FREDERIC W. COOK & CO., INC.

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Executive Compensation Year in Review: Looking Back on 2010 and Implications for 2011

Introduction

Each year, Frederic W. Cook & Co. publishes a year-in-review letter summarizing various executive compensation developments that occurred in the past year and what the implications may be for the current year. This letter provides a recap of major regulatory and technical developments that were detailed in our alert letters published in 2010, and comments on the issues companies are currently facing with regard to executive compensation design and corporate governance reform.

A list of all alert letters issued in 2010 is provided at the end of this document and each letter is accessible via our website at www.fwcook.com.

Executive Compensation in 2010

Summarized below are highlights of various items that impacted executive compensation in 2010, including:

1. Dodd-Frank Act
2. SEC Disclosure Enhancements
3. ISS (formerly RMG) Updates
4. Other Regulatory Updates

Dodd-Frank Act

Also known as the Wall Street Reform and Consumer Protection Act, this pivotal legislation was signed into law on July 21, 2010. Key items of the act that impact executive compensation are: (1) Say-on-Pay, (2) compensation committee and consultant independence, and (3) miscellaneous items such as additional disclosure and expanded claw-back policies.

Say-on-Pay applies to public companies with shareholder meetings on or after January 21, 2011 and requires a non-binding advisory vote on both (1) the compensation of named executive officers as disclosed in the proxy statement, and (2) the choice of frequency of the Say-on-Pay vote (i.e., "Say on Frequency"): every one, two, or three years. This latter frequency vote must appear on the ballot at least once every six years.

There must also be a separate vote in transaction proxies filed on or after April 25, 2011 (the effective date of SEC rules) where change-in-control payments would be triggered under a merger or acquisition, unless these payments were already covered under the earlier Say-on-Pay vote. This vote requires expanded disclosure (i.e., a specific table outlining the payments) in the transaction proxy. However, to the extent there were any modifications or new parachute payments triggered since the prior Say-on-Pay vote, these payments would require a separate vote.

In addition, broker discretionary voting of uninstructed shares is not allowed for Say-on-Pay and election of directors, and investment managers are required to report how they vote on Say-on-Pay.

Compensation Committee and Consultant Independence rules, which are expected to be issued by the SEC in 2011, are modeled after rules that are currently faced by audit committees, in particular with respect to the use of independent advisors. Selection of an independent consultant must consider the following criteria:

1. Other services provided to the company
2. Policies and procedures of the advisers designed to prevent conflicts
3. Amount of fees and percent of the adviser's total revenues
4. Business or personal relationships of the adviser
5. Company stock owned by the adviser

The compensation committee is responsible for retaining and overseeing the work of advisers, but is not required to retain one. If the compensation committee chooses to do so, however, the proxy must disclose the compensation consultant retained and if there are any conflicts of interest raised by the consultant's work.

Other Miscellaneous Provisions covered under the Dodd-Frank Act that are awaiting final SEC rule-making and are expected to be in effect for the 2012 proxy season include:

1. Disclosure on whether the company maintains an anti-hedging policy covering its employees and outside directors
2. Pay for performance analysis comparing executive compensation to company financial performance, which may require a chart
3. Disclosure of the ratio of median employee pay to CEO annual total compensation using proxy reporting methodology to calculate
4. Requirement to claw-back cash and equity incentives if there is an accounting restatement due to material non-compliance with federal financial reporting requirements,

to the extent incentives are “in excess of” what would have been paid “under the restatement”

- Claw-back would apply to compensation paid to all current and former executives for three years prior to the date restatement is required, and no fraud or malfeasance by such executives is required.

SEC Disclosure Enhancements

In 2010 the SEC initiated several reforms impacting disclosure requirements of executive compensation, including updated guidance on director and executive compensation disclosure, those discussed above under the Dodd-Frank Act, and additional disclosure of the compensation risk process used by companies, which is summarized further below.

The SEC approved amendments on December 16, 2009 that resulted in enhanced proxy disclosure on compensation and corporate governance matters. The revised rules require proxy disclosure in the event that compensation programs and policies for any employees (not just named executive officers) are “reasonably likely to have a material adverse effect on the issuer.” Guidance did not state how the risk analysis should be conducted in order to arrive at such a conclusion, and if it is determined that the programs do not encourage excessive risk-taking, there is no requirement to disclose this conclusion nor the nature of the analysis used to arrive at it.

