# Say on Pay (and Evaluating the Impact of Shareholder Advisory Groups)

Equilar's 2010 Executive Compensation Summit

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EXEQUITY

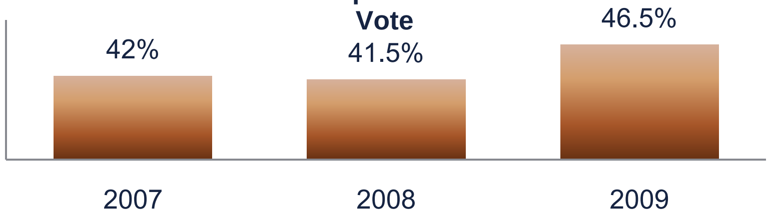
Independent Board and Management Advisors

# What is Say on Pay?

**"Say on Pay" (SOP) is used to refer to:**

- Shareholder proposals asking companies to put executive compensation and/or policies to a non-binding shareholder vote
  - As yet, there is no agreement on how companies should respond or how SOP will work
    - The populist view demands a vote on compensation policy and/or pay levels
    - Institutional investors appear to be more interested in regular discussion with Compensation Committees to ensure pay systems align with operating strategies

**Shareholder SOP Proposals Percent Affirmative Vote**




> **Why are shareholders pushing for SOP?**
> Perceived as a means of enhancing the level of communication between the Board and shareholders on matters pertaining to executive compensation

- Management SOP (MSOP) proposals asking shareholders to approve by a non-binding vote, the company's executive compensation and policies; in one of two forms (at the moment):
  - Mandatory MSOPs—where the company is required to provide shareholders with an MSOP vote because of a regulation or law, i.e., participants in TARP or CPP are required to provide shareholders with an MSOP vote and public companies incorporated in North Dakota are required to provide an MSOP vote to shareholders
  - Voluntary MSOPs—where the company has voluntarily adopted/provided an MSOP vote to shareholders when not required to do so by any regulation or law

# What is SOP?

**Form and Timing of MSOP Proposals**

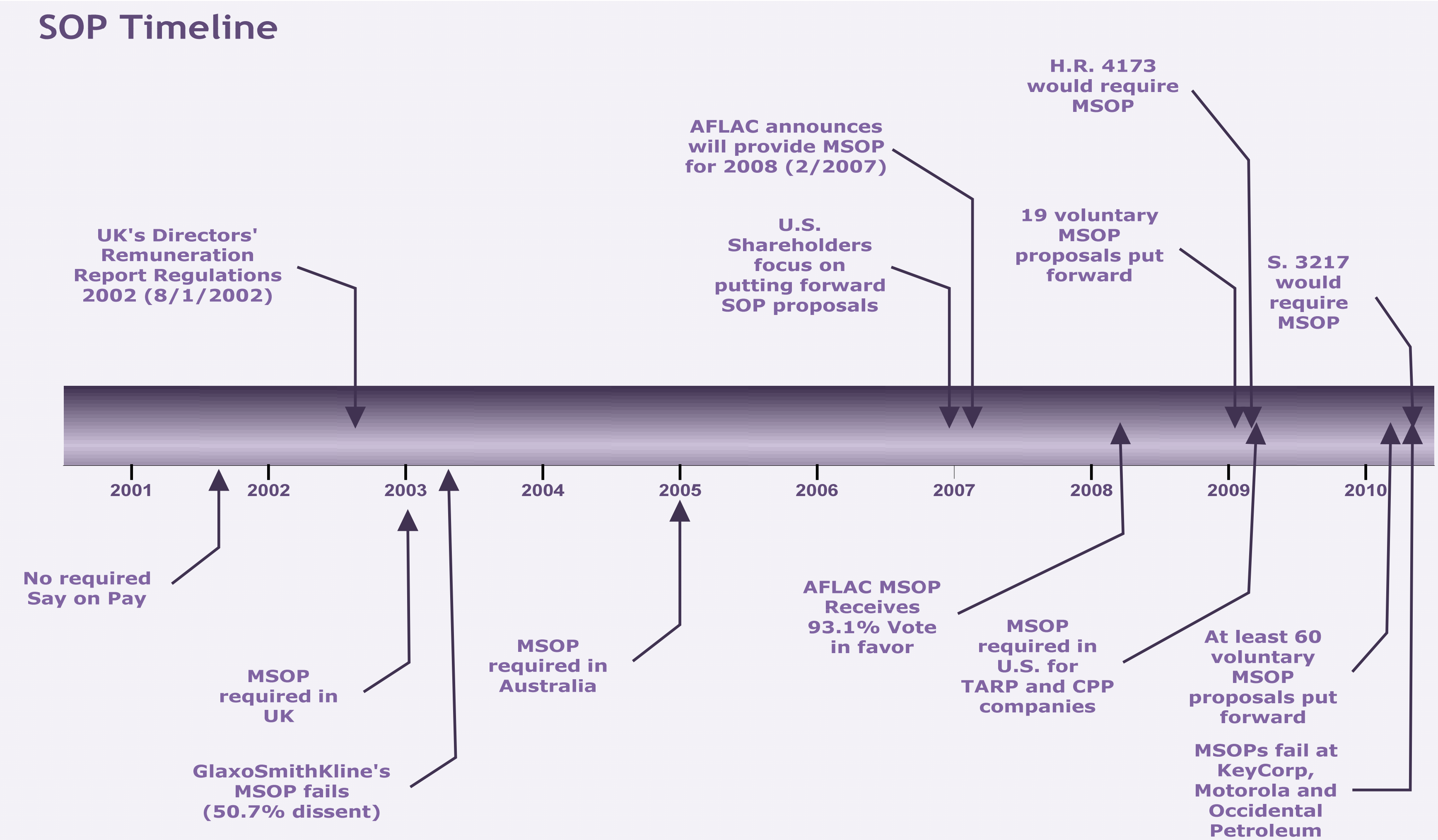
- Several approaches to MSOP proposals have appeared, though pending legislation and associated regulations could dictate the approach that must be taken

| Comprehensive Vote (Yea or Nay) | Segmented Vote | Other Mechanisms |
|---|---|---|
| ▪ Formulations vary—CD&A and tables, CD&A only; approval vs. ratification; annual vs. biannual vs. triennial<br>▪ Advantage is that a single vote is simple<br>▪ Disadvantage is that a single vote does not permit differentiation and is a blunt instrument that does not provide meaningful input | ▪ Vote separately on different aspects of the program, e.g., philosophy, decisions in previous year (RMG)<br>▪ CEO compensation is within 20% of an acceptable amount and director compensation is within 20% of an acceptable amount (Littlefield)<br>▪ Advantage is that these can provide for more meaningful feedback<br>▪ Disadvantage is that it is more complicated and risks micromanagement | ▪ Survey of investor views (Schering-Plough, Amgen)<br>▪ Hold meetings with large shareholders (Pfizer, Occidental Petroleum)<br>▪ Solicit feedback from shareholders on executive compensation disclosure (Prudential)<br>▪ Shareholder e-forum (Verizon) |

Approach likely to be taken by pending legislation; Approach taken for TARP/CPP companies

- Timing issues—how often will an MSOP be presented to shareholders?
  - Annually—typical structure among voluntary adopters; structure required for TARP/CPP companies
  - Biennially—Bristol-Myers Squibb; Colgate-Palmolive; General Mills
  - Triennially—Microsoft

