The Advisor

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Shareholders Have Their Say on Pay, But What Exactly Are They Saying?

By Shirley Westcott **July 2011**

Nearly a year has passed since the enactment of the Dodd-Frank Wall Street and Consumer Protection Act and with it the rollout of the first wave of corporate governance reforms. Among these, the most closely watched, reviewed and debated has been this year's shareholder advisory votes on executive compensation (say on pay or SOP). With proxy season in the rearview mirror, market participants are tallying their report cards of what went well and what didn't, but beyond preparedness and process, the overarching question remains, has SOP been a meaningful undertaking?

On the plus side, corporate and investor groups report that SOP has encouraged more dialogue between companies and shareholders on pay issues, which was touted as a primary objective of SOP. And, for this year at least, it has produced two ancillary benefits to issuers: it has shifted protest votes away from compensation committee members and lightened the number of shareholder-sponsored resolutions on pay.

Nevertheless, even in its inaugural year, the SOP vote appears more symbolic than substantive. Fewer than 2% of SOP votes have failed this season, despite the wellspring of criticism that has been leveled at corporations for many years over executive pay. Obvious, too, is that a number of institutional investors, particularly smaller ones constrained by time and resources, are relying on the analyses and opinions of proxy advisors in casting their SOP votes. While not all investors were in favor of a universal, mandatory pay vote, it is striking that in view of the additional workload burden, they overwhelmingly want to conduct this exercise on an annual basis (see Table 1).

Round one of SOP might be better characterized as a solution still in search of the problem. Dodd-Frank was a response to excessive risk taking by financial institutions, but the utility of extending SOP and other governance reforms to virtually all U.S. public companies isn't readily manifest, particularly in relation to the significant costs of compliance. Although shareholders are now armed with heftier disclosures and a mechanism for holding boards accountable for pay practices, this year's SOP votes should dispel any populist notions that this will somehow rein in escalating executive pay.

Alliance Advisors is presenting a two-part article recapping the first year of mandatory SOP. This first part of the article examines how SOP has trended this year, while the second part, which will be published in a few weeks, offers a sample review of the proxy advisors' SOP analyses.

What the Votes Say

If an up or down vote on executive compensation is meant to be a shareholder communication vehicle, then the message conveyed this year is that only 37 out of nearly 2,300 companies have a serious problem with pay. The number of failed votes is striking, not only because it doesn't reflect the intensity of outrage expressed for years over executive pay levels, but most of these companies are not big name firms that have achieved media notoriety for eye-popping CEO pay (see Table 2). In fact, of the companies whose CEOs were among the top 20 highest paid in 2010 (based on CNN Money, Wall Street Journal, and Forbes surveys), 65% received over 80% support on their SOP votes. Apparently, the sheer level of CEO pay isn't the real issue for most investors.

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What is evident is that many institutional investors are relying heavily on the opinions of proxy advisors in making their SOP voting decisions, particularly market heavyweight Institutional Shareholder Services (ISS). This is reflected in the degree that voting outcomes have mirrored ISS's recommendations. (Form N-PX filings, due at the end of August, will shed light on how specific institutional investors voted.) Where votes have been reported:

- All of the 37 companies where SOP failed received a negative ISS recommendation.
- Of the SOP proposals that ISS opposed (12% of the total), over half (52%) received less than 70% approval, and 71% received less than 80% approval.
- Of the SOP proposals that ISS supported, 83% received over 90% approval, and 95% received over 80% approval.

Statistics are not available on Glass Lewis's recommendations, though it has reportedly rejected a high percentage of SOP proposals this year. However, with a smaller subscriber base, Glass Lewis is less influential than ISS.

Both ISS and Glass Lewis use proprietary models to evaluate what investors care most about, namely whether CEO and NEO pay are decoupled from firm performance as measured against peers. They also take into account other criteria, such as the quality of compensation disclosures and "problematic" pay practices, which can cover a multitude of transgressions (excise tax gross-ups, excessive perquisites, lucrative severance and pension benefits, and other pay elements not directly tied to performance).

