike being received, whereas long-term benefits and equity remuneration are not significantly related to the likelihood of receiving a strike. In addition, greater media coverage of a corporation's remuneration practices is also linked to a higher likelihood of receiving a voting strike on the remuneration report. To further elaborate on these findings, an analysis of 200 news articles and an interview with a principal of a proxy

advisory firm is conducted to identify reasons for why shareholders vote against the remuneration report resolution. The awarding of pay for poor performance and poor communication with key stakeholders in respect of remuneration, primarily institutional shareholders and proxy advisers, are most commonly related to shareholder voting dissent. In addition, increased communication with these stakeholders following shareholder voting dissent moderated shareholder dissent in the subsequent year, with shareholders being more forgiving of excessive remuneration. Conversely, a small number of corporations conversely attempted to deny the existence of or divert shareholder attention away from perceived concerns about their remuneration practices, which is observed to have limited success in ameliorating shareholder dissent.

Overall, the findings reported in this thesis suggest that shareholders assess the executive remuneration of an Australian corporation primarily on a pragmatic legitimacy basis, rather than on solely the excessiveness of executive remuneration as suggested by optimal contracting theory. Positive media coverage of a corporation's executive remuneration and communication with institutional shareholders are alternative legitimising actions which may positively influence the outcome of the shareholder vote. Shareholder reliance on these alternative sources of legitimacy potentially reflects the difficulties in shareholder comprehension of remuneration reports in assessing whether executive remuneration is optimal, limiting the power granted by the two-strikes regime to shareholders to hold directors accountable for excessive remuneration practices. In addition, the reluctance of shareholders to pass a board spill resolution for especially unresponsive corporations over the sample period supports the assertion that the two-strikes regime may have limited effectiveness in dealing with such boards, as shareholders are unwilling to risk destabilising the corporation through a board spill to assert their discontent with executive remuneration.

II. Statement of Originality

This is to certify that to the best of my knowledge, the content of this thesis is my own work. This thesis has not been submitted for any degree or other purposes.

I certify that the intellectual content of this thesis is the product of my own work and that all the assistance received in preparing this thesis and sources have been acknowledged.

Benjamin Lay

8th May, 2021

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1. Introduction

1.1. Executive Remuneration and Say on Pay in Australia

The past decade has witnessed ever-increasing public interest in the compensation levels of executives of corporations, with substantial public and media criticism of large executive remuneration packages in the wake of the Global Financial Crisis of 2007-8 (Farmer et al., 2013; Gregory-Smith et al., 2014; Monem & Ng, 2013). In Australia, the most prominent displays of criticism are the shareholder votes against corporate resolutions to approve the executive remuneration report, which this thesis terms *voting dissent*. In 2018, National Australia Bank¹ recorded a vote of 88.1% against the approval of its remuneration report, the highest proportion of voting dissent recorded against a large Australian listed corporation since 2005 (Frost, 2018). Other instances of substantial voting dissent against executive remuneration include a 62% vote against Telstra's² report in 2018, a 61% vote against AMP's³ report in 2018, and a 50% vote against Commonwealth Bank's⁴ report in 2016 (Mason, 2018). Outside of shareholder actions, media reporting has highlighted a public perception that the executive remuneration of a number of Australian corporations is excessive for the performance of those corporations (Myer, 2019; Rhodes, 2019).

During this period of time the governments of several jurisdictions, including Australia and the UK, recognised a need to strengthen the regulation of executive remuneration without significantly impairing the market forces that are reported to determine executive remuneration efficiently (Conyon and Sadler, 2010; Sheehan 2009). In 2002 the UK was among the first countries to allow the shareholders of a company to vote on its remuneration policy, which was subsequently dubbed “say

¹ One of Australia's “big four” banks and one of the top 10 largest corporations listed on the Australian Stock Exchange (ASX) by market capitalisation (Australian Securities Exchange, 2020; Verrender, 2020).

² Australian telecommunications corporation within the top 20 largest corporations listed on the ASX (Australian Securities Exchange, 2020).

³ “Big four” bank and one of the top 10 largest corporations listed on the ASX (Australian Securities Exchange, 2020; Verrender, 2020).

⁴ “Big four” bank and one of the top 10 largest corporations listed on the ASX (Australian Securities Exchange, 2020; Verrender, 2020).

on pay” (Conyon and Sadler 2010, p. 298). This vote was merely advisory in nature and was not a precondition to the implementation of any remuneration policy. Australia adopted this advisory say on pay vote in 2004, with the Australian Treasurer at the time, Peter Costello MP, stating that it would “enhance transparency and... improve accountability... [to] shareholders” by providing a mechanism for shareholder activism (Commonwealth, 2003, pp. 23763–23764).

In 2011 Australia further strengthened the regulations on executive remuneration. The Government’s Assistant Treasurer, Chris Bowen MP, requested the Australian Productivity Commission to initiate a public consultation process to reform these regulations in response to “[concerns] raised over excessive [executive] remuneration practices” and stated that the “[2008] global financial crisis has highlighted the importance of ensuring that remuneration packages are appropriately structured and do not reward excessive risk taking or promote corporate greed” (Productivity Commission, 2009g, p. IV). Following the consultation process, the Productivity Commission recommended a form of binding say on pay voting be implemented that introduced consequences for a sufficiently high “no” vote on the say on pay resolution. This recommendation was subsequently implemented into law without alterations by the Australian Parliament (Explanatory Memorandum, Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011; Commonwealth Parliament, 2011; Productivity Commission, 2009g). Known as the “two-strikes” test, this new say on pay vote regime “targets the small number of boards that have not adequately addressed shareholder concerns over two consecutive years” (Commonwealth, 2011, p. 1097). Under the Corporations Act 2001 (Cth) Pt 2G.2 Div 9, if a resolution regarding the remuneration report receives at least 25% of votes against the resolution in two consecutive years, a board spill resolution must be voted on. If a majority of voting shareholders vote in favour of the spill, an election of all board members must be held within 90 days. Section 300A also requires a firm that has received 25% of votes against the remuneration report to disclose how they will address shareholders concerns in the following year’s directors’ report.

The introduction of shareholder say on pay reflects an implicit promotion of the role of institutional shareholders in restraining and regulating executive

remuneration, placing the onus of identifying inappropriate remuneration on these influential shareholders (Sheehan, 2009). This influence stems from their ever-increasing share ownership in companies as well as industry standards that tacitly require institutional shareholders to vote on all resolutions (Australian Institute of Company Directors, 2011; Sheehan, 2009). In turn, proxy advisory firms, who provide guidance to institutional shareholders on how they should vote on resolutions (Australian Institute of Company Directors, 2011), are similarly important in the process of approving executive remuneration.

1.2. Traditional Theories of Shareholder Voting Dissent

Under optimal contracting theory, corporate executives are assumed to act in their own self-interest (Gregory-Smith et al., 2014). In order to align the interests of executives with the interests of shareholders, rational shareholders will seek to incentivise executive behaviour to maximise shareholder value. That is, shareholders should favour executive remuneration plans which closely tie remuneration with the performance of the corporation, thus rewarding executives for increasing shareholder returns from improved corporate performance. However, under managerial power theory it is asserted that executives will engage in rent-seeking behaviour and seek higher than optimal remuneration from the viewpoint of shareholders while disguising that their pay is, in fact, not optimal (Bebchuk & Fried, 2003). The ability of executives to obtain non-optimal remuneration is limited by shareholder outrage, of which the binding say on pay presents one outlet for expressing such outrage in the Australian context.

There has been little consensus in the empirical literature as to whether executive remuneration is solely or substantially linked to corporate performance, as suggested by optimal contracting theory. Notably, Tosi et al. (2000) conduct a meta-analysis of 137 research articles and find that firm size has a greater effect on explaining the level of CEO remuneration compared to firm performance, with firm performance only accounting for 4.5% of variance in their remuneration variable (Tosi et al., 2000, p. 329). Similarly, Aguinis et al. (2018) in their examination of the fit of CEO performance and CEO remuneration to a power law distribution, observe that the “overlap between the distributions of CEO performance and CEO pay is

shockingly low”, particularly for the highest levels of performance and remuneration (Aguinis et al., 2018, p. 20).

Optimal contracting theory would suggest that economically rational shareholders would express their outrage at executive remuneration that is poorly linked to performance. However, research on say on pay in the Australian context has provided mixed support for this assertion. Monem and Ng (2013) observe that Australian firms receiving one and two voting strikes against the remuneration report are more likely to have poor CEO pay-performance links prior to those strikes. By contrast, Grosse et al. (2017) identify no significant relationship between voting dissent and excess CEO remuneration. This finding may reflect the camouflage of excessive remuneration by Australian managers from shareholders, or that shareholders take into consideration factors other than the optimality of executive remuneration in their voting decision. This research explores whether either or both assertions may explain the lack of consensus on whether less-than-optimal contracts motivate shareholder voting dissent.

1.3. Development of Research Question

The stated aims of the Australian two-strikes say on pay regime were to empower shareholders to hold directors to account for “[executive] remuneration structures that focus on short-term results, reward excessive risk-taking and promote corporate greed” (Commonwealth, 2011, p. 1096), and “better [align] the interests of shareholders... with the performance and reward structures of Australia’s corporate directors and executives” (Productivity Commission, 2009g, p. IV). Yet, the mixed support for less-than-optimal contracts as the primary motivator for voting dissent in the Australian say on pay literature puts doubt on whether these aims have been achieved. Thus, this research provides an examination of the following research question:

Have the policy goals of Australia’s two-strikes say on pay regime been realised in the regime’s operation?

This research identifies three inter-related policy goals of the two-strikes say on pay regime, presented in Chapter 3, and discusses the extent to which these goals have been realised in the operation of the two-strikes regime:

- To empower shareholders to hold board directors accountable for excessive executive remuneration practices, defined as practices which do not strongly align executive incentives with shareholder interests, while maintaining boards' ability to set their own remuneration (Commonwealth, 2011, pp. 1096–1097; Productivity Commission, 2009g, p. IV).
- To strengthen shareholder engagement with board directors on the setting and approval of executive remuneration policies (Commonwealth, 2011, p. 1097; Productivity Commission, 2009g, pp. 277, 389–390).
- To provide shareholders with the means to deal with boards that consistently refuse to address shareholder concerns with their executive remuneration policies, in the form of the board spill consequence (Productivity Commission, 2009e, p. 111, 2009g, p. 386).

This research focuses on the operation of the two-strikes regime in the time period after that examined in Monem and Ng (2013) and Grosse et al. (2017), as it is posited that shareholders will be more experienced and comfortable with the operation of the two-strikes regime and the board spill consequence. In contrast to prior studies of say on pay in Australian and other jurisdictions, this research is not limited to examining CEO remuneration. This research defines executive remuneration to include the remuneration of all executives detailed in the remuneration reports of Australian corporations, which recognises that the say on pay vote is to approve this report as a whole.

This research contributes to the executive remuneration literature and provides insights for policymakers in several ways. First, the Australian two-strikes say on pay regime is unique among other implementations of binding say on pay in the world. The structure of two advisory votes on the remuneration report resolution triggering a third spill resolution if sufficient votes against are recorded is likely to influence shareholder voting behaviour as compared to, for example, the

UK's direct binding vote on remuneration strategy. The Australian regime allows corporations to respond to voting dissent without initially attracting binding consequences and allows shareholders to express their dissatisfaction with the threat of a board spill if their concerns are not addressed. The 25% threshold potentially empowers a smaller proportion of shareholders to influence the remuneration strategy of the board. Conversely, the requirement for a 50% majority to pass the spill motion may hamper the effectiveness of this consequence for corporations with concentrated ownership, particularly if ownership is concentrated in board members (Monem & Ng, 2013). In light of the unique structure of Australia's regime there is a need to evaluate whether it has produced its intended outcome of restraining excessive executive remuneration. In particular, this research reviews the development of the two-strikes legislation to identify the policy goals of the legislation and discusses whether the outcomes to date reflect the meeting of these goals.

Second, this research identifies potential explanations for why shareholders of Australian corporations may not vote against excessive executive remuneration. Bruce and Buck (2005) levy the criticism that a substantial proportion of executive remuneration literature focuses on optimal contracting theory and the relationship between executive remuneration and corporate performance. Prior literature specifically examining say on pay voting in Australia has focused on this pay-performance relationship (Grosse et al., 2017; Kent et al., 2018; Monem & Ng, 2013). This excludes consideration of other reasons shareholders may find executive remuneration undesirable, such as the influence of news media coverage (Hooghiemstra et al., 2015). This research identifies and provides empirical and qualitative support for the assertion that shareholder voting dissent may be motivated for reasons other than a less-than-optimal executive remuneration structure.

1.4. Structure of Thesis

The following chapters provide an assessment of whether Australia's two-strikes say on pay regime has realised its policy goals. Chapter 2 details a review of the common theories used to explain the setting of executive remuneration and

empirical studies of the factors which may lead to shareholder dissent on executive remuneration. This review demonstrates the lack of empirical consensus on whether poor links between executive remuneration and corporate performance attract substantial or universal voting dissent, as suggested by optimal contracting theory. The need for further study of the determinants of, in particular, binding say-on-pay is highlighted in light of this lack of consensus.

Chapter 3 provides an analysis of the legislative process through which the two-strikes regime was created to identify the policy goals sought to be achieved by the legislation. This will allow for comparison with the subsequent analyses presented in the following two chapters and allow discussion of the extent to which the policy goals of the legislation have been achieved. A regulatory space lens (Hancher & Moran, 1989) is applied to the analysis of materials submitted to and published by the Productivity Commission Inquiry into Executive Remuneration, and it is found that the two-strikes regime was implemented to increase engagement of shareholders, particularly institutional shareholders, with the approval of remuneration. The Commission envisioned the two-strikes regime as a last resort tool to address recalcitrant boards unresponsive to shareholder concerns.

Chapter 4 presents an analysis performed on the voting strikes received on the remuneration report resolution for large listed Australian corporations regressed on variables reflecting the level of remuneration, firm performance, and news media coverage, among others. This analysis aims to identify the determinants of a voting strike and test three primary hypotheses. First, whether the level of executive pay is a significant and primary determinant of receiving a strike, as prior literature posits is the case (Borthwick et al., 2020; Carter & Zamora, 2007; Ertimur et al., 2011). A confirmation of this hypothesis would support the assertion that the two-strikes regime does empower shareholders to hold board directors to account for excessive executive remuneration practices. Second, whether the proportion of institutional ownership is a significant factor for receiving a strike. This hypothesis reflects the regulatory role institutional shareholders play in the Australian executive remuneration context and also the desire to increase institutional shareholder engagement noted by the Productivity Commission in their inquiry report (Productivity Commission, 2009g, p. XXXI; Sheehan, 2009). Third, whether

media attention is a significant determinant of voting dissent. As a means to weaken the legitimacy attached to a corporation's remuneration practices, media reporting has been found in prior studies to significantly affect corporate remuneration disclosures and shareholder voting behaviour (Hooghiemstra et al., 2015; Liu & Taylor, 2008).

Chapter 5 details a qualitative analysis performed on media articles which report on shareholder voting on the remuneration report resolution and identifies reasons for voting dissent in these articles. In particular, specific corporate and shareholders actions are identified on the basis of their impact on the pragmatic legitimacy attached to a corporation's remuneration practices, being legitimacy sourced from acting in a manner consistent with proximate stakeholder interests (Suchman, 1995). This chapter builds on the findings of the quantitative analysis presented in Chapter 4 and examines whether concerns with the pay-performance sensitivity of executive remuneration are reported as a substantial determinant of voting dissent on the say-on-pay resolution. The analysis also explores reasons presented in media articles for why a small number of boards remain unresponsive to shareholder concerns with their remuneration practices following multiple strikes.

Chapter 6 synthesises the findings and provides an overarching discussion of the analyses presented in the previous chapters. The findings of the quantitative and qualitative analyses provide weak evidence for optimal contracting theory as a factor in voting dissent, however they support the assertion shareholder perceptions of the pragmatic legitimacy of the corporation's remuneration may mediate or primarily motivate the likelihood of shareholders' voting against the remuneration report. The reliance on external assessments of a corporation's executive remuneration practices, including from media articles and proxy advisers, and the failure of shareholders to use the board spill consequence against persistently unresponsive boards are asserted as evidence for the policy goals of the two-strikes regime not being fully realised in its operation.

Finally, Chapter 7 outlines the contributions and limitations of this study and suggestions for further research. This research first contributes to the literature a novel empirical study of the drivers of voting strikes under Australia's two strikes

say on pay regime that includes consideration of media attention as an explanatory variable. Second, it makes a theoretical contribution by relating legitimacy theory and optimal contracting theory in explaining shareholder say on pay voting behaviour, framing optimal remuneration contracts and media reporting as sources of legitimacy for a corporation's remuneration strategy. Third, this study makes a practical contribution by evaluating the extent to which the two strikes say on pay regime has realised its policy goals including empowering shareholders to restrain excessive executive remuneration. It asserts the board spill component of the two strikes regime is generally not effective for this purpose when dealing with recalcitrant boards, due in no small part to shareholder reluctance to exercise it. This study calls for further qualitative research to understand the motivations behind shareholder voting behaviour; additionally further research is required to quantify any destabilising effect of a board spill, which has been offered as a reason for shareholder reluctance to vote in favour of a board spill.

2. Literature Review: Executive Remuneration Setting and Shareholder Voting

2.1. Introduction

In this chapter an overview of the extant literature on executive remuneration setting and shareholder voting on executive remuneration is presented. As a field of research primarily examined under the auspices of corporate governance, most research into executive remuneration has focused on the setting of executive remuneration by corporate boards, with the majority of studies assessing the degree to which such remuneration is based upon or contributes towards corporate performance (Bruce & Buck, 2005). These studies view executive remuneration as a means for shareholders to address the agency problem of executives not acting in a manner consistent with the interests of shareholders, often defined as maximising shareholder value through strong corporate performance. Yet the agency theory paradigm also acknowledges that the setting of executive remuneration in most jurisdictions is also subject to agency problems, as members of the board rather than the shareholder corpus generally sets remuneration policy and structure. Also, as mentioned in the prior chapter, Tosi et al. (2000) find in their meta-analysis of prior studies that firm performance is a poor explanatory variable for the level of executive remuneration. This research explores alternative theories that may explain the levels of executive remuneration set by corporate boards, recognising that no single theory advanced is able to explain the empirical observations of executive remuneration (Bruce & Skovoroda, 2015).

By comparison to studies of remuneration setting, studies of shareholder voting on executive remuneration comprise a small but growing proportion of executive remuneration research, reflecting the relatively recent introduction of say on pay legislation in jurisdictions globally. Again, reflecting the dominance of studies seeing this as an agency problem, the studies of shareholder voting dissent reviewed in this chapter generally focus on corporate performance as an explanatory variable for voting dissent or on the strength of the pay-performance link following

significant voting dissent. These studies demonstrate that research into the determinants of voting dissent are limited beyond considerations of the strength of the pay-performance link and further research into alternative determinants is warranted.

This chapter first presents a synopsis of the primary theories through which the setting of executive remuneration is analysed. This consists of the dominant optimal contracting theory, an application of agency theory to remuneration setting; managerial power theory; and institutional theory. These theories provide a framework for explaining the form and structure of executive remuneration shareholders would consider desirable. Next follows a review of empirical studies of the determinants of executive remuneration, which demonstrate a lack of consensus as to whether corporate performance is strongly linked to executive remuneration. Finally, a review is undertaken of studies of say on pay in the UK, one of the first jurisdictions to offer a non-binding say on pay vote; Australia; and the US.

2.2. Theories of Executive Remuneration

Research into executive remuneration is a subset of corporate governance research. It has focused largely on the link between executive compensation levels and the performance of the firm, as well as explaining the consistent growth in those levels over time (Gregory-Smith et al., 2014). Agency theory is the dominant paradigm through which executive remuneration is examined in the literature (Bebchuk & Fried, 2003; Tosi et al., 2000), however empirical studies have not unanimously shown the strong positive link between remuneration and firm performance proposed by agency theory (Bruce & Buck, 2005; Jensen & Murphy, 1990). Hence, other theories have been advanced to explain the variance between what is posited by the optimal contracting approach and empirical results, including managerial power theory and institutional theory (Bruce & Buck, 2005; Sheehan, 2009).

Under institutional theory the action of setting remuneration is subject to a set of rules and norms which lend social legitimacy to compliant organisations (Scott, 2005a). Hence, corporations that set their remuneration consistent with the

institutionalised rules and norms gain social acceptance of their remuneration plans. Importantly, as non-compliant remuneration will receive little or no social acceptance, change to these institutions is difficult and will meet resistance, a concept termed “inertia” (Bruce et al., 2005, pp. 1496–1497; Scott, 2005a). Where change does occur, it is the result of “functional pressures” such as market forces, “political pressures” from changes in the actors perpetuating the institutions, and “social pressures” reflecting changes in the diversity of stakeholder groups (Scott, 2005b, pp. 46–47; citing Oliver, 1997).

2.2.1. The Nature of Corporations and Agency Theory

For over a century academics have deliberated on the nature of corporations, asking what purpose they serve for society and for their members. Davis (1905) defines a corporation in part by the promotion of a “private interest” by a collective group of individuals undertaking activities which are better suited by being performed by a group, and in doing so also publicly benefits society (Davis, 1905, pp. 29–34). The example is given of the ownership of railways, which Davis opines would be more harmful to society in the hands of individuals than in the hands of corporations due to the risk of developing a plutocracy, without further elaboration. In context, it is likely Davis is referring to the separation of ownership and management or control that is one of the defining features of the corporation.

The neoclassical theory of the firm views the corporation as “a production function to which a profit maximization objective has been ascribed” (Williamson, 1981, p. 1539). The implications of this view are that executives are only valued by the corporation in the marginal benefit they contribute to the organisation (Holland et al., 2001). If this were the case, the level of executive remuneration would be set at the level at which this marginal benefit would be maximised. However, this theory of the firm has been criticised outside the field of economics for not identifying how the associate members of the firm achieve the objective of profit maximisation, viewing the firm as a “black box” (Jensen & Murphy, 1990, pp. 306–307). Notably, this theory disregards the separation of ownership and control and the costs associated with this immutable feature of corporations (Holland et al., 2001).

By contrast, Frederick W. Maitland invested the corporation with a “trust function”, holding trusts and corporations functionally identical in how each deals with ownership and property (Stoljar, 1958, pp. 34–38). Put simply, the plural owners of a corporation own an undivided share in the assets of the corporation, yet cannot deal with or purchase further assets individually (only owning a share in the assets) or as a group (as they “cannot together do the job of managing”) (Stoljar, 1958, p. 37). The example is given of “a hundred persons going into a shop to buy one ‘joint’ football” (Stoljar, 1958, p. 37). Hence, it is necessary for the owners of a corporation to delegate the responsibility of acquiring and dealing with the shared assets and generally manage the corporation.

Although each of these theories of the nature of corporations explains in part why executives are valued as a feature of the corporation, they offer limited guidance to how that value is calculated. In their seminal paper Jensen & Meckling (1976, p. 311) define corporations as:

...one form of a legal fiction which serves as a nexus for contracting relationships and which is also characterized by the existence of divisible residual claims on the assets and cash flows of the organization which can generally be sold without permission of the other contracting individuals [emphasis removed].

The implication of this definition is that the relationship between executives and the owners of the corporation is defined solely by the contract between them. This forms the basis for the central tenets of agency theory, which espouses that an agent acting under contract for a principal will act in their own interest, and those interests may not align with the interests of the principal (Jensen & Meckling, 1976). Because those interests do not align, the principal will incur costs in monitoring and incentivising agents to act in ways that align with the principal’s interests, or at least do not impair those interests. In addition, because the interests of agents and principals are unlikely to fully align, further costs are incurred when an agent’s actions do not “[maximise] the welfare of the principal” (Jensen & Meckling, 1976, p. 308). These costs are together termed agency costs. In the context of corporations, economically rational shareholders will seek to minimise agency costs, but are constrained by the costs of replacing executives and the opportunity cost of selling

their equity for an alternative investment (Jensen & Meckling, 1976). The implications of this for the incentivisation of executives to act to increase the value for shareholders through remuneration are set out in optimal contracting theory.

2.2.2. Optimal Contracting

The optimal contracting approach to executive remuneration is the application of an agency theory lens to the process of setting executive compensation, and views remuneration as an incentive for executives to align the interests of executives with the interests of shareholders (Gregory-Smith et al., 2014). Specifically, the approach assumes that remuneration for executives is economically efficient and designed such that executives act to maximise shareholder value (Bebchuk & Fried, 2003). Under institutional theory, optimal contracting may be viewed as a rational choice approach to institutionalisation, whereby shareholders impose the optimal contract to protect their own interests (Scott, 2005a).

However, after empirically examining the relationship between firm performance and executive compensation, Jensen and Murphy (1990) find that their “results are inconsistent with the implications of formal agency models of optimal contracting” (Jensen & Murphy, 1990, p. 227). Using a sample of US CEOs from 1974 to 1986, they regress the level of CEO compensation, including holdings of the firm’s shares by the CEO, on the change in shareholder wealth, represented by the change in market capitalisation in the year observed. This paper is notable for including the CEO’s shareholdings in measuring CEO remuneration, an aspect not captured in prior literature (Bruce & Buck, 2005). Jensen and Murphy find that a \$1,000 USD change in shareholder wealth is associated with at most an increase of \$3.25 USD in executive compensation (figures not adjusted for inflation), which they conclude is too low a level to be consistent with optimal contracting theory. They argue that political forces acting in remuneration committees that set executive compensation, as well as public and media scrutiny of high executive pay, result in inefficient contracts that fail to align executive and shareholder interests. However, the former argument conflicts with the implications of the managerial power theory outlined in Bebchuk and Fried (2003).

Murphy (2013) refers to a superset theory of optimal contracting termed “efficient contracting” (Murphy, 2013, p. 334), in which a combination of market forces for executives reaching equilibrium and optimal contracts which maximise shareholder value determine executive remuneration. In essence, the cost of replacing executives noted in Jensen & Meckling (1976) is included in the quantum of remuneration paid to CEOs, with a premium attached to CEOs hired outside of the corporation. In his discussion of the drivers of the massive CEO remuneration growth in the US during the 1980s-90s, Murphy argues that it is unlikely that efficient contracting alone would explain this trend. Instead, “the efficient contracting, managerial power, and political paradigms co-exist and interact” in the setting of CEO remuneration (Murphy, 2013, p. 346). The latter two are expanded in the following sections.

2.2.3. Managerial Power

Bebchuk and Fried (2003) present managerial power theory as a partially complementary theory to the optimal contracting approach which may explain why remuneration practices are inconsistent with optimal contracting, such as the results observed by Jensen and Murphy (1990). It is notable that more recent work has presented the optimal contracting approach and the managerial power approach as two competing viewpoints (for example Bruce & Buck, 2005; Gregory-Smith et al., 2014), which discounts the view of Bebchuk and Fried (2003) that the setting of executive compensation is influenced both by a desire for executives to maximise shareholder value, and by executive influence. The managerial power approach assumes that executives will engage in rent-seeking behaviour, obtaining compensation greater than what is economically efficient under optimal contracting, and that executives are able to influence their own level of compensation. Bebchuk and Fried (2003) justify this approach by stating that directors, who comprise the remuneration committee that sets compensation, have an incentive to agree with the CEO on compensation because the CEO has significant influence over the appointment of board directors.

This approach has two implications – executives have an incentive to hide their total compensation level or the specific structure of that compensation, termed

“camouflage”, and the compensation level is mainly limited by the negative reaction of external stakeholders to excessively large compensation levels, termed “outrage” (Bebchuk & Fried, 2003, pp. 75–76). Hence the process of setting compensation “is viewed not only as a potential instrument for addressing the agency problem but also as part of the agency problem itself” (Bebchuk & Fried, 2003, p. 72). These implications can be viewed as derivations of the rational choice approach to institutionalisation – executives act in their own self-interest, but may appear to constrain their own remuneration in order to achieve social acceptance of their remuneration and avoid outrage (Scott, 2005a).

The results observed in Jensen and Murphy (1990) may be explained by executives using their influence to increase their remuneration to a level much greater than their performance, reflected in increase in shareholder value, warrants. It follows that the managerial power approach offers a useful framework for explaining deviations from the optimal contracting approach, which itself offers a rational explanation for executive remuneration in general.

