Pay Definitions:

What Works Best in Pay for Performance Analysis

Robin Ferracone, Chief Executive Officer
Jack Zwingli, Leader, Information Services

November 2012

FARIENT
ADVISORS
PARTNERING
FOR PERFORMANCE

Executive Summary

Pay for performance. As the dust settles from year two of Say on Pay proxy voting, and more companies coalesce around accepted pay practices, the top issue for both shareholders and companies is whether pay is aligned with performance. While there is general acceptance that the performance side of that equation should primarily be based on total shareholder return (TSR), there is not yet a commonly accepted definition for pay. The result is that widely divergent compensation numbers currently are being used in pay for performance analysis, leaving shareholders and others unclear on how to evaluate this critical issue.

Given concerns around using the equity grant date values contained in proxy disclosures for pay and performance analyses, a growing number of companies are going beyond what is required in proxy filings and using alternative pay definitions when presenting executive compensation results in order to better make their case on pay for performance. The core issues are whether the right pay definitions are being used, whether the definitions are being used consistently, and whether disclosures allow shareholders and others to replicate these definitions across companies.

While there is agreement among the various definitions on many of the pay components, the debate centers on the valuation of equity long-term incentives (LTIs). Given that equity LTIs account for over 50% of total CEO compensation, pay for performance analysis is dependent on the fair representation of these values.

This report compares and evaluates the three most widely used alternative pay definitions – Realized Compensation, Realizable Compensation, and Performance-Adjusted Compensation. Each of these alternative definitions produces different compensation results, and some can offer egregiously misleading results caused by:

- Mismatched time periods for pay and performance
- Different option valuation methodologies, some of which systematically understate the value of options
- Using target vs. actual number of shares earned in performance share plans, thereby overstating or understating their value

Several principles are recommended in this report to best define pay and conduct pay and performance analyses. These principles include: all elements of compensation should be valued *after* performance has happened, pay and performance should be measured on a multi-year basis, the time horizon of pay should match the horizon of the performance measured, pay definitions should not favor one vehicle over another, and pay definitions should allow for comparability across companies. Performance-Adjusted Compensation comes closest to meeting these criteria for purposes of analyzing pay and performance.

Finally, there is a strong case to be made for better disclosure of pay outcomes. While disclosure has improved somewhat in recent years, there are still major gaps and inconsistencies in reporting. Until better disclosure is provided, even consistent pay definitions will lead to different analytical results across companies due to weaknesses in the reporting of executive compensation data. We hope that this report provides a better understanding of the issues and will hasten improved disclosures pertaining to the alignment between pay and performance.

Introduction

Two years of Say on Pay votes have put executive compensation at the forefront of corporate governance, and often at the center of engagement between companies and shareholders. A number of changes have emerged from the Say on Pay process. In particular, we have seen a significant decline in so-called "problematic" pay practices – what one major investor, CalSTRS, calls "irritants." These include pay system features, like gross-ups, single-trigger Change in Control plans, rich severance arrangements and evergreen employment deals. On the flip side, we have seen significant increases in the adoption of shareholder-friendly practices, such as clawbacks and ownership guidelines. Looking forward, as companies coalesce around common pay practices and remove many of the points of contention with shareholders, the focus for Say on Pay will move squarely to pay for performance.

At the heart of the matter is the definition of pay, i.e., how pay should be defined when assessing pay and performance. As noted in a recent *Wall Street Journal* article[1] (September 25, 2012), a growing number of companies are using alternative pay definitions to what is required in proxy filings when presenting executive compensation results. This is due to concerns with the inadequacy of the current rules on pay disclosures, and in anticipation of upcoming regulatory changes. In fact, the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), signed into law in 2010, mandated that the SEC adopt rules that require enhanced pay for performance disclosures. Until these standards emerge, either from the SEC or from the marketplace, there will be confusion on how to best present pay for performance results.

While the SEC has not yet issued its revised disclosure rules, many companies are taking a pre-emptive stance by reporting on pay for performance in the Compensation Discussion and Analysis (CD&A) section of their proxy reports to shareholders. The intent of these disclosures is to provide a clearer description of the relationship between compensation and actual performance, address inconsistencies in the pay definitions most commonly used today, and better make their case on pay for performance. At issue is whether the right pay definitions are being used, whether the definitions are being used consistently, and adequate to allow shareholders and others to replicate these definitions across companies.

At issue is whether the right pay definitions are being used, whether the definitions are being used consistently, and whether these disclosures are adequate to allow shareholders and others to replicate these definitions across companies.

This report will review the three most widely used alternative pay definitions – Realized Compensation, Realizable Compensation, and Performance-Adjusted Compensation. Specifically, it will clarify the definitions, assess the pluses and minuses of each, call out the practical matter of finding accurate data to calculate pay under each definition, illustrate the differences between the pay definitions, discuss the implications of using each definition for pay and performance analyses, and address whether the SEC should put a standardized definition in its proxy disclosure rules.

Areas of Agreement

For determining the quality of the relationship between pay and performance, most investors want to know whether actual pay (however defined): (1) is **sensitive** to and directionally consistent with performance over time, and (2) is **reasonable** relative to a comparative universe of companies. For the

[1] Executive Pay Gets New Spin, Wall Street Journal, September 25, 2012

[2] Restricted shares and Restricted Share Units (RSUs) are used interchangeably throughout this report

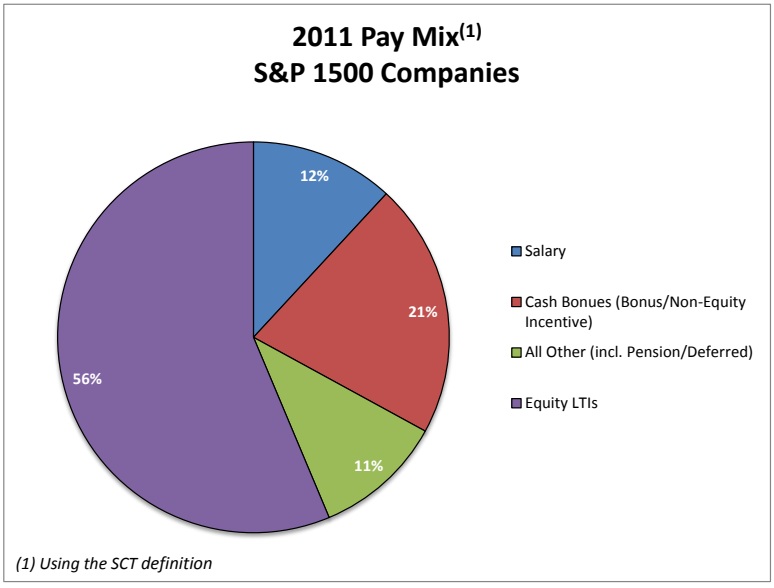
performance side of the equation, most investors agree that the accepted arbiter of performance is total shareholder return (TSR). TSR measures the annualized return to shareholders, based on stock price appreciation, assuming reinvested dividends. While other measures of performance including financial and strategic measures also might be considered, most shareholders ultimately are interested in whether their portfolio companies have provided them with a competitive return over time. On the pay side of the equation, however, the definition of actual compensation is increasingly under debate.

In evaluating pay for performance, attention is focused on CEO compensation. This is understandable because the CEO is usually by far the highest paid executive, and because CEO compensation often sets the tone for other executive officers. Given the compressed time to conduct analysis during the proxy season, CEO compensation often is all that can be reviewed by those who are voting proxies. The lack of a consistent definition of pay for purposes of analyzing pay for performance only makes the process more difficult, even for a single position.

