COMPENSATION LANDMINES & KEY ISSUES

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"I would not give a fig for the simplicity this side of complexity, but I would give my life for the simplicity on the other side of complexity." **Oliver Wendell Holmes, Jr.**

Executive compensation has continued to develop as a result of new Say on Pay ("SOP") disclosures and proxy advisory firms continuing to influence institutional shareholders. Listing standards related to independence requirements for compensation committee members and the selection of their advisors are now in place, all public companies are now influenced by SOP regardless of size, pay for performance continues to be a hot button, clawback policies are ambiguous but polarizing, and internal pay equity and the ratio of median company employee to the CEO now has legs to it. Steven Hall & Partners brings more color to this in their 2016 report, "Trends In Proxy Access Votes." It shows as of August, 39 companies (1.5%) of Russell 3000 Failed Say on Pay. Bottom line, it's tougher today than ever before if you have any responsibilities around pay.

As we all know, Institutional Shareholder Services ("ISS") and Glass Lewis ("GL") have a significant impact on how institutions vote on compensation-related practices and the boards that govern those companies. Now, more than ever, is the time for companies, executives, committees and board members alike to reach out to their major shareholders whom ISS and GL influence the most. Thus far in 2016,"ISS voted against 224/1,929 companies (12%)." So, of the 224 companies that were voted against 39 failed to receive majority shareholder approval, according to Semler Brossy. In fact, L&A is seeing more and more companies stepping up discussions with these key institutional shareholders to communicate to them what is important to the company and shareholders, identifying key components in compensation programs that align executives with shareholders, and ensuring that company performance plays a vital role in determining the measures used in those programs. What is most interesting is that a company can have an analyst at an institution rate them a "strong buy", but have a compliance person at the same institution vote against the company because they just robotically follow ISS and/or GL. This is a tremendous disconnect that, in time, needs to be corrected.

That being said, the most significant impact ISS and GL have on companies relates to the pay for performance disconnect. ISS and GL evaluate pay for performance alignment on both quantitative and qualitative measures. Quantitative measures seek to gauge the alignment of a company's executive pay practices to company performance and evaluating the CEO's compensation against the company's total shareholder return. Qualitative measures seek to determine how a company defines its peer group for benchmarking purposes, the ratio of performance-based equity to time-based equity awards, or the appropriateness of performance goals and how easily they can be achieved. Whatever the case, companies have continued to evolve their compensation programs to meet these stringent requirements by these shareholder activists.

As a result, many companies are continuing to implement performance-based equity programs so that compensation is directly tied to company performance. The continued elimination of tax gross-ups, implementation of anti-hedging policies for executives, and increasing executive's stock ownership requirements are just some of the ways that companies are conforming to ISS and GL. Even though companies are implementing these devices to appease the crowds, compensation committees and board members must keep in mind that they must do what is in the best interests of shareholders, even if that means gaining a negative vote from ISS and GL. These committees and boards know their company better than proxy advisors and know what it takes to attract, motivate, and retain the talent needed at their company, especially with a dwindling executive work force in all industries.

Every year that passes brings enhanced SOP legislation and new disclosures for companies to be cognizant of, which ultimately means that companies will continue to have to enhance disclosure of pay practices, performance measures, independence guidelines, etc. in their respective Compensation Discussion & Analysis ("CD&A") sections of their proxy statements to shareholders. As such, what better opportunity to let shareholders know what you as executive leaders, committee members, and board members are doing as fiduciary stewards of the company. While CD&A sections of the proxy statement are getting longer and longer as years pass, companies should use this opportunity to disclose best practices, give shareholders a sense of accomplishment for the year, and to define pay practices that set them apart from other companies. L&A suggests more use of charts and graphs, in lieu of less language, which helps to better illustrate compensation decisions, programs, and links between pay and performance. An executive summary describing company performance and compensation relative to that performance is a key component to the CD&A that companies need to utilize more frequently. A trend that is coming to the forefront which needs to be disclosed, especially in light of ISS and GL pushing so hard for executive pay packages to be reeled back in, is the concept of targeted vs. reported vs. realized compensation. How many times the compensation that is reported in the summary compensation table of the CD&A is actually realized by the executive, less than the general public, ISS, or GL actually are aware of, they only see what is reported and don't think about the latter.

Summary

Ultimately, compensation committees and boards of directors are responsible for the compensation packages that each of them receive and have a fiduciary role to shareholders to hold up their end of the bargain for it to be reasonable, market competitive, attracting, motivating, and retentive to all parties involved. As such, the buck stops there. All this legislation, new disclosures, nitpicking of company policies, and taking apart of executive compensation packages are not only getting outrageous but overwhelming for some companies. Companies are increasingly, with each new piece of legislation passed, being tempted with the opportunity to go private, discourage existing private companies from conducting an IPO, or even contemplate leaving the country in search of better corporate tax rates (but that's another discussion). All of this could eventually leave America wondering, what just happened?

If you have any questions regarding this issue, or any other compensation or corporate governance issues, feel free to contact us at 281-378-1350 or visit our website www.longnecker.com.

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