



Shareholder Advisory Votes on Executive Compensation – A “Say on Pay” Primer

The Administration’s announcement on June 10, 2009 that it intends to propose legislation that will give the Securities and Exchange Commission the authority to require public companies to give their shareholders an advisory vote on their executive compensation programs (“Say on Pay”) cements the growing belief that such a vote will be required as soon as the 2010 proxy season.

Under the Administration’s proposal, all public companies, not just financial institutions, would be required to conduct two votes each year at their annual meeting of shareholders:

- one on the executive compensation program as disclosed in a company’s proxy statement (including the Compensation Discussion and Analysis and the compensation tables); and
- one on the actual compensation of the named executive officers as reported in the Summary Compensation Table.

In addition, shareholders would have the right to vote on any “golden parachute” arrangements included in proxy materials for a merger, acquisition, or other transaction involving a change in control of the company. (Although it is unclear what would constitute a “golden parachute,” it is likely to cover any severance or other payment triggered by the change in control transaction.)

To underscore the significance of this proposal, the Treasury Department’s recently-announced plan for reforming the financial regulatory system also includes a recommendation for an advisory vote on executive compensation packages. Thus, it appears that the advisory vote concept is an important component of the

Administration’s efforts to stabilize and restore investor confidence in the financial markets.

While the Administration’s initiatives have received the majority of the headlines, they are not the only “Say on Pay” proposal in the works. Two bills recently introduced in Congress, S. 1074, the “Shareholder Bill of Rights Act of 2009,” and S. 2861, the “Shareholder Empowerment Act of 2009,” both contain provisions that would require an annual advisory vote on executive compensation. In addition, Representative Barney Frank (D-MA), the chair of the House Financial Services Committee, who successfully engineered passage of an advisory vote requirement in the House of Representatives in 2007, has yet to weigh in on the subject. He is expected to introduce his own “Say on Pay” proposal sometime this summer.

With the prospects for an advisory vote requirement at their highest level ever, this article explains the history of “Say on Pay,” summarizes its growth over the past four years, describes the different approaches being used to frame the vote, and offers suggestions on how companies can prepare themselves for the changes ahead.

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 periodic referendum on executive compensation will decrease the temptation to provide overly-generous compensa-



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tion packages to senior executives and enhance the relationship between pay and performance.

In reality, the designation “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 would be simply an additional factor for the Board of Directors or 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 policies and whether it is executing those policies 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 – and, perhaps more significantly, its Board of Directors or Compensation Committee. Thus, it would have the potential to significantly influence the executive pay-setting process.

Have any Alternative Proposals Surfaced?

While “Say on Pay” has become synonymous with an annual advisory vote, an alternate approach was proposed earlier this year, when the United Brotherhood of Carpenters Pension Fund submitted a shareholder proposal to 20 companies, including Procter & Gamble Co., seeking a non-binding advisory vote only once every three years.

This so-called triennial executive pay vote proposal would also require:

- in addition to an overall vote on named executive officer compensation, separate votes on a com-

pany’s (a) annual incentive plan, (b) long-term incentive plan, and (c) post-employment benefits (including retirement, severance, and change-in-control payments); and

- a “forum” between the compensation committee and shareholders on at least a triennial basis to discuss senior executive compensation policies and practices.

All of the companies receiving the proposal have annual meetings coming up later this fall or early next year, so we won’t know for several months how it fares compared to the more conventional annual vote proposal.

What is the Origin of “Say on Pay”?

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.

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 this year with the rejection of the RBS and Shell reports). While its impact is still being studied, the introduction of the advisory



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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.

What’s the History of “Say on Pay” in the United States?

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 of these proposals passed, they 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, Inc., Blockbuster, Inc., Clear Channel Communications, Inc., Ingersoll-Rand Company Ltd., Motorola, Inc., Par Pharmaceutical Companies, Inc., Valero Energy Corporation, and Verizon Communications, Inc. For the year, the measure averaged 42.4% support, consistent with the initial experience from 2006.

In addition, the Teachers Insurance and Annuity Association, College Retirement Equities Fund (“TIAA-CREF”) actually provided its policyholders with an advisory vote on its executive compensation policies and related disclosures 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 subsequent corporate decisions to conduct an advisory vote.