2.2.4. Institutional Theory

Bruce et al. (2005) expand upon the theories of optimal contracting and managerial power, as well as stakeholder theory, and argue that the environment of institutions surrounding a corporation alters the extent to which the three theories explain executive remuneration in that corporation (Bruce et al., 2005). In the context of their argument stakeholder theory draws upon Davis et al.’s (1997) theory of stewardship, where executives act for the benefit of certain “salient” stakeholder groups, though not necessarily for all stakeholders. This environment of institutions, both formal and informal, exerts “regulatory, normative and cognitive influences” on the corporation, such that any corporate action, including the setting of executive pay packages, must be viewed as “socially legitimate” to the surrounding institutions (Bruce et al., 2005, p. 1497). To demonstrate their argument, the executive remuneration structures and institutions in the UK and Germany are examined to explain the difference in remuneration schemes between these countries, and between the USA. The paper posits that through the appointment of executives to committees reviewing executive remuneration, the UK

has over time developed a self-regulated and standardised remuneration scheme which is viewed as socially legitimate by the surrounding institutions (Bruce et al., 2005, pp. 1499–1501). For example, they note that public criticism of executive stock options (ESO) eventually resulted in the Greenbury Committee, led by an executive, to adopt the public's position and warn against their use. Instead the use of long-term incentive plans (LTIP) has been promoted, which they assert is less effective for reaching an optimal contract and is partly responsible for the comparatively low executive pay in the UK compared with the USA. They conclude that executive remuneration in the UK emphasises social legitimacy over the pay-performance link that is emblematic of agency theory, as a result of the institutional environment in the UK.

2.2.5. Empirical Research on Remuneration Setting

2.2.5.1. *Quantitative determinants of remuneration*

Bruce and Buck (2005) present an overview of executive remuneration in the UK from the 1970s to the 1990s. Importantly, they briefly review the empirical research on the relationship suggested by optimal contracting theory between firm performance and executive remuneration in the US and the UK, as well as a small number of other papers which find variables including firm size and CEO tenure length as significantly associated with compensation levels. The primary criticism Bruce and Buck (2005) level at the empirical studies reviewed is the use of variables which do not comprehensively reflect the total compensation received by executives, which may explain why there is no unanimous observation on the strength of the relationship between performance and pay in the reviewed literature. The other criticism they make is that the majority of the literature has adopted the optimal contracting approach and focused on the relationship between performance and pay (for example Jensen & Murphy, 1990), which they suggest is at the expense of research into other explanatory variables for executive compensation levels. This focus on the application of agency theory to the study of executive remuneration has persisted in the following decade (Wowak et al., 2017). As firm performance is unlikely to be the sole or primary determinant of executive

remuneration, it is appropriate to consider whether shareholders punish firms that determine remuneration based on other factors, given that it may not result in an optimal contract desired by shareholders under the optimal contracting approach.

One of the major papers reviewed by Bruce and Buck (2005) is Tosi et al. (2000), whose main finding is that firm size is a greater determinant of CEO pay than firm performance, with the latter “[accounting] for 4.5% of the variance in CEO pay levels” (Tosi et al., 2000, p. 329). This finding is notable as it is the result of a meta-analysis of 137 articles measuring the relationship between CEO pay and any measure of firm performance or firm size, with factor analysis performed to account for the wide variety of variables used to represent firm performance and firm size. The results of the meta-analysis are significant and clearly show that the correlation between CEO pay and firm size (0.520) is much greater than the correlation between CEO pay and measures of firm performance (0.212, 0.117) (Tosi et al., 2000, p. 328). In a second meta-analysis where absolute financial performance measures are included as measures of firm size, the correlation between CEO pay and firm size increases in magnitude, “[accounting] for more than 40% of the variance in CEO pay” (Tosi et al., 2000, p. 329). These findings are strong indicators that the optimal contracting approach alone is unable to explain the setting of executive remuneration, and the authors posit that moderator variables such as industry, organisational structure, and ownership structure influence how remuneration is set.

Similarly, in the Australian context Shields et al. (2003) find that while firm size is significantly correlated with executive remuneration, measures of company performance were not significant predictors of remuneration for the financial years ended 2001 and 2002. Importantly, the individual components of executive remuneration – base salary, cash remuneration, shares and options – were regressed and none were found to be significant. However, these findings date prior to the introduction of say on pay and prior to the requirement to separately report short-term and long-term performance incentives for executives, and thus may not reflect the current state of remuneration setting in Australia.

2.2.5.2. Remuneration setting by remuneration committees

Ogden and Watson (2012) find no evidence of executive capture of remuneration committees in their study of five UK water companies, as suggested by the managerial power approach. Adopting a case study approach relying on company documents and interviews with parties involved in the remuneration setting process, they instead find that the remuneration committees primarily focus on setting competitive remuneration packages to attract and retain talented executives. This is in line with resource dependency theory, which holds that the firm will be competing with other firms to attract talented executives, a resource for the firm. To do so the remuneration committee must align their remuneration setting with industry practice, partly through the use of comparisons of executive remuneration with similar firms, in order to convince “[executives] that pay decisions were fair and reasonable” (Ogden & Watson, 2012, p. 509). The evidence provided by remuneration committee members also indicates that they take into account shareholder concerns regarding excessive remuneration, which under resource dependency theory is a constraint on their ability to attract quality executives. While the findings of this study may not necessarily extend to the majority of companies in the UK, they suggest that remuneration setting is dictated substantially by industry practice and market forces, which may conflict with the linking of firm performance to remuneration desired by shareholders under the optimal contracting approach. The question that follows is whether shareholders are agreeable to this approach if this conflict does arise.

Main et al. (2007) perform a series of interviews with 22 remuneration committee members of UK companies in order to assess whether the process of setting remuneration has been changed following the Cadbury Committee in 1992. The authors argue that following the Committee which examined corporate governance in UK companies, including remuneration practices, there is an expectation that remuneration committees consider the optimality of their remuneration – the linking of executive incentives with shareholder interests. Their key finding is that remuneration committees did not appear to primarily or solely take this into consideration when setting remuneration, but rather adopted industry-accepted practices and institutional shareholder recommendations to

appease these shareholders. This finding that “remuneration committees reach for the security of the institutional isomorphism and set in place remuneration arrangements that look very similar to those of their neighbours” lends support to institutional theory as an explanatory theory for remuneration setting (Main et al., 2007, p. 24). They note that by adopting industry-accepted practices for remuneration board directors expressed that institutional shareholders were less likely to relay concern about their remuneration practices. This can be mapped to the concept of adopting industry isomorphic remuneration practices to obtain social legitimacy (Bruce et al., 2005; Deephouse, 1996).

2.3. *Say on Pay* - Shareholder Voting on Executive Remuneration

The prior sections described the various paradigms in which the setting of executive remuneration is analysed. Notably, the empirical evidence suggests that CEO remuneration is not likely to be structured to maximise shareholder value. In this section the literature on shareholder approval of executive remuneration is outlined. The research on the shareholder approval of executive remuneration schemes has primarily examined the effect of weak links between company performance and executive remuneration on the approval of remuneration resolutions, and the response of companies to a negative voting outcome on a remuneration resolution. The consideration of factors external to the company is limited thus far to research on the advisory say on pay scheme in the US, where the effect of proxy advisers, third parties that provide recommendations on how to vote on resolutions, has been examined.

2.3.1. Say on Pay Shareholder Voting in the UK

Conyon and Sadler (2010) empirically examine shareholder voting on executive remuneration in the UK, asking whether shareholders are more likely to vote against resolutions relating to remuneration compared to other resolutions, and the effect of such voting dissent on CEO pay. They state that the UK was the first of a small number of countries allowing for shareholder voting on a “Directors’

Remuneration Report (DRR)” (Conyon & Sadler, 2010, p. 298) disclosing a firm’s future plans for executive remuneration. Implemented in 2002, this vote is termed “say on pay” (Conyon & Sadler, 2010, p. 296), although this vote is non-binding - it does not preclude adoption of the remuneration plan and acts only as a signal to the firm’s board. Using data on resolutions voted on in UK firms from 2002 to 2007, Conyon and Sadler (2010) regress the percentage of dissenting votes on a resolution against a binary variable representing whether the resolution is for approval of the DRR and observe that higher levels of dissent are associated with these resolutions compared to other resolutions. Similarly, they observe higher levels of dissent associated with all resolutions regarding executive remuneration. However, using a smaller sample of 200 UK firms in 2006, they also find no evidence of a relationship between CEO remuneration levels and the percentage of dissenting votes in the previous financial period. Viewed through the managerial power lens, these findings suggest that shareholders use votes on remuneration resolutions as an avenue to express “outrage”, however this “outrage” does not appear to translate into a reduction in CEO remuneration levels. Conyon and Sadler (2010) suggest that, due to the lack of knowledge regarding the relationship between say on pay and remuneration, more research is necessary.

Gregory-Smith, Thompson and Wright (2014) examine the suggestion that the period during and beyond the 2007-8 financial crisis may exhibit differences in voting dissent activity and its effect on executive remuneration (Conyon & Sadler, 2010), using data on UK FTSE 350 firms from 1998 to 2012. They postulate that general shareholder approval of executive remuneration may no longer be assumed following the Global Financial Crisis, as high executive remuneration is publicly perceived as contributing to the causes of the financial crisis and there has been an emphasis on institutional shareholders to act as monitors of corporations to avoid future financial crises, which may be exhibited in voting dissent (Gregory-Smith et al., 2014). They observe that higher executive remuneration levels are positively related to the percentage of shareholders voting against the Remuneration Report, though this association is small in magnitude. In contrast to Conyon and Sadler (2010), they find that the level of voting dissent in the previous financial period is negatively associated with executive remuneration when the level of dissent is greater than 10%. However, they assert that this result does not appear to be an

effect of the Global Financial Crisis and observe that dissent levels after the Financial Crisis match the levels in 2001-2. Given that both studies control for similar variables, including CEO age, shareholder return and proportion of non-executive directors on the board (Conyon & Sadler, 2010; Gregory-Smith et al., 2014), a possible explanation for the difference in observations is that voting dissent varies with individual financial periods and the limited sample used in Conyon and Sadler (2010) was affected by a downtrend in voting dissent in 2005 (Gregory-Smith et al., 2014). Future research may seek to identify the seasonality of voting dissent and its effect on executive remuneration.

2.3.2. Australia's Regulatory Framework for Executive Remuneration

Sheehan (2009) provides an overview of Australia's regulatory framework for executive remuneration, observing that this framework is not sourced solely from black letter law but also incorporates rules and guidance provided by stock exchanges, institutional shareholders, business interest groups, and proxy advisers. In the case of proxy advisers, they provide both "statements of good remuneration practices" as well as guidance as to how shareholders should vote on remuneration resolutions (Sheehan, 2009, pp. 283-285). These parties and the law together regulate and constrain the four activities involved in setting executive remuneration: the "practice" of setting remuneration, "remuneration disclosure", "engagement between the company and shareholders on remuneration", and "voting on remuneration" (Sheehan, 2009, p. 277). Sheehan concludes that if shareholders are to determine if remuneration is appropriate, they must be provided with adequate disclosures and an effective sanction for companies that do not meet the standard of shareholders. However, it is also suggested that it is more appropriate to rely on regulator groups instead, such as institutional shareholder groups or proxy advisers, if legislators are seeking to address the implications of the managerial power approach and "check unrestrained executive greed" (Sheehan, 2009, p. 303). This suggestion was made prior to the implementation of the two-strikes legislation, which does allow these regulator groups to invoke sanctions.

2.3.3. Say on Pay Shareholder Voting in Australia

Monem and Ng (2013) present the first quantitative study to examine the current Australian context in relation to say on pay, which differs from the UK regime examined thus far with a binding two-strikes rule instituted in 2011 – “if the remuneration report of a firm receives 25% or more dissent votes for two consecutive years..., the board of directors except the CEO may face re-election” (Corporations Act 2001 (Cth), sec. 250R(2), 250U-250Y; Monem & Ng, 2013, p. 237). Adopting an optimal contracting approach, they examine whether “the pay-performance link is weaker in [firms receiving their first strike]” and whether the link increases in strength in the following year, or decreases if the firm receives a subsequent strike (Monem & Ng, 2013, p. 241). They use a sample of 104 firms in 2011 and 105 firms in 2012 that received strikes in that year and match them with non-strike firms based on industry sector and operating revenue, providing a useful comparison given the sample size. They observe that in 2011 voting dissent was negatively and significantly associated with the one-year change in CEO remuneration in firms with a strike, which they suggest is due to a desire from shareholders to use their newly legislated power. From other observations, they conclude that the pay-performance link for firms with one strike is stronger in the following year unless they have received two strikes, in which case it is weaker. However, the adjusted coefficients of determination for several models estimated are substantially less than 0.1, which brings into question the explanatory power of these models in identifying the determinants of change in CEO remuneration given the small sample size and number of independent variables. Furthermore, Monem and Ng (2013) focus on company performance as the determinant of voting dissent to the exclusion of other factors, nor is the influence of institutional shareholders or proxy advisory firms considered. These results present the first evidence of the efficacy of the Australian legislation introduced in 2011. Additional research on the factors that influence voting dissent and whether the goals of policymakers are being met appears necessary, particularly to determine if the effect attributed to the introduction of the legislation in 2011 is limited to that year.

Grosse et al. (2017) provide a similar quantitative analysis of Australian corporations that received a strike, performing a matched-pair analysis of the 274

ASX listed corporations that received a strike in 2011 and 2012. The study focuses on the determinants of voting dissent, regressing various measures of CEO remuneration and firm characteristic variables on both the receiving of a strike and the percentage of votes against the say on pay resolution. The authors find that no measure of CEO remuneration (total, base salary, cash bonuses, equity) is significantly associated with either voting dissent or the receipt of a strike. This holds true for both absolute CEO remuneration and excess CEO remuneration, calculated by regressing CEO remuneration on firm characteristics. On the other hand, book-to-market ratio and leverage are found to be significantly associated with voting dissent, which the authors posit reflects shareholders voicing their concern with poor corporate performance or other non-remuneration related issues through the say on pay vote. They also find that firms that receive a strike reduce CEO cash bonuses by a greater amount than non-strike firms, despite approximately equivalent levels of excess CEO remuneration between strike and non-strike firms. Finally, the study reports that firms increase the quantity of remuneration disclosure following a strike.

By contrast, Bugeja et al. (2020) observe evidence that greater abnormal CEO remuneration⁵ and higher year-to-year growth of CEO cash remuneration increase the likelihood of an Australian corporation receiving a strike under the two-strikes rule. The authors estimate a probit regression model and find both of these measures of CEO remuneration are positively and significantly associated with the probability of a corporation receiving a strike, controlling for corporate governance and firm characteristic variables. The model is estimated using a sample of 5,595 firm-years, comprising Australian corporations in the period 2011 to 2014, as it is posited studying the determinants of voting strikes in the 2011-12 period alone may be confounded by changes in executive remuneration practices during this period resulting from widespread outrage regarding excessive executive remuneration. The total percentage owned by large shareholders (shareholders with greater than 40% ownership), market-to-book ratio, return on assets and market capitalisation are observed to be statistically significant negative influences on the probability of receiving a strike, whereas the CEO also holding the position of chairman is found to

⁵ Defined as “the residuals from [estimating] the regression model of CEO pay in Core et al. (2008)” (Bugeja et al., 2020, p. 40).

be a positive influence. They also estimate a matched-pairs model for the 369 strikes identified in their sample, and similarly identify growth in CEO cash remuneration as significantly and positively associated with the probability of receiving a strike. The authors find through further quantitative analysis that following a strike boards reduce the level of abnormal CEO remuneration and the proportion of CEO equity compensation; however, they also find that the sensitivity of CEO remuneration to corporate performance is not significantly influenced by the corporation receiving a first strike against their remuneration report.

Borthwick et al. (2020) compare the impact of the advisory say-on-pay regime in effect prior to 2012 with the two-strikes rule on the moderation of CEO remuneration. Using a sample of 2,074 firm-years ranging from 2005 to 2015, mean and quantile regressions are performed to identify determinants of shareholder dissent on say-on-pay resolutions, as well as the influence of dissent on subsequent CEO remuneration. Notably, the sample is restricted to ASX 300 corporations, as it “facilitates the generalisability of the results to other institutional contexts with larger mean firm sizes including the United States and UK... [and the index] comprises approximately 81 percent of Australian equity market capitalisation, thereby accounting for the majority of influential firms...” (Borthwick et al., 2020, p. 830). Total CEO remuneration is observed to be significantly and positively associated with voting dissent, including all quantile levels estimated in the study. However, the influence of CEO remuneration on voting dissent is observed to be lower following the introduction of the two-strikes rule compared to the prior advisory say-on-pay period. The authors posit the reason was that “shareholders were more judicious in their voting behaviour” (Borthwick et al., 2020, p. 853, citing Monem and Ng, 2013). Corporate performance, measured using industry mean total shareholder returns, is also significantly and negatively associated with voting dissent, lending support for their hypothesis that shareholders use the say-on-pay vote to punish poor corporate performance. In relation to the influence of dissent CEO remuneration, dissent that was above the sample mean of 8.22% was observed to be significantly and negatively associated with CEO remuneration in the following year. Interestingly, dissent below the sample mean was found to be significantly and positively related with CEO remuneration, with the authors proposing that boards

view low dissent as a “licence to increase CEO pay in subsequent periods” (Borthwick et al., 2020, p. 857).

Kent et al. (2018) study the impact of remuneration committee composition on voting dissent and CEO pay-performance in non-large Australian corporations prior to the introduction of binding say-on-pay. The authors hypothesise that corporations following ASX guidelines for remuneration committee composition, which recommend at least three independent members and an independent chairperson, will attract lower voting dissent. A remuneration committee with greater independent representation is theorised to limit rent-seeking behaviour on behalf of executive managers, addressing the agency concerns of shareholders, and also represents a “best practice” in remuneration setting that shareholders are less likely to express dissatisfaction in relation to (Kent et al., 2018, pp. 449–450). Similarly, the authors hypothesise that corporations following the ASX guidelines are positively associated with stronger CEO pay-performance links as guideline conforming committees limit rent-seeking behaviour and are expected to adopt remuneration practices in favour of optimal contracts. In their findings following a quantitative analysis of 711 and 738 Australian companies in the 2008 financial year for testing each hypothesis respectively, the former hypothesis was not found to be upheld, with companies that had a completely independent remuneration committee composition weakly significantly associated with a greater proportion of voting dissent. Return on assets was noted to be associated with lower voting dissent, whereas total CEO remuneration, the number of independent board members and company size were associated with greater voting dissent. In relation to the strength of the CEO pay-performance link, their study finds that remuneration committees with a mixture of independent and insider members are significantly associated with stronger links while completely independent committees were not significantly associated. The authors propose that independent remuneration committee members lack insider knowledge necessary to develop optimal remuneration policies that strongly link to company performance, and in turn are not accepted by shareholders. A notable qualifier of this study is that the sample excludes companies listed in the ASX 300 index, as the authors assert in line with institutional theory that larger companies, “motivated by mimetic and coercive isomorphism... and influenced by traditions, norms and bureaucratisation” will

adopt similar corporate governance practices (Kent et al., 2018, p. 447; citing Beatty & Zajac, 1994; DiMaggio & Powell, 1983; Conyon & He, 2004).

Liang et al. (2020) provide an alternative approach to identifying determinants of voting dissent on say-on-pay, using an experiment to test the influence of the pay-performance link and prior strikes on shareholder voting behaviour. Relying on agency theory and prospect theory, the authors propose that although rational shareholders would base their voting decision on the strength of the link between executive remuneration and corporate performance, a prior voting strike alters a shareholder's "frame of reference" and "[weakens] the association between the pay-performance link and shareholder voting intentions" (Liang et al., 2020, p. 955). Experiment participants were presented with a newspaper article reporting on a fictional firm that was manipulated at two levels (with either a strong or weak pay-performance link, and with or without a prior first strike), resulting in a sample of 479 responses from volunteer Masters students. They find that both the pay-performance link and the existence of a prior first strike are each significant influences on voting behaviour, but also find that a prior first strike "[reduces] the likelihood of shareholders voting in favour of a remuneration report when the pay-performance link is strong" (Liang et al., 2020, p. 962). As the authors note, this study provides a valuable insight into the determinants of shareholder voting dissent on say-on-pay that studies using "archival data... can only speculate on" (Liang et al., 2020, p. 946).

2.3.4. Say on Pay and Proxy Adviser Research in the US

Ertimur, Ferri and Oesch (2013) examine the basis for and influence of recommendations provided by proxy voting advisory firms in the US context, focusing on shareholder voting on non-binding say on pay resolutions. Notably, the two firms identified as most influential in the US market, Institutional Shareholder Services (ISS) and Glass Lewis & Co., also dominate the Australian market for proxy voting advice (Australian Institute of Company Directors, 2011), demonstrating a partial overlap in the institutional environments of these two jurisdictions. As part of their extensive analysis they observe that the recommendations of each of the firms have a highly significant and substantial influence on the dissent on say on pay

resolutions, with their models exhibiting high explanatory power for the level of dissent. The effect is further pronounced when both firms recommend a vote against the resolution, but it is also noted that the differences between firm recommendations are also significant, which they interpret as the recommendations of the firms appealing to different groups of investors. Furthermore, while the observed influence of proxy adviser recommendations is significant, the effect weakens with investors with a higher proportion of ownership, in line with their hypothesis that these investors “have greater incentives to perform their own research” (Ertimur et al., 2013, pp. 979–980). This research provides strong evidence for the influence wielded by proxy advisers over shareholder voting in the US context, and given the influence of the US framework of executive remuneration over Australian and UK executive remuneration (Bruce & Buck, 2005; Holland et al., 2001), it is expected that a similar result will be observed in the UK and Australian environments. The results also demonstrate that institutional investors do not merely delegate their voting decisions to proxy advisers, suggesting that the factors considered by proxy advisers in making their recommendation are not congruous with the factors valued by investors in making their voting decision.

Larcker, McCall and Ormazabal (2015) extend the literature on the influence of proxy advisers on say on pay resolutions. Using data from shareholder meetings held in 2011 from a sample of 2008 US firms, their study first lends support to the assertion that the recommendations of proxy advisers have a significant influence on reducing voting dissent on remuneration resolutions. The study also finds, based on a probit regression of ISS recommendations on a sample of 603 US firms, that firms will be more likely to change their remuneration plans to match the policies of proxy advisers if it is likely that they will receive a negative recommendation if no changes are made. However, it is important to note that this result is based on a prediction of what ISS would recommend if no changes were made based on empirical analysis of past ISS recommendations. This study provides further support for the influence proxy advisers wield and suggests that firms will align their remuneration policies with the recommendations of proxy advisers to lend legitimacy to their policies.

2.4. Conclusion

In this chapter, the three primary theories through which the setting of executive remuneration is analysed in the literature are presented. Although optimal contracting theory, as an application of agency theory to remuneration setting, has been the dominant paradigm for executive remuneration setting research, empirical support for corporate performance as the primary consideration in setting remuneration has been lacking. Managerial power theory offers a complementary theory for remuneration setting that explains the poor pay-performance links observed empirically as a product of rent-seeking behaviour on the part of managers, tempered by the possibility of shareholder outrage. Institutional theory instead proposes that executive remuneration is set according to norms formed by environmental pressures that standardise across corporations, in the process earning social legitimacy for their remuneration policies and the corporation itself. Thus, executive remuneration is not viewed as a means to create an optimal contract to align executive interests with shareholders', but rather as a process in which conformity with accepted norms reaps legitimacy for the corporation. These three complementary theories provide a framework for the following empirical chapters to aid in understanding what shareholders would consider as undesirable executive remuneration practices that would attract voting dissent.

The review of studies on say on pay presented in this chapter establishes that the strength of the pay-performance link is not the primary determinant of voting dissent and identifies several areas where additional research is warranted. In particular, Conyon and Sadler (2010) notes binding votes and the potential effect of legal consequences for rejected resolutions as areas for further research. Furthermore, the role of institutional shareholders and proxy advisers, key participants in the remuneration setting and approval process according to Sheehan (2009), on voting dissent on remuneration resolutions has not been examined to any substantial degree. This is notable given their theoretical role in determining both remuneration under an optimal contract and in generating outrage to restrain executive remuneration under managerial power theory. Most significantly, the role of legitimacy in influencing voting dissent on remuneration resolutions, such as the

adoption of commonly accepted remuneration structures as seen in the analysis of Bruce, Buck and Main (2005), has yet to be assessed in detail. Finally, empirical research on the determinants of voting dissent has focused on answering whether corporate performance is the primary explanatory variable, leaving a gap for research into other potential determinants of voting dissent.

In Chapter 3 an analysis of the historical development of Australia's two-strikes say on pay regime is presented. This analysis in part addresses Conyon and Sadler's calls for studies of the potential effect of a binding vote through identification of the rationale behind imposing a board spill consequence under the Australian regime. The institutional context presented in the following chapter also offers a preliminary examination of the role of institutional shareholders and proxy advisers in executive remuneration setting through their participation in the legislative process.

3. History of the Two-Strikes Legislation

3.1. Introduction

Since 2004 Australian legislation has required corporations to allow an advisory vote on executive remuneration reports at each Annual General Meeting held by the corporation. This legislation was introduced as part of the Corporate Law Economic Reform Program, in response to recommendations made by the Royal Commission into HIH Insurance⁶ (Productivity Commission, 2009g). The Royal Commission identified inappropriate executive remuneration schemes as one of the myriad reasons for the failure of HIH Insurance, with the schemes incentivising executives to engage in risky activities and acquisitions that lead to the collapse. In this chapter an analysis is undertaken of the legislative process through which the advisory vote was transformed into the binding two-strikes say on pay legislative regime that currently stands in Australia.

In March 2009, the Australian government requested the Productivity Commission (hereafter referred to as the Commission) conduct a review of the regulation of executive remuneration for corporations subject to the *Corporations Act 2001 (Cth)* (Productivity Commission, 2009g). As with the introduction of the advisory vote, the Productivity Commission Inquiry into Executive Remuneration in Australia (hereafter, Commission Inquiry) was prompted by a crisis in the corporate environment, specifically extensive public and media criticism of executive remuneration during the Global Financial Crisis underway at this time. Following the publishing of the report of the Productivity Commission inquiry, the Australian Government adopted the recommendations of the inquiry and implemented the binding two-strikes vote legislation in 2011. This chapter examines how and why the two-strikes scheme was formulated and chosen as the Australian Parliament's response to the widespread public criticism of executive remuneration of the time.

⁶ The collapse of HIH Insurance was Australia's largest corporate failure to date and prompted a Royal Commission to determine the causes of its failure. The findings of the Commission led to widespread legal reform of Australia's corporate legal framework (Damiani et al., 2015).

The Productivity Commission is one of several legal reform advisory agencies of the Australian Government. Part of its core responsibilities is to provide independent advice on matters referred to it by the Treasurer, which includes holding public inquiries where it is mandated by law to seek and consider the views of the community as a whole, and not just specific interest groups (Productivity Commission, 2018). The Productivity Commission purports to achieve this in their public inquiries by accepting public submissions and holding hearings over a period of 9 to 12 months generally, prior to publishing their inquiry report. Commissioners of the Productivity Commission have also represented the Commission as a source of objective and evidence-based policy advice (Bennett Moses et al., 2015). In some respects, these processes of inviting comment letters and issuing draft recommendations are similar to those employed by standard setters and regulators of the accounting profession (Canning & O'Dwyer, 2013; Larson, 2008). However, as an independent body entrusted with part of the statutory lawmaking process and ostensibly less beholden to political interests than Parliamentary lawmakers, the Productivity Commission does not have the same interest in maintaining a position as a regulator as with these standard setters and regulators. This difference may therefore result in a contrast in behaviour on the part of the Productivity Commission and the parties issuing comments that is of interest.

This chapter proceeds with a review of the literature examining legal reform commissions, as well as an outline of the Regulatory Space construct through which the analysis of the Commission Inquiry will be performed. The analysis of the written submissions to, and public hearing transcripts of, the Commission Inquiry follows. This analysis identifies the participants in the Commission Inquiry process that were most likely to have influenced the development Commission's two strikes scheme recommendation. Finally, a discussion of why particular participants may have been more influential over the Commission than others caps the chapter.

3.2. Prior Literature

3.2.1. Legal Reform Commissions

The formation of legal reform commission in Commonwealth jurisdictions can be traced to the law reform commissions established in the United Kingdom and the Ontario Law Reform Commission in Canada (Gower, 1973). Gower suggests that criticism of the slow progress of legal reform through “judge-made law” was the main impetus for the formation of these commissions (Gower, 1973, pp. 257–258). In the common law jurisdictions of these Commonwealth of Nations member states, the principle of *stare decisis* states that prior judicial decisions and interpretations of the law bind future judicial decisions of subordinate courts. However, the creation of a precedent on a particular legal issue at the highest level of the UK judicial system is dependent on the House of Lords choosing to hear an appeal on the relevant matter, and then the precedents must often be drawn out from the opinions of multiple Lords, wherein the legal principle is not clearly stated (Gower, 1973). Furthermore, there is a noted disinclination on the part of judges to overrule precedent regardless of changes in the facts of the case or social environment (Mason, 1971, 2005). Statutory legislation has therefore become the primary vehicle to effect law reform in the Commonwealth nations of the United Kingdom, Canada, Australia and New Zealand (Gower, 1973; Mason, 1971).

