

# ViewPoints

## The SEC, proxy advisers, and the compensation committee

On June 9–10, 2011, the Compensation Committee Leadership Network (CCLN) convened in Washington, DC, for its 14th meeting since the network's creation five years ago. As part of the meeting, members enjoyed a discussion on recent developments at the Securities and Exchange Commission (SEC) with SEC commissioner Kathleen Casey and former SEC commissioner Laura Unger. The conversation was off the record, and the commissioners' comments are not included in this document.

Members subsequently reflected on what recent developments at the SEC might mean for companies next year and what the most recent proxy season suggests for the role of proxy advisers going forward.

The following members participated in the discussion:<sup>1</sup>

- John Anderson, Meridian Compensation Partners
- Loren Carroll, KBR
- Jill Considine, Interpublic Group
- Tom Donohue, Union Pacific
- Don Felsing, Northrop Grumman
- David Goode, Caterpillar and Delta Air Lines
- Annette Leckie, Meridian Compensation Partners
- Linda Fayne Levinson, NCR and Western Union
- Laurie Siegel, CenturyLink
- Anne Stevens, Lockheed Martin
- Kelvin Westbrook, Archer Daniels Midland

## Concern over recent developments at the SEC

Members agreed that the SEC faces *“pressure from all sides.”* They expressed concern over the emergence of an *“adversarial relationship between corporate America and the SEC,”* observing the development of *“an underlying premise that directors and companies are not to be trusted.”* One member lamented, *“Directors are being vilified by the regulators.”* Another remarked, *“Years ago, companies and the SEC would have a discussion. I don’t see very many people in the SEC wanting to have an exchange right now.”*

Yet, members expressed appreciation for the opportunities that do emerge to interact with senior leadership at the SEC. CCLN members also recognized that *“a lot [of responsibility] was passed off onto the SEC by Congress through Dodd-Frank,”* and that the SEC faces political pressure to *“show they are doing something.”* Members were worried that an embattled SEC might *“[make] ... rules without understanding the consequences, especially with [executive] compensation.”*

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<sup>1</sup> The compensation committee chairs are identified by their board membership. John Anderson and Annette Leckie participated in their capacity as compensation experts. *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations. CCLN member quotes appear in italics.

## Challenges in the year ahead

As members considered the SEC's agenda for the rest of year, they agreed that their compensation committees will be facing additional fallout from the Dodd-Frank Act:

- **Clawback rules.** Section 954 of the Dodd-Frank Act requires listed securities to have a clawback policy in place.<sup>2</sup> Members granted that a clawback policy has benefits, and indeed, virtually all CCLN members' companies already have such policies in place. But members are concerned about the broadening of the circumstances that can trigger a clawback (any financial restatement, as opposed to restatements resulting from fraudulent or unethical behavior). Said one, *"There is no substitute for judgment and discretion ... I think how the rule was written before was right. Compensation committees had latitude to use their business judgment [to determine whether a clawback was necessary], and that has been taken away."*
- **Pay-for-performance disclosure.** Many members voiced concern that the SEC's proposed rules for disclosing pay-for-performance metrics and measures, which would require disclosing considerable detail, could have unintended consequences: *"Companies will not use certain measures in their compensation plans because they don't want to disclose them for competitive reasons. For example, companies use customer loyalty to gauge their performance internally, but they are not going to use that in compensation plans if they have to disclose the results. Their competitors would have a field day with that."*
- **Disclosure of pay ratios.** Section 935 of the Dodd-Frank Act, if implemented, will require companies to calculate and disclose the ratio of annual median employee pay to CEO pay. However, there are campaigns to remove or amend this proposal.<sup>3</sup> In a public statement, SEC commissioner Elisse Walter acknowledged that implementing the ratio will "at a minimum, be quite difficult."<sup>4</sup> Members said that *"calculating this ratio would be an impossible task"* and *"one that is not very useful."*

While each of these issues individually could present challenges to companies next year, members are most concerned that the cumulative effect will *"homogenize"* compensation plans and limit the board's ability to customize pay plans to particular circumstances: *"I worry that a lot of this rule making could make compensation less dynamic."*

## Proxy advisers and shareholder communication

According to results from the beginning of June, shareholders supported 98.3% of the say-on-pay proposals at S&P 500 companies.<sup>5</sup> ISS recommended against over 13% of the advisory votes at S&P 500 companies as of the beginning of June, yet only six failed to receive majority support.<sup>6</sup>

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<sup>2</sup> Securities and Exchange Commission, ["Corporate Governance Issues, Including Executive Compensation Disclosure and Related SRO Rules."](#) February 16, 2011.

