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SAY-ON-PAY FREQUENCY: A FRESH LOOK

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EQUILAR

With the 2017 proxy season approaching, institutional investors will be voting again on the frequency of say-on-pay votes. These nonbinding proposals, mandated by the Dodd-Frank Act to occur at least once every six years, allow shareholders to recommend whether companies should hold advisory votes on executive compensation annually, biennially or triennially. Since most companies have not held a frequency vote since 2011, the upcoming proxy season will include thousands of say-on-frequency proposals.

While say-on-frequency votes are not binding, shareholder preference drove frequency of say-on-pay votes at nearly all companies after 2011. Most shareholders support annual votes, although some shareholders support triennial, and a handful supported biennial votes or abstained from casting ballots on this issue.

This report analyzes data provided by Equilar on 818 U.S.-incorporated Russell 1000 companies to examine what frequencies companies chose and whether or not their choice impacts say-on-pay results. It then explores arguments for and against annual votes, and concludes by providing findings from an informal investor survey on future voting activity.

Taken together, voting trends, investor preferences, and results from a CII member survey indicate that support for annual say on pay in 2017 will be at or above the strong support seen in 2011.

Figure 1: Support for Frequencies in 2011

Frequency	Percent of companies at which shareholders favored that frequency	Percent of companies adopting that frequency	Average vote for that frequency among all companies	Average vote for that frequency among adopting companies	Highest support (among adopting companies)	Lowest support (among adopting companies)
Annual	89.4 %	90.1 %	76.5 %	82.3 %	100 %	7.5 %
Biennial	0.4	0.3	1.6	83.4	94.7	72.1
Triennial	10.2	9.6	21.9	73.2	100	49.2

What Happened in 2011: Influences on Say-on-Pay Frequency

In 2011, shareholders favored annual votes at an overwhelming 89 percent of the companies in the Equilar sample. Notably, they favored annual voting more than companies did. According to data from ISS, 56 percent of Russell 3000 companies that voted on say-on-pay frequency in 2011 recommended that shareholders support annual, 39 percent recommended triennial, 2 percent biennial and another 3 percent made no recommendations. Yet on average, more than 76 percent of votes cast favored annual say on pay (see Figure 1, third column). In contrast, triennial say on pay won support from an average of 22 percent of shares voted and biennial received less than 2 percent.

Shareholders almost always got their wish, as all but six companies implemented the favored frequency. Moreover, in each of these six exceptions, the companies made say-on-pay votes more frequent than shareholders requested.

Some—but not all—of the six companies offered reasons in filings with the Securities and Exchange Commission (SEC) for why they opted for a different frequency. Two companies said they sought to protect the interests of a sizable minority of shareholders that requested annual votes. Interestingly, two more companies noted that they had promoted triennial say on pay, but then decided that annual was a better fit, although neither elaborated as to why. The last two companies both implemented annual say on pay after none of the options won majority support, although neither of these companies explicitly stated why they decided annual was the most appropriate frequency.

After accounting for these switches, 90 percent of companies in the Equilar sample implemented annual say on pay, 10 percent adopted triennial and only two (Hormel Foods and Interactive Broker's Group) implemented a biennial frequency.

Extent of insider ownership correlates strongly with shareholder support for triennial votes. Insiders controlled a majority of votes at more than half of the companies at which shareholders supported triennial voting, and insiders controlled more than one-fifth of voting power at about 78 percent of companies at which shareholders supported triennial votes. Relatively larger holdings by retail shareholders also appeared to be a factor in support of triennial frequency, possibly because retail holders tend to support management more often.

Additionally, company size correlated with the frequency companies implemented, with the companies in the top quartile by market cap opting for annual votes 94.5 percent of the time, the middle two quartiles choosing annual about 89 percent of the time, and the bottom quartile (the smallest companies) choosing annual less than 85 percent of the time.

After these initial votes in 2011, companies rarely changed their frequencies, with just nine companies in the sample switching frequencies after the initial 2011 votes. All nine changed to annual.

How Does the Frequency Choice Correspond with Say-on-Pay Support?

From the Equilar sample, in say on pay votes between 2011 and 2017, companies with annual frequencies received an average of 90 percent support from shareholders on their executive compensation packages, whereas triennial companies received an average support of 93.4 percent for their executive compensation packages. Unsurprisingly, companies with high levels of insider ownership experienced marginally higher say-on-pay support. On average, companies with more than 50 percent of stock owned by insiders received 96 percent support for executive compensation, compared with just over 90 percent support at companies with the lowest levels of insider control.

Company size, as measured by market capitalization, did not correlate with shareholder support for executive compensation as much as it did for say-on-pay frequency. Smaller companies generally received slightly more support for their executive compensation plans than larger companies, with the average vote for each less than one percentage point apart.

Companies with annual voting also saw more “failed” say-on-pay votes (those earning less than majority support), with 1.7 percent of votes failing between 2011 and 2016. In the same time period, no biennial votes failed to win majority shareholder support and only 1.3 percent of triennial votes failed. The relatively small gap between these two failure rates is somewhat surprising, given the disproportionate number of triennial companies that have substantial inside ownership.

