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Corporate Governance Update: 'Say on Pay' in the 2012 Proxy Season

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As the 2012 proxy season draws to a close, it is clear that executive compensation issues, particularly "say on pay," again dominated the headlines. Though by some metrics say on pay was nearly a nonissue – after all, the median level of shareholder approval was around 90 percent, with fewer than 3 percent of U.S. companies experiencing a failed vote [1] – the vote results themselves are merely the tip of the iceberg. Say on pay was a topic of paramount concern to issuers this year and was the basis for a great deal of work both before and during the proxy season. Looking back on the past few months, two primary themes emerge: First, the importance of understanding and responding to the methodology of ISS Proxy Advisory Services (ISS), as its recommendations continue to be highly significant; and second, the importance of direct, frequent communication with shareholders and investment decision makers.

Directors who make compensation decisions that result in a negative ISS recommendation, shareholder disapproval, or other public criticism will wish to consider taking steps to minimize controversy surrounding company compensation practices. And, while, in some cases, shareholders have sued boards on the basis of a negative say on pay vote, directors can be confident that their compensation decisions, when made in good faith and in accordance with their fiduciary duties, are protected by the business judgment rule.

Addressing ISS Impact

The 2012 voting results show that ISS recommendations continue to be a significant factor in the results of say on pay votes. Of the S&P 500 companies that received a negative recommendation this year, 21 percent experienced failed votes,[2] as

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[1] *See* Semler Brossy, "2012 Say on Pay Results, Russell 3000," July 18, 2012, available at http://www.semlerbrossy.com/sayonpay. Of the 1,907 Russell 3000 companies that had voted as of July 17, 2012, 51, or 2.7 percent, had failed votes. *Id.*

[2] Information is as of July 16, 2012 and is based on a review of information from public filings, ISS and FactSet Shark Repellent.

compared to the overall average of 2.7 percent. Moreover, even when companies do receive a majority vote despite a negative recommendation, the level of support is substantially lower; according to one recent study, a negative ISS recommendation results in average support of 65 percent versus 95 percent for those with a positive ISS recommendation.[3]

ISS say on pay recommendations are determined using a fairly complex methodology. It is important for companies to understand how the methodology works so that they will have a sense for how ISS will evaluate their compensation programs and be prepared to respond quickly. ISS has released a substantial amount of information that companies can use to assess how their pay practices will be viewed by ISS and by company shareholders. In December 2011, ISS issued a white paper detailing the implementation of its "pay for performance" test.[4] In the vast majority of situations in which ISS has issued a negative recommendation, it is because ISS has determined that there is a "pay for performance disconnect."

One of the most important components of the pay for performance test for a company is the alignment of CEO pay and total shareholder return, and in particular how that alignment compares to that of the company's peer group (as selected by ISS, primarily based on S&P's Global Industry Classification Standard groupings, market capitalization, and revenue range) in recent years. Complaints about the ISS-selected peer companies were common this year, as in many cases the peer group for ISS' purposes was not similar to the peer group the company itself uses to assess corporate performance and often bore little resemblance to companies with which the company competes for investors or talent.[5] Of the 35 S&P 500 companies that chose to file supplemental proxy materials through May 27 of this year, 20 addressed deficiencies in the ISS peer group.[6] Representatives of ISS have suggested that ISS may reevaluate its peer group methodology for next year. Glass Lewis, ISS' most significant competitor, recently announced that it will change the way it develops peer groups as well as its performance metrics for the 2013 proxy season.[7]

[3] John D. England, "Say on Pay Soul Searching Required at Proxy Advisory Firms," Pay Governance, June 20, 2012, available at http://www.paygovernance.com/Includes/pdf/SOP_Soul_Searching.pdf. This is more pronounced than 2011, which saw companies receiving a negative recommendation from ISS obtaining 70 percent support from shareholders on average, as compared to the 95 percent average support obtained by companies receiving a positive recommendation. *Id.*

[4] The white paper is available at http://www.issgovernance.com/policy/2012/policy_information.

[5] *See, e.g.,* Alix Stuart, "ISS Peer Group Comparisons on Pay Raise Hackles" Compliance Week (May 2012) at 40.

[6] *See* Sullivan & Cromwell LLP, "Say-on-Pay – Review of 2012 Proxy Season Results" (July 17, 2012) available at www.sullcrom.com/Say-on-Pay-Review-2012-Proxy-Season-Results/.

