The Legal Intelligencer

Effects of Dodd-Frank 'Say-on-Pay' Two Years Later

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More than two years have passed since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act. For publicly traded companies with more than $75 million in public float, this also signifies the passage of a second proxy season with shareholders delivering an advisory nonbinding vote on executive compensation (say-on-pay). So how did the 2012 say-on-pay vote measure up to the 2011 season and what issues should companies consider with next year’s proxy season?

Thus far, the number of companies reporting that a majority of their shareholders delivered a negative say-on-pay vote increased from less than 2 percent in 2011 to approximately 2.5 percent in 2012. While companies’ shareholders continue to deliver overwhelming support for existing pay practices, with more than 90 percent of companies passing with at least a 70 percent approval rate, the vote continues to be a high-profile issue. The majority of those companies with failed 2011 say-on-pay votes received passing scores in 2012, suggesting that companies acted upon the prior results and engaged shareholders effectively. However, the failure rate still increased, meaning that some that passed in 2011 failed in 2012. Thus, what are the new lessons to be learned from the 2012 proxy season?

CAUSE AND EFFECT OF SAY-ON-PAY

With Dodd-Frank, Congress intended to force corporate boards of directors and their compensation committees to focus on executive compensation practices through say-on-pay. Shareholder activism and public focus on the potential connection between risk taken by corporate executives and the design of compensation programs for such executives also paved the way for say-on-pay. At the highest level, it is fair to say that say-on-pay has caused corporate boards to focus more on executive compensation practices. The greater influence on the say-on-pay votes, however, has come from shareholder advisory firms, such as Institutional Shareholder Services and Glass Lewis Co., as well as the widespread attention given by the media to negative say-on-pay votes when they occur.

Approximately 9 percent of companies that received majority shareholder approval received such approval with less than 70 percent support. Advisory firms view the 70 percent threshold as one below which remedial action is required. As a result, companies continue to be spurred into action to modify their executive pay practices. Several of the companies that did not pass their 2011 say-on-pay vote indicated in their 2012 proxy that they had taken action to address their shareholders' concerns and those of advisory firms. As a result, we may see more of these changes for the 2013 proxy season, including greater engagement of institutional shareholders and advisory firms, newly hired independent compensation consultants and implementation of significant changes to their pay structure and performance conditions.

LESSONS LEARNED FROM 2012

Prepare for a year-long process.

Companies and compensation committees have realized that the approval process cannot be undertaken solely during the proxy season. They have learned that the disclosure and approval of executive compensation is a year-round process. Engaging and communicating with shareholders is vitally important and must start early, beginning with the end of the most recent proxy season, and must occur frequently and regularly throughout the year. In addition to management, it may be appropriate for compensation committee members to participate in shareholder outreach directly.

Companies have approached shareholder engagement in several ways, such as creating a separate website to provide information and to accept comments directly from shareholders on executive compensation pay practice, and providing other forums where shareholders can communicate their concerns and comments. However, it is not enough for companies and their compensation committees to initiate the communication; they must listen and work to understand their shareholders' concerns. They should also use the opportunity to provide feedback to shareholders regarding how their concerns may already be addressed by current practices and/or what changes will be made for the upcoming proxy season to resolve their concerns. All of the methods used must adhere to and align with securities rules and regulations.

Influence of shareholder advisory firms.

The 2012 proxy season continues to demonstrate the influence and impact of the advisory firms, such as ISS and Glass Lewis. A significant portion of the companies that received a negative recommendation from ISS experienced failed say-on-pay votes. In addition, where a company received shareholder approval despite a negative report from ISS, the average shareholder support was significantly lower than for those companies receiving a positive report from ISS. The influence of such firms may be caused by investor vote fatigue. With the large number of say-on-pay votes taking place each proxy season, many investors do not have the time or the resources to analyze each company's executive pay practices. Thus, many companies pay a fee in exchange for the advisory firms' reports and rely on such firms' recommendations.

