Council of Institutional Investors
The Voice of Corporate Governance

Say on Pay

Identifying Investor Concerns

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This white paper was commissioned by the Council of Institutional Investors to educate its members and the public about say-on-pay proposals that failed to win majority support in 2011. The views and opinions expressed within do not necessarily reflect the views and opinions of Council members, directors or staff.

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Executive Summary

Advisory shareowner votes on executive compensation were the big story of proxy season 2011, the inaugural year for "say on pay" at most U.S. public companies. The Dodd-Frank Wall Street Reform and Consumer Protection Act, which President Obama signed into law in August 2010, requires U.S. public companies to provide their shareowners with a non-binding vote to approve the compensation of senior executives. The Securities and Exchange Commission's (SEC) implementing rule, adopted on Jan. 25, 2011, requires say-on-pay votes to approve the compensation of the named executive officers (NEO) at larger companies at least once every three years. The SEC granted smaller companies a two-year exemption.

Say on pay gives shareowners a voice in how top executives are paid. Such votes are also a way for a corporate board to determine whether investors view the company's compensation practices to be in the best interests of shareowners.

The Council of Institutional Investors, a leading advocate for say on pay, engaged Farient Advisors to analyze what motivated investors to vote against say on pay at companies where the proposal failed to receive majority support at 2011 annual meetings. The Council believes the report will benefit active investors by identifying compensation practices where support for change is greatest. It also could help them target initiatives for improved pay practices and provide useful input for structuring their voting policies. Companies will benefit, too, from knowing which compensation practices their owners view as detrimental to long-term shareowner value.

Between January 1 and July 1, 37 say-on-pay proposals fell short of majority support (Exhibit 1 on p. 6). Another 37 companies garnered significant, though less-than-majority opposition, with "against" votes of 40 to 50 percent (Appendix IV). While 37 "failed" votes is a tiny fraction (less than 2 percent) of the 2,340 say-on-pay votes at U.S. companies in the first half of the year, the total was surprisingly large compared with the track record of say on pay in other countries and the expectations of corporate governance professionals.

This report specifically examines:

- The driving factors that fueled majority opposition to say on pay at 37 companies
- The process investors used to determine how they would cast say-on-pay votes
- The influence that say on pay is having on executive compensation
- Potential next steps for shareowners to consider ahead of say-on-pay votes next year
- Potential next steps for companies where investor opposition to say-on-pay proposals was significant

Farient focused its investigation on advisory votes that failed to win majority shareowner support. Farient interviewed representatives from 19 Council member organizations (both U.S. pension fund and other members) about how they cast say-on-pay votes generally and more specifically at the 37 failed-vote companies. These investor participants consisted mostly of public employee pension systems (58 percent), followed by mutual fund firms (32 percent) and union pension funds (11 percent).[1] Collectively, their assets under management exceed $7.9 trillion. Farient also interviewed proxy advisers and solicitors, and consulted its extensive database on executive compensation.

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[1] Note that total may not equal 100 percent due to rounding

Farient found that investors cast advisory votes against executive compensation at the 37 companies for a variety of reasons, but the factors most frequently cited were:

- A disconnect between pay and performance (92 percent)
- Poor pay practices (57 percent)
- Poor disclosure (35 percent)
- Inappropriately high level of compensation for the company's size, industry and performance (16 percent)

Other findings include:

- Investors were extremely thoughtful about evaluating executive compensation for say-on-pay votes
- Due to resource constraints, investors used proxy advisory firms' analyses to varying degrees
- Investors considered multiple factors as well as inputs from various sources in determining their say-on-pay votes
- Investors evaluated performance and pay over multiple years, and focused primarily on total absolute shareholder return (TSR) over one-, three- and five-year periods
- Investors spent the most time and resources analyzing pay at "outlier" companies: those with large disconnects between pay and performance, high overall pay and/or low TSR in comparison to their industry or peers
- Investors focused on CEO pay, rather than the pay of other NEOs, and on the overall "reasonableness" of the level of compensation in view of the company's size, industry and performance
- Investors mostly regarded the say-on-pay vote as an opportunity to voice their concerns about a particular pay program, not a referendum on directors' oversight of compensation

Brief analyses of all 37 failed votes are provided in Appendix II. More detailed evaluations of say-on-pay vote outcomes at five companies (Constellation Energy, Freeport McMoRan, Hewlett-Packard, Nabors Industries and Stanley Black & Decker) where the issue failed for varying reasons are presented in Appendix III.

Among majority "against" say-on-pay votes, about two thirds had opposition levels of 50–59 percent. The rest had "against" votes of 60–70 percent. About one-fourth (27 percent) were in real estate, homebuilding or construction-related businesses — industries that were hit hard in the economic downturn and mostly are still hurting. About one-fifth (19 percent) were energy-related companies. Nearly half were large companies, with annual revenues greater than $1 billion.

This first year of mandatory say on pay has been a learning experience for all participants. Farient encourages investors to conduct a "post-mortem" of their voting processes, including an assessment of any additional resources needed to evaluate say-on-pay proposals fairly and efficiently. Concerned investors should follow up to see what steps, if any, companies take in response to failed say-on-pay proposals, and consider appropriate action.

Farient also offers two critical areas for improvement in deciding how to cast a say-on-pay vote:

- TSR should not be the sole filter investors use to determine which companies' pay plans deserve the most scrutiny. Problematic pay practices lurk at mediocre to modestly performing companies, too
- Assessing performance-adjusted pay — compensation that top executives could receive after performance is taken into account — and in particular the performance-adjusted value of equity — is more appropriate than focusing on the grant date value of equity incentives. The value on the date of grant, as determined by the stock price that day for shares (or options, using an options pricing model), does not reflect the compensation that executives ultimately earn

Companies that failed to win majority support for say-on-pay proposals, or that garnered substantial opposition, should reach out to key investors and engage them in dialogue about executive pay programs. They should also make sure their pay disclosures are clear and thoughtful and that their compensation programs are aligned with company performance. That means having a combination of pay that is sensitive to changes in performance, pay levels that are appropriate overall, and a substantial proportion of pay that is performance-based. In particular, companies should consider setting the *magnitude* of pay changes in response to performance, so that the changes swing proportionately with strong or weak performance.

Introduction

The 2011 proxy season marked the inauguration of mandatory say-on-pay votes on executive compensation at U.S. public companies. Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires U.S. public companies to provide their shareowners with a non-binding vote to approve the compensation of senior executives. The SEC's implementing rule, adopted on Jan. 25, 2011, requires say-on-pay votes to approve the compensation of the named executive officers (NEO) at larger companies at least once every three years. The SEC granted smaller companies a two-year exemption.

Say on pay gives shareowners a voice in how top executives are paid. Such votes are also a way for a corporate board to determine whether investors view the company's compensation practices to be in the best interests of shareowners.

Advisory votes on pay are not a new concept. Say on pay has been widely discussed in the United States as a way to hold directors accountable for runaway executive compensation for close to a decade, ever since the Enron (2001) and WorldCom (2002) scandals. The United Kingdom adopted mandatory say-on-pay votes in 2002, and Australia followed in 2004. Two U.S. companies — AFLAC and RiskMetrics — voluntarily held say-on-pay votes starting in 2008, with Motorola following in 2009, in response to strong investor support for shareowner resolutions requesting annual advisory votes on pay. The U.S. government required more than 350 companies that received federal bailout assistance after the 2008 global financial crisis to give their investors advisory votes on executive compensation, beginning with proxies filed after February 2009.

Say-on-pay votes are purely advisory; U.S. companies are not required to change their executive compensation programs in response to the outcome. But SEC rules do require that in subsequent proxy statements, companies discuss how the most recent say-on-pay voting results affected their executive compensation decisions and overall programs. Such follow-on comments are to be included in the Compensation Discussion and Analysis (CD&A) section of the proxy statement.

Public attention has focused on the relatively high number of "failed" say-on-pay votes (proposals that failed to win majority investor support), the impact of proxy advisory firm recommendations on shareowner voting, the reasons for "against" vote recommendations by proxy advisers and, and most recently, shareowner derivative lawsuits at companies where say on pay garnered majority "against" votes. It is clear from our interviews and public filing research that some companies have changed or promised to change their pay levels and programs in anticipation of a strong vote against their say-on-pay proposals, or in response to a substantial percentage of "against" votes.

What has not been analyzed closely, however, are the *reasons* investors voted against say on pay. As a result, the Council of Institutional Investors asked Farient to research what motivated investors to cast "against" votes on say on pay at companies where the proposal failed to receive majority support.

Methodology/Process

Farient identified companies that received majority "against" votes on their say-on-pay proposals between January 1 and July 1 of this year. Farient then interviewed institutional investors that voted against these proposals to understand their decision-making process and reasons for opposition.

Farient also interviewed representatives of 1) two proxy advisory firms, Institutional Shareholder Services (ISS) and Glass Lewis, and 2) proxy solicitor firm Morrow. We factored in Farient's Alignment Report[2] for companies with failed say-on-pay votes that are in Farient's Alignment Report database. In addition, Farient analyzed the proxies of the companies with failed say-on-pay votes to augment our understanding of investor comments.

