Los Angeles and San Francisco

Daily Journal

GUEST COLUMN TUESDAY, MAY 22, 2012

Proxy Season 2012: Seven Lessons for the Other 70 Percent

James D. C. Barrall *is a partner of Latham & Watkins LLP and the global co-chair of its Benefits and Compensation Group. He is a frequent author and lecturer on executive compensation and corporate governance matters.*

We are now approximately 30 percent of the way through the 2012 annual shareholder meeting season for Russell 3000 companies and the first 30 percent of the annual meetings and their proxy filings have taught seven important lessons to the remaining 70 percent.

As of last Wed., May 16, 934 of Russell 3000 Companies had held their 2012 annual meetings and conducted their second say-on-pay votes under the Dodd-Frank Act. At a macro level, the overall vote results are very consistent with those reported through mid-March in my March 27 *Daily Journal* update on the 2012 proxy season, "Lessons Learned From Early 2012 Proxy Filings," as well as with the final 2011 say-on-pay vote results. Eighteen companies failed their 2012 votes (approximately 2 percent, up from last year's 1.2 percent), 74 percent of the companies passed their votes with more than 90 percent support, and 92 percent of the companies passed their votes with more than 70 percent support. For more information on these numbers and other say-on-pay vote statistics see http://www.semlerbrossy.com/sayonpay.

These votes and proxy filings have taught the following seven important lessons for those companies still preparing for their 2012 annual meetings.

First, just because a company passed its 2011 say-on-pay vote with strong shareholder support does not mean that it will do so in 2012. This year, there are two clear categories of companies that have been losing votes or winning close ones. The first endangered category consists of those companies that failed last year's vote, or passed with less than 70 percent support. As expected, they have been targeted by proxy advisers and are drawing negative recommendations if they have not been responsive enough to their 2011 votes. The second category consists of those companies that easily passed their 2012 votes, in many cases with more than 90 percent support, but which have run afoul of the proxy advisers' new 2012 pay for performance voting policies, as discussed below. Clearly, some of these companies did not see the new tests coming.

Second, Institutional Shareholder Services (ISS) and Glass Lewis, the two leading US proxy advisers, continue to be important players in the say-on-pay arena. For reports issued as of May 16, ISS's negative recommendation rate was 14 percent (up from 12 percent last year) and its influence on the average vote was higher than last year; companies which received negative ISS recommendations received, on average, 28 percent less shareholder support than those which received a favorable recommendation. While Glass Lewis numbers and data are harder to find, we suspect that its negative recommendation rate is higher than ISS's and that its influence rate is lower.

Third, as reported in my last update, annual meetings continue to prove that 2012 is the Year of Pay for Performance. By far the single biggest issue has been whether a company's executive pay is aligned with its performance and the pay and performance of its peers. This has been proven by the content of the proxy adviser recommendations, its prevalence at the core of their negative recommendations, and by the large number of public disputes between companies and the advisers on the issue.

Fourth, SEC filings indicate that the battle between companies and proxy advisers relate primarily to ISS's new 2012 pay for performance policy. This policy applies three quantitative tests and one qualitative test to examine the alignment between a CEO's target pay opportunities over a period of years, as reflected in proxy

Summary Compensation Tables (SCT) (with ISS's adjustments, which increase the Black Scholes value of stock options for many companies), and the company's total shareholder return (TSR) over a period of years. These are measured both on an absolute company basis and relative to a peer group of companies generated by ISS based upon Global Classification Standard (GICS) categories. Companies are aggressively challenging the peer groups selected by ISS and the use of target pay opportunities rather than realizable pay (which includes equity and long term incentive compensation grants at their actual values payable to executives, rather than the often larger SCT pay opportunity values). These important issues and arguments are summarized in my March 27 update and are discussed in great detail in our recent Director Note published by the Conference Board. See "The Conference Board Director Notes: Proxy Season 2012: The Year of Pay for Performance," available at http://www.lw.com/thoughtLeadership/proxy-season-2012-the-year-of-pay-for-performance.

Fifth, we have learned that relatively few investors have the resources to read, much less analyze, the long and mind-numbingly boring Compensation Discussion and Analysis (CD&A) sections of 3000+ proxies. The 2012 proxies have revealed the difficulty that companies had in engaging with shareholders after their 2011 say-on-pay votes and it is increasingly clear that even the best-staffed and well-intentioned investors lacked the bandwidth to meaningfully engage with companies on pay plans, except in the case of their most important holdings. Well-advised companies therefore are drafting executive summaries in their CD&As to address the key issues, especially on pay for performance. To be effective, these summaries cannot simply restate the CD&A or mouth general platitudes, but need to address how the company performed in 2011, what the company did to its pay plans in light of and in response to its 2011 performance, how the company responded to its 2011 say-on-pay vote by engaging with shareholders and designing its pay plans (particularly if the 2011 vote failed or received less than 70 percent shareholder support), and how, over the last three- to five-year period, the company's executive pay has been aligned with its TSR and other financial performance metrics, as well as the pay and performance of its peers. To be effective, these summaries need to be short and succinct; charts and graphs as used by the proxy advisers are very helpful in making the case to harried shareholders.

Sixth, far more than last year, companies which have received negative recommendations from the proxy advisers are preparing additional materials to use in soliciting proxies and are filing those supplemental materials with the SEC, as required by the SEC rules. In order to be effective, these filings need to be succinct and surgical in attacking the proxy adviser recommendations and analytics. As of May 16, 77 companies had filed supplemental proxy materials challenging proxy adviser negative recommendations on say-on-pay votes based on pay for performance issues. At this rate, we are likely to see three times as many such filings in 2012 as in 2011. While it is too early to tell how effective these filings will be, based on our experience, investors are being influenced by those that make sound arguments and are relying on them to vote against proxy adviser recommendations.

Seventh, the 70 percent of companies that have not yet held their 2012 meetings need to be proactive and ready to respond to rapidly changing events in dealing with these issues.

- Every company that failed or had a close call on its 2011 say-on-pay vote needs to demonstrate that it was appropriately responsive to the vote and its shareholders' concerns. Examples of sufficient and insufficient responses can be found in the 2012 proxies of these companies.
- Every company should have its compensation consultants run a simulation of ISS's 2012 pay for performance test to determine its exposure on this front and review its pay plans against the voting policies of the proxy advisers and large shareholders.
- Companies with problematic pay issues need to address them head on in executive summaries in their CD&As and engage in shareholder outreach to seek shareholder support.
- If a company is likely to receive negative proxy adviser recommendations, it needs to be prepared to draft and file supplemental proxy materials that attack the advisers' conclusions and analytics, and consider whether it is willing to make changes to outstanding pay awards or plans, or make commitments regarding future changes, in order to induce shareholder support.
- If a company loses its vote it needs to prepare for the possibility of shareholder derivative litigation and begin to consider what to do before its 2013 vote.

Say-on-pay is here to stay, and given the politics of the times, there is no reason to expect that it will be any easier in 2013 than in 2011 or 2012.