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Top 5 Lessons From Say on Pay and Shareholder Engagement

Shareholder engagement is vital within the context of say on pay.

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Say on pay has ushered in a new era of shareholder engagement on executive compensation. In response, HR professionals accountable for executive pay issues must develop a new set of tools and capabilities. Managing shareholder influence is no longer just about writing a strong proxy or evaluating the reports of proxy advisory firms. For more and more companies — and not just those that failed say on pay — direct outreach and engagement with shareholders has become a key component of governance. In this new environment, it is incumbent on HR professionals to understand the changing landscape and participate directly in shareholder engagement.

The New Era of Shareholder Engagement

Prior to the financial crisis of 2008, the prevailing wisdom was that the investment community was not particularly interested nor engaged in the topic of executive compensation. Executive compensation rarely garnered any attention at investor days or on analyst calls, except for select, activist investors or in exceptional circumstances. Put simply, the C-suite had little reason to believe that executive compensation was anything but a nonissue for most shareholders. Most CEOs could honestly report, "I've never had a shareholder ask me about our executive pay."

The reality is that shareholders have long held an interest in elements of executive compensation, particularly in the use of equity incentives and their impact on shareholder dilution. This focus began in the late 1990s with the surge in equity compensation occurring at that time. More recently, this interest has expanded in both breadth and depth. First with the financial crisis and subsequent Troubled Asset Relief Program (TARP) regulations, which brought new focus to executive pay, and now with say on pay, which has given a voice to long-building shareholder concerns.

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As a result, many companies have learned — some to their surprise and fewer still, to their dismay — that shareholders really do care about executive pay practices and especially a clear link between pay and performance. The authors' analysis of say on pay voting results over the past two years has demonstrated that for hundreds of companies, more than 25 percent of their share ownership has been opposed to their executive pay practices. Perhaps more alarming, a positive vote result in one year is no guarantee of a similar response in the next. So far, more than half of the companies that received 70 percent or lower support for their 2012 say on pay proposal had greater than 80 percent support in 2011, with an average decline of more than 35 percent of shares voted.

How did this new focus on executive pay come to surprise so many issuers? As it turns out, most companies simply haven't engaged shareholders on compensation-related issues in the right way. Historically, senior management has primarily interacted with portfolio managers at large institutions when engaging investors, and mostly around performance issues and strategic positioning. A key lesson from the say-on-pay process is that those portfolio managers have a varied role in the proxy voting process. For many of the larger institutions, corporate governance policy-making and proxy-voting decisions are made through a centralized body rather than the individuals making the investment decisions. As one portfolio manager recently noted, "You wouldn't believe the headache we have to go through to overturn the recommendations of our proxy voting committee. Unless there's a really compelling case to be made, it just isn't worth it."

In the past, these centralized proxy voting and governance policy-making groups have not had a channel to directly influence executive pay practices, despite growing market concerns. With say on pay, they now have an explicit voice.

Top 5 Lessons from the 2012 Proxy Season

Throughout 2011 and early 2012, we learned that proactive engagement with shareholders is essential to avoiding unpleasant surprises when it comes to say on pay. In many respects, this is a new area for HR executives. Whereas other functions (e.g., investor relations, finance, legal) have historically played a prominent role in shareholder engagement, this has not always been the case for human resources. The heightened focus on the complex and nuanced aspects of compensation requires that HR leadership take on greater responsibility for shareholder outreach, working side-by-side with these other corporate functions.

In the past, year the authors have worked with a number of companies to undertake this new engagement process. In doing so, a substantial amount has been learned about

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what works. Following are the top five lessons learned.

1 | **Shareholder engagement is not just for companies with known issues.** If you've had strong shareholder pushback on executive pay in the past, the need for shareholder engagement should be obvious. But even if you haven't had any issues in the past, the best way to avoid unpleasant surprises in the future is to develop a process of regular shareholder outreach on pay matters. A proactive approach with annual engagement on compensation — even when you don't think you have any issues — is better than a reactive approach aimed at lobbying for investor support after a problem has already come to the surface.

That said, annual shareholder engagement isn't a realistic option for all companies. Smaller issuers tend to have fewer resources to devote to shareholder outreach, and investors — with finite resources of their own — are often over-burdened with requests for engagement. For companies that lack the resources or clout to regularly engage with shareholders, consider more targeted, but still proactive, outreach when material changes have been made to (or are being considered for) compensation programs.

2 | **Shareholders want to talk to you.** Perhaps the biggest surprise has been the discovery that shareholders are not only willing, but often eager to discuss their perspectives on your executive pay practices.

