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How to Win the Say on Pay Vote

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With proxy season approaching, public companies must consider their strategy for the second year of the mandatory say on pay advisory vote.

Even companies that passed last year's vote with flying colors should prepare for the upcoming season with a fresh perspective, as the second season of say on pay will present new challenges. Some investors may have applied more relaxed standards to companies last year in recognition of the fact that mandatory say on pay was new. In addition, shareholders and proxy advisory firms may focus on a company's response to the first mandatory say on pay vote, which was not an issue last year. Indeed, in its recently released 2012 draft policy changes, Institutional Shareholder Services (ISS) asked whether its voting recommendations should take into account a company's response to receiving a majority but less than 70% support for its prior year's say on pay vote. Further, an important factor in whether a company received a positive recommendation from the proxy advisory firms was the results of the total shareholder return (TSR) analysis described below and, accordingly, a change in performance can adversely affect the vote, even where compensation practices have not changed. Finally, ISS recently proposed revisions to its voting policies that may impact say on pay recommendations in the upcoming season.

Reasons for Negative Votes. The vast majority of situations in which ISS recommended against, and companies failed, say on pay votes last year involved a perceived pay for performance disconnect. A pay for performance disconnect generally was found to exist if both one-year and three-year TSR were in the bottom half of the company's global industry classification standard (GICS) industry group and the total compensation of the CEO as reported in the summary compensation table was in ISS' view not aligned with TSR over time. Most frequently, the disconnect was found to exist if there had been an increase in year-over-year compensation of the CEO. Pay practices deemed egregious by ISS also contributed in some cases to negative ISS recommendations and to failed votes. Such circumstances most commonly

included (1) option repricings without shareholder approval, (2) excessive perks or tax grossups or (3) entry into new or extended agreements that provide for excise tax grossups or single trigger severance payments.

Proposed ISS Updates for 2012. For 2012, ISS has proposed changing its pay for performance measurement in several meaningful ways. First, ISS has proposed replacing the GICS peer group with a sample of 14-24 companies from the GICS peer group selected based primarily on market cap and revenue. Second, ISS has proposed evaluating CEO pay alignment in both absolute and relative terms. In determining relative pay alignment, ISS would examine CEO pay over one and three years, with 40% emphasis on the one-year period and 60% on the three-year period. The CEO relative pay rank would then be compared to the company's relative shareholder return rank. In addition, ISS would examine the multiple of CEO pay relative to the peer group median in order to identify companies that perform well but in ISS' view nevertheless overpay. Absolute pay alignment would be determined based on an analysis of the rate of change of annual pay as compared to the rate of change of annual TSR over a five-year period.

How To Increase Support for Say on Pay. Each company's situation is unique, but as a general rule companies can take certain steps that will best position the company for the say on pay vote.

- *Understand How Programs Stack Up Against Voting Policies; Analyze Prior Year's Results.* Review the voting policies of major shareholders and understand the ways in which compensation practices may deviate from those policies. Monitor the degree to which ISS adopts its proposed policy changes. Revisit last year's vote results and proxy advisory firm recommendations in order to understand issues that may be particularly sensitive for the advisory firms.
- *Consider Changes.* Consider whether to make any changes to compensation programs as a result of the data points mentioned above. While companies should not make substantive compensation decisions that they do not believe are in the best interests of shareholders merely in the hopes of increasing support for their say on pay proposals, changes may be appropriate where a company feels upon reflection that its compensation arrangements could be improved based on feedback from its shareholders. In this vein, it should be noted that there is little benefit under the say on pay voting policies of ISS and of many institutional investors to eliminating excise tax grossups in "grandfathered" agreements, and that modifying one aspect of an arrangement may open all of its features to scrutiny.
- *The Proxy.* Begin work on the CD&A now, with an emphasis on the relationship between pay and performance. Use an executive summary to highlight key points and key developments since last year, shareholder favored practices that the company maintains

and hot button practices that the company does not maintain; recent analysis suggests that the say on pay proposals of companies using an executive summary received greater support than those that did not.

- *Other Communications.* Consider commencing a dialogue with institutional shareholders before ISS issues its report, particularly if low support was received last year or there is reason to believe that support this year will be low (*e.g.*, its one- and three-year TSR is low or it engages in "egregious" pay practices). Direct communication with shareholders made a demonstrable impact on say on pay vote results last year.
- *Responding to ISS' Recommendation.* After the proxy has been filed, ISS will issue its report regarding the say on pay proposal and will usually provide an issuer with 24 hours to comment on the report. To be in a position to respond promptly to the report, anticipate the timing of the report's release and assemble a task force in advance that will be available to respond on short notice. Comments to the report should focus on those areas that ISS has shown willingness to change: factual errors and inflammatory but irrelevant rhetoric. Regardless of whether ISS is responsive to comments, companies should take their case directly to shareholders, either through in person meetings or by filing supplemental proxy materials.

Advance preparation for the 2012 say on pay vote will help a company identify any issues that may give rise to concern and be in a position to more effectively communicate with its shareholders, whether through direct shareholder outreach or proxy materials.