2018 Proxy Season Review

Sullivan & Cromwell LLP, [excerpt, p.43–47, 53]

July 2018

III. SAY-ON-PAY VOTES

A. COMPANIES MAINTAIN STRONG SAY-ON-PAY PERFORMANCE

The following table summarizes the 2017 and 2018 say-on-pay voting results for meetings at U.S. S&P 500 and Russell 3000 companies through June 30, 2018:

	Russell 3000		*S&P 500*	
	2018	*2017*	*2018*	*2017*
Percentage passed (majority support)	***97%***	99%	***98%***	99.5%
Percentage with >70% support	***92%***	94%	***93%***	94%
Percentage with ISS “Against” recommendations	***13%***	12%	***10%***	9%
Average support with ISS “For” recommendations	***95%***	95%	***94%***	94%
Average support with ISS “Against” recommendations	***66%***	70%	***62%***	69%

U.S. companies, broadly speaking, had similar results on say-on-pay votes in 2018 as compared to 2017 and other recent years, with the vast majority of companies achieving high levels of support. In addition, say-on-pay results between the U.S. S&P 500 companies and the U.S. Russell 3000 companies have largely converged.

Although there has been a slight increase in the percentage of failed votes (*i.e.*, votes with less-than-majority support) in 2018 to date, very few say-on-pay votes overall came close to failing, consistent with prior years. The generally low rate of negative results is a result of the efforts that companies have made to engage with shareholders and address concerns through changes in compensation practices and clearer compensation disclosure. Companies, shareholders and shareholder advisory firms all have become more adept at effective off-season communications where the company can obtain feedback on the most recent voting results, as well as set expectations and hear concerns for the coming year.

There continues to be significant year-over-year turnover in failed votes. However, this year, the number of companies that failed their say-on-pay vote after failing in the previous year was meaningfully higher than in the past. Of the 22 companies that failed their say-on-pay votes in 2017 and have had their 2018 vote, only 13 achieved majority support in 2018, and only nine had support levels over 70%. Although companies with failed votes generally have been able to be successful in engaging in, and disclosing, shareholder outreach efforts and, as appropriate, implementing program changes in a way that brings high support levels in future years, this year’s results may suggest that low say-on-pay votes have become stickier.

Of the 50 companies in the Russell 3000 that failed say-on-pay votes in 2018 so far, only 10 had failed their 2017 vote, and 24 had support levels over 70% in 2017. The seven S&P 500 companies that failed say-on-pay in 2018 so far had support levels ranging from 66% to 99.7% in 2017. These reversals of results highlight the importance of continuous attention to compensation reporting and related shareholder concerns. Companies should be aware that the metrics that impact levels of say-on-pay support are endpoint sensitive and can change significantly year-to-year.

Increasingly, off-season shareholder outreach has become a regular feature of corporate governance and shareholder relations for many large companies, facilitating an open dialogue between issuers and investors on compensation and other key topics. Shareholder outreach takes various forms at different companies, including face-to-face meetings, one-on-one phone calls, group conference calls and web meetings, and, in some cases, includes board members. Companies conducting such outreach must be mindful that company representatives may not disclose material non-public information in these discussions due to selective disclosure concerns under Regulation FD.

Companies should ensure that the appropriate personnel at institutional clients are involved in the discussions and the decision process—often institutional investors have both governance experts and investment professionals, each of whom will have critical input into the voting process, but may have differing views. Companies should also ensure that the appropriate company representatives are part of discussions with institutional investors. Board representation in discussions with large investors, especially on topics such as succession planning or executive compensation, may be appropriate but should be evaluated on a case-by-case basis, taking into account the purpose of the meeting and the preferences of the investor with whom the company is engaging.

Companies have increasingly engaged with proxy advisory firms in the off-season as well. ISS[39] and Glass Lewis[40] post their engagement policies on their websites. The policies of both firms restrict their ability to engage with companies during the solicitation period for the annual meeting, which means broader discussions with these firms must occur in the off-season.

As discussed above, recommendations from proxy advisory firms continued to influence voting results this year, and the role of proxy advisory firms and their impact on shareholder voting continue to attract debate and legislative reform efforts. The Corporate Governance Reform and Transparency Act, which was approved by the U.S. House of Representatives in December 2017 but has not yet been approved by the Senate, would require proxy advisory firms to register with the SEC and provide issuers with greater opportunity to preview, and more time to respond to, the firms' reports. While it is unclear to what extent any such reforms would affect the role and impact of these firms, companies should closely monitor the progress of these efforts.

[39] ISS's engagement policies are available at http://www.issgovernance.com/policy/EngagingWithISS.

[40] Glass Lewis's engagement policies are available at http://www.glasslewis.com/for-issuers/glass-lewis-corporate-engagement-policy/.

For a more detailed discussion on trends in shareholder engagement, institutional investor influence and shareholder activism, see our publication, dated March 26, 2018, entitled "Review and Analysis of 2017 U.S. Shareholder Activism."