In Australia, former Chief Justice Anthony Mason viewed legal reform commissions as a necessary component of the legislative process in the context of federal and state Parliaments enacting greater numbers of increasingly complex statutory laws year on year (Mason, 1971). Mason points to three factors driving the need for legal reform – the substantial proportion of legislation in need of review, the increasing divide between UK and Australian law, and the challenge of drafting legislation to meet the needs of “an era of dynamic social and ideological change” (Mason, 1971, pp. 203–205). The traditional common law institutions of the Parliament and the courts alone are unable to meet these needs, with Mason noting the difficulties of recruiting parliamentary draftsmen as an indicator of the issues facing Parliament. The advantage of legal reform commissions in this respect is that

they invite public submissions on a specified set of issues, publicised through a working paper, that can then be taken into consideration in drafting a bill; in contrast with Parliamentary bill making in which the public is rarely able to view a proposed bill and respond (Gower, 1973; Mason, 1971). The length of time between the publishing of a working paper and the presentation of recommendations to Parliament, and then to the proposal of a bill, allows for public debate and input from academics and experts. Mason also suggests that commissions present “proposals [which are] considered, evaluated and evolved, initially at any rate, by experts who are uninfluenced substantially by political considerations” (Mason, 1971, p. 210), at least in comparison to Members of Parliament.

There are few prior studies of the process undertaken by Australian legal reform commissions to generate policy recommendations and the resulting laws passed based on those recommendations. Bennett Moses, Gollan, & Tranter (2015) is one of the few papers that examine the process undertaken by the Productivity Commission to develop policy recommendations, and questions whether the Commission’s evidence-based approach is an improvement over the processes undertaken by other legal reform commissions. The research notes that while one of the Commission’s espoused objectives in developing recommendations is to consult with the community and stakeholders (achieved through acceptance of public submissions and holding hearings), several former and current Commissioners of the Commission have stated that the process of developing recommendations is akin to a quantitative analysis of the net productivity or social benefits brought about by a reform (Bennett Moses et al., 2015). Furthermore, the reputation of the Commission for engaging in quantitative, “impartial” and “objective” analysis to generate policy recommendations is evinced through quotes from Australian and foreign politicians and the OECD (Bennett Moses et al., 2015, pp. 661, 665).

To determine whether this reputation is reflected in the process for developing policy recommendations, the authors refer to six inquiry reports and one research report of the Commission. For each of the recommendations listed in the report, the authors identified the evidence cited in the report as support for the recommendation and categorised each piece of evidence on the basis of whether it

was: a “logical or legal” argument, supported by a source of scientific evidence, supported by economic theory, based on the submitter’s personal experiences, or unsupported by any secondary evidence (Bennett Moses et al., 2015, pp. 670–671). They find that a majority of the evidence cited in the analysed reports were arguments, followed by assertions unsubstantiated by secondary evidence. In addition, a substantial majority (83%) of the evidence cited was sourced from submissions and hearings as opposed to published research and reports (Bennett Moses et al., 2015, p. 673). From their findings the authors conclude that either the Commission’s reputation for “evidence-based” policy recommendations is not reflected in their heavy reliance on logical and legal arguments and unsubstantiated assertions contained within public submissions, or posit that while the Commission’s recommendations may be initially or broadly based on scientific evidence or economic theory, the Commission cites arguments and assertions to justify their recommendation in the final report.

Beaumont et al. (2018) examine the actions undertaken by respondents to the Productivity Commission Inquiry into Executive Remuneration in Australia, which this research also examines in this chapter. Beaumont et al. specifically analyse the lobbying behaviour of respondents to the Commission Inquiry, categorising respondents into six groups and describing the actions taken by respondents to interact with the Commission Inquiry. Notably, while respondents classified as “Individuals”, “Representative Bodies” and “Professional Bodies” were observed to “present a consistent message” in pre-discussion draft and post-discussion draft submissions, “Industry” respondents were initially more passive before presenting more aggressive messaging in post-discussion draft submissions (Beaumont et al., 2018, p. 299). The views of respondents are also compared with the final recommendations of the Commission Inquiry, with the authors observing that generally non-Industry respondents did not oppose the recommendations, excepting the two strikes rule recommendation. The authors also perform a content analysis of the remuneration reports of Industry respondents, and find that the views of these respondents were unlikely to be motivated by a desire to prevent reforms that would impact their remuneration policies.

The research presented in this chapter is distinguished from Beaumont et al. (2018) in several aspects. First, this research focuses on the development of the two-strikes scheme recommendation throughout the Commission Inquiry, as opposed to a general analysis of the actions taken by respondents. Specifically, this research focuses on how the Commission's recommendation based on respondent submissions. Second, this research also examines the motivations of the Commission itself in making its recommendations and analyses how that may have influenced where ideas were sourced for its recommendations. Third, the approach taken in this research frames the influence of respondents on the Commission Inquiry and its two strikes recommendation within the Regulatory Space construct, as opposed to an analysis of their lobbying behaviour as presented in Beaumont et al. (2018). An explanation of the Regulatory Space construct follows.

3.2.2. Regulatory Space

Hancher & Moran (1989) outline an analytical construct through which the process of regulation setting may be examined, which they title Regulatory Space. The Regulatory Space construct is defined as a metaphorical physical space occupied by various organisations that may be engaged in the process of creating and enforcing regulations. The space occupied by each organisation differs in size depending on the ability of the organisation to influence the regulations created or enforced in the regulatory space, which could be defined as the power wielded by the organisation in the space. This power comes from the ability of the organisation to dedicate resources (wealth) to the regulation process and to field the knowledge and labour required for regulation activities (Scott, 2001). The regulatory space for a specific area of regulation also encompasses several issues, such as whether a specific economic innovation requires regulation, what form that regulation should take, and who should enforce that regulation. Analysis through the Regulatory Space construct involves identifying which organisations are included in the process of resolving these issues, which Hancher and Moran term as "arenas" (Hancher & Moran, 1989, p. 293), and which organisations are excluded. Notably, the organisations included in each arena may not necessarily include the most powerful organisations in the regulatory space, as how an issue is defined may exclude

organisations if the issue is outside of their domain (an example given is defining a work practices issue as under the domain of industrial relations or economic management), or if the issue is treated as a “technical” issue likely dealt with by private organisations or a “political” issue (Hancher & Moran, 1989, p. 293).

Among these “major” and “minor” organisations, they note that it is common to find a centrally-placed large firm (often a multinational firm) wielding the greatest amount of power in the regulatory space (Hancher & Moran, 1989, p. 272). However, they also note that in advanced capitalist economies the complexity of regulation activities, such as the creation of regulation institutions and their enforcement, it is rare that one organisation is able to resolve a regulatory issue alone. Specifically in these economies characterised by division of labour, the knowledge required for regulation activities spans multiple disciplines (“intellectual complexity”); the large number of “social actors” potentially affected by a regulatory issue necessitates a large number of arena participants (“social complexity”); and for similar reasons the institutions required to administer regulations must also be large and complex (“administrative complexity”) (Hancher & Moran, 1989, p. 295). For these reasons, Hancher and Moran explain that only organisations are capable of mustering the resources for regulation activities, and thus very few individuals are able to access the regulatory space except in their roles within these organisations. As the resolution of an issue in an arena necessitates organisations co-operate and/or conflict with other arena participants, analysis through the Regulatory Space construct also involves identifying the nature of interactions between arena participants, which Hancher and Moran term as “linkages”. These linkages are of “varying density of formality... [and] may be articulated in terms of formal, binding legal rules, standard operating procedures, or... mere convention” (Hancher & Moran, 1989, pp. 291–292). Rather than hierarchical representations of power with the regulator at the top, occupiers of the regulatory space may exhibit complex interdependent linkages of influence and power (Scott, 2001).

Young (1994) expands upon the regulatory space as an analytical lens by establishing the concept of a “logic of appropriateness”, whereby organisations within the regulatory space will act in a way that conforms with the role expected of them by other parties in a given regulatory arena (Young, 1994, p. 87). A new entrant

into a regulatory space can obtain legitimacy by establishing a role for itself and acting in accordance with that role, as seen in the creation of accounting self-regulation bodies in Australia and Ireland (Canning & O'Dwyer, 2013; Kent, 2003). Conversely, acting in accordance with the "logic of appropriateness" is a limiting factor for these parties, as to act otherwise would harm their legitimacy. For a regulatory body such as the United States Financial Accounting Standards Board, the process of establishing an action as appropriate can entail framing the action as a response to a problem, specifically an accounting problem that if unaddressed would harm the purpose of accounting information (Young, 1994). At other times, a regulatory body may be operating in an arena where the problem has been formulated by other parties, such as legislative bodies, and must respond to their expectations to gain legitimacy (Kent, 2003).

The Regulatory Space construct is suited in many respects for analysing the reforms suggested by the Productivity Commission and ratified in Parliament. Although the submission and comment process is ostensibly open to all public parties in Australia, the acts of providing submissions to and attending consultation meetings with the Productivity Commission reflects the power of these parties to muster the resources required to overcome some of the intellectual and administrative complexity inherent to this regulatory process. That is, their participation in the submission and comment process alone demonstrates their inclusion in the arenas surrounding the issues being considered by the Productivity Commission. Hence, the power wielded by these private parties may be evaluated by way of whether their arguments were aligned with the reforms recommended by the Commission. In addition, as the central arbiter of the regulatory arena the Productivity Commission occupies a role analogous to the standard setting bodies examined in prior literature (Canning & O'Dwyer, 2013; Kent, 2003; Young, 1994). Therefore the recommendations made by the Commission can be analysed in the context of the expectations of the parties that have formulated the problem, primarily the Australian Government.

3.3. Analysis of Productivity Commission Submissions and Hearings

3.3.1. Details of the Productivity Commission Inquiry into Executive Remuneration in Australia

On 18 March 2009, the Assistant Treasurer requested the Productivity Commission hold an inquiry into the “Australian regulatory framework around remuneration of directors and executives” for companies subject to the *Corporations Act 2011* (Cth) (Productivity Commission, 2009g, pt. IV). The Assistant Treasurer cited “interest from shareholders, business groups and the wider community” about executive remuneration in the context of the then-ongoing Global Financial Crisis, noting that remuneration practices had been identified as a contributing factor to the crisis by some organisations (Productivity Commission, 2009g, pt. IV). The Assistant Treasurer also stated that “internationally competitive reward structures” were important to allow companies to attract and retain talented executives.

The public and Australian Parliamentary perception of executive remuneration at the time of the Inquiry is likely reflected in the speech of the Leader of the Opposition Malcolm Turnbull to the National Press Club in 2008:

The fact is that many Australians are appalled by the level of executive salaries and even more astonished that shareholders’ opinions can be ignored.

The law should be changed so that the shareholders resolution on the remuneration report, or at least that part relating to the chief executive, as well as directors, is binding. This would clearly place the remuneration of senior executives and directors directly in the hands of shareholders. It is their company, and nobody else’s. Let the executives justify their pay to the shareholders and if the shareholders don’t approve it, then so be it (Turnbull, 2008).

The terms of the Commission Inquiry set out by the Assistant Treasurer were set out in seven points; an excerpt of points relevant to this study are presented below:

- 1. Consider trends in remuneration in Australia, and internationally, including, among other things, the growth in levels of remuneration, the types of remuneration being paid, including salary, short-term, long term and equity based payments and termination benefits and the relationship between remuneration packages and corporate performance.*
- 2. Consider the effectiveness of the existing framework for the oversight, accountability and transparency of remuneration practices in Australia including:... the role of other stakeholders, including shareholders, in the remuneration process...*
- 3. Consider, in light of the presence of large local institutional shareholders in Australia, such as superannuation funds, and the prevalence of retail shareholders, the role of such investors in the development, setting, reporting and consideration of remuneration practices (Productivity Commission, 2009g, p. V).*

In line with the Commission's established procedure for inquiries requested by the Government (Productivity Commission, 2018), the Commission accepted 105 initial submissions from the public and held 5 initial public hearings in Sydney, Melbourne and Brisbane. Following this, the Commission published a discussion draft of their report detailing their findings and policy recommendations on 30 September 2009. The Commission accepted 65 submissions and held 4 public hearings following the discussion draft and released their inquiry report on 19 December 2009.

Chapter 9 of the inquiry report is dedicated to assessing whether regulations regarding shareholder voting on the remuneration report should be amended. The outcome of this assessment is presented in Chapter 11 as part of the legal reform package recommended by the Productivity Commission. The Commission's discussion draft initially recommended a two strikes policy whereby a 25% vote against the remuneration report would trigger the first strike, and a vote against

above an undefined threshold in the following year would trigger a second strike (Productivity Commission, 2009g). The final recommendation was implemented in the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011* (Cth), requiring two consecutive votes of 25% against the remuneration report, followed by a majority vote on a spill of the board executives.

3.3.2. Methodology

A content analysis approach is adopted to aid in identifying the constituents of the regulatory space which potentially had the greatest impact on the resulting two strikes regime, which would be reflected in the level of support for reform of the advisory vote regime prior to the publishing of the discussion draft by the Productivity Commission, and by the level of support for the recommendation of the two strikes regime after the discussion draft was published. Content analysis allows for the application of quantitative and qualitative techniques in drawing inferences from these submissions and public hearings, “[classifying] textual material [and] reducing it to more relevant, manageable bits of data” (Weber, 1990, p. 1). Content analysis is a favoured tool in the analysis of comment letters submitted to regulatory bodies and standard setters (Holder et al., 2013; Messner & Reuter, 2015; Yen et al., 2007), situations analogous to the Commission inquiry process.

For the following analysis all published material related to the Productivity Commission inquiry provided on their website was downloaded. This included the inquiry report, the discussion draft issued on 30 September 2009, pre-draft and post-draft submissions from the public and transcripts of the public hearings held by the Commission during the inquiry. Parts of the submissions received by the Productivity Commission were omitted from the material published online, either due to the material being confidential or not permissible for a government body to publish. This material was then transferred to the Nvivo software to assist content analysis of the submissions and transcripts primarily.

In line with prior content analysis studies of comment letters (e.g. Holder et al., 2013; Messner & Reuter, 2015; Yen et al., 2007), each submission and each participant in the public hearings was coded as a case in Nvivo and classified

according to the type of organisation or as an individual. Where the submission was authored jointly by multiple organisations, the organisations were classified separately to account for organisations that also made sole submissions. The submissions and transcripts were then queried for the phrases “voting” (in all tenses), “strike” and “recommendation 15”, with the latter referring to the recommendation in the discussion draft relating to the two-strikes regime. This identified the submissions and sections of the public hearing transcripts in which voting on the remuneration report were potentially discussed. For submissions and transcripts prior to the release of the discussion draft, these identified submissions and sections were then read and coded on the basis of their position on the non-binding proxy voting regime in force at the time⁷:

- advocated for a stronger advisory voting regime, which would entail any reform granting additional rights to shareholders in relation to voting on the remuneration report but not a binding vote on the remuneration report;
- advocated for a binding voting regime, including any regime where only part of the remuneration package or a multi-year remuneration plan⁸ was subject to a binding vote;
- advocated to maintain the status quo;
- or was open to reform of the voting regime but did not advocate for a change from the status quo. This included submissions that stated that the current regime should be maintained but offered suggested reforms if the Commission felt that reform was necessary.

In relation to submissions and transcripts dated after the release of the discussion draft, these were coded on the basis of their support for the two-strikes regime set out in Recommendation 15 of the discussion draft. Specifically, whether the submitter:

- Approved of the recommendation with no qualification.

⁷ Under Australian legislation at the time, corporations under the purview of the *Corporations Act 2001* (Cth) were required to allow shareholders to vote to approve the corporation’s remuneration report at each Annual General Meeting. This vote was merely advisory, and no consequences were attached to a vote against.

⁸ A multi-year remuneration plan would set out the general policies for setting remuneration in those years, as opposed to the remuneration report which would specify the exact quantum of payment awarded to directors.

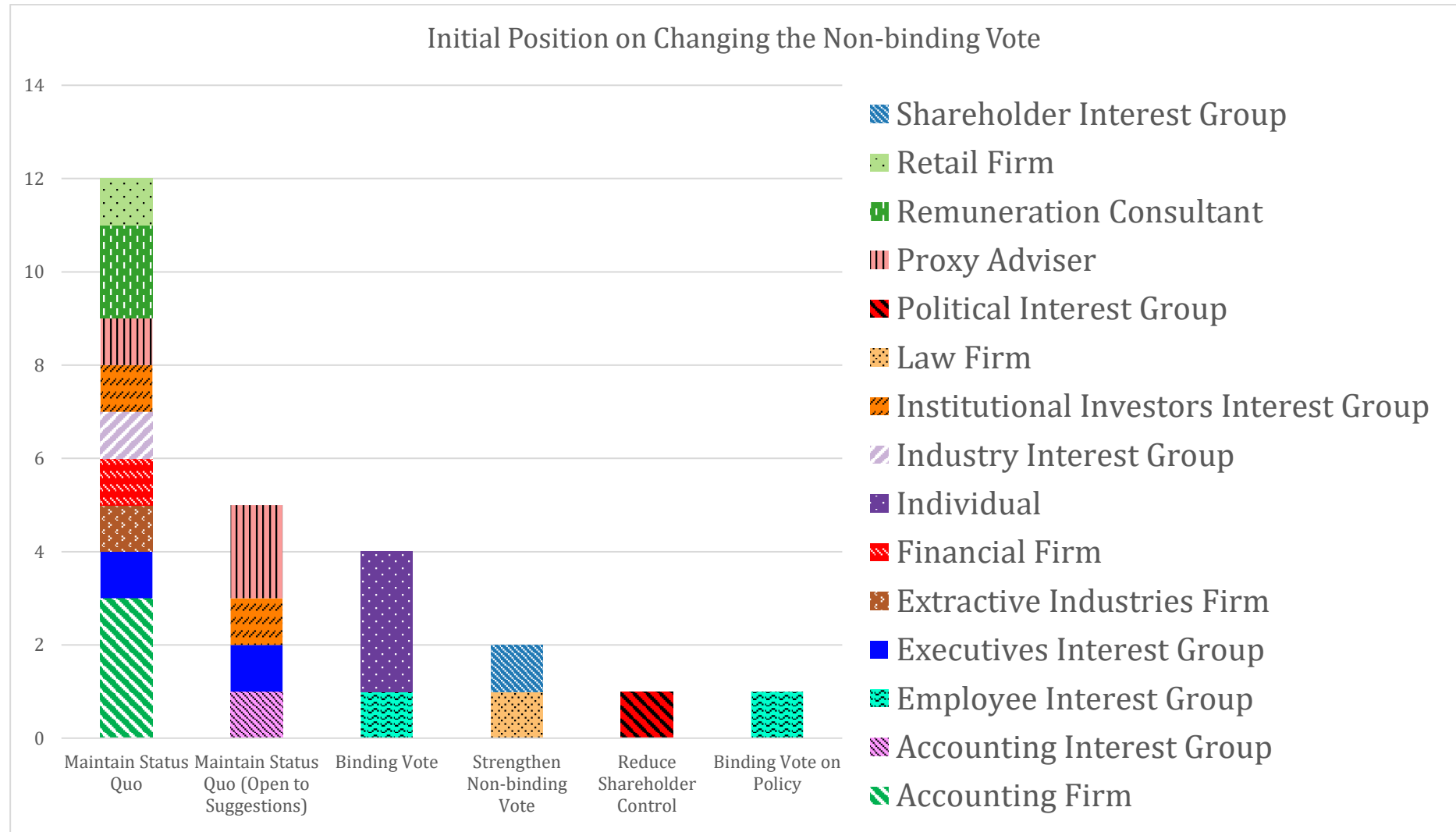
- Approved of the recommendation but suggested a change to the proposed regime.
- Disapproved of the recommendation and sought to maintain the non-binding vote regime.
- Disapproved of the recommendation, but also suggested a change to the proposed regime if the Productivity Commission sought to proceed with their recommendation.
- Disapproved of the recommendation in favour of a directly binding vote on the remuneration report.

3.3.3. Pre-draft Submissions

Figure 1 presents the number of individuals and organisations that expressed a specific view on changing the non-binding proxy vote to approve the remuneration report. Of the 133 individuals and organisations that made submissions to the Productivity Commission, only 31 discussed reform, or lack thereof, of the non-binding vote regime. The pre-draft submissions relating to the issue of shareholder voting and engagement on the remuneration report resolution can broadly be divided into three categories: submissions that support the status quo of the non-binding vote regime, submissions that seek to strengthen the non-binding vote without enforcing a binding vote, and submissions that seek a binding vote on the remuneration report resolution.

Of the 31 submissions that discussed reform of the non-binding vote, only 6 submissions advocated for a binding vote. Of these, 4 were from individuals. A common refrain amongst these submissions and the submission from the Australian Manufacturing Workers Union (AMWU), which also advocated for a binding vote, was that there were instances of excessive executive pay within Australia that needed to be remedied. Among the individual submissions, this was stated with either little justification (Braby, 2009; Murray, 2009), by comparison with the average wage of Australians (Thomas, 2009), or by reference to specific firms with perceived excessive remuneration (Shah, 2009). The latter is also the basis of AMWU's claim of excessive remuneration:

Figure 1 Initial Position on Changing the Non-binding Vote



When Australians read that former Telstra boss, Sol Trujillo “picked up more than \$30 million over his nearly four years at the company as its shares slumped almost 38%”, they might rightly be angry... The high level of compensation the Telstra board saw fit to confer on Mr Trujillo only fans discontent in the community; and with no one person or institution being bigger or better than the community itself, it is proper for the community’s representatives, viz., legislators, to intervene (Australian Manufacturing Workers’ Union, 2009, p. 8).

The remaining submission supporting a binding vote was provided by the Australian Human Resources Institute, advocating for a binding vote on a five-year remuneration plan that would inform and constrain the remuneration package awarded each year, while keeping the annual non-binding vote on the remuneration report. This regime was previously adopted by the Netherlands and Spain, but the Commission noted that these regimes did not include an advisory vote on the remuneration report (Productivity Commission, 2009b, p. 246).

By contrast, most of the remaining 25 submissions, including those advocating for some reform, rejected the implementation of a binding vote. Resistance to the binding vote is reflected in this quote from the Australian Institute of Company Director’s (AICD) pre-draft submission:

One proposal that has been raised by others is the introduction of a binding shareholder vote on remuneration packages before they are settled... This proposal has no or little support in the business community including business organisations such as AICD and the Business Council of Australia, or amongst the key shareholder and investor groups... (Australian Institute of Company Directors, 2009, p. 50).

The lack of support from both business organisations and shareholder groups is itself used as a reason against a binding vote by Chartered Secretaries Australia:

CSA strongly opposes a binding shareholder vote on the remuneration report, not only because it blurs the line between

owners and managers, but also because we note that significant representatives of institutional or retail shareholders hold a similar view (Chartered Secretaries Australia, 2009, p. 41).

The naming of both peak bodies and shareholder groups in rejecting a binding vote regime by these two business organisations appears to be a form of passive co-operation in this arena. By presenting two groups, whose interests would conflict according to agency theory in this arena, as in support of rejecting a binding vote regime, these two organisations are seemingly minimising the appearance of acting out of *mere* self-interest and also relying on the power wielded by shareholder groups in this arena, which is asserted in the following analysis as a relatively greater power than that wielded by business groups in this arena.

The 15 parties classified as supporting the status quo could be perceived to be parties that possess the considerable resources and established linkages necessary to dominate the regulatory space. These parties include 7 large firms, 3 professional bodies and 2 trade associations. Interestingly, these parties failed to halt the reform of the non-binding vote at all stages up to the passing of the law reform in Parliament. The submissions that support the status quo of the non-binding vote regime focus primarily on providing reasons against the introduction of a binding vote on the remuneration report. The reason most prevalent throughout the pre-draft submissions for maintaining the status quo is that the non-binding vote regime is sufficient for restraining executive remuneration in Australia by allowing shareholders to communicate their support (or lack thereof) for the remuneration report. For example, BHP Billiton in their submission state that the “non-binding vote on the Remuneration Report is an important – and effective – attribute of Australia’s regulatory framework” and that “the non-binding vote has evolved in Australia to the point where it is now functioning very effectively, and does not need strengthening” (BHP Billiton, 2009, p. 8). CGI Glass Lewis and Guerdon Associates in their joint submission give anecdotal evidence of this effectiveness, stating:

...directors of listed entities are highly sensitive not just to a report that is “vote down”... but also to a significant “protest” vote against the report (by even a quite small percentage of votes)... the non-

binding vote is working in Australia to achieve the purpose for which it is designed (CGI Glass Lewis & Guerdon Associates, 2009, p. 14).

Similarly, the Australian Council of Superannuation Investors provides anecdotal evidence that companies respond to the non-binding vote:

It is noteworthy that, where remuneration reports have attracted a high “no vote” from shareholders or a majority vote against, most companies have used this as a basis on which to better understand how they can improve the standard of disclosure and/or the substance of their remuneration practices (Byrne, 2009, p. 12).

Another reason relied on by submissions rejecting a binding vote is that a punishment mechanism already existed for companies that failed to respond to shareholders' views on their remuneration. The submission from Macquarie Group Limited notes that “[if] shareholders are unhappy about the governance of the company they can vote against reappointment of directors or seek to remove them” (Macquarie Group Limited, 2009, p. 8). Similarly, CGI Glass Lewis and Guerdon Associates identifies:

...the prospect that a potential further consequence of sufficient disapproval of a remuneration report is a binding vote against the re-election of the director when next up for election, which is an even more serious issue for the director. CGI Glass Lewis, for example, applies a policy of recommending against the re-election of a director who is the chairman of a remuneration committee that puts out a remuneration report that CGI Glass Lewis regards as seriously sub-par (CGI Glass Lewis & Guerdon Associates, 2009, p. 14).

The similarity between this form of argument and the board spill mechanism contained within the Productivity Commission's final recommendation suggests that these submissions may have influenced the idea for the Commission's recommendation. However, the reasoning given in these submissions is unlikely to be the reasoning adopted by the Commission for their recommendation, as these submissions fall into the category of supporting the status quo.

Only 4 parties suggested strengthening the non-binding vote regime, however another 6 parties were open to reform of the voting regime. Of those advocating for reform, 3 were individuals and the remaining party was the Australian Shareholders' Association, a members' association advocating for shareholders. Of the parties open to reform, 4 were remuneration consultants and proxy advisers, 1 was a law firm, and 1 was a trade association for institutional investors, the Australian Council of Superannuation Investors (ACSI). Most of these are parties whose interests are aligned, to varying degrees, with those of shareholders and investors at large. It is arguable that given the scope of the review handed to the Commission by the Assistant Treasurer noted above, which was framed as problem regarding the "oversight, accountability and transparency of remuneration practices", the Productivity Commission may be motivated to accept the arguments of these parties over those of the parties supporting the status quo.

Contrasting the submission of the Australian Shareholders' Association (ASA) with the submissions of the individuals advocating for a strengthening of the non-binding vote regime provides a possible reflection of the difference in power between these two groups. A concern highlighted in the submissions from individuals was, appropriately, the lack of power wielded by retail shareholders, defined as individual shareholders generally acting on their own behalf, in comparison with institutional shareholders, defined as corporate body shareholders generally acting on the behalf of clients. Michael Vanderlaan (2009, p. 2) argued that:

The difficulty in shareholders voting is that majority shareholders are likely to be other corporations or funds. And the problem with this is the perception of a self-interested "directors club" of board members, fund managers, and executives past & present. "You vote for my pay rise and I'll vote for yours"... To redress this, voting should be aligned with the fundamental democratic notion of one-person, one-vote...

Similarly, Rad Piljic (2009, p. 1) affirmed:

There have been a number of times were [sic] voting on the remuneration package, has been passed by a larger company or institutional investor, even though a great percentage of retail investors voted against it.

However, the discussion draft promulgated by the Productivity Commission makes little reference to the submissions of individuals in the chapters dealing with shareholder engagement and voting on the remuneration report (Chapters 8 and 9), with the two individuals cited comprising of a person acting in their capacity as director of a research consultant firm and a former Australian Senator. Similarly, very little reference was made to the small impact of an individual retail investor on a resolution vote in the discussion draft beyond the statement: “For a small retail investor, the benefits associated with voting are likely to be small” (Productivity Commission, 2009b, p. 254).

The ASA’s submissions by contrast appear to be closely tied with the Productivity Commission’s Recommendation 15. In their written submission they suggest a 75% threshold for approving the remuneration report, with the chair of the remuneration committee facing election if the report does not pass. The submission does not provide a specific reason for why they believe this reform is necessary, rather stating that there is “little middle ground” between the prevailing advisory vote and a binding vote on remuneration (Australian Shareholders’ Association, 2009, p. 16). However, they elaborate on their reasons for reform in their discussion at an inquiry public hearing:

...there was certainly a suggestion from one of the other institutional advisers that they vote against the chairman of the remuneration committee if that person comes around for re-election, but that’s all fairly random because they might not come around for re-election for another three years and the momentum is lost. So it’s an issue about making boards accountable, finding that momentum (Productivity Commission, 2009a, p. 53).

