EXECUTIVE COMPENSATION FROM THE PERSPECTIVE OF THE LARGEST INSTITUTIONAL INVESTORS

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Executive Compensation from the Perspective of the Largest Institutional Investors

Summary of Issues Covered

Twenty-two representatives from 20 of the largest 25 institutional investors were interviewed about their views on executive pay for, on average, between 35 and 45 minutes using a standard set of questions. A snapshot of their responses in roughly the order the questions were asked is included here.

- **Top Issue:** More than half of the organizations listed issues related to pay for performance among their most important issues of concern.

- **Pay Level:** About three out of four had no real concerns about the current levels of executive compensation in the United States but many investors wanted to see a strong connection between pay and performance.

- **Metrics and Performance:** All respondents were interested in seeing executive pay aligned with performance and several mentioned an interest in using multiple performance metrics.

- **SEC Rules:** Although more than one-third mentioned some positive aspects of disclosure, the overwhelming majority were very negative about disclosure, the tables and the CD&A (e.g. because of "jargon," "legalese," and that "companies didn't know how to disclose").

- **Disclosure of Metrics/Targets:** Investors were roughly split on their view as to whether disclosure of performance metrics/targets would lead to competitive disadvantages.

- **External Sources of Executive Pay Information:** Respondents use a variety of external sources for information and research on executive pay and about one-third were openly critical of the influence of some of the sources.

- **Say on Pay:** About one-half of organizations interviewed were against say-on-pay proposals, about one-quarter were in favor of them and about one-quarter had mixed or neutral views.

- **Severance and Change in Control:** Investors discussed the trade-offs that are inherent in large severance and change-in-control provisions. Some were concerned that these provisions may go too far in certain cases, while others viewed them as important in recruitment and retention.

- **Equity:** Most investors believed in providing some form of equity compensation to executives—for such reasons as aligning the interests of the managers with those of the shareholders. Investors also discussed the effect of vesting provisions and the impact of dilution.

- **Compensation Consultants:** Respondents were asked their views on compensation consultant independence. They were split on their views, with some supporting complete independence, some saying they had no problem with consultants having multiple business relationships with the company and some stating that they were not that concerned about this issue as long as relationships were disclosed.

- **Retirement:** As for retirement benefits, about one-fifth immediately discussed that companies should roughly "pay the going market rate." A similar fraction specifically stated that retirement benefits for senior executives should not differ greatly from those offered to other employees.

Introduction

> *"Executive compensation is one of the most difficult [issues] for boards to get right but one of the most important."* (one of the Institutional Investors interviewed)

Rules, practices, and procedures surrounding executive compensation in the United States have become increasingly complex. Recent actions taken by the Securities and Exchange Commission (SEC), the Financial Accounting Standards Board (FASB), and the stock exchanges have made the issues additionally complicated. Many feel that these organizations and others will continue to address these issues in the coming years. Obviously there are several constituent groups concerned with the issue of executive compensation including, among others, the executives themselves, workers, shareholders, public policy groups, advocates, the press, and the government.

This report is intended to give a credible and objective summary of the views on executive compensation of the largest institutional investors. The top 25 institutional investors based on management of U.S. equities were identified from *Institutional Investor* magazine. At least one person from each organization was identified and contacted by telephone and asked to participate. The goal of this report was to interview one person with clear knowledge of the organization's views on executive compensation. These included people who chaired or served as members of the proxy committee; who were involved with corporate governance and executive compensation; and, in some cases, the chair of the organization. When not specified, the responses are intended to reflect the position of the organization. In some instances, which are clear from the text or quotes, the respondent stated his or her personal views. In the end, 22 people from 20 of the 25 organizations were interviewed by telephone during the period of March through June 2008. Most interviews lasted from between 35 to 45 minutes. The longest was 74 minutes. To encourage the institutional investors to discuss their perspectives freely, those interviewed were guaranteed that their companies' and individual identities would not be disclosed.

