Skadden

Executive Compensation and Benefits Alert

October 4, 2012

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Preparing for the 2013 Proxy Season – Lessons Learned From the 2012 Proxy Season

2012 Results

Having reached the conclusion of the 2012 proxy season, we can report that approximately:

- 69 percent of say-on-pay proposals passed with more than 90 percent support;
- 21 percent passed with between 70.1 and 90 percent support;
- 7 percent passed with between 50 and 70 percent support; and
- 3 percent (53 companies) obtained less than 50 percent support.

While the overall proportions generally are similar to last year's results, it should be noted that in 2011 only 37 say on pay proposals obtained less than 50 percent support. Please note that these percentages follow the (For/(For + Against + Abstain)) formulation and have been rounded to the nearest percentage.

We have analyzed ISS reports and supplemental proxy filings throughout the 2012 season, and our reporting and analysis can be found in our four prior say-on-pay client mailings.[1]

Actions to Take Now

Based on the insights we gleaned from the 2012 season, we have the following recommendations for companies as they enter the fall compensation planning process:

1. Analyze Last Year's Advisory Reports

As a first step, companies should analyze the reports issued by Institutional Shareholder Services (ISS), Glass Lewis and other advisory firms in 2012 with respect to the company's 2011 executive compensation in order to better understand the concerns of those firms.

- Even if the company decides not to make changes in response to those concerns, it should note in the 2013 proxy that those concerns were reviewed and considered.
- If the company does make changes, it will be viewed favorably by ISS and other services if the changes are described in some detail and explicitly linked to the concerns that were raised.

1 See "Say on Pay – Early Lessons From the 2012 Proxy Season," "Continuing Developments in the 2012 Proxy Season," "Additional Updates on the 2012 Proxy Season," and "Two-Thirds of the Way Through the 2012 Proxy Season — Lessons Learned."

2. Conduct Shareholder Outreach and Document Those Efforts

ISS made clear in its 2012 reports that it expects any company whose say-on-pay proposal failed (or passed without extremely strong support) to conduct shareholder outreach efforts and to describe these efforts thoroughly in the next proxy. Companies in this situation should reach out to their largest shareholders to solicit reactions to the company's existing executive compensation program, as well as views regarding any concerns raised by ISS and others. Such outreach could include making presentations via teleconference, providing written materials regarding the company's current program and proposed changes, as well as holding in-person meetings.

3. Start Now to Prepare Proxy Disclosure With Respect to 2012

Companies should begin the proxy drafting process now by identifying those individuals who will need to provide input for the proxy, including individuals from legal, human resources, finance, stock administration and other departments, as well as external legal counsel, compensation consultants and accounting firms. Each piece of the puzzle will need to be integrated into a document that ultimately "tells the story" of the company's executive compensation programs in a coherent and compelling manner. Companies should consider using charts, graphs and an otherwise reader-friendly presentation in order to achieve maximum clarity for the company's message.

4. Incorporate Lessons Learned in 2012

In the face of ISS "against" recommendations during this past proxy season, many companies issued supplemental filings as a rebuttal. This year, companies will be able to take advantage of the knowledge gleaned from the past season in order to both address known ISS concerns preemptively with respect to 2012 proxy disclosure and make effective decisions with respect to 2013 compensation. Some ideas to consider are as follows:

- **Realizable pay**: Many supplementary filings focused on the perception by companies that ISS had materially overstated CEO pay by focusing on the grant date value of awards. For example, including the full grant date value of a stock option ignores the fact that the option has no actual value unless the company's stock price increases following the date of grant (which would generate gains for stockholders as well). At an extreme, stock options that expire "out of the money" (that is, if the stock price does not increase from the date of grant) would in fact expire with no realized value. Companies have noted that the ISS methodology allocates to one year (the year of grant) a lump sum amount based on the option's grant value for accounting purposes, an amount that is both potentially vastly overstated and allocated in a lump sum to a single year prior to the year (if any) that any value is or can be realized. To illustrate these arguments, companies often have presented charts showing realizable pay based on various assumptions. While many companies and firms have recommended to ISS that it shift its model to one focused on realizable pay, it is unclear whether it will make any such changes. In any case, companies may want to consider adding a realizable pay chart to the Compensation Discussion & Analysis (CD&A) in next year's proxy.
- **Peer Groups**: One of the most controversial issues during the past proxy season was the degree to which the peer groups chosen by ISS were different from the peer groups chosen by companies. Company-chosen peer groups tend to be selected based on nuanced analysis that takes into account the competitors with which the company competes for market share and executive talent. ISS, on the other hand, chooses peer groups based on an industry classification code, and in some cases the ISS-chosen peer group shared only one or two companies in common with the company-chosen peer group. Companies should consider providing more detail than in the past regarding the reasons why they chose the listed peer companies and, if there have been historical differences with the ISS peer group, it would be

wise to preemptively discuss the reasons the company disagrees with the ISS determination. It is unclear at this point if ISS will respond to pressure to make its peer group selection process more individualized. Glass Lewis has indicated that it will be using a new model that uses the company's peers and the peers of those peers to construct the Glass Lewis peer group, and critics suggested that ISS revamp its process as well. However, even if it does not do so, including additional information regarding the company's peer selection process will serve to provide more context for shareholders to make decisions regarding the company's say-on-pay proposal.

