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Lessons from the 2018 Proxy Season for Say-on-Pay and Equity Plan Votes

We explain the factors behind a drop in investor and proxy advisor support and what those involved in executive compensation can do to prepare in the off season.

Another proxy season has wrapped up, and this one can be considered challenging for some technology and life sciences firms that got caught in the crosshairs of evolving proxy advisory firm standards.

On the Say-on-Pay front, Institutional Shareholder Services (ISS) issued more negative recommendations this year versus last year, coinciding with lower average shareholder support. Recent stock market gains across all industries in 2017, higher equity compensation values and rising incentive payouts drove higher total executive pay levels in almost every industry last year. And, yet, many companies have struggled to convince investors and proxy advisory firms that executive pay levels and company performance are aligned. Declining support for Say-on-Pay in 2018 marks a departure from the improvement we saw starting in the 2015 proxy season.

Meanwhile, ISS and Glass Lewis are also increasing their scrutiny of share plan requests. ISS has recommended against around 36% of all share plan requests that have come to a vote this year to-date while Glass Lewis has advised against around 20% of them. This has caused more companies to pursue non-ISS compliant share plan requests. Companies have been fairly successful with these non-compliant requests partly because they are often seeking reasonable share requests for a limited time period (typically one or two years) and spend considerable time persuading shareholders to support the plan.

Let’s dig into the specifics around Say-on-Pay results.

Say-on-Pay

In every industry breakout we examined, the percentage of negative ISS recommendations increased, coinciding with lower average shareholder support as seen in Figure 1.

Empower Results®

Figure 1

Say-on-Pay Trends at Technology and Life Sciences Companies

Pharmaceuticals & Biotechnology (GICS 3520)

	2017	2018
ISS Against Recommendations	13.5%	14.7%
Failures	1.8%	1.3%
Average Shareholder Support	91.3%	90.7%

Health Care Equipment & Services (GICS 3510)

	2017	2018
ISS Against Recommendations	11.4%	12.8%
Failures	2.1%	1.6%
Average Shareholder Support	90.8%	90.3%

Software & Services (GICS 4510)

	2017	2018
ISS Against Recommendations	14.4%	17.1%
Failures	2.4%	3.7%
Average Shareholder Support	90.5%	89.3%

Technology Hardware & Equipment (GICS 4520)

	2017	2018
ISS Against Recommendations	9.6%	15.2%
Failures	0%	1.4%
Average Shareholder Support	91.1%	90.1%

Semiconductor Equipment (GICS 4530)

	2017	2018
ISS Against Recommendations	3.0%	10.5%
Failures	0.0%	2.0%
Average Shareholder Support	93.7%	89.5%

Source: ISS voting analytics platform

Aside from pay-for-performance misalignment, other issues contributing to lower Say-on-Pay support include:

- Inadequate disclosure around short- and long-term incentive goals

- Lowered incentive goals without adequate rationale
- Increased target incentive opportunities when underperforming relative to the industry
- Large one-off grants without sufficient rationale and/or risk-mitigating design features
- Above median benchmarking (especially when using outsized peers)

Approximately 8% of all Russell 3000 companies have triggered ISS' Board Responsiveness Policy for the 2019 proxy season. ISS expects companies to disclose their process for shareholder engagement and actions taken in response to any vote below a 70% threshold. Meanwhile 13% of Russell 3000 companies have triggered Glass Lewis' board responsiveness threshold. Glass Lewis raised its trigger for board responsiveness to Say-on-Pay support below 80% this proxy season.

Further complicating companies' messaging to investors is ISS' brand new secondary quantitative CEO Pay-for-Performance filters, called the Financial Performance Assessment (FPA). This screening measures a company's performance (outside of total shareholder return) and pay levels relative to the ISS generated pay-for-performance peer group. ISS uses three to four designated financial metrics to assess a company's performance under the FPA in each industry. Since the firm uses non-adjusted GAAP metrics, the application of this testing to companies with significant M&A or corporate restructuring activity resulted in poor pay-for-performance scoring for numerous companies in 2018. In many cases these companies had strong total shareholder return results.

