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Say-on-Pay: An Interim Report

With over 300 meetings held in the last week in April, we've marked the start of the meetings season. More than 1,000 meetings are expected in May. Say-on-pay has dominated discussions this proxy season, and we now have enough data to confirm several clear trends. All data (other than the failed votes) is as of late April.[1]

Strong Support for Say-on-Pay

Voting results*.* Average support for say-on-pay has been extremely high: 91% according to ISS at over 350 meetings so far. Our own data, tracking the universe of large accelerated filers, indicates that out of approximately 251 meetings only 41 companies received less than 80% favorable votes, with 24 of those receiving less than 70%.

ISS influence. ISS recommendations are influential but not decisive. ISS has recommended against 177 companies out of 1,411, approximately 12.54%. Of the companies that have already held meetings, only 11 out of 60 facing unfavorable ISS reports have actually lost. And a favorable ISS report does not mean you are home free: a handful of companies with favorable reports still received less than 70% approval.

Post-Mortem on Failed Say-on-Pay Votes

Statistics. Eleven companies[2] have received less than majority support for say-on-pay, four alone in the last week of April and thus far in May, as the season picked up:

- Jacobs Engineering (45.5%)
- Beazer Homes (46.1%)
- Shuffle Master (44.5%)
- Hewlett-Packard (48.7%)
- Ameron (41.7%)
- Stanley Black & Decker (39.1%)
- Umpqua Holdings (36.2%)
- Navigant (44.8%)
- Cogent (39%)
- M.D.C. Holdings (34%)
- Janus Capital (42%)

[1] As a means of comparison, vote tallies are reported on the basis of "for" and "against" votes. Abstentions would lower the level of support indicated.

[2] Some reports indicate a total of twelve instead, which appears to include Hemispherx Biopharma, a company that received more "for" than "against" votes but where the support level falls to 42.9% if abstentions are counted.

Cited reasons. According to ISS accounts, almost all of the results reflected concerns related to the correlation between pay and performance, in particular negative shareholder returns compared to the GICS peer group used by ISS coupled with an increase in CEO compensation from prior years. Other pay issues cited include the selection of the benchmarking group, the size of specific bonuses or awards, terms of severance arrangements, use of board discretion and lack of transparency in compensation decisions.

Apart from these general factors, most of the losing votes also had company-specific backstories:

- Janus Capital awarded its new CEO a sign-on package that included a relocation package with associated tax gross-ups.
- Cogent conducted an option exchange for its CFO's shares without shareholder approval.
- Umpqua had increased its executive compensation after exiting TARP.
- At Stanley Black & Decker the investor reaction was in part due to the perceived failure of the company to respond to low votes received for its compensation committee members in 2010, when the committee authorized grants of equity awards and bonuses related to the merger.
- A proxy contest at Ameron contributed to its vote result, as the dissident recommended against say-on-pay on its proxy card.
- Hewlett-Packard's well-known travails included up front sign-on awards to the new CEO.
- CEO compensation at Beazer Homes increased substantially when compared to the prior year, when the company's ability to grant equity awards had been constrained by a criminal and civil investigation by the U.S. Justice Department.

Lawsuits. The plaintiffs' bar, always sniffing for an opportunity, is making test forays at Jacobs Engineering and Beazer Homes, the first two companies that lost votes this year. Each is facing derivative actions against their boards with respect to the company's compensation decisions. The lawsuits specifically refer to the say-on-pay votes to support their allegations. If these lawsuits gain traction, this tactic may become more common.

Close Votes: What Does it Mean to "Win"? Several notable companies that obtained majority support for say-on-pay nonetheless faced significant opposition, most recently Johnson & Johnson (61.2%) and Pfizer (57.6%), which were also the subject of active campaigns by AFSCME. Other large companies with low votes include U.S. Steel (66.2%) and Northern Trust (66.9%).

It will be interesting to see whether a passing grade is sufficient. Already, some are suggesting that if the overwhelming majority of companies are receiving above 90% in support, then any votes below, say, 80% may warrant a closer examination of a company's executive compensation practices.

Dealing with a Negative Recommendation

Companies that are facing or anticipating a negative ISS recommendation are employing a variety of tactics in attempting to avoid a failed vote:

- Direct outreach to shareholders is of course the most common approach. Face-to-face meetings with key shareholder decision makers are often impracticable, but companies are conducting targeted telephone campaigns where senior executives tell the company's story. Particularly for companies facing meetings in the next two months, the height of the proxy season, it will be critical to have names and contact information for the right people so that busy calendars can be coordinated. ISS recommendations are typically issued about two weeks before the meeting, so advance preparation is a must.

- Another tactical response to a negative ISS recommendation is to circulate additional soliciting materials, which are usually brief statements used to enhance or update executive compensation information. These materials may also act as guidelines or talking points for direct investor communications. Some simply reiterate key points from the proxy statement demonstrating the alignment of pay with performance.[3] Others take a more confrontational approach by taking issue with ISS methodology, including the selection of the peer group, the time period against which the critical element of pay-for-performance is measured and the valuation methodology for option grants.[4] The use of additional soliciting materials is far from universal, as so far this year only a little more than a third of large accelerated filers that ultimately received less than 70% in support filed such materials to bolster their arguments. There is of course no way of knowing what the support levels would have been in the absence of the additional filings.
- Several large companies this year have responded to criticism by making substantive changes to their pay practices, including Disney (77.2%), Lockheed Martin (68.6%) and GE (79.3%). Disney amended several employment agreements in response to concerns regarding change-in-control provisions. Both Lockheed Martin and GE changed the terms of already-granted options to senior executives to provide for forfeiture if certain performance conditions were not met.

Annual Votes are the Norm

The endless debate on the frequency vote that dominated discussion earlier in the year is effectively over. Regardless of the board recommendation, investors are overwhelmingly in favor of annual say-on-pay votes. Of the 251 large accelerated filers that have already held their meetings, 90% received votes in favor of annual frequency (or 93.5% of the 108 S&P 500 companies).

With triennial recommendations looking increasingly quixotic, more companies are succumbing to the inevitable and recommending annual votes. Our data shows that over 60.4% of the large accelerated filers (or 67.5% of the S&P 500) that have issued proxy statements have recommended annual votes, an increase from 51% (or 56% of the S&P 500) in early March.

[3] Tyco: http://www.sec.gov/Archives/edgar/data/833444/000110465911008794/a11-6432_1defa14a.htm;
Telefax: http://www.sec.gov/Archives/edgar/data/96943/000095012311035124/c15504defa14a.htm;
J&J: http://www.sec.gov/Archives/edgar/data/200406/000020040611000054/defafourteena.htm.

[4] Disney: http://www.sec.gov/Archives/edgar/data/1001039/000119312511053723/ddefa14a.htm;
Navigant: http://www.sec.gov/Archives/edgar/data/1019737/000095012311035821/c64135defa14a.htm;
GE: http://www.sec.gov/Archives/edgar/data/40545/000119312511091124/ddefa14a.htm;
Unisys: http://www.sec.gov/Archives/edgar/data/746838/000095012311034847/w81808drdefa14a.htm.

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