GOVERNANCE CHALLENGES 2018

Board-Shareholder Engagement in the New Investor Environment

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Communicating Executive Pay in a New Era

By David Swinford, President and CEO, Pearl Meyer, and Jannice Koors, Senior Managing Director and Western Region President, Pearl Meyer

The current business climate—and that of the foreseeable future—points to an increase in organizational transparency and accountability. Stakeholders have found their voice. Major shareholders, institutional investors, activists, employees, pension funds, labor unions, and the general public are all becoming more outspoken about their distinct and sometimes conflicting interests in public companies.

Executive compensation per se is not always a top agenda item for these various stakeholders. That said, they look at disclosures around executive pay and will often infer corporate priorities based on what's said—and what isn't. Here, we outline guidance for boards about how to communicate the link between their pay programs and their business strategy and how to do so as clearly and openly as possible. And should companies become embroiled in a situation that calls for a defending response, we suggest how to meet that challenge and how to benefit in the future from lessons learned.

Rely on best practices to guide transparency and communication to all stakeholders.

When thinking about shareholder engagement, official channels of communication such as annual meetings or structured conference calls may come to mind. Directors we've spoken with say that, in general, the compensation committee does not regularly or proactively meet with shareholders and instead relies on the important compliance-based communication roles of investor relations (IR) and the general counsel.

Deborah Ellinger, lead independent director at iRobot, confirmed that view, but added, "Shareholders do occasionally request a direct line to the comp committee, especially in proxy season. If there is a very specific request, IR will manage the process. They gather the relevant information and make sure it meets the applicable disclosure standards."

She also notes that there have been exceptions at times when the compensation committee "wanted to get input from our shareholders on a specific topic and we reached out to invite that conversation."

While one-on-one conversations and how these interactions are managed may be one component of the strategy, the heart of external communication lies in the annual proxy statement. The Compensation Discussion & Analysis (CD&A) section should encapsulate all information relative to executive-compensation design and its implementation. According to a 2015 survey, "59 percent of institutional investors use proxy information for investment decisions."[1]

While the CD&A is technically a report to shareholders, as a publicly available document it is also a primary source of information for other interested stakeholders—employees, competitors, customers, suppliers, media, and the local community. We can expect that general awareness of the CD&A is likely to increase in 2018, with the first round of required CEO Pay Ratio disclosures. Given the potential for more interest from more parties, any perceived lack of wanted or needed information, or a narrative that is vague or confusing, could spark an issue.

However, when done well, the CD&A can provide compensation committees with a way to seamlessly deliver full transparency and offer clear rationale for the company's pay programs. It's the best vehicle for outlining how performance-based programs work and for explaining how the metrics they are based on drive the business strategy.

[1] https://www.gsb.stanford.edu/sites/gsb/files/publication-pdf/cgri-survyey-2015-deconstructing-proxy-statements_0.pdf

The most effective CD&As clearly explain plan design decisions, such as why certain metrics and goals are used in the short-term award program or how the committee determined the balance between time-based and performance-based long-term incentives. The committee might proactively clarify notable differences between realizable pay and the Summary Compensation Table data or discuss the board's views on what constitutes "long-term." The storyline—in plain English—weaves together all components of pay to reflect a carefully constructed program and provides data to show the pay program's results.

One future subject for compensation committees to bear in mind comes courtesy of tax reform and the removal of the Section 162(m) rule. While many directors agree that there aren't likely to be sweeping changes in plan design immediately for most companies, and many compliance experts believe that it may take time for the proxy advisory firms to clarify and codify their positions, the new law does represent an opportunity for change. As your committee talks through the pros and cons of any structural plan changes, it's critical that they are discussing at the same time, "How would we communicate this?"

Cynthia Jamison, director at Tractor Supply, Office Depot, Darden Restaurants, and Big Lots, notes, "In general, investors don't want to talk about tax law. They want to talk about business strategy. To that point, with or without 162(m), directors should make sure pay and performance are aligned."

The Four W's of Engaging with Shareholders on Compensation

What – The most valuable use of any time spent with shareholders is listening. Rather than focusing on promoting an agenda or telling a story, use outreach as an opportunity to learn about the shareholder's outlook on your programs and allay any concerns before they become larger issues.

Why – Consider the value of building important shareholder relationships. Time and effort spent promoting dialogue and building an atmosphere of trust can be a valuable investment in deterring activism. At a minimum, even if no conversations take place, the very act of being available to shareholders signals a willingness to be open and transparent. Practically speaking, it can also guide the company's compensation disclosure to a wider audience.

