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Executive compensation as a window into the boardroom

Investor intelligence and insights

It is has become a best practice for companies to engage with shareholders during the proxy "off-season"—the middle of the third quarter through the end of the fourth quarter. This is an excellent opportunity for companies to tell investors their story.

At the height of proxy season, proxy voters and governance staffs of major institutional investors are focused on voting their thousands of proxies accurately and fielding calls from companies hoping to sway votes. Many institutional investors have policies of refusing those calls during their busy season. The off-season, however, is an opportunity for companies to make their case to investors with their undivided attention. Companies can also use this time to get a sense of how key investors will view issues on upcoming proxies and test their reactions. Thus, it is advisable for boards to ensure that management has a robust plan for engaging with key shareholders in the off season. One issue always at the top of shareholders' engagement wish list is executive compensation.

Why executive compensation is the number one engagement issue

With the advent of the Compensation, Discussion and Analysis (CD&A) section of the proxy a decade ago and mandatory say on pay votes in 2010, there is more transparency and focus than ever on how the board aligns executive compensation objectives to enhancing shareholder value. For asset manager portfolio analysts and proxy voters, information is king. It's the basis for their models, analyses, and decisions on proxy voting matters. In an environment where investors have relatively little information beyond stock price upon which to judge director performance, the CD&A is the key source of information on board decision-making.

Shareholders view the CD&A as a "window into the boardroom," providing insight into how directors make decisions related to incentivizing management to focus on strategic priorities, and evaluating and rewarding performance. The CD&A is the board's opportunity to explain how it appropriately incentivizes management to enhance shareholder value—in effect, a proxy (no pun intended) of the board's expectations of and report on management.

Compensation decisions are also often viewed as a canary in the coal mine. Overcompensation, gaming of peer groups, misaligned incentives, and unexplained and under-explained compensation rationales may be indicative of failures in other areas.

With that in mind, how are investors grading directors on this important issue? The good news is that nearly half of institutional investors believe that executive compensation practices have improved in recent years, according to a June 2016 survey by Rivel Research Group. The bad news is that only 25 percent believe that companies do particularly well in linking management pay with company performance.[1]

[1] Rivel Research Group, *Board Oversight and Incentives What do Proxy Voters Look For?* June 2016

Practice tips

As noted previously, compensation is the top engagement issue for investors and can impact the outcome of annual say-on-pay votes. More importantly, board oversight of compensation is a key component used by investors to judge director performance. Engagement discussions should be designed to defend the board's compensation philosophy, provide clarity and explanation if required, and demonstrate the board's competency to oversee compensation. The following are key points for boards to consider as they prepare to engage with their most significant investors:

— Ensure that the compensation committee chair is prepared and willing to engage with key shareholders. The most effective approach is for investors to hear the compensation story unfiltered by management—especially if previous say-on-pay votes were under 70 percent.

— Ascertain, to the extent possible, the key issues investors wish to discuss in advance and prepare to address them.

— Demonstrate how the main tenets of the compensation program are designed to further the company's strategic priorities and aligned with long-term shareholder value.

— Emphasize how the board linked pay-for-performance metrics directly attributable to management's efforts.

— Explain in detail how and why discretion factored into compensation decisions. Most investors don't oppose exercising discretion provided that it is accompanied by a robust explanation.

— Review key investors' proxy voting policies. While proxy advisor recommendations matter, direct engagement with major investors can help overcome a negative recommendation.

— Promote the compensation committee members' knowledge and experience. Investors want evidence of the board's competencies in overseeing compensation.

— Obtain outside advice from communications specialists and other advisers to prepare for engagements. In these high-stakes encounters, communication soft skills are just as important as the substance of the discussions.

Stephen L. Brown, former head of corporate governance for TIAA, is Senior Advisor to the KPMG Board Leadership Center.

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