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BACKGROUND AND ACKNOWLEDGEMENTS

Executive compensation at major U.S. corporations has become more complex and controversial than ever. The combination of the ongoing economic and financial crisis that started in 2008 and the ensuing legislation that created Say on Pay votes has created more controversy and more pressure on executives, companies and their boards of directors. Despite, or arguably due to, these pressures, the pay model appears to be highly aligned with performance and thus very successful.

Our goal in writing this book is the same as it is in consulting for major companies — namely, to help our clients create alignment between a highly motivated executive team and long-term shareholder value creation.

We, in agreement with the bulk of executives, board members, shareholders and many other knowledgeable participants in this field, recommend and defend the general continuation of the current model with enhancements — discussed herein — that will help create further economic success for all participants, not just executives. We present strong evidence that dramatic changes are not necessary as they are based upon false empirical assumptions or seek to impose conditions that are mostly already in place.

We dedicate this book to our clients, who face all of the challenges described here and continue to thrive and to be part of the dynamic and highly successful U.S. economy. We wish to thank those clients for allowing us to partner with them in this journey to find the right balance between the executives and the shareholders. We welcome their participation on this important odyssey.

The Partners and Consultants of Pay Governance
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INTRODUCTION
THE EXECUTIVE PAY MODEL WORKS
BY IRA T. KAY

The U.S. executive pay model is characterized by large amounts of cash and stock incentives, which are generally earned only if challenging financial and stock price goals are achieved. Furthermore, these stock incentives typically only achieve substantial value if the share price rises significantly. It is a pay model that is different either quantitatively or qualitatively, or both, from those in most other developed countries, although it is similar to those in the U.K. and Canada. Most participants in the U.S. model — executives, board members and the preponderance of shareholders — believe that there is a high degree of alignment of pay and performance, properly measured.

This pay model, as part of the very successful prevailing corporate model, is highly effective at creating shareholder and overall economic value. This conclusion is based on compelling evidence from Pay Governance and academic research, discussions with hundreds of board members and executives, participation in hundreds of board/compensation committee meetings and decades of pay advisory experience. While challenges and outliers remain, most highly paid executives work at high-performing companies, and most underperforming companies pay their executives much less. While many factors — including a strong U.S. economy, great strategies, great employees and luck — have had an impact on the success of these companies, the role of executive talent and executives’ highly motivational pay packages should not be underestimated.
However, not everyone agrees with this assessment, and thus the U.S. executive pay model is at a turning point, a figurative fork in the road: in one direction, whether broadly to continue the current overall successful approach, with further corporate governance and design improvements; or, in the other direction, to continue the regulatory march — Dodd-Frank, the Fed and many other regulatory rules — toward further control over the pay model that basically wants to reduce pay amounts and modify the structure significantly. This is all in the service of allegedly increasing pay for performance, reducing excessive risk taking, and reducing income inequality. These regulatory pressures might end up reducing the levels of executive pay, and thus reducing income inequality and possibly reducing populist anger — but at what economic cost?

We, in alignment with most executives, board members, shareholders and many other knowledgeable participants in this field, recommend and defend the general continuation of the current model with enhancements — discussed herein — that will help to create further economic success for all participants, not just executives. We present strong evidence that dramatic changes are not necessary, as they are based upon false empirical assumptions or seek to impose conditions that are mostly already in place.

Our goal in writing this book is the same as it is in consulting for major companies — namely, to help our clients create alignment between a highly motivated executive team and long-term shareholder value creation. In the current environment of intense global competition, income inequality, populism, demanding shareholders, Say on Pay (SOP) votes, economic downturns, powerful proxy advisors and other regulatory pressures, executive pay programs are more difficult than ever to design ideally. Yet these programs are more important than ever as a tool to help corporations, their boards and their executives meet and surpass shareholders’ expectations and other challenges. Of course, those same pressures that make it imperative for a company to keep its executive team intact also mean that other companies want to recruit the best talent to meet their own challenges. Thus the importance of getting the entire pay package — especially the cash and stock incentives — properly calibrated to assist in this effort.

These highly motivational pay packages have played an important role, along with many other factors (the stimulus, the Fed, TARP, the dollar as a reserve
currency, the general entrepreneurial nature of the U.S. economy and many other important benefits), in the economic recovery from the 2008-09 financial and economic crises. The structure of the pay packages — performance metrics, pay mix, etc. — clearly indicates to the executive team and shareholders (as disclosed in the proxy) which are the most crucial parts of the strategy that need to be focused on. They also are highly motivational to the executive team and other managers and indicate to the executives how they will be rewarded for strategic success.

The U.S. corporate model, like capitalism, is volatile and not perfect, but despite those imperfections, it has created enormous wealth for shareholders and employees in addition to the executives. There is no doubt that some corporations and their boards made major mistakes throughout the financial and economic crisis: mortgage banks, home builders, investment banks, rating agencies, Fannie Mae, retailers, commodity companies and so on. Now, it is true that taxpayers, employees and others suffered along with the executives, their boards and their shareholders. But thus far, it does appear that they were mostly mistakes and not cases of deliberate risk taking, let alone criminal activity. The key policy question is whether the fundamental model and its executive pay structures and governance are supportive of better and less volatile performance. Is it sound and merely in need of tweaking around the edges, or is it deeply flawed and in need of restructuring and new regulation?

Not everyone agrees that the executive pay model has been successful for the corporations that employ those executives. The Say on Pay votes starting in 2011, emanating from Dodd-Frank, were an outcome of the fever pitch of criticism from some institutional investors, especially public employee pension funds. They were heavily supported by some government officials and the media. It was these Say on Pay votes and their causes and effects that motivated us to write this book to try to bring some logic and facts to the hotly disputed area of executive pay.

We will present the case that there exists a reasonably competitive labor market for executives, and to combat the conventional wisdom that executive pay is excessive and that there is no pay for performance. Most executives and board members are quite bewildered and frustrated about this conventional wisdom,
especially the alleged lack of pay for performance. This media and regulatory pressure is starting to change the pay model, sometimes in positive and sometimes in less than ideal ways. Arguably, positives include reductions in potential severance payments, especially during a change in control (e.g., large excise tax gross-ups paid to the executives). The greatest positive is in encouraging higher levels of shareholder outreach by the board and management. On the negative side, many corporate executives and board members believe that these SOP votes are starting to reduce motivational power and create overly homogeneous pay packages (e.g., much broader use of relative TSR as an incentive performance metric), both of which could be problematic. Obviously the use of TSR could be a negative or positive factor depending upon the individual company’s circumstances, but that should be based upon the strategy of the company and the judgment of the board/management, and probably should not be unilaterally imposed as part of a regulatory or quasi-regulatory process.

There are others who argue that the model is in fact broken and who primarily want to reduce executive pay levels. There is also some preliminary evidence from pay decisions made in 2011 and 2012 that cash and stock incentives are being reduced as a result of these votes and regulatory pressures. Again, this could be good or bad, but should be ideally determined by the board, not by outsiders with less information. As we will show, CEO pay already moves significantly up and down with overall performance of the company and the stock market.

Clearly, the media and various institutions believe that the model needs major correction. This conventional wisdom, however, has no direct supporting evidence, given the impossibility of proving something inherently “excessive,” but is more of a “feeling.” “The current levels of compensation for CEOs in corporate America are, in a word, outrageous,” said Jack Bogle, founder of The Vanguard Group [Fortune, “How Can We Address Excessive CEO Pay?” by Eleanor Bloxham April 13, 2011]. Even the article’s title presumes “excessive pay” without facts.
THE CRITICISMS OF THE EXECUTIVE PAY MODEL

We have developed an exhaustive list of the different criticisms that are offered as the basis for additional regulation or other methods to reduce executive pay or to change the structure of the pay model. These criticisms, which are clearly worthy of the responses provided in the next chapter, include:

1. **CEO pay packages are excessive** for many reasons, including its being a “rigged” market subject to crony capitalism, as manifested in the high and rising CEO pay multiple to the median employee’s pay.

2. **CEO pay only rises due to the “ratchet effect,”** in which companies chase an ever-rising market median — or higher pay level targets — compared with larger peers, thereby setting in play a pernicious upward spiral unrelated to the macro stock market and other overall performance indicators.

3. **These pay packages, at the individual company level, are not related to corporate performance.**

4. **The structure and pay levels of these CEO pay packages do not motivate higher levels of corporate performance.** The success of the U.S. corporate model occurs despite the executive pay model and is mainly driven by macroeconomic conditions in the U.S., including free markets, a large consumer sector, low interest rates, high human capital and the dollar as reserve currency, among many other factors. This criticism argues that the superior economic performance is the rising tide that pushes up stock prices and thus the pay packages, and not the other way around.

5. **CEOs rarely “quit” their current jobs to take a higher-paying CEO position at another large company or in a higher-paying industry.** These executives have limited employment alternatives because their skills are highly specific to their current employer, so they rarely quit. Thus it is not necessary to pay them “extra” for retention, and there are numerous other executives who can take their place. This criticism also says that this “lack of quitting” indicates that the universal methodology of using peer groups to set “competitive pay” is thus flawed, as it does not matter what other companies pay since the executives rarely leave for those opportunities.
6. Executives set easy/soft financial goals for their cash and stock incentive plans. These goals are endorsed by feckless, compliant and complacent directors. These goals are frequently set below the company’s own external earnings guidance as well as below the consensus of analyst expectations for the company. As a result, these cash and stock incentives pay out above the “target” dollar or stock payout level for the plan. Despite these large payouts, the achievement of these soft goals translates into weak or actually negative stock price appreciation.

7. These executives are rarely fired for poor performance, and the boards are slow to act on poor performance. The executives are equally highly paid for both success and failure.

8. U.S. CEOs are overpaid relative to equally high-performing CEOs in other countries.


10. Executives do not own enough stock to be aligned with the shareholders.

11. Corporate executive pay is part of the cause of the “income inequality” problem and debate that is raging in the political world.

12. The highly positive SOP votes of 2011 and 2012 were misleading and did not truly indicate that the shareholders endorsed the executive pay model. The pay-for-performance models of the proxy advisors (ISS, etc.) are truly indicative of alignment of pay to performance.

These are damning criticisms and, if completely or even mostly correct, would probably require major corrections of defects in the corporate pay and governance systems. We demonstrate in the next chapter that the empirical evidence shows that these criticisms are mostly mythology.
Executive pay, always controversial, has generated even more focused criticism as a major cause of the financial crisis and related economic distress. This crystallized denigration has implications that are lasting beyond the financial crisis itself and beyond the financial services sector, with numerous policy and governance implications, not all of them positive.

There are many critics in this camp including the media, the public, regulators, other government officials and some shareholders. They believe that the structure and level of the executive pay packages at major investment and commercial banks and other finance companies, including insurance companies and mortgage originators — and perhaps at all major companies — created moral hazard. Moral hazard is where an agent — an executive in this case — has all (or mostly) upside and limited or no downside, and is thus motivated to undertake excessive risks with the balance sheets.

Further, this criticism continues, CEOs in all industries are not paid proportionally to the performance of their companies, and thus make recovery from the economic crisis even slower and more likely to be weaker or worse. The outsiders blame cronyism and laziness on the part of the board members for these serious problems. Thus, major fixes — regulation, SOP votes, overall improved governance, enhanced disclosure, pay caps, higher taxes, etc. — are necessary for the good of corporations, shareholders, the economy and the public. The theory is that these fixes would either provide “backbone” for the board to make changes to the pay packages or would impose them from the outside. In fact, the Dodd-Frank regulatory legislation, with its mandated Say on Pay vote, among other features, was a direct result of the financial crisis and has already created new regulations and structural pay changes for all companies, not just financial companies.

Both of these significant and severe criticisms — excessive risk taking and no pay for performance — have been thoroughly evaluated in the academic literature and our own research. While there is not universal agreement, the bulk of the studies, and certainly the most thorough and convincing ones, show
that both of these criticisms are wrong, and that the basic executive pay model is working not only properly but well. This lack of consistency in insiders’ and outsiders’ perspectives on the executive pay model may stem from many factors, including diverging social and political points of view. That divergence may be impossible to fix inside the boardroom. However, there are also informational differences, including the substantial advantage related to non-public, strategic, highly judgmental, idiosyncratic and personal information about the company and its executives that is available to insiders. While the media and outside critics cast aspersions on the motives and skills of the insiders, the overall success of the model and the lack of successful lawsuits challenge the validity of that negative posture.

JUDGING EXECUTIVES’ PERFORMANCE IN THE CONTEXT OF PAYING THEM

Measuring the performance of a company and its executive team is an extremely challenging undertaking characterized by uncertainty, imperfect information and elements of randomness. Thus, such efforts are subject to considerable judgment by all parties. A wide range of factors, including differences in industry structure, changes in government policy, business strategies and varying executive talent, are blended together with the expectation of improved revenue, profits and, of course, stock price. When actual performance is below or above expectations, it is usually impossible to be certain why that happened and whether a different executive team or strategy might have done better or worse.

All of this uncertainty requires that the board use its judgment informed by information, experts and experience, as protected under Delaware corporate law’s business judgment rule, to evaluate and pay these executives. Thus the after-the-fact second-guessing by outsiders — that excessive risks were taken and that the executives are not paid for performance — is inconsistent with actual performance outcomes. This is caused by several factors, but especially the uncertainties and imperfect information at the time of the evaluation of the executives. The business judgment rule requires board members to determine executive compensation using “good faith, loyalty to the corporation, and due care.”
This rule provides enormous legal protection to board members deliberating on executive pay related to performance. However, it is our experience that most board members go well beyond this standard in determining compensation.

Most board members and the executives at their companies are perplexed by these criticisms, as their experiences at their own companies are essentially the opposite. Those board members clearly believe that they hold their executive team, especially the CEO, accountable for the performance of the company, in both good times and bad. These board members expect to see the executives do well economically only when the company, and hence the shareholders, do well, and to fare poorly — experiencing pay cuts and terminations — when company profits and the stock price swoon. They expect their shareholders to endorse them as board members when they do this properly. As for the media, they look for supportive — or, at a minimum, neutral — stories.

In our experience, and in most empirical studies, we see that boards and their executive teams explicitly structure pay packages so that cash bonuses rise primarily when sales and revenue increase, and go down when profits, etc., go down. Further, the value of stock incentives and prior stock ownership clearly goes up and down when the stock price moves. And as for risk, the executives in the financial sector owned billions of dollars of stock, so why would they have undertaken excessive risk deliberately?

Mistakes were clearly part of the cause of the recent financial and economic crisis, but many believe these mistakes were made in good faith, and executives — and their willing shareholders — paid massively for those mistakes with their wealth (and in the case of the executives, with their careers as well). Combining the research with the viewpoints of the directors/executives leads one to conclude that the model is working well — certainly not flawlessly, as it clearly did not prevent mistakes, but doing more things right than wrong. The solid results for the U.S. economy over the past four years (weak, but better than most other large economies) support the belief by many board members that the executive pay model has helped rather than hindered the recovery. Thus the enhanced regulation based upon those flawed conclusions is not necessary and could in fact do real economic damage.
THE EXECUTIVE PAY WAR

The U.S. executive pay model is clearly at a juncture, with profound disagreements over whether it works; whether it is motivational; whether shareholders endorse it; what its impact is on risk taking; whether it is fair and efficient; and whether executives are capturing rents as part of “crony capitalism.” It is one of only a handful of important economic/political/sociological topics that are subject to intense polemical and populist debate and disagreement, and even the facts and methodologies are disputed.

Astonishingly, there is no consistent method for measuring whether there is in fact pay/performance alignment. It is astonishing because proving or disproving the alignment is at the core of this entire field. As we will discuss extensively, our research shows that there is strong alignment, and other methods show there is not. The implications of being at a turning point are equally profound. If as we (and many in the corporate sector, the vast majority of shareholders and others) believe, the highly motivational executive pay model actually serves substantially to improve overall corporate and economic performance, then policies and legislation that damage the executive pay model will in fact damage the overall economy.

The challenge of demonstrating the effectiveness of the overall executive pay model via linkage between CEO pay and company performance became even more important and difficult during the 2011 and 2012 proxy seasons with the advent of mandated Say on Pay (SOP) votes. While the votes themselves are nonbinding (the U.K. is implementing binding votes), the impact of these votes is nevertheless quite substantial. This voting process was implemented by the SEC as part of the Dodd-Frank legislation to regulate U.S. business in an attempt to avoid future financial crises and reduce CEO pay levels.

The expectation of this vote was that shareholders would reject many of the features of the pay packages, especially the supposed extremely high pay levels and the lack of pay for performance at many companies, thereby forcing major change after the fact. This voting process, strongly recommended by a number of critical shareholders, the media and government officials, has also empowered the proxy advisory services, e.g., Institutional Investor Services (ISS), creating
further complexity, anxiety and concern. *Contrary to the desires and intentions of many of the original architects of these votes, the shareholders, ironically, heartily endorsed the executive pay model.* However, in fairness to the SOP process, many companies did indeed enhance their pay-for-performance linkage and explained to shareholders their pay-for-performance philosophies, but these changes were ones of degree rather than substance.

As a result of the original nature of the core programs and these enhancements — both of which increased the alignment of pay and performance — 98% of thousands of major companies received an endorsement in 2011 and 2012 from their shareholders of their executive pay programs in their SOP votes. Shareholders at these companies largely agreed that effective pay-for-performance standards were in place. This is a strong endorsement of the overall model, but it nevertheless has not quieted the critics. Even the implications of these positive votes are hotly disputed and have not put criticism of executive pay to rest. It is ironic that this elaborate voting process, which was intended to provide a forum for *rejection* of the overall pay model, has actually yielded an *endorsement*. Clearly, an overwhelming majority of shareholders at virtually all major companies believe that the executive pay model is satisfactory at worst and highly effective at best.

This book will tell the story of how effective pay packages are in motivating the executive team and many others to create successful companies, and thus to create enormous amounts of shareholder value, which in turn helps the economy. We will show that overall, the highest-paid executives, whose performance is properly measured, work for the highest-performing companies, and that poorly performing companies pay their executives much less. We will focus our discussion and research on the CEO, as this job is subject to most of the criticism and truly represents the U.S. corporation and the topic of executive compensation. Our research and that of others has shown that the pay packages for all top executives are sufficiently similar that a discussion of the CEO’s pay is relevant to the rest of the C-suite. We also will show the significant amount of effort the compensation committees of publicly traded companies expend, and the care with which they evaluate how much, and with what structure, to pay their executives so that they are motivated to succeed and create alignment
between realizable pay outcomes and the overall performance of their companies. The highly positive SOP vote outcomes are one of the clearest indications of shareholder support for the pay model in the 50 years that executive pay has been controversial.

Are there companies that need to improve in this regard? Of course. Are there executives who were paid well when their companies did not fare well? Yes, but there frequently were mitigating circumstances. Is it challenging to develop pay packages that are fair to both executives and shareholders in the current volatile and closely scrutinized environment? Yes. Are there valid reasons why shareholders are satisfied and thus voted so overwhelmingly positively for pay programs? While there are no simple solutions — judgment and experience are invaluable — this book will provide guidance helpful to those seeking to answer such questions.

The remainder of this book is organized first to address the criticisms listed above, with Chapter One providing high-level responses to these challenges. Next are several chapters that provide more detail on some of the more controversial criticisms that need to be addressed. We then provide a number of chapters covering best practices in executive pay corporate governance, including responding to SOP pressure, assessing risk, choosing performance metrics, optimal severance plans and related topics.
CHAPTER ONE
RESPONDING TO THE CRITICS: MYTHS OR REALITIES?
BY IRA T. KAY, BENTHAM STRADLEY AND BRIAN LANE

This chapter will provide brief responses to the criticisms outlined at the close of the introduction. This involves recognizing which ones have some validity and therefore may require a policy response, either by the company or by regulators. In later chapters we discuss what boards and their management can do to ensure further alignment of pay for performance and to enhance corporate governance and shareholder relations, all in the service of increasing total returns to shareholders. The remainder of the book contains further details on these challenges and criticisms, and several chapters on new trends in executive pay — Say on Pay, metrics, risk management and so on — that many board members and executives will find useful. Again, the goal is to enhance governance and overall corporate performance by getting the balance right between motivating the executive team and satisfying the shareholders, their advisors (ISS), the media, the public, regulators and so on.

NOTE: Throughout this book, we show data that demonstrates the positive alignment and correlations between CEO pay and performance. Namely, those companies with high levels of realizable pay had higher levels of performance, and those with low performance had low realizable pay and similar important correlations. The implication of our work and that of others is that the structure of the executive pay programs, or the high level of stock ownership, or the particular choice of performance metrics, etc., causes the superior performance. While we believe in that causality, we readily acknowledge that we are only
showing correlations and the strong logic of causality. The entire field of business economics is filled with such assumptions. For example, does advertising cause higher sales? Do price increases cause higher profits? Will a horizontal (or vertical) merger cause an increase in enterprise value? Boards of directors are bombarded at every meeting with proposed strategy and policy changes that supposedly would increase shareholder value.

Assumptions reflected by the above questions are usually correct, but the success of each resulting strategic decision is necessarily subject to a probability distribution.

Executive compensation falls into the same category. If we set a very hard EPS target for the annual incentive plan, will that cause a higher level of EPS? If we choose performance shares rather than time-vested shares, will our executive team be motivated to stay with our company and drive superior performance, or will they quit and go elsewhere with easier goals? As we will demonstrate throughout this book, there is strong evidence to support the conclusion that the executive pay structure causes alignment of pay with performance and possibly even superior performance overall.

INITIAL RESPONSES TO CRITICISMS

1. CRITICISM: CEO pay packages are excessive for many reasons, including its being a “rigged” market subject to crony capitalism, as manifested in the high and rising CEO pay multiple to the median employee’s pay.

RESPONSE: Mostly myth

Overall the executive labor market is reasonably competitive. We show an analysis of markets that indicates that, while the executive labor market may not be as perfectly competitive as the commodities market, it certainly has enough competitive aspects to counter the criticism that the market is “rigged.” By rigged, critics mean that CEOs effectively set their own pay because their boards are composed of friends who rubber-stamp their pay, along with other decisions.
Another piece of supporting evidence is that the amount of pay opportunity and the structure of the package are *highly similar* irrespective of the type of company and ownership structure (concentrated versus dispersed) and governance. For example, companies with as varying ownership and governance structures as public, private, family-owned, joint venture, private equity, bankrupt but emerging, restructured, etc., all have highly similar executive pay levels and structures. Executives and the boards at these varying types of companies all face the same pressures and competition for executive talent in the same or at least a similar labor market, and they all use the same publicly available pay data representing the top executive labor market as contained in annual proxy statements.

There is no accepted methodology for measuring “excessive executive pay.” Comparisons to the pay of athletes, musicians and actors can be made for context and sociological purposes, but that does not really answer the charge.

There is no doubt that CEOs are paid well by the standards of “regular people” and that the arithmetic of executive pay has created a phenomenon where the CEO pay multiple has indeed risen dramatically, from 40:1 in 1960 to 344:1 in 2007, and has moved up and down since to around 380:1 in 2011. The key questions that the board and shareholders must answer are whether there is a competitive labor market for CEO talent, and whether the board could fill this role with a much less expensive person and still meet its legal and economic obligations to shareholders. Our experience and research indicate that yes, companies compete for executive talent and that there is a fairly limited pool of talented executives who can fill these roles or, at a minimum, who can be identified and recruited. Recruiting outside of that pool carries the risk of doing billions of dollars of damage to shareholder value.

Regarding the CEO pay multiple, as a matter of economics, the markets for CEOs and for average employees are two entirely separate markets that cannot be compared because the general employee population cannot be substituted for top executives. The impact of the return on executive human capital on corporate performance, particularly on a global scale, makes such apples-to-oranges comparisons particularly trivial. The primary policy recommendation from these critics stemming from the CEO multiple of worker pay is to *reduce*
or cap executive pay. This policy solution is not valid. Nevertheless, the critics’
typically union pension funds) focus on these multiples, however irrelevant
to executive pay, raises the issue of the need to increase the return on human
capital for the average U.S. employee. Raising this multiple hinges on adequate
training, education and a strong economy characterized by a healthy level of
exports, all of which present difficult challenges not only for companies but for
the nation. A regulatory reduction in CEO pay, via a cap, for example, such
as the one in tax code Section 162(m), will not increase the pay of the average
employee, and arguably might reduce the performance of the company, thereby
lowering the pay of both executives and workers.

The increase in CEO pay over the past 25 years has been contemporaneous
with major improvements in corporate governance, including improved disclo-
sure, more independent directors, more separate CEOs and chairs of the board,
more lead directors, nominating committees selecting directors rather than the
CEO/COB, more director and executive stock ownership, and many other fac-
tors unrelated to executive compensation (e.g., reduction in two classes of stock,
majority voting, etc.) [“The State of U.S. Corporate Governance: What’s Right
and What’s Wrong,” Bengt R. Holmstrom and Steven N. Kaplan, working
paper, 2003].

Whatever cronyism there may have been in the past has been virtually elimi-
nated. That there are now headlines whenever a corporation gets into trouble for
an inappropriate relationship between the CEO and a board member reflects
the rarity of corporate cronyism today.

However, given the large size of equity grants to top executives, the neces-
sity of cash severance and generous pensions needs to be closely examined. In
the current political and governance environment it is challenging to support
a CEO’s retiring with stock valued in the high eight figures plus an eight-fig-
ure pension and a multimillion-dollar cash severance payout from a change in
control.

2. CRITICISM: CEO pay rises only due to the “ratchet effect,” where
companies chase an ever-rising market median — or higher — compared to
larger peers, thereby setting in play a pernicious upward spiral unrelated to stock

RESPONSE: Mostly myth

Regarding the facts, this assertion is categorically incorrect. Moreover, it is of questionable validity on its face because it is based on faulty logic. The chart below, with more in Chapter Seven, demonstrates that while CEO pay has generally trended up over the past two decades, CEO pay both rises and falls in general proportion to the stock market, as demonstrated by the Dow Jones Industrial Average.

CHART 1.1
CEO Pay 1989-2012 ($ million) - Realized Pay*

The data shows that approximately 30% or more of the time, CEO pay goes down year over year, regardless of how it is measured. Chart 1.1 shows this to be true for realized pay. Another study [“CEO Pay 231 Times Greater Than the Average Worker,” by Lawrence Mishel, May 3, 2012] using pay opportunity makes the same finding. In fact, that study shows a year-over-year collapse of
the multiple of 50% from its peak in 2000, as CEO pay dollars declined precipitously. Another study by Kevin Murphy shows the same findings for realized pay over the past 20 years.

This is primarily due to stock market volatility and the related choppy exercising of stock options year by year.

It is also incorrect to say that CEO pay has moved up more rapidly than the stock market. As Chart 1.2 below and additional data in a later chapter clearly shows, over the full period of the data (1989–2012 proxies) the stock market overall rose more rapidly than the CEO pay market — a 476% increase in the DJIA compared to a 320% increase in CEO pay.

CHART 1.2
CEO “Pay” Increases 1989-2012 compared to movements in the Dow Jones Industrial Average (DJIA)

![Chart showing CEO pay increases compared to DJIA]

*Source: Forbes.com, 4/4/12 (Salary + Bonus + other + Stock “Gains” [exercised stock options; vested stock]) 1989-1999 top 800 companies; 2000-2012 top 500 companies

At the company-specific level, we had one technology client that peaked at more than $100 billion in market cap in 2000, with more than $15 billion in employee stock option grants, only to have it decline by 90% after the tech col-
lapse. And another client in consumer products had a short attack and saw its
market cap decline from $20 billion to $8 billion in a matter of weeks, with a
disproportionate collapse in CEO and employee unrealized stock option gains.

There is also strong academic research that shows that large companies are
not choosing inappropriately large peers for making pay comparisons to set
higher pay that they can justify in their proxy.

There is also very limited evidence that companies are targeting the 75th
percentile or higher for their pay opportunity packages. Most companies target
the median or slightly above. Our research supports the notion that it could be
shareholder unfriendly to target a high percentile for opportunity, as that could
yield high realizable pay for mediocre levels of shareholder returns.

3. CRITICISM: These pay packages are not related to corporate
performance.

RESPONSE: Myth

Our research, using 2012 proxies from hundreds of large companies, demon-
strates a very strong alignment between the stock price performance of a com-
pany and the realizable pay of the CEO. This important finding, consistent with
our prior multi-year analysis and much academic research over the past decade,
thoroughly discredits this criticism. This research can be found in Chapter Two.

Nevertheless, there is no universally accepted methodology — by the SEC,
academics, the media, shareholders or any others — for evaluating whether
there is alignment between the CEO’s pay and corporate performance. Nev-
evertheless, our realizable pay methodology, using end-of-the-year stock price to
value the stock grants made during the performance period, is a logical and
robust formula for any company to demonstrate that the interests of the execu-
tives and the shareholders are aligned via the compensation program, especially
stock-based incentives. Our study shows that overall, it is primarily high-perform-
ing companies, as measured by above-median TSR, that have highly paid CEOs,
and low-performing companies have lower-paid CEOs.
4. CRITICISM: **The structure and levels of these CEO pay packages do not motivate higher levels of corporate performance.** The success of the U.S. corporate model occurs despite the executive pay model and is mainly driven by macroeconomic conditions in the U.S., including free markets, a large consumer sector, low interest rates, high human capital and the dollar as reserve currency, among many other factors. Superior economic performance is the rising tide that pushes up pay packages, not the other way around.

**RESPONSE: Mostly myth**

We responded to the prior criticism by showing empirical results that demonstrate the alignment of realizable pay with corporate performance, as measured by TSR. However, it is another matter entirely to demonstrate that the a priori structure and pay levels of executive pay packages — pay vehicle mix, performance metrics, goal difficulty, etc. — are successful at motivating executives to perform at a higher level and thus to generate superior economic returns for their corporations. This is very difficult to prove, but conversely, it is also difficult to prove that the pay packages do not work. In fact, our own and others’ research supports the conclusion that it is extremely difficult to demonstrate causality by showing that higher levels (above median) of pay opportunity (which includes the value of stock on the date of grant) are not associated with higher levels (above median) of TSR.