# SOP Timeline



# Historical Perspective

**SOP proposals were first discussed for U.S. Public companies in the context of shareholder proposals that sought to have companies implement non-binding shareholder votes regarding their compensation**

- Shareholder proposals fared fairly well in 2008 and 2009

| | Notable Voting Outcomes in 2008 | | Notable Voting Outcomes in 2009 | |
|---|---|---|---|---|
| *Companies where advisory vote proposals received a majority of votes* | Lexmark | 59.8% | Hain Celestial | 62.0% |
| | Motorola | 54.0% | CVS Caremark | 59.0% |
| | Sough Financial | 51.9% | Plum Creek Timber | 56.9% |
| | Apple | 50.7% | Pulte Homes | 53.5% |
| | | | Apple | 51.6% |
| | | | XTO Energy | 51.0% |
| *Companies where advisory vote proposals nearly received a majority of votes* | Hain Celestial Group | 45.6% | Frontier Comm. | 49.6% |
| | Anheuser-Busch | 42.7% | EMC | 49.5% |
| | Citigroup | 41.9% | Windstream | 49.1% |
| | Merrill Lynch | 37.5% | Sempra Energy | 49.0% |
| | US Bancorp | 35.4% | Colgate-Palmolive | 47.5% |
| | Capital One | 34.7% | Altria | 47.0% |
| | BNSF | 33.5% | Allstate | 46.5% |
| | Wachovia | 31.0% | Deere & Co. | 44.3% |

- Several companies voluntarily agreed to adopt such SOP proposals, with some starting in 2009, including:

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Aflac | Blockbuster | Hewlett-Packard | Intel | MBIA | Motorola | Tech Data | Verizon |
| Apple | Clear Channel | Ingersoll-Rand | Lexmark | Microsoft* | Occidental Petroleum | Valero | |

* Triennial pay vote

# Historical Perspective

- Effective February 17, 2009, the U.S. federal government **required** a non-binding vote on executive compensation at all TARP/CPP companies
- Legislation was proposed in 2009 that would have required say on pay proposals at **all** public companies
  - The House of Representatives approved the *Wall Street Reform and Consumer Protection Act of 2009* (H.R. 4173) that would require an annual, non-binding, separate shareholder vote to approve the compensation of executives as disclosed in the compensation committee report, the CD&A, the tables, and any related materials
- SOP shareholder proposals were also the second highest governance proposals put forward for the 2010 proxy season (58 reported by RiskMetrics)
- 2010 legislation includes a SOP vote for all public companies and is likely to be required starting in 2011
  - The *Restoring American Financial Stability Act of 2010* (S.3217) passed by the Senate in May 2010 calls for a non-binding, separate shareholder vote on any proxy to which the SEC's proxy solicitation rules apply to approve the compensation of executives, as disclosed in the proxy
  - S. 3217 also requires that the rules of national securities exchanges prohibit brokers from granting proxies to vote shares on the election of directors, executive compensation (including MSOP votes), and other significant matters (as determined by the Securities and Exchange Commission) unless the beneficial owner has instructed the broker how to vote on the proposal
    - H.R. 4173 does not address broker discretionary voting

# Voluntary Adoption of MSOP Proposals

- As mentioned previously, several companies voluntarily adopted MSOP proposals during 2008, 2009 and 2010. This raises the key question, why did they do it?
  - For some, doing so was viewed as being viewed as a good corporate citizen with good corporate governance
  - For others, it was viewed as a way to placate shareholders and/or proxy advisory firms that kept putting the SOP proposal forward
- If a company is evaluating a voluntary adoption of SOP on pay or if SOP becomes a mandatory requirement, companies should consider the following:
  - Clearly communicate compensation decisions in proxies
  - Focus on shareholder views
    - Most investors want to know what the board has done to establish a compensation plan that supports their corporate strategies, rather than whether the company has complied with guidelines established by proxy advisory firms
    - Investors want the facts and explanations from the company, rather than from firms selling governance opinions
  - Focus on proxy disclosure as the main source of shareholder information and influence
  - Be aware of the recommendations of proxy advisory firms
  - Know your shareholder base
  - Know how many of your shares are likely to be voted, and by whom
  - Explore ways to increase MSOP vote participation
  - Know the impact of broker non-votes and abstentions on your MSOP vote

# Voluntary Adoption of MSOP Proposals

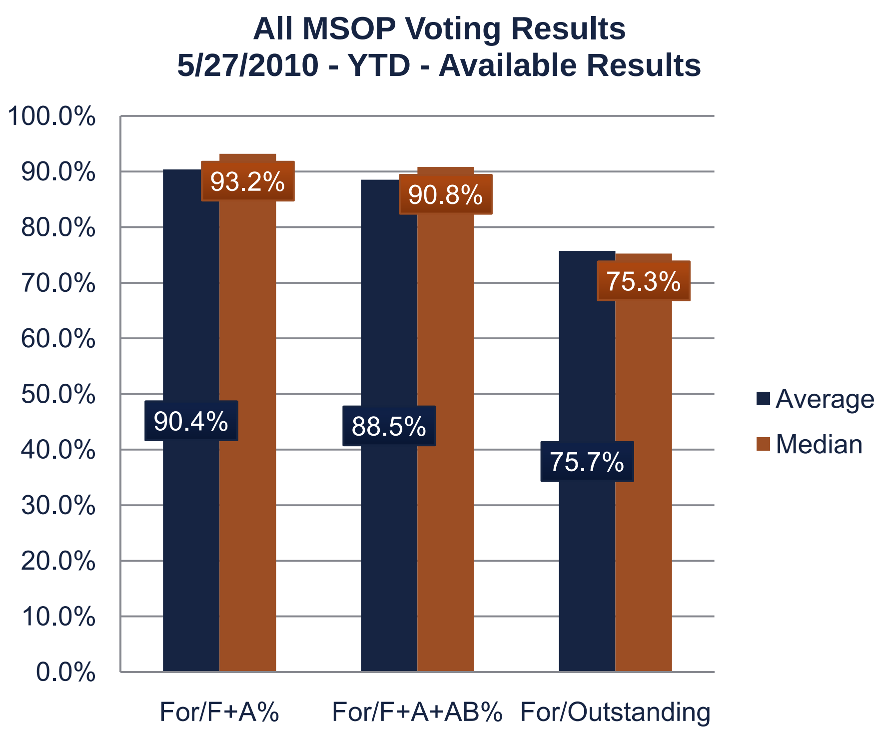
- Companies that have ***voluntarily*** adopted MSOP proposals include:

| | | | |
|---|---|---|---|
| AFLAC | Edison International | Littlefield | State Street* |
| Alaska Air Group | Fifth Third Bancorp* | Logitech | Steris |
| American Express* | Forest Laboratories | MBIA | SunOpta |
| Ameriprise Financial | Frontier Communications | Microsoft | SUPERVALU |
| Apple | Goldman Sachs Group* | Mobile Mini | SYSCO |
| Berkshire Hills Bancorp | Hain Celestial Group | Morgan Stanley* | Tech Data |
| Blockbuster | Hill-Rom Holdings | Motorola | Tecumseh Products |
| Bristol-Myers Squibb | Honeywell International | Occidental Petroleum | PNC Financial* |
| Capital One Financial* | Ingersoll-Rand | Pacific Gas & Electric | Tupperware Brands |
| Charming Shoppes | Intel | Par Pharmaceutical | US Bancorp* |
| CoBiz Financial* | Intuit | Pfizer | Valero Energy |
| Colgate-Palmolive | Jones Apparel Group | PG&E | Wells Fargo* |
| CVS Caremark | JPMorgan Chase* | Prudential | Windstream |
| Ecolab | Lexmark International | Southern California Edison | Zale |

