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SAY ON PAY USHERING IN PARADIGM SHIFT? WHAT YOU NEED TO KNOW NOW

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As we first alerted clients in July 2010 upon the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("*Dodd-Frank*"), Say on Pay advisory votes are now upon us. Over 200 "early filers" tracked by Grahall have filed their 2011 proxy statements, and the initial results are already creating quite a stir in the executive compensation world. In fact, if initial trends continue, the widespread belief of the anti- Say-On-Pay crowd – that this might all amount to nothing more than a glorified rubber stamping process – will have been stood squarely on its head. In fact, we may be heading for nothing less than a total transformation of the process by which executive compensation is both determined and implemented.

This Client Advisory is broken down into two main sections. The first provides an overview of the new Say-on-Pay requirements ("*SOP*"), including the initial Say-On-Frequency ("*SOF*") and Say-on-Golden Parachute ("*SGP*") rules. Second, we examine and comment on the events of the first 2 months, which already contain a few big surprises and clearly indicate the potential for the upcoming proxy season to be far more contentious and groundbreaking than previously anticipated.

OVERVIEW OF THE NEW RULES

On January 25, 2011, the Securities and Exchange Commission finalized its adoption of rules required pursuant to Section 951 of Dodd Frank. Pursuant to Dodd-Frank, all companies with annual or other shareholder meetings that occur after January 21, 2011 must provide shareholders with the opportunity to supply an advisory vote regarding each of the following:

- **Say On Pay** - Shareholders will advise the company as to whether they approve of the compensation of the company's named executive officers (as they appear in the compensation table), the Compensation Discussion and Analysis ("CD&A") and other executive compensation disclosures required by Item 402 of Regulation S-K
 - *Disclosure in CD&A* – In 2011, each company must explain the extent to which it took the SOP vote into its thought process with respect to determining compensation¹
 - **Grahall Comment: Small Company Delay, Not Exemption:** *While Dodd-Frank grants the SEC explicit authority to exempt any company or class of companies from the Say on Pay requirements – and many expected and pushed for a "small company" exemption the SEC chose instead to delay the applicability of SOP and SOF (but not SGP) regulations to small companies for 2 years²*
- **Say On Frequency** – Shareholders will advise companies whether the SOP vote should occur annually, biennially or triennially. Companies first may recommend a preferred period (as approximately 95% have done), or can choose to remain silent. This "Say-On-Frequency" vote occurs for the first time in 2011, and then shareholders must be given the opportunity to reconsider the duration no less than in six-year intervals thereafter.³
 - **Grahall Comment: Timing/Logistics:** *Once the shareholder vote results are determined, companies must determine whether to adopt the shareholders' recommendation if it is different from the company's. While an 8-K disclosing the results of the vote must be filed within four business days of*

¹ This applies to the most recent SOP vote only, except in cases where older SOP votes may have impacted the compensation committee's determination.

² Currently, the SEC defines a small company as one with \$75 million of annual revenues or less, but is not bound to this definition.

³ The rules permit a public company to commit to shareholders to have this vote more often than every six years if it desires to do so.

the shareholder meeting, the company has up to 150 days after the meeting to determine whether to adopt the shareholders' recommendation regarding the frequency or not⁴

- **Say On Golden Parachute** – Companies soliciting approval of any merger or acquisition or substantial asset sale must provide shareholders a separate advisory vote regarding Golden Parachute arrangements
 - **Grahall Comment:** *ISS is particularly concerned with severance packages it believes provide “inappropriate windfalls” and has indicated that any of the following Change in Control (“CIC”) benefits may lead to a negative vote recommendation:*
 - *excise tax gross up protection*
 - *single trigger payments upon a CIC (including cash outs), or “modified” single trigger payments*
 - *acceleration of performance equity where performance metrics haven't been satisfied*
 - *excessive severance (generally assumed to be in excess of 3x cash/bonus)*
 - *any single trigger acceleration of CIC benefits based on shareholder approval rather than actual deal consummation.*

INITIAL RESULTS FROM “EARLY” FILERS

Barely a few months into the Say-On-Pay era, and we've already experienced more than a few surprises, as the initial filings have highlighted many of the concerns and new challenges that will be brought to the forefront by the new say on pay process.