ISS, as of its 2012 tests, actually wants the causality to run the other way. Namely, it measures pay for performance to see if lower levels of TSR encourage (i.e., cause) the compensation committee of the company to lower cash bonuses or new stock grants for the CEO. Conversely, ISS evaluates whether larger bonuses and stock grants primarily occur only if TSR improves. There are several practical problems with the ISS pay/performance model — specifically, in the most recent year it examines, stock grants are typically made early in the fiscal year and ISS measures TSR through the end of the fiscal year. This causes great consternation among our clients. Despite ISS’ reversed causality, an examination of whether — and if so, how — the level and structure of CEO pay packages motivate higher levels of performance would, of course, be helpful.
CHART 1.3
Change in Gross Domestic Product Since the First Quarter of 2008

TABLE 1.4
MSCI Total Return Index: June 2009 - August 15, 2012

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>CHANGE IN STOCK INDEX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>27%</td>
</tr>
<tr>
<td>France</td>
<td>13%</td>
</tr>
<tr>
<td>Italy</td>
<td>-21%</td>
</tr>
<tr>
<td>Spain</td>
<td>-23%</td>
</tr>
<tr>
<td>Euro Zone</td>
<td>8%</td>
</tr>
<tr>
<td>United States</td>
<td>63%</td>
</tr>
<tr>
<td>Britain</td>
<td>47%</td>
</tr>
<tr>
<td>Japan</td>
<td>4%</td>
</tr>
</tbody>
</table>

Source: NY Times, August 16, 2012, “For The Tepid European Economy, a Lost Decade Looms,” Jack Ewing

Source: NY Times
Regarding this examination, the pertinent question, warranting an empirical answer, remains, “Is U.S. corporate performance — for corporations above and below the median level of TSR — higher than it would have been overall due to the nature of their executive pay packages?” In other words, do the pay packages motivate the executives to perform better than they otherwise would, even if their companies are below median? Based upon our research and experience, the clear answer to this is yes. As a matter of logic, executives are highly motivated to earn their cash incentives/bonus and to increase the value of their stock grants via an increase in their stock prices, even if their peers “outperform” them. Indirect empirical evidence of this is the rapid recovery of the U.S. economy from the economic crisis of 2008–09 and the superior results of the U.S. economy — GDP and productivity levels and growth, stock market performance — relative to other OECD countries (especially Europe and Japan) that have many of the same economic attributes as the U.S. It does appear that the executive pay model is helping the U.S. economy as it continues to struggle to recover from the 2008–2009 financial and economic crises. The U.S. recovery, and certainly the corporate sector and the stock market, are stronger than in most other developed nations. It is true that this current recovery is weaker than historical improvements and insufficient to bring unemployment rates down to more normal levels. Nevertheless, there is strong reason to believe that even worse outcomes were clearly possible — such as those experienced in Europe — given the economic headwinds, the weak global economy, a high level of debt and so on. The following charts demonstrate the strength of the U.S. recovery in terms of GDP growth and stock market performance.

While there are indeed many reasons for the recovery, even if weak, the motivational power of annual cash and longer-term stock incentives must arguably be viewed as one of the strongest, yet unsung, contributing factors. An article [“Buttonwood,” March 31, 2012] in The Economist magazine says, “Profit margins in America are higher than at any time in the past 6 years. That helps explain why the equity market has rebounded so strongly despite a lackluster economy.” The executive cash and stock incentive plans motivate cost cutting, revenue/pricing strategies, divestitures, acquisitions and the like by the leadership team and many other managers/employees, all in the service of increasing profits and the stock price.
While it is impossible to prove that the incentives cause the improved profitability and stock price appreciation, the same article asserts that executives are indeed “given incentives to boost margin.” The interviewee who said the latter argued that these margin improvements are short-term and ephemeral, as they are at the expense of long-term value for the shareholders. As we will show, the large amounts of cumulative stock-based incentives combined with the substantial company stock owned outright by the executives belie this latter point.

The large stock ownership, another major and deliberate improvement in executive compensation and corporate governance over the past 10 to 15 years, is highly motivational in precisely encouraging the executives to attempt to balance all the short-term-versus-long-term performance and risk implications, and many other trade-offs of various decisions. Obviously, executives make strategic and operational mistakes in evaluating these trade-offs, and some may in fact have lower ownership, but the bulk of the top executives we deal with explicitly try hard to get this balance right. And the outcomes of strong profits and stock price performance support this view.

The U.S. executive pay model is a significant part of the explanation for this superior short- and long-term performance.

5. CRITICISM: CEOs rarely quit their current CEO jobs to take a higher-paying CEO job a larger company or in a higher-paying industry. Executives have limited employment alternatives because their skills are highly/mostly specific to their current employer. Thus they rarely quit, so it is not necessary to pay them extra for retention and there are numerous other executives who can take their place. This criticism also says that this “lack of quitting” indicates that the universal methodology of using peer groups to set “competitive pay” is thus flawed, as it does not matter what other companies pay since executives rarely leave for those opportunities. [See Elson and Ferrere, 2012]

RESPONSE: Some reality, some myth

It is factually accurate that CEOs have a very low “quit rate,” probably ranging from 1% to 1.5% per year — fewer than 10 per year for the S&P 500. It is also true that 80% of CEO replacements (due to all reasons: retirement, involuntary termination (fired), death, cause, etc.) are from within the current
management ranks, a percentage that has increased dramatically over the past
decade. The total turnover of CEOs is around 10% per year, including retire-
ments and succession, but the explicit and “announced” quits are a small part.
It is well known in the academic literature and in the media that there are many
euphemistic “retirements” and voluntary terminations that are actually termina-
tions due to financial performance.

Nevertheless, whatever the label of the reason for a change in CEO, all of
these departures put upward economic pressure on the market price of a CEO.

As a matter of arithmetic, a CEO of a major company can only be recruited
to a larger public company or one in a higher-paying industry, or a highly lev-
eraged private equity or turnaround opportunity, so the demand for that em-
ployee has a cap on it. The quits are probably higher for other senior executives
as they have more job openings available to them.

However, there are many other important aspects to this phenomenon that
reduce quits by executives and yet probably only reduce the equilibrium pay
package a small amount. Executives are deliberately locked into their companies
by a number of explicitly designed features and factors:

a. Unvested stock incentives: Executives could leave millions, or
in some instances tens of millions, of dollars of unvested stock
value on the table if they quit;

b. Reduced exercise periods for stock options post-employment;

c. The confidence or hubris that the current CEO has that he/she
can drive up the stock price more than his replacement;

d. Large amounts of company stock ownership that have the same
impact as (c) above;

e. Pension values that are discounted for early departure;

f. Non-competes, which can make it nearly impossible to go to a
competitor;

g. Reputational risks and other factors.
There seems to be little doubt that voluntary terminations — i.e., quits — would be substantially higher, perhaps 3% to 5% per annum instead of the 1% reported level, without the above deliberate strategies to lock the executives into their companies. Thus the use of peer groups can be justified to quantify the opportunity cost of remaining with the current employer. However, companies should not, and typically do not, robotically follow the peer group data. Further, the SEC and ISS strongly encourage the use of peer data as good governance.

There also are structural/institutional reasons why executives do not quit more often for greater employment opportunities elsewhere. Some of these phenomena put upward and others, downward pressure on pay.

From the perspective of the employer, the board considers its greatest accountability to be management, particularly CEO, succession. In a large-cap company, CEO turnover can be disruptive and have very volatile impact on the stock price, to the tune of billions of dollars. Since the board members are part-time, it is in the interests of all shareholders to avoid that disruption and volatility by offering extra compensation, which as a matter of economics is probably only a dozen basis points of the market cap of the company (i.e., .12%, or $1.2 million of pay per $1 billion of market cap). In addition, the business judgment rule appropriately covers a board that does its best to retain its top executives, even if there is some additional cost associated with that, as the benefits to shareholders are enormous. Business judgment is also required in recruiting a top executive who has the appropriate background to ensure the highest likelihood of success. While the public may think, “Anyone could do that top job,” this is absolutely incorrect. There are precious few examples of people moving into a top job without experience as an executive at a major company.

Both private equity companies and private family companies with concentrated ownership tend to have board members who devote substantially more time and attention than public company directors to the companies that they own. Importantly, it is further proof of a competitive labor market that they also recruit from the same public company executive pool, use the same type of peer groups to help set pay opportunity, and pay their executives in a highly similar manner to public companies, both quantitatively and qualitatively. In many leveraged buyouts, the management team is left intact (albeit with the
requirement that its members roll over some of their equity holdings) and is the same management team that ultimately takes the company public again in the exit strategy.

However, there are also some factors that put downward pressure on CEO pay. From the perspective of the recruiting company, there are many risks in recruiting an outsider into the CEO role, ranging from personality fit and cultural “tissue” rejection to a very large buyout package. There is also external pressure from ISS, the media, academics and some shareholders to use internal candidates to replace the CEO. Further, most major companies have worked diligently on their management development and succession processes, including for the CEO position, and have created very strong benches to back up their key positions. All of these factors are part of the explanation for why the percentage of internal CEO promotions has risen from 60% of CEO replacements to 80% over the past decade. These put downward pressure on pay.

Elson and Ferrere also argue that many of the skills of a long-tenured executive are highly specific to his or her current employer and thus are not transferrable. There may be some validity to this. However, critics draw the further implication that executives are not generally transferrable and therefore comparisons of executive pay among peer companies is misleading, unnecessary and inflationary. This is contradicted by the record of many executives’ taking their general management knowledge from one company to another and quickly learning the new company. The result has frequently been a high level of executive performance.

Of course, in human capital (HC) theory, this concept of “firm-specific HC” has been well researched; both the employer and the employee benefit, and thus need to split the difference. However, the authors of this (Elson and Ferrere) argue that this vitiates the need for peer groups and setting pay at the median. They agree with the “split the difference” approach, but as was discussed at the Elson conference [on peer groups, Weinstein Center on Corporate Governance, May, 2012], how do you split the difference without a starting point, which requires peer group data from proxies?
6. CRITICISM: **Executives set easy/soft financial goals for their cash and stock incentive plans.** These goals are endorsed by feckless, compliant and complacent directors. These goals are frequently set below the company’s own external earnings guidance as well as below the consensus of analyst expectations for the company. As a result, these cash and stock incentives pay out above the “target” dollar or stock payout level for the plan. Despite these large payouts, the achievement of these soft goals translates into weak or actually negative stock price appreciation.

   RESPONSE: **Mostly myth**

   It is true that on the average annual and longer-term stock incentive plans do tend to pay out at or above target level. Are these target payouts due to strong operating performance that is at or above challenging targets? Or is it weak performance that is above an easy goal? Our research and experience is that these target payouts are due to the former — strong absolute and relative performance. We have seen at clients and in the research that payouts are correlated with TSR, meaning that as a general matter companies with higher payouts tend to have above-median TSR, and companies with lower payouts have lower TSR. This indicates that the operating performance (EPS, operating income, cash flow, revenue growth, etc.) is correlated with both TSR and payouts, and that the model is working as intended. Our research shows that companies generally set incentive goals above guidance and at or above analyst expectations, another indication of their difficulty. Our client work comparing incentive goals to detailed analysis of historical and prospective performance also indicates that for most companies, financial goals are challenging.

7. CRITICISM: **These executives are rarely fired for poor performance, and boards are slow to act on poor performance. The executives are equally highly paid for both success and failure.**

   RESPONSE: **Myth**

   CEOs are indeed fired for failure and are *not* entrenched. A number of studies find that between 2% and 2.5% of major company (typically S&P 500) CEOs are forced out each year. There are many examples where the boards at major companies, with well-known CEOs, terminated the CEO due to colos-
sal failures of strategy, declining stock prices over several years, bankruptcies, forced mergers and the like.

These terminated CEOs typically work at underperforming companies in underperforming industries, demonstrating that boards are in fact highly sensitive to overall corporate performance. One study evaluated 1,627 CEO turnovers of all types from 1993 to 2001. They found that TSR for the prior 12 months for the companies with the nearly 400 forced-out CEOs was minus 18%, far below the median TSR of all companies in the study.

Excessive cash severance, 280g gross-ups and other shareholder irritants regarding severance, however, need to be examined carefully, and eliminated over time. While these programs had utility in their day, the current governance environment makes them a distraction from the true pay-for-performance story.

8. CRITICISM: U.S. CEOs are overpaid relative to equally high-performing CEOs in other countries.

RESPONSE: Mostly myth

There are logical reasons why U.S. CEOs are paid more than their counterparts in other countries. In a seminal paper [“Are U.S. Top Executives Paid More? New International Evidence,” by N. Fernandes et al., ECGI working paper, 2012], the authors found that using raw data of 3,000 CEOs in 14 countries, the U.S. executives were indeed paid a 75% premium over the average of the other countries. This differential effectively disappeared to zero after adjustments were made for size, industry, performance, volatility, ownership, governance and, most importantly, the higher amount of risky stock-based incentives in the U.S. packages.

Do these higher and riskier (to the executives) stock incentives yield a positive return to shareholders? While this study does not address that question, Pay Governance research using realizable pay indicates that the answer is yes, as primarily the companies with the highest realizable pay tend to be those with the highest relative performance.
This study also found that executive pay packages in many countries are converging upon U.S. levels including higher levels of stock-based incentives, another data point in support of the efficiency of the CEO labor market. This convergence is driven by non-U.S. companies becoming more international in scope (e.g., more international sales) and incorporate more U.S.-style governance features, including increased institutional ownership, trading on the U.S. stock exchanges, board members with U.S. board experience, etc.

In a separate study also in support of this explanation, executive pay packages in the U.K. are rising even more rapidly than in the U.S. and are closing the gap. And the U.K. has had SOP since 2002, with some profound changes, not all of them desired by shareholders. [Jeffrey N. Gordon, Harvard Journal on Legislation, 2009] Thus these say-on-pay votes in both the U.S. and the U.K., for all of the other benefits they may bring to shareholders, are not achieving the original goal of these regulations, namely reducing executive pay, arguably because of the robust nature of the labor market.

9. CRITICISM: The executive pay model in the financial sector — high current cash compensation, low stock grants and stock ownership, insufficient deferrals — motivated short-term thinking and excessive risk taking. The historical Wall Street partnership model would have been far superior in controlling risk taking, and thus substantial new “risk controlling” regulation is required.

RESPONSE: Mostly myth

The criticism is that the emphasis on short-term profits and stock price appreciation motivated executives to deliberately undertake excessively risky strategies and drive up their stock prices so as to increase their annual cash bonuses and the value of their stock options. These executives deliberately over-leveraged their balance sheets and allegedly did not care about the long term as long as they received their short-term cash. These strategies included making risky mortgages, packaging and holding or selling bad mortgage bonds, inappropriate hedging and the like.
Yet there is no empirical evidence linking executive pay at Wall Street firms during the 2008–09 financial crisis to undertaking excessive risk deliberately. There is, however, a growing academic literature that shows that:

» Executives held enormous amounts of stock that, while mitigating moral hazard, did not prevent a colossal error in determining the true risk;

» Many, if not most, aspects of the conventional wisdom on executive pay and risk — e.g., high cash and stock options — are not in fact associated with excessive risk;

» Many of the proposed new policy prescriptions — deferrals and increased stock ownership — were already in place and did not work to prevent the crisis;

» Many of the existing programs were explicitly designed to mimic the best features of the historical partnerships;

» The pay programs at all of the Wall Street firms — both successful and unsuccessful — were essentially identical.

Wall Street CEOs lost billions of dollars of value in their own stock in the worst part of the crisis in 2008, with two CEOs losing nearly $1 billion each primarily due to overconfidence in their companies. Further, the employees at these companies owned tens of billions of dollars of stock representing 25% or more of the market cap, much of it vested, indicating their optimism about their employers, and consistency with a partnership model.

In their article “Is There a Case for Regulating Executive Pay in the Financial Sector,” Core and Guay [Working Paper, 2010] conclude, “… although we agree broadly with regulators’ views on the principles that should guide executive compensation practices, we believe that many of these principles are already engrained in the typical executive compensation plan” [emphasis added].

It is essential, however, to acknowledge as a reality and a valid criticism that the executive pay model did not motivate most executives to find the true risk in their balance sheets. This would have required these executives to override their
risk models, which at the time were signaling “safety” rather than “calamity.” Apparently, very few did that.

We also need to acknowledge the possibility that other highly paid employees—not executives, but originators of CMOs, CDs and the like — may have undertaken excessive risk with the balance sheets of their employers as they personally had more upside than downside. The real downside belonged to the Treasury, the Fed, the FDIC and, ultimately, the U.S. taxpayer. This type of asymmetrical risk and reward — called moral hazard by economists — needs to be addressed by companies, perhaps with policy changes.

10. CRITICISM: **Executive do not own enough stock to be aligned with the shareholders.**

RESPONSE: **Myth**

Executives at major U.S. companies own a great deal of stock. Our study of executive pay and stock ownership showed that in 2010, the median large-company CEO at 365 companies owned $16.5 million worth of stock. Their vested and unvested stock grants probably yielded an effective “carried interest” of more than $30 million. Of course, these are large market-capitalization companies and therefore these large dollar amounts do not represent a large percentage of ownership (typically 20 to 30 basis points), but when an employee owns that much stock they are highly aligned with the shareholders and highly motivated to create long-term shareholder value. The 75th percentile ownership was more than $35 million plus stock incentives.

Our research has shown that stock ownership has increased significantly over the past 15 to 20 years. Data from 1994 to 2010 shows CEO stock ownership has grown from around $3.5 million to the $16.5 million shown above, a growth rate much higher than the increase in stock prices. This shows a concerted effort to increase ownership.

These high and rising levels of ownership in fact show up as highly correlated with high levels of performance, as high-performing companies tend to have higher ownership than lower-performing companies. In addition, virtually all
large companies have stock ownership guidelines for their executives, which have increased stock ownership substantially.

Interestingly, and somewhat ironically, ISS and other executive pay critics, including some union pension fund shareholders, give no credit at all to the impact of stock ownership on performance and risk assessment. We think a case can be made that executive stock ownership is more important for motivating superior performance than annual compensation.

11. CRITICISM: Excessive executive pay is part of the cause of the “income inequality” problem and debate that is raging in the political world.

RESPONSE: Mostly myth

This is a problem that cannot be fixed inside the boardroom, but some data and logic helps put this in context.

This criticism has two aspects to it that are important for executives and board members to understand:

a. The high and rising corporate executive pay takes money away from the rest of the labor force.

b. The high CEO pay multiple is “unfair” to the rest of society and demotivates the labor force.

The sociological problem of income inequality and its impact on the economic mobility and overall culture and fairness of the U.S. is beyond the scope of this book. However, we are not aware of any studies that demonstrate that the high level of income inequality damages our economy. In fact, some of the prior economic analysis shows that the U.S. economy continues to outperform the European economy, which has lower inequality. Further, we estimate that the total CEO pay in 2011 for the S&P 500 companies was between $5 billion and $10 billion. If that amount was reduced by 50% and transferred to others via higher taxes, its impact would be far less than .1% of the total output of the U.S. economy.

However, it is most likely correct that growth in pay levels and the number of corporate executives explains a major part of the increase in income inequality
in the U.S. [“Jobs and Income Growth,” by Jon Bakija, 2010]. If there is indeed a competitive labor market and significant pay for performance, then the executive pay model that created that high pay for executives has also benefited the corporations and arguably all of society.

If that growth is caused by poor corporate governance — that is, if those executives “unfairly” made it into the top .1% by being overpaid — that may be an economic and corporate problem. However, even if there is a competitive labor market for executives, there still could be a sociological problem, although one that the corporations themselves cannot solve.

The data from 1979 to 2005 on public and private companies in this study is further support for the competitive labor market. In other words, it was not poor governance that yielded the high pay for the executives. Basically the research in this important study, using tax data, shows that the share of total national income of the top .1% of taxpayers attributed to executives from publicly traded companies has declined dramatically over that period. Meanwhile, the private companies’ (closely held) proportion rose significantly. This means that while there are many factors for this (including a switch from C to S corporations due to tax reform), the total income for executives at private companies was also growing impressively. Generally, private companies have more concentrated ownership and board members as major investors, and thus agency and governance problems at those private companies are not as pronounced as those of public companies. Since private company executives, overall, are paid similarly to those at public companies, it seems unlikely that income inequality was caused by the public corporate pay model

As a counterfactual thought experiment, would the U.S. have been wealthier if the U.S. executive pay model had mirrored historically the pay model of Western Europe and Japan? Perhaps income inequality would have been reduced, but on an absolute basis, all might have been poorer. A recent United Nations study [“The Real Wealth of Nations,” Free Exchange, The Economist, June 30, 2012] evaluated the total wealth of nations — human, physical and natural capital. The U.S. total wealth of nearly $120 trillion was nearly equal to the total aggregate wealth of the next five richest countries.
The high and rising level of income inequality in the U.S. indicates that we need to increase the return on the human capital for the average U.S. employee, which depends on training, education, a strong economy, exports, etc., all of which are high barriers to solving this problem. A regulatory reduction in CEO pay — via a cap, for example, as tried in Section 162(m), or much higher tax rates — will not increase the pay of the average employee and arguably might reduce the performance of the company, thereby reducing everyone’s pay.

12. CRITICISM: The highly positive Say on Pay votes of 2011 and 2012 were misleading and did not truly indicate that the shareholders endorsed the executive pay model. One New York Times columnist (Nicholas Dav- idoff) said that the shareholders “do not care enough to express their opinion strongly,” as only eight large companies failed their SOP votes in 2011. The pay-for-performance models of the proxy advisors (ISS, etc.) are truly indicative of alignment of pay to performance.

RESPONSE: Myth

As we said above, 98% of thousands of major companies received an endorsement of their executive pay programs from shareholders in their 2011 and 2012 SOP votes. The shareholders overall agreed that there was indeed substantial pay for performance at most companies. This is clearly an endorsement of the overall model, but it has nevertheless not quieted the critics. The argument that shareholders “do not care enough” to vote against these pay plans is preposterous and sour grapes, and violates the principle of Occam’s razor, namely, that the best explanation is usually the simplest one. These positive votes are clearly an approval of the overall nature of these pay plans.

Pay Governance research on the proxy advisor models draws the following conclusions:

a. Even the proxy advisors endorse nearly 90% of CEO pay packages.

b. In the nearly 10% of the cases where ISS found a failed pay-for-performance approach, our realizable pay model found alignment, indicating a false negative and possible undeserved SOP problems.
c. The shareholders reject ISS’ “against” recommendation 85% to 90% of the time, supporting these companies, though with fewer “yes” votes in these instances.

THE REMAINDER OF THIS BOOK

This book is organized to provide two things for our clients and other readers:

1. Additional empirical and logical support to combat the mostly incorrect criticisms described above;

2. Ideas for designs, methodologies, governance enhancements, disclosure and related items that will allow boards and their executive teams to address the swirling criticisms of executive pay in the current say-on-pay environment, which is filled with mythology and misinformation. Our goal always is to help our clients balance the tension between ensuring a highly motivated executive team and long-term shareholder value creation.
CHAPTER TWO
CEOS ARE PAID FOR PERFORMANCE
BY IRA T. KAY AND BRIAN LANE

Criticism: “Pay packages at the individual company level are not related to corporate performance.”

Response: Myth

INTRODUCTION

Is CEO pay aligned with performance? The long-standing criticism among many is that pay packages at the individual company level are not related to corporate performance. Our research, along with many academic studies over the past decade, has shown time and again that this criticism of pay packages being unrelated to corporate performance is a myth. Our latest research, using 2012 proxies for 300 large companies, supports these findings: Higher-paid CEOs work at higher-performing companies, and lower-performing companies reward their CEOs with lower compensation.

The constant controversy around executive pay, heightened amid the recent economic downturn and resulting Say on Pay votes, has perpetuated this criticism. Various commentators — including mass media organizations, the public, regulators, other government officials and some shareholders — believe that CEO pay is generally not proportionate with corporate performance. These critics claim that, in many cases, CEOs of low-performing companies are paid as
much or more than those of high-performing companies, and they view this lack of alignment as being extremely unfriendly to shareholders. Furthering the overall confusion about the alignment between pay and performance is that there is no universally accepted methodology — among the SEC, academics, the media and shareholders — for evaluating alignment.

There is a fundamental misunderstanding of the difference between pay opportunity or target pay and realizable pay and which of the two should appropriately be compared directly to the performance of the company, especially the stock price. We discuss this in detail below, but opportunity is set by the compensation committee annually and represents the grant date value of the stock and cash incentives. It is typically determined in comparison to market data and may or may not reflect recent stock price performance. Realizable pay represents the actual incentives paid out and the value of the stock grants at the end of their performance period. We think it is the ideal pay number to compare to company performance. This compelling logic is encouraging many companies, their institutional investors and proxy advisors (ISS) to incorporate realizable pay into their analytics.

At their core, CEO pay programs are typically designed to align with performance, up or down. The majority of value for a typical CEO pay package is tied to or can only be earned contingent on performance (stock price or other measures). On average, 80% or more of CEO annual pay opportunity is based on annual or long-term performance based incentives. Adding the millions of dollars the typical CEO holds in company shares to these short- and long-term incentives shows that large amounts of the individual’s wealth are tied to the performance of his/her company. In short, these cash and equity (stock and option) portfolios provide U.S. CEOs with strong incentives, as found by Core, Guay and Thomas in their 2005 study “Is U.S. CEO Compensation Inefficient Pay without Performance?” This performance relationship is borne out using realizable pay.

Our realizable-pay methodology is a logical and robust formula that any company can use to demonstrate that the interests of the executives and shareholders are aligned via the compensation program, especially stock-based incen-
Our recent research discredits the criticism by demonstrating that, when the appropriate pay metric is used, there is no factual basis for it. Findings show strong alignment of realizable CEO pay with companies’ stock-price performance: CEOs at high-performing companies earned higher realizable pay than their counterparts at low-performing companies. As shown in Table 2.1, cumulative realizable total direct compensation (TDC = base + annual incentives + long-term incentives) for CEOs at high-performing companies over three years was $35 million, 72% higher than that of CEOs at low-performing companies. Their performance was also proportionately higher. We have found similar alignment in other studies we have conducted over the past decade.

Our findings are also consistent with academic research on CEO pay conducted in recent years. By looking at actual pay, which they distinguish from pay opportunity or “theoretical pay,” Kaplan and Rauh (2008) find, “There can be absolutely no doubt that the typical CEO in the United States is paid for performance” (Kaplan, “Are U.S. CEOs Overpaid?” Academy of Management Perspectives, 2008). Specifically, as highlighted in the September 8, 2012, article from The Economist, “Bargain Bosses: American Chief Executives Are Not Overpaid,” they find that, over three-year periods, companies with CEOs that have actual pay in the top quintile (top 20%) generate returns that are 60% greater than those of other firms in their industries. Conversely, firms with CEOs in the bottom quintile (lowest 20%) of actual pay underperform their industries by 20%.

ANALYSIS AND DISCUSSION

In our 2012 study, the difference in realizable pay between high- and low-performing companies correlates with a wide disparity in total shareholder return (TSR). Three-year TSR for high-performing companies was 31.4%, compared with 7.6% for the low-performing companies. For the typical $10 billion-market-cap company, this disparity corresponds to a difference of about $10.3 billion in valuation over three years.
The challenge for companies to demonstrate such alignment in their proxies to shareholders became especially critical with the advent of Say on Pay (SOP) in 2011. These votes have empowered proxy advisory firms — e.g., Institutional Investor Services (ISS) and Glass Lewis — and created additional complexity and concern for companies and their compensation committees. In 2011 and again in 2012, many companies enhanced their pay-for-performance linkage and explained their philosophies on the subject to shareholders. In some cases, these disclosures provided shareholders with insights into the analyses conducted to assess this linkage.

Shareholders have reacted positively. Overall, they agreed that pay was indeed aligned with performance at most companies, as evidenced by their SOP votes. In these votes, more than 98% of companies received a shareholder endorsement of their executive pay programs in 2011 and 97% in 2012.

Nevertheless, whether a given pay program has strong pay/performance alignment remains the subject of debate among different interests, primarily because there is no definitive way to demonstrate it. Further, though the SEC may soon require the disclosure of the relationship between performance and pay actually earned by named executive officers, it is not clear how the agency would structure this requirement.

At its core, assessing pay/performance alignment involves answering three key questions:

1. What is the best way to measure CEO pay in the context of assessing pay/performance alignment?

2. Are CEOs at high-performing companies highly paid relative to those at low-performing companies?

3. What are the primary factors that can misalign CEO pay and corporate performance?

We address each of these questions in turn.

1. What is the best way to measure CEO pay in the context of assessing pay/performance alignment?
There are several different ways to measure executive pay. These include:

- **Pay opportunity.** Target cash compensation and the value of equity incentives on the date of grant (generally, as represented in the Summary Compensation and Grants of Plan Based Awards Table of a company’s proxy statement). The sum of target cash opportunity and equity grant opportunity is also known as target total direct compensation.

- **Realized pay.** Actual cash earned, the value of exercised stock options (as opposed to the value at grant) and the value of vested shares. The value of realized pay is approximately the same as actual pay, which is part of W-2 earnings.

- **Realizable pay** (the method we prefer). The sum of actual cash compensation earned, the aggregate value of in-the-money stock options, the current value of restricted shares, actual payouts from performance-share or -cash plans, plus the estimated value of outstanding performance-share or -cash plans.

Realizable pay is the best measure for assessing alignment, as it is a truer representation of the value attainable by an executive in a given time/performance period than is pay opportunity or realized pay.

This is because realizable pay allows for comparisons of pay and performance over concurrent time periods — i.e., performance over a certain three-year period has yielded a value of realizable pay over the same three-year period. By contrast, pay/performance alignment assessments that use pay opportunity are thrown out of kilter because the time periods are not aligned. Pay opportunity, which is set on the date of grant and does not change over time, is typically measured at the beginning of a period and compared to performance through the end of the period (performance that has no bearing on the determination of that opportunity in the first place). This is the methodology used by proxy advisors like ISS in their pay-for-performance tests.

For this reason, when working with our clients on specialized pay/performance studies of their industries and in conducting broad research, we have consistently used realizable pay. Typically, we make comparisons over three-year periods, though we have used longer time spans, capturing individual executives’
compensation over their entire careers. In these studies, we have found alignment between realizable pay and corporate performance at a preponderance of the hundreds of companies evaluated. This is largely because these companies’ compensation packages contain substantial amounts of stock-based incentives.

ISS uses its own version of pay opportunity — including new grants of stock options and full-value shares — for its renowned, widely scrutinized and highly controversial pay-for-performance test. Much to the dismay of their boards, hundreds of companies have failed this test. These results showed high or rising pay (based on opportunity) but a recently declining stock price and/or low returns to shareholders relative to the ISS-defined comparator groups.

At many companies that failed this test, confusion and consternation ensued because this failure ran contrary to the pay experience of executives and their boards. These executives experienced lower pay due to underwater stock options, forfeited performance-share grants and shrinking cash bonuses — all paralleling low or negative returns to shareholders. Accordingly, realizable executive pay at these companies was indeed correlated with corporate performance. Yet the ISS test failed to reflect this reality because it did not measure realizable pay. Unlike the ISS methodology, analyses using realizable pay can identify scenarios involving declines in executive pay that are concurrent with declines in shareholder returns.

