

CSUITE

INSIGHT

ENGAGEMENT



Shareholder Engagement 7
Engage in Our Proxy Quiz! 14
Consultant's Corner—Effective Engagement 17
A Global View of Engagement 25
CFO Pay Strategies 43
Seymour Cash Gets Engaged 48

INTERVIEWS

Stephen Brown, TIAA-CREF 30
Doug Chia, Johnson & Johnson 34
Jim Barrall, Latham & Watkins 38



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Features

14 | **SHAREHOLDER ENGAGEMENT QUIZ**
Answer these questions honestly and see how you rate!

17 | **CONSULTANT'S CORNER**
What is needed to effectively engage with shareholders? What issues that are not being addressed between issuers and their investors?

25 | **WORLDATWORK: A GLOBAL VIEW**
We need to keep our eyes open to see what governance and shareholder engagement concepts might be exported around the world.

48 | **LAST WORD**
Seymour Gets Engaged



COVER STORY



7

SHAREHOLDER ENGAGEMENT: A HOT TOPIC

Shareholder engagement is as a hot topic for C-suite executives and boards, joining governance, disclosure, and transparency.

by Roger Strukhoff, Aaron Boyd, and Nick Ezzo



Special Report

43 | CFO PAY STUDY

This analysis compares the percentile rankings of companies against those of their disclosed peers on a variety of factors including revenue, cash compensation, and total direct compensation.

Interviews

30 | STEPHEN BROWN, TIAA-CREF

"If we believe outlier practices link to performance issues, we can develop a set of companies that we need to focus on."

34 | DOUG CHIA, JOHNSON & JOHNSON

"For us, succession planning has always been something that's been thought out and which goes rather smoothly."

38 | JIM BARRALL, LATHAM & WATKINS

"In my experience, most of the larger institutional investors are increasingly sophisticated, thoughtful and reasonable in evaluating executive compensation."



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PUBLISHER
DAVID CHUN

EDITORIAL DIRECTORS
AARON BOYD
NICK EZZO

EXECUTIVE EDITOR
ROGER STRUKHOFF

PRODUCTION EDITORS
MEI CHEN

EDITORIAL ASSISTANT
RODALYN VINAS

ART AND DESIGN DIRECTOR
KRIS REESE

CIRCULATION/DISTRIBUTION
LEE ANN SCHNEIDER

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David has led Equilar from a pure start-up since its inception in 2000 to one of the most respected and trusted names in the executive compensation industry.

THE IMPORTANCE OF ENGAGEMENT

WITH THE START OF the new year, many companies are once again busy preparing for their annual shareholder meetings. Important issues will be debated and decided, from the election of directors to the incentive plans of executives. Robust dialogue between public companies and their shareholders has never been more important than it is today, so the theme of this issue of *C-Suite Insight* is engagement.

To explore the topic of engagement, we spoke with all parties involved. We sought the viewpoint of the institutional investor community in our discussion with Stephen Brown, Senior Director of Corporate Governance at TIAA-CREF. Representing the issuer's perspective, Doug Chia, Assistant General Counsel and Corporate Secretary for Johnson & Johnson, talks about the challenges that corporations face today in communicating pay philosophy and decisions. Finally, Jim Barrall, Partner at Latham & Watkins, provided the expert opinion of the legal advisor.

We also consulted with some of the leading compensation and governance experts. We asked six firms to describe what they consider to be effective shareholder engagement. We've also provided a helpful quiz to test how successful company engagement is. Finally, we asked CEO Seymour Cash how he engages with his shareholders.

We wish everyone a successful proxy season and look forward to seeing many of you at our 2013 Executive Compensation Summit this June in Boston. Thanks for your support and feedback. 



DAVID CHUN
CEO and Founder, Equilar
dchun@equilar.com

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The Role of Shareholder Engagement

Shareholder engagement is emerging this year as a hot topic for C-suite executives and boards, joining governance, disclosure, and transparency.



shareholder engagement

disclosure

governance

transparency



These four topics are inter-related, of course, and shareholder engagement is now seen as the most effective way to assure shareholders that the other three are being taken care of. Intuitively and generally engagement is seen as the smart thing to do, but there's a tangible aspect to it as well.

As Kelly Malafis, a partner with Compensation Advisory Partners, told *C-Suite Insight*, “Effective shareholder engagement requires that companies reach out to their investors on an ongoing basis to be aware of key shareholder concerns and not wait until there is a crisis moment to address an issue.”

(Kelly Malafis and several other industry experts offered extensive quotes and interviews for this issue of *C-Suite Insight*. Their insights can be found in the “Consultant’s Corner” feature as well as in three full-length interviews in this issue.)

BEFORE LOOKING AT SHAREHOLDER ENGAGEMENT IN DETAIL, A BRIEF REVIEW OF HOW WE GOT HERE SEEMS IN ORDER:

SOX

Shareholder engagement is a by-product of the fast-moving evolution in how public companies in the United States interact with their shareholders. It is part of the modern era of oversight, which began a little more than a decade ago with Sarbanes-Oxley, fondly known as SOX.

SOX didn’t require shareholder engagement directly, but put into law relatively massive new public-company reporting requirements, and exposed board members to potential criminal penalties for a range of misdeeds. Widely criticized as a job killer, SOX has nevertheless been endorsed by Former Fed Chairman Alan Greenspan and former SEC Chairman Christopher Cox. While SOX remains controversial, it is seemingly impenetrable today.

GLASS-STEAGALL

But wait. Didn’t the modern era really begin during the Clinton Administration, with the repeal of Glass-Steagall? The Glass-Steagall Act, formally known as The Banking Act of 1933, established the FDIC and placed restrictions on banks and their activities.

Two sections of the act were repealed in 1991, despite years of debate and tweaks. Section 20 prohibited banks from issuing, floating, underwriting, distributing, or holding public sales of securities. Section 32 prohibited bank officers and directors from conducting similar activities, unless granted an exemption.

This repeal can be seen as the root cause for the 2008 failure of the gigantic, consolidated financial institutions that were “too big to fail.”

DODD-FRANK

The current and future implementation of Dodd-Frank is a direct result of this era and the global economic damage done by financial institutions. All public companies get painted with the broad brush of Dodd-Frank today, with disclosure, transparency, governance, and finally, shareholder engagement highlighted in this newly painted picture.

THE EXPERTS SPEAK

So, what about shareholder engagement? It's something that can be tracked, but not measured, though it's too early to try to connect the dots between a high level of shareholder engagement and company performance (and in particular, long-term company performance and creation of shareholder value).

You could also state that shareholder engagement doesn't make a dime's worth of difference, except perhaps intuitively.

John Borneman, Principal at Semler Brossy Consulting Group, notes some difficulties occurring with shareholder engagement. "Dodd-Frank's Say on Pay requirement has opened new lines of communication between issuers and investors, but the dialogue has focused heavily on pay structure and features, and not enough on the performance the organization is trying to drive," he said. He says he has heard "repeatedly from executives struggling to incorporate sometimes disparate investor feedback into how performance is measured and rewarded."

Yvonne Chen, Managing Director with Pearl Meyer & Partners, says that when it comes to shareholder engagement, "It is easy to focus on the dollar value of pay and the latest best practices. However, the really difficult work for a Compensation Committee is when discretion is needed to address specific business needs."

Seconding that motion is Jim Kroll, Senior Consultant, Towers Watson, who says that "Even though greater dialogue with shareholders is a positive development, what's often lacking is an approach tailored to the best fit for (an individual) company."

From the perspective of the C-suite, Doug Chia, Assistant General Counsel and Corporate Secretary at Johnson & Johnson says, "The basic message I like to convey



to my peers is they should be open to engagement with shareholders who want to have real constructive dialogue. My experience shows that good disclosure and active shareholder engagement cannot overcome decisions that are perceived as bad decisions.”

Chia also told C-Suite Insight that Johnson & Johnson actively engages many major shareholders directly, particularly in familiarizing them with the company’s CEO succession process. He says, “By the time someone is in the position to be a CEO succession candidate, this person will have gotten a pretty good look by the major investors.”

Kelly Crean, Governance, Shareowner and Equity Team Leader at Mercer, would likely approve of this process. As she notes, “Companies cannot rely solely on the proxy statement and the annual meeting of shareholders to communicate with and garner feedback from investors. To enhance the engagement process, many companies are conducting year-round campaigns with their larger investors.”

