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Compensation Committees must see beyond spiraling regulatory requirements to effectively oversee executive pay programs.

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LETTER FROM THE PUBLISHER



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.

PRIORITIZING

IT'S A QUESTION we've been hearing a lot lately: With so many issues competing for attention, what should be prioritized in today's executive suites and boardrooms? Given the current environment, a better question might be, "What should not be prioritized?" With new regulations demanding increased transparency and attention from shareholders, Congress, and the SEC, it's not surprising that many companies and their boards feel a bit overwhelmed. As we head into a proxy season that promises major changes, companies are being questioned by investors and regulators on topics ranging from consultant conflicts of interest to the composition of boards.

To help answer these questions, we sought the advice of a few industry leaders, including Frederic W. Cook. Along with his fellow partners at his eponymous firm, Fred has served as a trusted advisor to numerous boards across America facing similar challenges. You'll hear his concerns about the absence of true long-term thinking among many executives and boards, and his advice on maintaining a clear perspective on the future.

As numerous experts will attest, the highest priority for boards and top management is to forego risky decisions and focus on long-term goals. We hope this issue of *C-Suite Insight* will help you stay aligned with your core principles in these turbulent times. And, as always, we're open to any questions or comments that can help us better address these challenges. ■

DAVID CHUN
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SIX DEGREES OF PREPARATION

Setting Board Priorities in Urgent Times



BY ROGER STRUKHOFF

We continue to live in interesting times, with a U.S. economy that may or may not recover fully this year, an economic power shift from the traditional North American and European nations to fast-growing countries in all corners of the world, and a new investor climate and regulatory environment that makes doing business more complex than ever. For many firms, the question isn't what to do—it's where to start.

When every new day brings five or six must-do tasks, it can be hard for even the most seasoned professional to maintain his or her priorities. The continual effort of staying on top of changes (all while staying calm) can be an even tougher challenge for board members, who don't experience the day-to-day operations of the companies they serve, but must make key decisions about their strategy and direction.

At *C-Suite Insight*, we considered two approaches to helping board members prioritize for the coming year and beyond. The first was to simply advise you to throw your hands up in the air and wail. The second (and more productive) was to interface with a handful of leading consultants in the executive-compensation business, and see what they had to say.

Needless to say, we chose the latter approach. Our big question for our experts: What compensation issues should boards be prioritizing right now? Their answers were a mixture of overarching lessons and sublime nuance. Here's what they told us...



Six Easy Pieces of Advice

When it comes to setting priorities, don't despair—do as the experts advise!



KNOW YOUR SHAREHOLDERS!

Russell Miller, Managing Director of the New York-based ClearBridge Compensation Group, LLC, says what many of us have been thinking: “There is no question that the hot topic of the day is say on pay.” Yet he advises, “While the vote is important, we recommend that boards focus on getting the pay program right—by assessing the program from both the strategic and governance perspectives.”

“Design your program to address your business priorities, such as driving success on key performance goals or attracting and retaining critical talent,” says Miller. “Use tools that reinforce shareholder alignment, including ownership guidelines and clawback provisions. Minimize governance-related lightning rods like excessive perquisites and tax gross-ups.”

And last but not least, Miller stresses, “Get to know your shareholders and what is important to them. Tell your story in the CD&A and make the case for your program design. This approach will result in a blueprint for an effective compensation program that avoids surprises in the current market environment.”



ALIGN PAY AND PERFORMANCE

James D. C. Barrall, Partner with the Los Angeles office of Latham & Watkins LLP, stresses that “boards that have not already done so should analyze whether their executive compensation aligns, over time, with the company’s financial performance, and that of peers relative to their pay and performance.”

He points out that this analysis “will be required for new ‘pay versus performance’ proxy disclosures under Dodd-Frank when the SEC and stock exchanges issue their rules,” which he says is “likely next summer.”

But more important to Barrall “is [to be aware of] what responsible shareholders should and do care about. By aligning pay and performance, and demonstrating the alignment as the headline in their 2011 proxies to support their say-on-pay vote recommendations, companies can reset the executive pay debate, reassert the board’s control over compensation judgment matters, and defang activist shareholders with political agendas and proxy advisors who have been using one-size-fits-all checklists to micromanage corporate pay practices.”



BEST FIT, NOT NECESSARILY BEST PRACTICES

With say on pay driving board-level conversations and decisions in public companies today, it’s easy enough to learn about best practices and institute them.

Easy, but perhaps wrong, according to **Andrew Goldstein, Executive Compensation Consultant and Central Division Practice Leader with the Chicago office of Towers Watson.** With “compensation committees today living in the proverbial fishbowl,” Goldstein says it’s “hardly surprising that many committees seek cover by trying to ensure that their companies’ pay programs are closely aligned with ‘market’ and/or supposed ‘best’ practices.”

Thus, “with ‘say on pay’ looming, we can expect even more convergence of pay program designs in a rush to the middle,” he adds. But “for many companies, the result will be ‘safe’ but largely homogenous pay programs that are deficient in driving higher shareholder value, or providing a competitive advantage in recruiting and retaining top talent.”

What to do? Goldstein advises that even though “understanding market practices and emerging best practices is essential in providing the necessary context for pay decisions, compensation committees need to exercise thoughtful judgment in considering this context.”

“They should instead focus on getting to the ‘best fit,’ that is, the total compensation package most appropriate for the company given its unique circumstances,” he believes.

How to do this? “Getting to the ‘best fit’ requires taking the long view, a willingness to accept differentiation and take measured risk, and a keen understanding of the particular business conditions facing the company.”

“Management can play an integral role in educating the board around these issues and in recommending solutions for the board’s consideration,” Goldstein says, “Ultimately, though, it is the board’s responsibility to look beyond the easy or safe answers and make the more difficult best-fit decisions on critical issues like incentive plan design and goal setting, managing compensation risk, executive recruitment and retention, and unpopular perks and severance.”



REMEMBER CORE PRINCIPLES

Don Delves, President of the Chicago-based Delves Group, reminds boards to adhere to their key values. “Compensation committees should use the core principles of executive compensation to help them stay focused on the most important aspects of their job,” he says.

“With all the new compensation regulations and disclosure requirements, it is too easy to lose sight of the purpose of executive compensation, which is to drive long-term performance and value creation. [So] the most important thing I am recommending to board compensation committees today is to avoid getting buried in the regulatory compliance weeds.”

Delves stresses that boards should remember to “promote alignment of management with shareholders, as well as alignment of focus and direction throughout the company. They must also maintain accountability by holding management accountable to achievement of strategy and key performance goals.”

Delves also advises board members to “foster engagement by making sure incentive plans are motivational and that compensation opportunities are attractive, competitive, and retentive, and to ensure clarity in logic, understandability, and communication of compensation plans to employees and shareholders.”



LOOK AT ALL THE ELEMENTS

Alvin Brown, Partner with the New York office of Simpson Thacher & Bartlett LLP, says that “the biggest issue facing boards, and especially compensation committees, is reviewing the senior management compensation package, both on an ongoing basis and in light of the occurrence of any termination or change of control...it behooves board members to be sure that they are comfortable with the different elements of what is in place.”

Noting that “all elements of the package are under closer scrutiny today than they have ever been,” Brown says that “to ignore these concerns is to raise the specter of negative comments or opposition from ISS/Risk Metrics and other watchdog groups, Congress, or the media.”

To avoid negative consequences, Brown recommends asking a series of questions:

- “Are there perquisites that the board can comfortably eliminate, and either replace with higher cash salary or greater bonus opportunity, or simply do away with?”
- “Are there benefit programs that have now attracted negative tax or other consequences, such as a discriminatory medical program, that can be folded up or replaced with other consideration?”
- “What triggers a right to the executive’s benefits—does it require a change of control, or must there also be an actual or constructive termination of the person’s employment?”
- “Have they put in any form of clawback—either as will be required by law, or in some other form—to address what happens if there are financial issues affecting the company?”
- “And finally, are the rewards for success or failure sufficiently tied to the fortunes of the company, and particularly their shareholders, so that the senior management has a unity of purpose to act in a manner that is consistent with its fiduciary duties to its shareholders?”



KEEP IT NOT COMPLICATED

Boil all this down, and you get a humorous sibling to the infamous KISS strategy, according to **Stewart Reifler, Attorney at Law with the New York office of Vedder Price P.C.** “The best advice I can give to boards, and particularly to compensation committees, is KINCI—Keep It Not Complicated,” he says. “This is imperative.”

“No matter what the issue or task is, boards must quickly, efficiently, transparently, and intelligently achieve the objective without a lot of mumbo-jumbo, multi-layer distraction, diversion and misdirection. For example, some compensation committees have embraced the concept of a one-time-only new hire equity compensation grant, assuming that the new employee would participate in the company’s equity compensation program...many private companies have been using this for years.”

“A one-time-only grant eliminates the time wasted year after year on analyzing and determining annual equity grants, burn rates, etc. This allows the committee to spend its time on other important issues,” Reifler says, “such as annual cash bonus arrangements.”

“Also,” Reifler notes, “if the program is structured properly, most companies will find that shareholder approval for shares under the equity compensation plan will be needed perhaps once every 10 to 15 years.”

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PREPARATION TEST!

If you're a corporate executive, take a moment to answer these ten simple questions. Consultants, imagine how your clients might answer. If you're an investor, determine whether to laugh or cry.

Note:

- This test is presented for entertainment purposes only. It is not meant as a guide for anyone who writes or reads proxy statements.
- This document contains no forward-looking statements, and certainly no intellectual property. SEC compliance is pending, and will be pending for quite some time.



1. How will you comply with the relevant provisions of Dodd-Frank?

Answer: _____

- a. Our proxy will demonstrate that we're not only complying with what the SEC has already implemented, but that we'll be proactive in setting the standard for our industry.
- b. We're satisfied that we can comply with SEC interpretations issued so far.
- c. We're sitting and waiting to determine the full effects of the legislation on our proxy.
- d. Who is Frank Dodd?

2. What does the term "transparency" mean to you?

Answer: _____

- a. Personal and trade-secret information aside, we need to be as open and transparent as possible with our stakeholders, regulators, and Congress.
- b. It means that we must answer truthfully to what is asked, and nothing more.
- c. We like to say it's the new stonewalling.
- d. We don't use transparencies anymore. PowerPoint only.

3. What is your view of say on pay?

Answer: _____

- a. We will give our shareholders whichever option they choose, and ensure that we maintain clear, two-way input on this very important issue.
- b. We will pay close attention to what our shareholders are telling us.
- c. Not a big deal. We can ignore it.
- d. Our CEO has the say, and we pay.

4. What is your view of compensation committee independence?

Answer: _____

- a. This is an important reform, one that we already instituted a few years ago.
- b. We believe in this principle and will be doing our utmost to comply.
- c. What do you really mean by "independence?"
- d. Yeah, right.

5. How are you implementing clawbacks into your executive compensation plans?

Answer: _____

- a. This is another important reform that we've already implemented.
- b. This is a difficult issue, but we plan to implement to the full extent required.
- c. Just another log-rolling exercise as far as we're concerned.
- d. Yeah, right.

6. How do you determine the members of your peer group?

Answer: _____

- a. There are few issues more important than this. We conduct a rigorous, independent peer-group review every year to ascertain the optimal group for our business.
- b. Although we believe our circumstances to be unique, we have conducted a thorough review and created a large, diversified group of peer companies.
- c. This is a dumb question. It's too hard to compare!
- d. Do you know anything about our company? We have no peers.

