

“SAY ON PAY”

WHERE WE ARE AND HOW DO WE MAKE IT WORK?

**Hosted by
TIAA-CREF
and**

National Association of Corporate Directors, NY Chapter

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“Say on Pay”: Point/Counterpoint

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INTRODUCTORY NOTE:

As this is the first presentation at the Program, the hope is to level-set some sort of baseline among the participants, so at a minimum, everyone starts off with a shared base of knowledge of the more typical pro and con positions in the recent “Say on Pay” debate in the US. There’s very likely more than a bit of repetition and overlap, and perhaps some internal inconsistencies. Moreover, given the nature of the presentation, I’ve borrowed from third party op/ed pieces and reports.

Ken Kopelman

POINT:

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COUNTERPOINT:

- Under our governance system, Shareholders elect Directors, and it is the job of those elected Directors — not the Shareholders — to oversee and monitor the corporation, including pay practices.

POINT:

2. Shareholders have always approved certain compensation items — such as new option plans and §162(m) plans. So this “Say on Pay” debate is not really a deep philosophical governance dilemma — it’s just a “line drawing” exercise. And it’s appropriate at this point in time to draw the line in a way that provides additional oversight and accountability.

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COUNTERPOINT:

- Approval of compensation *plans* — whereby Boards are typically given broad discretion to make specific *awards* — is a fundamentally different function from the complicated and nuanced task of setting overall pay.

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COUNTERPOINT *(continued)* :

- Shareholders are not privy to certain key data that informs many compensation determinations (e.g., company-competitive issues and alternative opportunities available to individuals), so their “Say on Pay” votes may be based on incomplete information.
- “Say on Pay” is a “slippery slope”: if there’s an advisory vote on pay — an area traditionally squarely within the Board’s sole purview — then

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COUNTERPOINT *(continued)* :

- why not an advisory vote:
 - on strategy,
 - on R&D budgets,
 - on approach to energy use and conservation,
 - on one or more specific compensation — related issues (e.g., capping bonus opportunity as a percentage of salary),
 - on anything?

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COUNTERPOINT *(continued)* :

- We should beware of turning business corporations into something they’re not: democracies run by voting shareholders.

POINT:

3. Shareholders aren't seeking to themselves set executive pay — rather the goal is to heighten Director sensitivity and accountability by ensuring that pay decisions will be closely scrutinized.
 - Shareholders need a route they can take to express their views on Board-approved plans, many of which have turned out to contain skewed financial incentives, in certain cases promoting reckless risk-taking with Shareholder money.

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COUNTERPOINT:

- There may have been excesses, but Shareholders already have a number of well-established routes to express their displeasure with pay practices:
 - via the Shareholder proposal process (which has led to an increasing number of advisory votes), and also

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COUNTERPOINT *(continued)*:

- via votes against the reelection of selected or all Compensation Committee/Board members.
 - NO votes in Board elections will be especially powerful starting in 2010, given the elimination of (pro-incumbent) discretionary broker voting [NYSE Rule 452].

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COUNTER-COUNTERPOINT:

- Proponents never claimed that “Say on Pay” is a “silver bullet” that would resolve the executive compensation debate singlehandedly. It is only one part of a broader initiative to focus Boards on shareholder concerns around executive compensation.
- “Say on Pay” will enable Boards more easily to push back against unreasonable compensation demands from executives.

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COUNTER-COUNTERPOINT *(continued)*:

- The Director removal process can be costly and unnecessarily divisive, perhaps out of proportion to the “Say on Pay” message that Shareholders want to deliver.
 - Vote NO campaigns might push out otherwise productive Directors.

POINT:

4. The UK (and some others) have “Say on Pay” and the sky hasn’t fallen.
 - The UK proxy advisory firms have been recommending no votes against somewhere between 10 and 15% of UK companies, the typical proposal garners 85-90% Shareholder approval, and the total number of outright rejections over the past 5 years is less than a few dozen, out of thousands of votes.
 - A high no vote is expected to result in engagement between the Compensation Committee and major shareholders, institutional investors, pension funds, etc. — hopefully, early on in the pay setting process for the following year.

POINT:

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COUNTERPOINT:

- At least five UK companies have received no votes on pay in 2009, including a no vote in the 90%’s at R.B.S., so the UK’s historical model may itself be undergoing drastic change.
- The UK governance regime, often lauded by activists, did not appear during the recent crisis to produce any better operating results/risk avoidance/value preservation than did the US system.

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COUNTERPOINT *(continued)* :

- The UK experience is not necessarily transferrable to the US, given a variety of important structural differences (e.g., concentration of votes, homogeneity of institutional holders).
- If the principal motivation behind “Say on Pay” is to encourage Company/Shareholder interaction and discourse, it seems like an awfully blunt instrument.

