The attention and focus of the institutional shareholder are only likely to increase.

The role and influence of the shareholder community has been steadily evolving in the areas of governance and executive compensation and assessment of corporate performance. This has been highlighted by the arrival of the activist asset class, continuing influence of proxy advisers and an increasingly engaged institutional shareholder community.

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By Steve Chan and Michelle Tan, Hugessen Consulting and Sandra Pace, Steven Hall & Partners

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There has been a notable increase in the activity of the institutional shareholders in the United States during the past few years. These shareholders have demonstrated an increasing willingness to challenge boards of directors when they have concerns with the performance or oversight of companies.

This increased level of engagement can, in some circumstances, moderate the influence of the proxy advisers, such as Institutional Shareholder Services, Inc. (ISS) and Glass, Lewis & Co., LLC, as they apply a more nuanced approach to their voting decisions.

The attention and focus of the institutional shareholder are likely to increase. As a result, directors, employees and professionals responsible for developing and overseeing compensation programs and related disclosure and shareholder communications will want to ensure they are knowledgeable about their shareholders: who they are, their investment theses and approach, their views on compensation and related governance issues, and their engagement policies.

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Institutional Shareholders on Executive Compensation

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>
> — Bess Joffe, Managing Director, Head of Corporate Governance, TIAA-CREF

These can each differ, in some cases significantly, from shareholder to shareholder.

To gather some insight on a wide range of compensation and governance-related topics, Steve Chan, Michelle Tan and Sandra Pace turned to two governance leaders at prominent institutional shareholders: Bess Joffe, managing director, head of corporate governance at TIAA-CREF and Drew Hambly, executive director, corporate governance at Morgan Stanley Investment Management, Global Equity Group.

Question:
Why do you think executive compensation is such a perennial hot-button topic?

Joffe: Executive compensation is an easy metric for the media to report. With numbers as large as they are, it makes sense that they often engender a strong reaction from the general public. While we recognize it can be a substantial amount of money on an individual basis, from an institutional shareholder perspective, we tend to focus on incentives and targets for the senior executives and whether they are sufficiently stringent to compel smart risks to be taken. Our expectation is that pay is aligned with long-term performance.

Hambly: Executive compensation acts as a window into the efficacy of the board and its role as a representative for shareholders. Since, as shareholders, we do not attend board meetings, we look to external signals such as executive compensation in order to understand how the board is performing. The way the board designs the compensation program, and the ultimate outcomes of this program, indicate to me who is actually in control.

Q: What bothers you about executive compensation in the U.S. today?

Joffe: Companies need to be cautious about asking for approval of, or modifications to, plans that end up treating executives better than shareholders. We understand that we are in a market that is unstable and facing significant macro headwinds and we certainly understand that there may be increased pressure to do something beyond the typical compensation program to retain executives at companies that have been hit hard by some of these headwinds. However, companies need to be calculated about what they ask shareholders to approve and be very clear as to why they believe there is a need. In these situations, we are also interested in hearing how the company approaches retention of key talent in the broader employee base, not just the executives.

Hambly: Overreliance on the use of total shareholder return (TSR) as a performance metric. While the board should certainly be cognizant of the shareholder experience throughout a given period, the management team can't directly impact the stock price (unlike, say, a free cash flow target, which the market will respond to). In my view, this dependence on TSR can create unwanted volatility in pay programs. The CEO should focus on running the business well and should expect consistent, reasonable pay for doing this. You don't want your CEO to worry about whether he/she is going to get a payout this year as a result of a highly volatile program.

Q: How would you respond to issuers who say the use of TSR was encouraged by the shareholder community and particularly the proxy advisers?

Hambly: The key question is, "Are these boards' leaders or followers?" Don't fall back on excuses such as "well, you told us to use TSR." I didn't tell anybody to do that. We want boards that are going to provide strong leadership and do what is ultimately in the shareholders' best interests. Rather than relying solely on TSR, I'd like to see boards consider other metrics that make sense for the business and clearly explain why they make sense.

Q: Any advice to the drafters of compensation discussion and analysis documents (CD&As)?

Joffe: The storytelling around the link between company performance and executive pay is getting better, more comprehensive and easier for investors to understand. We appreciate that additional context is increasingly provided. That being said, CD&As continue to be long and unwieldy. During the U.S. proxy season, when you might have hundreds of proxies to vote in a given week, having "CliffsNotes" from the company, not just proxy advisers, allows investors to focus on the most relevant data points. For example, the inclusion of pay and performance information in charts and graphs and the executive summary has been a very helpful practice.

Hambly: CD&As are lengthy, repetitive and challenging to read. Helpful disclosure clearly states the metrics the board and management think are the most important to drive shareholder value, why this might be, and what the outcomes were in the given year. It's important to be able to tell this story well, which ultimately communicates a well-thought-out plan. I find the regulatory-required disclosure in the summary compensation table to be lacking with regard to equity awards. These grants tend to be a year old once the proxy has been released and, as such, may not be representative of the discussions that the board would have had late in that most recent year. In light of this, we will sometimes look at Form 4s (a Securities and Exchange Commission filing related to insider trading) in order to get a sense of what decisions the board made more recently.

Q: If you have concerns about compensation, how might your organization determine a response?

Joffe: Engagement is the most important tool when we have a concern. If after engaging with a company the concern persists, or if we see that a company has not taken steps to fix a problem, then we will vote against.

This being said, we try to give companies the benefit of the doubt and give them time to make appropriate shifts to their compensation programs, recognizing changes don't happen overnight.

Hambly: While we do not disclose how we are voting prior to when the vote is held, we are happy to share our reasoning with the company after it has disclosed its results. We think it's helpful to the process to have an ongoing dialogue with companies with whom we have significant positions.

Q: Any suggestions for HR teams looking to get a more nuanced view of their shareholders' perspectives?

Joffe: The best thing that HR teams can do, particularly when dealing with large institutional investors that have significant investments in your company, is to make the chair of the compensation committee available for the purposes of engagement both proactively and reactively. Shareholders can only really have an effective conversation about CEO and executive compensation with compensation committee members. These are the individuals who set the compensation, make the decisions and are privy to all of the information. They should be the ones getting feedback about executive pay directly from the shareholders.

Hambly: Coordinate with your investor relations or legal teams (whoever has the relationship with the shareholders at your organization) and participate in their governance calls. Compensation is a big part of these conversations. While you don't have to lead the calls, if you want to hear shareholder concerns you should make yourself a part of the process. Don't limit your relationships to being only with the consultant and the board.

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Q: Do you have any final thoughts or advice for HR professionals responsible for executive compensation?

Joffe: As long-term shareholders, we're very cognizant of the microscope under which the compensation area has been put, and we really do appreciate the efforts that have been taken to be more transparent and communicate in a simpler way. We appreciate the efforts and the engagements to date, and we look forward to continuing to improve upon the discourse and involving compensation committee members.

Hambly: Spend less time worrying about what third parties like ISS or Glass Lewis think. Rather, make sure you know who your top shareholders are and what they think. We don't all think the same. You might talk to 20 shareholders and get 20 different answers, but this is a more valuable use of your time and would support better decision making rather than worrying about a third-party score or vote. ws

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