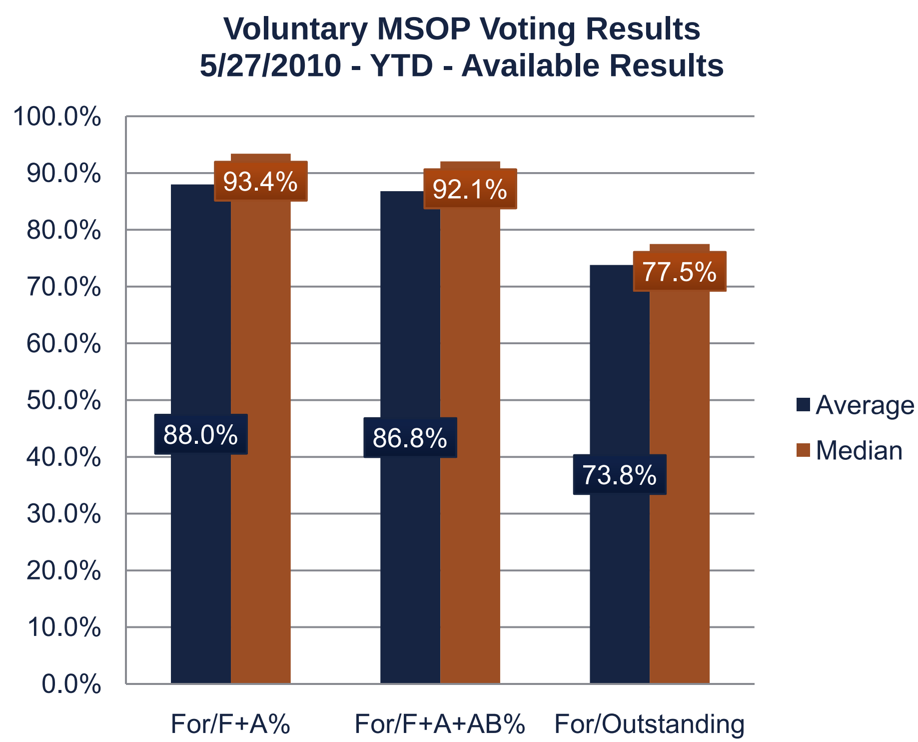
* TARP/CPP company that has since repaid funds to U.S. government, but has or will voluntarily include a MSOP proposal in its proxies

# 2010 Voting on MSOP Proposals

**All MSOP Proposals—Passed and Failed**
(n = 194)

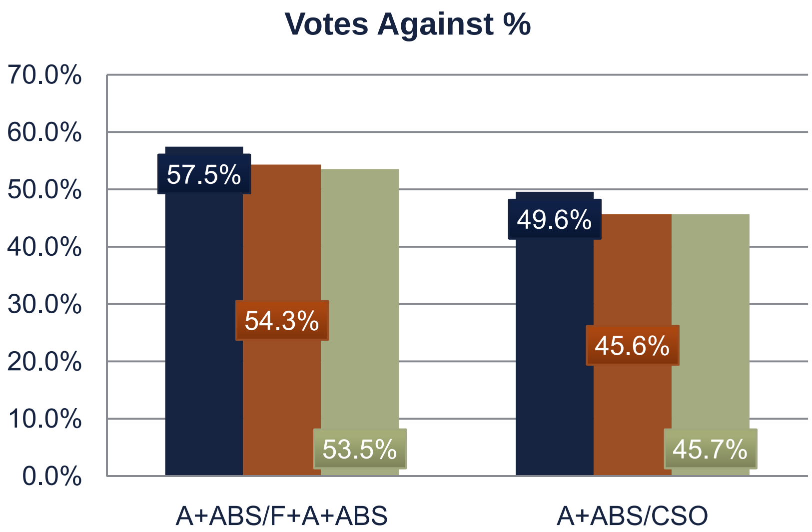


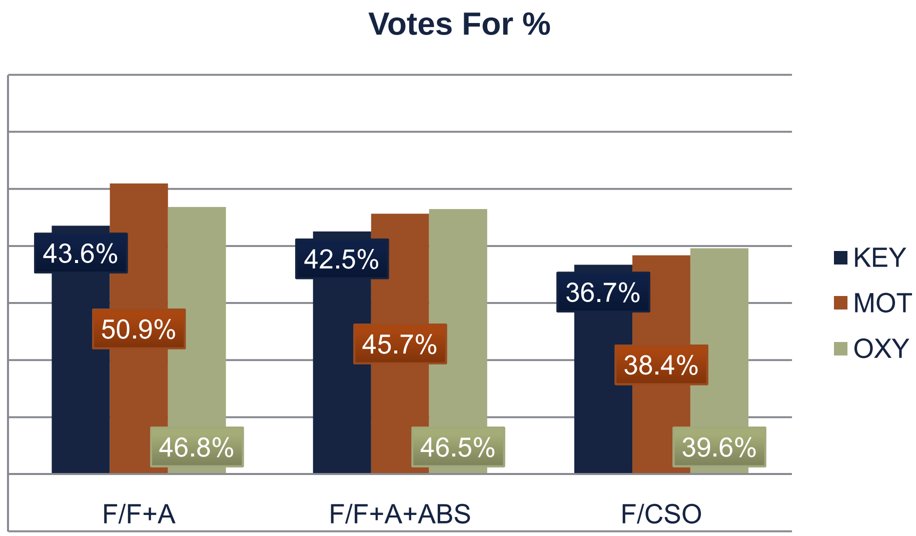

**Voluntary MSOP Proposals—Passed and Failed**
(n = 47)



# 2010 Voting on MSOP Votes That Failed

**MSOP Votes that Failed through May 27, 2010**




**Actual Vote Figures**

| Company | For (F) | Against (A) | Abstain (ABS) | CSO* |
|---|---:|---:|---:|---:|
| KeyCorp | 322,682,561 | 418,099,427 | 17,693,063 | 878,960,282 |
| Motorola | 887,793,923 | 855,021,547 | 201,440,789 | 2,314,437,239 |
| Occidental Petroleum | 321,676,254 | 365,053,432 | 5,722,279 | 812,155,102 |

*As of the proxy record date

# 2010 Voting on MSOP Proposals That Failed

**What were the MSOP proposals that failed?**

| Company | Resolution Voted on by Shareholders |
|---|---|
| KeyCorp (required) | “RESOLVED, that the shareholders approve KeyCorp’s executive compensation, as described in the **Compensation Discussion and Analysis and the tabular disclosure** regarding named executive officer compensation (together with the accompanying narrative disclosure) in this Proxy Statement. “ |
| Motorola (voluntary) | "Resolved, that the stockholders approve the **overall executive compensation policies and procedures** employed by the Company, as described in the **Compensation Discussion and Analysis** regarding named executive officer compensation (together with the accompanying narrative disclosure) in this Proxy Statement." |

