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RADFORD REVIEW

Selecting the Best Approach for Responding to a Negative Say-on-Pay Recommendation

Calibrate Your Response

Responding to Say-on-Pay criticism from leading proxy advisory firms like Institutional Shareholder Services (ISS) or Glass Lewis is not a one-size-fits-all endeavor. In some cases, aggressively challenging proxy advisor pay-for-performance assessments and peer group development methodologies is appropriate. However, at other times, side-stepping proxy advisor conclusions altogether to clarify internal decision-making can be best. And in most instances, effective responses to Say-on-Pay challenges include a mixed bag of aggressive and defensive tactics all aimed at producing a single, holistic argument in support of company practices.

Thus, when faced with a negative Say-on-Pay recommendation, we typically counsel clients to explore the full range of potential response tactics before settling on a few core arguments. Simply mimicking the actions of others (no matter how successful) is not the best course of action. Every case is different, and what works for one company may not work for all. Additionally, if all possible response scenarios are ignored, companies can easily leave convincing arguments on the table. Taking a wide angle view and then zeroing in on a powerful, personalized story will produce the best possible Say-on-Pay outcomes.

The Value of Supplemental Proxy Disclosures

When faced with a negative Say-on-Pay recommendation, most companies now opt for supplemental proxy disclosures along with direct shareholder engagement to explain their side of the pay-for-performance story. Several important factors driving the rise of supplemental proxy filings include:

- The desire by companies to create a public record outlining concerns with proxy advisor methodologies and conclusions, which over time could lead to changes;
- The ability for supplemental filings to serve as a foundation for direct engagement with shareholders— a conversation blueprint if you will; and
- The near impossibility of negotiating with proxy advisors to change their recommendations once public.

More generally, supplemental filings are the most visible part of a larger overall trend: the decision by companies to communicate directly with shareholders on a more consistent and forceful basis. Still, creating a supplemental proxy filing alone is not enough to guarantee Say-on-Pay success. This is especially true if the

goal is to exceed the 70% and 75% favorable vote thresholds currently endorsed by ISS and Glass Lewis, respectively. Defending a Say-on-Pay vote beyond these levels in the face of a negative recommendation requires more than just a fast, visible response. It requires a solid story backed by rigorous analytics and a clear point of view. To this end, the following sections of this report highlight a number measures our clients have adopted to successfully turn the Say-on-Pay tide.

Adopt a Data-Driven Response

It's well known that a number of companies have successfully challenged the methodologies used by proxy advisors to generate negative Say-on-Pay recommendations. However, simply disagreeing with the conclusions of proxy advisory firms is not enough— you must expose specific, relevant weaknesses in their approach to garner the attention of shareholders. Unfortunately, attacking Glass Lewis on the basis of their methodology is difficult given their overall lack of transparency. As such, most companies reserve data-driven responses for ISS, and for that reason our commentary in this section tends to be ISS-centric. In our experience, the most effective starting points for launching into a data-driven response include:

> **Highlight Factual Errors** – It is not uncommon to find factual errors in ISS reports, ranging from relatively minor mix-ups to major omissions. Yet, regardless of the scale of these issues, making shareholders aware of errors lends credibility to the rest of your arguments. However, as a word of caution, companies should carefully consider the value of using errors as the crux of their response. Undoubtedly, major errors can lead ISS to reconsider Say-on-Pay recommendations, but asking ISS or shareholders to change their minds based on minor issues can backfire. Unless the errors are material to one's understanding of a company's plans, focusing extensively on errors and omissions can be a distraction from other far more potent efforts.

> **Consider the Impact of ISS Option Valuations** – Due to the decision by ISS to continue valuing stock options based on their full term, ISS typically applies a significantly larger Black-Scholes value (commonly 30% to 40% higher) to options awards vs. a company's reported calculations. In certain situations, this can have a material impact on the outcome of ISS analyses. For example, if a company relies heavily on stock options while its ISS-selected comparator group does not, the company's CEO pay would appear inflated vs. the ISS peer group. In this case, option valuations might serve as solid ground for a challenge. However, the opposite could easily be true if the pay approaches described above are reversed. Therefore, before embarking on this mode of attack, companies should first dive into the details of their ISS peer group and the pay packages in place at each company.

> **Critique ISS Peer Groups** – The focal point of many challenges to negative Say-on-Pay recommendations is the make-up of ISS-selected comparator groups. This is the case because two of the three quantitative pay-for-performance tests employed by ISS compare pay and performance relative to peers. A few of the key areas worth considering when validating ISS peer groups include:

- *GICS Code Based Comparisons:* For some companies, industry comparisons based solely on the use of GICS codes (the current ISS model) simply don't work. This is particularly true for firms with diversified business models (e.g., semiconductor firms expanding into solar), companies operating in emerging sectors of their respective industry (e.g., new drug development) or companies working in a very narrowly-defined space with few real competitors. When presented with this situation, highlighting the degree to which business models at ISS-selected comparator companies differ from your own is particularly effective. Disconnects in this area are often identifiable by counting the number of 6-digit, 4-digit and 2-digit GICS code matches in an ISS peer group. If a large number of 4-digit and 2-digit GICS codes matches are found, this could indicate the ISS peer group is weak and worthy of deeper inspection.

