Market Pulse: Executive Compensation

Executive pay has become an increasingly contentious issue in the last few years. Compensation has reached record levels since the financial crisis despite lackluster stock market performance, triggering backlash from investors and the public alike. According to research from *The Wall Street Journal*, median executive compensation for S&P 500 companies rose 6.6% to reach $12.4m between 2017 and 2018, even as median shareholder return dropped to -5.8%.

In addition, a comprehensive 2018 study by the Economic Policy Institute revealed that average CEO earnings are not only 271x that of the typical American worker, but have also grown 70% faster than the American stock market over the past four decades.

With shareholders having more say on this issue than ever before, companies have been forced to reevaluate and in some cases overhaul existing executive pay schemes in response to external pressure. Based on interviews with 25 corporate counsel, corporate secretaries, and heads of investor relations at North American firms, Toppan Merrill's *Market Pulse: Executive Compensation* examines the ways in which companies are seeking to navigate this changing landscape.

The overwhelming majority of respondents (84%) report increased investor pressure surrounding executive pay over the last three years, with annual bonuses and benefits coming under the most scrutiny.

Respondents cite the misalignment of executive pay with company performance as a key concern for investors. And although companies are making visible efforts to address such concerns in advance—either by following market trends; holding preemptive dialogue with key shareholders; or making dramatic cutbacks to CEO salaries—survey results suggest there is no blueprint for navigating these new, unprecedented levels of transparency and investor involvement.

Toppan Merrill's *Market Pulse: Executive Compensation* provides detailed insight into the rapidly changing world of executive compensation based on feedback from those who know it best. We hope you find this month's report both informative and useful.

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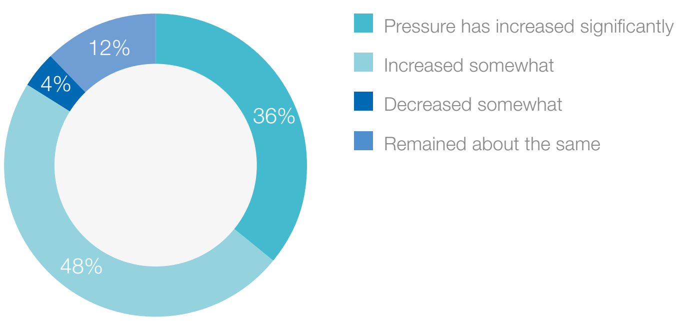
How pressure regarding executive compensation is changing

The pressure is rising

Our survey reveals that companies are coming under increasing scrutiny over executive compensation. The majority of respondents (84%) have faced mounting pressure with more than third (36%) admitting it has increased significantly. Only 4% of respondents say that there has been a decrease over the last three years.

Over the last three years, how has the level of pressure on your company and board regarding executive compensation changed, if at all?



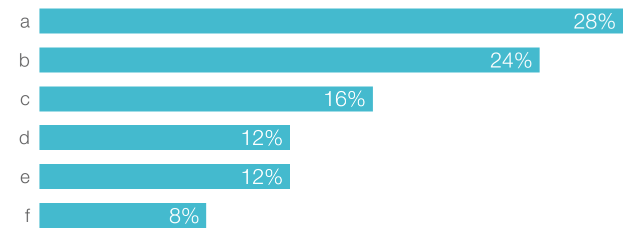
These results mirror broader developments in the market, with executive pay schemes at large public companies coming into the spotlight due to poor stock market performance. Celgene Corporation, a drugmaker acquired by Bristol-Myers Squibb last year; Fluor Corporation, a construction firm; and retail giant Gap are just three examples of large corporations whose leadership has publically had to justify executive pay in response to criticism that it was grossly misaligned with stock performance.

Gap provides perhaps the most telling example of the extent to which such criticism can influence actual compensation. The retailer saw CEO Arthur Peck forfeit his annual bonus in 2018 after news emerged that he would take home $20.8m despite the company's -21% annual return. The company also provided a public rebuttal to the numbers cited in the press, stating that Peck ultimately received $4.75m in cash and equity for the year after factoring in stock-price fluctuations and other external factors.

