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April 17, 2015

Shareholder Engagement on Executive Compensation
A Primer on the Why, When, Who and How?

As the 2015 proxy season enters the final stretch and shareholder votes are tabulated, calendar year public companies will be analyzing their Say-on-Pay outcome, lessons learned and next steps. While solid design and comprehensive proxy disclosure remain the most effective way to mitigate the need to defend a company's compensation policies and practices, direct shareholder engagement can help to clarify key issues and establish credibility with investors. Five years ago, the idea of board members and senior executives actively engaging in direct discussion with shareholders about executive compensation was almost inconceivable. Today, it is a rapidly growing trend that we expect to accelerate as shareholder interest in executive compensation policy and alignment between pay and performance continues to grow. The purpose of this article is to provide an overview of the shareholder engagement process with respect to executive compensation and related governance issues.

In general, interaction between shareholders and the directors and executives who lead companies happens formally once per year at the annual shareholders' meeting, as well as through the proxy solicitation process leading up to the meeting. "Shareholder engagement" is an opportunity to take this structured, single-point, annual interaction and transform it into an ongoing, less formal, two-way conversation.

For the company, shareholder engagement is an opportunity to inform, listen and solicit feedback from shareholders outside the formal proxy solicitation process. For shareholders, it is an opportunity to learn more about the company and how it is governed, and to express views on important topics in an informal setting. Without such opportunity, unhappy shareholders will express discontent by (i) abstaining or voting against the company's recommendations, (ii) selling their shares, or (iii) in the most extreme cases, launching a proxy contest or becoming an activist investor.

For public companies, shareholder engagement on corporate finance matters is long-standing and well established as evidenced by analyst earnings calls, investor days and corporate roadshows. However, shareholder engagement on executive compensation matters is a more recent phenomenon that began in the wake of "Say-on-Pay," which took effect for all US public companies in 2011 (see Appendix A for a historical timeline of the regulatory drivers that have resulted in greater shareholder engagement). Despite the fact that the Say-on-Pay vote is non-binding, it has transformed the manner in which executive compensation is designed, administered and communicated. There are several reasons why:

- The perception of a “pay-for-performance” disconnect invites investor activism and subjects the company to challenges regarding its organizational strategy and leadership

- Investor discontent over CEO pay creates leadership credibility issues and can demoralize the workforce, leading to further performance challenges. This is especially true in companies that have experienced financial difficulties resulting in low or no compensation increases for employees, benefit plan reductions and/or workforce reorganizations

- Failed or challenged Say-on-Pay vote outcomes attract unwanted media scrutiny to the company and call into question board governance and judgment

- Finally, challenged Say-on-Pay is not a single-year issue. Rather, a challenge in one year leads to increased scrutiny in the subsequent year, and failure to adequately address investor concerns may eventually lead to “against” or “withhold” votes on compensation committee member re-elections

Shareholder Engagement: Form and Objectives

In the executive compensation arena, shareholder engagement typically occurs in the context of one or a combination of the following scenarios:

☑ Part of a company’s **regular shareholder outreach** program

Regular shareholder engagement fosters a culture of transparency and openness, which helps establish credibility with investors. Companies that actively communicate with investors are more likely to establish goodwill and mitigate investor misunderstanding than those that reach out only in times of crisis.

☑ To **preemptively address** a potential pay-for-performance disconnect or a compensation decision that could be viewed negatively by investors

The goal of engagement in this scenario is to mitigate potential adverse investor and/or proxy advisory firm reaction to a perceived poor compensation decision or pay-for-performance disconnect by explaining the rationale for the compensation decision to shareholders. When executed carefully, this engagement can preempt a negative Say-on-Pay vote outcome by explaining and rationalizing to investors why a decision or action that may be perceived as inconsistent with “best practice” was reasonable and appropriate in the context of the company’s unique circumstances.

