Activists at the gate of executive pay

Why activists are concerned with executive pay and what boards and their compensation committees should be doing now to respond to these concerns.

By Roger Brossy and Blair Jones

Activists have become prominent and often divisive figures in corporate boardrooms and in the public eye. Activist campaigns are on the rise — a pace of increase of 35% from 2014 alone and 60% since 2013. Their impact is profound: over 15% of campaigns since 2013 have resulted in board seats for activist designees. Among activist areas of focus, executive pay has not escaped unscathed; in fact, we predict activism will be one of the key influencers of the executive compensation dialogue in the near future. Activism will magnify pay and performance conversations, spotlighting the alignment of pay design and decisions with activist business theses and using new information from the soon-to-be-released Dodd-Frank requirements to further reinforce their views.

So, is this good news or bad news, or maybe a little of both? This article explores the targets and impact of shareholder activism and reflects on what can be learned and applied by companies that want to forge an executive pay program that drives results and speaks to all stakeholders.

Dramatists vs. Constructivists

There are claims for and against the impact of activists on company performance. But it is unfair to clump all activists together. Shareholder activism comes in many forms and agendas. Some, such as public pensions and labor unions, focus on promoting social, political and environmental causes. The most significant rise in activist activity, however, has come from the class of investment managers concerned with shareholder value creation.

The modus operandi can vary even among the shareholder value focused group. On one end of the spectrum is the "dramatist," or overtly public campaign. Such activists specialize in the public forum and target management or board members directly, or use populist issues like executive pay to draw in other shareholders for support. These campaigns are replete with headlines and seemingly personal charges against incumbents.

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But there are also constructive activists who seek a low profile and approach companies with the intent of avoiding a public fracas. The "constructivists" hold strong views on corporate actions that should be taken, but, at least initially, they will seek collaboration and only escalate publicly if unsuccessful.

Why activists are concerned

While executive pay is frequently a prominent theme in activist campaigns, it is often not the central reason for activist involvement. Activists are concerned with executive pay for two primary reasons: to highlight weak governance or to cite an impediment to the financial and strategic decisions they think should be considered.

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The first reason can be critical for the public campaigns. Executive pay has been characterized as a litmus test for corporate governance and can illustrate governance shortcomings, particularly where pay is high but performance is poor or mediocre. As such, executive pay deficiencies can be used to draw in other investors. The largest institutional voting blocks may be less compelled to sign on for strategic or balance sheet-oriented actions that activists seek, but they may more readily resonate with a case for corporate governance failure and the need for fresh perspectives. Executive pay also resonates with individual shareholders. It has become more conspicuous in public discourse since "say on pay" can be a convenient lever to get the attention of retail investors.

The case against incumbent pay programs will typically focus on one or more of these three areas:

• *Pay for performance deficiencies.* By definition, the public campaign makes a case that performance has been weak and strategies are available to make it substantially better (potentially with fresh leadership). Odds are the campaign will also highlight generous pay doled out over the course of this weak performance. Like any PR campaign, the facts may be aligned conveniently to the case being made. For example, the campaign may pull pay figures from the proxy's Summary Compensation Table, which can be wildly divergent from what executives actually earn. Likewise, pay comparisons may be made to a single peer or select peer group that the company does not agree is representative.

• *Pay-related governance issues* include concerns over low say on pay outcomes or poor grades from proxy advisors. The activists may suggest these votes and recommendations highlight legitimate concerns and indicate that directors' lack accountability.

• *Peripheral issues* can include criticisms of peer groups, non-direct pay elements (such as supplemental retirement), stock ownership and stock sales. Some activists say companies "cherry pick" peers to defend pay increases. Others protest executives' lack of "skin in the game" due to limited share ownership, or question when CEOs have sold stock.

The second reason for activist focus on executive pay is its impact in either blocking or promoting management decision making. Activists may rightly diagnose a stable compensation program as one that is encouraging management complacency. Looking from the outside in, activists may surmise that a management team's failure to jettison declining businesses or make other hard choices is enabled by a pay system with few negative consequences. Or they may criticize pay designs as too operationally oriented, with little focus on the capitalization decisions they support such as returning excess capital through buybacks or special dividends.

Activists may seek to have significant influence on pay if they are successful in getting themselves installed on the board or otherwise gain the ear of the company's leaders. Here, the activist point of view may begin to separate from the views of the larger institutional share voting blocks. For example, an activist strategy may be to enact a highly leveraged, front-loaded "mega grant" which is an approach generally viewed unfavorably by institutional investors.

Incumbent boards should either welcome this dialogue with activists or have already considered and thoughtfully rejected the activist position. Constructive dialogue where activists are pushing for rationalized business lines, strategic combinations or divestitures, disciplined spending and investment and efficient capital strategies can — and has — resulted in meaningful shareholder wealth creation in many cases. Incentive compensation may not always be central to these strategies, but it can certainly play a role in encouraging or discouraging their adoption.

What boards should be doing now

Across the spectrum of board responsibility, much has been written about "thinking like an activist" in order to preempt an activist campaign. With respect to activists using pay program criticisms to build a voting coalition, it certainly behooves a board compensation committee to indeed "think like an activist." Relevant to the three areas we noted above, committees should be taking stock of:

1. Whether pay for performance holds up: is the rationale for the rewards both durable and appropriate and is it clear in the CD&A?

2. Whether the relative security or risk in the program is appropriate for the type of company and its strategy.

3. Whether governance-related issues "have legs" or can be legitimately refuted. For example, if proxy advisors have recommended "against" say on pay, do they have a point? Or did their methods miss a bigger picture that investors should recognize?

4. Whether peripheral issues are buttoned up: e.g., are peer groups appropriately selected; do stock ownership guidelines have the right teeth; and do buy/sell/exercise patterns for officers and directors show appropriate confidence?

With respect to the second concern of activists — the constructive linking of a thoughtful strategy with appropriate pay programs — this is the ongoing responsibility of both the board (affirming strategy) and compensation committee (supporting said strategy through pay). If companies can benefit from thinking like an activist in this respect, compensation committees may benefit from encouraging conversations apart from the standing calendar. Specifically, committees may consider engaging management in a "blank page" review of programs over one or two separate meetings.

When activists are already at the gate

Where activists have already commenced campaigns, consider: Is the investor willing to work behind the scenes to effect meaningful strategic change? Or, is the investor more interested in loud and public agitation for major transformation? Additionally, identify why compensation is being cited. Is it to grab headlines? Or is it due to genuine concerns with design or practices?

• If it's to grab headlines: consider changes where the charges have merit; plan an active engagement with shareholders to explain the rationale for what's being retained and acknowledge what's being changed.

• And if it's out of genuine concerns with design or practices: listen and engage. We have found that the experience, although perhaps not welcome, can, and often has, prompted decisions that needed a spark.

In summary, incumbent directors and management shouldn't confuse claims made against executive pay in an activist campaign as just a war of words. Before activists are at the gate, preempt these arguments with strong pay-for-performance relationships, clear rationale for defining what performance means (i.e., relative or absolute TSR and/or the financial and operational drivers that underpin them), an ongoing commitment to shareholder communication and strong pay program governance. That's always been the job of the board and its compensation committee, but even more so in this environment. ■

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