



## Proxy Advisor Influence - Say on Pay

### OVERVIEW

For the past three years, US companies have been under increasing pressure to provide shareholders with a non-binding vote on executive compensation (Say on Pay). Already a practice in the UK, Australia and other markets, global investors, activists, proxy advisors and others, accustomed to this “right” in these markets, have been seeking to extend this ability to their US holdings.

While a number of US companies were early, “voluntary” adopters (often following shareholder pressure on this issue), many more companies received shareholder proposals asking for this right. For the past two years, TARP companies have been required to provide annual Say on Pay votes.

The debate of “whether or not” to provide Say on Pay was finally settled at the end of 2010, as mandatory Say on Pay was an early provision of the Dodd–Frank Wall Street Reform and Consumer Protection Act (small companies with under \$75 million public float were given a two-year reprieve from this requirement).

The interesting wrinkle was the SEC also required companies to provide a vote on the future frequency of Say on Pay proposals (“Say When on Pay”), giving shareholders the right to choose between annual, biennial or triennial frequency.

### 2011 YEAR-TO-DATE

So at the beginning of 2011, while most companies knew they would be including Say on Pay proposals in their proxies, the primary discussion appeared to be about which future frequency to recommend. This commanded significant attention and discussion between companies, their investors and advisors.

### SAY WHEN ON PAY

Following is a breakdown of the frequencies companies recommended in their proxies, thus far in 2011.<sup>i</sup>

Management Recommendation:	Annual	Biennial	Triennial	None
Ballots:	923	51	688	50
% of Total:	53.9%	3.0%	40.2%	2.9%

Focusing on the two primary frequency recommendations, annual and triennial, following are the average voting results.

Avg. Support when Management Recommends:	Annual	Triennial
Support for Annual:	86.6%	50.2%
Support for Triennial:	10.9%	46.5%

### PROXY ADVISOR RECOMMENDATIONS - FREQUENCY:

ISS, in its 2011 Policy Updates, indicated they would in all cases recommend votes for annual frequency, irrespective of company recommendations, their governance, compensation or performance. This spring they have remained true to that policy, and have always recommended for annual frequency.

Glass-Lewis, on the other hand, indicated it would generally recommend votes for annual frequency, but would maintain some flexibility, stating:

“We will generally support *Annual* voting

– We believe the negative aspects of annual votes (namely, the time and costs involved) are far outweighed by the increased accountability

– We will consider well-crafted triennial or biennial proposals from management.”

Through the middle of May, they recommended FOR triennial frequency at the following 11, mostly smaller companies:

- Universal Health Realty Income Trust
- Two Harbors Investment Corp.
- PennyMac Mortgage Investment Trust
- Commonwealth REIT
- Winthrop Realty Trust
- Heartland Express, Inc.
- Hatteras Financial Corp.
- Berkshire Hathaway Inc.
- NuStar GP Holdings, LLC.
- North European Oil Royalty Trust
- Amazon

### SAY ON PAY

Thus far in 2011, 29 Russell 3000 companies failed to receive at least 50% support for Say on Pay, including 6 of the S&P 500 companies. These six were: Jacobs Engineering, Hewlett-Packard, Stanley Black & Decker, Janus Capital, Masco, and Constellation Energy.

### PROXY ADVISOR RECOMMENDATIONS - SAY ON PAY:

All of these “failing” proposals at Russell 3000 companies received negative ISS recommendations, with many also receiving negative recommendations from Glass-Lewis. Overall, ISS recommended AGAINST approximately 12% of all such proposals. As a result, on average, shareholder support was 25% lower when ISS recommended AGAINST than when it recommended FOR. Glass-Lewis also recommended AGAINST slightly over 12% of all such proposals it reviewed. So at this point it is fair to say that, at larger companies, a negative ISS recommendation is necessary – but not sufficient – for Say on Pay to fail.

ISS’ primary reasons for issuing negative recommendations were 1) where they perceived a “disconnect” between the company’s executive compensation and its total shareholder return, and 2) the presence of what ISS considers “poor pay practices”.

In addition to the companies where Say on Pay “failed”, at many other companies their proposals “passed” but with the owners of a meaningful percentage of shares registering their opposition. This gets us to the important question:

## “HOW SHOULD YOU MEASURE SUCCESS OR FAILURE?”

Following are the results, by percentage “tier” of support.

SoP by Tier:	0-49.9%	50-69.9%	70-79.9%	80-89.9%	90-100%
Ballots:	29	112	135	288	1197
% of Total:	1.6%	6.4%	7.7%	16.3%	68.0%

In our view, companies receiving less than 70% support for Say on Pay are likely to face extra scrutiny from the media, investors and others, at least until they hold their next Say on Pay vote.

Very significantly, companies with “failed” votes face an additional risk – shareholder derivative suits. Last year, both Occidental Petroleum and KeyCorp faced these actions, and thus far this year, Beazer Homes and Jacobs Engineering also have received such actions, with more potentially to follow.

## SOME COMMENTS ABOUT PROXY ADVISOR INFLUENCE:

While proxy advisor recommendations do affect the vote – and in some cases can make the difference between success or failure – in our experience, many companies and their advisors overstate the degree of proxy advisor influence at particular companies.

While a significant percentage of institutional investors subscribe to one (or multiple, or all) proxy advisors and related data services, they use them in different ways:

1. Only a minority of these “subscribers” automatically follow the proxy advisor recommendations. This includes investors that use proxy advisors as “voting agents”, in which case the proxy advisor actually executes the vote for the investor – following either the proxy advisors’ “benchmark” policies or perhaps a slightly “customized” version agreed to between the investor and the proxy advisor.
2. Other “subscribers” use proxy advisors as a screening tool to identify those portfolio companies at which the investor might want to directly analyze the issues further, and potentially may vote AGAINST, whether or not that was the proxy advisor’s recommendation. So here, their vote may mimic the proxy advisor recommendation, but it was not a direct result of the recommendation.
3. Another group of “subscribers” read the analyses but don’t even look at their voting recommendations. For example, they may feel that ISS does a good job summarizing board and governance-related issues, while Glass-Lewis may have a more nuanced and real-world approach to compensation (or vice versa). So they pick and choose the sections they like from each, again ultimately making their own voting decision. What this means for companies is, it is not enough to secure a directionally-favorable vote recommendation, as that is not what drives these investors. There might be one fact, or interpretation in the body of the analysis that catches the investor’s eye and may influence their voting decision. For this reason, it is important that companies read the ENTIRE analysis, and where warranted, point out and seek to correct areas that are factually incorrect, as you never know who is focusing on just that section.

In seeking to minimize the adverse voting impact of negative proxy advisor recommendations, we typically focus on helping companies develop relationships with the governance heads and proxy voters at groups 2 and 3 above, as these are NOT automatic proxy advisor followers and thus may maintain a greater degree of voting flexibility. Here, company performance, governance, compensation, clarity of disclosures and relationships DO matter.

For information on Phoenix and how our year-round advisory model can help your company address the ongoing challenges posed by Say on Pay, contact us at:

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<sup>i</sup>All numbers presented reference ISS Governance Analytics data for meetings from January 1 through May 31, where results were available.