Bonuses and benefits come under particular scrutiny

Public and media attention may generally focus on one key aspect—for example, a CEO's annual pay as listed in security filings—but shareholder concerns are more granular, with each element of executive pay coming under the microscope. Over the past three years, respondents say shareholders have been most concerned with annual bonuses (28%) benefits (24%) and contingent payments (18%). Long-term incentives, base salary and perquisites are seen as lesser priorities.

Over the last three years, which aspect of executive compensation have your shareholders been most concerned with?



a Annual bonus
b Benefits
c Contingent payments
d Long-term incentive package
e Base salary
f Perquisites

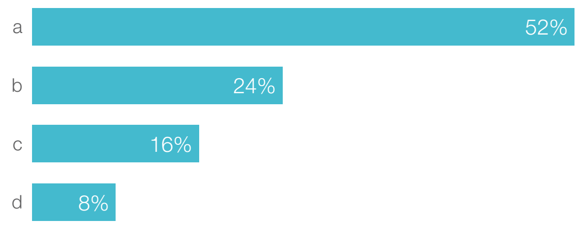
In areas where the link between performance and pay is ambiguous, the burden lies on companies to make the relationship explicitly clear. A respondent from the financial services sector notes that shareholders often "do not understand the depth of decisions" regarding benefits and perquisites, meaning leadership must maintain an open and educational dialogue to address potential concerns in advance. "The key here is to identify with queries being raised by shareholders and give them your full attention," he says.

In a similar vein, corporate counsel for a leading data analytics firm believes that companies must be prepared to explain any pay metrics that differentiate executives from other employees. "Shareholders are more inclined to be concerned with benefits rather than the regular payment structure," she says. "These areas are far different from what the rest of the employees in the company are entitled to."

Proxy advisory firms pile on the pressure

More than half of respondents say proxy advisory firms have put the most pressure on companies with regards to executive compensation. This reflects the widespread impact firms such as Institutional Shareholder Services (ISS), Glass Lewis, and Egan-Jones have had on high-stakes shareholder votes this year.

What is the greatest source of pressure on your company when it comes to executive compensation?



a Proxy advisory firms
b Activist investors
c Outside/independent observers
d Large institutional investors

Proxy advisory firms have become so influential that new regulations may soon try to rein in their powers: as this report goes to print, the SEC announced it would consider updating rules on the use of proxy advisory firms in an effort to increase transparency surrounding how their recommendations are formed, as well as to expose any potential conflicts of interest.

Outside of proxy advisory firms, just under a quarter identify activist investors as the group applying the most pressure, followed by outside observers (16%) and large institutional investors (8%). Yet although the pressure appears to be concentrated, a respondent from the healthcare industry argues that these various sources are in fact interrelated: "Independent observers provide more pressure than one would anticipate with their regular commentary about how compensation policies should be altered and what should be done to improve the performance of executives. Proxy advisory firms relate these concerns for those who seek guidance, such as larger institutions, and from there the pressure builds for companies to make alterations."

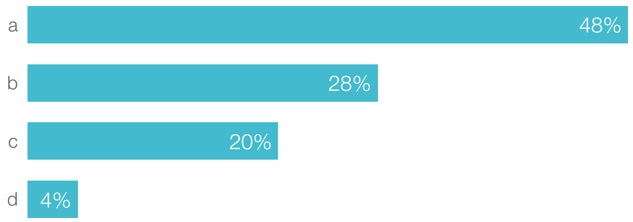
A respondent from a leading US-based construction and mortgage company similarly links executive pay pressures to a network of interested parties. "Activist investors are changing their approach to management, getting more vocal and presenting their stands for change," he says. "Often, this can lead to increased pressure on deals and other business activities. The increased involvement of rank and file shareholders has made clear that they want their opinions of top management compensation to be heard."