# 2010 Voting on MSOP Proposals That Failed

**What were the MSOP Proposals that failed?**

| Company | Resolution Voted on by Shareholders |
|---|---|
| Occidental Petroleum (voluntary) | "RESOLVED, that the stockholders approve the company's **compensation philosophy, objectives and policies as described below**:<br><br>Occidental's executive compensation program is designed to attract, motivate and retain outstanding executives, to incentivize them to achieve superior performance in the pursuit of Occidental's long-term strategic objectives and to reward them for unique or exceptional contributions to overall sustainable value creation for stockholders and the attainment of long- and short-term performance targets.<br><br>Specifically, the program is designed to:<br><br>▪ Maintain a clear linkage between performance and compensation by ensuring that a high percentage of the total compensation of executive officers is "at-risk", *i.e.*, contingent on the achievement of objectively identifiable performance targets;<br><br>▪ Apply clear performance measures and associated time horizons that measure both long-term stockholder value creation and the consistent annual execution of Occidental's business plan;<br><br>▪ Develop and execute a business model that produces returns well in excess of Occidental's estimated cost of capital by focusing compensation targets on the following key elements of value creation: capital allocation, risk management, cash flow, and financial strength and flexibility; and<br><br>▪ Align executive and stockholder interests by requiring a substantial ongoing equity ownership position for executives." |

# 2010 Voting on MSOP Proposals That Failed

**Why did these companies' MSOP Proposals Fail?**

| Company | Concerns Cited by RiskMetrics Group in Opposition to MSOP |
|---|---|
| **KeyCorp** (required) | ▪ **Summary**—pay for performance disconnect; STI plan more discretionary and performance results only generally referenced; same metrics used for both STI and LTI increasing KEY's risk profile<br>▪ **Short-Term Incentives**—more discretionary, performance results only generally referenced; 50% pool funding when target not met (for employees other than NEOs)<br>▪ **Long-Term Incentives**—same metrics used for STI and LTI<br>▪ **Pay for Performance Evaluation**—KEY below GICS peer group median 1- and 3-yr TSRs and 40.8% increase in CEO's compensation with significant increase in value of stock option grants and large salary stock increase<br>▪ **Non-Performance-Based Pay Elements**—historical tax gross-up on perks; frozen SERP and cash balance pension plan with benefits continuing to accrue; annualized salary increase of $2.3 MM<br>▪ **Communication**—risk assessment conducted and did not identify any plan that was reasonably likely to have a material adverse impact on KEY; same metrics used for STI and LTI which increase the company's risk profile |

# 2010 Voting on MSOP Proposals That Failed

**Why did these companies' MSOP Proposals Fail?**

| Company | Concerns Cited by RiskMetrics Group in Opposition to MSOP |
|---|---|
| **Motorola** (voluntary) | ▪ **Summary**—increase of $8 MM in Dr. Jha's payment if separation does not occur; Dr. Jha's amended agreement includes a modified excise tax gross-up provision; and, MOT adjusted results for the MIP program in an inconsistent manner<br>▪ **Short-Term Incentives**—adjusted results for MIP program in an inconsistent manner<br>▪ **Company Peer Group**—several peers outside 0.5x to 2x MOT's revenue<br>▪ **Agreements**—Dr. Jha's payment if business separation does not occur increased from $30 MM to $38 MM (inappropriate "pay for failure" arrangement); contains a modified excise tax gross-up provision |
| **Occidental Petroleum** (voluntary) | ▪ **Summary**—repeated failure to address: pay magnitude; pay disparity; peer group disparity; and, performance target issues<br>▪ **Short-Term Incentives**—performance target issues<br>▪ **Long-Term Incentives**—performance target issues<br>▪ **Company Peer Group**—not disclosed<br>▪ **Agreements**—CEO's CIC agreement has an excise tax gross-up provision |

# International Experience with MSOP Votes

| Country | Advisory / Binding | What is voted on? | Date implemented |
|---|---|---|---|
| U.K. | Advisory, annual | Director's Remuneration Report, which covers pay policy for next year(s) and prior year's compensation for each director (executive) | 2003 |
| Netherlands | Binding, upon policy change | Binding vote to adopt the remuneration policy for executives and major changes to existing policy. Annual Remuneration Report itself is not subject to the shareholder vote | Oct. 2004 |
| Australia | Advisory, annual | Remuneration Report, which discloses compensation practices for directors and NEOs for past year | July 2005 |
| Sweden | Binding, annual | Guidelines for remuneration of senior executives | CG Code: July 2005; Law: July 2006 |
| Norway | Binding, annual | Remuneration policy for senior management for coming year | Jan. 2007 |

Source: *What International Markets Say on Pay, An Investor Perspective*, Institutional Investor Services, April 2007.

# International Experience with MSOP Votes—UK

- MSOP votes were required for public companies in the U.K. starting in 2003 after adoption of the UK's Directors' Remuneration Report Regulations 2002 on August 1, 2002
  - Statement of company's policy on directors' [executives'] remuneration (set forth in Appendix)
- The goals of the MSOP movement in the UK were:
  - Improve the linkage between pay and performance
  - Empower shareholders and improve shareholder democracy
  - Create greater focus and ownership of compensation process by remuneration committees
  - Engage shareholders on remuneration policies in general

# International Experience with MSOP Votes—UK

**Significant UK Shareholder Rejections of Remuneration Resolutions**

| | | | |
|---|---|---|---|
| 2003 | GlaxoSmithKline | **Remuneration report**<br>➢ *excessive severance provisions* | 50.7% votes against |
| 2007 | Ericsson | **Long-term incentive plan**<br>➢ *excessive payout without commensurate performance* | 88.5% votes for, below 90% threshold |
| 2008 | Philips | **Long-term incentive plan**<br>➢ *elimination of one of the two performance targets (TSR)* | 57.8% votes against |
| 2009 | Shell | **Remuneration report**<br>➢ *use of discretion regarding unachieved performance targets (TSR)* | 57.1% votes against |

Source: RiskMetrics Group

# International Experience with MSOP Votes—UK

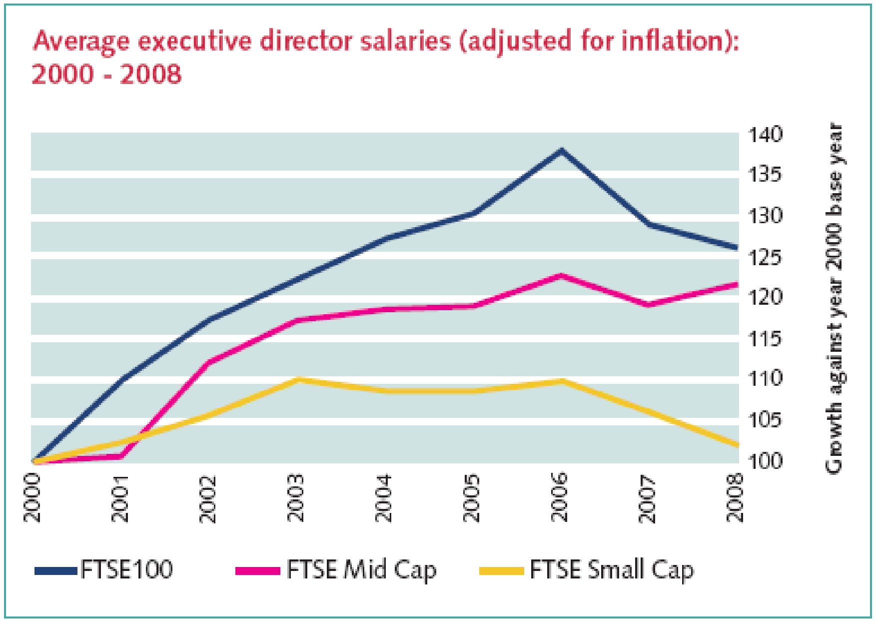
**Top 5 remuneration issues year-on-year in the U.K. (Source: PIRC Limited)**