Behind the Numbers: Arguments on Specific Frequencies

Ultimately, shareholder preference drives say-on-pay frequency. To start, most investors—as well as CII Policies—support annual say-on-pay votes. Other prominent supporters of annual voting include Vanguard, State Street Global Advisors, Fidelity, California Public Employees’ Retirement System (CalPERS), the Florida State Board of Administration, California State Teachers’ Retirement System (CalSTRS), the New

York State Common Retirement Fund and the New York City pension funds. Proxy advisory firms Institutional Shareholder Services (ISS) and Glass Lewis also support annual votes.

On the other side, prominent supporters of triennial votes include BlackRock, Capital Group, Loomis Sayles and the United Brotherhood of Carpenters.

By reviewing the proxy voting guidelines of these large asset managers and asset owners, as well as revisiting arguments from past debates, we highlight key reasons for and against annual and triennial say on pay:

Reasons Investors Support Annual Votes

- Annual say-on-pay votes allow shareholders to give timely and clear feedback to the company.
- Annual votes provide a mechanism for more responsible oversight of executive compensation and reduce the risk that boards will become complacent in their review and approval of executive pay packages.
- Shareholders should defer to compensation committees in the absence of red flags, but when they have significant concerns about pay, they should not have to wait up to two additional years before they can express collective views.
- Costs to companies in annual votes are relatively small and are outweighed by benefits to shareholders from more frequent accountability.
- Say-on-pay votes on a triennial basis could lead to further complexity in executive pay as some companies may be tempted to time certain grants and perquisites to minimize elements that shareholders dislike in the year leading up to the vote.
- The say-on-pay vote is a preferable mechanism for shareholders to express collective views on executive compensation as opposed to voting against board compensation committee members. Differences of opinions on executive compensation should not dictate whether investors disqualify a compensation committee member from re-election to the board.

Reasons Investors Support Triennial Votes

- Annual say-on-pay votes increase focus on the short-term. Triennial voting is a more appropriate pace for evaluating how well compensation committees align executive pay with long-term performance.

- Voting on the re-election of compensation committee members to the board is a more appropriate and more forceful avenue for expressing concerns about compensation.
- The costs and complexity of say-on-pay votes are significant for both companies and investors. Voting triennially gives investment staff more time to review compensation plans, preventing them from being overloaded and enabling a more careful and cost-effective review.

How Will 2017 Compare with 2011?

Many institutional investors have not yet finalized their voting policies for 2017. However, from current evidence, we anticipate a slight increase in support for annual votes in 2017 as compared with 2011.

Out of the Equilar sample, 27 companies held say-on-pay frequency votes between 2012 and 2017. Notably, annual say on pay received average support of 83.8 percent at these companies, as opposed to the average support of 76.5 percent it received from all companies in 2011. Overall, the annual vote option won in 25 of these 27 companies. These figures were affected by management recommendations, as every one of the 25 companies that adopted annual voting did so following a management recommendation.

One interesting example of growing investor and management support for annual say on pay come from Fifth Third Bancorp (FITB). FITB's board, which has consistently supported annual votes, also provides shareholders with a say-on-pay frequency vote every year. This unusual decision creates a great case study, as support for annual say-on-pay votes at FITB increased from 82.5 percent in 2011 to 95.9 percent in 2015, before settling at 91.4 percent in 2016.[1] This variation may be in part to shareholder compositional changes, although two major investors in FITB—Hartford Investment Financial Services and Pacific Life Fund Advisors—shifted from mixed votes that included support for triennial at FITB in 2011 to more consistent support for annual votes.

1 Change in the shareholder base could be a factor at Fifth Third. In particular, the ownership profile in 2011 may have been affected by Fifth Third's exit from the federal Troubled Asset Relief Program (TARP) earlier in the same month as the record date for the 2011 annual meeting.

Similarly, several investors have switched from abstaining on say-on-pay votes to actively voting. Two such investors are Gabelli Asset Management and Royce & Associates, both of which generally abstained in 2011, but by 2016 had switched to usually (but not always) supporting the management recommendation on say-on-pay frequency. Northeast Investors Trust continues to abstain on most frequency votes, by policy.

Evidence of growing support for annual say on pay isn't just limited to case studies. A November 2016 CII survey found that 24 of 26 replying institutions said they plan to support annual say on pay. The respondent group included 15 asset owners and 11 asset managers. Of those surveyed, 23 said that their organization supported annual say on pay in 2011 and plans to continue that support in 2017, while one respondent—an asset owner— plans to support triennial again in 2017 just as it did in 2011.

Most interesting are two CII members that switched support from one frequency to another since 2011. The first, an asset manager, supported annual in 2011, but plans to vote for biennial frequencies in 2017. Asked about the decision, a representative of the asset manager said that it was divided between annual and triennial, but ultimately decided that yearly votes were just not enough time for shareholders to see whether long-term compensation plans align pay with company performance. Additionally, the asset manager felt that annual votes become "a referendum on the stock price" and not a true examination of executive pay.

On the other hand, an asset owner that had supported triennial votes now favors annual votes. When asked to clarify that decision, a representative of the asset owner explained that say on pay succeeded at "opening up a dialogue with companies," a process it thought was best-suited for a yearly review.

These results indicate that annual say on pay is likely to continue to be the market norm for publicly traded companies in the United States. This widely preferred voting frequency may even become marginally more common, as a small but steady stream of companies adopt annual votes in line with the vast majority of shareholders that continue to prefer that option.