2. Are CEOs at high-performing companies highly paid relative to those at low-performing companies?

We conducted a pay/performance study that examined three years (2009–2011) of pay and performance of CEOs at 295 S&P 500 companies who had been incumbent for three or more years. The study was limited to companies that had filed proxy statements and had held SOP votes by June 30, 2012. The median revenue and market capitalization of these companies were $8 billion and $11.4 billion, respectively.

Contrary to the claims of compensation critics, there was a strong relationship between pay and performance, as reflected by realizable pay. CEOs at high-performing companies — as indicated by above-median total shareholder return (TSR) — had significantly higher realizable pay values (72% higher) than their
low-performing counterparts. High-performing companies delivered shareholders a median return of 31.4%. The typical CEO of the high-performing companies received $35 million in aggregate realizable total direct compensation over the three years reviewed, which was 138% of his or her pay opportunity. The low-performing companies had TSR of 8%, and hence, CEOs received realizable pay of “only” 84% of the value of granted LTI opportunity. These differences are economically and statistically significant.

The analysis in Table 2.1 bifurcates the sample of companies according to performance (i.e., high TSR means TSR above the overall median) and shows the median values of three-year TSR and realizable TDC and the ratio of realizable TDC value to opportunity for each of the high- and low-performing subgroups.

Significantly, when pay opportunity is used instead of realizable pay, the pay/performance relationship reverses. The CEOs granted higher levels of pay opportunity are actually those working at low-performing companies — though we know from the data in Table 2.1 that pay and performance are actually aligned. Unfortunately, this comparison is the one often cited by shareholder advocacy groups and media organizations to support their criticisms when railing against executive pay. Table 2.2 shows that CEOs at low-performing companies were granted three-year aggregate TDC of $24.6 million, compared to $23.4 million for their counterpart CEOs at high-performing companies.

<table>
<thead>
<tr>
<th>Group</th>
<th>Count</th>
<th>Total Shareholder Return (TSR)</th>
<th>Realizable TDC Value</th>
<th>Ratio: Realizable TDC Value to TDC Opportunity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies with high TSR</td>
<td>147</td>
<td>31.4%</td>
<td>$35.2M</td>
<td>1.4X</td>
</tr>
<tr>
<td>Companies with low TSR</td>
<td>147</td>
<td>7.6%</td>
<td>$20.4M</td>
<td>0.8X</td>
</tr>
<tr>
<td>All companies</td>
<td>294</td>
<td>17.6%</td>
<td>$26.6M</td>
<td>1.1X</td>
</tr>
</tbody>
</table>
We have in fact found in separate studies that testing pay-for-performance alignment using pay opportunity (as does ISS) can lead to situations that we call false negatives — companies with CEOs whose pay opportunity is not aligned with performance, but whose realizable pay is well aligned. Our research suggests that about 10% of companies fall into this category.

There are perfectly logical situations in which pay opportunity may not be correlated with performance but realizable pay would be aligned, all of which strengthens the overall alignment of pay with performance but might be overlooked by a pay-for-performance assessment that uses pay opportunity as opposed to realizable pay:

- **Attraction and motivation of new hires.** Premium compensation may be required to bring in a new externally hired CEO, which would unnaturally increase pay opportunity for the year of the hiring. However, a well-designed and performance-based new hire package could lead to aligned realizable pay.

- The effect would be similar for *additional incentives to achieve turnaround goals or retain high performers at critical junctures.*

- **High concentration of equity in TDC or a high concentration of options in LTI.** By way of an extreme example, compare a CEO granted a pay opportunity of $1 million in base salary to a CEO granted an all-option pay opportunity, also of $1

<table>
<thead>
<tr>
<th>Group</th>
<th>Count</th>
<th>Total Shareholder Return (TSR)</th>
<th>Cumulative TDC Opportunity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Companies with high TSR</td>
<td>147</td>
<td>31.4%</td>
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</tr>
<tr>
<td>Companies with low TSR</td>
<td>147</td>
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<td>$24.6M</td>
</tr>
<tr>
<td>All companies</td>
<td>294</td>
<td>17.6%</td>
<td>$24.2M</td>
</tr>
</tbody>
</table>

**TABLE 2.2**

Relationship Between Company Performance and LTI Opportunity
million. Thus, pay opportunity is equivalent for both CEOs. But in a scenario where stock price falls by 10% for the two example companies, our first CEO would still hold $1 million in realizable value after the drop in stock price, whereas our second CEO holds $0. The outcome for our second CEO is much more aligned with the shareholder experience.

- **The presence of well-defined and challenging performance goals in metrics that are correlated to TSR.** These goals would dictate the value of pay earned (realizable) after the grant date opportunity has been determined. Worse performance in these metrics or against these goals would yield lower realizable pay, and conversely, the better the performance, the higher the realizable pay (up to plan maximums). This is in comparison to an opportunity that remains static at grant, regardless of subsequent performance. Further, if the metrics are well correlated to long-term TSR, shareholders can expect their returns to directionally follow internal company performance, leading to good alignment between shareholders and executives.

- **After-the-fact adjustments to incentive plan payouts (via a TSR modifier or committee discretion).** Some companies in the aftermath of the 2009 economic downturn implemented and exercised discretion in payouts to ensure alignment with the shareholder experience even if operational performance was above target.

Nevertheless, this is an area that individual companies and their compensation committees need to monitor carefully, as it affects disclosure, SOP votes and ISS recommendations.

Though the distinction between pay opportunity and realizable pay is clearly critical, it does not receive due attention. All too often, that attention is trumped by pay opportunity, as it is readily available in the proxy Summary Compensation Table. Realizable pay, on the other hand, requires some calculations using several tables in the proxy.

Committees determine pay opportunity using market data, typically setting it around the median of their markets. Though recent stock-price performance
should be considered, market data is considered to be far more important. Nonetheless, the amount of compensation that is ultimately realizable from granted opportunity is highly dependent upon future stock price and corporate financial performance.

While many committees expect realizable pay to be significantly affected by these future performance factors, they understand opportunity to be relatively immune to recent stock price performance. Hence, seeking to encourage executive performance, they tend to focus on two things that are under their direct control: (i) setting the level of pay opportunity appropriately and (ii) ensuring that the design of pay elements is primarily performance-based.

Most committees operate these two levers skillfully, leading to their companies’ exhibiting alignment between realizable pay and performance. Some companies, however, face challenges in this area. Our research has shown that setting pay opportunity too high or too low can damage their perceived pay/performance alignment.

3. What are the primary factors that can misalign CEO pay and corporate performance?

Two factors that drive the amount of executive realizable values, in addition to actual company performance, are the level of pay opportunity set at grant and the design of the executive’s pay program (e.g., the mix of cash vs. equity, type of LTI vehicles being delivered, and whether the vehicles are more or less performance-based). Reviewing realizable pay allows us to also analyze the relationship between these factors, as well as how they relate to realizable pay values.

Table 2.3 shows that pay opportunity that is set too high or too low has the potential to damage the pay and performance relationship. A CEO with a top-third (i.e., above the 67th percentile) pay opportunity will earn 77th percentile realizable value even if his/her company provides only middle-third returns to shareholders (at a median TSR of 19.8%). In other words, a relatively high pay opportunity had the effect of insulating the CEO’s realizable pay from middle-of-the-pack shareholder return. Conversely, for the CEO with pay opportunity in the bottom third (below the 33rd percentile, at a median of $6.7M) even top-third TSR performance (median of 40.1%) over the three-year
period will not yield realizable pay that is above median. A review of this cross section of this CEO’s TSR performance (top third) and pay opportunity (bottom third) shows that the resultant rank of realizable LTI value will be at the 48th percentile.

Appropriate program design and proper pay leveling can mitigate the misalignment between pay and performance at high and low levels of pay opportunity.

**TABLE 2.3**

Pay Opportunity and Company Performance Driving LTI Realizable Value Results

<table>
<thead>
<tr>
<th>Companies with LTI Opportunity in the...</th>
<th>Companies with three-year TSR in the...</th>
<th>Median LTI Opportunity</th>
<th>Median Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Bottom Third</td>
<td>Middle Third</td>
<td>Top Third</td>
</tr>
<tr>
<td>Top Third</td>
<td>44th Percentile</td>
<td>77th Percentile</td>
<td>90th Percentile</td>
</tr>
<tr>
<td></td>
<td>$20.4M</td>
<td>$13.0M</td>
<td>$6.7M</td>
</tr>
<tr>
<td>Middle Third</td>
<td>28th Percentile</td>
<td>54th Percentile</td>
<td>77th Percentile</td>
</tr>
<tr>
<td></td>
<td>$13.0M</td>
<td>$3.0B</td>
<td>$2.1B</td>
</tr>
<tr>
<td>Bottom Third</td>
<td>10th Percentile</td>
<td>35th Percentile</td>
<td>48th Percentile</td>
</tr>
<tr>
<td></td>
<td>$6.7M</td>
<td>$2.1B</td>
<td></td>
</tr>
<tr>
<td>Median TSR</td>
<td>5.2%</td>
<td>19.8%</td>
<td>40.1%</td>
</tr>
</tbody>
</table>

The analysis in Table 2.3 focuses on the 126 companies with revenue less than $5 billion in our analysis and first divides companies into nine buckets based on which tercile their pay opportunity and TSR fit into, each bucket containing ~14 companies. The nine table entries provide the resulting percentile rank of the median LTI realizable value for the 14 CEOs in each bucket. We found very similar results when we tested larger (i.e., greater than $5 billion in revenue) companies as well.

**CONCLUSION**

Creating and demonstrating close pay/performance alignment requires far more than making decisions about and disclosing pay-opportunity levels. Committees must not only determine market-competitive pay opportunities to at-
tract, motivate and retain executive talent, but also ensure that compensation programs reflect corporate performance and describe their programs as such in annual proxy statements.

In this new, highly sensitive disclosure environment, companies must communicate this flexibility convincingly to shareholders who now, at most companies, perennially voice their concerns in SOP votes. As we await the SEC’s decision on pay/performance disclosures, committees should proactively assess alignment using realizable-pay analyses.

ADDENDUM: FIVE-YEAR PAY-FOR-PERFORMANCE STUDY

As we referred to earlier, we also study the relationship between pay and performance over time periods longer than three years. The following pages summarize a recent study of pay and performance alignment over five years for a group of long-tenured Fortune 500 CEOs.

Additional Research: Five-Year Analysis of Pay for Performance, by Lane Ringlee and John Sinkular

- As the second year of Say on Pay confirmed, companies, proxy advisory firms and investors use varying methods to determine if CEO pay is aligned with performance.

- While total shareholder return (TSR) may not be a perfect measurement of firm performance, particularly on a short-term basis, it is widely agreed that it is the best measurement of firm performance over the long term and is directly aligned with shareholder interests.

- Summary compensation table pay (SCT pay) from proxy disclosure (i.e., pay opportunity) has been proven to have poor alignment with total shareholder return and financial performance underlying compensation committee pay decisions, yet currently it forms the basis of proxy advisory firms’ assessments of pay and performance and their vote recommendations for Say on Pay proposals.
• Pay Governance’s five-year assessment of CEO compensation and TSR confirms that realizable pay has the strongest correlation with TSR and is the most appropriate single measure of pay for determining alignment with performance.

• Pay Governance’s research also finds a strong correlation to TSR for a combination of two different pay definitions: the ratio of (i) realizable pay to (ii) pay opportunity.

INTRODUCTION

In order to determine the composition of pay with the strongest correlation to long-term performance, Pay Governance analyzed the base salary, cash and equity incentives provided during 2007–2011 of a constant sample of long-service chief executive officers (CEOs) among Fortune 500 companies. Base salary and the actual annual incentive/bonus payouts were added to long-term incentives, which were valued in two different ways, resulting in the following definitions of pay:

• Pay Opportunity (with LTI valued based on grant date opportunity): Includes the grant date (accounting) value of awarded long-term incentives, with performance cash/share awards valued assuming target, not actual, performance.

• Realizable Pay: Earned long-term incentive grants are valued at the end of the examined period, based on each company’s closing stock price on March 31, 2012. For long-term performance plans we used the actual payout for completed cycles, otherwise we assumed target performance.

• Ratio of Realizable Pay to Pay Opportunity.

METHODOLOGY

We conducted a five-year analysis (2007–2011) of CEO compensation and total shareholder return for 27 U.S. companies that are components of the Fortune 500. These companies are unique compared to other studies of CEO
compensation in that all have had the same executive occupying the CEO role for the past decade to minimize the impact of unusual cash and equity award practices. To develop this group, we also excluded companies that had consummated meaningful acquisitions or mergers — transactions that resulted in a greater than 25% increase in sequential year-over-year revenues.

The study companies had median fiscal 2011 revenues of $8.9 billion and median market capitalization of $11.3 billion, as of March 31, 2012, and filed 2011 proxies by April 2012. To increase the homogeneity of the group, we removed companies from our original scan that were “outsized” to minimize the impact of size on compensation opportunity; this resulted in a range of revenues from $5.4 billion to $20.0 billion.

FINDINGS

1. Realizable pay has a strong relationship to TSR performance

We compared realizable pay and TSR performance at the end of the five-year period and found that high-TSR-performing companies have corresponding high levels of realizable pay (RP). Similarly, when we indexed TSR to the returns of the S&P 500 index, we found a very similar relationship of pay and TSR performance. Pay disclosed in the proxy — Pay Based on LTI Opportunity — has a weak correlation to TSR. This is mostly explained by the manner in which compensation committees will set pay opportunity. CEO pay opportunity is set primarily based on market data and not on recent stock price performance. Committee members understand, however, that future stock performance will create the desired alignment with performance-based program design.

<table>
<thead>
<tr>
<th>Measure</th>
<th>Correlation to TSR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Realizable Pay</td>
<td>70%</td>
</tr>
<tr>
<td>Pay Based on LTI Opportunity</td>
<td>33%</td>
</tr>
</tbody>
</table>
2. High-TSR performers have realizable pay relative to pay opportunity that is more than 150% of that of low-TSR performers

To test our conclusions on realizable pay and linkage to TSR, we segmented the study group into high and low performers based upon five-year TSR. Based on five years of pay data for these companies, high-TSR performers had realizable pay that was approximately 160% of the low-TSR performers’ relative to pay opportunity.

3. The ratio of realizable pay to pay based on LTI opportunity has the strongest correlation to TSR

The strength of the realizable pay/TSR correlation was confirmed over a five-year time frame using the same constant sample of companies. In addition to the two pay definitions, we also analyzed the correlation to TSR performance using five years of data (2007 to 2011) of the ratio of realizable pay to pay based on LTI opportunity (Realizable Pay to Pay Opportunity, or RPPO), which determines how much incremental pay was created or pay opportunity not realized by the application of stock price performance. If the RPPO is 100%, then all of the pay opportunity was realizable (specifically, the accounting expense of the stock grants was equal to the realizable pay from the grants).

Our analysis found that RPPO has the strongest positive correlation with TSR performance. This is not surprising, since the RPPO pay ratio is exactly how performance-based pay elements work: The future value of pay is leveraged to stock price at that same point in time (realizable pay).

<table>
<thead>
<tr>
<th>Segment</th>
<th>Median 5-Year TSR</th>
<th>Total RP Relative to Low Performing Group</th>
<th>Total RP ($Millions)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Median</td>
<td>Average</td>
</tr>
<tr>
<td>High Performers</td>
<td>83%</td>
<td>159%</td>
<td>162%</td>
</tr>
<tr>
<td>Low Performers</td>
<td>19%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>-1%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### TABLE 2.5
CHART 2.6

5-Year Realizable Pay as % of Pay Opportunity Percentile vs. 5-Year TSR Percentile

R=81%

CHART 2.7

5-Year Pay Opportunity Percentile vs. 5-Year TSR Percentile

R=33%
4. Pay opportunity is not correlated to TSR performance

Over the examined five-year period (2007 to 2011) during which CEO realizable pay was found to have a meaningful positive correlation with TSR, we found that pay opportunity by itself is not correlated to TSR. In other words, the measurement of pay largely used to assess competitiveness or appropriateness of CEO compensation has a very weak relationship with firm performance. As discussed above, the strongest correlation to TSR performance is achieved by a combined pay metric: the ratio of realizable pay and pay based on LTI opportunity.

5. Incentive design impacts realizable pay

We also studied our segmented group to assess differences in pay practices to see if different emphases or strategies lead to different reward outcomes for higher-TSR-performing and lower-TSR-performing companies. It is important to note that both groups outperformed the S&P 500 over the five-year time frame. Not surprisingly, the higher-TSR-performing group had greater emphases on long-term incentives based on pay opportunity, but the overall mix of long-term incentives (options, restricted stock and performance plans) was relatively consistent across the two groups.

TABLE 2.8

<table>
<thead>
<tr>
<th>Segment</th>
<th>Mix of Pay</th>
<th></th>
<th>Mix of LTI</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Salary</td>
<td>AIP</td>
<td>LTI</td>
<td>Options</td>
</tr>
<tr>
<td>High Performers</td>
<td>13%</td>
<td>25%</td>
<td>62%</td>
<td>41%</td>
</tr>
<tr>
<td>Low Performers</td>
<td>14%</td>
<td>35%</td>
<td>51%</td>
<td>41%</td>
</tr>
</tbody>
</table>

Note: totals do not equate to 100% due to rounding
CONCLUSIONS

Until there is a consensus on the pay definition used for pay/performance comparisons, and as long as the proxy advisory firms use a different pay definition (which is inconsistent with using actual performance for the comparisons), it is important for companies to assess “pay” from several perspectives. However, as we demonstrated, the strongest correlation to TSR is realizable pay and, as such, it should be incorporated in each company’s annual review of pay.
CHAPTER THREE
EVALUATING THE ISS TEST OF CEO PAY FOR PERFORMANCE FOR SAY ON PAY VOTES: A COMPARISON OF PAY OPPORTUNITY AND REALIZABLE PAY
BY IRA T. KAY, BRIAN J. LANE, AND BENTHAM STRADLEY

EXECUTIVE SUMMARY

1. Our new research indicates that many large companies may receive “high concern” or “medium concern” ratings for pay-for-performance alignment — and in more extreme cases, “against” recommendations for Say on Pay (SOP) votes from Institutional Shareholder Services (ISS) — despite the reality that, when properly measured, their pay programs exhibit true alignment. This may adversely affect the outcomes of Say on Pay votes.

2. There are many ways to measure CEO pay and its alignment with multi-year company total shareholder return (TSR). Based upon our research, we believe that realizable pay is the preferable metric for this comparison. Value delivered — not value granted — should be aligned with performance. This is the distinction that boards, in designing pay programs, and executives, in receiving annual grants of pay opportunity, expect.
3. Studying CEO pay at large companies, we tested pay/performance alignment across all industries in two ways: (i) using realizable pay and (ii) using pay opportunity in a manner similar to the new ISS Relative Degree of Alignment (RDA) test. Using realizable pay, we found that more than 91% of large public companies have pay programs that are aligned with TSR.1

4. Using both tests, approximately 86% of the companies examined exhibited the same results regarding alignment versus misalignment. However, our comparison of the two tests revealed:

- **False negatives.** We found that more than 10% of the companies for which the ISS opportunity-based test found misalignment (high pay opportunity with low TSR) had realizable pay that was actually aligned with performance. Neither board members nor executives expect pay opportunity to be aligned with TSR.

- **False positives.** We found that fewer than 4% of the companies that the ISS test found to have achieved alignment actually had high realizable pay and low TSR. This, however, is a very small group of companies with particular circumstances.

5. We found that in both tests, the level of pay opportunity relative to market levels plays a role in pay/performance alignment results; companies shown to be of high concern were also the group of companies with the highest pay opportunity.

6. Further, the companies with false negatives had extremely low relative TSR, which resulted in low realizable pay. Yet, since the ISS test measures pay opportunity but not realizable pay, it incorrectly indicated pay/performance misalignment. Thus, the ISS test results are often found to be a mystery at best and a frustrating disappointment at worst for the boards of these companies.

7. Lastly, companies that showed poor alignment regarding realizable pay typically had a steep dip in stock price from 2008 to 2009, with only partial recovery by 2010. However, stock grants made in 2009 had a relatively high value of realizable pay (53% of three-year total compensation), which increased

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1 For this test, we used a structure similar to the ISS RDA test (low, medium, or high concern) involving three-year TSR percentile and three-year CEO realizable-pay percentile.
amounts for three-year total realizable pay even though overall alignment of pay to TSR for the three-year period was lacking.

INTRODUCTION

Currently, thousands of companies are busy finalizing their 2012 proxy statements. Proxy advisors — such as ISS and Glass Lewis — are preparing to make their Say on Pay recommendations, and shareholders will be casting their votes. The single most powerful determinant of how positive or negative the outcomes of these votes will be is the overall alignment of CEO pay to company performance. Boards of directors, management teams and advisors have worked hard to ensure as much alignment as possible and to clearly demonstrate their pay-for-performance orientation in proxy statements.

And yet, despite the importance of pay/performance alignment, there is no universally agreed-upon test to determine its existence or strength. There is general agreement that TSR is, if not the “right” performance metric, certainly the most visible and important to shareholders, but there is substantial disagreement over how best to measure CEO pay. Some analysts use the total compensation figure from the proxy summary compensation table (SCT), which includes both prior-year cash payouts and “new pay” in the form of the grant-date value of stock and stock options. Others start with the SCT total compensation figure and strip out indirect pay such as pension values and non-qualified deferred compensation. Yet others modify the SCT number using proprietary calculations. And finally, some use realized pay values. Each method has its pros and cons, and each can produce significantly different results.

However, more and more companies are segregating and seeking to communicate the often very different figures of pay target or opportunity from realizable pay. For decades, companies have used opportunity for setting pay targets that are typically based on market data, internal equity and individual performance. The purpose of the pay target is to provide a powerful prospective opportunity that will base future compensation on future performance, allowing management to realize value only if stock price appreciation and other performance metrics are strong and superior to peers’ results. This contrasts starkly with ISS’
methodology that assumes that compensation committees link pay opportunities and equity grants to retrospective stock price performance. As a result, we think that while not perfect, a direct comparison of realizable pay to company performance during set periods has the capacity to measure performance on a relative basis and allows for a direct test of what boards intended.

As we have stated previously, Pay Governance research shows that prospective pay opportunity generally is not aligned with recent retrospective TSR, although realizable pay is strongly aligned with TSR (see the Pay Governance Viewpoint article, “CEOs Are Paid for Performance: Using Realizable Pay to Demonstrate Alignment with Total Shareholder Return”). We have found that when analyzing compensation systems using realizable pay, more than 90% of companies have compensation that is aligned with shareholder returns. Our unique pay-for-performance methodology allows us to test whether pay/performance alignment exists in the form that compensation committees intended and whether plans motivate executive teams to perform. Unsurprisingly, we have found that generally speaking, the highest-performing companies have the highest realizable pay, and the lowest performers have the lowest realizable pay. We believe that in considering their SOP votes, this is the alignment that should be of primary interest to shareholders.

However, proxy advisors generally prefer to use a variant of pay opportunity for this test. This is quite disconcerting to directors whose companies fail the ISS test because of low or negative TSR when they actually had true pay/performance alignment. Although executive teams understand that their low realizable pay was inevitable because of weak performance, they find it extremely disappointing to then receive negative SOP votes because shareholders mistakenly believe that pay and performance are not aligned.

USING REALIZABLE PAY (PAY GOVERNANCE) AND PAY OPPORTUNITY (ISS) IN PAY-FOR-PERFORMANCE TESTS

When Pay Governance conducts its pay-for-performance assessment for clients, we utilize a methodology that includes a comparison of (i) the competitive positioning (percentile rank) of realizable pay relative to that of peers to (ii) the
competitive positioning (percentile rank) of company performance (TSR) relative to peers, over a given multi-year time period.

In the release of its 2012 Policy Guidelines, ISS appeared to make many thoughtful adjustments and enhancements in redefining the manner in which it will evaluate pay-for-performance alignment. In reviewing 2012 proxy statements, the proxy advisory service will use a three-pronged quantitative approach to measure pay/performance alignment:

- **Relative Degree of Alignment (RDA).** This relative measure compares the percentile ranks of a company’s CEO pay and TSR performance relative to those of companies in the same industry and size over one- and three-year periods.

- **Multiple of Median (MOM).** This relative measure expresses the prior year’s CEO pay as a multiple of the median pay of its comparison group for the same period.

- **Pay-TSR Alignment (PTA).** This absolute measure compares trends of the CEO’s annual pay and the value of an investment in the company over the prior five-year period.

However, despite the more rigorous methodology and analyses adopted by ISS, they will continue using the same pay metric that it has used in the past, which combines ISS-calculated pay opportunity values with other proxy-disclosed pay values.

While ISS’ pay metrics are significantly different than ours, the methodologies used in its RDA test and our realizable-pay-for-performance studies are similar. Using CEO pay and company TSR data for a group of 373 companies, we compared the results of the two tests to identify companies with pay (opportunity and/or realizable) that is aligned or misaligned with company performance and to identify levels of concern.

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2 From the ISS white paper “Evaluating Pay for Performance Alignment”

3 Our analysis uses a simulation of the ISS methodology based on total direct compensation opportunity, or TDC = base + actual annual incentive + grant value of long-term incentive awards, which differs slightly from the definition of pay that ISS will actually use in its 2012 assessments. Further, we determine relative pay and performance by comparing a subject company to our entire sample of 373 companies, which is a simplified version of our more detailed standard methodology for client studies that takes industry and company scope into account (and utilizes a smaller group of peer companies to calculate relative pay and performance).
EVALUATING THE ISS TEST OF CEO PAY FOR PERFORMANCE FOR SAY-ON-PAY VOTES

METHODOLOGY

Our study uses three years of CEO pay data (from Equilar) from 373 S&P 500 companies with median revenues of $8 billion and a market capitalization of $12 billion that had filed 2011 proxies by mid-June. To simulate the ISS RDA test, we subtracted the percentile ranking (relative to the entire group of 373 companies) of each company’s three-year CEO total direct compensation (TDC) opportunity from the percentile ranking of the same company’s three-year TSR. We then compared this difference to the same thresholds that ISS set for each of the following levels of concern over pay/performance alignment:

- **High concern**: The difference is between -50 and -100 (i.e., pay and performance are highly misaligned).
- **Medium concern**: The difference is between -50 and -30 (i.e., pay and performance are somewhat misaligned).
- **Low concern**: The difference is between -30 and +100 (i.e., pay and performance are aligned).

We then performed the same analyses using realizable TDC. Comparing the results from both tests allows us to identify situations for which the two methodologies are consistent and, more interestingly, instances where there is a divergence between ISS’ approach (using pay opportunity) and ours (using realizable pay) leading to potential pitfalls for companies:

- **False negatives**: Companies that the ISS RDA test finds to have but show *good alignment* when realizable pay is considered
- **False positives**: Companies that the ISS RDA test finds to have *good pay/performance alignment* but have realizable pay that is actually *misaligned* with company performance

FINDINGS

Table 3.1 shows the number of companies that fall into each level of concern under both the ISS test and our realizable pay test. We found that 257 of the 373 companies reviewed (69%) have realizable TDC and TDC opportunities
that are both well aligned with company TSR performance (i.e., high pay and high performance or low pay and low performance). The table also shows the median SOP “for” vote percentages for each level of concern in 2011. “For” votes decrease as the level of concern increases, as the level of pay/performance alignment decreases, suggesting that shareholders react favorably to pay programs that are shown to be better aligned with performance. Nevertheless, all cohorts had relatively positive outcomes, indicating broad shareholder support.

**TABLE 3.1**

Number of Companies in Each Level of Concern: CEO 3-Year TDC vs. 3-Year TSR

<table>
<thead>
<tr>
<th>Level of Concern from ISS RA Test*</th>
<th>Level of Concern from Realizable Pay Test</th>
<th>Total # and % of All Companies</th>
<th>Median SOP % For Votes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low</td>
<td>Low</td>
<td>257/79%</td>
<td>95%</td>
</tr>
<tr>
<td>Medium</td>
<td>Medium</td>
<td>27/16%</td>
<td>85%</td>
</tr>
<tr>
<td>High</td>
<td>High</td>
<td>11/16%</td>
<td>84%</td>
</tr>
<tr>
<td>Total # and % of All Companies</td>
<td>295/79%</td>
<td>45/12%</td>
<td>33/9%</td>
</tr>
<tr>
<td>Median SOP % For Vote</td>
<td>95%</td>
<td>87%</td>
<td>84%</td>
</tr>
</tbody>
</table>

*simulation

In Table 3.1, we compare results from both tests and highlight the number of companies for which test results diverge (14% of companies) based on the testing methodology. For 10% of the companies, the ISS RDA test suggests that TDC opportunity is misaligned (medium and high concern) with company performance, when the CEO actually has realizable TDC that is commensurate with the level of company performance. In other words, realizable TDC is well aligned with performance, but the ISS test finds misalignment. Conversely, only 4% of the companies had a false-positive rating.

There are a number of possible program design and policy reasons for this outcome, all of which are overlooked by the ISS RDA test. These include:

a) A high concentration of equity in total direct compensation
b) A high concentration of stock options in long-term incentive values

c) The presence of well-defined, challenging performance goals

d) Above-median pay opportunity that is still in a reasonably competitive range (e.g., 60th or 65th percentile)

e) Incentive plan financial metrics that are well correlated with TSR

f) After-the-fact adjustments to incentive plan payouts (either via compensation committee discretion or payout multipliers based on TSR)

One factor at play in the false-positive companies is the portion of total three-year realizable pay that comes from 2009 equity awards (53%) and the high TSR experienced from the time of these grants through 2010 (32.2% versus 6.1% for false negatives). This suggests that these companies had a major dip in stock price in 2009 and that, as the stock prices recovered, equity granted in 2009 became much higher in realizable pay. The result was three-year realizable pay that was misaligned with overall three-year TSR, while the two-year period from 2009 to 2010, with high (+32.2%) TSR, yielded good alignment. We consider this to be a valid explanation, which further diminishes the importance of the false positives.
These companies also granted pay opportunities commensurate with the overall median (suggested by a MOM of 0.99), compared with pay opportunities approaching the 75th percentile for the false-negative category (MOM = 1.32).

