



The Say-on-Pay Solicitation Playbook: Practical Guidance on Strategies and More

Although the prospect of Congress mandating say-on-pay has earned our undivided attention for some time, the idea of this new requirement really shook the corporate community during this proxy season when three companies—Motorola, Occidental Petroleum and KeyCorp—failed to garner majority support for their management-sponsored say-on-pay agenda items at their annual meetings (up to this point known as “MSOPs”; but now referred to as “SOP” as they will be mandatory for most companies). It’s likely that a few more would have failed if broker nonvotes had not been counted as supportive (a practice that won’t be allowed to continue under the new legislation).

A Wake-Up Call: The Big Three

To put this development in perspective, only a few hundred companies had SOP on their ballot this season out of 10,000 public companies (so to extrapolate, if all companies were required to have SOPs, perhaps several hundred would have failed). And it took the United Kingdom about five years with mandatory SOP to have even a second company fail. We already have had three companies fail in the US—even before SOP became mandatory.

Even more riveting is the fact that these three companies are not Wall Street banks where the general public is so angry over banker bonuses. To boot, there were no organized campaigns against the pay packages at these three companies. This was a pure grass roots movement at each. And, Occidental had just conducted an extensive “governance” roadshow for its major shareholders—thus doing just what many advisors claim is the silver bullet for SOP: “shareholder engagement.” Motorola had been out engaging shareholders too.

The Drill Down: Why Did Shareholders Reject Motorola, Occidental and KeyCorp?

Motorola—Beginning in 2009, Motorola voluntarily put SOP up for a vote because a shareholder proposal—requesting that the company place SOP on the ballot—received majority support for two years in a row (effectively forcing the company to place it on the ballot in order to avoid an ISS recommendation against its director candidates). Last year, the company’s SOP received support from 63% of shareholders. So we imagine the company believed that this season would not have been any different, particularly because the company didn’t reverse a drop in executive’s salary levels from the prior year—even though Motorola’s financial performance improved. The company blew out the doors on its annual total shareholder return (TSR)—so pay-for-performance arguably was there. Finally, the company’s new GRId governance rating score from ISS for its compensation program was “green” (*i.e.*, low risk). However, the company had a pay-for-failure separation agreement with the CEO, as well as peer group issues and concerns over the inconsistent exercise of discretion in its incentive program.

Occidental Petroleum—With its CEO—including the company’s pay practices—long criticized and embattled, Occidental decided to engage its shareholders by conducting a “governance” roadshow before this year’s annual meeting. As part of its efforts to appease shareholders, the company also decided to voluntarily place SOP on its ballot. Like Motorola, its ISS GRId score for its compensation program was “green” and its compensation program included a number of “best practices,” such as strong ownership guidelines, mandatory hold-til-retirement provisions and it limited recent grants to only long-term incentives. However, the pay program had many perceived problems, including performance targets that were not viewed as challenging; a failure to benchmark against a peer group; paying dividend equivalents on its performance share awards; an excise tax gross-up; and a high degree of internal pay disparity, mainly because the CEO’s pay level was high.

KeyCorp—As a TARP company, KeyCorp was required to place SOP on its ballot. Hamstrung by conditions placed on its compensation program by TARP, the company was prohibited from structuring its compensation in a way that would be looked upon favorably by ISS and other proxy advisors. For example,

the largest problem in ISS's eyes was the more than 40% increase in total direct compensation (TDC) relative to TSR for the 1- and 3-year periods (but critics note that TDC went up due to TARP's mandatory pay reconfiguration; the company claims that compensation was set at 70% of the prior year's levels). However, the company did have problematic pay practices not dictated by TARP, such as the establishment of targeted goals that allowed for broad ranges of performance (including the compensation committee's discretion to use its judgment in setting performance targets and evaluating actual performance) and the compensation committee funding a pool of 50% of target incentive pay (even though NEOs were not permitted to receive a bonus under TARP).

The lessons learned? Getting your compensation program supported is not going to be easy; a "check the box" approach won't always work. Although it's hard to know for certain, Motorola's failure might have been due to years of ignoring shareholders (even though the stock had been up sharply over the past year); Occidental may have faltered due to long-time displeasure with the company's CEO (and his compensation) and KeyCorp could have been victimized by shareholders following proxy advisor recommendations that some would characterize as misguided (*i.e.*, the company's pay design was realigned consistent with government restrictions).

The bottom line is that it's hard to read the tea leaves when it comes to the real impact of proxy advisor recommendations and their pay guidelines (as well as the pay guidelines of institutions, many of which are either nonpublic or vague). Although we know that these three companies failed to obtain ISS support because they violated one or more of the proxy advisor's checklist of what it looks for in formulating a recommendation to support an SOP, we really don't know the true weight that this carried and whether there were other issues that prompted many shareholders to vote "no."

So even though mandatory SOP inevitably will lead some companies to homogenize their pay programs—particularly within industry groups—to fit the designs deemed appropriate by proxy advisors and large institutions, you need to be aware that real risks remain that could cause your company's SOP to be dinged by shareholders. Just fitting within neat boxes of what are deemed acceptable pay practices generally may not work—you need to dig into your shareholder profile and do the homework.

The Cry for Shareholder Engagement: What is "Shareholder Engagement"?

Many advisors are now advocating "shareholder engagement" as one of the keys to succeeding with SOP. Given that one of the primary jobs for a CEO and CFO is to interact with investors, what more is now recommended? The difference is that CEOs and CFOs traditionally talk about financial performance; not corporate governance issues. So the first hurdle is defining what exactly does "engagement" mean for your company in this context? What's the goal of the dialogue? It might be just getting SOP passed; it might mean much more. Consider what sort of relationship your company is really working towards. Is it just "process," or does it really represent company philosophy and beliefs?

