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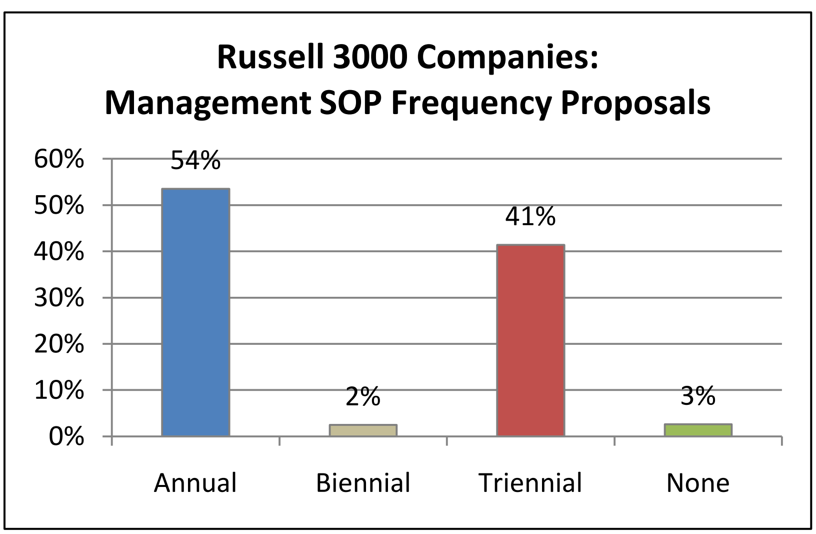
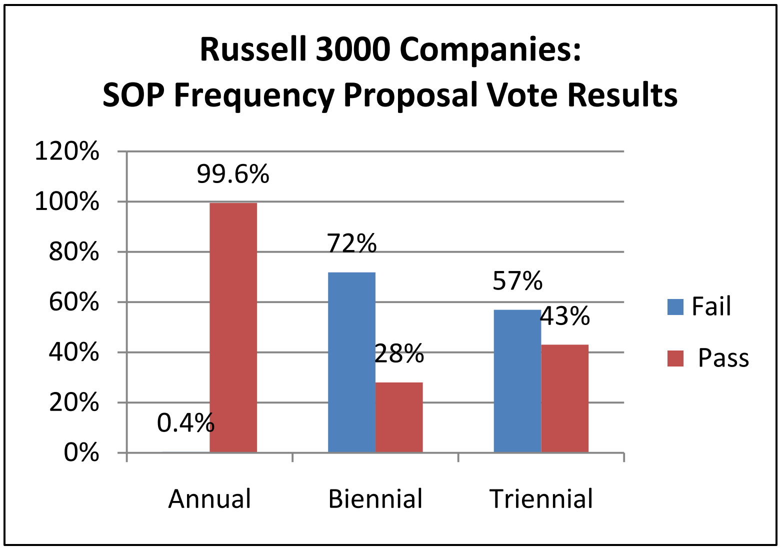
SAY-ON-PAY: 2011 PROXY SEASON DE-BRIEF

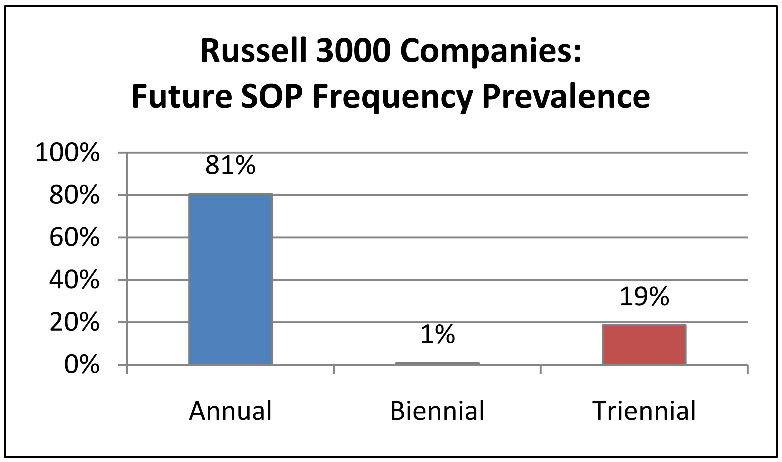
The first proxy season of required say-on-pay ("SOP") advisory votes for most U.S. public companies ended on June 30. Among the Russell 3000, 2,292 companies had annual shareholder meetings between January 21, the first meeting date companies were required to have an SOP proposal and thus the unofficial start of this year's proxy season, and June 30, the recognized end of the proxy season. Companies were also required to have an advisory vote on the frequency of future SOP proposals, with annual, biennial, and triennial frequencies permitted. For the majority of companies, the experience may not have been stress-free, but 98% of companies passed with average shareholder support over 90%. Shareholders also overwhelmingly supported annual SOP votes. This letter provides detailed SOP voting results for the Russell 3000 as constituted through June 30, and available as of July 29 in the Institutional Shareholder Services ("ISS") Voting Analytics database. It also analyzes ISS' voting recommendations for the 37 companies with failed SOP votes to identify key issues and lessons learned for ensuring successful future SOP vote outcomes.

