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PROXY SEASON 2014: MOVING BEYOND THE MANDATES

As proxy statements continue to evolve from SEC compliance documents to shareholder communications vehicles, it is more important than ever for companies to make them easier to read and navigate. Although there are no new disclosure requirements for 2014, many companies are providing disclosure that exceeds current mandates in order to help shareholders better understand company pay programs and decisions — particularly how pay relates to company performance. These enhancements have resulted in longer and more detailed proxies and concerns about "information overload," as noted recently by SEC Chair Mary Jo White. The SEC is currently seeking input from companies and investors on how to modernize and simplify disclosures to make them more useful to investors.

Even if the SEC decides to dial back the disclosure requirements, this may not result in shorter proxies as companies still must prepare for mandatory say-on-pay (SOP) votes and respond to demands for more transparency on pay and governance from institutional investors and proxy advisory firms. For example, even though the Dodd-Frank rules on hedging, pay for performance, and clawbacks are not yet in effect, many companies are addressing these issues in their proxy statements to improve SOP outcomes. Also, partly in response to proxy advisor and shareholder expectations, companies are enhancing disclosure on peer groups, shareholder engagement, pay practices, and risk mitigation.

IN THIS ISSUE, ANSWERS TO:

How did companies fare under say on pay in 2013?

Why are companies already addressing pending Dodd-Frank requirements?

How do the proxy advisory firms influence pay and governance decisions?

What has been the response to the proxy advisors' influence?

This *Perspective* lists steps that companies can take to improve their proxy disclosures and shareholder communications.

1. REVIEW 2013 SOP VOTE RESULTS AND TAKE ACTION IF VOTE WAS LOW

SOP vote results for 2013 for all companies were similar to those for 2012 and 2011:

- The percentage of companies that failed to receive majority support continued to be very low — about 2%.
- There was a clear relationship between companies' total shareholder return (TSR) and vote outcomes, as in prior years. For vote results greater than 90%, average TSR was 24%, while for companies that failed to receive majority support, average TSR was negative 1%.
- The impact of an "against" recommendation from a proxy advisory firm, such as Institutional Shareholder Services (ISS) or Glass Lewis & Co., was significant. In 2013, ISS recommended shareholders vote against SOP proposals at 12% of companies — the same percentage as in 2012 and close to 2011's 14%. Only about one out of every six companies that received an ISS "against" recommendation failed its SOP vote, but companies with SOP proposals that passed in spite of "against" recommendations had average favorable votes that were about 20%–25% lower than companies that received "for" recommendations.

Among S&P 500 companies, results have steadily improved: The percentage of companies receiving support above 90% increased from 64% in 2011 to 70% in 2012 and 75% in 2013.

Support of less than 70%–75% indicates that some shareholders are dissatisfied with certain aspects of the executive compensation program. Companies with low support should clearly explain in their 2014 proxy statements why shareholders that voted "no" in 2013 should vote "yes" in 2014.

2. USE TABLES, CHARTS, AND OTHER DOCUMENTS TO ENHANCE PROXY DISCLOSURES

A key goal of investor relations is to enhance proxy advisors' and shareholders' understanding of the company. The proxy statement should be a significant part of a company's overall outreach to shareholders on pay and governance issues. Companies are increasingly applying strategic communications expertise to enhance and support basic disclosures. Complex pay and financial information is best presented using tables, charts, graphs, pie charts, and infographics. Bulleted lists and plain language are easier to read than long blocks of dense, jargon-heavy text. Even the most informed shareholders will benefit when disclosures are easy to understand and key points can be quickly grasped.