7. How will you ensure that your comp consultants have no conflicts of interest?

Answer: _____

- a. There are no grey areas here. We have a rigorous process to make sure our consultants are conflict-free.
- b. Many of our consultants perform multiple services because of their expertise. It's going to be a challenge to eliminate this entirely.
- c. It's hard for these folks to make a living, so we don't see a problem.
- d. None of your business.

8. How are you managing perks & ben-nies in an era of increased scrutiny?

Answer: _____

- a. Obviously cushy perks are gone. We divide the rest into financial (e.g., insurance plans) and non-financial (e.g., security, air travel) and closely analyze the true need and scale of them individually.
- b. We justify each of our benefits, with the understanding that our top executives are unique people with unique needs that may not be apparent to everyone.
- c. We're trying to do the right thing, but our CEO sure does like to play golf!
- d. We are managing them quite well, thank you.

9. How do you determine board-member and committee-member compensation?

Answer: _____

- a. Peer-group analysis is required here, too. We have been aggressive in closely matching this compensation with that received by boards of similar companies.
- b. We've had a longstanding policy of compensating all of our board members fairly and consistently.
- c. OMG, don't tell me we have to worry about this, too!
- d. They're all friends of our boss, so we just do what we're told.

10. How would you evaluate your own proxy statement?

Answer: _____

- a. We are succinct, accurate, and transparent. We hope our proxy is a model for all public companies.
- b. We feel that we've met all provisions and produced something of benefit to everyone.
- c. It's a pretty stressful process. I hope ours turns out OK.
- d. Nobody really reads these things, do they?

ADD THE POINTS TO SEE HOW YOU RATE!

SCORING

Each "a" answer = 4 points x _____ = _____
Each "b" answer = 3 points x _____ = _____
Each "c" answer = 2 points x _____ = _____
Each "d" answer = 1 point x _____ = _____
Total Points = _____

RATING

10-15 points: Go directly to jail. Do not pass GO. Do not collect \$200.
16-25 points: Is your resume updated? It should be.
26-35 points: Good job. Your practices are perfect...for 2007.
36-40 points: Congratulations! Can you contribute an article to *C-Suite Insight*?



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INTERVIEW

FREDERIC W. COOK



INTERVIEW WITH FREDERIC W. COOK

“Executives whose goal it is to maximize the company’s current value will think and act differently from those whose goal it is to build long-term sustainable value for future generations.”

FREDERIC W. COOK IS the Founding Director of Frederic W. Cook and Co. Prior to forming the compensation consulting firm in 1973, Mr. Cook was a principal with Towers Perrin, which he joined in 1966 following four years as a U.S. Marine Corps infantry officer and graduation from Dartmouth College. Mr. Cook speaks and writes frequently on compensation topics. He is an honorary life member of the American Compensation Association, a fellow of the National Academy of Human Resources, and the 1996 recipient of WorldatWork’s Keystone Award.

A longtime advocate of long-term thinking, he cautioned us that he was not interested in critiquing the structure of today’s executive compensation plans, but rather “what we can all do in the future to build a greater balance among the short term, medium term, and long term.”

WE CAN AND SHOULD BUILD AN INCENTIVE SYSTEM THAT'S BASED ON TRUE LONG-TERM PERFORMANCE.

C-Suite Insight: Before plunging into the details, Mr. Cook, can you define what long-term thinking means to you?

Fred Cook: Long-term to me means someone's full career with a company, and even beyond. But, we have to be practical—you can't motivate and retain a management team with a reward that's decades away. However, we can and should build an incentive system that's based on true long-term performance.

CSI: We've noticed that most performance-based incentive plans for executives today are structured for about three years.

Cook: Yes, most executive long-term performance grants have a performance period of three years, sometimes four, rarely five. Goals are set for the performance period, performance is measured, and the payout occurs. This provides a nice balance with the short-term focus on annual bonus plans, but it's not really long-term.

CSI: What's driving the call for long-term thinking today?

Cook: I think the global financial crisis of 2008 and the resulting recession caused some observers to question whether businesses were really managed for the long term. And it led to a call, at least for global financial institutions, to adopt incentives that motivate and reward true long-term performance, and to penalize (or "clawback") incentives based on short-term performance that is not sustainable. While the focus is on financial firms, the objectives apply to other large companies as well.

The last few decades have seen an increasing focus in business on short-term performance. This has occurred for a variety of reasons, but not least because of pressure from stock-market

investors who seek above-market returns and because of the acceptance by many that the primary purpose of business is to maximize shareholder value.

But this is a strange sort of purpose—when speaking of value, you have to ask, over what time period and for whom?

CSI: Could you elaborate on this?

Cook: There's an interesting mismatch of time dimensions in a public corporation. A corporation by law is permanent, with no natural life. It can go bankrupt or it can be sold. But absent that, it can exist forever. Likewise, the shares have no natural life. The owners may change, but the shares last beyond the current owners.

Yet the holders of management positions and the current owners of shares have natural lives. So, if the goal to maximize the value of the company, does that mean for the current management and the current shareholders, or does the goal extend to future generations of executives and shareholders?

The term "to maximize" implies an end point where you can measure whether that goal has been achieved or not. To me, a goal of maximizing shareholder value is only useful if the goal is to sell the company

to the highest bidder. A better purpose for a corporation being built to last, in my view, would be to build long-term sustainable value for future generations of managers and investors.

CSI: So where do most LTI designs fall short? How effective are they?

Cook: They don't fall short. They accomplish what they set out to do, which is to align management's interests with shareholder interests, balancing the near-term financial performance and increasing the market price of the stock.

I'd say a majority are effective. The best programs are built on a portfolio approach that combines market leverage, executive retention, and long-term stock ownership.

It's only as a true incentive for long-term sustainable value creation that they fall short, because they're focused on the near-term.

CSI: And how do you define long-term sustainable value creation?

Cook: If you had a company that was capable of generating, say, a billion dollars of operating income more or less every year, and if the management team was able to improve operations and grow the company over a reasonable period of time such that it could generate two

billion dollars of operating income per year, with minimal dilution, I would say that you had built sustainable value.

Sustainable value means the performance is able to be repeated. The earnings capacity has momentum. It's not a one-time event, not a flash in the pan.

CSI: Can you provide examples of companies that think along these lines?

Cook: Sure, and it's nothing new. When I was entering into the business world, the blue-chip companies were built as enduring engines of business success. Managers and executives were trained or acculturated from the start to think of themselves as custodians or fiduciaries of the company's interests.

Their job was to improve the company and leave it in better shape than they found it. They were part of some sort of virtuous continuous cycle of improvement. People at IBM or GE, for example, wouldn't have thought that their job was simply to make a lot of money, then retire and let the next people who came along deal with things.

CSI: Those two companies are still around today.

Cook: Yes. And there are many others. Companies like Boeing, Johnson & Johnson, DuPont, J.M. Smuckers, L.L. Bean, Mars, McGraw-Hill, Ford Motor,

Cargill, Caterpillar, 3M, Eli Lilly, and Brown-Forman come to mind.

These companies have a history and a continuity of purpose that extends beyond making a current profit. Some of them are still family-oriented; the families have maintained a large ownership in the companies. As such, they view the companies as a family asset, something to pass on to future generations.

They tend to promote from within, even though their top managers today may not be family members. The family line may not be in the management, but they're still in the ownership.

Whether family-influenced or not, they tend to have a vision and culture that focuses on investing and managing for the long term, building value for all stakeholders and not just stockholders or the current generation of managers and owners.

CSI: And they're not thinking quarter-to-quarter or year-to-year.

Cook: They think the value of the stock at any particular point in time is less important than the value of the earnings stream. A strong earnings stream means that the company does not have to sell more stock or go into debt to support the business, and it pays dividends.

A BOARD CAN MOTIVATE ITS MANAGEMENT TO BUILD LONG-TERM VALUE.

If you're not looking to sell a stock, then the price at any point in time is not necessarily all that important, because that's not what the game is all about. But many companies don't think of themselves as an enduring institution; rather, they see themselves as an economic entity that's tied to its current value.

Executives whose goal it is to maximize the company's current value will think and act differently from those whose goal it is to build long-term sustainable value for future generations.

CSI: And this focus on sustainability is missing from most current compensation programs?

Cook: Yes, what's missing is this element of sustainability. There is nothing in a three-year incentive plan or a 10-year stock option plan to continue to reward you if you've built something sustainable, or to penalize you if you haven't. Having management hold a significant ownership in company stock is not enough. At least, it didn't seem to ameliorate the focus on short-term performance that contributed to the global financial crisis and resulting recession. It is possible that a large ownership position may motivate actions to keep the stock price up more than it does actions to build sustainable value for the future.

So I want to sensitize people to the fact that there may be something missing in the total rewards and compensation structure for key people in large companies.

CSI: How can boards proceed along this path?

Cook: A board can motivate its management to build long-term value by having a component of the plan based on growing the earnings capacity of the business, net of dilution. It would probably use a "banking" concept, whereby current performance creates an amount of money that is deferred for the management team, and paid out gradually over, say, a five-year period of time. This would produce an income stream, but the amount in the "bank" would be reduced if performance declined. This is a way to think about sustainability. Thus, the income stream would be affected both by current performance and the sustainability of that performance. This would capture an executive's attention more than a dividend stream on a grant of restricted stock.

CSI: And it continues beyond the current management's tenure?

Cook: Yes, this banking and this sustainability can work even after you leave the company. If you leave under good conditions, we can

continue to put money in the bank for you, based on continued growth. But if you built it up and it falls when you leave, we'll debit the bank balance.

The elements of a plan like this are not new. They have been around a while, been tested, and been found to be effective.

CSI: Will the adoption of a new incentive plan based on sustainable value creation really change behavior?

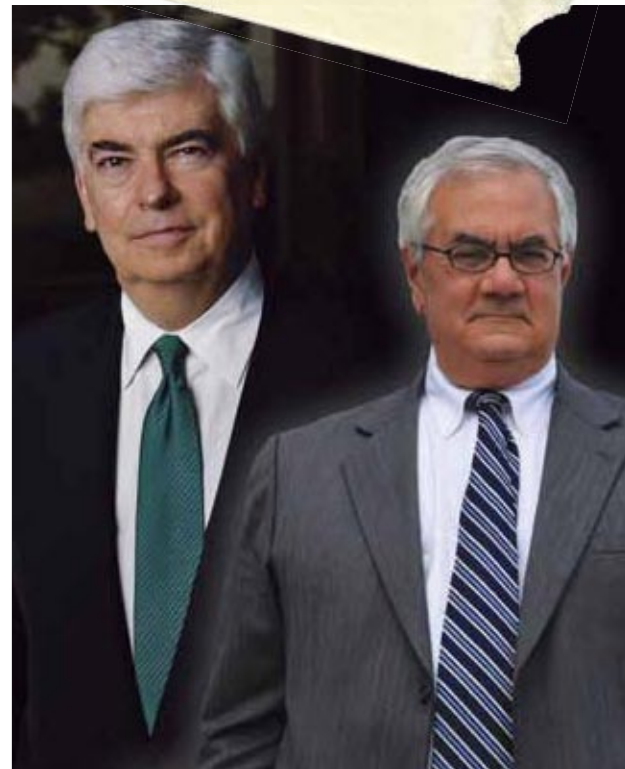
Cook: You can't just design a plan and impose it on an organization. The company needs to have a culture of long-term thinking and a vision of what it wants to be. That culture and vision has to emanate from, and be supported by, the top. But if a company has that culture and vision, a sustainable value creation plan can support and reinforce that vision. The problem today is that executives who want to build for the long term are actually operating against their own self-interest in doing so, because the incentive plans are focused on near-term performance and stock price.