The rhetoric harkens back to the terms of reference of the Commission Inquiry, establishing this suggestion as an effective measure to increase

accountability of the board to shareholders in Australia's framework for executive remuneration. Furthermore, the ASA make arguments against the institution of a binding vote, establishing a point of similarity with firms wishing to maintain the status quo while suggesting reform:

A binding blanket vote... potentially it means the winding back of remuneration that is already paid, so that's the first thing. The second thing is that it's not necessarily hugely helpful because different shareholders will have different views on different aspects of the remuneration report. So whilst three shareholders might vote against, they might vote against on very different parts of the report. So in that case we don't see that it's necessarily helpful or practical (Productivity Commission, 2009a, p. 46).

The Australian Shareholders' Association's success in influencing the recommendations of the Productivity Commission at this pre-draft stage is argued to come from a confluence of its position in the remit of the inquiry, the power and resources it wields as a retail investor membership body, and by establishing a point of unity with other powerful occupants and opponents in the regulatory arena. Hence, although numerically outnumbered in these conditions a single occupant in a regulatory arena was able to provide great influence over the regulatory outcome.

However, the ASA's suggestion specifically ruled out putting the entire board up for re-election as a consequence of a vote against the remuneration report on the basis that it would likely harm the company more than their suggested regime (Productivity Commission, 2009a, p. 53). On this point the Productivity Commission appear to have been influenced by the argument of Guerdon Associates in a public hearing:

...the assumption underlying a special election vote for rem co directors with large "no" votes on their rem report is that they're more accountable than the full board, and if you're considering that I think you need to consider the full board, because the rem co is doing the nitty-gritty but it's the full board that's really accountable

for remuneration decisions for the top execs. So you need to consider the accountability aspects (Productivity Commission, 2009a, p. 15).

As a remuneration consultant, Guerdon Associates would likely not be considered as a party that the inquiry's remit sought to assist, not being an institutional or retail investor. However, by drawing on its intellectual resources and using the rhetoric of accountability contained in the inquiry's terms, Guerdon Associates appear to have influenced the Productivity Commission's recommendations in the draft to include all board members rather than just the remuneration committee chair.

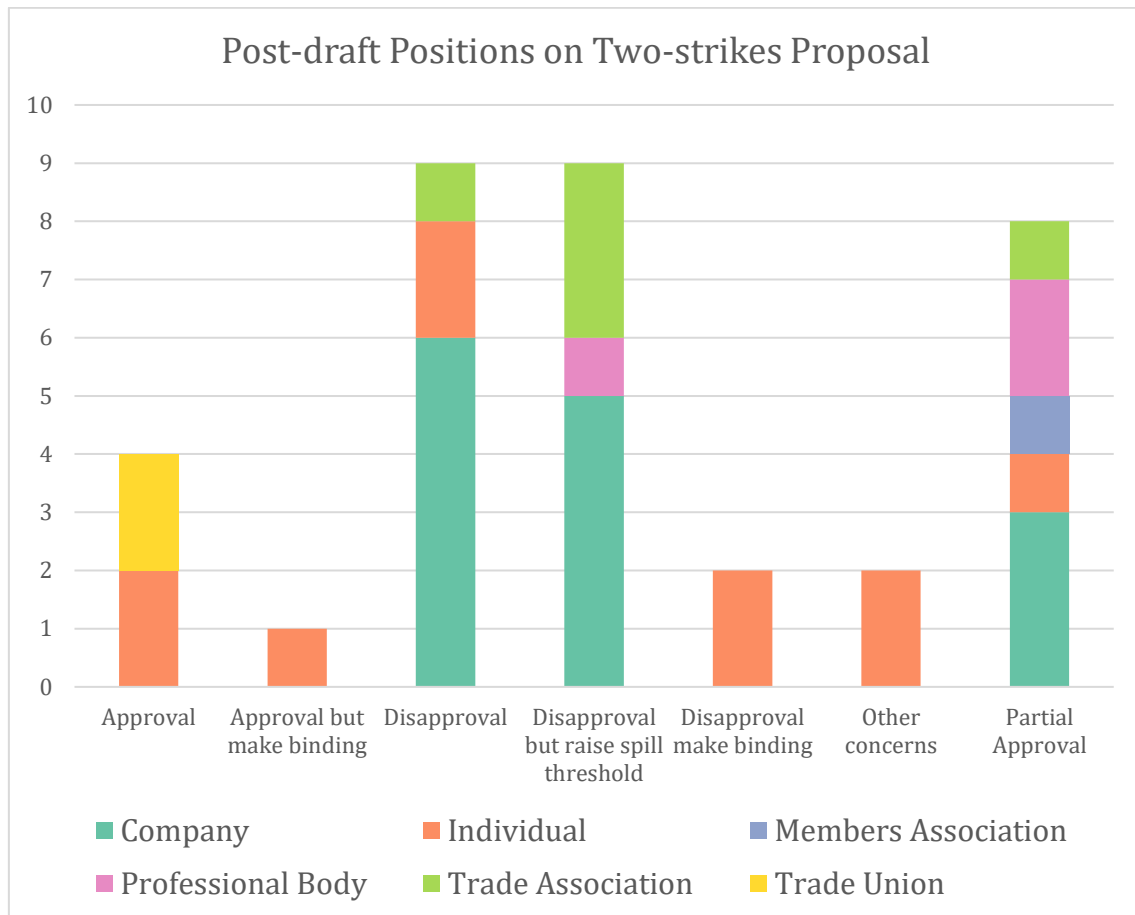
In summary, the parties which had the greatest influence on the Commission's recommendation to implement the two-strikes rule during the pre-discussion draft phase were arguably those that occupied substantial space in the regulatory arena. The Commission's remit to increase shareholder engagement with the process of setting and consideration of executive remuneration in turn diminished the influence of parties arguing for the status quo, namely industry firms and peak bodies. By contrast, individuals and the AMWU, who called for a directly binding vote on the remuneration report, lacked the intellectual resources and power to overcome the arguments against a binding vote by these peak bodies. The parties that likely occupied the greatest space in the regulatory arena, the ASA and Guerdon Associates, exercised sufficient intellectual capital and, in the case of the ASA, leveraged their position as representatives of shareholders to influence the Commission. Importantly, they appealed to the remit of the Commission to recommend a means of allowing shareholders to hold boards to greater account.

3.3.4. Post-draft Submissions

Following the publishing of the discussion draft 65 written submissions were received by the Commission and four hearings were held. Of the parties that submitted or attended a hearing, 35 expressed a view on the second part of Recommendation 15, which outlined the two-strikes voting regime. Figure 2 presents the number of parties that expressed some form of approval or disapproval on Recommendation 15. This does not include parties that only commented on the

first part of Recommendation 15, which would require companies to respond to a negative vote on the remuneration report. Of these 35, 20 expressed some form of disapproval of Recommendation 15 and 8 expressed partial approval contingent on some change to the proposed regime.

Figure 2 Post-draft Positions on Two-strikes Proposal



The parties expressing disapproval included 11 companies, 4 trade associations and 1 professional body. These parties made numerous arguments against the two-strikes regime, primarily on the basis of the consequences of spilling the board. Several stated that a small number of investors could use their vote to remove the board for their own interest (Boral, 2009, p. 6; Business Council of Australia, 2009, p. 8; Origin, 2009, p. 4). Another common argument was that shareholders could already vote out board members during their re-election at least every three years or by putting their own resolution (Business Council of Australia,

2009, p. 9; PriceWaterhouseCoopers, 2009, p. 11). These arguments were generally couched in the context that it was generally accepted that boards are best suited to determine their own remuneration strategies. For example, PriceWaterhouseCoopers (2009, p. 11) argued:

We do not support the Productivity Commission's [Recommendation 15]. This is because this part of the recommendation goes against generally-accepted governance principles.

Shareholders elect the directors of the board to act on their behalf in terms of determining the company's strategy, and this includes the remuneration strategy. Directors, in turn, have a fiduciary duty to shareholders to act in their best interests. If shareholders are not comfortable that a director, or the full board, is acting in their best interests, then they have the mechanism already in place not to re-elect the director when the director presents himself/herself for re-election.

A common theme amongst submissions from parties expressing disapproval was the potential for a minority of shareholders to impose their will on the company against the wishes of the majority. The rhetoric conveying the concerns of some of these parties about the board spill consequence in Recommendation 15 emphasised the damaging impact of supposedly undeserved board spills imposed by a minority of shareholders. Boral's submission stated that the board spill could be used to "destabilise the board [for reasons] which are unrelated to the remuneration report" (Boral, 2009, p. 6). Origin's submission argued that "A spill of 100% of the board will be enormously disruptive... At least in the case of the company, that punishment does not fit the crime" (Origin, 2009, pp. 5–6). According to Freehills' submission "The instability and uncertainty resulting from the 'two strikes' approach, particularly where it is set as low as 25 per cent, will inappropriately distract board and management and adversely impact on the governance of the company... the company will lose continuity, stability and reputation and may not be in a position to readily refresh that balance" (Freehills, 2009, p. 3). The common theme amongst these and similar submissions was to present the threat of undeserved board spills

as potentially fatal or highly damaging to the company and against the principles of good governance.

There are indications that the Productivity Commission may not have agreed with the sentiment that the board spill consequence would be as damaging as these parties conveyed and would instead increase accountability of the board to shareholders. During public hearing consultations, commissioners repeatedly noted that the re-election of directors would not necessarily lead to a spill of the entire board or be highly damaging to the company. For instance:

Mr [Peter] Wilson (AHRI): So the issue would be: is something likely to happen that would significantly destabilise the governance process or the condition of the company?... I hear the argument but I don't feel the magnitude of it. I think particularly if you inoculate the managing director from that spill, then the company is going to continue to be managed.

Prof Fels: The elections are for each individual member of the board... It wouldn't be "chuck the board out", it would be, "You vote on this, this, this and this person." (Productivity Commission, 2009c, p. 13)

Similarly, commissioner Gary Banks referenced previous responses comparing the likelihood of a fatal board spill to “the probabilities of being struck by lightning” (Productivity Commission, 2009d, p. 55). The Australian Shareholders’ Association also presented an argument against the potential damage that parties disapproving of Recommendation 15 alleged may result from the board spill mechanism:

Mr [Stuart] Wilson (ASA): The thing that I'm most concerned about is that a corporate raider can call a meeting and seek to remove the board and replace them now. Anyone with 5 per cent of the issued capital is able to do that. If that's the case I'm not sure that what you're offering, what you're recommending is any less onerous than that. It's still a 50 per cent vote. We've heard the criticism but we can't see how it would play out in practice. (Productivity Commission, 2009e, p. 154)

Some parties expressing disapproval of Recommendation 15 hedged their argument by also arguing that if the board spill consequence was retained in the final inquiry report recommendation, the threshold for receiving a voting strike should be raised from 25% to 50% (Cairns, 2009; Ernst & Young, 2009; Freehills, 2009; Harris, 2009; KPMG, 2009). In addition a number of parties expressed partial approval for Recommendation 15 though recommended raising the threshold for both voting strikes or the second voting strike to above 25% (Malley, 2009; Perpetual, 2009; Regnan, 2009; Robinson & McAuley, 2009; Wilson, 2009). The arguments for raising the threshold for receiving a strike stemmed from these parties' arguments for abolishing the board spill consequence, namely that a low threshold would enable minority shareholders to impose their will over the majority. Freehills also made the argument that a low threshold for the board spill consequence may incentivise institutional shareholders to not vote against a problematic remuneration resolution if it would result in a board spill (Freehills, 2009, p. 3).

Commissioner Professor Allan Fels' questioning during public hearings appears to express doubt that raising the threshold above 25% would be necessary for either of the two voting strikes required to trigger the board spill.

Prof Fels: That's not a bad deal, the two strikes, but then if you add to that, the second one is 50 per cent, well, we're hearing from many people this emasculates them. It will have no impact. It's about as likely as a lightning strike, according to one of the submissions. Aren't we, under the two strikes - with the second one being 50 - making it just too easy for boards? Why not just have a one strike 50? Wouldn't that make sense? (Productivity Commission, 2009d, p. 57)

Prof Fels: ...if you had 50 per cent votes all the way through or nothing further, that would emasculate the possible outcome. In other words there would be no consequences from your recommendations if it were two 50s or even if it stayed at non-binding. Indeed it would turn out quite simpler if the recommendations, whatever they prove to be, were not adopted at this stage... It would be a pretty clear signal that the law is not really

going to have much impact if it's reduced to fifty-fifty. (Productivity Commission, 2009f, p. 212)

In light of the final inquiry report's recommendation, which separated the board spill consequence from the second strike and attached it to a separate voting resolution requiring a majority vote to pass, the large number of parties of various types is likely to have swayed the Productivity Commission to amend their recommendation. In addition, the Australian Shareholders' Association submission may have influenced the Commission's final outcome, where they suggest the board spill be voted on in the annual general meeting following the receipt of the second strike:

[Recommendation 15] is likely to be criticised because of the risk that it will be abused to remove a board. This is unlikely, as any shareholder with the requisite number of shares to remove the board in this manner could much more efficiently requisition a meeting to remove the directors... The directors should only be required to submit for election at the next Annual General Meeting, to provide the maximum amount of time to address shareholders concerns. (Australian Shareholders' Association, 2009, p. 8)

3.4. Impact of Regulatory Arena Participants on Resulting Regulation

In the regulatory arena surrounding the development of the two-strikes regime it is clear that the Productivity Commission held much of the power in shaping the resulting legislation, with Recommendation 15 in the final inquiry report being implemented in its entirety in the resulting legislation passed by the Australian Parliament. Arguably however, the actions undertaken by the Productivity Commission in finalising Recommendation 15 were constrained by the Commission's logic of appropriateness. Explicitly the terms of the inquiry were set by the Australian Treasury, requiring the Commission to consider the current legal regime and the role to be played by institutional investors in overseeing executive remuneration. The inquiry followed the published procedures of the Commission

for conducting inquiries, allowing submissions from any interested individuals or entities. As a result the complexity of entering the regulatory arena was sufficiently low for a number of individuals to provide submissions which the Commission had to take into consideration, although their ultimate impact on the recommendations appears to have been minimal, as suggested by Hancher & Moran (1989).

In addition to the explicit terms of the inquiry and policies of the Commission, the Commission was also arguably constrained by the expectations of the Australian public and members of the Australian Parliament if it sought to act according to its logic of appropriateness. In the speech accompanying the second reading of the *Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Bill 2011* (Cth), David Bradbury MP noted that the 2008 Global Financial Crisis had “illustrated the dangers of remuneration structures that focus on short-term results, reward excessive risk-taking and promote corporate greed”, but also noted that Australia required a “system or remuneration that is not only internationally competitive, but that also appropriately rewards executives for their work” (Commonwealth, 2011, p. 1096). Malcolm Turnbull’s speech suggests that public sentiment at the time of the inquiry sought expanded regulation to constrain executive remuneration in some way, with Turnbull in particular asserting that a binding vote on executive remuneration was necessary (Turnbull, 2008). Thus the Productivity Commission arguably would need to provide recommendations that acceded to these sentiments in order to act according to its logic of appropriateness and ensure its survival as the “Australian Government’s independent research and advisory body on a range of economic, social and environmental issues affecting the welfare of Australians” (Productivity Commission, 2018). Failing to do so would potentially undermine the Commission’s reputation amongst the public and invite questions from Members of Parliament.

It follows that the Productivity Commission would favour suggestions that would increase shareholder engagement with the oversight of executive remuneration and constrain excessive executive remuneration. For this reason, the suggestions of the Australian Shareholders’ Association and Guerdon Associates that appear to have formed the foundation for the final Recommendation 15 were accepted by the Productivity Commission. Similarly, the Productivity Commission

did not seem to engage with suggestions that the existing advisory remuneration vote was sufficient nor that a 25% vote against the remuneration resolution should attract a strike due to the Commission following its logic of appropriateness, even though the number of submissions making these arguments made a substantial proportion of total submissions.

However, the impact of submissions arguing against the two-strikes regime or the low 25% threshold for a strike may be reflected in the Productivity Commission's disfavour of a directly binding vote on the remuneration report, despite the sentiments of Malcolm Turnbull. These arguments were couched in the context that it was beneficial for companies and their shareholders and required for good governance if boards were able to set the remuneration of executives. There are a number of possible explanations for the Commission's disfavour of a directly binding vote. A number of parties that agreed with the two-strikes recommendation also argued that directors were best placed to determine their own remuneration, including Guerdon Associates. Apart from the AMWU, the majority of submissions favouring a directly binding vote were from individuals, who are likely to have had less power in the regulatory arena compared to organisations. The majority of individuals arguably would not have the resources to attend public hearings and engage directly with the Commissioners in charge of the inquiry or to overcome any intellectual and social complexity inherent in making actionable suggestions to the Productivity Commission. Notably, the only individual cited in section 9.3 of the final inquiry report, in relation to attaching consequences to a significant vote against the remuneration report, was Senator Andrew Murray, a member of the Australian Parliament (Productivity Commission, 2009g).

3.5. Conclusion

The development of the two-strikes legal regime offers an interesting insight to how legal reform commissions alter the regulatory arena surrounding an issue that a commission has been tasked to conduct an inquiry into. A commission which acts according to its logic of appropriateness will favour arena participants that enable it to justify its survival to the government overseeing them, and in turn the public that provides political support to that government in turn. In this chapter,

participants that purported to have with views aligned with retail and institutional shareholders such as the ASA and the ACSI were found to have the greatest influence on the outcome of the Productivity Commission's consultation process. These views emphasised the accountability of the board to shareholders in the realm of executive remuneration setting. Although most participants agreed that the prior advisory vote mechanism worked towards this goal, these influential participants were able to strengthen the voting mechanism by invoking rhetoric referring to the mandate handed to the Productivity Commission by the Government – to allow shareholders to hold board directors accountable for excessive executive remuneration while maintaining corporate boards' ability to set their own remuneration.

Along with the goal of empowering shareholders to hold board directors accountable, the other policy goals that Recommendation 15 sought to achieve were to strengthen shareholder engagement with boards in relation to executive remuneration setting and to provide shareholders with the means to address boards who fail to amend their remuneration policies in response to a significant vote against the existing advisory vote on the remuneration report (Productivity Commission, 2009g). Notably, Commissioner Robert Fitzgerald stated that "99.99 per cent of the time [the board spill consequence] would never be used" (Productivity Commission, 2009e, p. 111). The Commission appears to have foreseen the board spill consequence as a last-resort option for shareholders faced with a particularly unresponsive company. The analyses performed in Chapters 4 and 5 will, in part, interrogate whether these policy goals have been achieved in the operation of the two-strikes regime.

4. What Drives Voting Strikes?

4.1. Introduction

In Chapter 2 a review of say on pay literature identified a lack of empirical support for the strength of the pay-performance link as the sole basis for shareholder voting dissent, as optimal contracting theory would suggest. Research into alternative explanatory factors for voting dissent was warranted, particularly for binding votes on executive remuneration. In Chapter 3, an analysis of the legislative process that formed the Australian two-strikes say on pay regime identified that the regime was intended to empower shareholders to hold directors accountable for excessive executive remuneration practices and force recalcitrant and unresponsive boards to address concerns with their executive remuneration, with a focus on empowering institutional shareholders. This chapter presents an empirical analysis of the determinants of voting strikes under the two-strikes regime.

The analysis presented in this chapter undertakes to answer the question:

What factors result in a large Australian corporation receiving a strike on their remuneration report resolution?

A strike is received on the remuneration report resolution if it receives a vote of 25% or more against the resolution from shareholders, and two strikes received consecutively will trigger a legal consequence – a mandatory board spill resolution. A strike therefore represents a threshold of voting dissent that boards will seek to avoid if they fear attracting the consequence. This may influence board remuneration setting behaviour, as boards may be willing to accept dismissing concerns of certain shareholders if their influence on the vote will not result in a strike.

Conversely, the threshold also sets a minimum consensus required among shareholders, dependent on the concentration of ownership, that the executive remuneration of the corporation is so undesirable that the threat of a board spill resolution is required. It is proposed that if the two-strikes regime does provide an

effective method for shareholders to restrain excessive executive remuneration, higher levels of executive remuneration for a given level of corporate performance should be more likely to attract shareholder dissent.

4.1.1. Executive Remuneration Hypothesis

Prior studies of the determinants of voting dissent have identified that higher CEO remuneration is associated with higher shareholder voting dissent (Borthwick et al., 2020; Carter & Zamora, 2007; Conyon & Sadler, 2010; Ertimur et al., 2011). It is asserted that shareholders will generally “vote against pay elements that they believe destroy firm value” (Carter & Zamora, 2007, p. 3). Under managerial power theory, shareholders will vote against executive remuneration they perceive as excessive and thus detrimental to shareholder wealth (Bebchuk and Fried, 2003). In turn, managers are incentivised to obscure their level of remuneration to avoid this perception, but this ability to camouflage excessive executive remuneration is constrained by the disclosures set out in the remuneration report. As such, for a given level of shareholder return it is expected that higher levels of total executive remuneration will result in shareholders more likely to identify the remuneration as excessive compared to lower levels of remuneration, where excessive remuneration may be more easily camouflaged through “suboptimal pay structures... linked only weakly to managerial performance” and thus less likely to generate shareholder outrage (Bebchuck and Fried, 2003, p. 8). Consequently, it is hypothesised that higher executive remuneration is associated with a higher likelihood of receiving a voting strike on the remuneration report resolution, as it is more likely that shareholders perceive such remuneration to be excessive.

Hypothesis 1: Higher executive remuneration for a given level of corporate performance is positively associated with a higher likelihood of receiving a voting strike.

For this analysis executive remuneration is separated into three components according to their presentation on a standard Australian remuneration report – short-term remuneration, long-term remuneration and equity remuneration. It is expected that this hypothesis holds for all three components as, controlling for

corporate performance, it is more likely shareholders would perceive higher levels of each component of remuneration to be excessive.

4.1.2. Institutional Ownership Hypothesis

The regulation of shareholder engagement in Australia on executive remuneration generally falls to institutional shareholders (Sheehan, 2009), and in Chapter 3 it was identified that institutional shareholders were the main party to shareholder engagement with corporations (Productivity Commission, 2009g). Institutional shareholders have greater resources to assess the impact of resolutions on their shareholdings and superannuation firms are legally mandated to vote on resolutions in Australia. Therefore, it is expected that institutional shareholders are better able to identify less optimal or less desirable executive remuneration structures and vote accordingly than retail shareholders (Ertimur et al., 2013), and this effect on the likelihood of a voting strike increases with the proportion of institutional ownership for a corporation.

Hypothesis 2: The proportion of institutional ownership is positively associated with a higher likelihood of receiving a voting strike.

4.1.3. Media Attention Hypothesis

Hooghiemstra et al. (2015) in their study of UK companies find that negative media attention was negatively associated with the level of voting dissent on the advisory say-on-pay resolution, with a substantial increase in voting dissent when news articles report on institutional shareholder criticism of a company's remuneration. The authors interpret their findings as reflecting two roles of media in relation to say-on-pay, being the "capturing" of the opinions of shareholders and proxy advisers who "have already identified problematic pay practices", and the influencing of shareholders exposed to these opinions through news articles (termed "causing") (Hooghiemstra et al., 2015, p. 769). This study interprets the dual roles of media attention as impacting the legitimacy that a corporation, specifically its remuneration practices, holds (Liu & Taylor, 2008). Given the substantial impact of the capturing opinions role of news media, with those opinions

focusing on problematic remuneration practices, it is expected that media attention will increase the likelihood of a voting strike.

Hypothesis 3: Media attention is positively associated with a higher likelihood of receiving a voting strike.

4.1.4. Structure of Chapter

This chapter proceeds with an explanation of the empirical model estimated for this analysis. A logit model is estimated with the probability of a voting strike as the dependant variable. Descriptions of each of the variables follows, including an exploration of data relating to votes on board spill resolutions for the small number of corporations in the sample that received or expected to receive a second strike. Finally, the results of the model estimation are then presented and discussed.

4.2. Method

4.2.1. Logit Model

The logit model is well suited for estimating binary choices or outcomes (Hensher et al., 2015). Under the binary logit model, an individual (n) faces one of two alternatives (j) and evaluates each alternative based on a utility function, given as:

$$U_{nj} = \lambda_j \sum_{k=1}^{K_j} \beta_{nk} x_{njk} + e_{nj}$$

In which x represents all explanatory variables that may influence the choice of alternative, β represents the individuals' preference for alternative j for a given explanatory variable k , λ is a positive scale factor for alternative j , and e represents the unobserved component of utility (Hensher et al., 2015, pp. 81–86). The unobserved component of utility is assumed to be independently and identically distributed under an EV1 distribution.

For an individual n , it is assumed they will choose the alternative that maximises their utility. Therefore, the likelihood that individual n will choose alternative j over alternative i can be calculated as the probability that the observed (V_{nj}) and unobserved components (e_{nj}) of utility for alternative j outweigh the components of utility for alternative i :

$$\begin{aligned} P_{nj} &= \text{Prob}(V_{nj} + e_{nj} > V_{ni} + e_{ni}) \\ &= \text{Prob}(e_{nj} - e_{ni} > V_{nj} - V_{ni}, \forall i \neq j) \end{aligned}$$

The parameters of a logit model are estimated by continuously estimating models with different values for the parameters with the goal of maximising the choice probabilities for all alternatives across the sample (Hensher et al., 2015). This is achieved by maximising the log-likelihood function LL_{ns} for individual n in choice situation s , where y_{nsj} is 1 when alternative j is chosen:

$$LL_{ns} = \ln \left[\prod_{n=1}^N \prod_{s \in S_n} \prod_{j \in J_{ns}} (P_{nsj})^{y_{nsj}} \right]$$

The parameters estimated in a binary logit model represent the natural log of the odds ratio, which is a ratio of the probability of alternative j being chosen over alternative i being chosen for a given value of the explanatory variable. Hence, the coefficients estimated for a binary logit model are best interpreted based on their sign and significance. When interpreting the impact of a variable on the likelihood of a specific outcome, the coefficients are ideally converted into an odds ratio form, which shows how a unit increase in the variable multiplies the probability of the outcome estimated in the logit model. For this reason this research presents both the coefficients and odds ratios for the primary model estimated, and the discussion that follows relies on both the coefficients and odds ratios.

For the analysis performed below the Python Statsmodels package was used to estimate logit models, using a Newton-Raphson solver function to maximise the log-likelihood.

4.2.2. Empirical Model

The following model is estimated for the primary analysis:

$$\begin{aligned} V_{n,strike} = & \beta_0 + \beta_1 \ln(\text{TotalAssets}) + \beta_2 \text{ROE} \\ & + \beta_3 \text{PercentageOwnership} + \beta_4 \text{TotalReturn} \\ & + \beta_5 \text{MarketToBook} + \beta_6 \text{MediaAttention} \\ & + \beta_7 \text{ShortTermRem} + \beta_8 \text{LongTermRem} \\ & + \beta_9 \text{EquityRem} + \beta_{10-19} \text{MorningstarSectorCode} \\ & + \beta_{20-22} \text{Year} \end{aligned} \tag{1}$$

Where:

- $V_{n,strike}$ is the estimated probability of an annual meeting vote on the remuneration report receiving a strike given the observed components of utility.
- $\ln(\text{TotalAssets})$ is the log-transformed total assets figure on the entity's balance sheet.
- ROE is the entity's return on equity, calculated as net income divided by average total common equity.
- $\text{PercentageOwnership}$ is the percentage of outstanding shares owned by institutional shareholders, as identified by Thomson Reuter's Eikon platform.
- TotalReturn is the 1-year total return on shares calculated at the end of the month prior to the date of the annual meeting.
- MarketToBook is the total market capitalisation divided by total common equity.
- MediaAttention is the number of news articles relating to the executive remuneration of the entity (as defined by the search term noted below) published by the largest newspapers in Australia by circulation.
- ShortTermRem is the sum of base salary, cash bonus, director's fees, non-monetary benefits and other short-term benefits for the executive with the highest total remuneration as published in the directors' remuneration report.

- **LongTermRem** is the sum of superannuation, retirement benefits and long-service leave for the executive with the highest total remuneration as published in the directors' remuneration report.
- **EquityRem** is the sum of share-based remuneration and options-based remuneration for the executive with the highest total remuneration as published in the directors' remuneration report.
- **MorningstarSectorCode** is an indicator variable for the industry sector the entity has been classified as by Morningstar Australia.
- **Year** is an indicator variable for the year that the annual meeting remuneration vote was held.

Each variable is discussed in detail below.

It is expected that increases in each of the three elements of remuneration will increase the odds of a strike being received against the remuneration report, and the coefficients should therefore be positive and significant. Media attention is expected to be significant, though no expectation is made of the sign of the effect. The percentage of institutional ownership is expected to increase with the likelihood of receiving a strike, and therefore the coefficient is expected to be positive and significant.