[7] *See* Kyoko Takahashi Lin and Ning Chiu, "Glass Lewis Changes Its Say-on-Pay Analysis," Davis Polk Briefing: Governance (July 16, 2012), available at

During the winter, after ISS issues its annual policy updates, companies should evaluate their prior say on pay votes and consider how compensation matters, ISS policies and methodologies, and other factors may present issues, if any, in the 2013 season. ISS typically provides S&P 500 companies a draft copy of its report and recommendations about 24 hours in advance of issuing its final report; companies will be able to make the most of this short turn-around time if they are prepared and have a team ready to respond promptly. When a company does provide comments to ISS, we have found that it is most effective to focus on any factual errors or inflammatory rhetoric rather than the underlying methodology.[8] In some cases, it may be possible or desirable for a company to contact ISS directly before the report is drafted at all, although, in our experience, ISS is not always willing to engage.

Direct Communication

While ISS recommendations are the most visible and knowable factors that affect say on pay votes and are highly influential, some shareholders independently assess an issuers pay programs and ISS recommendations are not dispositive.[9] Therefore, direct communication with shareholders plays a key role in winning the say on pay vote.

For example, the California State Teachers' Retirement System (CalSTRS) issued a report earlier this year that states at the outset that "a thorough review of pay practices is an important fiduciary duty that both boards of directors and institutional investors should exercise with diligence and care."[10] As the second largest public pension system in the United States, with assets of approximately $146 billion, CalSTRS sets a noteworthy example that is, unfortunately, the exception.

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www.davispolk.com/briefing/corporategovernance/blog.aspx?entry=198 ("ISS, which also uses a GICS code-based peer group selection system (albeit different from Glass Lewis), announced that they will be changing their process for the upcoming proxy season, with effect for companies with annual meetings after February 1, 2013").

[8] *See* Jeremy Goldstein et al., "Say on Pay 2012," Wachtell, Lipton, Rosen & Katz memorandum, available at http://blogs.law.harvard.edu/corpgov/2012/07/14/say-on-pay-2012/.

[9] In fact, during the 2012 season, for the first time, a company that received a favorable ISS recommendation lost its say on pay vote. *See* Semler Brossy, "Safety Insurance Group is first company to fail Say on Pay after receiving an ISS 'For' recommendation," available at www.semlerbrossy.com/sop/safety-insurance-group-is-first-company-to-fail-say-on-pay-after-receiving-an-iss-for-recommendation#.T8oNSlIU-So.

[10] CalSTRS, "Lessons Learned: The Inaugural Year of Say on Pay," Jan. 25, 2012, available at http://www.calstrs.com/CorporateGovernance/lessons_learned_say_on_pay.pdf.

There are steps that companies can take to maximize the effect of their shareholder communication efforts regarding say on pay votes.[11] First, companies should communicate frequently with shareholders throughout the year. Listening to shareholders' concerns and comments will help companies understand their shareholders' priorities and voting patterns, including the degree of influence that proxy advisors may exert. For their part, shareholders may be better disposed toward a company's arguments in support of its executive pay proposal if the company has been in contact prior to the start of the proxy season and before a negative recommendation is issued.

Second, companies should continue outreach efforts until the annual meeting takes place. Because shareholders can change their votes at any time before the meeting, companies should not consider a prospective negative vote from an institutional shareholder final until the meeting. It may be worthwhile to reach out to such institutions in order to hear their concerns, explain the board's rationale for the executive pay proposal, and attempt to persuade the institution to change its decision. In this regard, the example of Exxon Mobil is instructive. In May, the oil giant broke new ground by holding a conference call with investors to discuss executive compensation and specifically to address negative vote recommendations from both ISS and Glass Lewis. This tactic paid off, as the compensation proposal received about 78 percent favorable votes at the annual meeting.

Third, companies should keep in mind that institutional investment decision makers may not be aware that their organization's governance department is issuing a negative vote on a say on pay proposal. Companies may wish to contact investment professionals directly to find out whether the negative vote stems from substantive dissatisfaction with company performance and whether the investment decision makers are aware that the say on pay proposal is a concern.

Fourth, companies should consider which avenues of communication to pursue. Some companies, when faced with a negative vote recommendation, file supplemental proxy materials in support of their compensation proposal. Supplemental filings may be necessary under Regulation FD or other securities laws for companies that are otherwise communicating with certain shareholders, and they can be helpful in reaching shareholders who are otherwise not reachable. However, supplemental filings can draw unwanted attention and, if they do not convey new information, may be unnecessary. Companies may also wish to follow the lead of Exxon Mobil in hosting conference calls to discuss say on pay issues, and in some cases companies may wish to schedule in-person meetings with significant investors.

