MARKET REPORT

Evaluating U.S. Company Management Say on Pay Proposals

Four Steps for Investors

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KEY TAKEAWAYS

Thanks to the American Recovery and Reinvestment Act of 2009, signed by President Obama on Feb. 17, 2009, investors will face more than 300 advisory "say on pay" proposals in 2009 at companies that are participating in the U.S. Treasury's Troubled Asset Relief Program. In addition, approximately 15 other firms have voluntarily agreed to seek non-binding shareholder ratification of their executive pay programs this year. Shareholders will need to evaluate each company's compensation program in order to determine their votes.

- Unlike many other markets, the U.S. has no officially sanctioned code of corporate governance, or executive pay, although a body of generally accepted best practices continues to grow.

- While the SEC has issued little guidance for say-on-pay proposals, to date only a few companies have taken unique approaches to the proposal language; companies may continue to have some flexibility in that regard, however. An evaluation should begin with determining what the proposal is asking for. The wider the scope of the proposal's resolve clause, the wider the scope of the compensation analysis needed to conclude a vote for or against the proposal.

- Shareholders will likely consider specific areas of evaluation, chiefly: executives' pay relative to company performance; the relationship of incentive performance metrics and goals to the company's stated business strategy; the appropriateness of "non-performance related" pay elements and the company's pay benchmarking practices; clarity of disclosures; and the company's responsiveness to shareholder input on executive pay issues.

- In light of questions about incentives that may have contributed to "excessive" risk-taking at financial services companies, investors are also beginning to appreciate techniques that may mitigate risk-taking and strengthen long-term alignment between executives' and shareholders' interests, such as stringent "claw-back" policies, substantial holding requirements and/or bonus "banks" that tie ultimate payouts to sustained positive performance.

- Ultimately, each vote determination may involve a holistic evaluation of the company's pay system and its relationship to actual and potential long-term shareholder value. That said, high opposition votes for management say-on-pay proposals in the U.S. market are most likely to be seen at "outlier" companies that demonstrate poor board stewardship of shareholder interests with respect to executive compensation programs.

Say on Pay in 2009

The debate over "say on say" has moved from "whether" to "how" – specifically, how shareholders will evaluate these proposals at U.S. companies. The American Recovery and Reinvestment Act ("economic stimulus bill") passed by Congress, and signed by President Obama on Feb. 17, 2009, requires every company receiving government assistance under the TARP to obtain advisory shareholder approval of the company's executive compensation program. With the prospect of a broader mandate also growing, investors will need to determine which aspects of pay programs are most critical, and how their votes should be used to convey satisfaction or dissatisfaction with specific practices or the overall pay strategy.

Unlike many other markets, the U.S. has no officially sanctioned code of corporate governance, or executive pay. The economic stimulus bill included several other restrictions on compensation at TARP companies; however, these are scheduled to lapse when the company repays the funds received under the Capital Purchase Program (CPP) or other government assistance, and observers have already raised concerns about potential unintended consequences of restrictive regulation of compensation. While there is no code or even broad consensus about acceptable pay practices, a body of proposed best practices continues to grow, including in response to the current financial crisis. This paper summarizes the key factors that may be considered in evaluation of management say-on-pay proposals, with particular focus on the evaluation approach used by RiskMetrics Group (RMG) and outlined in RMG's U.S. Proxy Voting Manual.

A Brief Look Back

European Roots

A brief review of the origins of these proposals may be instructive before addressing the components that should constitute a compensation analysis to reach a vote recommendation.