Also bear in mind that "shareholder engagement" may mean more than just interacting with shareholders. Besides inbound and outbound communication, it also includes how to share information within the company and even includes issues that arise when the company is not a participant in the dialogue (unless it comments or intervenes) such as media coverage. We think an aspect of engagement is monitoring all of the foregoing and it's important to share that information appropriately within the company. For example, are the IR department and corporate communications team appropriately attuned to governance and pay concerns? Are the HR, legal and corporate secretary departments on the same page? Are they all sharing what they see and hear? Are they up-to-speed on best practices? How does the company let its staff know how and where they can engage in a dialogue? Is the company even inviting dialogue? All of these questions should be addressed once the big issues from the foregoing paragraph are resolved.

A game plan should be set very early by all the parties that will now be part of the company's SOP efforts. There are no "right" answers here. But it's critical that the company's overarching goal is agreed upon so that a means can be found to meet the chosen end. In creating your game plan, one thing stands out in this new SOP context, if you're going to make the effort to listen to shareholders about their governance concerns, you need to be prepared to follow up with meaningful action.

The Roadmap: How (and When) to Engage Effectively

1. Who are Your Shareholders—The first step is to figure out who your shareholders are. Most companies know their largest shareholders—but they may just know the contacts within those large shareholders that are responsible for investment decisions, not those responsible for voting decisions (and if you are in touch with those responsible for voting decisions, do you know if they have their own pay guidelines

as well as which proxy advisors they follow and whether they are willing to deviate from those advisors' recommendations?). For SOP, you need to be in touch with the proxy committees, etc. of your largest holders.

Depending on the makeup of your shareholder base—and how vulnerable you think the company is to a negative SOP vote—you may want to drill down further into your large shareholder list than you have before. You may be drilling 50 deep rather than 20, probably with the help of a proxy solicitor. And if you have a large retail base (or you expect a very close vote), you may need to engage retail holders on a large scale. And don't forget to engage your employee-shareholders, often overlooked.

2. Who Speaks for the Company—One issue that companies will have to address internally is who becomes the spokesperson for the company in the governance area? The CEO and CFO are not ideally suited to talk about their own pay—as shareholders may view that negatively. Depending on each company's circumstances, the general counsel, chief governance officer, corporate secretary, HR head, and/or the investor relations head may be tapped as governance spokespersons. Find out who already has relationships with your large holders' compliance side; you may already have staff that knows who the key voting decisionmakers are. Obviously, whoever is tapped must be fully up-to-speed on both the company's practices and the hot button issues of the particular shareholders that they engage (as each shareholder has their own pet peeves).

The most successful governance spokespersons tend to have regular interaction with the board. This also can help the board as the spokesperson can relay information about shareholder perspectives, which helps keep the board and committee informed. Regular board interaction also allows this spokesperson to highlight areas of the board and management's work that will be of interest to a particular shareholder, even if these items aren't on a pre-determined agenda when the company meets with a large holder. A spokesperson meeting with a key shareholder about compensation issues should also be fully aware of all of the shareholder's priorities. For example, the holder might ask questions about a recent board initiative relating to environmental sustainability—a topic that a corporate secretary likely could field but that someone in HR might not be too familiar with.

Some shareholders may insist on hearing from the compensation committee chair (and/or a nonexecutive chair or lead director) to ensure that they are actively involved in the pay-setting process. Having multiple members of the board involved may be too much to ask of them. And if a shareholder knows that the spokesperson regularly carries their comments back to the committee and board, these demands likely will decrease. [Note that the Corp Fin Staff recently issued a new Reg FD CDI—Question 101.11—which clarifies that directors are not prohibited from speaking privately with shareholders. This new CDI should be helpful to give directors comfort that private meetings are not problematic in their entirety so that they can participate in these governance engagement efforts if they are qualified and are aware of the Reg FD limitations (see our May-June 2010 issue at pg 4).]

3. When to Engage—The biggest challenge in the shareholder engagement process is finding shareholders with the time, resources—and willingness—to engage. Trying to engage shareholders in the midst of proxy season will be particularly tough, given that most investors have stakes in numerous companies. Plus, most institutions haven't devoted much in the way of resources to the proxy voting side of their house; the fact remains that it's not a profit center and thus they are not likely to devote more resources to making voting decisions anytime soon.

Knowing your shareholders well will help in your decision about when to engage. Some shareholders have a strict "checkbox" set of pay guidelines (e.g., CalPERS)—so trying to explain the rationale for your deviances likely is a waste of time. Some shareholders may refuse to discuss their concerns until they have seen the company's CD&A. And some shareholders refuse to talk during the proxy season due to a lack of time availability—but these holders may be willing to talk during other times of the year. It can be useful to keep a chart of your largest holders with one column devoted to when to contact them.

Even though it may not work for some shareholders, the engagement process should now be considered a year-round process and not solely tied to the proxy season. Desperate attempts to contact your largest holders are not likely to be successful right before an annual meeting if you have not attempted to contact them at some point earlier in the year. That "old school" of solicitation doesn't work anymore.

Besides earlier contact, the other key is to be informed. Smart companies will check with solicitors or compensation consultants beforehand to get a feel for how their large holders tend to vote on SOP—and what their hot button pay issues are—so that they don't go into a meeting blind. Know what "makes

them see red” before you engage. It can be helpful to join organizations and attend gatherings where shareholder representatives are present, such as the Council of Institutional Investors and the International Corporate Governance Network. While you likely won’t get time to discuss your company’s particular issues with them, you can begin the process of getting to know them—and if they speak on a panel, their public remarks can be helpful as you assess their perspective of the issues of the day.