[11] *See* Goldstein et al., *supra*, for a thorough discussion of this topic.

Finally, companies should consider carefully which of its directors, executives, or employees may be the best representatives to speak with shareholders and investment decision makers. In some cases, it is desirable for compensation committee members and lead directors to be available to discuss compensation practices directly with investors; in other cases, investors may wish to discuss topics better addressed by the head of human resources or the head of investor relations. The outreach team should coordinate to ensure that effort and time are not wasted nor their message scrambled by too many different voices.

Say on Pay Legislation Abroad

Say on pay was the corporate governance topic of the year in Europe as well as in the United States. The United Kingdom recently announced new proposed legislation regarding say on pay requirements.[12] In the U.K., companies would be required to provide shareholders a binding vote on company policy regarding director pay (including executive directors), with the approval threshold a bare majority. Binding votes would be required to be held annually or at least every three years if the policy is unchanged in that time; in the event of a failed vote, the company would be required to continue its existing pay policy until a revised policy could be approved by shareholders, either at a special meeting or an annual meeting. Meanwhile, the current annual advisory votes regarding the implementation of company pay policy would continue. Compensation disclosure would be enhanced, including the requirement of "single figure" compensation numbers for the total pay that directors received for the previous year and a chart comparing company performance and CEO pay. The new rules would not apply to executives who are not also board members. All U.K.-incorporated quoted companies would be bound by the new legislation, regardless of where they are listed. The legislation must be approved by Parliament, which is expected to do so despite criticism on both sides from politicians and business leaders, the former arguing that the new rules do not go far enough and the latter protesting that they go too far. The U.K. government has said that it expects the reforms to be enacted by October 2013.[13]

Precedents for binding shareholder votes regarding compensation exist in the European Union and appear to be on the verge of expanding. The Netherlands has since 2004 provided shareholders with a binding vote on key changes to executive pay

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[12] *See* U.K. Dep't for Business Innovation and Skills, "Directors' pay: guide to Government reforms," June 20, 2012, available at http://www.bis.gov.uk/assets/biscore/business-law/docs/d/12-900-directors-pay-guide-to-reforms.pdf.

[13] *See* U.K. Dep't for Business Innovation and Skills Press Release, "Government announces far-reaching reform of directors' pay," June 20, 2012, available at http://www.bis.gov.uk/news/topstories/2012/Jun/directors-pay-reform.

policies.[14] Switzerland will be holding a referendum sometime around March 2013 that could give shareholders a binding vote on executive compensation.[15] The EU's internal markets commissioner, Michel Barnier, reportedly has stated that he would like to see not only mandatory votes on executive pay, but also shareholders having the power to vote on the ratio between the lowest and highest paid employees in the company and the ratio between fixed and variable compensation.[16]

Director Liability

Compensation decisions are among the most important, and can be among the most difficult, decisions that a board of directors makes. The Dodd-Frank Wall Street Reform and Consumer Protection Act expressly provides that its say on pay requirements "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."[17] In a recent federal district court decision,[18] the first to dismiss an action arising out of a negative say on pay vote,[19] the court reaffirmed directors' authority to determine executive compensation despite shareholder disapproval. This decision stands for the proposition that a negative say on pay vote does not suffice to rebut the business judgment rule's deference to directors' decisions regarding executive compensation. Directors can remain confident that in say on pay matters, as in all other corporate governance matters, the protections of the business judgment rule apply to decisions made in good faith and in accordance with fiduciary duties.

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[14] *See* Cassell Bryan-Low, "U.K. Unveils Plan on Executive Pay," *The Wall Street Journal*, June 21, 2012, at B3.

[15] *See* Neil MacLucas and Marta Falconi, "Swiss Grapple Over Executive Pay," *The Wall Street Journal*, July 4, 2012.

[16] Carol Matlack, "A Tougher 'Say on Pay' Migrates to the U.K.," *Bloomberg Businessweek*, June 20, 2012.

[17] 15 U.S.C. § 78n-1(c).

[18] *Plumbers Local No. 137 Pension Fund v. Davis*, Civ. No. 03:11-633-AC (Jan. 11, 2012).

[19] The court in *Davis* expressly declined to follow a prior federal court decision that had denied a motion to dismiss in a say on pay action in the Southern District of Ohio, *NECA-IBEW Pension Fund v. Cox*, No. 11-451 (S.D. Ohio, Sept. 20, 2011).