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Preparing for the 2012 Proxy Season

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Background

- 2011 was first proxy season in which public companies (other than small companies) in the US had to give stockholders an "advisory" vote to approve or disapprove compensation of named executive officers (i.e., those for whom compensation disclosure is required in the proxy statement)
- Experience of companies in the 2011 season provides some helpful lessons and insights that can be instructive for companies making compensation and governance determinations in order to better position them for 2012 proxy season and future say-on-pay votes

Background (Cont'd.)

- Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) gave stockholders of public companies three types of "advisory" votes on executive compensation
  - To approve compensation to the "named executive officers" in the prior fiscal year
  - To approve how often the say-on-pay vote should be held
  - To approve "golden parachute" payments in connection with mergers and other corporate transactions

Background (Cont'd.)

- Initial focus on frequency of vote, but then shifted to issues regarding say-on-pay vote, including the rationale for supporting companies' compensation arrangements, contending with adverse recommendations, etc.
- SEC's final say-on-pay rules came out in January and apply to proxies for stockholders meetings after January 21, 2011 , with extension through 2013 for smaller reporting
- Final say-on-pay rules also apply to advisory vote on golden parachute payments required for proxies filed after April 24, 2011 seeking stockholder approval of mergers and other corporate transactions

Say-On-Pay Vote

- Vote relates to approval of compensation of "named executive officers" (i.e., named in proxy compensation tables) generally as disclosed in the proxy statement, but not individual elements of compensation or corporate practice
- Vote must happen at least every three years
- Vote results must be disclosed within four business days of stockholders meeting on Form 8-K
- Nature of vote is "advisory" so cannot compel companies to do anything (although effect of significant stockholder disapproval will get companies' attention)
- Going forward, companies must state whether they considered the results of the most recent stockholder say-on-pay vote and, if so, how that consideration affected executive compensation decisions and policies

Say-On-Pay Vote (Cont'd.)

- Focus has been on first time disclosures, recommendations by proxy advisers, company reactions and outcomes of votes
- Approximate results of 2011 votes: less than 2% of companies failed to get majority approval; 70% got 90%+ approval; and 90% got 70%+ approval
- Despite importance of recommendations, votes did not always follow proxy advisers' recommendations
- Smarter companies understood rationale for recommendations, highlighted pay-performance relationship and responded assertively/proactively
- Some failed votes resulted in stockholder suits

Frequency of Say-On-Pay Vote

- Companies initially considered whether to recommend holding say-on-pay stockholder votes every 1, 2 or 3 years, but proxy advisers favored annual votes (e.g., ISS)
- Initially, many boards leaned towards three year votes, but emerging results and adviser positions made stockholder preference for annual vote clear
- Next vote on frequency of say-on-pay vote required no later than 6th year after 2011 vote
- Decisions regarding frequency must be reported on Form 8-K

Golden Parachute Advisory Vote

- Vote applies to proxy statements filed after April 24, 2011 for stockholder approval of business combinations
- Specified disclosure (including tables and narrative) relates to golden parachute payments to named executive officers by both parties to combination, although vote applies only to such compensation to soliciting company's officers
  - Disclosures can apply to other filings for transactions where no vote mandated (e.g., tender offer, going-private)
- Companies may avoid separate transactional proxy vote through prior say-on-pay vote, but relatively few companies have currently taken this on

General Observations from 2011 Disclosures

- Minimizing non-performance-based pay
  - Many companies (e.g., AT&T) removed excise tax gross ups
  - A number of companies removed/lessened perks (e.g., free memberships, financial advice)
  - A few companies
    - Lowered CEO severance multiples from 3 times to 2 times cash compensation
    - Added provisions requiring stockholders to approve payouts more than 2.99 times cash compensation

2011 Observations (Cont'd.)

- Aligning interests with stockholders
  - Some companies implemented ownership guidelines that exceed the common 5-times salary threshold for CEO stock ownership (and go as high as 10-times)
  - A substantial number of companies reporting claw-back provisions strengthened these requirements, including by increasing the range of executives and items subject to claw-back
    - Guidance pending for Dodd-Frank claw-back requirements (which will further affect claw-back policies and require companies that do not have such policies to adopt them)

2011 Observations (Cont'd.)

- Communicating with stockholders
  - Say-on-pay has promoted companies' communication with stockholders to convey important elements of compensation policy to stockholders and get stockholder input
  - Say-on-pay has heightened importance of such communications in view of potential negative recommendations by proxy advisers
  - A number of companies preempted or responded to proxy adviser "against" recommendations with significant and proactive outreach to stockholders that likely helped overcome negative recommendations, including through supplemental proxy filings