Shareholders want more emphasis on performance pay

Focusing in on specific criticisms from shareholders, the majority (48%) are calling for a greater emphasis on performance pay as opposed to base pay. A further 28% believe that different metrics in evaluating performance as a guideline for compensation, i.e. using actual shareholder returns instead of earnings per share or stock price. And a fifth feel that pay packages are just too high in general.

Structural changes to executive pay at industry-leading companies demonstrate the lengths firms will go to in order to address these issues. American Airlines and Toyota have both made bold moves to align pay and performance, with American Airlines CEO Doug Parker opting to forfeit his own paycheck and be paid entirely in stock, and Toyota CEO Akio Toyoda announcing plans to pay executives partly in restricted stock as opposed to all cash. Both gestures represent efforts to encourage longer-term thinking on the part of leadership, and to showcase a greater commitment to aligning the interests of top management with those of shareholders and employees.

What has been the most common criticism your company has received from shareholders or observers regarding your executive compensation policies?



a More emphasis should be put on performance pay (and less on base pay)

b Different metrics should be used for performance pay (e.g. shareholder return as opposed to earnings per share or stock price)

c Overall pay packages are too high

d Compensation is not focused enough on the long term

According to Tim McIntyre, Executive Vice President of Communication, Investor Relations & Legislative Affairs at US-based chain Domino's Pizza, it is important for shareholders to see a clear mix of short-term and long-term incentives: "[Long-term incentives] create stability among our leaders [while] annual bonus targets are designed to create a 'sense of urgency' at the same time," he says. "We see a blend of long-term thinking and short-term objective-setting as important to our culture. The short-term incentive plan is EBITDA-based for all employees and leadership, consistent and bottom-line driven. Given our shareholder return track record of the past few years, we think we're on track."

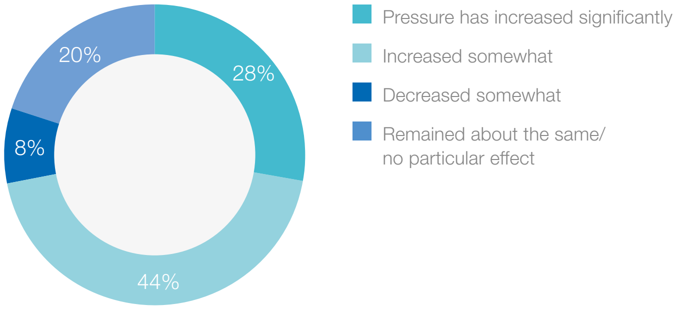
"We see a blend of long-term thinking and short-term objective-setting as important to our culture."

Tim McIntyre, Executive Vice President of Communication, Investor Relations & Legislative Affairs, Domino's Pizza

CEO pay ratio rule rings changes

Say on Pay regulations, which require shareholder approval of executive compensation as well as "golden parachute" arrangements, have understandably lead to increased shareholder pressure since their establishment under Dodd-Frank in 2011. Nearly three-quarters of respondents say the rule has ignited a moderate (44%) or significant (28%) increase in pressure from investors to change executive compensation at their company.

How has shareholder pressure regarding executive compensation changed at your company, if at all, since the CEO pay ratio rule came into force?



However, Say on Pay experiences vary widely for individual companies. While the large majority of S&P 500 companies see executive compensation packages approved by over 90% of shareholders, according to data analyzed by Equilar for The Associated Press, approval ratings at many large-scale conglomerates have been far from unanimous.

Compensation packages for GE and AIG were approved by 70% and 55% of shareholders, respectively, after leadership changes and stock performance shook investors' faith in leadership in 2018.

In an even more extreme example, 52% of Disney shareholders voted against the company's proposed executive compensation packages that year, causing Disney to cut CEO Robert Iger's annual earnings by $13.5m and raise the bar on the performance goals Iger would need to meet in order to earn his full bonus by 2021. After those changes were agreed to, Disney's pay packages were still only approved by a 57% majority.