The First “NOs”

The Compensation consulting world is abuzz with news that **Jacobs Engineering Group** received a “no” vote from its shareholders regarding its compensation scheme. Given the nature of Say-On-Pay advisory votes – which provide absolutely no detail to the company beyond a simple up or down vote – Jacobs is reportedly doing what it can – namely, going back to the drawing board and engaging shareholders as to what about the current program isn't acceptable.

⁴ The filing must also comply with Rule 14a-8, which requires at least 60 calendar days before the deadline for the submission of shareholder proposals for the next scheduled annual meeting.

As background, Jacobs had a challenging year in 2010. Annual revenues declined from \$11.5 billion to \$9.9 billion, and EPS declined 29% from \$3.21 to \$2.29 per share. Despite these results, CEO Craig Martin's Total Direct Compensation ("*TDC*") increased approximately 40% from \$4.6 million in 2009, to \$6.4 million in 2010, primarily as the result of a \$2.1 million restricted stock award⁵, partially offset by Martin's bonus, which declined roughly 30% from \$978,000 in 2009 to \$674,000 in 2010.

Lest anyone believe that Jacobs Engineering was an aberration, look no further than **Beazer Homes USA**, which also received a negative vote recommendation from shareholders.

Beazer's 2010 saw revenues flat versus 2009 and EPS significantly improved, though the company still lost \$.50 share vs. (\$4.60) share the prior year. CEO compensation at Beazer grew approximately 6% from \$6.4 to \$6.9 million in 2010 against 2009, primarily as the result of a \$1.05 million bonus partially offset by lower stock awards.

Exclusion of Broker Non-Votes

Both Jacobs Engineering and Beazer Homes are interesting cases not only because shareholders voted down the current scheme, but also because the vote in each case was relatively close and each plan would have passed had it not been for another significant change in proxy voting: the exclusion of broker non-votes ("*BNVs*") from the voting process.⁶

Historically, BNVs were almost always voted in support of management's position. In the case of Beazer Homes, the exclusion of 19.2 million BNVs was actually the deciding factor between what would have been approval of the current compensation scheme and outright rejection.⁷ Had the BNVs been counted in favor of the company, the compensation scheme would have passed by a margin of almost 2:1 – not great, but certainly not failure. Jacobs Engineering had a similar experience.⁸

Having said that, we don't think anyone at Jacobs Engineering or Beazer Homes would have been thrilled with such a narrow victory, and one can certainly argue that there is no real practical difference between a narrow victory, and an outright loss. Which raises an interesting question – how strong does a vote of approval have to be?

⁵ Note that in both 2009 and 2010, Martin also received a \$2.4 million option award.

⁶ Broker non-votes are those shares not indicating a preference on the issue at hand and which in the past, were free to be voted by brokers as they saw fit.

⁷ Specifically, at Beazer Homes, 20.2 million shares voted in favor and 23.6 million shares voted against.

⁸ 40.7 million votes in favor, while 48.75 million voted against. 16.2 million BNVs were excluded from the process.

“Tweeners”: Insufficient Majorities?

Next we consider **Monsanto**, where shareholders passed the recent compensation scheme, but did so with a majority of approximately 65%.⁹ This vote may best be described as a “tweener” – not low enough to be an outright loss, but with one in three shareholders voting against, certainly not strong enough to engender widespread confidence among the company’s governance ranks.

While Monsanto is listed #10 in the Fortune 500 5-year TSR with an annualized 5-year return of 25.4%. The company had a tough 2010 relative to 2009. Total revenue dropped about 10% to \$10.5 billion from \$11.7 billion in 2009, and EPS dropped a whopping 48% to \$2.58 share from \$5.00 per share in 2009. The company’s share price followed suit, falling approximately 15% for the year.¹⁰ While CEO Hugh Grant received no bonus payment, he did receive a large stock award of \$7 million in “strategic and financial RSUs,” which increased his reported annual compensation to \$13.2 million from \$11.7 million in 2009.

Monsanto is the first high profile tweener and, like Jacobs Engineering and Beazer Homes, it didn’t have great financial results in 2010. But tweeners haven’t been limited to companies with poor or middling operating results. Consider **Johnson Controls**. Revenues for 2010 were up over 20% from 2009, and EPS was \$2.19 share in 2010 compared to \$.20 loss in 2009. The Company’s share price recovered nicely, increasing approximately 40% from 2009, and adding approximately \$7.4 billion in market capitalization over the prior year.