Companies that failed to obtain majority approval in 2018 or fell below one or both proxy advisory firms' Board Responsiveness Policy thresholds in 2018 will be expected to disclose in 2019 that they engaged with shareholders to understand their concerns and took some action to address those concerns. Absent such action, companies face possible negative vote recommendations for both Say-on-Pay and the reelection of compensation committee members. Even if a company is technically above the proxy advisory firm voting thresholds for these policies, it is good practice to engage with investors if your Say-on-Pay results have gone down from the prior year as it indicates increased investor dissatisfaction with some element of your pay program.

Share Plan Proposals

When it comes to share plan requests, as we mentioned, more companies are seeking non-compliant share plan proposals if they find their request won't meet ISS or Glass Lewis standards without significant modifications the company isn't willing to make. In fact, many firms find that even if they adopt virtually all of the ISS-deemed best practices for plan features or grant practices, they can obtain only limited share pools. For instance, companies with significant share buyback activity or relatively low common shares outstanding generally have a hard time passing each firm's dilution and run rate policies, regardless of whether the lower common shares outstanding benefits shareholders or not. Alternatively, companies with very high outstanding underwater stock option balances in the overhang also have a hard time passing both the ISS and Glass Lewis dilution cost tests.

Figure 2 shows that while ISS negative recommendations haven't increased across all industries, they have been historically high (particularly when compared to Say-on-Pay vote recommendations).

Figure 2

Equity Plan Authorization Votes

Pharmaceuticals & Biotechnology (GICS 3520)

	2017	2018
ISS Against Recommendations	34.9%	31.8%
Average Shareholder Support	84.6%	82.4%

Health Care Equipment & Services (GICS 3510)

	2017	2018
ISS Against Recommendations	29.2%	20.0%
Average Shareholder Support	83.9%	85.1%

Technology Hardware & Equipment (GICS 4520)

	2017	2018
ISS Against Recommendations	18.8%	26.3%
Average Shareholder Support	87.4%	87.3%

Software & Services (GICS 4510)

	2017	2018
ISS Against Recommendations	23.8%	22.5%
Average Shareholder Support	87.5%	89.9%

Semiconductor Equipment (GICS 4530)

	2017	2018
ISS Against Recommendations	6.9%	16.7%
Average Shareholder Support	91.3%	90.9%

Source: ISS voting analytics platform

Companies that pursue non-proxy advisory compliant share plans need to campaign directly to their shareholders and make a persuasive case in the proxy statement to increase their chances of approval. Investors are often willing to take into account company-specific factors.

Some companies are waiting to go back for shares when their personal circumstances improve (i.e., financial performance, dilution profile, etc.). In the meantime, they are taking advantage of the inducement grant listing exchange exception (you can learn more about that in our article *To Fuel Growth, Companies Make a Case for Using Inducement Grants More Often*), changing their long-term incentive mix or taking other actions to extend the life of the share pool.

When deciding how many shares to request in your plan, we recommend a two-step approach. First, assess how many shares your company is likely to need in the next one to three years (with some cushion) to adequately fund market competitive grants throughout the organization. This process often requires some forecasting in headcounts, long-term incentive mix possibilities, as well as share price movement possibilities. Next, assess your equity profile and grant practices relative to ISS, Glass Lewis and your top investors' policies. If your company easily passes either the ISS or Glass Lewis models, the road tends to be a little easier to obtaining shareholder authorization. If you're not easily passing the proxy advisory firms' models, see if there is an easy modification to the plan you can make. However, if you find you may have to adopt too many restrictive plan features to get proxy advisory firm support, then it may be worth pursuing a vote without proxy advisor support and conducting greater shareholder outreach instead.

Next Steps

Given the continued focus on pay-for-performance, it is important that companies continue to monitor their exposure relative to investor and proxy advisory firm policies. Whether it's on Say-on-Pay, share plan proposals or other proxy votes, companies need to assess the pros and cons of moving ahead without a proxy advisory firm recommendation or making modifications necessary to securing an affirmative recommendation. Regardless of the approach taken, shareholder outreach is critical to obtaining higher support levels.

Our consultants are available to answer any questions you have about executive compensation and related corporate governance issues. To speak with a member of our compensation consulting group, please write to consulting@radford.com.

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