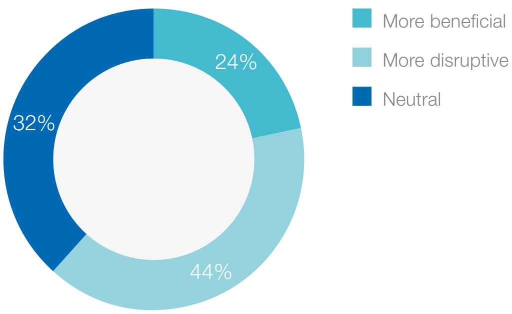
How companies are being affected by and responding to the pressure

The reaction to Say on Pay rules

Say on Pay has challenged companies to navigate shareholder relations in new ways since its establishment nearly a decade ago, and some actually credit the rules for improving shareholder relations overall. Yet respondents remain split when it comes to Say on Pay's true value: 44% believe the rules to be disruptive; 24% view them as beneficial; and 32% are neutral.

In attempting to address Say on Pay within their proxies, all respondents say they choose to engage consultants while close to half (48%) subscribe to peer group activities.

In your opinion, is Say on Pay voting more beneficial or disruptive to your company's corporate governance?



How are you addressing Say on Pay within your proxy—do you subscribe to peer group practices or have you engaged consultants?

There has been considerable debate as to whether Say on Pay is effectively influencing executive compensation trends and keeping leadership accountable for performance. A 2018 study by the Harvard Law School Forum on Corporate Governance & Financial Regulation suggests that Say on Pay has indeed helped to address a time-tested problem, which is that company directors have historically done a poor job of aligning executive pay with performance. But Say on Pay itself has flaws: most notably, its tendency to encourage short-term thinking and its potential to be misinformed and unfair to leadership. These issues notwithstanding, one respondent says that after some initial growing pains, Say on Pay has ultimately "proved beneficial" in helping all parties come to a "mutual understanding" of how executive pay is calculated. Another respondent says the rules have forced leadership to get creative in determining pay structures that are "feasible to shareholders, but not completely demotivating for CEOs."

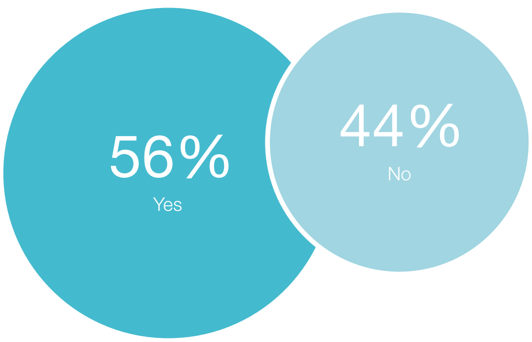
The direction of travel for executive compensation

Executive pay has been rising steadily since 2008, and this trend is clearly reflected in survey results. The majority of those polled (56%) have seen an increase in executive compensation for their company's top executive, and half of this group justifies the increase by stressing the need to keep pace with overall market trends. For over a third, improved company performance has been the primary justification while only 14% say their justifications have been sector-specific.

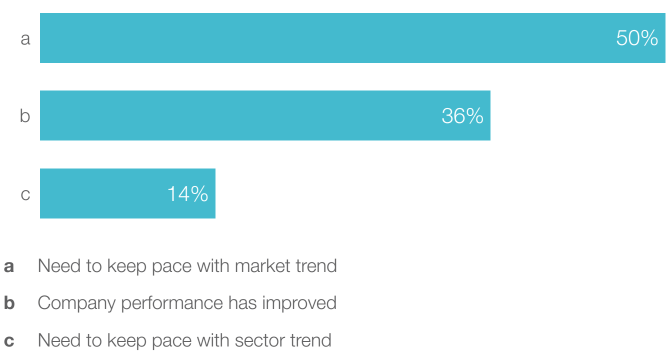
Across the board, respondents say shareholders increasingly want to see executives held individually accountable for performance. The Head of Investor Relations for an energy company explains: "Packages based on performance of the executive, apart from the company, are being emphasized in every meeting. These criticisms are increasing with time and the pressure is building. Although there is a long-term target in mind, it seems important to shareholders to align compensation with immediate achievements, meaning within a three- to five-year range."