Yet the shareholders vote in support of Johnson Controls’ compensation plan was a very tepid 62%.¹¹ The culprit? Perhaps the CEO’s increase from \$11.5 million to \$17.6 million, primarily as a result of an additional \$5.2 million in cash bonus. In any event, the company’s performance in 2010 was very good, and the increase in CEO pay of 55% was both performance oriented and his TDC in 2010 was still lower than his comparable TDC in 2008. Nevertheless, shareholder resistance was significant, at almost 40% of total votes cast.

⁹ Monsanto had 246.68 million votes in favor, 128.45 million votes against, and 58.8 million BNVs.

¹⁰ Monsanto’s closing prices: December 31 2009 \$81.75, December 2010 \$69.64.

¹¹ 323.9 million votes in favor, 195.5 million votes against, with 55.99 BNVs.

Say On Frequency – Annual Reviews to Ultimately Prevail?

Costco represents yet a third category of early filer, further illustrating the landscape change in favor of “shareholder engagement.” The company had a successful 2010, increasing revenues roughly 10% to \$77.9 billion, while EPS grew roughly 18% to \$2.94 share vs. \$2.49 share in 2009. The CEO received an increase of almost 30% in compensation vs. 2009.¹²

Costco’s shareholders overwhelmingly approved the compensation scheme, with roughly a 99% approval rating. Nevertheless, despite record earnings, solid EPS growth, and almost unanimous support of CEO pay, shareholders summarily *rejected* the Company’s recommendation for triennial Say On Pay review, opting instead for an annual review. Though the vote was close, Costco has indicated it would adopt the annual review period preferred by its shareholders.

Brave New World?

In sum, shortly after the official dawning of the Say-On-Pay era, we’ve already seen each of the following:

- Outright rejection of existing compensation schemes at two major companies
- The immediate impact of the disallowance of BNVs on compensation and say on frequency approval
- Luke-warm votes of approval at two other companies, including one with solid 2010 financial performance
- Shareholders eschewing companies’ requests for triennial review in favor of annual review of compensation programs

So what does this all mean? While this is a small sample, at Grahall we believe that we are potentially witnessing the development of a new paradigm in executive compensation where, for better or worse, Compensation Committees will be engaged more directly with shareholders towards developing, implementing and ultimately *defending* the compensation schemes employed by public filers. This new era of “shareholder engagement” will facilitate a more profound “broadening” of the stakeholder concept, whereby corporations are viewed as more complex organisms with multiple inputs and outputs, all of which are factored into determining “appropriate” compensation philosophies and programs.

¹² Costco CEO compensation on an “as reported” basis was \$3.5 million in 2010, and \$2.7 million in 2009, the bulk of which is delivered in performance based RSUs.

What's a Compensation Committee to do?

Not long ago, a “best practices” compensation scheme involved large option grants, a base salary and a target bonus. The lower the fixed and higher the variable percentage of pay, the “better” and more shareholder friendly the scheme was perceived to be. Awards were generally made as stock options, and increasing share prices provided “pay for performance”.

Unfortunately, larger and larger stock option awards potentially contributed to excessive risk taking, which has now been thoroughly repudiated. So companies simply must do a better job of balancing both upside and downside risk and reward, or risk falling behind the compensation/governance curve, which will eventually render the company less attractive to shareholders.

In our view, Compensation Committees ideally must engage in a process which addresses each of the following:

- **Step 1: *Goal Setting.*** Identify short- and long-term business goals
- **Step 2: *Alignment.*** Assure that the compensation scheme aligns with and supports achievement of the company's unique business objectives – and has significant variability. The program should be straightforward and designed to be presented clearly to shareholders – particularly if the company hasn't performed well. And if current trends hold up, pay increases for executives need to be proportionate and reflect true gains in financial performance.
- **Step 3: *Risk/Reward Balance.*** While assuring variability in pay levels, committees must also be mindful of the interplay between potential upside rewards and encouraging appropriate but not excessive risk in executive short- and long-term decision making.
- **Step 4: *Enhanced Proxy Disclosure.*** The proxy is the company's opportunity to explain and justify the reasons for the compensation decisions it makes, as well as the company's overall compensation philosophy. While statements must be factually accurate, companies should be as direct, clear and convincing as possible as to how pay was linked to performance and how shareholders benefit, rather than simply reciting a boilerplate belief that the relationship exists. All the best practices of stakeholder communications come into play, with some pretty high stakes in the balance. Companies should also consider adding an executive summary section to make the proxy easier to digest.
- **Step 5: *Shareholder Engagement.*** Whether it's referred to as shareholder outreach, solicitation or engagement, companies would be well served to reach out to shareholders to gauge reaction to existing and proposed pay schemes or any major modifications. Doing so may help avoid surprises. If performance hasn't

been good, this step becomes even more important. Again, communication experts generally urge companies to communicate “early and often” to keep stakeholders informed and help head off misleading rumors. An ongoing dialogue is ideal.

- **Step 6: Pay Practice Analysis** – companies need to understand the potential strengths and weaknesses of their pay programs. In addition, if there is significant institutional ownership, there needs to be a compensation and governance review by which companies can assess their compliance with ISS’ evaluation tools. This would include gauging where the company is regarding each of the following:
 - GRID
 - Relative TSR versus peers for the recent year
 - Burn rate vs. GICS classification and allowable cap
 - CIC arrangements
 - “Poor Pay Practices”
 - Repricing without shareholder approval
 - Excessive perquisites or tax “gross-ups”
 - New/extended contracts that provide for excessive CIC payments, single or modified single triggers, or excise tax gross-ups

ISS Gaining Influence

It can be argued that ISS is also an early “winner” in 2011. The advisory service has come out strongly in favor of annual reviews, and advised against the pay packages at Jacobs Engineering and Beazer Homes, both of which were voted down. Companies that want to compete for and retain top management talent will have to be cognizant of how their programs will be perceived by institutional investors, and ISS. Companies must also be mindful that while ISS has reduced the number of poor pay practices; it has also adopted a more stringent policy of no longer accepting a future commitment by offending filers to remedy such poor pay practices.¹³ So there will be an enhanced premium going forward on getting it right to begin with.

¹³ ISS has stated that it will continue to consider promises to remedy poor practices regarding pay-for-performance, burn rate violations, and limited equity plan modifications.

CONCLUSION

While it is early in the proxy season, initial filings suggest that Say On Pay reforms may combine with the disallowance of broker non-votes to tip the scales in favor of newly empowered shareholders not afraid to create some waves. To be successful in the future, Compensation Committees and Boards must be extremely diligent in design, implementing, and ultimately defending compensation schemes which not only attract and retain, but create appropriate risks and rewards specific to the company's short and long term goals, and do so in a manner that can be clearly communicated to shareholders.



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R. Garrett Rogers is a Consultant with Grahall Partners, and provides counsel to Boards of Directors, compensation committees and executive management. Mr. Rogers has 25 years of professional experience, including 15 years in the compensation and benefits arena.

Prior to joining Grahall, Mr. Rogers worked in the New York office of Pearl Meyer & Partners for 10 years. In such capacity, he consulted with publicly and privately held companies in the design and implementation of annual incentive design and long term equity participation programs and incentives for subsidiaries, business units, spin-offs, IPOs, bankruptcies, joint ventures, and mergers and acquisitions. Mr. Rogers also specializes in the design and negotiating of employment, change-in-control, severance and retention arrangements. While his experience covers a wide spectrum of different industries, he has worked extensively with clients in the financial services industry (including private equity and hedge funds), health care, insurance and technology industries.

Previously, he was with the law firm of Sills Cummis Epstein & Gross, where he advised public and private companies regarding the structuring and negotiation of employment, change in control and severance arrangements and mergers and acquisitions. Mr. Rogers also interned in the Washington D.C. office of current Senate majority Leader Harry Reid. While interning, Mr. Rogers authored a white paper on the impact of then proposed IRC Section 280G, and consulted on a variety of health care issues.

Mr. Rogers holds advanced degrees from each of New York University Law School (J.D.) and Cornell University's Johnson Graduate School of Management (MBA-Finance) and received a bachelor of arts in World Political Economics from Colorado College.

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