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PROXIES

Three Predictions for Proxy Season 2015

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As compensation committees and corporations navigate the 2015 proxy season, they must continue to anticipate investor reaction to changes that have the potential to impact shareholder value or garner the unwanted attention of activist investors. An admittedly tenuous endeavor, they must also attempt to forecast the future—looking ahead before the season's trends take shape fully and make headlines.

As part of the Farient leadership team, we have identified three areas to watch in 2015: 1) corporate goal-setting and whether those goals are sufficiently rigorous and effectively communicated to shareholders; 2) the pay ratio rule and whether the controversial provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act will ever become a reality; and, 3) the implications of Institutional Shareholder Services Inc.'s new Equity Plan Scorecard (EPSC).

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A Look Back—Proxy Season 2014 Trend Highlights

To help inform our look ahead, it's helpful first to recap and reflect on the outcomes of proxy season 2014. We know shareholders largely voted in favor of executive compensation and supported most management proposals last year. In addition, the distribution of say-on-pay (SOP) support remained fairly consistent with prior years. Finally, we also saw several emerging trends that will remain on our radar in 2015, including:

The pay gap in the executive suite

Investors continue to evaluate the disparity between chief executive officer and named executive officer (NEO) pay. Significant pay gaps may indicate a weak executive team, power imbalance and/or succession issues, all of which may impact value creation. Several ratings and governance agencies consider CEO pay in relation to an average of other NEO pay of three times to be the extreme threshold for pay disparity in the executive ranks. Companies that exceed this limit often are called out for the disparity.

Pay mix matters

In general, for the past several years, executive compensation design has been moving toward a greater proportion of performance-based long term incentives (LTI) in an attempt to improve alignment of management interests with those of long-term shareholders. What is interesting is that the move toward performance-based LTI compensation has been in addition to other types of LTI pay, not a replacement, and is primarily responsible for the increase in CEO target pay.

Shareholder engagement is becoming mainstream

In the history of Securities and Exchange Commission legislation, nothing has given shareholders a stronger voice on executive compensation than SOP. According to a 2014 study from the Investor Responsibility Research Center (IRRC) and ISS, shareholder engagement is up more than 50 percent over the past four years, with 80 percent of all Russell 3000 companies engaging with investors.

2015 Prediction #1: Emphasis on Goal-Setting

Driven by pressure from both ISS and activist investors, we expect to see a new focus on corporate goal-setting in 2015. Specifically, the spotlight will be on whether targeted performance levels are sufficiently rigorous, alongside a call for greater disclosure and transparency. Select companies may be the focus of activist investors for lowering their targets to what will be deemed more easily achievable goals. What will often be left out of the conversation is the difficulty in assessing and evaluating a company's targeted performance. We recommend that companies be prepared to provide insights on why they made specific decisions. For example, a company might provide insight on why revenue is declining and thus goals are lower when their competitors' revenue is increasing. Goal-setting is not simply a quantitative exercise, but activist investors may treat it as such.

Takeaways

- To this end, directors should consider developing an easy-to-understand disclosure process to manage investor and proxy advisor concerns. This may mean providing an overview of industry dynamics and relative performance comparisons with peers, including an explanation of why some peers' performance is more relevant than others if the peer group characteristics are not fairly homogenous.

- In addition, it may be helpful to convey the underlying strategic priorities that the company seeks to achieve in both the short and long term.

- This will be particularly important if any performance goals (threshold, target or maximum) are lower than in the past year. Boards will need to communicate explicitly to investors the business case and rationale for lowering performance goals relative to prior years, setting targets that fall short of previous guidance or designing incentive plans that yield consistently high payouts, in order to demonstrate that such payouts are warranted by shareholder returns.

- That said, as the broader economy continues its gradual recovery, higher investor expectations coupled with increased company confidence in goal setting will compel boards to set performance thresholds and/or targets that are in excess of prior years' actual results. If performance goals don't increase, boards should provide a clear explanation and strong rationale for why they are not higher and how they are handling the associated incentive payouts

We predict that more scrutiny of companies in 2015 will result in greater standardization around disclosures related to performance in 2016 and beyond. This should encourage compensation committees to take a proactive approach in the coming years.

