T. Rowe Price

How say-on-pay voting is shaping trends in executive compensation

From the Field
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Key Insights

- It has been more than 15 years since regulators in major markets began requiring companies to seek shareholder approval of their executive compensation plans via so-called say-on-pay votes.
- Recently, a shift of power has been evident in the U.S. and UK markets, with company compensation committees more willing to make decisions they know will be unpopular in the say-on-pay vote.
- In assessing compensation matters, we place high expectations on companies in our portfolios to maintain a strong connection between pay and performance, understanding there may be nuances and exceptions along the way.

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More than 15 years have passed since regulators in major markets began requiring companies to seek shareholder approval of their executive compensation arrangements. These votes, which take various forms, are referred to as say-on-pay votes. In most markets where say-on-pay votes exist, the analysis of executive pay has an annual cadence. This short-term focus creates a structure for investors to remain informed about the pay-related decisions that these corporations' compensation committees make on our behalf each year.

However, it is also important to step back periodically and examine the long-term trends evident within the executive incentive landscape. Accordingly, the purpose of this paper is to assess the

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>
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Say-on-Pay

ADVANTAGES

Since its introduction, it is reasonable to suggest that the say-on-pay movement has delivered mixed results. Some of the positive advantages for investors we would highlight include:

An effective and broad level of engagement between investors and companies. This engagement aspect has clearly gained traction as a result of pay-related discussions. Prior to the advent of say-on-pay, dialogue on governance matters between companies and their major shareholders was occasionally practiced in the UK, but rarely so in the U.S. Discussions about executive pay opened a door, and such engagement is now a frequent and important component of how investment managers practice stewardship over the assets entrusted to them.

Raising the bar for basic, sound compensation practices. While there is robust debate about many aspects of incentivizing executive teams, the transparency into pay practices brought about by say-on-pay voting has unquestionably resulted in certain misaligned practices of the past being phased out. Examples include extravagant personal perquisites for executives, certain expensive and inefficient tax reimbursement benefits, contractual terms that were poorly aligned with shareholder interests, and unusual pay decisions that were not explained by the board.

DISADVANTAGES

On the other hand, say-on-pay voting has not solved many of the core challenges involved in establishing appropriate incentives for corporate leaders. Indeed, in several respects, it has made things worse, as highlighted in the following examples.

Increased disclosure requirements for issuers. With the introduction of say-on-pay voting, regulators understood that they could not ask investors to approve complex executive pay programs without also providing an adequate level of detail to properly assess the plans. Inevitably, shareholders are not the only ones putting this increased transparency to use. Internal visibility of pay details within companies, particularly in the early years, caused some level of disruption as employees gained new insight into what their executive leaders earned.

Perhaps the main cost of providing more detailed compensation data, however, has been its use by each company's competitors. Detailed public disclosure on the composition of executive compensation packages has driven executive pay levels steadily higher, as each party has visibility on what peers are doing.

Increased complexity of executive compensation. This is a clear trend within the large UK and U.S. markets, one that can be tied directly to the advent of say-on-pay. As companies have sought investor support for their compensation programs each year and investor-issuer engagement has become commonplace, companies are receiving much more feedback on pay than they ever had before—in terms of both volume and variety.

Shareholders do not have uniform views on the optimal approach to incentives; in fact, there is surprisingly wide variation in perspectives about topics such as the use of options; the validity of performance-based awards; the appropriate level of pay in absolute terms; what constitutes a long-term program; which perks are appropriate; the use of environmental, social, and governance (ESG) metrics in variable compensation; and much more. In an effort to accommodate investors' wide-ranging perspectives, many companies have layered in mechanisms to demonstrate responsiveness to this feedback. For example, adding or amending the key performance indicators that drive the compensation plan or replacing stock options with performance-based restricted stock. Indeed, new twists are being added every year. After more than 15 years in this cycle, corporate pay programs in the U.S. and the UK have never been more complex than they are today.

compensation environment in two major markets—the U.S. and the UK—some 15+ years after say-on-pay voting was introduced.