In assessing CEO compensation, investors, issuers, and proxy advisors alike acknowledge that the fixed aspects of CEO compensation, i.e., salary, pension, perquisites, and "other compensation" found in the Summary Compensation Table (SCT), can be used as reported in the definition of actual compensation. Similarly, most agree that the Non-equity Incentive Compensation and Bonus amounts found in the SCT capture the actual value of cash incentives (short-term and long-term) *after* performance has happened.

The Big Debate

So the debate then centers on the one remaining aspect of compensation: equity long-term incentives (equity LTIs). Equity LTIs are comprised of stock options and SARs, restricted shares, and performance shares that typically vest and are earned over a period of three or more years. Equity LTIs are not only at the heart of the debate, but also represent by far the largest portion of CEO compensation, regardless of how these LTIs are counted. Based on Farient Advisors research, equity LTIs now comprise over half of total compensation for CEOs in the S&P 1500. Moreover, the prevalence of performance-based (versus time- based) equity has shifted dramatically, with approximately 70% of companies offering performance-based equity today, up from 20% in 2000. It is no wonder that determining the value of equity LTIs is critical to appropriately analyzing pay and performance.



Grant Date Value of Equity Long-term Incentives

The primary definition of equity LTIs being used today to analyze pay and performance is the Grant Date Value (GDV) of the equity. This is because GDV is easy to obtain . . . it can simply be pulled from the proxy Summary Compensation Table (SCT). As indicated by its name, GDV is the value of the equity awards at the time of grant, using the company stock price at that time.

Institutional Shareholder Services (ISS), the most influential proxy advisory firm, uses GDV for assessing pay and performance as an input to its Say on Pay recommendations. ISS argues that GDV is a useful way to look at equity LTIs because it indicates the intent of the company and the board when putting compensation plans in place. The difference between the SCT Grant Date Value and the ISS value is that the SCT uses financial accounting standards (FASB ASC Topic 718) for valuing stock options in the Black-Scholes Option Pricing Model, while ISS uses its own standard set of assumptions. *(See box on page 12 for an explanation and illustration of the Black-Scholes model and the impact of different assumptions.)*

The problem with GDV is that companies and investors generally view this approach as an inappropriate way to assess whether pay is aligned with performance. This is because GDV measures the value of equity at the time of grant – *before* performance happens, rather than measuring the value of the equity *after* performance happens. In other words, using GDV as the basis for equity LTIs does not match pay and performance periods.

GDV often is criticized by companies that have received a negative Say on Pay recommendation from ISS. Over 220 companies have filed a supplemental proxy in 2012, mostly to refute the ISS analysis and many to specifically challenge the ISS pay definition. One example is Autodesk Inc. (ADSK), which stated in its supplemental proxy:

- ISS' Pay for Performance methodology is flawed: ISS confuses timing of equity decisions — Equity grants made in March 2011 were based on operational performance in fiscal 2011. ISS is analyzing March 2011 pay against fiscal 2012 performance results
- Realizable pay provides a more realistic metric for measuring pay for performance by measuring actual gains from equity awards and bonus payouts as of a specific date

Similarly, Adobe Systems Inc. (ADBE) stated in its supplemental filing:

- ISS ignores "Realizable Compensation": We believe the most appropriate metric for assessing pay for performance is "Realizable Compensation," whereas the ISS report uses grant date value (or "pay opportunity") as determined by ISS' methodology as its lone measurement. Realizable compensation reflects the real value of equity awards and increases or decreases with fluctuations in market value. When determining the annual equity grants to our executives in January of each year, our Executive Compensation Committee believes it is important to take into account not only the grant date values included in our Summary Compensation Table, but also to consider the effect of the value of our stock on those awards at the end of our fiscal year.

Alternative Pay Definitions

To address the issues with using GDV for equity LTIs, a variety of alternative pay definitions have emerged. Three primary equity LTI definitions have surfaced in proxy disclosures over the past few years - Realized Compensation, Realizable Compensation, and Performance-Adjusted Compensation. Unlike Grant Date Value, each of the alternative definitions makes some attempt to represent the true value of equity *after* performance happens, i.e., taking performance into account. But below the surface, these alternative definitions are very different. Each definition is described in detail below.

Unlike Grant Date Value, each of the alternative definitions makes some attempt to represent the true value of equity after *performance happens, i.e., taking performance into account.*

Realized Compensation

Realized Compensation focuses on actual cash awards earned during a specified time period, and includes the value of stock options exercised, regardless of the original grant date. In essence, Realized Compensation is meant to approximate an executive's "W-2" earnings over the same time period. Focusing on the equity LTI components of compensation, Realized Compensation captures:

- **Stock options:** the gain from any stock options exercised during a given time frame
- **Restricted shares (and Restricted Share Units)[2]:** the value of any restricted shares that vest during this time frame
- **Performance shares (and Performance Share Units)[3]:** the value of performance shares that vest during this time frame

The arguments in favor of this definition are that it captures the actual value of the awards received and is not subject to interpretation or manipulation. One argument against this definition is that in the case of stock options it picks up investment decisions by the executive, i.e., decisions on when to exercise stock options. The effect of this exercise behavior can lead to volatility in this pay measure.

Realized Compensation also includes options that were granted before the time horizon of the performance being measured. For example, while investors may be measuring pay against a 3-year TSR period, the Realized Compensation from all LTI vehicles may be based on equity LTI awards granted in years well before the TSR period being measured. This is true particularly for stock options, which have the longest time horizon of all LTI vehicles. As a result, the time horizon of Realized Compensation does not match the time horizon of the performance being measured.

Realizable Compensation

The term Realizable Compensation is showing up more frequently in company disclosures, and a version of this definition has been picked up by the second largest proxy advisor, Glass Lewis. Focusing on the equity LTI components of compensation, the most commonly used definition of Realizable Compensation captures:

[2] Restricted shares and Restricted Share Units (RSUs) are used interchangeably throughout this report
[3] Performance shares and Performance Share Units (PSUs) are used interchangeably throughout this report

- **Stock options:** the "embedded" value of stock options at the of a given performance period (i.e., the difference between the stock price at the *end* of the performance period and the exercise price)
- **Restricted shares:** the value of any restricted shares granted during the performance period (including those vested and unvested), calculated at the stock price at the *end* of the period
- **Performance shares:** the value of the *target* number of performance shares granted during the performance period, valued at the stock price at the *end* of the period. Because *target* shares (rather than actual shares earned) are used in this definition, performance shares are valued like restricted shares

The argument for using the embedded value method for valuing stock options is that it is simple. However, this method also is problematic in that it undervalues stock options since it does not count the remaining "tail value," or life, left in the options. But, underwater options are worth more than zero as long as they have life in them. Executives intuitively know this fact. While some may argue that their underwater stock options do not have any value, at least at that point in time, they intuitively acknowledge that their underwater options are generally worth something on a present value basis since they also are not willing to relinquish underwater options that have not yet termed out.

The second issue with realizable compensation is that it uses the *target* number of performance shares, valued at the end of the performance period, rather than the *actual* number of shares earned. This treats performance shares the same as time-based restricted shares, ignoring that the number of shares earned will be based on still-to-be-determined performance. While the target number of performance shares is an easier number to ascertain than the actual number of performance shares earned, it is worth the effort to determine the actual number of shares earned since using the actual number of shares will do a better job of assessing pay and performance.