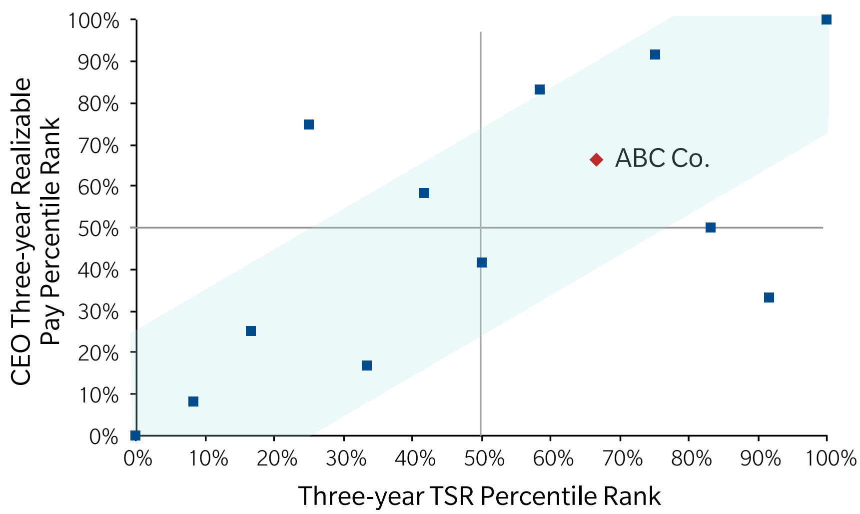
Along with employing better design and writing, companies may want to add communications documents that wrap around the proxy statement to support and explain it. A wraparound document could be a hard copy brochure, executive summary, or letter that summarizes the company's pay philosophy and practice in a well-designed and easy-to-read format. A company might consider posting a short summary about executive rewards on its website or redesigning the site's investor relations section to make pay and governance information easy to find and access. Using professional design and attractive images, a company can create a proxy statement that is as polished as the corporate annual report.

"THE PROXY STATEMENT SHOULD BE A SIGNIFICANT PART OF A COMPANY'S OVERALL OUTREACH TO SHAREHOLDERS ON PAY AND GOVERNANCE ISSUES."

3. DEMONSTRATE PAY FOR PERFORMANCE WITH REALIZABLE PAY

To provide a better comparison of pay and performance, many companies disclose realizable pay in proxy statements to supplement the summary compensation table (SCT) pay figures (see Figure 1).

Figure 1: Realizable Pay Disclosure Example (TSR Percentile Rank vs. Peer Group)



Realizable pay disclosure typically demonstrates how the pay that executives may actually receive varies with the company's performance. Although the term has no standard definition, it is typically the actual or potential value of compensation granted during a stated period, regardless of when it was received and is often presented as cumulative pay over three or five years. For example, realizable pay may include the in-the-money or Black-Scholes value of unexercised stock options at the end of the reporting period, rather than the accounting grant-date fair value.

Disclosing realizable pay may allow companies to influence the pending Dodd-Frank mandate to disclose the relationship between compensation actually paid to executives and corporate financial performance. The SEC has indicated it is considering a realizable pay approach as it drafts its proposed rules to implement the pay-for-performance disclosure mandate. The proxy advisory firms may consider realizable pay in analyzing pay-for-performance alignment in determining vote recommendations on SOP proposals. Also, a recent National Association of Corporate Directors report summarizing the group's views on communicating the link between executive pay and company performance recommends using realized and realizable pay and includes proposed definitions. As more organizations address realized and realizable pay, standard definitions are likely to emerge.

"MANY COMPANIES INCLUDE ENHANCED DISCLOSURE THAT MAY DEMONSTRATE TO SHAREHOLDERS AND PROXY ADVISORS THAT THE PEERS ARE APPROPRIATE COMPARATORS."

4. ENHANCE PEER GROUP DISCLOSURE

Current SEC rules require companies to disclose their use of benchmarking, identifying the benchmarks used to determine total compensation or any element of compensation and naming the peer group companies. Although the rules do not explicitly require detailed descriptions of the pertinent characteristics of the peer group companies, proxy advisors will consider a company's peers in making pay-for-performance comparisons, so companies may want to provide details. For example, in developing a peer group for its quantitative analysis of CEO pay and performance, ISS considers a company's self-selected peers in addition to other criteria. Glass Lewis also considers a company's pay and performance compared with its self-selected peers in analyzing pay programs.

Many companies include enhanced disclosure that may demonstrate to shareholders and proxy advisors that the peers are appropriate comparators. This disclosure might include revenue, net income, market capitalization, common industry gross margin, global presence, business complexity, and innovation emphasis.

5. LIST PAY PRACTICE DOS AND DON'TS IN PROXIES

Current SEC rules require companies to disclose material information about their pay practices such as policies for allocating between long-term and currently paid out compensation, between cash and noncash compensation, and among different forms of noncash compensation. Also, best practices, such as policies and decisions regarding clawbacks, the basis for selecting termination or change-in-control triggers, stock ownership guidelines, and pay benchmarking, should be disclosed if material.

