Say on Pay Primer

This primer gives an overview of the key factors for the success and failure for say-on-pay (SOP) proposals.

While most SOP proposals gain support, with average support at slightly over 92 percent in 2015, there are many companies who fail their vote or receive poor support, making them vulnerable to shareholder activism, opposition to director elections and more. For example, the 2015 proxy season saw executive compensation become an issue of increasing focus in proxy fight situations. Dissidents at Qualcomm Inc., DuPont Co. and Perry Ellis criticized the companies on the use of performance metrics that inappropriately rewarded executives for lack of true performance. At Shutterfly Inc., where the company's SOP proposal has received low shareholder support in the past two years, the CEO's pay became the dissident shareholder's main complaint. In addition to supporting two of the dissident's three nominees, shareholders rejected the company's SOP proposal with over 78 percent opposition.

Passing a SOP vote is no guarantee of future success. Many companies with failed votes experienced precipitous declines in support from prior years. If a company has any compensation changes or if the performance suffers, continued attention to pay-for-performance linkage is warranted.

Even a moderate level of opposition on the compensation vote should be taken seriously as it often indicates a lack of support for management (if not the compensation committees), stock option plans and the boards of directors. In addition, the proxy advisory firms Institutional Shareholder Services (ISS) and Glass Lewis raised the bar for successful SOP votes by establishing the so-called "red zones". Thus, opposition votes of higher than 20-25 percent invites greater scrutiny by the advisory firms of a company's compensation practices. The company is expected to engage in a shareholder outreach and likely make pay changes based on investor feedback.

The effect of ISS and Glass Lewis recommendations on SOP votes has been apparent – in 2015, the level of support at companies that received ISS's negative recommendation declined to just more than 64 percent. In many cases in which an "Against" recommendation on SOP proposal was rendered, proxy advisory firms also issued a "Withhold" recommendation on Compensation Committee members who were up for re-election.

Problematic pay practices

The main reason for low levels of support on SOP proposals from shareholders and proxy advisory firms continues to be "pay-for-performance disconnect," where the CEO's pay level is misaligned with the company's stock price performance.

Relative TSR performance, comparing a company's TSR to their industry peer group, is the key metric used to measure any performance disconnect. Companies that underperformed relative to peers without a corresponding decline in CEOs' relative pay often face difficulties passing their SOP vote.

In certain cases strong shareholder returns alone may not be enough to ensure a strong SOP outcome. With CEOs' pay outpacing shareholder returns, investors may still question the linkage of pay and performance in such instances.

Other problematic pay practices that are common factors for negative votes include:

- **Special awards to CEOs** – mega-grants often in lieu of some other problematic benefit that CEOs (and/or other named executive officers) previously gave up. One-time grants such as these, if they are provided without adequate justification and/or lacking performance conditions, have increasingly been a concern for shareholders.
- **Peer selection and benchmarking** - use of outsized peers or above median targeting
- **Lack of performance goals or their rigor** – hurdles set below previous targets and/or actual results without a corresponding decrease in incentive opportunity
- **Concerns over employment agreement provisions** – hire-on equity grants that had no performance conditions for new CEOs, and unjustified or unexplained pay increases for existing CEOs
- **Time-based retention grants** – significant retention awards without performance conditions

Turning around a failed vote

Companies that failed their SOP vote have a number of strategies to employ to gain support in the following year:

1. **Highlight improvements in company's performance.**
   Any improvements in TSR (and other business and financial performance) should be communicated in the outreach efforts as well as highlighted in the company's proxy statement, since companies that have overcome a failed vote often have improved TSR performance. Note: one-year absolute TSR performance has been more influential than favorable one-year relative TSR performance.

2. **Undertake an aggressive investor and proxy-advisor outreach program to understand the concerns of shareholders, and to solicit feedback on steps for improving executive pay practices.**
   Engagement can give shareholders and proxy advisory firms them a better understanding of the company's compensation practices, while also giving the company a better understanding of the shareholders' and proxy advisors' concerns.

   It is important for companies to pay attention to their specific situations. The companies should address any shareholder concerns from the previous year(s) or any misalignment that may have resulted from changes in compensation programs or as a result of poor performance.

   Outreach should be made to the proxy voting contact (usually different from the normal investor relations contact) at the institutional investor. As appropriate, outreach can benefit from the involvement of a compensation committee member with assistance from senior management. Such outreach should be done during the off-season and early in the planning cycle for the next year's shareholder meeting.

3. **Make changes, as appropriate, to the company's compensation practices to address shareholder and proxy advisory firms' concerns.**
   Based on the feedback from investors and the proxy advisors, the companies can make changes in all areas of compensation: short-term compensation, long-term compensation, compensation practices in the face of change-in-control (CIC) situations, equity and non-equity compensation, etc. Such changes should be communicated in continued outreach to both shareholders and proxy advisory firms.

4. **Provide clear disclosure in the CD&A section describing the steps taken to address the SOP issues.**
   It is critical that the companies provide useful and easy-to-understand disclosure of their pay practices and decisions in the CD&A. This should include discussion of the investor outreach efforts including the specific feedback received as well as the resultant compensation changes. These disclosures are often picked up in proxy advisory firms' advisory reports.

5. **Consider using the services of a proxy solicitor.**
   The data shows that hiring a proxy solicitor, after not using one when the failed SOP vote occurred, leads to better voting results than the average of those not utilizing a solicitor. Not only do proxy solicitation firms play a significant role in assisting with the solicitation at annual shareholder meetings to help ensure higher positive votes, but several companies used proxy solicitors to assist in shareholder outreach efforts.

In summary, companies that have a prudent plan consisting of a proactive outreach to shareholders and proxy advisory firms, reviewing the executive pay practices and making changes, as appropriate, can turn around a failed or low shareholder vote on their SOP proposal.

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