From the institutional investor side, Stephen Brown, Senior Director, Corporate Governance at TIAA-CREF stresses that “Companies have to prepare and have the right team on board to do that type of engagement. I’d suggest using the advisor that you have, whether it’s a proxy solicitor or your compensation consultant, to do a mock engagement. This person will understand investor conversations, and the mock engagement will get you honest feedback from your outside advisor about how the conversation might go.”

Brown also notes that there are times when “We may have an issue which we believe is a market-wide problem. We start with the actual governance issue in mind, then focus on the company. We are still thinking about performance, but it’s less of an issue in this kind of case than it is about how the company may have behaved with respect to that particular governance issue.”

Michael Powers, Managing Partner at Meridian Compensation Partners seems to be on the same wavelength. He told C-Suite Insight, “Large institutional shareholders more often want a dialogue about other issues: business strategy/execution risks, succession planning and board leadership practices.” Confirming Johnson & Johnson’s process, Powers says “Succession planning remains a high priority for most boards.”

This is not to say that companies will fully engage all of their shareholders. Jim Barrall, Partner with Latham & Watkins told us, “I don’t think you engage with activists and investors that have hot-button issues that they want to micromanage for political reasons. But I think it’s important to talk to sophisticated larger investors and explain to them what you’re doing.”

And John Borneman says, “You will never satisfy all of your shareholders, but you can be absolutely clear on what kind of performance you are trying to drive and why.” Words to the wise, it seems.



WHATEVER HAPPENED TO...?

Get elected to national office, co-sponsor something important, and your name will retain some historical importance long after most people remember you and your career. So let's take a brief trip down memory lane to check in on some Members of Congress who've had a major influence on public-company legislation over the decades. Specifically, whatever happened to the characters behind Dodd-Frank, Sarbanes-Oxley, and Glass-Steagall?



Recruiting a board member?



Sen. Chris Dodd (D-Conn.) and Rep. Barney Frank (D-Mass.) are easy enough to remember, even though both of them are now gone from Congress. Dodd decided not to run for re-election in 2010. He is now Chairman and CEO of the Motion Picture Association of America (MPAA). He'll turn 69 later this year. The 72-year-old Frank just retired from Congress in January.

Most *C-Suite Insight* readers will also remember Senator Paul Sarbanes (D-Md.). He retired from the Senate in 2006, and reached his 80th birthday this year. Rep. Mike Oxley (R-Ohio) retired from the House in 2007, and is 69 and a lobbyist.

Stepping further back in time, we find that Sen. Carter Glass (D-Va.) was born before the Civil War, and was 75-years-old when the legislation bearing his name was issued in 1933; he died while still in office 13 years later.

Rep. Henry Steagall (R-Ala.) was 60 years old when the act was passed; he died while still in office 10 years later.

Glass had previously co-sponsored the creation of the Federal Reserve system in 1913, a bill signed into law by President Woodrow Wilson. Steagall co-sponsored legislation in 1937 that created the Federal Housing Authority.

It's interesting to note that Glass-Steagall and Sarbanes-Oxley were bi-partisan efforts, even as the nature of the two primary American political parties has changed over time. Glass-Steagall was signed into law by Democratic President Franklin Roosevelt, and Sarbanes-Oxley by Republican President George W. Bush. Dodd-Frank was sponsored by two Democrats, passed with limited Republican support, and then was signed into law by Democratic President Barack Obama. **c**

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PRESENTING *C-SUITE INSIGHT'S* SHAREHOLDER ENGAGEMENT QUIZ!



It's time for the C-Suite Insight Shareholder Engagement Quiz!
**Answer the following questions honestly
and see how you rate!**

1. How do you define "engagement" with your shareholders?

Answer: _____

- a. If they have something to say to us, we'll listen.
- b. We actively arrange meetings, keep a steady stream of information flowing to them, and work hard to let them know we are listening.
- c. We don't plan to marry them, so no reason to become engaged with them.

2. How does your company engage with major shareholders?

Answer: _____

- a. We've always sent key team members out when we think it's necessary.
- b. We actively engage investors using as many C-suite and board members as possible.
- c. See answer to Question 1.

3. How important is your proxy in delivering a good Say on Pay vote?

Answer: _____

- a. We were over 50% last year, so it must be working.
- b. It's critical, because we're not happy unless our Say on Pay vote is over 90%.
- c. Say on Pay is not binding. Next question.

4. What is your approach to the CD&A this year?

Answer: _____

- a. We will provide everything that needs to be in it.
- b. We consider it a critical piece of our shareholder engagement strategy.
- c. Haven't listened to CD&A since they sang "Woodstock" and "Wooden Ships."

5. How has your organization changed since SOX, and now Dodd-Frank?

Answer: _____

- a. We've had to hire a bunch more people to deal with this stuff.
- b. We had policies in place to address these issues even before the legislation, and we continue to set a good example in the areas of disclosure, transparency, and governance.
- c. We don't like people prying into our business — this is all just a fad, it will go away.

6. How do you package long-term incentives into executive compensation?

Answer: _____

- a. We've thrown in some long-term stuff and the execs seem to be responding well.
- b. We use a variety of vehicles with significant portions incentivized over 3 and 5 years, and we explain our packages in detail in the CD&A.
- c. Yeah, yeah, yeah. Don't you know it's all about quarterly results?





7. How do you defend your perquisites in your proxy statement?

Answer: _____

- a. No more gross-ups and we have a smaller plane.
- b. We've eliminated most perks and make sure that our practices are in line with other companies.
- c. Defend them? If you've ever flown in a Gulfstream you'd understand.

8. How do you view board diversity?

Answer: _____

- a. We have a great board! Our CEO loves them all!
- b. It's a serious issue and we seek a broadly based, diverse board in all its definitions, while being sure we have adequate industry expertise.
- c. Some of our board members are left-handed, and one of them says grey is his favorite color.

9. How do you maintain a relevant board that keeps up with the changing times?

Answer: _____

- a. We've never had a problem in this area.
- b. We have term and age limits, but we review our board members every year to ensure we have the right people going forward.
- c. I didn't think the board actually did anything?

10. What role do proxy advisors play in your strategy?

Answer: _____

- a. They're useful in helping us construct shareholder friendly policies.
- b. We pay attention to their policies, but we make sure to engage with shareholders directly to discuss any issues and make sure they understand the reasoning behind our decisions.
- c. We know what we're doing, trust us.

ADD 'EM UP, AND SEE WHERE YOU RATE!

SCORING

Each "a" answer = 1 points x _____ = _____

Each "b" answer = 2 points x _____ = _____

Each "c" answer = 0 points x _____ = _____

Total Points = _____

RATING

0-5 points: You have a great strategy, for 1954.

6-10 points: You've moved along the timeline, all the way to 1987.

11-15 points: Congratulations! You..are..average!

16-20 points: You either work for a great company, or you're lying.



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CONSULTANT'S CORNER



Corner Questions

- What is needed to effectively engage with shareholders?
- What issues that are not being addressed between issuers and their investors?

See next page...



John Borneman
Principal
Semler Brossy Consulting Group

Say on Pay has opened new lines of communication between issuers and investors, but the dialogue has focused heavily on pay structure and features and not enough on the performance the organization is trying to drive. Conversations with portfolio managers on performance are not always neatly connected to conversations with the same shareholders regarding executive pay.

I hear repeatedly from executives struggling to incorporate sometimes disparate investor feedback into how performance is measured and rewarded. For example, the largest shareholder of one high-growth company recently told the CEO “we don’t like pay programs that encourage risk.”

That is a rational perspective, but the company’s strategy explicitly seeks to drive superior returns through risk-taking. How to bridge such gaps? Through transparency and communication. You will never satisfy all of your shareholders, but you can be absolutely clear on what kind of performance you are trying to drive and why.

John Borneman has been an executive compensation advisor since 1998, with broad experience consulting to senior management and boards of directors on compensation, performance measurement, and governance issues. Prior to joining SBCG, John was a Senior Vice President with Farient Advisors and a Principal with Mercer Human Resource Consulting and SCA Consulting. John holds the designation of Certified Executive Compensation Professional (CECP).



