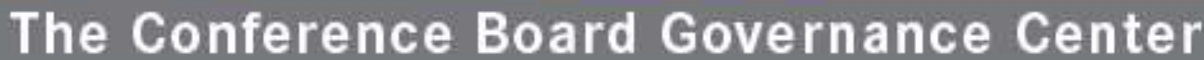

Myths and Realities of Say on Pay "Engagement"

Corporate America has weathered (with mixed results) two years of annual "Say on Pay" votes and is gearing up for a third. One theme which emerged during 2012 is that companies should not view the annual vote as a 60-90 day event that needs to be managed as best as possible given the hand the company has been dealt (or, in some senses, the hand it has dealt for itself). Rather, companies need to view Say on Pay as a year-round exercise in which the outcome of the annual vote can be positively affected if the company "engages" successfully with its investors on the topic of executive pay.

However, the meaning of the term "engagement" in this context is by no means obvious. And, while a number of companies have implemented sound engagement programs based on an accurate assessment of corporate governance dynamics, too many common prescriptions for engagement are based more on myth than reality.

Myth Number 1: Engagement means effective communication with portfolio managers and buy-side analysts about a company's strategy and the linkage of its executive compensation programs to that strategy.

Reality: Portfolio managers and equity analysts are largely, sometimes entirely, divorced from voting decisions on Say on Pay at most large institutions. Traditional IR communication channels and traditional IR communication strategies are at best of marginal utility in the world of Say on Pay. Say on Pay voting (along with all other shareholder votes on governance matters) at most large institutional investors is vested in a wholly separate group of corporate governance specialists, who typically answer to the general counsel or another senior administrative officer, not to the chief investment officer. While portfolio managers may have ability on paper to debate a proposed vote on a governance matter within the organization, most often the portfolio manager is put in the position of explaining why the institution's voting policies should be overridden. Needless to say, a portfolio manager has to care an awful lot about a governance vote to take on this burden. Most don't.

Myth Number 2: Engagement with corporate governance activists is like engagement with portfolio managers. The lingua franca boils down to corporate performance.

Reality: Not so, for many reasons.

- Say on Pay is truly about pay, not performance. It was not an isolated provision in Dodd-Frank, but rather one of several that were intended to reduce the size of executive pay in the US, including mandated disclosure rules for so-called "pay equity"—the relationship of CEO aggregate pay to that of the average pay for all world-wide full and part time employees.

- Corporate governance specialists are not trained investment professionals. Their discipline is not measuring company performance, but rather advancing corporate governance in accordance with their view of best practices. They assert that good corporate governance, on the whole, promotes good company performance. Accordingly, their mission is to insist on good corporate governance, not to determine whether a company is producing good or bad performance.

- In any event, corporate governance specialists in any institution are too few in number to deal with sophisticated, fact-specific measures of company performance across an institutional portfolio. They not only lack the skill set to judge the quality of performance, they lack the manpower to do so on a company specific basis. To the extent that performance is relevant to their decisions, they rely on simple one-size-fits-all metrics– such as Total Shareholder Return (TSR)– as the sole performance measure relevant to Say on Pay voting.
- Communicating to corporate governance specialists requires using their language and points of reference. Their world is one of corporate governance, not relative or absolute company performance. Communicating to them in the same terms as portfolio managers and equity analysts would be like speaking Swahili to an Inuit. Successful engagement in the realm of Say on Pay requires communicating about issues the governance specialist cares about in terminology the specialist can understand, not the issues a portfolio manager cares about in the terminology the portfolio manager can understand.

Myth Number 3: Say on Pay can be successfully dealt with by utilizing internal resources, except in a crisis situation, such as a negative proxy advisory recommendation.

Reality: Say on Pay is not an occasional crisis brought on by a specific failure to meet the metrics of the proxy advisors and corporate governance specialists. It is an annual recurring event that can all too easily threaten core relationships between a CEO and his/her board as well as among board members. There have been a number of instances where CEOs and/or Non-Executive Chairs have been severely embarrassed or forced to step down over failed Say on Pay votes, and far more instances where directors have been seriously embarrassed.