4. Form of the Engagement—Of course, it doesn’t make sense to engage if you can’t figure out what shareholders are really concerned about. Companies are going to have to experiment with what works best for their shareholders as some engagement tactics may work well for some shareholders, but not others. Multiple avenues of engagement should be considered and experimented with, such as:

- *Surveys*—Over the past few proxy seasons, the first companies have more formally surveyed their shareholders about pay practices to gather feedback well in advance of the proxy season (see the column noting the differences between the survey approaches of Schering-Plough, Lockheed Martin and Northrop Grumman on CompensationStandards.com’s “The Advisors’ Blog”). Some shareholders may be willing to fill out a survey, some not—some may do so depending on the nature and length of the survey. And some may bother to fill out the survey but fail to list their real concerns.
- *Group Meetings*—Group meetings allow the face-to-face contact that may be necessary to get open-ended feedback that surveys aren’t well suited for. The key is finding a date and location that works for shareholders and your key spokespersons, which can be tricky (and this may be multiple dates and locations if these meetings are taken on the road). One limitation is that some shareholders may not be willing to voice their real concerns in a group setting—or may not send their key decisionmakers to such a meeting. Further, sometimes not everyone can be invited or have a chance to speak due to time, location and cost constraints—and those who feel left out may wind up being more disgruntled than if no meeting were held at all.
- *One-on-One Meetings*—The obvious problem with one-on-one meetings is that they are time-consuming and resource intensive. Even if a shareholder is willing to do this, your key spokespersons may not have time (one of the benefits of naming a governance officer and making shareholder engagement part of their job is that engagement becomes part of the regular routine, just like investor relations and media outreach). Most experienced governance spokespersons believe that the benefit of one-on-one meetings is significant as you can more easily drill beyond an investor’s platitudes (e.g., “we want to see pay-for-performance”) and ask more pointed questions about what type of design features they will accept.

You are more likely to find out if concerns are really about pay (or truly based on deep knowledge about your pay program) or about something else. It wouldn’t be surprising to see shareholders make noise about your executive pay practices in order to get a private meeting to voice other concerns—something that happens in the Rule 14a-8 shareholder proposal process routinely.

- *E-Forums*—Intel and Verizon are the first large companies to try e-forums to allow shareholders to vent. This may help spot common concerns and potentially could be useful with retail holders who can’t be reached directly without hiring Broadridge. The problem with these is that large holders likely won’t participate—or even if they do, they may not be willing to list their real concerns on a web site.

5. Acting on Shareholder Concerns—Once you understand the real shareholder concerns, the hard decision is what to do about them. Merely meeting with shareholders normally doesn’t cut it, as Occidental Petroleum learned; there needs to be follow-up. Formulating a game plan should take input into account from many quarters and that can be a challenge, particularly as there may be conflicting concerns.

To back up a little, the company should ask itself as part of the overall planning process: “How does engagement fit into the governance and compensation decision-making processes in this company?” Also ask “Do we intend to get investor input early enough in our compensation design and governance policy design processes to realistically allow them to influence us for the upcoming proxy season?” If the answer is “yes,” a realistic calendar should be created that allows investors plenty of time to provide input and also allows the appropriate persons within the company to fully process all the inputs, propose changes and integrate that dialogue with the compensation committee and board meeting calendar (plus the proxy drafting calendar). This is not an easy task.

Once the company decides to make changes (if it indeed decides to do so), run them by the shareholders who raised concerns to ensure that it satisfies them before announcing the plan. This is particularly necessary if the proposed changes don’t squarely address their concerns and you need to explain why

the company went that route. As with any human interaction, showing respect, building trust and being transparent when communicating can help quite a bit, even if complete alignment is not possible. Thanks to Susan Wolf for her thoughts on this subject.

Overcoming Reg FD Concerns about Engagement

Having just noted that companies should consider running proposed changes by shareholders before publicly announcing them, it's useful to address the elephant in the room: Regulation FD. For some time, a fairly common practice among "enlightened" companies that routinely communicate with their larger shareholders is to "test the waters" before making a final plan design decision. This happens all the time before a company places a new equity plan on the ballot for shareholder approval. [Experience proves that shareholders are not willing to sign a confidentiality agreement—which is permitted under Reg FD—mostly because that doesn't solve potential tippee liability if the shared information proves material.]

To avoid a Regulation FD violation, the key is to not share material nonpublic information (e.g., earnings targets). Some practitioners have gotten comfortable with the practice of "walking the plan around" in which a draft compensation plan is shared with key investors for their input, particularly if the company is in the early stages of developing a working draft of the plan. Other practitioners feel it's safer to not share a plan document—but rather limit the discussion to a list of proposed design changes. The reality is that most investors don't have the resources (or desire) to review an actual plan document even if you felt comfortable giving it to them.

For the most part, many practitioners have gotten comfortable that most governance modifications aren't considered "material" and thus don't pose Reg FD concerns. The bigger concern is that in the midst of a conversation about governance, a question is asked about financial performance. Spokespersons must be well versed in how Reg FD is applied in practice, so they don't slip and inadvertently say something they shouldn't have. Fresh compliance training and reminders may be necessary (involving securities counsel and including Rule 10b-5 concerns)—particularly debriefing new spokespersons that weren't acting in that role before and are now being trotted out to explain the compensation program. Another technique some companies have used successfully is to have a proxy solicitor run plan design and award payout scenarios by key shareholders without using a company's name. While the feedback is not as reassuring as a one-on-one discussion with all facts spelled out, it often is enough to be confident that the new plan design is—or is not—on the right track.

Peeking Under the ISS Hood

Although there are some competitors, ISS is by far the largest—and most influential—of the proxy advisory firms, with over 1,300 investor clients and a staff of several hundred analysts that cover nearly 40,000 shareholder meetings worldwide each year. ISS has grown like wildfire over the past decade, with much of its staffing increase in the international arena. ISS now has offices in nine countries and covers over 100 markets. The other players in this space—including Glass Lewis and Proxy Governance Inc.—have struggled to compete and have undergone changes over the years (and will likely continue experimenting to find their niche). ISS itself may be going through some changes as its parent—RiskMetrics—was just acquired by MSCI (deal closed on June 1st) and the proxy advisory unit (namely ISS) is rumored to be sold off in the near future.

