

# PROXY UPDATE

November 22, 2010

## Commentary on Say on Pay and Say on Frequency

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### SETTING THE STAGE FOR 2012

In planning a strategy for dealing with Say on Pay and Say on Frequency votes in 2011, it is important for issuers not to lose sight of the fact that the proposed rules could set the stage for future shareholder activism.

Indeed, the results of the Say on Pay and Say on Frequency votes in 2011 could impact future director elections or invite future shareholder proposals. And with proxy access likely to become a reality in 2012, the results on these issues could also be reason enough for some shareholders to launch a Board campaign.

Once the proposed rules ([click here for a summary](#)) are adopted, we will update our clients on the impact of the final rules for the 2011 annual meeting and beyond.

### CD&A Disclosure In 2012

One of the proposed rules would require issuers to disclose in the CD&A section of their proxy statement whether compensation policies and decisions have taken into account the results of the last Say on Pay vote, and if so, how. Thus, if the proposed rule is adopted, issuers will have additional disclosure in 2012 regarding the 2011 vote. Therefore, even moderate opposition to the Say on Pay proposal in 2011 could put the compensation committee in the uncomfortable position of having to disclose in next year's CD&A how this vote factored into their compensation policies and/or practices.

Even if this provision is not mandated in the final rules<sup>1</sup>, companies that receive moderate to high opposition to their Say on Pay vote will still face pressure the following year if it appears that the results are not adequately considered by the compensation committee.

### High Against Votes Will Have An Impact

A high vote against Say on Pay in 2011 coupled with inaction the following year could have an impact in 2012 in the form of withhold votes on directors, even higher votes against subsequent Say on Pay proposals, or the submission of shareholder proposals. There is also certain to be negative publicity, as issuers with the highest negative votes on Say on Pay will be highlighted in major financial publications and financial and governance websites.

### Disclosure On The Frequency Vote

Although the frequency vote is “non-binding”, the proposed rules would require issuers to disclose in the 10Q filing following the 2011 annual meeting (or 10K in some cases), which frequency they have chosen and whether or not that frequency is consistent with the results of the shareholder vote. For issuers that seek a frequency of greater than one year, it will be important

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1 A number of comment letters ask the SEC to consider dropping this disclosure in the CD&A.

to consider that if they lose that vote, and ignore the results, they could find themselves the target of shareholder proposals for greater frequency in 2012 or, more importantly, find themselves vulnerable to withhold or against votes on governance and compensation committee members.

The proposed 10Q disclosure after the vote is likely to be well in advance of the deadline to submit 14a-8 shareholder proposals the following year, thus shareholders will have plenty of time to prepare for a response if the company ignores the vote.

### PLANNING FOR THE 2011 SOLICITATION

In light of Say on Pay and Say on Frequency, advanced planning for the solicitation in 2011 has become more important than ever before. We believe companies would be well served to outline a solicitation plan that keeps opposition to Say on Pay at a minimum, since opposition to your Say on Pay proposal can have future implications.

Issuers can take specific steps to place themselves in the most advantageous position possible to be successful in 2011, including: (1) evaluate and understand their shareholder profile, (2) identify and develop relationships with the voting decision-makers at key institutions, and (3) assess their vulnerability to a negative recommendation from the proxy advisory firms including the identification of potential “poor” pay practices that can attract significant opposition from shareholders. Moreover, issuers can begin to form a long-term strategy that will effectively manage the annual decision-making and disclosure of executive compensation.

#### Know Your Shareholders And The Vote In Advance

Being familiar with your shareholder composition (how many shares are held by individuals, insiders, institutions, etc.), and distinguishing the voting power versus the investment authority of each of your institutions is a critical first step in being prepared. It is also critical to be knowledgeable about the voting policies of your institutional shareholders, including the degree to which they are influenced by one of the institutional proxy advisory services. Staying current on institutional voting policy changes is essential.

#### Say On Frequency: Choosing A Biennial Or Triennial Approach

We believe that a great number of companies that choose a biennial or triennial vote could face difficulty in getting that choice approved unless they engage in an active proxy solicitation. In its recent 2011 policy update, ISS has adopted a new policy to recommend for an annual Say on Pay vote as a matter of policy - with no exceptions (ISS states that Say on Pay is “at its essence a communication vehicle, and communication is most useful when received in a consistent and timely manner”). We expect that Glass Lewis will recommend for an annual vote in most instances, but not all. These factors alone will make it difficult for some issuers to get a greater frequency approved.

Support for greater than an annual frequency could vary significantly depending on your shareholder profile, compensation practices, and corporate governance practices. Therefore, if you are considering seeking a biennial or triennial Say on Frequency vote, in addition to knowing your shareholders and their voting policies, it will be essential to assess the likely outcome of the

vote. Knowing the potential outcome in advance serves two important purposes. First, it could become an important factor for management and the board to consider when choosing which frequency to recommend. If it appears the Board's choice might be defeated, will they still be willing to make that recommendation in the first place? If so, the Board should consider how they will respond should shareholders disapprove of the biennial or triennial vote. And, if the Board decides to stick with their recommended choice, they should be prepared for the possible consequences.

