What to make of say on pay?

By Robin A. Ferracone

Just like death and taxes, it was a virtual certainty that public companies were going to have to subject their executive compensation arrangements to a nonbinding vote by shareholders. Now, with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) on July 21, 2010, it is an absolute certainty. This so-called say on pay provision of the law will pertain to proxies and business transaction prospectuses for annual or special shareholder meetings that will take place on or after January 21, 2011.

It is unrealistic to think that shareholders will have the resources to take a deep dive into the pay programs of the companies in which they have invested. Instead, they will more likely have to rely on the company or on shareholder advisory groups to make a convincing case one way or the other.

At this point, approximately 75 companies have voluntarily adopted say on pay, including such household names as Hewlett-Packard, Microsoft, General Mills, Avery Dennison, and Pepsico. Our firm, Farient Advisors, estimates that approximately 20% of large companies have now either voluntarily or involuntarily adopted say on pay. For most of these companies, the vast majority of their shareholders have voted affirmatively for the executive pay arrangements.

However, for a few companies, most notably Motorola, Occidental Petroleum, KeyCorp, and Abercrombie & Fitch, the majority of investors voted “no” on the pay programs. And for others, like Wells Fargo, a significant minority voted “no,” which is hardly a vote of confidence. Those firms with a significant percentage of “no” votes will be persuaded to consider reforms in their executive compensation

programs and practices.

When investors say “no” to pay, they do so for three primary reasons. The first is that they view executive pay as being too high; the second related reason is that they do not see the company demanding sufficiently high performance in return for the high pay; and the third is that they do not think that the pay programs and decisions are transparent enough, which implies that they do not trust that the board will make decisions on executive pay that are in their best interests.

The questions then for boards (and their compensation committees) are: (1) how can companies ensure that there is proper alignment between performance and pay; and (2) how can they demonstrate, in a clear, concise, and transparent way, that good performance and pay alignment exists? Moreover, if the relationship between performance and pay is weak, how can they identify and fix any alignment issues up front, before these issues become apparent to investors as they cast their say on pay votes?

The first step in answering these questions is to analyze the relationship between the company’s performance and its total executive compensation levels over time.

Farient Advisors has created an alignment analysis, called the Alignment Report, which assesses a company’s performance-adjusted pay (i.e., total compensation adjusted for actual performance) relative to its actual performance, as measured by total shareholder return (TSR), over time, and does so in relationship to its peers or industry sector. We say that performance and pay are aligned when total compensation, after performance has been factored in, is both:

— Sensitive to company performance over time; and
— Reasonable relative to the market for executive talent and for the performance delivered.

Farient’s Alignment Report visually shows whether or not these two conditions have been met. If so, then the company has an easy way to communicate the integrity of the pay program to investors, leading to a “yes” vote on say on pay. If

not, the company has an opportunity to diagnose and correct the features of the pay program, or pay actions, which may have caused misalignment in the past, but will be corrected for the future, heading off a “no” vote “at the pass.”

As say on pay becomes a reality, it doesn’t have to turn into an extreme event. Clear and proactive steps can be taken to ensure that say on pay becomes a useful communication platform between companies and their investors, and nothing more.

These steps are: (1) get the facts — do an alignment analysis; (2) diagnose any alignment problems and take corrective action, if needed, for the future; and (3) take your case for alignment to investors.

We think that say on pay can be a nonevent. By taking these steps, companies can ensure, rather than merely hope for, this outcome.

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