4.2.3. Sample Selection

The sample chosen for the following analysis were entities which have been listed as part of the ASX 200 on 1 July for the years between 2013 and 2017 as collected by an independent aggregator of market index information (ASX200list.com, 2019). The sample includes entity-years where the entity was not listed on the ASX 200 in that year but was listed on the ASX 200 in other years. The sample comprises large listed entities to maximise the likelihood of observing entities with high levels of media attention related to executive remuneration and institutional ownership, and to maximise financial data coverage. In addition, the use of large entities "facilitates the generalisability of the results to other institutional contexts with larger mean firm sizes including the United States and

UK” (Borthwick et al., 2020, p. 830), and the use of the ASX 200 index is consistent with Monem and Ng (2013).

Prior studies using archival data have primarily focused on the period immediately following the introduction of the two-strikes regime up to 2014 (Bugeja et al., 2020; Grosse et al., 2017; Monem and Ng, 2013), therefore the period for the sample was chosen to complement these studies and observe voting behaviour from shareholders more experienced with the operation of the two-strikes rule compared with prior studies. Annual general meeting (AGM) voting results were collected for annual meetings held between 1 January 2014 and 30 December 2017 by the sample listed entities, resulting in an initial sample of 967 data points across 274 entities, of which 60 were entity-years that attracted a strike on their vote. These dates were chosen to cover almost the entirety of annual general meetings held following an entity’s 2014 to 2017 financial reporting periods.

Entity-specific financial and executive remuneration data was sourced from SIRCA Gateway, which sources part of this data from Morningstar. As the three letter codes used to represent companies on the ASX may be abandoned by an entity and then reused by a different entity in subsequent years, Morningstar’s name and code change data was used to identify the correct entity for each year when collecting entity-specific financial and corporate data. As the data provided by SIRCA was collected on varying dates and timescales, for the purposes of this analysis the most recent entity financial data prior to the date of the annual general meeting was used. This reflects the assumption that shareholders would vote on the basis of executive remuneration information in the annual report, and on the basis of the most recently disclosed financial performance and metrics of the entity. After collating entity financial, remuneration and institutional ownership data, a usable sample of 704 entity-years was obtained, of which 48 received voting strikes.

4.3. Variable Measurement

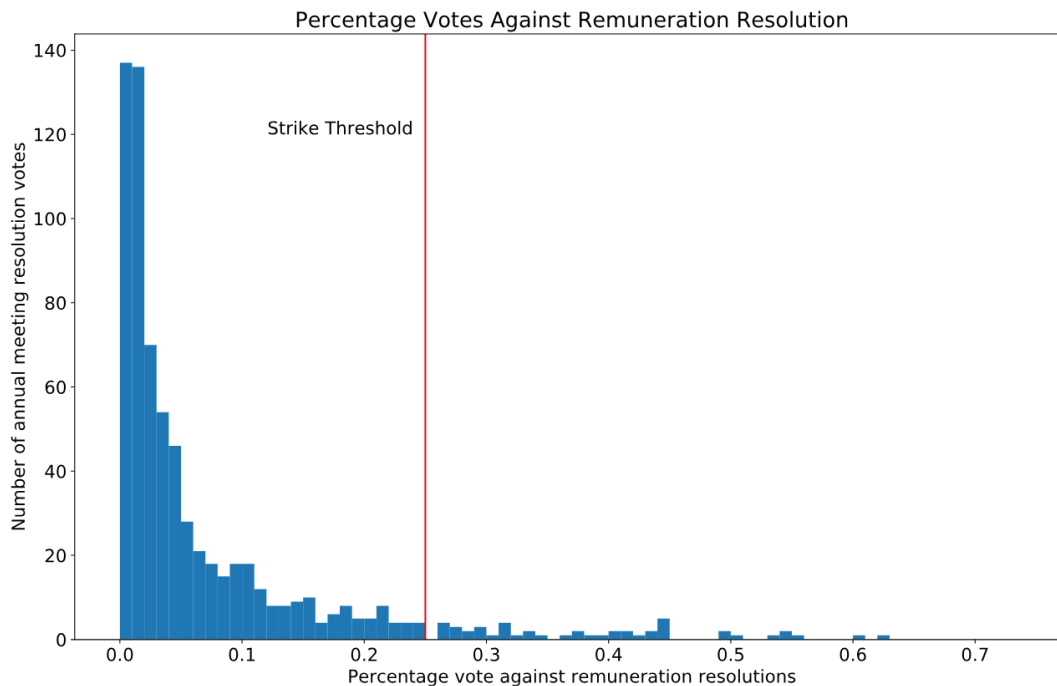
4.3.1. Dependent Variable: Voting Strikes Against Remuneration Resolution

4.3.1.1. *Annual meeting voting results on remuneration resolutions*

Annual meeting voting results were hand-collected from Australian Stock Exchange announcements of AGM results from sample entities, sourced from SIRCA Gateway. This is consistent with the approach taken by Monem and Ng (2013) and Clarkson et al. (2011). Where the vote to approve the remuneration report was conducted via a show of hands, the proxy votes disclosed were recorded. Proxy votes that were delegated to the chairman or another representative were classified as votes *for* the remuneration report where no statement of how these votes were directed was given. Where an entity adopted proxy and direct voting simultaneously, votes were totalled before calculating the percentage of votes for and against the report. Votes abstaining from the vote were not included in calculating the percentages for and against the report.

Figure 3 presents the histogram of votes against the remuneration resolution at an annual meeting in the sample. An interesting observation from this histogram is that no votes are observed with a dissenting voting percentage between 25% and 26%, which is just above the threshold for receiving a strike. This may suggest that listed entities may have antecedent knowledge of voting results that are likely to be just over the threshold for a strike and engage in activities to convince a small subset of shareholders or a single shareholder to change their vote.

Figure 3 Histogram of percentage votes against the remuneration resolution at entity annual meetings (n = 704, bins = 1%)



4.3.1.2. Voting strikes

In line with the legal definition of a strike, the dependent variable was set to 1 when the vote against the remuneration report resolution was recorded as greater than 25% of the votes cast. In one annual meeting vote instance the show of hands passed the remuneration report resolution, however the proxy votes recorded a 25% vote against the resolution. As the entity acknowledged this vote as requiring a reconsideration of their remuneration policy, this instance was not removed from the sample and was treated as equivalent to a strike for the entity (Acrux Limited, 2017).

4.3.1.3. Annual meeting voting results on board spill resolutions

Data was also collected for votes on the motion to spill the board following two strikes, including where the entity did not receive a second strike but still provided proxy voting counts on the spill motion. The same procedure as the collection of the voting results on the remuneration report resolution were followed. However, the resulting sample of 18 entities, of which 7 received a second strike,

was considered too small for quantitative analysis beyond an examination of the descriptive statistics.

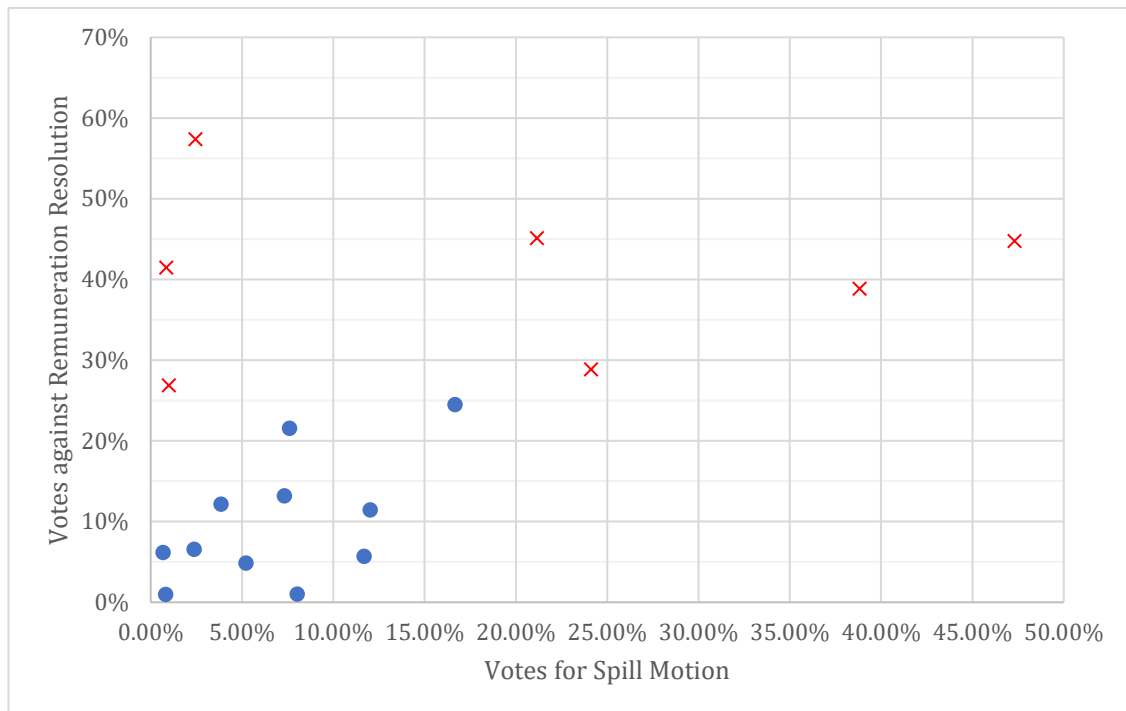
Entities that conducted a spill motion vote are plotted in Figure 4, with the percentage of votes supporting the spill motion plotted on the horizontal axis and the percentage of votes against the remuneration resolution plotted on the vertical axis. Of the 7 entities that received a second strike, 3 entities had votes supporting the spill motion that did not exceed 2.5%, whereas the other 4 entities had votes above 20%. This would suggest that the shareholders that vote against the remuneration report and trigger a second strike are for the most part unified in their decision to either support the spill motion or reject it. No entity has had a spill motion pass in the sample. Unsurprisingly, entities that did not trigger a second strike also had low support for the spill motion. Table 2 presents historical context for the 4 entities with the highest percentage of votes supporting the spill motion, on the basis of company announcements (sourced from SIRCA Gateway) at the time of the AGM.

Table 1

Context for four highest spill motion votes in sample data, based on entity ASX company announcements at the time of the notice of annual meeting and at the time of publishing annual meeting voting results.

Entity	Year	% Votes for Spill Motion	Context
Sundance Resources	2015	47.30%	Minority shareholder seeking seat on board.
Macmahon	2016	38.83%	Low profitability, change in CEO, closure of two mine locations.
Slater & Gordon	2017	24.10%	Proposed recapitalisation scheme to avoid insolvency, agreement with key stakeholders to renew board afterwards.
UGL Ltd	2015	21.14%	Results below expectations, sale of subsidiary business, change in CEO and executive team.

Figure 4 Percentage votes in support of the spill motion resolution plotted against percentage votes against the remuneration resolution at the annual meeting.



Crosses indicate votes against the spill motion that attracted a voting strike at the annual meeting.

4.3.2. Executive Remuneration

The executive remuneration data provided by Morningstar is collated into three categories for the analysis – short-term remuneration (*ShortTermRem*), comprising cash salary, cash bonus, non-monetary benefits and miscellaneous short-term remuneration; long-term remuneration (*LongTermRem*), comprising superannuation, retirement benefits, and long-service leave; and equity-based remuneration (*EquityRem*), comprising shares and options. Each is measured in \$100,000 units to aid in interpretation of the odds ratio results, which will indicate the increase in the likelihood of a strike for a \$100,000 increase in the respective remuneration component. It is argued that using these three components of remuneration in estimating the determinants of voting dissent is an improvement over the measures of CEO remuneration used in prior studies, such as total CEO remuneration (Borthwick et al., 2020; Conyon & Sadler, 2010; Kent et al., 2018) or the individual components of base pay, cash bonuses, and equity (Grosse et al., 2017). Firstly, shareholders will be presented these three values in the

remuneration report and are likely to base their judgement of the appropriateness of the remuneration at least in part based on these values.

Secondly, consistent with Monem and Ng (2013) long-term benefits are included in the analysis, but by contrast equity remuneration is also included. As the purpose of this analysis is to identify potential factors which would influence a voting strike, equity remuneration is pertinent in light of literature suggesting shareholders may consider the equity vested in executives when making voting decisions (Ferri & Maber, 2012). Furthermore, as the equity remuneration is disclosed in the remuneration report, it is prudent to examine if this disclosure has an influence on the receipt of a voting strike. The long-term and equity remuneration of a small number of executives was recorded as negative in the annual reports, which generally was the result of long-term incentive and equity grants being forfeited by the executive upon retirement.

For each AGM voting result the executive with the highest total remuneration was identified and their remuneration values used to estimate the models below. This approach was taken as opposed to relying on the remuneration levels of the CEO as this should represent the upper bound of the pay-to-performance calculation under optimal contracting theory and thus also the individual executive remuneration most likely to trigger shareholder outrage. Across 377 entity-years between 2014 and 2015, there were 37 executives with the highest level of total remuneration who were not the CEO.

It is expected that higher levels of each form of remuneration (*ShortTermRem*, *LongTermRem*, *EquityRem*) will be positively associated with the likelihood of receiving a strike, as higher remuneration indicates an increased likelihood of excessive remuneration under optimal contracting theory and is more likely to trigger shareholder outrage (Bebchuk & Fried, 2003).

4.3.3. Institutional Ownership

The percentage of institutional ownership (*PercentageOwnership*) has been examined in the context of whether changes in CEO pay following voting dissent are moderated by the level of monitoring by shareholders (Ferri & Maber, 2012). Ferri

& Maber find that the level of monitoring, using the percentage of institutional ownership as a proxy measure, did not significantly influence such CEO pay changes. Given the primacy to which the Productivity Commission assigned institutional investors in executing the two-strikes voting regime (Productivity Commission, 2009g), it is prudent to examine the influence of this variable on the likelihood of an entity receiving a voting strike. It is anticipated that entities with a greater level of institutional ownership will exhibit greater investor scrutiny of their remuneration strategy, and therefore will be associated with an increased likelihood of receiving a strike against their remuneration report.

Institutional investor ownership data was sourced from Thomson Reuters' Eikon platform. This data is based on tracking the ownership holdings of over 30,000 institutional investment entities globally and the platform purports to be "the most comprehensive and up to date representation of the investment players... moving markets" (Refinitiv, 2019, p. 1). As such, the data is not limited to the top 20 shareholders disclosed by Australian listed corporations but also includes the ownership of all institutional entities tracked by Thomson Reuters. Institutional entity ownership data for each entity in the sample, expressed as a percentage of total shares issued, was obtained for the first of each month from 1 January 2014 to 1 December 2017. The most recent ownership data prior to the date of the annual general meeting was then used for the analysis. As Thomson Reuters divides its institutional ownership data between investment entities, banking entities, and other institutional investors, the percentages of these three groups were combined. It is noted that the number of significant figures between entity-month data varies from 2 to 6 significant figures, which may bias the results of the analysis to a minor degree.

4.3.4. Media Attention

MediaAttention is a measure of the level of media coverage of executive remuneration for a given entity in the nine months leading up to the annual general meeting. It is a count of newspaper articles concerning executive remuneration published in widely circulated Australian newspapers. An approach informed by Liu and McConnell (2013) and Hooghiemstra et al. (2015) was adopted to obtain the

data for this variable. Using Factiva's search tool, the following query string was used to identify articles relating to the executive remuneration of a given entity:

[Company Name] near20 (remuneration or ((ceo or executive) near10 (pay or bonus or salary or option))) and (rst=advtsr or rst=ageeol or rst=agee or rst=austol or rst=afnr or rst=austln or rst=canbtz or rst=nlcrmw or rst=coumai or rst=nldltw or rst=daitel or rst=nlhrsw or rst=mercury or rst=sage or rst=smhhol or rst=smhh or rst=nladlw or rst=ausmag)

The intention of this query string was to return articles that contained phrases similar to "remuneration", "CEO pay" or "executive pay" that were linked to the company being queried (using the "near20" restriction to restrict the search to within 20 words of the company name). This query string limited the newspapers searched to the largest newspapers in Australia by circulation (Adelaide Advertiser, The Age, The Australian, Australian Financial Review, Courier Mail, Daily Telegraph, Herald Sun, The Mercury, Sydney Morning Herald, West Australian), with the Australian Financial Review also representing a premier source of Australian financial news (Roy Morgan, 2019). Unlike Hooghiemstra et al. (2015), the search query was not limited to articles about the CEO's remuneration, but was extended to all articles related to the remuneration of a company. In general, the first word of the company name was used in the search query, however if the results returned showed the word used in sentences as its natural meaning the full company name excluding Limited or Pty Ltd was used (for example, Premier Investments).

For a given annual meeting, articles were searched between 9 months prior to the annual meeting and the day of the meeting. This window was chosen to capture as many relevant articles leading up to the annual meeting without overlapping with articles that solely reported the results of the prior annual meeting (which may have been held less than a year prior to the current annual meeting). A wide scope similar to that used in Liu & McConnell (2013) is adopted, as opposed to Hooghiemstra et al. (2015) who search for articles between the end of the fiscal year and the day of the AGM, as instances were observed where articles critical of an entity's executive remuneration were published prior to the end of the fiscal year as a supplement to other criticisms of an entity's business practices (for example, the

Big 4 Australian banks). It is posited that these articles may be taken into consideration by institutional investors and proxy advisers in planning their voting or recommendation strategies respectively in the lead up to an AGM. Although these articles may exhibit positive, neutral, or negative coverage of an entity's remuneration practices, it is posited that the media focuses on entities which are believed by shareholders to have excessive remuneration practices (Core et al., 2008). Alternatively, media coverage of an entity "[reduces] information asymmetry between agents and principals [and] negative media coverage imposes reputational costs on executive and non-executive directors who do not act in the shareholders' interests" (Hooghiemstra et al., 2015, p. 756). In this way the media brings to the attention of shareholders entities which may exhibit problematic remuneration practices. Hence, it is hypothesised that greater media coverage is positively associated with the likelihood of an entity receiving a strike.

The number of results were counted manually to identify duplicate articles not identified by Factiva's automatic processes and to exclude article headlines and abstracts that clearly were not related to the executive remuneration of the entity (such as articles discussing conflicted remuneration issues for financial advisers).

4.3.5. Control Variables

4.3.5.1. *Financial control variables*

In light of prior literature identifying a positive relation between entity-size and the strength of the pay-to-performance link and a negative relation between market-to-book and the pay-to-performance link, entity total assets (*TotalAssets*) and market-to-book (*MarketToBook*) ratios are included in the models estimated. *TotalAssets* is measured as the dollar value of the total assets held by the entity and was log-transformed to account for differences in scale in comparison to the other variables. It is expected that larger entities will inherently attract greater shareholder attention and scrutiny, in part due to the larger nominal executive remuneration they would likely offer given their resources in comparison to smaller entities. *MarketToBook* is measured as the market capitalisation divided by the total book value of equity.

Various measures of entity performance used in prior studies are also included (Clarkson et al., 2011; Gregory-Smith et al., 2014; Monem & Ng, 2013) – return on equity (*ROE*) and total 1 year shareholder return (*TotalReturn*). *ROE* is measured as the total equity divided by net income as of the end of the financial year. *TotalReturn* is measured as the change in share price plus dividends paid during a 1-year period divided by the share price at the start of the year. Both measures were calculated by Morningstar, with the most recent calculation for each measure prior to the AGM used. Under agency theory, it is expected that entities with low or negative return on equity and shareholder return will attract a greater likelihood of a strike against their remuneration report due to poor performance.

4.3.5.2. Industry and year dummy variables

Industry sector and year are controlled for in the following models. *MorningstarSectorCode* is a set of dummy variables representing an entity's inclusion in one of Morningstar's 10 sector groups: basic materials, consumer cyclical, financial services, real estate, consumer defensive, healthcare, utilities, communication services, energy, industrials and technology. It is possible that industry sectors that attract greater media and/or investor scrutiny, including the basic materials and financial services sectors, are more likely to attract voting dissent as a result. *Year* is a set of dummy variables representing the calendar year in which the annual general meeting took place. Monem and Ng (2013, p. 250) noted that investors may have been "over-enthusiastic in exercising their voting power" in the first year of their sample, and it is therefore prudent to control for any time related effects.

4.4. Empirical Results

4.4.1. Descriptive Statistics

Table 2 Descriptive statistics for strike and non-strike data points.

No Strike (n = 656)					
	Mean	Std. Dev.	Max	Median	Min
Against%	0.05	0.06	0.25	0.03	0.00
ln(TotalAssets)	23.93	25.54	27.61	21.21	17.33
MarketToBook	2.99	3.72	43.58	1.74	0.14
MediaAttention	1.93	5.51	86.00	0.00	0.00
PercentageOwnership	32.13	17.11	90.16	31.53	0.00
ROE	0.08	0.27	1.75	0.11	-1.98
TotalReturn	18.27	78.71	1118.18	9.78	-83.33
ShortTermRem	16.24	12.02	68.54	12.93	0.00
LongTermRem	1.05	3.03	34.47	0.27	-1.93
EquityRem	6.14	9.75	74.50	2.03	-20.55
Strike (n = 48)					
	Mean	Std. Dev.	Max	Median	Min
Against%	0.40	0.11	0.76	0.38	0.26
ln(TotalAssets)	23.85	25.62	27.56	21.17	17.67
MarketToBook	2.47	3.36	15.11	1.49	-0.05
MediaAttention	2.96	9.75	67.00	1.00	0.00
PercentageOwnership	29.47	18.85	73.39	27.77	0.89
ROE	-0.49	2.82	0.58	0.01	-19.40
TotalReturn	-8.11	50.82	177.22	-6.17	-87.81
ShortTermRem	17.91	14.23	55.38	13.12	0.98
LongTermRem	0.71	1.49	8.33	0.30	-0.58
EquityRem	4.92	8.46	36.73	1.50	-5.40

Against% is the percentage votes against the remuneration report resolution. ln(TotalAssets) is the total assets of the entity. MarketToBook is the market capitalisation of the entity divided by total common equity. MediaAttention is the number of news articles published in top circulating Australian newspapers related to the remuneration practices of the entity in the nine months prior to the annual meeting. PercentageOwnership is the percentage of outstanding shares owned by institutional investors. ROE is the return on equity, calculated as net income divided by average total common equity. TotalReturn is the 1-year total return on the entity's shares. ShortTermRem is the sum of base salary, cash bonus, director's fees, non-monetary benefits and other short-term remuneration for the executive with the highest total remuneration in the remuneration report. LongTermRem is the sum of superannuation, retirement benefits and long-service leave for the executive with the highest total remuneration in the remuneration report. EquityRem is the sum of share-based remuneration and options-based remuneration for the executive with the highest total remuneration in the remuneration report.

Table 3 Pearson correlation matrix

	A	B	C	D	E	F	G	H	I	J
(A) Strike	1.000									
(B) ln(TotalAssets)	-0.053	1.000								
(C) ROE	-0.184	0.047	1.000							
(D) TotalReturn	-0.086	-0.090	0.085	1.000						
(E) PercentageOwnership	-0.039	-0.011	0.088	0.047	1.000					
(F) MediaAttention	0.044	0.543	-0.002	-0.036	-0.145	1.000				
(G) ShortTermRem	0.035	0.571	0.079	-0.021	-0.008	0.315	1.000			
(H) LongTermRem	-0.029	0.132	-0.017	-0.047	0.010	0.142	0.044	1.000		
(I) EquityRem	-0.032	0.452	0.028	-0.026	0.045	0.272	0.467	0.071	1.000	
(J) MarketToBook	-0.036	-0.218	0.163	0.321	-0.034	-0.049	0.024	-0.013	0.019	1.000

Table 2 presents the financial, institutional ownership, media attention and executive remuneration properties of entities receiving a voting strike against non-strike entities. The mean return on equity (*ROE*) and 1-year shareholder return (*TotalReturn*) for strike entities are negative and lower than that of non-strike entities. However, the values for strike entities are more widely distributed about the mean, suggesting that entities with good performance are still liable to receive a voting strike. Surprisingly, the level and distribution of remuneration components between strike and non-strike entities does not appear to differ greatly. From an optimal contracting perspective, this may suggest that reduction in the pay-performance link is more likely to be the result of poor performance than changes in the level of remuneration.

Table 3 shows the Pearson correlation matrix of the variables in the model above. Media attention (*MediaAttention*) is observed to be highly correlated with the size of the entity (as measured by total assets), which reflects the notion that the public at large is more interested in the executive remuneration of these larger entities (Hooghiemstra et al., 2015). Media attention is also correlated to a notable degree with each of the remuneration components, indicating that larger remuneration amounts attract greater media attention, which may suggest that the media focuses on entities which are more likely to exhibit excessive remuneration practices (Hooghiemstra et al., 2015).

4.4.2. Determinants of the Likelihood of a Strike

Table 4 Results of estimating Equation 1 (n=704).

Variables	Coefficient Mean	Two-tailed p-Value
Intercept	3.9092	0.2188
<i>ShortTermRem</i>	0.0000***	0.0014
<i>LongTermRem</i>	-0.0000	0.2442
<i>EquityRem</i>	-0.0000	0.4200
<i>MediaAttention</i>	0.0655**	0.0103
<i>PercentageOwnership</i>	0.0017	0.8567
<i>ln(TotalAssets)</i>	-0.3806**	0.0177
<i>MarketToBook</i>	0.0223	0.7121
<i>ROE</i>	-0.8973*	0.0828
<i>TotalReturn</i>	-0.0099**	0.0189
Industry Sector Dummies	Yes	
Year Dummies	Yes	
Pseudo R ² (Equivalent linear R ²)	0.141 (0.3 - 0.4)	
n	704	

Against% is the percentage votes against the remuneration report resolution. *ln(TotalAssets)* is the total assets of the entity. *MarketToBook* is the market capitalisation of the entity divided by total common equity. *MediaAttention* is the number of news articles published in top circulating Australian newspapers related to the remuneration practices of the entity in the nine months prior to the annual meeting. *PercentageOwnership* is the percentage of outstanding shares owned by institutional investors. *ROE* is the return on equity, calculated as net income divided by average total common equity. *TotalReturn* is the 1-year total return on the entity's shares. *ShortTermRem* is the sum of base salary, cash bonus, director's fees, non-monetary benefits and other short-term remuneration for the executive with the highest total remuneration in the remuneration report. *LongTermRem* is the sum of superannuation, retirement benefits and long-service leave for the executive with the highest total remuneration in the remuneration report. *EquityRem* is the sum of share-based remuneration and options-based remuneration for the executive with the highest total remuneration in the remuneration report. Significance: ***<0.01, **<0.05, *<0.10.

Table 4 presents the results of estimating the model. It is noted that the pseudo-R² of 0.141 for this logit regression is equivalent to an R² measure of model fit for a linear regression between 0.3 and 0.4 (Domenich & McFadden, 1975; Hensher et al., 2015), representing an improvement over the analogous linear model estimated in Conyon & Sadler (2010). It can be observed from the standard logit model that the short-term remuneration component was positively and significantly related to the likelihood of a voting strike ($p < 0.01$). To aid in the interpretation of the coefficients presented in Table 4, Table 5 shows the equivalent odds ratios and associated confidence intervals for the coefficients of the non-dummy variables. It

indicates that each additional \$100,000 of short-term remuneration awarded to the highest paid executive multiplies the odds of the entity receiving a strike by 1.053.

Table 5 Log-odds ratios and confidence intervals for the estimated coefficients for Equation 1.

	2.50%	97.50%	Odds Ratio
ln(TotalAssets)	0.499053	0.936075	0.683485
MarketToBook	0.90825	1.151288	1.022574
ROE	0.14792	1.123438	0.40765
TotalReturn	0.98193	0.998361	0.990112
PercentageOwnership	0.983791	1.019854	1.00166
ShortTermRem	1.020403	1.087656	1.053493
LongTermRem	0.77438	1.067263	0.909102
EquityRem	0.939221	1.02649	0.981886
MediaAttention	1.015558	1.12241	1.067648

Surprisingly, the long-term remuneration and equity remuneration components were not significantly related to the likelihood of a voting strike at any level, suggesting that investors are primarily concerned with the magnitude of the short-term remuneration component when considering whether an entity should receive a voting strike. A possible explanation for this focus, drawn from comments made to the Productivity Commission Inquiry, is that investors face difficulties in assessing whether long-term and equity remuneration plans in the remuneration report are justified by the entity's performance (Grosse et al., 2017, p. 704; citing Deane, 2007). Particularly retail investors may focus on the base salary and cash bonus components over calculating the present value of share-based and option-based compensation and judging if such compensation is justified. Similarly, investors may have difficulty parsing and understanding remuneration reports, and therefore choose to focus on the components that are easiest to extract from the report, being the short-term components. There may also be a subset of investors that have invested for short-term returns, and therefore are less concerned with long-term and equity remuneration. These possible reasons for this focus on short-term remuneration do not intuitively apply to institutional investors, who would presumably have the resources and experience to judge whether long-term and

equity remuneration is justified by the entity's performance and vote accordingly. Thus, it is posited that short-term remuneration is more likely to generate shareholder outrage and thus attract a voting strike, whereas managers are better able to camouflage any excessive long-term or equity remuneration and avoid shareholder outrage.

