The "Say-on-Pay" Advisory Vote

By Josef Rashty and John O'Shaughnessy

The corporate governance of U.S. public companies has evolved during the past decade. Two recent landmark legislations, the *Sarbanes-Oxley Act* (SOX) of 2002 and the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank) of 2010, have required public business entities (PBEs), among many other things, to provide more disclosures to shareholders regarding their executive pay. Specifically, Dodd-Frank has empowered shareholders to cast their non-binding votes on executives' pay. The 2015 proxy season was the fifth season that shareholders of PBEs cast their non-binding votes on the executive compensation subsequent to the Securities and Exchange Commission's (SEC's) promulgation on the "say-on-pay" law.

This article presents an overview of the say-on-pay law and provides guidance to investors for their non-binding votes on executive compensation. It deals with the information that is available to shareholders and the overall impact of shareholders' "no vote" on PBEs' corporate governance. Finally, it raises the question of whether this law has prompted a display of shareholders' discontent in recent years.

Background

Dodd-Frank requires that PBEs obtain a non-binding shareholder vote on executive compensation (say-on-pay) at least once every three years. Say-on-pay is a primary way for shareholders to express their satisfaction with the company's CEO and other executives' compensation. The say-on-pay law went into effect in 2011 for larger companies; the smaller companies had an additional two years to comply with the law. However, Section 102 of *The Jumpstart Our*

Business Startups Act (JOBS Act), which was signed into law on April 5, 2012, exempts the emerging growth companies from say-on-pay votes (including say-on-golden parachutes).

The say-on-pay law received a great deal of attention initially and has remained the most significant discussion item during each proxy season since then. The authors reviewed several corporate governance surveys conducted by accounting and law firms and reviewed the 2014 proxies of 30 large accelerated filers in preparation for writing this article.

The Advisory Vote

Say-on-pay allows shareholders to express their views on their satisfaction with the executive compensation program at least once every three years. However, the preference of most institutional shareholders and the two major institutional proxy advisory firms, Institutional Shareholder Services (ISS) and Glass Lewis, is for execution of an annual say-on-pay vote.

Companies disclose the say-on-pay voting policy that they have adopted no later than 150 calendar days after their annual meetings, but at least 60 calendar days prior to the company's deadline for submission of shareholder proposals for the next annual meeting. An overwhelming number of companies that conduct say-on-pay votes have received a majority of shareholders' support.

PBEs do not take shareholder approval for granted. Companies that have not received a favorable vote or have low shareholder support for say-on-pay often devote a prodigious amount of time, resources and consideration to the administration and disclosure of their executive compensation programs. In summary, say-on-pay has impacted the PBEs in several fashions that will be discussed in the remaining sections of this article.

Corporate Governance

Even though say-on-pay is technically an advisory vote, in reality it has serious consequences for corporate governance, as well as the decision-making process of the boards of directors and their decision-making processes. A say-on-pay proposal that fails or receives significant opposition requires the attention of the proxy advisory firms. Morrow & Co.[1] has reported that ISS requires an explicit response from the board to any say-on-pay proposal that receives 30 percent or more opposing votes. Glass Lewis has a similar policy with a lower 25 percent threshold.

Negative recommendations from proxy advisors do not necessarily result in a failed say-on-pay vote. There are precedents for companies receiving majority approval on the say-on-pay proposal even though proxy advisors recommended voting against them. Nevertheless, it is most likely that a lack of support from proxy advisory firms would lower the shareholders' percentage of approval. Therefore, PBEs usually make an effort to obtain the support of the proxy advisory firms.

In June 2012, the SEC adopted the final rules to implement Dodd-Frank Act Section 952, requiring national securities exchanges to prohibit the initial or continued listing of any PBE's stock that does not satisfy compensation committee and compensation advisor independence criteria. Both the NYSE and NASDAQ have adopted rules regarding compensation committee and compensation advisor independence.

PBEs usually avoid the appearance of any interlocking relationship between any member of their compensation committees and any member of the compensation committee of another company. If such a relationship exists, they usually disclose it in their proxies.