- Every Say on Pay vote at every public company should be viewed as a potential proxy contest and treated with the same degree of attention and expertise. As a matter of prudence, that means the company should consult with experienced outside counsel, proxy solicitors and corporate communication specialists.
- The team should be assembled well before the annual meeting and should be actively involved in the compensation committee's and board's deliberations on the executive compensation package for the forthcoming year.
- The team should also go through the standard proxy contest drill of obtaining the best available information concerning current institutional ownership, voting records and methodologies of those institutions on Say on Pay and governance matters and assessing, in advance, the pros and cons of the compensation decisions being considered by the compensation committee and the board.
- Say on Pay communication programs and outreach should not be reserved for the crisis of a negative Say on Pay recommendation by a proxy advisory firm. Rather, they should be viewed as part of a year-round, year after year program of successfully dealing with the separate universe of corporate governance specialists. This is what "engagement" means and what successful "engagement" requires.

Myth Number 4: Engagement amounts to a "schmooze" session or two, with a premium on a "feel good" outcome.

Reality: Engagement must be substantive and sustained to be successful. The point of the exercise is two-fold:

- First, to educate the company's corporate governance constituency about the positive aspects of the company's corporate governance, including in no small part the rationale for its executive compensation program and its relationship to the company's business strategies and priorities.
- Second, to listen and to respond to the reasonable concerns of the corporate governance constituency and, where possible, to foster a constructive dialogue and mutual understanding.

Obviously, a great deal of the engagement process depends on thoughtful and consistent messaging in terms the corporate governance community can understand and relate to. Beyond the fundamentals, however, a good corporate governance communications program should help frame the issues in terms most favorable to the company and, over time, it should challenge and, optimally, change the corporate governance community's appreciation of the company's commitment to effective corporate governance and its steps to achieve that goal.

Myth Number 5: Say on Pay will become more routine over time, and in due course Corporate America will weather this storm relatively "unscathed".

Reality: Say on Pay will not become easier to deal with over time. On the contrary, it is likely to continue to adversely impact much of the public company universe each year. Like it or not, every year every public company will have to face the critical issue of whether to tailor its executive compensation program to meet the latest and greatest Say on Pay metrics of the proxy advisory and activist governance community or to do what its board thinks "is right" under its particular circumstances.

Moreover, Say on Pay is not the only executive compensation hurdle companies will have to face in the future. Corporate governance activists won other significant victories in the Dodd-Frank legislation, which await SEC rule making for implementation but which are likely to increase the level of scrutiny surrounding executive pay. Today's annual Say on Pay campaigns are the tip of a much larger iceberg.

- One new provision requires the SEC to adopt rules requiring annual disclosure by every public company of the relationship of executive pay and company performance. While the SEC has yet to propose these pay for performance rules, few observers believe they will be favorable to public companies in their definitions and details.
- Dodd-Frank also requires the SEC to issue rules for mandatory disclosure of the relationship of the CEO's compensation to that of the average worker at the company, taking into account full and part time employees every where in the world. Aside from the huge burden companies will inevitably face in collecting world-wide compensation data, the outcome can hardly be viewed as a positive for current CEO pay levels. This rule is very plainly designed to embarrass CEOs and boards and to lead to investor and political pressure drastically to reduce CEO compensation in the name of "pay equity".

The stark reality is that Corporate America is facing a long-term challenge to its existing governance models, most particularly in the realm of executive pay. Companies cannot afford to deal with this fundamental challenge through one-off proxy-like contests on those occasions when their CEO compensation runs afoul of the proxy advisory metrics of the day.

Rather, public companies need to recognize that Say on Pay is just the beginning, not the end. To deal with this challenge requires a long-term view and a long-term communications program aimed at a fundamental reshaping of the thinking and voting of their institutional investors. The goal is to wean investors away from the simplistic one-size-fits-all metrics of the proxy advisory services or their own internal voting policies and to get the voting decision makers (corporate governance specialists and/or portfolio managers and analysts) to base their Say on Pay voting a more nuanced and fact specific understanding of each company's strategy goals and executive pay policies and practices.

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