June 28, 2012

Say on Pay 2012

The following are our observations on the second year of mandatory "say on pay" votes for U.S. public companies under Dodd-Frank thus far this proxy season.

Results of Vote. As of June 25, 2012, of the companies that have reported results for 2012, 54 have failed their say on pay votes. This is an increase from 2011 and there remain a number of companies left to report. Four companies have failed two years in a row. 396 companies in the S&P 500 have reported say on pay results as of June 22, 2012, of which 384 received majority shareholder support (97%). Similar to last year, the mean level of shareholder approval is 89% and the median level of shareholder approval is 95%.

Influence of ISS. The recommendation of ISS continues to have a measurable impact on voting results. ISS has recommended against say on pay proposals at approximately 14% of the S&P 500 companies as of June 22, 2012. Of companies receiving unfavorable vote recommendations from ISS, 21% of those that had reported results as of June 22, 2012 failed to receive majority support. Companies receiving negative ISS recommendations that have nonetheless received majority support have generally done so with considerably lower margins than those receiving a favorable ISS recommendation. According to a recent study by Pay Governance, a negative ISS recommendation results in an average shareholder support level of 65% versus 95% for those receiving a positive ISS recommendation (for S&P 500 companies, the difference in support levels based on such recommendations is 59% versus 94%). According to the same study, this is a 10% increase over last year's correlation. During the approximately two years of mandatory say on pay proposals under Dodd-Frank, only one company that received a positive ISS recommendation failed to receive majority shareholder support. The median change in voting results following a year-over-year change in ISS recommendation is approximately 27%.

Reasons for Negative Vote Recommendations. In the vast majority of situations in which ISS has recommended a vote against say on pay, it is because ISS believes that there is a "pay for performance disconnect." A "pay for performance disconnect" generally exists if, in ISS's view, (1) there is a lack of alignment between CEO pay and TSR as compared to an ISS-selected peer group over a one-year (weighted 40%) and three-year (weighted 60%) period, and there is a lack of absolute alignment between CEO pay and the company's TSR over the preceding five-year period and (2) the company does not provide compensation that from a qualitative perspective is sufficiently performance-based.

In determining whether compensation satisfies ISS's qualitative measures, ISS assesses (1) the ratio of performance- to time-based equity awards, (2) the ratio of performance-based compensation to overall compensation, (3) the completeness of disclosure and rigor of performance goals, (4) the company's peer group benchmarking practices, (4) actual results of financial/operational metrics, such as growth in revenue, profit, cash flow, etc., both on an absolute basis and relative to peers and (5) special circumstances (*e.g.*, a new CEO in the prior fiscal year or biennial equity grants).

Problems with the ISS Methodology. The criticisms of ISS's methodology are well-known (see our 2011 memorandum, [Say on Pay So Far]). This proxy season, we witnessed a particular emphasis on one aspect of ISS's methodology: its selection of peer companies. The peer group used by ISS to determine whether a company has a "pay for performance" disconnect is chosen from the company's GICS group, with an emphasis on companies with revenue and market capitalization which approximate that of the subject company. However, this methodology for a number of reasons often bears little relation to the peers against which a board might assess corporate performance, including the size of the GICS group, the varied businesses of the companies comprising the group, and the fact that competitors against which a company may compete directly for talent may be significantly larger or smaller than the company. For instance, in a widely cited example, ISS refused to agree with Marriott International's request to include Hyatt or Starwood in its group of peers (even though ISS included Marriott as a peer company of each of Hyatt and Starwood) and instead included such firms as Penske Automotive, Icahn Enterprises and Genuine Parts Co. Similarly, JC Penney was criticized for including "aspirational" peers like Disney, Target, Nike and Pepsi, even though JC Penney had recently recruited senior executives from those firms. In fact, of the 35 S&P 500 companies to file supplemental proxy materials through May 27, 2012, 20 addressed deficiencies in ISS's chosen peer group. In response, ISS representatives have recently suggested that its peer group methodology may be subject to review for the next proxy season and that ISS may consider including peers in a company's peer group that have larger or smaller market capitalizations to avoid exclusion of clearly relevant companies.

The second major criticism of ISS's methodology is its continued reliance on targeted compensation as reported in the summary compensation table. ISS attributes its use of compensation as reported in the summary compensation table to its interest in making sure that it evaluates a compensation committee's compensation decisions as of the time those decisions are made. Many investors and companies have begun to focus on "realized pay" by including supplemental tables in the annual proxy showing the amount of compensation actually achieved by the named executive officers. While many investors with whom we have discussed the concept of realized pay are quite interested in the numbers as a significant data point, they are struggling with the fact that there is not a uniform means of evaluating it.

How to Win the Vote. The following are several actions that a company may wish to consider taking to help achieve a successful say on pay result.

- *Understand How Compensation Programs Stack Up Against ISS and Shareholder Standards.* While there is no need to conform executive pay practices to the standards of ISS and institutional shareholders, companies should understand how their practices deviate from such policies and be prepared to explain why their practices differ. In addition, companies should understand where their practices deviate from ISS standards.

- *Disclosure.* Companies should include an executive summary to the CD&A section of their annual proxy that clearly states its targets (to the extent not competitively harmful) for performance-based compensation, the actual performance and the payout based on that performance. In addition, companies should include supplemental compensation tables that include realized pay by the named executive officers. Finally, companies should clearly explain the rationale for the companies that were included in their peer group.