Many key people at companies want to believe in something beyond the quarterly profit, the annual and mid-term bonus, and the stock price. They see themselves as part of a vision that can last beyond them. It's a natural human motivation. **C**

TARP AND DODD-FRANK:

WHERE
DO WE TAKE IT
FROM
HERE?

BY ROGER STRUKHOFF



Dodd-Frank

After signing the Dodd-Frank Act into law, President Barack Obama stated, “Because of this reform, the American people will never again be asked to foot the bill for Wall Street’s mistakes. There will be no more taxpayer-funded bailouts—period.”

The President was referring to TARP, and the provisions of Dodd-Frank that promise it won’t be repeated. But can we believe this? Was TARP really such a bad thing?

A TARP report in October 2010 estimated that the program will cost American taxpayers about \$30 billion, slightly less than the multi-trillion-dollar estimates that were being tossed around by many commentators in the scary, early days of the program.

About 70% of the money lent to banks had been repaid at that point, and the government now expects to no longer be an owner of GM, AIG, or Citigroup by the end of this year. Would things be better economically for today’s U.S. if the Bush and Obama Administrations had simply let everyone fail? Is a policy of “no more bailouts” the right thing to do, no matter how many populist nerves it hits?

Interestingly, it seems as if TARP wasn’t such a bad investment after all. It was only its potential to go sideways that brought on fear and loathing. TARP, ironically, may have been riskier than the risky Wall Street actions it was developed to fix. But it worked.

WHO GETS THE BLAME?

Within this context, it’s important to note that Dodd-Frank is formally called the Dodd-Frank Wall Street Reform and Consumer Protection Act. A more accurate title might have been “Wall Street and Detroit Automakers Reform and Consumer Protection Act,” but there’s no reason to quibble now.

Although some of Dodd-Frank’s burdens will be shared by all public companies, Wall Street is the clear target here.

But a look at the S&P 500 shows that only 80 of these companies—16% of them—are financial services companies. Of those 80, only 17 (or 3.4% of the S&P 500) are based in New York.

And it was a sub-group of these companies—plus a few more that no longer exist—that has received most of the negative coverage throughout the Great Recession and fledgling recovery. We all know who they are.

So is it fair to say that all the problems of the Great Recession and its aftermath can be placed on the shoulders of a very small percentage of the S&P 500? Are 96.6% of the S&P 500—and almost 100% of Americans—being penalized for the actions of the 3.4%?

For example, what did Colgate-Palmolive, also based in New York City, do to cause these problems? What did Deere & Co. or Johnson Controls, two companies that are decidedly not based in New York, have to do with it all? Should they be required to operate under the same provisions of Dodd-Frank as the problematic companies of Wall Street?

THE INVESTOR POV

From the point of view of investors, the answer is an emphatic “yes.”

The provisions that do apply across the board involve corporate governance—say on pay (and say on golden parachutes), proxy access to nominate directors, regulating conflicts of interest, independent compensation committees, clawbacks—and some of them may help investors find that idyllic level playing field they all seek.

In reality, many of Dodd-Frank’s provisions don’t directly apply to most companies. This list includes the Consumer Protection Act, and provisions that involve derivatives, mortgage reform, hedge funds, and credit agencies.

Other provisions (with luck) won’t apply to a majority of firms, including the commitment to end bailouts, new powers of de-registration, and provisions to ensure more orderly corporate bankruptcy procedures. The provisions granting the SEC the power to stop companies from becoming “too complex” and “too big to fail” could be troubling, but are clearly targeted at the small group of arrogant executives who made the latter argument during the crisis.

These latter provisions could also be used, in theory, to stop companies from getting their hands into too many businesses. But as one noted consultant told us, “We’re not in the age of conglomerates anymore. You just don’t see the ITT-type company today.” The notable exception is Berkshire Hathaway, which has become more of an investing tutorial than a model corporation; it’s the exception that proves the rule.

BAD BEHAVIOR OR BAD ENVIRONMENT?

Despite having PR skills on par with those of the North Korean government, the most notorious of the Wall Street firms may be the recipients of a little too much scorn. They certainly did not act alone. Wall Street was given the green light to slice and dice and rock and roll with the elimination of the Glass-Steagall Act in 1999, an event that itself happened more than a decade after the end of the “greed is good” era and the alarming Wall Street crash of 1987.

So blame Wall Street if you want. Or, blame Freddie Mac and Fannie Mae. Blame whichever political party you wish to blame. The reality is that a very large number of people—and the companies that sold them products and services—had a great time riding the equity escalator, into houses many of them knew they couldn’t really afford. That is, until the whole structure began tumbling down.



“Those of us who have looked to the self-interest of lending institutions to protect shareholders’ equity—myself especially—are in a state of shocked disbelief.”

—Alan Greenspan

CAUSE AND EFFECT, OR JUST EFFECT?

Dodd-Frank was an inevitable result of that tumble. We recently contacted its authors’ offices to see how they felt it was working so far.

Congressman Frank e-mailed us just before the holidays with the following response: “I am hopeful that the regulators will use the authority that the bill gives them in a responsible way, and if they do I believe we will substantially lessen the extent to which the structure of compensation packages has incentivized excessive risk-taking.”

Sen. Dodd did not seek re-election in 2010, and we were unable to get a follow-up comment from him.

But we can see that Rep. Frank continues to connect the dots between the structure of executive compensation and excessive risk-taking. He believes in pure cause and effect here. Reading between the lines a bit, one can also hear his concern that the SEC won’t necessarily, or always, implement the Act’s provisions as strongly as he might like.

A number of industry consultants we’ve interviewed at *C-Suite Insight* over the past 18 months don’t connect the dots this way. They see the effect, but believe the cause is much more complex.

For example, they point out that the top management of the most notorious Wall Street firms actually lost more money than anybody in the crash. Why would they take chances that put their entire companies, and therefore their own personal finances, at peril?

Former Fed Chairman Alan Greenspan echoed this belief in his October 2008 remarks to Congress. “Those of us who have looked to the self-interest of lending institutions to protect shareholders’ equity—myself especially—are in a state of shocked disbelief.” Aren’t we all.

Risk is also hard to quantify. If something is successful, it’s not deemed to have been too risky. If it fails, it is.

Steve Jobs, for example, has steadfastly refused to license the Apple Macintosh’s operating system for more than 25 years; he quickly squelched licensing deals made during his absence as CEO. Yet the roadside is littered with companies who followed the same strategy—who now remembers the Tandy TRS-80, the TI Professional Computer, or the Commodore Amiga? Can we state that any of these companies took more of a risk than Apple?

LEGISLATIVE TANGLES

One of the concerns we’ve heard from *C-Suite Insight* interviewees over the past 18 months doesn’t involve risk at all. Instead, many industry players are concerned that legislation, once passed, tends to stay in play, even if the conditions that led to its intent have changed.

IRS Section 409A, for example, was put into place in 2005, in the wake of the Enron scandal. It addresses non-qualified deferred compensation, and has been driving people nuts for years. It will not go away soon.

The Sarbanes-Oxley Act, or SOX as it’s fondly known, is a bigger (and slightly older) thorn in everyone’s side. It was enacted in 2002, and aimed to bring accountability to the executive suite and the boardroom. SOX, like Dodd-Frank, was a reaction to numerous public-company scandals (including Enron), but none of them took place on Wall Street.

SOX was also truly bipartisan; its co-sponsors came from both of the major parties, and it had little trouble passing through Congress. (Dodd-Frank, on the other hand, was sponsored by two Democrats, and was passed along party lines.)

SOX comes with its own agency, the Public Company Accounting Oversight Board (say that three times quickly). This board has given rise to a cottage industry of consultants, and has provided large institutional investors a tool that allows them to view public companies in a more uniform way.

It also routinely gets blamed for curbing innovation, particularly in Silicon Valley. The old paradigm of a company making an IPO early on, then building out the business on the magic carpet of newfound equity, is now anachronistic.

Innovative companies are by definition risky, and many venture capitalists (who serve as start-up company board members) have become gun-shy with SOX regulators continually hunting in the woods.

Almost unanimously approved by Congress, and signed into law with glowing approval by President George W. Bush, SOX doesn’t appear to be going anywhere soon.

Yet a very consequential piece of legislation, the Glass-Steagall Act of 1933, did go away. Glass-Steagall kept banks from diversifying into other financial services and getting involved in conflicts of interest in which they would often, in effect, be betting against themselves or their clients.

Its elimination, possibly more than anything else, seems to have led to the turmoil that started in late 2008.

Glass-Steagall died a quiet death during the Bill Clinton administration. Lobbying efforts made it a bipartisan effort in the end, and it seems certain that a Clinton veto would have been overridden.

The death of Glass-Steagall followed more than a decade of new adventurism by the credit-card operations of banks. They were originally empowered by President Jimmy Carter, who allowed them to charge annual fees for the first time.

President Carter’s belief was Puritanical in nature; he believed that such fees would discourage Americans from acquiring ever more cards and using them with ever more abandon. In a classic demonstration of unintended consequences, the fees only encouraged the credit-card companies to take ever-more-aggressive steps to put cards into the hands of Americans.

ENTER PAUL VOLCKER

Talk of Glass-Steagall was revived after the meltdown, with the debate led by former Fed Chairman Paul Volcker; his advocacy resulted in the Volcker Rule that’s now a part of Dodd-Frank. Implemented as Section 619, it restricts a bank to gambling (er, investing) no more than three percent of its Tier 1 capital in proprietary trading, hedge funds, and private equity funds.

As always, there are exceptions. The exceptions seem to make sense: banks can make trades on behalf of customers, for example. Certain risk-mitigating hedging activities are allowed. Transactions in government securities (federal, state, and municipal) are allowed.

The devil is always in the details, and it is in the details where devilish things are known to happen. An exception can also be viewed as a loophole.

As former SEC chairman Harvey Pitt told the *Wall Street Journal*, Dodd-Frank “contains loopholes so large that a fleet of trucks could get past the supposed barriers. Where the bill accomplishes something: it is largely likely to harm competition, force a ‘brain drain’ of



“THERE IS DREAD ON WALL STREET THIS SEASON ABOUT ‘SINGLE-ZERO’ BONUSES.”

THE WALL STREET JOURNAL

talent away from Wall Street, and boost the performance of commercial and investment banks located outside the U.S.”

WHAT NEXT?

The SEC will continue to implement Dodd-Frank as the year progresses. Its initial rulings on say on pay took a fairly loose view of the legislation, leaving many details up to individual corporations (a possible explanation for the concern Congressman Frank expressed to us).

But no matter how this process progresses, it seems there will never be a shortage of smart people on Wall Street who think they are too smart to fail. And it’s impossible to legislate everything; without a change in mindset, it’s likely just a matter of time before the next great scandalous meltdown occurs from somewhere.

A recent story in the *New York Times* provides a telling example. As reported by the Times, there is dread on Wall Street this season about “single-zero bonuses,” that is, no bonuses at all. (Bonuses are typically announced in January and paid in February.)

The single-zero option won’t be visited upon anyone in the upper echelons, of course, but rather to lower- to middle-level employees. Even so, “the Zeroes,” as this group is called, likely won’t be forgotten completely. As a hardbitten senior manager commented to the *Times*, “We’ll throw \$20,000 or \$25,000 at each of the Zeroes so they’re not discouraged.”

Consensus wisdom in the executive compensation industry dictates that pay in and of itself is not a problem. If a board can justify compensation—through performance, peer groups, specific market conditions, unique strategy, or some combination—then raised eyebrows will go back down.