- *Overlap with Existing Compensation Peers:* While some companies deserve blame for picking inappropriate (or "aspirational") benchmarking peers, the vast majority of companies take peer group development seriously and examine a far more extensive list of variables than ISS. As a result, whenever ISS-selected peers differ dramatically from existing compensation peer groups

this can reflect a fundamental miscalculation on the part of ISS. In our experience, overlap rates under 60% merit further exploration.

  - *Misaligned Selection Metrics:* The current ISS selection process only considers revenue and market capitalization when looking at the financial condition of potential peers, and ISS clearly favors revenue when its preferred framework needs to be relaxed to build adequate peer counts. For certain industries, this approach can lead to severely distorted comparator groups. At biopharmaceutical companies for example, Compensation Committee selected peer groups are commonly developed based on market capitalization, research & development expenses and stage of development. Revenues are often explicitly excluded as a metric, as they rarely reflect the size of operations for companies involved in drug-development. Similar disconnects exist in other industries (e.g., fabless semiconductors vs. those with their own foundries) and can serve as a strong foundation for challenging ISS-selected peers.

> **Explain Special Cases** – To a large extent, leading proxy advisory firms take a check-the-box approach to their Say-on-Pay analyses. So naturally, many well-intentioned companies may not fit perfectly into their respective views on compensation and corporate governance. When faced with criticism based on unique circumstances or practices, it becomes critical to explain to shareholders why proxy advisor recommendations are off the mark. In two specific cases, disconnects can be glaring.

  - *CEO Transitions:* ISS captures CEO data on a year-end basis. As a result, if a CEO joins a company recently and has an inducement grant (which is typically much larger than an annual grant) pay-for-performance calculation can be skewed for up to three years. In our experience, ISS has shown very little willingness to modify recommendations based on this factor; however, shareholders typically respond favorably whenever this issue is clearly explained.

  - *Differences in Plan Structure:* We already discussed situations where companies using stock options could be portrayed by ISS as overpaying their CEO— especially when ISS-selected comparator groups happen to rely primarily on restricted stock. Now consider instances where a company makes long-term performance-based equity grants every three years. Due to the fact that ISS includes all compensation in the year it was granted, companies with this compensation structure will likely have uneven pay-for-performance assessments. Every three years their CEO will be overpaid, and in the interim years he or she will likely appear underpaid.

In either of the cases mentioned above, companies should communicate to shareholders that negative recommendations might reflect fundamental misunderstanding for how structural decisions or CEO changes can affect interpretations of compensation. Additionally, companies with recent shifts in the structure of their compensation programs are advised to consider pre-emptive disclosures and shareholder outreach to get ahead of possible misinterpretations.

> **Focus on Realized Pay** – The question of using realized compensation for conducting pay-for-performance assessment remains open to debate; however, a number of companies are moving full-speed ahead in this direction. Over the past two years, the number of realized compensation tables appearing in regular and supplemental proxy filings has increased significantly, along with tables tracking pay levels against various non-TSR performance metrics. At the very least, companies are encouraged to explore this track going forward to see how they fare when considering actual take-home compensation. With additional SEC disclosure rules on the horizon and modifications to ISS and Glass Lewis methodologies likely becoming an annual affair, it’s not unrealistic to expect the use of realized pay comparisons to proliferate in the near future.

> **Examine Testing Outcomes Across Multiple Scenarios** – Building upon many of the angles described above, we often counsel clients to recreate ISS analyses across a number of potential scenarios. For example, companies can reconstruct ISS testing outcomes using their self-selected peers, note the degree to which results change if stock option valuation premiums are removed, modify the treatment of pay for newly hired CEOs when applicable, or mix-up pay methodologies by looking at realized compensation. Additionally, companies may want to run other performance metrics (outside of

TSR) through the ISS model to see how relative performance changes. Admittedly, presenting shareholders with different pay-for-performance scenarios can be challenged as a “cherry-picking” exercise, so companies are advised to back revised scenarios with solid data and clear explanations for why a different view of the situation is merited.

