Director Notes

The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions

by David F. Larcker, Allan L. McCall, and Brian Tayan

This report examines current evidence regarding the influence of third-party proxy advisory firms' voting recommendations on shareholder proposal voting outcomes, particularly say-on-pay votes. It also presents the findings of a study, conducted by The Conference Board, NASDAQ, and the Rock Center for Corporate Governance at Stanford University, which shows that proxy advisory firms have a substantial impact on the design of executive compensation programs. However, the impact of those firms on governance quality and shareholder value is still unknown.

A growing body of evidence demonstrates the influential role that third-party proxy advisory firms play in affecting the voting outcome of proposals made to shareholders in the annual proxy, particularly say-on-pay votes, which became mandatory for most public companies in 2011. There is less evidence, however, to establish the extent to which companies respond to this influence by changing the size and structure of executive compensation plans to conform to proxy advisor voting polices. A recent study conducted by The Conference Board, NASDAQ, and the Rock Center for Corporate Governance at Stanford University found that proxy advisory firms have a substantial impact on the design of executive compensation programs.

Say on Pay and Proxy Advisory Firms

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires that public companies allow shareholders the opportunity to cast an advisory vote on executive compensation—a process known as say on pay (SOP). Depending on how that voting information is used by the board of directors, SOP can have an important influence on a company's compensation policies. While a shareholder vote against the executive compensation program does not obligate a company to make changes, rejection of a plan or low levels of shareholder approval can bring increased scrutiny of the program and governance

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practices overall by institutional shareholders, the media, proxy advisory firms, and corporate governance activists. In addition, several companies that failed SOP votes have had shareholder derivative lawsuits filed against them, including Cincinnati Bell, KeyCorp, and Occidental Petroleum. For these reasons, companies and boards of directors care greatly about the outcome of SOP votes.

Also important is the role that proxy advisory firms play in assisting institutional investors in their determination of shareholder votes. Institutional shareholders have a fiduciary duty to vote their shares on all proxy items, including SOP, and are required to disclose their voting policies and their actual votes to the public. To ensure that their voting policies and process are not in conflict, many institutional investors subscribe to third-party proxy advisory firms such as Institutional Shareholder Services (ISS) and Glass Lewis to receive research, analysis, and vote recommendations on proxy proposals—and in many cases, to determine whether they should vote for or against a proposal. These voting recommendations are developed based on a set of criteria considered by proxy advisory firms to be desirable structural features for elements of corporate governance or executive compensation.

Institutional Shareholder Services examines the following attributes in formulating its recommendation on SOP:

- CEO pay and performance;
- problematic pay practices;
- communication and responsiveness to shareholders;
- the performance metrics used in incentive plans;
- the use of peer groups in benchmarking executive pay; and
- the balance of performance and non-performance-based pay.[1]

Institutional Shareholder Services also offers consulting services through which companies can receive feedback and guidance on ways to improve their executive compensation program and increase the likelihood of a favorable SOP recommendation. Access to ISS's recommendations is made available on a subscription basis, so firms and their advisors as well as academics can research recommendations made for other firms.

Glass Lewis generally provides less public detail of the implementation of its policies. However, they use criteria similar to ISS in forming their recommendations:

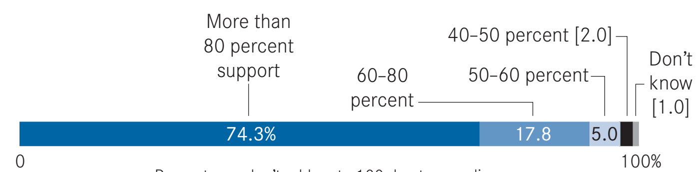
- the overall design and structure of the company's executive compensation program, including performance metrics;
- the quality and content of the company's disclosure;
- the amount paid to executives; and
- the link between compensation and performance as indicated by the company's current and past pay-for-performance grades.[2]

It should be noted that Glass Lewis does not offer consulting services to companies and does not generally provide access to their recommendations to corporate issuers or to the academic community.