The US Research group is headed by Patricia Mitchel. That group, supported by a team of five specialized executive compensation analysts headed by Valerie Ho, produces the reports advising shareholders whether to vote for management's agenda items for US companies. Before each proxy season, this U.S. team typically hires a dozen extra analysts, each whom has a solid background in research as well as the law, finance and/or compensation.

It's worth noting that ISS recently launched a new corporate governance ratings product—GRId—to replace its CGQ. Like CGQ, the GRId ratings are not focused on particular management proposals—so they have no direct impact on how shareholders might vote on a company's SOP. In fact, a company may have a strong score under GRId and yet experience a recommendation from ISS against its SOP. So companies may not want to overly focus on GRId at the expense of how ISS's proxy analysts will think about the design of a pay package.

How ISS Produces a Company's Report—Once a proxy statement is filed, ISS begins to work on its report. The report is first drafted by a line analyst and then is subject to review by a senior analyst. The US team is organized by sector, so typically the same analyst reviews proxies filed by companies in the same industry and also may review the same companies year after year (barring turnover, etc.). The final

report is issued about two weeks before a company's annual meeting (or roughly 2-4 weeks after definitive proxy materials are filed; ISS doesn't review preliminary proxy materials). The final report typically is 10-15 pages in length and contains several pages of background data on the company and its practices, as well as item-by-item analysis of ballot proposals.

Once a report is delivered to institutional clients, a company may obtain the final report if it contacts the US Research Helpdesk or requests it from ISS's online data verification site. Corporate Services clients are notified via email when their report is available. Otherwise, probably the only way to access an ISS report is by requesting one from a proxy solicitor.

How to Prepare In Advance of ISS Issuing Your Report—Each year, ISS updates its detailed voting manuals and summary guidelines well ahead of the proxy season (typically in November, with input solicited during an open comment period held a month or so ahead of the annual updates being finalized). Although ISS makes its annual policy updates and summary guidelines publicly available, its detailed voting manuals are not—those are made available solely to clients (e.g., institutional investors, proxy solicitors).

Particularly for those companies with a large institutional investor base, it's critical to have some idea regarding how ISS will react to the annual meeting agenda items—and this certainly is true for SOP. Reading the annual policy update is a first step, but knowledge of the detailed voting manual may be necessary too. Most proxy solicitors and compensation consultants can help predict what ISS may feel about a company's proposals, as they are not only familiar with ISS's guidelines but also familiar with each of the analysts on ISS's US Research team.

Can ISS Help You Pass Your SOP?—ISS also has a service where it will analyze a company's proposals ahead of drafting the proxy statement—a practice that has been criticized by some due to the potential for conflicts of interest. Although many companies hire ISS to help them if they have a new compensation plan on the ballot (particularly if they have a large institutional shareholder base), it is doubtful that this type of service will be available specifically for say-on-pay. That is because shareholder approval of new compensation plans primarily involves an objective, quantitative approach related to the estimated cost of the plan and the presence or absence of certain provisions. In comparison, an evaluation of whether to recommend voting for a company's SOP is more holistic and likely to be too hot a potato for ISS to handle.

Can You Appeal to Change ISS's Recommendations?—Given the influence of ISS's recommendations, companies often are unhappy if they receive an ISS report that says "thumbs down." Although it may be possible to make factual corrections after a report is issued, it is hard to get ISS to change a recommendation once made. It's critical that companies review their ISS report as soon as it's out to determine if there are any factual errors; it's not uncommon for errors to show up and time often is of the essence to fix them. So bear in mind the tight timeframe as a company won't even see ISS's recommendations about their ballot items until about two weeks before the annual meeting (and ISS won't change a recommendation for any reason within five business days of an annual meeting).

S&P 500 companies have a slight leg up here as they generally get a draft 24-48 hours before ISS makes a company's report available to its clients. ISS does this because these large companies are so widely held and ISS wants to spare itself the embarrassment of issuing a subsequent alert to make a correction. So, ISS offers this draft to allow these companies to come forward and make factual corrections. It's rare that ISS will change a recommendation—that typically happens only if the corrected facts would lead ISS to a new conclusion.

If a correction is made to an ISS report, ISS has an alert process to inform its clients of the change. In most cases, ISS won't bother sending an alert to call attention to the correction of a factual error unless it believes that the correction could impact the vote. In comparison, alerts are sent when a potentially influential factual correction or a rare change in recommendation occurs. Hundreds of alerts are issued during a typical proxy season—but the vast majority are for technical/informational reasons that do not result in a change of recommendation.

Even though the name(s) of the ISS analyst who wrote a particular report is listed on each report, ISS requires that corrections and questions be directed to a central "help desk" mailbox—usresearch@riskmetrics.com—because the analysts are too busy during the proxy season to field them. ISS also believes that it can better handle these centrally because its policies are well-developed and transparent, rather than subjective to individual analysts' interpretation. Of course, those that deal with ISS often—such as proxy solicitors, compensation consultants and some of the larger companies—often have relationships with the analysts on the US Research team that enable them to better navigate the proxy advice process.

How Proxy Advisors & Major Institutions (& Employees) Vote on Pay

Clearly, one critical aspect of your ability to successfully navigate SOP will hinge on whether you spend the time and resources to ascertain what pay practices turn proxy advisors and investors “on” and “off.” This is a “first step” *before* you engage with shareholders. For many companies, they will build up that expertise in-house, supplemented by advice from outside experts. Some companies will completely out-source this function—or completely rely on their own personnel—both of which can be quite risky.

The former is risky because even the experts make mistakes and you know your own pay practices better than anyone else (plus your advisors will be very busy during proxy season). The latter is risky because changes in a proxy advisor’s (or shareholder’s) position often happens during the midst of the proxy season and only those with their finger on the pulse are likely to know of these changes.