The other valuable purpose of projecting the frequency vote is to allow for efficient planning of the proxy solicitation process in order to optimize the outcome.

### **Clear Disclosure On The Rationale Of Frequency Choice Is Critical**

Companies that choose to seek a biennial or triennial frequency vote will need a persuasive argument as to why these timeframes work for their particular circumstances, and why it is best for their particular company and shareholders (such as explaining how a biennial or triennial vote corresponds with the company's compensation scheme, or is consistent with a long-term view regarding executive compensation). This will be an absolutely critical strategic component for issuers that wish to engage and solicit their shareholders.

### **Identify Your Governance Vulnerabilities**

Issuers should also assess their governance and compensation vulnerabilities and should be aware how these perceived vulnerabilities could impact the votes on Say on Pay and Say on Frequency. For example, has your company been deemed in the past by ISS to have a pay-for-performance disconnect (negative one and three year total shareholder return vs. peer companies based on the four digit GICS)? Does ISS currently consider you a poor performer? Will you be vulnerable this year? What has been your pay for performance grade from Glass Lewis (A through F scale)? Do you employ any problematic pay practices?

Issuers should consider whether to eliminate compensation practices that proxy advisory firms or larger institutions find objectionable ahead of these actual votes.

### **Good Performance May Not Offer Protection**

Based on some of the management Say on Pay votes in the last couple of years, companies which perform well are not necessarily shielded from a negative recommendation or against vote. Other factors, such as the sheer amount of the CEO's compensation (despite stellar performance and share price growth) may be enough for an against vote or negative recommendation.

### **Engage, Engage, Engage**

Communication with institutional shareholders is more critical than ever, and should not be limited to the solicitation. Issuers would be well advised to reach out to their larger institutional holders now, establish a line of communication, and understand their policies, especially for those issuers that are considering biennial or triennial frequency votes.

### Importance Of Tracking And Understanding The Say On Pay Vote

Tracking the voting by larger holders during the solicitation serves two purposes. First, in the event there are votes against the proposal, you will have the opportunity to be reactionary to the institutional holders vote and obtain a clear understanding of their concerns, and perhaps learn what it could take to reverse their vote.

Knowing the reasons a shareholder voted against your Say on Pay serves the second purpose of informing senior management and the Board of the specific concerns of their shareholders. This knowledge could prove valuable after the annual meeting as institutional outreach after the annual meeting may become important in deciphering the meaning of your last Say on Pay vote.

This could also become a key determinant in the event the proposed rules requiring mandated future disclosure of how the results of the Say on Pay vote affected compensation policies and procedures are adopted. Regardless, understanding the meaning behind the vote will be the most effective way of preparing the Board and compensation committee for the following year.

As a result of Dodd-Frank, investment managers, including hedge funds, with greater than \$100M under management will now be required to disclose their votes on compensation. This will be in addition to mutual funds that already disclose their votes. These filings occur in late August, so issuers that don't have a proxy advisor can still comb through SEC filings and develop this understanding by September.

### Say On Severance / Say On Golden Parachutes

The proposed Say on Severance rules allow that, if an issuer discloses additional information related to golden parachute compensation in the annual meeting proxy statement, they will not need a separate shareholder vote on golden parachute compensation in the event of a shareholder vote on a merger, acquisition, or consolidation; unless there had been a change to the severance agreements since the Say on Pay vote.

While each issuer must decide whether to include this additional disclosure in the annual proxy, it is likely to be more beneficial to make that disclosure in the merger proxy, since the proposal would be non-binding, and the merger transaction would not be dependent on the vote. In addition, many issuers continue to allow for tax gross-ups in their change in control agreements which will continue to be a hot button issue with ISS and could become a primary cause for an against recommendation from ISS on the overall Say on Pay proposal - regardless of whether there has been a new or materially amended agreement in the last year.<sup>2</sup>

Another consideration is that the announcement of a merger often results in a change in the target's shareholder profile, with institutions selling shares and arbitrageurs and hedge funds buying. Thus, the post-announcement shareholder profile may be one that has a greater interest in the deal and is less concerned about matters of compensation.

We note, however, that we will not be surprised if the inclusion of golden parachute compensation within an annual meeting Say on Pay vote becomes an activist sponsored corporate governance issue in the future.

In preparation for 2011, Morrow can assist in helping you understand your shareholder profile, provide advice on the crafting of your proposals, provide you with the appropriate institutional voting contacts, assess your vulnerability to a negative advisory firm recommendation on Say on Pay, project the likely reaction to your frequency choice, and coordinate your solicitation process to maximize support for your agenda, and track voting during the solicitation. Morrow & Co. is available at any point to answer your questions or assist you as you move toward the 2011 proxy season. Please feel free to contact your Morrow representative with any questions you may have. You may also contact Tom Ball, John Ferguson, or Fred Marquardt at 203-658-9400.

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