We believe that the combination of these positive and negative after-effects of say-on-pay has seen a new dynamic emerge in investor-issuer dialogue on compensation—namely, resistance. We observe a nascent shifting of power taking place in these key markets, with frustrated compensation committee members more willing to make decisions they know will prove unpopular in the say-on-pay vote but that are, from their perspective, necessary to further the interests of the company. While the drivers of this trend are similar, the effects are playing out differently in the UK and the U.S. Given these different impacts, each environment warrants more detailed exploration.

UK

The UK market has both triennial forward-looking binding remuneration policy votes and annual backward-looking advisory votes on a company's remuneration report. Companies seeking to increase the size of the pay envelope must get advance support through the remuneration policy vote. Investors expect that companies will consult in advance on any significant change to the remuneration policy, leading to robust dialogue between the chair of the remuneration committee and the company's top investors before the meeting materials are published. This allows investors the opportunity to provide input to the company's proposals, which the company hopes will lead its investors to support what is ultimately proposed at the annual meeting of shareholders.

The degree of consultation in the UK market is unusual compared with other markets. In recent years, this mechanism has allowed asset managers to encourage companies to show restraint in setting executive pay. UK policymakers and asset owners have also added weight to this push for restraint, given that they see social inequality as a growing systemic problem.

However, for the last 18 months, there has been a rising clamor from the corporate sector, questioning whether this focus on compensation restraint is inhibiting the global competitiveness of UK companies. Concerns have been raised by certain board chairs regarding the ability of UK companies to attract top talent from the U.S., which is a particular impediment if the company is UK incorporated but the bulk of its operations, customers, and revenues are U.S.-based. The concerns relate to total pay quantum

Two of the highest profile pay votes in the UK 2024 annual general meeting (AGM) season were at AstraZeneca plc and Smith & Nephew plc. Both companies were seeking shareholder approval for a new remuneration policy: the proposals passed but with significant dissent. TRPA's voting took a case-by-case approach reflecting the company's specific situation, including performance.

AstraZeneca plc

At the April 11, 2024, shareholder meeting, TRPA's investment strategies[1] voted FOR the executive remuneration program. The proxy research we received from ISS had recommended AGAINST the remuneration policy and a resolution to amend the company's performance share plan. The company sought to increase the maximum long-term incentive plan grant from 650% of salary to 850% at the same time as increasing the maximum bonus grant from 250% to 300%.

We were consulted on the proposal in the off season in 2023 and recognized that this was a very large compensation package in the UK context. However, we felt that the increase was reasonable given a sustained share price performance[2] under the current chief executive officer (CEO) and the need for the company to have an attractive offer, especially given the majority of its peer set is U.S.-based. At the April 11, 2024, shareholder meeting, TRPA's investment strategies[1] voted FOR the executive remuneration program, along with 64% of shareholders.

Smith & Nephew plc

Smith & Nephew has had four CEOs in a five-year period, one of who allegedly left because the company could not match his pay expectations. Over half of the company's revenue is generated in the U.S., and the CEO is also based in the U.S. but paid according to UK norms. The company sought to introduce a new restricted share plan for U.S.-based executive directors and executive leaders only.

During the off season remuneration consultation in 2023, our view was that the company should hold off on the uplift until share price performance had improved. We were also unconvinced by the proposal to exclude UK functional leadership from the restricted shares plan, and so voted AGAINST the remuneration policy along with 43% of shareholders and the restricted share plan at the May 1, 2024, annual general meeting.

[1] Excluding TRPA's Impact strategies.
[2] **Past performance is not a reliable indicator of future performance.**
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While this section is part of our 2023 ESG Annual Report, the votes took place in 2024 as part of the 2024 UK AGM. However, the off season meetings described took place in 2023.

as well as framework design. Much of the criticism, for example, centers on the outsized role that proxy advisors are thought to play in determining the vote outcome. However, a 2023 report from the UK Financial Reporting Council,[1] the regulator that oversees the UK Stewardship Code, sought to build an evidence base on this contentious topic. It found that a vote of 20% or more against a resolution relating to director elections or remuneration occurred in only half of the cases where one or both of Institutional Shareholder Services (ISS) or Glass Lewis, the two largest proxy advisors, had made such a recommendation in 2022, although this increased to 77% of cases when both did so.