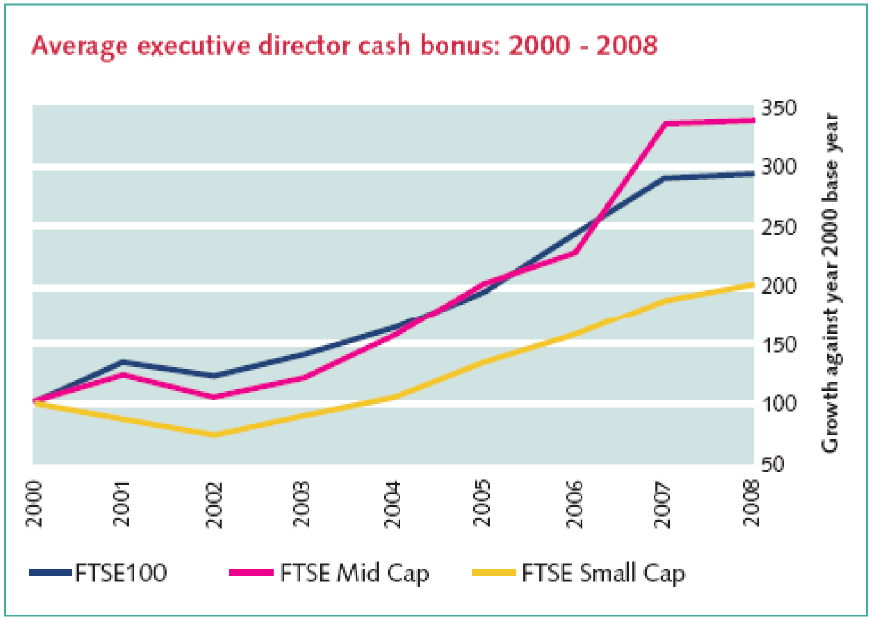
**Type of Issue:** Contracts | "Challengingness" | Dilution | Disclosure | Excessiveness | One-Off Award

| Issue | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|
| 1 | Excessive payout potential | Excessive severance payout | Unchallenging targets | One-off award | Unchallenging targets | Lack of disclosure regarding performance targets | Golden hello |
| 2 | Option scheme for non-executive directors | Breach of US dilution limits | Lack of disclosure regarding performance targets | Excessive liquidation damages | One-off cash bonus | Excessive severance payout | Excessive severance payout |
| 3 | Breach of dilution limits | One-off option award | Excessive severance payout | Lack of disclosure regarding performance targets | One-off award | Unchallenging targets | Unchallenging targets |
| 4 | Breach of US dilution limits | Excessive severance payout | Unchallenging targets | Golden hello | One-off award | Unchallenging targets | One-off award |
| 5 | Breach of US dilution limits | Unchallenging performance conditions / excessive severance payout | Lack of disclosure regarding performance targets | Unchallenging targets | Breach of dilution limits | Excessive liquidation damages | Unchallenging targets |

# International Experience with MSOP Votes—UK

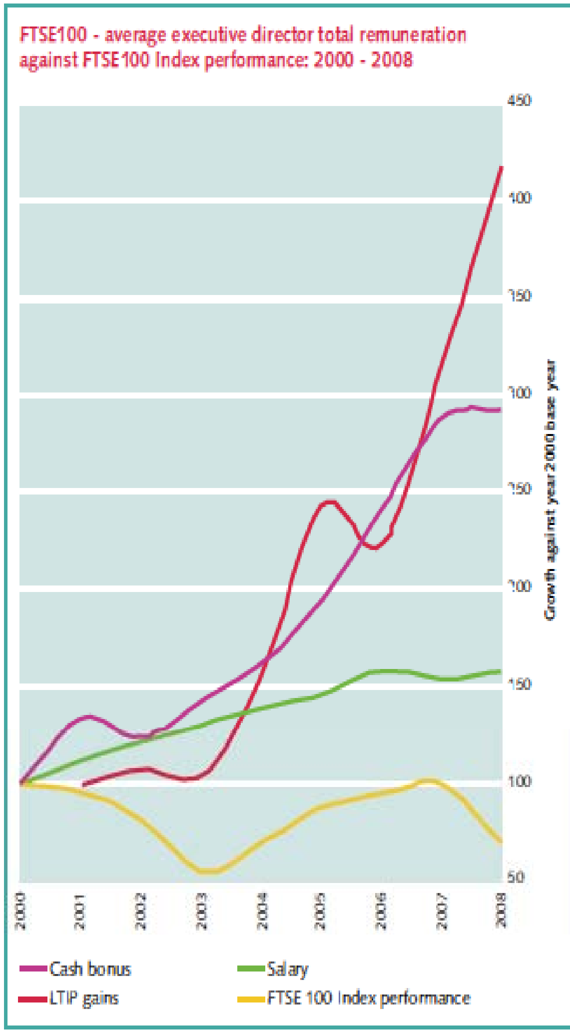
- UK company response
  - Have used the MSOP vote as an opportunity to gain shareholder endorsement of their pay practices
  - More focused engagement process for companies and an increase in engagement activity with shareholders
  - Role of remuneration committees seems to have been enhanced
  - Forced members of committees to take ownership of the remuneration policy and structures
  - Companies have embraced consultation with shareholders
- Impact on executive pay in the UK

