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Welcome to Say-on-Pay Season 1: Have Shareholders Had Their Say?

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This proxy season marks the first season in which all public companies, save smaller reporting companies, were required to undertake say-on-pay (SOP) shareholder advisory votes pursuant to § 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

On January 25, the Securities and Exchange Commission (SEC) adopted new rules implementing the provisions of Dodd-Frank's § 951 requiring public companies to hold a shareholder advisory vote on executive compensation—the say-on-pay vote—at least once every three calendar years, a separate shareholder advisory vote at least once every six calendar years on whether the say-on-pay vote should be held every one, two or three years (say on frequency), and, with respect to certain significant transactions, a shareholder advisory vote on certain golden parachute arrangements with executives of the public company or its target (say on golden parachute).[1]

Upon adoption of these rules, the SEC stated that it hoped that the rules would have "a transformative impact on the relationship between chief executives and institutional investors,"[2] and would involve shareholders in certain "behind the scenes" decisions of board members. Now that the majority of public companies with fiscal years ending on December 31, 2010, have held these votes, insights into the repercussions have begun to emerge, and companies can begin to assess how their compensation decisions and disclosure will affect future SOP votes and their relationship with their shareholders.

SOP Timeline

In 2007, Rep. Barney Frank (D-Mass.) proposed the "Shareholder Vote on Executive Compensation Act," seeking an amendment to the Exchange Act that would have required a proxy, consent, or authorization for a shareholder meeting occurring on or after January 1, 2009, to permit a separate nonbinding shareholder vote to approve executive compensation.[3] Although that bill passed in the House, a matching Senate bill, originally proposed by then-Sen. Barack Obama (D-Ill.) never made it out of the Senate.[4]

Despite the failure of the bill, SOP began to gain traction and in 2008 more than 90 corporations received stockholder resolutions for SOP, more than double the number from the prior year.[5] Public companies began to consider adopting voluntary SOP votes, and in March 2008, Aflac Inc. became the first public company in the United States to voluntarily undertake an SOP advisory vote, receiving an approval rating of 93%.[6] In presenting the vote to its shareholders, Aflac noted that, although the vote would be nonbinding, "the Compensation Committee [would] take into account the outcome of the vote when considering future executive compensation arrangements."[7] In that same year, 11 public companies agreed to undertake voluntary SOP votes,

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and by 2010, more than 70 public companies had agreed to undertake such voluntary votes.[8]

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In 2009, in connection with the establishment of the Troubled Asset Relief Program (TARP), the Emergency Economic Stabilization Act of 2008 required companies participating in TARP to undertake nonbinding shareholder votes on executive compensation.[9] On July 21, 2010, President Obama signed Dodd-Frank into law, with its executive compensation provisions requiring SOP, say on frequency and say on golden parachute votes for shareholder meetings occurring on or after January 21, 2011. On January 25, the SEC adopted its rules implementing Dodd-Frank's executive compensation requirements.

Lessons from the United Kingdom's SOP Scheme

Dodd-Frank's SOP provisions were largely modeled on the United Kingdom's SOP regime—the Directors' Remuneration Report Regulations 2002 (DRR). DRR requires certain public companies formed and registered under the U.K.'s Companies Act of 2006 to include an executive compensation report in their annual filings and submit such report to a nonbinding shareholder vote.[10] Similar to Dodd Frank's SOP provisions, the DRR was intended to "increase[e] accountability, transparency, and performance linkage of executive pay."[11]

Following its adoption, DRR appeared to be an immediate success, as some high profile companies saw their shareholders reject companies' executive compensation practices. For example, in the 2003 U.K. proxy season—the first under DRR—GlaxoSmithKline was the first FTSE 100[12] company to fail its shareholder SOP vote and was required to modify certain provisions in its executive pay plan that had led to the negative vote.[13] The company also began an ongoing shareholder consultation process to address shareholder concerns. In 2004, after revising its executive employment agreements to one year instead of two, and removing controversial golden parachute provisions, Glaxo achieved 85% shareholder approval.[14]

DRR has not, however, curbed significant growth in CEO pay in the U.K. In the period immediately preceding the DRR, CEO pay for U.K. companies had been relatively flat. In 2001, mean CEO cash compensation declined by approximately £4,000 as compared to the preceding year.[15] In 2002, average CEO cash compensation had increased by approximately £40,000 from the prior year, and in 2003, the first year following DRR, there was another average increase of approximately £40,000. By 2005, average CEO cash compensation had increased by £190,000 since 2001, and average CEO total compensation had increased by more than £400,000 in that same period.[16]

