Stewardship Principles

Addressing executive pay in the US technology sector

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November 2021

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Listed US technology companies often continue to be run by their founders, who also retain large or majority shareholdings. This situation can lead to questions over their compensation policies. Regardless of the type of ownership, concerns arise when boards fail to read the expectations of shareholders – evidenced by poor outcomes at shareholder meetings – and this requires active investors to engage directly with the board.

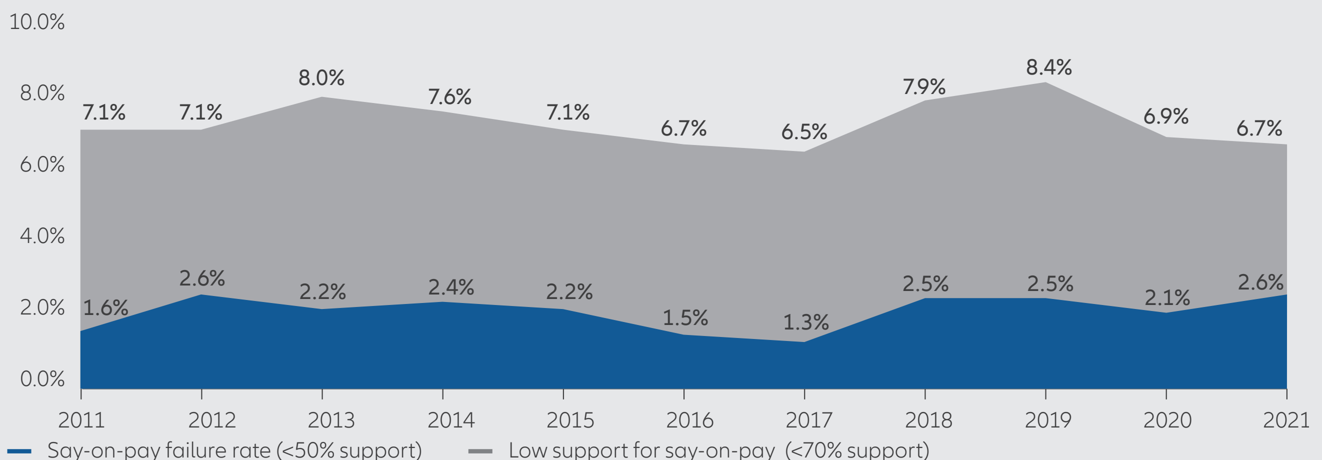
This year's US AGM season threw up a growing number of cases where companies failed to win shareholder support for their advisory vote on pay. Research shows that 2.6% of AGM votes on pay went against management, up from 2.1% last year.[1] And many of these expressions of dissent took place at technology company AGMs. We view these instances as red flags, which in some cases were followed by share price underperformance. This is not surprising; the board's failure to read the expectations of their company's largest shareholders could be indicative of broader governance blind spots.

At Allianz Global Investors, our approach to questions around executive pay is shaped by our Global Corporate Governance Guidelines.[2] The fundamental premise is that the structure and level of executive pay should be designed to promote the long-term success of the company. This entails the board having a clear ongoing apprehension of the expectations of shareholders. The guidelines detail the issues we expect boards and compensation committees to consider, such as the use of share-based compensation to help align the interests of management and shareholders. We support

1. ISS: United States – Compensation – 2021 Proxy Season Review
2. Available on www.allianzgi.com

Key takeaways

- A clear alignment between management and shareholder interests is essential, irrespective of the company's ownership structure
- We see an increased risk that governance weaknesses in founder-controlled technology companies may lead to the adoption of compensation schemes that fall short of the alignment we seek
- Low level of support for an advisory vote on pay is a governance red flag and, in some cases, has been followed by share price underperformance
- Executive pay controversies can harm workforce perceptions of the company, a material risk factor for technology companies facing competitive employment markets
- Engagement with companies can provide more detail on their compensation structures and the reasons for their adoption
- Where questions remain, we will continue to engage and set out our case for change



Source: ISS Governance – 2021 Proxy season review, United States compensation

long-term incentive plans that set demanding, multi-year targets and encourage outperformance.

From governance guidelines to practice

The public equity market in the US is more dominated by large institutional shareholders than other regions.[3] Interestingly, it also exhibits the least concentrated ownership among the OECD economies, with ownership of each company typically spread across a broader number of shareholders. This means that our policy can be readily applied to the US equity market.

However, in this context the technology sector is an outlier within the US; it has emerged in recent decades and many of its companies are still run by their founders. Among more recently established technology companies that have chosen to go public, the founders often retain ownership and voting control.[4] In this, the technology sector differs markedly from others, where founding entrepreneurs are no longer significant shareholders in companies with previously concentrated ownership (eg, multi-generational, family-controlled businesses).