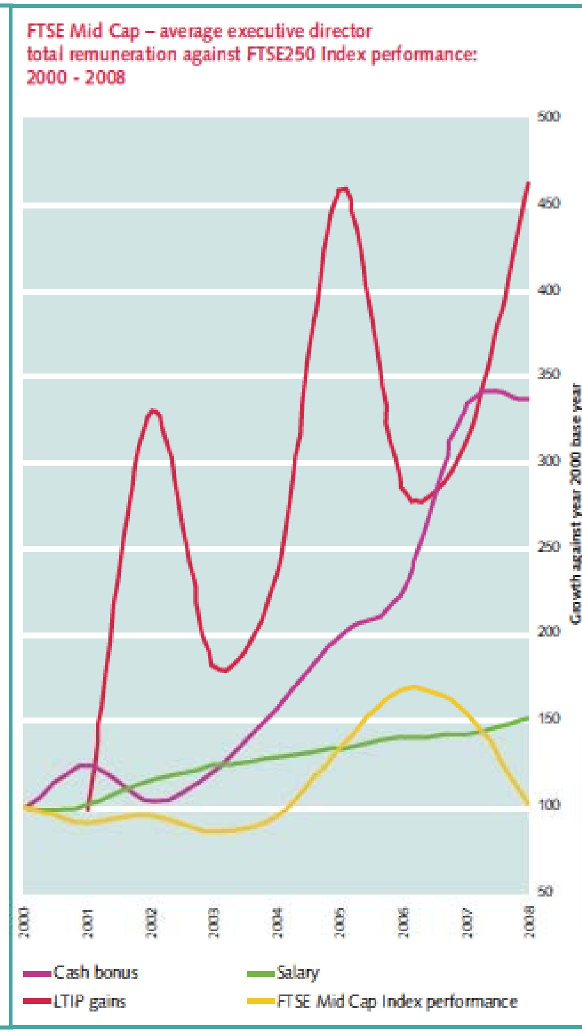


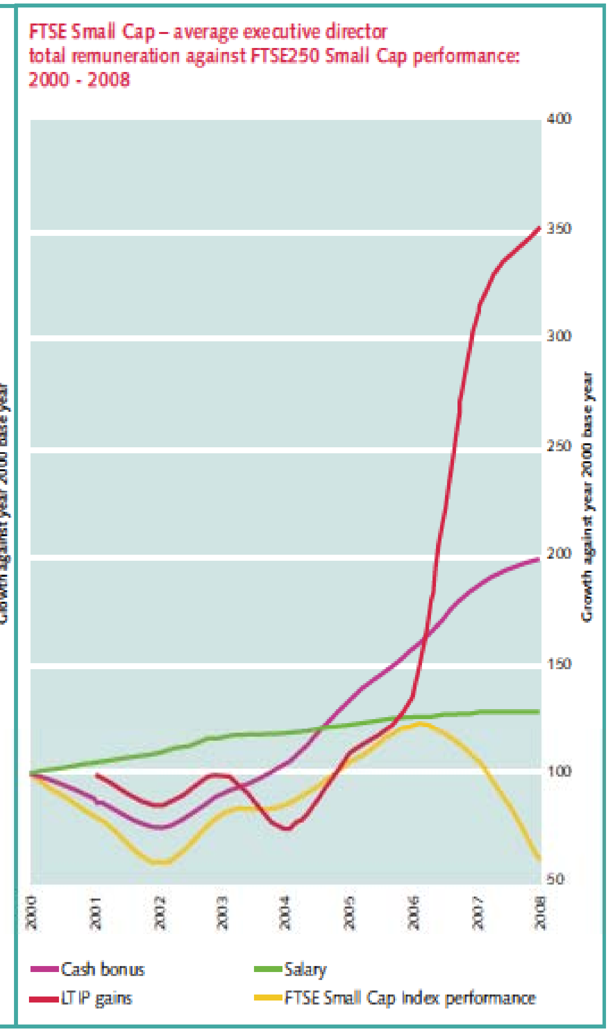




Source: *Say on Pay, Six Years On, Lessons from the UK Experience*, a report by Railpen Investments and PIRC Limited (September 2009)

# International Experience with MSOP Votes—UK

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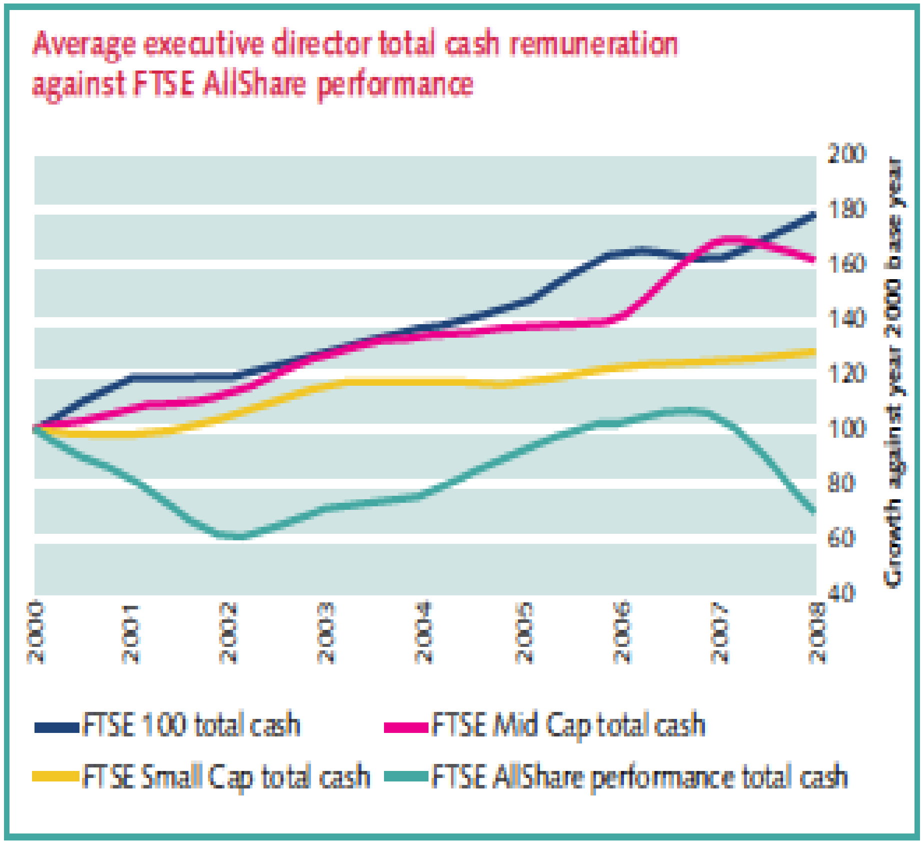
# International Experience with MSOP Votes—UK




Incentive share schemes introduced during by year, by type


| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|
| ESOS | 72 | 43 | 26 | 27 | 15 | 18 | 10 | 12 |
| Matching shares | 11 | 10 | 10 | 22 | 29 | 26 | 4 | 6 |
| LTIPs | 30 | 38 | 36 | 75 | 56 | 107 | 52 | 47 |

Source: *Say on Pay, Six Years On, Lessons from the UK Experience*, a report by Railpen Investments and PIRC Limited (September 2009)

# International Experience with MSOP Votes—UK

**Reasons for UK Shareholders' opposing, abstaining, or voting for an MSOP proposal**

| Voting against: | Voting to abstain: | Voting in support: |
|---|---|---|
| A variety of issues can cause concern:<br>▪ Performance conditions have been changed which causes them to be easier to meet<br>▪ High levels of pay and there is no real link to the performance achieved, or to be achieved<br>▪ Annual bonuses continue to rise and salaries continue to increase, perhaps double digit salary increases become a pattern<br>▪ Structural issues and overall lack of performance linkage<br>▪ Performance targets do not align with the long-term strategy of the company | ▪ No evidence of excess and a good level of disclosure; but salaries have been increased year on year and there is no justifiable reason as to why<br>▪ Overall, there are no structural issues but there is a general lack of disclosure and there is scope for more information to be disclosed and for the company to be more transparent | ▪ Clear disclosure of the main aspects of remuneration (ie, performance criteria, maximum awards, any departures from normal practices/scheme details)<br>▪ No evidence of excess<br>▪ Clear link between pay levels and performance<br>▪ Clear alignment of the interests of shareholders and directors through robust remuneration practices<br>▪ Remuneration committee demonstrates behaviors that protect the interests of shareholders whilst offering pay packages and remuneration policies which allow incentivisation and retention<br>▪ Performance targets for the long-term incentive plans do support the long-term strategic plan of the company |

Source: *Say on Pay, Six Years On, Lessons from the UK Experience*, a report by Railpen Investments and PIRC Limited (September 2009)