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Even today, CEO pay in the U.K. continues to rise at a greater rate than before DRR. According to a recent study, executive pay for FTSE 100 companies grew 32% in the last year, while the index itself grew 9%.[17] Furthermore, the study found that over the past 12 years, some share prices had not increased, but pay deals for chief executives had quadrupled.[18]

Despite this continued growth in U.K. CEO compensation, analysis of additional statistical data shows that there is greater sensitivity in the U.K. of CEO pay to negative performance, and that pay-for-performance concerns appear to

have increased in the post-DRR period as compared to the pre-DRR period.[19] Comparing pre- and post-DRR data shows a noticeable and statistically significant increase in sensitivity of CEO pay to negative performance.[20] The highest sensitivity of pay-to-performance was "concentrated in firms characterized by particularly high CEO pay in the pre-DRR period and in firms with high voting dissent against the remuneration report at the time the rule was introduced."[21] The basic conclusion that can be drawn from this analysis is that, while SOP votes have not curbed significant increase in CEO pay in the U.K. since DRR was enacted, shareholders are more likely to reject increases in executive compensation without related positive company returns.

2011 SOP Results in the United States

As of July 11, of the 2,532 public companies that had undertaken SOP votes in accordance with the new SEC rules, only 40 (approximately 1.6%) failed those votes.[22] Of these 40 companies, 38 received negative recommendations from proxy advisor Institutional Shareholder Services (ISS). (ISS did not issue voting recommendations with respect to the remaining two companies.) However, an ISS negative recommendation did not necessarily equate with a subsequent failed shareholder vote. So far this year, ISS has recommended against SOP proposals at 289 (11%) of U.S. companies.[23] For Russell 3000 companies ISS recommended against 12.6% of those companies' compensation practices. For the S&P 500 index, ISS issued negative recommendations at 15% of the companies.[24]

In reviewing SOP proposals, ISS bases its recommendation on aspects of a company's structure and payment practices, such as the balance of performance-based and nonperformance-based pay, the company's one-year and three-year shareholder returns as compared to the company's industry group, and whether the total compensation of a CEO who has served at least two consecutive fiscal years is aligned with the company's shareholder return over that two-year time period. It also looked at the alignment (or lack thereof) of CEO pay and company performance, and whether the company (i) exhibited poor communication between the board and shareholders; (ii) provided incentives that may motivate excessive risk-taking; (iii) had excessive prerequisites or tax gross-ups; or (iv) replaced underwater stock options without shareholder approval.[25]

Companies that received a negative recommendation from ISS garnered on average 25% fewer shareholder supporting votes than those that had received a positive rating.[26] The average shareholder approval rate for companies treated positively by the ISS was 94%, while it was only 69% for those with negative recommendations.[27] Additionally, no SOP votes failed at companies receiving positive recommendations on their SOP proposals.

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Of companies that had received negative recommendations from ISS, at least 105 of them have opted to respond to such negative recommendation prior to holding their SOP votes.[28] These responses were generally in the form of additional soliciting materials issued in connection with proxy statements, and tended to cite issues related ISS' peer group recommendations, option valuation and claims of factual errors. Ninety-eight (98) of the companies filing such responses subsequently received approval from their shareholders in their SOP votes, while seven did not. Of the remaining 31 companies that received negative recommendations from ISS and later failed to receive shareholder approval of their SOP proposals (not counting the two companies that ISS did not review), none filed any response to ISS.[29]

All seven of the companies that responded to ISS and subsequently failed to receive shareholder SOP approval received negative recommenda-

tions from ISS due to pay-for-performance issues. In their responses, each of the companies addressed ISS' stated concerns, albeit with varying degrees of detail. For example, in its additional soliciting materials, The Talbots, Inc., explained in greater detail how its compensation practices were valid, refuting the negative recommendations from both ISS and another proxy advisory firm, Glass Lewis & Co., Inc. (Glass Lewis).[30] Talbots laid out various aspects of its executive compensation structure, arguing that the ISS and Glass Lewis recommendations were based on "incomplete analysis and a 'one size fits all' approach" and that such recommendations failed to account for the fact that the company is in a turnaround and had structured its "pay programs around achievement against [its] turnaround progression."[31] Talbots argued that, despite comments from ISS and Glass Lewis to the contrary, there was not a disconnect in its pay-for performance structure and that the negative recommendations were "misplaced" and failed to accurately reflect "how and on what basis [its] CEO was compensated in 2010." Despite this, on May 19, 53% of Talbot's shareholders voted against its executive compensation proposal.