During the 2008 proxy season, advisory vote proposals were submitted to nearly 85 companies (of which 66 proposals actually went to a vote). Of the proposals that received shareholder action, 14 won majority support, with the measure averaging just over 43% support. Six companies conducted advisory votes at their annual meeting of shareholders: Aflac Incorporated, H&R Block, Inc., Jackson Hewitt Tax Service, Inc., Littlefield Corporation, RiskMetrics Group, Inc., and Zale Corporation. In addition, either as a result of an advisory vote proposal that received majority support or under pressure from its shareholders, several other companies, including Apple Inc., Blockbuster, Inc., MBIA, Inc., Par Pharmaceutical Companies, Inc., Tech Data Corporation, and Verizon Communications, Inc., agreed to institute advisory votes during the 2009 proxy season.

What Was the “Say on Pay” Experience During the 2009 Proxy Season?

The recently-completed proxy season saw significant developments on two “Say on Pay” fronts. First, there was a continuing increase in the number of advisory vote proposals submitted to companies by shareholder activists (over 100), with numerous proposals receiving majority support. In addition, approximately 15 companies conducted advisory votes on a voluntary basis, including nine which provided the vote for the first time: Alaska Airlines, Inc., Blockbuster, Inc., Forest Laboratories, Inc., Intel Corporation, MBIA, Inc., Motorola, Inc., Par Pharmaceutical Companies, Inc., Tech Data Corporation, and Verizon Communications, Inc.

Finally, the enactment of the American Recovery and Reinvestment Act of 2009 in February resulted in a new corporate governance standard requiring all of the financial institutions participating in the federal government’s Troubled Asset Relief Program (“TARP”) – over 300 companies – to include an advisory vote in their proxy statements filed on or after February 17, 2009 and conduct such a vote at their 2009 annual meeting of shareholders.



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The results of these shareholder proposals and advisory votes are reflected in the Exhibit attached to this article.

What Does an Advisory Vote on Executive Compensation Look Like?

While there is not yet any specific format for the content of the advisory vote, the resolutions submitted for shareholder action so far have been influenced by two overriding considerations. First, the resolutions either seek approval of a company’s “compensation philosophy, policies, and practices” (or some combination of these specific items) or a company’s “executive compensation” (which, although somewhat ambiguous, is assumed to mean the amounts actually paid for the last completed fiscal year to its named executive officers). Second, the resolutions seek 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 approve either a company’s “policies and practices” or actual “compensation” based on the presentation of these items in its Compensation Discussion and Analysis, Summary Compensation Table, and related compensation tables, or some combination thereof.

Based on the dozen or so examples that were developed and used during the 2009 proxy season, the resolutions can be grouped into two broad categories:

The “Policies and Practices” Approach

Most of the companies that voluntarily gave their shareholders the opportunity to vote on their executive compensation programs employed an approach seeking approval of their executive compensation “philosophy, policies, and practices” (or some combination thereof). These companies included, among others, Aflac, Inc., H&R Block, Inc., Par Pharmaceutical Companies, Inc., and Verizon Communications, Inc. For example, the Aflac resolution reads 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.

Although most of these companies referenced both their narrative (the Compensation Discussion and Analysis) and tabular (the Summary Compensation Table) disclosure, a few based their request for approval on their CD&A alone. For example, the Intel resolution reads as follows:

The Board of Directors asks you to consider the following statement: “Do you approve of the Compensation Committee’s compensation philosophy, policies, and procedures as described in the ‘Compensation Discussion and Analysis’ section of this proxy statement?”

While the precise scope of these resolutions is problematic, it is most likely that shareholders are being asked, in the main, to approve the policies and practices governing the executive compensation program, with any reference to the specific amounts earned or paid only intended to be illustrative of the application of those policies and practices. Presumably, by focusing on the policies and practices underlying the specific compensation decisions reflected in the tabular disclosure, the company is seeking ratification of the philosophy that guides its decision-making, rather than the decisions themselves. From the standpoint of a compensation committee looking for feedback to guide its future actions, this is preferable to a vote focused exclusively on its past decisions.

