Executive Compensation

Rich Ferlauto
AFSCME Corporate Governance & Investment Policy

Introduction

Compensation is an annual concern; It involves difficult and sensitive issues; it requires boards to exercise independence, skill, and judgment; and it is integral to a company's long-term strategy and performance. Long-term shareholders support compensation policies that promote the creation of sustainable value. The importance of compensation is further underscored by the Securities and Exchange Commission's (SEC) extensive disclosure requirements, which are substantially more detailed than for other issues in the proxy statement.

There is widespread support for reforming executive compensation, as 90 percent of institutional investors think the current executive compensation system has overpaid executives,[1] while 76 percent of investment professionals support giving shareholders "Say on Pay."[2]

Additionally, the Administration's recently announced campaign to reform executive compensation overlaps with many of the measures advocated here, including mandated "Say-on-Pay" votes, "clawback" procedures for recovering bonuses based on faulty information, independent compensation consultants, enhanced disclosures, and limiting golden parachutes.

Say on Pay

An annual advisory vote on executive compensation, also known as "Say on Pay," is seen as a useful engagement tool between a company and its shareholders, encouraging a company to explain and justify the executive pay policy. The shareholder vote would not override compensation decisions, but would allow shareholders to weigh in on whether they believe the executive compensation is warranted. A company should communicate to its shareholders how executive pay is tied to performance, and Say on Pay encourages this.

In the United Kingdom, Say on Pay is widely viewed as a useful means of engaging with companies on the issue of executive pay. The mechanism of having an advisory vote sets up the basis for having a dialogue, and that is what is companies and investors find useful.

Long-term investors want mechanisms that better link pay and performance while avoiding pay for failure. Studies find that an annual advisory vote on executive compensation, also known as "Say on Pay," produces fewer rewards for failure and creates value for

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[1] Watson Wyatt, "Institutional Investors Dissatisfied with U.S. Executive Pay System, Watson Wyatt Study Finds," Dec. 13, 2005. Fifty-five institutions managing $800 billion in assets were surveyed.

[2] Whitehouse, Kaja, "Investment Professionals: Give Holders a Say on Pay," *Wall Street Journal*, Apr. 4, 2007.

shareholders.[3] There is widespread support for giving shareholders an advisory vote on pay, as 76 percent of investment professionals support giving shareholders Say on Pay.[4]

Independent Compensation Consultant

Compensation consultants advising board compensation committees play a key role in the pay-setting process. Executive compensation consultants face potential conflicts of interest that can lead to higher recommended levels of CEO pay, including the desires to secure repeat business and "cross-sell" additional services. Studies find that executive pay is higher in companies using executive compensation consultants where the consulting firm also provides other services.[5]

Clawbacks

Clawback provisions enable companies to recover performance-based compensation. The "clawback" occurs when it is later determined that performance goals were not actually achieved, whether due to a restatement of financial results or for other reasons.

An effective clawback policy typically requires an executive to disgorge bonuses, incentive- and equity-based compensation, and profits on sales of company stock that they receive within a defined time period following the public release of financial information if there is an accounting restatement, financial misconduct or a similar material failure to comply with financial reporting requirements.

No Excessive Golden Parachutes

In the past decade, Boards of Directors have too often agreed to lavish payments to executives in the event of a change in control of the company or if the executive is terminated. These agreements bring little or no value to shareholders, impose an economic cost on the company and can reflect a Board's misplaced allegiance to the Chief Executive rather than the shareholders.

Necessary Elements of Disclosure

Pay disclosure should clearly communicate how a compensation plan is performance-based and promotes long-term value creation, which is the primary objective of shareholders. It should clearly describe how the compensation plan is linked to the company's business strategy.

The compensation plan's metrics, goals and hurdles should be clearly and specifically disclosed. A reader should be able to easily read and understand these metrics and hurdles.

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[3] Sudhakar Balachandran, Fabrizio Ferri & David Maber, *Solving the Executive Compensation Problem through Stockholder Votes? Evidence from the U.K.*, Nov. 2007, available at http://www.columbia.edu/cu/ciber/research/balchandranCIBER_Grant_Paper_UK_Voting.pdf; Cai, Jie & Walkling, Ralph A., *Stockholders' Say on Pay: Does it Create Value?* Dec. 08, 2008, Drexel College of Business Research Paper No. 2008-06, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1030925.

[4] Kaja Whitehouse, "Investment Professionals: Give Holders a Say on Pay," *Wall Street Journal*, Apr. 4, 2007.

