Frederic W. Cook & Co., Inc.

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REALIZED PAY – NEW APPROACH FOR MEASURING PAY

The use of realized pay analyses to evaluate the relationship between executive pay and performance and, in some cases, address any perceived disconnect between pay and performance has been increasing. Disclosure of executive realized pay in company proxy statements, often in comparison to target or proxy-reported compensation and/or company performance (typically total shareholder return or TSR), is also becoming more prevalent.

Because this is an evolving practice, there is currently no standardized definition of realized pay, resulting in various definitions being used by companies and compensation professionals. Investors are seeking a standardized definition to facilitate comparisons across companies, while ISS and Glass Lewis are evaluating the use of realized pay in formulating say-on-pay vote recommendations.

Some critics have characterized executive pay as being a case of "clear market failure"[1], mostly because of a perceived disconnect between reported executive pay levels and company performance. In light of this perception, some companies are using realized pay as an alternative approach to measure pay in a way that helps them monitor the results of the compensation program in place (i.e., analyzing the relationship between the intended compensation determined when setting pay structures and levels and actual pay). This exercise helps to better demonstrate the linkage of executive pay and company performance, identify potential disconnects between executive pay and company performance, and understand strengths and weaknesses of the program in supporting other objectives (e.g., internal pay equity, actual payout leverage, retention considerations, etc.). Furthermore, these results can be shared with investors to provide additional insight into a company's compensation program for say-on-pay vote decisions.

For simplicity, we use the term "realized" pay in this letter to capture the various alternative pay definitions, including realized, realizable and earned pay, unless otherwise noted.

NEED FOR REALIZED PAY

While investors, executives and board members agree that executive compensation should be aligned with company performance, the common practice today is to use the Securities and

[1] http://www.businessweek.com/news/2012-06-19/u-dot-k-dot-to-give-shareholders-votes-on-top-pay-boost-disclosure

Exchange Commission (SEC)-mandated form of compensation disclosure in proxy statements when studying market pay structures and levels. The Summary Compensation Table, as required by SEC rules, contains a mix of earned pay and target pay, specifically earned amounts for cash compensation and target grant date fair values for options and other equity awards, which may be worth more or less (or even nothing) when vested or paid. Because equity values typically make up the majority of total pay for executives, reported pay does not always align with a company's reported financial and market performance. Consequently, due in large part to the implementation of shareholder say-on-pay votes, a growing number of companies are experiencing the need to explain their pay-for-performance alignment by disclosing the actual pay realized by their Named Executive Officers (NEOs) in their proxy statements.

One approach that companies have taken is to provide a supplemental realized pay table for their CEO (or for all NEOs) in comparison to the Summary Compensation Table to explain the alignment of pay with company performance. The key issue in preparing the supplemental disclosure is how to define "actual pay" as there is currently no standardized practice for evaluating whether executives' realized compensation is aligned with the company's performance. Alternative pay definitions include:

- *Earned pay*, which is the amount the executive earns the right to keep (e.g., intrinsic value of vested options and full-value equity grants)
- *Realizable pay*, which is the amount the executive expects to realize in the near future (e.g., value of vested and unvested options and full-value equity grants)
- *Realized pay*, which is the amount that the executive reports as W2 income (e.g., intrinsic value of options exercised and vested full-value equity grants)

MARKET PRACTICES AND TRENDS

Frederic W. Cook & Co. has researched market practice and trends relating to alternative definitions of pay among the "Top 250" publicly-traded U.S. companies (ranked by market capitalization as of February 29, 2012) also used in the Frederic W. Cook & Co. 2012 Top 250 survey – an annual survey of long-term incentive grant practices. The sample companies used for studying market practices and trends on realized pay included all companies that provided supplementary compensation tables among these 250 companies.