PBEs pursuant to SEC rules select and disclose their peer companies in their proxies so that shareholders can compare and contrast their executive compensation with their peer companies. PBE compensation committees usually apply their intimate knowledge of their business to select their companies' peers for executive compensation analysis. When PBEs benchmark their executive compensation against other companies, they typically specify how the peer group was established and how the pay for named executive officers compared with the established benchmarks, and they also provide an explanation if actual compensation differs from the targeted percentiles.

Equity awards ordinarily represent the lion's share of executive compensation programs. Equity awards, for the most part, have replaced the traditional pension and retirement plans as an incentive to retain top-performing executives. PBEs, subsequent to enactment of say-on-pay, tend to grant more performance-based rather than time-based equity awards. Many PBEs have reduced CEOs' salaries while at the same time increasing the grant of equity awards. Of the 30 large accelerated filers the authors surveyed, 25 (83 percent) of the companies have changed their equity award programs to make them more performance-based. The rank of equity awards based on performance criteria is as follows:

- Performance-based stock awards
- Performance-based stock options
- Time-based stock options
- Time-based stock awards

The survey conducted by the authors confirmed that companies in general were compliant with the statutory requirements of executive compensation disclosures. Some PBEs have made changes to their corporate governance above and beyond the legal requirements to justify their executive pay to their investors and proxy advisors. The authors believe that say-on-pay generally has improved compensation practices among the PBEs. Under Dodd-Frank, directors pay more attention to executive compensation when they know that shareholders and proxy advisors will scrutinize executive pay packages.

Even though board members and management of PBEs in general have strong incentives to care about the result of a say-on-pay vote, there are instances where some PBEs have shrugged off the no-vote on pay. *The Wall Street Journal* on Aug. 26, 2014,[2] reported that about two dozen renegade companies have kept the compensation of top officers sky-high despite the no-vote by investors. These companies (including Oracle, RadioShack and Cogent Communications) have dug in their heels, paying high compensation to their top officers mostly due to the fact that their founders still run the companies.

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However, *The Wall Street Journal* reported on the same subject on July 8, 2015, that even though the top three executives of Oracle received the same number of share options this fiscal year compared to a year earlier, the company altered the terms of its grants in a way that the value of awards granted are lower[3].

Presentation and Disclosures

PBEs pursuant to SEC regulations have included extensive disclosures regarding the five highest paid executives' compensation in their proxies. Item 402 of Regulation S-K requires extensive disclosures on executive compensation for registration statements. Additionally, the SEC requires that companies disclose how this year's shareholders' vote has influenced the compensation program in the subsequent years.

SEC rules require companies to disclose a combination of grant date fair values for long-term equity-based awards and actual payments for annual and long-term cash awards. While the Summary Compensation Table (SCT) is the principal source of specific executive compensation disclosure, shareholders can also look at a variety of tables, in addition to the SCT in the proxy reports, to decide on their votes. These tables provide all the information related to executive pay in one place and make it easier for shareholders to obtain the information needed.

Compensation Tables

Summary Compensation Table (SCT) – This table provides a summary of cash compensation and equity grants to each executive. There has been an argument that there is a certain disconnect between the cash compensation and equity grants components of the pay in the SCT. Critics have argued that actual realized benefits (rather than grant information) is a more appropriate measure for equity-based awards. In response, a number of companies have presented alternative approaches to defining executive compensation in their proxy disclosures to better demonstrate pay and performance alignment.

Grants of Plan-Based Awards Table – This table follows the SCT and provides additional information about plan-based equity and non-equity compensation granted during the most recently completed fiscal year. Companies usually have narrative disclosures for any additional factors that help understand and give context to the information included in this table and the SCT.

Outstanding Equity Awards – This table reflects all outstanding option awards and unvested stock awards held by the executives as of the end of the most recently completed fiscal year.

Option Exercises and Stock Vested Table – This table reflects the number and value realized upon exercise and vesting of options and stock awards granted to executives.