Companies have been highly critical of these methodologies and have pushed back against negative recommendations with supplemental filings, outreach to top holders, and even last-minute revisions to their pay programs to avert a failed SOP vote. Some of the most frequent complaints about the proxy advisors' models include:

- In the case of ISS, use of a single, short-term performance metric. ISS screens companies whose one- and three-year total shareholder returns (TSR) are below the median of their peer group.
- Use of broad peer groups that do not aggregate companies that are most similar in size and lines of business. ISS uses Standard & Poor's/MSCI's four-digit (industry group) Global Industry Classification Standard (GICS), while Glass Lewis uses a combination of peer groups based on enterprise value, sector and sub-industry.
- Valuing equity awards at grant date fair value, which reflects potential value rather than actual payouts. This also overstates compensation relative to what companies report (i.e., the portion of awards that must be expensed under GAAP).

While any formulaic approach to SOP is open to criticism, the reality is that proxy advisors, like institutional investors, are up against a formidable challenge in analyzing hundreds of compensation plans over a few months in the spring. The fact that a number of institutional investors have shifted this task to proxy advisors to fulfill their compliance obligations only underscores the inherent shortcoming of Dodd-Frank: it invites a one-size-fits-all comparison of companies' executive compensation programs.

Recognizing this, issuers can deflect the impact of proxy advisor opinions on future SOP votes by familiarizing themselves with their policies and addressing with their top holders any areas where their pay programs come up short. Although proxy advisors are influential, issuers should bear in mind that ultimately it is their shareholders--not the proxy advisors--that they need to persuade of the soundness of their compensation programs. The second part of this article discusses in more detail ISS's policies as they pertain to compensation programs.

Coming Up (Perhaps): Internal Pay Equity

One of the more contentious compensation provisions of Dodd-Frank that may factor into future SOP votes is the comparison of CEO pay to the median pay of employees. Although still awaiting SEC rulemaking, some shareholder advocacy groups are already contemplating how to utilize the ratio. The U.S. Proxy Exchange, a non-profit organization of individual investors founded by Glyn Holton and James McRitchie, recently drafted guidelines to aid its members in screening out companies where CEO pay packages are prima face excessive, irrespective of firm performance. The two suggested tests offer retail investors a simplified approach to SOP voting:

- A ratio test: Using the ratio of CEO pay to median worker pay, a shareholder could set a standard threshold for voting against SOP at any company.
- A median test: Using the median CEO pay of an index of companies (such as the S&P 500), a shareholder could vote against SOP at any company where CEO pay exceeds the median or a percentage of the median of the index.

While an income equality approach to SOP may appeal to some individual investors, and certainly labor unions, mainstream institutional investors have shown little interest in CEO/employee pay data, as evidenced by the low support (10% or less) they have given shareholder proposals over the years seeking pay gap disclosures. A more widely used internal pay comparator, by both proxy advisors and some institutional investors, is between the CEO and other named executive officers.

At this juncture, Section 953(b) of Dodd-Frank is facing vocal corporate and legislative challenges (the aptly named "Burdensome Data Collection and Relief Act," which has passed the House Financial Services Subcommittee on Capital Markets), which could likely delay it from taking effect by 2012. Companies should, in any case, stay apprised of how this issue develops.

Compensation Committee Vulnerability

Champions of SOP maintained that the advisory vote would relieve shareholders from using the "blunt instrument" of a withhold vote from compensation committee members for expressing dissatisfaction with pay. So far this year, shareholders seem to be largely sticking to this approach.

According to ISS, opposition to directors is down overall this year, primarily due to fewer votes against compensation committee members. Of the companies where SOP failed, at only a few (Cadiz, Cogent Communications, Hewlett-Packard, and Stewart Information Services) did board members receive high opposition votes (over 30%) in apparent connection with pay practices. Both ISS and Glass Lewis state in their policies that they will recommend against both SOP and compensation committee members in particularly egregious situations, such as companies with longstanding, unresolved pay issues. ISS reported in June that it had opposed compensation committee members at only 22 companies.

Next year, however, could be a different matter. Even though SOP and say-when-on-pay (SWOP) are advisory, boards that do not heed the outcome of the votes—either by rectifying compensation practices or honoring shareholders' preference on SWOP—will likely face investor backlash in 2012. Unlike responses to precatory shareholder resolutions, board actions on pay votes will undergo more sober scrutiny and in all likelihood more immediate repercussions against compensation committee members.

Beyond protest votes against directors, a failed SOP vote can carry more far-reaching consequences in the form of shareholder derivative lawsuits. A number of companies are already facing this prospect, notwithstanding Dodd-Frank's stipulation that the advisory votes would not carry any additional liability

for directors. Although legal experts believe such suits are without merit, companies will still be faced with the time and expense of defending against them.

SOP Versus Shareholder Resolutions on Pay: Mixed Messages?