The remainder of this report examines 12 main topic areas that were covered in the interviews. The questions were developed in conjunction with the Center On Executive Compensation and the order of the questions was based, in part, on priorities set by Center. (Not every respondent was asked every question because the interviewee's time did not allow it). The topics covered included top issues of concern; the level of pay; metrics and the alignment of pay and performance; SEC disclosure rules; performance targets and metrics; external sources used for information related to executive compensation; say on pay; severance and change in control; equity in executive compensation program design; the role of the compensation consultant; retirement plans for senior executives; and other issues. The order of these issues presented in this report roughly follows the order of the questions in the questionnaire. Quotes from the investors interviewed are shown in *italics.*

The Most Important Executive Compensation Issue

Representatives of the largest Institutional Investment organizations ("investors" or "institutional investors" throughout this document) had a series of different concerns when they were first asked about executive compensation. It was interesting to start the interviews with an "open-ended" question: "What is your view of the issue of executive compensation today?" and then to go on to ask if there were top issues of concern. There was a wide diversity of responses to these questions.

More than half of the representatives noted that they were concerned with issues that could be broadly classified under the heading of alignment of pay with performance. In many instances they mentioned that they sought alignment between pay and performance; others emphasized that they thought alignment between pay and performance was lacking.

> *We want pay aligned with performance and pay aligned with peers.*
>
> *First of all, we want compensation to be aligned with performance. We want to strengthen the link between pay and performance. We also want to see more customized compensation programs tailored to the specific companies.*
>
> *The link between performance and pay is not always there anymore. [There has been an] upward spiral. People can see what other people are doing. [There is] a lot of inappropriate use of non-cash compensation. Some [of this] is based on tax and accounting issues.*
>
> *I think there is general agreement that the metrics used for executive compensation are not the best for long-term value.*
>
> *Probably the top issue from my perspective is the linkage between pay and performance or lack of linkage between pay and performance … We have no objection to executives making a substantial amount when investors make a lot too, or when they leave with a lot when they have made a lot for shareholders …We worry about tarring [Y] thousand execs for the behavior of a few.*
>
> *One, linking pay and performance. One of our major investment strategists is very focused on incentives.*
>
> *We are not too worked up about the absolute level. But that it is tied to performance and not just stock price.*
>
> *One is the fact of its lack of correlation with corporate results.*
>
> *The view is that some don't have incentives in line.*

The second most frequently mentioned concern respondents discussed dealt with the importance of the Board and the Compensation Committee in designing sound executive compensation arrangements. Roughly 40 percent of the organizations mentioned the board of directors—or more specifically the compensation committee of the board—as being an issue. Many of these respondents highlighted the importance of having a compensation committee that could be trusted and of the incorporation of general good governance practices. Some felt that it was not really the job of the institutional investor to micro-manage the details of executive compensation design on a day-to-day basis; rather, they were more likely to be concerned with outliers and related issues.

The most important thing is a compensation committee we can rely on. We don't feel it is the role of the shareholders to set compensation. But it is our role to elect the board. We look at the composition of the compensation committee.

We can't perform surgery either. So we hope those performing surgery know what they are doing. It is hard to substitute your judgment for the judgment of the members of the compensation committee. ... We are just not experts at executive compensation. It is a bewildering world to get into.

Overall we think compensation practices are best left to the board. Except when there is a big disconnect between pay and performance; but for the majority, that is not a big issue.

By and large, [considering executive pay] is for boards. [If they don't like it] shareholders can vote with their feet.

In general, we view [our company] as a non-compensation specialists. It is up to the board and consultants. In general, we prefer to not micro-manage compensation. We want transparency and disclosure. As much as possible; lay it out. See what the mix is and make decisions. Among the 57 items on the checklist, this is just a piece.

A few were specifically concerned with conflicts of interest and board oversight.

Compensation committees should be more responsive. One of the most important characteristics of compensation committee members should be responsiveness to shareholders. They should be much more open to shareholder concerns.

Compensation committee accountability ... reducing conflicts of interest in directors setting executive compensation.