While corporate boards continue to exercise business judgment when setting executive compensation, they are also making changes to bring their pay practices in line with those suggested by advisory firms. Advisory firms have made a large portion of their methodologies publicly available and compensation committees have engaged their compensation consultants and legal advisors to assist them with understanding how their companies' pay practices will be viewed based on such methodologies. Glass Lewis has indicated that there has been an increase in the number of companies that have engaged it to discuss its say-on-pay recommendations. Some of the policies championed by the firms include eliminating executive tax gross-ups, reducing executive severance benefits, adding clawback policies and increasingly exploring ways to tie in company performance to an executive’s overall compensation. Companies should consider communicating with the advisory firms earlier in the process and engaging directly with such firms to explain or contest negative reports. The additional communication allows companies a better chance to ensure their executive pay practices are understood by the advisory firms before a potentially negative report is issued.

THE HOTTEST TOPICS REMAIN HOT

Pay for performance.

One area that has drawn significant attention is advisory firms’ analyses of whether a company’s executive compensation practices adequately reflect “pay for performance,” an area still pending SEC rulemaking. While companies need to be able to clearly and effectively explain to shareholders the connection between executives’ pay and the company’s performance to secure shareholder support for future say-on-pay votes, this is not an easy task.

In most cases where ISS has issued a negative recommendation, the advisory firm has indicated that a disconnect between pay and performance exists. The ISS analysis of pay for performance focuses heavily on the alignment of an executive’s total pay and total shareholder return (stock price performance plus any paid dividends). ISS then compares this ratio to those found at the company’s peer group. Thus, in some cases, all other items being equal, the company’s stock price movement may dictate the recommendation from ISS.

Not surprisingly, one of the strongest complaints and points of contention from reporting companies has been ISS’s selection of peer companies. In most cases, the peer group selected by ISS did not reflect the peers selected by companies in their proxy disclosures. Several companies have chosen to address negative advisory firm recommendations by providing shareholders with additional information to distinguish the company’s peer group selection from the advisory firms’ peer group selection.

Pay for performance clearly reared its head in the 2012 proxy season as the correlation between a company’s total shareholder return (TSR) and the results of say-on-pay increased when measured against the 2011 proxy season. The lower a company’s TSR, whether over a one-year or three-year period, the higher the chance that the company received a negative say-on-pay vote from shareholders during the 2012 season. There also appears to be a tie-in with companies that failed or received a lower portion of shareholder support for say-on-pay with the amount that such companies increased pay for their executives. Thus, the pressure continues for companies to clearly demonstrate and explain their pay for performance compensation policies.

Clawback policies.

Another mandate of Dodd-Frank, subject to pending rulemaking by the SEC, requires companies to develop, adopt, implement and disclose clawback policies to recoup executive incentive-based compensation for current and former executives over a three-year period in the case of an accounting restatement. By not explicitly requiring a connection between the executive’s misconduct and the restatement, the clawback mandate will extend beyond the typical clawback provisions companies may already have in place.

Similar to the pay for performance requirement, clawback policies have become a focus point for companies despite the lack of guidance from the SEC. Such policies received attention prior to Dodd-Frank in the wake of the 2008 financial crisis. Existing company policies may only cover the top few executives and may be limited as to the scope of compensation covered. While it is unclear how broad a group will be affected once the SEC provides rules, companies should be prepared to expand the scope of their policies.

Two recent high-profile financial scandals have helped put the spotlight on not only the implementation of such policies but companies’ willingness to enforce them. Following significant losses at UBS AG and JPMorgan Chase & Co., in excess of $1 billion and $5 billion, respectively, the banks recouped bonuses and incentive compensation from the employees involved. In a recent survey, however, only 17 percent of global banks indicated that they actually clawed back compensation to employees in the wake of losses. The discrepancy suggests that banks may be reluctant in the ordinary course to claw back employee compensation unless pressured to do so by outside forces, such as from the media. Part of the issue may be that companies struggle at a practical level with how to recoup amounts that have already been paid to employees. To the extent the SEC provides companies with flexibility as to how to structure their clawback policies, advisory firms and institutional shareholders may have a new focus.

WHERE DO WE GO FROM HERE?

The rules have not changed and neither has the advice:

- Ensure that say-on-pay and the proxy process is a year-round effort.
- Engage and communicate with shareholders and advisory firms on executive pay practices early, frequently and regularly.
- Clearly explain and document the connection between executive pay and company performance.
- Consider implementing or expanding clawback policies before the SEC promulgates rules.

Finally, a note for small reporting companies:

As a reminder, it will be critical for smaller reporting companies, those with less than $75 million of public float, to implement the lessons learned from the first two proxy seasons as they will become subject to the say-on-pay vote requirement for the first time during the 2013 proxy season.

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