Implement a Practice-Based Defense

As we note above, challenging negative Say-on-Pay recommendations outright with new data makes sense in some situations; however, it’s not the only successful response tactic— especially when ISS conclusions are based on qualitative factors or your challenge comes from a more opaque Glass Lewis report. In these cases, it’s typically better to structure a response that highlights the performance-based elements of your compensation program and draws attention to your company’s overall corporate governance structure. Common response tactics in this area include:

> **Explain Your Thinking** – In this day and age, it’s not uncommon for Compensation Discussion & Analysis (CD&A) reports to be 30 pages or more. Yet, that’s often not enough text to satisfy ISS or Glass Lewis. Using supplemental filings to close the communication gap by providing new details backing-up your compensation practices is a strong response tactic appreciated by shareholders. Adding additional color on the following topics via supplemental filings is increasingly common:

- *Benchmarking Targets:* Both ISS and Glass Lewis view compensation benchmarking targets above the 50th percentile with a skeptical eye. While targets above the 50th percentile are appropriate in certain cases (e.g., highly competitive talent markets or to reward top-level performance), explaining the decision to target pay beyond the mid-point of the market now requires extra justification. Successful explanations usually focus on the fact pay targets may differ for each element of compensation and that variable awards have sufficient downside even when targeted above the market 50th percentile. Additionally, being able to demonstrate a history of above-market performance, especially in terms of stock price appreciation, will carry additional weight with shareholders.

- *Performance Metrics*: Increasingly, ISS and Glass Lewis have attacked performance plans with only one metric, opaque performance targets, or metrics overlapping with other compensation programs. Their reasoning, based primarily on concerns over excessive risk taking and potential Compensation Committee discretion, are justifiable. However, this does not mean companies should no longer consider such practices. Rather, companies need to be ready to explain why the metrics they choose make sense in the context of corporate goals and to open the door wider to reveal award calculations. Explain to shareholders *why* these measures are critical to the company’s definition of “winning.”

- *Provide Extra Detail on One-Time Events:* Every company encounters unusual situations on occasion, and in these cases, providing extra disclosure is often warranted. Common examples in this space include special retention grants, executive turnover (see CEO transitions above), cancelled performance grants and even the impact of acquisitions or divestitures on compensation. Revealing the strategic thinking behind compensation decisions related to these issues is encouraged with or without proxy advisor pressure.

> **Make the Narrative Simple –** Many investors rely on proxy advisory firms because explanations of executive compensation have become so prolix. Tell a straightforward, concise story— *“Here is our pay philosophy; this is why we use it; here are our results; this is the market we compare ourselves to and why; and this is why we believe our approach is necessary and critical to our success.”* If the narrative in your original proxy statement is unclear, use supplemental filings as an opportunity to rethink your communication style.

> **Leverage Third-Party Information** – While ISS and Glass Lewis are major players among proxy advisory firms, their views are not the end-all, be-all in compensation and corporate governance. If

other reputable sources (including institutional shareholders, consulting firms, or your own primary research) promote divergent opinions, these observations should be included in supplemental proxy statements. Reaching out to institutional investors is very helpful in this area, as they commonly have favored policies and practices that differ from ISS and Glass Lewis.

> **Restate Shareholder-Friendly Best Practices** – Over the past five years, companies have moved aggressively to adopt new corporate governance practices, including claw-back policies, ownership guidelines, anti-hedging policies, equity grant controls, risk assessments and reduced or eliminated perquisites and severance benefits. Simply put, reiterating these practices does not hurt. Amid a deluge of information in CD&A statements, clearly drawing attention to these actions year after year is critical. And when faced with Say-on-Pay pressure, devoting an entire section of your supplemental proxy statement to highlight positive Compensation Committee actions is recommended.

Make Changes

There are some instances where making concessions is the appropriate response. If negative proxy advisor recommendations are "practice-based" (e.g., the company has gross-ups, or there is a lack of ownership guidelines or some combination of factors), it may be easier, simpler, and better from a governance perspective to adopt some of those proposed changes. If done in a timely fashion, this is one situation where proxy advisors *have* been known to change their recommendations. However, when considering possible program changes, companies need to consider the following questions:

> **What is the purpose? –** Why did the company implement this practice in the first place? If, for example, the company provides gross-ups on perquisites, is that merely a holdover from the past, or is there a business purpose?

> **What does it cost? –** What will it cost the company to eliminate the practice? What will it cost the recipients, and is there a need to reimburse them?

> **What is the expected impact? –** Are the changes sufficient to make a proxy advisor change their recommendation?

As we note in the Radford Review titled *Mobilizing the Right Team to Respond to a Negative Say-on-Pay Recommendation*, preparing key corporate stakeholders like the Compensation Committee Chair to entertain potential program changes is a critical first step in assessing response approaches. At the very least, companies should explore their options when proxy advisors choose to call-out on specific practices (or the lack thereof).

Next Steps

As we noted in the opening section of this article, directly attacking proxy advisor methodologies is a frequent response to negative Say-on-Pay recommendations. However, dumping mountains of data-driven counterattacks on shareholders should not be done in isolation. Using supplemental proxies to shed light on your pay-for-performance culture, the proactive nature of your Compensation Committee, and the strategic considerations behind pay decisions is also just as important. Together, data-driven and practice-based approaches to supplemental proxy development will generate more successful Say-on-Pay outcomes. To learn more about the latest developments in corporate governance and Say-on-Pay trends, we encourage clients to visit Radford's Executive Compensation Governance Center at http://www.ExecCompGov.com/.

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