

# Navigating Say on Pay

## The Basics

### What is a say on pay vote?

“Say on Pay” is the common term for a non-binding, advisory vote by shareholders on executive compensation disclosed in public companies’ proxy statements. Say on Pay was mandated under The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) which requires U.S. public companies to hold Say on Pay votes at shareholder meetings occurring on or after January 21, 2011. Companies are not required to take any specific action with regard to a negative vote outcome. However, a public company is required to disclose in their proxy statement whether, and if so, how the company has taken into account the results of the prior year Say on Pay vote in determining compensation policies and decisions.

The Dodd-Frank Act also requires public companies to hold a vote on the frequency of future Say on Pay votes (i.e., annually, biennially or triennially).

### What vote outcomes have been experienced to date?

During the 2011 proxy season, the overwhelming majority of Say on Pay proposals were approved by large margins, on average 89% of the votes cast. A number were more narrowly approved, e.g., with 60% “FOR” votes.

However, a few companies, less than 2% of the Russell 3000 and S&P 500, failed to obtain majority support for their Say on Pay proposals. These results already exceed the cumulative number of failures in the United Kingdom, where Say on Pay has been in effect since 2002. This difference may be due to the high prevalence of U.K. companies’ direct engagement with shareholders in advance of annual shareholders’ meetings and the more concentrated ownership of U.K. companies relative to U.S. norms.

Regarding the U.K. experience, an academic study<sup>1</sup> found no evidence of change in the level and growth rate of CEO pay after the adoption of Say on Pay. However, the study documented an increase in the sensitivity of CEO pay to poor performance. In addition, significant homogenization of pay programs in the U.K. occurred following the introduction of Say on Pay.

### How influential is ISS’ vote recommendation on a Say on Pay vote outcome?

Institutional Shareholder Services’ (ISS’) clout has increased in the Say on Pay environment. Nonetheless, its direct impact on vote outcomes is mixed. ISS issued an “AGAINST” recommendation on Say on Pay proposals for approximately 260 component companies of the Russell 3000 index. Of these 260 companies, only 34 companies failed to receive majority support for their say on pay proposals. However, an ISS negative vote recommendation clearly reduced the level of support for a company’s Say on Pay proposals. Over time, repeated negative vote recommendations by ISS may ultimately result in a company failing Say on Pay.

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<sup>1</sup> Fabrizio Ferri and David Maber. “Say on Pay Vote and CEO Compensation: Evidence from the UK”. Harvard Business School. March 2009.

ISS influence in the Say on Pay environment is evidenced in more subtle ways than vote outcomes. In response to actual or potential negative vote recommendations by ISS during the 2011 proxy season, a number of large companies took the following steps: (i) where a negative vote recommendation had been issued by ISS, certain companies issued supplemental disclosures to advise shareholders as to the flaws in ISS analysis of their pay programs and/or the reasonableness of their pay programs or (ii) where ISS indicated that it will be issuing a negative vote recommendation, certain companies agreed to significant changes in their executive compensation practices in advance of their annual meetings to ensure a positive vote recommendation by ISS. These changes included adding performance measures to existing equity grants and eliminating tax gross-up provisions from existing employment contracts.

## The Details

When navigating Say on Pay, companies should consider both the proxy voting policies of their major institutional shareholders' and ISS. It is important to note that many institutional shareholders vote in accordance with their own proprietary proxy voting policies and, therefore, are not influenced by ISS vote recommendations. In addition, although it is important for companies to understand ISS proxy voting policies, these policies should not trump what pay policies company directors believe are in the best interest of shareholders.

Actions companies have taken in order to increase the likelihood of obtaining a favorable Say on Pay vote outcome include:

- Making representations in their proxy statement that certain pay programs or practices have been discontinued;
- Providing a supporting statement for Say on Pay in the proxy statement;
- Contacting major institutional investors to discuss any executive compensation programs and issues;
- Filing supplemental materials to provide shareholders additional supporting information regarding pay programs; and
- Changing executive compensation practices to address specific concerns raised by shareholders or set forth in ISS' proxy report.

## ISS' Proxy Voting Policy on Say on Pay

ISS evaluates Say on Pay proposals on a *case-by-case basis* by examining a company's executive pay and pay practices. ISS' Policy Guidelines provide that ISS will recommend a vote AGAINST management Say on Pay proposals if:

- There is a misalignment between CEO pay and company performance (pay for performance);
- The company maintains problematic pay practices; and/or
- The board exhibits poor communication and responsiveness to shareholders.