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COUNTERPOINT *(continued)* :

- Widely-accepted Pay Guidelines of the type adopted by the UK pension organizations, combined with the UK’s “comply or explain” approach, may lead to standardized pay packages, stifling creativity.
- If pay receives approval, Boards may be loathe to make any changes, fearing they would be “waking the baby” — even if changes in the company’s going forward business strategy would indicate changes in its going forward approach to pay and incentives.

POINT:

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COUNTERPOINT:

- Boards and Compensation Committees have been making good progress over the last few years in eliminating, or at least reining in, abusive pay practices. The balance of power is clearly moving away from management, and squarely towards the independent Compensation Committee, with clear trends towards adopting best practices, including:
 - More frequent Executive sessions
 - 360° Performance Reviews of NEOs
 - Scrutinizing Peer Group selection

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COUNTERPOINT *(continued)* :

- Testing management performance hurdles vs. analysts' outlooks
- Hiring wholly independent advisors, whose only work for the company is to advise the Compensation Committee
- Cracking down on severance pay packages and eliminating many, if not most, perqs
- Some are even starting to look at bringing aboard new Directors with deep, real-world compensation expertise (a la audit committee standards of "financial literacy" and "financial expert")

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COUNTERPOINT *(continued)* :

- Moreover, we've only had a few years with the SEC's new, more detailed, compensation disclosure rules, and only one year with mandated "Say on Pay" votes at TARP-recipient firms, so why not "muddle through" for a few more years under the current system?

POINT:

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COUNTERPOINT:

- Which Shareholders are we talking about?
 - Given the broad diversity in investing styles, time horizons and return on investment goals represented within each single company's shareholder base, will Boards be able to glean and put into effect a single set of "shareholder-friendly" suggestions on how compensation should be structured and paid?

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COUNTERPOINT *(continued)* :

- Concerns re: there being a smaller group of vocal Shareholders with narrow, parochial interests (not necessarily tied to pay issues), who may seek to embarrass the company and the Board by turning compensation determinations into a “public sport”.

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COUNTERPOINT *(continued)* :

- Concerns re: the actual voting determinations often being made by mere intermediaries, who do not beneficially own any meaningful portion of the shares being voted; are these intermediaries making informed, long-term company-by-company decisions, with long-term return on investment considerations their primary motivation, or merely applying the most recently published “good governance” practices “du jour”, and on a one-size-fits-all basis?

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COUNTERPOINT *(continued)*:

- These concerns are amplified by the absence of any definitive study showing that adoption of “good governance” practices leads to improved corporate performance and/or value.
- Concerns re: there being Shareholders who, through derivative products, have bought the right to vote without having the economic risk attendant to their stock position.

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COUNTERPOINT *(continued)* :

- The Compensation Committee is willing to engage in meaningful dialogue with interested and responsible long-term shareholders who own significant amounts of their company's shares, but not to submit itself to a public flogging rife with emotion and hidden agendas.
- Shareholders are entitled freely to vote their own individual self-interests; only the Board is best positioned, through the exercise of its fiduciary duties, to balance the longer-term interests of ALL Shareholders (and stakeholders).

POINT:

7. It's only an advisory vote, it's not binding, so what's the big deal?

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COUNTERPOINT:

- If it's not a big deal, then why are so many spending so much time on it?
- Boards will be forced to dedicate a significant slice of their limited time and attention to the issue, and at a time when many are struggling with true “corporate survival” issues.
- There's the media headline factor/the “what are you doing wrong” factor.

POINT:

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COUNTERPOINT *(continued)* :

- Most importantly, combined with the widespread adoption of Majority Voting, it is disingenuous to view “Say on Pay” votes as merely “advisory” — as the follow up vote — which *will* be binding — will likely be to unseat “non-compliant” Directors.
- At the extreme, this “one-two punch” [no on pay, then voting against Directors] may be viewed as a back-door assault on the business judgment rule.

POINT:

8. “Say on Pay” will give the proxy advisory services -- who don't have any fiduciary duties or skin in the game – even more power.
 - Shareholders don't have the requisite sophistication or knowledge to decipher 25 to 75 pages of dense (and, some say, of questionable utility) compensation disclosure and cast thoughtful votes on complex pay packages.
 - A universal requirement for “Say on Pay” votes will not only require Institutional Shareholders to spend more time and \$\$ on analyzing compensation (at a significant cost to their participants), but — given their less than unlimited resources — will also lead them to farm out many voting decisions, and depend more than ever on proxy advisory firms.
 - The Proxy Advisory Firm business model may well lead to oversimplification of the issues (quantity over quality) and a check the box exercise. This is exacerbated by many such advisors' use of a proprietary “black box” approach.
 - Concern that “Say on Pay” is likely to turn out to be “Pay as I Say”, even though pay is not susceptible to being set via a “cookbook” or “manual of scientific procedures” approach.

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COUNTERPOINT:

- This is a red herring. Responsible Shareholders will look to the proxy firms for analysis and advice, but will not follow that advice slavishly; rather, many will vote according to their own internal policies, and will engage with companies prior to, and after, the vote.