Among the survey respondents, ISS and Glass Lewis made the same recommendation 75.0 percent of the time. However, ISS was generally more likely to recommend voting against management's SOP proposal, doing so in 19.2 percent of cases, while Glass Lewis recommended a vote against management in approximately 16.5 percent of cases. These figures are consistent with the overall proxy season statistics of 17.5 percent and 12.5 percent respectively, recommended by Glass Lewis and ISS in 2011.[3]

Chart 1

Distribution of "for" votes during latest SOP vote



Percentages don't add up to 100 due to rounding.

Chart 2

Distribution of SOP voting recommendation by ISS

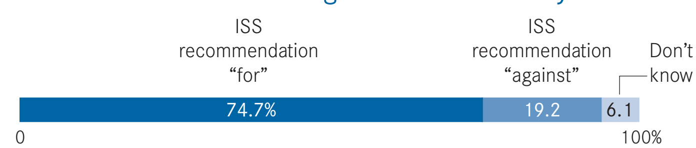
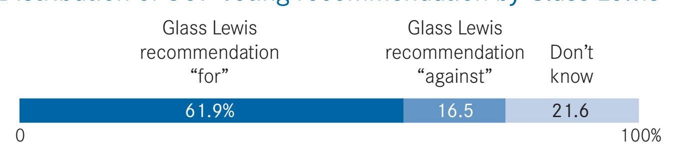


Chart 3

Distribution of SOP voting recommendation by Glass Lewis



Source: The Conference Board/NASDAQ/Stanford University, 2012.

Evidence suggests that institutional investors respond to the voting recommendations of proxy advisory firms.[4] For example, a negative recommendation from ISS, the largest proxy advisory firm, has been shown on average to influence between 13.6 percent and 20.6 percent of votes cast on management-sponsored proposals.[5] During the 2011 proxy season, no company that received a positive recommendation from ISS failed its SOP vote, and 12.0 percent of companies that received a negative recommendation from ISS failed their SOP vote.[6]

The evidence is considerably less established, however, about whether companies themselves respond to the policies and voting recommendations of proxy advisory firms as they relate to SOP. Companies might be more likely to change their executive compensation plans if they believe that a major proxy advisory firm is poised to issue a negative recommendation, given the influence that these recommendations have on voting outcomes. Furthermore, ISS provides extra scrutiny to companies that receive less than 75 percent support for SOP, and Glass Lewis provides extra scrutiny for companies that receive less than 80 percent support for SOP.

Companies might make changes to their compensation plans to secure the positive recommendation of these firms with the hope of keeping support above these thresholds. For example, following criticism from ISS in 2011, The Walt Disney Company removed tax gross-up provisions from the employment agreement of four senior executives, and General Electric voluntarily changed the structure of the equity incentive program offered to CEO Jeffrey Immelt. As a result of the changes, ISS reversed its negative voting recommendation on both companies' SOP proposals.[7]

In 2012, Shuffle Master specifically referenced ISS's negative vote recommendation during the previous year as the reason for its decision to amend the change-of-control provision in the employment agreement of Chief Operating Officer David Lopez.[8]

Survey Methodology and Sample

Results are based on a sample of 110 companies surveyed by The Conference Board, NASDAQ, and the Rock Center for Corporate Governance at Stanford University between October and December 2011.

Chart A

Industry composition

Chart B

Breakdown by exchange listing

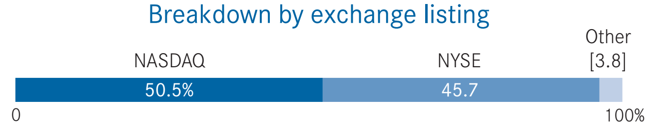


Table A

Revenue composition

Percentile total FY2010 worldwide revenue (in US$ millions)	
25th	$345
50th	1,448
75th	9,613
Mean	11,695

Table B

Full-time employees

Percentile number of full-time employees	
25th	204
50th	3,530
75th	19,000
Mean	25,575

The Conference Board, NASDAQ, and the Rock Center for Corporate Governance at Stanford University survey found that proxy advisory firms had a very direct influence on the compensation structures employed by companies, and that the policies and recommendations of these firms compelled many companies to make changes to their executive compensation programs that they would not have otherwise made.

During the 2011 proxy season, 72.0 percent of companies reviewed the policies of a proxy advisory firm or engaged with a proxy advisory firm to receive feedback and guidance on their proposed executive compensation plan.