B. OVERALL ISS APPROACH ON SAY-ON-PAY EVALUATION

ISS has a multipronged approach to assessing executive compensation for the purposes of recommending a vote for or against the management say-on-pay proposal.[41] However, an analysis of ISS's 2018 negative recommendations for S&P 500 companies suggests that the most important criterion continues to be the pay-for-performance assessment, and that the most important factor under this pay-for-performance assessment is the alignment of CEO pay with Total Shareholder Return (or TSR) in relation to the ISS-determined peer group.[42]

ISS's policies provide that it will recommend a vote against a company's say-on-pay proposals if any of the following is true:

- there is a significant misalignment between CEO pay and company performance (pay-for-performance);
- the company maintains significant problematic pay practices (for example, excessive change-in-control or severance packages, benchmarking compensation above peer medians, repricing or backdating of options, or excessive perquisites or tax gross-ups); or
- the board exhibits a significant level of poor communication and responsiveness to shareholders.

ISS applies these standards by assigning companies a "high," "medium" or "low" level of concern for each of the five evaluation criteria listed in the following table, which shows the number of "high concerns" under each criterion for U.S. S&P 500 companies that received a negative say-on-pay recommendation from ISS in 2018:[43]

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41 Glass Lewis's executive compensation assessment policy appears to be less formulaic than ISS's, though Glass Lewis publicly discloses less detailed information about its policy than ISS does. Based on Glass Lewis's published information, it evaluates compensation based on five factors: overall compensation structure, implementation and effectiveness of compensation programs, disclosure of executive compensation policies and procedures, amounts paid to executives and the link between pay and performance. In evaluating pay for performance, Glass Lewis looks at the compensation of the top five executive officers, not just the CEO. In addition, Glass Lewis looks at performance measures other than total shareholder return—it measures performance based on a variety of financial measures and industry-specific performance indicators. See http://www.glasslewis.com/wp-content/uploads/2018/01/2018_Guidelines_United_States.pdf for more information.

42 Of the 41 S&P 500 companies that received negative ISS recommendations in 2018, nearly all warranted "high concern" on their pay-for-performance assessment, indicating a misalignment between CEO pay and company performance.

43 The numbers for the categories add up to more than the total because some companies received "high concerns" in more than one category.

	U.S. S&P 500 Companies with Negative ISS Recommendations
Total with negative recommendations	41
Number that had "high concern" on:	
• Pay-for-Performance	39
• Compensation Committee Communication and Responsiveness	2
• Severance/Change-in-Control Arrangements	3
• Peer Group Benchmarking	1
• Non-Performance-Based Pay Elements	4

These results indicate that, although pay-for-performance is just one factor in the overall compensation assessment, it is the dominant determinant of ISS's outcome on the say-on-pay vote. A more detailed discussion of ISS's pay-for-performance policies and how they were applied in 2018 follows.

C. ISS PAY-FOR-PERFORMANCE ANALYSIS

Since the 2012 proxy season, ISS's methodology for evaluating the pay-for-performance prong of its assessment of executive compensation in the context of say-on-pay proposals begins with a quantitative analysis of both relative and absolute alignment of pay-for-performance.[44] If the quantitative assessment reflects an apparent pay-for-performance disconnect (*i.e.*, a "high" or "medium" concern), ISS applies a qualitative analysis, including an in-depth review of the company's Compensation Discussion & Analysis, to "identify the probable causes of the misalignment and/or mitigating factors."

1. Components of Quantitative Analysis

Beginning for 2018, there are four components of ISS's quantitative assessment:

- ***Relative Degree of Alignment, or RDA (relative alignment of CEO pay and total shareholder return over three years).*** The metric that is given the greatest weight in the quantitative assessment is the alignment of CEO pay and TSR,[45] relative to those of a peer group. The relative alignment metric looks at the difference between (a) the percentile rank within the ISS-selected peer group of a company's TSR and (b) the percentile rank within that peer group of a company's CEO pay.[46] The company's score is based on this difference calculated on a three-year basis. The threshold for receiving "high concern" is a difference of 50 percentile points or more. *As discussed below, this metric continues to be the strongest predictor of ISS recommendations and of overall voting results.*
- ***Multiple of Median, or MOM (relative CEO pay to peer group median over one year).*** The second relative component of the pay-for-performance assessment is prior-year CEO pay as a multiple of the peer group median. This metric considers pay independent of

[44] Technical information and guidance on ISS's say-on-pay methodology is available on the ISS website.

[45] TSR measures how much an investment in the stock would have changed over the relevant period, assuming the reinvestment of dividends.

[46] See Section III.C.3.a for a discussion of how "CEO pay" is calculated and some potential comparative problems this may cause.

company performance. ISS's scoring system may trigger a "high concern" if this multiple is 3.33x or higher.