But a certain amount of sensitivity to public perception is also required. And there are many parts of the U.S. in which \$20,000 to \$25,000 is still a large amount of money. Those parts of the U.S. would, in fact, include almost all of it. A separate reality seems to continue to exist on Wall Street.

Congressman Frank is often characterized as “no friend of business.” He has agreed with the U.S. Chamber of Commerce at a rate of 25% during his tenure in Congress. (Sen. Dodd retired from the Senate in agreement with the Chamber about 32% of the time over his career.)

But, one wonders, how often has business itself been “a friend of business” over the past decade? Even if everyone agrees that blame for the Great Recession should be dispersed widely, why would some on Wall Street continue to make themselves the objects of scorn?

There may never be another TARP, but there will very likely be more legislation. If Dodd-Frank only reins in certain specific actions but has no effect on mindset and behavior, will it surprise anyone if Congressman Frank feels the need to introduce more legislation sooner rather than later?

He would have no problem in finding someone in the Senate to join him. In fact, if the next scandal is broad enough, he’ll be able to make his next effort a truly bipartisan one.

How does “Frank-Shelby” sound? ■



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INTERVIEW WITH JOHN A. SEETHOFF

“Govern as you would cook a small fish. Don’t overdo it.”

At the beginning of the new century, Microsoft’s board and top management started to look closely at governance issues. By 2004, the company had created a formal lead independent director function and implemented governance principles that anticipated the current era by several years. Today, Microsoft remains at the forefront of governance practices. According to John Seethoff, Vice President and Deputy General Counsel

at Microsoft, “It has always been our desire to make sure our management practices and business efforts align with the interests of our stakeholders. We continue to evaluate our governance policies and revise them to bolster what we believe is an already strong corporate governance platform.” We recently interviewed John to see how Microsoft has developed its governance strategy, and what the company is up to today.

A HISTORY
OF GOVERNANCE

C-Suite Insight: What overarching principles have you relied on over the years in setting Microsoft's governance strategy and policies?

John Seethoff: I still remember the original slide deck that was discussed with Steve Ballmer and Bill Gates, which had a quote from Lao Tzu on the front page: "Govern as you would cook a small fish. Don't overdo it."

That quote helped inform our thinking. One of our key founding principles is that governance should be structured in a way that is appropriate to Microsoft. What policies and practices embody our values, while helping us reach our business goals? Governance for the sake of governance is not the point.

CSI: How have you channeled that wisdom into specific policies?

Seethoff: The aim is to adopt a system that is flexible: that provides appropriate structure for the company at the time, makes allowances for change over time, and has a long-term perspective that matches our business goals and strategy.

The spirit in which we started was, essentially, the notion that we would consistently assess where we were and what else we might do to maintain accountability to our stakeholders. Implementing the independent director function early on was one result.

Also, in 2003 we were a path breaker in moving away from options as our equity vehicle, moving to stock awards. We showed a commitment to transparency by

expensing equity compensation before accounting rules required it.

We were an early adopter of majority voting, the first company to adopt non-annual say on pay, and one of the very earliest adopters of a no-fault clawback. We continue to evaluate our corporate governance framework, and talk with our board about what is right for us and our shareholders.

DODD-FRANK
AND MICROSOFT

CSI: As we look at current affairs, compliance with the requirements of Dodd-Frank will be the big issue. It's still early, but can you tell us how you think Dodd-Frank will affect Microsoft?

Seethoff: I think, partly because of what our board has accomplished over the past decade, Dodd-Frank will have a modest impact on us.

We've already started down the say-on-pay path—we held our first vote in 2009. We also have a no-fault clawback that we believe meets the requirements of the statute. We'll have to see what regulations might come out with regards to implementation, but we think we've satisfied the statute.

We have long had a policy for compensation committee consultants that requires strict independence, so that consultants act only for the compensation committee. And we have promptly announced our voting results from our annual shareholder meeting for a number of years. Meeting that requirement was a formalistic step to confirm what we'd already been doing previously.

CHALLENGES

CSI: As the SEC continues to implement Dodd-Frank, do you foresee any potential challenges?

Seethoff: Yes, there are several challenging areas. It will be interesting to see what happens with proxy access, how that evolves. Proxy access is less likely to affect us and other very large-cap companies. I certainly am sympathetic to the point of view that small and mid-cap companies have about potential risk.

CSI: What about the CEO pay-ratio disclosure? This seems to represent a major challenge for multinational companies.

Seethoff: We have the same concerns that many other large, multinational companies have expressed. It is

truly impossible, given the multiplicity of payroll systems and the way that we internally track payroll costs, to come up with a median employee compensation amount, as defined under the SEC rules for calculating total compensation. It's just unworkable.

CSI: What about the ratio itself?

Seethoff: As it's currently set up, it wouldn't be so concerning for us. I know there are other companies where you would get a very high ratio, because the markets in which they have many employees have pay that is low relative to U.S. pay. They would get a skewed median, if you will.

In our case, we're in a high-paying industry, so we're not as concerned about where the ratio would be, generally speaking.

Our CEO does not receive equity, and his current compensation is about \$1.5 million a year. If there were a workable way of calculating median pay, our ratio would be one of the lowest you might find.

As a whole, I am confident that one way or another, this issue will be addressed through a statutory amendment or agency rulemaking. The business community is doing a good job of inform-

ing legislators and regulators about the challenges there, and needs to continue that effort.

SAY ON PAY AND MICROSOFT

CSI: Can you elaborate a bit on say on pay and Microsoft?

Seethoff: Sure. Our management and board adopted and held a triennial say on pay vote in 2009. We had received two shareholder proposals—one for an annual vote and one for a triennial vote.

In addition to an open and constructive dialogue with the two proponents, we sought input from some of our largest institutional shareholders, governance advocates, and other companies.

Our board approaches compensation as a multi-year program. Our executive compensation structure is designed to consider a variety of factors, many of which have multi-year horizons. Even though it's administered annually, the results really play out over a number of years. We believe these elements create multi-year accountability that aligns the interests of our executives with those of our long-term investors.

In our view, a triennial vote really best met the needs of our shareholders as they

WHAT POLICIES AND PRACTICES EMBODY OUR VALUES, WHILE HELPING US REACH OUR BUSINESS GOALS? GOVERNANCE FOR THE SAKE OF GOVERNANCE IS NOT THE POINT.

had expressed them to us, and was consistent with our compensation philosophy. I should emphasize, however, that this is what we think is appropriate for Microsoft. We wouldn't necessarily say that's the best or most appropriate approach for every company.

CONSTRUCTING COMPENSATION

CSI: Let's go back to how you structure your compensation program, and what you've done historically.

Seethoff: In 2003, we moved away from options. We understood at the time that the world had changed, that what we'd seen in terms of option performance through the 80s and 90s wasn't something that was going to occur in the future. This was particularly true for large-cap companies.

It was important to develop a compensation structure that recognized this, yet continued to provide people rewards for good performance and used a vehicle that provided alignment with shareholders. We moved to restricted stock units after going through a very thoughtful, measured, and detailed analysis of how to provide a comparable target value for all levels of employees.

I think we've been successful in doing that. If you look at our equity executive compensation, you'll see a very high percentage of executive compensation through equity. In our peer-company comparisons, one sees that we have a higher percentage than the average. And our executive-officer stock-ownership policy helps ensure accountability to shareholders, by requiring our executives to have a significant, ongoing stake in the company.

TRANSPARENCY AND MICROSOFT

CSI: Generally speaking, institutional investors and the government now are both looking for transparency even more than the numbers. What are your traditions and thoughts on transparency today?

Seethoff: One of Microsoft's company values is to be open and respectful. The open part is simply a different way of expressing the concept of transparency.

Our aim is to be appropriately transparent, which involves striking the right balance. There is some tension, for example, in what may be confidential proprietary company information or information that is personal to the particular executive

and may not be appropriate to share broadly.

If you look at our latest proxy statement, you will find that we also provide an alternative compensation table that shows what our executives received in salary, cash incentives, and equity awards for their performance in a given year. In addition, in our discussion of how our board determined actual incentive award levels, you will find both areas of success and areas where we could have done better. This balanced view helps our investors assess the connection between pay and performance.

BOARDS AND INDEPENDENCE

CSI: What's your view on how board members should conduct their business?

Seethoff: First, I believe boards should assert leadership for stronger governance. A corollary of that is directors being more public in talking about what they do and what their views are.

There continues to be a lack of understanding about how boards work and the tremendous quality of the vast majority of boards and individual directors. From my discussions with a variety of stakeholders, I believe that directors would serve them-

selves well by speaking out about their unique perspective, which is separate from management's.

CSI: What are your views on board-member independence?

Seethoff: I think one could observe that the governance community may have over-optimized for director independence by focusing on categorical independence. The pendulum may have swung too far in the direction of a formulaic view of independence that is elevating objective attributes of independence over other characteristics that might be used to select perspective directors.

CSI: Relevant experience counts as well.

Seethoff: The focus on independence may have trumped the importance of having industry expertise and business knowledge among directors.

CSI: How does that principle relate specifically to Microsoft?

Seethoff: We're in so many different businesses, and we compete in so many different markets—from our traditional software products, to hardware and component manufacturing, as well as online services and entertainment—and our customers span all demographics and sizes of organizations around the world. As a consequence, there are experienced executives who might be excellent contributors to our board, but they wouldn't qualify as independent because of their company's relationship with Microsoft.

As one focuses on independence, those candidates are then excluded from consideration. We've begun seeking input from our large shareholders to evaluate their openness to having one or more directors that have a business affiliation with us. ■

WE AIM TO LEAD IN EVERY ENDEAVOR THAT WE'RE INVOLVED IN.



“Our fund has been a long-time supporter of say on pay.”



INTERVIEW WITH ANNE SHEEHAN

ANNE SHEEHAN BEGAN her assignment as the Director of Corporate Governance for the California State Teachers' Retirement System in October of 2008. In this newly created position, she is responsible for the development and implementation of major corporate governance initiatives approved by the Board of Directors of the second-largest pension fund in the United States. Prior to accepting this position, Ms. Sheehan has had a long and distinguished career in government.

At 29, she was appointed by President Ronald Reagan as the Deputy Assistant Secretary for Congressional Affairs in the Department of Energy. She had the distinction of being the youngest person to hold such a position in the Reagan administration. Upon her departure from Washington, Ms. Sheehan came to California and served two Republican governors in a variety of senior positions.

CalSTRS, the California State Teachers' Retirement System, has 852,000 members and manages more than \$140 billion in its investment portfolio. As a prominent institutional investor, CalSTRS has a significant interest in how executive compensation is determined, not to mention a major stake in how the SEC implements and enforces the Dodd-Frank Act.

To gain perspective from an influential investor of this magnitude, *C-Suite Insight* interviewed the pension plan's Director of Corporate

Governance, Anne Sheehan. We discussed her role in the organization, and how CalSTRS will view executive compensation in the age of Dodd-Frank.

C-Suite Insight: As we understand it, the position of Director of Corporate Governance was created for you when you joined the organization in September 2008. This seems like incredible timing, because the market declined almost immediately. What were the first few months on that job like?

Anne Sheehan: Well, you're exactly right. I joined CalSTRS when the market was just going off a cliff, and it was crazy those first few months at this job.

However, CalSTRS already had a very active, longstanding corporate governance unit in place before I joined. By bringing me to the team, the board felt it was time to increase the profile and increase the priority of our governance activities; that's why the position was created.

The first couple of months were crazy, not only because the markets were crashing generally, but because of all the particular companies that were going under. The weekend before I started my job, Lehman Brothers went under, for example.