A large majority of companies (70.4 percent) reported that their compensation programs were influenced by the guidance received from proxy advisory firms or by the policies of these firms.

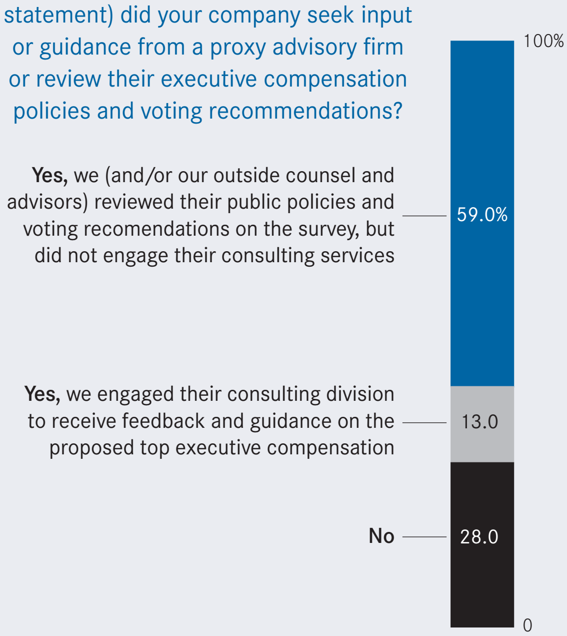
Survey Results

The following are questions and results from the survey conducted by The Conference Board, NASDAQ, and the Rock Center for Corporate Governance at Stanford University entitled, “The Role of Proxy Advisory Firms in the Company’s Decision-Making Process on Employee Compensation.”

Use of proxy advisory firm guidance and review of executive compensation policies and vote recommendations

Question 1b

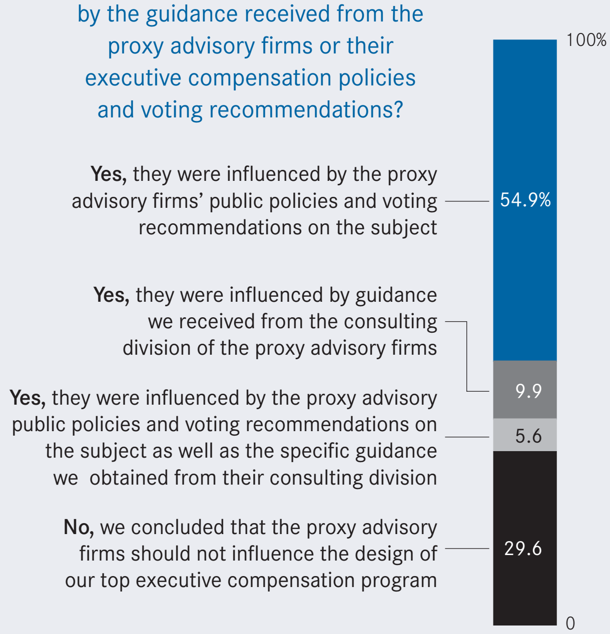
In formulating your company’s most recent request for a SOP vote by shareholders (FY2010, as reported in the 2011 proxy statement) did your company seek input or guidance from a proxy advisory firm or review their executive compensation policies and voting recommendations?



Influence on features of the top executive compensation program submitted to a shareholder vote

Question 1c

Were any features of the top executive compensation program submitted to a shareholder vote influenced by the guidance received from the proxy advisory firms or their executive compensation policies and voting recommendations?



Companies reported making a broad range of changes to their compensation program in response to proxy advisory firm policies. Roughly a third (31.7 percent) enhanced disclosure in the annual proxy, and 23.8 percent reduced or eliminated certain severance benefits. In addition, 15.8 percent reduced other benefits and perquisites, 12.9 percent adopted stock ownership guidelines or retention guidelines, and 8.9 percent introduced performance-based equity awards.

Approximately half of companies (51.2 percent) anticipate making changes to their executive compensation program for the 2012 proxy season. Companies are most likely to make changes to their disclosure policies and practices, to introduce performance-based equity awards, and to change to the peer group used for benchmarking purposes.