Alignment in founder-run companies is not guaranteed

We recognise that founders can be an integral part of a company's investment case. However, founder-run or controlled companies face a variety of corporate governance risks, ranging from skewed control and ownership structures to issues over the balance and composition of the board. One high-profile consequence can be that compensation and long-term incentive structures do not align management's interests closely enough with those of minority shareholders.

Pay is not the only way to ensure an alignment of interests between management and shareholders. Another key factor is the board, which provides checks and balances to prevent abuse of power by the CEO and management and hold them accountable for performance. The effectiveness of the board is, therefore, another factor we consider when assessing executive compensation. For example, seeking to establish the robustness of the pay-setting process, we consider whether the board – and critically the compensation committee – has sufficient level of independence.

We apply our Global Corporate Governance Guidelines equivalently in all cases, seeking a clear alignment between management and shareholders, irrespective of the ownership structure. Ad-hoc research provided to us recently finds variations between sub-segments of the technology sector, with some founder CEOs receiving compensation in line with peers, while in other cases there are material differences. An important consideration for us as investors is the extent to which management performance is reflected in share price performance.

Our experience so far does not indicate any correlation between compensation structures and inadequate alignment of management and shareholder interests; there is no particular feature of pay in founder-managed companies which makes them more or less prone to poor alignment. There are instances of founder CEOs who choose to receive below-market pay, in some cases nil, suggesting that they see themselves primarily as shareholders in the company. In other cases, we observe that founders' pay is in line with, or sometimes well above, market rates.

Hence, in situations where we have questions about the degree of alignment between management and shareholders, we may decide to engage with the board to gain a clearer understanding of the details of these compensation structures and how they reflect performance. The results of this engagement may be an overriding factor in determining whether we accept management's voting recommendations on pay.

3. OECD "Owners of the World's Listed Companies", available on www.oecd.org
4. CFA Institute "Dual-Class shares: the good, the bad, and the ugly" www.cfainstitute.org

Engagement in pursuit of deeper insight

A well-designed executive compensation scheme should support the alignment of management, primarily with shareholders but also with key stakeholders.[5] In the case of companies run by the founding individual, there tends to be a substantial or controlling shareholding. Where we question the appropriateness of compensation levels or structures, we engage with the board to better understand the rationale and long-term strategy behind compensation schemes.

As an active asset manager, we are keen to differentiate between high and misaligned levels of compensation. We are comfortable supporting high levels of compensation where the company has performed well, and we consider its strategy to have positioned it positively for the long term. In our engagement, there are several areas we regularly explore to gain insights that will supplement our analysis of published corporate reports. These include:

- The rationale behind the compensation policy or specific Compensation Committee decisions.
- The alignment of executive compensation trends with those of the workforce, which can provide insights into the organisation and identify potential areas of internal friction.
- The board's perspective on the company's social profile. Does it have an inclusive approach to all stakeholders (eg, employees, customers, local external stakeholders)?
- Management responsiveness to shareholder and stakeholder views and feedback. How regular, extensive and meaningful is the outreach?

Engagement in pursuit of change

Should the answers to our questions highlight risk factors or areas for improvement, we would continue our dialogue to focus on these issues. Our policy clearly explains our favoured governance structures, especially in cases involving companies that have a large base of institutional investors and are run by professional managers with small shareholdings. We will engage with management teams to discuss how they could amend compensation structures to be more aligned with our guidelines. In discussing the design of long-term incentive schemes, we may encourage companies to:[6]

- Reduce reliance on share options – these can provide an asymmetrical and geared incentive versus long-term shareholdings or strategy. This means that although their value is linked with upward share price movement, their economic value grows at a faster rate than the corresponding share price growth. Additionally, while shareholders may experience loss, recipients of share options can only experience an upside.
- Extend performance stretch targets – high levels of compensation should not be delivered unless linked to outperformance against peers or expectations, not business-as-usual.
- Reduce or eliminate equity awards that are not subject to performance criteria or thresholds.
- Avoid judging performance over periods shorter than three years.

Conclusion: we will deepen our engagement with technology companies

We have identified technology as a particular segment of the US market where we believe there is scope for improved compensation structures and will continue to engage with several of our investee companies on this topic. We will use this engagement process to make clear our expectations and the basis on which we will vote in next year's AGM season.

5. Increasingly stakeholder considerations are also in play. For example, certain aspects of pay affect issues of inclusive capitalism, they include pay gaps across gender or ethnicity.
6. This is a partial list focused on typical shortcomings of long-term incentives. Please refer to our Global Corporate Governance Guidelines for a fuller outline of our expectations.

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Active is: Allianz Global Investors

Data as at 30 September 2021

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