Russell 3000 SOP Frequency Results

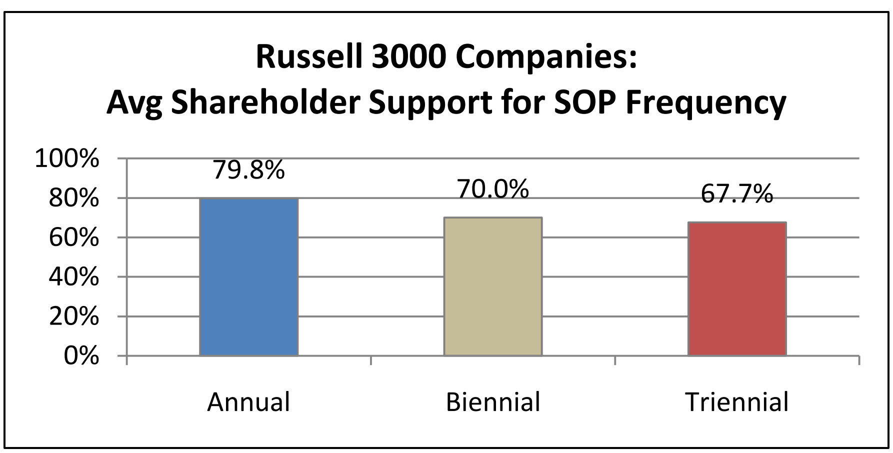
At the beginning of the proxy season, a large majority of companies recommended a triennial SOP vote frequency, but shareholders quickly made apparent their preference for an annual frequency. The three graphs that follow present the prevalence of company SOP frequency recommendations, which shifted to annual in response to early shareholder voting results, the pass/fail rates for management frequency proposals, and the final prevalence of voting frequency for future SOP proposals.







Before the proxy season began, there was concern that SOP frequency results would not be meaningful due to shareholders having four vote choices (i.e., the three frequencies plus to abstain), which was unprecedented. Companies were hoping for a sufficiently clear plurality to indicate shareholder preference. This concern was dispelled when shareholder voting results showed majority outcomes in most cases. The table below shows average shareholder support for each of the three frequencies.



Russell 3000 SOP Results

For the 2011 proxy season, 98% of Russell 3000 companies' SOP proposals passed and 2% failed. For companies with below-median one- and three-year total shareholder return ("TSR"), and thus potentially subject to closer scrutiny under ISS' Pay-for-Performance Policy, voting results drop slightly to 96% passing and 4% failing. The table below summarizes SOP voting results for the full Russell 3000 and for companies with below-median TSR over one and three years.

Russell 3000 Companies: SOP Voting Results

	All Companies	Below-Median TSR Companies
SOP Vote Results:		
— Pass	98%	96%
— Fail	2%	4%
ISS Vote Recommendations:		
— FOR	87%	72%
— AGAINST	13%	28%
Average Shareholder Support:		
— Passing Companies	91%	87%
— Failing Companies	42%	42%
Average Passing Vote When:		
— ISS FOR Recommendation	94%	92%
— ISS AGAINST Recommendation	73%	72%

A conclusion that can be drawn from the above data is the influence of ISS on voting results: 21 percentage points for all Russell 3000 companies and 20 percentage points for companies with below-median one- and three-year TSR.

Glass Lewis, another major proxy advisor, but with less influence than ISS on institutional shareholder voting in our experience, does not make similar voting results information available. However, we have been told by Glass Lewis that, overall, they recommended AGAINST 17% of companies, which compares to 11% for ISS (13% for Russell 3000 companies).

In our experience, Glass Lewis' vote recommendations influence between 5% and 10% of the vote results, but for a small number of companies Glass Lewis can impact 20% or more of the vote, similar to ISS' influence. Therefore, it is important for companies to understand the proxy voting guidelines of their major institutional shareholders and whether such shareholders follow ISS' or Glass Lewis' vote recommendations.

Factors Leading to a Failed SOP Vote

The 37 companies with a failed SOP vote and shareholder support for their SOP proposal are listed below.[1] Companies in bold are part of the S&P 500.