Survey Results (continued)

Compensation program features influenced by proxy advisory firm guidance or executive compensation policies and voting recommendations

Question 1d

Which features of your company's current top executive compensation program were influenced by the guidance received from the proxy advisory firms or their executive compensation policies and voting recommendations? (Check all that apply)

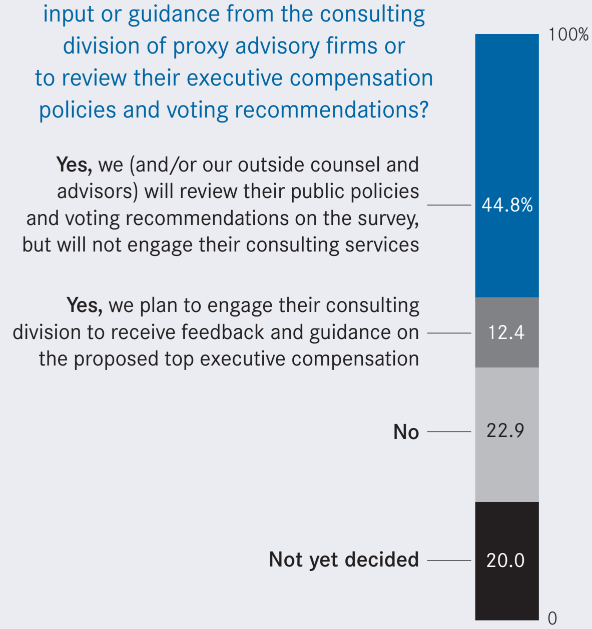
The enhancement of proxy statement disclosure to address specific concerns of proxy advisors (e.g., disclosure of incentive plan performance targets)	31.7%
The reduction or elimination of certain severance practices (e.g., generous severance payments; golden parachute payments or benefits, including single trigger golden parachutes; excise tax gross-ups)	23.8
The reduction or elimination of other executive benefits and perquisites (e.g., personal use of corporate aircraft, pension or deferred compensation benefits, golden coffins, tax gross-up provisions)	15.8
The adoption of stock ownership or share retention guidelines	12.9
The introduction of performance-based equity awards (such as performance shares, performance-units settled in stock or performance-vested stock options)	8.9
The amendment of an outstanding award plan (e.g., by adding performance contingencies to the vesting or by reducing the contractual term)	5.9
A change in target-pay positioning by the company (e.g., median as opposed to 75th percentile market objective)	3.0
Restrictions on equity-based compensation (e.g., the elimination of the ability to exchange underwater stock options without shareholder approval or the commitment to a maximum level of annual equity usage/burn rate)	3.0
A change in the peer group used by the company for benchmarking purposes	2.0
A reduction of total executive compensation levels	1.0
The introduction of long-term cash incentive plans (e.g., an incentive that is paid based on achievement of performance objectives over more than 2+ years)	0.0
Other	6.9

Note: Percent values will not total 100 percent since participants were able to select multiple options.

Plans to seek proxy advisory firm input or guidance or to review executive compensation policies and voting recommendations

Question 2

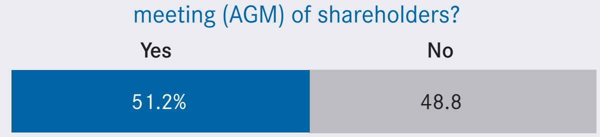
In formulating its next request for a SOP vote by shareholders (FY2011, as reported in the 2012 proxy statement) does your company plan to seek input or guidance from the consulting division of proxy advisory firms or to review their executive compensation policies and voting recommendations?



Anticipated changes to top executive compensation program

Question 2a

Do you anticipate that your company will make any change to its current top executive compensation program prior to the next annual general meeting (AGM) of shareholders?



Companies that received low support for their SOP proposal in 2011 are more likely to make changes in 2012, whereas those who received high support are significantly less likely to plan to make changes.

These companies are much more likely to engage the consulting division of a proxy advisory firm to receive feedback and guidance on their proposed executive compensation plan. They are also much more likely to reduce overall pay levels, introduce performance-based equity awards, make changes to the target level of their pay relative to their peer group, and enhance disclosure.

Table 1

Companies reporting that they expect to make changes to their compensation programs in 2012

	Low support (less than 80 percent)	High support (greater than 80 percent)
Yes	70.0%	43.6%
No	30.0	56.4

Percentages refer to the level of support that companies received for their say-on-pay votes in 2011, as a percentage of shareholder "for" votes cast.