Performance-Adjusted Compensation (PAC)

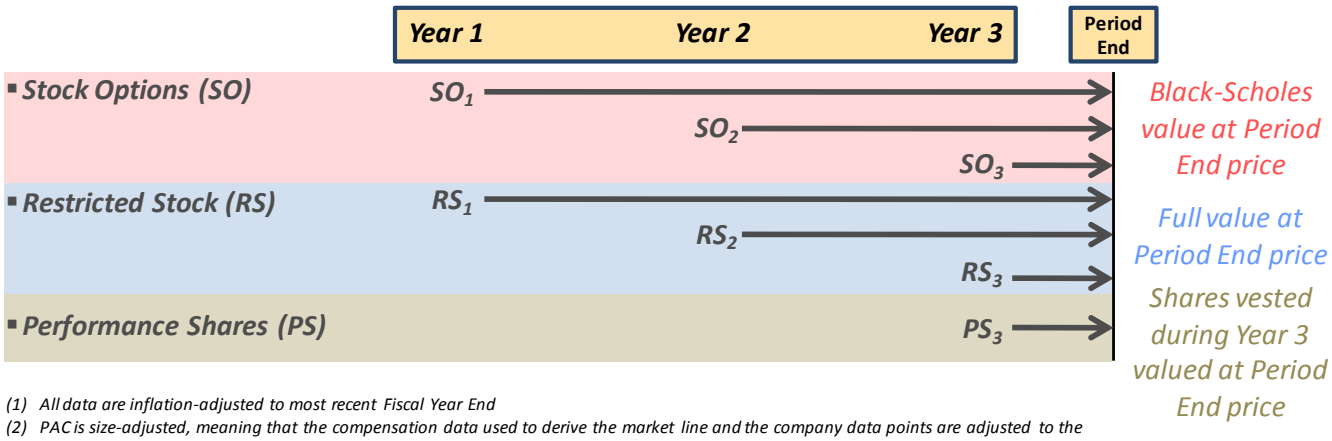
Performance-Adjusted Compensation (PAC) was developed by Farient Advisors for purposes of evaluating the alignment between pay and performance. It is similar to Realizable Compensation, but addresses the issues raised above. PAC is defined as annualized total compensation *after* stock price performance is taken into account. The equity LTI components of PAC are defined as:

- **Stock options:** the Black-Scholes value of any options granted during the period over which performance is being measured (including those vested and unvested), valued on the basis of stock price at the *end* of that performance period. In essence, this quantifies the value of in-the-money or out-of-the-money options, including the value of the remaining expected term, or tail, on those options
- **Restricted shares:** the value of any restricted shares granted during the performance period (including those vested and unvested), calculated at the stock price at the *end* of the period
- **Performance shares:** the value of any performance shares earned and vested during the final year of the performance period, calculated on the basis of the stock price at the *end* of the period

This definition is illustrated below, assuming a 3-year performance measurement period, which is the typical time horizon of many pay plans and also is supported by many investors as a reasonable time period over which to evaluate pay and performance.

3-Year CEO Performance-Adjusted Total Compensation (PAC) [(1) (2) (3)]

Performance-Adjusted Value of Long-term Incentives (LTI)



(1) All data are inflation-adjusted to most recent Fiscal Year End
(2) PAC is size-adjusted, meaning that the compensation data used to derive the market line and the company data points are adjusted to the current size of the subject company
(3) Stock Options and Restricted Stock are calculated as a 3-year average ((i.e., Year 1 + Year 2 + Year 3) ÷ 3); Performance Shares reflect the actual number of shares vested in the most recent fiscal years' payout, valued at Period End price (i.e., Year 3 ÷ 1)

PAC was designed to be used in pay for performance analyses, and to address the issues associated with GDV and other alternative approaches to equity valuation. As a result, PAC measures all elements of LTI compensation *after* performance has happened, matches the time horizon of pay to that of performance, and eliminates upward or downward biases in equity LTIs, which allows each equity LTI component to be compared with any other pay component, and also allows companies with different pay mixes to be easily compared with one another.

Finding the Source Data

A summary of each pay definition by component and the sources for each are shown in the table below. As noted by the color coding, the source of the component values comes from one of three proxy tables:

1. Summary Compensation Table (SCT)
2. Grants of Plan Based Awards Table
3. Option Exercises and Stock Vested Table

While the fixed, short-term incentive, and cash bonus elements of compensation can be gleaned from the SCT, the equity long-term incentive awards, i.e., options, restricted shares and performance stock, must be derived from data in the other two tables. Given the sometimes poor or confusing nature of proxy disclosure, a fourth table, the Outstanding Equity Awards table, also may be needed, particularly to determine the number of performance shares actually earned.

Pay Definitions and Sources

	Grant Date Compensation	Realized Compensation	Realizable Compensation	Performance-Adjusted Compensation (PAC™)
Salary	Same Base Salary used for all definitions			
Bonus	Same Bonus used for all definitions			
Non-Equity Incentive Plan, Short-term	Same Non-Equity Incentive Plan used for all definitions			
All Other	Same All Other used for all definitions			
Pension Change/Deferred Compensation	Same Pension Change/Deferred Compensation used for all definitions			
Options	Black-Scholes value of options as of the grant date	Value realized on exercise of option awards	The embedded value of the options: Number of options * (period end price - exercise price); if out-of-the-money, value is set to $0	Black-Scholes value of options at the end of the performance period, taking into account the in-the-money or out-of-the-money status of the option and the remaining tail value
Restricted Stock (RSUs)	RSUs granted * grant date price	Value realized on vesting of stock awards	RSUs granted * period ending price	RSUs granted * period ending price
Performance Stock (PSUs)	Target PSUs * grant date price		**Target** PSUs * period ending price	**Earned** PSUs * period ending price

Proxy Statement Sources
Summary Compensation Table (SCT)
Grants of Plan Based Award Table (GPBA)
Option Exercises and Stock Vested Table (OESV)

What Difference Does It Make?

Does the definition used for assessing pay and performance really make a difference? The short answer is an emphatic "yes." An example is helpful to illustrate how the alternative pay definitions are calculated, and where the differences are in valuing equity LTIs. To illustrate the point, we have used Cooper Industries plc (CBE) and its CEO, Mr. Kirk S. Hachigian.

Does the definition used for assessing pay and performance really make a difference? The short answer is an emphatic "yes."

We chose Cooper Industries because Mr. Hachigian has been the CEO since 2005, allowing us to evaluate compensation over time. In addition, Cooper Industries offers a variety of LTI programs, allowing us to analyze the impact of different definitions by type of LTI plan. Further, Cooper Industries is in the process of being acquired by Eaton Corporation, making any biases regarding the company moot.

Finding the Data

The data for the different pay definitions can be gleaned from the proxy tables. The 2012 Cooper Industries proxy report contains the **Summary Compensation Table** shown below. This table is consistent with standard SEC disclosures.

Cooper Industries plc
2011 Summary Compensation Table (SCT)

Name and Principal Position	Fiscal Year	Salary	Bonus	Stock Awards	Option Awards	Nonequity Incentive Plan Compensation	Changes in Pension Value and Nonqualified Deferred Compensation Earnings	All Other Compensation	Total
Kirk S. Hachigian	2011	$1,266,667	$0	$10,078,354	$4,822,121	$3,800,000	$11,994	$1,149,536	$21,128,672
Chairman, President	2010	$1,200,000	$1,000,500	$15,347,083	$3,246,687	$2,999,500	$4,805	$1,277,938	$25,076,513
and Chief Executive	2009	$1,200,000	$270,400	$3,065,518	$2,856,767	$2,279,600	$3,191	$1,080,768	$10,756,244
	Avg	**$1,222,222**	**$423,633**	**$9,496,985**	**$3,641,858**	**$3,026,367**	**$6,663**	**$1,169,414**	**$18,987,143**

The **Grants of Plan-based Award Table** contains disclosures on equity and non-equity (cash) awards, which are used to value options and stock awards in the Realizable and PAC pay definitions. Realizable Compensation calculations use the Target number of shares granted, while PAC uses the actual number of shares earned.