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COUNTER-COUNTERPOINT:

- This may be true for large, well managed Institutional Investors, but the vast bulk of smaller investment firms/pension funds may well find that outsourcing their voting decisions is the most rational business decision for them.

POINT:

9. Executive Compensation is too complicated a subject to be boiled down to a simple “up or down” vote. If a Company receives a high no vote, how can it know what message it should take away?

- Was the problem with our disclosure?
- With our selection of peer groups?
- Was it the options/the bonus plan/the perqs?
- Is pay just too darn high?
- How will we know what the biggest problem areas were?
- How will we know what we should be changing? How can we make the vote “actionable”?

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COUNTERPOINT:

- Companies will know:
 - By reading the proxy advisors’ reports
 - By reading the press reports
 - Most importantly, by speaking to larger Shareholders who voted no, hopefully (in future years) in advance of pay program finalization

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COUNTERPOINT *(continued)* :

- Moreover, votes against the re-election of Compensation Committee members are just as “non-illuminating” in terms of specifics as are “Say on Pay” votes

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COUNTERPOINT:

- Notwithstanding that some sort of mandatory universal rule may be politically irresistible, there have been a number suggestions to move away from the “one size fits all” approach:
 - Professor Gordon’s (Columbia Law) “opt in” via Shareholder vote approach, or having required votes apply only to some subset of public companies

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COUNTERPOINT *(continued)* :

- Permit companies who receive support above a certain threshold to skip a year (or two or three) before having to go back to Shareholders
- Permit only those Shareholders who have held their shares “long” for some period (6 months?) to have a “Say on Pay” vote (to ameliorate concerns re: vote buying/renting)

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COUNTERPOINT *(continued)* :

- Schering-Plough’s shareholder survey — mailed out with the 2009 proxy (Company recently reported there was a 0.05% response rate)
- Permit flexibility in fashioning the resolution: e.g., Littlefield Corporation’s “are we within 20% of an acceptable number?” approach

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COUNTERPOINT *(continued)* :

- RiskMetrics initial tripartite approach, calling for separate annual votes on:
 - Compensation Philosophy
 - Awards made in prior year
 - Goal setting for current year
- Microsoft’s triennial approach, adopting United Brotherhood of Carpenters’ call for a vote once every three years, correlating more closely to many companies’ strategic business plan cycles.

POINT:

11. Given the overwhelming support that “Say on Pay” proposals received this past proxy season – RiskMetrics Group reports that an average of 88% of votes were cast in support of management, with TARP-mandated votes at Goldman, JP Morgan, Wells Fargo and Morgan Stanley receiving more than 93% approval – will “Say on Pay” turn out to be a toothless tiger/mindless ratification process – especially when instead of having to vote on a few hundred proposals, universal adoption results in 3-5,000 annual proposals?

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COUNTERPOINT :

- 2008 compensation levels at TARP recipients was severely down, with zero bonuses (and even \$1/year salaries) not unusual.
- Although no “Say on Pay” proposal was voted down, Citi received a 16% NO vote, and BoA received a 29% NO vote, making the point that compensation issues concerned Shareholders.
- Moreover, a number of Citi and BoA directors were targeted in “vote NO” campaigns, which may have taken the focus off the “Say on Pay” vote efforts.

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COUNTERPOINT *(continued)* :

- The TARP-recipient votes were made mandatory quite late in the proxy season, and many investors did not yet have voting guidelines in place.
- It will take time for investors to figure out how to best deploy this new tool.

POINT:

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COUNTERPOINT:

- Perhaps true under the current rules of play, where investors “pick and choose” their presumably most deserving targets, but beware the possibility that universal “Say on Pay” will end up being overkill, overwhelming the proxy system and diluting the impact of NO votes, even where NO votes are appropriate.

POINT:

12. “Say on Pay” is a measured, focused tool to help Institutional Investors towards achieving their long-term goals.

COUNTERPOINT *(continued)* :

- Beware other possible impacts of the law of unintended consequences:
 - Note the results of prior government/regulatory initiatives in the pay area, e.g., golden parachutes and §162(m)
 - Some suggest that the wholesale adoption of option grants in the 1990’s (now generally discredited) resulted at least in part from Institutional Investors’ enthusiasm for options as a close to perfect “pay for performance” vehicle

POINT:

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COUNTERPOINT *(continued)* :

- Another possible unanticipated consequence: If a company’s Shareholders approve the “Say on Pay” resolution, will Directors of that company somehow be shielded from later charges of excess compensation/corporate waste?
- Consider whether having to “run the gauntlet” of annual “Say on Pay” votes will encourage top executive talent to gravitate towards the private sector.

POINT:

12. “Say on Pay” is a measured, focused tool to help Institutional Investors towards achieving their long-term goals.

COUNTERPOINT *(continued)* :

- Lastly, and perhaps most importantly: Companies and Shareholders alike — and the entire “governance industry” — will be committing significant resources to the “Say on Pay” process; consider, on a “cost/benefit” analysis, whether such commitment will ultimately really be worth it?