Only three mentioned the issue of "say on pay," a non-binding, annual shareholder vote on executive compensation, as one of their top concerns. This topic is given much more detailed analysis later in the report. One investor mentioned "say on pay" and noted that there should be less focus on pay levels and pay of executives relative to other occupations. This investor said:

Say on pay would be one. The political nature of executive compensation and what that means to companies' compensation levels. It is difficult for large investors to get beyond the rhetoric. You have to decide what you mean by top investors. I have a problem with [people saying] "it's just too much." If shareholder value is going one way and pay another, then I would have an issue but not just with the level of pay. …Some have started to believe that socialism is better than capitalism. When someone gets upset at a guy hitting a little baseball [and earning high pay] then let's talk.

The remaining issues that were raised by the institutional investors included pay for failure, the structure of compensation, the level of compensation, the media, and regulation.

… we don't want companies to rely on benchmarks and peer groups and industry standards as that has led to the escalation of pay. Consider size, business strategy and competitive position.

… pay for failure. Severance agreements are just out of whack. [It is] somewhat understandable to pay someone to [leave another organization].

[Another issue is] disclosure. We have more but people are having trouble getting a handle on it.

You have to look at the economics of the specific operating business. You need metrics that are simple. It has to be directly related to the things you want to do. Figure out what you want to do. Communicate that to investors and employees.

The whole category of stealth pay— gross ups, change-in-control provisions and nasty surprises.

The media and the popular press typically doesn't get it right.

I have a sanguine view. As an investor, if you disagree, you don't have to invest in the company.

To summarize, when asked an open-ended question about their view of executive compensation in the United States and any issues of concern, pay for performance was most-often mentioned, followed by issues surrounding the board of directors and the compensation committee. This section also reported on a number of other issues of importance to the respondents including say on pay, disclosure, and pay for failure. The next section of the report will focus on the level of executive compensation.

The Level of Executive Compensation

Roughly three out of four of the investors interviewed did not seem very concerned about the level of executive compensation in the United States as long as it was tied to performance. In the end, these investors were interested in returns to shareholders. If, in light of high returns, executives received large levels of compensation, this did not seem to be a problem. Some suggested that comparisons needed to be made by company type. Several noted that the specific details of executive compensation level and design were up to the board and that the investor's role was to elect and monitor a well-governed board. Roughly 20 percent of the institutional investors suggested a mixed view on the level of executive compensation (e.g., certain dollar amounts may seem "high" but they opposed any restrictions on pay levels). Only one organization interviewed seemed strongly opposed to high pay levels.

Again, an overwhelming majority of the institutional investors had no real concern about the level of executive compensation.

We tend to not opine on the level. We focus on is it appropriate for what is accomplished? We tend to look for outliers relative to performance or relative to peers. We don't see that we want to get involved with the societal question of how much is too much. We seek to evaluate the compensation committee and leave detailed compensation issues to them.

We don't care about $100 million, but we do care about it [when there] is a loss.

We aren't focused on the amount or level. We have an overall view. Consistent with our overall view, we understand it is the responsibility of the compensation consultants and the boards. We don't have the resources to look at [X] thousand companies. We don't want to substitute our judgment for theirs. We want the boards to explain how it will drive the business.

We don't focus on levels of compensation per se. We focus on incentives: if they make sense and are related to our valuation ideas.

As a general rule we consider it fair in terms of total and in consideration of what is put forth. It is not easy to run large organizations. We need highly motivated people. Is it aligned in our interest? By and large, I think it is. …We philosophically leave much of this to the board within a wide range of reason.

I have no problem with paying a lot if executives add value.

As long as [things are] spelled out and performance-related [we are not concerned]. If there are adequate performance metrics then [we have no problem].

Across the board we would say that we disagree that CEO pay is too high. Every situation is context dependent. But what can we do about it generally in those cases?

We don't think of it as too high or too low. But what is its effect on the bottom line? We don't have an opinion on whether it is too high or low.

Slightly more than one in five organizations had a mixed view about the level of compensation. This may have been because they had not thought about this specifically, they outsourced the issue, or they thought the issue was nuanced and could not be addressed easily.