- Fifteen of the Top 250 companies (6%) provided supplemental realized compensation tables or charts in their 2012 proxy statements for some or all of their NEOs (four for all NEOs and eleven for only the CEO)
- Nine of the companies with supplemental disclosure (60%) compared their executives' realizable pay with absolute and/or relative TSR
- Eleven companies (73%) made a direct comparison between their executives' reported and/or target pay and their realized pay[2]

[2] Comparison against company peers are uncommon since peer information required for calculating realized pay values is often not available at the time of filing the proxy statement

- The most common reason cited by companies for including supplemental realized pay tables was to provide shareholders with the company's perspective on its pay-for-performance alignment, using pay values that are considered to be the NEOs' "real" compensation rather than their "pay opportunity" or "estimated" compensation shown in the Summary Compensation table
- Nine out of these fifteen companies (60%) included similar realized compensation disclosure in their prior year (2011) proxy statements

Because realized pay is still very much an evolving topic, particularly due to the lack of any regulatory-mandates requiring disclosure, companies have so far been able to customize pay definitions for presenting pay-for-performance alignment. For these fifteen companies, the most prevalent definition (used by companies such as Allstate Corp., Boeing, and Eaton Corp.) of realized long-term incentive (LTI) compensation was:

- Gains upon **stock option exercises** for the most recently completed fiscal year, irrespective of when the awards were granted
- Fair market value of all **full-value awards** (restricted stock/restricted stock units and performance shares/units) **that vested** in the most recently completed fiscal year, irrespective of when the awards were granted
- Value of actual long-term **performance cash paid** for the performance cycle ending with the most recently completed fiscal year

Other major variations of the LTI compensation definition include:

- In-the-money value of outstanding stock options and the fair market value of unvested full-value awards (performance-based awards at target), usually for equity awards granted during the last three fiscal years and compared against company's three-year TSR/performance (i.e., realizable compensation); for example, Anadarko Petroleum Corp. and Johnson & Johnson.
- In-the-money value of stock options at vesting instead of actual option exercise activity (i.e., earned options); for example, Hewlett-Packard.
- All equity awards (usually grants made during the last three fiscal years) measured at latest fair market values, i.e., capturing the Black-Scholes value of stock options and fair market values for full-value awards (i.e., realizable option value); for example, Deere & Co.

It is important to note that because the Summary Compensation Table already includes earned/realized amounts for salary and annual bonus compensation, there is no difference in these values and the values calculated under the alternative pay definitions discussed above. The primary difference is in the calculation of equity compensation, which is typically measured on a vested/exercised/intrinsic value basis under the alternative definitions rather than on a grant date fair value basis.

There were many other companies in the Top 250 that did not provide additional realized compensation tables or charts in their proxy statements but discussed realized pay as being a significant factor taken into consideration by the Compensation Committee for its future compensation decisions.

INVESTOR, SEC AND PROXY ADVISORY FIRM PERSPECTIVES AND DEVELOPMENTS

This subject has gained further prominence as most institutional investors have expressed clear interest in looking at these alternative measurements of pay for say-on-pay voting purposes. As a result, major proxy advisory firms such as Institutional Shareholder Services (ISS) and Glass-Lewis are considering incorporating these alternative definitions of pay for their future evaluations of companies' pay-for-performance alignment.

In evaluating whether or not to disclose a realized pay analysis, it is important to note that the SEC has recently cautioned companies regarding use of alternative definitions of pay in company proxy statements, which it believes, could be "misleading to investors."[3] It is possible that the SEC will bring some clarity to the disclosures with a definition for compensation "actually paid" to executive officers under to-be-released rules as required under the Dodd-Frank Act.[4]

Even though it is currently unclear if and when a standardized definition of realized pay will be developed, investors are seeking ways to achieve uniformity of disclosure among companies to facilitate realized pay comparisons. Therefore, we expect the practice of companies disclosing realized pay for their CEO and Named Executive Officers to become more widespread in the near future as companies attempt to communicate pay-for-performance alignment to shareholders for use in determining say-on-pay votes.

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This letter was authored by Arjun Prakash and Erin Bass-Goldberg. Questions and/or comments should be directed to Mr. Prakash at aprakash@fwcook.com or (914) 460-1104 or to Ms. Bass-Goldberg at ebassgold@fwcook.com or (610) 527-1049. Copies of this letter and other published materials are available on our website, www.fwcook.com.

[3] http://blogs.wsj.com/cfo/2012/10/04/sec-urges-caution-over-new-pay-disclosures/
[4] As of current, there is no timeline for SEC release of proposed rules on disclosure of compensation "actually paid"