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Shareholders Have Their Say on Pay, But What Are the Proxy Advisory Firms Saying?

By Erin McNally **August 2011**

This is a the second part of the two-part series Alliance Advisors has published on year one of mandatory Say on Pay. Part one was published two weeks ago.

Alliance Advisors looked at a sample of 20 companies of various market cap size and industries that received a negative recommendation on the Say on Pay (SOP) proposal between January and June of 2011. The following is an analysis of the factors driving the negative recommendations of Institutional Shareholder Services (ISS) on SOP for the 2011 proxy season.

While there were a few cases where ISS came out against the SOP proposal due to a single, fundamental rationale (such as an amended change-of-control agreement with excise tax gross-up provisions), most of the 'no' recommendations we found were a composite of ISS's pay-for-performance and problematic pay practice policies.

Pay for Performance Disconnect

Without question, the primary driver of ISS's negative recommendations on SOP was a pay-for performance disconnect. This disconnect is loosely defined as 1- and/or 3-year total shareholder returns (TSR) below a company's GICS code industry median and a corresponding rise (or moderate decrease) in CEO year-over-year total direct compensation (TDC) that is not linked to performance[1].

In these cases, ISS looked at, among other things:

- The magnitude of the pay increase and whether the increase was performance-based;
- A review of TSR and CEO pay levels over a 5-year period;
- The rigor and transparency of a company's short and long-term incentive compensation plans;
- The presence of any problematic pay practices.

Note that a frequent critique of ISS's pay for performance policy among institutions that have their own internal guidelines (i.e., do not follow the ISS recommendation) is that ISS puts too much weight on the 1-year TSR and 1-year CEO pay changes. Although these institutions are looking at TSR and CEO pay, the feeling is that three- and five-year periods are more appropriate time frames to analyze SOP.

Nature and Size of the Pay Increase

Of the 20 company reports Alliance reviewed, over half (13 companies) received a negative ISS recommendation primarily because ISS attributed the pay increase to non-performance-based pay.

In these cases, ISS recommended against the SOP where they determined that the main driver of the pay increase was what they consider to be non-performance-based pay, which typically included: time-based restricted stock, traditional stock options, and/or discretionary/subjectively determined incentive cash awards. Too often, what a company typically considered to be performance-based compensation, ISS did not. In one instance, we noted that ISS penalized a company because the annual bonus awards for the year did not qualify under Section 162(m).

[1] ISS defines total direct compensation as the sum of base salary, bonus, non-equity incentives, stock awards (full grant date value), option awards (ISS uses a Black-Scholes model, which typically assigns a higher value than what is reported in the proxy), target value of performance shares/units, change in pension value and nonqualified deferred compensation earnings and all other compensation as disclosed in the proxy statement.

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In several reports, ISS cited the magnitude of the pay increase as the chief reason for the negative recommendation. While ISS does not disclose a quantitative measure of what they consider to be "excessive" pay, Alliance found a few consistent features across the sampled reports:

- Pay increase greater than 20 percent year-over-year;
- Nominal increase (less than 10 percent), but the CEO's TDC for the fiscal year was found to be significantly higher than the ISS-selected industry peer group median;
- When the increase was below 20 percent and a cash or equity award was significantly larger than similar awards made to the peer group CEOs;
- Compensation committees that benchmark CEO pay above the median of the company's peer group.

ISS may also say 'no' not only on the SOP but on an equity plan (where the CEO participates) when the increase is attributed to non-performance based equity compensation. This was the case at one company in our sample group where the main driver of the CEO pay increase were non-performance-based equity grants, and ISS recommended against both the equity plan proposal and the SOP proposal. In its analysis, ISS further pointed out that the new employment agreement with the CEO increased the target long-term incentive awards from 300 percent of base salary to 350 percent of base salary, which indicated an ongoing practice of awarding large, non-performance based equity grants.

Short and Long-term Incentive Programs

While ISS faulted companies where they deemed the incentive program to be too discretionary, they also took issue with short- and long-term incentive programs at 15 companies in our sample group for a lack of disclosure and/or rigor of performance metrics. Alliance also found that even with disclosed performance metrics, ISS criticized a program if there was any subjective evaluation of achievement of performance measures by the compensation committee in determining an award.