Corner Questions

- What is needed to effectively engage with shareholders?
- What issues that are not being addressed between issuers and their investors?



Yvonne Chen
Managing Director
Pearl Meyer & Partners

Say on Pay has prompted institutional investors and proxy advisory firms to re-examine what levels and types of compensation will meet their quantitative and qualitative pay for performance tests. What may have been lost in all the analysis is the original basis for all compensation decisions—sound business judgment applied in the context of a well-conceived compensation philosophy.

As companies engage with shareholders about executive compensation, it is easy to focus on the dollar value of pay and the latest “best practices.” However, the really difficult work for a Compensation Committee is when discretion is needed to address specific business needs. For example, bonus adjustments to recognize market share growth in a down market, special equity awards to address succession planning and retention issues, or perhaps discretionary awards to deal with long-term goals that were too aggressive in hindsight.

Directors should rely on business judgment and, while not an everyday occurrence, they should have the fortitude to apply upward (or downward) discretion in compensation decisions. Similarly, companies need to work with shareholders to help them understand the qualitative aspects of compensation decisions.

Yvonne Chen, Managing Director in the New York office, joined the Firm in 1998. With more than 25 years of business experience, Ms. Chen consults with companies, subsidiaries and joint ventures in the development of compensation objectives, value-based performance measurement and incentive plan design. She has worked extensively with clients in the asset management, real estate, telecommunications, non-regulated energy and manufacturing sectors.

A graduate of the Massachusetts Institute of Technology, Ms. Chen holds an M.B.A. in Finance from the University of Chicago Graduate School of Business. Ms. Chen previously was a Principal in the executive compensation practice group of William M.

Mercer, Incorporated and held positions at SCA Consulting, KeySpan Corporation and Aetna Life & Casualty Corporation.



Kelly Crean

Governance, Shareowner and Equity Team Leader

Mercer

Companies cannot rely solely on the proxy statement and the annual meeting of shareholders to communicate with and garner feedback from investors. To enhance the engagement process, many companies are conducting year-round campaigns with their larger investors.

A year-round dialogue program involves educating key investors on company policies and listening to and easing their concerns and issues. This helps to mitigate significant problems that are not being addressed between issuers and their investors.

Issues that often arise are due to investors not understanding how to balance standard voting policies with unique company issues (often exasperated by proxy advisory firm guidance) and issuers seeking (and not receiving) more details from shareholders on their voting rationale.

The company's engagement team should include individuals from throughout the organization. While the investor relations department may continue to manage the process, many companies now have a team of individuals from various company functions, as well as the board of directors, who engage with shareholders.

Also, investors have directly approached companies to engage them through company websites or other online communication vehicles. This is a much improved process compared with the limited approach used in the past of writing letters to the corporate secretary and waiting for a response.

Kelly Crean is a principal in Mercer Human Resource Consulting's Atlanta office. He consults with clients on equity based compensation practices, board of director pay, business analysis, and incentive plan design. He is one of the firm's leading consultants on executive pay from the shareholder and institutional perspective. Mr. Crean has

written numerous articles on executive compensation and equity-based pay practices for various corporate governance publications.



Corner Questions

- What is needed to effectively engage with shareholders?
- What issues that are not being addressed between issuers and their investors?



Jim Kroll
Senior Consultant
Towers Watson

A disciplined approach that highlights sound company decisions and proactive communications is critical to effective engagement. Executive pay has been the most visible topic of recent proxy seasons, but neither boards nor long-term shareholders are focused on single issues. The focus has already begun to shift to other governance topics, such as succession planning and board leadership.

While greater dialogue with shareholders is a positive development, what's often lacking is an approach tailored to the "best fit" for the company. Such a focus can allow boards and investors to find common ground that recognizes each company's unique circumstances and how company programs and decisions align with shareholders' interests.

Based on our experience helping companies prepare for Say on Pay votes, one key element in effective shareholder engagement is initiative. A defensive starting point, such as a negative proxy advisor vote recommendation, makes it harder for a company to establish a mutually beneficial dialogue.

An approach characterized by disciplined proactive communications allows companies to prepare tailored messages and build trust over time. This approach moves the needle from a reactionary process to one that enhances understanding between boards and shareholders—as well as minimizing surprises at the annual meeting.

Mr. Kroll is a senior consultant in Towers Watson's Executive Compensation Practice, based in New York. Mr. Kroll specializes in corporate governance and executive compensation issues. He assists clients across a broad range of industries with shareholder approval of equity plans, advisory votes on executive pay and with other compensation-related governance issues. He has more than 15 years of experience in corporate governance consulting and primarily works with clients to help them prepare for shareholder approval of such matters.

Prior to joining Towers Watson, Mr. Kroll was a director at two leading proxy solicitation firms, where he advised issuers in the U.S. and other markets on corporate governance issues and shareholder communications. He also headed the global research department at Institutional Shareholder Services (ISS). In this capacity, he participated in the development of ISS' governance and proxy voting guidelines and produced proxy advisory reports on companies' governance and compensation practices.



**Kelly Malafis**

Partner

Compensation Advisory Partners

Effective shareholder engagement requires that companies reach out to their investors on an ongoing basis to be aware of key shareholder concerns and not wait until there is a crisis moment to address an issue. Since shareholders have many issuers in their portfolio, it is important for companies to be prepared for meetings and to also listen to the shareholder's concerns instead of trying to push the company's point of view.

When we move beyond executive pay, a key topic where we see shareholder interest is CEO succession planning. Shareholders know how disruptive an abrupt change in management can be and they want assurance that companies are taking steps to make sure that they have adequate internal bench strength to replace executives internally or a clear plan for going to market to replace key talent.

Kelly Malafis is a Partner with Compensation Advisory Partners in New York. She has over 12 years of executive compensation consulting experience working with compensation committees and senior management teams. Kelly has worked with both large and small publicly traded companies in a variety of industries, including financial services, pharmaceutical, retail, insurance and publishing. Kelly has also provided advice on compensation issues for privately-held companies and companies with

special circumstances such as spin-offs and mergers and acquisitions.

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Corner Questions

- What is needed to effectively engage with shareholders?
- What issues that are not being addressed between issuers and their investors?



Michael Powers
Managing Partner
Meridian Compensation Partners

While shareholder interest in executive compensation design practices and absolute pay levels remains high, large institutional shareholders more often want a dialogue about other issues: business strategy/execution risks, succession planning and board leadership practices..

While executives and directors need to be cognizant of Reg. FD requirements when meeting individually with major shareholders, providing visibility on the business plan and key execution risks is often high on shareholders' wish lists. Management should take the lead on these conversations as they are far closer to the business than outside directors.

Succession planning remains a high priority for most boards. Turnover in the executive suite is a fact of life. Shareholders need to be assured that their investment is protected through the sound design and regular review of an executive succession plan.

Finally, board leadership structure remains top of mind for many shareholders. While only one-third of major companies have split the roles of Chairman and CEO, two-thirds have a combined role, but have identified a "lead" director.

Boards should periodically assess the effectiveness of their current leadership structure and be prepared to explain to shareholders the rationale for that approach. Not surprisingly, expectations of lead directors have grown dramatically over the past five years.

Michael Powers is a Managing Partner of Meridian. He has 25 years experience consulting on executive compensation design issues at the board of director level. Michael has testified to the U.S. Congress, the SEC and the FASB on executive pay and governance issues and is a current member of the Compensation Committee Leadership Network.

Michael is a frequent lecturer at national conferences and the author of articles in publications including *WorldatWork Journal*, *Journal of Compensation and Benefits*, and *Directors & Boards magazine*. Michael co-authored a chapter on executive compensation in the book *Leadership and Governance from the Inside Out*.

Prior to joining Meridian, Michael was at Hewitt Associates for 25 years and was a Principal and the global practice leader for executive compensation and corporate governance consulting at Hewitt Associates. Michael also served on Hewitt's stockholder committee for the four years following Hewitt's IPO.





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A Global View

of Shareholder Engagement



BY
RYAN M. JOHNSON, CCP,
AND DON LINDNER, CECF
WORLDATWORK

There is a great ad campaign running in the United States right now for one of the big car companies that carries the simple line, “Imported from Detroit.” The line is effective because for so many years, especially with automobiles, the word “imported” has carried a perception of greater quality for Americans.