# International Experience with MSOP Votes—Australia

**Australia's Proposed Changes to MSOP Votes**

- The Productivity Commission (PC) released a review of executive pay in Australia in January 2010
- The Australian government responded to the PC's report in April 2010 and indicated it would introduce legislation to implement many of the PC's 17 recommendations, including the "two strikes" proposal for MSOP votes
- As currently proposed, the two strikes proposal for MSOP votes would work as follows:
  - A minimum 25% "no" vote on remuneration report triggers reporting obligation on how concerns addressed, and
  - A subsequent "no" vote of at least 25% activates a resolution for elected directors to submit for re-election within 90 days
    - Unclear whether this would apply to the entire board, or just the remuneration committee or chair
- Additionally, the proposals with which the Australian government agreed included:
  - Prohibiting key management personnel from voting undirected proxies on remuneration resolutions, and
  - Prohibiting key management personnel that hold shares from voting on their own remuneration arrangements

# Shareholder Response to MSOP Proposals

- Shareholder response to MSOP votes is likely to be heavily influenced by the ***type*** of shareholder they are:
  - Retail account (mom & pop) shareholders—likely to ignore MSOP votes (and all other votes) unless something captures their attention and makes them want to vote
  - Active investors—short-term (hedge funds, opportunists, etc.)—looking for the lowest cost response that will maximize short-term share returns
  - Active investors—long-term (mutual funds)—looking for low cost response that will maximize long-term share returns
  - Index investors—long-term owners with little overhead costs from investment activities – looking for most effective response that will result in the best long-term share returns possible
- Interestingly, in the UK, it was the index investors which led the adoption of MSOP votes. Largely because they had funds available due to their structure and could not take a “Wall Street Walk” if a company began to disappoint them
  - Felt the best way to improve on their investments was to agitate for change and open dialogues with management and boards

# Shareholder Response to MSOP Proposals

**Several Possible Shareholder Approaches to MSOP Votes**

| Shareholder Approach to MSOP | Cost to Shareholder | Impact on Investment Decision | Impact if Broker Non-Votes Excluded | Other |
|---|---|---|---|---|
| **Ignore** | Low | Neutral | Negative (a broker non-vote); increases influence of shareholders that vote | Likely approach for retail shareholders |
| **Support Management** | Low | Supports | Positive | Sound argument assuming same management as when investment made |
| **Abstain** | Low | Unknown / Negative (depending on how abstentions counted) | Negative | Could be a negative if media focuses on shareholders that do nothing about excessive pay |
| **Develop Own Analysis** | High | Supports | Unknown; to extent shareholder owns significant stakes in many companies, could increase its influence | Complicated, resource intensive task; unable to leverage |
| **Outsource to Proxy Advisor** | Medium (lowest relative cost for informed vote) | Unknown – could support or be negative | Unknown; likely to increase influence of proxy advisors | Provides “cover” for shareholders at lowest cost possible; minimizes cost for informed vote |

# RiskMetrics Group Policies Regarding MSOP Proposals

- Assesses MSOP proposals on a case-by-case basis, considering the following factors in light of a company's specific circumstances and the board's disclosed rationale for its practices:
  - Relative Considerations
    - Assessment of performance metrics relative to business strategy, as discussed and explained in the CD&A
    - Evaluation of peer groups used to set target pay or award opportunities
    - Alignment of company performance and executive pay trends over time (e.g., performance down; pay down)
    - Assessment of disparity between total pay of the CEO and other NEOs
  - Design Considerations
    - Balance of fixed versus performance-driven pay
    - Assessment of excessive practices with respect to perks, severance packages, SERPs, and burn rates
  - Communication Considerations
    - Evaluation of information and board rationale provided in CD&A about how compensation is determined
    - Assessment of board's responsiveness to investor input and engagement on compensation issues
- RiskMetrics Group also will use MSOP proposals as the primary vehicle to address "problematic pay practices"

# RiskMetrics Group Policies Regarding MSOP Proposals

**Problematic Pay Practices**

- Formerly referred to as "poor" pay practices
- Now, two groups:
  - "Major"—can lead to negative vote recommendations if one exists; set out in the 2010 Policy Updates
  - "Minor"—can lead to negative vote recommendations if more than one exists; set out in the 2010 Compensation FAQs
- RMG will utilize MSOP proposals as the initial vehicle to address problematic pay practices. RMG may recommend votes:
  - Against MSOP proposals
  - Against/Withhold from compensation committee members or, in rare cases where full board is deemed responsible for the practice, all directors, or when no MSOP item is on the ballot, or when the board has failed to respond to concerns raised in prior MSOP evaluations
  - Against an equity-based incentive plan proposal if excessive non-performance-based equity awards are the major contributor to a pay-for-performance misalignment

# RiskMetrics Group Policies Regarding MSOP Proposals

### “Major” Problematic Pay Practices

- Multi-year guarantees for salary increases, non-performance-based bonuses, and equity compensation
- Including additional years of service that result in significant additional benefits, without sufficient justification, or including long-term equity awards in the pension calculation
- Perquisites for former and/or retired executives, and extraordinary relocation benefits (including home buyouts) for current executives
- Change-in-control payments exceeding 3 x times base salary and target bonus
- Change-in-control payments without job loss or substantial diminution of duties (“single triggers”)
- New or materially amended agreements that provide for “modified single triggers”
- New or materially amended agreements that provide for an excise tax gross-up (including “modified gross-ups”)
- Tax reimbursements related to executive perquisites or other payments such as personal use of corporate aircraft, executive life insurance, bonus, etc.
- Dividends or dividend equivalents paid on unvested performance shares or units
- Executives using company stock in hedging activities, such as “cashless” collars, forward sales, equity swaps, or other similar arrangements
- Repricing or replacing of underwater stock options/stock appreciation rights without prior shareholder approval (including cash buyouts and voluntary surrender/subsequent regrant of underwater options)

### “Minor” Problematic Pay Practices

- Excessive severance and/or change-in-control provisions
- Payments upon an executive’s termination in connection with performance failure
- Liberal change-in-control definition in individual contracts or equity plans which could result in payments to executives without an actual change in control occurring
- Overly generous perquisites, which may include, but are not limited to, the following:
    - Personal use of corporate aircraft
    - Personal security systems maintenance and/or installation
    - Car allowances
    - Executive life insurance
- Internal pay disparity-excessive differential between CEO total pay and that of next highest-paid named executive officer
- Voluntary surrender of underwater stock options by executive officers
- May be viewed as an indirect repricing/exchange program especially if those cancelled options are returned to the equity plan, as they can be regranted to executive officers at a lower exercise price, and/or executives subsequently receive unscheduled grants in the future
- Other pay practices deemed problematic but not covered in any of the above categories

# Glass Lewis (GL) Policies Regarding MSOP Proposals

- Will support MSOP proposals where:
  - Pay is aligned with performance, and
  - Shareholders are provided with a clear, comprehensive discussion of the processes and procedures related to executive compensation
- Specifically, GL's approach to evaluating MSOP proposals involves the following:
  - CD&A Analysis
    - Evaluates content and clarity, consists of a nuanced approach when assessing companies' rationale for significant adjustments made to performance metrics, target payouts, and benchmarking
    - CD&A disclosure is rated based on a critique of several key elements, including:
      - Whether the company provides a reasonable rationale for benchmarking at a specific percentile
      - Its disclosure of performance metrics
      - Its disclosure of how actual performance translates into pay decisions
      - Its evaluation of a companies' rationale for granting discretionary cash or equity awards, and
      - Its review of the extent to which performance plays a role in the granting of equity incentives
  - Proprietary Pay-for-Performance Analysis
    - Evaluates the relationship between relative executive compensation and relative performance
    - GL benchmarks the compensation of the NEOs to the compensation of the NEOs at peer companies and compares the company's performance to that of those same peers