"Say on Pay" refers to management proposals seeking shareholder ratification of executive compensation programs. These are typically non-binding, or advisory, as is the case with those that originated in the United Kingdom. With the introduction of the 2002 Directors' Remuneration Report Regulations in the U.K., companies were required to issue an explanatory remuneration report for their directors and allow shareholders an advisory vote on it. One of the first votes against management occurred in 2003 at pharmaceutical giant GlaxoSmithKline (GSK). With a 50.7 percent vote against several elements of its compensation structure and significant pressure from the media, GSK made a number of reductions to the compensation package for its CEO over the next few years. GSK also launched an active communication campaign with its individual and institutional shareholders during this time. Due to the company's active response to the high opposition vote, shareholders realized the value such a vote could provide. In 2005, Sweden and Australia both adopted requirements for non-binding shareholder votes on remuneration reports. A few other markets, such as the Netherlands, require binding shareholder approval of the executive remuneration policy.

U.S. Landscape

The "say on pay" concept began to take hold in the U.S. in 2006, amid option backdating scandals and continuing media focus on lucrative executive severance packages. Enhanced disclosure requirements released by the Securities and Exchange Commission ("SEC") in 2006 provided greater transparency that enhanced shareholder understanding of executive pay practices. Unlike in Europe, however, "say on pay" was not initiated through that regulation. Instead, the American Federation of State, County, and Municipal Employees ("AFSCME") filed the first shareholder proposals in the US that sought a non-binding referendum on executive compensation.

The shareholder proposal, submitted to eight companies for 2006 shareholder meetings, asked for pay votes patterned after those adopted abroad, and received significant support (about 40 percent, on average, for seven that came to a vote). By mid-2007, a "Working Group on the Advisory Vote on Executive Compensation Disclosure" was formed, comprised of representatives from four U.S. state pension funds, two large funds from the U.K., and a number of publicly traded companies. Since that time, more than a dozen companies – including some that participated in the original working group – have voluntarily agreed to put forth non-binding management proposals for advisory shareholder votes on compensation. In 2008, there were seven such votes (including at RiskMetrics Group – RMG), all of which "passed," although the resolution at Jackson Hewitt Tax Services received relatively high opposition of 37.5 percent of votes cast for and against (see the chart below).

On the regulatory front, a "Say on Pay" bill aimed at addressing shareholders' concerns over excessive executive pay in the U.S. was introduced in the House of Representatives in February 2006. Sponsored by Rep. Barney Frank (D-Mass.), the "Shareholder Vote on Executive Compensation Act" would have allowed shareholders of US companies to cast a non-binding advisory vote to approve executive compensation packages. The bill also would have required a shareholder vote on the "golden parachutes" provided to executives in the event of a change in control or sale of the company. This bill passed in the House by a wide margin of 269 to 134, but the companion bill never left committee in the Senate, where it was sponsored by then Sen. Barack Obama.

The financial services meltdown and resulting global economic crisis put new focus on executive pay, first raising questions about the role played by incentives in motivating managers to take "excessive" risks that ultimately toppled their companies and destroyed trillions in shareholder value. Draft legislation that implemented TARP and the related Capital Purchase Program (CPP) originally included a requirement for participating companies to offer advisory votes on compensation to their shareholders. The final bill excluded that provision, although it retained certain restrictions on pay to executives of TARP companies.

Ensuing events—including images of CEOs "corporate jetting" to Washington to request taxpayer funding, and reports of luxury office upgrades and conference events as well as millions of dollars of bonus payments to employees of struggling investment banks—revived legislative interest in broader regulation of executive pay. Ironically, the say-on-pay concept was intended to provide a market mechanism to restrain compensation and avoid the need to regulate it. But the economic stimulus bill that President Obama signed on February 17, 2008, stipulated both a range of pay restrictions and a requirement that all TARP participants, both current and future, seek non-binding shareholder approval of their executive pay programs. Sen. Christopher Dodd (D-Conn.), whose amendment to the bill instituted this reform, indicated in a letter to the SEC his belief that say-on-pay votes would be required at all covered companies that issued their proxy statements after the Feb. 17, 2009 effective date of the legislation, which view the SEC subsequently endorsed.