The same might not be said, however, for how Americans, in general, have viewed corporate governance ideas from foreign shores. Of course, there were some notably unpopular ideas “imported” before the founding of this country that led to infamous tea and stamp protests.

But more recently—and obviously more on point here—are things like the International Accounting Standards Board (IASB), which formed in London in 2001 to develop a single set of high-quality global accounting standards. Many working in executive compensation—particularly in Silicon Valley—still vividly recall the battle over the expensing of stock options that the IASB standard effectively ended in 2004.

More recently, another “import” was brought to U.S. shores from the United Kingdom, but not via the IASB. It is well documented that the concept of shareholders’ “Say on Pay” had its origins in the U.K.’s Company Act. Within just a few years of that law’s passage in the U.K., U.S. Representative Barney Frank held hearings in the House Financial Services Committee, and the non-binding advisory vote subsequently became the law of the land in the U.S. via the Dodd-Frank law of 2010.

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Whether you agree with these corporate governance concepts in whole or in part—or not at all—there seems to be a historical trend in the last decade telling us at WorldatWork that we need to keep our eyes on foreign lands to see what new governance and shareholder engagement concepts might be exported around the world next.

At the moment, there are a few in the shareholder engagement realm that are noteworthy.

DEVELOPMENT DOWN UNDER

In 2011, Australia's Corporations Amendment ("Improving Accountability on Director and Executive Remuneration") amended the Corporations Act with new sections 250R(2), and 205U-V that go well beyond the concept of a non-binding shareholder vote to full-blown sanctions. Under the 2011 law, if more than 25% of shareholders vote in two consecutive years against the company's remuneration, the company must put its board of directors up for re-election within 90 days.

In effect, Say on Pay has become a "two-strikes-and-the-board-is-out" binding shareholder vote in Australia. At least two cases related to this law have now made headlines down under.

In November 2012, a large construction company named Lend Lease saw a slim 26% of shareholders deliver a no vote on the company's remuneration disclosure. Despite the fact that a "super-majority" of 74% of shareholders approved of the executive compensation, the company announced it would immediately cut executive bonuses by 10% across the board. The company is not taking chances on earning a second consecutive fail vote in year two, which will occur later in 2013.

Another Australian company, however, is already there. Penrice Soda (a manufacturer of soda ash) discovered at the end of October 2012 that it was the first company to have failed two consecutive years under the new law. It is now facing the mandatory sanctions, including board re-election.

Media reports about the Penrice Soda case hint that the two consecutive no votes (well above the required 25% by the way) are perhaps more due to shareholder frustration over the company's overall financial performance—and are not specifically about executive compensation.

If it's true that shareholders are protesting a low share price, the second consecutive vote which has now triggered a board re-election brings the possibility of further share price decline as the company's governance loses continuity and the company arguably faces a period of even more uncertainty. The company could find itself scrambling in the next few months to find qualified new directors. Further confusing the situation is



IMPORT

the fact that shareholders already have the right to not re-elect directors if they want to. One has to wonder if this is really what the law was intended to do.

DEVELOPMENTS IN THE UNITED KINGDOM

The government in the United Kingdom, where the non-binding vote concept originally emerged, seems to be proceeding down the Say on Pay path a bit further—but perhaps not quite as far as Australia already is.

In the U.K., companies have been required to provide shareholders with an annual “advisory” vote on a remuneration report since 2003. Under the law, and like the U.S.-version, a simple 51% majority of shareholders is all that is required for passage of the non-binding vote.

But this is almost certainly not the final evolution of the U.K.’s Say on Pay. Political winds can change rapidly, but writing in the Summer of 2012 in the Harvard Law School Forum on Corporate Governance and Financial Regulation, Edward Greene commented, “the U.K. government has expressed concern about the effectiveness of the existing shareholder vote requirement, on the basis that, as it is advisory, it does not force companies to address directly shareholder concerns.”

Consistent with this notion, in July 2012, the U.K. Parliament began consideration of the Enterprise and Regulatory Reform Bill, which includes new compensation disclosure requirements and a mandate that each company put its executive remuneration plan (including its approach to termination payments) to an annual binding shareholder vote.

Under the proposed law, passage would continue to be the current >50% affirmative requirement, not the more stringent >75% requirement that Australia has implemented. In addition, U.K. companies that choose to leave compensation plans unchanged would be required to hold a binding shareholder vote every third year.

In addition to making the shareholder vote binding, new U.K. disclosures being considered, (according to Edward Greene) include:

- A new table containing details of remuneration listed under the following headings: purpose, operation, opportunity, performance metrics, and changes to policy
- Information on employment contracts
- Scenarios showing what payments might occur at performance levels above, below or on target
- Information regarding percentage changes in the company’s profits and dividends in the context of the company’s overall spend on remuneration
- Principles upon which exit payments will be made, including how they will be calculated
- Material factors that have been taken into account when setting the remuneration policy, specifically employee remuneration and shareholder views

The bill was scheduled for additional discussion in Parliament in January 2013. ■



The purpose of this article is not to raise the fears of U.S. companies, nor to imply that any of the above is a fait accompli in North America anytime soon. Instead, we acknowledge that corporate governance has evolved considerably in the past decade and seemingly continues to do so at a rapid pace.

As the recent experience with the spread of Say on Pay around the globe demonstrates, evolutionary or innovative governance ideas are not exclusive to the United States anymore, nor is it out of the question that the U.S. shareholders and policymakers are willing to look abroad for ideas.

INTERVIEW WITH **STEPHEN BROWN**

Stephen Brown is Senior Director, Corporate Governance, at TIAA-CREF, based in New York City. On behalf of the boards of the TIAA-CREF group of companies, Mr. Brown and his colleagues in the Corporate Governance Group work to enhance the governance/ social responsibility practices of companies held within TIAA-CREF's investment portfolios with the objective of increasing shareholder value and improving long term performance of targeted companies.

Additionally, Mr. Brown advises management and the boards of the TIAA-CREF group of companies on internal corporate governance operations.

Prior to joining TIAA-CREF, Mr. Brown practiced corporate and securities law with Wilmer, Cutler, Pickering, Hale and Dorr, LLP and Skadden, Arps, Slate, Meagher and Flom, LLP in New York City. At both firms, Mr. Brown represented industrial companies, investment advisers, hedge funds, private equity funds, and mutual fund complexes. Prior to practicing law, Mr. Brown was a financial analyst with Goldman Sachs.

"PERFORMANCE IS A FACTOR WE USE AS WE LOOK AT OUR ENGAGEMENT FOCUS AND HOW WE EVALUATE ISSUES THAT ARE ON THE PROXY"

C-Suite Insight: TIAA-CREF owns stock in about 8,500 companies and has more than \$500 billion under management. With such a large portfolio, what are your high-level corporate governance goals?

Stephen: First and foremost for us is performance. As we approach any issue in corporate governance, we always think first about how the company has performed over the long term and what we think about their performance in the immediate term.

Performance is a factor we use as we look at our engagement focus and how we evaluate issues that are on the proxy. Since we can't fully engage with all of our portfolio companies, we look for outlier practices that we believe have no plausible rational link to sustainable long term shareholder value.

CSI: How do you determine the outliers?

Stephen: We look at the poor performers in a particular timeframe, then out of that group we determine if there are governance issues that are outlier practices. Then, if we believe those

outlier practices link to performance issues, we can develop a set of companies that we need to focus on in a particular time.

The other way that we do deep engagements is that we may have an issue which we believe is a market-wide problem. We start with the actual governance issue in mind, then focus on the company. We are still thinking about performance, but it's less of an issue in this kind of case than it is about how the company may have behaved with respect to that particular governance issue.

CSI: Can you give an example of this type of outlier issue?

Stephen: A perfect example would be a majority-vote initiative. We are very open-minded and rational about how we think about governance issues, but there are certain things that are very important to us—one of these is to have a majority-vote standard. Most companies in the Russell 3000 have adopted majority vote standards, but there are still some outliers.

CSI: You've described Dodd Frank as a "watershed event" for boards and also for investors. Neither Senator Dodd nor Congressman Frank is in Congress anymore, but there are tools that are inherent in that legislation. How are you using these tools, as interpreted by the SEC so far, to engage companies?