2015 Prediction #2: The CEO Pay Ratio Rule Is Further Delayed or Eliminated

As part of the Dodd-Frank Act's financial reforms, the pay ratio rule would require public companies to disclose the ratio of CEO compensation to the median compensation of their employees.

An outline for the pending pay ratio rule is expected to come from the SEC by October 2015, but not if Republican lawmakers have their way. Lawmakers continue to voice their concerns about the controversial rule, urging the SEC to discard it and instead focus on other rules they feel are more closely linked to the causes of the financial crisis. There is significant pressure from corporations for repeal as well. Most recently, the National Association of Corporate Directors (NACD) stated its opposition to implementation, noting the rule ''would take global companies months and thousands of hours to come up with a completely useless number.'' Finally, some investors have indicated that they do not know how they would make use of the pay ratio for comparison. This last point stems from the fact that companies have different business models, even in the same industry.

Takeaways

- Unlike other provisions of Dodd-Frank, such as the alignment of pay and performance—Section 953 (a)—and clawbacks—Section 954—where many companies have adopted the rules before they have become law, only a handful of companies have taken on the pay ratio rule voluntarily. Whole Foods and Noble Energy are two examples.

- While reporting voluntarily demonstrates a display of good citizenship and transparency that comes with this disclosure, most companies are waiting to see whether this piece of law is eliminated (or substantially scaled back) in the coming months, given the politicized prospects for completion of final rules.

- Individual directors should consider the best approach by looking at the preliminary calculations, seeing how they would interpret the numbers for shareholders and finally deciding when and how to disclose and communicate the findings in a way that is both transparent and low key.

2015 Prediction #3: ISS' Equity Plan Scorecard (EPSC) Causes Confusion

ISS' new ''scorecard'' model changes how companies need to think about equity program design and plan features. The scorecard includes numerous factors for consideration in order to provide for a more-formulaic consideration of equity plan proposals. Unfortunately, this methodology is less transparent and offers a spectrum of positive and negative factors that may counterbalance each other as policy guidance is still unclear. Further, the weightings for the 13 EPSC factors used in the evaluation process are not specified. Many companies may face confusion as they go through the cycle for the first time in 2015.

ISS has historically recommended against approximately 30 percent of equity plan proposals each year under the existing policy. ISS states that the proposed policy is not designed to increase the number of companies that would receive an ''against'' recommendation, but the true impact of the scorecard is uncertain.

Takeaways

■ We anticipate the EPSC will actually lead to an increase in the number of companies facing negative vote recommendations.

■ One reason for this is the mere presence of outstanding incentive design or equity plan features that ISS does not advocate. For example, single trigger accelerated LTI vesting upon a change in control increases the risk that ISS will recommend a ''no'' vote, as does having discretion to accelerate vesting of an award unrelated to a change in control, death or disability (e.g., for involuntary terminations not-for-cause).

■ Additionally, ISS will now specifically incorporate the proportion of the CEO's most recent fiscal year equity awards that is conditioned on achievement of specific performance objectives, as well as the time period required for full vesting of the CEO's equity awards.

■ As both analyses will have a three-year look back, even those companies not seeking shares this year should evaluate their CEO performance conditions and vesting provisions under such plans, since today's grants will be evaluated with a historical look back when seeking shares in the future.

■ Most importantly, the new scorecard portrays ISS' highly opinionated view of what constitutes a ''preferred'' equity plan based on the 13 design factors. Companies will likely need to engage in expanded shareholder outreach when seeking new shares to ensure that investors understand the rationale when issuers deviate from the ISS template.

Conclusion

Concerns about activism and the influence of proxy advisers' vote recommendations will remain high this year. As we've outlined, new issues will take center stage, bringing with them the potential for contentious annual meetings. As a result, investors will have more to consider when casting proxy votes in 2015, as ISS and institutional shareholders deepen the scope of their corporate governance and executive pay examination.