2011 Observations (Cont'd.)

- Using disclosure effectively:
  - Companies used CD&A to "tell the story" about compensation decisions and rationale; avoided boilerplate descriptions
  - Some companies showed effective use of "layered" narrative, highlighting critical aspects of compensation and pay-performance early in CD&A
  - Say-on-pay increased the importance of (now common) executive summaries
  - Say-on-pay increased importance of highlighting pay-for-performance relationship and using graphs and charts to communicate the message more effectively

2011 Observations (Cont'd.)

- Some companies (e.g., GE) used proxy summary as well for better overview and comparisons about pay and performance
- Some companies (e.g., Lockheed) included total stockholder return (TSR) vs. CEO pay
- Some companies used proxy performance graph and variations of that graph
- Graphs that were used tended to focus on TSR, but some graphs were also used for pay and performance based on measures such as revenue and earnings per share growth

– Companies using summaries and layered disclosure were more effective generally in securing higher say-on-pay support from stockholders

Considerations for 2012

- Highlighting link between pay and performance
- Reducing nonperformance-based pay/enhancing alignment between executive compensation and stockholders
- Proactive communications and outreach to substantial stockholders
- Using disclosure to effectively communicate with stockholders in order to receive a favorable say-on-pay vote

Negative Say-On-Pay Votes

- Between January 21 and June 17, 2011, 2,225 Russell 3000 companies held say-on pay votes
- 37 companies –1.6%-- received negative votes
- In addition to failed votes, ISS reports that more than 30 companies received between 50% and 60% support
- When ISS recommended a negative vote, 52% received less than 70% approval and 71% received less than 80% approval

Say-On-Pay Approval

- Most companies had executive pay practices approved, often by a high percentage
  - 71% of the Russell 3000 companies reporting through June 23, 2011 reported approval rates of at least 90%
  - ISS reports that the investors averaged 91.2% support
- Of the Russell 3000 say-on-pay votes held through June 17, 2011:
  - ISS recommended negative votes for 276 companies
  - say-on-pay was approved by slightly more than 86% of the companies that received negative ISS recommendations

Additional Proxy Material

- The Conference Board reported than more than 100 companies challenged proxy adviser recommendations and valuations
- Generally, these responses were filed with the SEC as definitive proxy materials
- Formats varied:
  - Letter to some or certain shareholders
  - Supplement to proxy statement
  - Sides containing graphs and charts
  - Talking points/script

Arguments Made in Response to ISS Proposals

- Specific aspects of the ISS methodology were wrong or flawed
  - Inappropriate peer group
  - Short-term performance focus
  - Narrow performance criteria
  - Equity valuations based on future estimates
- Specific facts cited by ISS were incorrect
- Above median pay is not a valid basis for a negative vote on pay
- Emphasis on company performance
- Explaining business reasons for certain decisions

Other Actions Taken in Response to ISS Negative Recommendations

- Some companies changed elements of existing pay practices to induce ISS to change its recommendations
  - Lengthened performance periods
  - Changed performance metrics
  - Added performance measures
  - Eliminated tax gross-ups
  - Such actions often required co-operation of executives who had to agree to changes in their compensation
- Reaching out to certain shareholders without additional proxy materials
- Involving the compensation committee/board in the process

Common Factors in Failed Say-On-Pay Votes

- Several years of below-median total stockholder return and higher CEO pay
- Unresponsiveness to prior issues, such as majority withhold votes for compensation committee members
- Excessively high CEO pay or retention awards
- Excessively high increases in CEO pay
- Pay practices deemed to be egregious

Lawsuits Arising from Negative Say-On-Pay Votes

- Nine lawsuits have been filed following negative say-on-pay votes
  - These lawsuits have received a lot of publicity
- Awareness of the litigation risk may have motivated more strenuous responses to negative ISS recommendations
- In addition there have been some 162(m)-based lawsuits relating to pay for performance

Companies Where Pay Litigation Has Been Brought

- Dex One Corp.
- Cincinnati Bell
- Bank of New York Mellon
- Hercules Offshore
- Umpqua
- Beazer Homes USA
- Jacobs Engineering Group
- Hercules Offshore
- Occidental Petroleum
- Keycorp

Litigation Fact Pattern Allegations

- Pay not connected to performance despite pay for performance disclosures
- Negative vote on say-on-pay
- Company did not change compensation following vote

Claims Raised by Litigation

- Directors breached duty of care and loyalty
- Misrepresentation
- Corporate waste
- Consultants aided/abetted and/or breached contract
- Executives unjustly enriched

Risks from Litigation

- Dodd-Frank expressly provided that the say-on-pay vote
  - Was non-binding
  - Did not overrule decisions of the board of directors
  - Did not change fiduciary duties
  - Did not add fiduciary duties
- Reputational risk
- Costs
  - Keycorp settlement amount-$1.75 million in legal fees to plaintiffs counsel