Stephen: As you say, the SEC is not finished with Dodd Frank because Congress has given the agency a pretty tall task, so they're still in the midst of writing the rules. But at TIAA-CREF we've had a long history of enhanced monitoring when it comes to corporate governance.

So, the issuance of Dodd Frank didn't make us do anything new because we've always had a long, consistent practice of doing the types of things needed to address the issues within the corporate governance section of Dodd Frank.

For example, mandatory Say on Pay is one of the prominent governance provisions in Dodd Frank. The fact that investors had to pay closer attention to executive compensation

was nothing new to us. We had been advocates of Say on Pay for many years prior to the passage of the law—we even voluntarily adopted it for ourselves several years ago. That said, this mandate was new for many investors. The jury is still out about how investors will react over time, but we think boards need to understand that investors as a whole will be a little bit more active.

CSI: You mention Say on Pay, do you believe that regulation is a mandate for company and investor engagement and how does Say on Pay affect company and board behavior?

Stephen: The Say on Pay mandate certainly calls for engagement. It's the primary issue that's increased focus for all investors who want to vote intelligently on all the votes that they have to make. Because this vote has such a direct effect on boards, namely the compensation committee members, and even though it's non-binding, a negative vote will put you in the space of a very small but highly visible minority.

CSI: How small?

Stephen: Fewer than 3% of companies have

failed their vote in each of the first two years. So companies, I believe, have taken comfort that 97%+ of them pass. You just don't want to be in that minority of 2% to 3% that fail. In fact, most boards really want to win their votes with overwhelming support—typically thought of as achieving more than 75 - 80% of the shares voting in favor.

As a result, companies are sending their troops out there and telling them, "Engage with shareholders so that we can win that vote." My advice is to continue that engagement, especially with your top investors. But companies also have to prepare and have the right team on board to do that type of engagement.

It's not a matter of simply calling up investors and saying, "We would like to talk about the vote and we want to hear what you think." To have discussions with your top investors, you should know as much about them as you can, and read their policy statement.

CSI: Who should be on the team?

Stephen: It used to be that the CFO, General Counsel, and Corporate Secretary were the only people who

could participate in these conversations.

Today, however, it's important to have someone who can speak intelligently about the compensation plan. That usually means the most senior in-house person in human resources, the person who is in charge of the plan.

It's a new development to see the head of executive compensation on the road with the CFO, the General Counsel, and the regular team that does shareholder engagement. This person can answer specific questions about nuances in the plan, rather than those at a meeting having to say "we'll get back to you on that."

This type of engagement is new to some issuers and it can't be taken lightly. Your investor relations person is used to talking to the people who buy and sell stock, but when you are with a large investor that has a governance team that does the proxy voting, that is a different conversation. It requires a different set of skills, so the IR team has to raise its governance IQ.

CSI: How can they accomplish this?

Stephen: We suggest using the advisor that you have, whether it's a proxy solicitor or your compensation

consultant, to do a mock engagement. This person will understand investor conversations, and the mock engagement will get you honest feedback from your outside advisor about how the conversation might go.

CSI: What's your view on the role of proxy advisors?

Stephen: TIAA-CREF doesn't blindly follow the proxy advisors. We have our own policy statement and it's always nice when people read it before they start conversations with us.

CSI: Then, when it comes to the proxy and the CD&A, how important is it to tell the executive-compensation story convincingly, especially if you're close to being an outlier?

Stephen: When CD&A's first started in 2006-2007, they were quite verbose. We couldn't really figure out what folks were trying to tell us. But over the years they've gotten better. It may take another five years, unfortunately, to get the lawyers comfortable with the idea that the CD&A is not simply a compliance document designed to meet the regs that were put out for the SEC.

Now, particularly because of Say on Pay, the CD&A is

"TO HAVE DISCUSSIONS WITH YOUR TOP INVESTORS, YOU SHOULD KNOW AS MUCH ABOUT THEM AS YOU CAN, AND READ THEIR POLICY STATEMENT"

one of the chief marketing tools that you have to win your vote. It is the document that many investors rely on to make a decision on the Say on Pay vote.

CSI: How are companies doing with this?

Stephen: They have gotten better, but there is still a long way to go.

I'm a former disclosure lawyer, and securities lawyer, so I know I've always thought about "Who is going to read this?" when writing disclosures. So both I and our team at TIAA-CREF have a great appreciation for those who write those things well.

CSI: Overall and over time, how do you view boards and their responsibilities? Have they changed?

Stephen: Boards are seeking a deeper understanding of their shareholder base and what shareholders expect and want. That is most certainly the case. They are also more attentive to their composition and the expertise on their board.

I give kudos to the SEC for this. A few years ago, when the SEC required enhanced disclosure of board of directors' backgrounds, companies were required to not only list what directors have done for the last five years of their lives, but also to explain to shareholders the experience, qualifications, and skills that led the board to conclude that that person should serve as a director at that company.

This has caused boards to look at their composition and make sure they have the right level of expertise. **C**

INTERVIEW WITH **DOUGLAS K. CHIA**

Douglas K. Chia is Assistant General Counsel & Corporate Secretary at Johnson & Johnson, the world's most comprehensive and broadly-based manufacturer of health care products, headquartered in New Brunswick, New Jersey. His responsibilities include providing legal counsel to the corporation on matters of corporate governance, securities regulation, public company disclosure, and Sarbanes-Oxley Act compliance.

Prior to joining Johnson & Johnson, Mr. Chia was Assistant General Counsel, Corporate at Tyco International. In private practice, Mr. Chia was an associate at the law firms of Simpson Thacher & Bartlett and Clifford Chance, practicing in the New York and Hong Kong offices of each firm. While in private practice, Mr. Chia provided legal counsel to issuers and underwriters on securities offerings and cross-border transactions.

Mr. Chia is a member of the Corporate Practices Committee and Policy Advisory Committee of the Society of Corporate Secretaries & Governance Professionals. He previously served a member of the Society's Board of Directors and Executive Steering Committee, Chairman of the Membership Committee and Chairman of the 2012 National Conference. Mr. Chia is also a member of the Corporate & Securities Law Committee of the Association of Corporate Counsel, as well as a member of the National Asian Pacific American Bar Association (NAPABA).

“WE HAVE THE BENEFIT OF BEING ABLE TO TRAIN UP-AND-COMING LEADERS IN A VARIETY OF BUSINESS SITUATIONS”

C-Suite Insight: What are the big issues that you're considering as Johnson & Johnson prepares for proxy season?

Doug: Like many other high-profile companies, executive compensation is a critical item for us during proxy season, and we are looking at the continuum of the story that we've been telling for the last few years in our proxy statements.

As you may have seen, there have been some major changes in our executive suite from last year to this year, specifically a succession from a long-tenured CEO, who is retiring after a remarkable 41-year career at J&J, to a new CEO. So, obviously this recent leadership succession will be a big focus area. We'll also continue to emphasize the changes in the design of our compensation programs that have been made over the past few years, which we put a lot of effort into describing in last year's proxy statement.

CSI: Succession planning is a weakness in a lot of companies. So could you take us through succession planning at Johnson

& Johnson, when it started, and how you worked your way through it?

Doug: For us, succession planning has always been something which has gone smoothly because it's been thought out in advance. J&J has had only seven CEOs since becoming a public company in the early 1940s, and each one has come from the internal ranks. In the current case, we have an outgoing CEO who had served in the position for the past decade. The process of identifying potential successors for him started a number of years ago, in the 2010-2011 timeframe, and the lead candidates became apparent to the public. Our major investors were familiar and quite comfortable with the individuals who were being considered.

CSI: In succession planning and other major processes at J&J, how do you view long-term sustainable value and how do you view your engagement with shareholders?

Doug: We've always managed our business for the long-term, which is reflected in our culture by the fact that people tend to have very

long careers at Johnson & Johnson. So, we have the benefit of being able to train up-and-coming leaders in a variety of business situations and give our Board exposure to them along the way.

In terms of shareholder engagement, our major investors get exposed to many of our senior business leaders through investor conferences and meetings where they can talk in-depth about the businesses they are running. Over time, investors get familiar with a small cadre of J&J senior business leaders.

CSI: We have to mention Say on Pay. How did this issue affect you initially, and how do you address it when you're writing a CD&A?