Other Disclosures

There could be other disclosures in the proxies of PBEs that may help the shareholders determine their position on voting.

Golden Parachutes – Executive compensation usually includes retirement and other post-termination benefits. SEC rules pursuant to Section 951 of the Dodd-Frank Act require companies to provide disclosure regarding pension plans, nonqualified deferred compensation plans, and severance and termination benefits. Golden parachutes are subject to shareholders' advisory vote similar to other executive compensation. Of the 30 companies the authors surveyed, 25 companies (83 percent) disclosed their golden parachutes policies.

Nonfinancial Targets – PBEs have traditionally used quantitative financial measures (e.g., revenues, earnings per share, et al.) to measure the performance of their executives. Quantitative goals are usually easier to measure, and are less subjective and more transparent. However, use of qualitative measures (e.g., achievement of sustainability, customer satisfaction, et al.) is on the rise.

Of the 30 large accelerated filers the authors surveyed, six companies (20 percent) used only quantitative measures and 24 companies (80 percent) used a combination of quantitative and qualitative measures to measure the performance of their executives.

Peer Group – SEC rules require that companies disclose their peers in their proxies to enable the shareholders to compare and contrast the executives' compensation of their company with its peers.

Of the 30 large accelerated filers the authors surveyed, all have listed the peer group and all have provided rationale for the criteria that they have used in selection of the peer group. Fifteen companies (50 percent) have shown performance metrics and summary statistics for each peer group, but only one company (3 percent) has shown compensation data of their peers.

Pending Additional Disclosure

There are several Dodd-Frank mandates awaiting the SEC's proposal and finalization.

Hedging Policy Disclosures – In February 2015, the SEC proposed new rules required by Section 955 of the Dodd-Frank Act for PBEs to disclose hedging policies for directors and employees. The SEC's proposed new rules would require companies to disclose whether their directors, officers and other employees are allowed to hedge or offset any decline in the market value of shares that are granted to them by the company as compensation or held directly or indirectly by employees or directors. These new rules are expected to provide investors with additional disclosures regarding governance practices of PBEs.

Generally, companies are required to disclose their policies regarding hedging the economic risk of owning company securities pursuant to Item 402(b)(2)(xii) of Regulation S-K. Of the 30 large accelerated filers the authors surveyed, 29 companies (97 percent) disclosed their hedging policies.

Pay-for-Performance Disclosures – In April 2015, the SEC proposed new rules required by Section 953(a) of Dodd-Frank for PBEs to disclose the relationship between compensation actually paid to executives and the financial performance of the company. The disclosure is required for the last five years (the last three years for small companies, as defined in Rule 12b-2 under the Exchange Act). PBEs would also be required to tag the disclosure in an interactive data format using XBRL. This is the first time the SEC has required use of XBRL in proxy filings. The disclosure can be done in a narrative form, graphically or a combination of both.

Clawback Provisions – In July 2015, the SEC proposed new rules that would require executive officers of PBEs to pay back incentive-

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based compensation that they were awarded erroneously. Under this proposal, required by Section 954 of the Dodd-Frank Act, companies would clawback the unearned incentive compensation from current and former executive officers regardless of fault. PBEs would be required to disclose the recovery policies and their actions under these policies.

The clawback proposal would apply to incentive-based compensation that is tied to accounting-related metrics, stock price or total shareholder return. The clawback would apply to excess incentive-based compensation received by executive officers in the three fiscal years preceding the date a PBE is required to make restatements.

SOX includes clawback provisions for CEOs and CFOs of PBEs, but Section 954 of Dodd-Frank requires the SEC to issue expanded rules regarding clawback requirements for all current and former officers of PBEs in addition to CEOs and CFOs. It also requires national exchanges to bar the listing of any company that has not implemented a clawback policy that does not include recoupment of incentive-based compensation for current and former executives for a three-year period.