However, subsequent guidance from and action by the SEC indicate that companies whose proxy statements are selected for review and that provide no disclosure on the risk assessment process will receive a comment letter requesting the rationale used by the company to determine that no material risk was present in the compensation program. ISS also encourages voluntary disclosure on the risk assessment process, including steps taken to evaluate risk and whether any risk mitigators, such as clawback and anti-hedging policies, are in place at the company.

As a result of both the SEC and ISS initiatives, many companies have adopted and disclose a formal process evaluating risk in relationship to their compensation plans and practices.

ISS Updates

Although not a public agency, Institutional Shareholder Services, or ISS, is considered by many to occupy a uniquely powerful ability to influence shareholder voting outcomes, due to the number of investors who read and are influenced by its voting recommendations. This makes it appropriate to consider several ISS developments during 2010.

GRId

In 2010, ISS introduced the GRId (Governance Risk Indicators) tool to assist institutional investors in evaluating the level of governance-related risk present at a company. GRId replaced ISS’ prior tool, the Corporate Governance Quotient (CGQ). GRId measures the level of risk in four governance categories: Audit, Board, Compensation and Shareholder Rights, and determines whether each risk presents a low, medium or high concern level (identified by a color-coded system of green, yellow and red, respectively).

There are a total of 63 questions that comprise the GRId for U.S. companies. Each category contains subcategories with questions that are scored generally from -5 to +5, with higher scores indicating greater alignment with good governance. Scores are then weighted depending on the category; e.g., the most important question with respect to the compensation category of the GRId relates to change-in-control severance pay triggers. This question is weighted 22.75%, and companies are penalized for having single trigger arrangements (i.e., severance pay paid upon change-in-control even if employment has not terminated), modified single triggers (i.e., executive can voluntarily leave during a window period and receive severance pay) or for making modifications to agreements within the past year and maintaining these arrangements.

The GRId also penalizes companies for providing excise tax gross-ups on change-in-control payments, not disclosing sufficient details (e.g., performance measures) on annual incentives, not requiring holding periods for executives on company stock, and sub-standard (i.e., less than 3x salary) ownership guidelines for the CEO and directors, in addition to several other items.

Note that in light of regulatory changes in 2010 and 2011, it is expected that ISS will release documentation on an updated GRId framework in early 2011.

2011 Policy Updates

ISS issued its policy updates for the 2011 proxy season on November 19, 2010. Most notable items are the recommendation on the frequency of Say-on-Pay voting, refinements to its list of problematic pay practices, and changes with respect to ISS' acceptance of prospective commitments eliminating problematic pay practices. Highlights of the policy updates include the following:

- With respect to the Say-on-Pay frequency vote, out of the four choices of annual, biennial, triennial or abstention from voting, ISS will recommend an annual Say-on-Pay vote, as annual vote results in greatest accountability to shareholders.

- With respect to votes on golden parachute arrangements in an acquisition, merger, consolidation or proposed sale, ISS will recommend on a case-by-case basis depending on the level of problematic pay practices that exist at the company. Practices that may lead ISS to recommend against a golden parachute arrangement include:

    - Recently adopted or materially amended agreements since prior annual meeting that include excise tax gross-ups and modified single trigger provisions;

    - Single-trigger payments that will be made immediately upon a change in control, including cash severance and the acceleration of performance-based equity despite the failure to achieve performance objectives;

    - Single-trigger vesting of equity based on a definition of change in control that requires only shareholder approval of the transaction (rather than consummation);

  - Potentially excessive severance payments (defined as more than 3x cash compensation);

  - Recent amendments or other changes that may make packages so attractive as to influence merger agreements that may not be in the best interests of shareholders;

  - In the case of a substantial excise tax gross-up from a pre-existing/grandfathered contract: the element that triggered the gross-up (e.g., option mega-grants at low point in stock price, unusual or outsized payments in cash or equity made or negotiated prior to the merger); or

  - The company's assertion that a proposed transaction is conditioned on shareholder approval of the golden parachute advisory vote, which would be viewed as problematic from a corporate governance perspective

- ISS will use Say-on-Pay proposals as the primary vehicle for voting against a company's executive compensation program if "problematic pay practices" exist. In the absence of the Say-on-Pay proposal, ISS may revert to withhold vote recommendations against compensation committee members up for re-election. Problematic pay practices have been refined to provide for three "egregious" practices that may result in a withhold vote recommendation on a stand-alone basis:

  - Repricing or cash buyouts of underwater stock options/SARs without shareholder approval

  - Excessive perquisites or tax gross-ups

  - New or extended agreements that provide for (1) CIC severance in excess of 3x base salary plus bonus, (2) CIC severance without termination of employment (i.e., single or modified single trigger arrangements), and (3) excise tax gross-ups, including modified gross-ups

- Also, ISS will no longer accept prospective commitments to eliminate problematic pay practices in order for the company to reverse a negative vote recommendation, except in cases of (1) the pay-for-performance and burn rate commitments and (2) modification of plan language on equity grant practices (e.g., related to CIC definition) where the change would result in a more favorable outcome for shareholders.