A real estate respondent echoes the opinion. "The setting of performance goals and managing payments based on facts, rather than on previous experience or expertise of executives, are the more common criticisms we are hearing where executive compensation policies are concerned."

Over the last three years, has executive compensation increased for your company's top executives?



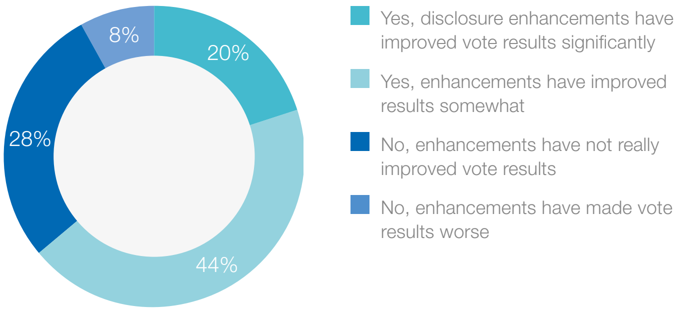
If yes, how has your company justified the increase?



Effects of increased disclosures on proxy votes

Respondents report mixed results from increased executive compensation disclosure requirements on proxy vote results. Overall, 62% say increased disclosure has had a significantly (20%) or moderately (44%) positive impact on vote results, leaving a substantial 36% reporting a negative result.

Have past executive compensation disclosure enhancements improved your proxy vote results?



While respondents on the whole are familiar with Say on Pay at this point, more recent SEC rules requiring companies to disclose the ratio of CEO pay to employee pay have been presenting new challenges. One respondent describes the effects of these new disclosure requirements at his firm. "Since the CEO pay ratio rule came into force, we've had to address additional criticism from shareholders on existing compensation policies," he says. "The tendency of investors has been to make comparisons to companies of similar merit and value. The pressure is growing, and it's more than we had anticipated."

Pay ratio disclosure rules have indeed already lead to heightened public scrutiny of executive pay structures in the broader market, with companies like Yum Brands and Mattel raising eyebrows in 2018 for having CEO-employee pay ratios of 1000x and 4000x, respectively.

Gaps of this size may be easily explainable—for example, manufacturing operations in countries with lower wage standards can magnify the CEO-employee pay discrepancy—but companies are nevertheless on the hook for justifying such disproportions to a skeptical public in more detail than previously required.

Conclusion: The issue of executive pay will not go away

Executive compensation promises to remain a focal point for companies and investors in the months and years to come, thanks to the twin forces of increased transparency and more hands-on shareholder involvement. And although there is no one-size-fits-all approach for companies to deal with the ramifications of this increased scrutiny, respondents to this survey have consistently stressed the need for absolute transparency and ongoing communication.

Shareholders are intensifying the pressure on businesses to explain what executives are doing to warrant their earnings in the short term; likewise, public data on CEO pay ratios—even if mathematically and ethically sound—are putting the onus on businesses to provide explanations that ward off potential criticism and reputational damage.

Finally, one of the main communication challenges going forward will be to validate the true merit of executive level work. One respondent says his company now seeks to communicate exactly “the level of business acumen required” for executive level positions, so that bonuses and other privileges can be viewed as rational rather than excessive.

Another respondent says shareholders’ tendency toward side-by-side “comparisons to competition” in areas like contingent payments means companies must explain precisely what their executives are doing differently to warrant such rewards. In the months ahead, we can expect companies to become both more thorough and more creative in their communication styles—and, perhaps more importantly, restructure executive pay in such a way that will limit potential backlash in the first instance.

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>
> **Corporate counsel, medical equipment company**

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