New York Law Journal
Corporate Governance
WWW.NYLJ.COM
An ALM Publication
MONDAY, NOVEMBER 28, 2011

Say on Pay 2011: Proxy Advisors On Course for Hegemony

BY CHARLES NATHAN,
JAMES D.C. BARRALL
AND ALICE CHUNG

THIS YEAR was the first proxy season in which there was a universal requirement for a Say-on-Pay advisory vote at all major US public companies. Before the 2011 proxy season began, a number of observers wondered whether institutional investors and the proxy advisory services with their principally one-size-fits-all voting paradigm could handle the stress of several thousand say-on-pay advisory votes, each of which seemingly would require some sort of company specific analysis.

The results of the 2011 say-on-pay experience are now in, and the answer is yes. One-size-fits-all voting policies, coupled with simple metrics, can handle the quantitative challenges of an annual say-on-pay vote at thousands of U.S. companies.

Institutional Shareholder Services Inc. (ISS) and Glass, Lewis & Co. LLC (Glass Lewis) each dealt with the onslaught of say-on-pay votes by running simplistic company-specific metrics through a proprietary executive compensation model. It is less clear how institutional investors handled the burden of the several thousand extra voting decisions required by the say-on-pay vote. While some may have been able to examine each company situation separately, many either defaulted to a proxy advisory recommendation or developed an internal system for identifying only a small percentage of portfolio companies that would be reviewed individually and defaulting to a "yes" vote for all companies not on their internal "hit" list.

Moreover, institutional investors and the proxy advisory firms overwhelmingly supported annual say-on-pay votes, rather than a biennial or triennial vote. The logistical difficulties of coping with several thousand annual say-on-pay votes obviously were not so challenging that institutional investors and proxy advisory firms would voluntarily forgo the leverage inherent in an annual say-on-pay vote.

The 2011 say-on-pay advisory vote experience not only demonstrated the mechanical feasibility of coping with the extra voting decisions, it also provided several other very important lessons, based on the over 2,200 say-on-pay advisory votes at companies included in the Russell 3000 index.[1]

ISS recommended a no vote at approximately 300 companies, or about 12.5 percent of the Russell 3000 companies in the sampled universe. Although harder to track, Glass Lewis seems to have recommended a negative vote at a somewhat higher percentage of companies, reportedly as high as 17 percent. Importantly, the difference between receiving a favorable recommendation from ISS and an unfavorable one, on average, was a swing of approximately 25 percent of all votes cast. Glass Lewis' recommendations

seemed to produce about an additional 5 percent swing in votes cast.

A second relevant key statistic is that companies receiving a negative proxy advisory recommendation from ISS averaged less than a 70 percent positive shareholder vote, compared to those receiving positive proxy advisory recommendations, which routinely scored 90 percent or higher positive shareholder votes.

The importance of the below 70 percent average positive vote where ISS has issued a negative say-on-pay recommendation becomes startlingly clear when set against ISS' almost certain voting policies for 2012. As is its custom, ISS has polled the jury of corporate governance opinion and is on the verge of concluding that a less than 70 percent "yes" vote is sufficiently indicative of investors' lack of confidence in a company's pay practices to require corrective action by the company. Failing corrective action, the ISS policy in 2012 would be to recommend a withhold vote for directors on the Board's compensation committee and/or an automatic recommendation to vote "no" at the next annual say-on-pay vote.[2] The only open issue appears to be whether a company should be given more than one proxy season to implement sufficient changes in its pay policies to receive a positive ISS voting recommendation (as one ISS spokesperson has put it—a "yellow card/red card" approach), or whether a company should be required to make those changes prior to the very next proxy season.

In either iteration, the consequences would be stark. Unless the company were to change its executive pay policies to suit the ISS voting policies and metrics of the moment, members of its compensation committee would be living under the threat of a withhold vote recommendation from ISS. And as ISS has so successfully demonstrated over the past several years, this is a place very few directors want to go. Many directors view receiving a far lower shareholder vote than other nominees as an unacceptable consequence of a corporate policy that can be changed to avoid personal embarrassment. Given the choice, directors to date have consistently sacrificed the policy to avoid a withhold vote recommendation, thus giving ISS tremendous leverage to impose its view of good governance on corporate America.

An additional important development in the 2011 say-on-pay voting season was the use by over 100 companies of a supplemental proxy statement to rebut a negative say-on-pay vote recommendation by ISS and/or Glass Lewis. Although the rebuttals addressed a number of issues, about 50 percent took issue with proxy advisory determinations of a pay for performance disconnect.[3]

Many of the supplemental proxy statements were used proactively by the companies to solicit favorable say-on-pay votes from large investors through in-person visits and telephonic conference calls. Whether and to what extent these unusual solicitation efforts were successful is hard to determine. That over 100 companies thought the unusual effort worthwhile is itself telling.