**TABLE 3.3**

Anonymous Company-Specific Examples

<table>
<thead>
<tr>
<th>Company</th>
<th>TSR</th>
<th>TDC Opportunity</th>
<th>Realizable TDC</th>
<th>Level of Concern</th>
<th>TDC Opportunity as Multiple of Overall Median</th>
<th>SOP % For Votes</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Agreement</td>
<td>31&lt;sup&gt;st&lt;/sup&gt;</td>
<td>99&lt;sup&gt;th&lt;/sup&gt;</td>
<td>97&lt;sup&gt;th&lt;/sup&gt;</td>
<td>High</td>
<td>High</td>
<td>3.31</td>
</tr>
<tr>
<td>B. False Positive</td>
<td>47&lt;sup&gt;th&lt;/sup&gt;</td>
<td>77&lt;sup&gt;th&lt;/sup&gt;</td>
<td>91&lt;sup&gt;st&lt;/sup&gt;</td>
<td>Low</td>
<td>Medium</td>
<td>1.48</td>
</tr>
<tr>
<td>C. False Negative</td>
<td>11&lt;sup&gt;th&lt;/sup&gt;</td>
<td>61&lt;sup&gt;st&lt;/sup&gt;</td>
<td>24&lt;sup&gt;th&lt;/sup&gt;</td>
<td>High</td>
<td>Low</td>
<td>1.14</td>
</tr>
<tr>
<td>D. False Negative</td>
<td>27&lt;sup&gt;th&lt;/sup&gt;</td>
<td>83&lt;sup&gt;rd&lt;/sup&gt;</td>
<td>53&lt;sup&gt;rd&lt;/sup&gt;</td>
<td>High</td>
<td>Low</td>
<td>1.69</td>
</tr>
</tbody>
</table>

* simulation

To highlight some of the differences between the two tests on a company-specific level, in Table 3.3 we provide anonymous data on four of the companies in our study. Significantly, only Company A, upon which the two tests agreed regarding high concern, experienced a low, failing SOP vote. Also of note is Company C. Despite relatively low TSR performance (11th percentile), an above-median pay opportunity (61st percentile) and a high concern rating from the ISS RDA test, this company had realizable pay that is aligned with TSR performance and received 96% support from shareholders in its SOP vote.

**CONCLUSION**

Pay/performance alignment will continue to be the paramount concern of compensation committees designing executive pay packages and the shareholders who are asked to vote on them. And now more than in the past, committees and management teams must continually ensure this alignment exists by periodically conducting analyses, using a study such as Pay Governance’s “Re-
alizable Pay for Performance” assessment. While our research summarized here draws from a broad group of large companies, we have conducted many of these studies for clients, applying relative pay/performance comparisons within their industry peer sets.

There are many potential policies available to boards — pay opportunity, performance goals, equity mix, etc. — that can help balance the goals of motivating executive teams and creating/maintaining excellent corporate governance. In our experience, most boards are highly thoughtful in selecting and designing these policies. Communicating the results of these studies and policies in the context of your company’s overall pay-for-performance story in the CD&A can help shareholders cast appropriate SOP votes.
CHAPTER FOUR

SAY ON PAY SOUL-SEARCHING REQUIRED AT PROXY ADVISORY FIRMS

BY JOHN D. ENGLAND

As the U.S. proxy voting season fades into the sunset, it is an appropriate time for a postmortem on how institutional shareholders are served by proxy advisory firms providing voting guidance on Say on Pay proposals. Institutional Shareholder Services (ISS) is the focus of our postmortem, not because Glass Lewis or Egan Jones does anything “better,” but because ISS is the most influential and transparent proxy advisory firm providing Say on Pay voting recommendations. More than likely, many of the same reflections are applicable to all proxy advisory firms, not just ISS.

Let’s first acknowledge that outsourcing some or all of the unbiased fact-gathering necessary to make informed decisions with respect to Say on Pay voting is not only understandable but also a very reasonable division of labor between institutional investors and expert proxy advisory analysts, given the length and detail found within Compensation Disclosure & Analysis (CD&A) reports and related compensation tables.

But on behalf of the compensation committees, senior executives, investor relations and human resources professionals, lawyers and consultants who spend countless hours each year examining how pay programs attract, retain and motivate those who build long-term shareholder value, we would respectfully submit that subscribers to proxy voting guidance reports should do some
soul-searching as to whether they are receiving recommendations grounded in a commensurate level of effort and diligence.

Why do we suggest that proxy advisory firms and their subscribers do such soul-searching? Not just because of the perceived conflict of interest involved in having one division selling consulting and products while another division of the same firm makes recommendations on proxy proposal voting. And not just because yet another division offers full-service proxy receipt and voting execution on clients’ behalf. We want to highlight the market-moving power of an “against” recommendation. In 2011, the average level of Say on Pay support for companies receiving an ISS “against” voting recommendation was 70%, versus 95% for companies fortunate enough to receive a “for” recommendation. Thus far, in 2012, the pattern is the same, though even more pronounced — an “against” recommendation results in average support of 65%, whereas a “for” results in average support of 95%. Given this proof of ISS’ profound influence over voting results, it’s pretty important for ISS to get it right when it comes out with the profoundly condemning recommendation of an “against” vote.

Yet, while ISS’ influence is pronounced, the fact that average support of 70% and 64% in 2011 and 2012, respectively, in the face of “against” recommendations has to mean that the majority of shareholders don’t agree with ISS’ conclusions. In fact, 88% of companies receiving an “against” recommendation from ISS in 2011 received majority support in their Say on Pay votes. Thus far in 2012, 80% of companies’ shareholders have rejected ISS’ “against” recommendations.

Why do so few ISS “against” recommendations produce Say on Pay failures? And why should companies receiving “for” recommendations not be smug (because their turn in the barrel may come someday, too)? We think it has to do with informed shareholders’ recognizing some combination of the following:

1. No Interest in Using Say on Pay as a Cudgel. Most shareholders do believe that compensation committees and management are doing their best during unsettled economic times. Particularly when an investor outreach program regarding executive compensation is implemented, there is strong evidence that large institutional shareholders give companies the benefit of the doubt by supporting Say on Pay proposals. Based upon a review of hundreds of 2011 and
2012 ISS “against” Say on Pay recommendations, it’s hard not to wonder if ISS enjoys wielding its cudgel. How else would one explain an “against” recommendation when a company’s Governance Risk Indicators (GRid) score goes from 68 to a perfect 100? Or writing “too little, too late” and “the committee has been too slow to implement changes” when significant program changes have been adopted?

2. **Flawed Peer Group Selection.** Rather than evaluating pay and performance using peer groups approved by each company’s board of directors, ISS ignores them, and constructs its own 14- to 24-company peer groups on the basis of GICS codes within .45 times to 2.1 times revenue groupings. If there are insufficient peers within a six-digit GICS code, instead of relaxing the revenue range in recognition that size does not constrain talent competitors, ISS broadens out to a four-digit or even a two-digit (!) GICS code to supplement the total number of ISS-assigned peers. This leads to oddities such as retailers’ being included in an entertainment company’s ISS-assigned peer group, or a refining and marketing company in an exploration- and production-based oil company’s ISS-assigned peer group, or having an HR consulting firm in a digital communications company’s ISS-assigned peer group — fundamentally different business economics and competitive markets for talent in each case. Flawed peer groups. Flawed conclusions.

3. **More Than Relative Total Shareholder Return (TSR).** There is no quarrel that relative TSR is a fundamental measure of long-term shareholder value creation, but it should be a starting point rather than an ending place. Reasonable people should be able to accept many other short- and long-term objectives that companies strive to achieve, one- and three-year relative TSR being just two of them. When relative TSR is being assessed, the peer group needs to be correct, the math needs to factor out abnormalities that can arise by using single-day closing prices, and some judgment needs to be made about anomalies that have occurred before, during and after the period of measurement. Equity research analysts do this when they produce reports on companies. ISS does not.

4. **Recognizing Pay Timing.** At most companies, the largest component of an executive’s annual total direct compensation is offered in the form of long-term incentives (LTI) — stock options, performance plans and restricted stock.
Those grants generally occur in the first quarter of the year, coincident with annual bonus decisions for the prior year’s performance. At the end of the year, when ISS runs its relative pay and performance math, all that is left to be paid is the annual incentive; 75% to 80% of the pay package has already been delivered in salary and LTI grants. Even with a perfect peer group, does ISS really expect that LTI grants made nine to 10 months before the end of the year will accurately predict end-of-year relative TSR? Or that LTI grants will be canceled? Or that annual incentive formulas will be overruled and payouts slashed if ISS-determined relative TSR and pay are not perfectly aligned?

5. Weighing Prospective Changes. ISS may believe it is the only player in the executive compensation process, but it is not. It’s not at all uncommon for a compensation committee to approve changes for the next fiscal year — changes in LTI programs, new performance measures in annual incentive plans, and other governance changes related to perquisites, share ownership, pay targeting, etc. But the CD&A and pay tables in the proxy statement are mostly backward-looking. The track record of ISS in qualitatively overruling its backward-looking analytics because of positive prospective changes is mixed, at best.

6. Misguided Views on Stock Options. While the U.K.-based National Association of Pension Funds’ (NAPF) guidelines, to which ISS subscribes, suggest that stock options are not “performance-based pay,” most institutional investors, compensation committees and executives on this side of the Atlantic disagree. ISS puts stock options and time-based restricted stock in the same “non-performance-based pay” category. Yet, one vehicle pays only when the stock price increases, and the other pays regardless of stock price outcome. Then, ISS makes it even worse by rejecting the SEC-approved GAAP valuation of stock options by running its own full-term valuation, which can almost double what’s reported in the proxy statement’s pay tables. That means that if a company has a higher proportion of stock options in its LTI mix than ISS-assigned peers, pay ranking will be impacted by ISS’ stock option valuation. If a company used full-term option valuation in its pay tables, it would be filing defective public disclosures and would be liable for SEC penalties and exposed to lawsuits.
7. **Considering Realized or Realizable Pay.** “You can’t eat Black-Scholes” is a saying referring to the fact that an up-front valuation of an incentive plan’s mathematical expected value bears absolutely no relation to what the incentive plan payout might turn out to be. A stock option valued at $100,000 at grant is worth zero to the holder if the company’s stock price never increases. A popular relative TSR share design with an opportunity to earn from 0% to 200% of the shares at grant but valued at the stock price at the end of three years is almost never worth exactly its grant value. Even a share of time-lapse restricted stock will almost never be worth at vesting what it was when granted. As it is a great deal more work to evaluate and compare what one company’s CEO has realized or could realize from LTI awards, realized or realizable value is a far better pay/performance analytic than comparative grant value.

Another “perfect storm” affecting voting recommendations has its origin in the calendar. About two-thirds of U.S. companies tie their fiscal years to the calendar year. The SEC requires that proxy statements be issued no less than 40 days before the date of the annual meeting. ISS strives to publish voting recommendations 10 to 14 days before the annual meeting date. Most meeting dates occur between mid-April and early June, with May being the peak month, when no fewer than 1,200 to 1,300 annual meetings occur. Do the math: Three hundred-plus comprehensive and intelligent recommendations per week on board of director elections, and four to seven shareholder proposals per company, including Say on Pay? Perhaps ISS hires part-time analysts in the U.S. or elsewhere to meet peak demand, though this has its own pitfalls related to training and supervision. Realistically, how much time can an ISS analyst and his or her supervisor spend carefully evaluating each assigned company’s proxy statement to reach critical Say on Pay vote recommendations? It can only be a minuscule fraction of the time the compensation committee, management and advisors expend during the entire year on managing an executive compensation program.

Proxy advisory firms — particularly ISS — appear to have a significant impact over the final outcome of Say on Pay proposals. That power should be wielded with great caution. On behalf of shareholders, compensation committees and management, we believe some soul-searching needs to be done by all
such proxy advisory firms in view of how frequently their advice is rejected when “against” recommendations are made. We suggest possible reasons why subscribers and non-subscribers choose to differ with the “against” Say on Pay advice provided by proxy advisory firms. We believe that the outcome of such soul-searching will be a better process for all.
CHAPTER FIVE
‘BETTER THE SECOND TIME AROUND’: HOW SAY ON PAY ‘LOSERS’ BECAME ‘WINNERS’ IN 2012

BY JOHN D. ENGLAND AND BRIAN JOHNSON

Thirty-seven companies in the Russell 3000 had less than majority shareholder support in their Dodd-Frank-mandated Say on Pay advisory vote in 2011. As of June 2012, 26 of these companies became second-time “winners,” with an average Say on Pay voting support of 39 percentage points over their 2011 ignominy. Unfortunately, four of 2011’s Say on Pay losing companies and 48 new firms have had shareholders reject their 2012 proposals. We think Say on Pay winners and losers should examine the factors behind the tremendous turnaround in support from 2012’s 26 second-time winners so far. First, here are the facts:

Pay Governance worked with compensation committees and management from a number of these companies to achieve their 2012 turnaround Say on Pay success. Armed with this direct experience, and supplemented by interviews and CD&A disclosures, a fairly consistent pathway was developed that presents Say on Pay proposals in a winning light.

While much of this pathway involves outreach to real shareholders rather than proxy advisory firms, the market-moving power of Institutional Shareholder Services (ISS) and Glass Lewis voting recommendations cannot be mini-
ized (see our June 2012 article, “Say on Pay Soul-Searching Required at Proxy Advisory Firms” for additional commentary).

TABLE 5.1

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Beazer Homes USA, Inc.</td>
<td>46%</td>
<td>95%</td>
<td>+49%</td>
</tr>
<tr>
<td>BioMed Realty Trust, Inc.</td>
<td>46%</td>
<td>98%</td>
<td>+52%</td>
</tr>
<tr>
<td>Blackbaud, Inc.</td>
<td>45%</td>
<td>98%</td>
<td>+53%</td>
</tr>
<tr>
<td>Cadiz Inc.*</td>
<td>38%</td>
<td>N/A</td>
<td>N/A</td>
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<td>Cincinnati Bell Inc.</td>
<td>30%</td>
<td>89%</td>
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</tr>
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<td>Cogent Communications Group, Inc.</td>
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<td>68%</td>
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<td>77%</td>
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<td>Intersil Corp.</td>
<td>44%</td>
<td>98%</td>
<td>+54%</td>
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<td>Jacobs Engineering Group Inc.</td>
<td>45%</td>
<td>96%</td>
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<td>Janus Capital Group Inc.</td>
<td>40%</td>
<td>61%</td>
<td>+21%</td>
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<td>30%</td>
<td>-19%</td>
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<td>M.D.C. Holdings, Inc.</td>
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<td>45%</td>
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<td>+49%</td>
</tr>
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<td>Nutrisystem, Inc.</td>
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<td>94%</td>
<td>+53%</td>
</tr>
<tr>
<td>NVR, Inc.</td>
<td>45%</td>
<td>87%</td>
<td>+42%</td>
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<td>93%</td>
<td>+52%</td>
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<td>73%</td>
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<td>+41%</td>
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<td>39%</td>
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<td>+55%</td>
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<td>49%</td>
<td>98%</td>
<td>+49%</td>
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<tr>
<td>Superior Energy Services, Inc.</td>
<td>39%</td>
<td>96%</td>
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<td>Synaptics Inc.*</td>
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<td>The Talbots, Inc.**</td>
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<tr>
<td>Tutor Perini Corp.</td>
<td>49%</td>
<td>38%</td>
<td>-11%</td>
</tr>
<tr>
<td>Umpqua Holdings Corp.</td>
<td>36%</td>
<td>95%</td>
<td>+59%</td>
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<tr>
<td><strong>Average</strong></td>
<td><strong>42%</strong></td>
<td><strong>81%</strong></td>
<td><strong>+39%</strong></td>
</tr>
</tbody>
</table>

* 2012 Proxy not filed as of June 2012  ** Say on Pay results not available for 2012 due to acquisition activity

In 2012, ISS processes resulted in “for” vote recommendations for 20 of the 30 companies that lost their 2011 advisory votes (seven companies had not held their 2012 SOP vote at the time this article was written). All 20 of these companies earned a “low” or “medium” concern rating following ISS’ alphabet soup of RDA, MOM and PTA quantitative tests and its qualitative reviews of the companies’ pay programs. That’s an extraordinary stroke of luck, as ISS ignores CD&A-disclosed peers and selects its own group of “peers” for applying its relative pay/performance mathematics. Nevertheless, while it’s certainly better to be
assigned a “low” or a “medium” concern rating than a “high” one, every 2011 Say on Pay–losing company underwent ISS’ qualitative assessment. And it is here that the concerted efforts of committees, management and advisors made all the difference in winning 2012’s Say on Pay referendum.

With planning and execution strategy that would make the Pentagon proud, the most common actions taken in response to 2011 failed Say on Pay votes include:

1. Shareholder Outreach

Ninety percent of companies indicated that they conducted a shareholder outreach program in an effort to understand investor concerns over their pay program. Some of this outreach occurred just before 2011’s proxy vote, but most companies took the time to meet with major shareholders to understand their concerns in more detail, and later, when program changes were made, to proudly present them via meetings, webcasts and website postings.

**Intersil (DEF14A 3/13/2012):**
“We met with many of our largest shareholders..... [We] met with individuals responsible for the proxy voting as well as other analysts in each of these organizations.”

**Jacobs Engineering Group (DEF14A 12/16/2011):**
“During fiscal 2011, the equity component of the Company’s pay programs was reevaluated, taking into account... discussions with major institutional shareholders.”

2. Proxy Advisor Outreach

Prior to 2011, ISS seemed to welcome summer and fall pilgrimages to its offices in Rockville, Md., whereas Glass Lewis prided itself on not permitting any forms of influence. Both firms appear to have changed their policies: ISS now limiting meetings to those who lost their Say on Pay vote, and Glass Lewis now showing receptivity to face-to-face meetings. Who should attend? Our experience is that groups including the committee chair, the lead director or non-executive chairman of the board, the head of HR or other HR executive with detailed knowledge of programs, and the general counsel are an effective team
to communicate that the shareholder message has been received and positive responses have been made.

**Umpqua Holdings (DEF14A 2/27/2012):**
“As a result of productive discussions with ISS, Glass Lewis and our shareholders, the Committee worked to more closely align incentive compensation earned in a given year or period with the returns realized by our shareholders over that same period.”

**Nutrisystem (DEF14A 4/23/2012):**
“...[W]e contacted Institutional Shareholder Services (ISS) to discuss and evaluate the issues ISS raised in its recommendation to our stockholders......”

### 3. Actual or Target Pay or Benefit Reductions

Some companies have taken actions to reduce executive pay as a means of “sharing the pain” during periods of lagging shareholder returns. Although this can be a difficult measure to take, doing so can show the committee’s commitment to aligning executive compensation with company returns, and is viewed favorably by proxy advisory firms.

**Curtiss-Wright (DEF14A 3/22/2012):**
“...[T]he Company addressed stockholder concerns by implementing the following changes: (i) modified its compensation philosophy to target the 50th percentile in compensation and performance, (ii) reduced target award levels......”

**Freeport-McMoRan Copper & Gold (DEF14A 4/27/2012):**
“No participant in the [Annual Incentive Program (AIP)] may receive an award under the plan having an aggregate value in excess of six times his or her salary (reduced from the eight times limit in the plan). In addition, the total value of the cash award under the AIP may not exceed three times the executive’s salary (reduced from the four times in the plan). These changes reduce the magnitude of each executive’s potential awards under the plan.”

### 4. Enhanced Detail on Incentive Plan Goals and Outcomes

Increasing the transparency of the goal-setting processes and outcomes of incentive plans has become critical for demonstrating pay-for-performance linkage in executive pay programs. Shareholders and proxy advisory firms are look-
ing for a clear explanation of the metrics used and how actual performance translates into award payouts.

**Penn Virginia (DEF14A 4/2/2012)**

“Following our negative Say on Pay vote in 2011... the Committee took the following actions:

- Established Purely Quantitative Bonus Pool Funding Metrics. The Incentive Award Guidelines provide for the establishment of a cash bonus pool based on several financial and operational performance metrics.”

**BioMed Realty Trust (DEF14A 4/16/2012):**

Creation of formulaic annual bonus program effective for 2011:

- An executive’s annual bonus is tied to five financial, operating and individual/strategic measures, with “threshold,” “target” and “maximum” performance levels corresponding to the executive’s bonus payout levels

- Performance goals are determined in advance and actual performance relative to those goals determines the bonuses earned, limiting the use of discretion in annual bonus decisions. The five measures utilized for 2011 were:

  - Funds from operations per diluted share
  - Leasing volume (square footage)
  - New investments (aggregate capital investment)
  - Leverage ratio (debt/total assets)
  - Strategic and individual measures

**5. Long-term Incentive (LTI) Program Modifications**

Two-thirds (20 of 30) of companies disclosed changes made to their LTI programs, with almost all of the changes involving the use of performance-based awards going forward.

**Navigant Consulting (DEF14A 4/3/2012):**

“...[T]he compensation committee ... added performance-based vesting conditions linked to the Company’s relative annual total shareholder-
er return ... to a portion of the restricted stock awards granted to our [named executive officers] in March 2011;"

**Monolithic Power Systems (DEF14A 4/30/2012):**
“Beginning in 2012, 50% of the equity compensation payable to our NEOs ... will be based on the Company’s long-term financial performance, as set from time to time by the Board, and the relative alignment to the performance as measured by total stockholder return.”

6. Enhanced Stock Ownership Policies

Fifty percent of companies (15 of 30) have either implemented or increased stock ownership guidelines for their CEOs and other NEOs.

**Stanley Black & Decker (DEF14A 3/9/2012):**
“Minimum stock ownership requirements for executive officers have been significantly increased. The Company’s new stock ownership policy also includes a requirement that executive officers hold the net after tax shares received upon vesting of RSUs or the exercise of stock options for a period of one year from the date of vesting or exercise, as applicable.”

**Stewart Information Systems (DEF14A 3/26/2012):**
“In April 2011, the Compensation Committee approved the implementation of stock ownership guidelines that require executive officers to acquire a meaningful level of stock ownership in the Company.”

7. Writing CD&As Transparently and Compellingly

Even companies that take pride in their CD&As need to be sure shareholders and proxy advisors can easily recognize the program changes made following the Say on Pay loss. Some companies used separate letters right up front in their proxy statements to highlight changes. Others addressed changes in the opening paragraphs of their CD&As and provided additional detail in the pages that followed.

**Blackbaud (DEF14A 4/27/2012):**
“We took the following actions, as more fully discussed in the accompanying Proxy Statement:

• We amended [the CEO’s] employment agreement to eliminate its automatic renewal feature, eliminate the tax gross-up for penalties imposed by Section 409(A) of the Internal Revenue Code of 1986, as
amended, and implement a clawback of [the CEO’s] incentive-based compensation in certain circumstances;

• We eliminated [the CEO’s] annual equity award payable in time-based [stock appreciation rights] as provided in his former employment agreement and replaced it with a potential grant of performance-based restricted stock units to reinforce our commitment to pay-for-performance compensation and increase the amount of (the CEO’s) “at risk” compensation; and

• We granted performance-based restricted stock units to all our named executive officers to reinforce our commitment to pay-for-performance."

**Hewlett-Packard (DEF14A 2/3/2012):**
“Changes to Executive Compensation Program in Fiscal 2011

• Targeted the compensation of our executives within a competitive range of the market median

• Restructured our incentive compensation programs to limit the use of discretion

• Redesigned our annual incentive plan to reinforce linkage between pay and performance

• Disclosing more detailed information about historical performance targets, actual performance against targets, and payouts under our annual incentive plan

• Changed structure and design of CEO compensation

• Eliminated tax gross-ups for Section 16 officers except with respect to relocation benefits as to which gross-ups are generally available to most employees

• Amended our severance plan for executive officers to be consistent with current market practice and to reduce the need for individual agreements and the use of discretion in determining plan benefits.”

“Second-time winner” is a well-deserved outcome after suffering the ignominy of a Say on Pay defeat. But the real “win” is not losing the first time. Regardless of a company’s total shareholder return (TSR) against its own or
ISS-assigned peers, a campaign involving shareholder outreach, enhanced disclosure on how pay and performance are implemented, well-designed operating metrics or relative TSR long-term incentive plans, strong equity ownership levels and transparent CD&As is the best offense for achieving successful Say on Pay advisory votes.
CHAPTER SIX
COMPENSATION COMMITTEE RESPONSIBILITIES AND BEST PRACTICES
BY JEFFREY W. JOYCE

INTRODUCTION

The responsibilities associated with serving on the compensation committee of a company’s board have increased significantly in recent years with the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and mandated Say on Pay, governance reform and enhancements, and increased shareholder activism. In addition to the key responsibility for strategic oversight of a company’s executive compensation program, matters pertaining to compliance, risk management and shareholder relations have assumed comparable stature on the annual agendas of today’s compensation committees.

With the increasing complexity of the executive compensation landscape, effective management of the ongoing operations of the compensation committee has become increasingly challenging. An understanding of the fundamental responsibilities of the compensation committee and some “best practice” guidelines for committee procedure is essential to effective and responsible committee operations.
COMPENSATION COMMITTEE RESPONSIBILITIES

Identifying and formally stating the responsibilities of the compensation committee is one of the cornerstones to effective committee operations. While the scope of committee responsibilities may vary among organizations, publicly traded companies must meet certain minimum standards for the company to be listed on the major exchanges. These standards vary depending on whether the company is listed on the NASDAQ or the New York Stock Exchange. Regardless of whether a company is public or private, the listing standards pertaining to the role of the compensation committee provide a useful foundation upon which the full scope of responsibilities of the compensation committee may be developed.

The NASDAQ stock market listing standards require that the compensation of the CEO and all other executive officers be determined or recommended to the board for determination by either a majority of the board’s independent directors or a compensation committee composed solely of independent directors. New York Stock Exchange listing standards provide more specific requirements and state that companies must have a compensation committee composed entirely of independent directors with a written charter. The charter must include a listing of the duties and responsibilities of the committee, which, at a minimum, must include the review and approval of corporate goals and objectives as they pertain to CEO compensation, evaluation of the CEO’s performance relative to these goals and objectives, and the determination of the CEO’s resulting actual pay based on the committee’s evaluation of performance\(^1\). Additionally, the committee must be responsible for recommendations to the board with respect to incentive-compensation plans and equity-based plans.

Building on these required responsibilities, a full of listing of compensation committee duties may be developed. This will certainly vary by company; some companies may give the compensation committee the final authority to approve executive compensation programs and decisions, whereas other companies may require the full board to approve executive compensation matters based on the recommendations of the compensation committee. Additionally, some compa-\(^1\) NYSE listing standards state that the charter must address the purpose, duties and responsibilities of the committee and other governance-related items (e.g., annual evaluation of committee performance, qualifications for committee membership, procedures for committee member appointment and removal, etc.).
nies may delegate certain compensation matters to other committees to balance the workload (e.g., the nominating and governance committee may be responsible for non-employee director compensation). Thus, the full scope of responsibilities of the compensation committee must necessarily be tailored to meet the needs and practices of the company. Ultimately, all directors of the board are responsible for executive compensation decisions, and thus the scope of committee responsibilities and adequate processes to keep the full board informed of committee decisions will need to be developed with this in mind.

The following provides an illustrative listing of duties for which the compensation committee may be responsible:

- **Strategic oversight of executive compensation programs**
  
  Develop and maintain the executive compensation strategy/philosophy, which should be aligned with the company’s business strategy and talent needs
  
  Review and approve all compensation and benefit plans designed to support the executive compensation strategy
  
  Review and approve performance measures and standards as they pertain to CEO and executive officer compensation
  
  Review risks associated with compensation programs and approve necessary modifications to programs and/or practices to mitigate these risks
  
  Ensure regulatory, accounting and stock exchange listing compliance
  
  Review executive compensation market trends and emerging developments, particularly regarding the potential implications for the company
  
  Review programs relative to corporate governance best practices and approve appropriate modifications to programs
  
  Discuss the organizational structure with the CEO, including highlights of any recent major changes, and discuss key senior talent/succession planning
• **Pay administration**

Review and approve compensation adjustments for the CEO and executive officers

Ensure the competitiveness of executive compensation programs and pay levels

Supervise the administration of, and review any material changes to, the company’s compensation and benefit plans

Review and approve incentive plan performance goals and associated award opportunities, any adjustments to incentive plan performance goals, and award payouts for the CEO and executive officers

Review and approve equity-based and other long-term incentive grants for executives and total expenditure for annual long-term incentive awards to all plan participants

Review broader compensation and benefit plans and associated total costs of programs

• **Other**

Develop and regularly review the committee’s charter to ensure that it remains contemporary with the current responsibilities and authority of the committee

Work with management to prepare the compensation discussion and analysis (CD&A) section of the annual proxy filing

Review and recommend inclusion of the CD&A in the company’s annual report or proxy statement

Oversee executive and non-employee director stock ownership guidelines

Hire and define the scope of responsibilities for the independent compensation consultant and any other advisors

Develop succession plan for the CEO and other key executives
Recommend to the board all aspects of compensation for non-employee directors

COMPENSATION COMMITTEE EFFECTIVENESS

As we’ve discussed, the responsibilities of the compensation committee are significant. Overseeing the executive compensation program is continuing to grow more challenging with regulatory change, governance reform and shareholder and proxy advisor influence on pay programs, not to mention simply responding to the impact that evolving needs and changes in a company’s business may have on the pay program. To help ensure the committee executes its duties responsibly and effectively there are a number of procedural “best practices” that may be employed; these include:

1. Member Selection

There are a number of important independence standards for directors that must be considered when determining the composition of the compensation committee. These include director independence standards of the NYSE or NASDAQ listing requirements, Internal Revenue Code Section 162(m) and various SEC rules (i.e., Section 16(b)-3 and Section 10C of the Securities Exchange Act of 1934). Details of these standards are beyond the scope and intent of this material; however, companies will want to be sure that directors serving on the compensation committee satisfy these independence standards to ensure compliance with listing requirements and that the company qualifies for important exemptions provided under IRS regulations and SEC rules.

In addition to satisfying the various standards for independence, committee effectiveness can be greatly enhanced if membership includes at least one director with executive compensation experience (e.g., from prior service on a compensation committee, a leadership role that has the responsibility for compensation decisions, etc.). It can also be beneficial if membership includes a

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2. On June 20, 2012, the SEC issued final rules to implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, which added Section 10C to the Securities Exchange Act of 1934. Among other things, the rules require that securities exchanges prohibit the listing of an equity security unless each member of the listed company’s compensation committee is “independent.” The rules will apply to proxy statements for annual meetings that occur on or after January 1, 2013. Details of the rules may be found in The Federal Register, Volume 77, No. 124 dated June 27, 2012.
director with related, albeit not direct, subject matter expertise (e.g., a financial background that may be useful in the determination and assessment of performance measures and goals), which can add useful perspective to committee deliberations. Regardless of the specific background of the director, intellectual curiosity, willingness to engage in debate, diplomacy and a firm commitment to ethical and moral standards are characteristics that make for a strong committee member.

2. Committee Charter

As noted previously, NYSE listing standards require that the compensation committees of listed companies must have a written charter addressing the committee’s purpose, duties and responsibilities, and annual performance evaluation process. The NASDAQ does not have a requirement that listed companies have a compensation committee or written charter.

Regardless of whether it is required, it is advisable that companies adopt a written compensation committee charter to serve as the governing document for committee responsibilities and operations.