The “Historical Numbers” Approach

Another approach, which was used by Blockbuster, Inc., MBIA, Inc., and Tech Data Corporation, was to seek ratification of the specific compensation amounts as reported in the Summary Compensation Table and accompanying narrative disclosure. For example, the Blockbuster resolution reads as follows:



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Resolved, that the stockholders hereby ratify the compensation of the named executive officers set forth in the Summary Compensation Table and the accompanying narrative disclosure in this proxy statement of material factors provided to understand the Summary Compensation Table (but excluding the Compensation Discussion & Analysis).

Consequently, shareholders were not asked to consider the company’s compensation policies and practices, but only the reasonableness of the actual amounts earned or paid for each individual compensation element (as well as overall total compensation) for the fiscal years reported in the Summary Compensation Table.

What Should an Advisory Vote on Executive Compensation Look Like?

Instead of treating “Say on Pay” as an obligatory nuisance, companies and their board compensation committees may want to view the advisory vote as an opportunity to obtain meaningful feedback from their shareholders on the long-term direction of their executive compensation programs. Rather than simply seeking approval of your “executive compensation” or some other equally vague formulation, companies should develop a voting framework that combines the best aspects of the two approaches described above.

Consequently, we recommend conducting two votes – the first on the company’s overall executive compensation philosophy, policies, and procedures, as described in the Compensation Discussion and Analysis, and the second on the execution of that philosophy and the attendant policies and procedures as reflected in the compensation decisions for its named executive officers for the last completed fiscal year, again as described in the CD&A and reported in the Summary Compensation Table. Such as proposal might look as follows:

Resolved, that the shareholders approve the Company’s overall executive compensation philoso-

phy, policies, and procedures, as described in the Compensation Discussion and Analysis presented in this Proxy Statement.

Resolved, that the shareholders approve the compensation decisions made by the Compensation Committee of the Board of Directors based on the performance of the Company’s named executive officers for 2008, as described in the Compensation Discussion and Analysis, Summary Compensation Table, and accompanying narrative and tabular disclosure presented in this Proxy Statement.

This approach will enable the board compensation committee, as well as management, to evaluate the investor feedback it receives on the basis of whether its shareholders agree with its overall compensation policies and practices, as well as the application of those policies and practices as reflected in its actual pay decisions.

We note that this approach appears to be consistent with the approach outlined in the Administration’s proposal, which also contemplates two separate votes – one on the executive compensation program itself and the other on the actual compensation of the named executive officers as reported in the Summary Compensation Table.

It remains to be seen whether the SEC, which is likely to be the ultimate arbiter of the advisory vote requirement, requires that the advisory vote resolutions all be framed in the same way or, as it has done so far with the TARP participants, lets companies decide for themselves how to structure the vote resolution.

What is the Likely Impact of “Say on Pay”?

An advisory vote requirement will have several immediate consequences. First, it will compel most companies to reevaluate their current approach to the presentation of executive compensation information in their proxy statements. Instead of drafting this disclosure to meet the expectations of regulators, it will now have to be



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prepared for a different audience – institutional and retail investors – and for a different purpose – to persuade shareholders to approve the company’s executive compensation policies and practices. As a result, we are likely to see significant changes to this disclosure, including greater use of executive summaries and graphics to convey the company’s key compensation message, more faithful adherence to the “plain English” requirements, and an increased emphasis on placing the program in a favorable light to garner investor support.

In addition, some companies are likely to find that, in many instances, it will be necessary to mount a proactive campaign to ensure a favorable vote result. These companies – and their directors – will not want to deal with the adverse publicity and other fallout that is likely to accompany a negative vote. As has become standard practice with proposals seeking adoption of an employee stock plan, these companies may need to devote additional time and resources to gain the support of key shareholders well in advance of the annual meeting.

Finally, a “Say on Pay” requirement may increase the influence of the major proxy advisory firms, which will be expected to formulate voting recommendations for their institutional investor clients. Given these firms’ rigid adherence to guidelines that penalize companies for “poor pay practices,” many advisory vote critics have predicted that executive compensation programs will gravitate towards conservative, “safe” pay practices.