The bulk of the research focused on investor perspectives. The Council initially contacted its members, inviting them to participate, and Farient followed up selectively. Morrow provided insight about which Council members were likely to rely more heavily on their own internal assessment process for say on pay, than on proxy advisory firm analyses. Nineteen Council member organizations with combined assets under management exceeding $7.9 trillion agreed to participate (Exhibit 5). Farient interviewed at least one representative of each of the investor participants to:

- Understand the investor's process for evaluating a company's executive compensation programs
- Determine the extent to which the investor relied on analysis and recommendations from proxy advisers when casting say-on-pay votes
- Determine why the investor voted against specific say-on-pay proposals

Given the relatively high number of failed say-on-pay proposals and the desire to capture overarching themes, investors were not asked to comment on and provide reasons for their votes at all companies where they cast "against" votes on say on pay. As a result, most of the findings of this report are presented in a largely anecdotal way. Quantitative results are included whenever the data are sufficient to be meaningful.

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[2] The Alignment Report measures the relationship between Performance-Adjusted Compensation™ (PAC™), total shareholder return and size, as measured by revenue. Performance-Adjusted Compensation is total compensation (including the value of salary, cash bonuses and equity incentives) after performance has been taken into account

Failed Say-on-Pay Vote Companies

The table below identifies the 37 companies where advisory votes on executive compensation failed to win majority support from shareowners, their annual meeting dates, the percentage of votes "against," their fiscal year-end revenue and their industry.

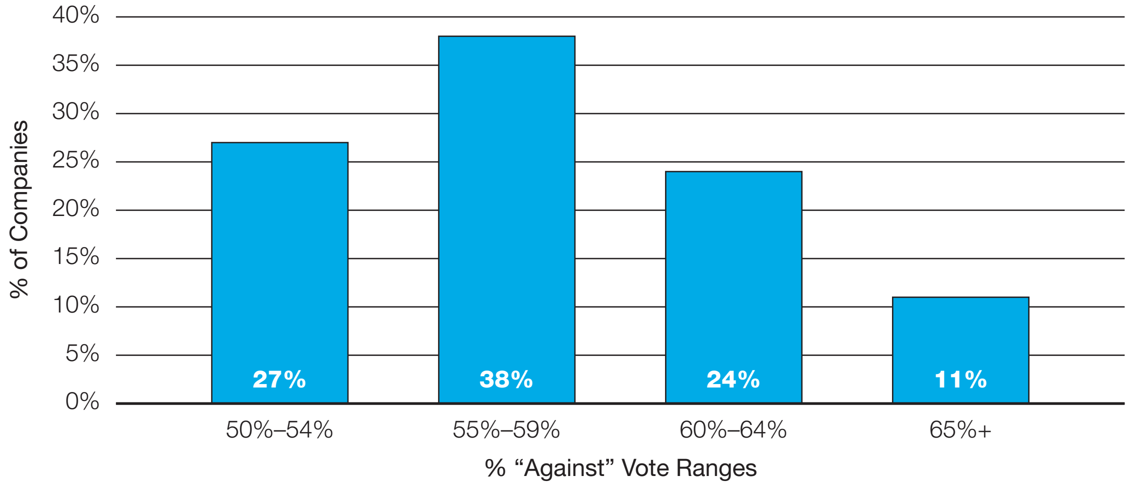
Exhibit 1
Companies with Failed Say-on-Pay Votes as of July 1, 2011

Company Name	2011 Annual Meeting	% Voting Against	FYE Revenue ($MM)	Industry
Ameron International	03/30	59%	$503	Capital Goods — Construction
Beazer Homes USA	02/02	54%	$1,010	Homebuilding
BioMed Realty Trust	05/25	54%	$381	REITs
Blackbaud	06/22	55%	$327	Software
Cadiz	06/02	62%	$1	Water Utilities
Cincinnati Bell	05/03	70%	$1,377	Diversified Telecom Svcs
Cogent Communications Group	04/27	61%	$263	Diversified Telecom Svcs
Constellation Energy Group	05/27	61%	$14,340	Power Producers & Energy Traders
Curtiss-Wright	05/06	59%	$1,893	Aerospace and Defense
Cutera	06/13	65%	$53	Healthcare Equipment & Supplies
Dex One	05/03	52%	$991	Media
Freeport-McMoRan Copper & Gold	06/15	54%	$18,982	Metals and Mining
Helix Energy Solutions Group	05/11	68%	$1,200	Energy Equipment & Svcs
Hercules Offshore	05/10	59%	$657	Energy Equipment & Svcs
Hewlett-Packard Company	03/23	52%	$126,033	Computers & Peripherals
Intersil	05/04	56%	$822	Semiconductors/Semiconductor Equip.
Jacobs Engineering Group	01/27	55%	$9,916	Construction & Engineering
Janus Capital Group	04/28	60%	$1,016	Capital Markets
Kilroy Realty	05/24	51%	$302	REITs
Masco	05/10	55%	$7,592	Building Products
MDC Holdings	04/27	66%	$959	Homebuilding
Monolithic Power Systems	06/16	64%	$219	Semiconductors/Semiconductor Equip.
Nabors Industries	06/07	57%	$4,175	Energy Equipment & Svcs
Navigant Consulting	04/24	55%	$704	Professional Services
NutriSystem	05/12	59%	$510	Internet & Catalog Retail
NVR	05/03	55%	$3,057	Homebuilding
Penn Virginia	05/04	59%	$254	Oil, Gas & Consumable Fuels
PICO Holdings	05/13	61%	$32	Diversified Financial Services
Premiere Global Services	06/15	52%	$442	Diversified Telecom Svcs
Shuffle Master	03/17	55%	$201	Hotels, Restaurants & Leisure
Stanley Black & Decker	04/19	61%	$8,410	Machinery & Tools
Stewart Information Services	04/29	51%	$1,672	Insurance
Superior Energy Services	05/20	61%	$1,682	Energy Equipment & Svcs
The Talbots	05/19	53%	$1,213	Specialty Retail
Tutor Perini	06/01	51%	$3,199	Construction & Engineering
Umpqua Holdings	04/19	64%	$349	Commercial Banks
Weatherford International	05/25	56%	$10,221	Energy Equipment & Svcs

>60% No Votes | Energy Related | Other
Real Estate, Homebuilding & Construction | Technology Related

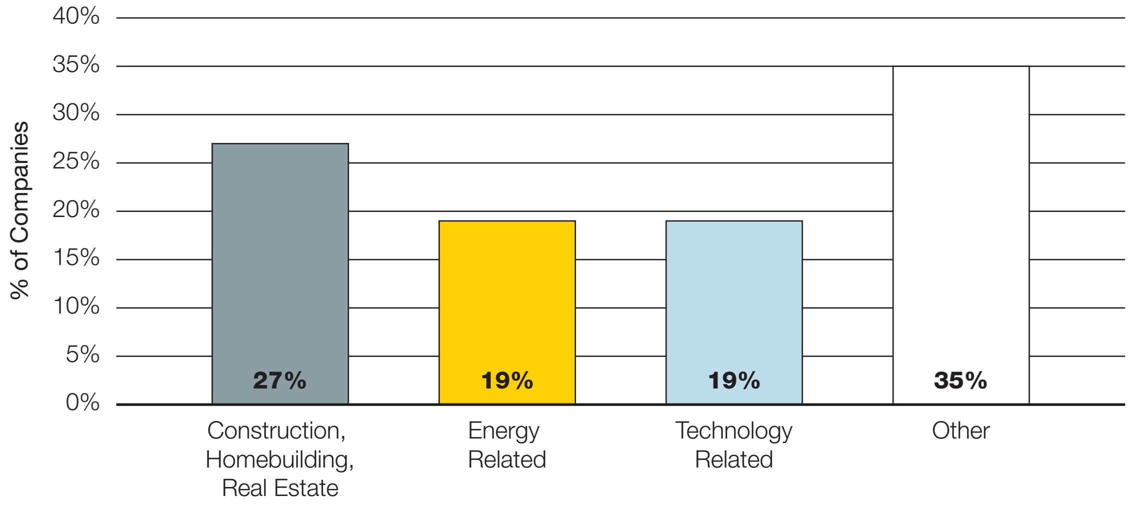
Approximately two-thirds of those where say on pay fell short of majority support had 50-59 percent "against" votes; one-third had between 60-70 percent "against." No say-on-pay proposal had greater than 70 percent opposition.

