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CalSTRS Releases Say-On-Pay Report

On February 1, 2012, the California State Teachers' Retirement System ("CalSTRS") released a report commenting on corporate pay practices and the say-on-pay vote during the 2011 proxy season. The report is noteworthy because CalSTRS is the second largest public pension system in the United States with assets of approximately $146 billion. But more importantly, the report makes clear that CalSTRS assumes responsibility for deciding how to respond to the say-on-pay vote of the companies in which it invests. This is another example of a major investor taking direct responsiblity for voting proxies, rather than simply outsourcing that decision to non-investor proxy advisory firms whose "one-size-fits-all" models of corporate goverance often fail to take into account the specific circumstances of individual companies (see our memo of January 19, 2012 discussing Blackrock's similar approach). The CalSTRS report identifies the review of pay practices as an "important fiduciary duty" of institutional investors, a perspective that we have consistently advocated.

CalSTRS considered say-on-pay at 2,166 companies during the 2011 proxy season, voting against 23% of them. While only 2% of companies actually lost say-on-pay votes in 2011, CalSTRS's reasoning for its negative votes described in the report is significant. CalSTRS takes into account a number of factors familiar to those who study the views of the proxy advisory firms. For example, it views negatively overly broad board discretion to award compensation regardless of actual performance and objects to a ratio of more than three-to-one of CEO pay to that of the other named executive officers. It claims that negative vote recommendations often stem from what it views as "problematic pay practices" such as tax gross-ups, excessive perquisites (generally $250,000 or more), supplemental executive retirement arrangements and severance pay, and points out the continuing challenge of selecting appropriate peer groups.

Notably, the CalSTRS report is clear that the overwhelming reason for it voting against say-on-pay in 2011 was a disconnect between pay and performance. As a long-term investor, CalSTRS often initially targets companies with absolute negative performance over a five-year period. It then looks at the one- and three-year performance of those companies, and compares that performance with executive pay over the same period. Every one in a sample of 120 companies included in the report as to which CalSTRS voted against say-on-pay exhibited a pay for performance disconnect. There is no evidence that testing a company's executive compensation program against a group of "problematic pay practices," such as whether a company's executives have golden parachute excise gross-ups or an equity plan includes single trigger change of control vesting, bears any relationship whatsoever to the long-term creation of shareholder value. The only true test of a company's compensation program is whether pay is aligned with performance over an extended period of time.

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