Anecdotally, at least, companies and institutional investors alike were frustrated by the shortness of time available to evaluate company responses to negative ISS and/or Glass Lewis recommendations. The short time frame was compounded by lack of corporate governance staff at many institutional investors to deal with the attempted one-on-one solicitations by beleaguered companies.[4] Some companies engaged in this effort also noted the difficulty of persuading portfolio managers and buy-side analysts to support the company's views on the merits with the internal governance staff that was responsible for the voting decision.[5]

In sum, the overriding lesson of the 2011 say-on-pay season is that companies have two practical choices in dealing with say-on-pay votes in the future.

- Try harder to explain to investors why a board's executive pay policies that run afoul of a proxy advisor's model nevertheless are appropriate in the company's particular circumstances. The hope would be that, by focusing on clarity and conciseness of presentation, institutional investors would "get it" and opt out of the tyranny of a one-size-fits-all voting policy and accompanying executive compensation metrics, whether of the investor's or a proxy advisory firm's devising. The goal of the effort would be to achieve a sufficient positive vote from shareholders to avoid a lower than 70 percent positive vote and the consequence of a withhold vote campaign against compensation committee members.[6]
- Tailor the board's executive compensation programs to ISS metrics, to "game the system" so to speak.[7] Compensation committees and boards taking this tack would be adhering to the time honored and too often effective principle of "going along to get along." In the view of these boards, if you "can't beat the system, you might as well join it" and thereby avoid the potential for a negative say-on-pay vote recommendation that would raise the specter of a less than 70 percent positive vote.

> Institutional investors and the proxy advisory firms **overwhelmingly supported annual say-on-pay votes**, rather than a biennial or triennial vote.

Neither of these choices is satisfying on a theoretical level. They illustrate the irreconcilable dilemma of trying to squeeze the variety and complexity of thousands of companies' particular circumstances and pay policies

CHARLES NATHAN *is of counsel at Latham & Watkins' New York office,* JAMES D.C. BARRALL *is a partner in the Los Angeles office, and* ALICE CHUNG *is an associate in the Silicon Valley office.*

into a relatively rigid mold of a one-size-fits-all governance model, driven by low cost methodologies.

More important, on a practical level, is the probability that, over time, most boards will pick the far easier and least controversial route of tailoring compensation policies to ISS metrics, rather than the higher visibility, higher cost, higher risk route of trying to convince their shareholders that ISS "got it wrong." The end result almost certainly is going to be the practical hegemony over pay policies and practices by ISS and, to a lesser extent, Glass Lewis.

As so many predicted when say on pay was being debated, the outcome of mandatory say-on-pay advisory votes will be the ascendency of the proxy advisory firms' executive compensation voting policies and associated metrics, whether or not the proxy advisors have any expertise or knowledge about executive compensation, whether or not their executive compensation metrics are well founded conceptually and fairly and accurately applied in practice, and whether or not those metrics are at least more often than not applicable to specific companies facing specific issues in terms of management retention, management incentives and shareholder value creation.

Defenders of ISS are likely to cite ISS' annual surveys of institutional investors and public companies followed, at least in the case of the 2011 say-on-pay experience, by changes in its executive compensation voting policies and associated metrics, as indicating a willingness to respond to fair criticisms from the corporate world.[8]

The proposed changes, however, mask several critical underlying realities. First and foremost, notwithstanding the arguably "positive" changes,

> An **additional important development** in the 2011 say-on-pay voting season was the use by over 100 companies of a **supplemental proxy statement** to rebut a negative say-on-pay vote recommendation by ISS and/or Glass Lewis.

ISS still owns the policy and the policy will continue to be essentially one-size-fits-all.[9] While ISS has stated it intends to be more "holistic" in evaluating pay and performance in 2012, there has been no corresponding commitment to employ the substantial resources that would be required to thoughtfully evaluate each company in the context of its strategic and tactical business objectives and other particular circumstances (such as whether there is a new management team that is embarking on major strategic initiatives or a long-serving management team that, while successful, is not reinvesting in the business, not to mention the myriad of the other real life differences among so-called peer companies). As a result, there is inevitable concern that a badly executed "holistic" approach would amount to not much more than redefining the boxes to be checked in a way that makes the ISS determinations even less transparent and accountable.

Second, while ISS may be willing to give a pass on "qualitative" grounds to some companies with weak alignments between pay and performance, it's hard to see how ISS, given its time and personnel constraints, could fairly evaluate each company's case, whether made before the 2012 proxy season begins or after ISS has issued its voting recommendation. The bottom line, it seems, is that a company would be ill-advised to rely on the ISS qualitative review if it does not score well on ISS' quantitative metrics.

Finally by redefining say-on-pay "failure" as less than a 70 percent positive vote, ISS has deftly managed to put far more fish in the 2012 proxy season barrel and thereby increased its relevance and leverage in the determination of so-called "acceptable" pay policies.

In sum, say-on-pay advisory voting demonstrates the strengths and weaknesses of ISS' one-size-fits-all voting policies paradigm. On a superficial level it works, it is far less expensive than a paradigm that would require specific company situations to be taken into account,[10] and it enhances the power and prestige of the activist corporate governance community that many observers view as ISS' core constituency.

