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 policies. 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.
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.\(^3\)

---

1. CEO pay and performance;
2. Problematic pay practices;
3. Communication and responsiveness to shareholders;
4. Performance metrics used in incentive plans;
5. Use of peer groups in benchmarking executive pay; and

---

Evidence suggests that institutional investors respond to the voting recommendations of proxy advisory firms. 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. 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.

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.

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.

### 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**

<table>
<thead>
<tr>
<th>Services</th>
<th>Manufacturing</th>
</tr>
</thead>
<tbody>
<tr>
<td>66.3%</td>
<td>33.7%</td>
</tr>
</tbody>
</table>

#### Chart B

**Breakdown by exchange listing**

<table>
<thead>
<tr>
<th>NASDAQ</th>
<th>NYSE</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>50.5%</td>
<td>45.7</td>
<td>[3.8]</td>
</tr>
</tbody>
</table>

#### Table A

**Revenue composition**

<table>
<thead>
<tr>
<th>Percentile total FY2010 worldwide revenue (in US$ millions)</th>
<th>25th</th>
<th>50th</th>
<th>75th</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$345</td>
<td>1,448</td>
<td>9,613</td>
<td>11,695</td>
</tr>
</tbody>
</table>

#### Table B

**Full-time employees**

<table>
<thead>
<tr>
<th>Percentile number of full-time employees</th>
<th>25th</th>
<th>50th</th>
<th>75th</th>
<th>Mean</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>204</td>
<td>3,530</td>
<td>19,000</td>
<td>25,575</td>
</tr>
</tbody>
</table>
The Conference Board, NASDAQ, and the Rock Center for Corporate Governance at Stanford University surveyed 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?

- **Yes,** we (and/or our outside counsel and advisors) reviewed their public policies and voting recommendations on the survey, but did not engage their consulting services
- **Yes,** we engaged their consulting division to receive feedback and guidance on the proposed top executive compensation
- **No**

#### 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?

- **Yes,** they were influenced by the proxy advisory firms’ public policies and voting recommendations on the subject
- **Yes,** they were influenced by guidance we received from the consulting division of the proxy advisory firms
- **Yes,** they were influenced by the proxy advisory firms’ public policies and voting recommendations on the subject as well as the specific guidance we obtained from their consulting division
- **No,** we concluded that the proxy advisory firms should not influence the design of our top executive compensation program
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?

- Yes, we (and/or our outside counsel and advisors) will review their public policies and voting recommendations on the survey, but will not engage their consulting services 44.8%
- Yes, we plan to engage their consulting division to receive feedback and guidance on the proposed top executive compensation 12.4%
- No 22.9%
- Not yet decided 20.0%

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?

- Yes 51.2%
- No 48.8%
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.

**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.

**Table 1**

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

<table>
<thead>
<tr>
<th></th>
<th>Low support (less than 80 percent)</th>
<th>High support (greater than 80 percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>70.0%</td>
<td>43.6%</td>
</tr>
<tr>
<td>No</td>
<td>30.0</td>
<td>56.4</td>
</tr>
</tbody>
</table>

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.


**Table 2**

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

<table>
<thead>
<tr>
<th></th>
<th>Low support (less than 80 percent)</th>
<th>High support (greater than 80 percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enhance disclosure</td>
<td>57.1%</td>
<td>29.2%</td>
</tr>
<tr>
<td>Introduce performance-based equity awards</td>
<td>35.7</td>
<td>29.2</td>
</tr>
<tr>
<td>Reduce severance</td>
<td>28.6</td>
<td>12.5</td>
</tr>
<tr>
<td>Change target pay positioning</td>
<td>28.6</td>
<td>4.2</td>
</tr>
<tr>
<td>Reduce compensation levels</td>
<td>14.3</td>
<td>4.2</td>
</tr>
</tbody>
</table>

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.

Endnotes


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).


6 These results are estimated using ISS voting analytics data.


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)
About the Authors

David F. Larcker is James Irvin Miller Professor of Accounting at the Graduate School of Business of Stanford University; director of the Corporate Governance Research Program; and senior faculty, Arthur and Toni Rembe Rock Center for Corporate Governance. His research focuses on executive compensation, corporate governance, and managerial accounting. Professor Larcker presently serves on the Board of Trustees for Wells Fargo Advantage Funds. He has co-authored a book on corporate governance entitled Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences, available from FT Press.

