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In Governance

Engaging Shareholders on Pay

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Recent results on say-on-pay votes suggest that, at times when shareholders become unhappy with executive pay programs, boards are sometimes caught unaware. This lapse seems to happen for a couple of reasons: oftentimes board members don't visit shareholders themselves to hear about pay concerns. And company executives don't learn about the concerns when they visit shareholders because they talk with portfolio managers who don't necessarily bring the subject up.

When this communication is not happening, the worst can happen: An unforeseen dive in say-on-pay voting results — in which the percentage of shareholders voting "yes" plunges into the danger zone of 70 percent or less. Data from Semler Brossy show this happened to a number of firms in 2013: Forty-six Russell 3000 companies that earned over 70 percent "yes" votes in 2012 failed their say-on-pay votes in 2013 with under 50 percent support.

No compensation committee wants to suffer such a reversal, treading on safe ground one year, tripping into danger the next. We advise compensation committee chairs to work with corporate secretaries, investor relations chiefs, and human resources chiefs on pay-specific outreach efforts. This means meeting specifically with a shareholder's governance group — or in the absence of a governance group, with the portfolio manager.

Boards that conduct regular outreach can avoid — or quickly exit — the danger zone. In 2012, Pitney Bowes received 35 percent of the vote, but in 2013, after outreach and program changes, it earned 94 percent. Among its pay-practice changes: Increased weighting of financial performance in the annual incentive plan; removal of duplicative metrics in the annual and long-term incentive plans; reinstatement of a cumulative three-year total-shareholder-return adjustment for cash incentive units; stronger disclosure of performance goals; adjustment of the peer comparator group; and elimination of excise-tax gross-ups upon a change in control.

Coming back from a failed vote is not that difficult with the right effort. Semler Brossy data show that of the 57 companies that failed 2012 say-on-pay votes, all but three reached out to shareholders and made pay-practice changes. All but eight then passed their 2013 votes. The numbers suggest the power of outreach to turn things around. If you've just failed a say-on-pay vote — or just as important, if you want to be sure you never do — you can take six steps to shareholder engagement to stay on safe ground:

Step 1: Understand the Reasons for Failure

After proxy season, review the correspondence you've received on pay practices from investors. Also review reports by proxy advisors ISS and Glass, Lewis & Co. Did you miss warning signs? Common shareholder concerns include: limited or no shareholder outreach over pay, limited disclosure of pay practices, a lack of performance-linked long-term compensation, outsized awards to new or terminated CEOs, "problematic" pay provision such as tax gross-ups, and a poor link between the previous year's rewards and performance.

After this review, prepare a "listening tour" with shareholders. Meet with your top institutional investors, those collectively holding over 50 percent of your stock. What do they like and not like about your compensation program? What would they like you to change? How are they evaluating different aspects of the compensation programs? Be sure to meet with the governance expert, if the shareholder has one.

Contrary to convention, we recommend compensation committee chairs go to such meetings alone. Although the corporate secretary, head of HR, investor relations chief and compensation head often attend, a committee chair going alone signals that the board, not management, controls pay. If the chair cannot go solo, he or she should lead the conversation, to project more credibility and elicit more candor.

We suggest you kick off these meetings by explaining key elements of your pay program, their history, and how they serve the company's strategy. Then, dedicate the meeting mainly to asking questions: Are we hearing shareholders correctly? Have we heard everything that concerns you? Which items are most controversial? Explain your plan but delve into your shareholders' hot buttons. A script is a useful aid, to keep you on a "listening" track. Topics to include: most critical metrics, performance-based pay, peer group selection, gross-ups and other pay elements, fixed pay elements and guarantees, and disclosure transparency.

Step 2: Decide Whether Changes Are Warranted

Condense the results of your listening tour into several themes. By November or December, discuss the feedback you received and tentatively determine which things you should change and how. This step requires balancing the direction from shareholders with what's required to support the business strategy.

Step 3: Consult with the Proxy Advisors

Schedule visits with the proxy advisors — ISS and Glass, Lewis & Co. Share the feedback from investors. Ask another round of questions: What are your concerns? What about our disclosures in the Compensation Discussion & Analysis (CD&A) section of the proxy could be better? Discuss changes on the drawing table and reasons you plan to stand pat on important provisions. Once again, the compensation committee chair should lead these conversations.

Step 4: Decide Which Changes to Make

Carefully consider the objections of shareholders and proxy advisors. Do they result from one-time economic or business challenges that won't recur? What will be the consequences of making changes — help the company, hurt the company, be neutral? Where will you hold your ground? Be sure to heed governance trends, so as not to lag competitors and best practices.

After this internal discussion, develop changes. Here are some common ones (although the right ones for your company should be ones that align with your business priorities): changing pay benchmarks, stopping gross-ups, adopting an anti-hedging policy, shifting to performance-based long-term incentives, improving disclosure, adding a total-shareholder-return incentive, adopting a clawback policy, adopting share-ownership guidelines, and eliminating single-trigger provisions.

Step 5: Re-Engage with Key Constituents

In January and February, circle back to shareholders and proxy advisors. Share the themes from your tour. Explain planned changes, and fine tune them. Discuss disclosure. Let your contacts know what you've learned, raise potentially controversial issues, and explain your rationale for handling them. Now go ahead and finalize your changes.

Step 6: Prepare Your Disclosure

Incorporate your changes and rationale in the CD&A of the proxy. Be sure to communicate changes clearly to allay concerns. Give a compelling explanation if you didn't make some changes shareholders suggested. This disclosure positions you well to engage again with key constituents after proxy filing — a good way to prepare for meeting again after the proxy season.

In sum, no company can manage its pay program with foresight and confidence without dialogue to find out what shareholders care about. The compensation committee chair, especially when acting as a solo emissary, can show shareholders the board is aligning pay with both performance and shareholder gains. He or she can also show the board operates independently — and takes compensation seriously as part of good governance.

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