On the other hand, the paradigm clearly forces portfolio companies to live under the tyranny of one-size-fits-all voting policies. Moreover, it saddles Corporate America with an increasing number of corporate governance and pay policies that in too many cases lack a convincing connection to the creation of shareholder value. Finally, it wholly ignores the costs imposed on U.S. companies that currently invest significant time and energy in trying to cope with the straightjacket of ISS' one-size-fits-all metrics, either by rearranging (sometimes in a wholesale way) their pay practices and policies to conform to the ISS metrics d'jour or by trying to appeal over the head of ISS, so to speak, to investors who in all probability don't have the time or resources to cope with a case-by-case analysis either.[11]

1. See Semler Brossy Consulting Group, LLC, "2011 Say-on-Pay Results: Russell 3000: Shareholder Voting and Responses to Proxy Advisers (Aug. 26, 2011), available at http://www.semlerbrossy.com/pages/pdf/SBCG%20-%20SOP_Update_082611.pdf (Semler & Brossy).

2. See ISS 2012 Draft Policies for Comment, available at www.issgovernance.com/policy/2012comment. See also "ISS 2011-2012 Policy Survey Summary of Results," available at www.issgovernance.com/policy.

3. See Semler & Brossy, supra note 1. The companies' challenges were typically based on asserted factual errors by ISS, or disagreement with ISS' metrics for correlating pay and performance, usually centered on peer group selection for measuring relative performance and pay and the methodology for valuing equity compensation by focusing on grant day valuation rather than compensation actually received.

4. Another telling anecdote is that one Fortune 100 company spent considerable time and effort to include an easily readable "plain English" summary of its compensation policies in its initial proxy statement. In subsequent discussions with investors, it was disappointed to hear that while some applauded the effort, many others complained the 3-4 page summary was too long—in the height of the proxy season with tens of thousands of proxy statements to review every week, the institutional investor staffs just didn't have time to read more than one page at most.

5. We have previously noted that many institutional investors have completely separate staffs for making investment decisions and making voting decisions, with the two staffs often appearing to inhabit separate universes. See Latham & Watkins Corporate Governance Commentary, "The Parallel Universes of Institutional Investing and Institutional Voting" (March 2010), available at www.lw.com/upload/pubContent/_pdf/pub3446_1.pdf.

6. Adding a short and truly plain English summary of a company's compensation policy to its initial proxy statement and actively soliciting favorable say-on-pay votes from leading institutional investors from the "get go" would help solve the last minute crunch problem experienced by the 100 or so firms that reacted to a negative ISS or Glass Lewis say-on-pay recommendation in 2011. However, whether a four or five week active solicitation would achieve success as compared to a one week or shorter solicitation remains uncertain. For this reason, a number of advisors are recommending that public companies of every ilk "engage" with their investors on a year-around basis, rather than waiting for proxy season. In any event, active year-around engagement and/or active proxy season solicitation, even if confined to 20 or so of a company's largest investors, would impose additional costs on the company, not just for the time of its legal, financial and proxy solicitation advisors, but also in terms of directors' and executives' time and focus.

7. While ISS say-on-pay metrics in 2011 were hardly transparent, it was possible to predict ISS conclusions with some degree of confidence. This was not the case at Glass Lewis. Moreover (and perhaps more to the real point), ISS has announced a new consulting service that would assess a company's pay practices, including whether it suffered from a pay for performance disconnect or the like. This would seem to be an invitation to companies to buy the consulting service so as to reverse engineer ISS' say-on-pay methodology. It is not clear whether the announcement of this new consulting service is serendipitous or an effort to better the ISS economic model by finding a way to make money out of its developing "yellow card/red card" voting policy.

8. See ISS, "2012 Draft Policies for Comment—Evaluation of Executive Pay" (Management Say on Pay), supra note 2. One major proposed change would test each CEO's total pay relative to the company's peer group median, "which may identify cases where a high performing company may nevertheless be overpaying." This proposed policy makes clear what many suspected in 2011: that absolute pay does matter, notwithstanding performance. Whether introducing the sheer size of a CEO's paycheck (particularly as ISS computes it) is an "improvement" could be debated.

9. The proposed ISS policy for 2012 does call for a qualitative review for companies "demonstrating a weak alignment" between pay and performance as measured by ISS' one-size-fits-all metrics. The question, of course, is whether and how often the qualitative review will outweigh the quantitative metrics. As noted above, ISS has also started a separate executive pay consulting service, presumably walled off from its proxy voting services. Skeptics might wonder how ISS' executive pay consulting service could survive if it supported pay practices that run afoul of its "separate" say-on-pay model, particularly in light of the new "qualitative" review built into the model for companies with weak alignment between pay and performance.

10. And therefore is far more appealing to most institutional investors who appear to view voting as a regulator-imposed cost of doing business, not as an investment performance booster.

11. As Harvard Business Professor, Jay Lorsch, recently wrote in an opinion in Agenda Magazine, "Most shareholders do not care enough about the size of executive compensation to put a brake on it. What they care about is the value of their shares and this is largely driven by the company's economic performance. At most companies, the compensation of top officers, including the CEO, is a miniscule fraction of total costs."