Companies With Failed SOP Votes

Ameron International (41.3%)	**Masco (44.7%)**
Beazer Homes USA (45.9%)	M.D.C. Holdings (33.5%)
BioMed Realty Trust (45.8%)	Monolithic Power Systems (36.2%)
Blackbaud (44.7%)	**Nabors Industries (42.5%)**
Cadiz (37.5%)	Navigant Consulting (44.8%)
Cincinnati Bell (29.8%)	Nutrisystem (41.1%)
Cogent Communications (39.3%)	NVR (44.5%)
Constellation Energy (38.6%)	Penn Virginia (41.0%)
Curtiss-Wright (41.2%)	PICO Holdings (38.9%)
Cutera (35.3%)	Premiere Global Services (48.0%)
Dex One (48.0%)	Shuffle Master (44.5%)
Freeport-McMoRan Copper & Gold (45.5%)	**Stanley Black & Decker (39.1%)**
Helix Energy Solutions (32.0%)	Stewart Information Services (48.5%)
Hercules Offshore (41.0%)	Superior Energy Services (39.2%)
Hewlett-Packard (48.2%)	The Talbots (47.4%)
Intersil (44.2%)	Tutor Perini (49.1%)
Jacobs Engineering (44.8%)	Umpqua Holdings (36.2%)
Janus Capital (40.1%)	Weatherford International (44.0%)
Kilroy Realty (48.9%)	

A summary profile of the information from the ISS proxy analysis reports on the failed companies is shown in the table on the next page and indicates that the majority had a pay-for-performance disconnect, determined as below-median TSR and increased CEO pay. Not shown in the summary profile is that the increase in CEO pay was typically driven by components that are non-performance-based as defined by ISS, which includes stock options and time-vesting restricted stock.

[1] Excludes three companies (i.e., Cooper Industries, Hemispherix Biopharma, and ISO Ray) with open questions regarding vote counting.

Profile of Failed Companies

• 1-/3-year TSR:	78%	Below Median
	22%	Above Median
	3%	Not Applicable
• CEO Pay Change:	73%	Increased
	24%	Decreased
	3%	No Change
• GRId – Compensation Level of Concern:	14%	Low
	46%	Medium
	35%	High
	5%	Not Rated
• SOP Issues:	73%	Pay-for-Performance Disconnect
	27%	Problematic Pay Practices
• Negative Director Vote Recommendation Due to Compensation Issues:	19%	

The key take-aways from our research are:

- ISS is doing holistic reviews. While ISS has a "check-the-box" methodology for evaluating companies' executive compensation programs against their policies, they appear to be using significant judgment and discretion in developing SOP vote recommendations.

- Companies with above-median TSR are not immune from an AGAINST SOP vote recommendation and failed SOP proposal, primarily due to high non-performance-based pay or egregious problematic pay practices. The same is true for companies with "low concern" in the GRId compensation area, which indicates strong alignment with "best practices."

- ISS' focus has shifted from problematic pay practices to pay-for-performance for developing SOP vote recommendations, and elimination of problematic pay practices will not cure a pay-for-performance disconnect.

- True to its word, ISS used its SOP vote recommendation to express concern with a company's executive compensation levels and/or practices rather than recommending AGAINST or WITHHOLD for re-election of directors on the compensation committee. Only the presence of egregious problematic pay practices resulted in negative vote recommendations for compensation committee members (unless another non-compensation issue led to negative vote recommendations for some or all directors).

- Perhaps the most important finding is that having a failed SOP vote appears to require more than an AGAINST vote recommendation from ISS (and/or Glass Lewis). Issues identified for the companies with failed SOP votes include one or more of the following: multiple years of below-median TSR and higher CEO pay; unresponsiveness to previously identified compensation issues, including majority withhold votes for compensation committee members; excessively high CEO pay or special retention awards; excessively high year-over-year increase in CEO pay; and egregious problematic pay practices.

A significant risk of failing the SOP vote is the possibility of being sued. Five of the 37 companies (i.e., Beazer Homes USA, Cincinnati Bell, Hercules Offshore, Jacobs Engineering, and Umpqua Holdings) are currently the subject of a derivative suit on behalf of shareholders. Each suit names the members of the compensation committee, the committee's compensation consultant, and various other executive officers. While legal experts expect that all companies with failed SOP votes will eventually be sued, they also expect that all of the suits will be dismissed without merit. Two shareholder suits related to failed SOP votes in 2010 were settled this year for reimbursement of plaintiff's legal fees, which sets an unfortunate precedent and encourages such suits.