Exhibit 2
Opposition Ranges for Companies with Failed Say-on-Pay Proposals



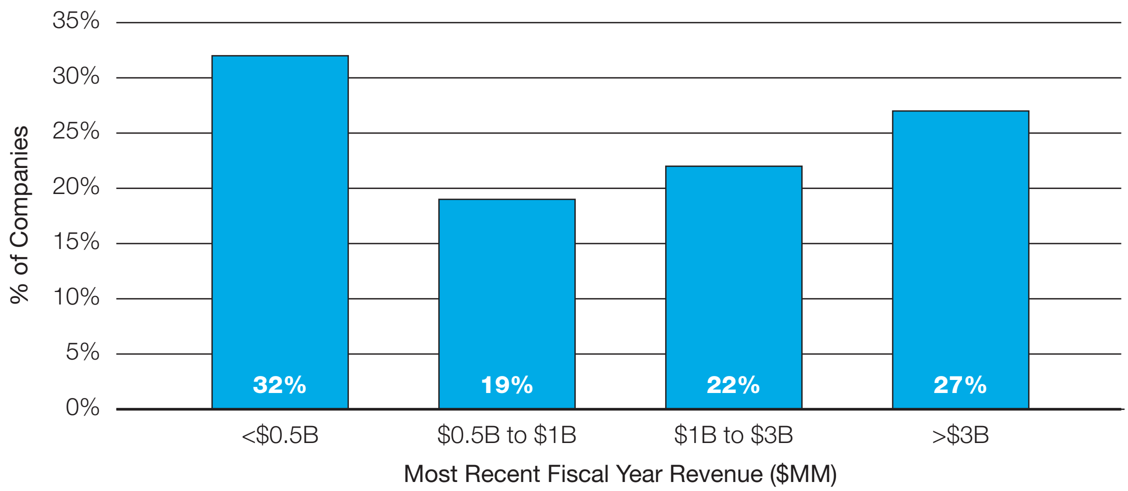
More than one-quarter (27 percent) of the companies with failed say-on-pay proposals were in real estate, homebuilding or construction-related businesses — industries that were hit hard in the economic downturn and are still hurting. Two other industries where say on pay tended to fail were energy (19 percent) and technology (19 percent).

Exhibit 3
Distribution of Companies with Failed Say-on-Pay Proposals by Industry Group



As shown in Exhibit 4 below, nearly half of the companies with failed say-on-pay proposals were large companies, with annual revenues greater than $1 billion.

Exhibit 4
Distribution of Companies with Failed Say-on-Pay Proposals by Revenue Size



Investor Participants

To respect investor confidentiality for those investors that have not yet disclosed voting results, this report cites specific factors that drove "against" votes on say on pay at specific companies, but does not attribute the reasons to any particular investor.

Exhibit 5 lists the 19 institutions that Farient interviewed for this paper. Their combined assets under management exceed $7.9 trillion and median assets under management were $141 billion.

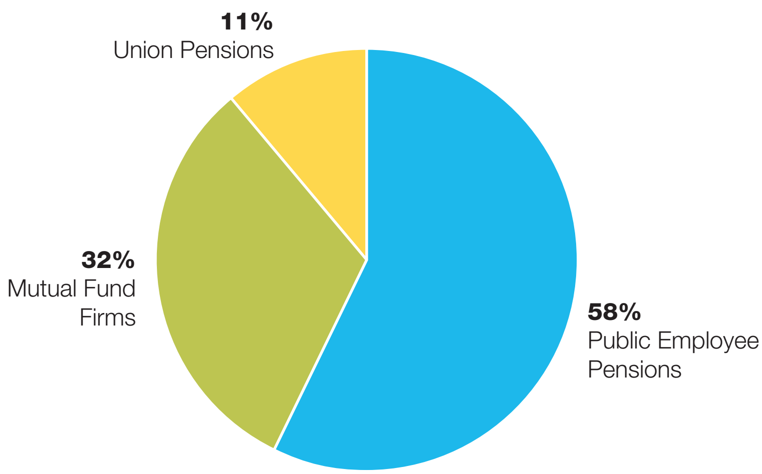
Exhibit 5
Investor Participants by Fund Type and Size

Investor Participants	Fund Type	Assets Under Mgmt ($B)[1]
AFSCME	Union Pension	$95
BlackRock	Mutual Fund Firm	$3,650
California Public Employees' Retirement System	Public Employee Pension	$239
California State Teachers' Retirement System	Public Employee Pension	$130
Capital Research and Management	Mutual Fund Firm	$1,000
Florida State Board of Administration	Public Employee Pension	$157
Morgan Stanley Investment Management	Mutual Fund Firm	$279
New York State Common Retirement Fund	Public Employee Pension	$141
New York City Pension Funds	Public Employee Pension	$122
Ohio Public Employees Retirement System	Public Employee Pension	$76
Pennsylvania Public School Employees' Retirement System	Public Employee Pension	$34
PGGM Investments	Public Employee Pension	$151
Public Employees' Retirement Association of Colorado	Public Employee Pension	$36
State of Wisconsin Investment Board	Public Employee Pension	$84
T. Rowe Price Group	Mutual Fund Firm	$510
TIAA-CREF	Mutual Fund Firm	$453
UAW Retiree Medical Benefits Trust	Union Pension	$45
UBS Global Asset Management (Americas)	Mutual Fund Firm	$621
Washington State Investment Board	Public Employee Pension	$82
Median		**$141**
Total		**$7,905**

[1] Assets under management according to Web site as of 7/1/2011

The investors surveyed represent a mix of public employee pension systems (58 percent), followed by mutual fund management firms (32 percent) and union pension funds (11 percent).

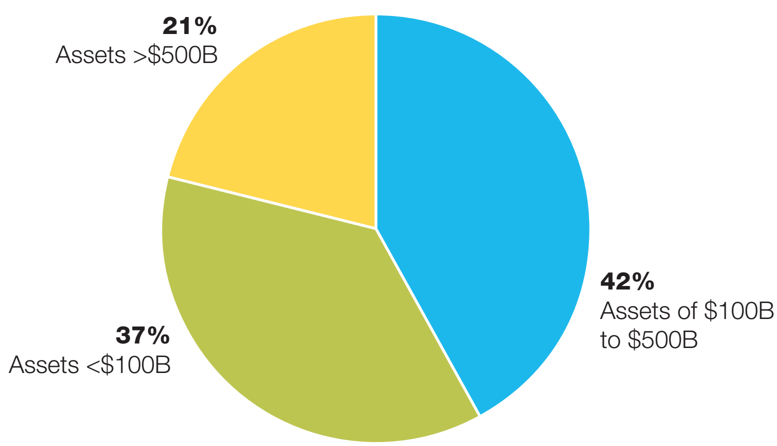
Exhibit 6
Distribution of Investor Participants by Fund Type



Note: Total may be greater or less than 100% due to rounding

Similarly, those interviewed represent a broad cross section of fund sizes, ranging from under $100 billion to more than $3 trillion.

Exhibit 7
Distribution of Investor Participants by Fund Size
(Assets Under Management)



Investor Voting Decision Process

Institutional investors were thoughtful about how they evaluated executive compensation when casting say-on-pay votes. Approaches varied, but virtually all included a review of proxy advisory firm analyses (typically ISS and/or Glass Lewis). They also utilized their own internal scoring methods to identify “potential offenders.” Such methods generally included one or more of the following factors:

- Investor-determined rating or ranking systems for pay programs and performance disconnects
- Input on voting from the investors’ portfolio managers or in-house financial analysts
- Proxy voting oversight committee

In addition, total shareholder return (TSR) was often used as “a gateway” to identify problematic compensation programs. As one investor commented on the evaluation process, “It’s not a check the box [process]; it is a totality of circumstances.”

Investors generally cast votes based on their evaluations of pay and performance over multiple years. Performance was reviewed for one, three and/or five years. Pay was similarly considered over a multi-year period. This last point was one reason why some investors disagreed with ISS’ recommendations. The proxy advisory firm’s evaluation process tended to emphasize year-over-year changes in pay vs. performance, which some investors viewed as too short a time horizon.

Many investors focused on “outlier” companies: those with a big disconnect between pay and performance, high overall pay and/or low TSR in comparison to their industry or peers. This was due in part to staffing and time constraints. Some investors with large portfolios had more than 600 company say-on-pay proposals to evaluate within about eight weeks at the peak of the proxy season. But focusing on outliers was a deliberate strategy for some investors. They believed that concentrating on the worst offenders would sharpen the effectiveness of say-on-pay “against” votes. Said one Council member: “Say on pay would be meaningless if 30 percent of companies failed. ‘Against’ votes should be reserved for the few companies that are really bad.”

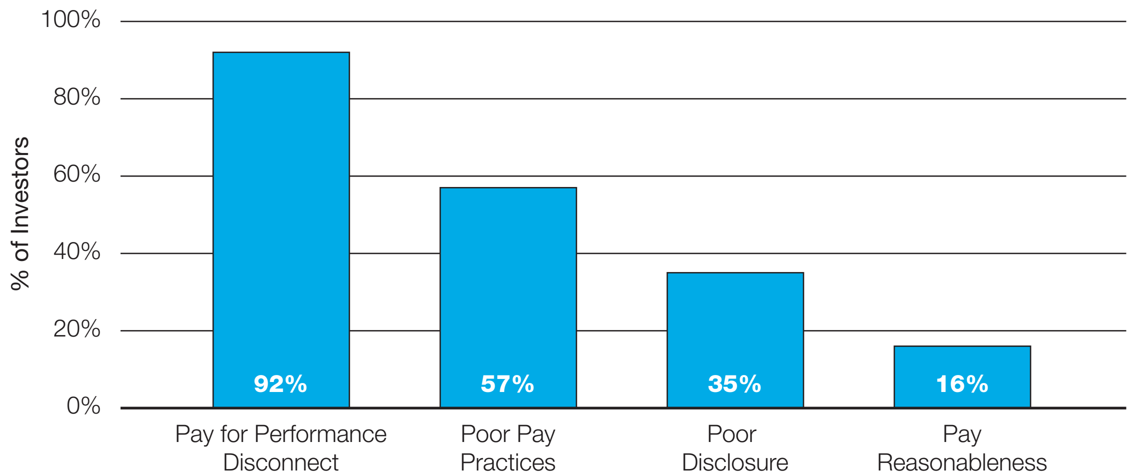
Funds that relied more heavily on proxy adviser analyses cited resource constraints as a factor. But they, too, were thoughtful about their process for determining how to cast their votes. One investor compared the analytic methodologies of proxy advisory firms to the investor’s own point of view on executive pay, in advance of the proxy season. This investor then selected the proxy advisory firm with a perspective that aligned most closely with the investor’s own viewpoint. So, in choosing to vote in accordance with that proxy adviser’s say-on-pay vote recommendations, the investor was voting in sync with its own outlook. Other investors also exercised judgment with respect to the vote, reviewing the proxy advisory firm analyses and recommendations for each company, cross-checking one adviser’s point of view with another, and taking a closer look if the recommended votes differed.