Grants of Plan-Based Awards Table (GPBA)

		Estimated Future Payouts Under Non-Equity Incentive Plan Awards			Estimated Future Payouts Under Equity Incentive Plan Awards			All Other Stock Awards: Number of Shares of Stock or Units	All Other Option Awards: Number of Securities Underlying Options	Exercise or Base Price of Option Awards	Grant Date Fair Value of Stock and Option Awards
Name and Principal Position	Grant Date	Threshold ($)	Target ($)	Maximum ($)	Threshold (#)	Target (#)	Maximum (#)	#	#	$/Sh	$
	2/14/2011	$975,000	$2,925,000	$3,900,000							N/A
	2/14/2011				33,625	100,875	147,950				$10,078,354
	2/14/2011								269,000	$65.76	$4,822,121
Kirk S. Hachigian	2/14/2010	$749,900	$2,249,600	$2,999,500							N/A
Chairman, President	2/14/2010					109,125[1]	160,050				$7,247,064
and Chief Executive	2/14/2010								291,000	$43.78	$3,246,687
Officer	11/2/2010							152,256			$8,100,019
	2/8/2009	$749,900	$2,249,600	$2,999,500							N/A
	2/8/2009					72,348[1]	106,110				$3,065,518
	2/8/2009								424,350	$28.89	$2,856,767

(1) Estimate based on 2011 FY target to maximum ratio

Finally, the **Option Exercises and Stock Vested Table** provides data on equity awards that have been monetized (option exercises) or are owned outright (vested stock). Data from this table are used to value stock options and stock awards for the Realized Compensation definition.

Option Exercises and Stock Vested Table (OESV)

		Option Awards		Stock Awards	
Name and Principal Position	Fiscal Year	Number of Shares Acquired on Exercise (#)	Value Realized on Exercise ($)	Number of Shares Acquired on Vesting (#)	Value Realized on Vesting ($)
Kirk S. Hachigian	2011	280,000	$5,079,743	0	$0
Chairman, President and	2010	200,000	$3,901,975	84,823	$3,713,551
Chief Executive Officer	2009	280,000	$5,523,926	152,000	$4,391,280

Adding It Up

As noted earlier, there is agreement across all pay definitions around the fixed and cash components of compensation. These can be found in the SCT for Mr. Hachigian, and are summarized as follows:

Fixed and Cash Components of Compensation for Mr. Hachigian of Cooper Industries

Pay Component	Value	Comments
Salary	$1,266,667	Actual received in 2011
Bonus	$0	$0 is not unusual as this column generally represents cash payments that are not subject to a specified incentive plan (only 20% of S&P 1500 companies use this element)
Non-equity incentives	$3,800,000	Actual received in 2011
Pension changes and Deferred compensation/ All other	$1,161,530	While pension accruals can be lumpy, differences tend to average out over time
TOTAL	**$6,228,197**	Used by Realized, Realizable, and PAC definitions

The elements above tend to be used by all three alternative pay definitions - Realized, Realizable and Performance-Adjusted Compensation. As a result, all differences in total compensation values are attributable to equity LTIs.

To illustrate the point, stock options are valued differently by all definitions *(see box on following page for further explanation)*. Two of the definitions, SCT and PAC use the Black-Scholes pricing model.[4] The Black-Scholes model generates different values for the SCT and PAC (i.e., $4.8 million and $3.4 million respectively), since the SCT and PAC input assumptions differ.

For Cooper Industries, the SCT assumptions set the stock price and the exercise price at the same value, while PAC assumptions set the stock price at a lower value than the exercise price since the stock price went down between the date of exercise and the date of measurement (thus treating the option like a premium-priced option).

In contrast, Realized Compensation does not use the Black-Scholes Model. Instead, Realized Compensation counts the value of the options exercised that year, regardless of when those options were granted. For Cooper Industries, the Realized Compensation definition values Mr. Hachigian's options at $5.1 million in 2011, due to the fact that he chose to exercise options during the year – options awarded in 2006, well before the performance period.

The remaining definition, Realized Compensation, also does not use the Black-Scholes Model. Instead, it counts the embedded value of the options granted, which in Mr. Hachigian's case is $0, since the options granted in 2011 were underwater by the end of the year.

[4] In addition, ISS uses the Black-Scholes model, but derives a different value by using its own assumptions

The Black-Scholes Model

The Black-Scholes Model is a Nobel-prize winning formula that determines an estimated value for stock options based on a set of variables, or assumptions. It is used in the SCT, Grant Date Value and Performance-Adjusted Compensation (PAC) pay definitions to determine the value of stock option awards. The model's equation is complex, but the variables are easy to understand. The key variables and assumptions in the Black-Scholes model are:

- **Exercise Price (or strike price)** – fixed price at which the option holder can purchase a share of stock
- **Stock Price** – the stock price at the time performance is being measured
- **Term (Expected Life)** – assumption for the period between the time of grant and exercise
- **Volatility** – the magnitude of stock price movements over time
- **Dividend Yield** – assumption for expected future dividend payments
- **Risk-free Rate** – generally based on the U.S. T-Bill rate, with a maturity matching the expected life

Any change in a particular variable can have substantial effects on the valuation of the option award. Although companies use FASB standards for valuing options as reported in the SCT, various assumptions are up to the company's discretion, as long as they are reasonable, supportable, and determined in a consistent manner from period to period. This makes the SCT results not comparable across companies.

The results below value the 2011 options in a range of $3,408,009 to $6,906,319, illustrating the potentially large impact of different assumptions.

2011 Black-Scholes Calculations - An Example Using Cooper Industries (CBE)

		SCT	Grant Date Value (ISS)[1]	PAC[1]
Exercise Price	Definition	Grant date price	Grant date price	Grant date price
	Value	*$65.76*	*$65.76*	*$65.76*
Stock Price	Definition	Grant date price	Grant date price	Price at end of period
	Value	*$65.76*	*$65.76*	*$54.15*
Term/Expected Life	Definition	Company-derived Expected Life	Full term	Standard Expected Life
	Value	*4.5 years*	*7 years*	*6 years*
Volatility	Definition	Company-derived expected volatility	3-year daily average price volatility through grant date	3-year daily average price volatility through period end date
	Value	*34.8%*	*43.9%*	*36.9%*
Risk-free Rate	Definition	T-Bill Rate matching time horizon of expected life at grant date	T-Bill Rate matching time horizon of full term at grant date	T-Bill Rate matching time horizon of expected life at period end date
	Value	*2.2%*	*3.0%*	*0.8%*
Dividend Yield	Definition	Company-derived expected yield	Actual 5-year average through grant date	12-month average through period end date
	Value	*1.8%*	*2.2%*	*2.1%*
2011 Options Value		**$4,822,121**	**$6,906,319**	**$3,408,009**

(1) PAC and GDV use a standard set of assumptions for each variable to allow for comparability across companies

If stock options represent one of the more complex forms of equity pay, then restricted shares is one of the simplest. With restricted shares, all three alternative definitions count the restricted shares at $0 value in 2011 since no restricted shares were granted to or earned by Mr. Hachigian during this time period. However, the definitions differ in 2009 and 2010. This is because Realized Compensation counts vested amounts, valued at the time of vesting; Realizable Compensation and PAC count granted amounts, valued at the end of the performance year; and GDV counts granted amounts, valued at the time of grant.

Finally, with respect to performance shares, the values under all four definitions vary:

- The SCT uses target performance shares granted, valued at the time of grant;
- Realized Compensation counts performance shares earned, valued at the time they are vested;
- Realizable Compensation counts performance shares granted, valued at the end of the performance period;
- and PAC counts performance shares earned, valued at the end of the performance period.