It was clear from the sample companies that ISS wanted to see specific, objective hurdles and the required results that drive incentive payouts. ISS also criticized specific features of incentive programs that it claimed motivated excessive risk taking, such as:

- If there was a carryover or a carryback of performance results over a 5-year period;
- The use of an "alternative goal methodology" that provided for a full award as long as one of multiple goals was met;
- A reduction of minimum return on assets threshold from 15 percent to 5 percent because the company had not paid out cash bonuses for the past 3 years;
- Usage of the same performance target on a 1-year performance cycle for both short- and long-term incentive plans;
- COO received the same 'significant' bonus payment amount as the current CEO;
- The compensation committee moved away from performance-based pay by restoring the practice of granting time-based restricted stock and stock options.

Problematic Pay Practices

What ISS considers to be the most problematic pay practices, such as new or amended employment or change-in-control (CIC) agreements that contain excise tax gross-ups or single-trigger severance benefits, caused ISS to recommend against the SOP regardless of other factors. ISS policy on tax gross-ups states that if the company should enter into new or materially amend employment/severance/CIC agreements with the named executive officers (NEOs), they will recommend against the SOP proposal. (Note that in the 2010 proxy season, ISS recommended against/withhold on compensation committee members where there was a

problematic pay practice and no SOP proposal was on the ballot.)

Three companies in the sample group filed new or amended agreements in the last fiscal year that contained a gross-up benefit related to CIC-related severance payments. In one instance, the amended agreement with the CEO provides excise tax gross-ups on the CIC-related vesting of equity awards made under the previous employment agreement, but prohibits tax gross-up payments on future equity awards granted under the new agreement. ISS took issue with the fact that the company did not eliminate the gross-up provision entirely.

In addition to single triggers and excise gross-ups in new or amended employment agreements, the following problematic pay practices in general, as defined by ISS, are sufficient enough to generate an 'against' recommendation from ISS:

- Repricing or replacing of underwater stock options/SARS without prior shareholder approval (including cash buyouts and voluntary surrender of underwater options);

- Excessive perquisites or tax gross-ups, including any gross-up related to a secular trust or restricted stock vesting;

- CIC severance formulas exceeding 3 times base salary and bonus.

Alliance noticed a situation with one of the sample companies where the CEO and other executives were reimbursed for tax payments and gross-ups in connection with Social Security and Medicare taxes. Note that the company did not have a pay-for-performance concern (as defined above) but the tax reimbursement payments and gross-ups themselves were enough to trigger an 'against' recommendation from ISS.

Aside from the problematic pay practices that we call 'automatic triggers' for a 'no' recommendation, ISS also deems other types of compensation as problematic, the presence of which carry significant weight in a negative assessment. In the Alliance sample group, these pay policies alone did not cause ISS to come out against the SOP; however, these practices, coupled with lagging shareholder returns and increased CEO pay fueled the negative recommendations:

- Large pensions and supplemental pension agreements that add additional service credit for years not actually worked;

- Personal use of company's aircraft;

- Large relocation and home loss benefits.

ISS also recommended against SOP at a company that did not have a pay-for-performance issue or any automatic triggers for an 'against' recommendation; but where ISS found the pay practices too unreasonable. Specifically, ISS took issue with the fact that the pay levels were increased in pre-existing consulting agreements with two former executives and directors. ISS had criticized the consulting agreements in prior years and used the SOP proposal to penalize the company in 2011.

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Industry-wide Snapshot of ISS Against SOP Recommendations

Alliance also looked at ISS SOP recommendations on an industry-specific basis, as determined by GICS code.

There were three industries where 20 percent or more of the companies received an against recommendation: Energy, Food Staples & Retailing, and Diversified Financials.