The debate on UK competitiveness is not restricted to pay. Other concerns expressed by company chairs include whether the UK Stewardship Code's focus on reporting outcomes has fostered an adversarial tone to investor-company dialogue. And whether the UK corporate governance framework, which for a long time has been seen as an international gold standard, is overly restrictive to the point that it may be discouraging companies from listing in London. Significant consultations on the UK listing rules and the UK Stewardship Code in 2024 are expected to opine on both of these issues.

TRPA casts proxy votes with the objective of best supporting the long-term success of our investee companies. We take account of accepted UK good practice, but we are also open to supporting non-standard plans offering a compelling rationale. To inform our case-by-case assessment of nonstandard pay practices, we expect to be consulted in advance by the companies where we have a significant holding.

U.S.

In the U.S., say-on-pay votes are generally held annually. They are backward-looking and advisory in nature. In essence, they serve as a shareholder referendum on the compensation committee's decisions over the past year. Although they are non-binding, our experience over the past 15 years has been that most companies that have not received strong support (generally, more than 80%) for their pay votes have been genuinely interested in seeking subsequent feedback directly from their largest shareholders. If the weak level of support indicated a serious concern with the terms or structure of the underlying plan, boards have generally been willing to address these in advance of the next vote.

However, we began to observe a shift in this stance after the outbreak of the coronavirus pandemic in 2020. In the two years that followed, the already complex environment for compensation design became, in many cases, unmanageable. Several economic sectors saw dramatic declines in market capitalization as investors predicted a prolonged period of consumer spending headwinds. The volatility in their stock process caused many companies' performance-based awards to become worthless (or at least their vesting became highly improbable) due to factors clearly outside the control of management teams. Faced with the unprecedented circumstances, and a pressing need to retain stability in key leadership positions, many U.S. compensation committees elected to implement stopgap measures. These included special retention awards and/or a resetting of the terms of executives' original performance-based awards.

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Given the uncertainty of the time, we observed considerable tolerance on the part of investors during the 2020 proxy voting season as companies put these stopgap measures into place. However, that same degree of flexibility from investors was extended to far fewer companies in the following two years. Nevertheless, the use of "special retention grants" suddenly became a common way for compensation committees to replace previous equity awards that lapsed unvested due to the pandemic or other factors. We have observed a distinct change in tone from companies using such awards over this time. In the past, companies were quite hesitant to make use of awards that they knew would be opposed by many of their shareholders. Currently, however, it seems U.S. compensation committees have little fear of say-on-pay backlash and will readily implement special awards if they deem them necessary.

Moving forward

Overall, our conclusion is that the current state of issuer-investor engagement on compensation matters is less constructive than originally hoped. While a general shift has been evident among issuers in recent years, leading to a deterioration in alignment with investors, issuers also argue that:

- Some investors are unnecessarily rigid in their expectations of pay programs and do not take company-specific circumstances into account

[1] "The influence of proxy advisors and ESG rating agencies on the actions and reporting of FTSE350 companies and investor voting," The Financial Reporting Council Limited, published July 2023.

- Investors are overly focused on the absolute amount of executive pay and do not appreciate the intensity of competition for top executive talent

- Investors rely too much on the advice of proxy advisors on pay matters, although the Financial Reporting Council's (FRC) research also found that 75% of investors who responded to the FRC's questionnaire requested voting research based on the investor's own in-house, customized, voting policies rather than a proxy advisor's standard policies

- Investors are not forthcoming with their feedback and may oppose pay programs without any advance notice to the company, undercutting the spirit of engagement