Several of the investors told Farient that they planned to revisit and potentially revise their voting guidelines after this first year of mandatory say on pay. For example, one investor aimed to spend more time on peer groups, including looking more closely at the appropriateness of company-selected peers. Others said they hoped to improve their say-on-pay evaluation processes by making them less time consuming without undermining the quality of the assessment.

Reasons Investors Voted Against Say on Pay Where Proposals Failed

Investors voted against say-on-pay proposals for a variety of reasons, but the most frequently cited by far was a disconnect between pay and performance (92 percent), followed by poor pay practices (57 percent), poor disclosure (35 percent) and unreasonably high pay (16 percent).

Exhibit 8
Most Common Reasons Investors Voted Against Say on Pay



Investors defined "pay-for-performance disconnect" in a variety of ways, but their definitions were generally one or both of the following:

- Performance below a peer group median while pay stayed the same or increased (performance vs. peers was generally based on TSR over one, three and five years)
- Absolute performance based on additional financial measures (e.g., revenue growth, growth in EBITDA (earnings before interest, taxes, depreciation and amortization), net income growth, operating cash flow growth, income margins) over multi-year time frames (e.g., one, three and five years)

Some investors told Farient that, because of time and resource limitations, they tended to give companies with high TSR relative to industry peers a "pass." A few said that they might consider focusing in the future on pay for performance at companies with both high and as well as low relative TSR.

Pay practices that investors identified as "poor" ranged widely. The table below shows those cited most frequently:

Exhibit 9
Most Frequently Cited Poor Pay Practices

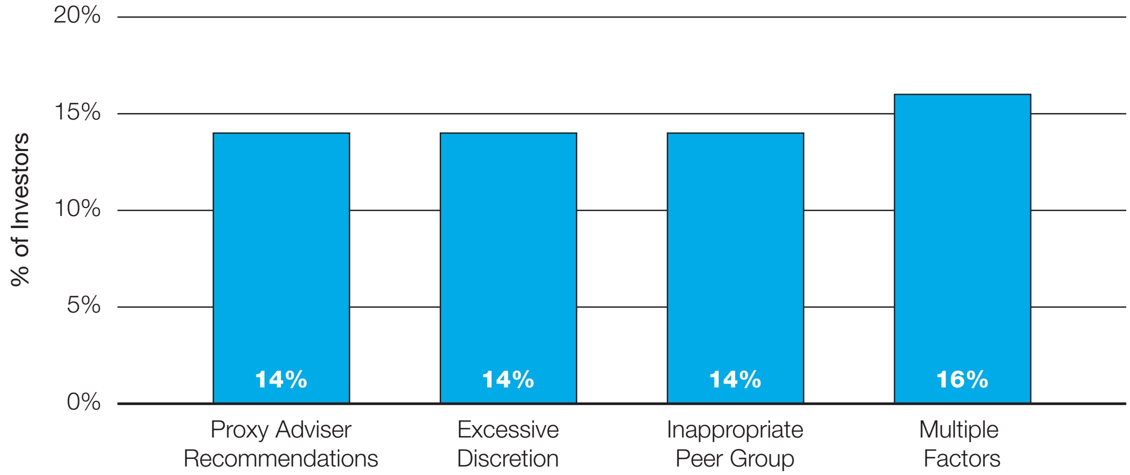
Category	Poor Pay Practice
General Pay Program	■ Excessive long-term incentives (e.g., restricted stock) without performance measures ■ Bonus measures too easy to achieve ■ Poor choice of performance measures ■ Changing performance goals/measures mid-year ■ Targeting executive pay at the 75th percentile of the comparator group
Special Awards	■ Retention awards, especially when performance was poor ■ Special bonuses ■ Special make-up equity grants (e.g., sign-on grants, or grants to make up for other compensation plans that did not pay out) ■ Special retirement payments
Termination Pay	■ Too much severance paid out ■ Gross-ups on change-in-control related excise tax
Other	■ Tax gross-ups (i.e., for items other than change-in-control payments, such as use of company aircraft or apartments, special health benefits and other perquisites) ■ Lack of clawbacks

When investors cited poor disclosure as a reason for casting an "against" vote, the issue tended to be the lack of transparency around measures and goals. This ranged from the "not very clear" to "not disclosed at all." At a minimum, investors expected companies to disclose the measures and goals at least after the fact so that outsiders could assess the payout and determine how difficult or easy the performance goals were to achieve. Other types of poor disclosures cited were inadequate explanations of maximum awards paid and rationales for special awards.

Investors that cited unreasonable compensation as a key factor were generally balking at the sheer magnitude of the CEO's pay (particularly relative to the size of the company) as reported in the proxy statement Summary Compensation Table. Some of these assessments were based on the investor's general knowledge, while others factored in pay data from various sources.

Some of the other reasons that investors cited for casting "against" votes on say on pay could be considered poor pay practices as well. When investors complained about an inappropriate peer group, the issue tended to be that the company used a peer group for pay that was comprised of much larger companies. This potentially inflates market pay comparisons, since larger companies tend to pay more than smaller ones for the same position.

Exhibit 10
Other Reasons Investors Voted Against Say on Pay

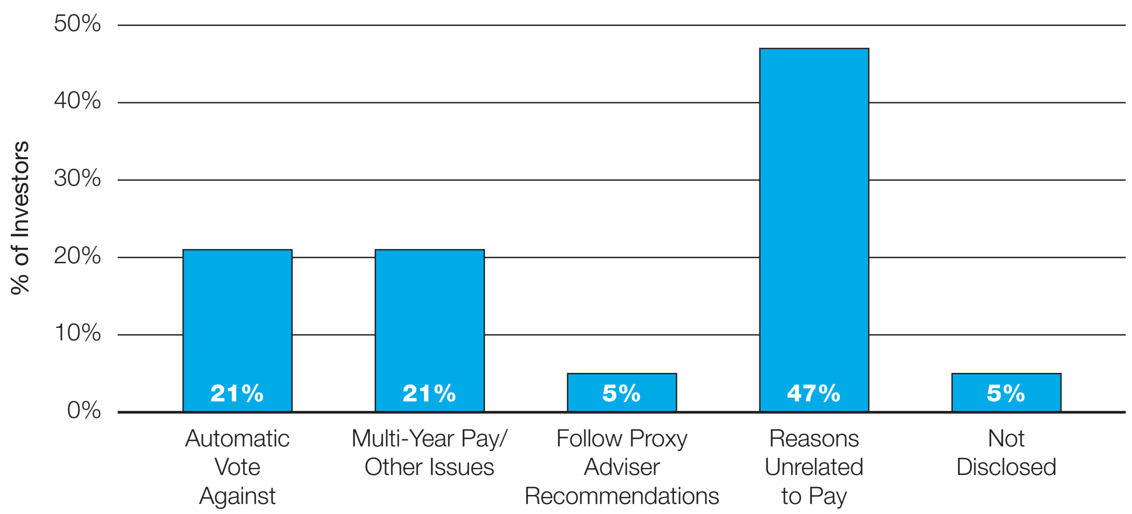


Investors surveyed also took a dim view of excessive board discretion in doling out pay. One investor representative summed up his fund's perspectives on poor pay practices and disclosures this way: "We value transparency. We value concrete performance measures. We understand discretion may have a role, but we look askance at [discretion], especially when it seems to make up for poor performance." Concerns about discretionary payments surfaced in the vote at Intersil, for example. The company paid discretionary bonuses in the second half of 2010 that were not earned under the plan's formulaic approach. It had originally set goals for the second half of 2010 at the beginning of 2010, and then redefined the target goals higher for the second half at the mid-point of the year. At the end of the second half of 2010, no payouts were earned per the formula, but Intersil paid discretionary bonuses anyway because it believed the redefined target goals were too much of a stretch and end-of-year actual performance was in line with budget.