As a result, the value of performance shares varies widely for Cooper Industries in 2011, from a low of $0 to a high of $10.1 million. According to PAC, performance shares were worth $0 in 2011 since the 2009-2011 performance cycle did not result in any shares being earned. However, according to the SCT, performance shares were worth $10.1 million in 2011, driven by the number of target shares granted multiplied by the stock price at the date of grant.

The table below shows total compensation under each definition as well as the component parts. Mr. Hachigian's 3-year average total compensation varies considerably from a low of $13.4 million in Realized Compensation to a high of $19.0 million, as reported in the SCT. This spread from low to high is even more dramatic when considered on an annual basis, with the entire difference driven by the equity LTI valuations. Given these comparisons, it is not hard to see that the conclusions drawn regarding how well pay and performance are aligned can be swayed considerably based on the definition used.

… conclusions drawn regarding how well pay and performance are aligned can be swayed considerably depending on the definition used.

Pay Definitions - Cooper Industries (CBE)

Summary Compensation Table (SCT) **FYE: 12/30/2011**

Fiscal Year	Salary	Bonus	Restricted Stock	Performance Stock	Option Awards	Non-equity Incentive Plan	Change in Pension/ Deferred	All Other	Total
2011	$1,266,667	$0	$0	$10,078,354	$4,822,121	$3,800,000	$11,994	$1,149,536	$21,128,672
2010	$1,200,000	$1,000,500	$8,100,019	$7,247,064	$3,246,687	$2,999,500	$4,805	$1,277,938	$25,076,513
2009	$1,200,000	$270,400	$0	$3,065,518	$2,856,767	$2,279,600	$3,191	$1,080,768	$10,756,244
Avg	**$1,222,222**	**$423,633**	**$2,700,006**	**$6,796,979**	**$3,641,858**	**$3,026,367**	**$6,663**	**$1,169,414**	**$18,987,143**

Realized Pay

Fiscal Year	Salary	Bonus	Restricted Stock	Performance Stock	Options	Non-equity Incentive Plan	Change in Pension/ Deferred	All Other Comp	Total Pay
2011	$1,266,667	$0	$0	$0	$5,079,743	$3,800,000	$11,994	$1,149,536	$11,307,940
2010	$1,200,000	$1,000,500	$0	$3,713,551	$3,901,975	$2,999,500	$4,805	$1,277,938	$14,098,269
2009	$1,200,000	$270,400	$0	$4,391,280	$5,523,926	$2,279,600	$3,191	$1,080,768	$14,749,165
Avg	**$1,222,222**	**$423,633**	**$0**	**$2,701,610**	**$4,835,215**	**$3,026,367**	**$6,663**	**$1,169,414**	**$13,385,125**

Realizable Pay

Fiscal Year	Salary	Bonus	Restricted Stock	Performance Stock	Options	Non-equity Incentive Plan	Change in Pension/ Deferred	All Other Comp	Total Pay
2011	$1,266,667	$0	$0	$5,462,381	$0	$3,800,000	$11,994	$1,149,536	$11,690,578
2010	$1,200,000	$1,000,500	$8,244,662	$6,360,896	$3,017,670	$2,999,500	$4,805	$1,277,938	$24,105,972
2009	$1,200,000	$270,400	$0	$3,084,907	$10,719,081	$2,279,600	$3,191	$1,080,768	$18,637,947
Avg	**$1,222,222**	**$423,633**	**$2,748,221**	**$4,969,395**	**$4,578,917**	**$3,026,367**	**$6,663**	**$1,169,414**	**$18,144,832**

Performance-Adjusted Compensation (PAC)

Fiscal Year	Salary	Bonus	Restricted Stock	Performance Stock	Options	Non-equity Incentive Plan	Change in Pension/ Deferred	All Other Comp	Total Pay
2011	$1,266,667	$0	$0	$0	$3,408,009	$3,800,000	$11,994	$1,149,536	$9,636,206
2010	$1,200,000	$1,000,500	$8,244,662	$4,944,333	$5,297,422	$2,999,500	$4,805	$1,277,938	$24,969,160
2009	$1,200,000	$270,400	$0	$6,481,280	$10,701,865	$2,279,600	$3,191	$1,080,768	$22,017,104
Avg	**$1,222,222**	**$423,633**	**$2,748,221**	**$3,808,538**	**$6,469,098**	**$3,026,367**	**$6,663**	**$1,169,414**	**$15,065,619**

(1) SCT does not break out RSUs and PSUs; for comparison purposes, this example separates out RSUs and PSUs, derived from the GPBA table

Stock - Realized amounts are based on vested (stock) awards.
The large differences between Realizable and PAC performance shares are due to using **target** PSUs (Realizable) vs. **earned** PSUs (PAC)

Options - Realized amounts are based on exercised options during the period.
The large differences between Realizable and PAC amounts are based on using **embedded** value (Realizable) vs. the **Black-Scholes** value at the end of the performance period (PAC)

Proxy Statement Sources
Summary Compensation Table (SCT)
Grants of Plan Based Award Table (GPBA)
Option Exer. & Stock Vested Table (OESV)

PAC uses the performance share value from the most recent fiscal year as part of the 3-year average, to reflect earning the award over the 3-year performance period

It is worth noting that Cooper Industries is hardly an isolated case. As shown in the table below, Agilent and Alcoa provide an additional case in point.

Calculations for Alternative Pay Definitions
2011

		SCT	Realized Pay	Realizable Pay	PAC
Total Compensation					
Cooper Industries	CBE	$21,128,672	$11,307,940	$11,690,578	$9,636,206
Agilent Technologies	A	$10,252,265	$16,289,146	$6,047,472	$7,817,275
Alcoa Inc	AA	$14,043,692	$6,170,607	$8,591,621	$6,379,657
Stock Options					
Cooper Industries	CBE	$4,822,121	$5,079,743	$0	$3,408,009
Agilent Technologies	A	$3,788,302	$13,346,688	$564,612	$4,874,817
Alcoa Inc	AA	$1,900,027	$0	$0	$1,010,698
Restricted Shares					
Cooper Industries	CBE	$0	$0	$0	$0
Agilent Technologies	A	$0	$0	$0	$0
Alcoa Inc	AA	$0	$0	$0	$0
Performance Shares[(1)]					
Cooper Industries	CBE	$10,078,354	$0	$5,462,381	$0
Agilent Technologies	A	$3,521,505	$0	$2,540,402	$0
Alcoa Inc	AA	$7,600,158	$1,627,100	$4,048,114	$825,452