Media attention is somewhat significantly and positively related to the likelihood of a voting strike ($p < 0.05$), with the odds ratio inferring that for each article published in a major Australian newspaper about the executive remuneration of a company, the company's odds of receiving a voting strike in that year's annual meeting multiply by 1.067, *ceteris parabis*. As this measure does not distinguish between positive, neutral or negative in tone articles related to executive remuneration, this may suggest that increasing media attention of any tone prompts investors to more carefully scrutinise the remuneration report. These results potentially suggest that the role of the media as an overseer and "information arbiter", as observed in prior literature (see Hooghiemstra et al., 2015, p. 756), is justified. The media conveys information from proxy advisers and other stakeholder groups about potentially excessive or problematic executive remuneration to investors, which undermines the legitimacy of these problematic entities, and in turn leads the investors to vote against the remuneration report (Liu & McConnell, 2013).

Alternatively, the media in its "capturing" role may simply devote greater coverage to entities which have already been identified by shareholders as potentially problematic in regards to remuneration practices, reversing the causal link between shareholder voting and media coverage (Hooghiemstra et al., 2015, p. 768). Under either explanation, these findings support the hypothesis that media attention impairs the legitimacy of the corporation and its remuneration practices, inviting voting dissent and a voting strike.

The percentage of institutional ownership is not significantly related to the likelihood of a voting strike ($p > 0.10$). This result may suggest that retail shareholders are not passive or non-active voters in AGMs and are instead just as active as institutional shareholders in assessing and voting on entity's remuneration strategy. If it is assumed that institutional shareholders undertake substantial

research and analysis in accordance with their fiduciary duty before voting on a remuneration resolution (Productivity Commission, 2009g), it would also necessitate the assumption that in general retail shareholders are able to perform or at least access the same research and analysis undertaken by institutional investors. This may be the case if a large proportion of retail investors also rely on proxy advisers as with the large proportion of institutional investors (as suggested by the Australian Institute of Company Directors, 2011). An alternative explanation is that the majority of entities have institutional ownership percentages above the strike threshold of 25%. Once this threshold is passed the effect of additional institutional ownership on a voting strike diminishes as fewer votes are needed to guarantee a strike. Thus, there is little difference between an entity with 30% institutional ownership and an entity with 70% institutional ownership on the likelihood of receiving a voting strike. Hence institutional investors may still be performing their oversight role while retail investors act passively on the vote, but this would not be visible in the results of the model.

It is observed that both size (represented by the natural log of total assets) and total shareholder return are negatively and significantly related to the likelihood of a voting strike ($p < 0.05$). The relationship between size and the likelihood of a strike is potentially explained by the greater resources of these entities to undertake corporate governance best practices, such as maintaining a sufficiently independent remuneration committee, and engage with institutional investors and proxy advisers prior to publishing their remuneration report. The coefficient for total shareholder return is consistent with optimal contracting theory, indicating that investors consider the performance of the entity when voting on executive remuneration. Alternatively, investors may vote against the remuneration report to solely indicate displeasure with the performance of the entity as opposed to a pay-performance basis.

Amongst the sector control variables, the variable representing an entity's membership in the Morningstar utilities sector group is weakly, positively related to the likelihood of a strike ($p < 0.1$). It may be conjectured that Australian utility entities, given their history of privatisation following government ownership and potential oligopolist markets, may result in a greater likelihood of excessive

executive remuneration and thus shareholder dissent. Further research is necessary to examine this association. Similarly, the variable representing an annual general meeting held in 2016 is also weakly, positively related to the likelihood of a strike ($p < 0.1$). It is possible that investors were “over-enthusiastic” in exercising their voting dissent in this year following relatively lower dissent activity in the prior years, similar to the phenomenon observed by Monem and Ng (2013, p. 238).

4.4.3. Deviation from industry remuneration practices

To determine whether deviation from industry sector remuneration practices may influence the likelihood of a strike on the remuneration report, an alternative model is estimated which replaces the three remuneration component variables with measures of remuneration normalised to industry sector remuneration. These are proxy measures for the level of isomorphism in a corporation’s remuneration practices, which are hypothesised to increase the legitimacy attached to those practices (Deephouse, 1996; Liu & Taylor, 2008). A corporation adopting isomorphic remuneration practices is anticipated to have executive remuneration closer to the industry sector mean for remuneration as they adopt similar remuneration practices for a given level of corporate performance. In addition, industry benchmarks have been identified as a remuneration setting best practice by remuneration committee members and as a potential means for shareholders to assess remuneration suitability (Carter & Zamora, 2007; Ogden & Watson, 2012).

$$\begin{aligned}
 V_{n,strike} = & \beta_0 + \beta_1 \ln(TotalAssets) + \beta_2 ROE \\
 & + \beta_3 PercentageOwnership + \beta_4 TotalReturn \\
 & + \beta_5 MarketToBook + \beta_6 MediaAttention \\
 & + \beta_7 |ShortTermRemNorm| \\
 & + \beta_8 |LongTermRemNorm| + \beta_9 |EquityRemNorm| \\
 & + \beta_{10-19} MorningstarSectorCode + \beta_{20-22} Year
 \end{aligned} \tag{2}$$

4.4.3.1. Variable: Director remuneration normalised to mean sector remuneration

To capture deviation from industry sector remuneration practices three variables are constructed using the ratio of top entity remuneration (*ShortTermRem*, *LongTermRem*, *EquityRem*), defined as the remuneration of the director with the highest total remuneration in the remuneration report, normalised to the average (*SectorAverage*) and standard deviation (*SectorStdDev*) of top entity remuneration in an industry sector for each of the components of remuneration (*ShortTermRemNorm*, *LongTermRemNorm*, *EquityRemNorm*). This measure is therefore a calculation of how many standard deviations an entity's highest remuneration is away from the industry sector's average highest remuneration.

$$RemNorm = \frac{Rem - SectorAverage}{SectorStdDev} \quad (3)$$

To calculate the average and standard deviation of top entity remuneration in an industry sector every data point in the Morningstar remuneration data provided by SIRCA Gateway was obtained for the years 2014 to 2017, resulting in 4,695 entity-years across 26,396 records. The executive with the highest level of remuneration for each entity was identified, and an average calculated for all identified executives within a given sector. Entities were classified on the basis of Morningstar's industry sector classification, comprising 11 sectors⁹ into which entities are divided on the basis of their "primary business" (Morningstar, 2019). These measures act as a proxy for the extent an entity is consistent with industry norms of remuneration setting, which institutional theory suggests is inversely related to the likelihood of the entity's remuneration report receiving a strike (Bruce et al., 2005). Therefore, it is expected that each *RemNorm* measure (*ShortTermRemNorm*, *LongTermRemNorm*, *EquityRemNorm*) will be positively and significantly associated with the likelihood of receiving a strike, with higher scores for *RemNorm* indicating greater deviation in remuneration away from the industry

⁹ The 11 sectors are Communication Services, Energy, Industrials, Technology, Healthcare, Consumer Defensive, Utilities, Basic Materials, Consumer Cyclical, Financial Services, Real Estate.

sector mean. The absolute values of the normalised remuneration variables are used so that higher values indicate greater deviation from the industry sector average.

4.4.3.2. Empirical results

The results of estimating Equation 2, shown in Table 6, are highly similar to the results of estimating Equation 1 in terms of coefficient significance. Comparing the log-likelihoods of the estimated models suggests that using the deviation of remuneration from industry sector averages to measure remuneration has minimal impact as opposed to the nominal amount of remuneration. *ShortTermRemNorm* is positively and significantly associated with the likelihood of a strike, implying that voters compare short-term remuneration of directors to industry sector peers in making their judgement as to the excessiveness of the remuneration and whether the entity should receive a voting strike. This model is subject to a limitation in relation to remuneration components, in that this effect is not isolated from the effect of the total quantum of short-term remuneration on the likelihood of receiving a voting strike. However, estimating a model controlling for the amount of top entity remuneration components gives rise to multicollinearity issues. As with the previous model, long-term and equity remuneration components are not significantly associated with the likelihood of a voting strike. Hence, the legitimacy sourced from remuneration practice isomorphism appears to be limited to the short-term remuneration components. This may, as proposed for the findings of the first model, reflect shareholder difficulties in assessing the suitability of these latter remuneration components.

Table 6 Results of estimating Equation 2 (n=704).

Variables	Coefficient	Mean (two-tailed p-value)	Two-tailed p-Value
Intercept	3.5310		0.2551
<i>ShortTermRemNorm</i>	0.3867***		0.0010
<i>LongTermRemNorm</i>	-0.1683		0.2353
<i>EquityRemNorm</i>	-0.1037		0.4004
<i>MediaAttention</i>	0.0638**		0.0101
<i>PercentageOwnership</i>	-0.0016		0.8610
<i>ln(TotalAssets)</i>	-0.3461**		0.0245
<i>MarketToBook</i>	0.0170		0.7872
<i>ROE</i>	-0.9698*		0.0707
<i>TotalReturn</i>	-0.0096**		0.0222
Industry Sector Dummies	Yes		
Year Dummies	Yes		
Pseudo R ² (Equivalent linear R ²)	0.144 (0.3 - 0.4)		
n	704		

Against% is the percentage votes against the remuneration report resolution. *ln(TotalAssets)* is the total assets of the entity. *MarketToBook* is the market capitalisation of the entity divided by total common equity. *MediaAttention* is the number of news articles published in top circulating Australian newspapers related to the remuneration practices of the entity in the nine months prior to the annual meeting. *PercentageOwnership* is the percentage of outstanding shares owned by institutional investors. *ROE* is the return on equity, calculated as net income divided by average total common equity. *TotalReturn* is the 1-year total return on the entity's shares. *ShortTermRemNorm* is the sum of base salary, cash bonus, director's fees, non-monetary benefits and other short-term remuneration for the executive with the highest total remuneration in the remuneration report, normalised against the highest director remuneration of entities within the same industry sector. *LongTermRemNorm* is the sum of superannuation, retirement benefits and long-service leave for the executive with the highest total remuneration in the remuneration report, normalised against the highest director remuneration of entities within the same industry sector. *EquityRemNorm* is the sum of share-based remuneration and options-based remuneration for the executive with the highest total remuneration in the remuneration report, normalised against the highest director remuneration of entities within the same industry sector. Significance: ***<0.01, **<0.05, *<0.10

4.5. Conclusion

In this chapter analysis was performed to identify the determinants of a large Australian corporation receiving a voting strike on its say-on-pay resolution. This analysis found that short-term remuneration was significantly associated with the likelihood of a corporation receiving a voting strike, controlling for corporate performance, whereas long-term and equity remuneration were not associated to any significant degree. Thus, despite the significant association of short-term remuneration with a voting strike, these findings do not lend substantial support to the hypothesis that shareholders would perceive that higher levels of each

component of remuneration for a set level of corporate performance to be excessive, as might be expected from prior literature and under managerial power theory (Bebchuck & Fried, 2003; Borthwick et al., 2020; Carter & Zamora, 2007; Conyon & Sadler, 2010; Ertimur et al., 2011). Instead, these findings may suggest that shareholders are unable to assess the suitability of long-term and equity remuneration components in aligning executive incentives with shareholder interests (Grosse et al., 2017, p. 704; citing Deane, 2007). Arguably, the effectiveness of the two-strikes regime in empowering shareholders to hold board directors accountable is impaired by the ability of shareholders to identify excessive remuneration in those components.

The observation that no spill motion resolution was passed for the corporations in the sample may suggest that shareholders are unwilling to exercise this option to address boards unresponsive to shareholder concerns, possibly because shareholder concerns with the remuneration practices are outweighed by the negative consequences of a board spill for shareholder value. A possible explanation for this unwillingness is explored further in Chapter 5, in which articles discussing unresponsive boards are identified.

The proportion of institutional ownership was not found to be significantly associated with the likelihood of receiving a strike. Given the regulatory role of institutional shareholders in the Australian legal framework surrounding executive remuneration, this finding may suggest that institutional shareholders are not effectively using the two-strikes regime in their role as a watchdog (Sheehan, 2009). Alternatively, this may be explained by the 25% threshold for a strike, which sets an upper limit for the required institutional ownership of a corporation before a strike has the power to threaten the board.

The estimation of a second model to assess the impact of isomorphic remuneration practices on the receipt of a voting strike yielded similar findings to the first model estimated. Short-term remuneration normalised to industry sector averages was found to be significantly associated with the likelihood of a voting strike whereas long-term and equity remuneration were not significantly associated. These findings suggest legitimacy may be sourced from complying with industry norms of remuneration setting for short-term components, however it is

noted that industry sector normalised remuneration is a limited proxy measure for isomorphism in remuneration setting. Notably, it assumes that adoption of industry norms will revert remuneration to the industry mean over time and may be confounded by the effect of pay-performance sensitivity on the likelihood of a voting strike.

An important finding was that media attention was identified as significantly and positively associated with the likelihood of receiving a voting strike. This lends support for the assertion that a shareholder bases their voting decision partly or wholly on the legitimacy attached to the corporation and its remuneration practices. In the following chapter an analysis of news media articles discussing voting dissent will be performed. The aim of this analysis is to identify the corporate actions reported on in news articles that impair this legitimacy, and in turn contribute to the likelihood of a voting strike. This analysis will also examine how the two-strikes regime affects shareholder engagement with boards on executive remuneration, and how shareholders react to boards that consistently ignore concerns about their executive remuneration practices.

5. Analysis of Media Articles Discussing Voting Dissent

5.1. Introduction

This chapter presents an analysis of news media articles that report on the say-on-pay votes on Australian corporations. In Chapter 2, the legitimacy attached to a corporation and its remuneration practices was identified as a potential determinant of executive remuneration in the remuneration setting process (Bruce et al., 2005; Main et al., 2007; Ogden & Watson, 2012). Here it was suggested that remuneration committees may adopt remuneration practices that were consistent with industry norms in order to benefit from the legitimacy secured by such conformity (Deephouse, 1996). In turn, shareholders assess the suitability of executive remuneration based on this legitimacy attached to the remuneration practices of the corporation.

In Chapter 4, media attention was identified as a significant determinant of the likelihood an Australian corporation received a voting strike. News media reporting, through its reporting of the opinions of institutional shareholders and proxy advisers to other shareholders, is expected to impact the legitimacy of a corporation and its remuneration practices (Hooghiemstra et al., 2015; Liu & Taylor, 2008). Given the substantial impact of negative news media reporting of institutional shareholders on voting dissent (approximately 6% increase in dissent) in Hooghiemstra et al. (2015, p. 769), it was hypothesised that media attention would be positively associated with the likelihood of a voting strike. This hypothesis was confirmed in the model estimated, lending support for legitimacy explanations for shareholder voting behaviour on the say-on-pay resolution.

This chapter proceeds by outlining the theoretical foundation for this analysis: legitimacy theory. The majority of the analysis presented in this chapter examines actions that specifically affect the “pragmatic legitimacy” of the corporation, which is legitimacy derived from acting consistently with the self-interest of proximate stakeholders (Suchman, 1995, p. 577). Then a brief overview

of the method for this analysis is presented. The analysis was performed on news media articles from Australia's largest newspapers, using a Factiva search for articles discussing the two-strikes say-on-pay vote. Following this the results of the analysis are presented, in which corporate actions which impair the legitimacy of the corporation's remuneration practices, or repair it, reported in the news media articles were identified. Finally, a discussion of the findings is presented.

5.2. Theoretical Foundation

Deephouse et al. (2017, pp. 9–10) in their review of legitimacy in academic literature define organisational legitimacy as “the perceived appropriateness of an organization to a social system in terms of rules, values, norms, and definitions”. The perception referred to in that definition is sourced from external stakeholders to the organisation, specifically “media, regulators, and other industry actors (advocacy groups, employees, etc.)” (Bitektine, 2011, p. 159), and can be construed to be the social contract within which an organisation is bound to act (Deegan, 2006). While the legitimacy of an organisation is defined by and assessed against the beliefs of these external stakeholders, part of the literature also views legitimacy as a resource which managers of an organisation are able to build up, maintain and repair when damaged (Suchman, 1995).

Suchman (1995) identifies three broad categories of legitimacy reflecting different reasons why external stakeholders view the organisation as appropriate to the social system it is embedded within – pragmatic legitimacy, moral legitimacy, and cognitive legitimacy. An organisation derives pragmatic legitimacy by performing actions which align with the self-interest of stakeholders most closely linked to the organisation. Moral legitimacy “rests... on judgments about whether the activity is ‘the right thing to do’... whether the activity effectively promotes societal welfare, as defined by the audience’s socially constructed value system” (Suchman, 1995, p. 579). Pragmatic legitimacy and moral legitimacy can be viewed as opposing constructs on a spectrum of the number of parties that will benefit from the organisation (Bitektine, 2011). Finally, an organisation obtains cognitive legitimacy by being perceived as necessary in its social setting, with the removal or absence of the organisation either resulting in societal chaos or being “literally

unthinkable” (termed “taken-for-granted legitimacy” (Suchman, 1995, pp. 582–583)) in the minds of the stakeholders. A corporation would generally only obtain cognitive legitimacy by being entrenched in a socially essential function by force of law. Thus, in the context of setting and approving remuneration this form of legitimacy is irrelevant.

Pragmatic legitimacy manifests in several different constructs (Suchman, 1995). Exchange legitimacy arises where stakeholders expect an organisation to directly benefit their interests, they will in return provide support for that organisation’s policies. Bribes to benefit specific stakeholders would be one example, although from a moral legitimacy perspective would likely be considered inappropriate by a wider range of societal stakeholders. Influence legitimacy arises when organisations, though not necessarily directly benefitting stakeholders, are perceived to be “responsive to their larger interests” (Suchman, 1995, p. 578). This legitimacy arises not from the output of organisational policies and actions, but from communication with and the appearance of subordination to close stakeholders. Dispositional legitimacy reflects a human tendency to anthropomorphise organisations, in which “constituents are likely to accord legitimacy to those organizations that ‘have our best interests at heart,’ that ‘share our values,’ or that are ‘honest,’ ‘trustworthy,’ ‘decent,’ and ‘wise.’” (Suchman, 1995, p. 597). This latter construct likely overlaps with stakeholder considerations of moral legitimacy of an organisation in deciding whether to lend support for that organisation’s policies.

Suchman (1995) identifies specific activities of a corporation which build or damage its legitimacy, and in the context of shareholder voting on remuneration report resolutions the focus is on the pragmatic legitimacy of its remuneration structure. A corporation may build up its pragmatic legitimacy through meeting the demands and needs of its closest stakeholders, and by attracting shareholders receptive to the remuneration strategies of the corporation. By contrast, managers who have suffered damage to the legitimacy of their corporation’s remuneration are likely to repair their pragmatic legitimacy by denying the existence of any problem related to their remuneration in the hope that stakeholders will accept this denial, or failing that, by establishing or relying on third-party “monitors and watchdogs”

to oversee future actions and provide an avenue to redress stakeholders' future concerns (Suchman, 1995, p. 598).

By contrast, Lindblom (1994; cited in Deegan, 2006) provides a generalised set of responses organisations may take to repair their legitimacy. First, they may provide information to stakeholders of actual changes the organisation has undertaken to conform with stakeholder expectations more closely. Second, stakeholders may be influenced to perceive changes in the organisation's actions and policies that more closely conform with their expectations without actual change being effected. Third, stakeholder attention may be diverted from the issue harming organisational legitimacy to a related area of concern where the organisation has established and maintained its legitimacy. Finally, the organisation may influence stakeholders to temper their expectations and to accept the current actions and policies of the organisation.

5.2.1. Development of Research Questions

Shareholder voting on the remuneration report can be construed as an exhibition of the pragmatic legitimacy attached to a corporation's remuneration structure by shareholders, with shareholders voting against remuneration that is not in their self-interest. Under optimal contracting theory, voting assent for the remuneration resolution reflects the exchange legitimacy obtained from shareholders who value aligning corporate performance with the executive remuneration. However, it does not necessarily reflect the acceptance of that remuneration structure by other stakeholders. Proxy advisers and the media with poor perceptions of a corporation's remuneration may exert their influence over shareholders, in turn increasing voting dissent on the remuneration report resolution. On the other hand, proxy advisers and the media may also reveal to corporations shareholders' expectations for remuneration (Bitektine, 2011; Pollock & Rindova, 2003), and thus guide the actions of corporations in establishing or repairing pragmatic legitimacy. As such, these parties could also be considered as closely proximate stakeholders alongside shareholders as providers of legitimacy for the remuneration report.

In the context of voting on the remuneration report resolution, media coverage is likely to focus on potential (ex-ante) or actual (ex-post) voting strikes, as the media either disseminates information of most relevance to shareholders or focuses on “sensational” stories that entertain its readers (Hooghiemstra et al., 2015, p. 756). In the former, shareholders would be most concerned with remuneration that is inappropriate and would focus their attention on news that highlights this. In the latter, inappropriate remuneration provides journalists with stories that highlight the inappropriate quantum of remuneration that may trigger social outrage. Thus, the questions of concern in the following analysis are:

- What managerial actions impair the legitimacy of a corporation’s executive remuneration strategy (termed remuneration legitimacy)?
- What actions do managers undertake to repair damaged legitimacy in relation to executive remuneration?

5.3. Method

A Factiva search was performed using the search term “remuneration near 20 strike” of widely circulated Australian newspapers¹⁰ between the dates 1 January 2014 and 30 December 2017, matching the time period of the sample used in the quantitative analysis in Chapter 4. The search term substantially restricted the news articles to those discussing corporations that had or might receive a voting strike, resulting in an initial sample of 613 news articles.

The news articles were imported into Nvivo software to assist in coding. The first 100 articles (sorted by Factiva’s relevance to the search term) were then read, and an initial coding of themes present in relation to impairment or repairing of remuneration legitimacy was performed. Several distinct overarching themes were identified, and the articles were read again to confirm the coding structure. The following 100 articles in the sample were then coded, which primarily confirmed the themes identified. Thus, it was determined that theoretical saturation had been achieved from the articles, and the following analysis was primarily performed on

¹⁰ Adelaide Advertiser, The Age, The Australian, Australian Financial Review, Courier Mail, Daily Telegraph, Herald Sun, The Mercury, Sydney Morning Herald, West Australian

the basis of those 200 articles. The headlines of the remaining articles were read to identify any articles which potentially could provide additional information, with a small number also coded as part of this analysis.

In addition, a semi-structured interview was undertaken with an employee of an Australian proxy advisory firm (Interviewee A), and the data from the interview was used to validate the themes identified in the analysis and identify any themes that may not have been identified in the media articles. Given the influence of proxy advisers on voting dissent on remuneration resolutions in Australian corporations (as noted in Chapter 2) and the highly concentrated nature of the Australian proxy adviser market, a single interview was viewed as sufficient in light of the research project's resources. The interview was conducted at the offices of the firm, and questions were asked that aimed to elicit the interviewee's approach to providing voting recommendations on remuneration report resolutions. Appendix A provides the list of questions that acted as a guide for the interview. Additional questions were asked to provide further insight into specific cases raised by the interviewee in answering the set questions. The interview was transcribed and coded following the same procedures as performed for the news articles.

5.3.1. News Articles

A common factor for the majority of news articles coded for this study was a focus on a single corporation, generally prompted by a recent vote on the remuneration report resolution. The structure of these articles generally identified the percentage of votes against the remuneration report, the amount of pay awarded to an executive in the prior year, the financial performance of the corporation if it was notably poor, and a quote from at least one stakeholder. The remaining articles were broadly divided into articles focusing on an upcoming vote on the remuneration report resolution for corporations that previously suffered a strike against the resolution, articles discussing voting on the remuneration report resolution in general or across multiple corporations, and articles discussing the influence of proxy advisers on shareholder voting. The majority of these articles also featured a quote from at least one stakeholder.

As a result, the coding of the news articles tended to focus on quotations from individuals, as comparatively few articles provided specific editorial reasons for voting dissent. The individuals quoted generally comprised directors from the corporations focused on in the article, spokespeople from proxy advisers and the Australian Shareholders' Association (ASA), and spokespeople from institutional investors.

5.4. Corporate Actions Impairing the Legitimacy of Executive Remuneration

A set of common themes emerged from the media articles that reported on why a corporation's remuneration was deemed as likely to attract, or had attracted, notable voting dissent. First, the awarding of executive pay for poor or as-expected corporate performance was unsurprisingly the most common theme identified. Within this theme a number of specific reasons for shareholder and stakeholder discontent with remuneration were identified: the awarding of bonuses for poor or mediocre performance, the use of easily achievable hurdles for awarding remuneration (termed soft targets) and the inconsistency amongst shareholders of what constituted acceptable remuneration hurdles. The second theme identified was poor communication between the board and stakeholders, specifically institutional shareholders and proxy advisers. Finally, the third theme identified was shareholder discontent with the board for reasons other than their remuneration strategy. These themes are explored in more detail in the following sections.

5.4.1. Inappropriate Pay Structure Awarding Pay Regardless of Performance

The most common theme identified in the reasons given for voting dissent on the remuneration report was failings in the corporation's remuneration structure. Specifically, the quantum of payment itself was generally not the issue, but the awarding of pay for poor or status quo performance.

"There has been an increasing trend of complexity in these remuneration structures and the result is a lack of transparency and certainty as to what is the end outcome. We don't begrudge people being paid well for very good jobs done, we begrudge people being paid very well for average or poor jobs," says Simon Mawhinney, managing director of Allan Gray, one of the most vocal institutional critics of the way executive pay is structured (Smith, 2015).

Several articles juxtaposed the amount of pay awarded to executives with the financial performance of the corporation, though few articles specifically stated a causal link between the two. More commonly poor performance was attributed to negatively affecting the "mood" of shareholders, followed by reporting of their voting against the remuneration report.

With Ansell shares dropping 35 per cent since the release of its disappointing full-year earnings result in August, shareholders were in no mood to be generous and more than a third voted down the adoption of the company's remuneration report yesterday... ("Ansell suffers 'first strike'", 2015).

However, articles that reported the poor performance of the corporation almost always reported a reason for voting dissent not specifically related to the poor performance. In the case of Ansell, workers' union displeasure with the board following the closing of a factory overseas and volatile currency exchange rates affecting the awarding of bonuses were cited as additional reasons. The lack of blame for voting dissent solely attributed to poor performance may reflect the stakeholders quoted in these articles. Proxy advisers, the ASA and institutional shareholders are unlikely view the vote on the remuneration resolution as the appropriate forum for voicing displeasure with poor performance given the availability of more appropriate mechanisms to do so (e.g. direct communication with the board, election of directors, or offloading of shareholdings).

5.4.1.1. Bonuses awarded despite performance

The problematic elements of pay structure often related to target-based incentives, both short- and long-term, focusing on the use of subjective or non-financial metrics or easily achievable targets (“soft targets”) to award bonuses and other incentives. The primary concern raised by proxy advisers and institutional shareholders was that bonuses and incentives were being considered as part and parcel of executives’ base pay, rather than being awarded only for improving the performance of the corporation. According to institutional shareholder AustralianSuper’s CEO Ian Silk:

Silk has strong views on executive remuneration, which he outlined in an interview with The Australian this week, including that executive bonuses should be bonuses for exceptional performance — and should not be considered a de facto part of an executive’s base pay (Korporaal, 2017).

Incentive-based remuneration that was awarded based on what the CEO and executives should be doing as part of their job attracted substantial criticism from people quoted in the news articles.

[Commonwealth Bank of Australia (CBA)] was proposing a new “people and community” measure to determine 25 per cent of chief executive Ian Narev’s long-term incentive, with another 25 per cent determined by customer satisfaction and the remainder based on total shareholder return.

Proxy adviser ISS condemned policies aimed at improving diversity and organisational culture as “essentially HR policies” that were part of the day jobs of executives, including Narev (Gluyas, 2016).

Interviewee A noted several examples of executives receiving bonuses for taking actions within the normal purview of their job:

The classic one I always use as an example is the CFO of Billabong before it hit the wall, [he] got a bonus one year for undertaking a cost-basis analysis of the business, and as a number of people said,

that's the CFO's job. All banking executives for not going outside the board's approved risk parameters - again, I would say, if you go outside the board's approved risk parameters, you are fired. Staying within them does not get you a bonus. Succession planning... talent management... delivering a new strategy. I don't mean executing a new strategy, I mean just here is my new strategy. No there's a whole range of things. Turning up to work is effectively what [we] look for (Interviewee A, personal communication, 19 November 2018).

The extreme example of Mortgage Choice highlights how soft target bonuses can attract voting dissent, with the corporation attracting four strikes against their remuneration resolution within the time period of the articles analysed. One article noted:

Proxy firms ISS and Ownership Matters had recommended a vote against the board's package because chief executive short-term bonuses had paid out at 100 per cent for the past seven years due to dividends paying on unvested shares (Roddan, 2016).

Similarly, retention payments arose as an issue in the case of Downer EDI, which received a strike in 2015, and Boral, which received a strike in 2017.