I think from an investor's point of view the U.S. tends toward high executive pay that is hard to justify. But most don't mind paying a lot if it will pay off to shareholders.

I think it is all over the map. I don't think you can have a single view. There may be companies where it may be egregious. At the same time, in most of the Fortune 500 it is not a problem. You have to look at the industry and the company and then make a decision about what to invest.

It totally depends on the industry. Clearly there are excesses … [but]…if they actually generate the value they should be paid a ton.

More than $15-$20 million raises a question and we start to look at it. But we have opposed proposals that would have restricted a compensation committee.

In light of the issue of say on pay and the expectation that shareholders can relatively easily become informed about the issues of executive compensation, one respondent had an interesting view when asked about his views on the level of executive compensation.

We use services to vote our proxies. In a majority of cases we take a case-by-case view.

Compensation is a complex, dense topic. Most, if not all, investors are not experts [on compensation]. Expecting that shareholders will have a view on this is a lot to ask.

Finally, perhaps in a bit of a Lake Wobegon sense, one representative from an institutional investor had this to say:

I was just at a conference. [The audience was asked] is executive pay too much? Yes. Are the executives at your company paid too much? No.

The large majority of institutional investors did not really seem concerned with the level of executive compensation in the United States. They were interested in returns to shareholders. If that came along with generous executive compensation, they did not seem too concerned.

Metrics and the Alignment of Pay and Performance

All of the large institutional investors favored pay for performance. Most organizations favored multiple performance metrics for a variety of reasons. Several noted that they felt that some metrics (e.g., EPS) are easily manipulated by management and should, therefore, be avoided. One commented, "[For any] metric [designed, executives] can game against [the metric]." Others noted that the appropriate metric depends on multiple factors such as industry, the compensation and pay mix of peers, and the time frame in question. Still others reiterated in this section that they are not interested in the micro-management of compensation design. They noted that they elect board members who have the responsibility and knowledge of the firm to design appropriate packages.

The idea that pay should be aligned with performance seemed absolutely unquestionable to the institutional investors.

It all starts with sensible pay tied to performance. The more context they can provide to put their program in the sensible box, the better we are to reach a conclusion.

Stock price is attractive in that it is entirely objective. It is what we experience as stockholders.

The rule of thumb [is] the best way of garnering shareholder loyalty [is] high stock price. Aligning CEO wealth with a high stock price.

There ought to be some part of compensation that is tied to [stock price]. How much depends on industry and volatility.

More than one-third of the organizations clearly noted an interest in multiple performance metrics to help tie pay with performance. Examples of these include the following.

We like there to be more than a single metric. But there have been instances where the committee wants the executive to focus on a particular metric. What we often learn when we engaged with a compensation committee is that they have a lot more information than we have. We don't want to micromanage or opine on what the metrics ought to be since they vary by industry, etc.

We like to see a range of performance metrics. Often times we see EPS. We also like to see ROI and other factors that reflect well on how well management is deploying capital. We want to stay away from EPS or total revenue [since they are] easy to manipulate. Also [we seek] a clear explanation of targets.

This really should be a board decision that has objective and subjective [components] and is not just formulaic. You may have a great CEO in a down industry. Having said that, return on equity, stock price, growth rates; whatever metrics are most pertinent. I think we found out the overuse of options can be disastrous. [It] gives the opportunity to swing for the fences. There has to be a balance.

We try to look on a peer basis. We are a little skeptical on metrics used most commonly, particularly EPS which, to be blunt, is manipulable, for example, through share repurchases. It biases decisions. I think cash flow is better. Most people think some elements of share price should be in there. But some think [this is] too much reward to the short-term. [We also consider] return on invested capital and return on equity. …Boards need to relate what they are paying.

It is what we experience as shareholders. [Things] that are relatively hard to manipulate [are good performance measures]. [Examples include] return on equity or invested capital. But EPS can be more easily manipulated. The more objective and fewer opportunities to game the better.

It is important to have a mix between long-term and annual performance. We invest for sustainable long-term performance. It is important, however, to reward executives for incremental performance that has yet to translate into shareholder value.