3. Executive Compensation Philosophy

The philosophy statement provides the foundation for the administration and design of the executive compensation program. It provides the framework for making compensation-related decisions and can help ensure a common understanding of the goals and objectives of the executive compensation program among committee members and management. Additionally, the philosophy can foster continuity of understanding among the committee as committee membership changes over time, as well as serve as the basis for the development of the company’s CD&A to be included in the proxy statement or annual report.

To be meaningful, the philosophy should be more than a simple statement of the company’s targeted market positioning of executive pay, and should include a statement of purpose, the authoritative responsibility for various aspects of the design and administration of the executive compensation program, the population covered by the philosophy, the company’s fundamental pay principles and goals of the executive compensation program, discussion of the types of peer
companies used for pay and performance comparisons, and the role of each pay element in achieving the stated goals.

4. Annual Calendar

An annual calendar of items to be covered at meetings throughout the year should be developed prior to the beginning of the annual compensation cycle to allow committee members ample time to prepare and formulate questions in advance of meetings. The calendar should be developed jointly with management, and if appropriate, with the independent compensation consultant to ensure all relevant matters are included and that meeting agendas are contemporary with emerging trends and needs of the company.

5. Meeting Agendas

Meeting agendas should be developed jointly between management and the committee to ensure that all matters requiring the committee’s attention are covered. Ideally, the agendas for several upcoming meetings should be shared with the committee in advance of meetings to allow time to modify the agendas as necessary, work with an outside advisor to prepare any relevant analyses or materials (particularly if any items were not anticipated at the time the annual calendar was developed), and prepare for upcoming meetings.

6. Pre-Meetings with Committee Chair

Management should plan to meet in advance of scheduled committee meetings with the committee chair to review agenda items and proposals, as well as discuss any controversial topics. Best practice is to schedule the pre-meeting with the committee chair at least two weeks in advance of the committee meeting (preferably longer for more substantive matters) to allow the chair to review proposals, ask questions, socialize key issues with other committee and board members, request modifications, and review revised materials. In some cases, several pre-meetings may be required.

7. Advance Mailings of Materials

The meeting agenda and associated materials should be sent to committee members at least one week in advance of meetings to allow committee members
sufficient time to review and formulate questions. For more substantive meeting agendas, materials should be mailed as far in advance as practical (e.g., at least two weeks in advance of the upcoming meeting).

8. **Time Management**

Committee meetings should be scheduled so that all items on the agenda may be covered and that adequate time is provided to discuss each item fully and to the satisfaction of the committee. Ideally, significant proposals should be scheduled to be presented over multiple meetings (e.g., initial presentation at one meeting with subsequent refinements and approval at a second and/or third meeting).

9. **Regular Distribution of Executive Pay Program Information**

Executive compensation information should be provided as reference material at each meeting in which executive pay programs or pay levels are discussed (e.g., as an appendix to the committee book). Information should include a summary of the compensation philosophy, program design summaries, pay/performance analyses (such as realizable pay), individual total compensation profiles (“tally sheets”), executive biographies and pay histories, share ownership levels and any other relevant information identified by the company or committee.

10. **Executive Sessions**

The committee should hold regularly scheduled meetings at which non-management directors and selected other individuals (e.g., compensation consultants) are invited to participate (“executive sessions”) to permit private and candid discussions of relevant issues.

11. **Minutes Taking and Distribution**

Detailed minutes should be taken at every meeting to record the committee’s deliberations and provide a summary of conclusions/recommendations. Any materials presented during the meeting should be referenced in, and attached to, the minutes. Minutes should be drafted promptly after meetings and distributed to participants in a timely manner, well in advance of subsequent meetings.
12. Executive Compensation Consultant

The committee should have sole authority to retain and terminate an independent compensation consultant. Ideally, the consultant should attend a majority of committee meetings (preferably in person, but phone participation may be necessary in certain instances) and be available to the committee chair as needed.

The committee should establish terms for the engagement, including authority for retaining and terminating the consultant, independence standards for the consultant, process for how the consultant is to work with management in the normal course of providing advisory services to the committee, process for delivering sensitive materials, how the consultant is to respond to ad hoc requests from management, and the performance review process of the consultant.


The committee should regularly review executive compensation levels and delivery to ensure the program remains aligned with business and compensation objectives. Competitive pay reviews should include an assessment of company performance, both in absolute and relative terms. Equity plan share usage and dilution should also be reviewed on a regular basis to monitor the dilutive impact of the program. Generally, competitive pay reviews should be conducted annually, but may be conducted every other year depending on the pay practices of the company.

Pay trends, regulatory updates and governance developments should be reviewed on a regular basis to ensure committee members stay current with prevailing practices and so that any potential impact on the executive compensation program may be addressed in a timely and thoughtful manner.

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3 Included in the rules released by the SEC on June 20, 2012, were amended proxy disclosure rules regarding the use of compensation consultants and related conflicts of interest. The amended rules require that compensation committees of listed companies may select a compensation advisor only after consideration of certain factors regarding the independence of the advisor. The rules provide that listed companies must give the compensation committee the sole authority to retain a compensation consultant or other compensation advisor (e.g., independent legal counsel) and to provide funding to the committee to do so. In addition, listed companies must disclose any conflicts of interest of any compensation consultant advising their compensation committee. For details of the amended proxy disclosure rules please see The Federal Register, Volume 77, No. 124 dated June 27, 2012.
14. **New Member Orientation and Continuing Education**

The company should provide a new director orientation program to facilitate the assimilation of new members onto the board and committees. Orientation should include meetings with senior management and selected board members as well as briefings on the company strategy and operations and board processes. Directors should be encouraged to attend relevant conferences and participate in continuing education opportunities to continue to develop their skills and understanding of executive compensation matters. To facilitate the continuing education of directors, management should provide a listing of programs that will be held during the year that directors may attend.

15. **Committee Annual Performance Evaluation**

The committee should review its performance annually. The self-appraisal should be documented and include a comprehensive review of key functions of the committee, including committee structure and operations (e.g., adequate size, independence, qualifications, selection process, etc.), meeting process (e.g., annual calendar, time management, etc.), committee effectiveness (e.g., fulfillment of responsibilities), management support (e.g., advanced mailings, orientation/continuing education), and individual committee member performance (e.g., attendance, participation, knowledge, etc.). Aggregated findings of evaluations should be shared with the committee and/or chairman of the board to determine if any corrective action is required.

**CONCLUSION**

The responsibilities associated with service on a compensation committee are greater than ever before. A clear understanding and statement of these responsibilities and adherence to a few “best practice” procedures can help the committee effectively and responsibly execute its duties.
CHAPTER SEVEN

DOES EXECUTIVE PAY ONLY RISE VIA ‘RATCHET/LAKE WOBEGON’ EFFECTS?

by Ira T. Kay

THE RATCHET EFFECT: DOES CEO PAY ONLY RISE? ARE ALL CEOS PAID ABOVE AVERAGE BECAUSE THEY ARE ABOVE-AVERAGE EXECUTIVES?

“Pay has escalated dramatically over the past two decades, significantly outpacing shareholder returns in most years.” [“What Is a CEO Worth? Don’t Look to Peers,” by Charles M. Elson and Craig K. Ferrere, Directors and Boards, third quarter 2011]. Charles Elson, an expert in corporate governance and a longtime critic of CEO pay, attributes a purportedly ineluctable, permanent rise in CEO pay to the “ratchet effect” that comes from compensation committees’ supposedly being slaves to market data. He argues that this presumed effect results from companies’ chasing ever-rising median market pay levels at best, and 75th- and even 90th-percentile pay levels at worst. To be clear, a company that targets the 90th percentile wants to give its executives pay opportunity above the opportunity of 90% of its peers.

Elson’s theory, echoed by many critics, states, “… [I]f every board aims for the 50th percentile or higher, this has the effect of ratcheting up general pay levels by double-digit levels each year. A rising tide floats all boats. In other words, all CEOs are moving [pushing] up the median. Obviously, every time a CEO
moves [pushes] up the median, the median goes up, ‘ratcheting up’ executive compensations. That is where the tremendous growth in executive compensation is coming from” [“The Answer to Excessive Executive Compensation Is Risk, Not the Market,” by Charles M. Elson, Journal of Business & Technology Law, No. 2, 2007, page 406]. John Bizjak, a meticulous economic researcher, has drawn a similar conclusion, although he has found that large companies are highly discriminating in their peer group selection and thus have reduced the ratchet effect [“Does the Use of Peer Groups Contribute to Higher Pay and Less Efficient Compensation?” by John M. Bizjak, April 2003].

We think this is significantly overstated. First, as shown in the charts below, executive pay rises and falls with the stock market. This is true of pay opportunity, but it is especially true of realized and realizable pay. Second, if there were not a market for executives, they could not command these pay levels. If there were no alternative employment opportunities, boards would not be worried about losing executives because of pay levels. As we discussed earlier, although the number of CEOs who quit their companies for CEO jobs at larger or higher-paying companies is low, this is because they are locked into their current employers via unvested shares and various other retention devices. Again, the low number of quits is an outcome of deliberate policy reactions to a robust market for executives. It is incorrect to conclude that the low number of quits demonstrates that there is no executive market and thus no need for competitive pay.

The theoretical ratchet effect cannot exist in isolation. Saying executive pay has this problem is economically identical to saying that there was a ratchet effect in housing from 1995 to 2007. There was an upward ratchet precisely until a downward spiral began. There are thousands of historical examples of markets that might have been tainted with the ratchet effect, when in reality the increases reflected true supply and demand shifts or, ultimately, were averaged out by substantial corrections. These markets have included tulip bulbs, gold, silver, artwork, coins, Tokyo real estate, oil, natural gas, tech stocks and many other assets and items. What appears to be a “one-way ratchet” is in fact a temporary phenomenon. For meaningful analysis, we must have a long enough time period. Most, if not all prices, including the price of CEOs, move up and down.
As we showed earlier, executives are paid via a reasonably efficient but somewhat imperfect labor market. Hence, ratcheting is an outcome, not a cause.

Many critics and the public believe that CEO pay only rises and never falls. This is categorically incorrect. The following charts from Forbes.com demonstrate that, while CEO pay has generally risen over the past 20 years, it clearly both rises and falls proportionately with the stock market, specifically, the Dow Jones Industrial Average.

CHART 7.1
CEO Pay 1989-2012 ($ million) - Realized Pay*

Further, because of corrections, CEO pay moves both up and down. We demonstrate this using two very different definitions of CEO pay: one showing total compensation using the realized value of stock incentives, and the other showing total compensation including the grant-date value of stock incentives (including stock options). Chart 7.1 shows a peak in realized pay in 2007, and Chart 7.3, a peak in grant-date value in 2000, when tens of billions of dollars in value in stock options (using a hypothetical value derived from the Black-Scholes options pricing model) granted at high-tech companies ended up being worthless, i.e., had no realized value.

CHART 7.2
CEO “Pay” Increases 1989-2012 compared to movements in the Dow Jones Industrial Average (DJIA)

*Source: Forbes.com, 4/4/12 (Salary + Bonus + other + Stock “Gains” [exercised stock options; vested stock]) 1989-1999 top 800 companies; 2000-2012 top 500 companies

CHART 7.3
Median Grant-Date Compensation for CEOs from S&P 500 Firms, 1992-2011

*Source: “Executive Compensation: Where We Are, and How We Got There” Kevin J. Murphy, forthcoming in the Handbook of the Economics of Finance, working draft, August 2012
We used Forbes.com data for “realized CEO pay,” as it covers the longest period of pay data that we could find and is arguably one of the best pay metrics along with realizable pay. We also confirmed that the results for 1989–2012 results would be very similar for the S&P 500, so it is certainly incorrect to say that gains in CEO pay, using realized pay, outstripped market gains (Chart 7.2).

Similar results come from examining grant-date values of stock grants rather than realized value. These results are shown in Chart 7.3, which reflects the findings of a major study by Kevin Murphy. While CEO pay opportunity has also generally risen over the past 20 years, there is clearly a cyclical element to it that tracks the stock market. Thus, there is no ratcheting per se.

These charts show that:

CEO pay, as valued using realized pay (including the exercised value of stock options plus vested stock) moves significantly up and down over the years, primarily due to stock market volatility and the exercising of stock options.

It is incorrect to say that CEO pay has moved up “more rapidly than the stock market.” As Chart 7.2 clearly shows, over the full period of the data (1989–2012 proxies), the stock market as a general matter rose more rapidly than the CEO pay market — a 476% increase in the DJIA, compared to a 320% increase in realized CEO pay. We chose three periods: the longest period and the two periods between the 2000 and 2007 peaks and 2012. Other periods would show similar results. Importantly, the size of the companies grew after 1999 when Forbes.com changed its methodology to cover only the 500 largest companies, not the 800 largest. This means that CEO pay for the first 10 years of the survey was almost certainly higher, thereby reducing the demonstrated growth in CEO pay. The Murphy data show a 200% increase cumulatively over the past 20 years.

It is widely known from economic research on executive pay that increasing the size of the company — sales, market cap, assets, etc. — and improving performance (total shareholder return, profit growth, ROE, etc.) of companies will yield an increase in pay. The larger and more complex the company, the greater the human capital needed by the CEO and other executives to manage it. This is true of both pay opportunity and realized pay, which is shown in the bar chart. Thus, the strong overall growth and performance of these corpora-
tions has placed valid economic upward pressure on the compensation packages of these top executives.

These charts put the well-known criticism of the high and rising CEO pay multiple (of average/median employee pay for the broad U.S. labor market) in an important, and limiting, context. The critics wonder why CEO pay has risen so rapidly at a time when average wages and salaries are relatively stagnant. The logic of the critics is that CEO pay packages, and thus the multiples, have risen as part of a self-dealing, crony-driven corporate model, and that this is unfair to the “median” employee.

The arithmetic of the multiple is indisputable; that is, CEO pay has clearly gone up much faster than employee pay. This may be a sociological problem regarding income inequality, but no board of directors can solve that problem. However, as we discuss below, as a matter of economics, there are excellent reasons — including increases in the scale and performance of the companies and thus the return on executive human capital — to believe that these are two separate labor markets that cannot be compared to each other, as employees are not substitutes for executives. Hence, this multiple carries limited policy implications for CEO pay.

Most critics argue that the supposedly flawed executive compensation model is created, or at least enabled, by cronyism between the CEO and the board members. This is primarily because the CEO chooses the board members, or because the CEO is also typically the chairman of the board. The charts disprove this theory (see Kaplan and Helmstrom) because all three periods included major improvements in corporate governance, including fuller disclosure, more independent directors, more companies separating the CEO position from the chairman of the board (COB) role, more lead directors, nominating committees selecting directors rather than the CEO/COB, more director and executive stock ownership, and many other factors unrelated to executive compensation (e.g., reduction in the use of two classes of stock).

There also are tremendous variations in CEO pay levels, even for executives in the same industry working at similar-size companies. Depending on the particular industry involved, the variation from lowest- to highest-paid can
be 100% to 300% or more in pay opportunity. When evaluating realized or realizable pay, including the value of in-the-money stock options, the disparity between the lowest paid and the highest paid could be several thousand percent. For example, there are industries where the lowest-performing company had a CEO earning a few million dollars and the CEO of the highest-performing company earned more than $100 million, while the shareholders made billions. Thus it is clear that, when properly evaluated, not all CEOs are paid “above the average.”

**IS THE LABOR MARKET FOR CEOS “RIGGED,” OR IS IT COMPETITIVE?**

The fundamental pertinent economic question is whether the labor market for top executives is truly a competitive, or reasonably competitive, market. Is there a semblance of supply and demand that follows most of the economic rules of arm’s-length transactions? This requires basically independent parties to negotiate in good faith to balance competing interests and situations where the “answers” — specifically, the amount of pay opportunity and the structure of the pay package — are highly similar, irrespective of the type of company, whether it is public, private, family-owned, private equity, bankrupt but emerging, restructured, etc. This is because the executives and the boards all face the same pressures and competition for executive talent, and they all use the same publicly available pay data from proxy statements representing the top-executive labor market. There are logical reasons why U.S. CEOs are paid more than their counterparts in other countries — the larger size of U.S. companies and the greater proportion of at-risk compensation in U.S. pay packages [Fernandez and Murphy]. Or is it a rigged game, characterized by inside deals, managerial power, rent-seeking executives and crony capitalism?
### TABLE 7.4

Is the Executive Labor Market “Competitive”?  

<table>
<thead>
<tr>
<th>Attributes of a Competitive Market</th>
<th>Type of Market</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Buyer (&quot;bidder&quot;)</td>
<td>Cattle ranch</td>
<td>Company</td>
</tr>
<tr>
<td>2. Seller (&quot;asker&quot;)</td>
<td>Corn farmer</td>
<td>Executive</td>
</tr>
<tr>
<td>3. “Arms length” transaction (Parties are independent and equal footing)</td>
<td>Yes</td>
<td>a. Annual Pay/Contract Renewal: somewhat</td>
</tr>
<tr>
<td></td>
<td></td>
<td>b. Promotion: Board has negotiation power also</td>
</tr>
<tr>
<td></td>
<td></td>
<td>c. External hire: yes</td>
</tr>
<tr>
<td>4. Infinite buyers (demand) and sellers (supply)</td>
<td>Yes</td>
<td>No, but quite a few potential employers and fairly broad supply</td>
</tr>
<tr>
<td>5. Regulatory and Company Policy interventions in Marketplace impacting transactions and pricing</td>
<td>Yes-ethanol</td>
<td>Yes-sec, tax, SOX, Dodd Frank, plus company policies to reduce turnover (vesting, pensions, etc.)</td>
</tr>
<tr>
<td>6. “Judgment” by experts impacts pricing</td>
<td>No</td>
<td>Yes, but many facts, much experience, expert opinion and market indicators and parameters “frame” the bid/ask</td>
</tr>
<tr>
<td>7. Zero entry and exit barriers (supply)</td>
<td>Yes</td>
<td>Yes-free labor market encourages supply (changing jobs), subject to restrictive covenants</td>
</tr>
<tr>
<td>8. Perfect factor mobility</td>
<td>Yes</td>
<td>Mostly yes; can switch among public, private, private equity, etc. employers</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Type of Market</th>
<th>Regulated electricity distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Corn</td>
<td></td>
</tr>
<tr>
<td>Executive Labor Market</td>
<td>No</td>
</tr>
<tr>
<td>Regulated electricity distribution</td>
<td>No</td>
</tr>
</tbody>
</table>

Yes - buyers
No - seller (monopoly)

Yes-EPA, safety, nuclear regulations, etc.

Yes-Regulators apply judgment based upon facts, history, expert testimony and experience

No - Large barriers, due to capital requirements

No - no alternative use for transformers
The preceeding table shows a comparison between the executive labor market and the attributes of a competitive market. We also show a clearly competitive market — the commodity corn — and a market that is clearly not competitive, namely the regulated industry of electricity distribution.

This table indicates that while the executive labor market may not be as perfectly competitive as a commodity, it certainly has enough of the same dynamics to invalidate the claim that it is a “rigged” market.
FACTORS DEMONSTRATING A COMPETITIVE AND REASONABLY EFFICIENT CEO LABOR MARKET

We believe that another concept in support of the competitive market is that in CEO new hire/promotion/contract renewal/pay negotiations, the terms “bid and ask” are explicitly used. These are competitive market/auction terms, where the “ask” is what the executive — the supplier or the seller in the auction, the owner of the goods, in this case labor — is initially requesting for the package in terms of pay levels and terms and conditions. The board or buyer who wants to purchase the labor is the bidder. A negotiated agreement somewhere in the middle is usually the outcome.

However, although the primary explanation for the rise in executive pay is a rise in the return on executive human capital due to global competitive pressures, there are some temporary bubble aspects, as the charts above show.

Another fact that contradicts the ratchet effect theory embraced by critics of the U.S. model is the size of the pay increases at CEOs’ promotions and recruitments. As a general matter, newly promoted internal CEOs are paid less — in our experience, sometimes much less — than their predecessors. We have seen numerous examples where the board thought that the current CEO enjoyed more-than-comfortable pay opportunity, but there was little that could be done because he was the incumbent. The CEO promoted from within was paid 20% to 30% less.

By contrast, outside recruits are frequently paid more than their predecessors, especially if they are already the CEO of another company. A recruiting premium of 25% relative to their current employment package — to make the new position attractive and viable — frequently yields a premium to the prior CEO’s package, especially when the buyout of unvested equity is accounted for. However, there has recently been a medium-size shift in the labor market for newly recruited CEOs, where the company sets out to find a subsidiary head who is excited to be the CEO of a public company and may therefore be willing to sign up for less than the prior CEO was earning. This has many advantages from a cost and shareholder/ISS perspective. While this can yield a lower pay package, it is not without its own risks. As discussed previously, the percentage
of outside CEO hires has declined from around 40% to 20% over the past 10 years, as companies have substantially improved their management succession planning processes. While many believe this is a major enhancement to corporate governance and the CEO pay process, even the 20% outside-hire premium can influence the overall labor market significantly.

Thus, again, the pay packages can go up and down; an examination of internal promotions and external hires confirms this.

Nevertheless, as a matter of corporate policy, and in the spirit of good governance and the business judgment rule, we endorse the principle that boards should try to approximate the median of pay opportunity and then let stock and financial performance drive realizable pay up and down. Research shows that aiming much higher or lower than that target is a problem.

HAS THE RETURN ON HUMAN CAPITAL FOR CEOS RISEN OVER PAST DECADES?

A supplemental competitive labor market theory explaining how/why CEO pay has more often risen than fallen over the past few decades follows:

1. Academic research and corporate experience demonstrates that the return on CEO human capital has risen over the past few decades due to many factors, including global competition. Given today’s economic challenges, the CEO position, as well as all managerial positions, is more important than ever;

2. Hence, CEO pay opportunity at public companies would rise in an economically appropriate way, given the size and competitiveness of the markets and the labor market alternatives for this human capital in private equity or investment banking;

3. This CEO pay increase would have been appropriately faster than GDP growth (as were the prices of housing, gold, corn and many other goods for a while);

4. Stock market returns have been high over the last 20 years, with indexes rising faster than GDP as companies have become
more efficient due to many factors, including CEOs highly motivated to cut costs and to grow revenues and to make other strategic changes due to their cash and stock incentives. Thus, in a competitive market, pay opportunity, realized pay and realizable pay could rise faster than GDP.

In many years, it would appear that CEO pay moves inexorably up due to the targeting of pay to the median or any point in the range of the company’s peer group. In those years, the median would indeed tend to increase. Further, this increase, which is by no means inexorable, is an outcome of human capital returns, rather than a cause of rising pay.

This series of events has occurred while Say on Pay was being implemented and other corporate governance features were improving dramatically and becoming far more widespread, and while the media and regulators were putting enormous pressure on boards and corporations to reduce executive pay.

In the unlikely event that the basic corporate model were to no longer require CEOs possessing a high level of human capital (as is currently the case at some corporations in other economies), returns from human capital would decline, reducing CEO pay packages.
CHAPTER EIGHT
EXECUTIVE COMPENSATION GOVERNANCE
BY JOHN SINKULAR AND IRA T. KAY

SUCCESS IS ABOUT PAY-FOR-PERFORMANCE AND TALENT OUTCOMES

In today’s Say on Pay environment, it is critical for compensation committees to establish a solid corporate governance foundation for designing, implementing and administering executive compensation programs. Ultimately, however, a committee’s success will not be assessed by this foundation, but by the soundness of compensation programs built upon it. This structural integrity is measured by outcomes: the degree of alignment between total realizable executive pay* and corporate financial and shareholder returns on the one hand and the motivation of the executive team on the other.

Since each company’s circumstances are unique, the governance process used may vary. Yet a focus on achieving results through outcomes-based analysis should be universal. As companies achieve results, delivering their pay-for-performance promises in the short and long terms, they should make shareholders aware of this fulfillment through clear, concise communications in public filings and other available venues.

Scrutiny of executive compensation programs has never been more intense than in the current environment of seemingly endless views on “best,” “right” and “wrong” pay practices. Accordingly, the need for appropriate corporate
governance practices and an objective approach to managing pay programs is greater than it has ever been. Though there have been high-profile governance breakdowns at some large corporations, the reality is that most companies in the U.S. already possess the attributes necessary for successful compensation governance.

There is no single correct approach. As with a company’s business strategy and operational footprint, the governance system used must be a good fit and flexible enough to evolve over time with the company. Yet all companies have some common compensation governance needs. These include the need to incorporate and consistently apply pay-for-performance criteria, to use a disciplined process, and to conduct analytical reviews to assess pay/performance outcomes.

**STEPS FOR SUCCESS**

In the end, success in compensation governance is measured by pay-for-performance results. Here are some key steps for success and some of the critical considerations involved:

1. **Assure that fundamental compensation governance elements are in place, i.e.:**

   - A compensation committee composed of independent board members with diverse expertise and perspectives
   - A board charter that details the committee’s primary responsibilities
   - An annual meeting calendar that sets the dates for a minimal number of meetings annually — four, for example
   - A business strategy that is clear about financial and operational priorities over the short and long term
   - An executive compensation philosophy that documents the targeted market positioning and primary role of each pay element and design principle
• Incorporation of the company’s talent-evaluation/succession-planning framework into the executive compensation program

2. **Follow a well-defined process to focus discussion and decision-making at each committee meeting.**

• Present materials that explain key considerations and recommended courses of action (with supporting details relegated to appendices).

• Distribute and review these materials well in advance of meetings.

• Ensure that discussions are led by an active chairman.

• Seek support, as appropriate, from an independent executive compensation advisor and outside legal counsel.

• Hold executive sessions without management present (with or without the presence of outside advisors).

• Provide materials after each meeting that summarize decisions and set the agenda for the next meeting.

3. **Gather and analyze facts.** The centerpiece of discussions should be the analysis of facts concerning past and potential pay/performance outcomes, incorporating relevant internal data and relative market comparisons.

   **A.** Benchmark compensation and set goals to establish the context for annual pay decisions. Market data, while important, should not be the sole driver of target-setting. Rather, it should be one of numerous factors that committees should consider in determining pay opportunity, i.e.:

   • Selecting peer groups composed of direct competitors, companies in the same industry or a broader sector group, using criteria that ensure relevance and unbiased comparisons

   • Using benchmarking methodologies and design practices that are consistent with the company’s pay philosophy, design principles and competitive market ranges
• Analyzing the achievability of different levels of performance to determine relative degrees of difficulty. Such analyses use historical and prospective performance data from the company and its peer group to determine the probability of achieving a range of performance levels for each measure used.

B. Assess the historical alignment of pay with performance and manage compensation-linked risk by conducting:

• Pay-for-performance analyses looking at multi-year total realizable pay relative to financial results and total shareholder return (TSR)

• Value-driver analyses to identify financial measures that have the strongest correlation with value creation as measured by TSR

• Risk assessments of compensation practices and policies

4. Consider relevant perspectives. In discussing current practices and alternatives, committees should focus on internal considerations while ensuring that practices are within the competitive market range, taking shareholder perceptions into account, i.e.:

• Talent needs. Evaluate data on executive turnover, retention and recruiting.

• Say on Pay advisory votes on compensation programs, held annually by most companies

• Shareholder value creation, as defined by several financial measures and TSR over various time periods

• The range of best- and worst-case performance scenarios and assessments of whether resulting pay outcomes for each would be commensurate

• “Analyses” by proxy advisory firms

• Various analyses of outcomes to demonstrate the correlation of pay with performance. If this correlation is not strong, a clear course of action should be charted to strengthen it.
• Pay tally sheets that include accumulated wealth and compensation from historical and recent compensation opportunities
• Full, transparent disclosure in proxy statements

5. Make pay decisions. Ensure that salary levels, actual and target incentives and other pay elements are aligned with the business strategy, talent needs and compensation philosophy.

• Review and approve performance results and corresponding payouts for incentive performance cycles that closed at the end of the previous year.
• Make any necessary changes in program design.
• Determine base salaries, incentives and other pay levels for the coming year.
• Set incentive goals and corresponding award opportunities for ensuing cycles.

6. Fully and clearly disclose pay program details. Engage in dialogue with shareholders, participants and other interested parties.

• Provide participants with total compensation statements, plan summaries and periodic updates regarding recent performance and its implications for pay.
• Issue a well-written, transparent proxy statement that clearly presents the company’s pay-for-performance story in the context of recent performance, business strategy and talent needs.
• Provide an executive summary.
• Present analyses of single- and multi-year pay/performance relationships.
• Proactively disclose all material pay practices and provide context pertinent to hot-button issues of external parties.
• Be clear and specific about plan design, pay levels and performance outcomes. Anticipate objections to any features that have brought
criticism in the past and proactively present a compelling case for them, providing context to establish the rationale.

- Reach out to major shareholders to discuss the company’s pay-for-performance story.

CONCLUSION

Compensation committees should be aware of external views on what constitutes good governance. Yet what ultimately matters is that their actions are appropriate for their companies’ business strategies and talent needs. Executive compensation governance is about substance, not form. This substance is weighed by outcomes in the relationship between pay and performance and in the motivation and retention of highly qualified executive talent. Critical to success is a willingness to incorporate into the pay-setting process considerable fact-based analyses and to perennially make refinements that reflect dynamic economic and business conditions and changing needs for talent.
CHAPTER NINE
TERMINATIONS, SEVERANCE AND VOLUNTARY TURNOVER — WHAT ARE THE FACTS?

WIN OR LOSE, CEOS ARE CRITICIZED

Being a CEO is a well-compensated, highly attractive, powerful and yet very challenging job. It also is a highly dangerous job from a career reputation, economic, human capital and public relations/stigma perspective. The reality is that CEOs are excoriated for failure and, occasionally, for success. Many are criticized for high levels of pay and reward even when they are successful and create billions in market capitalization for the shareholders and millions — and in some cases billions — for the employees. And of course, they are especially highly criticized when they “fail,” their stock price suffers and they are paid severance.

Even a hugely successful company such as Apple has been targeted by the media, with questions such as “Is any C.E.O. worth $1 million a day?” [“A Rich Game of Thrones,” by Natasha Singer, The New York Times, April 8, 2012]. The article discusses the 2012 proxies on the 100 very large companies that had already published their proxies containing the 2011 CEO pay levels. The article generally finds that pay levels were flat from 2010 to 2011 precisely proportionate to the their stock prices, but focuses on the new CEO of Apple, who received a 1 million-share grant of stock upon his promotion to CEO during 2011. The
grant was worth more than $300 million when it was made. Ironically, the value of that stock had nearly doubled since grant, again reflecting the spectacular profit performance of Apple as a company and the impact of those profits and growth on its stock valuation. The article also makes it clear that the shareholders are delighted with the stock price appreciation, and have overwhelmingly endorsed the Apple pay levels and models via their Say on Pay vote. Therefore, why the populist and inflammatory headline?