Responses to SOP

According to a survey performed by Towers Watson, a global professional services firm, prior to final adoption of the SOP legislation, when asked what actions they were taking or planning in preparation for the new SOP requirements, nearly seven out of 10 survey respondents (69%) said they were identifying potential executive pay issues and concerns in advance, while six in 10 (60%) said they were improving their Compensation Discussion & Analysis disclosure in their proxy statements to better explain the executive pay program's rationale and appropriateness for the company.[32] In addition, many companies indicated they were engaging with proxy advisors (44%) to discuss areas of concern, meeting with key institutional shareholders (29%), and preparing a formal communication plan (23%).[33]

Some companies that did not receive shareholder SOP approval in the 2011 proxy season have taken a proactive approach, publicly addressing their response to the failed votes and their plans in the future. Following its negative shareholder vote, Talbots publicly issued a response noting how it is dealing with shareholder feedback. On May 25—six days after its failed vote—Talbots stated that although the SOP vote was advisory, it intended to take it seriously, and that it is "committed to the continuous evaluation of [its] compensation programs and to considering appropriate adjustments to those programs in order to reflect progress made towards the Company's turnaround as well as input from [its] shareholders."[34]

Other companies that failed their SOP votes have taken similar proactive approaches. For example, following its failed vote, Helix Energy Solutions Group, Inc., issued a statement that it was:

> **determined to take the following actions: (i) implement defined performance metrics for the 2011 Cash Bonus Program for executive officers with the Committee… and (ii) modify the long-term incentive compensation awarded to executive officers to include additional pay for performance elements in future grants.[35]**

Similarly, on April 25, Umpqua Holdings filed a Form 8-K in which it stated that "its board of directors takes the results of this vote seriously and is considering ways to address this concern."[36] Approximately two months later, on June 20, Umpqua filed an additional Form 8-K, in which it stated that its "Compensation Committee has taken action to more closely link executive compensation to stock price and dividend performance."[37]

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Shareholders have also responded to failed SOP votes, beginning a new trend of litigation at companies where SOP proposals were not approved. As of July 7, at least eight companies that failed to receive shareholder approval of their executive compensation proposals now face, or have faced, derivative lawsuits arising from their negative say-on-pay votes. Despite Dodd-Frank's explicit statement that "the shareholder vote… may not be construed… to create or imply any change to

the fiduciary duties of such issuer or board of directors… [or] any additional fiduciary duties for such issuer or board of directors,”[38] several companies—Hercules Offshore Inc., Beazer Homes Inc., Janus Capital, Cincinnati Bell, Occidental Petroleum, Keycorp, and Jacobs Engineering Group, Inc.—have had shareholders file suit against them following negative SOP votes. The complaints in all of the cases are similar, alleging, among other things, that the directors:

> **(i) breached their duty of loyalty by deliberately diverting corporate assets to the executives at the expense of the shareholders and aided and abetted each other in these actions; (ii) committed corporate waste and caused unjust enrichment; and (iii) breached their duty of candor and full disclosure by stating in the proxy statement that pay was based on performance, concealing the overpayments.[39]**

None of the cases have yet gone to trial, and at least two of these companies—Keycorp and Occidental Petroleum—both of which were sued in connection with 2010 SOP votes, have settled their suits, agreeing to make changes to their executive compensation practices.[40]

During the 2011 proxy season, some companies addressed compensation practice concerns highlighted by ISS, reaching out to their shareholders and committing to change their practices. For example, after receiving a negative ISS recommendation related to tax gross-up provisions in executive employment agreements, The Walt Disney Co. amended those employment agreements “to remove… a provision for payment to the executive to cover excise taxes incurred by the executive… with respect to payments received by the executive upon termination following a change in control.”[41] Walt Disney subsequently received shareholder approval of its SOP proposal.

SOP Votes Can Give Shareholders a Voice

In a speech to the Social Investment Forum on June 10, SEC Commissioner Luis Aguilar observed that advisory votes appear to be facilitating an increase in communication between issuers and shareholders, and have resulted in positive changes to many companies’ executive pay practices. Commissioner Aguilar stated:

> **Many companies are putting in more performance-based compensation plans and they are addressing items that shareholders often criticized, such as: excessive severance; perks; federal income tax payments; and pensions. For example, approximately 40 of the Fortune 100 companies have eliminated policies that had the company pay certain tax liabilities of executives.[42]**

While it remains too early to make any pronouncements that Dodd-Frank’s SOP provisions are giving shareholders an effective voice in determining executive compensation practices, it is clear that there has been some impact on the landscape. Although the overall number of failed shareholder votes represents only a small percentage of all public companies, the growth of shareholder derivative suits addressing executive compensation practices, as well as increased responsiveness by some companies to shareholder concerns on executive compensation, suggest that SOP will, at a minimum, require continued thought and careful consideration as companies make and disclose their compensation decisions in the future.

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