Votes Against Compensation Committee Members

Only 21 percent of the investors surveyed automatically voted against (or withheld votes for) compensation committee directors if they voted against the say-on-pay proposal. Many investors thought the say-on-pay vote provided an opportunity to voice their concerns about a particular pay program, and planned to reserve a vote against directors for repeated "offenses" and failure to listen and respond to investors. Nearly half (47 percent) of investors indicated that votes against compensation committee members reflected concerns on issues unrelated to say on pay.

Exhibit 11
Reasons Investors Voted Against Directors on Compensation Committees when Voting Against Say on Pay



Note: Total may be greater or less than 100% due to rounding

What to Make of the Overall Strong Investor Support for Say on Pay

Investors were keenly interested in seeing if their voices have been heard by the companies that received against votes. How these companies respond will be an important consideration for how investors vote on subsequent say-on-pay proposals.

Roughly 98 percent of say-on-pay proposals passed with majority support. Broadly speaking, investors' views were mixed as to whether that broad trend suggests that companies are doing a good job of managing executive compensation. But most generally agreed that it is too early to draw conclusions based on this first year of say on pay. Comments ranged from "a majority of companies are getting executive pay right" to assertions that they are not, as indicated by the comments below:

- "Many investors are still blindly following board/management recommendations"
- "Investors are too soft [in evaluating pay programs]"
- "Say-on-pay votes are dependent on who the companies' investors are, not necessarily the quality of their program"
- "Just because a company was found not guilty doesn't mean [it is] innocent"

Views of Proxy Advisers and Proxy Solicitors

To get a big-picture context for say on pay, Farient spoke to representatives of the two most influential proxy advisory firms, ISS and Glass Lewis. Farient spoke also with an executive at proxy solicitor Morrow.

The views of proxy adviser representatives were generally consistent with those of the investors in this study. Both said that often a key reason their firms recommended “against” votes was that the pay levels were too high in the context of performance. Another reason was large one-off payments or awards, regardless of performance. The ISS official also said contributing factors included problematic pay practices such as tax gross-ups, lack of share ownership guidelines, “evergreen” provisions in employment agreements and single-trigger change-in-control payments.

Developing an effective voting policy for say on pay is more difficult than for stock option plan share requests, which lend themselves to a more formulaic approach, one proxy adviser representative said. With say on pay, facts and circumstances differ from company to company, and so, unique, company-specific processes, and specialized resources are needed to evaluate say on pay properly. Black-and-white approaches to say on pay are more difficult to craft than for other types of proposals, such as stock option plans, shareowner proposals and even director elections, the proxy adviser representative said.

The Morrow representative commented that the number of companies where say on pay failed to win majority support may be a small fraction of all companies with poor pay practices. The reason, he said, is that many companies modified their pay practices prior to the vote, in response to preliminary “against” vote recommendations of proxy advisers.

Farient's Recommendations for Investors

- Evaluate the say-on-pay decision-making process
- Reconsider using below median TSR as a primary filter
- Focus on the performance-adjusted value of equity vs. grant date value of equity incentives
- Track company responses to poor say-on-pay vote tallies and consider engagement or other action to encourage improvements in compensation

Investors have done a good job in many respects with how they went about making say-on-pay voting decisions. They incorporated multiple sources of information, such as proxy advisory firm analyses and internal evaluation methods that included multiple internal points of view (e.g., a proxy analysis team, analysts or portfolio managers, a proxy voting oversight committee). In addition, many investors assessed pay and performance over multiple years when making say-on-pay vote determinations. Finally, investors considered TSR as the primary indicator of pay-for-performance alignment, while taking other factors into account on a case-by-case basis.

With the high season for voting on proxy proposals behind them, investors can step back and evaluate their say-on-pay review process to see what worked and what did not.

Beyond conducting a "post-mortem" of their voting processes, investors may want to consider whether additional resources are needed to evaluate say-on-pay proposals in as fair and efficient a manner as possible. Farient believes that shareowners should reconsider their use of below median TSR if they are relying on it as the main screen to identify potential "against" vote companies. Many companies that perform well based on TSR do not have pay programs that are both sensitive to performance and reasonable in terms of the level of pay. And past is not necessarily prologue. These companies will continue to fly under investors' radar, perhaps overpaying for performance, until they stumble and become that proxy season's poster child for poor executive pay practices.

Farient also believes that some investors (and proxy advisers) are not defining long-term incentive compensation in the best way possible for assessing the relationship between pay and performance. Most investors (following ISS' methodology) look at the grant date value of the equity as a factor in determining whether compensation is appropriate for the performance delivered. However, the grant date value of the equity represents the *expected* value of the equity at the time the grant is made, assuming that certain performance conditions are met. This methodology is analogous to looking at the *target* value of a bonus, which represents the *expected* value of the bonus, assuming that certain performance conditions are met. In other words, both the *grant date value* of equity and the *target* value of a bonus are *expected values* based on certain assumptions.

To assess pay for performance, investors need to look at the *performance-adjusted value* of equity grants, just as they look at the *actual value* of bonus awards, after performance has happened. In doing so, they can assess what executives really have earned from their grant of equity relative to what they have delivered in real performance. For example, giving executives a high grant date equity value for good performance is like giving them a high *target* bonus for good performance. The actual value of the equity award could be much higher than an already inflated grant date target. Making a highly valued equity grant for good past performance also has the effect of putting more risk into the executive compensation system. The way this works is that investors sanction an above market equity grant value for good past performance, but this above market equity grant value is likely to yield an extremely high actual value if performance is good, and a modestly above market actual value, even if performance is poor.

Investors can also follow up to see whether companies with failed say-on-pay proposals take steps to improve their pay programs and disclosures. Are these companies responding publicly to the criticism? Are they making changes, or pledging to consider changes? If the company is silent, investors may want to try to start a dialogue. If the company is unresponsive to a dialogue, or does not articulate clearly its reasons for maintaining its pay programs, investors may want to consider next steps, which can range from a letter-writing and/or a media campaign to voting against the compensation committee members at the next director election.

Farient's Recommendations for Companies

- Pay attention to what investors are looking for and be responsive to their issues
- Reach out to key investors and maintain a dialogue with them about executive pay
- Reassess the alignment between pay and performance in pay programs
- Provide clear and complete CD&A disclosure

A company that fails to garner majority shareowner support for its say-on-pay proposal, or where say on pay draws significant opposition, should respond to investor concerns. This means understanding what the investors' issues are, revisiting the pay program and making appropriate changes or providing better disclosure.

Reaching out to investors on an ongoing basis will foster goodwill and help investors understand the intent and underlying rationale of the structure of pay programs. Better CD&A disclosure, especially about performance goals and measures, will avoid some problems. The easier the CD&A is to read and the clearer the rationale for determining goals and pay structure, the more likely investors are to support the say-on-pay proposal.

The more aligned pay and performance are, the better. This is a combination of pay sensitivity to changes in performance, the overall size of compensation and the proportion of performance-based pay. If performance has declined, then performance-adjusted pay also should decline (e.g., small or no bonus, low equity values) over a multi-year time horizon (e.g., over three or more years). Companies should set the *magnitude* of pay changes in response to performance, and those changes should swing proportionately with strong or weak performance. For example, corporate performance above the median of a peer group but not in the top quartile should not translate into top quartile pay for senior executives. Conversely, if a company performs below the 25th percentile of the peer group, executive pay should be significantly lower, not just a little below target or the peer median. Further, the link between pay and performance alignment in any given year is not sufficient to indicate a true pattern of pay for performance.

In Closing

Legislation has forced both investors and companies to pay more attention to executive compensation. Compensation committees and boards have become much more thoughtful about their executive pay programs and pay decisions. Companies and boards in particular are articulating the rationale for these decisions much better than in the past. Some of the most egregious practices have already waned considerably, and may even disappear entirely.

Say on pay is a non-binding advisory vote. Investors by and large agree that they do not want to dictate executive pay arrangements. Rather, they want to ensure that the executive pay programs of their portfolio companies incentivize executives to increase shareowner value for the long term. Moreover, if the pay programs are not benefitting long-term owners, investors want the ability to influence their portfolio companies to make the necessary changes. This seems to be what say on pay is all about.