(1) These companies use PSUs only

Highest Row Value
Lowest Row Value

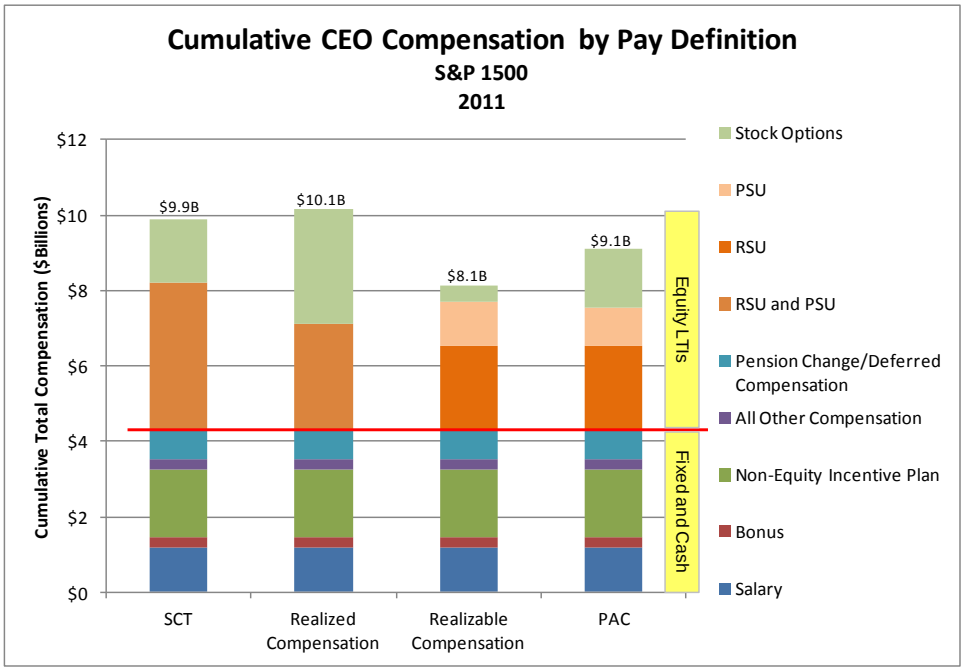
A comparison of all three companies further illustrates how significant pay differences can be for each definition. Additional observations on just these limited examples include:

- Realizable pay consistently produces the lowest option values because it only counts one year of stock price movement, severely under-representing the true value of the option
- Grant Date Values can be very different compared to period end values, as illustrated by the performance share values for all three companies – the differences reflecting a large drop in share price between the grant date and period end
- Focusing on one year of results highlights distortions, supporting a case for multi-year averaging when analyzing pay and performance

Differences Across the S&P 1500

Research by Farient Advisors across the broader market only serves to further reinforce the findings suggested by the examples above. Comparing the pay definitions on a company by company basis shows consistently wide variations in total compensation value. Comparing Realizable Compensation with PAC, for example, over half (57%) of S&P 1500 companies had a greater than 10% difference in total compensation, while one-third had a difference of over 25%. These differences reinforce the importance of using a consistent, comparable definition of compensation.

Moreover, these differences do not cancel each other out. They add up. As shown in the chart below, the total 2011 SCT compensation paid to all S&P 1500 CEOs was approximately $10 billion. This compares to a little over $10 billion for Realized Compensation (likely to be higher than GDV in good years and lower in poor years), approximately $8 billion for Realizable compensation (likely to be systematically lower than GDV), and approximately $9 billion for PAC (may be higher than GDV in good years and lower in poor years, but likely will not swing as dramatically as Realized Compensation). The results for individual companies often show much greater variances. These types of differences cannot be ignored. As a result, the choice of pay definitions is critical to evaluating pay for performance.



The Argument for a Standardized Definition

While we can show the differences in actual compensation using different pay definitions, it is difficult to know what to make of these numbers without some context. To provide this context, much of corporate America would accept – and likely welcome – a common compensation definition for comparing pay and performance. This is the only way in which investors will be able to make the appropriate comparisons between companies, and allow companies to better communicate compensation results.

… much of corporate America would accept – and likely welcome – a common compensation definition for comparing pay and performance.

Regarding the definitions, we would suggest that any standards that are created adhere to a number of principles, such as the ones shown below:

- Data should be shown over the long-term (e.g., at least three 3-year rolling cycles). This longitudinal analysis will help companies and investors smooth annual fluctuations or distortions in pay and performance, without overreacting to 1-year swings
- All elements of compensation should be valued *after* performance has happened, not at grant date
- The time horizon of the pay components should match the horizon of the performance measured

- The pay definition should put the various LTI vehicles on comparable footing. If a method favors one vehicle over another, then pay and performance comparisons will be distorted
- The pay definition should make it easy to compare actual pay across companies. (For example, the Realizable Compensation definition, as described above, will favor companies that issue stock options vs. companies that use other forms of LTIs since using embedded value understates the value of stock options relative to other LTIs. In addition, Realized Compensation will overstate compensation for CEOs when large, lumpy stock option exercises are made)
- The pay and performance discussion should cover total compensation, including salary, short-term incentives, long-term incentives, and the value of benefits and perquisites, so that pay mix does not distort the analysis of pay and performance
- The data should be readily available and easily replicated by third parties

In evaluating the various pay definitions against these standards, Performance-Adjusted Compensation comes closest to meeting the criteria for pay and performance analyses.

Evaluation of Pay Definitions for Pay and Performance Analyses

Principles	SCT	Realized Compensation	Realizable Compensation	PAC	Reasons Why Definition Does Not Meet Principles
Data can be calculated over multi-year periods	✔	✔	✔	✔	*All definitions support 3-year (or longer) time periods*
Compensation is measured after performance happens		✔	✔	✔	*SCT measures pay before performance happens*
Time horizons of pay and performance match			✔	✔	*Realized can pick up grants from before the performance period; SCT is forward-looking, while performance period is backward-looking*
LTI vehicles are on comparable footing	✔			✔	*Realized and Realizable can significantly under or over-value LTI awards based on actual vs. target pay*
It is easy to compare actual pay relative to performance across companies				✔	*LTI pay mix can distort comparability (e.g., SCT assumptions differ; Realized is dependent on option exercise choice; and Realizable systematically understates option values)*
Pay definition covers total compensation	✔	✔	✔	✔	*All definitions use Total Compensation*
Data are easy to obtain	✔	✔			*Performance shares are not well disclosed*

We would suggest that the definition used for pay and performance analyses meet the principles stated above to the extent possible. We also would suggest that companies, after meeting the minimum requirement, be free to present additional data, if desired.

Testing Pay for Performance Alignment

ISS introduced its pay for performance tests in 2011 for the 2012 proxy season. The ISS test is a three-part test that uses GDV compensation. It analyzes:

- Relative Degree of Alignment
  - Compares the percentile ranks of a company's CEO pay and TSR performance, relative to ISS' peer group, over one- and three-year periods
  - Is weighted 40% for one-year period and 60% for three-year period
  - The score reflects the difference between the weighted average TSR percentile rank and the weighted average pay percentile rank
- Multiple of Median
  - Expresses the CEO pay as a multiple of the median pay of the ISS peer group for the most recent year
- Pay-TSR Alignment
  - Compares the trends of the CEO's annual pay and the value of an investment in the company over the prior five-year period
  - More recent values receive greater weighting
  - The score reflects the difference between the weighted linear regression slopes for normalized TSR and normalized pay

Glass Lewis grades pay and performance based on GDV and Realizable Pay vs. a number of performance factors (including TSR, operating cash flow growth, EPS growth, ROE, and ROA), all relative to Glass Lewis' peers as well as the company's stated peers. For determining officer compensation, Glass Lewis calculates the 3-year weighted average total compensation, with the current year weighted more heavily. (The exact weighting is not disclosed.)

Farient uses PAC and its Alignment model to test pay and performance. Farient's Alignment Reports present a snapshot of whether CEO compensation aligns with TSR performance over time for a given company relative to other companies in its industry or peer group. In order to use a standardized definition over many years and across companies of all sizes, Farient inflation-adjusts and size-adjusts (through regression analysis) all compensation data to the current year. Through its Alignment Reports, Farient shows Performance-Adjusted Compensation over time relative to a group of peers in the company's industry and/or stated peer group. *(See box on following page for an example of Farient's Alignment Reports.)*

The Alignment Reports below on Cooper Industries show a pattern of misaligned pay and performance and explain, at least in part, why Cooper Industries received a negative Say on Pay Vote in 2012, with only 29% of shareholders approving management's Say on Pay proposal. The chart on the left shows Cooper Industries compared to its industry group, while the chart on the right shows Cooper Industries compared to its selected peer group.