The giant here is ISS, as it has more influence on how shareholders vote than any other organization. For a long time, ISS has been a vocal leader in promoting responsible pay practices, just as it has in other areas of corporate governance. In reaction to SOP arriving on the first ballots during 2008, ISS established a “management say-on-pay” policy, which really was just an extension of its existing executive pay related policies (excluding equity plans) that had been in place for some time. To provide more clarity about its positions, ISS restated all of its executive pay policies into a single “Evaluation of Executive Pay” policy in late 2009.

This restated policy covers both management say-on-pay agenda items and the election of board nominees—including compensation committee members, as some shareholders still prefer to vote against directors as an indication of their displeasure over a company’s pay practices rather than go the non-binding SOP route. In general, if a company has problematic pay practices, it would first receive a negative recommendation from ISS on its SOP, but ISS may also urge an “Against/Withhold” from compensation committee members or, in rare cases, the full board if it is deemed responsible for the problematic practice.

Under its policy, ISS assesses SOP proposals on a case-by-case basis, considering the following key factors in light of a company’s specific circumstances and the board’s disclosed rationale for its practices:

- There is a misalignment between CEO pay and long-term company performance (“pay-for-performance”);
- The company maintains problematic pay practices (*i.e.*, certain non-performance-related pay elements);
- The board exhibits poor communication and responsiveness to shareholders.

Additional factors that may be considered in ISS’s SOP evaluations include evaluation of performance metrics, the company’s peer group benchmarking practices and the overall balance of performance- versus non-performance-based pay.

ISS’s pay-for-performance assessment focuses on companies whose shareholder return has underperformed its peer group median for both of the past 1- and 3-year periods, in which case an increase or only a marginal decrease in CEO pay for the most recent fiscal year would be evaluated in light of the company’s lagging performance. The “problematic pay practices” (formerly known as “poor” pay practices before the 2009 policy changes) evaluation covers a range of non-performance-based pay elements, such as excessive perks or severance packages, tax gross-ups, etc. ISS identifies two groups of problematic pay practices—“major” and “minor.”

If a company is deemed to have one “major” (a common example is excise tax gross-ups), it can lead to a negative vote recommendation on its SOP. If a company has a number of “minors”—there is no precise formula as to how many of these it takes—ISS similarly may recommend “thumbs down.” Some of these practices previously were not widely viewed as being problematic but quickly caught the eye of many investors, such as excise tax gross-ups, which ISS views as contrary to shareholder interests based on research showing that they are associated with higher-than-average severance packages (unrelated to the gross-up amount) and are generally not necessary to ensure that executives receive equivalent value from their golden parachutes.

In comparison, Glass Lewis’s executive pay policies are more subjective; it hasn’t publicized how they weight various problematic practices—but those that regularly deal with them are able to figure that out pretty quickly. If your company has a number of large holders that subscribe to Glass Lewis, you will need to keep them on your radar.

Shareholder response to a company’s SOP will likely be heavily influenced by the type of shareholder they are. Retail holders are likely to ignore SOP votes unless something captures their attention. Active investors

(e.g., hedge funds) typically look for the lowest cost response that will maximize short-term returns. Long-term investors (e.g., mutual funds) often look for a low cost response that will maximize long-term returns. And index investors—long-term owners with little overhead costs from investment activities—look for the most effective response that will result in the best long-term returns possible. One often overlooked group is employee-shareholders. Securing their approval can be crucial not only for obtaining a majority vote, but also because widespread dissatisfaction over executive pay by this group is indicative of a larger morale problem within the company. As noted above, some institutions have their own pay guidelines while some don't; some publicize their guidelines (e.g., Fidelity) and some don't (e.g., Glass Lewis). Much thanks to Ed Hauder and Robbi Fox of Exequity for their help in this section.

The Roadmap: “When” and “How” to Hire a Proxy Solicitor

Even for seemingly routine annual meetings, we believe that most companies will supplement their in-house expertise with outside experts that know the pay “hot buttons” for their large shareholders and intimately know how the proxy advisors function. Even though most companies readily know the names of their 10-50 largest holders—and may even have excellent relationships with them—it may be necessary to drill down to an even longer list or go through an intermediary to anonymously canvas holders on their views about a specific pay practice.

– Who to Hire?—Each of the proxy solicitors tends to have its own particular specialty, even though all of them can—and do—work in all the solicitation niches. There are a little more than a half dozen capable solicitor firms. And a proxy solicitor is not the only type of expert that can help you with SOP. Many compensation consultants also have the ability to assist with setting strategy, with one or two persons on staff who regularly interface with ISS. But note that many compensation consultants are not well versed in the specific hot buttons of each institutional investor; that remains mostly the province of the proxy solicitors.

As in hiring any advisor, personalities matter—but in addition, you may want to ask your prospective expert these eight questions during the interview:

1. What is the background of the staff that would handle our solicitation?
2. How many solicitations like ours have you handled?
3. How many solicitations have you lost?
4. How many contacts do you have at our major institutional holders?
5. What type of solicitation do you typically recommend?
6. Does your firm have sufficient resources to launch a retail holder solicitation?
7. As solicitors handle a lot of confidential shareholder information, what is the solicitor's security and business continuity plans? How do you protect shareholder information? Do you have a risk management plan that assures that our solicitation will not be interrupted by system problems or disasters?
8. Do you maintain good relations with industry organizations and thought leaders, including the major pension funds and CII (and even the SEC)?

– When to Hire?—Some companies are in constant contact with their expert all year round, a trend that we think will grow as year-round planning increasingly is necessary. Of course, much of that planning is prep work as a company can't solicit until it files definitive proxy materials. But lining up your favorite expert well before the proxy season is a good idea as demand for their services likely will explode with mandatory SOP.

– How Much Will It Cost?—Of course, it will depend on what services they provide (e.g., how many shareholders you are soliciting)—which partially depends on how close your vote is expected to be—but expect to spend anywhere between \$5,000-\$35,000 for a SOP solicitation. A large retail solicitation may cost you more by a factor of 4x compared to an institutional investor solicitation.