There have been countless examples of highly criticized companies over the past 20 years that were extraordinarily successful and had highly talented CEOs, who, yes, did indeed become wealthy. These criticized companies include a “Who’s Who” of corporate America, including Disney, Goldman Sachs, Coca-Cola, Hewlett-Packard, ATT, Occidental, Exxon Mobil and dozens of others.

On the other side of the ledger are the unsuccessful companies whose boards terminate their CEOs and then search for a turnaround successor. For these executives, it is their severance packages — cash and stock payments that are made at termination, some previously vested and others newly vested — that are controversial. However, severance for these top executives is usually essential, or at least very helpful, to ensure that the executives take the long-term perspective on their companies and their careers. If an executive is worried about being fired over the short term and not being compensated for that, they may not make the proper long-term investments. Further, severance makes the termination and management succession process much smoother and easier, and less embarrassing for both the company and the executive, and it avoids lawsuits that can become public. It also is essentially impossible to recruit and promote a new CEO without some type of severance protection, both for a regular termination and for one after a change in control.

We present some ideas in the next chapter for balancing the tension between executives and shareholders regarding severance plans as well as in factoring in public perception — e.g., sunset on cash severance, caps on cash severance based upon the size of the equity gain, etc. But whatever the size or the nature of the severance, it is also true that these terminated CEOs do indeed suffer reputational and human capital damage, and of course direct economic damage
in the form of losing their jobs and all their future compensation, despite the severance payments.

Severance at a change in control, where the company is bought or merged, is also a very helpful tool to ensure that the top executives have a balanced perspective on the deal in terms of maximizing shareholder value and facilitating a smooth deal and ownership/management transition process during the negotiations and after the close. Many executives, especially the CEO and CFO at the target or purchased company, do indeed lose their jobs, and many of them are unable to find other top jobs given their ages and, frankly, their interests. If there were no accelerated vesting at termination, these executives might have lost parts of three years’ worth of equity grants, which are a significant portion of their pay packages and probably their net worth. It does indeed seem fair to have those shares pay out. Now in the context of a large equity gain, these extra shares can seem to be superfluous, but the executive did indeed earn the shares and these were contractually committed to at grant.

These executives at taken-over companies are not generally considered failures, as is the case for executives terminated due to poor performance. Quite the contrary, target executives almost always sell their companies for substantial premiums — in the range of 25% to 50% — to their recent stock prices, and are thus effectively “heroes” to their shareholders. Whether a CEO who has made $100 million at the CIC is entitled to additional cash severance is a legitimate corporate governance question that the board should discuss, but these executives do not deserve to be excoriated in the press. And indeed there have been examples of this, where the CEO was the leader in creating billions or even tens of billions of total shareholder values, yet was criticized for his large separation package, the preponderance of which was due to stock appreciation on his watch. Gillette, MCI, Georgia Pacific and many other companies are examples of this type of second-guessing.

Extra severance, however, especially at a change in control of the company, in the forms of excise tax gross-ups, cash severance for an already wealthy CEO and “single trigger” accelerated stock vesting, is considered by many to be unfriendly to shareholders, as we will discuss later (because it is expensive and makes it harder to retain the management team of the acquired company, etc.).
Boards are starting to manage the severance process as part of good governance and responding to shareholders. Further, thanks to shareholder pressure, and especially pushback from ISS in their SOP recommendations, many of these severance features are being reduced in prevalence.

The original theory for the 280G “gross-up” was to neutralize a federal excise tax of 20% on “parachute payments,” i.e., large severance payments of cash and stock (via a highly complex calculation). This excise tax, created in 1984, was intended to reduce executive severance payments by taxing the executives themselves for these types of payment and by having the company forfeit its corporate tax deduction. It failed at reducing the severance payment. The gross-up is where the company paid the excise tax and the income tax on the excise tax on behalf of the executive, saving the executive (and thereby costing the company) millions of dollars, typically two times the actual excise tax. The prevalence of this gross-up was approaching 80% of executives at various points over the past decade. The theory of the gross-up was to make the executive “neutral” to the takeover. As a general matter, the concept of severance is successful at that, but one wonders whether an additional gross-up is necessary to have the executive pursue a transaction at a major premium, thereby already yielding many millions of dollars of stock payments. In any event, shareholders are adamant about eliminating these, and we predict they will be dramatically reduced in one generation of executives.

We have been involved in eliminating the gross-up for more than five years now. One of our technology clients eliminated its gross-up in 2007, long before it was fashionable. The CEO believed that was the right thing to do. We also have been involved with several major severance reductions in the middle of a takeover battle. In these instances, we were advising the target, and after the board saw the total “walk away” value, they asked their CEOs to forgo the gross-up and cash severance. In one instance the forgone value was more that $40 million, and in another, more than $100 million — in both instances around 25% of their total packages. This trend toward reduced severance, especially for successful CEOs at a CIC, could be a positive development. This is because severance and other shareholder irritants (or at least ISS irritants) are a distraction from the main event — mainly, whether these executives are paid
commensurately and proportionally to the performance of their companies, as typically measured via stock price or total shareholder returns.

Irrespective of any payments for either success or failure as a top executive, it is important to remember that CEOs do lose their jobs, and do ultimately stop being paid. This is another very important aspect of the labor market for executives, as it demonstrates that the demand for a particular executive can fall to zero, as does their compensation. But what are the facts about termination?

**DO CEOs LOSE THEIR JOBS?**

Another important manifestation of a competitive labor market that allocates executive resources effectively is whether the top executives, especially the CEO, periodically and appropriately lose their jobs due to poor performance. Some critics believe that, unlike regular employees from the shop floor to upper management, CEOs and other top executives are rarely if ever fired due to their individual and company performance. Thus executives, these critics believe, are “entrenched” in their jobs for very long periods of time, because they appointed all of the board members, who are therefore beholden to the executives, and thus the board members are their business and social “cronies.” This meme further says that the board members serve the executives, instead of the other way around.

As a result of this alleged special treatment, the executives can keep their jobs as long as they want at high and rising pay, irrespective of their individual and company performance. These critics recognize that occasionally a CEO is terminated, but usually maintain that the board waited way too long to act under prudent corporate governance protocols, and only responded to outside pressure from shareholders and the media, and that additional shareholder value was destroyed. Further, they say, these failed CEOs were paid excessive “golden parachutes” beyond what they deserved.
WHAT ARE THE MYTHS AND REALITIES OF EXECUTIVE TERMINATIONS?

As with most mythologies, there are some truths in here, but as a general matter, this is grossly exaggerated [See “Outrageous CEO Pay Revisited,” by Holman W. Jenkins, The Wall Street Journal, October 2, 2002].

Here are the facts:

1. Board members at major companies are being chosen independently of the CEO, and acting accordingly;

2. CEOs are indeed fired for poor corporate performance [Note: Being fired for poor performance is not the same thing as being fired for cause, which is usually defined as relating to some type of misconduct — violating the ethics rules, expense account abuse, accounting irregularities, felony conviction, etc.];

3. It does legitimately take a few years to measure their performance, and even then it is difficult due to confounding variables;

4. Their average tenure is only five or six years due to their age at accession as well as the challenges of the job, and the desire by the board to have fresh perspectives and strategies every few years; this average tenure has declined over the past 10 years;

5. When an executive is fired for poor individual or corporate performance — typically a declining stock price — their cash severance is typically two years of cash compensation, and some but not all of their outstanding unvested equity grants will have accelerated vesting, with the rest forfeited. These packages are higher than the severance for regular employees, as it is argued, with some legitimacy, that the stigma of being fired at the executive level is significant and damaging to future job prospects. Nevertheless, those amounts are declining;

6. And boards are in fact showing strong corporate governance in this area of CEO supervision and are intrinsically sensitive to the viewpoints of shareholders.

Obviously, being fired means the company and board no longer require the services of the executive, and it is the ultimate pay cut and commentary on
individual and corporate performance under an executive’s stewardship. Many resignations are really just another way for the committee or board to change leadership in a discreet but nonetheless accelerated, fashion. These accelerated transitions often include resignations that might be labeled as “voluntary,” especially where the replacement CEO has not already been recruited, plus other orderly/formal CEO succession processes and even some retirements. Even in the common circumstance where the CEO has had a long and successful career, is pension and/or retirement eligible, and has organized a smooth succession process, the board may accelerate the process for many reasons, including:

- Being ready for the next corporate chapter,
- Organizational fatigue by both the board and the CEO,
- Trying to keep the preferred internal CEO candidate from leaving,
- Wanting the next phase of strategy, organization and leadership to begin.

We have seen examples of all of these circumstances.

Pensions plus scheduled and/or accelerated vesting of stock can make these latter types of transition processes very smooth and friendly for all cooperating parties, when in fact they are part of the board’s strategy to change leaders sooner rather than later. These payments also can avoid expensive and disruptive lawsuits. These are clearly shareholder-friendly transitions and soothing to the stock market.

Our consulting experience clearly shows that the best-performing CEOs — or, more precisely, the ones who work for successful companies — are rewarded best on average by the use of realizable pay as the pay metric and by their having the long tenures and successful careers. It clearly appears to us and the boards of these companies that the weakest-performing CEOs at the weakest companies are paid less in realizable pay, and are the most likely to be terminated or retired early. The big-picture results clearly endorse these findings of reward for success and punishment and accountability for failure.

While there are always mistakes, disagreements and errors in judgment — mostly where an unsuccessful company retains its CEO longer than others
deem appropriate or correct — the board members clearly act in good faith and try to act in the best long-term interests of the shareholders. The number of lawsuits where the shareholders sue the board for keeping an allegedly failing CEO too long is essentially nil.

Again, there is a robust academic and professional literature on this topic that supports the latter big-picture observations, namely whether CEOs are fired at all, and that the reason for the termination is usually poor performance (typically stock price). In reviewing our own experiences plus a number of articles on this topic, we identified these issues:

1. Are CEOs fired or are they entrenched? A number of studies find that between 2 and 2.5% of major company (typically S&P 500) CEOs are forced out each year [Sources: Spencer Stuart and the Conference Board]. There are many examples where the boards at well-known companies, with well-known CEOs, terminated the CEO, or the CEOs lost their jobs due to colossal failures, bankruptcies, forced mergers and the like. These include Tyco, AIG, Merrill Lynch, Hewlett-Packard, Mattel and many Wall St. firms, in cases of bankruptcies and many other circumstances.

2. Are CEOs at poorly performing companies fired? Yes, these terminated CEOs typically work at underperforming companies in underperforming industries, demonstrating that boards are in fact highly sensitive to overall corporate performance. One study [“CEO Turnover and Relative Performance Evaluation,” by Dirk Jenter and Fadi Kanaan, Stanford University, 2008] evaluated 1,627 CEO turnovers of all types from 1993 to 2001. They found that the total shareholder returns for the prior 12 months for the companies with the nearly 400 forced-out CEOs was -18%, compared with positive returns for voluntary turnover (retirements, etc.), at +12%, and nearly +30% where the CEO was retained. Other studies have found similar results. [“How Has CEO Turnover Changed?” by Steven N. Kaplan and Bernadette A. Minton, University of Chicago, 2008; “The 2011 CEO Succession Report,” Spencer Stuart CEO transition research and the Conference Board]. These findings that the TSR for the retiring CEO was lower than the returns for the retained CEOs are consistent with our view that even smooth succession processes and retirements have some “organizational fatigue” associated with them.
3. Is the CEO termination rate too low? Some critics believe that this rate of terminations is too low and that many boards act too slowly to terminate their CEOs because of the “crony” effect. The theory is that the boards have been “captured” by the CEO due to his role in recruiting them and given their social and business relationships. While there may have been some truth to this in prior generations, there is very little of this currently at major companies in light of numerous factors, including SEC disclosure requirements, NYSE independence rules, the media, Say on Pay votes and numerous other enhancements to corporate governance. These governance enhancements have been well documented.

Furthermore, there are a myriad number of complexities of measuring “success and failure” for these major jobs at gigantic, complicated companies, combined with the risk of economic and organizational damage from acting too soon/precipitously. Therefore, there are valid governance and economic reasons for moving conservatively. There also is fear of moving from the devil you know to the devil you don’t know. With billions of dollars of market capitalization at stake, these are not minor considerations.

4. Are boards moving too slowly to terminate poorly performing CEOs? The criticism that boards move too slowly is not consistent with our personal experience, and we are not aware of any academic studies that support it. “… [I]t is not clear what rate of forced CEO turnover we should expect from a well functioning Board. It is therefore difficult to judge whether the observed 2% rate is low or high. If it is indeed too low, it is not clear how much shareholder value is being destroyed” [“Why Are CEOs Rarely Fired? Evidence from Structural Estimation,” by Lucian Taylor, Journal of Finance, 2011].

5. What impact have these terminations had on average CEO tenure? Further, according to the Conference Board, the average tenure has dropped around 20%, from 10 years to eight years, over the past 10 years. We view this as further indication that the CEO position is very challenging and risky. (Note: The Conference Board uses a different methodology for tenure than Spencer Stuart.)
6. How does the termination rate for CEOs compare to other employees? The termination rate for CEOs is still most likely lower than the termination rate for the broader employee population. While some may criticize this, there are some logical reasons for it, including the governance issues referenced below, plus the fact that very high-achieving and performing employees are selected as CEO after winning many “sub-tournaments.”

These “winners” thus are highly motivated as individuals — and by their pay packages — to succeed. In addition, their impact on the performance of the company can be very difficult to discern and isolate over a given short period of time from historical, economic and industry factors. After the fact, strategic errors in pricing, acquisitions, divestitures, expansions, research, etc., are easy to discern. Determining who should have known what beforehand is very difficult, and thus the board is protected from Monday-morning quarterbacking by the business judgment rule. However, boards do indeed try to hold their executive team, and especially their CEO, accountable for the results of the company, but there are valid reasons why the termination rate for CEOs would be relatively lower.

Nevertheless, we estimate the comparable termination rate for all employees is around 4% to 5% per year, not that much higher than the pure CEO rate, and possibly the same or even lower if all of the sundry euphemistic reasons are factored in. The general employee population also has risks in its employment stability, as employees face layoffs where the company is cutting costs, having little or nothing to do with the individual performance of the employee. As a general matter, top executives are rarely terminated for such a reason. [Note: We used BLS data showing that for 2011 there were approximately 21 million aggregated “layoffs and discharges” (BLS does not have the ideal microeconomic data to separate layoffs), which represents around a 15% rate on the 140 million employed. However, layoffs are for economic reasons where the company faces reduced demand for its products or other reasons to cut costs dramatically. We estimate that around 75% of this total was layoffs based upon the difference between the BLS data on layoffs and discharges and other government data on new claims for unemployment insurance. This leaves around 4% for being fired, including performance and misconduct.]
7. Why are boards careful in removing a CEO? While there is a low but perceptible probability that a CEO will be terminated in any given year, there is very good reason for the board to be conservative as to when and how it reacts to a few years of weak stock price and other performance indicators. First, it is very hard to be sure what the accountability of the CEO is for the performance of the company, or whether it is for exogenous reasons, although clearly at some point the CEO “owns” the problem.

8. That having a CEO change is highly disruptive to the company and shareholders and that it something that the board and company have to live for several years after making that change. One study [Luke Taylor, Wharton School, reviewed in Board Works, February 2011] indicated that firing mistakes in both directions are made — namely, that some boards wait too long and others act too quickly — and second, that it is very expensive to make a change, in the neighborhood of $1 billion-plus in intrinsic and extrinsic costs.

9. What is the total amount of CEO separations/successions in a given year? At an additional 7% to 8% of those companies during 2011, the CEO retired, was replaced during a planned succession, or left for other reasons, for a total of around 10% transitions in 2011 (Spencer Stuart research, CEO transitions and the Conference Board, “The 2011 CEO Succession Report”). As described above, most of the CEOs in these transitions have had highly successful careers with strong shareholder value creation. Nevertheless, the board was desirous to move on to the next chapter for the company. We estimate that 1 to 3 percentage points of the 7% to 8% really include CEOs who had had performance issues, but the company was able to have a very smooth succession process where the performance issues were masked by other events and compensation plans, e.g., pensions. Thus, approximately 3% to 5% of CEOs are terminated annually for the weak performance of their companies.

The notion that many CEO transitions are performance-related is supported by research by the Conference Board (“2011 Report on CEO Succession”). The board found that, irrespective of whatever face-saving label companies may put on CEO successions/transitions, the facts show that many of them are performance-based.
10. **What about turnaround situations?** It can be very challenging for an outsider, even a sophisticated investor or shareholder, to distinguish between a poorly performing CEO and a CEO in the middle of a turnaround of a challenged and underperforming company. It all depends upon whether the board, with its enormous information advantage, has confidence in the CEO and his/her ability to fix the company. We have all seen many situations where the CEO was in charge of the company during a market or industry correction and the stock lost 90% of its value. And then, through enormous effort, the CEO, the board and the management team turned the company around and achieved a tripling of the stock price, but still well below its pre-crash high. Is that CEO a hero or a goat? Experts disagree.

**TABLE 9.1**

<table>
<thead>
<tr>
<th>Company Performance</th>
<th>Average rate of CEO transitions from 2000 to 2010 (% of all CEOs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top Quartile</td>
<td>10% (range: 7-12%)</td>
</tr>
<tr>
<td>Bottom Quartile</td>
<td>14% (range: 1-22%)</td>
</tr>
</tbody>
</table>

11. **Where do CEO candidates come from?** According to the Spencer Stuart study, around 80% of new CEOs in 2011 were promoted internally, and thus around 20% were recruited from the outside. This is a fairly dramatic change since 2004, when only 64% of new CEOs were internal promotions. Most governance experts consider internal promotions to be best practice as the internal candidate understands the culture and of course is already an expert in the company and the industry (firm- and industry-specific human capital). Of course, the trade-off for that archival knowledge is that the external candidate brings a fresh perspective from other companies and industries and does not have any “sacred cows” to fear. The jury is still out on whether the corporate governance experts are in fact correct that internal candidates are superior to external candidates. Clearly ISS has a bias against outside candidates, and others think that they are too expensive. Nevertheless, companies need to do what is right for their situation, culture, strategy and board desires.

12. **How do the pay packages for internally promoted CEOs compare to the packages for external hires?** Regarding compensation, the annual pay
target packages of both internal and external candidates tend to be very similar. However, because most, but not all, external candidates need to have their unvested equity from their prior employer “bought out,” it is very expensive, and in fact very risky, to bring in an outside CEO. Kevin Murphy [“Explaining Executive Compensation: Managerial Power vs. the Perceived Cost of Stock Options,” *University of Chicago Law Review*, 2002] argues that any premium paid for outside candidates, including these buyouts, demonstrates that executive pay rises in general due to labor market phenomena, and not because of crony capitalism or captured boards. How could a board be captured by an outside candidate?

One strategy we have seen utilized with good success is to recruit a “retirement eligible” candidate whose stock has fully vested. Naturally, a candidate who is eligible for retirement may not have sufficient runway left to have a successful career at the new employer. We have also seen successful recruitments where the new CEO had lost the CEO “horse race” at his/her prior employer. Those executives, however, are more likely to have large amounts of unvested stock that needs to be replaced, thus dramatically increasing the cost and risk of hiring them.

13. **Have CEO transitions increased or decreased during the recent economic crisis?** The total has decreased, despite the economic volatility and the increased emphasis on good governance. In 2004, the total transition rate — including retirements, normal successions, resignations, ousters, etc. — tracked by Spencer Stuart was around 13%. For 2011, that rate was 9.5%. This is fascinating, given how many companies had major stock and profit declines in 2009, and then major recoveries. This is a major endorsement of the top executives at hundreds of companies, indicating that their boards think that they are the right teams to lead in this time of crisis and challenge. In reading the proxies of hundreds of companies, it is obvious that boards truly believe this, given how many of them comment on the extraordinary performance of their CEOs and their teams during the economic adversity. It also says that for all of the media and governance pressure on boards, they still have the fortitude to do what they think is in the best long-term interests of the shareholders, whether that is exhibiting confidence in a CEO of a struggling company or terminating that CEO and starting afresh.
With these facts as context for CEO terminations, the next chapter presents the evolving best practice in executive severance in a Say on Pay world that is characterized by more shareholder activism.
In the current economic environment, as discussed in the prior chapter, there is a significant probability that a CEO or other senior executive will not serve until retirement or perhaps even for as many as five years. In fact, some research shows that the average tenure of a CEO has declined to between five and six years owing to the frequency of performance-based firings, mergers and acquisitions, and private equity buyouts. The tenure of other senior executives has also declined in recent years for the same reasons plus the tendency of new CEOs brought in from the outside to bring in new senior executive teams. Thus, in many cases the board will need to make critical decisions about the treatment of pay and benefits at the termination of a CEO or other senior executive whether in company plan provisions (equity, retirement, severance) and employment agreements, or ad hoc at the time of termination.

Severance and change-in-control benefits are a hot-button issue with major institutional investors and their advisors. The value of severance or exit payments to executives terminated for poor performance is increasingly challenged by investors as “pay for failure” and not in the interest of shareholders. In addition, the value executives realize upon termination following a change in control is often challenged as excessive and adding too high a cost to shareholders for
the transaction. Defenders of prevalent severance and change-in-control benefits argue that they are aligned with the interests of companies and their shareholders in encouraging executives to join a company that is facing significant problems and risks, to take appropriate risks in the business, to consider fairly offers to acquire their company or to take it private, and to leave without a fight when it is deemed by the board to be in the best interests of shareholders.

In response to these growing pressures, more and more companies are breaking from past practices and employing new approaches in an effort to strike a more appropriate balance between legitimate company needs and shareholder concerns. This chapter provides a thorough discussion of severance issues and provides guidance for boards of directors in attracting and motivating the key talent required while reducing or eliminating practices that are increasingly considered unacceptable to major investors.

**TYPES OF SEVERANCE BENEFITS**

**Cash Severance.** Severance is generally understood to be an additional cash payment made by the company to a departing executive. The payment represents a continuation of cash compensation, typically .5 times to three times an executive’s annual cash compensation (base salary and average or target annual incentives), which is intended to enable the executive to meet her or his financial commitments until another job can be found. Such severance benefits are common given the risks associated with executive positions if company performance falters or a new CEO arrives. In exchange, companies typically obtain a waiver of claims against the company, which essentially eliminates legal risks and costs associated with the termination. The severance benefits also assure continuing executives of fair treatment so they can stay focused on the tasks at hand. Because most employees receive health care coverage through their employer, often companies also pay for continuation of health care benefits for the same period of time represented by cash severance. Some companies also continue supplemental executive benefits such as disability or life insurance for similar reasons.

**Equity and Retirement Benefit Acceleration.** The second type of exit benefit involves acceleration of vesting on incentive awards and retirement plans
where vesting is tied to future company service or achievement of performance goals. The rationale advanced for accelerated vesting of service-based awards and benefits in a change in control is that the event took away the ability of the executive to earn the awards or retirement benefit, and hence it is fair to credit the executive with the additional service required for full vesting. The same logic is often employed for performance-vested incentives, although the basis for such vesting may not be strong if the company is being sold due to sustained poor performance and dim prospects. Weaker still is the case for accelerating vesting on incentives and retirement benefits if the executive is being terminated for poor performance, yet CEOs and other executives commonly negotiate for partial or full acceleration of vesting in their employment agreements.

**Excise Tax Gross-Up.** The third category of severance benefits provides additional cash payments to offset excise taxes on excess parachute payments in a change in control. Such excise tax gross-ups are a response to a tax law that triggers a 20% excise tax if the value of the parachute benefits, calculated as prescribed by law and regulation, exceeds three times an executive’s average taxable employment income with the current employer over a period of up to the last five years. If the parachute value exceeds this excise tax threshold, then the value of the parachute in excess of one times the executive’s average taxable employment income is subject to the 20% excise tax. The calculation of the excise tax is often hard to predict given changes in an executive’s taxable income from variable incentive payments and stock option exercises as well as changes in the parachute value from variations in equity grant types and vesting schedules. Thus, since this law was passed in 1984, most large companies provided executives with this excise tax gross-up benefit as a way to ensure that the executive received the intended benefit in a change in control. In recent years, categorical opposition to excise tax gross-ups by proxy advisory services has virtually eliminated the extension of such gross-ups to new executives, which has resulted in a rapid decline of its prevalence.

**Other Benefits.** In addition to the three categories of exit benefits described above, a few companies have provided additional executive benefits and perquisites to terminated CEOs and executives. Common examples are personal use of company aircraft, office space and administrative staff, lifetime medical ben-
benefits, life and disability insurance and perquisite allowances. The business justification for such benefits is hard to sustain, and very few companies continue to provide them. A possible exception is where the terminated executive uses an office to continue to represent the company in an unpaid capacity to industry associations or charitable organizations. Of course, this is not likely in the case of an executive terminated for poor performance.

**WALK-AWAY VALUE**

In addition to the exit benefits described above, the media and other observers often include the value of vested but unexercised stock options, equity owned outright, deferred compensation accounts and accrued pension values in their assessment of executive exit packages. Of course, these are not benefits conferred by the company at termination, but benefits that have already been earned by the executive. Deferred compensation consists substantially of the executive’s own compensation that was electively deferred. The value of vested but unexercised options and equity owned outright at termination are a reflection of the executive’s investment decisions, influenced by company share ownership guidelines for executives as well. Pension benefits have similarly been earned unless additional service was credited at termination. Nonetheless, adding these values to the exit benefits provides an “all-in” value that boards should understand when making decisions about the level of severance and incentive acceleration that is appropriate.

**EMPLOYMENT AGREEMENTS**

CEO and executive employment agreements are declining in prevalence as companies seek greater flexibility on severance terms. By keeping an executive’s employment “at will,” the company can retain control and flexibility over executive severance plans and provisions on treatment of equity and other benefits at termination. This also avoids the need to negotiate with an executive to change a benefit already conferred in an employment agreement.
THE EFFECT OF SAY ON PAY

The introduction of a shareholder advisory vote on executive compensation in 2011 increased the visibility and stakes involved in maintaining and providing severance benefits that are unacceptable to investors. Shareholder advisor ISS has influenced 15% to 25% of votes cast on Say on Pay among large companies with substantial institutional share ownership. Their influence has helped to move the Say on Pay vote from approval to failure in a number of cases. It has also reduced support to levels that place substantial pressure on a company to make changes to policies that are unacceptable to investors. Not only are there shareholder pressures to change from a failed vote on Say on Pay, but most directors are sensitive to the reputational harm from being associated with a company that has been singled out for poor pay practices. In addition, in a number of cases failed Say on Pay votes have led to shareholder lawsuits, which distract companies, incur unnecessary costs, and further taint the reputations of sitting directors on the compensation committee. Thus, ISS policies on severance have strong leverage on company practices.

ISS voting guidelines identify certain “most egregious” pay practices that carry significant weight and may in and of themselves result in adverse vote recommendations with respect to Say on Pay or other executive compensation policies taken to shareholders in the regular annual proxy process. Among the most egregious and problematic practices that may occur in a severance arrangement that may trigger criticism from ISS include:

- Excessive perquisites or tax gross-ups
- Excessive or single-trigger change-in-control payments pursuant to a merger/acquisition transaction deemed a change in control
- Tax gross-up payments pursuant to a change-in-control arrangement triggered by a merger/acquisition transaction

With respect to other “problematic” pay practices, ISS has also identified certain adverse practices that are contrary to a performance-based pay philosophy and may lead to negative recommendations if they are deemed to be inappropri-
ate or unjustified relative to executive pay best practices. Included in this category are egregious pension/SERP payouts that credit additional years of service not worked and result in significant additional benefits. Although it does not appear that crediting additional years of service not worked to a pension/SERP arrangement will necessarily result in a negative Say on Pay or withhold-vote recommendation, such a pay practice typically would be reviewed as part of the ISS qualitative analysis if ISS quantitative tests identify a pay-for-performance disconnect.

In addition to the advisory vote on executive pay practices, the Say on Pay rules also provide for an advisory vote on change-in-control severance arrangements in the proxy filed to approve a change in control. While there is little experience with this vote to date, it is likely that a failure would add to the complaints of plaintiffs in a shareholder suit related to the deal (most deals evoke a suit from at least one dissident shareholder).

THE GROWING CHALLENGE TO THE BUSINESS JUDGMENT RULE

Historically, directors’ decisions on executive compensation have been upheld by courts under the business judgment rule, which requires that directors should be motivated in their decisions by a bona fide regard for the interests of the corporation and its shareholders and that they should not do breach their fiduciary duties of good faith, loyalty and due care. While the business judgment rule continues to prevail in all but the most egregious cases in court, it is under increasing attack by shareholder advisors in their Say on Pay vote recommendations. For example, in 2012, the Best Buy compensation committee was harshly criticized by ISS for giving the departing CEO a more lucrative severance package than that called for in the company’s proxy disclosure. The company disclosed in the proxy that a voluntary termination on the part of the CEO would yield no severance and no vesting of equity. However, the committee awarded the CEO a cash severance payment of $2.85 million and the continued vesting (post termination) of 131,876 previously awarded restricted shares including a recent “retention” award of 110,000 restricted shares. In describing the reasons
for its recommendation against the Say on Pay vote at Best Buy (which the company failed in 2012), ISS wrote:

“A severance arrangement that far exceeds the disclosed termination payments for any of the possible characterizations for this separation (for cause, without cause, or voluntary resignation) raises significant concerns regarding the Committee’s and the board’s oversight of executive compensation. Dunn’s failure to abide by company policy yielded, ironically, the vesting of the very awards that were intended to retain his services (and illustrate how retention grants without performance conditions can break the pay-for-performance linkage).”

**BEST PRACTICES ON SEVERANCE**

As always, best practices are those that are in the best interests of the company and its shareholders. Nonetheless, there are a number of approaches to severance that directors should consider when making decisions on employment-agreement provisions and company policies and in termination negotiations. Pay Governance has advised clients on each of these approaches.

1. **Avoid employment agreements.** By employing executives “at will,” a company maintains control and flexibility over the terms governing treatment of pay and benefits at termination. These policies can be maintained in an executive severance plan and in incentive plan documents. By avoiding the need to negotiate over such policies, it is easier for a company to end up with treatments that are acceptable to shareholders.

2. **Reduce or phase out cash severance for termination without cause.** In an era where equity grants make up 70% or more of a CEO’s annual pay package, should a CEO need two or three years of cash severance as a bridge to another job? Cash severance standards are declining over time with the median for termination without cause currently at two times base and bonus and trending toward one times or 1.5 times over time. Indeed some companies have attracted their new CEO while offering no cash severance. In the case of a CEO or executive brought in from the outside, there is a rationale for providing a larger cash severance for the first few years until initial equity grants have vested and the
potential for an unexpected set of problems at the company has diminished. In the case of an executive who is at retirement age and who the board knows will retire after termination, it also makes little sense to offer cash severance ostensibly intended to bridge the executive until another job is found.