A simple review of the pay points over the past several years show that Mr. Hachigian's compensation was higher than industry and peer norms given the company's size, industry, and the TSR performance delivered. *(Please see the Appendix for a more detailed description of Farient's Alignment Reports.)*

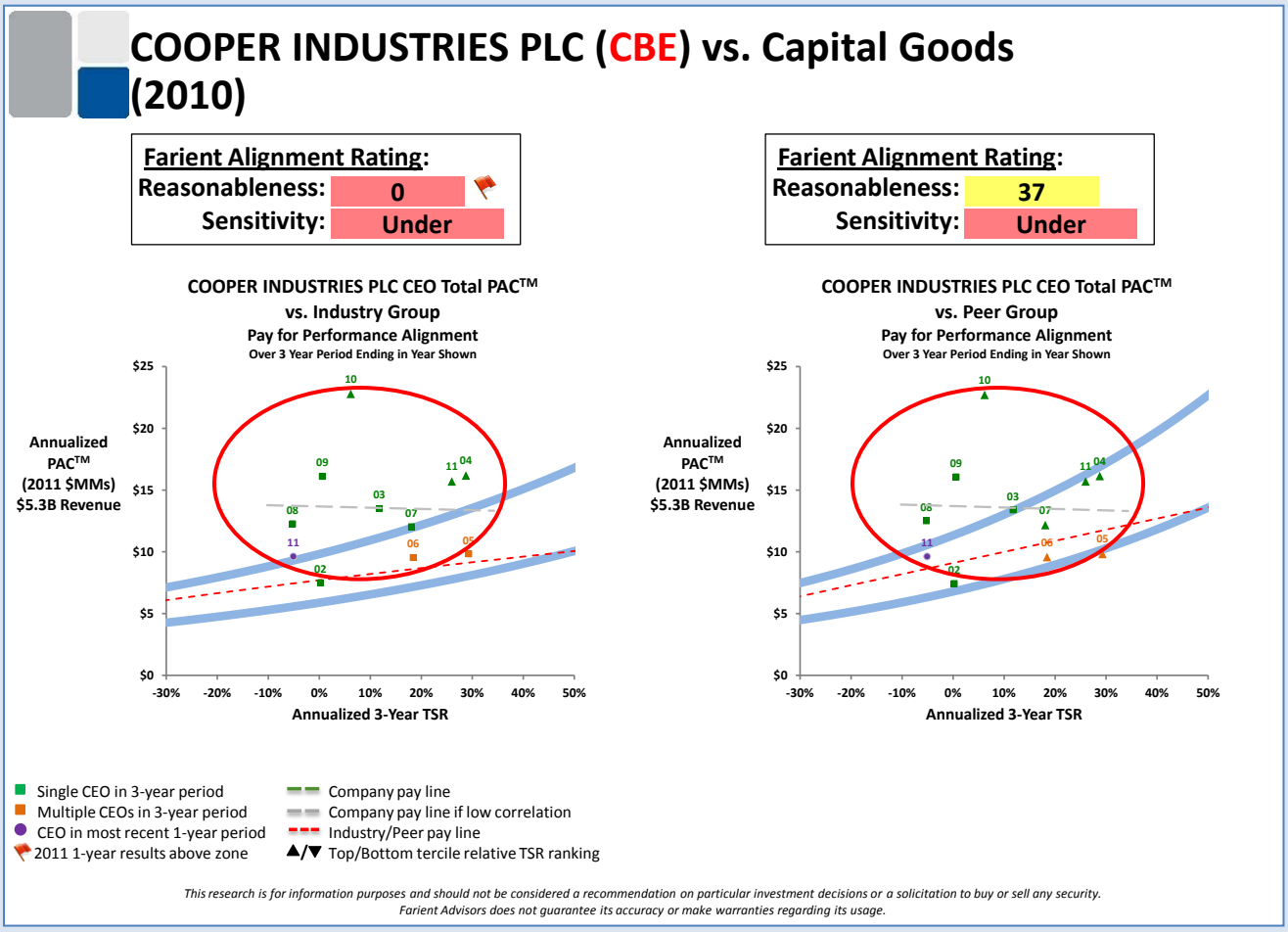
Evaluating Pay for Performance

The Farient Alignment Reports evaluate pay for performance, using PAC as the pay definition and plotting 3-year average pay points for each of the last 10 years against 3-year average TSR for the same time period – showing a trend of pay vs. performance (e.g., the data point labeled "11" represents the pay for performance for the period 2009-2011).

The Alignment Zone, as denoted by the blue lines, indicates a range of acceptable compensation, given the TSR performance level (the red line is a peer average). The chart on the left compares Cooper Industries to industry peers, based on its 4-digit GIC, while the chart on the right compares Cooper Industries to the company's self-selected peer group.

A visual tool such as this can easily spot instances where pay is consistently high vs. performance, as in the example below. The red circles were added to highlight the number of compensation data points that were above the Alignment Zone over the past ten years. In this case, there are issues with both compensation reasonableness – as indicated by the number of data points above the Alignment Zone – as well as pay sensitivity. The compensation levels were relatively the same regardless of TSR, indicating a lack of sensitivity of pay to performance.

Further details on how to read the Farient Alignment Reports are included in the Appendix.



This research is for information purposes and should not be considered a recommendation on particular investment decisions or a solicitation to buy or sell any security. Farient Advisors does not guarantee its accuracy or make warranties regarding its usage.

The Case for Better Disclosures

The foundation of doing a responsible job of analyzing pay and performance starts with a sound pay definition that adheres to the principles listed above. In theory, pay definitions and data sources can appear straightforward. Multiple tables are available in the proxy from which to obtain information for each pay definition. But obtaining information from these different areas in the proxy, often across multiple years, and quality controlling the data extracted in order to develop consistent, comparable pay definitions can be painstaking and often requires significant compensation expertise. For example, plans can have unusual vesting periods or performance provisions, including additional vesting after performance awards have been earned.

In analyzing the 2012 proxies, Farient found that the disclosures often were poor, confusing, inadequate, or just plain inaccurate. To make matters worse, inaccurate or incomplete data also made its way into many of the packaged data bases that are used by companies and investors today. In fact, Farient found data issues in approximately 70% of the S&P1500 companies it has analyzed so far this year. It is *caveat emptor* – buyer beware – on the data front.

Some of the disclosure issues have been noted in the examples provided above. A summary list of disclosure issues surrounding the calculation of alternative pay measures includes:

- Combining RSUs with PSUs
- Lack of disclosure on PSUs
- Combining short-term and long-term cash incentives into a single reported number
- Confusing (or combining) discretionary bonuses with short-term incentive plans
- Inconsistency of reporting from year to year
- Showing pro-rated numbers without stating the actual or target numbers for comparison
- Lack of clarity on pay targets, e.g., referring to maximum rather than target awards
- Using target numbers that are not consistent with plan design, e.g., disclosing the "stretch" goal as the target
- Including information in footnotes rather than disclosing it in the standard tables
- Changing pay plan design without providing a clear explanation
- Using different variations of Black-Scholes

The list goes on, with the top concern being the wholly inadequate disclosure of performance shares – grant amounts, vesting, metrics, targets and results. We also note that one of the drawbacks of all of the definitions is that they do not yet include the value of dividends earned on restricted shares and performance shares. We anticipate that this will be an improvement that will be made in the future.

Until better disclosure is provided, even consistent pay definitions will lead to different analytical results across companies due to weaknesses in the reporting of executive compensation data.

Until better disclosure is provided, even consistent pay definitions will lead to different analytical results across companies due to weaknesses in the reporting of executive compensation data.

