THOUGHTFUL PAY ALERT

Compensia

APRIL 30, 2008

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10 Questions (and Answers) About "Say on Pay"

As the 2008 proxy season unfolds, it is becoming increasingly clear that executive compensation is the predominant topic on shareholders' minds. The agendas of many annual meetings feature a shareholder proposal (or two) seeking to influence, if not change outright, a company's executive compensation practices. Chief among these initiatives is the proposal calling for an advisory vote on executive compensation, or "Say on Pay."

Unlike most shareholder proposals on executive compensation matters, Say on Pay is a recent phenomenon. In three short years, it has gone from a novel idea at the margins of the executive pay debate to center stage as the leading hope for ensuring shareholders have a voice in the compensation-setting process.

What is Say on Pay? Where did it originate and where is it going? What are its potential implications for companies and their shareholders, and for executive compensation programs generally? To help you sort through these issues, here are 10 questions and answers about an advisory vote on executive compensation.

1. What Is Say on Pay?

"Say on Pay" is the name commonly given to the practice of an annual shareholder advisory vote on executive compensation. In essence, each year, at its annual meeting, a company would solicit feedback on its executive compensation program from its shareholders by asking them to approve its executive compensation policies and practices as reflected in the executive compensation disclosure included in its proxy statement. The belief is that giving shareholders a referendum on executive compensation will decrease the temptation to provide overly-generous compensation packages to senior executives and enhance the relationship between pay and performance.

In reality, the name "say on pay" is a bit of a misnomer. First, the vote is nonbinding; that is, a company is not obligated to abide by its outcome or take any specific action in response. Instead, the result simply would be an additional factor for the board of directors or board compensation committee to consider in setting the company's executive compensation policies and implementing specific pay practices.

Second, the vote would not affect any actual individual executive compensation decisions. Rather, it would serve as a referendum on a company's executive compensation philosophy and whether it is executing that philosophy in a thoughtful and effective manner. Nonetheless, the name has caught on and today virtually everyone refers to this advisory vote – and its various permutations – as Say on Pay.

Nonetheless, the vote would have tremendous symbolic importance, operating as the equivalent of a vote of "no confidence" in the company's executive compensation program. Thus, it would have the potential to significantly influence the executive pay-setting process.

2. Where Did Say on Pay Come From?

Advisory votes on a company's executive compensation program originated in Europe. The practice first began in the United Kingdom in 2003 under a law (Statutory Instrument 2002 No. 1986) permitting the shareholders of United Kingdom-quoted companies to cast an advisory vote on the traditional Directors' Annual Remuneration Report (describing a company's executive compensation practices and decisions) that is presented to shareholders each year. This advisory vote was viewed as a relatively simple mechanism to enable shareholders to directly offer their opinion about the company's executive compensation program and to provide feedback on whether they viewed the program as being properly aligned with their interests.

Since then, advisory votes on executive compensation have been adopted in Australia, the Netherlands, Norway, South Africa, and Sweden.

Shareholder proposals seeking an advisory vote on executive compensation first appeared in the United States during the 2006 proxy season. Proposals sponsored by the American Federation of State, County and Municipal Employees (AFSCME) were submitted for a vote at seven companies. While none passed, the proposals garnered significant shareholder support (averaging over 40% approval), an extraordinary result for a first-time measure.

During the 2007 proxy season, AFSCME, having joined forces with Walden Asset Management and a coalition of institutional and retail investors, submitted advisory vote proposals to over 70 companies. Gathering momentum as the year progressed, the proposal won majority support at eight companies (of the 53 proposals that actually went to a vote): Activision, Blockbuster, Clear Channel Communications, Ingersoll-Rand, Motorola, Par Pharmaceuticals, Valero Energy, and Verizon. For the year, the measure averaged 42% support, consistent with the initial experience from 2006.

3. What Has Been the Experience with these Advisory Votes?

While there were initial concerns in the United Kingdom that an annual advisory vote would thwart timely executive compensation decision-making, apparently this has not occurred. Since the advisory vote was instituted, only a few boards of directors have received a majority vote against their Remuneration Report (the most prominent of these occurring in 2003 with the rejection of the GlaxoSmithKline report). While its impact is still being studied, the introduction of the advisory vote appears to have had two immediate effects: it has strengthened the links between pay and performance and it has resulted in a reduction in the size of severance packages. So far, it has not led to a decrease in overall CEO compensation.

Its impact for US companies has been hotly debated. Some critics point to the closely-knit and largely insular community of institutional investors in the United Kingdom as the chief reason why the vote has not had a noticeable effect on UK companies. They note that it is unlikely that the same result would occur here given the much broader investor community and the diverse agendas of these groups. However, proponents believe that the vote will improve communication between boards of directors and shareholders on executive compensation and strengthen the connection between executive pay, a company's strategic objectives, and shareholder value creation. In reality, no one knows for sure since the initial votes have yet to take place.