Frequency Votes

- ISS reports that as of June 30 Boards made the following frequency recommendations:
  - Annual - 53.6%
  - Triennial - 41.4%
  - Biennial - 2.5%
  - No recommendation - 2.6%
- ISS reports that investors at 1,792 of the Russell 3000 companies supported annual votes
- ISS also reports that investors did not accept triennial recommendations at 564 of 978 companies
- Most companies have accepted shareholder frequency recommendations, but there are exceptions

Frequency Policies and 8-K Filings

- Voting results must now be reported on a Form 8-K within four business days of the annual meeting
  - Reporting under Item 5.07
- With respect to frequency votes only, the SEC has clarified the number of broker non-votes does not need to be disclosed
- The company's policy on frequency needs to be disclosed
  - Even if the proxy statement contained a recommendation with respect to frequency, the policy the company adopts after the advisory vote must be disclosed
- The frequency policy can be reported by amendment
  - Not later than 150 calendar days after the meeting but not later than 60 calendar days prior to shareholder proposal deadline

Technical Variations on Reporting Frequency Filing

- Company may disclose frequency policy in a Form 10-K or 10-Q that is that is filed on or before the due date for the Form 8-K amendment
- If a company reports voting results in a Form 10-Q or Form 10-K, it may file a new Item 5.07 Form 8-K, rather than an amended Form 10-Q or Form 10-K, to report its frequency policy
- If the company separately reports voting results and frequency policy in a Form 8-K, then the frequency policy must be filed as an amendment to original Form 8-K and not as a new Form 8-K

Pending D0dd-Frank Compensation Rulemaking

- Pay-for-performance
  - SEC required to adopt rules requiring companies to disclose material information showing relationship between executive compensation paid and financial performance
  - Must take into account change in value of shares and dividends
- Internal pay comparisons
  - Disclosure of median of annual total compensation of all employees except the CEO
  - Total CEO compensation
  - Ratio of these numbers

Pending D0dd-Frank Compensation Rulemaking (Cont'd.)

- Hedging
  - Companies will be required to disclose whether employees or directors are permitted to hedge market value of securities granted as compensation
  - Whether held directly or indirectly
- Clawbacks
  - SEC must direct stock exchanges to prohibit listing if company does not develop a policy with respect to recovery of incentive-based compensation
- Time frame
  - SEC plans to propose rules in 2011
  - SEC plans to adopt rules between January and June 2012

Compensation Committee Independence and Compensation Consultant Disclosure

- On March 30, 2011, the SEC proposed new Rule 10C-1, requiring the exchanges to consider the following when determining independence requirements for compensation committees:
  - The source of a board member's compensation, including any consulting, advisory or other compensatory fee paid by the issuer to such board member, and
  - Whether a board member is affiliated with the issuer, a subsidiary of the issuer or an affiliate of a subsidiary of the issuer
- The exchanges may also consider other factors in determining independence requirements, subject to the SEC's approval process for exchange listing standards
- The SEC did not include safe harbors for particular relationships in proposed Rule 10C-1

Compensation Committee Independence and Compensation Consultant Disclosure (Cont'd.)

- As proposed, the stock exchanges would determine the details of compensation committee listing standards not expressly mandated by the Dodd-Frank Act
- Proposed Rule 10C-1 does not mandate a "look-back" period for the required factors
  - the SEC has solicited comments on whether the required factors should also extend to a look-back period
  - it is possible that a look-back could be added by an exchange when proposing its listing standards
- Listing standards to be adopted under proposed Rule 10C-1 must provide procedures that give listed companies the opportunity to cure defects
- Neither the Dodd-Frank Act nor proposed Rule 10C-1 requires any company to have a compensation committee
  - Compensation committee requirement arises from applicable stock exchange listing standards

Compensation Advisers

- Proposed Rule 10C-1 provides that the compensation committee may retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser
- The compensation committee is directly responsible for the appointment, compensation and oversight of such advisers
- The compensation committee is not required to implement the recommendations of any such adviser
- The issuer must provide appropriate funding for such advisers

Compensation Advisers (Cont'd.)