<sup>3</sup> Center on Executive Compensation, ["Congress Should Pass H.R. 1062 to Remove the Dodd-Frank Pay Ratio Which Fails to Give Investors Useful Information."](#) Policy Brief, April 4, 2011.

<sup>4</sup> [Ibid.](#), 1.

<sup>5</sup> See attached, Meridian Compensation Partners, "Memo to CCLN Members," June 2, 2011.

<sup>6</sup> [Ibid.](#)

Some members theorized that advisory votes may not have followed the negative ISS recommendations because *“there is a trend in the direction of challenging ISS.”* One member said, *“I think this season showed that ISS is not as influential as even they thought they were.”*

To some, it seemed third parties were more vocal in criticizing the proxy advisers this season. In a comment letter to the SEC in December, the Society of Corporate Secretaries and Governance Professionals stated that “proxy advisory firm voting influence undermines the integrity of the voting system for a number of reasons: (1) certain proxy advisory firms (primarily ISS) are subject to conflicts of interest; (2) all proxy advisory firms make factual mistakes (sometimes material or egregious) in their analysis ... and (3) all proxy advisory firms to our knowledge lack an economic interest in the shares they vote and therefore have no responsibility to ensure their recommendations achieve the best economic outcome for shareholders of a particular company.”<sup>7</sup>

Nevertheless, members noted that ISS exerted considerable influence over at least two large US companies. Both General Electric and Disney modified their pay plans this year in order to receive “for” recommendations from the adviser.<sup>8</sup> Members generally opposed this practice: *“When should we make deals with ISS? When they raise an issues that the compensation committee also believes is an issue, it should be addressed. But if the compensation committee does not agree or thinks ISS is wrong, we shouldn’t bend. We should talk to shareholders. The committee should be spending time with shareholders rather than trying to get ISS to reverse their recommendation.”*

Members said one of the big differences this year was the amount they engaged with shareholders. One member said, *“The companies that took ISS to the mat and went out to their shareholders to tell their side of the story came away successful. It shows that companies should be going out to shareholders.”* Many members reported that *“proactively reaching out to shareholders was really beneficial”* and said they are going to make sure their companies *“do that more next year.”*

Still, members noted a challenge with communicating with shareholders because of the division of labor in many of the large asset managers. One member said, *“We would talk to the [portfolio managers and analysts], and they would say, ‘We’re happy.’ Then we would talk to the governance people, and they had issues with the plan.”* Members agreed there is a disconnect between the two groups, and it is *“troublesome that the person making the investment decisions is not the same one making the voting decisions.”* In light of this, one member said, *“It’s really important to jump that wall and get [portfolio managers] involved when it’s a really big issue.”*

Many members plan to rely on management to lead shareholder engagement activities going forward, but were willing to get involved if the issue warranted it: *“Management is better positioned to engage with shareholders on an ongoing basis, but if there is a big compensation issue, I could envision the compensation committee chair going out because this person has some clout.”*

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<sup>7</sup> Neila Radin, Secretary, Society of Corporate Secretaries and Governance Professionals, to Elizabeth Murphy, Secretary, Securities and Exchange Commission, [“Re: Concept Release on the U.S. Proxy System, File No. S7-14-10 Proxy Advisory Firms \(Section V\).”](#) December 27, 2010, 5.

<sup>8</sup> Joann S. Lublin, [“Firms Feel ‘Say on Pay’ Effect.”](#) *Wall Street Journal*, May 2, 2011.

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Strong boards and compensation committees are even more important in this era where the SEC is active, yet difficult to engage and proxy advisers have more influence than accountability. Undoubtedly, the compensation committee's role will continue to become more challenging as additional regulations are enacted by the SEC. However, as evidenced by the say-on-pay results from the most recent proxy season, the majority of their shareholders are behind them and the proxy advisers' influence may be dwindling.

### About this document

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