COMPENSATION

THE RISE OF SHAREHOLDER OUTREACH

Assessing the need for shareholder engagement—and how to get it right.

IN RECENT YEARS, a door opened by the introduction of Say on Pay has been flung wider still. Shareholders who were once content with companies conducting outreach after a negative proxy vote surfaced now expect a more proactive approach to engagement, explains Matt Lum, a principal at FW Cook.

More and more actively managed and passive funds are pursuing open and continuous dialogues on governance and executive pay with their portfolio companies, says George B. Paulin, chairman and head of FW Cook's Los Angeles office. "Already, as large funds invest in governance infrastructure, we're seeing deeper dives into pay practices become a regular occurrence, not only something that occurs when there's a Say on Pay problem," he says. "That's likely to continue."

"Firms like BlackRock, Vanguard, State Street and Fidelity have been pushing for a more active, ongoing dialogue," agrees Lum. "So, rather than scramble and conduct outreach after a negative Say on Pay voting recommendation from proxy advisory firms, many companies are engaging with shareholders about compensation on a more regular, ongoing basis."

Many leading investment funds are developing their own internal governance resource and analytical capabilities, making it increasingly crucial that companies seek to identify and address concerns in advance of proxy season. Anticipating issues enables public companies to take defensive measures, says Paulin.

"We go through a process with companies where we project ISS's Say on Pay test numbers, simulating what the results will be if a company has done something unique that might potentially create some friction," explains Paulin. "It acts as kind of a leading indicator: Do you have an issue? Or will you be a low concern on the ISS quantitative analysis? Where there may be issues, we urge clients to be proactive in the way they write their proxy and in their engagement."

Areas of Risk

Identifying which compensation actions, if any, will serve as areas of risk for Say on Pay is a critical step in the process.

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Compensation Actions that May Require Outreach or Additional Disclosure

- ✔ Large sign-on package provided to a new hire
- ✔ Special awards
- ✔ Increases in compensation in a period of declining stock price performance
- ✔ Above target bonus payouts if total shareholder return is meaningfully negative
- ✔ Above target bonus payouts based on a lower financial goals compared to the prior year
- ✔ Payments provided to outgoing executives that are outside of a previously approved policy or plan, or in situations where severance payments are provided and the executives departure is described as "voluntary" or "retirement"

The table at left outlines some of these compensation actions that, if undertaken, will likely result in a need for shareholder outreach of additional disclosure.

In addition to practices like providing large sign-on packages to new hires, compensation increases at a time when share prices are declining and above target bonus payouts when TSR is negative, discretionary pay is another compensation practice that frequently comes under fire. Proxy advisory firms generally frown on the application of discretion when determining awards—by lowering goals midyear or increasing calculated payouts, for example. That, in turn, puts the onus on companies to defend discretionary pay by detailing the how and why behind its use.

"More and more, we're trying to make the case that there are metrics driving discretion or judgment; it's not just a whim," explains Paulin. "The same is true of special grants—we need to disclose why we're making them and how they are performance-based. There are a whole set of factors that need to be addressed defensively and proactively."

Using the CD&A as an Effective Shareholder Outreach Tool

Ideally, companies will assess potential areas of risk like these and address them in their Compensation Discussion and Analysis (CD&A), which has evolved from an SEC compliance document into one of the best tools in a public company's communications arsenal. "We need to be using CD&As in a way that tells our story in a unique way and that highlights some of the issues that proxy firms miss in their analysis," says Lum. "By explaining why we did things specifically this way, we can try to bring the reader into the committee's decision-making process." For example, a CD&A might outline the process the company followed for setting goals, demonstrate that the established goals are rigorous and provide the business rationale for any use of discretion and any special or unique compensation actions.

Done effectively, a CD&A can head off anticipated problem areas before proxy season by clarifying the rationale for them front and center in the executive summary. "Potential issues need to be addressed right up top, not buried in the legalese of the 20 pages of SEC-driven language that makes up the body of the proxy," notes Paulin.

How the approach proxy advisers and large investment funds use to evaluate long-term incentives (LTIs) is likely to play out for companies is another area worth examining, notes George B. Paulin. "Their analysis is based on information in the summary compensation table, which shows the accounting grant value of long-term incentives," he explains. "However, LTIs are primarily delivered based on performance, and you have to look somewhere else and be a relatively sophisticated user of financial statements to determine how much pay is really being delivered."

In practice, that means that a company may run afoul of Say on Pay standards due to having a plan with high grant values, even when grants aren't actually being earned based on company performance. Heading into proxy season, a company in that situation should consider attempting to explain the pay delivery, suggests Paulin. "Companies need to move the focus away from the summary compensation table grant date value—which may or may not be earned for performance," he advises. "You would want to make sure that you clearly articulate, 'Look, we're not paying out what's in the summary compensation table' in your communications with shareholders. That's the most compelling connection you can make."

The Need for Specific Shareholder Outreach Efforts

There are many circumstances that will call for companies to contact shareholders directly rather than just rely on the CD&A. "Where there are issues, such as when your total shareholder return performance doesn't support your disclosed pay, you're going to have to do certain things in your disclosure, and you're going to have to aggressively, proactively reach out to your big investment funds."

Outreach efforts vary, but companies generally reach out to five to 10 of the largest shareholders at a minimum, seeking to meet with a portfolio manager or a governance/portfolio engagement team, depending on who is responsible for voting the shares. When discussing executive compensation and governance, a company should be prepared to address the following:

• Rationale behind the company's compensation philosophy and compensation strategy;

• Specific circumstances that influenced the administration and execution of the company's compensation programs; and

• Proxy advisory firms' view of the company's compensation programs.

• Wider-ranging conversations that may delve into other areas of shareholder interest, such as environmental, social and governance (ESG) issues.

This is the first of a two-part series on shareholder outreach. The next installment, to be published in the Q3 issue of CBM, *will focus on best practices in analyzing and responding to shareholder feedback.*

Matt Lum, a principal at FW Cook, has extensive experience working with companies on aligning incentive plans with long-term strategy, advising on total compensation structures and comparing pay and performance.

George B. Paulin, chairman and head of FW Cook's Los Angeles office and the company's former president and CEO, is widely recognized as an authority on strategic executive compensation program design across industries.