- *Assemble a Task Force*. In advance of the proxy season, companies should identify a task force to evaluate the prior year's say on pay vote and and consider issues that might arise with respect to compensation matters in the upcoming proxy season. If possible, companies should try to surface concerns of institutional shareholders about compensation as part of ordinary course shareholder outreach. Early notice of potential issues provides an opportunity to engage in dialogue, consider modifications and tailor proxy disclosure to address such issues. Once the proxy is filed, ISS usually provides companies in the S&P 500 with a draft copy of its report and recommendations 24 hours in advance of making the recommendation. To be in a position to timely respond, companies should anticipate the likely timing of the release of the draft report and ensure that task force members are available to respond to the report. In preparing for the report, companies should be aware that ISS may issue the draft report over the weekend.

- *Know Your Limits*. As blunt an instrument as ISS's approach may be, comments to ISS on the report should not focus on criticizing ISS's methodology, which in our experience, ISS is unwilling to change in connection with this process. Instead, comments should focus on factual errors in the report and on toning down rhetoric in the report that may be inflammatory but irrelevant to the say on pay question. While ISS is not always willing to fix errors in its reports, it is sometimes willing to do so.

- *Reach out to Shareholders*. No technique is more effective in winning the vote than direct shareholder outreach. The difference between companies that have passed and those that have failed the vote in the face of a negative ISS recommendation is often willingness to engage directly with shareholders. This year, in what appears to be a first, Exxon Mobil held an investor call in order to rebut an unfavorable vote recommendation on say on pay from ISS. Be mindful that outreach to shareholders in the face of a negative ISS recommendation is likely to be more effective if there has been prior contact from the company, so consider making contact in advance of proxy season. Moreover, a vote already made can be changed at any time before the shareholder meeting, so the receipt of a negative vote from a particular institutional shareholder should not dissuade a company from reaching out to the institution and attempting to persuade it to reverse its decision.

- *Importance of Listening*. Meetings with shareholders should be viewed as an opportunity to listen to shareholder concerns. It is often unnecessary to communicate any particular message to shareholders; the mere fact that companies meet and listen to shareholders can result in a favorable result. That said, companies should be prepared to discuss and respond to concerns raised by shareholders with respect to pay practices.

- *Who Should Speak*. In our view the question of who should speak with a shareholder should be evaluated based on the reason for the shareholder's concerns about the company's practices and the relationships that may exist with a particular shareholder. While lead directors, compensation committee chairs and other board members should be available to speak with shareholders, many institutional investors want to hear from individuals with in-depth knowledge of the company's pay programs and performance, so the heads of human resources, executive compensation and investor relations should be included as active members of the outreach team.

- *Use Relationships with Investment Decision Makers*. Companies should consider reaching out directly to those making investment decisions. Investment professionals may be satisfied with the company's performance, may not be aware that the say on pay vote is an issue and may be surprised to learn that their organization's governance department is taking action against the company's board. Communicating directly with investment decision makers can prove helpful in this context.

- *Supplemental Materials*. Many companies have filed supplemental proxy materials as a way to communicate directly with their shareholders. Sometimes these materials merely reiterate principles set forth in the CD&A; sometimes they convey new information. Either way, such materials may help companies to reach investors with whom they may be unable to meet in person. While supplemental materials may be necessary under the securities laws for companies that are otherwise communicating with select shareholders, careful consideration should be given in other cases as filing materials may not affect the vote more than conversations with shareholders and may merely draw the attention of the press. Some large institutional shareholders may prefer to have written materials to support internally reversing a decision or voting contrary to a negative ISS recommendation.

- *Changing Compensation Practices*. While ISS has made clear that prospective commitments to change compensation practices will not be effective in changing its recommendation, ISS has changed its vote recommendation where companies have agreed to change compensation practices retroactively. This will not be a solution for most companies, nor should companies make substantive decisions not otherwise in the best interests of its constituents in order to win the support of ISS. However, it has proven successful in certain circumstances and may be appropriate where a company feels upon reflection that the criticism leveled by ISS or by other investor groups is valid. Either way, it is important for directors to understand that there is no legal obligation to change corporate policy in response to the threat of a negative vote if in the directors' business judgment it is determined that existing compensation programs are well-designed and are working well.

Losing the Vote and Director Liability. While there has been heavy coverage of lawsuits deriving from lost say on pay votes at certain companies, courts will protect directors' decisions so long as the directors act on an informed basis, in good faith and not in their personal self interest. In fact, the Dodd-Frank Act expressly states that the shareholder vote "may not be construed" to "create or imply any change to the fiduciary duties of such issuer or board of directors" or to "create or imply any additional fiduciary duties for such issuer or board of directors." If a company loses the vote, it should consider the reasons and, in consultations with its advisors, consider whether it wishes to revise any practices that may have contributed to shareholder discontent or a negative recommendation from ISS. If a board follows appropriate procedures in its review process, there will be no legal liability. Directors therefore need not be deterred from paying executives in the manner that they determine to be appropriate to attract, retain and incentivize executives, regardless of the results of the say on pay vote. Indeed, doing so effectively is one of the highest priorities for any board of directors.

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