☑ To **firefight** a negative Say-on-Pay vote recommendation by the proxy advisory firms or the dissident view of an activist investor

In our experience, in the absence of a clear factual error, the proxy advisory firms are unlikely to be persuaded to change a negative vote recommendation. Thus, the goal of shareholder engagement in this context is usually to persuade institutional investors directly (and sometimes even retail investors) to disregard the proxy advisory firm’s recommendation. The effort can be time-consuming and have mixed effectiveness, as some institutional investors may have voting policies that align with their independent third-party proxy advisor. [1]

- ☑ To **recover** from a failed or low Say-on-Pay vote outcome

  A failed or low (e.g., below 70% support) Say-on-Pay vote is generally an indication that shareholders perceive a misalignment between executive pay and company performance (for example, CEO pay is in the top quartile of peer companies, but the company's total shareholder return is in the bottom quartile of its peers). A failed Say-on-Pay scenario is perhaps the most challenging and time-consuming type of shareholder engagement and may require significant changes to the company's executive compensation program to address the actual or perceived "pay-for-performance" disconnect and/or pay practices that are viewed as inconsistent with a performance-based compensation philosophy (e.g., bonus guarantees; payment of dividends or dividend equivalents on unearned performance awards; excessive severance provisions; etc.).

Shareholder Engagement: When?

Timing is driven by the reason for engagement and will vary depending on each company's specific facts and circumstances. For example, regular shareholder outreach typically occurs during a pre-set annual timeframe established by the company, firefighting a negative proxy advisory firm recommendation will typically occur during the final two weeks leading up to the annual meeting (i.e., following issuance of the recommendation), and recovering from a failed Say-on-Pay vote is a lengthy process that begins soon after the annual meeting, will span several months and may involve multiple meetings with the same investors.

In general, proxy advisory firms and institutional investors are most receptive to meetings during the proxy off-season (i.e., June to late fall time frame) and may refrain from communicating during a company's proxy solicitation period (i.e., the period between the proxy statement filing and the annual meeting date).

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[1] *An Overview of Proxy Advisor Say-on-Pay Recommendations*

When developing vote recommendations on Say-on-Pay proposals, each of the major proxy advisory firms -- ISS and Glass Lewis -- evaluates a company's executive compensation program on a holistic basis, which includes both quantitative and qualitative components. Both firms use the quantitative alignment between pay and performance (i.e., "pay-for-performance") as the foundation of their analysis. ISS focuses solely on the CEO and measures performance based only on total shareholder return. Glass Lewis focuses on all of the proxy officers and measures performance based on a multi-faceted proprietary model including GAAP financial measures and total shareholder return. Companies with strong alignment usually receive a "for" vote recommendation unless the absolute magnitude of CEO pay is deemed to be excessive or the company maintains problematic pay practices. Companies with "improper" alignment are subjected to a higher degree of qualitative scrutiny and are more likely to receive an "against" vote recommendation, especially if there are problematic pay practices or other policies that are deemed to be inconsistent with a pay-for-performance compensation philosophy.

Shareholder Engagement: By Whom?

Who should represent the company in front of shareholders depends on the reason for the engagement, the subject matter to be discussed and the severity of the situation. For example, in case of a failed Say-on-Pay vote, either the Chair of the Compensation Committee or non-executive Chairman of the Board would normally lead the shareholder outreach (as management will be viewed as conflicted), and shareholders are most interested in hearing from the individuals who made the decisions that led to the vote outcome. In contrast, regular shareholder engagement is typically conducted by members of management, which typically include representatives from investor relations, the corporate secretary's office and HR/Executive Compensation.

Some practical considerations are:

- Participants should be well prepared; they should know the proxy advisory firms' and institutional investors' voting policies, and how the company's compensation philosophy and pay design aligns with those policies

- Directors should be used strategically. Investors generally recognize that directors have limited time and therefore value receiving direct attention from a member of the Board

- If multiple participants are involved, messaging should be consistent and parties should speak with one voice

Shareholder Engagement: With Whom?

In order to determine which shareholders to engage with, the company will need to evaluate the company's ownership base (e.g., Institutional, Retail, Insider) and Say-on-Pay voting patterns, including whether the investor typically votes based on an independent analysis or follows the recommendations of a specific proxy advisory firm. Proxy solicitors can assist with this analysis by identifying the voting policies of the major investors.

