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Executive Compensation

# Shareholder Challenges Apple Pay Practice

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An Apple Inc. shareholder has proposed the following resolution be adopted at the 2017 annual shareholders' meeting:

"Resolved: shareholders recommend that Apple Inc. engage multiple outside independent experts or resources from the general public to reform its executive compensation principles and practices."

In a no-action letter issued Oct. 26, 2016, the SEC concurred with the shareholder, Dr. Jing Zhao, that the proposed resolution be included in Apple's proxy statement for the 2017 meeting.[1]

In its Oct. 7, 2016, letter to the SEC regarding Zhao's proposal, Apple stated, "the Company believes that it may omit the Proposal from its 2017 Proxy Materials in reliance on (i) Rule l4a-8(i)(7) because the Proposal relates to the Company's ordinary business operations, (ii) Rule l4a-8(i)(3) because the Proposal is vague and indefinite and (iii) Rule 14a-8(i)(6) because the Company lacks the power or authority to implement the Proposal." In view of the SEC's position in its no-action letter, Apple presumably will include Zhao's proposal in its proxy statement for the 2017 annual meeting.

In support of his proposal, Zhao notes that all the Named Executive Officers (NEOs), except for Tim Cook, the CEO, received the same compensation for the fiscal year ended Sept. 26, 2015 (the fiscal year 2015). All five positions, as listed in the Summary Compensation Table of the proxy statement for the 2016 annual meeting (the 2016 Proxy Statement), carry the title of Senior Vice President and, in addition, the following titles describing their respective functional areas: Chief Financial Officer; Retail and Online Stores; Internet and Software Services; Hardware Engineering; and General Counsel and Secretary.

Each NEO other than the CEO received the same salary, $1 million, the same bonus, $4 million, and the same long-term incentive award value, $20,000,105 (in the form of Restricted Stock Units (RSUs) (60 percent) and Performance RSUs (40 percent))—a total of $25 million for each executive. A review of SEC filings on beneficial ownership of securities for Apple's senior executives indicates that similar equity awards, also in the amount $20 million, were made to three senior executives below the NEO level in the fiscal year 2015 and that the lock-step practice as to equity awards has continued for the fiscal years 2016 and 2017 (thus far). Such lock-step compensation for NEOs and other senior executives at public corporations is very unusual.

The CEO, Cook, received a salary of $2 million and a bonus of $8 million but no equity award for the fiscal year 2015. The reason Cook did not receive an equity award in 2015, or for other years after 2011, probably is due, at least in part, to the fact that in August 2011, in connection with his promotion to CEO, he was awarded a "mega" grant of RSUs with a grant date value of $376 million. The award, modified in 2013 to include performance targets for approximately one-third of the award, is subject to vesting over the 10-year period ending in August 2021.

## Lock-Step Compensation

The Compensation Discussion and Analysis (CD&A) in the 2016 Proxy Statement explains, at page 25, the Compensation Committee's reasoning for the "lock-step" compensation as follows:

> **Internal Equity.** Our executive officers are expected to operate as a team, and accordingly, we apply a team-based approach to our executive compensation program, with internal pay equity as a primary consideration. This approach is intended to promote and maintain stability within a high performing executive team, which we believe is achieved by generally awarding the same base salary, annual cash incentive, and long-term equity awards to each of our executive officers, except Mr. Cook.
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> **Performance Expectations.** We have clear performance expectations of our executive team, and the design of our executive compensation program reflects these expectations. First, each executive officer must demonstrate exceptional personal performance in order to remain part of the executive team. We believe that individuals who underperform should either be removed from the executive team with their compensation adjusted accordingly, or be dismissed from Apple. Second, each executive officer must contribute to Apple's overall success rather than focus solely on specific objectives within his or her primary area of responsibility.

The concept of the senior executive officers working together as a team is a valid management objective, but the lock-step practice itself ignores distinctions in individual function and individual performance. In Zhao's words:

> What is [the] use of the Compensation Committee when it could not differentiate the contribution of the tremendously different functions of the CFO, the Retail and Online Stores SVP, the Internet Software and Services SVP, the Hardware Engineering SVP and the Secretary of our company?

The only "adjustment" for a senior executive officer's failure to meet the expectation that such officer provide "exceptional personal performance," according to the CD&A statement quoted above, is removal from the executive team or the executive's being "dismissed from Apple." This seems rather draconian. Variations in functions served by executives, including senior executive officers, typically are reflected in variations in pay according to function. Variations in performance over time are reflected in variations in the individual's pay, including annual and long-term incentive awards. Significant job demotion or job dismissal due to failure to provide "exceptional personal performance" does not appear to be a very sensitive tool for managing senior executives.

## Perspectives

Another question is whether the very high compensation level can be justified for each NEO position. It is true that Apple's market capitalization, revenues and earnings put its size at the very top of public corporations. But it is a legitimate question whether Apple's size alone justifies the NEO compensation levels at Apple.

The CD&A in the 2016 Proxy Statement contains the following statement, at page 31, regarding the equity amounts awarded to the NEOs (other than the CEO):

> The value and relative mix of the Annual RSU Awards was a subjective determination by the Compensation Committee based on its own business judgment after taking into consideration such factors as market compensation data provided by its independent compensation consultant, its subjective assessment of the appropriate relationship between time- and performance-based awards, historical equity grants, and, with respect to the value of the awards, financial results and market capitalization compared to peer companies.