One collateral effect of Dodd-Frank is a marked decrease in the number of shareholder resolutions on pay. Excluding shareholder-sponsored SOP resolutions, the number of shareholder proposals to date dealing with various aspects of compensation is down by 47% from 2010 and by 41%-46% from their levels in 2008 and 2009 (see Table 3). The number receiving majority support has also fallen. So far this year, only two shareholder resolutions on compensation (at Lowe's and Whirlpool) have received majority support. This compares with four majority votes in 2010, five in 2009 and seven in 2008. Most of the majority-supported resolutions dealt with shareholder approval of executive severance benefits.

Although Dodd-Frank doesn't restrict shareholders from filing resolutions on executive compensation (except those seeking to change the frequency of a company's SOP votes), it makes them less relevant. Some provisions of the legislation address issues that have been frequently raised in shareholder campaigns, such as a shareholder vote on golden parachutes and stricter clawback policies. Moreover, the mandatory SOP vote provides shareholders with a recurring opportunity to express their dissatisfaction with executive pay.

Shareholder resolutions singling out a specific feature of compensation can end up creating noise rather than focusing a board on a bona fide pay problem. As indicated in Table 4, vote results and proxy advisor opinions on shareholder proposals versus SOP can send wildly disparate messages. With the exception of a few companies, high support (over 30%) for a shareholder proposal on pay didn't translate into high opposition to SOP--at least this year. The companies most at risk for SOP fallout are those where a shareholder resolution has received high support over multiple years. Because this is still murky territory, companies targeted with pay-related shareholder proposals should proactively address the underlying issue with both the proponent and top holders.

See Tables Next Page.

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Table 1: Say-on-Pay Frequency Votes

Frequency	Percentage of companies where supported (plurality of votes)
Annual	80
Biennial	1
Triennial	19

Source: SharkRepellent.net, based on 2,072 companies

Management recommendation	Percentage where annual was supported	Percentage where biennial was supported	Percentage where triennial was supported
Annual	100	0	0
Biennial	88	12	0
Triennial	73	0	27
No recommendation	100	0	0

Source: Say-on-pay.com, based on S&P 900

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Table 2: Failed SOP Votes

Company	CEO's 2010 Total Direct Compensation (millions of dollars)*
Ameron International	3.9
Beazer Homes USA	6.9
BioMed Realty Trust	5.0
Blackbaud	4.6
Cadiz	2.3
Cincinnati Bell	8.6
Cogent Communications Group	4.0
Constellation Energy Group	15.7
Curtiss-Wright	7.9
Cutera	1.2
Dex One	5.2
Freeport-McMoRan Copper & Gold	39.5
Helix Energy Solutions	4.0
Hercules Offshore	2.5
Hewlett-Packard	23.9
Intersil	4.4
Jacobs Engineering	6.4
Janus Capital Group	20.3
Kilroy Realty	6.4
Masco	7.0
M.D.C. Holdings	9.2
Monolithic Power Systems	5.6
Nabors Industries	13.5
Navigant Consulting	1.9
Nutrisystem	5.3
NVR	30.9
Penn Virginia	4.0
PICO Holdings	14.3
Premiere Global Services	8.2
Shuffle Master	0.7
Stanley Black & Decker	32.7
Stewart Information Services	1.3
Superior Energy Services	6.4
Talbot's	6.3
Tutor Perini	9.0
Umpqua Holdings	3.7
Weatherford International	13.2

*As reported in the companies' summary compensation tables

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Table 3: 2010 and 2011 Shareholder Proposals on Pay*

Shareholder Proposal	2010	Average Support (%)**	2011 (through mid-June)	Average Support (%)**
Equity retention	34	23.5	7	23.9
Internal pay disparity	10	6.3	3	9.2
Performance-based awards	8	31.0	4	34.5
Severance pay	4	60.9	4	45.0
Golden coffins	4	39.7	3	28.1
Pay-for-superior performance	4	36.1	1	31.5
Clawbacks	3	42.4	3	26.2
Bonus banks	3	26.0	0	
SERPs	2	41.8	3	29.8
Tax gross-ups	2	40.2	2	33.4
Compensation disclosure (executives earning over $500,000)	2	10.4	2	11.6
Compensation committee independence	2	8.1	1	13.8
Cap executive pay	2	5.1	0	
Ban stock options	2	6.3	0	
TARP compensation	2	34.4	0	
Link pay to social issues	0		4	5.2
CIC accelerated vesting of equity awards	1	28.3	3	41.5
Director pay	0		4	19.8
Benchmark pay at peer median	0		1	29.9
TOTAL	**85**		**45**	

