



Executive compensation decision makers at publicly traded companies faced the 2011 say-on-pay vote mandated by the 2010 Wall Street Reform and Consumer Protection Act (Dodd-Frank) with apprehension.¹ For the first time ever, longstanding executive compensation practices and conventions would undergo intense investor scrutiny and be subject to their (nonbinding) approval.

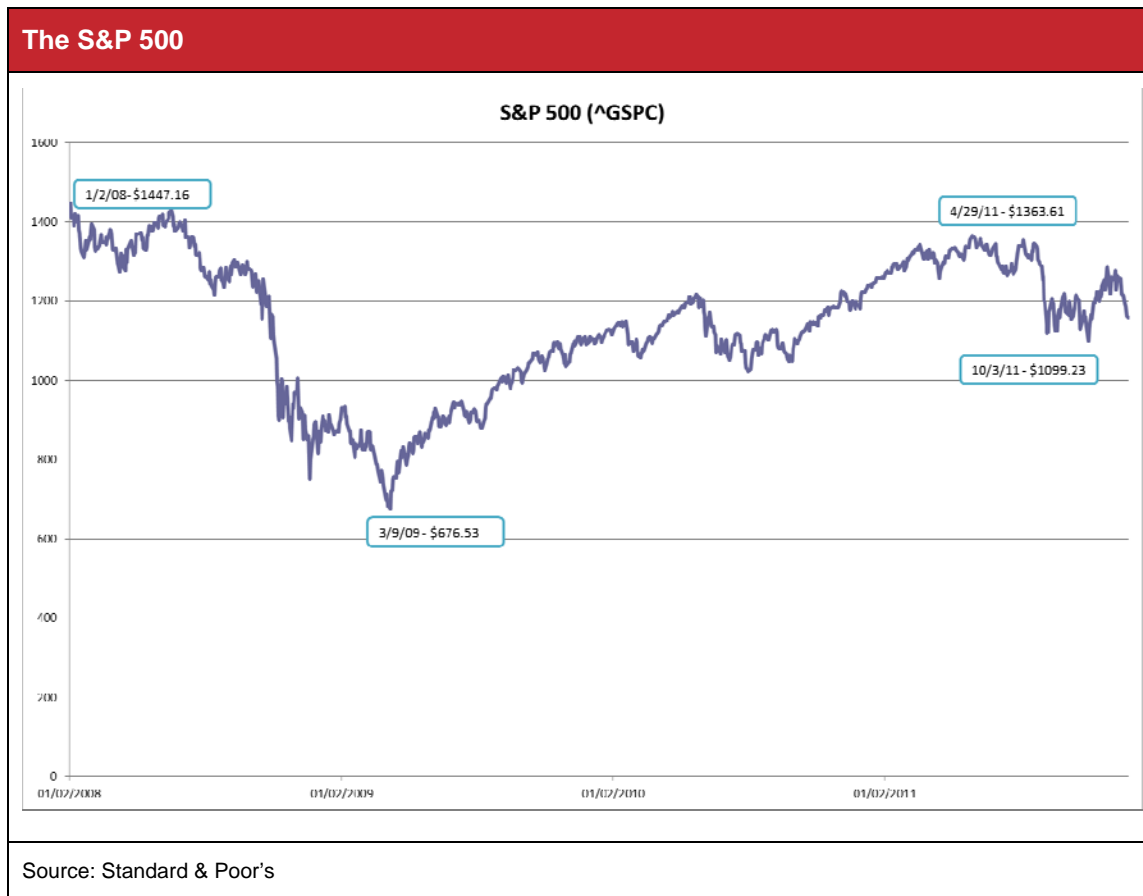
In anticipation of the initial say-on-pay vote, many companies revised what could be perceived as poor pay practices and learned how to better communicate about pay with their investors. These actions, buoyed by a relatively healthy stock market at the time of the vote (see the graph on the next page), meant that most publicly traded companies (*i.e.*, more than 90 percent of the Russell 3000 Index) received a “for” say-on-pay vote.

Because of this first-year success, compensation decision makers may be lulled into complacency when looking ahead to the 2012 proxy season. Some may think, “We got over 90 percent approval on our say-on-pay vote last year, which was well above the minimum requirement of 50 percent. No need to worry about the 2012 vote.” Regrettably, a struggling economy, a volatile stock market and evolving governance protocols suggest otherwise. Rather than fade into a routine procedure similar to the annual ratification of the independent accounting firm, the say-on-pay vote has emerged as a high-profile component of the executive compensation decision-making process, one that requires continued, disciplined oversight.

In anticipation of the 2012 say-on-pay vote, institutional investors and their advisors are refining their analytical approach, particularly around the alignment of pay with performance. Moreover, the Securities and Exchange Commission (SEC), as required by Dodd-Frank, will further influence say-on-pay outcomes when it issues its pay-for-performance and pay-parity disclosure requirements.

¹ The legislation, which President Obama signed into law on July 21, 2010, requires public companies to provide their shareholders with a non-binding vote to approve the compensation of senior executives. Say-on-pay votes give shareholders a voice in how the top five named executive officers are paid. These votes are also a way for a corporate board to determine whether investors view the company's compensation practices to be in the best interest of shareholders.