This statement is helpful in indicating the methodology used by the Compensation Committee. It does not, of course, explain how the committee evaluated specifically this compensation element or made specific comparisons within Apple or with other companies. CD&As do not typically contain such specific detail as to NEOs.

Following are two survey-based perspectives on NEO pay (not including the CEO):

> 1. For NEOs (excluding the CEOs) in the top 10 Fortune 500 technology companies (excluding Apple)—measured by revenues—, the median total compensation in 2015 was $9.7 million.[2]
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> 2. For NEOs (excluding the CEOs) in the S&P 500 companies (made up of the largest U.S. public companies in terms of market capitalization), the median total compensation in 2015 was $3.6 million. The 90th percentile total compensation was $8.7 million.[3]

These two survey-based perspectives suggest reasons why a shareholder like Zhao might have concerns over NEO pay at Apple. In citing them, the author of this column does not intend criticism of the Apple Compensation Committee or Board of Directors. Based on the statement in the CD&A quoted above the committee reviewed relevant data and other information in deciding how to pay the NEOs. On the other hand, surveys such as the two noted above suggest that careful review be given to the current NEO compensation practice at Apple.

## Independent Experts

Zhao suggests that Apple retain "multiple outside independent experts or resources" in review of its principles and practices. Compensation Committee schedules at most major corporations are very busy. It is important for a committee to obtain sound outside advice and to select its outside executive compensation consultant carefully. The consultants used currently and in the past by Apple are widely recognized and well respected consultants in the executive compensation field. It could be confusing for a compensation committee to receive overlapping consulting reports on its executive pay program from two or more consultants or "independent experts."

The use of multiple consultants to advise as to the same aspects of executive pay programs and practices appears to be limited in the U.S. to a relatively small percentage of public companies. See Kevin J. Murphy and Tatiana Sandino, "Executive pay and 'independent' compensation consultants."[4] In the U.K. apparently a larger number of public companies use multiple consultants, but the number appears to be less than one-half. In an article in the journal Research in International Business and Finance, the authors report "significantly higher equity-based pay for CEOs of firms that rely on more than one compensation consultant."[5]

At least one possible step in response to Zhao's suggestion would be for the Compensation Committee to retain an independent expert to review the committee's year-end decisions and the process followed in reaching those decisions. The critique could be provided within a short period following the year in respect of which the decisions are reached. This would give the committee an independent perspective on how it is handling its own management of the process. Even such a limited critique would have to be handled very carefully to avoid confusion and time-consuming debate within the committee.

At the annual meeting of Apple shareholders scheduled for 2017, it will be interesting to see what the shareholder response is to Zhao's proposal as well as to see the result of the Say-on-Pay vote. The Say-on-Pay vote at Apple has fluctuated over the past five years. The results, starting with the 2012 annual meeting and ending with the 2016 annual meeting, were as follows: 83 percent, 61 percent, 97 percent, 75 percent and 95 percent.[6]

## Apple's Performance

Apple's performance during fiscal year 2016 was not outstanding. Its total shareholder return (TSR) for the one-year period ended Sept. 30, 2016, was 4.5 percent, compared to the TSR for the S&P 500 Index of 15.5 percent for the same period. The recent TSR performance may be attributable, at least in part, to the reported drop in iPhone revenues. According to Apple's 10-K, for the fiscal year 2016, iPhone revenues, which accounted for 63.4 percent of Apple's revenues in that year, dropped 11.8 percent from the iPhone revenues for the fiscal year 2015.

For the four fiscal years 2009 through 2012 Apple's revenues grew at an extraordinary annualized rate of 42.9 percent and its TSR, annualized, was 51.2 percent. For the four fiscal years 2013 through 2016 its revenue growth slowed to an annualized rate of 8.3 percent and its TSR, annualized, was 6.4 percent. In light of the more recent performance, Zhao's proposal for a review of the senior executive compensation principles and practices at Apple makes sense. Certainly the lock-step design and level of pay for the NEOs other than Cook should be considered carefully.

**Endnotes:**

1. A copy of Dr. Zhao's June 13, 2016, letter to Apple (containing his shareholder proposal with a supporting statement) is attached to the Oct. 26, 2016, SEC no-action letter referred to in the text. (Available at https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2016/jingzhao102616-14a8.pdf.)

2. The 10 companies are: AT&T Inc., Verizon Communications Inc., Amazon.com, Inc., HP Inc. (formerly Hewlett-Packard Company), Microsoft Corporation, International Business Machines Corporation, Alphabet Inc. (formerly Google Inc.), Comcast Corporation, Intel Corporation and Cisco Systems, Inc. (The complete list of the Fortune 500 technology (including telecommunications) companies for 2016 is available at http://fortune.com/2016/06/07/fortune-500-technology-companies/.)

3. "CEO and Executive Compensation Practices–2016 Edition" published by The Conference Board in collaboration with Arthur J. Gallagher & Co. and MyLogIQ (September 2016), authored by Matteo Tonello, Paul Hodgson and James F. Reda, at p. 63.

4. Journal of Accounting and Economics 49 (2010), 247-262, at p. 250.

5. See Rezaul Kabir and Marizah Minhat, "Compensation Consultants and CEO Pay," Research in International Business and Finance, Vol. 32, 2014, 172-189, at p. 174.

6. The percentages are calculated by dividing the number of votes approving by the sum of the number of votes approving and the number of votes against.

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