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Standing on Higher Ground: How and When To Adopt Pay Practices That Don't Comply With Proxy Adviser Guidelines

BY KENNETH J. LAVERRIERE AND DOREEN E. LILIENFELD

Good corporate governance inevitably requires compensation committees to consider pay practices that may not align with the standardized guidelines of proxy advisers or institutional investors. The individuals who serve on compensation committees share the same duty as all directors to act on an informed basis to advance the best interests of the corporation and its shareholders. ''Best practices'' and ''voting guidelines'' by definition are generic. At some point, what is right for a business will invariably be at odds with guidelines written without the burden of the particular facts that may be relevant to a difficult pay decision.

Committees do not always benefit from balanced advice on when to depart from proxy adviser guidelines. A company's internal lawyers and officers responsible for compensation may be understandably reluctant to recommend a pay practice that will engender a negative voting recommendation. Outside consultants and legal advisers often define part of their ''value add'' as warning when a practice will run afoul of proxy adviser guidelines, with the unfortunate result that the proxy advisers' point of view creeps in disproportionately to what otherwise should be objective advice. In addition, some of the guidelines promulgated by proxy advisers appear purposefully vague and require knowledge of a secret sauce that is available only to those who pay for the recipe.

Fortunately, there appears to be an emerging consensus on the best way to reach the higher ground when considering a pay practice that runs contrary to the stated preferences of proxy advisers. The following is what seems to work.

The authors are partners in Shearman & Sterling LLP's Executive Compensation and Employee Benefits Group and regular speakers and writers on the topics of pay and governance.

Ongoing and Focused Shareholder Outreach

A welcomed trend is for companies to engage in regular outreach to their shareholders on pay matters. Outreach helps compensation committees with tough decisions because it gives the committee members real-time access to the concerns and preferences of key investors. Done right, outreach also sets a positive tone with investors and helps communicate the committee's message on pay. This, in turn, may garner shareholder support of compensation programs that are not squarely within proxy adviser best practices.

The most effective outreach typically occurs throughout the year, is coordinated through investor relations or the company's compensation function, and is made directly to key institutional investors that collectively hold a significant percentage of the company's stock. In many instances, a member of the compensation committee oversees or actually participates in the outreach. To avoid running afoul of the Securities and Exchange Commission's rules against selective disclosure, those who engage in outreach typically work from a prescribed set of topics and do more listening than speaking.

Shareholder outreach can often lead to positive results following a negative voting recommendation by a proxy adviser or a lower than expected say-on-pay vote.

Two recent and well-publicized outreach efforts at Coca-Cola and McKesson illustrate this point. In 2013, only 22 percent of McKesson's shareholders voted in favor of the company's compensation program in its say-on-pay vote. Following the vote, McKesson launched an expansive shareholder outreach effort, directly engaging with shareholders representing more than 50 percent of the company's outstanding shares. As part of the outreach process, McKesson designated a senior executive to lead the effort, ensured the involvement of the lead director and compensation committee chair, and opened direct lines of communication for shareholders to address concerns with the lead director, its board and senior governance executives. McKesson passed its 2014 say-on-pay vote with 95 percent shareholder approval as a result of these efforts.

Coca-Cola's recent shareholder outreach offers a similar lesson. Coke maintains a ''shareowner forum'' on its website through which shareholders may submit questions and the company regularly engages with shareholders on various topics throughout the year. However, following strong say-on-pay approval in 2011 and 2012, it appeared that the company might receive a lower level of support in 2013. The company responded quickly by expanding its shareholder engagement efforts and prior to its 2013 annual meeting, announced that it capped its 2013 annual incentive awards in response to shareholder concerns. Coke's say-on-pay approval fell to 77 percent in 2013, a significant decrease, but still a passing vote. Following the 2013 annual meeting, the company continued its communication with shareholders and adjusted its 2014 compensation in response to their concerns. Coke received approval from 91 percent of its shareholders for its 2014 say-on-pay vote.

Enhanced Disclosures

The SEC's proxy rules are premised on the idea that the ''sunlight'' of uniform disclosure is the best way to keep pay practices in check. As a result, a significant portion of each proxy statement is dedicated to describing, explaining and quantifying a company's pay philosophy and practices for its named executive officers.

Prescribed disclosure, however, is not necessarily the most effective disclosure. The SEC's disclosure rules do not always allow companies to describe fairly, or sometimes even accurately, what executives are paid and why. For this reason, companies frequently resort to supplemental disclosures to bridge the gap and better tell their stories. For many, the benefits of additional disclosures appear to outweigh the costs and risks of providing them. Three such practices may be particularly effective.

Alternative Pay Disclosures

There has been a consistent increase in the use of supplemental pay disclosures that distinguish between the ''total compensation'' required by SEC rules and realizable or realized pay. *Realizable* pay broadly means the pay that could actually be earned by an executive based on current performance and share price. *Realized* pay generally refers to the amount actually pocketed by an executive for a given year in the form of base salary, bonus payments, option exercises and award settlements. The precise use of these terms can vary among companies and practitioners, making company comparisons difficult, but they both act as a foil to the SEC's required disclosure which is an amalgam of cash, accounting and accrued pay values.