Doug: You cannot write the CD&A only thinking about the Say on Pay vote. This reminds me of what my teachers in school used to say: You shouldn't "study to the test." Instead, study the subject, master the subject, and then you will do fine on the test.

So for us, writing the CD&A each year is about making sure we tell the story that reflects what's taking place at the company, our

compensation philosophy, the values we are trying to instill through our compensation plans, how our executives are paid, and what performance is being rewarded. We try to illustrate that we manage our business for the long-term and thus place a lot of focus on aligning executive compensation with our long-term investors.

That being said, you do want to consider the vote outcome, keeping in mind the “advisory” nature of the vote. Suffice it to say that ours have not been where we want them to be, although we did gain support from over a majority of the votes cast in each of the last two years.

CSI: What have you done about this?

Doug: Over the past summer and fall, we had some of our Board members and senior management sit down with a diverse mix of investors, in one-on-one settings, specifically to talk about executive compensation. Through those discussions, we have been able to better understand the parts of our executive compensation program and our disclosure that could be enhanced.

One point the investor discussions drove home that is important for all of us to remember when writing the CD&A is that for investors, the proxy statement is really all they have to rely on for information; they likely know very little else about the company's pay programs. So, we have to take a critical eye to what we've presented in the past and ask ourselves, “How can we tell our story better in order to make people understand the important context and rationale underlying these compensation decisions?”

I think it's fair to say that this process has helped us identify specific areas where we could have done a more effective job of telling our story. That's something we'll continue to work on this year and every year.

CSI: We've talked to major institutional investors such as TIAA-CREF and CalPERS, and also companies like BlackRock. They've stressed to us the importance of private engagement. In many cases, they think it's more effective if they engage you privately. Is that your experience and what's your view, how much do you welcome that sort of private engagement?

Doug: I think that's right. One-on-one engagement is a very effective method of communication between companies and investors. The advantage of this direct engagement is the candid nature of the discussion that ensues when there is not an “audience” of outsiders. Over time, you can build strong relationships this way.

In particular, “real-time” engagement, either by phone or in-person, provides the opportunity for the kind of constructive back-and-forth discussion that helps tease out critical issues. It helps both sides more precisely identify areas that need to be clarified. In the one-on-one meetings we had over the summer and fall, the investors we met with were able to get a real sense of just how much time and thought our Board members put into the decisions around executive compensation and how many factors come into play. Those are hard things to effectively illustrate to investors through a written document like a proxy statement.

CSI: Have these private dialogues increased in the last few years, in the era of Dodd-Frank?

“DON’T BE AFRAID TO MAKE A BREAK WITH YOUR PAST PRACTICES ON WHAT YOUR DISCLOSURE LOOKS LIKE”

Doug: Yes, I can say they have for us. We are more proactive than we had been in the past, and many of our investors have also become more proactive. Some who were not inclined to talk to us in the past are now more receptive to having a conversation.

CSI: How do you balance the tension between short-term results and a long-term commitment to spending money on R&D and creating long-term value?

Doug: It’s a tricky balance, but J&J has a long-term philosophy. It’s no secret to the investment community as we constantly emphasize that we manage the business for the long-term. So, to a certain extent, we’re expecting investors who have made significant investments in our company to have that same mindset. Most are investing in the company as a long-term play. However, when you have so many shareholders, they are not all going to agree with you

on everything, so naturally there are going to be some shareholders who have a shorter-term outlook for a variety of reasons.

CSI: What sort of big-picture advice would you give public companies, and in particular corporate secretaries, as they prepare for proxy season?

Doug: As far as corporate secretaries go, we exchange know-how quite a bit. One of the most rewarding parts of my job is establishing the kinds of relationships with my counterparts where we can help each other be better at what we do. On the subject of engagement, the basic message I like to convey to my peers is that they should be open to engagement with those investors who want to have real constructive dialogue. It’s a dynamic environment out there right now and you have to be thinking about how to make strategic adjustments.

Also, don’t be afraid to make a break with your

past practices on what your disclosure looks like, or how much disclosure you want to give. We should all take a fresh look every year and ask ourselves, “What are people asking for and what makes sense to give to them?” These days, you can’t approach every disclosure requirement as something for which you’re only going to provide what a rule demands. If you do, your company will be missing a huge opportunity to tell its story.

Finally, for all of us, and corporate secretaries in particular, the key to the debate around executive compensation is creating an environment where your board members have everything they need to make well thought-out decisions. That’s what I think of when I hear people refer to “good governance.” We need to keep the focus on the integrity of the decisions, the underlying decision-making process, and the people who have the duty to make those decisions. ■

INTERVIEW WITH **JIM BARRALL**

Jim Barrall is a partner in the Los Angeles office of Latham & Watkins and is the global Co-chair of the firm's Benefits and Compensation Practice. Mr. Barrall specializes in executive compensations, corporate governance, employee benefits, compensation-related disclosure and regulatory matters.

He is regularly interviewed and quoted by such publications as the *Wall Street Journal*, *Agenda*, *The Conference Board*, *BloombergLaw*, *Compliance Week* and *Corporate Secretary*. Mr. Barrall is a frequent author, contributing editor and lecturer on executive compensation, corporate governance, disclosure and other regulatory matters. He is a co-author of the chapter on extensions of credit to directors and officers in the American Bar Association's Practitioner's Guide to the Sarbanes-Oxley Act.

Mr. Barrall is a member of the Board of Advisors of the UCLA School of Law and Founding Chair of the UCLA Law Firm Challenge. Mr. Barrall has lectured at the UCLA Law School, the UCLA Anderson School of Management and the Aresty Institute of Executive Education at the Wharton School, University of Pennsylvania.

**"EXECUTIVE PAY HAS BECOME
THE MOST IMPORTANT CORPORATE
GOVERNANCE ISSUE TO COMPANIES"**

C-Suite Insight: You're known as an expert in the rules of shareholder engagement with respect to executive compensation. How did we get here and what does it mean for companies and shareholders?

Jim Barrall: The world of U.S. executive compensation has changed dramatically in the last ten-plus years. During this period, executive pay has become the most important corporate governance issue to companies and investors and executive compensation is being examined under the microscope.

This roughly started with the Sarbanes-Oxley Act (SOX) in 2002. While SOX primarily dealt with financial matters, it also contained a prohibition on extensions of credit to directors and executive officers, which was the first US federal law regulating executive compensation other than on disclosure or tax matters. In the following years, the Securities and Exchange Commission (SEC) adopted new and

rigorous disclosure rules for executive compensation that were predicated on the notion that sunlight was the best disinfectant. These new SEC rules introduced the summary compensation table and other tables, and most importantly, the compensation discussion and analysis (CD&A) portions of the proxy, which require extensive disclosure of executive pay plans and practices—not only what they provide but why.

The financial sector meltdown of 2008 then gave us the Dodd-Frank Act in 2010, which adopted a host of prescriptive rules regulating executive compensation, such as requiring independent compensation committees, mandatory clawbacks, and most importantly, periodic advisory shareholder votes on executive pay and golden parachute payments (the "Say on Pay" and "say on golden parachute" votes). In addition, it added even more in terms of disclosure requirements, relating to the disclosure of hedging policies,

pay-versus-performance and chief executive officer (CEO) pay disparity, among others.

All of this has meant that shareholders are very focused on pay, related proxy disclosure and governance issues. Companies need to engage with their shareholders directly on an ongoing basis about their compensation plans and policies.

Within this context, I think the most important thing for companies to know is that not all shareholders are alike. They can't just think about shareholders or investors and reach meaningful conclusions. There are some who are political activists and have hot-button issues they care about. There are also some who want to micromanage boards of directors. But in my experience, most of the larger institutional investors are increasingly sophisticated, thoughtful and reasonable in evaluating executive compensation. They want to understand it and are willing to engage with the

company. They have geared up for Say on Pay and have developed communication channels between their governance teams and the investment managers and analysts who buy and sell the stocks. More and more, they're not just relying on proxy advisor analyses and recommendations, but are making their own determinations based on their own guidelines and analysis.

CSI: Are companies trying harder now to engage because they know they have to?

Jim: In a word, yes. Direct shareholder engagement on pay matters picked up substantially in 2011 when the companies which had failed their Say on Pay votes in 2011 or were within the proxy advisors' "red zone" of less than 70% share-

holder support, reached out to shareholders to discuss why. The 2012 proxies of many of these companies chronicle the outreach they conducted, the things they heard from their shareholders, and the changes they made to their compensation plans and disclosures in response.