We like when packages are created that are more return-oriented; total shareholder return can be part of it. I like ROIC, ROI, ROA imbedded.

For us a very good way is return on capital or sustain it over a period of time -- that translates to stock returns. The stock price itself should be part of the metric; not necessarily a year but over a period of time. Raise return on capital.

…Earnings targets are great but there are a lot of things you can do to play with that.

Some investors did not want to be involved with specific details of setting executive compensation.

We don't support specific ratios. We don't want to be prescriptive and we don't want to micromanage.

We elect directors and the directors set the compensation. If you don't like it, vote against the compensation committee members of the board.

In terms of the pay-for-performance issue, several investors were interested in longer-term metrics than shorter-term ones. Some examples include the following:

[We] need a long-term, three-to-five year view.

One of the things I learned since I joined [this company] is that many managers have been within the company [they are investing in] for years and they often have qualitative views.

We look over a three- or five-year period.

You need to look over a period of time. How are they doing? If a five-year period, then shareholder returns are best.

We would like companies to tell us about long-term metrics that aren't tied to EPS and share price, such as quality and research and development; longer-term that create a better view. We'd like pay tied to fundamental performance but not necessarily EPS. That will come if you get the basics right.

In some of the interviews conducted there was time to get investors' views on whether pay should be capped. Most felt that there should not be any caps on pay but a few had different views, including these:

My job is to pay people what I think they are worth and what I need to keep them and not a penny more.

No [pay should not be capped, even in cases of extraordinary performance].

From an absolute standpoint, there should be a limit to pay but we haven't yet settled [on this] from a philosophical standpoint. The limit is probably different given industry and size. A classic example is pay for Wall Street firms. [Some think it is too much sometimes]. On the other hand for certain firms to keep people they have to pay that. It is much easier to swallow when you look at how much they returned to shareholders. But more than $15-$20 million raises a question.

The investors spoke about pay based on "relative performance." Until a few years ago, stock options were not reported as an expense in company balance sheets, as long as the strike price and number of options were fixed in advance. This is one reason firms suggested they did not (in the past) use "floating" or "indexed" strike prices on options. Now that all options are counted as an expense, the idea of pay based on relative performance no longer has this associated cost. Some of the investors talked about pay relative to peers and relative to some pre-set index.

[On indexing] I guess it doesn't come up much. If you are designing [a plan] from scratch, [indexing] might make sense. Now we index to the past. But switching to [indexing] … would be difficult.

I think having vesting dependent on some goals relative to peers or an absolute number is not a bad idea. It is good to benchmark against peers. Are they creating value or just riding a cycle?

A few of the respondents were interested in talking not about the successful managers but those who failed. One investor had the following insight.

We have tried to answer three questions: (1) What is the threshold of performance below which performance pay won't be earned [using perhaps a competitive group of the S&P500]? (2) Do you currently have a plan in place

that would compensate people whose performance is below that? We are looking in advance. (3) What happens when a perfectly [poorly performing] CEO leaves with $25 million? People don't want their hands tied; a world of contractual thinking. What would be deemed a failure? Just pick [the metric]. We don't give a [darn] what it is.

One institutional investor discussed the fact that he thought compensation design for many executives was too complicated and that plan design would be better if it were more straightforward. He also thought that some decisions should be up to the judgment of the compensation committee.

Any compensation plan should be [so simple that is can be] written on a [single] piece of paper. It is not inappropriate to be partly related to stock price. Performance relative to peers [is important]. But any metric can be gamed. [It is best to] really rely on common sense and ... directors; much more common sense than a formula.

In general, the large institutional investors agreed that there needs to be some sort of pay for performance for senior managers of firms. They had a diversity of related opinions about what the right metrics might be, how peers should be used, issues of timing, and relative performance.

SEC Disclosure Rules

Recently the Securities and Exchange Commission made the first major change since the early 1990s in the way executive compensation needs to be reported. This has created a lot of interest among shareholders and caused substantial additional work for those working for the firms that have to report compensation information in a new detailed way in the proxy report. Given that most companies have only just produced one or two proxies using the new format, there is still much to be learned about the new proxy reporting. Further, many feel that reporting may change slowly over the next few years as more is learned about disclosure.