Appendix I
Reasons for Investor Say-on-Pay "Against" Votes

Failed Companies	Explanation for Against Vote by Investors							
	Pay for Performance Disconnect	Poor Pay Practices	Poor Disclosure	Excessive Compensation	Proxy Advisory Recommedation	Excessive Discretion	Inappropriate Peer Group	Multiple Factors
Ameron International	X	X	X					
Beazer Homes USA	X							
BioMed Realty Trust	X	X					X	
Blackbaud	X					X		
Cadiz	X	X						
Cincinnati Bell	X				X	X		
Cogent Communications	X							
Constellation Energy Group	X		X	X				
Curtiss-Wright	X		X			X	X	
Cutera	X	X						X
Dex One	X	X						
Freeport McMoRan	X			X				
Helix Energy Solutions	X		X			X		
Hercules Offshore	X	X	X					
Hewlett Packard	X	X		X				
Intersil	X	X				X		X
Jacobs Engineering Group			X				X	
Janus Capital Group	X		X	X				
Kilroy Realty	X	X	X					
Masco	X							
MDC Holdings	X	X					X	X
Monolithic Power Systems	X	X		X				
Nabors Industries	X	X			X			X
Navigant Consulting	X		X		X			
NutriSystem	X	X	X					
NVR	X							
Penn Virginia	X	X						
PICO Holdings	X				X			
Premiere Global Services		X						X
Shuffle Master	X	X						
Stanley Black & Decker	X			X				
Stewart Information Services	X							
Superior Energy Services	X	X						
The Talbots	X	X	X					
Tutor Perini	X	X			X		X	
Umpqua Holdings	X	X	X					
Weatherford International		X	X					X
Total (investors)	**34**	**21**	**13**	**6**	**5**	**5**	**5**	**6**
Prevalence (investors)	**92%**	**57%**	**35%**	**16%**	**14%**	**14%**	**14%**	**16%**

Appendix II
Reasons for Failed Say-on-Pay Proposals by Company

Ameron International — received **59% Against** vote because of a pay-for-performance disconnect for the last three years, poor pay practices and poor disclosure.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$5,868	$503	29.1%

Beazer Homes — received **54% Against** vote because of pay sensitivity relative to underperformance against homebuilder peers. Its annual incentive plan is 100% discretionary, it has poor compensation practices that include evergreen provisions within employment agreements and change-in-control tax gross-ups and consistent poor performance on key financial metrics.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$6,893	$1,010	-17.2%

BioMed Realty Trust — received **54% Against** vote because of a pay-for-performance disconnect associated with long-term incentives (LTI) being delivered 100% in restricted stock. Additionally, the company had below median performance versus a questionable peer group coupled with a target benchmark at the 75th percentile. Its short-term incentive plan is 100% discretionary.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$5,033	$381	22.5%

Blackbaud — received **55% Against** vote because of a pay-for-performance disconnect and excessive discretion within its compensation plans.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$4,552	$327	11.7%

Cadiz — received **62% Against** vote because of a pay-for-performance disconnect associated with lagging shareholder returns and poor pay practices including equity vesting over a period of less than three years.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$2,325	$1	3.9%

Cincinnati Bell — received **70% Against** vote because of a pay-for-performance disconnect associated with a special cash retention bonus and excessive discretion. Company also has several poor pay practices.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$8,562	$1,377	-18.8%

Cogent Communications — received **61% Against** vote because of a pay-for-performance disconnect associated with LTI being delivered 100% in restricted stock. Additionally, compensation plan and metrics are poorly disclosed.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$3,991	$263	43.4%

Constellation Energy Group — received **61% Against** vote because of a pay-for-performance disconnect associated with historical underperformance, overall excessive compensation and poor disclosure.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$15,716	$14,340	-10.3%

Curtiss-Wright — received **59% Against** vote because of a pay-for-performance disconnect associated with excessive discretion, poor disclosure and an inappropriate peer group.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$7,948	$1,893	7.1%

Cutera — received **65% Against** vote because of a pay-for-performance disconnect associated with negative TSR over all time periods, poor pay practices including equity vesting over a period of less than three years, excessive dilution and a stock option exchange.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$1,150	$53	-2.6%

Dex One — received **52% Against** vote because of poor pay practices and long-term cash awards granted to replace previously cancelled awards associated with declaration of bankruptcy.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$5,165	$991	-77.8%

Freeport McMoRan — received **54% Against** vote because of a pay-for-performance disconnect associated with high payouts under the annual incentive plan and overall unreasonably high compensation.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$36,753	$18,982	52.7%

Helix Energy Solutions — received **68% Against** vote because of a pay-for-performance disconnect associated with highly subjective plans, poor disclosure and excessive discretion.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$4,001	$1,200	3.3%

Hercules Offshore — received **59% Against** vote because of a pay-for-performance disconnect associated with historical underperformance, poor practices and poor disclosure.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$2,516	$657	-27.2%

Hewlett Packard — received **52% Against** vote because of a pay-for-performance disconnect associated with large new hire and severance packages, overall unreasonably high compensation and poor practices.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$8,097	$126,033	-10.8%

Intersil — received **56% Against** vote because of a pay-for-performance disconnect, poor pay practices, excessive discretion and an overall poor compensation program.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$4,447	$822	3.3%

Jacobs Engineering Group — received **55% Against** vote because of a pay-for-performance disconnect associated with historical underperformance, poor disclosure and an inappropriate peer group.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$6,378	$9,916	-10.3%

Janus Capital Group — received **60% Against** vote because of a pay-for-performance disconnect associated with large new hire award, poor disclosure and overall excessive compensation at all levels of the organization.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$20,338	$1,016	-3.3%

Kilroy Realty — received **51% Against** vote because of a pay-for-performance disconnect associated with historical underperformance and too much weighting on the short-term incentive plan relative to long-term incentives, poor pay practices and poor disclosure.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$6,399	$302	24.1%

Masco — received **55% Against** vote because of a pay-for-performance disconnect associated with constant year-over-year value-based equity grants and option focused LTI.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$10,059	$7,592	-6.2%

MDC Holdings — received **66% Against** vote because of a pay-for-performance disconnect associated with too much time-based equity, poor pay practices, an inappropriate peer group and an overall poor compensation program.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$9,206	$959	-4.2%

Monolithic Power Systems — received **64% Against** vote because of a pay-for-performance disconnect associated with too much time-based equity and a larger 2010 equity grant to make up for 2009 when no grants were made, poor practices and overall unreasonably high compensation.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$5,626	$219	-31.1%

Nabors Industries — received **57% Against** vote because of a pay-for-performance disconnect associated with historical underperformance, performance metrics that were too easy to achieve, poor pay practices and an overall poor compensation program.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$13,537	$4,175	7.2%

Navigant Consulting — received **55% Against** vote because of a pay-for-performance disconnect associated with negative TSR across all time periods coupled with high compensation, poor disclosure and modifications to old retention awards.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$1,883	$704	-38.1%

NutriSystem — received **59% Against** vote because of a pay-for-performance disconnect associated with underperformance across all time periods including underperformance against peers on key financial metrics, a guaranteed minimum bonus for the CEO, poor pay practices and poor disclosure.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$5,265	$510	-30.0%

NVR — received **55% Against** vote because of a pay-for-performance disconnect associated with significantly weighted LTI with poor performance metrics.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$30,880	$3,057	-2.8%

Penn Virginia — received **59% Against** vote because of a pay-for-performance disconnect and poor pay practices.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$4,040	$254	-20.1%

PICO Holdings — received **61% Against** vote because of a pay-for-performance disconnect associated with poor TSR performance relative to peers and overall unreasonably high compensation.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$14,278	$32	-2.8%

Premiere Global Services — received **52% Against** vote because of the cumulative effect of poor compensations practices and design.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$8,147	$442	-17.6%

Shuffle Master — received **55% Against** vote because of poor pay practices, appropriateness of the peer group, lack of performance criteria in LTI and pay-for-performance disconnect associated with discretionary bonuses.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$695	$201	20.5%

Stanley Black & Decker — received **61% Against** vote because of a pay-for-performance disconnect associated with increased compensation as a result of the merger and overall unreasonably high compensation.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$32,730	$8,410	32.9%

Stewart Information Services — received **51% Against** vote because of a pay-for-performance disconnect associated with negative TSR over all time periods and significant increases in base salary, lack of performance related vesting requirements. Also, company ignored majority opposition to the re-election of incumbent compensation committee members.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$1,260	$1,672	2.7%

Superior Energy Services — received **61% Against** vote because of a pay-for-performance disconnect associated with significant new hire award and severance award to departing CEO, special retention award and other poor pay practices.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$6,442	$1,682	44.1%

The Talbots — received **53% Against** vote because of a pay-for-performance disconnect, poor pay practices and poor disclosure.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$6,268	$1,213	-47.0%

Tutor Perini — received **51% Against** vote because of a pay-for-performance disconnect associated with negative TSR over all time periods, poor pay practices and an inappropriate peer group.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$9,002	$3,199	23.7%

Umpqua Holdings — received **64% Against** vote because of a pay-for-performance disconnect associated with discretionary bonuses and the upward adjustment of awards, lack of performance metrics on LTI and poor disclosure.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$3,731	$349	-7.7%

Weatherford International — received **56% Against** vote because of poor pay practices, discretionary bonuses and poor disclosure.