Source: Alliance Advisors LLC and ISS

*Excludes 2010 shareholder-sponsored SOP resolutions
**Percentage based on FOR+AGAINST votes

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Table 4: 2011 Shareholder Proposals on Pay (through mid-June)

Company	Shareholder Proposal	Shareholder Proposal Vote*	ISS Recommen-dation	SOP Vote*	ISS Recommen-dation
Anadarko Petroleum	CIC accelerated vesting	36.7%	FOR	78.7%	FOR
Bank of America	Clawbacks**	35.5%	FOR	92.9%	FOR
Bristol-Myers Squibb	Pay disclosure	7.4%	AGAINST	94.8%	FOR
Caterpillar	Golden coffins	12.7%	AGAINST	89.6%	FOR
	Equity retention	22.1%	FOR		
Chesapeake Energy	Director pay	43.0%	FOR	58.0%	AGAINST
Chevron	Link pay to social issues	5.6%	AGAINST	97.8%	FOR
Coca-Cola Enterprises	Severance pay**	37.7%	FOR	94.3%	FOR
Consolidated Edison	Pay disclosure	15.8%	AGAINST	92.0%	FOR
Dean Foods	Tax gross-ups**	42.5%	FOR	62.8%	AGAINST
Dominion Resources	SERPs	25.4%	FOR	94.4%	FOR
E.I. du Pont de Nemours	Pay disparity	5.8%	AGAINST	97.8%	FOR
EOG Resources	CIC accelerated vesting**	42.5%	FOR	61.3%	AGAINST
Equity Residential	Link pay to social issues	3.7%	AGAINST	98.1%	FOR
First Commonwealth Financial	Pay disparity	17.4%	AGAINST	94.1%	FOR
General Electric	Clawbacks	7.4%	AGAINST	79.5%	FOR
	Performance-based awards	29.4%	FOR		
Goldman Sachs	Equity retention**	20.7%	FOR	73.2%	AGAINST
	Pay disparity	4.3%	AGAINST		
Harley-Davidson	Golden coffins	26.6%	FOR	97.4%	FOR
Lowe's	Severance pay	57.9%	FOR	95.6%	FOR
	Link pay to social issues	4.6%	AGAINST		
Medco Health Solutions	Equity retention	26.3%	FOR	86.0%	FOR
Navistar International	Severance pay	31.7%	FOR	94.3%	FOR
NV Energy	Equity retention	24.9%	FOR	98.1%	FOR
PulteGroup	Performance-based awards**	36.3%	FOR	76.0%	AGAINST
Raytheon	SERPs**	31.1%	FOR	94.0%	FOR
	Equity retention	24.9%	FOR		
Republic Services	Golden coffins	45.1%	FOR	62.6%	AGAINST
Rite Aid	Tax gross-ups	24.3%	FOR	96.6%	FOR
Sempra Energy	SERPs	32.9%	FOR	75.3%	FOR
	Link pay to social issues	6.9%	AGAINST		
Sprint Nextel	Equity retention	23.0%	FOR	85.9%	FOR
Sunoco	CIC accelerated vesting	45.2%	FOR	85.8%	FOR
Target	Benchmark pay at peer median	29.9%	FOR	92.2%	FOR
United Technologies	Equity retention	25.7%	FOR	97.6%	FOR
U.S. Bancorp	Director pay	7.7%	AGAINST	94.3%	FOR
Verizon Communications	Pay for superior performance	31.5%	FOR	97.2%	FOR
Walt Disney	Performance-based awards	29.5%	FOR	77.2%	FOR
Walgreen	Performance-based awards**	42.6%	FOR	***	***
Weis Markets	Compensation committee independence	13.8%	FOR	90.7%	AGAINST
Wells Fargo	Director pay	5.1%	AGAINST	96.9%	FOR
West Bancorporation	Director pay	23.3%	AGAINST	93.4%	FOR
Whirlpool	Severance pay	52.7%	FOR	97.5%	FOR
Zions Bancorporation	Clawbacks	35.6%	FOR	96.4%	FOR

Source: Alliance Advisors LLC and ISS

*Based on FOR + AGAINST votes
**Repeat proposal
*** Walgreen's annual meeting preceded Dodd-Frank's implementation date for SOP.