- A compensation committee may only select a compensation consultant, legal counsel or other adviser after considering factors identified by the relevant exchange in its listing standards:
  - The provision of other services to the issuer by the person that employs the adviser
  - The amount of fees received from the issuer by the person that employs the adviser, as a percentage of such person's total revenue
  - The policies and procedures of the person that employs the compensation adviser that are designed to prevent conflicts of interest
  - Any business or personal relationship of the adviser with a member of the compensation committee
  - Any stock of the issuer owned by the adviser

Compensation Consultant Disclosure and Conflicts of Interest

- Proposed amendment to Item 407 of Regulation S-K integrates the Dodd-Frank Act and existing disclosure requirements relating to compensation consultants and conflicts of interest
- Amended Item 407 will require disclosure of whether the compensation committee has "retained or obtained" the advice of a compensation consultant during the previous fiscal year
- Companies will have to disclose whether the compensation consultant's work raised any conflict of interest
  - If it did, the nature of the conflict of interest and how it is being addressed will have to be described
  - No carve-out for advice on broad-based plans or the provision of non-customized benchmark data

Timing for Compensation Committee Independence and Compensatory Consultant Matters

- SEC plans to adopt final rules in 2011
- The SEC has proposed giving exchanges have 90 days after the SEC's final rule is published in the *Federal Register* to submit proposed listing standards to the SEC for approval
- The SEC has proposed that the exchanges must have final listing standards that comply with the SEC's final rule not later than one year after the SEC's final rule is published in the *Federal Register*
- The compensation consultant conflict of interest disclosures will not be required before the effective date of the SEC's final rule

General Shareholder Proposal Process

- Following receipt of a proposal, determine whether eligibility and procedural requirements are met and notify proponent of any deficiencies (14 days)
- If intend to exclude proposal, must notify SEC and proponent (no later than 80 calendar days before definitive proxy materials are filed)
- If seek SEC concurrence of exclusion, may be subsequent written communications discussing positions taken among public company, SEC and proponent

Likely Shareholder Proposal Topics – Corporate Governance Issues

- Board declassification/annual director elections
  - Focus will be on mid- and small-cap companies
- Majority voting
  - Those that failed were mostly at companies with plurality voting with a resignation policy
  - Again focus will be on mid- and small-cap companies
- Action by written consent
  - Concerns about disenfranchisement of some shareholders

Likely Shareholder Proposal Topics - Corporate Governance Issues (Cont'd.)

- Special meetings
  - Seek to enhance shareholder ability to call special meetings
- Cumulative voting
  - Institutional shareholders generally not in favor
- Independent chairman
  - If strong alternative structure, shareholders not likely to approve
- Supermajority voting
  - Seeks to remove supermajority voting provisions

Likely Shareholder Proposal Topics – Environmental Issues

- Climate change
  - Typically a report on efforts to reduce greenhouse gas emissions
  - Also, financial risks arising from climate change, adoption of principles to stop global warming
- Sustainability
  - File reports on sustainability efforts
- Other environmental issues
  - Hydraulic fracturing, coal-related proposals, recycling, water scarcity, oil sands, toxic substances

Likely Shareholder Proposal Topics – Environmental Issues (Cont'd.)

- Political contribution related proposals
  - Following the U.S. Supreme Court's *Citizens United* decision lifting many restrictions on corporate and union political spending
- Human Rights
  - General human rights policies, genocide-free investing
  - Sexual orientation nondiscrimination

Proxy Access

- On August 25, 2010, the SEC adopted its proxy access rules allow shareholder director nominations through a public company's proxy statement
- In addition, the SEC amended Rule 14a-8 to require public companies to include in their proxy materials shareholder proposals to amend governing documents relating to nomination procedures or disclosures related to shareholder nominations
- On October 4, 2010, the SEC stayed application of its rules pending the outcome of the legal challenge by the Business Roundtable and the U.S. Chamber of Commerce to Rule 14a-11

Proxy Access (Cont'd.)

- On July 22, 2011, the U.S. Court of Appeals for the District of Columbia vacated Rule 14a-11
- Effective September 16, 2011, all remaining related rules become effective
  - 14a-8 requiring inclusion of shareholder proposals
  - New Form 14N required by any party nominating a director for inclusion in a company's proxy statement
  - 14a-4 changes to proxy card requiring voting separately for each director if a shareholder nominee
  - 14a-2 exemptions from proxy solicitation requirements
  - Form 8-K filing if change in meeting date of more than 30 days from prior year's date

Proxy Access (Cont'd.)

- Creates two-step process
  - Year 1 shareholder proposes changes to nomination procedures in governing documents
  - Year 2 shareholder proposes nominee for inclusion in public company proxy materials
- Consider options if receive proposal
  - Propose or adopt alternative scheme
  - Seek exclusion of shareholder proposal for technical non-compliance
  - ISS response

Proxy Plumbing

- On July 14, 2010, the SEC issued a "Concept Release on the U.S. Proxy System"
- The SEC identified three categories of issues in the proxy system that they were seeking comment on:
  - Accuracy , transparency and efficiency of the voting process
  - Communications and shareholder participation
  - Relationship between voting power and economic interest
- No timetable for SEC action

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