– What Can Your Expert Do?—The most important job for your expert is to provide detailed analysis of your shareholder base and offer specific strategies to help achieve a majority vote. Depending on what the game plan looks like, a number of different tactics to bring in the vote can be used:

1. *Call Campaigns*—A proxy solicitor has the ability to reach out to registered holders and NOBOs (non-objecting beneficial owners) through direct calling campaign efforts, which can be particularly effective with retail holders. Through a call campaign, your solicitor should have the ability to

capture and record NOBO vote instructions directly over the phone and transmit the instructions to Broadridge for processing and confirmation. This is one of the most effective solicitation strategies to boost responses in a short amount of time. In addition, a follow-up mailing to top unvoted OBOs (objecting beneficial owners) may help drive up their voter responses. Also, a proxy solicitation firm can initiate an institutional outreach to those that disclose their ownership through Schedule 13F filings.

2. *E-Mail Campaigns*—Emails can help remind proxy committee members within institutions that can be hard to reach by phone, particularly during peak proxy season. You (and your solicitor) have to be careful though that any solicitation material e-mailed is not different from what is on file with the SEC, otherwise it must be filed as supplemental proxy material before it is sent. Some companies provide their solicitors with language to be used in e-mails sent to employee-owners—this tailored communication can be effective in reaching those shareholders and getting them to vote.

You can also work with Broadridge to send an interim or reminder mailing to your beneficial shareholders. In doing so, Broadridge can stratify your reminder mailing to target only un-voted shareholders; un-voted shareholders based on number of shares held or only send the solicitation to those shareholders who have elected to receive materials via e-delivery. Interim or informational type mailings related to regulatory and non-proxy communications can also be selective, based on the number of shares owned or delivery preference. Broadridge can supply a share range analysis and help strategize on how to best approach both interim and reminder mailings.

3. *Web Campaigns*—For some time, we have been writing about the need for companies to create annual meeting home pages (e.g., the article in the Spring 2008 issue of InvestorRelationships.com entitled “The Coming Online IR Campaigns: The Future of Director Elections”). The presence of SOP on ballots only increases the urgency here. Proxy solicitors may not have much experience in this area because web campaigns have been less prevalent than expected. The few examples in the US tend to be part of a contested election (Target’s annual meeting home page in 2009), but there are overseas companies that create them annually (Bayer, BP) as well as a few US companies that do so (IBM and Dell). This year, some large companies have followed Intel’s lead from last year in creating online e-forums ahead of their annual meeting to gather input (Best Buy, Charles Schwab and Dell) and some smaller companies have been doing this for several years (Amerco). As recognition of the importance of online campaigning grows, experts who are leaders in this area should emerge.

The Preliminary Vote Count Looks Close: What Can You Do?

If the vote is looking close as the meeting date nears and proxies pour in, a company will want to determine who is voting against SOP. This is not an easy task as most shareholders hold their stock in street name and are thus “masked” (i.e., they are not listed in the company’s stock ledger). In addition, many companies have confidential voting policies that restrict them from looking at the proxies regardless of whether they are cast by registered or street name holders.

To help divine who is voting (and how), proxy solicitors can often track the voting as it comes through the custodian banks. They deal with institutions enough to know which shareholders are voting which way. It is more art than science, but those with enough experience can usually piece it together as the votes come in. This also is a case where shareholder engagement becomes key as there is nothing wrong with contacting one’s largest holders—emphasizing that you do not know how they voted - and asking them if they voted “against” SOP and if so, you would appreciate their input. The trick is getting them to return a call; that is more likely to happen if the company has been engaging them on a consistent basis (and of course, many shareholders aren’t going to return the call regardless during a busy proxy season).

Confidential Voting Policies: Proper Implementation

– *A Little History; Where Might Your Policy Be?*—Most confidential voting policies date back to the late ‘70s and early ‘80s when the late Gilbert brothers (who would file literally hundreds of shareholder proposals each year) began to introduce shareholder proposals that called for confidential voting in all corporate elections—mostly at large and prominent companies. Interestingly, the Gilbert proposals rarely recommended what these policies should say, or exactly how they were to work in practice. The concept was quickly endorsed by large institutional investors—some of whom thought it would reduce the large numbers of pestering phone calls they were receiving from proxy solicitors, and also from some company officers back then. Most institutions quickly came to consider it as a “best practice” and many of these proposals received majority support—in which case, the targeted company would amend their bylaws to provide for it.

Soon, other companies decided to adopt “confidential voting” on their own—sometimes to forestall a shareholder proposal; sometimes, to be perceived as being a “good corporate citizen”—but mostly because they saw the opportunity to craft the specifics of their confidential policy themselves. In these circumstances, companies typically did not amend their bylaws to add a confidential voting provision. Rather, they adopted a stand-alone policy or added it somewhere else (remember, corporate governance guidelines were not “invented” yet). Then, almost as suddenly as the confidential voting proposals came onto the scene, activist investors shifted their attention and confidential voting lost steam. All in all, it is likely that only a small minority of companies today actually have adopted a confidential policy—but that may very well change soon.

– *Where Should Your Policy Be?*—In our opinion, having a confidential voting policy is a sound governance practice—and likely will be among the next “big things” that investors clamor for. In terms of where it should reside, we think that the policy should be enshrined in the company’s bylaws where it won’t get forgotten over time or interpreted on an ad-hoc or “casual” basis. In addition, the policy should be mentioned—and explained—in the company’s proxy statement each year.

– *How to Implement Your Confidential Voting Policy*—Before each annual meeting, the tabulator and inspector of election should be reminded of the details of your confidential voting policy and they should be asked to agree, in writing, to observe them. Independent inspector Carl Hagberg reports that he has seen far too many cases of inadvertent disclosure of voting information via on-line reports, etc.