CSI: How did you manage to adapt in this environment?

Sheehan: One of the first things was to look at the consolidation in the financial industry—Bank of America and Merrill Lynch, for example. We have some relationship with all of the parties and counter-parties,

etc. If nothing else, we're holders of their stock. So that kept us very busy.

The other thing is that President Obama came in, looking at what was going on in Congress with the TARP funding, and we had to weigh in. To say that we went from zero to 60 very quickly would be an understatement. But we began to put together a coalition of other public pension funds to look at the financial regulation discussions going on in D.C., and that group actually still exists to this day.

CSI: What did you prioritize?

Sheehan: Obviously some of the highest priorities were set by the Chief Investment Officer, Chris Ailman, in terms of the issues our fund was being exposed to. At that point we managed about \$160 billion, and that fell to below \$110 billion. We're now back up to about \$142 billion, so you can imagine the day-to-day roller-coaster ride.

From a corporate governance perspective, we wanted to know: What

lessons did we learn from that experience that we could incorporate into our program in the future?

HOW CALSTRS GOVERNANCE EVOLVED

CSI: All the insanity aside, how has governance evolved at CalSTRS over the years?

Sheehan: Although CalSTRS has had governance policies in place for years, we and the companies we invest in are taking them even that much more seriously. We have about 7,000 companies in our portfolio, and we vote the proxies for about 4,000 of them. So we have a very active engagement with those companies.

CSI: What are the expectations of the teachers, whose money you handle when making investments? How much risk are they willing to accept in this economic climate?

Sheehan: They look to us as stewards of their money; to look out for their retirement, to make sure the fund is



there to pay out their retirement when they're ready to leave the classroom.

I wouldn't really say they are risk-averse, but they have been very socially conscious, historically. They were fairly supportive of the discussion on tobacco divestment, for example. Our board is a very responsible investor in that regard, and very much reflects the views of the teachers.

CSI: How did the meltdown in 2008 affect the views of the teachers and the board?

Sheehan: They don't want us to be in very risky investments, and I think the meltdown in 2008 sort of reinforced that. The board really thought "OK, what is our risk profile? How do we make sure we're looking to protect our risk, on both the upside and the downside?" And then the 2008 experience really gave us that opportunity to further refine our discussion on risk management here at the board, and in the governance unit.

THE DODD-FRANK ACT...

CSI: What are your thoughts on Dodd-Frank, and which aspects of this legislation are most important to you?

Sheehan: We are supportive of Dodd-Frank. To me,

its most important aspect, from a governance perspective, was the proxy access provision, which enabled large, long-term shareholders the ability to nominate a director to a board, to a company slate, if they own 3% of the company, for at least three years.

That really is the most important aspect, from our perspective.

We are supportive of the executive compensation provisions of Dodd-Frank as well. Our fund has been a long-time supporter of say on pay.

CSI: How is say on pay working so far?

Sheehan: During this past proxy season, I think we saw about 120 companies that had say-on-pay votes. Three of the votes went down. One of them, at Occidental, we were very involved with.

But I think the fear that many companies had about say on pay has not been proven out. For the most part, the shareholders support the compensation structures of these companies, if the companies take the opportunity to discuss, engage, and explain their comp structure to shareholders.

CSI: And how do you view the other executive compensation aspects of Dodd-Frank?

Sheehan: We're really focusing on pay for performance. One of our mantras, as we talk to companies about executive compensation, is long-term metrics and pay for performance.

As you can appreciate, as a teachers' retirement fund, we are the quintessential long-term investor. Our Chief Investment Officer likes to say, "As long as there are teachers in the state of California, we're going to be invested in the public market."

We want the comp structure aligned with our interest as shareholders, to get the good people to be there and to get them to stay, but also to look at the long run and not take unnecessary risks on our behalf. So we are supportive of some of those new provisions in Dodd-Frank on the compensation side.

...AND THE SEC

CSI: How do you think the SEC is doing in implementing Dodd-Frank so far?

Sheehan: I have to take my hat off to them in light of how many rule makings and reports they've had to do. I compliment them on how they have prioritized what needs to be done sooner rather than later. I'm especially complimentary

of how the SEC is trying to make sure that they have the resources to make the rule makings they have to make and to ensure the future.

CSI: Such as...

Sheehan: One example is the new whistleblower function. They're going to make sure they've got the resources to implement that. [SEC Chairwoman] Mary Schapiro has a tall order in front of her with more than 200 proposed rule makings. I don't envy their jobs, but I think they are being very diligent and responsible in the way they are approaching it.

REFRESHING THE BOARD OF DIRECTORS

CSI: Large institutional investors such as yourself can pressure corporate boards to refresh themselves, whether they want more independent members or specific expertise. What's your impression of how boards are doing in this area now, and how important is it to you?

Sheehan: It's a very important issue. We are the providers of the capital to that company, and the board members, whom we elect, are our representatives in the boardroom. So refreshing the board is a very important issue to us.

THEY NEED PRACTICES AND POLICIES IN PLACE AT THE FRONT END. BOARDS REALLY DO NEED TO DO A BETTER JOB ABOUT THEIR OWN SUCCESSION PLANNING.

In terms of how they're doing, well, not as well as they could be doing. We still do see a bit of clubbiness in the boardroom. The way I would describe it is on the spectrum of a 12-step process: they've acknowledged that they need to improve their ability to refresh the board.

CSI: So they're only on step one.

Sheehan: Yes, and they haven't quite got to the next step, which is exactly how to refresh the board. Because when it's time for someone to go, boards have a hard time getting rid of that person.

CSI: Sure. How can they advance to the next step, though?

Sheehan: They need practices and policies in place at the front end. Boards really do need to do a better job about their own succession planning.

They need to think and say, "OK, we're going to review what skill sets we need on a regular basis, we're going to make sure we are keeping up with the business plan and have the right skill sets and the right diversity of thinking."

They also need to think and say, "Our board is very committed to greater diversity in the boardroom, not just traditional gender, ethnic, but also diverse skill sets."

CSI: How should they proceed?

Sheehan: Bring in someone from academia, for example. They should also get new companies represented. I think some board members at some companies really didn't understand what was going on at the financial services companies during the meltdown.

Now, Dodd-Frank is going to force board members to be more responsible and take their jobs very seriously.

SAY ON PAY IS LEADING TO GREATER MANAGERIAL ENGAGEMENT AND DISCUSSIONS WITH SHAREHOLDERS.

COMMITTEE EXPERTISE

CSI: We can presume that you think expertise is especially important to the major board committees.

Sheehan: Yes. If a board member is in a leadership role at a company, expectations regarding the standards of performance for that person are even higher than for your average board member.

The chairs of the compensation committee, the governance committee, and the audit committee, by virtue of the fact that they have that leadership role, are setting the agenda for that committee. They're carrying out the responsibilities of that committee, so absolutely it's that much more important for those people to take those jobs seriously.

We are a fund that does withhold votes on board members, and we do it frequently, a lot of times over compensation. Many times, before say on pay, if we had concerns with the comp, the CD&A, or other concerns, we'd withhold on compensation committee numbers.

CSI: What sort of direct connection do you see between what you require in corporate governance, the criteria that you're setting to invest, and actual company performance?

Sheehan: We do believe there is a connection. The chances of a better-governed company performing better are much higher than those of a poorly-governed company performing as well, especially in the long run.

But our governance is really about long-term shareholder value, and the best use of capital by those companies. We want to be sure that companies use our capital well, and that we gain as shareholders. Good company performance is the actual ultimate in corporate governance for us, in terms of our returns.

IT'S PROXY SEASON!

CSI: What are you going to be looking for when you're reading proxies this year?

Sheehan: I think boards and company management will need to have a better, more

active dialogue with their shareholders. You know, who are their large shareholders? What are their concerns? What do they need to hear from them?

One of the important things coming out of Dodd-Frank is not just proxy access, but also executive compensation access. Say on pay is leading to greater managerial engagement and discussions with shareholders, and companies are listening to their concerns.

CSI: During this process, to what extent do you look at what proxy advisors like ISS are doing, whether in their general guidelines or the individual company recommendations?

Sheehan: We look at both. We are subscribers to all of the proxy advisory firms, and I know a lot of companies are fearful of their influence.

To us, though, they simply provide one more piece of data that goes into our equation as we're looking at how we build proxies. These firms provide good research, good background, but their work is not the dispositive of how we view our positions on certain issues on the proxies. **C**

FOCUS ON RESEARCH BOARD COMPENSATION REFLECTS COMPANY SIZE

SOME COMMITTEES ARE MORE EQUAL THAN OTHERS, TOO

COMPENSATION COMMITTEES FACE unprecedented pressure when determining executive and board pay practices today. Scrutiny of committee decisions will intensify as regulatory agencies implement and enforce the Dodd-Frank Act. Compensation committee members shoulder the additional responsibilities of maintaining say on pay, committee independence, compensation disclosure, clawbacks, and hedging policies.

Members of compensation committees must also grapple with how the board members themselves are compensated. Research from Equilar Inc. addresses these challenges by providing a comparative overview of committee member tenure, meetings for audit, compensation, and governance committees, year-over-year pay trends for committee chairs and members, and current pay structures.

(Note: This article is based on three reports from Equilar, Inc., entitled "2010 S&P SmallCap 600 Board Committee Trends Report", "2010 S&P MidCap 400 Board Committee Trends Report" and "2010 S&P LargeCap 500 Board Committee Trends Report.")



Figures 1-3

Equilar conducted three separate studies for S&P 600 Small-Cap companies, S&P 400 Mid-Cap companies, and the S&P 500 Large-Cap Index.

Small-cap companies had average revenues in the range of \$550 million, compared to \$1.6 billion for the mid-caps and \$6.9 billion for large-cap companies.

Board compensation data for the S&P 1500 confirms key similarities in director pay – and one big difference.

For example, tenure was as important relatively throughout the range of companies. Members of governance committees at small-cap companies had an average tenure of 7.7 years, against 7.3 years for compensation committee members and 6.8 years for audit committee members.

Members of governance committees at mid-cap companies had an average tenure of 8.3 years, against 7.5 years for compensation committee members and 6.9 years for audit committee members.

Members of governance committees at large-cap companies had an average tenure of 7.8 years, while compensation and audit committee members averaged 7.2 and 6.3 years respectively. Overall, audit committee members met more frequently than other committees.

As shown in Figures 1-3, a high percentage of companies in the S&P 1500 offer annual retainers for board members who head the audit, compensation, and governance committees.

Bigger Company, More Comp

Predictably, the level of board compensation increased with a company’s market cap. On average, small-cap board members received \$101,750 per annum, their mid-cap peers earned \$138,500, and large-cap board members made \$190,000.