Analyzing "Say on Pay" Proposals

With hundreds of management sponsored say-on-pay proposals now looming for the U.S. proxy season, investors are considering how they will approach analyzing and voting on them. The format and components of "Say on Pay" proposals seen to date are generally the same, with some exceptions. A "resolve clause" specifies out what shareholders will vote on. In 2008, there were essentially three variations:

- AFLAC, H&R Block, Inc. – one general resolution:

  Resolved, that the shareholders approve the overall executive pay-for-performance compensation policies and procedures employed by the Company, 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.

- Littlefield – two resolutions:

  A. The President & CEO's total compensation is within 20% of an acceptable amount.

  B. The Director total compensation is within 20% of an acceptable amount.

- RiskMetrics Group: three resolutions:

  A. Resolved that the shareholders approve the Company's overall executive compensation philosophy, policies and procedures, as described in the Compensation Discussion and Analysis (Sections I and II) in this Proxy Statement.

  B. Resolved that the shareholders approve the compensation decisions made by the Board with regard to NEO performance for 2007, as described in the Compensation Discussion and Analysis (Sections III and IV) in this Proxy Statement.

  C. Resolved that the shareholders approve the application of the Company's compensation philosophy, policies and procedures to evaluate the 2008

> performance of, and award compensation based on, certain key objectives, as described in the Compensation Discussion and Analysis (Section V) in this Proxy Statement.

The resolve clause has been the focus of much debate surrounding "say on pay" proposals. Critics contend that, regardless of the voting results, a broad proposal will not provide the Compensation Committee with information specific enough to act upon, since they will not know what aspect of the total executive compensation package shareholders approved or disapproved. Supporters note that, in the absence of say-on-pay proposals, the recourse most available to shareholders who object to company pay practices is to withhold votes from, or vote against, directors who serve on the Compensation Committee, which also does not pinpoint the source of dissatisfaction.

Four Steps to a Say-on-Pay Analysis

Investor expectations and perceptions of executive compensation practices vary widely. Unlike many markets, the U.S. has no governance code establishing guidelines for pay; neither are there broadly accepted best practices, although there is a growing body of best practice literature. RiskMetrics Group (RMG) utilizes a comprehensive process to evaluate advisory pay resolutions and to provide a recommendation for clients under its benchmark voting policy, and many investors may use a similar approach, which can be summarized in the four basic steps outlined below.

Step One: Determine what the proposal asks for

The evaluation of any proposal begins with determining what the proposal is asking for. This sets the direction of the analysis by targeting the compensation component or components the analysis should focus on. Most management say-on-pay proposals seek shareholder ratification of the executive compensation section of the proxy statement, including the Compensation Disclosure & Analysis (CD&A), i.e., discussion about the pay philosophy and programs; and the compensation tables, i.e., the actual amounts paid or accrued for the prior fiscal year to the five highest paid executive officers, as named in the proxy statement (NEOs).

The SEC has indicated that it will not stipulate specific language for proposals mandated for TARP participants by the economic stimulus bill, relying instead on the legislation's requirement that affected companies allow a non-binding shareholder vote to approve their executive compensation, as disclosed in the CD&A, related compensation tables, and other related material disclosed in accordance with SEC rules. While most companies are expected to utilize what has become fairly standard proposal language (see the Aflac and H&R Block examples, above), some may take more targeted approaches that should further guide evaluations.

Step Two: Identify the data required

The typical proposal calls for a comprehensive review of the overall executive pay policies and specific elements. This information is concentrated in the CD&A section of the company's most current proxy statement, as well as 8K, 10K and other SEC filings from the company since the last shareholders meeting. Clear disclosures will facilitate data collection and avoid misunderstanding about a company's programs and intent. While CD&A's necessarily include some redundant discussions in different sections—about the features of incentive awards, for example—it is important for companies to present information in a consistent fashion to avoid confusion.