ISS' Policy Guidelines specify the following additional *case-by-case considerations* in evaluating management Say on Pay proposals:

- **Evaluation of performance metrics in short-term and long-term plans**, as discussed and explained in a company's Compensation Discussion & Analysis. ISS will consider the performance measures, goals, and target awards reported by the company for executive short- and long-term incentive awards, the

alignment of performance goals with the company's business strategy, and whether goals appear to be sufficiently challenging in relation to resulting payouts.

- **Evaluation of peer group benchmarking used to set target pay or award opportunities.** ISS will consider the rationale stated by the company for constituents in its pay benchmarking peer group, as well as the benchmark targets it uses to set or validate executives' pay (e.g., median, 75<sup>th</sup> percentile, etc.) to ascertain whether the benchmarking process is sound or may result in pay "ratcheting" due to inappropriate peer group constituents (e.g., much larger companies) or targeting (e.g., above median); and
- **Balance of performance-based versus non-performance-based pay.** ISS will consider the ratio of performance-based (which does not include time-vested stock options) vs. non-performance-based compensation paid to a company's CEO.

### How ISS Identifies a Pay-for-Performance Disconnect

The primary reason ISS recommends against a Say on Pay proposal is that it believes there is a "pay for performance disconnect." For Russell 3000 companies, ISS will initially determine whether a company has demonstrated a strong, satisfactory or weak alignment between total shareholder return (TSR) and CEO pay over an extended period (Quantitative Analysis). If the Quantitative Analysis determines that the alignment between a company's TSR and CEO pay is weak, ISS will then subject the company to a more in-depth qualitative analysis (Qualitative Analysis). In a significant break from prior policy, a CEO with tenure of less than two years will no longer exempt a company from ISS pay for performance test.

Under its Quantitative Analysis, ISS considers the following three factors:

- **Factor 1:** The degree of alignment between the company's TSR rank and the CEO's total pay rank within the peer group, as measured over one- and three-year periods (weighted 40/60); and
- **Factor 2:** The multiple of the CEO's total pay relative to the peer group median (this may identify cases where a high-performing company may nevertheless be overpaying).
  - *Peer Group Development.* The peer group will include a minimum of 14 companies but generally no more than 24 companies that are selected by ISS on the basis of market capitalization, revenue (or assets for financial firms) and GICS industry group, via a process where the median revenues (assets, if applicable) of the peer group are intended to approximate the revenues of the subject company.
- **Factor 3:** ISS will evaluate the trend in CEO pay and the company's TSR over the prior five fiscal years, i.e., the difference between the slope of annual pay changes and the slope of annualized TSR changes during the prior five-year period.

Companies that demonstrate strong or satisfactory alignment will generally receive a positive vote recommendation from ISS (in the absence of other pay-related issues). In cases where CEO pay for performance appears weak, ISS will undertake a further in-depth qualitative analysis to determine causal or mitigating factors relating to apparent pay misalignment, considering the following factors:

- The ratio of performance- to time-based equity awards;
- The ratio of performance-based compensation to overall compensation;
- The completeness of disclosure and rigor of performance goals;
- The company's peer group benchmarking practices;

- Actual results of financial/operational metrics, such as growth in revenue, profit, cash flow, etc., both absolute and relative to peers;
- Special circumstances related to, for example, a new CEO in the prior fiscal year or equity grant practices; and
- Any other factors deemed relevant.

If ISS finds that the foregoing factors facilitate the CEO pay-for-performance disconnect or do not sufficiently mitigate the disconnect, then ISS will recommend a vote AGAINST a company's Say on Pay proposal.

### **Companies' Responses to AGAINST Recommendations Issued by ISS**

During the 2011 proxy season, four major companies—General Electric, Walt Disney Company, Alcoa and Lockheed Martin—made significant concessions regarding executive compensation practices after initially receiving AGAINST recommendations from ISS on Say on Pay. In three of the cases, ISS had raised concerns about a pay-for-performance disconnect. Each company garnered ISS' support after agreeing to make the following design changes to existing pay programs:

- Disney agreed to eliminate tax gross-up provisions from existing employment contracts for four top executives.
- GE **retroactively** added performance vesting requirements to 2 million stock options that had been granted to its CEO, Jeff Immelt, a year earlier. Under these new vesting requirements, Mr. Immelt's stock options will vest if GE meets a four-year cumulative cash flow goal and achieves a four-year total shareholder return above the S&P 500 Index. GE also restarted in 2011 the practice of granting Mr. Immelt's equity-based compensation **solely** in performance share units based on disclosed goals.
- Lockheed Martin agreed to add performance goals to its CEO's 2011 stock option grant under which 50% of the option grant would vest if the company met a cash-from-operations goal and the remaining 50% of the option grant would vest if the company met an ROIC goal.
- Alcoa gained ISS' support after it changed the performance metrics associated with short-term and long-term incentives and provided for a three-year performance period with regard to performance-based restricted stock units.