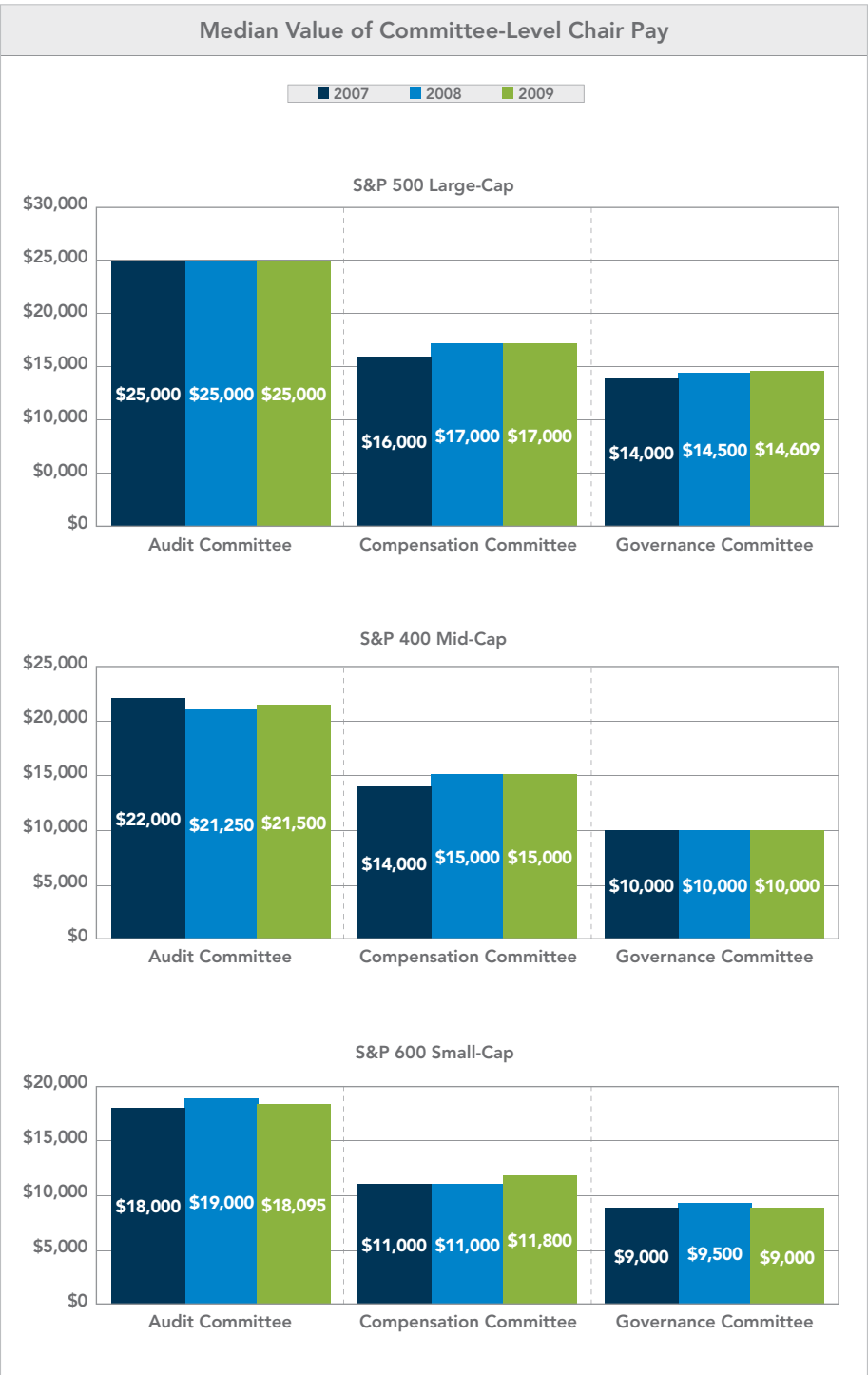
These figures include cash retainer fees, annual equity awards, and total meeting fees paid for service on the board. They exclude any fees paid for committee service.

S&P 1500 companies offered similar board compensation structures. For example, the most common pay structure for committee chairs was a single annual retainer.



Figures 4-6

Source: Equilar, Inc.



Figures 7-9

The 2007-2009 studies reported an increase in median committee chair compensation from the S&P 400 to the S&P 600 and a pay difference based on committee type. Audit chairs consistently had higher median retainer fees and total annual pay than compensation or governance chairmen. Figures 7 through 12 illustrate these general trends, which are expected to continue in the upcoming year.

Audit Committee Compensation

Small-Caps: From 2007 to 2009, median compensation for audit chairs rose 0.5 percent to \$18,095 while audit member compensation declined 9.1 percent to \$9,000. In 2009, the average total committee-level compensation was \$20,384 for audit chairs and \$10,410 for audit members.

Mid-Caps: Median compensation for audit chairs declined 2.3 percent, to \$21,500. Audit member compensation decreased 5.1 percent, to \$10,200, during the same period. In 2009, the average total committee-level compensation was \$23,861 for chairs and \$12,319 for members.

Large-Caps: Median compensation for audit chairs remained constant, at \$25,000, Audit committee member compensation, however, increased, rising 10.2 percent to \$13,500 during the same period. In 2009, the average total committee-level compensation was \$28,344 for audit chairs and \$14,897 for audit members.

Comp Committee Compensation

Small-Caps: Median compensation for compensation chairs rose 7.3 percent, to \$11,800, while compensation member fees remained constant, at \$6,000. In 2009, the average total committee-level compensation was \$13,079 for chairs and \$7,289 for members.

Mid-Caps: Median compensation for compensation chairs rose 7.1 percent, to \$15,000, while compensation member fees remained steady, at \$7,500. In 2009, the average total committee-level compensation was \$15,923 for chairs and \$8,847 for members.

Large-Caps: Median compensation for compensation chairs rose 6.3 percent to \$17,000, while compensation member fees remained steady, at \$10,000. In 2009, the average total committee-level compensation was \$20,535 for chairs and \$11,588 for members.

Governance Committee Compensation

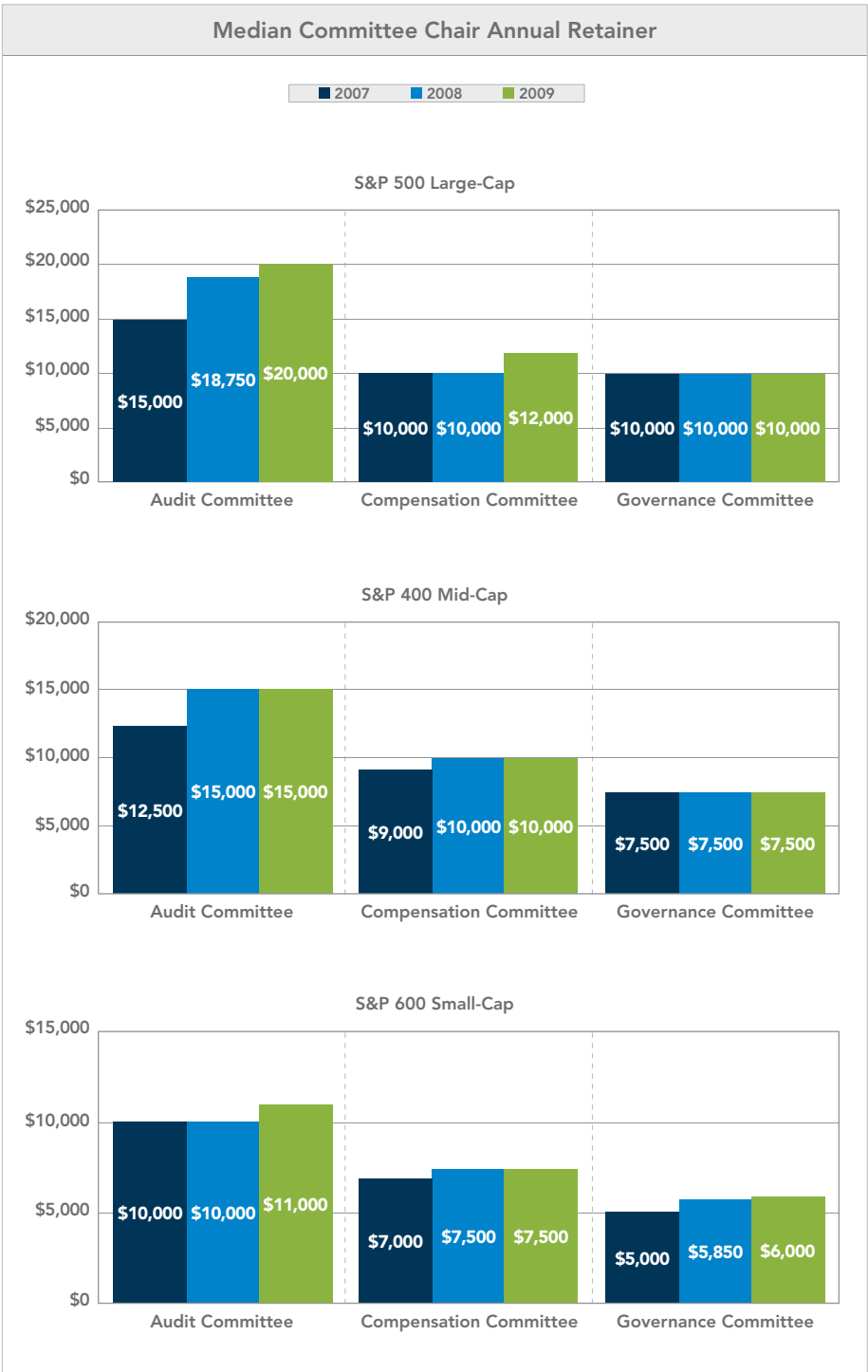
Small-Caps: Median compensation for governance chairs stayed constant, at \$9,000, while governance member fees also held steady, at \$4,500. In 2009, the average total committee-level compensation was \$10,004 for governance chairs and \$5,176 for governance members.

Mid-Caps: Median compensation for governance chairs and members remained constant, at \$10,000 and \$5,000, respectively. In 2009, the average total committee-level compensation was \$11,448 for chairs and \$5,960 for members.

Large-Caps: Median compensation for governance chairs rose 4.4 percent, to \$14,609. Governance member fees increased 7.1 percent, to \$7,500, during the same period. In 2009, the average total committee-level compensation was \$15,880 for governance chairs and \$8,378 for governance members.

Pay levels for committee chairs were driven by changes in annual retainer amounts. Figures 10 through 12 illustrate the changes to annual retainers over the last 3 years.

Want to learn more? See the full report by visiting www.equilar.com, calling (650) 286-4512, or e-mailing info@equilar.com.



Figures 10-12

FOCUS ON RESEARCH

CLAWBACKS ARE HERE TO STAY

DODD-FRANK MEANS UBIQUITY AND COMPLEXITY

CLAWBACk POLICIES ALLOW companies to recover erroneously awarded compensation from executive officers. They have increased in popularity over the past few years, and will become a fixture of executive compensation plans now that the Dodd-Frank Wall Street Reform and Consumer Protection Act has passed and is being implemented.

Specifically, Section 954 of the Dodd-Frank Act requires the SEC to adopt rules prohibiting national securities exchanges and associations from listing any company that fails to implement a clawback policy.

Although Dodd-Frank criteria are more stringent than the clawback provisions in Sarbanes-Oxley's Section 304, many Fortune 100 companies have existing policies that meet some mandated conditions within the Dodd-Frank Act.

Research by Equilar, Inc. has found that from 2006 to 2010, the prevalence of Fortune 100 companies with publicly disclosed clawback policies increased from 17.6% to 82.1%. Many of these policies allow companies to recover compensation in the event of a financial restatement or ethical misconduct.

As one would expect, most clawbacks are triggered by ethical or financial misconduct. In 2010, 81.3% of Fortune 100 clawback policies included provisions allowing for the recovery of compensation in the event of a financial restatement. Moreover, 78% of clawback policies have provisions allowing companies to recoup pay in the event that an executive behaves unethically.

In many cases, these triggers overlap. For example, some policies trigger a clawback only when a restatement is caused by the unethical behavior of an executive. In fact, 63.7% of clawback policies within the Fortune 100 included provisions containing both financial restatement and ethical misconduct triggers.

Digging Into the Data

As shown in Figure 1, from calendar year 2006 to calendar year 2010, clawback policies have grown from a little-known concept to a widely accepted corporate governance practice at Fortune 100 companies.