Although the SEC has not yet issued the final rules on this provision, a number of companies are already disclosing their clawback policies, likely because proxy advisory firms such as ISS and Glass Lewis take into account companies' clawback policies when making their say-on-pay voting recommendations. Of the 30 large accelerated filers the authors surveyed, 27 companies (90 percent) disclosed their clawback policies.

Pay Ratio Disclosures – In August 2015, the SEC adopted a final rule requiring PBEs to disclose the ratio of the compensation of their

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From left standing: *Judy Bozeman, Donnie Roberts, Allen Lewis and Michael Ringger* From left seated: *Bill Cunningham, Maureen Phillips, Rick Morales and Tom Williams*

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CEOs to the median compensation of their employees pursuant to Section 953(b) of the Dodd-Frank Act. Under this rule, PBEs would have to disclose the ratio of the annual total compensation of the median employee, other than the CEO, with that of the total CEO compensation.

PBEs will be required to provide disclosure of their pay ratios for their first fiscal year beginning on or after Jan. 1, 2017. The rule does not apply to smaller reporting companies, emerging growth companies, foreign private issuers, Multijurisdictional Disclosure System filers or registered investment companies.

Shareholders' Discontent

There is little evidence that the individual shareholders of PBEs have a robust understanding of executive compensation plans of their companies. Many shareholders probably cast their votes based on performance of the company and its stock price. On the other hand, most institutional shareholders outsource their say-on-pay vote to proxy advisors for a fee.

Ernst & Young in its *2016 Proxy Statements* publication stated that in the 2015 proxy season, investors continued to demonstrate support for most executive compensation packages. According to this publication, the average say-on-pay support for S&P 500, S&P 1500 and Russell 3000 companies in 2015 was approximately at 92 percent (consistent with 2014).[4]

Boardridge + PwC in its second edition of 2015 *ProxyPlus* also reported that support level had remained relatively unchanged in the 2015 proxy season (compared to the 2014 proxy season) with respect to say-on-pay vote.[5]

However, *The Wall Street Journal* on June 6, 2014, reported that the non-binding say-on-pay vote seeks to limit executives' equity awards subsequent to mergers and acquisitions. According to the article, the shareholders of several public companies voted to prevent executives from cashing in on certain equity awards in case of a merger transaction.[6]

There have been several waves of litigation arising out of say-on-pay and proxy compensation disclosures. The litigations alleged breaches of fiduciary duty by the board of directors for the companies that failed on their say-on-pay vote or suits alleging insufficient compensation disclosures. Even if plaintiffs are not successful in these litigations, the cost of defending such cases are high and may also negatively impact the reputation of the defending companies. Of the 30 large accelerated filers the authors surveyed, five companies (17 percent) have had outstanding litigations regarding their executive compensation.

It appears that shareholders have become more assertive in expressing their views regarding executive compensation. This trend may impact the corporate governance of PBEs in coming years significantly, particularly if the stock market begins to decline. Investors are usually less likely to become outraged by the sizable and disproportional amount of executive compensation as long as the stock market has an upward trend and the stock price continues to rise.

Final Remarks

In a survey of PBEs, PwC reported[7] that 84 percent of directors surveyed stated that say-on-pay has caused them to look at executive compensation in a different way. The say-on-pay has encouraged the PBEs to reach out directly to their shareholders (or proxy advisors in case of some institutional investors) and explain their strategies underlying their executive compensation plans. Many PBEs have changed their compensation structure from time-based to performance-based bonuses and equity awards.

The say-on-pay advisory vote has empowered shareholders to express their views on executive compensation. The Dodd-Frank Act has significantly expanded the scope of such disclosures in proxies, and PBEs have endeavored to obtain a favorable vote from their shareholders. The say-on-pay law could very well encourage shareholders to be more assertive on "right sizing" of executive pay in coming years. However, the authors of this article do not believe that say-on-pay has affected the right sizing of CEO compensations in corporate America in a meaningful way at this time. There are still companies that shrug off the result of the non-binding vote, but this trend may change in coming years, particularly if the upward trend of the stock market changes direction. ■

Footnotes

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