[5] Kevin J. Murphy & Tatiana Sandino, "Executive Pay and 'Independent' Compensation Consultants," Apr. 28, 2009, available at http://ssrn.com/abstract=1148991.

Incentives should be explained clearly, with emphasis on how they are designed to meet specific short and long-term business challenges and customized to suit the company's size, industry, performance, competitive position.

Well disclosed compensation plans should explain how senior executive compensation complements the company's overall compensation program, including reinforcing internal pay equity and promoting the success of the entire business enterprise.

Holding Equity Shares until Two Years Past Termination of Employment (Hold through Retirement)

Companies provide their executives with equity as part of compensation, but most do not require their executives to maintain their equity in the firm past the tenure of their executive positions. Short tenured executives therefore might not have the same interests as long-term shareholders. To assure the alignment of those interests, executives should be required to hold their equitable interests for two years past their termination of employment, also known as "hold through retirement", or "HTR" for short.

HTR has been promoted by legal scholar and compensation consultant Jesse Brill as having a variety of benefits that promote long-term shareholder value, "including aligning executives and shareholders, encouraging a long term focus, fostering a companywide ownership culture and providing a continuing and growing personal incentive to work towards superior performance . . . these requirements help to alleviate concerns raised by recent scandals relating to timing of option exercises and stock sales by senior executives as well as by the general increase in the size of equity compensation awards over the past 20 years."[6]

Research has shown companies with a high percentage of ownership by chief executive officers, excluding options, substantially outperform other companies with higher chief executive officer pay, and that the most powerful link between shareholder wealth and executive wealth is direct stock ownership by the CEO.[7] And research also shows companies whose CFOs held more shares generally showed higher stock returns and better operating performance.[8]

Equity retention is a key provision of the Aspen Principles,[9] which resulted from the culmination of yearlong study by leading investors and business representatives to identify the factors leading to short-termism, as well as the most promising strategies for reintroducing

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[6] Jesse Brill, "Hold 'Til Retirement for Equity Awards: How to Pick and Implement What's Right for Your Company," *The Corporate Executive*, Sept./Oct. 2008.

[7] Michael Jensen & Kevin Murphy, *CEO Incentives: It's Not How Much You Pay, But How*, in FOUNDATIONS OF ORGANIZATIONAL STRATEGY (Michael C. Jensen, Harvard University Press 1998); Harvard Business Review, No. 3, May-June 1990, pp. 138-53, available at http://ssrn.com/abstract=146148.

[8] Alix Stuart, "Skin in the Game," *CFO Magazine*, Mar. 1, 2008. For the group of 110 large companies that Watson Wyatt studied, for example, the high-performing half of the stocks returned an average of 52 percent to shareholders between 2003 and 2006, including stock-price gains and dividends, compared with the 39 percent the low-performing half returned. Among other differences in those groups was median CFO stock ownership: $13.9 million (excluding both vested and unvested stock options) for the top performers, only $2.8 million for the low performers.

[9] Aspen Institute, "Long-Term Value Creation: Guiding Principles for Corporations and Investors," June, 2007 ("Compensation that supports long-term value creation . . . [r]equires that senior executives hold a significant portion of their equity-based compensation for a period beyond their tenure.").

long-term bias and returning greater balance to capital markets. Similarly, the Council of Institutional Investors recently endorsed a set of best practices for executive pay policies and disclosures, which included "[e]xecutives should own a meaningful amount of the company's common stock. A significant portion of their pay should be equity-based and they should be required to hold it for a period beyond their tenure."[10]

Bonus Banking

A responsible executive compensation program should not pay out short term bonuses unless performance is maintained a period of time, to avoid the possibility of rewarding executives just prior to a collapse in performance. Short-term incentive plans, if not designed with effective safeguards, could inappropriately encourage senior executives to manage for the short term and take on excessive risk. Evidence indicates that the current financial crisis was exacerbated by executives being rewarded for short-term financial performance without regard to whether that level of performance was sustainable.[11]

Short term bonus payments to top executives of failed financial institutions have renewed interest in finding more efficient methods of compensation. Tens of millions of dollars in bonus payments were made to firms such as Bear Sterns, AIG and Lehman Brothers.[12] Congressional response has been to mandate the clawback of bonuses from failed companies receiving government support. In 2007, the Committee for Economic Development, a distinguished panel of business and academic leaders, found that "[d]ecision making based primarily on short-term considerations damages the ability of public companies, and therefore, of the U.S. economy to sustain superior long-term performance."[13]

UBS recently announced that it would adopt a system of bonus banking that will be "focused on the long-term and more closely aligned with the value creation of the firm," where executives will forfeit previously earned bonuses if they underperform.[14] And in April 2009 before the Council of Institutional Investors in a speech calling for new pay standards, Goldman Sachs Chairman and CEO Lloyd Blankfein agreed with this approach, stating that "an individual's performance should be evaluated over time so as to avoid excessive risk taking and allow for a 'clawback' effect. To ensure this, all equity awards should be subject to future delivery and/or deferred exercise over at least a three-year period."