The companies that engaged their shareholders generally did much better on their votes in 2012, but then a whole new crop of companies had problems. These were the companies that had pay for performance disconnects in the views of ISS or Glass Lewis. These companies reacted to proxy advisor negative Say on Pay voting recommendations by filing more than 100 proxy supplements contesting peer groups and the definitions of "pay" and

"performance" used by the advisors in their pay for performance analyses.

This year, in response to the 2012 pay for performance tumult, many more companies have reached out to shareholders to discuss their pay plans and disclosures, starting right after the 2012 meetings and continuing thereafter. This direct and ongoing communication, unmediated by the proxy advisors, is healthy for both companies and investors. Not only does it help improve pay plans and disclosures but it creates better understandings and relationships that will benefit companies if and when they may have performance or other business problems and need support from their important and engaged shareholders.

"THE COMPANIES THAT ENGAGED THEIR SHAREHOLDERS GENERALLY DID MUCH BETTER ON THEIR VOTES IN 2012"

CSI: With the discussions that have taken place between companies and shareholders, there's been an increasing demand from shareholders that members of the compensation committee be able to speak directly to them. How do you see this?

Jim: I would say that it's relatively unusual for investors to need to talk to members of the board or the compensation committee. I don't think it's required in routine cases. However, if a company is having business problems, financial problems, management problems, problems with pay practices that are viewed as systemically problematic, or failed Say on Pay votes, institutional investors are increasingly likely to ask to speak to a member of the compensation committee. Investors do expect directors on compensation committees to understand the company's pay plans and policies and why they are structured the way they are, and to be able to discuss them knowledgeably, listening as well as speaking. But in most cases where the only issue is a single

failed say-on pay vote or disappointing results on more than one vote, the response and shareholder communications can be handled by the company's legal, investor relations, compensation and human resources teams.

CSI: Do you think the level of expertise or understanding with regards to executive compensation has gone up among compensation committees and boards in general?

Jim: Absolutely. As I have said, the executive compensation world has changed fundamentally, and compensation committees have responded by improving their policies and practices dramatically in the last ten or so years. Most compensation committees understand that it is their responsibility to take charge of executive compensation, working with independent compensation consultants who are responsible to them and not the company's management, to design pay plans that are in the interests of the company's shareholders.

As a result of all of the developments of the last ten years, compensation committees are far more knowledgeable about the policy, design, governance, disclosure and optics issues relating to their executive compensation policies than they were in the past.

CSI: Now that we've had two full years of Say on Pay, how critical are shareholders going to be in 2013?

Jim: I think Say on Pay in 2013 will follow the 2012 trend and focus mostly on how to test pay for performance alignment over time, including how to determine and assess peer groups and define "pay" for these purposes. I don't think the pass/fail results of Say on Pay votes will change dramatically.

Before Say on Pay and in its first year, 2011, many companies were attacked by the proxy advisors for allegedly poor pay practices relating to perquisites, tax gross-ups (including 280G gross-ups), and excessive severance. Most large and midcap companies have addressed these

"I'M HOPEFUL THAT 2013 WILL BE A MORE THOUGHTFUL AND CONSTRUCTIVE SAY ON PAY SEASON THAN 2011 AND 2012"

practices and have taken them out of the Say on Pay vote discussion.

In 2011, about 1.5% of the Russell 3000 companies failed their general Say on Pay advisory votes. In 2012, the failure rate was slightly higher because of the new proxy advisor focus on pay for performance. More broadly, during the first two years of Say on Pay, approximately 70% of the general advisory votes received more than 90% shareholder support and approximately 90% of the votes received more than 70% shareholder support. These overall results should not change much in 2013. What is likely to change is which companies have total shareholder return, or TSR, performance problems and therefore pay for performance and responsiveness problems with their Say on Pay votes.

I'm hopeful that 2013 will be a more thoughtful and constructive Say on Pay season than 2011 and 2012. I think we are positioned for that now that a lot of the underbrush on poor pay practices is gone and the debate has focused squarely on pay for performance alignment. In addition, I think the thoughtful investors have made it clear that they're interested in bigger issues, not micromanaging plan design, and companies are doing a better job at reaching out to them and engaging with them at this level.

CSI: Is there a best practice for how companies should deal with pushback from shareholders?

Jim: I don't think companies should spend time and effort engaging with activists and investors that have hot-button issues

that make them want to micromanage for political or other reasons, but I do think it's important to talk to responsible investors, who are primarily concerned with achieving a return on their investment, to discuss what the company is doing and why. And this process starts in the proxy CD&A.

Investors are concerned first and foremost with company performance. Then they're concerned with how the company adjusted its pay plans in response to poor performance, how its pay plan design can incentivize better performance, and how its pay has been aligned with performance over a period of three to five years. This story needs to be told succinctly in an executive summary of the CD&A, with the rest of the CD&A providing detailed information for those who want to dig into it more. **c**



REPORT

S&P SMALLCAP CFO PAY STRATEGIES 2012

AFTER YEARS OF focus on dramatic economic changes and sweeping legislation impacting executive compensation, no topic generated as much interest in 2011 as the SEC's implementation of Say on Pay. One of the first measures adopted after the passage of Dodd-Frank was the requirement that companies hold an advisory vote on executive compensation. Although the overall impact of the regulation is still uncertain, it is clear that Say on Pay is now firmly rooted in the executive compensation landscape.



Companies faced increased scrutiny on executive pay from shareholders and the public, and many companies scrambled to engage their large stakeholders to ensure successful first Say on Pay votes. Only a small number of companies failed their first Say on Pay votes, but the regulation brought about shareholder-friendly changes to pay plans, leading many companies to remove unpopular pay practices like tax gross-ups or add performance goals to equity grants.

Perhaps the biggest impact caused by Say on Pay in its first year was the increased level of company engagement with shareholders. Many companies held discussions with their largest investors, looked to provide clearer disclosure in the CD&A, and filed amended proxies to address specific issues surrounding their compensation practices.

While the first year of Say on Pay provided companies with some uncertainty about investor response, the economy steadily continued to improve. In 2008 and 2009, large volatility and declining stock prices showed that even the most conservative growth estimates had been too high. 2010 brought the stock market

PERHAPS THE BIGGEST IMPACT CAUSED BY SAY ON PAY IN ITS FIRST YEAR WAS THE INCREASED LEVEL OF COMPANY ENGAGEMENT WITH SHAREHOLDERS

back despite worries about another dip in the economy, and most executives exceeded performance targets set at the beginning of the year. Last year finally brought a level of stability back to the markets, despite concerns over European debt and a summer stock slump.

While considering these events, this report is intended to provide a broad-base analysis of S&P SmallCap CFO compensation strategies used during the past year. The report also provides insight into the differences between the various industries, and a look at CFO characteristics by gender. Responsible for managing financial risk and making sound fiscal decisions, chief financial officers play an important role in a company's success. Understanding the emerging trends surrounding CFO pay can provide some insight into key compensation strategies for 2012 and beyond.

Equilar's analysis of S&P SmallCap CFO compensation is based on recently filed proxy data for 494 chief financial officers at 494 companies in the S&P SmallCap. All companies studied have had CFOs in place for at least two full years. By selecting only incumbent CFOs,

the study avoids distortion from new-hire awards and more accurately tracks year-over-year changes in compensation. The companies included in this report filed their most recent proxy between January 1, and May 31, 2012.

TOTAL COMPENSATION INCREASES

Median total compensation for S&P SmallCap CFOs grew 8.4 percent from 2010 to 2011. Median total compensation in 2011 was approximately \$943,802, up from \$870,609 in 2010. For this analysis, total compensation includes base salary, annual and long-term cash bonus payouts, the grant date value of stock and option awards made during the year, and other compensation including nonqualified earnings on deferred compensation and all other compensation.

For fiscal 2011, most pay components increased at least 5.0 percent, except for cash bonuses and options. Median total bonuses had the only drop in pay, down from \$191,700 in 2010 to \$173,807 in 2011. The median value of total stock had the sharpest increase, up 32.0 percent from \$163,679 in 2010 to \$216,129 in 2011. While the median option award

in 2011 was \$16,741, the median value of option grants in 2010 was \$0 with a prevalence of 48.2 percent.

