Client Update

PHOENIX
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Say on Pay Frequency: Annual, Biennial or Triennial

Considerations in Making Your Recommendation

As you know, the Dodd-Frank Wall Street Reform and Consumer Protection Act requires companies to provide shareholders with Say on Pay (SoP) advisory votes on executive compensation.

1. "Say on Pay"

2. "Say When on Pay" (i.e. future frequency of Say on Pay votes)

3. "Say on Golden Parachutes" in the event of a merger

In implementing this requirement, on October 18 the SEC proposed rules which require that, commencing with annual meetings held on or after January 21, 2011, all US public companies will have to provide shareholders with the first two proposals: The Say on Pay proposal itself, and Say When on Pay (i.e. every one, two or three years, or "abstain"). Thereafter, at least once every six years, companies will again present "Say When on Pay" proposals.

The result of the "frequency" vote will be non-binding, so issuers may ignore the expressed preference of its shareholders (at their risk, as this may invite criticism, heightened scrutiny and possibly future shareholder-sponsored "frequency" proposals). Companies that follow the preference of a plurality of shares voting will not have to include shareholder-sponsored "frequency" proposals on future ballots, at least until the 6th year at which time it has to hold another "frequency" vote.

A significant issue you must decide – and one which many of our clients are asking us about -- is "which frequency should we recommend, and what will the shareholder reaction be?"

To assist our clients in making informed choices on this important new issue, Phoenix Advisory Partners has engaged in conversations with a meaningful number of significant institutional investors. These, in turn, are in the process of determining their preferences, and how they will evaluate and vote on the multitude of such proposals they will start reviewing as early as December (as most companies with meetings on January 21 or soon thereafter will be filing and mailing their proxies during December).

Deciding on One, Two or Three Years – Things to Consider

One Year

This is the expressed preference of most investors we surveyed, but certainly not a unanimous requirement.

Support for "annual" includes:

- Walden Asset Management this fall sent a letter, co-signed by 9 other investors including AFCSME, AFL-CIO, Christian Brothers Investment Services, and State of Connecticut to many US issuers calling for the universal adoption of annual SoP.

- The Council of Institutional Investors (CII) has consistently stated its preference for universal, annual SoP.

- We were not surprised by the comments of a few European based investors: they are used to annual SoP in Europe and are therefore well prepared to evaluate and vote on the issue. They felt it was long overdue in the US and will push for an annual vote.

- On October 11, Professors Lucian Bebchuk and Robert Jackson recommended to the SEC that it adopt a "default" annual SoP requirement in cases where no preference achieves a majority of votes cast, as opposed to the present construct in which companies that adopt the "plurality" preference are deemed to have followed investor guidance and will not have to face shareholder-sponsored "frequency" votes until the sixth year thereafter, as the draft rules presently contemplate.

Two Years

Requesting less than annual SoP votes means you are asking investors to provide a longer leash and a greater degree of faith or trust. Companies with reasonably positive compensation, governance and performance stories may wish to elect this "middle" option.

This should receive support from investors such as the Carpenters Union, CalSTRS and others which acknowledge the significant effort that universal, annual SoP would place on them and their finite resources in thoughtfully analyzing and voting on thousands of such proposals each year, and have requested some sort of

"staggering" of these votes. Unlike with gasoline or water rationing, where government may stagger or alternate access to finite resources by "odd or even" license plates or street addresses, we don't think this will occur with SoP. In this case, only significant selection of biennial or triennial votes by companies, supported by sufficient percentages of shareholders voting, will provide investors with some relief from the burden of reviewing and voting SoP on every proxy, every year.

That said, a number of investors as well as issuers have indicated to us they feel that less than annual SoP will increase the visibility and attention to these less frequent votes, putting the issuer and its pay practices under greater scrutiny than if they conducted the votes annually.

Three Years

This might be the appropriate recommendation for companies with the strongest compensation, governance and performance stories.

While most investors we spoke with would prefer to see companies adopt an annual vote, many stated they are open to hear "compelling arguments" as to why a company should adopt a triennial vote and intend to review the issue on a case-by-case basis. There was no substantive disclosure of what will sway them as part of the "compelling argument", but we can assume it will be a combination of the following factors that also weigh in to SoP voting:

- Clear and compelling disclosure including the CD&A, and linkage of pay to corporate strategy;
- Clear Pay-for-Performance connection;
- Strong company performance;
- Adoption of a majority of "best practice" corporate governance standards;
- History of Board responsiveness to shareholder concerns;
- No pre-existing compensation and/or board related concerns.

T. Rowe Price has indicated publicly that it may take a quantitative "scorecard" approach to identify compensation outliers, based on the relative presence of pay practices they accept versus those which they object to, and under such an approach they should approve less then annual frequency at companies without significant pay issues. We think many other leading investors will follow this type of "focus on the outliers" approach.

A number of institutions who were not strictly opposed to a triennial vote also mentioned how it could help convince them if a company agreed to revisit the frequency issue in three years along with SoP. The rationale being that if they approve a triennial vote they are clearly happy with the company's present compensation standards, but want the ability to re-evaluate in three years in order to ensure the company adheres to these standards. This would very subtly, but potentially crucially, change the message to investors from "a vote *every* three years", to "a vote *in* three years". This could help to provide an added level of comfort, in that the institutions feel they can push for an annual vote if they feel it necessary in the future.

RELATED CONSIDERATIONS

- Many investors have for years used withholding votes from members of the compensation committee as one way to have a 'say' on pay. A large number of investors have indicated their preference in 2011 will be to first express any compensation dissatisfaction via the SoP vote, and if they remain dissatisfied, they may also withhold votes from the compensation committee in subsequent years. So if SoP is the "canary in the coal mine" for future director withholds, companies providing less than annual SoP votes may experience heightened levels of compensation committee member withhold votes in years in which they do not provide a SoP vote.

- What will the proxy advisors position be? As of this writing, ISS has not yet released its 2011 voting guidelines or policies with respect to "frequency" votes. Will there be a defined evaluation process to determine if an issuer should hold SoP voting every one, two, or three years? Or will the proxy advisors simply call for the universal adoption of annual SoP voting? If the latter, this would further tilt the scales in favor of annual, as companies will have to make compelling cases to their investors to ignore this advice and accept less frequent votes.

- We have a number of clients with late January and early February meetings who will be in the vanguard of the new required SoP and "frequency" votes. This will provide us with an early window into how their investors are evaluating and voting on these issues, which we can then share with our calendar year-end clients who will hold their meetings in April, May and June.

- Interestingly, one institution expressed a more traditional approach, a throw-back to the old Wall Street Rule: they feel investors have no right to vote on SoP, and intend to vote with management. If the PM and/or proxy analyst have concerns with compensation they will directly contact the issuer to discuss, but if they have significant concerns, they will vote with their feet and sell out of the stock.

For more information on how to prepare for SoP and the increasing challenges of the 2011 proxy season, please contact either:

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