While ISS has indicated that grandfathering of agreements will continue to apply as long as the agreements are not modified, there are no guarantees since ISS reviews each company on a case-by-case basis, and may give greater scrutiny to contracts with evergreen provisions that are amended to eliminate some, but not all, problematic pay practices.

Burn Rate Tables

In late 2010, ISS published updated burn rate tables for Russell 3000 and non-Russell 3000 companies that apply to shareholder meetings on or after February 1, 2011. Under its Burn Rate

Policy, which remains unchanged except for the implementation of a cap on year-over-year changes in burn rates of two percentage points, if a company's three-year average burn rate exceeds (1) the higher of its industry group's mean plus one standard deviation or (2) two percent of weighted average common shares outstanding, ISS will recommend a vote against the company's equity plan proposal. A company can avoid this negative outcome by committing to a future three-year average burn rate that will not exceed the greater of (1) two percent or (2) the industry group's mean plus one standard deviation at the time of the commitment.

According to ISS, 2011 burn rates are higher than historical levels primarily as a result of increased grant levels and the continued shift to full-value shares, which are converted to option equivalents for purposes of the burn rate calculation using a multiple based on annual stock price volatility. Given the lower stock price volatility in 2010 vs. 2009, full-value awards were converted at higher multiples, which contributed to the higher burn rates.

Other Regulatory Updates

In June 2010, several banking regulatory agencies comprised of the Comptroller of the Currency, the Office of Thrift Supervision (OTS), the FDIC and the Federal Reserve adopted final guidance to ensure that incentive compensation plans in place at financial organizations do not undermine the soundness of the organization or encourage excessive risk-taking. This final guidance covers approximately 8,000 banking organizations under the purview of these collective agencies and applies to incentive compensation for the following "covered employees":

1. Senior executives and those who oversee the organization's firm-wide activities or material business lines

2. Employees, including non-executives, who may expose the organization to material risk

3. Groups of employees subject to similar incentive compensation arrangements who may, in the aggregate, expose the organization to material amounts of risk

The guidance is based on three key principles that are consistent with the Financial Stability Board's[1] "Principles for Sound Compensation Practices":

1. Balanced Risk-Taking Incentives – incentive compensation arrangements should be balanced in design and implemented to ensure actual payments vary based on risk-adjusted performance or ultimate risk outcomes. A full range of risks, including credit, market, liquidity, operational, legal compliance and reputational risk, should be considered

2. Compatibility with Effective Controls and Risk Management – organizations should have controls in place that ensure their processes for achieving balanced compensation

[1] The Financial Stability Board (FSB) is an international organization established to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. The SEC, Treasury Department, and Federal Reserve are represented on the FSB.

arrangements are followed, while maintaining the integrity of their risk management and other functions

3. Strong Corporate Governance – strong and effective corporate governance should be in place at the organization to ensure sound compensation practices, and the board of directors should closely monitor the performance, design and function of incentive compensation arrangements

The agencies completed a review of incentive compensation practices and issued their assessment of these practices in 2010 that included the following areas considered to be deficient at several companies:

1. Identification of the employees who can expose the organization to material risk

2. Designing risk sensitive compensation that fully captured risks involved, and applying such design to enough employees

3. Tailoring deferral arrangements to type or duration of risk, rather than a "one-size-fits-all" approach

4. Evaluating whether the established practices are successful in balancing risk

Banking organizations are expected to take immediate actions to address any such deficiencies. The final guidance provides suggestions and examples on how to comply, and serves as a framework for all public companies to assess their incentive compensation programs for material risk.

Section 956 of the Dodd-Frank Act directs the Federal Reserve, the Office of the Comptroller of the Currency, the FDIC, the Office of Thrift Supervision, the National Credit Union Administration Board, the SEC, and the Federal Housing Finance Administration to jointly issue regulations regulating incentive compensation arrangements by financial institutions that would encourage inappropriate risk-taking. While regulations have not yet been formally proposed, draft regulations contain many features modeled after the guidance.