- **Bonus Disclosure**: A number of negative ISS comments this year addressed disclosure of incentive compensation. ISS indicated that it views vague descriptions of the manner in which annual and long-term bonuses are calculated as problematic, and we recommend that companies take a fresh look at whether the narrative description of such plans is detailed sufficiently. In addition, if the same performance measurement (***e.g.***, earnings per share or EBITDA) has been used for more than one plan, we recommend that the company provide its reasoning for that decision, since the use of the same measure across plans was commented on negatively by ISS in a number of its reports. A company may wish to consider diversifying measures used in its incentive plans so as not to give the impression that individuals are being compensated twice for the same performance. In addition, companies should consider whether their incentive plans have multiple performance measures but permit payout if only a subset of those measures are met. ISS was critical of such arrangements during this past proxy season, particularly when the subset of measures that could trigger payout were qualitative rather than quantitative in nature. Finally, it should be noted that ISS has not hesitated to analyze the actual payment thresholds and measurements in plans and deem them insufficiently challenging. Companies should take care to use analytical rigor in setting goals and provide a description of the process via which any payment thresholds were set.
- **Equity Awards**: ISS, despite many complaints by companies in their supplemental filings, does not consider stock options to be performance-based pay, and a large grant of stock options can skew dramatically the ISS determination of CEO pay in the year of grant. Furthermore, equity-based awards with time-based (rather than performance-based) vesting schedules are viewed extremely negatively by ISS, particularly when they comprise all or substantially all of the awards made under a company's equity award program. Companies should keep this fact (among other relevant factors) in mind in considering the terms of future grants.
- **Total Shareholder Return**: ISS considers total shareholder return (TSR) to be the most important measure of a company's performance in determining whether there is a "pay for performance disconnect." A number of companies argued strongly against using a single measure in this manner. If a company believes that measures other than total shareholder return are more relevant to its stockholders — such as quality of assets held (in the case of financial institutions) — safety (in the case of industrial companies) or low volatility and consistent dividends (in the case of utilities), it should discuss this point in the CD&A to provide stockholders with that context.
- **Pay Disparity**: ISS indicated to a number of companies that it views a significant disparity between the pay of the CEO and the other executive officers to be problematic because it suggests inadequate succession planning and may impact executive morale. We recommend that companies with significant pay disparity provide disclosure regarding the reasons for the disparity and a general description of any succession planning processes in order to show that the company has considered the issue.
- **Retention Bonuses**: Based on ISS reactions during the 2012 proxy season, we recommend that companies providing retention bonuses, stay bonuses or

similar awards provide a detailed explanation of how it was determined that such an award was appropriate, the conditions under which it was to be paid and any other relevant information.

- **CEO Transitions and Tenure**: For companies that have gone through a CEO transition, we recommend that detailed disclosure be provided as to the rationale for any payments made to the exiting CEO and any special payments or grants made to the new CEO in connection with the transition, together with any relevant factors considered in making any of their payments and grants. Conversely, companies with a long-tenured CEO who also is highly compensated should consider highlighting the CEO's years of experience.
- **Excise Tax Gross-Ups**: ISS reserves its most negative comments for "golden parachute" excise tax gross-ups in new or renewed agreements and arrangements. The inclusion of such a provision can be sufficient on its own to draw a negative vote recommendation. In at least one case the rescinding of the provision was sufficient to trigger a change in the ISS voting recommendation to "for". While most companies are well aware of the issue in the context of new arrangements, they should be careful to monitor the renewal or extension of existing arrangements without the elimination of any existing provision for an excise tax gross-up.
- **Corporate Performance**: A decline in corporate performance is not sufficient in and of itself to trigger a negative recommendation if pay is decreased, for example by exercising discretion to decrease or eliminate a bonus payout or changing the compensation benchmarking percentage to something lower than 50 percent. ISS provided a "for" recommendation in some cases of poor company performance when accompanied by lower compensation. In some circumstances, ISS provided an "against" recommendation where performance was excellent but pay was too high even given that performance. Accordingly, when making decisions for 2013, companies should consider, as always, the relationship between compensation and the company's historical and predicted performance to avoid the perception of a disconnect.

A Final Note

The views of ISS and other advisory services represent a significant factor in making decisions with respect to executive compensation. However, their views are not the only relevant factor (or perhaps not even one of the most relevant factors) in making these decisions. The interests of the company and its stockholders may best be served by making a decision that is contrary to the views of the advisory services. This is a complex and nuanced area with a tremendous amount of media scrutiny, and we urge companies to consult with internal and external advisers as early in the process as possible in order to make the most appropriate and strategically intelligent decisions with respect to their executive compensation programs.