Many companies provide enhanced disclosure of best pay practices in a detailed checklist format since proxy advisors weigh best and problematic pay practices in reviewing SOP proposals (see Figure 2). Also, current SEC rules on risk mitigation require companies to disclose compensation policies and practices that are reasonably likely to have a material adverse effect on the company. Although affirmative disclosure that there are no material risks is not required, many companies include a list of risk mitigation techniques (often in response to SEC staff comments or proxy advisors' policies). This approach allows the proxy advisors' analysts to check the appropriate box.

Figure 2: List of Pay Practice Dos and Don'ts

What we do:

- Review pay and performance alignment.
- Assess and mitigate risk in compensation plans.
- Include double-trigger change-in-control provisions for stock awards.
- Subject all incentive compensation to clawbacks.
- Prohibit hedging transactions and short sales by employees and directors.
- Prohibit employees and directors from pledging shares in margin accounts.
- Maintain robust stock ownership and retention guidelines.
- Mitigate the potential dilutive effect of equity awards through share repurchases.
- Review the independence of the compensation committee's advisors.
- Include pay caps on bonuses.
- Balance short- and long-term incentives, cash and equity, and fixed and variable pay.
- Include both quantitative and qualitative goals in incentive plans.
- Limit perquisites.

What we don't do:

- No employment contracts.
- No dividends on unearned performance shares.
- No performance share payouts for relative performance below peer group median.
- No repricing underwater stock options.
- No tax gross-ups on perquisites or excise tax gross-ups on a change in control.
- No bonus payouts when goals are not achieved.

6. ENGAGE WITH SHAREHOLDERS AND DISCLOSE THE ENGAGEMENT PROCESS

Under current SEC rules, companies must disclose whether and how they considered SOP vote results in determining compensation policies and making pay decisions. ISS and Glass Lewis, in particular, look for companies to explain how they engaged with shareholders to determine and respond to their concerns.

ISS policies state that companies with less than 70% support should disclose "engagement efforts with major institutional investors regarding the issues that contributed to the low level of support." These could be detailed descriptions of the number or percentage of shareholders contacted, engagement activities undertaken, and management and board members involved (see Figure 3). ISS also asks companies to include "specific actions taken to address the issues that contributed to the low level of support." Also, Glass Lewis may recommend voting against compensation committee members if support is 75% or less and the company failed to respond to shareholder concerns.

Figure 3. Disclosure of the Engagement Process Could Answer the Following:

Who	... were the team members from the company and the investors?
What	... were the key issues identified and discussed?
When	... will any changes or modifications be disclosed/implemented?
Where	... when, and how did the dialogue occur?
How	... will the company address the issues identified?
Why	... did the company select its plan of action?

7. ADDRESS HEDGING AND PLEDGING POLICIES

Under Dodd-Frank, the SEC must adopt rules requiring companies to state whether employees or directors can purchase financial instruments (for example, prepaid variable forward contracts, equity swaps, collars, and exchange funds) to hedge or offset any decrease in the market value of equity holdings.

Although the SEC has yet to act, companies are increasingly addressing hedging and pledging policies in their proxy disclosures. From 2009 to 2012, the percentage of Fortune 100 companies disclosing executive hedging policies rose from 46% to 90%, and the percentage disclosing director hedging policies increased from 12% to 50%, according to a 2013 Equilar report. This is in part because the proxy advisors have implemented policies on hedging and pledging. ISS views significant pledging and any hedging as a board failure of risk oversight. Glass Lewis has a 2014 policy calling on companies to prohibit hedging and will consider pledging policies in its SOP analysis.

8. ADOPT AND DISCLOSE A CLAWBACK POLICY

Current SEC rules require companies to disclose their material policies and decisions on the adjustment or recovery of awards or payments if the relevant performance measures on which they were based are restated. As a result of this rule and proxy advisor voting guidelines that consider clawback policies to be a best pay practice, many companies disclose clawback policies in their proxy statements. The percentage of Fortune 100 companies disclosing clawback policies rose from 18% in 2006 to 89% in 2013, according to an Equilar survey.

Dodd-Frank requires the stock exchanges to go beyond disclosure and adopt rules prohibiting the listing of a company's securities unless the company has a fairly stringent clawback policy. These policies must recover incentive pay from current or former executives paid during the three years preceding a financial restatement due to material noncompliance with securities laws. Although the rules are still pending, shareholders are not waiting for SEC and stock exchange action but instead are submitting shareholder proposals asking companies to adopt clawback policies with teeth. Several companies adopted stronger clawback policies in 2013 in response to shareholder proposals.