Industry	# of Companies	ISS FOR	ISS AGAINST	ISS % FOR	ISS % AGAINST
Food Staples & Retailing	14	11	3	78.60%	21.40%
Diversified Financials	83	66	17	79.50%	20.50%
Energy	142	113	29	79.60%	20.40%
Media	51	41	10	80.40%	19.60%
Retailing	93	78	15	83.90%	16.10%
Commercial Services & Supplies	68	59	9	86.80%	13.20%
Food, Beverage & Tobacco	46	40	6	87.00%	13.00%
Pharmaceuticals & Biotech	135	118	17	87.40%	12.60%
Consumer Services	73	64	9	87.70%	12.30%
Capital Goods	199	175	24	87.90%	12.10%
Consumer Durables & Apparel	60	53	7	88.30%	11.70%
Real Estate	139	123	16	88.50%	11.50%
Banks	195	173	22	88.70%	11.30%
Healthcare Equipment & Services	154	137	17	89.00%	11.00%
Insurance	98	89	9	90.80%	9.20%
Materials	114	105	9	92.10%	7.90%
Transportation	51	48	3	94.10%	5.90%
Automobiles & Components	22	21	1	95.50%	4.50%
Household & Personal Products	11	11	0	100.00%	0.00%

Data: ISS for Russell 3000 companies for Jan.1, 2011 – July 26, 2011.

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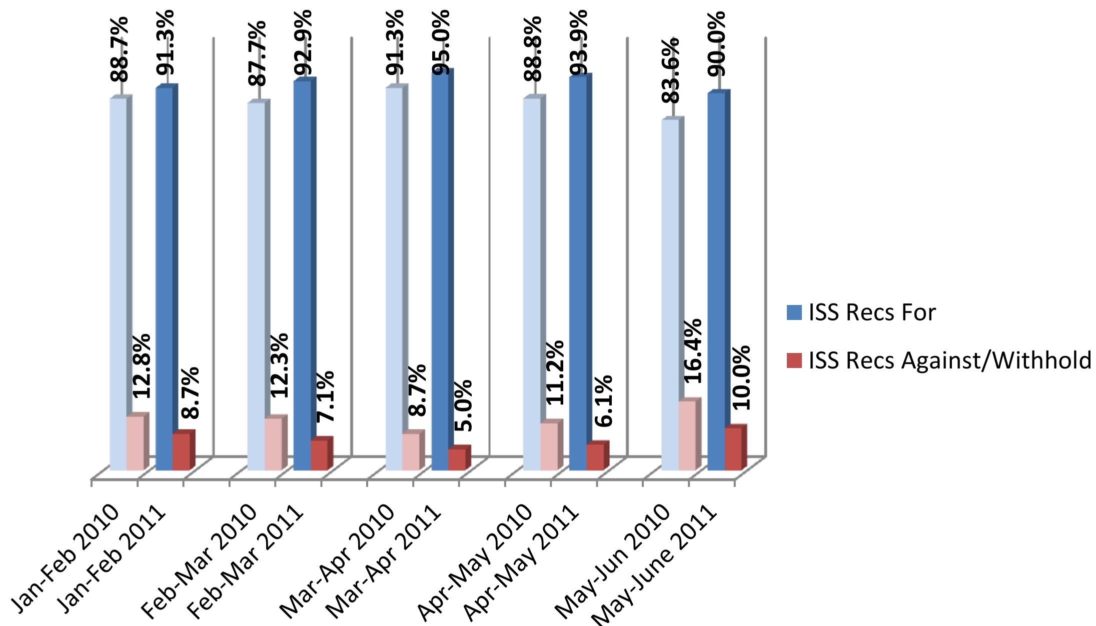
SOP and Director Elections

Historically, when ISS determined that a company had a pay-for-performance disconnect or problematic pay practices, they issued against or withhold recommendations on compensation committee members (or potentially other directors when no compensation committee members were up for election at the annual meeting). With the advent of mandatory SOP proposals, ISS has used the SOP as the main vehicle for criticism of a company's pay practices and has recommended against directors less often this year than in past years.