# Other Influential Voices

**Council of Institutional Investors—Top 10 Red Flags for SOP Voting**

- Stock ownership and holding policies—Do top executives have paltry holdings of company stock and can they sell most of their company stock before they leave?
- Clawbacks—Does the company lack provisions for recapturing unearned bonus and incentive payments to senior executives?
- Performance Drivers
  - Is only a small portion of the CEO’s pay performance-based?
  - Is the company’s disclosure of pay-related risk management controls and procedures non-existent, vague or suggestive of weak oversight by the board?
  - Is the CEO’s annual bonus based on a single metric?
  - Is long-term incentive pay also linked to the same target?
- Perks
  - Are executive perks excessive?
  - Do they seem related to legitimate business purposes?
- Internal Pay Equity—Is there a wide chasm (more than 3 times) between the CEO and those just below?
- Stock Option Practices
  - Did the company reprice underwater stock options?
  - Did the CEO receive options that vest after a period of time, with no performance requirements?
- Performance Goals
  - Did the CEO get a bonus even though the company’s performance was below that of peers?
  - Does the company disclose performance goals?

# Other Influential Voices

**Council of Institutional Investors—Top 10 Red Flags for Say-on-Pay Voting (continued)**

- Post-employment pay
  - Does the company guarantee severance payments to executives who leave as a result of poor performance?
  - Are CIC payments so lucrative as to incent executives to sell the company even if not in the best interests of shareholders?
  - Do retired executives get perks?
  - Does the company make payments beyond earned or vested compensation upon the death of an executive?
  - Do SERPs us guaranteed or above-market rates of return or add phantom years or service or have other sweeteners not available to other employees?
- Compensation policy and philosophy
  - Is the CD&A confusing, vague or incomplete?
  - Does the narrative focus on the what's and how's, with short shrift to the whys?
  - Does the disclosure fail to explain how the overall pay program ties compensation to strategic goals and the creation of shareholder value?
  - Does the company's peers leave you scratching your head, and does the company do a poor job of explaining and justifying its process for selecting pay peers?
- Compensation adviser independence—does the firm advising the compensation committee earn much more from services provided to the company's management than from work done for the committee?

# Other Influential Voices

**The Corporate Library**

- A 10-Point Test, *When we have Say on Pay, how will I decide whether to vote yes or no?*
  Paul Hodgson, Senior Research Associate
  - 10 Ways to Tell if a Company Passes the Compensation Smell Test:
    - Is the CEO's base salary more than $1 million?
    - Did the CEO get a "bonus" as well as a "non-equity incentive compensation" payment?
    - If performance faltered in the past year, did the CEO's annual cash incentives react accordingly and vice versa?
    - Is the CEO paid more than 3 to 5 times the average of the other NEOs?
    - Is the change in pension value and non-qualified deferred compensation (NQDC) earnings larger than other elements of pay?
    - Does the CEO's "all other compensation" stand out?
    - Do the profits made on the exercise of stock options and value realized on the vesting of equity awards seem to match long-term performance?
    - Is the annual bonus based on a single performance metric, and is the long-term incentive based on the same one?
    - Does the company pay incentives for below median performance?
    - Does the CEO's change of control payment look like a conflict of interest?

# Research on Impact of MSOP Votes

| Date | Study | Findings |
|---|---|---|
| June 2008 | Academic Paper by Fabrizio Feri and David Maber, Harvard Business School | ▪ SOP does not have a great impact on most companies<br>▪ No evidence that SOP changes the levels of growth of executive compensation<br>▪ Higher sensitivity of CEO cash and total pay to negative operating performance |
| August 2009 | Jeffrey N. Goldman, Columbia University | ▪ The details of pay-for-performance may be too complex to effectively communicate to shareholders<br>▪ Annual voting requirements may result in a narrow range of compensation best practices<br>▪ Smaller firms would be unlikely to benefit from SOP and restrictions to act like larger firms may negatively impact their ability to grow<br>▪ Truly abnormal pay may be limited to large companies in a small group of industries |
| August 2009 | Jie Cai and Ralph A. Walkling, Drexel University | ▪ Stocks of firms with the highest abnormal CEO pay and low pay-for-performance sensitivity react in a significant, positive manner to SOP<br>▪ More value created in companies with strong ownership by “vote no” mutual funds; dissenting voice creates pressure for change |

Source: Say on Pay, The Real Impact of Shareholders, Regulators, and Governments on Executive Compensation, Updated May 21, 2010, Dan Walter, CEP, Performensation

# Outlook for Mandatory MSOP in 2011 and Critical Steps

- MSOP proposals are likely to be ***required*** for 2011 and beyond (new reality for public companies in the U.S.)
  - MSOP provisions included in both the House of Representatives' and Senate's financial reform legislation (H.R. 4173 and S. 3217)
  - Form likely will be a comprehensive vote (yes/no) on all the executive compensation disclosed in the proxy—CD&A, required tables and associated narrative
  - Timing will typically be an annual vote; but, could end up with more than one vote each year in certain situations, i.e., if a company has to put out more than one proxy in a year which must disclose compensation then the current language of S. 3217 would require a MSOP vote on each proxy
- Shareholders will likely continue to scrutinize MSOP proposals
- Critical steps:
  - Know your shareholder base, what they want and what they do not like regarding your compensation policies, designs, awards and payments
  - Open up lines of communication with your shareholders before next proxy season – both the investment and voting sides of your institutional shareholders
  - Understand what compensation issues your shareholders could have with your company, and how those might influence their vote on MSOP proposals and your directors
  - Explore ways to address any perceived issues with your compensation
  - Evaluate any compensation changes or tweaks through the rubric of the MSOP vote so you can anticipate any negative reaction that such changes or tweaks might engender and act to minimize or address any shareholder concerns
  - Review disclosures to ensure executive compensation is understandable (plain English, executive summary, charts, graphs, tables should be utilized as much as possible), the whys of compensation decisions are explained, and the rationale for controversial pay practices is clearly articulated

# Appendix

# UK Company Law Disclosures Requirements

**Statement of company's policy on directors' remuneration**

3. (1) The directors‘ remuneration report must contain a statement of the company‘s policy on directors‘ remuneration for the following financial year and for financial years subsequent to that

(2) The policy statement must include—

(a) for each director, a detailed summary of any performance conditions to which any entitlement of the director—

(i) to share options, or

(ii) under a long term incentive scheme, is subject

(b) an explanation as to why any such performance conditions were chosen

(c) a summary of the methods to be used in assessing whether any such performance conditions are met and an explanation as to why those methods were chosen

(d) if any such performance condition involves any comparison with factors external to the company

(i) a summary of the factors to be used in making each such comparison, and

(ii) if any of the factors relates to the performance of another company, of two or more other companies or of an index on which the securities of a company or companies are listed, the identity of that company, of each of those companies or of the index

(e) a description of, and an explanation for, any significant amendment proposed to be made to the terms and conditions of any entitlement of a director to share options or under a long term incentive scheme; and

(f) if any entitlement of a director to share options, or under a long term incentive scheme, is not subject to performance conditions, an explanation as to why that is the case