You may have heard (or even experienced firsthand) that shareholders are unresponsive to requests for engagement around executive compensation. Such perceptions may arise from anecdotes of smaller companies that endure a fruitless (and, assuredly, frustrating) outreach effort with limited responsiveness. Other anecdotes may come from companies where investors simply aren't concerned about their pay practices (i.e., where no response can often be seen as good news). However, the authors' experience has been that many shareholders are more than happy to engage in a dialogue around the topic of executive compensation.

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Of course, engagement is also a matter of timing. For many companies, the ideal time might be at the end of the summer or early fall, when few proxies are being voted and the individuals with proxy voting authority have time to discuss their perspectives and philosophies. Waiting until your proxy has been filed or, worse still, an issue has been raised, may be too little, too late.

3 | **It's important to know with whom to engage.** A key challenge to engaging with shareholders on executive pay issues is that the most frequent point of contact for management — the portfolio manager — is often not involved with or has limited influence over proxy voting.

Every shareholder is different, and it can take some time to identify the right people to talk to. For example, the investor relations function for one of the authors' clients undertook great effort to arrange a call to discuss executive compensation with a large institutional shareholder. A meeting was scheduled with the analyst that follows the stock and it quickly became clear that the analyst had no insight or perspective on executive pay or proxy voting issues — that simply wasn't her responsibility. The authors eventually connected with the right individuals, receiving the input needed to better understand how they think about executive pay.

Unfortunately there is no universal roadmap to determining who has proxy voting authority. HR professionals should work with their counterparts in investor relations to diligently identify and engage with the appropriate representative(s) for each shareholder.

4 | **Have an agenda and be prepared to listen.** Shareholders will expect that you have an agenda. While there is a time and a place for open-ended conversation, be prepared to focus on specific issues. At the same time, be prepared to listen and learn what is on your shareholders' minds. The underlying objective of a company's outreach process should be the mutual sharing of information and perspectives.

Your goal should be two-fold: first, to learn what your shareholders care about and what is influencing their decisions; and second, to share information on your philosophy and perspectives regarding executive pay.

To do so effectively requires that you be knowledgeable of the investors' published proxy voting policies and, if applicable, prior voting record and/or issues raised. It also requires that you be knowledgeable of the relevant facts and context of your own situation — that is, know your story and don't lose sight of the relevant business context. While the focus may be on compensation, a narrative that is founded in the broader, business-based considerations will help to ensure a holistic understanding of the internal and external landscape for compensation decisions. It is often helpful to communicate program outcomes within a pay-for-performance framework.

Finally, companies should avoid two common pitfalls. First, ensure that your story does not run afoul of any proxy solicitation issues (e.g., you should be gathering general perspectives, not trying to influence a vote on specific issues or share any new, nonpublic information). Second, ensure that the message is focused. This is not an appropriate channel for criticizing the methods and approaches of proxy advisers.

5 | **Be prepared to take action.** To support your ongoing process of shareholder engagement, it is important that you are willing to be responsive to the feedback provided by your investors. This holds most true for those companies undertaking an outreach effort in response to particularly undesirable (or failed) say on pay outcomes. But, in all cases, you should be ready to respond to your investors with material changes to your pay programs, if warranted. The good news, though, is that being responsive to shareholders will generally pay dividends in the future. On average, companies that failed say on pay in 2011 have received 38 percent more support in 2012, often thanks to meaningful changes to their compensation programs.

Take for example, Jacobs Engineering, which increased its rate of say on pay approval from only 45 percent support in 2011 to 96 percent in 2012. This dramatic increase was the direct result of an extensive outreach process and subsequent, material changes to the company's programs, including more performance-based stock, fewer stock options, higher stock ownership guidelines and other improved governance provisions. The net result was a significant increase in shareholder support.

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Conclusion

Say on pay has led to a new era of shareholder engagement on executive compensation. With a proxy vote on executive pay, there may be new constituents within shareholder organizations who are now involved in the process of evaluating your pay practices and will need to be heard. These constituents — the corporate governance policy-making departments, proxy voting committees, etc. — will have greater influence over governance practices going forward and are likely to put increasing pressure on outlier compensation practices and underperforming companies. As a result, regular communication with your key shareholders on executive pay will be the best way to avoid surprises in your next proxy season. It will be incumbent on HR professionals to take the lead in understanding the perspectives of these new constituents and also in facilitating an ongoing investor outreach process with respect to pay. ws

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