To test this 'SOP as a shield' policy, we looked at ISS recommendations and voting results for meeting dates between January 21 (six months after the enactment of Dodd-Frank) and June 21 for both 2011 and 2010. In 2010, there were 13,390 proposals to elect directors, and ISS recommended against or withhold in 1,664 instances, or 12.4 percent of the total. In 2011, there were 13,009 proposals to elect directors, and ISS recommended against or withhold in 931 instances, or 7.2 percent of the total, representing a 78.7 percent decrease from 2010. The average percentage of FOR recommendations for directors in 2010 was 94.1 percent, while the average percentage FOR recommendations increased to 95.3 percent.

The following graph illustrates the reduction in ISS against/withhold recommendations for the same months of the 2010 and 2011 proxy seasons (January 21 – June 21).



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On par with ISS, GL also uses the SOP proposal as the initial means of criticizing a company's compensation practices. However, GL's policy on SOP is much less transparent than ISS's, and therefore more difficult to gauge. We found that a large part of what informed GL's negative SOP recommendations this year was its' proprietary pay-for-performance model that assesses company's performance relative to NEO pay, and subsequently issues a 'grade' of A to F. If a company paid more to its NEOs than its peers, but performed below its peers, then GL will issue a low or failing grade.

If a company receives an 'F' under the model for the most recent fiscal year, then GL will recommend against the SOP. Also, a history of deficient or failing grades GL over the last 3 years will most likely cause GL to come out against the SOP. In addition, GL will recommend against both the SOP and compensation committee members if the company receives an F and they find "egregious" pay practices. While GL does not codify what constitutes problematic pay practices like ISS, there are certain issues that weigh heavily on a negative recommendation, such as: excessive bonuses and equity awards that are not clearly linked to performance, discretionary bonuses paid when performance targets are not met, large supplemental pensions and severance payouts.

In a comparison of 6 companies in our sample group that received a 'no' vote on the SOP from ISS, GL recommended against 3 of these companies and supported the other half. Each of the three companies GL came out against had received deficient or failing grades (D or F) for the current fiscal year or the last 3 years under GL's pay-for-performance metric. GL also noted the absence of performance-based pay at these companies, whether it was time-based restricted stock grants or subjectively determined incentive awards. Nonetheless, it appears the main driver of GL's negative recommendations was a poor grade under its pay-for-performance model.

Conclusion

What are some of the key takeaways regarding the largest proxy advisory firms and SOP? First and for most, companies need to perform well. Obvious enough…but having a 1- and/or 3-year TSR above the industry median and positive grades under GL's pay-for-performance model will go a long way in avoiding a negative SOP recommendation. Second, companies need to be mindful of problematic pay practices such as single trigger CIC agreements, "excessive" perks, discretionary bonuses, and excise tax gross-ups. As we've seen in our sample group of companies, the existence of these 'automatic' triggers of an against recommendation can trump a company's positive performance record.

In the Dodd-Frank era the proxy statement is a marketing document, and companies need to be as transparent as possible in it, for example disclosing performance metrics, bonus targets, and employing objectively-based short and long-term incentive plans. ISS and GL like to see a link between pay and performance. When there is a questionable pay practice, such as a large non-performance based cash award, a company is advised to divulge the complete details and rationale underlying the compensation decision.

A negative ISS recommendation is not the kiss of death for the SOP proposal, however. To date, ISS has recommended against about 12 percent of SOP proposals in the Russell 3000 (It is estimated that GL has recommended against about 17 percent of SOP proposals thus far in 2011). However, only 1.5 percent of all proposals have failed. Looking ahead, however, where there is a negative recommendation in 2011 and the company fails to show movement toward addressing the issues raised, ISS and GL may take action against compensation committee members in addition to the SOP for 2012 – this is more likely if the SOP vote failed. Admittedly this one of the biggest open SOP questions for 2012.

What are the proxy advisors (and shareholders) going to want to see a company do to respond to not only a failed SOP vote, but a vote that received support from 75 percent, 65 percent, or 55 percent of the shares cast?

It is advised that that all reporting companies tell and defend their compensation story to their shareholder base. A key part of this strategy involves understanding who the shareholders are, the level of influence of ISS and GL at these institutions, and identifying those institutions that use their own internal proxy voting guidelines. This outreach is even more important for companies with negative recommendations from the proxy advisory firms and a failed SOP vote that chose not to adjust their executive compensation program.

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