The Drivers that Continue to Dog Say-on-Pay

By Ning Chiu on September 18, 2017 POSTED IN EXECUTIVE COMPENSATION, ISS

Although the failure rate for 2017 say-on pay results achieved an all-time low of just 1.3%, the number belies the fact that more than 2,000 say-on pay proposals have either received negative recommendations from ISS or less than 70% support, or both, since say-on-pay resolutions started in 2011.

Approximately 12% to 14% of companies run into problems every year. As companies have become more proactive with shareholder engagement, the number of companies that received "against" recommendations from ISS and still achieved more than 70% support has increased in the last three years, while the number of companies with those negative recommendations that received less than 70% favorable votes have fallen. What may be most surprising to companies, however, is that about 10 to 15 companies each year received positive endorsement from ISS and still obtained less than 70% support.

ISS Analytics has identified the seven main drivers that leads to say-on-pay issues, in addition to the magnitude of pay and shareholder return.

Compensation committee responsiveness. Failure of the compensation committee to demonstrate responsiveness after a low, although passing, say-on-pay vote could lead ISS and investors to question the committee's effectiveness, including a committee's failure to engage with shareholders or follow through on compensation-related commitments, or not acting when a formulaic program produces results that seem to be out of line with business outcomes.

Discretionary awards outside of plans. Retention grants, replacement grants and make-whole awards are all discretionary awards that can be particularly problematic if they are essentially re-grants of previously forfeited awards or used to replace foregone performance-based awards. Discretion, or any adjustments, can be appropriately applied, even upward discretion, if specifically linked to tangible business events that benefited shareholders. A separate ISS Analytics report indicated that discretionary cash bonuses have continued to decline, making up just 10% of the S&P 500 in 2016, while 86% of those companies paid non-equity incentives.

Incentive plan construction. Questions may arise around a program that relies exclusively on subjective components or has an ineffective mix of time-and performance-based awards. The use of options and SARS

have declined to 24% of the S&P 500 in 2016 compared to 49% in 2011, as companies move to full value awards like restricted stock and RSUs. Since 2014, more than half of the proportion of CEO equity compensation is delivered in performance equity awards.

Selection and disclosure of performance metrics. Some companies do not disclose their metrics or how those metrics makes sense in light of the company's strategy. Then there continues to be what can only be characterized as a love-hate relationship with relative TSR, which is the most popular long-term metric used by companies. Investors may believe three years is too short and companies should select other metrics for that time span as part of their long-term incentive programs.

Rigor of performance goals. The situations that generate the most concern include setting goals below last year's actual or target performance without explanation, goals that always achieve maximum payouts or a company's failure to disclose goals at all even after the award cycle is completed.

Peer group and benchmarking practices. Some companies continue to select aspirational peer sets where the median company is significantly larger, or benchmark above the median without explanation.

Employment agreements. While there has been tremendous change in practices over the last seven years, some perennial issues that arise and always garner attention include large severance multipliers, guaranteed multi-year awards, inducement grants, replacement awards, retirement grants and separation benefits.