4. Do All Shareholders Support Say on Pay?

No. While many shareholders and investors groups, as well as the major proxy advisory firms, such as ISS Governance Services (a part of RiskMetrics) and Glass, Lewis & Co., have endorsed the advisory vote concept, support is far from unanimous.

For example, the United Brotherhood of Carpenters and Joiners, a long-time activist in the corporate governance and executive compensation areas, opposes an advisory vote, contending that the complexities inherent in today's executive compensation programs make meaningful analysis of their proxy statement descriptions virtually impossible and eventually would lead to standardized pay packages; potentially severing the pay for performance connection that investors seek. Similarly, some large investment companies, including Fidelity Investments, have yet to embrace the advisory vote; deferring to the judgment of their portfolio companies' directors on the details of their executive compensation programs.

Other critics, including Charles Elson, a well-regarded corporate governance expert and Director of the John L. Weinberg Center for Corporate Governance at the Lerner College of Business and Economics at the University of Delaware, believe that shareholder dissatisfaction with an executive compensation program should be handled through the director election process and not by pressuring companies to modify specific compensation practices. They also fear that an advisory vote will encourage activists to seek to wrest power away from the board of directors in other areas.

While some institutional shareholders share these concerns, they see the advisory vote as an effective tool for ensuring that independent directors develop compensation programs that align with their interests.

5. Have any Companies Adopted a Say on Pay Policy?

Yes. In the past year, several companies have either adopted or agreed to adopt a policy giving their shareholders an annual advisory vote on executive compensation. The first, and perhaps most prominent of these companies, is AFLAC, the Columbus, Georgia-based insurer. Its shareholders will conduct their first advisory vote this May. RiskMetrics Group, the parent company of ISS Governance Services, also will hold an advisory vote at its annual meeting in May.

Other companies that saw their shareholders approve a Say on Pay proposal in 2007 that have announced that they will conduct an advisory vote starting in 2009 include Blockbuster, MBIA, Par Pharmaceuticals, and Verizon.

In addition, the Teachers Insurance and Annuity Association portion of TIAA-CREF, the multi-billion dollar financial services company, held an advisory vote on its executive compensation policy in June 2007. However, since TIAA-CREF, as an investment company, is not subject to the SEC's executive compensation disclosure rules, its initiative has not received the same attention as AFLAC's action.

6. What Does an Advisory Vote on Executive Compensation Look Like?

While there is no specific format for the content of the advisory vote, it has been instructive to see how it is being developed by the companies that have already agreed to solicit their shareholders' feedback.

Most of the shareholder proposals have sought to tie the vote to the executive compensation disclosure in a company's proxy statement as required by SEC rules. Consequently, these proposals contemplate that shareholders would be given the opportunity to vote on the Compensation Discussion and Analysis, Summary Compensation Table, and related compensation tables. The obvious drawback of this approach is the ambiguity of a unfavorable vote in actual practice and how it should be interpreted. Since the vote would not be targeted at any specific compensation element or practice, a company would have to investigate further to determine what aspect or aspects shareholders oppose.

Recognizing this dilemma, the two management-sponsored advisory votes that are being held this year seek to narrow the focus of what shareholders are being asked to consider.

AFLAC's proposal solicits shareholder input as follows:

"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."

RiskMetrics goes even further, dividing its Compensation Discussion and Analysis into five discrete sections and then instructing its shareholders as follows:

"The Board, after consulting with its Nominating and Corporate Governance Committee, has determined that the best way to implement this principle – giving shareholders as much opportunity to comment

as possible – is to accord shareholders THREE votes. First, shareholders may indicate their position (by a yes or no vote) with regard to the Company’s overall executive compensation philosophy, policies and procedures. These are described above in the Compensation Discussion and Analysis, Sections I and II. Second, shareholders may indicate their position (again by a yes or no vote) with regard to whether the Board executed these principles appropriately in making its 2007 compensation decisions. These decisions are described above in the Compensation Discussion and Analysis, Sections III and IV. Finally, shareholders may indicate their position (yes or no) with regard to the Board’s application of its compensation philosophy, policies and procedures to the 2008 objectives. These objectives are described in the Compensation Discussion and Analysis, Section V.”

Thus, the company will be able to evaluate the feedback it receives on the basis of whether its shareholders agree with its compensation philosophy and policies, the implementation of that philosophy and policies in its 2007 compensation decisions, and its application of that philosophy and policies to its 2008 compensation objectives.

While the pool of available examples is small, it is evident that companies that sponsor an advisory vote will want to structure the resolution in a way that lets shareholders know precisely what they are being asked to vote on. This will maximize the vote’s usefulness to the board compensation committee and minimize the potential ambiguity that an unfavorable vote could create.

