Post #39: The Impact of Lower Stock Prices on 2016 Say on Pay

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The current industry downturn is already impacting compensation programs and will likely also impact the upcoming Say on Pay season. Based on our research, the market decline will cause an increased number of energy companies to trip a key ISS test in 2016. Fortunately, it's easy to spot now so companies can anticipate the issue and address it in their CD&A.

ISS's Absolute Stock Price Test

ISS uses three quantitative tests in their evaluation of companies' Say on Pay votes. One of these tests compares 5-year absolute TSR to 5-year CEO compensation (as disclosed in the Summary Compensation Table or SCT). Companies receiving a Medium (score of -20 to -35) or High Concern (score < -35) on this test receive a more in-depth qualitative review of their compensation programs from ISS and are more likely to receive an AGAINST vote recommendation for Say on Pay. According to ISS, companies with a Medium or High Concern receive AGAINST recommendations 22% and 50% of the time, respectively.

The scores on this test for companies in the oil & gas industry will be down significantly this year. We took a sample of 32 E&P companies and 20 oilfield services/drillers and compared their scores in prior years vs. projected scores this year (assuming no changes to SCT compensation). The results are summarized in the following table:

	2014	2015	Projected 2016
Average Score			
• E&P	4	0	-12
• Services/Drilling	2	-5	-18
Percent of Companies with Medium Concern			
• E&P	3%	25%	34%
• Services/Drilling	5%	25%	30%
Percent of Companies with High Concern			
• E&P	0%	0%	25%
• Services/Drilling	5%	0%	15%

Note: The table only shows scores/concern levels on ISS's pay and absolute performance alignment test. Other ISS quantitative tests may have resulted in Medium/High Concern levels for the companies analyzed.

Based on this analysis, we expect a moderately higher prevalence of Medium Concerns and a significantly higher prevalence of High Concerns. This modeling can be estimated pretty accurately right now for any company by using projected compensation results. This allows a company to anticipate the issue before the proxy is filed and the ISS report is released.

Proactively Addressing in the Proxy

As we've mentioned before, the best place to address potential ISS issues is in the CD&A. In this case, a poor score on this ISS test indicates to ISS that there may be a misalignment of pay and absolute performance. To mitigate that concern, it's important to clearly disclose how executives are linked with the decline in share price. Potential CD&A disclosures might include the following, where applicable:

- An actual bonus that is reduced from prior years and/or below target (note: this could also help improve the ISS score in the above test)

- Negative discretion applied by the compensation committee to incentive payouts to reflect the declining stock price environment
- A decline in the potential realizable value of outstanding awards, both performance-based and time-based
- A reduction in the value of outstanding equity holdings
- Other actions taken by the Committee in early 2016 to address the current equity environment (e.g., lower 2016 LTI grant values)

While there is little a company can do at this point to influence the score on the above ISS test or to explain to ISS the test's flaws, companies should identify where they are likely to fall on ISS's tests and focus on demonstrating to shareholders that the Board took action to align executives' pay with the declining stock price.