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Prep and planning on pay and performance

by Janet Dignan | 29 Mar 2012

A look ahead to the 2012 proxy season

The incoming proxy season will mean different things for different companies, but most should see it as a season of observations and preparation – an opportunity to prepare better responses to critical governance issues by refining, researching or reconstructing their strategies for next year and beyond. That's the view of Matthew Scott, editor of *Corporate Secretary*, the sister publication of *IR magazine*.

In the US, for example, almost all companies get a reprieve on pay disclosure issues because the SEC's final rules on clawbacks, chief executive pay ratios, pay for performance and hedging by employees and directors have been delayed until 2013.

'Companies in effect have another year to look at how others handle these disclosures, decide how they want to proceed and get help if they need it,' notes Scott.

'Moreover, when it comes to say on pay, observations of firms that received passing votes last year should have provided enough information to improve companies' chances of getting their votes through this proxy season.'

US companies also have this proxy season to observe how shareholder proposals filed under the new proxy access rules play out with regulators.

'The shareholder proposals that have already been filed should be studied extensively to determine what was done right or wrong,' Scott advises.

'Most of these proposals give companies insight into governance mistakes to avoid – now it's up to them to engage their investors and change policies to make sure they are not targeted in the same way next year.

'If any of the current proposals comes to an actual vote, it will instantly become the blueprint shareholder groups will use to influence proxy votes in the future.'

So 2012 may well turn out to be something of a watershed, setting the tone and clarifying the likely nature of debate in coming years. John Wilcox, chairman of Sodali, former head of governance at TIAA-CREF and past chairman of Georgeson, says he's noticed a lot more preparation going on in advance of the 2012 proxy season.

'That in itself is interesting,' he observes. 'Companies are now thinking ahead. In the old days they'd go blindly into the AGM assuming they'd get the vote.'

Now they do much more advance planning. ‘I see companies now being more savvy and figuring out where they’re likely to have problems – for instance, on compensation or split chair/chief executive roles or other corporate governance issues,’ Wilcox adds.

Major challenge

SEC rules or not, everyone – from the Occupy movement to members of government and religious groups – now endorses the need for shareholders to step up to the plate on this.

In the UK the coalition government is planning to introduce a binding vote on pay for shareholders, although this won’t actually come into force until 2014. The Netherlands, Norway and Sweden, on the other hand, already have binding votes.

So might this be replicated in the US, where last year was the first in which even an advisory vote was required, under Dodd-Frank?

‘I don’t think they’ll ever have a binding vote in the US,’ says Wilcox. ‘Shareholders are much more comfortable with an advisory vote; they want to be able to use it to express concern or disapproval and to get explanations.

‘They want companies to justify their decisions and explain what strategic goals are advanced by their incentive schemes, or how these will translate into increased shareholder value. But they recognize they don’t have the detailed knowledge to make the business decisions.’

For Wilcox, the idea that companies should do a better job of explaining their business decisions will be ‘one of the great governance themes of the next decade’.

These explanations will have to be ‘good, detailed and company-specific’ – which, Wilcox suggests, won’t be too big a deal for European companies, since they already live in a principles-based, comply-or-explain world.

He cites the UK’s Stewardship Code, which genuinely aims to enhance the quality of engagement between companies and shareholders, for instance by requiring investors to publish their voting policies. This helps companies understand the concerns of their key shareholders.

This development will, however, be ‘a very big challenge for US companies because of the legal restraints,’ says Wilcox. He points out that governance in the US is all about rules, whether at state level, SEC level or as established by the courts.

The compliance and governance space is populated with lawyers and rooted in the legal system; and the legal community is very cautious about allowing directors to speak to shareholders with candor.

Rather, ‘they are advised to disclose only what’s required by the rules,’ notes Wilcox. ‘That makes it difficult for boards to tell the story of how decisions are made and why they’re in the best interests of shareholders.’

For Wilcox it’s important there be a board role in compensation discussions and there needs to be discussion and dialogue about the advisory vote. ‘Companies fought tooth and nail against [the introduction of the vote] rather than managing it,’ he says.

‘It’s not been an efficient approach. It has made things more adversarial, which is unfortunate. My advice to companies has always been to have a non-confrontational approach.'

Under review

Perhaps this is one reason why only the US, of the 12 countries worldwide (see *Countries requiring a vote on pay*, below) now requiring some kind of shareholder vote on compensation, saw so much controversy over the mechanics of say on pay.

But the US is now in step and, significantly, companies there have to disclose in their compensation discussion & analysis whether and how they have taken into account the results of their last say-on-pay votes in determining their current compensation policies.

For ISS, that means companies with more than 30 percent opposition in 2011 (Glass Lewis' cut-off is 25 percent) will have to give a clear response on improvements to their pay practices if they want a 'yes' vote this year.

James Barrall of lawyers Latham & Watkins says the ISS policy 'puts 164 companies on the Russell 3000 Index in the crucible, including 50 S&P 500 companies.'

The most exposed, says Barrall, are the eight S&P 500 companies and the 38 Russell 3000 firms that got a 50 percent (or lower) support level.

GMI dubbed these results 'maybe on pay'; and Paul Hodgson of GMI suggested that where votes in favor were very low, this often prompted investors who had voted yes 'to take another look and see whether they were missing something.'

What they are typically looking for is any disconnect between pay and performance or between one company and the others in its peer group. But what does that peer group comprise and who decides this?

Anne Sheehan, director of corporate governance at CalSTRS, acknowledged in a Harvard Law School blog in late February 'the challenges companies face when selecting a peer group and that peer groups are entwined with performance measurement and compensation.'

But she charges that in some cases companies' justification for selecting a particular peer group 'is unacceptable because the number of companies in the group is too large, the sheer size of the companies is mismatched, or the peers are in an unrelated industry.'

Change in policy

ISS plans to evaluate CEO pay and relative performance against a peer group of its own choosing. This is a new policy for ISS, which says it will select peer groups of 14-24 companies on the basis of size (market cap, revenues, assets) and industry (the relevant Global Industry Classification Standard group).

It will also test the connection between pay and performance over the past five years, in another change from its past approach.

So companies have their work cut out for 2012. They will need a strong, clear narrative in their proxies on the question of pay for performance; and those in any doubt about the likelihood of getting a positive vote through should be engaging in active dialogue with shareholders sooner rather than later.

They might also think to include an executive summary at the beginning of the proxy statement, which proved popular with both shareholders and the SEC last year.

This year will at least be easier than 2013, when the SEC will have finally issued its disclosure rules on pay for performance.

In the meantime, in 2012, and for many years to come, the challenge for companies will be to bring their IR professionals and legal teams together to help senior managements and boards, wherever possible, to engage in constructive dialogue with shareholders – and just maybe find solutions in the common interests of both.