Analysis should encompass all NEOs but will likely focus on the CEO, who sets the compensation "pace" at most companies. In addition to contractual arrangements and pay programs or policies, investors' review will encompass pay amounts reported for the prior fiscal year. That generally includes the "grant-date value" of equity-based awards, rather than the accounting expense amount cited in the Summary Compensation Table. That is because most investors view the grant-date value of these awards as the most relevant measure of the level of compensation that the board intended to deliver to top executives in that year. Other elements should also be reviewed, such as performance metrics and goals (if disclosed), bonus and long-term incentive targets, and non-performance-based pay elements such as perquisites; tax gross-ups, supplemental executive pensions (SERPs) and other deferred compensation arrangements, and potential severance in the event of an executive's termination without cause (the most common separation scenario for top executives) or termination in connection with a change in control.

Step Three: Ask the key questions

Once the compensation data is compiled, organizing it chronologically may assist in establishing the chain of events that have created the current compensation packages and practices. Each of the following questions focus on components that may be considered with respect to most proposals:

1. *Does the company demonstrate a strong link between executive pay and performance?*

Although a company may state that its compensation philosophy is to "pay for performance," investors generally wish to confirm that actual and potential pay support this philosophy. This requires a comprehensive evaluation of the pay elements and the company's strategy in linking a substantial portion of top executives' pay to the accomplishment of its business strategy and to shareholder value creation. It is helpful to break down the elements of the CEO's total annual direct compensation (TDC) into slices of a total pay "pie," for example, to see the proportions of performance and non-performance-based compensation.

The CEO's TDC should be evaluated in the context of performance achieved. Investors may question why a CEO's pay has increased, for example, if the company's shareholder return has lagged its peer group for an extended period. Additionally, the total pay package should not be overweighted with high levels of "non-performance-based" elements, such as perquisites, supplemental pensions (SERPs), and severance.

2. *How does the company use employment agreements?*

Many companies argue that payments made to executives are required per the terms of their employment agreements, which are binding legal documents. This does not exempt the company from scrutiny, however, as the board and compensation committee are responsible for approving the terms of these agreements when they are initiated. The board should utilize a compensation "tally sheet" to ensure that potential payments under a proposed contract will not be deemed excessive in certain circumstances, such as the executive's departure after a severe performance decline.

It is useful to note the terms of the CEO's employment agreement, including length. Best practice guidance increasingly suggests that contracts should be used for limited periods, e.g., the first two to three years after a top executive is recruited, rather than indefinitely. Importantly, does the employment agreement provide for guaranteed and/or recurring base pay increases or cash or equity-based incentives regardless of performance? If so, this is in conflict with the pay for performance philosophy.

3. *Are severance and/or change-in-control provisions reasonable?*

A key consideration is the potential of "pay for failure" scenarios due to generous severance packages or other post-termination pay. If the company has a severance policy or agreements, it is important to review the termination scenarios that would provide a payment (detailed in the last section of the CD&A). What potential payments are provided, and for how long?

Long-standing tax code provisions established three-times annual pay as a reasonable "golden parachute" package. Change-in-control triggers should also be considered. Industry best practice is referred to as a "double-trigger," which requires two events to take place: both a change in control and termination of employment (either by the company or by the executive for a defined "good reason"). Modified single-triggers allow a departure with severance, at the executive's sole discretion, generally within a stipulated period of time. Ultimately, this may give the executive no incentive to stay at the newly formed company beyond that time, requiring the new company to offer a more lucrative compensation package in order to retain him or her. Most problematic is a "single trigger," which provides severance payments regardless of any job loss or diminished responsibility.

Excise tax gross-ups have come under increasing criticism. These payments are designed to compensate an executive for the 20 percent penalty tax levied on "excess" golden parachute payments made in connection with a change in control. RiskMetrics' analysis of potential parachute payments disclosed by S&P 500 companies in their 2008 proxy statements indicated that companies that offer excise tax gross-ups to executives tend to pay much higher severance packages than those that do not. Companies are beginning to eliminate these provisions as a best practice. It should be noted that the high payouts triggering an excise tax are typically due to accelerated vesting of equity-based awards upon a change in control. Although this practice remains widespread, it is receiving increasing scrutiny. Many argue that the benefits of long-term performance awards should not automatically accrue to executives solely due to a change in control, but rather should continue in some form unless the individual's employment terminates.