Under the Dodd-Frank Act, if a company does not disclose a clawback policy, the national securities exchanges and associations will be prohibited from listing the company's securities.

Surging Popularity

The surging prevalence of publicly disclosed clawback policies at Fortune 100 companies suggests that the majority of policies were implemented very recently. From the 56.5% of clawback policies that actually listed a date of adoption, effectiveness or amendment, the amount of disclosure available seems to support the assertion that clawback policies are a fairly new phenomenon.

In fact, among Fortune 100 companies that disclosed the implementation date for their clawback policies in their fiscal 2009 proxy statements, 95.8% adopted their policy in calendar year 2006 or later. Furthermore, 67.3% of the group disclosed clawback policy amendment and implementation dates effective in 2009 or 2010.

This data suggests that many companies have recently taken extra measures to polish or implement their clawback policy. Figure 2 displays the prevalence of clawback policy adoption dates disclosed in the Fortune 100's fiscal 2009 proxy statements.

A Trigger-Happy Process

Clawback policies are primarily used to deter management from taking actions that could potentially harm the financial position of a company. Therefore, many clawback policies are triggered by a financial restatement, especially when caused by misconduct.

In some cases, there must be a clear link between personal misconduct and a financial restatement to trigger a clawback.

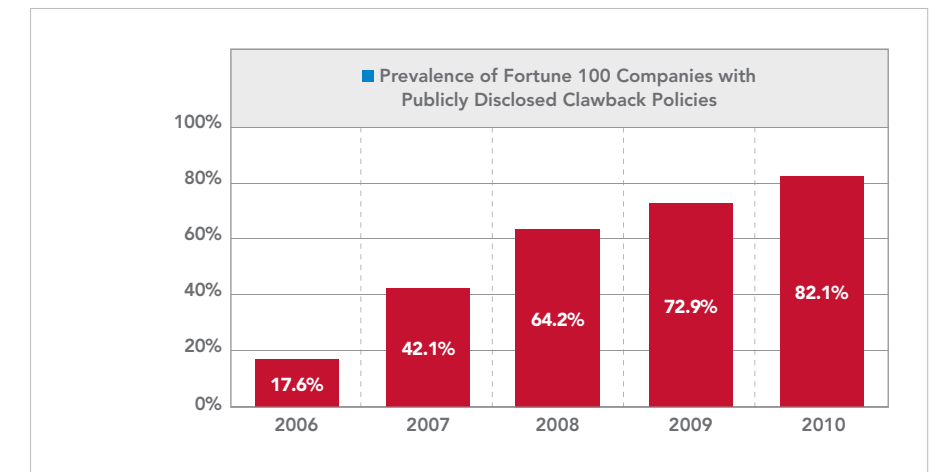


Figure 1

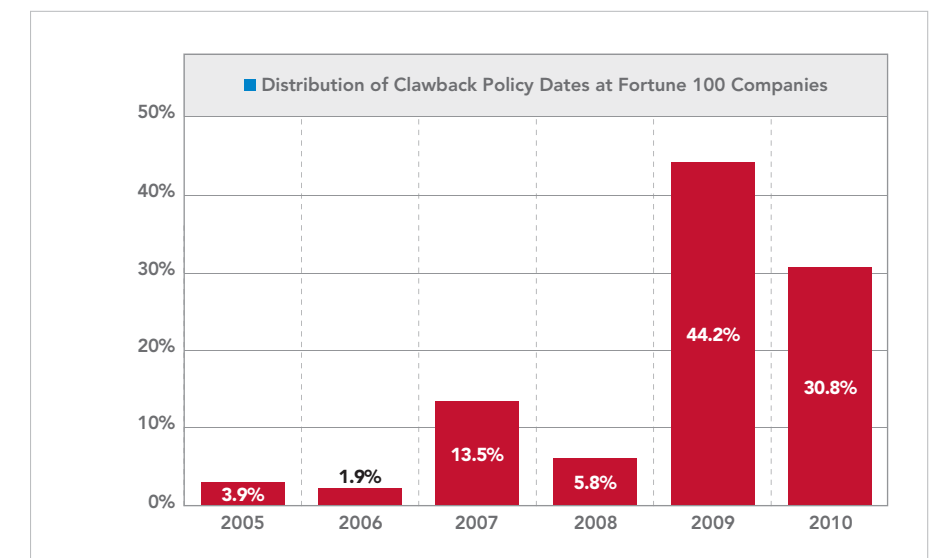


Figure 2

In other cases, a restatement, regardless of its cause can trigger the recovery of past compensation for anyone whose compensation was tied to false information.

Other clawback policy triggers include the violation of non-compete provisions, ethical violations not related to financial restatements, and the termination of employment shortly after the exercise of stock options or vesting of restricted stock.

Again, as one would expect, specific definitions for triggers vary greatly and often overlap, creating a situation where the majority of policies fall into multiple categories. In 2010, 68.1% of Fortune 100 clawback policies had triggers in more than one category. Among policies with multiple triggers, the majority had a blend of triggers relating to financial restatements and ethical misconduct.

To illustrate this point, Figure 3 displays the overlapping nature of Fortune 100 clawback policy triggers in 2010.

Under the Dodd-Frank Act, executive officers will have to reimburse their company if a financial restatement occurs, regardless of misconduct. This is a more stringent provision than that of Sarbanes-Oxley, which tied clawbacks to a financial restatement caused by misconduct.

As illustrated in Figure 3, many clawback triggers contain both financial restatement and misconduct triggers, but only 17.6% of the triggers were based solely on the occurrence of a financial restatement.

A Steadily Increasing Scope

Clawback policies have diversified from basic guidelines limited to recovering cash bonuses to all-encompassing policies that cover all performance-based pay and equity awards. This trend was evident in 2010, when more than 80% percent of clawback policies covered equity incentives and/or cash incentives.

As clawback policies reach a greater assortment of compensation elements, the areas of coverage become more difficult to classify. That said, clawback policies can be placed into specific categories based on covered compensation:

- Cash incentives
- Equity incentives (including performance shares)
- Outstanding options
- Vested options
- Restricted stock/units
- Other

In most cases, clawback policies fit into several of the categories listed above. Of the 78 Fortune 100 companies disclosing clawback policies in 2010, 88.5% percent had policies covering more than one key element of compensation, and 44.9% had policies covering three or more elements of pay.

Additionally, the “Other” category typically includes deferred compensation, but also includes sales commissions, flexible perquisite accounts and supplemental retirement plans.

A majority of policies included both cash and equity incentive compensation, with 70.7% falling into this category. Many policies already cover both cash and equity incentive compensation, but only 25% or so mention recovering compensation derived from or in the form of vested and/or outstanding options.

Figure 4 displays the prevalence of policies covering each of the compensation categories listed above, without regard to whether or not policies cover more than one element of pay.

Who is Clawable?

While clawback policies often do not cover all employees at a particular company, disclosure on clawback policy coverage is usually vague.

In 2010, for example, 67.4% of disclosed Fortune 100 clawback policies were captured in the broad category, “Key Executives and Employees.” This is primarily because most companies don’t

provide enough information to place examples into narrower categories, such as Section 16 Officers or Named Executive Officers.

Since many clawback policies now link to incentive plans, the number of employees covered by a compensation recovery policy in any given year can change based on incentive plan participation. Some clawback policies also cover both non-employee directors and employees.

Figure 5 provides a breakdown of clawback policy employee coverage at Fortune 100 companies in 2010. The “Other” category includes policies limited to Section 16 officers and Chief Financial Officers and/or Chief Executive Officers. The “Directors and Employee Category” includes policies for Directors in addition to Key Executives, Named Executive Officers, or All Employees.

Section 954 of the Dodd-Frank Act is fairly specific regarding employees who must be covered by clawback policies: “any current or former executive officer who received incentive-based compensation during the three-year period preceding the restatement.”

Again, this coverage is much broader than that of Section 304 of the Sarbanes-Oxley Act, which targets only the chief executive officer and the chief financial officer who receive compensation in the year after an erroneous filing.

Of the clawback policies disclosed in 2010, however, only 3.3 percent exclusively targeted the chief financial officer and/or chief executive officers, while the majority of policies cover key executives or employees, which, as the broadest category, includes executive officers.

More to Come

In recent years, clawback policies have become much more likely to impact all compensation vehicles. Certainly, the design trends described here are apt to evolve, as the implications of the Dodd-Frank Act become more clear and as