If a company has adopted a confidential voting policy, it should never look at how registered holders voted. Nor should Broadridge tell a company how its street name holders voted—or, worse yet, how its employee holders voted. One possible exception is if there is a challenge raised as to the results—since many confidential voting policies provide for that as a necessary exception, but note this is limited to a review *after* the meeting is held. That said, it is usually a simple matter to have the tabulating agent provide a summary of the votes by a specific category of holders without revealing the way a specific holder voted (again, after the meeting).

Companies should check to see if they have indeed adopted a confidential voting policy and remind those involved in the voting process to observe it scrupulously (there might be some newbies now in the proxy voting process and they need to be educated too). To ascertain whether your company already has adopted a confidential voting policy, you may need to check in a number of places, including the bylaws, corporate governance guidelines, etc. Remember it could be just a stand-alone policy.

– *Don’t Be Tempted to Check How Employees Voted*—Some companies are tempted to see how employee-owners have voted and this can cause big problems (even if the company doesn’t have a confidential voting policy) because regardless of the motive, it would be natural for employees to assume that this was done with malice aforethought. And some employees inevitably find out about such “snooping” and spread the word. Thanks to Carl Hagberg, our “go-to” independent inspector of elections, for his wisdom in this section.

How to Calculate Voting Result Percentages: Read Your Bylaws (and Compare with Your Proxy)

Carl Hagberg also observes that he has seen many mistakes by practitioners (including inspectors of election and tabulators!) when they report on percentages because they have not read or interpreted the company’s bylaws correctly (or the certificate of incorporation, which sometimes contains voting standards and controls over bylaws). Many bylaws have language agreed to many years ago and whose intent is long forgotten.

This can be a confusing exercise, particularly figuring out whether—and how—abstentions count (see “Broc’s Blog” dated February 19th and 11th on TheCorporateCounsel.net). The rules differ depending on a company’s state of incorporation. For example, New York and Delaware have different rules on this (and to dig deeper for Delaware companies, there are the state law percentages—and then there is the Rule 14a-8 approach, which is the approach that shareholder proponents use, that looks only at votes cast). As close votes may well end up in court, practitioners need to roll up their sleeves and not blindly rely on election inspectors and tabulators for the answers here. Someone needs to check the math and the methodology.

Also, don’t blindly rely on proxy statement disclosure about the mechanics of the voting math, as it is not uncommon for the bylaws to say one thing—and for the proxy statement to say another. Another surprisingly frequent occurrence is for the proxy statement to contain incorrect, vague or ambiguous “interpretations” of what it takes to pass a proposal. And a proxy statement may even contain contradictory statements as to what it takes for a proposal to pass! And of course, the proxy statement also has to

accurately describe how state law applies. Now that votes really “count,” these sloppy drafting mistakes need to be reined in. We could see an argument in the event of a close vote that proxy statement’s inaccuracies were so misleading that they tipped the balance and a new vote should be held. [See the recent post entitled “Some Thoughts on How to Overcome the Challenges of Disclosing Voting Percentages” on TheCorporateCounsel.net’s “Proxy Season Blog.”]

Note that Item 5.07 of Form 8-K doesn’t require companies to disclose voting percentages; it only requires disclosure of raw voting data. Shareholders are already grumbling about this possible oversight from the SEC’s recent rulemaking and may demand more disclosure. Some companies—such as IBM—already are doing the full math and voluntarily disclosing the percentages in their 8-Ks. Thanks to Carl Hagberg for his help on this section; check out his invaluable checklist of qualifications that you should consider before appointing an inspector of election (e.g., your inspector should have a well-documented set of procedures as what exactly they will inspect) posted in the “Inspector of Elections” Practice Area on TheCorporateCounsel.net.

When a SOP Fails to Garner a Majority: What Now

If a majority of shareholders don’t vote in favor of a management SOP, there clearly could be reputational repercussions with shareholders if the company decides to do nothing in response, particularly as ISS has a policy that ignoring a majority vote will likely result in their recommending a vote against reelection of incumbent directors at the next meeting. Ignoring a majority vote is a real sticking point for investors. Recall that in the SEC’s 2003 proxy access proposal, lack of response to a successful stockholder proposal was considered as a trigger event that would open up a board seat to a stockholder nomination. This notion hasn’t been repeated in the latest reiterations of proxy access rulemakings.

But what is a board’s fiduciary duty in this situation? Does a board even have a duty to deliberate given that the vote was nonbinding? Or is their knowledge of what was disclosed in the proxy sufficient for the directors to be considered “informed” when they decide to not even deliberate further?

Most practitioners would advise boards to at least deliberate after the vote. In fact, proxy statements with SOP proposals often state that the board will “consider” the results of the vote in making compensation decisions going forward. However, it is unclear what exactly a board is supposed to do to “consider” the shareholder vote. Part of the problem is the nature of what was voted upon—a long-standing criticism of say-on-pay—because these votes are an up-or-down regarding the disclosures of a company’s executive compensation program. Perhaps if the votes were a specific referendum on a severance package or performance targets, the answer would be different—but the SOPs just aren’t that narrow.

Prudent companies should interpret a negative vote as a message to engage their largest shareholders and ask for recommendations on changing their executive pay design—and then the compensation committee will need to focus on meaningful changes. (In this connection, see the just-issued Summer issue of *Compensation Standards*, at pgs 3-4, which covers specific practices that companies will want to address to achieve a positive shareholder outcome.)

Binding vs. Non-Binding: Does It Make a Difference?—Proposals brought before a shareholder meeting can be either binding (requiring the board to take some action) or non-binding (advisory only). The new SOP law requires only that companies place non-binding proposals on their ballot and it’s doubtful that companies would decide to place a binding one instead (we assume that this would be permitted under the law if a company chooses to do so).