3. **Reduce cash severance for termination following a change in control.**

   In the future, only longstanding (grandfathered) executives will have excise tax gross-up protection from the company, so it makes little sense to provide three times base and bonus cash severance to a CEO in a change-in-control severance benefit, which ensures that the parachute payment will be subject to excise tax. Assuming approximately 45% to 50% federal, state and local income taxes plus a 20% excise tax, that puts the executive’s marginal tax rate on excess parachute payments at 65% to 70% while the company loses the tax deduction for the excess parachute payment. Such highly taxed payments are hard to rationalize as being in the best interest of the company and its shareholders and not the IRS. Cash severance following a change in control should be informed by modeling parachute values and 280G taxes. In some cases, companies decided to eliminate cash severance because the equity values by themselves are a sufficient benefit and avoid excise taxes.

4. **Require a double trigger for equity acceleration in a change in control.**

   The only practical reason for a different treatment between cash severance (which requires a double trigger) and equity acceleration (typically requiring only a single trigger) is if the company cannot negotiate conversion of outstanding equity into equity of the acquiring company or in the event the company is going private. Many companies in the technology sector have used double triggers because (i) their business plan was to be acquired, and (ii) much of the value of the company resides between the ears of the company’s executives and employees. Providing a big payday by accelerating equity in a change in control provides these key employees the financial flexibility to leave the company following the acquisition, which is not in the company’s best interests. Given the relatively short vesting periods of today’s equity grants (typically three to four years), the converted equity would be realizable in a reasonably short period of time anyway.
5. Avoid equity acceleration in the event of a termination without cause. “Pay for failure” is a real issue with investors of all stripes. Acceleration or continuation of equity vesting post termination should be granted only if the company receives something of equivalent value in return, such as a noncompetition agreement (where enforceable) or an agreement to cooperate with the company on outstanding regulatory investigations or lawsuits.

6. Avoid the temptation to go beyond plan provisions and boundaries. Dismissing a senior executive is always an unwelcome task. Too often, there is a temptation on the part of the board’s compensation committee or other board members to provide “something extra” beyond that which is specified in the executive’s employment agreement or the company’s severance policy and executive compensation plans. For example, some companies have provided additional years of age and credited service to the supplemental executive retirement plans of terminated executives as a consideration for the executive’s individual circumstances and unanticipated termination. Others have gone beyond the terms of the organization’s long-term incentive plan and granted agreements to fully accelerate all outstanding stock options and/or other equity awards when an executive was terminated before expected retirement. In the absence of a valuable quid pro quo, boards should expect to be criticized for such discretionary largesse, and perhaps to lose their Say on Pay vote.

Pay for performance is changing the severance landscape. Companies would be well advised to review and update their severance treatments as appropriate in order to avoid undesirable issues with shareholders.
One of the key functions of an incentive plan is to align participants with the interests of shareholders; such a pay philosophy has become especially relevant in the post-Say on Pay world’s focus on good compensation governance. As a result, recent years have seen increased utilization of total shareholder return as a specific metric in incentive programs, specifically long-term performance plans. The reasons for this increase are many, including greater focus on the impact of TSR on incentive payouts and proxy advisors’ increased reliance on TSR for assessing the alignment of CEO pay and performance. In many instances, however, total shareholder return is not an appropriate incentive plan metric, as short-term share prices are increasingly influenced by factors other than the company’s performance, including macroeconomic cyclicality, sector rotation, market volatility and high-frequency trading. Therefore, companies should assess which metrics best align participants with the interests of shareholders and could use a combination of operating, financial and TSR-based metrics in their incentive programs as this will help drive long-term value creation.
PERFORMANCE METRIC SELECTION

But one question remains: When total shareholder return is not an appropriate metric, how can a company determine which other metrics best align incentive plan participants with shareholders? One method is the statistical concept of correlation, which measures the dependent relationship between two variables, or how well the two move together. Correlations vary between positive one, when the two variables move in lockstep (termed perfect correlation), and negative one, when the two move perfectly in opposite directions; when two variables have no noticeable relationship, the correlation is equal to zero. As financial markets internalize company, industry and macroeconomic variables, there is no metric that correlates perfectly with shareholder return. In addition, the unique factors facing each firm and its respective industry means there is no one best metric for all companies. Rather, boards should consider correlation analyses to calibrate incentive plan design with the value drivers that best align with shareholder interests.

Given the volatility in market performance over the past few years, no correlation analysis should be conducted without a robust sample of data. Such a sample includes performance from multiple companies over a long period of time. A larger sample of companies minimizes some of the impact arising from the company’s unique circumstances, and the long history validates the strength of the relationship implied by the correlation over the business cycle. In general, a 10-year history from a company’s compensation peer group is sufficient. However, it should first be confirmed that the companies considered are in a similar industry and stage of growth, have similar business models and customer bases, and generally move together in the business cycle.

PERFORMANCE METRICS AND THE BUSINESS LIFE CYCLE

Recent research from Workspan has found that “understanding where a company is in the business life cycle is the most important consideration when selecting performance metrics for a company’s incentive plans.” Start-ups have
relatively low revenues, and are focused on efforts that will increase future income streams. Meanwhile, mature companies are flush with cash, and have more predictable and steady growth prospects. These results were borne out not only in the correlations between the metrics and TSR, but also in practice in the incentive plans at the companies themselves. Early-stage companies were found to focus on research and development and operating profit in their incentive plans, whereas later-stage companies focused more on EPS and revenue growth. These metrics were generally found to have the highest correlation with TSR in

Table 11.2
Overall findings of Metric Correlation to TSR by Industry (Workspan)

<table>
<thead>
<tr>
<th>Industry</th>
<th>Early-Stage / Hyper Growth</th>
<th>Midstage / High Growth</th>
<th>Late-Stage / Maturing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Medical Devices</td>
<td>EBITDA, EBIT</td>
<td>EBIT, Revenue, EPS</td>
<td>EBIT, CFOPS, CFPS (1)</td>
</tr>
<tr>
<td>Biotech/Pharma</td>
<td>BVPS, EBIT</td>
<td>BVPS, EBITDA, EPS</td>
<td>EPS, CFPS, BVPS</td>
</tr>
<tr>
<td>Software/Services</td>
<td>CFPS, EBITDA, EPS</td>
<td>EBIT, CFPS, BVPS, EPS</td>
<td>EPS, BVPS, Revenue (2)</td>
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<td>EBITDA, BVPS, EPS</td>
<td>EBITDA, EPS, Revenue, CFPS</td>
</tr>
<tr>
<td>Semiconductors</td>
<td>Revenue, BVPS, EPS, Return Metrics</td>
<td>EPS</td>
<td>EPS, Revenue</td>
</tr>
</tbody>
</table>
the respective industries, indicating that most companies already identify value drivers and include them in incentive plans.

1. The most common performance metrics among 10 large-capitalization medical-devices firms were found to be EBIT, EPS, CFOPS, CFPS (Workspan, Figure 4).

2. The most common performance metrics among 10 large-capitalization software and services firms were found to be EPS, EBITDA, Revenue, CFPS (Workspan, Figure 5).

Not surprisingly, earnings metrics tend to correlate highly with TSR among companies in all industries and growth stages. The only industry where earnings were found to be less relevant was early-stage biopharmaceuticals, where TSR was more highly correlated with book value per share (which included goodwill, patents, etc.) and expenditures for research and development. While this makes intuitive sense, it does not necessarily imply that BVPS or R&D are appropriate as the sole incentive plan metrics, as both have the potential to lead to malinvestment by participants. However, this is a clear indication that the efficient-market hypothesis is in effect — the market internalizes the investment expenditures undertaken by these companies, despite a lack of earnings, and the respective share prices are revalued based on the probability of long-term payout.

MITIGATING RISK IN INCENTIVE PLANS

Correlation analyses can also help mitigate some risks in incentive plans. Two metrics may be found to be highly correlated with TSR as well as each other (termed multicollinearity). For example, revenues and net income are correlated with each other (i.e., larger companies in an industry tend to have larger net income), because large net income is generally dependent on large revenues. Improperly set goals could result in less profitable increases in revenue simply to drive higher incentive plan payouts. However, it is not uncommon for incentive plans to include both top- and bottom-line growth measures; boards simply need to ensure such risks are mitigated in the goal-setting process (see Bout and Lane, Chapter Twelve). For example, net income growth in excess of revenue
growth — stated alternatively, an increase in the profit margin — may reduce or eliminate the risks associated with using both revenue and net income in the incentive plan.

While correlation analyses are an important part of the incentive plan design toolkit, they are not a panacea. Additional care should be taken to minimize inappropriate risk-taking and undesirable behaviors associated with the plan. Ultimately, the purpose of incentive plans is to encourage positive behaviors and reinforce the long-term goals of the business. Correlation analyses are adept at determining appropriate financial metrics that appropriately align with shareholder return, but may miss out on non-financial or other relevant metrics that are difficult to measure. It is therefore important that companies consider these non-financial factors in the incentive plan, provided they are viewed as furthering the long-term business plan or company philosophy. These metrics tend to be more industry specific, such as customer satisfaction in the services industry, or worker safety and environment in the manufacturing and energy industries, but could also be company specific, such as exiting bankruptcy protection within a specified period of time.

CASE STUDY: MATURE RETAIL INDUSTRY

A recent Pay Governance correlation analysis of 22 mature consumer goods retailers corroborate the results of the Workspan study, specifically that earn-
ings are highly correlated with shareholder return over both the short and long term. In addition, some seemingly counterintuitive results were also discovered; namely that on a one-year basis, revenue growth, return on invested capital and profit margin were not significantly correlated with shareholder return. Granted, most of these metrics were significantly correlated with TSR in at least one year over the previous five-year period, however, no significant annual relationship could be found over the long term of the study.

What could cause such a striking result? In general, shareholder return was more highly correlated with increases in these growth metrics. This implies that shareholders not only expected these retailers to maintain their current rate of growth, but that further annual returns were conditional on the company’s exceeding the prior year’s growth rate.

Still, these results are somewhat astounding. How is it possible that revenue growth has no statistically significant impact on shareholder return? In fact, when three-year revenue growth is compared against three-year shareholder return, there is a significant relationship. In any given year, shareholders may or may not value revenue increases; in the short term, the major concern is with growth in earnings. Over the long term, however, growth in earnings cannot be sustained without growth in revenues. We would expect a similar relationship

**TABLE 11.4**

<table>
<thead>
<tr>
<th>Correlation</th>
<th>Revenue Growth</th>
<th>Earnings Growth</th>
<th>Return on Invested Capital</th>
<th>Increase in Return on Invested Capital</th>
<th>Profit Margin</th>
<th>Increase in Profit Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>All 1-Year Cycles</td>
<td>0.02</td>
<td>0.33</td>
<td>0.03</td>
<td>0.38</td>
<td>0.11</td>
<td>0.32</td>
</tr>
<tr>
<td>2011</td>
<td>0.62</td>
<td>0.55</td>
<td>0.35</td>
<td>0.31</td>
<td>0.51</td>
<td>0.24</td>
</tr>
<tr>
<td>2010</td>
<td>-0.05</td>
<td>0.37</td>
<td>-0.27</td>
<td>0.41</td>
<td>-0.29</td>
<td>0.39</td>
</tr>
<tr>
<td>2009</td>
<td>0.21</td>
<td>0.67</td>
<td>0.60</td>
<td>0.48</td>
<td>0.63</td>
<td>0.56</td>
</tr>
<tr>
<td>2008</td>
<td>0.47</td>
<td>0.89</td>
<td>0.57</td>
<td>0.72</td>
<td>0.12</td>
<td>0.61</td>
</tr>
<tr>
<td>2007</td>
<td>-0.10</td>
<td>0.19</td>
<td>-0.33</td>
<td>0.41</td>
<td>0.00</td>
<td>0.04</td>
</tr>
</tbody>
</table>
with increases in same-store sales, which represent growth in efficient revenues. Hence, the results of the three-year correlations tend to be more stable and more significant than the one-year.

### THE CASE FOR TSR IN LONG-TERM INCENTIVE PLANS

However, as institutional shareholders become more concerned with the long-term alignment between executive pay and company performance, the use of other financial metrics in incentive plans, regardless of correlation with shareholder return, may not be sufficient. It will therefore be more important for companies to monitor TSR performance and to consider whether TSR should be a specific measure in their long-term incentive plans.

Historically, companies have delivered all or most of their long-term incentive award opportunity through equity-based vehicles (performance shares, stock options and restricted stock). The use of equity awards means that the value realized upon settlement is based on stock price performance (the key component of TSR) over the performance/vesting period. Stock settlement ensures that the realizable value from long-term incentives is aligned with the interests of shareholders. With performance shares, which require the achievement of specific goals, there is greater alignment with shareholders’ interests because minimum
goals must be achieved for executives to earn shares. Companies are increasingly considering the explicit use of a TSR metric as part of long-term performance plans, which adds a “double leverage” effect if it is part of performance share program.

TSR, the stock price appreciation plus reinvested dividends over a period, is the ultimate measure of a company’s achievement for shareholders over the long term. Higher TSR results in greater capital gains for shareholders, stock price appreciation for employee-owners and potential for future success. Accordingly, TSR is closely monitored by shareholders and executives, as well as by the media and proxy advisory services.

The specific inclusion of TSR as part of the officer pay program can provide some comfort to compensation committees that awards earned were commensurate with TSR outcomes. Under the most common TSR design used today, a company’s three-year TSR is compared to a comparator group (often a specific peer group or a market index). This relative TSR performance comparison may be viewed as a type of fail-safe correlation feature that is helpful to compensation committees in making incentive payouts.

**IS TSR AN INCENTIVE FOR EXECUTIVES?**

While TSR plans can provide a strong, positive correlation for pay delivery, they are not typically a direct incentive to participants. Well-designed incentive plans typically include motivation of participants as a primary objective, which is often achieved through competitive award opportunities, transparent measures that can be impacted by participants (“line of sight”) and appropriate goal setting. The use of TSR as a long-term performance metric diminishes this engagement and motivation.

Relative-TSR plans can be significantly affected by external factors, including economic and market conditions, but not necessarily by financial and operational performance results. Relative-TSR plans do not foster insights for participants or shareholders into how the company can or will outperform the comparator group, which diminishes executive engagement and motivation. As
a result, many companies using relative-TSR plans limit their applicability to senior executives.

**KEY FACTORS TO ASSESS IN CONSIDERING THE USE OF TSR**

TSR has become more prevalent, with nearly 40% of large companies now using it as a measure in their long-term performance plans. Most companies using relative TSR typically also include financial metrics as part of the long-term performance plan. The increased prevalence in the use of TSR as a specific metric is likely to continue, driven by several factors:

- Optics
- The difficulty of setting multi-year goals for financial and operational measures
- The absence of a better financial measure that does not overlap with annual incentives
- Institutional Shareholder Services’ focus on relative TSR in its CEO pay/performance test

Under its CEO pay/performance assessment method for 2012, ISS considers TSR at the end of one- and three-year periods (based on single price points), relative to a comparator group it selects. Companies need to be aware of ISS’ approach but, when designing relative-TSR plans, companies should focus comparator group development based on their determination of direct peers and other comparable companies.

In contemplating the use of TSR in long-term performance plans, companies should consider the following factors:

- Business strategy
- Financial measures currently used in annual and long-term incentive plans
• The company’s ability to set reasonable performance goals for its long-term incentive plan — those that management and the board feel are balanced (with targets falling into the “challenging but achievable” category with a probability of achievement of approximately 50%)

• The availability of a reasonable comparator group of companies that could be used for relative-TSR comparisons

• Historic alignment of pay and performance

• Criticisms, if any, from large shareholders and other parties of interest

TSR PLAN DESIGN ALTERNATIVES

Once the decision has been made to incorporate TSR as part of the pay program, the appropriate role and specific design needs to be determined. There is a wide range of approaches for using TSR, with the majority of companies using TSR typically incorporating it into their long-term incentive program using relative comparisons.

In the typical relative-TSR plan, TSR is measured at the end of a three-year performance cycle and based on the ending stock price versus the starting price, with dividends reinvested during the cycle. The company’s resulting TSR percentile performance, relative to that of a comparator group, determines award payouts, if any.

Below we summarize the advantages and disadvantages of the following alternative TSR plan designs:

• Relative TSR, which compares the company’s TSR performance to a selected group of companies

• Absolute TSR, which compares the company’s TSR performance to a performance schedule set at the start of the performance period, without consideration of the TSR performance of other companies

• Both relative and absolute TSR
- TSR modifier, which uses TSR performance to adjust the award amount determined by financial or operational metrics

**TABLE 11.6**

<table>
<thead>
<tr>
<th>TSR PLAN DESIGN</th>
<th>ADVANTAGES</th>
<th>DISADVANTAGES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relative TSR</td>
<td>Payouts are commensurate with TSR relative to relevant companies</td>
<td>Unless safeguards are in place, could result in substantive payouts even when the company's absolute TSR was negative</td>
</tr>
<tr>
<td></td>
<td>Avoids the need to set multi-year internal goals</td>
<td>May over- or under-reward for absolute TSR performance</td>
</tr>
<tr>
<td></td>
<td>Assists, in most cases, in gaining ISS support and a successful Say-on-Pay vote</td>
<td>Limited &quot;line of sight&quot; for executives</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Payouts can change dramatically at the end of the performance period</td>
</tr>
<tr>
<td>Absolute TSR</td>
<td>Payouts are commensurate with the company’s actual TSR</td>
<td>May be difficult to set appropriate absolute TSR goals</td>
</tr>
<tr>
<td></td>
<td>No awards when TSR is negative</td>
<td>May over- or under-reward based on broad market TSR performance, since no relative component</td>
</tr>
<tr>
<td></td>
<td>Somewhat better “line of sight” for executives</td>
<td>Does not, in most cases, help in gaining ISS support</td>
</tr>
<tr>
<td>Combination of Relative and Absolute TSR</td>
<td>Payouts are commensurate with both actual and relative TSR</td>
<td>May be difficult to set appropriate absolute TSR goals</td>
</tr>
<tr>
<td></td>
<td>No awards when TSR is negative</td>
<td>May be perceived as complex</td>
</tr>
<tr>
<td></td>
<td>May assist in gaining ISS support and a successful Say-on-Pay vote</td>
<td>Somewhat limited “line of sight” for executives</td>
</tr>
<tr>
<td>TSR Modifier</td>
<td>Payouts typically still have a strong “line of sight” for executives</td>
<td>May be perceived as complex</td>
</tr>
<tr>
<td></td>
<td>Final payouts still incorporate relative TSR performance</td>
<td>Depending on the financial goal setting, may still result in a disconnect between pay and performance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>May not receive full &quot;credit&quot; from ISS and shareholders for the explicit use of TSR</td>
</tr>
</tbody>
</table>

There are company-specific situations in which one of the foregoing designs may be better, based on the company’s primary needs and objectives, than the other alternatives. The decision of whether to use TSR and the appropriate design for a company’s long-term incentive plan should consider the company’s
primary objectives, the performance metrics it uses in other incentive plans and other factors.

CONCLUSION

The use of TSR as a performance measure creates a critical, unusual trade-off: strong pay delivery alignment, but a weak incentive for executives who cannot directly affect the stock price of the company or the comparator group. As companies consider using TSR or changing its weight as a measure in their incentive plans, they should bear in mind that the plans they ultimately craft to deliver long-term shareholder returns should balance the critical goal of retaining and motivating a highly qualified, committed executive team with positive optics.

In the end, the use of relative TSR is less about the incentive-related effects on participants and more about the optics of executive pay delivery. The use of relative TSR is likely to increase in prevalence as companies continue to review their executive pay programs to ensure the strongest possible relationship between pay and performance outcomes and to minimize potential external criticisms. It is the latter point — external views, particularly among proxy advisory groups — that will likely drive the increased use of such plans, as TSR may not be an effective incentive in the purest sense because of limited line of sight. Fortunately, choosing the right operating and financial metrics, ones that have a strong long-term correlation with TSR, and high stock ownership will help ensure that executives are truly aligned with shareholders’ interests over the long term.

AUTHORS NOTE

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CHAPTER TWELVE

DEBUNKING MYTHS OF EASY GOALS AND TOOLS FOR ASSESSING THE DIFFICULTY OF GOALS

BY AUBREY BOUT AND BRIAN LANE

INTRODUCTION

Often, in the absence of facts, speculation and mythology fill the void and become perceived reality. The majority of the general public and mainstream media believes that CEOs control their boards, which allows them to reap excessive pay packages that are not aligned with actual company performance. As a result of the perceived imbalance of power, critics have also attacked one of the central foundations of performance-based pay design: the setting of sufficiently challenging incentive performance goals. The following myths have prevailed:

- **Myth #1:** Companies deliberately set low performance goals to make it easy for executives to receive higher bonuses.
- **Myth #2:** Companies set internal incentive goals below communicated guidance and analyst expectations, so they can be assured of large bonuses.
- **Myth #3:** Most companies’ long-term performance share plans pay out well above target and there is little correlation to stock price performance.
The authors have conducted extensive research to test whether these myths are real or false public perceptions; for the most part, our research has shown these myths to be false. However, in a Say on Pay world, boards cannot afford to be complacent, and many are increasingly requesting that their independent advisors test the difficulty of annual incentive goals by comparing management’s goal to historical company and peer performance and to analysts’ future expectations. Later in this chapter we provide a case study and overview one of these “goal difficulty assessments.”

DEBUNKING MYTHS OF EASY GOALS

To test the first two myths, the authors studied S&P 200 companies’ (172 companies, which had filed proxies by the time of the study, were included) goals and financial results over a two-year period (2007–2008). The study revealed that shareholder-friendly pay-for-performance compensation packages are alive and well by confirming that companies that set more difficult incentive plan goals achieved a higher level of total shareholder return (TSR) and had higher price-to-earnings ratios.

Companies setting hard goals not only delivered relatively higher returns than those that set less challenging goals, they delivered them in spite of the stressed financial and macroeconomic environment of 2008. It seems that setting challenging goals may also help companies weather and recover from severe economic downturns. In other words, companies and their shareholders benefit when executives are successful in motivating and energizing their employees to meet challenging goals in difficult economic times. Of course, goals that are too difficult can be demotivating. The challenge for boards and top management is to get the balance right.

ACHIEVING GOALS LEADS TO A WIN-WIN FOR SHAREHOLDERS AND EXECUTIVES

In an effective pay-for-performance model, actual performance that beats predetermined targets should yield higher actual pay relative to target than
does below-target performance. And further, the above-target payout should be shared with shareholders via higher returns for them.

Our historical research finds that 74% of S&P companies (in 2007) met or exceeded their annual incentive plan target performance goals, which resulted in a median CEO annual incentive payout at 152% of target. By contrast, CEO payouts in companies that failed to meet their target goals were just 73% of target, as most plans provide some lower payout for performance below target but above a preset threshold. For example, a typical CEO who has a $1 million salary and a target bonus of 100% of salary, in the case where goals were met, would receive a $1.52 million bonus while his/her counterpart at an underperforming company receives a $730,000 bonus. Many would agree that a delta of $790,000 in bonus payouts validates the occurrence of performance differentiation. More importantly to shareholders, the companies that achieved their annual goals had a one-year TSR (2007) of approximately 26 percentage points higher than those who failed to meet their goals.

DEFINING CHALLENGING GOALS

The majority of S&P companies set financial performance goals in their incentive programs. The question for shareholders is, are these goals sufficiently difficult to drive the behaviors that will produce growth and returns for their companies and their investments? Our research also revealed that the typical S&P company sets target goals that have a 53% probability of attainment — i.e., the company can expect to meet or exceed target performance about half of the time, five years in every 10. This is evidence of rigorous and balanced goal-setting policies and processes. If goals were “easy” as purported by many critics, we would expect to see probabilities of attainment closer to the 70% or 80% range or even higher.

But how, exactly, is the difficulty of a goal determined? In our research and client studies, the difficulty of performance goals is determined by the probability of attainment of a particular goal relative to proxy-disclosed peer 10-year performance and to the company’s own 10-year performance. The lower the probability in percentage terms, the higher the difficulty factor (see Table 12.1).
Layering on the difficulty of performance goals, one would expect CEOs at companies that achieve more difficult goals to be rewarded with higher payouts than those achieving less difficult goals. Our research also supports this finding: Companies with more difficult goals saw CEO short-term incentive payouts at 135% of the total bonus target when these goals were achieved, while companies with low difficulty goals paid out 124% for achievement. Contrasted with myth #1 (that executives set easy goals to gain high bonuses), our research presents a counter argument, indicating that to earn a larger bonus than their counterparts, executives must set harder goals. In combination, the findings that (i) target performance goals are on average attainable only half the time (53% probability of attainment) and (ii) that CEOs at companies that set more difficult goals have higher bonus payouts than CEOs at companies that set less difficult goals handily refute myth #1.

Overall, S&P companies with high-difficulty goals had a one-year TSR (2007) approximately 10 percentage points higher than those with low-difficulty goals and a two-year TSR (2007 to 2008) that was 5.6% higher. Moreover, board members and shareholders who want C-suite executives to be held to higher goals may now have the evidence they need to push for challenging growth goals, given that based on the author’s research, it results in higher shareholder returns.

### CHALLENGING GOALS DELIVER GREATER TSR

TABLE 12.1

<table>
<thead>
<tr>
<th>PROBABILITY OF ATTAINMENT</th>
<th>ASSESSMENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>0% to 19%</td>
<td>Extremely Challenging</td>
</tr>
<tr>
<td>20% to 39%</td>
<td>Very Challenging</td>
</tr>
<tr>
<td>40% to 59%</td>
<td>Challenging</td>
</tr>
<tr>
<td>60% to 79%</td>
<td>Moderately Challenging</td>
</tr>
<tr>
<td>80% to 100%</td>
<td>Not Challenging</td>
</tr>
</tbody>
</table>
With respect to myth #2 and whether companies set their goals above or below the guidance they communicate to the street, an analysis of a random subset of the S&P companies shows that at least 90% of companies set internal compensation plan targets at or above Wall Street analyst annual earnings guidance. Our experience in boardrooms supports this finding. Myth #2, that a majority of companies set internal goals below analyst guidance, is absolutely false. It rarely happens, as CEOs and CFOs would lose credibility and boards would not tolerate such a practice (see Table 12.2). In most cases, it would be very difficult for a company to pay bonuses above target when the analyst guidance was not achieved, which in most cases adversely impacts the stock price. Further, investors might take note of the performance differential, above-target bonus payments versus a stock price decrease. Investors would genuinely be upset as management paid above-target bonuses when they did not meet expectations.

ANOTHER STRONG ARGUMENT FOR DIFFICULT GOALS: HIGHER PRICE-TO-EARNINGS RATIOS

Consistent with higher TSR, another metric positively correlated to difficult goals is higher price-to-earnings ratios. Companies with high-difficulty goals experienced an average price-to-earnings ratio of 19.1 in 2007, compared to 16.5 for those with low-difficulty goals (see Table 12.4). This differential was sustained the following year (even in the face of the great recession), suggesting that investors reward companies that set hard goals with more favorable valuation multiples in both up and down markets. The level of a company’s price-to-earnings ratio can be attributed to many factors. This research finding suggests that companies with more difficult goals could have higher P/E ratios because more difficult goals imply faster rates of growth (relative to industry peers —

---

**TABLE 12.2**

**Analyst Guidance vs. Internal Performance Goal**

<table>
<thead>
<tr>
<th>Internal goal is set higher than guidance</th>
<th>27%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal goal is same as guidance</td>
<td>64%</td>
</tr>
<tr>
<td>Internal goal is set lower than guidance</td>
<td>9%</td>
</tr>
</tbody>
</table>
Wall Street typically repays companies that have higher growth rates with higher valuations. Investors ultimately reward companies that consistently meet or beat their hard growth goals with higher TSR and a more favorable valuation multiple.

In sum, consistently setting difficult performance goals in your incentive plans appears to be rewarded by investors. However, to be sure, these goals must be attainable and perceived as such by incentive plan participants. Otherwise, you may be facing another spectrum of issues. Unattainable goals that rarely or never result in payouts come with myriad problems, including employee relations concerns and retention issues, both of which can ultimately lead to concerns for shareholders. Balance is key.

### TABLE 12.3
**Goal Difficulty, TSR, and Bonus Payout**

<table>
<thead>
<tr>
<th>Scenario</th>
<th>High Goal Difficulty</th>
<th>Low Goal Difficulty</th>
<th>Difference (% Points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Median One-Year</td>
<td>15.71%</td>
<td>5.86%</td>
<td>9.85</td>
</tr>
<tr>
<td>Median Two-Year</td>
<td>-2.71%</td>
<td>-8.28%</td>
<td>5.57</td>
</tr>
<tr>
<td>Median Payout as a Percent of Target</td>
<td>135%</td>
<td>124%</td>
<td>11.00</td>
</tr>
</tbody>
</table>

### TABLE 12.4
**Price-to-Earnings Ratio**

<table>
<thead>
<tr>
<th>Year</th>
<th>High Goal Difficulty</th>
<th>Low Goal Difficulty</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>19.1</td>
<td>16.5</td>
</tr>
<tr>
<td>2008</td>
<td>12.9</td>
<td>12.2</td>
</tr>
</tbody>
</table>

i.e., alternative investments). As Tables 12.5 and 12.6 show, it is generally true that annual and longer-term stock incentive plans do tend to pay out at or above target level — on average.
Are these target payouts due to strong operating performance that is at or above challenging targets? Or is it weak performance that is above an easy goal? Our earlier research has shown that it is the latter — that goals tend to be difficult and that it is strong operating performance against these goals that dictates any at- or above-target payouts.

Further, when one additional step is taken to examine these payouts against performance, we find strong pay and performance alignment. While overall payouts are commensurate to target, payouts under CEO annual and long-term plans at high-performing companies significantly exceeded those at low-performing companies. The tables below summarize our findings of 2008 and 2009 payouts for 100 large U.S. companies.

