December 12, 2013

Compensation Season 2014: Shareholder Engagement

For many public companies, the new year marks the beginning of compensation season. As in years past, we have set forth below some of our thoughts on what to expect from the current compensation environment. Unlike previous years, the upcoming proxy season is not marked by new legislative or regulatory developments. And, as described in our memorandum of November 26, 2013, the Institutional Shareholder Services (ISS) voting policies regarding compensation matters have remained largely unchanged. The most significant development this proxy season is the continuation of a single trend: increasing levels of shareholder engagement.

Why Has Engagement Become More Important? Since the implementation of the mandatory say on pay vote, it has become increasingly important for companies to consider engaging with shareholders about executive compensation. While initially it seemed that engagement was advisable primarily in cases in which a company received a “no” recommendation from ISS on say on pay or other negative feedback from significant shareholders, it has become evident that shareholder outreach may be beneficial, regardless of the prior year’s say on pay results. As noted by SEC Chairman Mary Jo White, at a recent corporate governance conference, the advice on how to respond to shareholder engagement has evolved significantly – “[t]he process has become less defensive and more proactive.”

This development has occurred because now, more than ever, company performance – which is by nature less predictable than shareholder reaction to pay practices – drives say on pay recommendations and voting at least as much as pay practices. Consequently, all companies are susceptible to a “no” recommendation or vote based on a perceived disconnect between pay and both absolute and relative stock price performance, regardless of how carefully they adhere to so-called “best practices” in matters of compensation. As such, while it is not necessary for companies to adopt a written policy on shareholder engagement, companies should have a well-considered strategy for engagement.

Who Are Our Shareholders? The first step in developing a shareholder engagement strategy is identifying a company’s top shareholders. Identifying these holders, which typically will be large institutions, focuses a company’s outreach efforts. Many companies attempt to reach out to the top 20 holders, although the actual number of shareholders with whom a company ultimately engages should be based on the concentration of ownership, the willingness of shareholders to engage and the availability of company resources.

What Are Their Policies? Once the most significant shareholders are identified, it is important to discern their voting policies. Some shareholders follow the recommendations of ISS or Glass-Lewis without deviation. Others vote according to their own policies. Still others will generally vote as ISS or Glass-Lewis recommends but are subject to persuasion in certain circumstances. While there is no need to conform executive pay practices to the standards of any particular shareholder, companies should understand where their practices differ from those standards and be prepared to explain why those deviations are appropriate.

Understanding the policies of individual shareholders will also enable companies to focus their efforts on those investors that will thoughtfully consider a compensation program. As described below, most large institutions (*e.g.*, Fidelity, Vanguard, Blackrock) have dedicated teams that make proxy voting decisions based on their own guidelines, are not beholden to ISS or Glass-Lewis recommendations and, in our experience, are more willing to listen and respond to reasonable explanations of company-specific pay practices than are the proxy advisory firms.

<u>When Should We Engage?</u> While it may be attractive to focus on shareholder outreach solely during the proxy season, it is advisable to engage with shareholders at other times of year. For smaller companies or for companies for which a particular shareholder's holdings represent only a small portion of a portfolio, it may be easier to get the attention of the shareholder when the shareholder is not inundated with requests from other companies. Also, developing relationships with the appropriate persons at institutional investors and getting a company's executive compensation story out at a less frantic time of year may make it easier (or, in fact, possible) to get the attention of shareholders if unexpected issues arise with the proxy advisory firms or otherwise during proxy season. Finally, communicating with shareholders in advance of proxy season will reduce the possibility of a surprise voting position arising in the middle of proxy season.

<u>With Whom Should We Engage?</u> It is important for companies to identify who the decision makers are at the shareholder with respect to the say on pay vote. In some cases, the portfolio manager makes determinations regarding say on pay. More commonly, at large money managers, the institution delegates decisions on compensation matters to a separate governance team which has sole authority for say on pay voting decisions. At some institutions, multiple groups may share responsibility for say on pay voting decisions. Regardless of the identity of the individuals at the shareholder charged with responsibility for the say on pay vote, it is important for the individuals at the company charged with shareholder outreach on executive compensation to coordinate with internal and external investor relations professionals to ensure a holistic approach.

<u>Who Should Engage?</u> There is no easy answer to the question of who should spearhead company outreach. We have heard from many institutional investors that interaction with company officers or directors who have a complete understanding of the company's executive compensation programs is most productive. In many circumstances, direct communication between shareholders and compensation committee members, who are the persons directly responsible for approving executive compensation arrangements, can be particularly effective. In other circumstances, a company's executive compensation experts – typically, the general counsel, head of human resources or head of executive compensation – are appropriate. If, as is frequently the case, the CEO's compensation is likely to be a primary subject of the discussion, a company should consider deploying a representative other than the CEO. Whoever is responsible for the outreach should be briefed on the issues and the constraints of Regulation FD, and care should be taken to ensure that all company representatives speak with a unified, consistent voice to avoid confusion in the company's public posture.

<u>How Should We Engage?</u> When meeting with shareholders, it is important to have an agenda with talking points prepared in advance. The company representative should be prepared to address any ways in which the company's compensation policies deviate from policies favored by the shareholder and the rationale for such deviations. Importantly, meetings

with shareholders should be viewed as an opportunity to listen to shareholder concerns and any agenda proposed in advance should reserve time to listen to these concerns. Any proposed written presentation materials should be vetted with securities counsel to determine if they would need to be publicly filed with the SEC before use with shareholders and, if so, whether the benefits of their use outweigh the public spotlight on executive compensation such a filing would bring.

What Should We Disclose About Engagement? Many companies are already engaged in shareholder outreach efforts in respect of their executive compensation programs; however, the disclosure of those efforts may not be sufficiently detailed in order to get credit for it with ISS and shareholders. In light of sensitivity to this issue and expanded expectations of shareholder groups, we recommend that companies consider including in their annual proxies thorough disclosure of shareholder engagement activities. In addition, companies that have filed their proxy statement and have received a negative say on pay recommendation from ISS on the basis of a lack of responsiveness to previous year shareholder concerns should consider a supplemental filing indicating specific actions taken in response to the prior year's vote. Such disclosure should include a statement as to how many significant shareholders have been engaged, what percentage of the company's shares the holders represent, the concerns discussed and any modifications to the company's compensation programs that resulted from the discussions.

* * * * * *

Shareholder engagement will be the theme of the 2014 compensation season. More broadly, while shareholder outreach has accelerated as a result of mandatory say on pay, engagement has far reaching consequences for issues beyond say on pay. Well-established relationships with significant investors can be outcome determinative if controversies arise or activists attack, and a company's outreach can increase corporate credibility, enhance transparency, pre-empt shareholder proposal and proxy fights and otherwise enable a company to navigate potentially contentious issues with shareholders.

Michael J. Segal
Jeannemarie O'Brien
Adam J. Shapiro
Jeremy L. Goldstein
David E. Kahan