Vas Kolesnikoff, head of Australian and New Zealand research at ISS, told Fairfax Media that the proxy group was concerned retention payments had no correlation with executives' performance, and that they did not necessarily stop executives from leaving a company if they got a better offer. "We question whether they work, and whether they actually achieve any shareholder benefit," Mr Kolesnikoff said, adding that disclosure of the payment in Downer's annual report had been "poor" (Wiggins, 2015).

By referencing the damage to shareholder interests that these executive pay practices are argued to inflict and portraying these bonuses as rewards for "turning up to work" (Interviewee A, personal communication, 19 November 2018), proxy advisers and institutional shareholders seek to delegitimise these practices. The strikes that the corporations listed in this section have received suggest that their

shareholders share a similar perception of their inadequate pragmatic legitimacy. In the case of Downer EDI, the ambiguity of whether retention payments provide value for shareholders demonstrates that exchange legitimacy may suffer where shareholders are unable to clearly identify if their interests are benefitted (Suchman, 1995). Mortgage Choice's track record of 100% payment of bonuses likely reflects inadequate influence legitimacy as stakeholders perceive the corporation as not being responsive to their values and expectations.

5.4.1.2. *Soft targets*

The overuse of non-monetary targets in awarding incentives was noted in several cases as the reason for parties recommending a vote against the remuneration report.

The ASA says Harvey Norman's STIs are all paid in cash, as opposed to a mix of cash and shares, and financial criteria account for only 20 per cent of the total award, with 80 per cent subject to non-financial criteria. Further, the use of subjective non-financial hurdles for LTIs do not appear to align the shareholder and management interests (Mitchell, 2015).

Specifically, as the quote highlights, subjective non-financial metrics were considered problematic for shareholders and related parties. In the case of Harvey Norman, the ASA's objection was despite the lack of notable poor performance according to Gerry Harvey. It is noted that "subjective" metrics are not defined in the article, though in this context the definition is taken to be metrics which substantially rely on subjective judgement to construct.

This view is supported by Interviewee A, who stated that not all non-financial metrics would be an issue in the process of making voting recommendations:

You will also get a whole range of things that are financial or semi-financial. Efficiency goals, sometimes those are reasonably easy to assess, so that is close that office, fire those people (pointing)... Other times they will be more like productivity savings, which, you know, who knows how you assess that. And when you ask directors so how

do you assess productivity savings and they often laugh... so there's a lot of discussion a couple of years ago in the context of CBA about soft non-financial targets. I guess my observation would be, given how often I have seen financial targets achieved or partially achieved no matter how terrible they are, is that soft is entirely in the eye of the beholder. The target that you are most likely not to meet is company safety. From my observation that's the one that tends not to be met (Interviewee A, personal communication, 19 November 2018).

Similarly, Interviewee A also identified subjective financial targets as a source of discontent with the pay structure of a corporation.

...a lot of companies, almost all companies, will use some adjusted earnings or cash flow number, and surprising how often managers are assessed on earnings minus the bad stuff... EBIT or EBITDA is be a pretty standard measure that they will use. Some companies will also use cash flow or working capital as a measure of a particular contractor's fee. Occasionally, not that often, but occasionally companies will use returns type measure or return on funds employed type measure (Interviewee A, personal communication, 19 November 2018).

The common thread amongst arguments against subjective target and/or soft target incentives was the failure to align managerial interests with shareholder interests, as per optimal contracting theory. By contrast, in some cases directors argued that these types of targets would benefit shareholders. In such situations voting dissent was often attributed to a failure to communicate this to shareholders.

[Outgoing] CBA chairman David Turner pledged to be more consultative with investors but maintained the bank needs to use non-financial performance measures to improve its culture. The board is confident such measures can deliver value to shareholders over the long term, he added (Eyers & Sprague, 2016).

The view presented by proxy advisers and institutional shareholders in these articles, at least, suggests that the use of these targets substantially damages the

pragmatic legitimacy of a corporation's pay structure. Although it is possible that CBA's non-financial metrics may have actually provided value to shareholders, the perception resulting from the use of these metrics appeared to undermine the exchange and influence legitimacy of CBA's remuneration structure. Close stakeholders were not able to identify how these metrics benefitted shareholders' interests, and CBA's assertions that would benefit shareholders' interests paradoxically could signal that CBA was not subordinate to shareholder interests.

5.4.1.3. Plurality in acceptable pay metrics

Some board directors noted that different shareholders and proxy advisers had differing opinions on what constituted acceptable targets and pay metrics to base incentives on.

Woodside Petroleum chairman Michael Chaney... said it was "impossible" to devise a system of remuneration and bonuses that would please all shareholders while also attracting and retaining executive talent. "I go into some (investor meetings), some will say they insist on using relative total shareholder return (RTSR) ... then I go into another meeting and they say 'we hate RTSR and we're going to vote against you if you use it'. It's the same with a whole lot of different elements," Mr Chaney said (Garvey, 2016).

The difficulty in obtaining a consensus on best practice remuneration setting may possibly contribute to the perception that a corporation is relying on subjective targets, if some shareholders prefer or tolerate the use of such targets. Often news articles reporting on a corporation receiving a strike against their remuneration report disclosed that proxy advisers and the ASA did not agree on their recommendations on voting for or against the report.

By contrast, institutional investor Blackrock's spokesperson was quoted as stating that the approach of attempting to please all stakeholders was a flawed approach:

...Pru Bennett, Blackrock's Asia-Pacific Hong Kong-based head of corporate governance and responsible investment. She tells The

Australian Financial Review that at a board level, some remuneration committee chairs "try to please all without coming up with what's right for the company and then communicating it to shareholders".

"While these structures do not result in egregious outcomes of pay, they do not necessarily result in rewards when reward is deserved and they may result in reward when reward is not deserved," she says (Uribe, 2017).

Again, the argument reported returns to the core tenet of optimal contracting theory, aligning managerial interests with shareholder interests.

5.4.2. Poor Communication with Stakeholders

Another theme which emerges from the reasons provided in the news articles for voting dissent is insufficient communication with shareholders and proxy advisers. Almost unanimously this reason is provided by executives as their belief as to why their remuneration report has received a strike.

[Spark Infrastructure chairman] Dr McTaggart... acknowledged that the voting results made it clear the board hadn't done a good enough job in engaging investors on their concerns, which range from remuneration, to the terms of the TransGrid deal (Macdonald-Smith, 2016).

This failure in communication arises in two key areas – the remuneration report itself, and in meetings with institutional shareholders and proxy advisers. The former is often related with the issue of subjective or soft targets, as articles often note that shareholders are unable to determine how these targets provide them value from the remuneration report. The latter is often presented as a solution to failure to communicate in the former, such as in CBA's case above. Interviewee A noted that:

I suppose the thing that's probably hardest to see is a lot of the time, a lot of the time, I'd say probably a quarter to a third of the time we're

looking and saying "I don't know, I don't know". We talk to a lot of companies... all in the lead up to their annual meetings. ...so when you go to the board and you say 'this looks really weird, can you tell me what the thinking was', and a lot of the time, from talking to the board you get the impression that there was a sound commercial reason for why they did something. You may disagree with it, but there's a sound commercial reason and that's often enough to tip you over because you go 'well, then I think [it's a] commercial judgement and I may disagree with it but I'm not privy necessarily...' and then you go I can understand why they're doing it (Interviewee A, personal communication, 19 November 2018).

Given that the need for communication appears to arise with elements of remuneration which proxy advisers and institutional shareholders are unfamiliar with, communication is best viewed as a managerial tool for building pragmatic legitimacy. The forms of communication which are successful at building pragmatic legitimacy are likely those which establish that the remuneration elements will generate shareholder value, and are based on past performance or analogous remuneration elements in other corporations in that respect (Suchman, 1995). In the absence of past performance or analogies, the spokesperson must garner procedural legitimacy by establishing that the novel remuneration elements will result in value for shareholders, which may be difficult (see for example the non-financial targets used by CBA in section 5.4.1.2).

5.4.3. Discontent with the Corporation's Board

Poor corporate performance, and in turn discontent with the board, are noted as issues for several corporations that received or may receive a strike in news articles. However, the majority of these articles do not list poor performance as the sole reason for voting dissent. Notably, it may take several years of poor performance before shareholders register voting dissent on the remuneration report resolution:

[Wilson Asset Management] and [Alder & Partners] are attempting to shake up the board of Templeton Global Growth and improve the fund's performance. The key investors complain the vehicle, which has been trading since 1987, has underperformed its benchmark for 10 years and is trading at a big discount to the value of the underlying assets... The representative said the fund was frustrated by the aggrieved shareholders' intention to use the remuneration report as a means to express their anger (Patten, 2016).

In a comparatively small number of these articles discontent with the board is stated as the primary reason for voting dissent. One instance was reporting on Seven Group's voting dissent on Prime Media Group's resolutions due to criticism of the corporation's strategy (or lack thereof):

The Australian revealed online yesterday that Seven used its 11.4 per cent shareholding in Prime to vote against the smaller media company's remuneration report and against the granting of performance rights to Prime chief executive Ian Audsley... it is understood Seven's vote against key resolutions was largely due to its questioning of Prime's strategy beyond calling for media reform.

The vote also follows Seven Group chief executive Ryan Stokes's launch of an extraordinary attack on Prime's management in August.

"It's a little distressing that Prime's only strategy ... is about removing the reach rule," Mr Stokes told The Australian at the time (Davidson, 2016).

Discontent with the board does not necessarily follow poor performance. Ansell faced voting dissent which may have been partly influenced by worker union discontent, as noted above. Several news articles reported the lack of independent directors on the board as an issue for companies that received a strike against their remuneration report. This alone does not appear to motivate the receipt of a voting strike, as the lack of independent directors is generally referred to along with poor corporate performance or issues with the remuneration structure. The

recommendation of ISS to approve Brickworks' remuneration report resolution in 2014 despite considering the board as not independent is an example of this (refer to 5.4.1.1).

Corporate representatives are highly critical of the use of the remuneration report resolution to signal criticism of non-remuneration aspects of the corporation. A possible explanation for the use of the remuneration report resolution to register such criticism may come from the comparatively low impact of the consequences of a voting strike. The other form of resolution required to be voted upon at an annual meeting are to approve the election of a director to the board, and a majority vote against would result in an understaffed board until an extraordinary meeting is called to appoint (or reappoint) a director. Alternatively, the lower threshold for a consequence (25% in comparison to the 50% required to prevent the election of a director) means it is more likely that a board will take note of voting dissent on the remuneration report resolution, thus shareholders may focus the signalling of their discontent through this resolution.

Regardless, the use of the remuneration report resolution in this fashion may suggest that in some cases the vote reflects the pragmatic and/or moral legitimacy of the corporation and not merely of its executive pay structure.

5.4.3.1. Use of two-strikes to spill board

Only one corporation was reported in the sample data to have received a successful vote to spill the board following a second strike. Logistics corporation Chalmers received a vote of 79.9% for the board spill resolution. The Australian's reporters Will Glasgow and Christine Lacy attribute this outcome primarily to the desires of substantial shareholder Lindsay Fox:

[Glasgow & Lacy] hears that Fox sat himself in the front row of Chalmers' sparsely attended AGM, a perfect spot to eyeball Murrowood and his board and hector the company over their performance.

The billionaire — who some have speculated could be interested in Chalmers' land portfolio — also made it known that he voted his 19.9

per cent stake against the company's remuneration report (Glasgow & Lacy, 2017).

This outcome appears to be prompted by the poor performance of the corporation and/or the desire by Lindsay Fox to obtain the assets of the corporation. Hence, it could be considered an extreme signalling event to the board of shareholder outrage or as an attempt to use the two strikes rule to force a hostile takeover. In either case, Fox clearly did not perceive Chalmers as having any significant pragmatic legitimacy.

Other situations where the news article reported that the primary reason for voting dissent on the remuneration report was to force a spill vote resolution all involved private equity groups or individuals with substantial shareholders attempting to affect a board change. Engineering group Cardno received a strike after private equity shareholder Crescent Capital (19.6% shareholding) voted against the remuneration report resolution and director re-election resolutions, which followed a takeover offer from Crescent (Bleby, 2015; Garvey, 2015).

5.5. Corporate Actions Taken to Repair Pragmatic Legitimacy

5.5.1. Good Communication with Shareholders

Good communication with shareholders and related parties was identified several times as the reason why a remuneration resolution did not attract high voting dissent or negative proxy adviser recommendations despite issues with the pay structure.

While there are concerns about some aspects of its remuneration structure, particularly the introduction of cash return on equity into long-term incentives, they are not as deep-seated or as longstanding as CBA's so-called "soft" targets...

There's been some active discussion between the chairman of Westpac's board remuneration committee Ewen Crouch and proxy advisory firms in recent weeks.

While concern has been conveyed to Crouch, it seems unlikely there will be blanket opposition to the remuneration report. Or a first strike, for that matter.

Westpac is regarded as more responsive and transparent than CBA, which ran the gauntlet of shareholder opposition and earned a 49 per cent "no" vote on its remuneration report for its trouble (Gluyas, 2016).

Similarly:

Pay for senior executives and directors of AGL, including Mr Vesey, "remains well above peers", noted ISS, which is also critical of the company's use of underlying profit to determine executive performance. But ISS, which last year recommended against the remuneration report, said AGL has made enough improvements to its pay structure to warrant supporting it this time (Macdonald-Smith, 2017).

Improved communication following a first strike appears to allay the concerns of proxy advisers and institutional investors and they appear to be more lenient in their recommendations and voting respectively, notably where the board has taken action to address the concerns raised.

ISS, another major governance and proxy adviser, also believes the board is "not majority independent". But ISS has recommended shareholders approve Brickworks' remuneration report... "On balance, the company is taking steps to better align its remuneration policies with local market standards. Therefore, a vote in favour of this resolution is warranted," ISS said (Binsted, 2014).

In a significant proportion of reporting on corporations receiving voting strikes executives are quoted stating the need to communicate with institutional shareholders and proxy advisers in order to address the issues in their remuneration report that attracted voting dissent. Thus, institutional shareholders and proxy advisers are invoked as the "monitors and watchdogs" Suchman (1995,

p. 598) proposed as a means to repair pragmatic legitimacy. By appearing to conform with the expectations of these two classes of stakeholders, shareholders at large are likely to view the corporation as chastened and receptive to their values, restoring the pragmatic legitimacy of the corporation and its remuneration structure.

Conversely, it may also point to communication with shareholders as a means of camouflage of executives' rent-seeking behaviour. The improvement in communication with shareholders raises the threshold for shareholder outrage to result in a voting strike, potentially allowing for a "big bath" situation where executives may put forward a remuneration plan that provokes substantial shareholder outrage, in order to put forward a remuneration plan in the following year that provokes less outrage but is still considered a less than optimal contract for the shareholders.

5.5.2. Denial of Problem

In contrast to boards that communicated with shareholders to repair their legitimacy, a relatively small number of executives denied that there was an issue with their pay structure following a high dissenting vote on the remuneration resolution. The executive chairman of Harvey Norman, Gerry Harvey, justified a remuneration report facing a second-strike vote, and which the ASA had recommended a vote against, by arguing that strong performance obviated shareholder concerns with the remuneration structure.

"If (earnings) were down 25 per cent I'd agree with you - let's get rid of the whole board, we're never going to turn it around," [Harvey] said. "At the moment Harvey Norman is one of the best performing retailers out there in the market place public or private," he said, pointing to a 27.8 per cent lift in pre-tax earnings in the September quarter and 26.6 per cent net profit growth in 2015.

"Instead of people out there being critical they should take their hats off and say 'you guys are doing a great job'" (Mitchell, 2015).

Following its third strike Mortgage Choice CEO John Flavell rejected criticisms of its remuneration structure:

Mr Flavell said the board had a “fundamentally different view” [to institutional shareholder Fidelity International] of the remuneration structure and believed it properly aligned shareholder interests with incentives.

“At the end of the day you can’t satisfy (all the proxy voters), so I focus my energies and my efforts on delivering positive outcomes in terms of earnings growth for the business and to position the business for long-term growth and profitability,” he said (Roddan, 2016).

Similarly, Macmahon Holdings did not make substantial changes to its remuneration structure following a strike and were penalised with a second strike in 2016.

Macmahon said in its notice of meeting that after consulting with shareholders and others, the board had decided pay packages were “necessary and appropriate” for the company’s current circumstances.

“As a result, Macmahon has not made any significant changes to the remuneration arrangements that were in place at the last AGM,” the notice said (Williams, 2016).

These examples are not merely denials of an issue as Suchman (1995) envisioned in relation to repairing pragmatic legitimacy, which Suchman notes are liable to further impair the legitimacy of the corporation. Rather, in the former example, Gerry Harvey appears to also be using the third course of action stated by Lindblom (1994) by diverting attention to an area of the corporation in which it has greater pragmatic legitimacy from shareholders: the strong performance of the corporation (Deegan, 2006). Similarly, John Flavell attempts to place greater attention to the board’s work on earning growth and long-term performance following the denial. Flavell also appears to invoke the fourth course of action proposed by Lindblom, attempting to influence shareholder and proxy adviser

expectations of remuneration by asserting that their remuneration structure does align managerial interests with shareholder interests. Macmahon similarly attempts to influence shareholders by justifying their lack of changes to the remuneration structure with the consultations that they purport to have performed with shareholders and other stakeholders.

Whereas board members that accepted there was an issue with their remuneration structure invoked proxy advisers and the ASA as “watchdogs” to repair their legitimacy, board members that denied that there was an issue invoked proxy advisers as a scapegoat. A few corporate executives and board members were quoted as blaming proxy advisers and the ASA for strikes against the remuneration report resolution, as well as institutional shareholders that followed their recommendations without performing their own research.

...a common criticism — rejected by the advisory firms — that the voting recommendations are too “formulaic” and lacking in practical considerations. Others charge that the firms don’t engage properly with the companies before making their recommendations, are not transparent or they don’t have the necessary expertise to make the calls they do (Smith, 2016).

The representation of proxy advisers and the Australian Shareholder Association amongst the individuals quoted in the sample news articles is substantial in comparison to spokespeople from institutional shareholders. This may be due to the journalists’ ease of access to these individuals and their nature as a more centralised nexus for an explanation of a voting outcome in comparison with the less concentrated shareholders of a corporation. Arguably, regardless of the reason for their inclusion in news articles, their substantial representation is itself evidence for the significant influence of proxy advisers and related groups on the voting outcome of remuneration report resolutions.

5.6. Legitimising Remuneration Practices

The analysis above does not point to a uniform and concrete identifier of corporations that would attract a strike against their remuneration report resolution, however certain potential features of such corporations are highlighted.

The voting dissent attracted by soft target incentives, defined as targets which are achieved in the normal course of an executive executing their job, is a logical outcome under optimal contracting theory, though the focus on awarding bonuses for poor performance may also be explained by the media's desire to sensationalize stories to entertain readers (Hooghiemstra et al., 2015). Under the legitimacy construct soft target bonuses also impair the pragmatic legitimacy of a corporation's remuneration practices, as shareholders find their personal welfare impacted by what they perceive as rent-seeking behaviour on the part of managers. This may be extended to the proxy advisers that institutional shareholders retain to provide advice on voting matters – proxy advisers will recommend against them to continue to be valued by these institutional shareholders, thus building their own pragmatic legitimacy as an organisation.

Notably however, the findings suggest that impairment of pragmatic legitimacy is not limited only to soft targets that definitively do not align with shareholder interests, but also to targets and remuneration structures which shareholders and proxy advisers find ambiguous as to whether they align with shareholder interests, such as in the case of Downer EDI. These “novel” remuneration structures or elements appear to be actively harmful to the legitimacy of a corporation's remuneration practices and managers generally respond by communicating with institutional shareholders and proxy advisers to repair their legitimacy, followed by modifying or removing elements to conform with the expectations of the consulted. This finding suggests that where stakeholders are unable to determine if an organisational procedure or policy is in their interests, the construct that Suchman (1995) defines as procedural legitimacy (where an organisation obtains moral legitimacy by conforming with socially accepted procedures and policies) may also be an applicable form for pragmatic legitimacy to

manifest as close stakeholders influence the organisation to reduce ambiguity by removing such procedures or policies.

A related finding, given the concentration of the proxy adviser market in Australia, is that this may theoretically contribute to a normalisation of remuneration structures across corporations (that attract proxy adviser recommendations) as the remuneration committees of the corporations seek pragmatic legitimacy by avoiding novel remuneration elements and follow the best practices of proxy advisers. This may present a paradox for some corporations, as procedural legitimacy is derived from relying on pay structures deemed socially appropriate by stakeholders, yet certain institutional investors warn that following a standard model of remuneration may not generate shareholder value and thus impact pragmatic legitimacy (Uribe, 2017). Similarly, if the stakeholders of a corporation are inconsistent on what constitutes acceptable remuneration it will be difficult for a corporation to obtain pragmatic legitimacy uniformly across their stakeholders (Suchman, 1995).

Poor performance prior to the vote on the remuneration report resolution would seemingly impact the pragmatic legitimacy of a corporation. But alone it appears unlikely to influence voting dissent on the remuneration report resolution. Prolonged poor performance may lead to discontent with the board and thus an impairment of the pragmatic legitimacy of the corporation and its remuneration structure. However, the loss of legitimacy associated with discontent with the board based on poor performance or other non-remuneration related concerns that leads to a voting strike would suggest a dilution of the signalling power of a strike. If a strike is not confined to reflecting the legitimacy of a corporation's remuneration practices, but extends to its greater legitimacy, the effectiveness of the two-strikes regime in allowing shareholders to hold directors accountable for excessive executive remuneration practices may be blunted.

A primary finding of this analysis is the identification of post-strike communication with institutional shareholders and proxy advisers as the foremost tool to repair damaged remuneration legitimacy. This finding suggests that corporations that undertake such communication should attract a lower voting dissent rate in the following annual meeting. Firstly, this communication ideally

results in the board adjusting their remuneration structure to conform with the expectations of consulted stakeholders, who are likely the largest shareholders or proxy advisers with influence over large shareholders. This is the first course of action envisioned by Lindblom (1994), in which the organisation communicates actual changes to policies and procedures they have undertaken to stakeholders. Secondly, the data suggests that corporations that adjust their remuneration to partly meet the expectations of consulted stakeholders receive a more lenient assessment of their remuneration in the following annual meeting. This reflects that the act of communication with stakeholders itself may generate pragmatic legitimacy, with these stakeholders perceiving the corporation as subordinating to the values of shareholders and inviting proxy advisers in their role as watchdogs to oversee future remuneration setting. These findings lend support for a strengthening of shareholder engagement with boards regarding executive remuneration following the implementation of the two-strikes regime.

Conversely, the analysis finds that denial of an issue with a corporation's remuneration structure is unlikely to repair its pragmatic legitimacy following a strike. This appears to be the case even when paired with rhetoric intended to divert attention to areas of the corporation that enjoy higher legitimacy, such as the strong financial performance of the corporation, or to the asserted negative influence of proxy advisers over shareholders. Suchman identified the potential of denial to impair rather than repair pragmatic legitimacy where the denial was not perceived to be sincere (Suchman, 1995). There may be several explanations for why denials do not appear to repair remuneration legitimacy, stemming from why they are perceived not be sincere. The presentation of the remuneration report may make it difficult for corporations to state they are making changes to their remuneration without actually making changes, which is the second course of action to repair legitimacy that Lindblom (Lindblom, 1994) proposed. When coupled with the failure to make substantial changes, as the first course of action Lindblom put forth suggests, pragmatic legitimacy remains damaged. This finding may also indicate that Lindblom's third course of action to repair legitimacy, diverting attention to an area of the organisation with greater legitimacy, is ineffective where close stakeholders (i.e. shareholders) are able to make their voice heard on the area of the organisation with damaged legitimacy (the vote on the remuneration report). Diverting attention

to the influence of proxy advisers may also be ineffective, as the pragmatic legitimacy afforded to proxy advisers from retaining shareholders is logically greater than the pragmatic legitimacy afforded to board members, as proxy advisers justify their existence on the value they provide to a retaining shareholder who is free to fire them and shareholders are free to ignore their advice, whereas board members are beholden to a plurality of shareholders and shareholders must work with the board as elected.

In summary, the characteristics of corporations likely to receive a strike, on the basis of a lack of legitimacy for their remuneration practices, appear primarily to be a remuneration structure that awards remuneration for poor or status quo performance or the use of novel remuneration elements rarely examined by stakeholders. This is moderated by the level of communication with key stakeholders explaining how incentive hurdles or novel remuneration elements provide value to shareholders. Sustained poor corporate performance or an aggressive shareholder angling to oust the board are secondary features that may indicate a strike. Where a corporation does receive a strike, they are likely to reduce their chance of receiving a subsequent strike through communication with institutional shareholders and proxy advisers and implementing changes based on that communication.

5.7. Conclusion

In this chapter the corporate actions which impair or repair the legitimacy of a corporation's remuneration practices, as reported in news media articles and in an interview with a proxy adviser employee, were identified and discussed. These actions were examined in the context of the legitimacy framework described in Suchman (1995), focusing on the actions taken by corporations to impair or repair their pragmatic legitimacy – gained by performing actions that benefit their shareholders and other proximate stakeholders. According to Suchman, corporations may seek to deny a problem exists or appoint a watchdog when seeking to repair pragmatic legitimacy.

Three categories of corporate actions were identified in the analysis that impaired the legitimacy of the corporation's remuneration practices. Remuneration that exhibited or appeared to exhibit poor pay-performance sensitivity, i.e. a less than optimal contract, was found to impair legitimacy. Specifically, the awarding of bonuses during periods of poor corporate performance and the use of non-financial or novel hurdles to award remuneration were prominent actions noted to impair legitimacy. Failure to communicate with shareholders was the second category of actions identified as impairing legitimacy. These actions were problematic in cases where shareholders required clarification as to how specific remuneration practices incentivised executives to act in shareholders' interests, such as in the use of soft targets as hurdles for remuneration. Finally, discontent with the board due to poor corporate performance or for actions not related with executive remuneration comprised the third category of actions which impaired legitimacy. This category is potentially the most problematic for corporations, potentially requiring boards to repair both its pragmatic and moral legitimacy.

The primary finding of this analysis are that corporations may moderate executive remuneration concerns from shareholders through increased communication with shareholders. This communication should either explain the remuneration practices chosen or adopt the recommendations of watchdog parties such as proxy advisers, in order to repair the legitimacy of the remuneration practices. These concerns typically arise from poor pay-performance sensitivities or the use of novel hurdles to award remuneration. The former suggests that optimal contracting theory has application to the voting behaviour of shareholders, though its explanatory power is moderated by legitimacy theory. The latter provides support for isomorphism in remuneration practices as a source of legitimacy, as posited in Chapter 2 (see for example Bruce et al., 2005; Main et al., 2007). This finding supports the assertion that the two-strikes regime has met its policy goal of strengthening shareholder engagement with boards on their executive remuneration practices.

In the following chapter the findings of Chapter 4 and Chapter 5 are synthesised and compared, leading to a discussion of the extent to which the two-strikes regime has met its policy goals in enabling shareholders to hold directors

accountable for excessive executive remuneration, strengthening shareholder engagement with boards on executive remuneration practices, and providing shareholders with a means to address unresponsive boards.

6. Discussion of Study Findings

6.1. Introduction

Chapter 4 presented the findings of an analysis of two-strikes say on pay voting results in large Australian corporations, with the aim of identifying the drivers of voting strikes. The identification of media attention as a significant determinant of a corporation receiving a voting strike prompted an analysis of Australian news media articles reporting on say on pay voting, the findings of which were presented in Chapter 5. This chapter synthesises the findings of these analyses and provides an overarching discussion addressing the question of whether, and to what extent, the Australian two-strikes say on pay regime has realised its policy goals.

This chapter first discusses the shareholder voting behaviour for corporations with excessive executive remuneration, defined as executive remuneration practices that do not strongly align with shareholder interests. One of the policy goals of the two-strikes regime was to empower shareholders to hold directors accountable for excessive executive remuneration practices. Given the finding presented in Chapter 4 that long-term and equity remuneration is not significantly associated with the likelihood of a voting strike, and prior literature finding that voting dissent on approving executive remuneration is not associated with the strength of the pay-performance link (Grosse et al., 2017), it is asserted that shareholders are unable to effectively assess whether executive remuneration is excessive based on remuneration disclosures. As a result, it is argued that shareholders voting behaviour is best explained using legitimacy theory. Whether shareholders vote against approving executive remuneration is arguably dependent on their perception that the corporation and its remuneration practices are sufficiently legitimate and thus aligned with the shareholders' interests, with media reporting being a significant source of legitimacy.

An assessment of whether the two-strikes say on pay regime has resulted in the other outcomes desired by its legislators follows. In Chapter 3 it was identified that the two-strikes regime was also envisioned by the Productivity Commission as

a means to increase shareholder engagement with boards in the setting and approval of executive remuneration, and as a last-resort option of dealing with boards resistant to meet shareholder expectations. The findings presented in the previous chapters demonstrate that in practice these policy goals have only been partially achieved, with the most notable criticism being the lack of board spill resolutions actually passed to address persistently unresponsive boards.