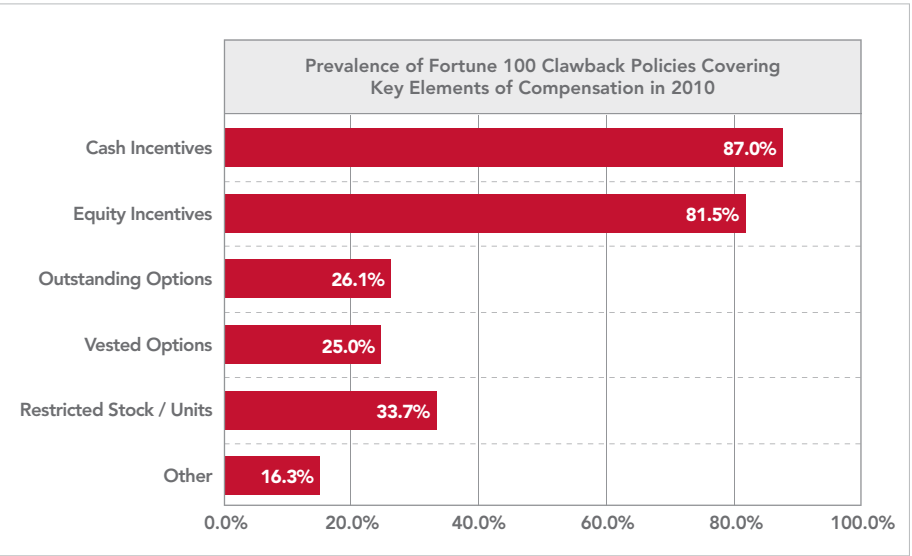


Figure 4

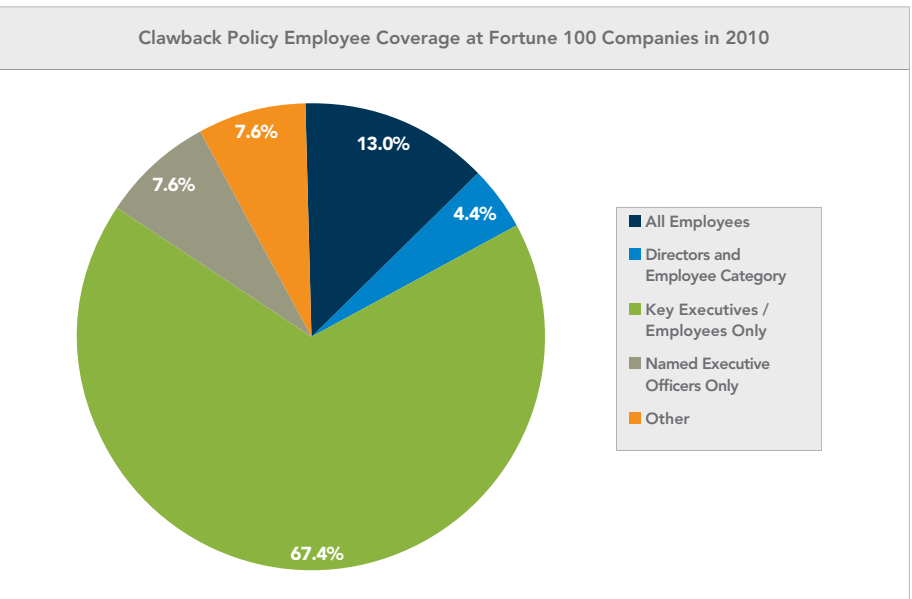


Figure 5

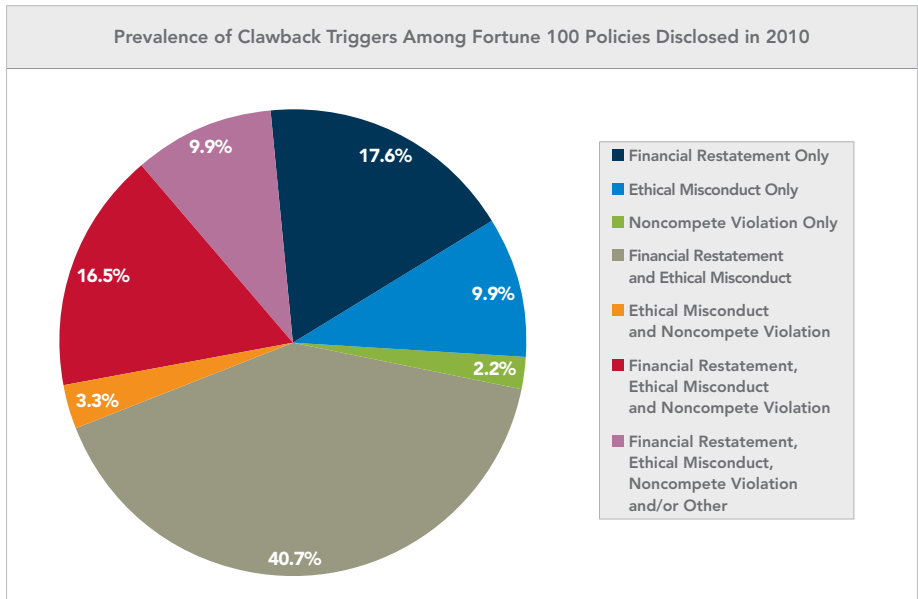


Figure 3

specific incidents trigger newly written clawback provisions.

In a time of sweeping change for the fields of executive compensation and corporate governance, all concerned parties will have a continuing need to seek data and conduct analysis on one of the most important new topics under their purview.

Want to learn more? See the full report by visiting www.equilar.com, calling (650) 286-4512, or e-mailing info@equilar.com.

INTERVIEW WITH ROBERT MCCORMICK

"If we can encourage better and clearer disclosures, so we and shareholders are in a position to make a better decision, then that's what we think is the most appropriate opportunity for us in engaging with companies."

GLASS LEWIS & Co. is an independent governance and proxy voting firm, headquartered in San Francisco, with research offices in New York and Sydney.

We caught up with Robert McCormick, Esq., the firm's Chief Policy Officer, to discuss proxy voting, Dodd-Frank, and corporate governance. Bob earned his law degree from Quinnipiac University School of Law after graduating with honors from Providence College.

Prior to joining Glass Lewis, he served as the Director of Proxy Investment Research at Fidelity Management & Research Co., where he managed the proxy voting of more than 700 retail and mutual fund accounts.

COMPANY FOCUS AND MISSION

We started by asking him about his current role at Glass Lewis.

Bob McCormick: As a proxy advisory service, we develop policies for the 100 or so markets that we cover companies in. My role is to ensure that the guidelines that we have developed for each of the markets are reflective of our underlying philosophy of director accountability, promoting shareholders' rights, aligning pay with performance, and avoiding diminution in shareholders' rights or adoption of takeover protections while also considering local market regulations and practices.

C-Suite Insight: And your customers are large institutional investors and managers of big funds?

McCormick: That's right. They really run the gamut, from small and boutique-type investment shops to many of the largest institutional investors and mutual funds in the world.

CSI: How do you view your firm's role?

McCormick: We don't feel we're in a position to tell companies what to do, or to design their compensation programs for them. We don't see that as our role. But if we can encourage better and clearer disclosures, so we and shareholders are in

a position to make a better decision, then that's what we think is the most appropriate opportunity for us in engaging with companies.

CSI: What expectations do you bring to this role?

McCormick: We really try to get a sense of whether a company put a lot of thought and design into its compensation program. How have they done in selecting appropriate metrics? Have they provided some background about how challenging they think these metrics are? Did they describe any sort of discretion, and about how it would be used—or how it has been used—to provide some comfort that it's not just a willy-nilly thing used to bolster compensation in a down year?

We simply try to encourage good and clear disclosure about compensation: how the board came to the decision about which performance metrics to use, and how they're implemented.

THE DODD-FRANK ACT

CSI: So far, how has Dodd-Frank affected executive compensation?

McCormick: Obviously, say on pay is the big aspect of Dodd-Frank that's having the most immediate implications regarding compensation, both with evaluation and voting.

We've already heard from some institutions that are hearing from more and more

companies. They just want to check in and see if we have any concerns, and if so, how to address them.

To me, this is a positive step, in that Dodd-Frank is providing a framework for the discussion about compensation.

CSI: And a framework for continuing dialogue, we'd assume.

McCormick: Yes, because there will not only be this vote on compensation. There is also an opportunity for conversation about other issues. You set up the meeting, you talk about compensation, and then you have a natural segue to ask, "How else do you feel about our governance structure?"

CSI: What's your take on what the SEC has done so far, in terms of stating how it will be implementing Dodd-Frank?

McCormick: First of all, I think they moved pretty quickly. They recognized that say on pay would be in place in January 2011, and that there needed to be some rule-making in that area.

So I think that SEC regulators understand the issues, and I think they're doing a good job of soliciting input.

CSI: Input in what specific areas?

McCormick: In terms of framing the basics of it, like what should the proposal be called? Should there be

standard language? What sort of information should companies have to disclose to help make this decision? Should there be exceptions for smaller companies in certain areas?

It's very healthy to get that feedback, and I think the SEC has done a good job by moving quickly and really addressing some of these open questions.

GETTING TO "YES"

CSI: Companies want "yes" votes. What would cause your firm to recommend a "no" vote on say on pay?

McCormick: We start by looking at compensation from many points of view.

We start from the quantitative point of view. Has the company done a good job of aligning pay for performance by looking at a host of quantitative factors, compared to one-year, two-year and three-year performance, measured against four peer groups?

The second part is qualitative, which is a bit more subjective, but in a good way.

CSI: How so?

McCormick: Well, we look at the design of the compensation program: the selection of peer groups, the performance metrics and how challenging they seem to be. We also want to see the disclosure—some explanation about why the compensation committee or board as a whole selected those par-

THE BOTTOM 10% OF COMPANIES IN OUR MODEL GET FS IN OUR LETTER-GRADE SCORING PROCESS.

ticular performance metrics, how they're reviewed, and what sort of discretion the Board has to deviate from the performance metrics. This last aspect can defeat the purpose of even setting performance metrics.

CSI: It sounds as if you've done this before...

McCormick: Well, we've seen proposals like these for a number of years in the U.K., Australia, and some other markets; it's not like we haven't seen these sorts of proposals before. As a result, we have a pretty well-developed system for analyzing compensation on a qualitative basis over several years.

Then, turning back to the quantitative standpoint, we employ a pay-for-performance analysis where we grade on a scale. The bottom 10% of companies in our model get Fs in our letter-grade scoring process. We generally look to the compensation committee as being responsible for misaligning pay and performance in those cases.

CSI: What happens at that point?

McCormick: Whereas in the past we may have recom-

mended voting against the compensation committee, now we would recommend voting against the say-on-pay proposal. There's been some criticism that it's a blunt tool, but a vote against directors is even blunter, I would say.

Having to vote on this proposal affords us the opportunity to focus on this relatively narrow issue. Where we see a misalignment of pay and performance in which a company gets an "F," it's a pretty strong indication that the design is faulty.

CSI: And that's your final determination?

McCormick: No, then we look to disclosure. This is an important aspect, because if it looks like the compensation is misaligned, but the disclosure is very convincing about unique circumstances, maybe because a new CEO or entire management team was brought in to address some strategy, or some other sort of one-off situation, we believe it is important to consider that. If there's good disclosure, that's really helpful in making a decision.

CSI: But...

McCormick: But if there are poor practices and poor dis-

closure, that's a pretty strong supposition that we would recommend voting against.

CSI: Have companies where shareholders rejected the say-on-pay vote done something positive to change your mind?

McCormick: It's still a little early, but I think some companies certainly have responded in general, by setting up longer performance periods, making grants less discretionary, or requiring some sort of holding period.

As this evolves, I think we'll see some changes as a result. I think it's instructive there were only three companies out of over 300 or so with say-on-pay votes that actually lost their compensation votes this year: Motorola, Key Corp., and Occidental. This tells me that shareholders are treating their proposals pretty judiciously.

CSI: Companies are always going to say they have unique circumstances, though.

Glass: Yes, and you know, I think the information that is least helpful is when a company says that the board decided in its discretion simply to do X. That really doesn't provide any color on the amount of time they spent looking at it, the alternatives they may have reviewed, how they got to that decision, or whether they made a change year over year.

We are looking to determine whether the compensa-

tion committee members really stepping into the shoes of shareholders, to make sure the compensation plan design is aligned with the ultimate goals of the firm.

INDEPENDENCE & COMPETENCE

CSI: What are your views on independent directors, and independent directors on a compensation committee? Are there enough of them? Are they truly independent? How important is this in having companies be effective in their executive compensation policies?

McCormick: I think we've solved that. It's rare that we see someone conflicted on a compensation committee, and there are requirements under the NYSE and Dodd-Frank that address those independence issues.

But the real question is one of competence. You can have the most independent board in the world, but if the members are not effective, it doesn't really matter.

CSI: What sort of competence do you mean, regarding members of compensation committees?

McCormick: You can start by looking at audit committees. If we look at 10 years ago, there were examples of audit committee members who had very little financial or no audit experience. In some cases, not a single audit committee member

had any financial experience. The requirements under Sarbanes-Oxley changed that; that committee now has to have someone with financial experience, a certified financial expert.

Now, I don't know that we'll get to the point where someone needs to be a certified compensation expert. But I think there's a recognition that, given the complexity of compensation plans and designs, and the increasing significant attention focused on compensation from shareholders, someone on the compensation committee should have some familiarity with how compensation programs work.

At least one person should have some familiarity with compensation plan design, or have worked in that area.

PROXY SEASON

CSI: What's your strategy going into proxy season this year?

McCormick: Some people may have the feeling that Dodd-Frank is, all of a sudden, going to require institutional investors to come up with processes and policies from scratch to evaluate compensation. I think that's a bit overstated. We've already been getting more and more requests for more information about compensation every year.

I think many institutions have already been looking at this issue pretty closely,

looking for outliers. That's where they're looking for us to help them, by providing a very detailed analysis of compensation programs and those issues that make a company an outlier.

CSI: And it's not the money per se.

McCormick: Right. It may not actually be specific amounts. The institutions may not necessarily be looking for something that leaps off the page in terms of an amount, but rather, anything that makes a company seem different from their peers.

CSI: Could you give us an example?

McCormick: You know, a golden coffin, a guaranteed bonus, or any sort of compensation program that makes them a bit different. Or maybe a compensation program that is only available to the CEO, without any real explanation or color around it.

I would say the general theme is "proportionality." Is the compensation proportional?

I've heard this several times from several clients. They'll say, "[This package] doesn't make sense for the size of the company based on their performance." But if a compensation package is clear and well-explained, then most institutions will be pretty satisfied. That's the type of information that we're going to provide to our clients. ■

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