In Summary

Say on Pay has driven executive compensation to the forefront of corporate governance, where it is likely to remain for the foreseeable future. The increasing adoption of shareholder-friendly practices is likely to put the focus squarely on pay for performance going forward.

The need to appropriately evaluate the alignment between CEO pay and performance has led an increasing number of companies to seek alternative pay definitions that do a better job than the two most widely referenced definitions today – the Summary Compensation Table in the annual company proxy, and a variation of the SCT used by ISS. Alternative pay definitions that measure pay *after* performance has happened – which must be the goal – include Realized Compensation, Realizable Compensation and Performance-Adjusted Compensation.

Each of these pay definitions has its pros and cons, in particular with how equity LTI awards are valued. There are large differences in calculating compensation numbers depending on the definition used. These differences can and do lead to inconsistent conclusions on pay for performance alignment. The differences are caused, in part, by varied approaches to valuing the three primary components of equity long-term incentive awards – options, restricted shares, and performance shares. The key issues outlined in this report are summarized in the table below and include:

- Mismatched time periods for pay and performance
- Different option valuation methodologies, some of which systematically understate the value of options
- Using target vs. actual number of shares earned in performance share plans, thereby overstating or understating their value

Summary of Pay Definitions and Caveats in Using Each

		Grant Date Value	Realized Pay	Realizable Pay	PAC
Options	Definition	Grant date value, with FASB or other assumptions	Value of options exercised	Options awarded, valued at the difference in the period end price and the grant date price	In-the-money or out-of-the-money Black-Scholes value at the end of the performance period
	Caveats	*Options do not reflect performance*	*Pay and performance periods do not match, as the options exercised can be accumulated from prior periods*	*Undervalues options, particularly "underwater" options, which are valued at zero*	*Black Scholes assumptions are critical*
Restricted Stock (RSU)	Definition	Grant date value of shares * Number of shares awarded	Value is based on awards that vest during the period	RSUs granted * period end price	RSUs granted * period end price
	Caveats	*Share values do not reflect performance*	*Pay and performance periods do not match, as the shares vesting may have been awarded in earlier time periods*	*Poor disclosure can make it difficult to distinguish RSUs versus PSUs*	*Requires validation of RSU and PSU awards*
Performance Stock (PSU)	Definition	Grant date value of shares * Target number of PSUs	Value is based on awards that vest during the period	Target PSUs for current period * period ending price	Earned PSUs in current period * period ending price
	Caveats	*Number of shares and share values do not reflect performance*	*Pay and performance periods do not match, as the shares vesting may have been awarded in earlier time periods*	*Number of shares do not reflect performance*	*Requires validation of RSU and PSU awards*

Performance-Adjusted Compensation addresses many of these issues, as it most closely matches compensation to the performance time period analyzed and more effectively removes distortions in stock option and performance share valuations. PAC is as reliable as any approach, but still must depend to some extent on the quality of the disclosures.

There is a strong case to be made for using a standard pay definition for purposes of analyzing pay and performance, to benefit both companies and shareholders. Through the use of a standard definition, companies can be compared to one another and also can be tracked from year to year. Finally, improving disclosures to take the guesswork out of finding and interpreting pay and performance data is a fundamental requirement for getting the pay definition right.

There is a strong case to be made for using a standard pay definition for purposes of analyzing pay and performance, to benefit both companies and shareholders.

Research tools such as Farient's Alignment Report are starting to emerge to help companies and investors evaluate the alignment between executive pay and performance. The SEC can assist in this process by setting forth principles and standards for data reporting, as well as for discussing pay and performance alignment in the CD&A. We hope that this report will hasten the emergence of best practices in this regard.

Appendix

Explanation of Farient Alignment Report and Ratings

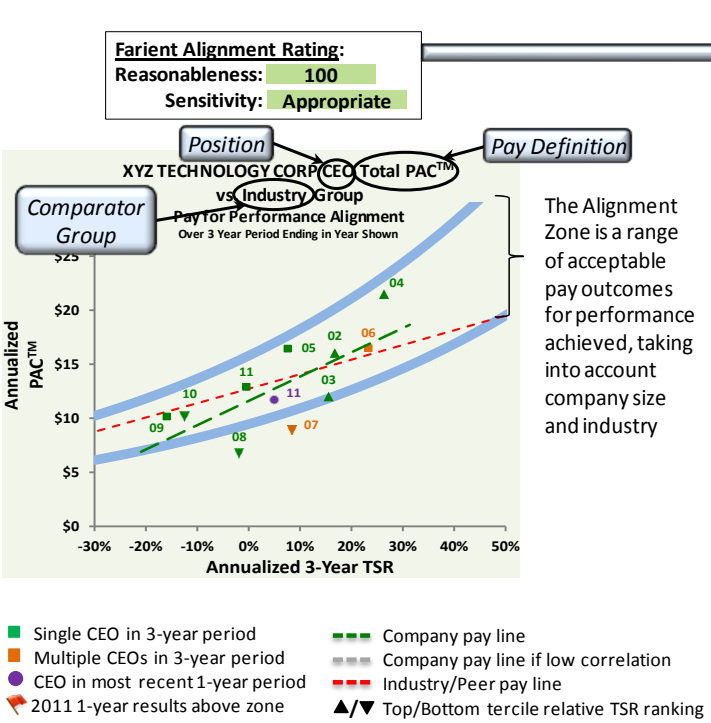
Definition of Alignment

*Aligned pay is when total compensation, **after** performance has been factored in, is:*

1. ***Reasonable** relative to market comparables and for the performance delivered*
2. ***Sensitive** to company performance over time*

Definition of Alignment Zone

A range of acceptable pay outcomes for performance achieved, taking into account company size and industry (or peer group)



The Alignment Zone is a range of acceptable pay outcomes for performance achieved, taking into account company size and industry

Farient Alignment Ratings

1. Reasonableness

- Measures whether Performance-Adjusted Compensation (PAC™) is reasonable for the size, industry, and performance of the company over time
- Numerical ratings range from 0-100 based on the full history (up to 10 years) of pay and performance, weighted more heavily on recent years, relative to the Alignment Zone

76-100: Reasonable	Weighted average is below the high end of the Zone
25-75: Potential Issue	Weighted average is at or slightly above the high end of the Zone
Below 25: Systemic Issue	Weighted average is above the high end of the Zone
	The most recent year is above the high end of the Zone

2. Sensitivity

- Measures whether Performance-Adjusted Compensation (PAC™) is sensitive to performance over time
- Sensitivity ratings are over, under, or appropriately leveraged based on the slope of the Company Pay Line using the full history (up to 10 years) of whether pay is sensitive to performance
- If the individual in the position holds a large equity position (i.e., over 20 x predicted Total Compensation), then the leverage is deemed appropriate regardless of slope

Appropriate	Slope is positive, but not unusually high
Ownership	Slope indicates over or under leveraging, but high ownership overrides slope and indicates appropriate leverage
Under	Slope is negative
Over	Slope is unusually high

About Farient Advisors

www.Farient.com

Farient Advisors LLC is an independent executive compensation and performance consultancy that helps clients make performance enhancing and defensible executive compensation decisions that are in the best interests of their shareholders. Farient provides a comprehensive array of executive compensation and performance advisory services, including compensation strategy and planning, program design and decision support, process support, and other services including employment contract negotiations, board of director compensation, CD&A and other technical reviews, and assistance in transactional situations (e.g., IPOs, M&A, etc.). In addition, based on its extensive data base covering the S&P 1500, Farient offers a proprietary performance and pay Alignment Model that assists companies in diagnosing and improving their pay and performance alignment, and in improving their communications with the investment community.

Farient Advisors was founded in 2007 and has offices in Los Angeles, New York and London through our affiliate Kepler Associates.