7. What’s Happening in 2008?

During the 2008 proxy season, shareholder proposals seeking adoption of an advisory vote policy have been (or will be) introduced at over 90 companies. So far, the results have been mixed. While shareholder proposals received majority support at Apple and Lexmark International, they have been defeated at Bank of New York Mellon, Citigroup, Goldman Sachs, Merrill Lynch, and Morgan Stanley. Still, the measure continues to generate almost 40% support per company, a reminder that the concept continues to enjoy widespread shareholder appeal. Most of the remaining votes will take place during May and early June.

Separately, a group of companies, investors, and other interested parties, including the two principal advisory vote proponents, AFSCME and Walden Asset Management, have been collaborating on possible ways to address the issues underlying the Say on Pay movement: enhanced communications between the board of directors and investors on executive compensation matters and strengthening the pay-for-performance relationship. The group held a roundtable in early April to share information and look for ways promote further dialogue on this subject. Both sides appear to be anxious to avoid a legislative response to the issue.

8. What Is Congress Doing?

Congress has not been idle in the face of the widespread criticism of excessive executive compensation. Rep. Barney Frank (D-MA), who chairs the House Financial Services Committee, successfully engineered passage of the “Shareholder Vote on Executive Compensation Act” (HR 1257) in the spring of 2007 by a vote of 269-134. This bill, which would require public companies to hold an annual non-binding shareholder vote on their executive compensation programs, also would require a separate shareholder vote on severance payments triggered by a change in control or other specified corporate transactions.

A companion bill (S. 1181), sponsored by Senator Barack Obama (D-IL), has been introduced in the Senate, although, to date, no action has been taken on the measure.

As proposed, the advisory vote would be based on the executive compensation information required by the Securities and Exchange Commission to be included in corporate proxy statements (the Compensation Dis-

cussion and Analysis, the compensation tables, and any related material).

Because Say on Pay is calculated to give shareholders greater input on executive compensation matters, it has become a popular cause in Congress and will likely continue to be part of any reform package taken up in the future.

9. What's Likely to Happen Next?

Interestingly, Say on Pay has become an issue in the 2008 presidential campaign. Earlier this month, Senator Obama endorsed the concept of a shareholder advisory vote and urged Congress to pass S. 1181. In addition, in mid-April Senator Hillary Clinton (D-NY) introduced a package of executive compensation reform measures (S. 2866) that includes a similar advisory vote proposal. Further, the likely Republican candidate, Senator John McCain (R-AZ) has voiced his concern about excessive executive compensation and plans to address it in his campaign platform.

Consequently, it should come as no surprise that many observers believe that a change in Administrations in 2009 will invariably lead to legislation aimed at addressing the disparity between executive and rank-and-file compensation. In this environment, it is likely that an advisory vote on executive compensation will have significant traction, particularly given its widespread support in Congress.

In anticipation of more advisory vote policies being implemented in the near future, ISS Governance Services has developed a set of policies that it will use to formulate its voting recommendations on these votes. While these voting recommendations will be made on a case-by-case basis, ISS has indicated that it may recommend against a proposal seeking shareholder ratification of a company's executive compensation program if, in its view, the board of directors has "failed to demonstrate good stewardship of investors' interests regarding executive compensation practices."

10. What Should Companies Be Doing?

The populist appeal of the advisory vote on executive compensation has gained such traction in the past three years that it is difficult to imagine that some form of Say on Pay won't be widely adopted (if not mandated) in the next few years. Yet, companies should not simply sit back and await the inevitable. The balance of corporate power is shifting and it will be critical to be proactive in determining how this shift affects your company. Accordingly, it is important to recognize the issue that is driving Say on Pay – communication; or, more precisely, the lack of communication between shareholders and directors on compensation matters – and address it now.

At a minimum, companies should consider how they can improve communication channels with their investors (both institutional and retail) to better enable them to share their views and concerns about executive pay policies and practices. This year, Pfizer initiated a meeting between its largest institutional shareholders and board of directors to discuss corporate governance matters, including the company's executive compensation policies. While it isn't necessary for companies to take similar action, it underscores the value of direct communication between investors and the board. An enhanced investor relations program that provides shareholders the ability to communicate with directors on a regular basis (which could range from simply attending the annual meeting to establishing a web site or other place for shareholders to ask questions of the compensation committee) may be sufficient to initiate a dialogue that will allay many investor concerns. Another approach is to hold a regular (for example, semi-annual) "town hall" meeting between shareholders and the compensation committee chair to discuss executive pay. Further, the SEC has relaxed the rules on establishing an electronic shareholder forum; a mechanism that many companies may find appealing.

A willingness to try these or other ideas will be critical to successfully navigating the challenges ahead. Ignor-

ing investor requests, or attempting to block them with procedural maneuvers, simply won't work in the face of today's reality. You should be looking to get ahead of the curve by implementing practices that will bring investors to the compensation table, rather than trying to exclude them entirely. And, in most cases, this involves communicating with them ahead of time, rather than after the pay decisions have been finalized. Not only will this minimize criticism, ultimately it will largely render the impact of an advisory vote moot. ◆

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