No Golden Coffins

Death benefits are defined as termination payments triggered by death, also known as "golden coffins." According to Equilar, as of 2006, 17.2 percent of Fortune 100 companies disclosed that their CEO is entitled to receive death benefits. Golden coffin programs pay out

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[10] Council of Institutional Investors, "Council of Institutional Investors Statement on Executive Pay," Nov. 25, 2008.

[11] Christopher Keller & Michael Stocker, "Executive Compensation's Role in the Financial Crisis," *National Law Journal*, Nov. 18, 2008.

[12] Christine Harper "Lehman's 2007 Bonus Pool Rises Almost 10% on Higher Revenue," *Bloomberg*, Dec. 13, 2008.

[13] Committee for Economic Development, *Built to last: Focusing Corporations on Long-Term Performance* p. 1 (2007).

[14] UBS Press Release, "New UBS Compensation Model," Nov. 17, 2008. UBS explained that the new program "should bring about a cultural shift in the company. Those who are rewarded will be those who deliver good results over several years without assuming unnecessarily high risk."

significant long term compensation that is unrelated to performance after the death of the CEO and attract negative media attention that hurts the reputation of the company.

Tax Gross-ups are reimbursements for senior executives paid by the company to cover an executive's tax liability. Providing gross-ups to executives has been a widespread phenomenon, as a 2007 study found 77% of companies provided executive gross-ups.[15] The contractual provision of tax gross-ups to executives undermines the concept of pay for performance. The Council of Institutional Investors states that companies should not compensate executives for any excise or additional taxes payable upon the receipt of severance, change-in-control or similar payments. Noted executive compensation consultant Ira Kay of Watson Wyatt recommends "eliminating full tax gross-ups for new executives and phasing them out of existing agreements"[16] and Paula Todd of compensation consultant Towers Perrin has called gross-ups "an incredibly inefficient use of shareowners' money."[17]

The amounts involved in tax gross-ups can be sizeable, especially gross-ups for excess parachute payment excise taxes, which apply to changes-of-control. Michael Kesner of Deloitte Consulting has estimated that gross-up payments on executives' excess golden parachute excise taxes can account for 8% of a merger's total cost.[18]

Performance-vesting Shares

Equity compensation grants to senior executives should be shares of stock that require the achievement of performance goals as a prerequisite to vesting. Performance-vesting shares are a better form of equity compensation than fixed-price stock options or time-vesting restricted stock. Fixed-price stock option grants provide senior executives with incentives that may not be in the best interests of long-term shareholders. Fixed-price grants promise executives all the benefit of share price increases while limiting their exposure to the risk of share price declines. Performance-vesting shares also counter the common practice of awarding executives large amounts of restricted stock based on the length of time they serve, rather than the company's performance during their tenure.

Cap the Tax Deductibility of Executive Compensation

The current U.S. tax code places a $1 million cap on tax deductibility for executive compensation, but this provision has been meaningless in practice because it allows exceptions for so-called "performance-based" pay. On October 14, 2008, the Treasury Department issued rules for executive pay for firms participating in the Troubled Asset Relief Program. Included in these rules is a $500,000 cap on tax deductibility for all forms of executive compensation, regardless of whether it is "performance-based."[19] This policy should be extended to all financial sector firms as a means of reducing taxpayer subsidies for excessive compensation and also reducing the gaps between the pay levels of financial executives and regulators of that industry.

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[15] Jane Sasseen, "When Shareholders Pay the CEO's Tax Bill," *Business Week*, Mar. 5, 2007.
[16] Kay, Ira, and Steven Seelig, "A Reasonable Approach to Severance and Change-in-Control Payments," *Watson Wyatt Insider*, Aug. 2007.
[17] Jane Sasseen, "When Shareholders Pay the CEO's Tax Bill," *Business Week*, Mar. 5, 2007.
[18] Gretchen Morgenson, "The CEO's Parachute Cost What?" *The New York Times*, Feb. 4, 2007.
[19] U.S. Treasury Department, "Treasury Announces Executive Compensation Rules Under the Emergency Economic Stabilization Act," available at http://treas.gov/press/releases/2008101495019994.htm.