Using realizable and realized pay is particularly effective at demonstrating the alignment between pay and performance and at linking the level of executive pay with total shareholder return. For example, in its 2014 proxy statement, ExxonMobil included a chart comparing its CEO's reported pay with realized pay over an eight-year period. On average, the CEO's realized pay represented only 44 percent of his reported pay during this period. A downside of adding supplemental disclosure is that it can be difficult to eliminate the disclosure in later years without offering an explanation for the change.

The List of Accomplishments

A second useful practice is the ''what we do/what we don't do'' list. Essentially, the company catalogs all of the so-called ''best practices'' that it has adopted and emphasizes the verboten practices that it avoids. This is particularly useful in setting an investor-friendly context when reporting on one or two practices that may be at odds with proxy adviser guidelines.

Based on our review of 2014 proxy statements, common investor-friendly practices that have emerged for the ''we do'' part of the list are (1) robust share ownership and retention requirements, (2) prohibitions of hedges and pledges, (3) performance-based pay structures, (4) regular shareholder outreach, (5) clawback policies and (6) the use of independent consultants. The ''we don't'' part of the list is typically punctuated by the absence of gross-ups, employment agreements, excessive perquisites, dividend payments on unearned equity awards and single-trigger change-in-control equity vesting.

Focusing on what a company does and does not do also helps the compensation committee evaluate a one-off or long-established pay practice that may not align with the preferences of institutional investors, but may be in the long-term interest of the corporation.

Emphasis on Outreach

As noted above, many companies are engaging in regular outreach to investors. Those that do are also letting investors know about it and telling their shareholders what they have learned from the process.

Sixty-two percent of the companies in Shearman & Sterling's ''12th Annual Survey of Corporate Governance Practices of the Largest US Public Companies'' disclosed their shareholder engagement efforts in 2014, an increase from 45 percent in 2013. The content of these disclosures varied but often included the number of shareholders contacted and their average ownership percentage, the feedback received and any changes implemented.

Some companies, such as Target and Coke, provide detailed charts showing what they heard from shareholders, changes that were implemented (including the applicable effective dates) and the ensuing results.

ExxonMobil took a different approach by disclosing both the practices that received positive shareholder feedback and those where shareholders requested additional information—noting where such additional information can be found in the proxy statement.

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Established Committee Process

Finally, the best way to justify a pay practice that may be identified as problematic is to adopt it as part of a rigorous committee process. A relentless focus on process allows informed, independent director judgment to control the setting of pay levels and practices. It also has the derivative benefit of protecting committee members based on long-established legal precedents that protect the proper exercise of business judgment by directors.

There are three key aspects to a well-developed committee process. First, the members of the committee should be truly independent. Stock exchanges impose general and categorical independence requirements on all outside directors and specific independence requirements on members serving on compensation committees. In addition, certain provisions of the tax code and the securities laws impose differing independence requirements on compensation committee members. Proxy advisers may also apply their own framework to the independence analysis.

These standards, however, are not always sufficient. True independence is also bolstered by a lack of social or other entanglements between a committee member and the senior officers of the company, a committee member's stature as a leader within the business or academic communities, and the member's ability to resign from the committee, if needed, without any adverse personal financial impact. Many companies have adopted independence standards that consider these factors.

The second aspect of a well-developed process is a regular calendar for committee actions. The role played by compensation committees is increasingly complex and benefits from established policies and procedures. A well-formed committee process will typically include a predictable schedule that allows for the orderly implementation of policy and pay programs, meaningful input from management on the performance of the business, reasonable opportunity to assess executive performance, as well as sufficient time to consider and make grants and awards, determine annual pay levels and bonuses, and undertake self-assessment.

Finally, even the most talented committee needs direct access to advisers and management. It is increasingly difficult for a compensation committee to function without access to its own compensation consultant, particularly given the complexity of performance measures and the need to rely on normative data for a company's peer group, industry and competitors. Although stock exchange rules do not strictly require consultants to be independent, experience suggests that most companies require consultants not to have any other commercial relationships with the company.

Committees also benefit from access to outside lawyers who are experts in governance and legal aspects of setting pay and benefits. Lawyers typically offer committees the best help in documenting their actions through appropriate minutes and other committee records. Access to outside legal counsel is important at major inflection points in the compensation cycle, such as the hiring or termination of an executive officer, the adoption of a new equity plan or the formulation of a strategy to address a negative say-on-pay vote or say-on-pay recommendation.

An informed committee will also have a direct line of communication to the compensation officers responsible for overseeing and administering the company's compensation and benefit plans.

Problematic Pay Practices and Say-on-Pay

Problematic pay practices, when properly disclosed, do not necessarily have a negative impact on say-on-pay results. An informal survey of proxy statements from 2014 indicates that at least 90 percent of proxy advisers have categorized as problematic one or more pay practices at companies that had an affirmative say-on-pay vote. These practices include (1) a significant one-time bonus or equity grant to a new CEO; (2) the grant of stock options over other performance-based equity awards; (3) the use of company-specific performance metrics instead of more objective metrics like total shareholder return; (4) a lack of meaningful stock ownership and retention guidelines; and (5) single-trigger vesting of equity awards upon a change in control. Importantly, the guidelines of proxy advisers may not automatically result in a negative say-on-pay recommendation solely on the basis of one or more problematic pay practices.

All of the above leads inexorably to the view that investor pay guidelines are an important factor for compensation committees to consider in setting its pay philosophy, pay components and pay levels, but they are not the most important factor and are not a substitute for the committee's sound judgment. Committees must analyze their compensation program as a whole and make decisions on pay that are right for the company's business.