Shareholder-originated say-on-pay proposals have generally sought non-binding advisory votes. That’s because the SEC has long taken the position, under Rule 14a-8(i)(1), that companies may exclude shareholder proposals that mandate board action, if the action would conflict with the laws of the company’s state of incorporation. Delaware has typically taken a narrow view of the rights of shareholders to mandate board action. For example, a few years ago, the Delaware Supreme Court held that a shareholder-proposed bylaw that would mandate reimbursement of a shareholder’s proxy expenses was not an appropriate subject for shareholder action, as it would eliminate the board’s ability to deny such reimbursement if it believed it was its fiduciary duty to do so (in *CA, Inc. v. AFSCME Employees Pension Plan* (Del. Sup. Ct., 2008)). [Note that it probably doesn’t matter that the AFSCME case was about a bylaw rather than a proposal.] To avoid this potential conflict, most shareholder-originated proposals are therefore set up on a “precatory” or advisory basis.

So we know that Delaware courts have weighed in and decided that nonbinding shareholder proposals don’t require boards to act if they are supported by a majority of shareholders—but does the equation change when the nonbinding proposal is placed on the ballot by management?

It's an issue that the Delaware courts have not weighed in upon. Potter Anderson's John Grossbauer says that he doesn't think the fact the board has been forced "voluntarily" to place a proposal on the ballot that—on its face is nonbinding—makes it somehow binding. And even if the proposal were "binding," there is nothing the board has agreed to be "bound" to do (exposing again a fundamental flaw in SOP). However, if the board voluntarily agrees to take specific action in response to a "no" vote—then the *board* has made a decision to take direction from shareholders. That is, the board has conditioned the exercise of its authority on shareholder approval. So, by analogy, if a stock plan approved by shareholders says the board won't reprice without a vote, the board is probably stuck with seeking a vote even though it has authority to reprice as a matter of law—and even though a shareholder proposal could not impose such a requirement by itself.

The issue is further complicated in the SOP context by the fact that affected officers may have contract rights that would permit them to refuse any changes unless they agree to permit the board to change their compensation package in response to a negative SOP vote. This makes it far from clear whether any legal remedy would be available to a shareholder who is unhappy with the ultimate effect (or lack thereof) of a company's response to a negative SOP vote.

Disclosure of a Board's Deliberations: Required?—To minimize the repercussions of a failure to obtain a majority vote, a prudent company will promptly disclose that it is deliberating what to do—and then will disclose what actions the company has decided to take in response once it has figured that out. But is the board *required* to disclose that it deliberated after it received a majority vote on its nonbinding proposal? If so, what type of details must be disclosed? Unless Congress or the SEC enacts additional disclosure requirements, there are no existing rules that require the company to disclose its deliberations to the shareholders until the next CD&A. For example, the three companies whose say-on-pay proposals were defeated this year merely issued a Form 8-K announcing the results of the voting, as required under new Item 5.07, without a press release or other accompanying management comment indicating whether the company intended to respond.

The Importance of Making Your Compensation Disclosure "Usable"

As Mark Borges and Dave Lynn will cover extensively in an upcoming issue of "Proxy Disclosure Updates" (a quarterly publication that is part of the "Lynn, Borges & Romanek's 'Executive Compensation Annual Service'"), the adoption of mandatory SOP is a great opportunity for re-evaluating your CD&A—since a key to obtaining a favorable SOP vote will be how you craft your CD&A disclosures (look for disclosure practice pointers and examples in this upcoming issue). Proxy advisors and shareholders increasingly will rely on the CD&A to make their voting decisions, so the disclosure will need to be much more "usable." For example, we expect many companies to replace some of their narrative descriptions with graphic and bulleted presentations as a starting point.

How to Gear Up for Mandatory Say-on-Pay

With the focus now on Say-on-Pay and compensation disclosure and practices, the upcoming "7th Annual Executive Compensation Conference" and "5th Annual Proxy Disclosure Conference" will be a must for every public company. The Conferences will be held in Chicago in conjunction with the "18th Annual NASPP Conference" on September 20-23. Any reader who cannot make it to Chicago should make sure to sign up for the live Nationwide Video Webcast.

Among the 40-plus panels, we have tailored a special track to help you prepare for mandatory say-on-pay including these panels:

- "Say-on-Pay: The Proxy Solicitors Speak"
- "Say-on-Pay: Successfully Communicating Externally and Internally"
- "The Proxy Advisors & Investors Speak: Their Hot Button Issues and Say-on-Pay"
- "The New Compensation Legislation: What to Do About Say-on-Pay and More"
- "Five Hot Button Compensation Fixes: In Light of Say-on-Pay and More"
- "This Coming Year's Grants: How to Deal with Last Year's Inadvertent Gains"
- "The Big Roundtable: Consultants, Directors and Top HR Heads"
- "Directors Speak Their Minds on Executive Compensation"

With Conference registrations going strong—on track to reach nearly 2000 attendees—you don't want to be caught unprepared as we head into next year. Last year's Conference sold out a month in advance—and that was without the reality of mandatory say-on-pay hanging over our heads.

—Broc Romanek

The Publisher of *The Corporate Counsel*, **Jesse M. Brill**, is a member of the New York and California Bars and received his J.D. from Yale Law School. Mr. Brill, formerly an attorney with the Securities & Exchange Commission, is Chair of the NASPP, CompensationStandards.com and DealLawyers.com. Mr. Brill has chaired and participated on numerous panels and seminars. Editor: **Michael Gettelman**, LL.B. Harvard University (mike@thecorporatecounsel.net).

The Corporate Counsel is published bi-monthly by Executive Press, Inc., P.O. Box 3895, San Francisco, CA 94119. Subscription is \$895 per year. This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting or other professional service. If legal advice or other expert assistance is required, the services of a competent professional person should be sought.

Executive Press, Inc. • P.O. Box 21639 • Concord, CA 94521-0639 • Tel. (925) 685-5111 • Fax (925) 930-9284 • info@TheCorporateCounsel.net

For Renewing or No-Risk Trials, Go to TheCorporateCounsel.net