4. Is the company's compensation peer group appropriate?

Does the company disclose its peer group and the criteria used when selecting compensation benchmarks? Are the selected companies a reasonable match? Are these companies in a similar industry? Are they similar in size, based on annual revenue or market capitalization? Peer group selection is a highly-debated issue among Compensation Committees and corporate governance advocates, amid suggestions that pay benchmarking has contributed to executive pay inflation as companies "leapfrog" one another to pay above median compensation for perceived superior performance or to be competitive. Since compensation tends to be highly correlated with company size, benchmarking is especially sensitive to this factor: selecting peers with significantly higher annual revenue can inflate the median salary and total compensation benchmarks of the peer group.

Further, if the Compensation Committee has targeted above median rates for base pay, incentives, or equity awards, a strong justification should be provided. "Competitiveness" alone is a weak argument. If the company selected peer companies with higher revenue than their own, and also targeted above-median compensation levels, it is likely that its executives' compensation has been inappropriately elevated.

5. Are the performance criteria and target thresholds appropriate?

This is probably the most challenging aspect of a say-on-pay evaluation, but one that is of critical importance to shareholders in evaluating the Compensation Committee's oversight of management pay. Essentially, investors seek assurance that the performance metrics utilized for incentive awards make sense relative to the company's business strategy. For example, if both annual and long-term incentives are tied to earnings or EPS metrics, executives may be too focused on short-term performance at the expense of longer term shareholder value (or may even be tempted to manipulate financials to maximize earnings). Although investors generally do not seek to "second guess" management's choice of reasonable yet challenging performance goals, disclosure in the CD&A should provide meaningful justification for the performance targets. Additionally, the analysis should focus on the performance targets versus the actual performance reached and the cash and equity awards provided. If executives did not reach the performance targets for a bonus payout, did the company provide a payout anyway? This practice would not be considered pay for performance. If so, what was the company's explanation as to why?

Also considered is the company's commitment to variable pay. In the current economy, for example, many companies are finding that the performance thresholds set at the beginning of the year or long-term cycle will not be met, or that a high proportion of stock options are underwater. In general, performance metrics and thresholds should not be changed mid-cycle due to market conditions. If the performance thresholds are not reached, targeted payments or equity awards should not be made, particularly to the most senior executives whose long-term incentives should be closely aligned with shareholder interests.

In light of questions about incentives that may have contributed to "excessive" risk-taking at financial services companies, investors are also beginning to appreciate techniques that may mitigate risk-taking and strengthen long-term alignment between executives' and shareholders' interests. For example, does the company have a comprehensive "claw-back" policy requiring executives to repay rewards if it is subsequently determined that they were based on inaccurate financial returns? Are there substantial holding requirements for shares delivered via incentive awards, to ensure executive alignment with long-term shareholder value? Does the company utilize bonus "banking," to tie ultimate payouts to sustained positive performance? While these features have not yet been widely adopted, they may be viewed as positive elements at companies seeking shareholder approval of say-on-pay resolutions.

6. Is there significant pay disparity among top executives?

Is the company overpaying the CEO relative to other key executives? Is his (or her) base salary and/or total compensation several multiples higher than that of the next highest paid executive officer, for example? This may create tension within the executive team and suggests that the board is not encouraging development of in-house talent in its CEO succession planning.

7. What perquisites are provided to executives?

Does the company provide excessive perquisites, and are tax gross-ups paid on top of these? For example, does the CEO have a high amount of imputed income for personal use of corporate aircraft or for security services, with the company grossing up those amounts to cover the resulting additional taxes? Or, has the company made a point to eliminate perquisites?