Because companies do not have a "right" to convene a meeting with proxy advisory firms and institutional investors, the larger, well-known companies often find it easier to obtain meetings. Thus, the goodwill and relationships developed over time by a company's management team and/or members of the Board will be key to securing necessary meetings, especially for smaller organizations. Companies can also leverage relationships their compensation consultants have with the proxy advisory firms, as well as relationships their proxy solicitors have with institutional investors.

While it is natural to seek to engage with the company's largest shareholders, it is important to have a balanced perspective by meeting not only with investors who voted against the Say-on-Pay proposal (or abstained) but also those investors who voted in favor of the Say-on-Pay proposal. The goal of engagement is to identify areas of consensus, and determine reasons for divergent views on particular compensation decisions/actions.

Some practical considerations when engaging with institutional investors are:

- Know who makes the Say-on-Pay voting decision. For example, at some institutions the voting decision is made directly by the investment team, but at other institutions the voting decision is made by a separate governance team

- Know whether the institutional investor follows proxy advisory firm recommendations or has its own internally developed Say-on-Pay voting polices. Even investors with internally developed voting policies may nevertheless subscribe to proxy advisor reports and factor in the proxy advisor's recommendations

- To the extent proxy advisory firm recommendations are influential with the company's institutional investor base, consideration should be given to engaging directly with the proxy advisory firms

Shareholder Engagement: How?

The logistics of shareholder engagement will depend on the reason for the engagement. Thus, while regular outreach can be efficiently done telephonically, recovering from a failed Say-on-Pay vote is better conducted in face-to-face and one-on-one meetings.

Companies are also creatively engaging with retail investors on a "one-to-many" basis using broadcast media, investor information websites and blogs to mass communicate their message. In doing so, they are able to inform and shape "Main Street's" perception of an issue.

Some practical considerations on shareholder engagement logistics are:

- Determine the scope and complexity of any advance work that is needed for the engagement. When a company takes action that it knows may generate scrutiny from investors and influence the vote recommendations of the proxy advisory firms, prepare for the possible challenge in advance and be ready to explain and rationalize the decision

- Set a clear agenda to make sure topics that need to be discussed are adequately covered, and recognize the importance of ensuring that the meeting stays on topic to avoid triggering Reg. FD disclosure implications. Instruct directors and executives who are involved in the engagement to decline questions about unrelated topics that are better addressed as part of the ongoing, public engagement with shareholders (e.g., corporate strategy, financial results, CEO succession)

- Last, but not least, get full credit for engagement -- explain in the compensation discussion and analysis (CD&A) in next year's proxy statement, the shareholder engagement effort and actions taken that are responsive to feedback received

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<u>Appendix A</u>

Shareholder Engagement Timeline: Regulatory Drivers

- **2003 – Equity Compensation Plans Require Shareholder Approval**
  - Empowered shareholders by requiring a <u>binding</u> vote with respect to shares reserved for director, management and employee equity awards (with limited exceptions)
  - Investors begin to focus on company's share usage, dilution and burn rate
- **2009 – Introduction of Say-on-Pay for TARP Recipients**
- **2010 – Eliminated broker discretionary voting in director elections and executive compensation matters**
  - Previously, brokers were permitted to vote uninstructed shares in uncontested director elections and executive compensation matters; brokers typically followed the incumbent board's recommendations
  - Now, uninstructed shares cannot be voted and are considered "broker non-votes"; impact on ultimate vote result depends on state corporation law and a company's articles and bylaws
- **2011 – Say-on-Pay for All Public Companies**
  - Non-binding advisory Say-on-Pay vote on executive compensation at least every three years for all public companies
  - Say-on-Pay vote results (i.e., number of shares voted For / Against / Abstain / Broker Non-votes) have to be disclosed in Form 8-K filing
  - Although non-binding, investors now have a prominent and public forum to demonstrate their support or opposition to executive compensation decisions