While we do not believe that “Say on Pay” will be the death knell of creativity and innovation in compensation program design, almost certainly it will lead to a stronger connection between executive rewards and long-term shareholder value creation. Thus, compensation committees will need to be more cognizant of the policies of these firms, as well as those of their major shareholders, when developing their incentive compensation program.

While the ultimate impact of an advisory vote requirement is problematic, the increased role of the proxy

advisory firms will clearly present companies with another potential obstacle in conducting their annual meeting of shareholders.

What Should Companies be Doing Now?

Unlike most shareholder proposals on executive compensation matters, “Say on Pay” is a recent phenomenon. In four 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. Further, the popular appeal of an advisory vote on executive compensation, particularly in the current environment, makes it difficult to imagine that some type of “Say on Pay” requirement won’t be enacted in time for the 2010 proxy season. 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.

Ultimately, it is important to recognize what is driving the “Say on Pay” movement – communication; or, more precisely, the lack of communication between shareholders and directors on compensation matters – and begin to address this issue within the context of your own shareholder communications strategy. At a minimum, companies should consider whether they need to improve communication channels with their investors (both institutional and retail) and, if so, how. While newly-public companies are likely to decide that they well understand the objectives and views of their major shareholders, mature companies, with a more diverse group of investors, may not have a firm grasp on this information. In these instances, they may want to consider whether to take steps to enable their shareholders to share their views and concerns about executive pay policies and practices.

Some companies have already begun to engage their shareholders on executive compensation. For example, Pfizer has initiated an annual meeting between its largest institutional shareholders and board of directors



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to discuss corporate governance matters, including the company’s executive compensation policies. Another large pharmaceutical company, Schering-Plough, posted a compensation survey for its shareholders on its corporate website in an effort to survey investors about its executive pay practices. And recently Amgen invited its shareholders to offer comments on TIAA-CREF’s insightful position paper for evaluating a Compensation Discussion and Analysis.

While it may not be necessary for you 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 website or other place for shareholders to ask questions of the compensation committee) may be sufficient to initi-

ate 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.

Need Additional Assistance?

Compensia has had significant experience in helping technology and life sciences companies in preparing their executive compensation disclosure and developing strategies to address an advisory vote requirement. If you have any questions on the subjects addressed in this Thoughtful Pay Alert or would like assistance in assessing how Say on Pay is likely to affect your company, please feel free to contact us. ■

About Compensia

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Exhibit

“Say on Pay” Results during the 2009 Proxy Season

1. COMPANY PROPOSALS (ACTUAL ADVISORY VOTES ON EXECUTIVE COMPENSATION)

Company	Vote in Favor of Executive Compensation Program
Aflac Incorporated	97.4%
Alaska Airlines, Inc.	96%
Blockbuster, Inc.	N/A
Intel Corporation	96.5%
Littlefield Corporation	97.4%
MBIA, Inc.	72.1%
Motorola, Inc.	63.5%
Par Pharmaceutical Companies, Inc.	N/A
RiskMetrics Group, Inc.	N/A
Tech Data Corporation	N/A
Verizon Communications, Inc.	90%



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2. SHAREHOLDER PROPOSALS (PROPOSALS SEEKING AN ANNUAL ADVISORY VOTE)

Company	Vote in Favor of Annual Advisory Vote
Allstate	46.5%
Altria	47%
Apple Inc.	52%
Burlington Northern Santa Fe	30%
Colgate-Palmolive	47.5%
Coca-Cola	37%
CVS Caremark	59%
Edison International	Approved (voting results N/A)
Eli Lilly	30%
EMC	49.5%
Ford Motor Company	13% (the Ford's own 40%)
Frontier Communications	49.6%
General Electric	43%
Haines Celestial Group	62%
Honeywell	Approved (voting results N/A)
Johnson & Johnson	46%
KB Homes	Approved (voting results N/A)
Lexmark International	Approved (voting results N/A)
Marathon Oil	Approved (voting results N/A)
Pfizer	52%
Prudential Financial	62%
Pulte Homes	53.5%
Qwest Communications	31%
Sempra Energy	49%
Valero Energy	Approved (voting results N/A)
Waddell & Reed	51%
Windstream	49.1%
XTO Energy	51%