Allan L. McCall is a Ph.D. candidate in accounting at the Graduate School of Business of Stanford University. His research focuses on corporate governance, compensation, and incentives. McCall is a co-founder and principal of Compensia, Inc., a national executive compensation consulting firm.

Brian Tayan is a member of the Corporate Governance Research Program at the Stanford Graduate School of Business. He has written broadly on the subject of corporate governance, including case studies and other materials on boards of directors, succession planning, compensation, financial accounting, and shareholder relations. Tayan is co-author with David Larcker of Corporate Governance Matters.

Acknowledgments

The authors would like to thank Michelle E. Gutman, Frank Hatheway, and Matteo Tonello for assistance in the preparation of this survey and article.

About NASDAQ

The NASDAQ stock exchange is the largest U.S. electronic stock market. With approximately 3,200 companies, it lists more companies and, on average, its systems trade more shares per day than any other U.S. market. It is home to companies that are leaders across all areas of business including technology, retail, communications, financial services, transportation, media, and biotechnology. For more information about NASDAQ, visit the NASDAQ at (http://www.nasdaq.com) or the NASDAQ Newsroom at (http://www.nasdaq.com/newsroom/).

About Stanford University’s Rock Center for Corporate Governance

The Arthur and Toni Rembe Rock Center for Corporate Governance is a joint initiative of Stanford Law School and the Stanford Graduate School of Business, created with the idea that advances in the understanding and practice of corporate governance are most likely to occur in a cross-disciplinary environment where leading academics, business leaders, policy makers, practitioners, and regulators can meet and work together. The Rock Center’s goal is to conduct research and tap this wealth of expertise to advance the practice and study of corporate governance. The Rock Center works closely with the Corporate Governance Research Program.
About Director Notes

Director Notes is a series of online publications in which The Conference Board engages experts from several disciplines of business leadership, including corporate governance, risk oversight, and sustainability, in an open dialogue about topical issues of concern to member companies. The opinions expressed in this report are those of the author(s) only and do not necessarily reflect the views of The Conference Board. The Conference Board makes no representation as to the accuracy and completeness of the content. This report is not intended to provide legal advice with respect to any particular situation, and no legal or business decision should be based solely on its content.

About the Series Director

Matteo Tonello is managing director of corporate leadership at The Conference Board in New York. In his role, Tonello advises members of The Conference Board on issues of corporate governance, regulatory compliance, and risk management. He regularly participates as a speaker and moderator in educational programs on governance best practices and conducts analyses and research in collaboration with leading corporations, institutional investors, and professional firms. He is the author of several publications, including Corporate Governance Handbook: Legal Standards and Board Practices, the annual U.S. Directors’ Compensation and Board Practices and Institutional Investment reports, Sustainability in the Boardroom, and the forthcoming Risk Oversight Handbook. Recently, he served as the co-chair of The Conference Board Expert Committee on Shareholder Activism and on the Technical Advisory Board to The Conference Board Task Force on Executive Compensation. He is a member of the Network for Sustainable Financial Markets. Prior to joining The Conference Board, he practiced corporate law at Davis Polk & Wardwell. Tonello is a graduate of Harvard Law School and the University of Bologna.

About the Executive Editor

Melissa Aguilar is a researcher in the corporate leadership department at The Conference Board in New York focusing on issues of corporate governance, regulatory compliance, and risk management. Prior to joining The Conference Board, she was a contributor for more than five years at Compliance Week, where she reported on a variety of corporate governance topics, including proxy voting developments, executive compensation, risk management, and shareholder activism. Her work has also appeared in Bloomberg’s Bloomberg Brief Financial Regulation newsletter. Previously she held a number of editorial positions at SourceMedia Inc. Aguilar is a graduate of Binghamton University.

About The Conference Board

The Conference Board is a global, independent business membership and research association working in the public interest. Our mission is unique: to provide the world’s leading organizations with the practical knowledge they need to improve their performance and better serve society. The Conference Board is a nonadvocacy, not-for-profit entity, holding 501 (c) (3) tax-exempt status in the United States.