TOP TAKEAWAYS

Compensation Committee Roundtable

These are the top takeaways from the **Compensation Committee Roundtable** moderated by Foley Partners Jessica Lochmann Allen and Steven Vazquez on November 17, 2011 as part of the NDI Executive Exchange, a segment of Foley's National Directors Institute. Featured participants in the roundtable were Michael Kesner of Deloitte Consulting LLP, Patrick McGurn of Institutional Shareholder Services (ISS), Georgia Nelson of PTI Resources, LLC and Mark Williamson of Putnam Roby Williamson Communications.

1. **Say on Pay – Takeaways from 2011.** Most companies received strong support for their say on pay votes in 2011, with a few notable exceptions. Some lessons from the first year of say on pay include the following:

   - Be familiar with your significant shareholders, their voting policies and how they evaluate pay and performance.
   - Reach out specifically to the governance personnel at your significant shareholders. At many institutional investors, the investment and governance functions are divided, and the mere fact that investment personnel are pleased with your financial performance does not ensure a "yes" vote on governance matters such as say on pay.
   - It is advisable to communicate with significant shareholders about say on pay well in advance of proxy season, as it can become difficult to secure time for calls or meetings once proxy season activities commence.
   - Based on the examples of companies with significant "no" votes on say on pay in 2011, warnings signals typically include poor stock price performance combined with increasing pay or mediocre stock price performance combined with extraordinary pay increases.

2. **Compensation Discussion & Analysis (CD&A) in a Say on Pay World.** Say on pay prompted many companies to re-evaluate their CD&A disclosure in their proxy statements in 2011, with a particular focus on communicating the relationship between pay and performance, and continued focus on this area is expected in 2012. Suggestions for CD&A disclosure in 2012 highlighted by the roundtable included the following:

   - *Transparency* – Making the proxy statement disclosure as transparent as possible can diminish the role of proxy advisers in the say on pay vote by enhancing direct communications with shareholders.
   - *Executive Summary* – A short (two-page) executive summary to the CD&A is recommended in 2012 to highlight the most important elements of the company's compensation arrangements.
   - *SEC Compliance* – Although CD&A has become in part a sales document as a result of say on pay, companies should remember that the CD&A also must satisfy the SEC's technical requirements, including the new requirement to discuss the effect of the most recent say on pay result. The SEC staff continues to review CD&A disclosures and issue comment letters when it deems the disclosure deficient.

3. **Pay for Performance – Definition of Performance-Based Compensation.** Compensation committees should be made aware of how proxy advisers and investors will view the compensation arrangements they establish, especially in cases where those views may differ from internal characterizations. For example, some companies may consider all stock options to be performance-based compensation for internal purposes, whereas some proxy advisers (including ISS) generally do not consider time-vesting stock options to be performance based compensation.

4. **Pay for Performance – Selecting Appropriate Performance Measures.** Companies should continue to use care in selecting appropriate performance measures. While earnings per share continues to be a common performance measure, it may become less prevalent when clawbacks become mandatory under the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). ISS does not prescribe any single performance measure for all companies, but prefers that companies use multiple measures and is wary of situations where companies are permitted to "cherry pick" performance measures from a broad menu of alternatives. In light of say on pay, companies should also be careful about choosing performance metrics that may result in incentive payments to management despite stock price declines. Performance measures should be selected in view of the overall corporate strategy and a determination of the key metrics to ensure the company remains on track to execute that strategy.

5. **Pay for Performance – Response to Economic Uncertainty.** If compensation committees are not comfortable locking in performance goals for a full year due to economic uncertainty, alternatives include using shorter performance periods or including a modifier based on peer performance. Retaining discretion may be an attractive alternative for compensation committees to address uncertainty, but doing so may create issues in other areas, such as tax deductibility and shareholder relations.