**TABLE 12.5**
Annual Incentives vs. One-Year EPS Growth

<table>
<thead>
<tr>
<th></th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>EPS Growth</td>
<td>Actual Bonus Payout % of Target</td>
</tr>
<tr>
<td>High Performers</td>
<td>18%</td>
<td>119%</td>
</tr>
<tr>
<td>Low Performers</td>
<td>-55%</td>
<td>21%</td>
</tr>
<tr>
<td>Overall</td>
<td>-3%</td>
<td>95%</td>
</tr>
</tbody>
</table>

**TABLE 12.6**
Performance Shares (number) vs. Three-year TSR

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>TSR CAGR</td>
<td>Actual Perf. Share Payout % of Target</td>
</tr>
<tr>
<td>High Performers</td>
<td>4%</td>
<td>119%</td>
</tr>
<tr>
<td>Low Performers</td>
<td>-9%</td>
<td>87%</td>
</tr>
<tr>
<td>Overall</td>
<td>-3%</td>
<td>100%</td>
</tr>
</tbody>
</table>
Boards need to be cautious that they do not push management to set unrealistic goals that could pressure senior executives, and in turn line managers, to take excessive risks or compromise ethical standards. Most management teams have a very rigorous annual budgeting and strategic planning process that feeds into their annual goal-setting process, which in turn translates into annual goals for their incentive programs. Most companies employ a combination of top-down and bottom-up approach for forecasting sales and cost, while ensuring that the company is growing profits year-over-year. Most compensation committees trust that management has employed a thorough budgeting process, but are increasingly seeking an outside perspective to help ensure that the annual goals are challenging and are turning to their independent advisors to test the difficulty of annual incentive goals by comparing management’s goal to historical company and peer performance while also comparing the goals to future analyst expectations. Most compensation committee members have indicated that they are looking for a broader perspective and our goal-difficulty assessment provides some financial facts using probabilities while providing some much needed external perspectives.

While management’s goal-setting process is often very rigorous, with some application of judgment, it is critical that the independent advisor review of goals is robust and based on facts. In reviewing the level of goal difficulty, we start by analyzing the following four perspectives:

1. Ten years of historical company performance
2. Ten years of historical peer-company performance
3. Upcoming-year analysts’ estimates for the company
4. Upcoming-year analysts’ estimates for peer companies

After gathering the historical financial data and analyst forecasts for the company and its peers, we then analyze the cumulative probability distribution for each metric.
We provide some highlights of a goal-difficulty analysis we conducted for a large global financial services firm (Company ABC). In this case study, the company uses revenue as one of several financial measures that are part of its annual incentive program. The company’s annual goal was to grow revenue 3.3% in that fiscal year. The company has achieved this level of growth or greater five out of 10 times over the last 10 years, which translates into a 50% probability of achievement, implying that this is a “challenging” goal (refer to Table 12.7 for a range of probabilities and the corresponding level of difficulty). Similarly, we also reviewed the 3.3% proposed growth level versus peer historical growth rates and found that this level of growth or greater was achieved 34 out of 50 times over the last 10 years, which translates into a 68% probability of achievement, and this corresponds to a “moderately challenging” goal.

<table>
<thead>
<tr>
<th>Assessment of Difficulty*</th>
<th>2012 Revenue Growth (Internal Goal: 3.3%)</th>
<th>2012 Diluted EPS Growth (Internal Goal: 6.6%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Historical Company ABC Performance</td>
<td>Probability of Achievement</td>
<td>50%</td>
</tr>
<tr>
<td>Pay Governance Assessment</td>
<td>Challenging</td>
<td>Moderately Challenging</td>
</tr>
<tr>
<td>Median Historical Co. ABC Performance</td>
<td>3.4%</td>
<td>8.2%</td>
</tr>
<tr>
<td>2. Historical Peer Company Performance</td>
<td>Probability of Achievement</td>
<td>68%</td>
</tr>
<tr>
<td>Pay Governance Assessment</td>
<td>Moderately Challenging</td>
<td>Moderately Challenging</td>
</tr>
<tr>
<td>Median Peer Performance</td>
<td>5.8%</td>
<td>12%</td>
</tr>
<tr>
<td>3. 2012 Company ABC Analyst Estimates</td>
<td>Probability of Achievement</td>
<td>10%</td>
</tr>
<tr>
<td>Pay Governance Assessment</td>
<td>Extremely Challenging</td>
<td>Extremely Challenging</td>
</tr>
<tr>
<td>Median Co. ABC Analyst Estimate</td>
<td>1.9%</td>
<td>5.2%</td>
</tr>
<tr>
<td>4. 2012 Peer Company Analyst Estimates</td>
<td>Probability of Achievement</td>
<td>55%</td>
</tr>
<tr>
<td>Pay Governance Assessment</td>
<td>Challenging</td>
<td>Very Challenging</td>
</tr>
<tr>
<td>Median Peer Analyst Estimate</td>
<td>3.8%</td>
<td>5.7%</td>
</tr>
<tr>
<td>Overall Assessment</td>
<td>Challenging</td>
<td>Challenging</td>
</tr>
</tbody>
</table>

It is important to observe that increasing the revenue goal to 4.5% would make the historical peer part of the analysis a “challenging” goal as the probability distribution curve is fairly sharp at that level of growth. Also, the compensation committee would have to take into account qualitative factors such as a slow-growth global economic environment, the regulatory winds that companies in this industry are facing, and the fact that capital constraints have created reduced growth opportunities.
The strength of this analysis is that future growth expectations are also factored, since company and peer growth estimates are also analyzed. The company’s planned growth rate of 3.3% is well above what analysts are expecting (1.9% at the median), so this gave management and the committee some comfort that the growth rates are safely above analyst expectations for the company and were determined to be “extremely challenging.” Similarly, the company’s growth is in line with the analyst-expected growth rate for its industry peers, so this received a “challenging” level of difficulty.

Averaging the results across all categories allows us to conclude that Company ABC’s revenue goal overall was “challenging.” A similar analysis was conducted for EPS, which was the primary other metric the company used.

In addition to the above four perspectives for determining how challenging annual goals are, compensation committees should also consider:

- How often have historical annual bonus payouts been paid above target? If the company has had above-target payouts in eight out the last 10 years and the stock price has trailed peer share price, maybe the annual goals have not been challenging enough.
• How was prior-year performance, and did they beat their goals? In our experience, we have observed that if a company had challenging goals and then beat those goals, the executives were typically rewarded with above-target bonuses. We have also observed that in these circumstances the company tended to outperform peers and TSR is relatively strong.

• How are this year’s growth goals compared to last year’s? Investors and boards typically expect to see year-over-year growth, and exceptions are made in rare cases — the growth rates do not need to be higher than the prior year but sufficiently challenging given the economic environment.

CONCLUSION

Debunking the myth that companies deliberately set lower goals in order for executives to receive higher bonuses not only affirms a strong American work ethic at the top, it also paves the way for new executive compensation strategies that are good for leaders and shareholders alike. Indeed, the public scrutiny resulting from Say on Pay demands these approaches. Finally, boards of directors, the ultimate stewards of the future, can confidently insist that their CEOs earn every dime of their keep by delivering on the kind of challenging goals that drive growth, profitability and long-term share appreciation.

AUTHORS NOTE

Portions of this article are adapted from a fourth quarter 2010 WorldatWork Journal article, “The Myths and Realities of U.S. Executive Incentive Goals,” by Aubrey Bout and Ira Kay. The authors and Pay Governance would like to thank WorldatWork for allowing them to reuse sections of this article.
CHAPTER THIRTEEN

COMPENSATION RISK ASSESSMENTS: A PROCESS FOR ACTIVE PLAN MANAGEMENT AND CONTINUOUS IMPROVEMENT

BY ERIC MARQUARDT AND CHRIS BRINDISI

INTRODUCTION

Compensation Discussion and Analysis (CD&A) sections of public company proxies contain a statement about pay and risk that typically reads like the following:

“Our Compensation Committee, with assistance from internal risk management staff and the Committee’s compensation consultant, has assessed our compensation programs and concluded that our compensation policies and practices do not create risks that are reasonably likely to have a material adverse effect on us.”

Companies reluctantly make negative disclosures like this (e.g., “our compensation policies and practices do not create risks”) due to concerns over liability. This all-too-common statement in the CD&A about compensation risk nonetheless fails to communicate another very important perspective: whether management is appropriately incented to balance the size and frequency of potential losses with the potential gains.
Risk is a necessary part of the process through which a company can create value for shareholders. Compensation committees can go far beyond merely demonstrating a lack of material risk. Use of an effective risk-assessment process in the management of their incentive programs can also position committees to emphasize how their compensation program, with an appropriately balanced set of reward opportunities tied to a variety of performance outcomes, contributes to creation of shareholder value.

In this article, we present a set of standards for conducting an effective risk assessment. The information gathered in such assessments should enable compliance with required compensation-risk disclosure, enhance the potential for incentive plans to produce desired business results and reward management appropriately relative to performance.

DISCUSSION

An appropriate level of risk is essential for any business to survive and produce acceptable risk-adjusted returns for stakeholders. Eradicating all risk in compensation programs is not desirable or feasible. However, actively managing risks undertaken — and understanding their relationship with the executive compensation structure and design — is.

The Federal Reserve’s guidance on incentive-compensation risk assessment is consistent with this view. This principles-based guidance recognizes that no single incentive design is appropriate for all organizations. In the Fed’s view, incentive arrangements should be:

- Balanced regarding financial rewards so as not to encourage employees to imprudently expose their organizations to risk
- Compatible with effective controls and risk management
- Supported by strong corporate governance

From our recent experiences, most companies have stepped up and eliminated the more obvious types of corporate exposure to imprudent risk-taking linked to pay, such as mega-grants of stock options, performance incentives based
entirely on top-line growth or significant “guaranteed” severance packages. Yet, in the areas of controls and corporate governance practices focused on managing pay risk over time, there is substantial room for improvement.

Four specific types of risk are associated with compensation programs: financial, operational, reputational and talent-related. Sharp focus on each of these areas will go a long way toward meeting the Federal Reserve standards and achieving objectives for managing risk.

1. **Financial.** A company’s incentive plans could place an undue financial burden on the company or fail to motivate behavior critical to financial success.

   These assessments often balance financial impact and potential for risk generation. The graphic below shows how different incentive plans within an organization might fall along the spectrum of the combined dimensions of materiality and risk.

   ![CHART 13.1](image)

   **Financial Risk Assessment**

   In this example, the organization has a number of incentive plans in which the size of individual payments to participants and the overall cost to the com-
pany are deemed material. In this context, materiality involves a company-specific definition of the relationship of incentive plan costs to company profitability and/or cash flow. (This is not a legal definition.)

Also, none of the plans shown in the example represented more than a moderate risk regarding types of executive behavior and performance scenarios. The risk that these plans might pay out significant amounts for undesirable behaviors or performance outcomes is limited.

An example of an executive incentive plan that did, in fact, create significant potential for material risk to the business and for payments for undesirable performance outcomes occurred at a publicly traded consumer durable goods company. The company, a manufacturer/wholesaler, had seen its revenues decline and was facing significant cash payments over the ensuing three years to meet debt covenants with its lenders. The board’s compensation committee decided to implement a new three-year long-term cash incentive plan that would pay solely for meeting a targeted level of cumulative free cash flow. The plan would represent approximately two-thirds of the executive team’s target long-term incentive value, replacing value previously split between stock options and time-based restricted stock.

Using the risk/materiality matrix above, this plan would likely have been placed in the box corresponding with high potential for risk and high material impact on the company (the upper right-hand box). This risk lay in the variety of ways available to achieve free cash flow, unencumbered by any requirement in the long-term incentive plan for profitability or returns.

Revenues in the business did not recover during the incentive plan performance period, nor did profitability. To meet cash requirements, management sold off much of its inventory below cost, creating significant charges against income and eventually leading to related declines in stock price. However, the free cash flow generated by the unprofitable sales of inventory resulted in a maximum payment (200% of target) from the long-term incentive plan. The materiality of the plan proved to be present in cash payouts that were a burden on an already cash-strapped business. These payments led to numerous shareholder-initiated lawsuits that attempted to recoup the long-term incentive payments.
**Risk Management Lesson:** There is no universal definition of risk potential when applied to compensation. Company-specific risk factors, many of which are used in assessing other business risks, should all be considered when assessing compensation-related risk. These include debt-to-equity ratios, the potential for efficient incremental profits and stock beta.

However, incentive plans that (i) reward a single measure of performance, (ii) represent a disproportionately large percentage of overall performance incentives, and (iii) have a highly leveraged pay and performance relationship, such as the plan described in the above example, will almost always create material adverse financial risks.

Some simple plan changes could have significantly reduced the financial risk in the example plan without diluting the emphasis on sustained cash flow performance. A required performance threshold of break-even profitability accompanying cash flow goals would have capped the amount of inventory sales at a loss that could have been used to generate cash flow. Payment of the incentive in shares, rather than cash, would have eliminated the cash flow impact of the plan payments themselves. In addition, with payments in shares, the upside tied to cash flow performance could have been capped at 150% of target, rather than 200%. Additional upside would still exist in the potential increase in share price during the performance period, but it would require investors to value the cash flow achievement in the context of overall business results.

2. **Operational.** Processes in place concerning the governance and administration of compensation programs are not sufficient to mitigate errors in judgment or calculated payments.

Operational risk assessments are fundamentally a process review with a focus on pay governance. Below is a sample operational review of pay risk and its assessment.

The company reflected in this sample appears to have the right organizational units involved in the audit and approval of the pay-determination process. Also, the process is not controlled or overly influenced by a single segment of the organization, and those who determine pay draw on appropriate internal resources for legal, financial and human resources expertise.
A common source of operational risk lies in the rote use of GAAP (Generally Accepted Accounting Principles) financials in determining incentive plan performance without adequate processes or guidelines in place for the compensation committee to exercise discretion in determining the incentives earned for financial performance.

A healthcare supply company, with performance incentives that paid substantially for net operating profits after tax (NOPAT), acquired a business that was immediately accretive to earnings. At the end of the incentive plan performance period that included the acquisition, GAAP numbers for NOPAT indicated an incentive payment at a targeted level. In fact, but for the acquisition, the payment based on NOPAT would have been zero, indicating the company had fallen far short of expectations set at the beginning of the performance period for its existing ongoing businesses. Though the authority existed for the committee to withhold incentive payments, absent any existing guidelines for adjusting GAAP performance and any history in similar circumstances, the committee chose to make payments based on unadjusted GAAP results.
Risk Management Lesson: In general, incentive plans that operate and make payments solely by formula are risky compensation plans. It is almost impossible to anticipate all contingencies. Some discretion is needed to mitigate operational risks.

This capacity to be informed by guidelines and exercise discretion in determining amounts to be paid under formula-based incentives can be an important part of executive incentive plan governance. This practice can not only minimize the kinds of operational risk described in this example, but can also be an important tool for maintaining desired performance accountability and fairness in incentive plans.

3. Reputation. The design of certain pay programs, while not in violation of any regulatory or legal requirements, could draw negative attention from the company’s constituents, including investors.

Reputational risk assessments will most often be based on evaluation of incentive pay in relation to a checklist of items judged externally to be poor pay practices. In 2011, for example, the presence or absence of a defined policy on clawbacks was on most checklists, as were items such as severance payments for non-renewal of executive employment agreements.

Reputational risk should be balanced against the intended business purpose of pertinent pay practices. Continuing to provide executives with excise-tax protection may, in itself, pose a serious reputational risk for companies, but an alternative may be needed to help ensure that executives are not discouraged from objectively evaluating prospective transactions that might trigger this tax.

During 2010 and 2011, following the inception of Say on Pay advisory votes by shareholders, many publicly traded companies faced the important business decision of whether to maintain existing change-in-control excise tax protection features in their executive pay programs. Shareholders were focused on new or newly amended employment contracts or severance plans with these features. For companies choosing to maintain excise tax protection in these new or amended programs, they could expect a decrease in favorable Say on Pay votes of upwards of 20 percentage points. For many of these companies, a
relatively low favorable vote from shareholders, less than 70%, was damaging to their reputations as well-governed businesses.

The reputational risk seemed most difficult for those companies with existing excise tax protection plans that were not yet the focus of shareholders, but still certain to be subject to eventual scrutiny as plans or contracts expired and were subject to potential renewal. The question was when to take action. The answer revolved around how to balance the reputational risk of maintaining a program that was clearly unpopular with shareholders but not yet “required” to be changed with the loss of the original business purpose for the excise tax protection and the probable strong negative reaction from executives if changes were made unnecessarily.

For many companies facing this question, the answer was to “sunset” the provision. This meant that a company would, in its CD&A disclosure in the proxy, commit to ending the excise tax benefit at a specific date in the future. They chose to take a proactive step to maintain their reputation for being well governed and responsive to shareholders, while at the same time delaying the actual elimination of the benefit until at or close to the time shareholders would require its removal.

**Risk Management Lesson:** Retain a principled approach to compensation decisions, and use business judgment to determine the relative importance of external views in making compensation decisions.

Shaping pay decisions around a checklist of items judged by external sources to be poor pay practices will be, at best, an effective short-term solution to managing reputational risks, and at worst a reflection on the board’s leadership. Checklists change, and not always for reasons particularly relevant to an individual business.

The sunset approach in our example allowed the company to retain the benefits to the business of excise tax protection until a countervailing and eminent risk became present.

**4. Talent.** The design or absence of some types of compensation plans could result in a loss of critical talent.
Risk of losing talent may stem from simply not paying competitively. But more often, it is caused by a weak pay/performance relationship, typically resulting from any or all of the following:

- Overly aggressive performance expectations
- Insufficient leverage in rewards for exceeding expectations
- Excessively harsh penalties for failing to meet expectations
- No recognition for significant outperformance versus peers

A digital advertising company with healthy profit margins, sustained growth in profitability and a strong revenue to market capitalization ratio budgeted very aggressively for continued above-market year-over-year growth. The annual incentive plan required operating profit performance of at least 90% of budget before any bonuses could be paid. At 90% performance, the incentive plan paid out at 50% of the target incentive opportunity. Below this level, it paid nothing.

In a year in which the company budgeted for growth in profits at twice the expected market rate, two large advertising accounts were lost in the first quarter, making threshold profit performance extremely difficult to attain, if not unattainable, even though the expected profits for the year would still be more than 85% of plan and would grow faster than those of the company’s peers.

Fearing the risk of loss of key sales executives, and the potential loss of further business, the company made two changes to its annual incentive plan. First, it chose to extend the payouts in the current year for performance below 90% of plan, allowing for payments between zero and 50% of target for performance between 80% and 90% of plan. In the next year, the company changed its annual incentive plan to set the threshold performance at 80% of budget and pay 50% of target at that level of performance, and payouts scaling up pro rata to 100% of target at plan performance. Only performance below 80% resulted in a zero payout.

These changes allowed the company to continue to budget aggressively without risking loss of talent from non-payment for otherwise strong profit performance.
**Risk Management Lesson:** Where financial risks are present for overpaying executives, significant talent risks may also exist for underpaying executives, based on performance.

Regulations expected from the SEC on implementation of the Dodd-Frank requirement for annual pay and performance disclosures will make pay and performance assessment part of annual pay program management for most organizations, and mitigate the potential for problems similar to the ones described in this example. In addition, it will become part of many companies’ talent-risk assessments.

In the specific example noted above, Institutional Shareholder Services (ISS), a division of MSCI and provider of investment decision support tools, recommended *against* the company in its annual Say on Pay advisory vote to ratify executive compensation indicating:

“A vote AGAINST this proposal is warranted due to a pay for performance disconnect driven by the payment of a discretionary bonus when threshold targets were not met under the annual incentive plan.”

The company, in turn, filed additional proxy materials with the SEC, following the ISS recommendation, presenting its business case for alignment of pay and performance. Though the company experienced some erosion of shareholder support from the prior year in the Say on Pay voting, the decline was modest, and overall shareholder support for the executive compensation program remained above 75%.

In the context of our recommended principles-based approach to risk assessment and the Federal Reserve guidelines, below is a set of standards from which to evaluate the effectiveness of your company’s pay-risk assessment. Does it:

1. **Set oversight priorities** that identify pay plans relating to the highest-risk businesses and positions and ensure that both management and the compensation committee monitor them closely?
2. **Incorporate risk assessment into plan-design philosophy** by avoiding extremes and by maintaining a balanced mix of fixed and variable pay, short- and long-term incentives and corporate and business-unit performance goals?

3. **Assure that plans are well designed** by addressing any red flags raised by features that may encourage excessive risk-taking, such as steep incentive curves, uncapped payouts, completely formulaic awards and misaligned timing of payments — or, if such features are used, assuring that their effectiveness has been carefully vetted?

4. **Get performance metrics right** by carefully evaluating whether an incentive plan’s measures are comprehensive and support the efficient use of capital, sustainability of profits and linkage with shareholder value creation?

5. **Define pay-plan governance processes** by clearly defining oversight roles, ensuring that plans are consistent with both business goals and risk tolerances, and stress-testing results under a range of scenarios characterized by realistic assumptions about conditions?

**CONCLUSION**

The SEC continues to issue comment letters to domestic publicly traded companies asking that they not only disclose their conclusions about the existence of material pay risks, but also describe their assessment processes. (For an example of a process disclosure, see Brown-Forman Corporation’s DEF14A, 6-25-2010, p. 36). This particular disclosure, and the company’s identification of criteria used in its evaluation, is extremely instructive, as it reflects many of the standards by which the implementation of pay philosophy is being judged.

As pay-risk disclosures evolve, either by company initiative or with a push from the SEC, let’s hope that we see a change to something more like the following:

“Our compensation programs are part of our performance culture. They provide balanced reward opportunities tied to a variety of performance outcomes that drive shareholder value. The Compensation Committee subjects the programs to continual
review with assistance from management and the committee’s independent consultant, and has concluded that these plans are designed to contribute to our success and reasonably unlikely to have a material adverse effect on our company.”
CHAPTER FOURTEEN
DO COMPANIES WITH HIGHER PROFIT MARGINS PAY THEIR CEOs MORE?
BY CHRISTINE O. SKIZAS, MATT ARNOLD AND IRA T. KAY

It is well known that larger companies, in terms of revenue and market capitalization, provide higher CEO pay opportunity than smaller companies. This aspect of executive pay is recognized by boards, shareholders, academics and proxy advisors (e.g., ISS).

Motivated by client questions, we decided to examine whether, as a separate and general matter, companies and industries with higher profit margins — which we define as earnings before interest, taxes, depreciation and amortization (EBITDA) divided by revenues — have higher pay opportunity¹ than lower-margin companies. The theory to be tested is whether the “better” business model, which yielded the higher margin, would motivate, or at least allow, the board to provide higher compensation opportunity to the CEO than companies with lower margins.

We set out to answer the following questions:

1. Do companies and industries with higher margins, when adjusted for size, have higher pay opportunities?

2. Is the pay opportunity differential commensurate with the margin differential?

¹ Defined as base salary, target bonus/annual incentive award and grant date value of long-term incentive awards.
3. Do higher-margin companies have higher realizable pay?

4. Based on the findings of this research, what are the practical steps that companies can take to ensure fair and competitive compensation opportunity?

To gather data on compensation and profit margin, we focused on the S&P 500. We reviewed CEO compensation opportunities, profit margin, EBITDA and total shareholder return (TSR) (see Table 14.1).

**Table 14.1**

<table>
<thead>
<tr>
<th>S&amp;P 500 Co. Sample</th>
<th>Market Cap ($B)</th>
<th>Revenue ($B)</th>
<th>EBITDA ($M)</th>
<th>EBITDA Margin</th>
<th>Shareholder Return 1-Year</th>
<th>Shareholder Return 3-Year CAGR</th>
<th>CEO Target Total Pay ($M)</th>
</tr>
</thead>
<tbody>
<tr>
<td>25th Percentile</td>
<td>$6.76</td>
<td>$3.58</td>
<td>$822</td>
<td>14.2%</td>
<td>6.3%</td>
<td>-8.3%</td>
<td>$5.36</td>
</tr>
<tr>
<td>50th Percentile</td>
<td>$11.47</td>
<td>$7.62</td>
<td>$1,483</td>
<td>22.8%</td>
<td>20.5%</td>
<td>1.2%</td>
<td>$7.86</td>
</tr>
<tr>
<td>75th Percentile</td>
<td>$23.33</td>
<td>$15.85</td>
<td>$3,253</td>
<td>32.3%</td>
<td>37.4%</td>
<td>6.7%</td>
<td>$10.94</td>
</tr>
</tbody>
</table>

and total shareholder return (TSR) (see Table 14.1).

1. **Do companies with higher margins have higher pay opportunities?**

Among both large and small S&P 500 companies, companies in the energy, healthcare and IT industries have consistently higher margins and consistently higher CEO pay opportunity than industrial, consumer staples, consumer discretionary and materials companies.

To conduct our research, we segmented the S&P 500 companies. First, we identified industries with above- and below-median margins. We then created two size-based samples ($5 billion−$10 billion in revenues and $10 billion−$20 billion in revenues). Table 14.2 illustrates these groupings.

We found that, after adjusting for company size and industry, margin is associated with pay opportunity levels (see Table 14.3 below). Specifically, among the largest-company sample ($10 billion−$20 billion in revenues), high-margin companies provide approximately 46% higher compensation opportunity than low-margin companies. The differential for smaller companies ($5 billion−$10 billion in revenues) is approximately 21%.

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2 All data are as of fiscal year-end 2010
However, when size and industry are not accounted for, margin is not correlated with CEO pay opportunity across the total sample of the S&P 500.

**TABLE 14.2**

**Company Groupings**

<table>
<thead>
<tr>
<th>Companies $5B-$10B Revenues Industry (Descending Order by Margin)</th>
<th>Revenue ($B)</th>
<th>MEDIAN STATISTICS</th>
<th>CEO Target TDC ($M)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy</td>
<td>$6.14</td>
<td>26%</td>
<td>$8.79</td>
</tr>
<tr>
<td>Information Technology</td>
<td>$7.13</td>
<td>26%</td>
<td>$10.06</td>
</tr>
<tr>
<td>Health Care</td>
<td>$7.34</td>
<td>24%</td>
<td>$8.62</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>$6.71</td>
<td>21%</td>
<td>$7.37</td>
</tr>
<tr>
<td>Industrials</td>
<td>$6.97</td>
<td>18%</td>
<td>$7.38</td>
</tr>
<tr>
<td>Materials</td>
<td>$6.63</td>
<td>18%</td>
<td>$7.59</td>
</tr>
<tr>
<td>Consumer Discretionary</td>
<td>$6.07</td>
<td>18%</td>
<td>$7.70</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Companies $10B-$20B Revenues Industry (Descending Order by Margin)</th>
<th>Revenue ($B)</th>
<th>MEDIAN STATISTICS</th>
<th>CEO Target TDC ($M)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Energy</td>
<td>$12.16</td>
<td>48%</td>
<td>$12.52</td>
</tr>
<tr>
<td>Information Technology</td>
<td>$13.97</td>
<td>38%</td>
<td>$13.15</td>
</tr>
<tr>
<td>Health Care</td>
<td>$12.84</td>
<td>27%</td>
<td>$10.34</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>$14.07</td>
<td>19%</td>
<td>$7.85</td>
</tr>
<tr>
<td>Consumer Discretionary</td>
<td>$14.47</td>
<td>15%</td>
<td>$8.50</td>
</tr>
<tr>
<td>Materials</td>
<td>$13.42</td>
<td>14%</td>
<td>$8.53</td>
</tr>
<tr>
<td>Industrials</td>
<td>$12.55</td>
<td>13%</td>
<td>$7.66</td>
</tr>
</tbody>
</table>

Importantly, EBITDA and TSR are also not correlated with pay opportunity levels in this sample.

2. **Is the pay opportunity differential as great as the margin differential?**

Between high- and low-margin industries, pay differentials are 46% for the larger companies and 21% for the smaller companies. The margin differential between high- and low-margin companies (as segregated by the median level of margin performance) is much greater, between 171% and 47%, respectively, for the same samples. This supports the theory that CEOs of large companies receive a “minimum” level of pay opportunity for the substantial accountabilities of the position. This is similar to the relationship between pay and revenue, wherein revenue differentials are much greater than pay differentials. Neverthe-
less, this analysis shows that once industry and company size have been neutralized, margin differential has a measurable impact on CEO pay opportunity.

3. Do higher-margin companies have higher realizable pay? Should they?

No. We found that generally speaking, across the entire sample of the S&P 500, low-margin companies have higher realizable pay as a percentage of pay opportunity than high-margin companies. This could, and probably does, vary throughout the business cycle. Across the total sample, the difference between CEO realizable pay and pay opportunity is primarily a function of share price appreciation.

However, drivers of share price appreciation vary significantly across industries and market cycles. Larger companies with high margins have higher pay opportunity. The efficient-market hypothesis would dictate that these higher margins are “baked into” stock price as soon as they are recognized. Thus superior TSR and its impact on realizable pay requires that the higher margin companies outperform market expectations. Clearly, this does not always happen. This analysis is consistent with our general research finding that company performance has a major impact on actual compensation received by CEOs.

3 Defined as base salary plus the actual cash incentives earned plus the current intrinsic value of long-term incentive awards.

<table>
<thead>
<tr>
<th></th>
<th>Median CEO Target TDC ($M)</th>
<th>Median Revenues ($B)</th>
<th>Median Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Companies $5B-$10B Revenues</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>High-Margin Industries</td>
<td>$9.16</td>
<td>$6.87</td>
<td>25%</td>
</tr>
<tr>
<td>Low-Margin Industries</td>
<td>$7.56</td>
<td>$6.56</td>
<td>17%</td>
</tr>
<tr>
<td><strong>Differential</strong></td>
<td></td>
<td></td>
<td>21%</td>
</tr>
</tbody>
</table>

| **Companies $10B-$20B Revenues** |                           |                      |              |
| High-Margin Industries       | $12.00                    | $12.99               | 38%          |
| Low-Margin Industries        | $8.23                     | $13.48               | 14%          |
| **Differential**             |                           |                      | 46%          |
The higher pay opportunity provided by higher-margin companies is not always converted into higher realizable pay. Rather, it is highly dependent on TSR.

4. Considering these margin research findings, what practical steps can companies take to ensure fair and competitive compensation opportunity?

a. Setting Pay Opportunity

Companies lacking ideal comparators — those with identical or similar business models — or comparable-size industry peers can benefit from using margin comparisons to assist in making decisions regarding pay opportunity levels. Conglomerates could also benefit from factoring in margin when setting pay, depending on the existence of similar-size and similarly structured organizations.

b. Industry Differences

Companies operating in different industries with different business models, and hence different margins, often have different pay opportunities for CEOs and other senior executives. There are, of course, many reasons why different industries offer higher or lower pay packages, including different business and talent strategies. Margin may be only one of several factors involved.

c. Size Differences

A margin-oriented comparison can be critically important if a company is among the largest or smallest in its industry (or its Global Industry Classification Standard group). If pay level competitiveness is assessed using pay opportunity levels, which is how summary compensation tables (and ISS) define pay, large companies with reasonable revenue-based comparators but variable margins may reach incorrect conclusions. For example, if a large company with high margins were to compare its pay to that of similar-size industry peers that have low margins, it might incorrectly conclude that its pay levels are too high.
CONCLUSION

Our research supports the traditional wisdom that company size is the greatest determiner of pay opportunity. However, our study’s findings also confirm the importance of using industry and margin analysis to assess pay competitiveness. This is an important factor that should be included in competitive pay analyses for executive positions.

Christine Skizas is a partner, Matt Arnold is a consultant and Ira Kay is a managing partner with Pay Governance
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