Winners' Game Plan:
The Next Say-on-Pay Vote May Not Be as Easy to Win as the First



Call to Action

Compensation committees and corporate management need to “up their game” for the 2012 proxy season and its accompanying say-on-pay vote. The game plan requires stronger analytics, more transparent disclosure and evidenced alignment of pay with performance. To “win the vote in 2012,” compensation decision makers must take steps to:

- Foster a non-complacent, collaborative, fact-based executive compensation and governance decision-making, design, delivery and disclosure process,
- Assess the company’s actual alignment of pay with performance, taking into account findings from the 2011 say-on-pay vote, institutional advisory perspectives and an objective audit of the company’s compensation realities,
- Enhance plan designs to strengthen the alignment of pay with performance and address the unique needs of the business and its executives, and
- Improve the execution of executive compensation decision making at the leadership level.

Assessment Framework

To help companies assess the state of their executive compensation programs, Sibson Consulting has developed an assessment framework that consists of two checklists, the “Outside-

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In Audit" and the "Inside-Out Audit." Executive compensation decision makers can use the "Outside-In Audit" (see table 1 below) to identify the "outsider" context in which the company's executive compensation decisions and corresponding disclosures are evaluated.

Table 1: The "Outside-In Audit"	
What do "outsiders" say about the company?	
Category	Questions
Headline News	Which of our pay decisions "made the "news?" Why? What remediation was required?
Poor Pay Practices	To what extent have we been cited for poor pay practices? By whom? In what context?
Inadequate Disclosure	What have the SEC and other outsiders said about the transparency and quality of our pay disclosure? What remediation was required?
Comparative Success	Against whom do outsiders compare our company's performance? What is the assessment of business analysts as to our execution of our strategy relative to these comparators?
Metrics	According to outsiders, what are the key financial and operational measures of success for our company? What is the external assessment of our company's performance relative to these measures?
Pay-for-Performance	What is the outsiders' assessment of the alignment of pay with performance for our executive pay programs? What are the variances identified by outsiders compared to peers? Who said what?
Risk Taking	What investments do outsiders think are required to ensure sustainable profitable performance? What risks are associated with these investments? Have our pay programs been cited because they reward or encourage unreasoned risk taking? Who said what?
Investor Context	Who are our company's largest shareholders? What are their investment objectives? Which institutional advisors provide recommendations to them? What policies influence their votes?
Voting Power	What is the voting power balance among the company's voting constituencies — institutional investors, retail investors that vote, private equity, significant individual owner?
Director Qualifications and Committee Membership	Have institutional advisors recommended a "withhold/against" vote for our directors? On what basis? What was the outcome of the actual vote? What post-vote remediation did the company take?
Source: Sibson Consulting	

The "Inside-Out Audit" (see Table 2 on the next page) can be used to test the company's pay plan designs, decision-making process and disclosure against outsiders' standards and expectations.

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Table 2: The "Inside-Out Audit"	
From the "insider's" perspective, what does the company do?	
Category	Questions
Compensation Architecture	How unassailable are our pay designs and practices? Which legacy plans or plan provisions are redundant with other pay program components?
Peer-Group Defensibility	How does the peer group we use differ from the peers used in outsiders' analyses? Which are the relevant metrics to validate our peer group selection (<i>i.e.</i> , revenue; earnings before interest, taxes, depreciation, and amortization; operating income; return on investment)? How do we explain significant ranking differences from the median?
Poor Pay Practices	What pay practices are criticized by the outsiders who influence our shareholders? Which of these poor pay practices exist in our pay arrangements? Why? What remediation is planned and/or is in process?
Cost of Leadership	How does the total spend for our proxy officers compare to our peers? In total? By pay components?
Metrics Selection	What is the rationale for the selection of the specific financial and operational metrics used in our incentive plans? Which measures are the same as/different from our peers? What behaviors and actions do we expect to drive?
Pay-for-Performance Alignment	What evidence do we have to support a linkage between the pay realized by our executives in the past three years and our company's short- and long-term financial performance over the same period?
Risk Management	Do our incentive plans encourage unreasonable risk-taking? What plan provisions allow the company to recoup ill-gotten gains? What processes do we have in place to manage potential risk associated with our pay plans?
Equity	How adequate is our share reserve? At our current run rate, when will we need additional authorization? If needed <i>today</i> , would we pass the ISS* burn rate and shareholder value transfer tests?
Voting Power	How did each shareholder constituency vote on management proposals in the last proxy season? What intervention is needed?
Disclosure	How robust and transparent is the compensation discussion and analysis disclosure of the "what, why, how much" of our pay programs and practices? In the light of the say-on-pay vote, have we adequately explained our pay-for-performance alignment and the rationale behind pay practices which have poor optics from the investors' view?
* ISS stands for Institutional Shareholders Services, Inc., a provider of corporate governance solutions to the global financial community. See footnote 2 on page 2.	
Source: Sibson Consulting	

By compiling and reviewing the data required to answer the questions in these tables, companies can identify the vulnerabilities in their executive compensation programs. These vulnerabilities should be addressed through redesign and disclosure in preparation for the 2012 say-on-pay vote.

Conclusion

Although the results of the first say-on-pay vote in 2011 were overwhelmingly positive, executive compensation decision makers should not become complacent. The economic, financial, regulatory and legislative environments are uncertain and continue to change. A “for” vote in 2012 is far from a sure thing. Steps need to be taken to prepare the company for another “big win”: a second successful say-on-pay vote.

About the author:

Myrna Hellerman is a senior vice president in the Chicago office of Sibson Consulting. She advises management and boards in the design and implementation of innovative, effective and sustainable people and reward strategies that lead to improved business results. She can be reached at 312.456.7914 or mhellerman@sibson.com.

This article is from the December 2011 issue of *Perspectives*, Sibson Consulting's e-magazine. It is available on the following page of Sibson's website:

http://www.sibson.com/publications/perspectives/Volume_19_Issue_3/winners-game-plan.html.

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