6. **ISS Update – Say on Pay Frequency.** ISS issued its updated 2012 proxy voting policies on November 17, 2011, the day of the roundtable. With respect to say on pay frequency, ISS intends to recommend "against" or "withhold" votes in the case of boards of directors who adopt a frequency that is less frequent than the alternative supported by a majority of shareholders. In cases where the say on pay frequency receiving the most votes achieved only a plurality, and not a majority, of shareholder support, and the company selects a frequency less frequent than the alternative receiving a plurality, ISS will evaluate its recommendation on a case by case basis.

7. **ISS Update – Response to Say on Pay Vote With Low Support.** ISS will generally recommend "against" or "withhold" votes in the case of compensation committees (or full boards in exceptional cases) failing to take measures that ISS considers adequately responsive after a say on pay vote receiving the support of less than 70% votes cast. ISS would like companies receiving less than 70% support for say on pay to determine responsive changes (including prospective changes or promises to undertake future changes) through engagement with shareholders, and to disclose the changes early on a voluntary basis, rather than waiting until the proxy statement for the next annual meeting.

8. **ISS Update – Pay for Performance Analysis.** ISS's new approach to its pay for performance analysis will involve an initial, quantitative "screen" that will consider:

   - "Peer group alignment," consisting of (1) the degree of alignment between the company's total shareholder return rank and the CEO's total pay rank within a peer group, as measured over one- and three-year periods (with the one-year period weighted 40% and the three-year period weighted 60%), and (2) the multiple of the CEO's total pay relative to the peer group median.
   - "Absolute alignment" between the trend in CEO pay and company total shareholder return over the prior five fiscal years.

Companies that do not pass this initial, quantitative screen will be evaluated in a second, qualitative analysis before ISS recommends an "against" vote in say on pay.

9. **Committee Adviser Independence.** Dodd-Frank required the SEC to issue rules concerning exchange listing standards that would require compensation committees to consider independence of advisers and to have the authority to hire advisers.

    - The SEC has proposed rules calling for listing standards mandating:
        - The compensation committee must have the authority, in its sole discretion, to retain or obtain the advice of compensation consultants, independent legal counsel and other advisers (collectively, the "compensation advisers"), and must be directly responsible for appointing, compensating and providing oversight of the work of the compensation adviser
        - Companies must provide appropriate funding (as determined by the compensation committee) for payment of reasonable compensation to compensation advisers.
    - The proposed rules on compensation committee advisers also would mandate listing standards requiring compensation committees to consider certain independence criteria prior to hiring compensation advisers, including the following factors: (1) the provision of other services to the company by the firm employing the compensation adviser; (2) the amount of fees received from the company by the company employing the compensation adviser, as a percentage of that firm's total revenue; (3) the policies and procedures adopted by the firm employing the compensation adviser that are designed to prevent conflicts of interest; (4) any business or personal relationship of the compensation adviser with a member of the compensation committee; and (5) the compensation adviser's ownership of the company's stock.
    - The SEC has also proposed rules requiring proxy statement disclosure of adviser conflicts of interest and how the issuer addressed the conflicts.
    - The SEC plans for adoption of listing standards and disclosure rules in November – December 2011.
    - Many compensation consultants currently have procedures in place to verify independence from the compensation committee, and compensation committees have begun taking steps to ensure adviser independence.

10. **Compensation Committee Composition.** Dodd-Frank required the SEC to issue rules concerning exchange listing standards that would require heightened independence requirements for compensation committee members.

    - The SEC proposed rules in early 2011 that would require listing standards requiring each compensation committee member to be "independent."
    - Independence would be defined by the exchanges considering:
        - Sources of compensation of the director, including any consulting, advisory or other compensatory fee paid by the company to the director.
        - Whether the director is affiliated with the company or any of its subsidiaries or their affiliates.
    - The SEC plans for adoption of listing standards in November – December 2011.
    - Significant changes at most compensation committees are not expected because many current compensation committee members already satisfy heightened independence standards. Exceptions may include smaller capitalization companies or companies that are currently exempt from the independence requirements imposed by the stock exchanges.

For more information

For more information on the Compensation Committee Roundtable session, please feel free to contact the moderators directly:

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