Implications for 2011

Say on Pay

The most critical item for companies in late 2010 and early 2011 has been planning for Say-on-Pay. Many companies were proactive in reviewing their plans to determine compliance with the new regulations before they were even finalized. Companies are encouraged to begin the process early by considering the following steps in preparation for their 2011 proxy season and both the Say-on-Pay and Say on Frequency votes:

1. Inventory major shareholders and determine their executive compensation voting policies with assistance from investor relations staff and proxy solicitor

2. Maintain an open dialog with major investors in advance of the vote in order to avoid surprises

3. Develop a strong communication document, such as a detailed executive summary, for inclusion in the Compensation Discussion and Analysis that would assist in explaining and "selling" the executive compensation program to shareholders as part of the Say-on-Pay proposal

4. Demonstrate how executive compensation levels are reasonable and aligned with performance

5. Carefully explain the business rationale for maintaining certain practices that may not be aligned with current governance standards, such as excise tax gross-up provisions on change-in-control payments

6. If not already in place, consider adopting elements that are relatively straightforward to implement and are considered "best practices," such as stock ownership guidelines, an anti-hedging policy and a clawback policy

7. Determine a rationale for recommendation on frequency vote of future Say-on-Pay voting, recognizing that proxy advisory firms and many institutional investors prefer annual voting

Initial Say-on-Pay frequency vote recommendations indicated a strong preference by companies for a triennial vote frequency, with the number of recommendations for triennial about double the number for annual. As of March 18, 2011, however, approximately 740 companies had filed, with 328 companies recommending a triennial vote, 361 companies recommending an annual vote, 25 companies recommending a biennial vote, and 25 companies making no recommendation. Of the companies that recommended a triennial vote and have published their voting results, approximately 40% have had shareholders indicate their preference for annual votes. It is generally expected that companies will continue to defer to shareholder preference on this matter.

Preliminary voting results for approximately 125 companies thus far indicate that with respect to Say-on-Pay votes, ISS has recommended against Say-on-Pay at over 14 companies, and of these, three companies have had their Say-on-Pay proposal fail.

Companies in 2011 will continue to consider the implications of implementing other provisions of the Dodd-Frank Act, such as clawback policies and evaluating pay-for-performance, but are waiting to take action until final guidance from the SEC is released later this year.

Proxy Advisory Firms

Companies have taken a proactive approach to determining whether they will come under ISS scrutiny with respect to two of ISS' evaluation criteria: (1) the existence of problematic pay practices and (2) failure of the CEO pay-for-performance test. The result of this test is critical since it is one of three factors, along with problematic pay practices and board communications and responsiveness, which ISS reviews when developing its Say-on-Pay vote recommendations. The CEO pay-for-performance test applies to companies in the Russell 3000 whose TSR is below the median TSR of their four-digit GICS industry peer group on both a one- and three-year basis, measured as of the company's most recent fiscal year end. If both one- and three-year TSR are below the median, ISS will then review CEO compensation to determine whether or not it has increased or decreased by a material amount year-over-year. If ISS determines that the increase was material, or the decrease not material enough, ISS will review each element of compensation to determine whether the increase was performance-based and whether other problematic pay practices are in place at the company. Failure of the CEO pay-for-performance test may result in ISS recommending against Say-on-Pay, although it will likely consider this in conjunction with the other factors mentioned above.

It will be interesting to observe how influential proxy advisory firms such as ISS and Glass-Lewis remain in 2011 and beyond. Initial voting results indicate that not all institutional investors automatically vote with ISS with respect to Say-on-Pay proposals. The proxy advisory firms continue to face criticism with respect to the accuracy of their analyses and their "one size fits all" approach when applying their policies to individual companies. Part of this problem stems from the size of the task at hand, and these firms may be considered to be "biting off more than they can chew" given the amount of voting recommendations they issue in a short, concentrated period of time (i.e., most companies have calendar fiscal year-ends and proxy season is generally concentrated to a three to four month period). Review of annual proxy statements was onerous enough before, but with the advent of Say-on-Pay in 2011, the number of recommendations will increase significantly and prompt further concern as to the basis on which these recommendations are formed. It is near impossible for individual company facts and circumstances to be carefully reviewed by ISS or Glass-Lewis as part of developing their voting recommendations, and companies are concerned that the process will likely become even more automated and formulaic.

The SEC has issued inquiries into the role and accountability of proxy advisory firms, and received responses that would indicate a preference that they become subject to SEC regulation, which might result in improved and more transparent processes with respect to voting recommendations.