Although a few of the large institutional investors found the new disclosure to be interesting and somewhat useful, the overwhelming majority were very negative about disclosure, the tables, and the Compensation Discussion and Analysis ("CD&A").

There were very many complaints and issues that the investors had with the new SEC disclosure rules.

The negative may be too much information and legalese that has not achieved its intent. Since it is influenced by lawyers, I think they have lost the point. This always happens in public documents. I think that with some companies [the CD&A have] done a really good job and with others not so good. I met with a company yesterday. After reading their CD&A and meeting with them, I still don't understand the metrics.

[The new CD&A] is not helpful. ...No, we do not make use of [the tables in proxies].

[There is] some frustration [concerning SEC disclosure]. It may be a settling-out period, as in the early 1990s. A, companies didn't know how to disclose. B, people didn't know what they were looking at. …In my point of view [it would be] nice if [the CD&A] were less wordy [and had fewer] tables.

What we have seen from last year is still pretty complicated disclosure. Things are not as user-friendly as planned. So it lends itself to a more simplistic view of compensation. …[Disclosure] is driving substantially good talent into private equity [where] you don't have to disclose compensation to a shareholder with two shares.

On the one hand the tables are useful. But we struggle since it is in so many places and there are so many bases for presentation.

[The new CD&A has] not yet [given greater insight]. We are really waiting for the next round. Some companies have been much bolder in talking about how the sausage is made. We aren't there yet. I think there is still a lot we are missing.

We really are screening for outliers. The nuance of the detail doesn't help to determine an overall investment over a three-to-five-year plan.

The SEC recently updated disclosure requirements. A lot of companies just didn't get around to it and were not forthcoming. I don't think corporate America is trying to hide these things. They are all well aware that they don't want to be on the end of a [wow] headline.

[The new SEC disclosure rules] help. Those things are so dry. I rely on ISS and RiskMetrics to make them readable. Not that we do anything about it.

There is a lot of [junk] and jargon in [the CD&A].

To be blunt, it's provided a little bit of insight, but I don't look too closely Given that we meet with managers, I am not sure the disclosure has added too much to what we know.

However, several indicated that they found the new disclosure to be helpful.

The positive has been more information and transparency.

From where I sit, it is great to have all of this new detail.

Good CD&As have been helpful.

In general I am pretty negative on regulatory [matters] and it is all going to be worked around but the disclosure is really useful.

[The CD&A disclosure] is useful to the extent that it gives you insight into corporate culture. If you like the approach, that's okay. [This] may be more useful than the numbers. … In a way, [the CD&A] could be very helpful.

This may put us in the minority. I thought the investment community and the commission came down hard. I expected things to be safe and boilerplate. I was more forgiving. They can get better and are getting useful …I think [the CD&A and disclosure have given institutional investors greater insight into the rationale

for pay]. …The SEC made a move in the right direction. But it was very dense. You lose the forest for the trees. As time moves, we'll get better at it. We appreciate the disclosure.

Some others noted that they use the CD&A for specific purposes. For example, some only really look to the CD&A if some sort of outlier is identified through quantitative analysis. Others have noted that they specifically focus on the narrative.

We tend to go to the CD&A as a secondary source. We tend to rely on the [quantitative] research first. We only go to the CD&A if the research providers suggest something. If two of the three [research providers] spot some issue, then we go to the CD&A. …My view [of the CD&A] is probably skewed since I only look at the ones that have been identified as issues.

The [CD&A] is probably most difficult to write. The philosophy, rationale, and goals. But we use a set of questions to evaluate qualitative aspects of CD&A. We are willing to be convinced, if given explanation …We focus less on the tables because we are more focused on the narrative.

A vast majority of the large institutional investors seem unhappy, for varying reasons, with the new disclosure and CD&A. Some feel that what is being reported is not clear and others think that it will take time to see what this new round of changes in disclosure—the first in roughly 15 years—will bring.