Who – In the normal course of business, most basic queries from shareholders regarding executive pay can be handled by management, typically by the general counsel and investor relations, and in some cases by senior HR staff and the CFO. These management teams should then provide reports and feedback to the compensation committee. However, if compensation becomes a point of contention, especially concerning the CEO, a board leader (committee chair, lead director, etc.) may need to directly engage with shareholders.

When – Proactively reach out to shareholders on an annual basis as a normal course of business. Select a time of the year when both sides are best able to schedule a discussion.

Defend your programs when required, but do so carefully.

Even the best plans can be met with criticism. After a proxy advisor no-vote recommendation, under the glare of the media spotlight, or during an activist assault, you may need to determine how you can defend your compensation program without appearing defensive.

The best first step may be going back to your core communication. Can the issues raised be addressed with information already available in the proxy disclosure? Perhaps expanding on that information by providing additional examples or data, or offering to clarify certain points will suffice. Some boards choose to make their compensation consultant available for specific technical inquiries.

Any deeper investigation of your compensation program by stakeholders likely means both the board and management are fielding complicated questions, possibly from different angles. This is where an explicit board policy on outbound communication, preferably one that outlines how questions are handled based on the constituency, will be helpful. Ensure that the board's policies complement corporate policies and that the board and management are in lockstep.

When activist investors are in the mix, bear in mind that they are likely to implicate both management and the board, citing a laundry list of alleged failures. Directors and experts agree that while executive compensation is not typically the catalyst for aggressive investor actions, it is frequently used as "proof" of board mismanagement. The assessment of pay and performance may prove to be one of their more antagonistic arguments.

Jamison advises targeted companies to ". . . look to the same things that ISS [(Institutional Shareholder Services)] looks to. If an activist is targeting a company, they will meet with ISS as part of their push to vote their slate. Examine ISS's definitions of performance, even if they aren't your definitions, and then do a really good job explaining how your pay and performance are defined and the rationale behind them."

Ellinger says, based on experience, "You must communicate with activists to understand their perspectives, but there has to be heightened awareness and care when dealing with them. I'm not as concerned when the conversation is with a shareholder with whom you already have an ongoing dialogue, but with an activist there is a higher risk that something could be misconstrued, no matter how careful you are." She advises, "Try to have more than one person in the room."

Jamison agrees. "There's always the risk that directors have the best of intentions in answering questions, but the conversation can quickly and inadvertently veer into territory that is nonpublic."

The perception of a conflict of interest in the company's senior management discussing CEO/executive pay programs may necessitate direct board involvement. But that doesn't mean directors should be "flying solo." Communications should be coordinated with management, especially the office of the general counsel who will already be integrally involved in any publicly contentious circumstances.

Once you've weathered a crisis or witnessed others do so, what lessons can you take away?

Activist investor case studies and high-profile media stories are in abundant supply. Boards can safeguard their executive compensation position with a periodic review of what's happening in the market. Combine structured Monday-morning-quarterback discussions on sticky issues and how they could have been better managed with a checklist for self-assessment.

- ✔ Develop complementary board- and committee-level policies for both shareholder engagement and broader stakeholder communication.
- ✔ Implement a periodic review (an annual review, at least) of these policies at the board and committee levels and update as needed, particularly in light of any recent issues or lessons learned that need to be factored in.
- ✔ Assess compensation-related risks, perhaps prior to the development of the annual CD&A:
    - Has the board been selective using discretion when determining payouts and has it clearly communicated its reasoning?
    - Are any disconnects between payouts and total shareholder return clearly explained?
    - Has the committee provided a clear explanation for its selection of peers and/or its market-based targets?
    - Does the compensation program in any way reward behaviors that will be counter to either the business strategy or environmental, social, and governance issues?
- ✔ Determine if the board itself has any deficiencies that might spark investor attention or provide an add-on issue to a complaint, such as "exorbitant" director pay or significant gender or racial imbalance.
- ✔ Evaluate relationships with proxy advisors and, where possible, encourage ongoing dialogue.

If deeper analysis is warranted, the committee may choose to reflect on other issues the company faced and what unanticipated questions had to be managed. Were there any concerns that focused elsewhere, but could have had a "dotted line" to your pay programs? For example, Ellinger noted that during a period of activism with one of her boards, "The specific topic of executive compensation didn't come up during those conversations; that simply wasn't the hot topic for them. However, we did have some spirited discussions about peer goup comparisons, and that can affect compensation."

Finally, citing a need to strike a balance, Jamison cautions against the reactive impulse to do too much after a crisis. "There is always a risk that the board could 'over engage.' You don't want to appear to be in an ongoing defensive posture and you don't want to overplay the engagement card."

1515 N. Courthouse Road, Suite 1200
Arlington VA 22201
Phone 571-367-3700
NACDonline.org

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