Continued Focus on Pay-for-Performance and Compensation Plan Design

Investors will continue to focus on pay-for-performance in 2011 and beyond and the Dodd-Frank Act will aid in improving transparency of disclosure and encouraging elimination of legacy arrangements that are not considered performance-based. Practices such as SERPs and executive life insurance arrangements are being restricted for new participants and generally being phased out to the extent there is not a continued legal obligation by the company to provide such benefits.

Other non-performance-based compensation practices, such as perquisites and severance packages, have been downsized over time and this trend will likely continue, particularly in light of ISS scrutiny of programs with overly generous severance multiples or excessive perquisites (including tax gross-ups). By way of example, the 2010 Frederic W. Cook Study of Change-in-Control Practices comparing 2010 and 2007 practices found the following trends:

1. Shift to lower cash severance multiples (generally from 5x or 3x to 2x)

2. Change in equity vesting from single trigger (i.e., CIC with no termination) to double trigger (i.e., CIC with termination)

3. Decreased prevalence of excise tax gross-ups

Long-term incentive ("LTI") plan design has changed dramatically over the past several years, and will continue to evolve given the significant portion (approximately two-thirds) of executive compensation that is delivered in the form of LTI. The movement from stock options to full-value stock has been dramatic, and companies are beginning to recognize that full-value awards should be performance-based and not just contingent on service requirements, as has been the practice in recent years. The shift away from stock options over the past 10 years is evidenced by the table below:

Long-Term Incentive
Grant-Value Mix*

	2000	2010
Stock Options/SARs	86%	42%
Restricted Stock/Units	10%	22%
Performance Shares/Units	4%	36%
Total Annualized Value	100%	100%

* Estimated for proxy officers of S&P 500 companies.

Performance-based LTI is generally tied to a multi-year period and earned based on goal achievement during that period. Companies have faced challenges in implementing performance plans due to the difficulty of goal-setting, but it is likely that the Dodd-Frank Act will result in further scrutiny of company LTI vehicles to ensure there is a continued focus on pay-for-performance.

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General questions about this letter may be directed to Silvana Nuzzo at (212) 299-3714 or by email at sanuzzo@fwcook.com, or to Claude Johnston at (212) 299-3708 or by email at cejohnston@fwcook.com. Questions regarding specific topics covered in this letter may also be addressed directly to the consultant(s) referenced at the end of the related "Alert" letters listed below, which may be found along with additional information about our firm on our website at www.fwcook.com.

2010 ALERT LETTERS

01/22/10	ACCOUNTING FOR STOCK COMPENSATION UNDER FASB ASC TOPIC 718 (Originally April 29, 2005)
02/25/10	SEC AND RISKMETRICS GROUP SEEK GREATER EXPLANATION OF COMPENSATION RISK ASSESSMENTS IN 2010 PROXY STATEMENTS
03/03/10	RISKMETRICS GROUP RELEASES GOVERNANCE RISK INDICATORS (GRId) TOOL TO MEASURE GOVERNANCE-RELATED RISK
03/16/10	SEC RELEASES INTERPRETIVE GUIDANCE ON NEW EXECUTIVE COMPENSATION DISCLOSURE RULES (Originally January 29, 2007)
03/24/10	RISKMETRICS GROUP DISCLOSES COMPLETE METHODOLOGY OF GOVERNANCE RISK INDICATORS (GRId)
04/05/10	ACCOUNTING FOR STOCK COMPENSATION UNDER FASB ASC TOPIC 718 (Originally April 29, 2005)
04/21/10	EXECUTIVE COMPENSATION 2009 – THE YEAR IN REVIEW AND OUTLOOK FOR 2010
05/13/10	RISKMETRICS GROUP DISCLOSES COMPLETE METHODOLOGY OF GOVERNANCE RISK INDICATORS (GRId) (Originally March 24, 2010)
06/16/10	SEC RELEASES INTERPRETIVE GUIDANCE ON NEW EXECUTIVE COMPENSATION DISCLOSURE RULES (Originally January 29, 2007)
06/28/10	BANKING AGENCIES ISSUE FINAL GUIDANCE ON SOUND INCENTIVE COMPENSATION POLICIES
06/29/10	EXECUTIVE COMPENSATION AND CORPORATE GOVERANCE PROVISIONS IN DODD-FRANK BILL
10/21/10	SEC PROPOSED RULES ON SHAREHOLDER ADVISORY VOTES ON SAY-ON-PAY, FREQUENCY OF SAY-ON-PAY VOTES, AND GOLDEN PARACHUTE COMPENSATION
11/23/10	ISS ISSUES 2011 POLICY UPDATES
12/17/10	UPDATED ISS BURN RATE TABLES