BONUSES DECLINE

Aggregate bonus payouts, which include annual incentive payouts, discretionary bonuses, and long-term cash incentive payouts, decreased from a median of \$191,700 in 2010 to \$173,807 in 2011, a 9.3 percent drop. The prevalence of bonuses given to CFOs decreased from 90.1 percent 2010 to 86.4 percent in 2011.

The value of annual bonus payouts, which represent the largest share of the aggregate bonus declined from 2010 to 2011. The median value of annual bonuses decreased from \$148,816 in 2010 to \$125,843 in 2011, a 15.4 percent drop. The prevalence of S&P SmallCap CFOs who received an annual bonus payout in 2010 decreased in 2011, from 69.6 percent to 68.2 percent. Long-term bonus payouts increased in prevalence, from 3.0 percent to 3.4 percent of CFOs receiving a multi-year bonus payout. Discretionary bonus payouts decreased in prevalence, from 30.6 percent in 2010 to 25.1 percent in 2011.

THE MOST NOTICEABLE CHANGE WAS THE INCREASE IN THE AVERAGE STOCK COMPONENT OF TOTAL COMPENSATION

RESTRICTED STOCK, OPTIONS, PERFORMANCE SHARES

The prevalence of CFOs receiving equity awards in the form of restricted stock, options, and performance shares all increased in 2011. Options had the smallest increase of the three equity vehicles, up to 50.4 percent in 2011 from 48.2 percent in 2010. The increase in options awarded reverses a trend seen in previous years when companies had moved away from the use of this equity award. Restricted stock remained the most utilized equity vehicle, increasing in prevalence from 63.8 to 67.0 percent. As companies continue to look for ways to align pay and performance, more companies are moving toward the use of performance shares as a primary incentive. This increasingly awarded equity vehicle increased in prevalence to 38.5 percent in 2011, up from 33.0 percent in 2010.

PAY DESIGN REFLECTS CHANGE IN STRATEGY

While the overall design of pay packages has remained relatively stable over the past few years, there were some notable

changes in 2011. The most noticeable change was the increase in the average stock component of total compensation. This can be explained by a general increase in all components of pay as a result of merit increases and the improving economic landscape, coupled with a decrease in stock awards due to a few large decreases resulting from a biannual stock granting policy.

EQUITY MIX SEES SHIFT TO MULTIPLE EQUITY VEHICLES

In 2011, there was a shift among companies to diversify the types of equity vehicles granted to CFOs. An additional 10 companies granted all three equity vehicles in 2011, a 22.2 percent increase. Other areas that saw noticeable increases were the use of both restricted stock and performance shares, which grew by 23.3 percent (from 60 to 74 individuals), and the use of both options and performance shares, which increased by 19.2 percent (from 26 to 31 recipients). Equity mixes that saw year-over-year declines were the use of both restricted stock awards and options as well as performance shares, which fell 4.5 percent (111 to 106 CFOs)

and 6.3 percent (32 to 30 CFOs), respectively. The number of CFOs that did not receive any equity vehicles decreased 30.8 percent from 65 individuals in 2010 to 45 individuals in 2011.

PAY BY INDUSTRY

As might be expected, CFOs in certain industries saw larger gains than in other fields. Basic Materials and Healthcare companies had the largest increase in median total compensation for CFOs, rising 29.4 percent and 18.0 percent, respectively, from 2010 to 2011. With a median total compensation of \$1.2 million, Basic Materials companies paid the most to their CFOs compared to other industries. Next, chief financial officers at Industrial Goods and Services firms had increases in pay of 8.8 percent and 6.2 percent, respectively, from 2010 to 2011. Industries that had a decrease in median total compensation were the Consumer Goods and Financial industries, where pay fell by 2.2 and 0.8 percent, respectively. ■

KEY FINDINGS

Total Compensation Rises

Median total compensation for S&P SmallCap CFOs grew by 8.4 percent from 2010 to 2011. In 2011, median total compensation for Small Cap CFOs was \$943,802, up from \$870,609 million in 2010. This compares to S&P 500 Large Cap and S&P 400 Mid Cap median total CFO compensation of \$3.1 million and \$1.6 million, respectively.

Bonuses Are Smaller and Discretionary Bonuses Are Less Prevalent

The bonus payout as a component of total compensation declined from 2010 to 2011. Median total bonus payouts for S&P SmallCap CFOs decreased to \$173,807 in 2011, down 9.3 percent from the 2010 median of \$191,700. Additionally, 25.1 percent of CFOs received a discretionary bonus in 2011, versus 30.6 percent in 2010.

Restricted Stock, Option Awards, and Performance Shares Rise

Restricted stock rose in prevalence from 63.8 percent in 2010 to 67.0 percent in 2011, while remaining the most awarded equity vehicle. Though the prevalence of options had been declining for several years, the prevalence of option awards grew to 50.4 percent, up from 48.2 percent in 2010. Performance shares also increased in prevalence during 2011, growing to 38.5 percent from 33.0 percent. While the use of performance shares increased, the levels are lower than the 64.2 percent and 52.6 percent of the S&P 500 Large Cap and S&P 400 Mid Cap, respectively.

Pay Design Reflects Change in Strategy

While the overall design of pay packages has remained relatively stable over the past few years, there were some notable changes in 2011. Both bonuses and options decreased as overall components of total compensation, while salary and stock components increased. This increase means stock awards now represent a 30.9 percent component of compensation for S&P SmallCap CFOs, which is similar to the 33.9 percent stock award component of Small Cap CEOs.

Equity Vehicle Mix Shifts to Multiple Equity Vehicles

During the past year, the prevalence of chief financial officers receiving options, restricted stock, and performance shares grew 22.2 percent. This move towards multiple vehicles reflects a trend seen in both Large Cap and Mid Cap CFO compensation, where use of all three vehicles increased by 6.1 percent and 13.3 percent, respectively. Another area that increased was the use of restricted stock and performance shares, which grew 23.3 percent. The number of CFOs not receiving awards through any equity vehicle decreased 30.8 percent from 65 individuals in 2010 to 45 individuals in 2011.

Basic Materials CFOs Receive Highest Total Pay

Basic Materials CFOs received the highest compensation, with a median total pay of \$1.2 million in 2011. Median total CFO compensation within the Basic Materials and Healthcare industries had the largest year-over-year growth, increasing 29.4 percent and 18.0 percent, respectively. S&P SmallCap median total CEO compensation within the Basic Materials industry also saw the greatest growth this past year, with a 26.7 percent increase to \$2.5 million.

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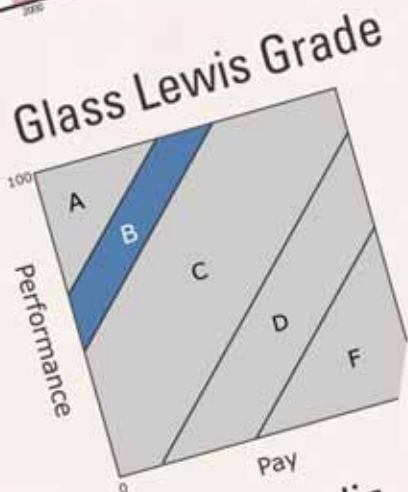
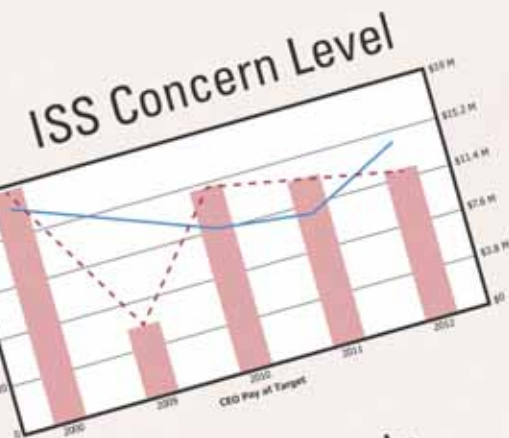
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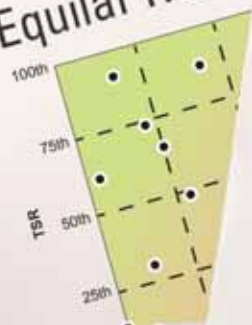
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