6.2. Shareholder Voting Behaviour in Relation to Excessive Executive Remuneration

In the quantitative analysis presented in Chapter 4, it was identified that corporations that awarded relatively high short-term remuneration (controlling for shareholder return) were significantly more likely to receive a voting strike, whereas other components of remuneration did not have a significant association with the likelihood of a voting strike. In Chapter 5, it was identified that the awarding of pay for poor corporate performance or for executive work in the normal course of their duties was one of the primary reasons identified in media reporting for a corporation receiving a voting strike against their remuneration report resolution. This finding would suggest that either issues with the awarding of pay for poor performance are restricted primarily to the short-term remuneration component, or the identification of pay awarded for poor performance in long-term or equity remuneration components is difficult or not being performed by stakeholders.

In relation to the former suggestion, instances in media reporting of stakeholders finding issues with long-term incentives were identified in Chapter 5. However, it is possible that only large institutional shareholders have the resources to assess the excessiveness of long-term and equity remuneration, whether through internal assessment or by retaining proxy advisers. Thus, a potential explanation for this dissonance is that a majority of shareholders, particularly retail shareholders, are unable or unwilling to perform the analysis of whether the long-term or equity remuneration of a corporation is not an excessive reward for executives. The argument that shareholders potentially have difficulties assessing the pay-performance sensitivity of remuneration is consistent with Grosse et al. (2017, p.

704; citing Deane, 2007). In addition, boards may be better able to camouflage long-term and equity remuneration shareholders would perceive as excessive, when compared to short-term remuneration. If these arguments hold true, shareholders may be instead relying on more easily accessible information as to whether a corporation has excessive remuneration practices – namely media reporting. This would explain the finding that media attention is significantly associated with the likelihood of a voting strike reported in Chapter 4. Under this assumption, media reporting would be a source of delegitimisation of a corporation's remuneration practices. Shareholders may supplement or replace their assessment of the optimality of a corporation's remuneration structure with media assessments of a corporation's remuneration when judging whether to vote against the remuneration report resolution. The significant association between shareholder return and the likelihood of a voting strike may be similarly explained. A corporation may accrue pragmatic legitimacy for its executive remuneration simply by providing benefits to shareholders in the form of positive shareholder returns, a form of exchange legitimacy (Suchman, 1995).

The finding that larger corporations are less likely to attract a voting strike has several potential explanations. Larger corporations may have greater resources for communicating with shareholders in comparison to smaller corporations. As concluded in Chapter 5, shareholders are more willing to be forgiving of corporations with problematic remuneration if they communicate with stakeholders, particularly institutional shareholders and proxy advisers. As such, these corporations maintain legitimacy by being able to respond to their diverse group of stakeholders, who may have differing standards for appropriate remuneration (Deephouse et al., 2017). Larger corporations may also derive exchange legitimacy by their virtue of their market capitalisation – shareholders may not desire the impact on their shareholdings if the corporation fell into disarray and thus may choose to approve the remuneration report to avoid the possibility of a board spill (Suchman, 1995).

Overall, the findings presented in Chapter 4 provide weak support for excessive executive remuneration as the primary determinant for shareholder voting behaviour, with shareholders mainly concerned with short-term

remuneration. Whether due to shareholder difficulty in assessing the excessiveness of long-term and equity remuneration, the ability of boards to camouflage excessive remuneration, or a combination of both, a better explanation for the observed shareholder voting behaviour in this research would be to treat the optimality of the executive remuneration as a source of practical legitimacy for that remuneration, alongside corporate communication with shareholders and news media coverage. What shareholders consider as problematic executive remuneration does not appear to turn solely upon the excessiveness of that remuneration, raising the question of why shareholders are willing to make a voting decision which impairs shareholder value under optimal contracting theory. The following section conjectures that shareholders are willing to accept less-than-optimal executive remuneration in part due to failings in remuneration disclosure and the continued widespread belief that boards are best equipped to plan their executive remuneration.

6.3. Increased Shareholder Engagement with Boards

In Chapter 3, one of the policy goals identified in the Productivity Commission's report to the Australian Government and in its public consultations was a desire to increase shareholder engagement with boards on the setting and approval of executive remuneration. The Productivity Commission noted the need to balance the shareholders' ability to force changes to excessive executive remuneration with the commonly accepted notion that boards are best placed to determine the best remuneration structure that maximises shareholder value (Productivity Commission, 2009g). For this policy goal to be achieved as the Productivity Commission envisioned, the regime should have "[improved] responsiveness across the breadth of public companies" in responding to "shareholder concerns with the remuneration report", noting the example of corporations with large voting dissent in consecutive years (Productivity Commission, 2009g, p. 285).

Interviewee A asserted that the new two-strikes regime "forced boards and shareholders to communicate with each other more", a process which was slowly occurring under the prior advisory voting regime but was accelerated by the new

regime (Interviewee A, personal communication, 19 November 2018). This is seemingly borne out by the use of communication to repair damaged legitimacy in respect of remuneration practices identified in Chapter 5. The finding that shareholders are more forgiving to firms that communicate is itself evidence that shareholder engagement with executive remuneration setting has been achieved at some level. However, the small number of corporations identified which refused to change their remuneration practices following a voting strike illustrates a shortcoming of the two-strikes regime. Where corporations such as Harvey Norman are able to ignore the threat of the board spill resolution passing, for example due to concentrated ownership aligned with the board or shareholder desire to avoid destabilising the company, the boards are able to avoid responding to shareholder concerns about remuneration entirely. The example of Mortgage Choice not changing their remuneration strategy following a third strike against the remuneration report is a clear indicator that the two-strikes regime has not completely met the intentions of the Productivity Commission.

Conversely, the increase in shareholder engagement has led to potentially unforeseen consequences from the perspective of the Productivity Commission. The finding of the quantitative analysis illustrating that news media coverage is a significant factor in the likelihood of a voting strike suggests that, at the least, shareholders are taking into account external assessments of the suitability of executive remuneration in making their voting decisions if not relying on them solely. Similarly, the substantial influence of proxy advisers noted in the analysis of media articles in Chapter 5 seemingly reflects this greater dependence on external assessments by shareholders. These findings suggest that shareholders do not, and potentially cannot, solely rely on the remuneration report to identify whether the remuneration structure of a company benefits shareholders. For instance, Interviewee A noted that in making proxy adviser recommendations they would on occasion need to communicate with board members when faced with an unusual remuneration structure in order to determine whether there was a “sound commercial reason” for the remuneration (Interviewee A, personal communication, 19 November 2018).

This raises the question of whether the existing remuneration report is fit for use by shareholders to assess whether the remuneration of executives is appropriate and desirable for shareholders. In particular, the lack of association between long-term and equity remuneration and the likelihood of a voting strike may potentially indicate that most shareholders are unable to assess whether these remuneration components are appropriate for the level of performance of the corporation (Grosse et al., 2017, p. 704; citing Deane, 2007). The “length and complexity of [remuneration] reports” was a concern raised during the Productivity Commission Inquiry (Productivity Commission, 2009g, p. 247), and although changes to remuneration disclosure were implemented as a result of the Inquiry’s report these findings suggest that further improvements to disclosure may be necessary. Hence, the two-strikes regime arguably does not empower shareholders to hold directors accountable for excessive remuneration practices to a significant degree, as shareholders appear to have issues identifying such excessive remuneration practices in the first place.

6.4. Spill Motion as a Last Resort Measure of Holding Board Accountable

As identified in Chapter 3, the spill motion was envisioned as a last resort method of forcing “continuously unresponsive” boards to address shareholder concerns in respect of executive remuneration (Productivity Commission, 2009g, p. 296), with Commissioner Robert Fitzgerald stating that “99.99 per cent of the time [the board spill consequence] would never be used” (Productivity Commission, 2009e, p. 111). The Commissioner correctly envisioned the rarity of its use, with the only known successful board spill between the implementation of the two-strikes regime in 2011 to 2018 being the spill of Chalmers’ Logistics’ board (Glasgow & Lacy, 2017).

However, given corporations such as Mortgage Choice which have had multiple consecutive voting strikes against their remuneration report there is an expectation that the board spill consequence should be exercised more frequently. The reluctance on the part of shareholders to exercise the spill motion consequence

for corporations continually unwilling to address shareholder concerns regarding executive remuneration brings into question whether the two-strikes regime is meeting its policy goals, especially as a last resort option. Not only are shareholders not using this mechanism to hold boards accountable, but the continued failure to exercise this spill option arguably undermines the signalling power of voting dissent. Board directors may be less inclined to address shareholder concerns over their remuneration practices if they believe there is no actual risk that a board spill will ever occur.

The reluctance of shareholders to spill the board is potentially explained by a concern raised by a number of submissions to the Productivity Commission Inquiry, that a board spill would have a destabilising effect on the corporation and impair shareholder value (Productivity Commission, 2009f, p. 13, 2009g, p. 298). Assuming a rational shareholder, the potential impairment to shareholder value from a board spill would need to outweigh the current impact on shareholder value due to a less-than-optimal executive remuneration strategy for the shareholder to approve a board spill. Given the rarity of board spills, shareholders may not have the ability to estimate the cost of approving the board spill and thus vote in favour of keeping the board even when the board is resistant to addressing shareholder concerns. Despite Commissioners of the Productivity Commission Inquiry stating that passing a board spill motion would not necessarily lead to every director being ousted, thus limiting the resulting destabilisation (Productivity Commission, 2009f, p. 13), shareholders appear to not have the confidence that passing the board spill will lead to better outcomes.

Conversely, given the fear that shareholders appear to have of implementing a board spill, it is possible that board directors also view the threat of a board spill as a catastrophic existential threat to both their job security and the going concern of the corporation. That is, even though it has yet to be exercised to deal with recalcitrant boards and may never be, the mere possibility of its exercise motivates most boards to engage with their shareholders in relation to problematic remuneration practices. The instances of boards increasing communication with shareholders following a voting strike (refer to 5.5.1) may support this assertion, or be motivated by a desire to repair legitimacy following the damage of receiving a

voting strike. However, the existence of boards not cowed by the threat of a board spill may suggest a strengthening of this last resort option for shareholders is required.

As an aside, the fear raised by some submission providers to the Productivity Commission inquiry that activist minority shareholders would be able to use the two-strikes regime to effect a board change or takeover has not borne out widely. The case of Lindsay Fox's spill of Chalmers Logistics' board is arguably the exception that proves the rule, being the only recorded instance of a board spill resolution successfully passed in the time period covered in the analysis in Chapter 6. Interviewee A echoed this sentiment:

[The] thing that gets talked about in company director land and in the leeches that feed off companies, um, this idea about it being used as a stalking horse by activists. It's ridiculous. It is utterly ridiculous, because an activist who is going to use the two strikes rule as a way to get there is a really patient activist. Really patient. If you have 5% of a company before two strikes and after two strikes you can requisition a meeting tomorrow (Interviewee A, personal communication, 19 November 2018).

Ultimately, the rarity of board spills as a consequence for unresponsive boards is evidence for, and a contributor towards, the ineffectiveness of the board spill component of the two-strikes say on pay regime as an improvement over the prior advisory say on pay regime in Australia. Shareholders appear unwilling to use the spill as they are unable to assess the cost to shareholder value, and the rarity of board spills deprives shareholders of the information needed to assess whether the cost is acceptable to hold a board to account.

6.5. Conclusion

The implementation of the two-strikes say on pay regime in 2011 allowed the Australian Government to appear responsive to public calls to restrain perceived widespread excessive executive remuneration. The regime as recommended by the Productivity Commission remained consistent with the principle that boards were

best suited to decide their own remuneration, held almost universally amongst respondents to the Productivity Commission Inquiry.

However, whether the two-strikes regime has realised its policy goals to any significant degree is questioned in this chapter, especially in comparison with the prior advisory say on pay regime. This research has identified anecdotal evidence of increase in communication between shareholders and boards prior to and after shareholder voting on the remuneration report following implementation of the two-strikes regime, however this was a process already underway under the advisory say on pay legislation. The failure of shareholders to use the board spill consequence to prompt consistently unresponsive boards to respond to shareholder concerns about excessive executive remuneration is both a symptom and potentially self-perpetuating cause of the ineffectiveness of the two-strikes regime compared to its prior advisory vote.

Finally, shareholders appear to be assessing executive remuneration from a legitimacy perspective in approving potentially excessive executive remuneration, relying in part on external assessments of the appropriateness of executive remuneration and direct communication with boards as sources for the legitimacy of that remuneration. If, as according to optimal contracting theory, executive remuneration that poorly links executive pay to corporate performance negatively impacts shareholder value, the reliance on external assessments potentially reflects the lack of understandability of remuneration disclosures and the ingrained nature of the philosophy that boards are best equipped to set executive remuneration. As a result of shareholders' willingness to accept seemingly excessive executive remuneration, or their inability to widely identify such remuneration without external assessments, it is arguable that the two-strikes say on pay regime has been ineffective in empowering shareholders to hold directors accountable for such excessive executive remuneration practices, at least in respect of long-term and equity remuneration components. While shareholders may be empowered in terms of the punishment they may inflict on corporations with excessive remuneration practices under the two-strikes regime, they appear to be limited by their ability to identify such practices.

7. Conclusion

This research studies the extent to which the Australian two-strikes say on pay regime has realised its policy goals: empowering shareholders to hold directors accountable for excessive executive remuneration practices, strengthening shareholder engagement with boards on the topic of executive remuneration, and to act as a last resort measure for unresponsive boards through the board spill consequence. In this chapter a summary of the findings of this research is presented. This is followed by the contributions and limitations of the research. Finally, suggestions for future research directions are outlined.

7.1. Summary of Research Findings

7.1.1. Historical Development of Two Strikes Legislation

In Chapter 3 submissions to the Productivity Commission Inquiry into Executive Remuneration were analysed through a regulatory space construct. This construct allowed the identification of parties proximate with institutional shareholders, including proxy advisers and superannuation firms, which were instrumental in establishing the legislative regime. This was due in part to the Australian Parliament, acting according to the “logic of appropriateness” (Young, 1994, p. 87) and favouring changes to restrain executive remuneration in an appeal to their constituents. By contrast, corporations and associations acting on behalf of executives and corporate secretaries wielded comparatively less influence over the Productivity Commission in the regulatory arena and were therefore ineffective in preventing the recommendations that they saw as less than desirable put forward by the Productivity Commission. However, as most parties engaged in the process were wedded to keeping the prerogative of boards to set executive remuneration, the result was an acceptance of recommendations that did not completely undermine this concept. Thus, the two-strikes regime recommended by the Australian Shareholders’ Association and modified based on input from parties proximate to institutional shareholders was put forward as the recommendation from the Productivity Commission to Parliament.

The policy goals of the regime as identified by the Productivity Commission in their report and in consultations were threefold. First, the two-strikes regime sought to empower shareholders to hold directors accountable for excessive executive remuneration practices. Second, to increase shareholder engagement with boards in the setting and approval of executive remuneration. Third, the board spill consequence was envisioned as a means to force persistently unresponsive boards into addressing shareholder concerns. The empirical results presented in this thesis presents evidence that these policy goals were only partly achieved.

7.1.2. Quantitative Analysis of Voting Strikes

In Chapter 4 a quantitative analysis was performed to identify potential determinants of an Australian corporation receiving a voting strike against their remuneration report resolution. It sought to answer the question of: What factors result in a large Australian corporation receiving a strike on their remuneration report resolution? It was hypothesised that higher levels of executive remuneration for a given level of corporate financial performance would be associated with a higher likelihood of receiving a voting strike. Higher levels of institutional ownership and media attention to the corporation's executive remuneration were also hypothesised to be positively associated with the likelihood of a voting strike. Institutional shareholders were posited to have the resources to better identify less-than-optimal remuneration, and media reporting was asserted to convey the opinions of shareholders and proxy advisers that had identified less-than-optimal remuneration to other shareholders.

The main findings of the analysis in Chapter 4 were that the quantum of short-term remuneration and the level of media attention were significantly and positively related to the likelihood of a corporation receiving a strike, controlling for firm performance and size, whereas the proportion of ownership by institutional investors was not significantly related to the likelihood of receiving a strike. The former suggested that a substantial proportion of shareholders focused on the short-term remuneration of executives when making their decision in how to vote, in contrast to the expectation under optimal contracting theory that all remuneration components should be significantly associated with voting dissent

(Carter & Zamora, 2007; Conyon & Sadler, 2010; Ertimur et al., 2011; Grosse et al., 2017; Monem & Ng, 2013). The focus on the short-term remuneration component may potentially be attributed to the difficulty of assessing the appropriateness of long-term and equity-based remuneration in linking executive interests with that of shareholders (Grosse et al., 2017, p. 704; citing Deane, 2007), or due to a focus on short-term returns on behalf of a number of shareholders. These findings are consistent with the various studies of executive remuneration which show that executive remuneration is not strongly linked with firm performance (Conyon & Sadler, 2010; Gregory-Smith et al., 2014). However, the finding that short-term remuneration is significantly associated with voting dissent has not been observed in prior studies and offers a new perspective on shareholder voting behaviour. This is likely due to prior studies focusing on individual components of remuneration, such as base pay, cash bonuses and equity in Grosse et al. (2017) or on total CEO remuneration (Borthwick et al., 2020; Conyon & Sadler, 2010; Kent et al., 2018), whereas it is argued that shareholders may substantially assess the appropriateness of remuneration based on the time frame in which incentives are awarded to executives, rather than the form in which they are awarded.

By contrast, the lack of relationship between the proportion of institutional ownership and the likelihood of a voting strike potentially indicated that retail shareholders were not as passive as perceived in the Productivity Commission Inquiry, or that media attention prior to the annual general meeting would highlight problematic remuneration identified by institutional shareholders and/or proxy advisers, which would then be disseminated to retail shareholders (Hooghiemstra et al., 2015). Alternatively, the 25% threshold may simply set an upper limit on the required institutional ownership needed for the threat of a voting strike to be effective in compelling a board to respond to shareholder concerns.

The positive relationship between media attention prior to the annual general meeting and the likelihood of receiving a strike warranted further examination, as a number of potential explanations could be put forth and no conclusion could be made as to the direction of the causal link. Increasing media attention paid to a corporation's remuneration could prompt shareholders, both retail and institutional, to more carefully examine the remuneration report and

determine whether it was appropriate for their own interests. Alternatively, media attention may focus on exaggerating the inappropriateness of executive remuneration to generate entertainment for readers, but also in turn influencing shareholders independent of their own judgement of the corporation's remuneration setting (Hooghiemstra et al., 2015). A third explanation is that the media reports on executive remuneration that has already been judged by shareholders or the proxy advisers they have retained as problematic or excessive, and therefore media attention is simply a proxy measure for pre-vote shareholder opinions on remuneration or the recommendations of proxy advisers (Hooghiemstra et al., 2015). In light of the relative importance of media attention on the likelihood of a voting strike, an analysis of media reporting on shareholder voting behaviour was performed in Chapter 5.

7.1.3. Media Reporting of Remuneration Voting

Using a pragmatic legitimacy construct, an analysis of media reporting of the two-strikes regime and voting strikes received by corporations. This study was conducted to answer two questions: first, what managerial actions impair the legitimacy of a corporation's executive remuneration strategy? And second, what actions do managers undertake to repair damaged legitimacy in relation to executive remuneration?

The analysis identified several reasons why the remuneration structure of a corporation may be voted against as reported in media articles, including the awarding of pay for poor performance and poor communication with shareholders and close stakeholders. These managerial actions were demonstrated to impair the pragmatic legitimacy of the corporation's remuneration structure, reflected by recommendations against and voting dissent on the remuneration report resolution from proxy advisers and shareholders respectively. The analysis also identified actions undertaken by the boards of corporations that had suffered damage to the legitimacy of their remuneration structure to repair this legitimacy. This was primarily in the form of a purported increase in communication with shareholders and other close stakeholders and modifying their remuneration structure in response to those criticisms. Notably, the changes that resulted from such

discussion did not need to fully address concerns raised by stakeholders to repair the pragmatic legitimacy of the remuneration structure. On the other hand, a small number of board members denied the existence of an issue with the remuneration structure and attempted to divert stakeholder attention to the performance of the corporation. Diverting attention was observed to have little success at repairing the pragmatic legitimacy of the corporation's remuneration structure.

7.1.4. Synthesised Findings

Chapter 6 discussed whether the two-strikes say on pay regime realised its policy goals. This research demonstrates that the two-strikes say on pay regime has only realised its policy goals to a limited degree and offers little increase in effectiveness over the prior advisory say on pay regime in Australia. An increase in engagement between shareholders and boards regarding the setting and approval of executive remuneration is identified. However, this improvement in communication was already underway under the prior advisory say on pay regime. The failure of shareholders to exercise the board spill consequence for boards which consistently refuse to address shareholder concerns regarding executive remuneration is a substantial indicator of the lack of effectiveness of the board spill component of the two-strikes regime. This is potentially motivated by uncertainty as to the cost to shareholder value of a successful board spill resolution, and as a result impairs the coercive power of the two-strikes regime. Finally, the reliance of shareholders on assessing the suitability of executive remuneration by the legitimacy it engenders, rather than by the extent to which it aligns executive incentives with shareholder interests, may be the result of poor remuneration disclosures, increasing the value of external assessments of the suitability of remuneration from news media reporting and proxy advisers. Thus, the effectiveness of the two-strikes regime to empower shareholders to hold directors accountable for excessive remuneration practices is to a large extent limited by the ability of reporters and proxy advisers to identify and disseminate such practices to shareholders.

7.2. Contributions

This research offers three primary contributions. First, it offers an examination of the drivers of voting dissent in listed Australian corporations under the unique two-strikes say on pay regime, with a focus on news media coverage as an explanatory variable. The inclusion of news media coverage as a variable in this Australian context is a novel contribution among the few studies that have examined the two-strikes regime, especially considering its significant and substantial association with voting dissent. Relatedly, this research offers one of the few studies of the drivers of voting dissent by means of a qualitative analysis of news articles supplemented by an interview. Analysis of say on pay voting and executive remuneration is dominated by quantitative analysis of the factors motivating voting dissent and determinants of executive remuneration. This novel approach has aided in the explanation for the lack of quantitative evidence for voting dissent motivated primarily by examining the relationship between executive remuneration and corporate performance.

Second, this research offers a theoretical contribution through providing a link relating optimal contracting theory and legitimacy theory in explaining shareholder voting behaviour. This research frames legitimacy theory as the primary explanation through which say on pay voting can be examined, with voting dissent motivated by the legitimacy, or lack thereof, a corporation's remuneration has attracted. Optimal contracting theory becomes a subordinate theory in this framework, explaining how strong links between executive pay and corporate performance lend pragmatic legitimacy to the remuneration practices of the corporation. However other sources of legitimacy, including external assessments of the suitability of the remuneration from news media reports and proxy advisers, affect the overall level of legitimacy for those remuneration practices and in turn how shareholders vote on the remuneration report. The application of legitimacy theory also lends itself to explaining how corporate actions such as communication with institutional shareholders and proxy advisers can repair the legitimacy of a corporation's remuneration strategy in the view of shareholders and avoid voting strikes in subsequent years.

Third, a practical contribution this study provides is that it evaluates the effectiveness of the two-strikes say on pay regime in empowering shareholders to restrain excessive executive remuneration, which would be of relevance to policymakers and associated stakeholders. The conclusion of this research that the two-strikes say on pay regime does not appear to offer a substantial improvement over the prior advisory say on pay regime in restraining executive pay is of value to both Australian policymakers evaluating changes to the regime and to policymakers in other jurisdictions in evaluating the Australian system. The key contribution in this regard is identifying a probable explanations for the continued existence of boards which are continuously unresponsive to shareholder concerns over their executive remuneration. These explanations centre on shareholder reluctance to exercise the binding board spill consequence and corporations with concentrated ownership that precludes the receipt of a voting strike. In addition, this research has identified the reliance of shareholders on external assessments of the suitability of executive remuneration from news media articles and proxy advisers likely reflects an issue with the ability of retail investors to fully comprehend and understand remuneration disclosures. These are areas in which policymakers may wish to concentrate in future reforms to say on pay.

7.3. Limitations

Due to the widespread and diverse ownership of large listed Australian corporations it is difficult to make definitive conclusions as to shareholder voting behaviour. Notably, the quantitative analysis performed for this thesis assumes that shareholders base their vote on the remuneration report upon the information in the remuneration report for the financial year prior to the annual general meeting. As the long-term and equity components of remuneration in the remuneration report are calculated based on fair value assessments of the future value of these components provided by the corporation, this research does not account for any adjustments of the estimations of fair value of these components that shareholders may make. This may be significant where the corporation's estimates of fair value differ substantially from shareholders' own estimates.

This diversity of shareholders also extends to the proxy advisers they retain. The qualitative analysis performed focused on quotes reported in news articles and an interview with an employee of a proxy advisory firm. As a result, the sample is biased towards shareholders and proxy advisers approached by or able to contact news reporters willing to report on say on pay voting. This essentially excludes retail shareholders apart from the Australian Shareholders' Association from the analysis. The diversity amongst institutional shareholders may also impair the generalisability of conclusions reported from the qualitative analysis. This issue is less prominent for proxy advisers, as Australia's market is heavily concentrated amongst three major firms, but still presents an issue for the generalisability of the conclusions drawn.

The focus on large listed Australian corporations for the quantitative analysis precluded the inclusion of the presence of several corporate governance variables as explanatory variables. As noted by Kent et al. (2018), large corporations adopt similar corporate governance practices under the guide of best practices, leading to eventual uniformity in practices. For instance, in relation to this study, substantially all of the corporations in the sample had a remuneration committee, leading to issues regressing a model with a variable representing the presence of a remuneration committee included. This limitation was also subject to general availability of data.

7.4. Areas for Further Research

The framing of shareholder voting behaviour being motivated by an assessment of the legitimacy of executive remuneration, rather than its optimality, presents several areas for further research. Identification of alternative sources of legitimacy for a corporation's executive remuneration strategy would assist in providing a more complete picture of what motivates shareholder voting dissent. This would also extend into research of the implied cost of these alternative sources of legitimacy, that is, how much is a shareholder willing to sacrifice in terms of the link between executive remuneration and corporate performance for a given unit increase in another source of legitimacy. In addition, further empirical research across a larger sample and a different timeframe may identify differences in the

significant drivers of voting dissent on say on pay resolutions to those identified in this study.

There is also a need for further qualitative research to understand the motivations of institutional and retail shareholders in order to obtain a fuller picture of the sources of legitimacy shareholders value in making a voting decision on the remuneration report resolution. Such research would not only aid in explaining the weak relationship between voting dissent and pay-performance sensitivity, but also improving the understanding of the link between executive pay and corporate performance would also assist in explaining why shareholders are reliant on external assessments from news media reports and proxy advisers. The latter would contribute towards an understanding of whether remuneration disclosures are sufficient and understandable for various types of shareholders, with the obvious implications for policymakers seeking to further reform executive remuneration governance.

The implication from this research is that shareholders are unwilling to execute a board spill to compel a stubborn board to respond to their concerns because of the uncertainty of its impact on shareholder value warrants further consideration. While this may currently not be feasible in the Australian context due to the relative paucity of such incidents, alternative jurisdictions or partial board spills may help quantify any cost of a board spill and whether shareholders are justified in avoiding their use if the cost outweighs the benefits in increasing the optimality of executive remuneration. Alternatively, a comparison of the mechanisms available to shareholders to deal with obstinate boards unresponsive to concerns regarding executive remuneration across jurisdictions may identify elements of policy best suited for this purpose. Such research would be beneficial from a policy perspective, as it would indicate that a board spill is an insufficient or inappropriate means of compelling unresponsive boards to respond to shareholder feedback.

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A. Appendix A: Proxy Advisor Principal Interview Questions

- What is the title of your role in your firm?
- What is your area of expertise, and what is your history in this area?
- How long have you worked at your firm?
- Describe your activities at your firm.

Recommendations

- Describe the process of making a voting recommendation on a resolution on the remuneration report.
- What, if any, specific criteria do you use?
- How do weigh each of the factors in the criteria?
- Is your process a purely quantitative approach or does it involve a heuristic or “gut-feeling” process?
- Why do you consider factors other than how the pay of executives is linked to the performance of the firm?
- Have you discussed with or received feedback from your clients about your recommendations? If affirmative:
 - How has feedback from your clients changed your process for making recommendations?

Two Strikes

- Has the introduction of the binding say-on-pay vote changed the process of making a voting recommendation?
- Has it made you more conservative in your recommendations, knowing that an against vote might potentially lead to a board spill?
- Do you alter your recommendations if a company is on its second strike and at risk of a board spill resolution?
- What is your process for making a voting recommendation on the spill motion?
- Do you believe you are conservative with regards to how often you recommend voting for a spill motion?

Conclusions

- How do you believe companies have changed their remuneration policies or reports since the introduction of the binding say-on-pay vote?
- Do you believe there are differences in how institutional shareholders and retail shareholders vote on these resolutions?
- Is there anything else you would like to tell me/us about the process of making recommendations that we have not covered?