- ***Pay-TSR Alignment, or PTA (absolute alignment of CEO pay and TSR over five years).*** The third component measures alignment between the long-term trend in the CEO's pay and the company's shareholder returns over a five-year period. This does not depend on year-by-year sensitivity of CEO pay to changes in TSR, but instead compares the straight-line slopes of five-year trend lines (based on a linear regression) for each of CEO pay and TSR. A "high concern" may be triggered if the CEO pay trend slope exceeds the TSR trend slope by 35 percentage points or more.
- ***Financial Performance Assessment, or FPA (relative alignment of CEO pay and financial performance over three years).*** This new relative measure compares the percentile ranks of a company's CEO pay and financial performance across three or four financial metrics, relative to the ISS-selected peer group, over the prior three-year period. FPA was first introduced as part of the pay-for-performance qualitative evaluation in 2017. As of 2018, the FPA measure has been added to the quantitative assessment and is applied as a secondary measure after the traditional three components (RDA, MOM and PTA) have been calculated. The FPA uses three or four of the following financial measures, depending on the company's industry: return on invested capital, return on assets, return on equity, EBITDA growth and cash flow. Performance is measured using the 12 most recent trailing quarters. The weighted average performance rank is compared to the company's CEO pay rank, similarly to the RDA.

The "medium concern" and "high concern" thresholds for non-S&P 500 companies are summarized as follows:

Primary Quantitative Measure	***Medium Concern Threshold***	***High Concern Threshold***
Relative Degree of Alignment	-40	-50
Multiple of Median	2.33x	3.33x
Pay-TSR Alignment	-20%	-35%

For S&P 500 companies, ISS updated its policy for meetings held on or after February 1, 2018, lowering the MOM medium concern threshold from 2.33x (which continues to be applicable for other Russell 3000 companies) to 2.00x. The lower threshold corresponds to the intensified investor scrutiny on the escalating CEO compensation among large-cap companies.

Primary Quantitative Measure	***Medium Concern Threshold***	***High Concern Threshold***
Relative Degree of Alignment	-40	-50
Multiple of Median	***2.00x***	3.33x
Pay-TSR Alignment	-20%	-35%

Based on the preceding, ISS will assign an initial quantitative score (ISS may deem multiple "medium concern" levels as the equivalent of an overall "high" quantitative concern). ISS then applies the FPA score as a potential modifier. The FPA will modify the initial score only if a company has either (a) a medium concern or (b) a low concern that borders on a medium concern threshold under one of the three primary measures.

IV. EQUITY COMPENSATION PLAN APPROVALS

	ADOPTION OR AMENDMENT OF OMNIBUS STOCK PLANS			
	Russell 3000		S&P 500	
	2018	2017	2018	2017
Number of proposals voted on	***478***	785	***68***	129
Percentage with ISS “against” recommendations	***21%***	20%	***9%***	5%
Average level of support with ISS “for” recommendations	***91%***	93%	***93%***	93%
Average level of support with ISS “against” recommendations	***77%***	77%	***73%***	76%
Number of failed proposals (<50% support)	***2***	3	***0***	0

U.S. listed companies are required under stock exchange rules to obtain shareholder approval for the plans under which they award executive compensation to employees and directors.[52] Because shareholders generally support the use of equity compensation by public companies as a means to align the interests of employees with those of investors, in most cases these proposals are uncontroversial and pass by a wide margin. As indicated in the chart above, the average support levels for these proposals are typically around or above 90%, and only two proposals failed to achieve majority support this year.

Beginning in 2015, ISS introduced an “equity scorecard” approach to assessing equity plans. The scorecard method, in which the passing score was raised from 53 to 55 in the 2018 policy updates, considers factors under three main categories:[53]

- ***Plan cost.*** Cost is calculated as the Shareholder Value Transfer relative to industry/market-cap peers; this measures the dilutive effect of the new shares requested as well as shares remaining for issuance under existing plans (often called “dilution” or “overhang”), and is calculated both with and without outstanding unvested awards.
- ***Equity plan features.*** Specifically, penalizing lack of minimum vesting periods, broad discretionary vesting authority, liberal share recycling and single-trigger change-in-control provisions.
- ***Historical grant practices.*** Specifically, three-year “burn rate” relative to market and industry peers, among other factors.

ISS recommended against around 21% of equity plan proposals, but recommended against only 9% in the case of S&P 500 companies; this difference is likely due to the impact of the larger public float on the plan cost and the movement away from problematic plan features. ISS recommendations have a fairly significant impact on voting results—in 2018, the average support level was 91% when ISS recommended “for” approval and 77% when ISS recommended “against.”

[52] *See* Section 303A.08 of the NYSE Listed Company Manual; Nasdaq Stock Market Rule 5635.

[53] ISS’s current equity plan scorecard approach is described in its U.S. Equity Compensation Plans: Frequently Asked Questions.