Source: The Conference Board/NASDAQ/Stanford University, 2012.

Table 2

Changes that companies expect to make to their compensation programs in 2012

	Low support (less than 80 percent)	High support (greater than 80 percent)
Enhance disclosure	57.1%	29.2%
Introduce performance-based equity awards	35.7	29.2
Reduce severance	28.6	12.5
Change target pay positioning	28.6	4.2
Reduce compensation levels	14.3	4.2

Percentages refer to the level of support that companies received for their say-on-pay votes in 2011, as a percentage of shareholder "for" votes cast.

Source: The Conference Board/NASDAQ/Stanford University, 2012.

Conclusion

The survey results clearly show that companies do respond to the SOP policies adopted by proxy advisory firms. The majority of companies determine in advance whether their executive compensation programs are likely to receive a favorable recommendation from ISS or Glass Lewis; and companies are likely to make changes to a program in anticipation of a negative recommendation from these firms. All areas of the compensation program are affected, including disclosure, guidelines, and plan structure and design—although the degree to which these areas are affected varies considerably.

While the evidence suggests that companies are aware of and react to proxy advisory policies as they relate to SOP, the evidence does not speak to whether these changes are positive or negative for shareholders. Until proxy advisory firm methodologies are vetted by third-party examiners, it cannot be determined whether these changes are beneficial to companies and their shareholders. However, proxy advisory firms are an important influence on compensation plan design.

Endnotes

1 Institutional Shareholder Services 2011 voting policies, (www.issgovernance.com/policy/2011/policy_information).

2 Glass Lewis voting policies, (http://ims.schwab.wallst.com/repository/?doc=ProxyVotingProcedures).

3 Glass Lewis figure from *Glass Lewis*, "Say on Pay 2011, A Season in Review." ISS figure estimated using voting analytics data obtained from ISS.

4 During the 2011 proxy voting season, Nuveen Asset management voted in lock-step with ISS's recommendation on SOP 99.7 percent of the time. That is, among the 2,350 SOP proposals on which Nuveen voted, it differed from ISS's recommendation only six times. Many large institutional investors also had high levels of accordance with ISS, including Dimensional Fund Advisors (99.9 percent), Calvert Asset Management (99.8 percent), and JP Morgan Asset Management (98.2 percent).

5 Jennifer E. Bethel and Stuart L. Gillan, "The Impact of Institutional and Regulatory Environment on Shareholder Voting," *Financial Management,* 2002, pp. 29–54; Jie Cai, Jacqueline L. Garner, and Ralph A. Walkling, "Electing Directors," *Journal of Finance* 64, 2009, pp. 2,389–2,421. The survey found that firms with a negative SOP recommendation obtain about 20 percent lower votes for their compensation program.

6 These results are estimated using ISS voting analytics data.

7 Joann S. Lublin, "Firms Feel 'Say on Pay' Effect," *The Wall Street Journal*, May 2, 2011; and Andrew Dowell and Joann S. Lublin, "Strings Attached to Options Grant for GE's Immelt," *The Wall Street Journal*, April 20, 2011.

8 See Shuffle Master, proxy statement, filed February 3, 2012, p. 34, which states: "At the March 17, 2011 Annual Meeting of Shareholders, the shareholders of the Company voted, on an advisory basis, against approval of the named executive officer compensation disclosed in our proxy statement dated as of February 4, 2011. The Company believes that the negative shareholder vote was a result of the issuance on February 17, 2011 of the ISS Proxy Advisory Services report (the "Report"), which contained a recommendation against such advisory vote based solely on the inclusion of the "modified single trigger" provision in the employment agreement of Mr. David B. Lopez, the Company's Executive Vice President and Chief Operating Officer, in effect at such time. On May 24, 2011, the Company amended Mr. Lopez's employment agreement, with the primary change being the deletion of the provision that permits the termination of the employment agreement by Mr. Lopez and the receipt of certain benefits upon a "change of control" of the Company. [...] As the Company does not include "single trigger" or "modified single trigger" change of control provisions in any executive officer employment agreements, the Company believes that it has remedied the sole basis for ISS previous recommendation to vote against the advisory vote." (http://ir.shufflemaster.com)

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