9. UNDERSTAND INSTITUTIONAL SHAREHOLDER AND PROXY ADVISOR VOTING POLICIES

To craft appropriate disclosure and prepare to respond to shareholder and proxy advisor concerns, companies should be familiar with the proxy advisors' voting policies as well as those of the companies' largest institutional investors. Although there were no significant changes in ISS policies this year, the 2014 policies include two updates on executive pay and board elections. One simplifies the relative degree of alignment (RDA) measure of the pay-for-performance test ISS uses to analyze SOP proposals, and the other tweaks the policy on board responsiveness to majority-supported shareholder proposals:

- Pay-for-performance assessment. One of ISS' three quantitative tests that screen for companies with pay and performance misalignment is the RDA test, which measures the relationship between a company's TSR rank and its CEO's total pay rank within a peer group. In 2013, RDA was measured over one- and three-year periods, weighted 40% and 60%, respectively. In 2014, ISS will calculate annualized TSR over a three-year period (or as many full fiscal years that the company has been publicly traded and has disclosed pay data, if less). With the elimination of the one-year period, companies whose relative performance improved over the three years will likely do worse under the new test than the old one, and vice versa.
- Board responsiveness. ISS' may recommend that shareholders vote against or withhold votes from a company's board of directors if the board failed to act on a shareholder proposal approved by the majority of shares cast in the last year.

"ONE PENDING DODD-FRANK REQUIREMENT THAT MOST COMPANIES HAVE NOT ADDRESSED VOLUNTARILY IS THE CEO/EMPLOYEE PAY RATIO."

Glass Lewis' 2014 updates addressed compensation committee and consultant independence and hedging and pledging, as noted above.

10. PREPARE FOR THE PAY RATIO RULE

One pending Dodd-Frank requirement that most companies have not addressed voluntarily is the CEO/employee pay ratio. This controversial provision of the act requires companies to disclose the relationship between the CEO's annual total compensation and the median annual total compensation of all other employees using the SCT definition of total compensation. For many companies — especially those with global operations, multiple lines of business, and decentralized payroll or human resource information systems — compliance will be challenging.

Most companies have never tracked the CEO/median employee pay ratio, and few investors have been seeking this information. This may be evidence that most companies, shareholders, and proxy advisory firms do not consider this information useful. Representatives from ISS, Glass Lewis, and some institutional investors have informally indicated they are not sure how they will use the pay ratio or how valuable it will be. They may be more likely to look at year-to-year changes for an individual company and not necessarily compare a company's pay ratio to those of its peers.

Companies should not try to calculate the actual ratio yet since the final rule could differ from the proposal and is unlikely to be effective until 2016 for most companies. But taking preliminary steps to figure out potential approaches and compliance costs, forming an internal team, and preparing a work plan will help with compliance when the rule is finalized — tentatively by late 2014.

PROXY ADVISORS' DE FACTO MANDATES CRITICIZED

Much of the pressure on companies to adopt best pay practices, enhance proxy disclosures, and actively engage with shareholders stems from the influence of the proxy advisory firms under an SOP regime. This influence — which many observers view as outsized — has triggered a call for review of the policies and practices of the proxy advisory firms themselves. Lawmakers, regulators, and other stakeholders have criticized the proxy advisors, citing the industry's domination by ISS and Glass Lewis and expressing concerns about their one-size-fits-all approach, conflicts of interest, and data accuracy.

There are several current initiatives in the US, Canada, and Europe to study the role and influence of the proxy advisors. Even if these initiatives result in changes in the proxy advisory industry, the influence of ISS and Glass Lewis is unlikely to wane quickly so companies should continue to consider their power over executive pay and governance decisions in the SOP context in 2014 and beyond.

ADDITIONAL RESOURCES

To learn more about some of the topics discussed in this article, see our prior *Perspective* issues:

- Proposed Pay Ratio Rule: Mercer Recommendations Would Reduce Costs, Improve Consistency (January 2014).
- The Role of Realized and Realizable Pay in Disclosure, Performance Measurement, and Compensation Planning (December 2013).

We also encourage you to visit our complete library of *Perspective* articles and visit

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