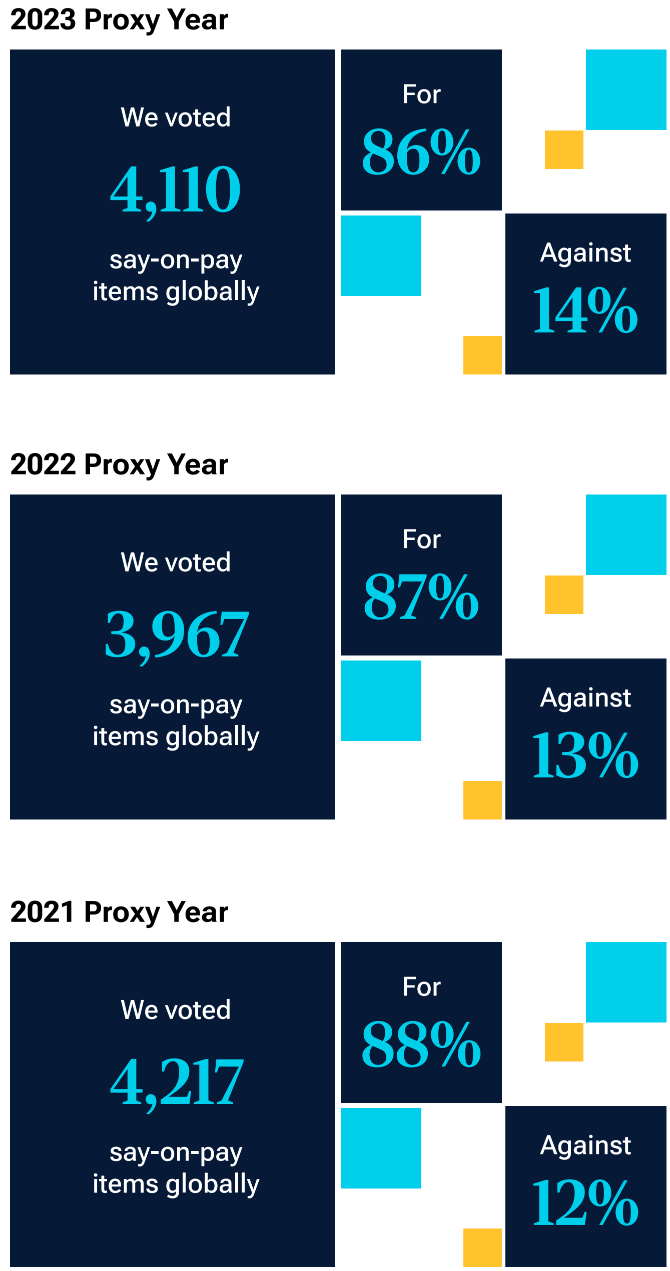
We agree that some 15 years after the arrival of say-on-pay votes, there is still much room for improvement in executive pay practices, investors' understanding of them, and overall alignment of executives' and investors' interests. However, we find the criticism coming from some issuers on this point is not fully supported by the facts, as highlighted in the FRC study cited above. Our engagement on compensation matters is continually aimed at reducing these areas of friction.

A particular area of focus for us in the U.S. this year is the use of performance-contingent equity. Performance stock units (PSUs) were designed expressly for the purpose of linking executive pay with specific performance goals. In theory, they should have improved the alignment of interests with investors. However, after a period of rapid adoption of PSU-based plans, frequent redesigns of the terms of the awards, and constant pressure from proxy advisors and compensation consultants to build incentive programs around PSU awards, our conclusion is that they are not working as originally intended.

Through engagement with many U.S. companies, we are encouraging compensation committees to take a more bespoke approach to plan design—one that meets the company's specific challenges. In short, our observation is that PSUs are not the only way (or the best way) to construct a performance-based approach to pay.

TRPA Say-on-Pay Voting

(Fig. 1) Our approach is pragmatic, investment-centered, and independent.



Source: T. Rowe Price Associates, Inc.

Conclusion

Remuneration is only one topic within the array of corporate governance issues we follow at TRPA. However, it is a topic of heightened importance to corporate executives, board members, asset managers, and our clients. Incentives are clearly significant drivers of behavior and outcomes, which is why this subject area merits our time and focus.

We are proud of our pragmatic, investment-centered, and independent approach to compensation assessment of companies at TRPA. We do not rely on outside advisors for this analysis, and we do not outsource decision-making. We look at the context within which each company makes its pay decisions: its industry, life-cycle stage, performance, competitive environment, and need for talent. We place high expectations on the companies in our portfolios to maintain a strong connection between pay and outcomes delivered to investors, but we also understand that exceptions and nuance may be necessary along the way.

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