The practice of providing executives with perquisites is on the decline in recent years. While most shareholders do not criticize moderate use of perquisites for executives, excessive perks and other forms of pay that are unrelated to performance may contribute to an "entitlement" mentality among senior managers. Disproportionate personal use of corporate aircraft, expensive home security systems, and even generous auto and/or relocation allowances, especially when provided with tax gross ups, may be a particular concern in the context of the total pay evaluation.

8. Is the compensation disclosure clear and complete?

The ease of data collection related to a say-on-pay analysis provides insight into the strength and clarity of a company's compensation disclosure. Rationale about how compensation is determined and why certain elements and pay targets are used should be clearly articulated in the CD&A. Companies should disclose the retrospective goals that generated specific payouts, as well as prospective goals when that is reasonable. Although all publicly traded companies are required to follow the CD&A guidelines established by the SEC, significant discretion is allowed in the narrative disclosure, and companies should take care to provide comprehensive yet succinct discussion. Enhanced SEC disclosure requirements have provided unprecedented detail about U.S. public company executives' pay, but the SEC has made it clear that the "why" is as important, if not more so, than the "what" and "how" of top management pay packages.

9. Is the board responsive to investor input on compensation issues?

Many supporters of the concept of advisory votes on executive compensation maintain that its key benefit is in increasing the sensitivity of boards and management to investor views about the pay program. In markets such as the U.K. and Australia, "say on pay" is credited with encouraging engagement and consideration of shareholder input prior to actual votes.

Most U.S. corporations have a widely dispersed investor base, but more companies are establishing communication channels with investors, including scheduling regular meetings with large investors. In addition, shareholders may express opinions through votes on a variety of shareholder proposals. While recognizing the fundamental role of the board and compensation committee to oversee top management's compensation, shareholders expect directors to acknowledge and respect the judgments expressed through their voting. A board's disregard for investors' input on pay issues indicates that directors may not be aligning the program with shareholder interests.

Step 4: Draw conclusion and determine vote decision

Answers to the above questions will paint a detailed picture of the company's compensation practices. Different investors will "weight" each component of the analysis in their own way to determine how to vote on a say-on-pay proposal. Persistent concerns about spiraling pay levels, perceived executive "greed," and a short-term incentive focus that risks long-term sustained performance will motivate most investors to thoughtfully assess whether pay systems are designed to maximize long-term shareholder value or are overly driven by competitive considerations and/or management self-interest. Most will base their vote on the overall balance of pay practices, including consideration of particularly egregious practices. And notwithstanding special cases, such as the TARP companies now subject to various regulatory limitations, shareholders will continue to expect compensation committees to ensure that top executives' pay is competitive, effective, and largely performance-driven.

2008 Advisory Votes

Several U.S. companies elected to present non-binding "say on pay" proposals on their ballots for 2008 shareholder meetings. As cited above, most of these utilized a generic approach in seeking shareholder ratification of the compensation program presented in the CD&A and related tables in the proxy statement. Both RiskMetrics Group and Littlefield took an alternative approach in specifying particular aspects of their compensation programs for shareholders to ratify. All of the proposals received a majority of favorable votes; Table 1 shows the result and support levels as a percentage of all votes cast.

Table 1: Management Say-on-Pay Vote Results at U.S. Companies in 2008

Company	Result	% Support from All Votes Cast
AFLAC Incorporated	Pass	93.1
RiskMetrics Group, Inc-Compensation Philosophy	Pass	94.1
RiskMetrics Group, Inc-2008 Compensation	Pass	94.2
RiskMetrics Group, Inc-2009 Performance Objectives	Pass	94.1
H&R Block, Inc.	Pass	89.6
Littlefield-CEO Compensation	Pass	96.8
Littlefield-Director Compensation	Pass	97.2
Jackson Hewitt Tax Service, Inc.	Pass	53.6
Zale Corp.	Pass	93.8

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