<u>Challenging SOP Vote Recommendations</u>

A new phenomenon this year related to the SOP vote is the issuance of supplemental proxy solicitation materials either to address issues with proxy advisors' facts and analyses or to disagree with a negative SOP vote recommendation. We are aware of supplemental filings made by over 40 companies.

We are also aware of six companies that went so far as to make retroactive changes to their compensation programs so that ISS would change its SOP vote recommendations. ISS no longer accepts commitments from companies to make prospective changes to address problematic pay practices identified in compensation programs; the only way to get ISS to change its SOP vote recommendation is to make a retroactive change to eliminate the pay practice. The companies and the changes made are summarized in the table on the following page; four of the changes eliminate problematic pay practices and two address a pay-for-performance disconnect.

Companies Making Retroactive Program Changes	
Alcoa	Lengthened long-term incentive performance period to three years; changed performance metrics to eliminate duplication between short-term and long-term incentives; increased performance-based equity to be 50% of shares granted
Assured Guaranty (Bermuda)	Eliminated housing allowance tax gross-up; eliminated FICA tax reimbursement; eliminated change-in-control excise tax gross-ups, single-trigger equity vesting, and modified single-trigger severance (i.e., "walk-away window")
Disney	Eliminated change-in-control excise tax gross-ups
General Electric	Added performance vesting to CEO's stock options (half based on cumulative cash flow goal over four years and half based on TSR vs. S&P 500 Index over same period); committed to 100% performance shares and disclosed goals for CEO's future equity compensation
Lockheed Martin	Added performance vesting to CEO's stock options (half based on cash flow goal for 2011 and half based on return on invested capital goal for 2011); committed to 50% of future shares being subject to disclosed performance goals
Renaissance Re (Bermuda)	Eliminated tax gross-ups on all perquisites (i.e., housing allowances, FICA tax, personal/family aircraft use, automobile use, club membership, financial and tax planning) for current and future NEOs

Securing a Positive SOP Vote Outcome

What can companies do to improve their chances of a positive SOP vote outcome? Clearly, having strong pay-for-performance alignment in the design and operation of the executive compensation program is critical. Key features of such a program include the following:

- Use of objective performance criteria, which can include a non-financial portion, for determining annual and long-term incentive payouts;
- Avoidance of discretionary overrides or target goal resets when low or no incentive payouts would otherwise have resulted; and
- Avoidance of high non-performance-based compensation and large non-performance-based retention awards.

ISS and Glass Lewis also prefer that different performance metrics be used for annual and long-term incentives and that long-term incentives measure performance over a multi-year period.

Elimination of problematic pay practices is also important. The presence of any one of ISS' three egregious problematic pay practices (i.e., repricing underwater options/SARs without shareholder approval; excessive perquisites and gross-ups; or new or extended agreements with severance greater than three times salary plus bonus, excise tax gross-up or single-trigger severance) will result in an automatic AGAINST vote recommendation on SOP and possibly also the re-election of compensation committee members. But the presence of multiple problematic pay practices of lesser concern could also lead to a negative SOP vote recommendation.

A new "best practice" is for the Compensation Discussion and Analysis section of the proxy to begin with an executive summary that makes use of graphics and tables as much as possible to:

- Discuss the highlights of company's performance for the reported year;

- Discuss how performance was viewed by the compensation committee and translated into decision-making with regard to incentives for the reported year, and possibly also target compensation for the current year;

- Present in tabular format the principal components of the compensation program, the reasons for providing them, and how they relate to performance;

- Provide a brief description of any significant changes or new features added to the compensation program, especially those consistent with "best" practices and good governance; and

- Provide a brief description of key risk mitigating and governance aspects of the compensation program (e.g., clawback policy, anti-hedging policy, stock ownership guidelines).

Finally, proactive engagement with major shareholders to ensure an understanding of any concerns with compensation levels or practices is essential, especially if support for a company's SOP proposal is below 90% or declines from one year to the next.

Companies can no longer afford to be viewed as active defenders of entrenched management entitlements, falling back on the overused rationale of "needing to be competitive." The corporate governance environment is increasingly dynamic, and there are no more untouchable "sacred cows" in a SOP world. Good board and management governance require companies to show responsiveness to expressed concerns they believe have merit and to engage with large, long-term shareholders.

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This letter was authored by Wendy Hilburn, with research assistance from Ross Perry. Questions and/or comments should be directed to Ms. Hilburn in our New York office at wjhilburn@fwcook.com or 212-299-3707. This letter and other published materials are available on our website, www.fwcook.com.