CEO SCT TDC (000s)	FYE Revenue (MM)	FYE 1-yr TSR
$13,164	$10,221	27.3%

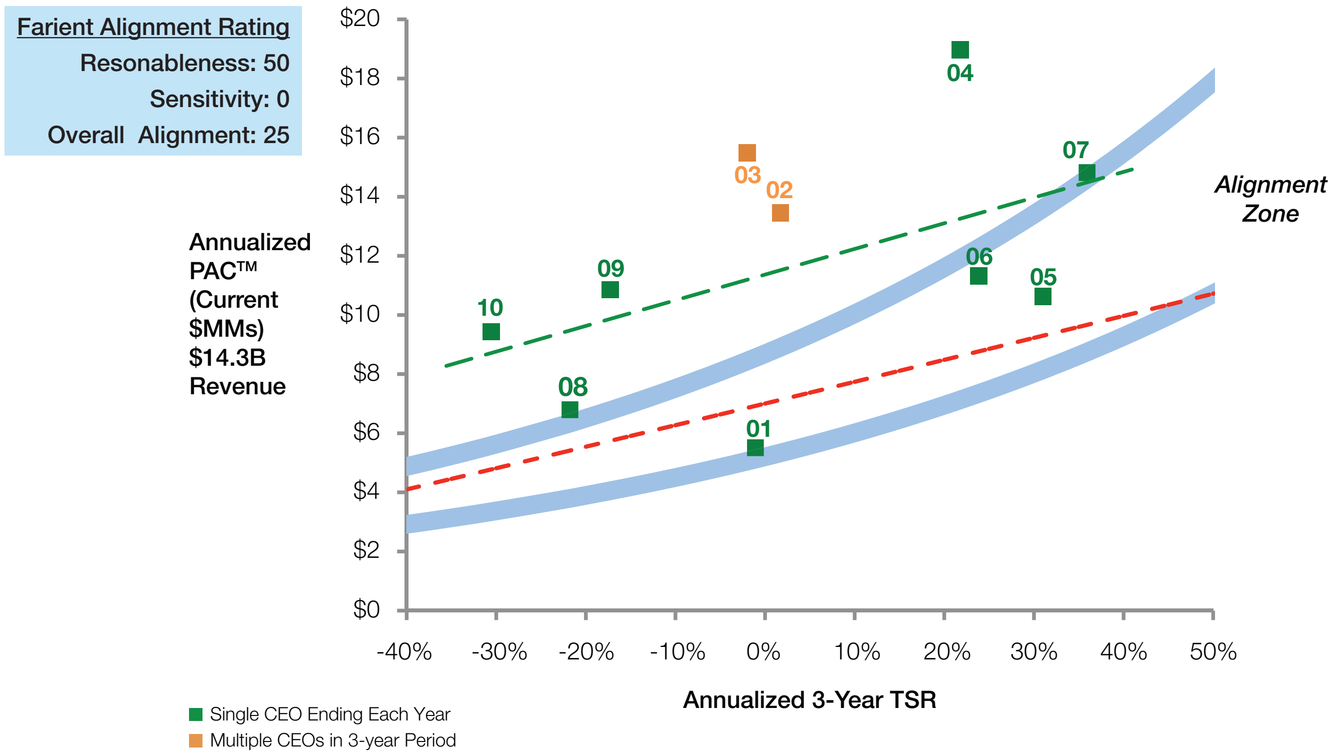
Appendix III
Additional Explanation of Failed Say-on-Pay Proposals for Select Companies

Constellation Energy — Investors balked at the overall high level of compensation (even if change in pension value were excluded). They also expressed concerns about the annual incentive plan design. While the plan factored in a plethora of metrics, there were no weightings assigned and the determination of performance and payouts was at the discretion of the board. Also, Constellation Energy did not disclose the plan's target award values for NEOs and the maximum award was not capped. Investors noted that performance has lagged peers while compensation continues to exceed peers.

Constellation Energy Group vs. Utilities (GICS 5510)

Constellation Energy CEO Total Direct PAC™ Pay for Performance Alignment

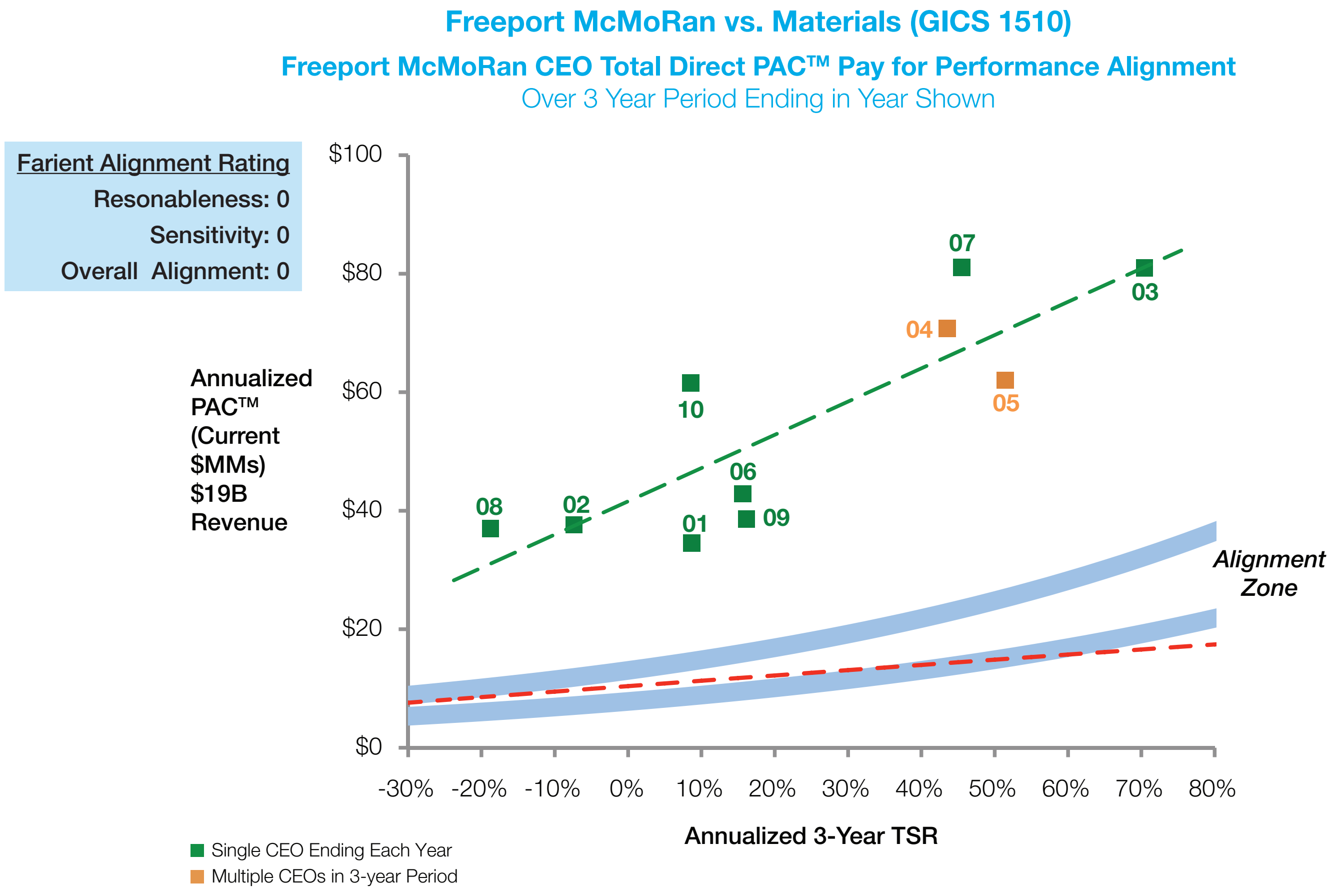
Over 3 Year Period Ending in Year Shown



The Alignment Report measures the relationship between Performance-Adjusted Compensation™ (PAC™), total shareholder return and size as measured by revenue. Performance-Adjusted Compensation is total compensation (including the value of salary, cash bonuses and equity incentives) after performance has been taken into account

- *Each company is rated based on 'reasonableness' (the extent to which the level of pay within the context of performance is within an 'acceptable' range; Farient calls this range the alignment zone) and 'sensitivity' (the degree of responsiveness of a company's compensation levels to changes in performance, i.e., total shareholder return); total alignment rating is calculated by taking the average of the reasonableness and sensitivity scores*
- *The red line represents the 'market line' which is plotted by regression analysis on the reference company's comparator group (4 digit GICS code); market data for the alignment analysis is based on 15 years of historical data inflated to 2010 constant dollars*
- *The green line represents the best-fit 'company line'; each data point is a 3-year average*

Freeport-McMoRan Copper & Gold — Investors cited a pay-for-performance disconnect in the annual incentive plan design (bonus pool based on cash flow), which they believed led to excessive payouts for the CEO and chair. They also said high annual incentive payouts contributed to unreasonably high overall compensation levels for executives.



