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ASK THE EXPERT INTERVIEW | JUN 2024

Say-on-Pay Didn't Go Well: Here's What You Can Do Next

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Most publicly traded companies hold their annual shareholder meeting in the springtime. Leading up to this meeting, companies will file a proxy statement which includes the proposals that shareholders will be asked to vote on, how the board believes shareholders should vote on each proposal, detailed information to support their recommendations, and other information required by the US Securities and Exchange Commission. Most of these proposals are governance-related, such as the election of directors, but many companies are required to hold a "say-on-pay" vote on the company's executive compensation program. Say-on-pay became a requirement in 2010 and has garnered significant attention by investors, media, and corporate boards ever since.

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One of the positive developments regarding the US executive pay model is that a vast majority of companies receive overwhelming support on say-on-pay, with 90% of shares voted "For" on average. There are of course a subset of companies each year that will receive suboptimal support levels (usually defined as 80% support or less) due to a host of reasons including but not limited to perceived excessive compensation, disconnects between pay and performance, or poor program governance features. For those that receive suboptimal support, the next logical question is often "What should we do about it?" We offer a Q&A-based guide below, intended to provide advice and actions for these companies.

Q: Should we do anything about our low say-on-pay vote support?

Technically, a company has no obligation to do anything about the vote since it is a non-binding advisory vote. However, the answer to this question is certainly yes. It is important to try to understand—and address—a low vote outcome. Say-on-pay is often referred to as a blunt instrument because it is a simple "For" or "Against" vote. The company will not know exactly why shareholders voted against the company's executive compensation program; they will just know that the support levels were lower than the norm. Therefore, it is best practice to conduct outreach to better understand concerns that shareholders may have about the program or compensation-related decisions, and fulfill the board's inherent responsibility to shareholders. Failing to do so can have a spillover effect on shareholder relations in other areas. It can also put a company in a cycle of continued low support on future say-on-pay votes due to a perceived lack of responsiveness, and in certain cases can also result in against vote recommendations for compensation committee members.

Q: What are the steps we should take in response?

I advise companies to break the activities down into four main steps. First, the company should internally assemble the right working team for this process. Typically, the core team is a combination of internal investor relations, legal, and HR executives. This team will also likely bring in outside resources like a proxy solicitor and the board's independent compensation advisor. The CEO and other board members may also be asked to review materials or participate in meetings as needed.

Second, the core team should develop an approach and strategy to identify which shareholders to canvass in the outreach, how to contact them, and what to cover with those shareholders that agree to engage in a discussion. Third is to develop any materials that will be circulated to shareholders that agree to have a dialogue on say-on-pay. Typically, these materials summarize the key points around the company's compensation program and decisions, and mirror what is disclosed in the proxy materials. Fourth, the core team should summarize and report back to the compensation committee the outcomes of the outreach and engagement discussions.

Q: What should we expect from these meetings?

The tone and tenor of the meeting can vary depending on the relationship the company has with each shareholder, and the current situation surrounding that relationship. Often the discussions are led by the governance teams at large institutional investors but could also include the portfolio manager or members of the investment team, and others as needed. These meetings are intended to be a dialogue between the company and the shareholder regarding the current executive compensation program, and so it's wise to plan for approximately equal time speaking and listening. It is important to share any key points with the shareholder on

- How the compensation program is linked to the business strategy;
- What the process is to determine the program and make decisions;
- Why the executive compensation program works well; and
- Highlight key positive features of the program from a shareholder and governance perspective.

It will also be important to review any of the proxy advisory reports in advance to understand any of their critiques, as well as any specific areas that each shareholder may question. When actively listening to the shareholder, we advise against committing to any changes during this investigative phase; rather document in detail their concerns or ideas, and bring them to the committee for internal discussion. You may also find that shareholders want to discuss areas outside of executive compensation, such as the company's board structure or other corporate governance topics. It is important to address those items on the calls as well, assuming the correct company representative is on the call and able to respond to the questions, but make sure the executive compensation topic is sufficiently covered.

Q: What are some common issues or pitfalls to avoid?

There are a few that come to mind. One of the first things to avoid is delegating any actual engagement discussions to more junior team members. The expectation from shareholders is that senior executives, and in many cases board members such as the chair of the compensation committee, board chair, or lead director, will represent the company. It is also important to not disclose any material non-public information in any circulated materials or on any engagement calls. Also, as I mentioned previously, agreeing to any recommended changes on the calls would be problematic.

One of the more common issues that companies will run across is that the feedback from shareholders can be disparate or conflicting. For example, one shareholder may suggest increasing the weighting on relative TSR in the long-term incentive program, while another may suggest decreasing the weighting to focus more on internal financial results. This can make being responsive to their suggestions difficult. In these cases, the best advice is to make decisions on a more holistic basis based on what is best for the company given its business and leadership strategy and environment and then be ready to address why certain specific actions were considered but not adopted.

Q: Our investor base is very fragmented. What are the best strategies if we cannot conduct a robust shareholder outreach effort?

It is important to put forward the effort to outreach even if the company has a diverse shareholder base. It may be that the outreach is only to a select few groups, as retail investors are typically not part of any outreach effort. For example, instead of a company strategizing to contact their top 20 largest shareholders, they may decide to outreach to any shareholder who owns more than 2% of the company's stock. In this example, it may end up that this list is five shareholders, and only two of the five agree to meet. The engagement aspect of the process will be less fruitful, but the board and company can feel comfortable that they did their best to understand shareholder concerns. Companies in this case may also weigh the commentary from proxy advisory firms more heavily—as the name implies, they serve as a proxy for how investors may evaluate their programs.

Q: What comes after the engagement process?

The engagement process typically culminates with a summary for the compensation committee and/or board of the process that was undertaken, the key themes (and detailed comments) from the shareholders that were engaged, and some perspective on the feedback from the company's standpoint. The committee should then have a robust discussion regarding the feedback, including alternatives to consider to be responsive. Decisions will need to be made on whether to respond to a particular piece of feedback, and if so, how to change the program to align with that feedback. My advice is always to look at it through the lens of what is the best outcome for shareholders given what the committee/board knows about the business strategy, leadership team, and the implications of a given change.

This process, and the key outcomes, should be documented in the company's next proxy statement. The narrative is commonly found in the Compensation Discussion & Analysis (CD&A), but could reside in other areas if a CD&A is not required or if the change is broader than a compensation change. Clearly disclosing the process, including details like how many shareholders were contacted, what percent of the company's outstanding shares that represents, how many shareholders agreed to engage, and who participated in the engagement process from the company are all important disclosure points. Additionally, the company should clearly lay out the key themes that were heard as part of the engagement process, and link those themes to the company's response and changes if appropriate.

About the Author

Terry Newth is a managing director at Pearl Meyer. He consults on the design, development, and assessment of executive compensation programs that support each organization's business

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