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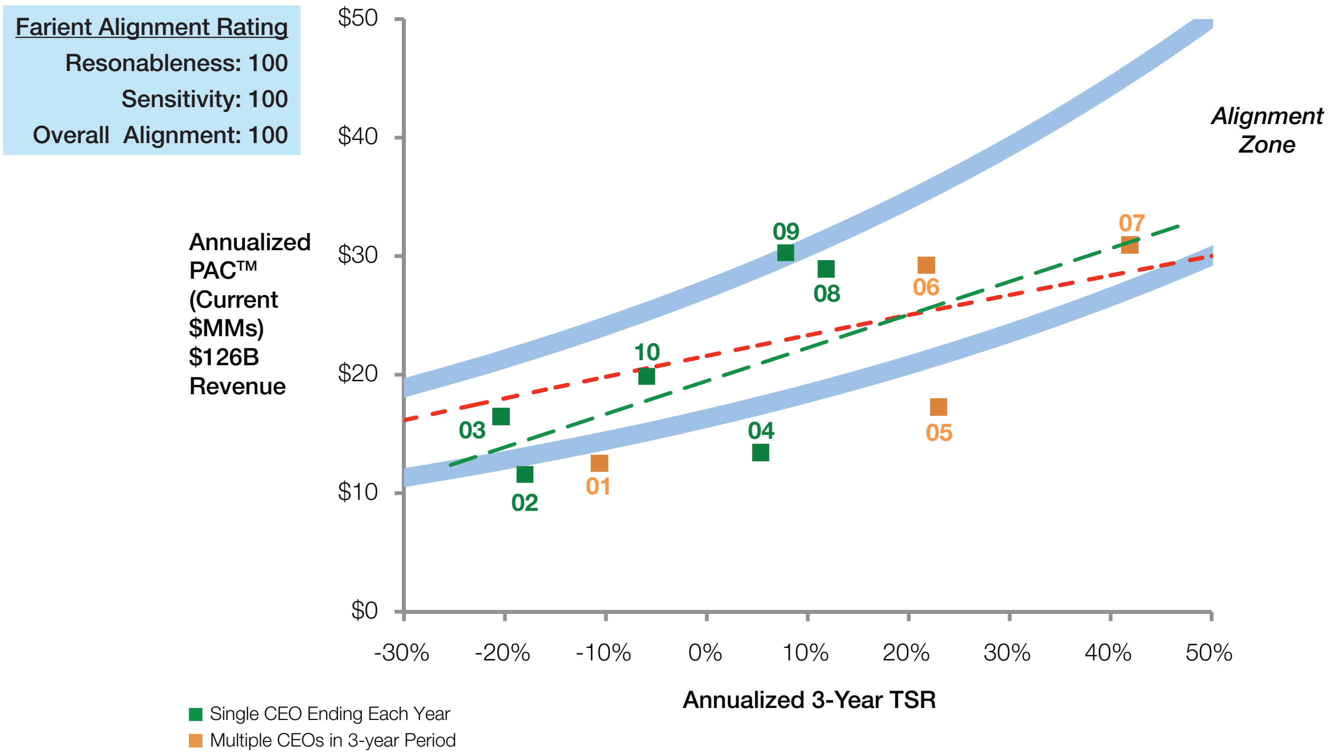
Hewlett-Packard — Opposition to Hewlett-Packard's pay program centered on the lucrative new hire package awarded to the CEO and the questionable independence of five new board members whom the new CEO helped recruit. Additionally, investors were dismayed by H-P's history of large new hire awards and large severance packages for recent CEOs. Investors also noted the lack of performance metrics and the questionable use of earnings per share (EPS) as a metric for performance pay. Hewlett-Packard uses substantial discretion to determine incentive payouts; any metrics used are not disclosed, raising investor concerns about a lack of transparency.

Hewlett-Packard vs. Technology Hardware & Equipment (GICS 4520)

Hewlett-Packard CEO Total Direct PAC™ Pay for Performance Alignment

Over 3 Year Period Ending in Year Shown



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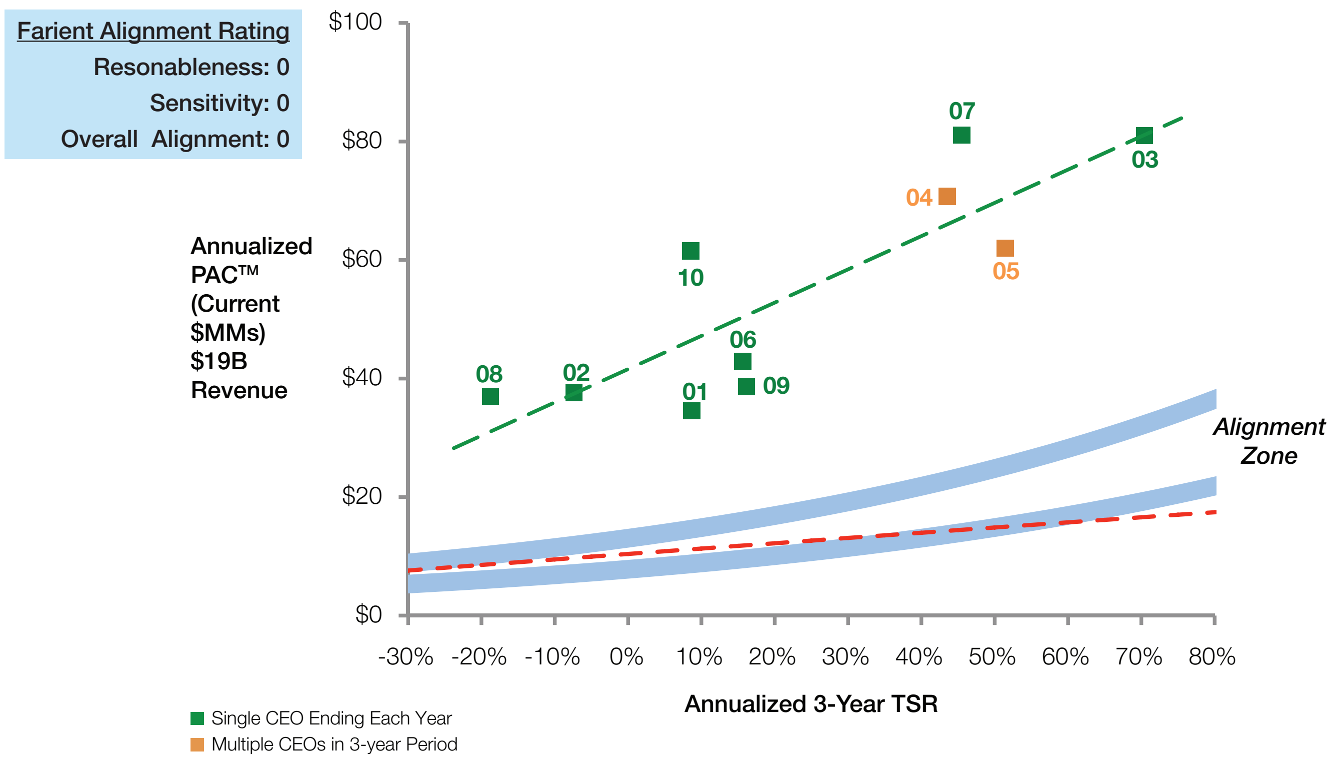
- *The green line represents the best-fit 'company line'; each data point is a 3-year average*

Nabors Industries — Investors expressed a variety of pay program concerns including: history of bad practices, poor goal-setting leading to easy achievement of short-term incentive targets, and underperformance relative to peers over the last three and five year periods. Examples of poor pay practices cited by investors include: tax gross-up, lack of clawbacks and share ownership guidelines and the company's preference for a triennial say-on-pay vote in conjunction with poor pay practices and the pay-for-performance disconnect.

Nabors Industries vs. Enegry (GICS 1010)

Nabors Industries CEO Total Direct PAC™ Pay for Performance Alignment

Over 3 Year Period Ending in Year Shown



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- *The green line represents the best-fit 'company line'; each data point is a 3-year average*

Stanley Black & Decker — Investors expressed concern that the poor pay practices of Black & Decker have taken precedence over Stanley Works' historically rational pay since the two companies merged in 2010. One investor said this warranted an against vote on principle alone. In addition, the large equity package granted to the chair last year, which included a synergy-related bonus, along with the CEOs mega-grant, failed the test of reasonable pay levels in the context of performance test for many investors. Compensation committee members received low support for re-election both last year and this year. Secondary factors included tax gross-ups, single-trigger equity and annual incentive payouts with a change-in-control.

Stanley Black & Decker vs. Enegry (GICS 1010)

Stanley Black & Decker CEO Total Direct PAC™ Pay for Performance Alignment

Over 3 Year Period Ending in Year Shown

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Appendix IV
Companies Where Say-on-Pay Proposals Nearly Failed

Companies with 40%–50% “Against” Votes on Say on Pay		
Abercrombie & Fitch	Douglas Emmett	Rigel Pharmaceuticals
Adobe Systems	Electronics For Imaging	Safeway
Affiliated Managers Group	Group 1 Automotive	Southern Union
Affymax	Headwaters	Staples
Allegheny Technologies	ION Geophysical	SunPower
Allos Therapeutics	Jarden	Allstate
Amedisys	LaSalle Hotel Properties	St. Joe
Amgen	Liz Claiborne	TNS
Cenveo	Penn National Gaming	VCA Antech
Chesapeake Energy	Pfizer	Vornado Realty Trust
ConocoPhillips	Photronics	Willbros Group
CONSOL Energy	Plains Exploration & Production	
Devon Energy	PPL	

Council of Institutional Investors
The Voice of Corporate Governance

About the Council of Institutional Investors

The Council of Institutional Investors (CII) is a nonprofit association of pension funds and other employee benefit funds, endowments and foundations with combined assets that exceed $3 trillion. The Council is leading voice for good corporate governance and strong shareowner rights.

The Council strives to educate its members, policymakers and the public about good corporate governance, shareowner rights and related investment issues, and to advocate on its members' behalf. Corporate governance involves the structure of relationships between shareowners, directors and managers of a company. Good corporate governance is a system of checks and balances that fosters transparency, responsibility, accountability and market integrity.

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