Performance Metrics and Targets

There has been growing discussion in the business press and other circles about the disclosure of performance metrics and targets in firm proxy statements. Some have argued that additional disclosure of types of measures and especially specific hurdles may reveal too much and put the firm making the disclosure at a potential relative disadvantage compared with competitors. Others have argued that it is important to fully disclose the specific details of executive compensation contracts in publicly held companies.

Performance metrics and targets were discussed with many of the investors. Among those interviewed about this issue, opinions were almost perfectly evenly split. Roughly one-third fell into the "disclosure can lead to competitive disadvantage" group; one-third thought this was not an issue; and one-third was uncertain or had mixed feelings about the issue. In addition, some also felt that too much focus on a particular metric could lead to manipulation. Still others questioned the usefulness of targets, since there could be incentives to create very low targets that are easy to achieve.

Several of the investors saw a real disadvantage to disclosing performance metrics and targets. Specifically, they thought this would put their firms at a relative disadvantage.

The companies don't want to disclose too much since they could be at a competitive disadvantage. I don't think disclosure needs to go to specific financial targets such as EPS. It should be enough [disclosure] to give comfort but not insight so there will be competitive disadvantage.

But even if you can tell me what the bar is, I am not sure I can evaluate that. …But maybe too much disclosure in advance gives too much information to competitors.

I'm finding ISS a little frustrating in [terms of the issue of disclosure of performance metrics]. There can be proprietary reasons for not disclosing this. When you are talking about an internal metric I think you are looking in the weeds. I am concerned that we are getting to demand too much specificity.

If you disclose the way in which your senior officers are being paid, you are in some ways disclosing the strategy of the firm.

About one-third saw competitive disadvantage entirely as a non-issue and were much more interested in disclosure.

A significant majority have chosen not to disclose targets. [There are] probably mixed concerns about whether they disclose competitive risks. My personal view is that this is overstated. If they are backward looking, I can extrapolate from that. If backward [looking] then less of a competitive issue.

We don't have a problem with being specific with milestones. It does fit with a system of high integrity. If published, at least they are out there. The transparency is probably a good check and balance. [As for potential negative consequences of disclosure of performance targets] we don't buy it.

I think [the idea that this would put a firm at a competitive disadvantage] is hogwash.

I can't imagine that compensation behavior, in any sector or for any large company, would lead to any competitive disadvantage. In fact, it might actually force boards to be more accountable for negotiating packages for new CEOs.

I don't think [the potential negative consequences of target disclosure] is too legitimate. I'm not sure how that puts you at a competitive disadvantage. Just because you know his metrics, that doesn't mean you will lose business.

Another group of investors felt that this was a more nuanced issue and were largely left on the fence. While several of those in the two camps above stated both sides of the issue, in the end, they aligned with one side or the other. The respondents in this group were decidedly more "mixed."

I don't know enough to have an informed view. I've heard, if you tell me the metric then I'll tell you how to manipulate it …Is the metric real? They may shoot for a metric that is so easy to achieve. Is the metric susceptible to gaming?... We need transparency. If it helps the market, I am in favor of it.

[The disclosure of performance metrics] is certainly lacking. Even when we have disclosure of performance there is little detail. As investors, we want to think about the probability of future events. Information about the past is helpful but we want to see where we are going. We are sensitive to the competitive norm. But we wouldn't recommend [disclosure of targets] if we thought it would cause competitive harm.

There could be some downside [to disclosing performance targets] but we haven't thought about it much. We'd like more of it. I can see both cases. If the company thinks it is critical in a competitive environment not to disclose it [I can

see that]. We are trying to support management and the board. Unless for some reason we should not. … Once you disclose targets they aren't including judgment.

[The idea of potential negative consequences of disclosing performance metrics] is a good question and a tough one, too. I'm sympathetic but I would guess that nine times out of 10 it is [nonsense]. Maybe you can say part of it is based on competitive position and underlying dynamics.

Disclosure of performance targets is one of the many issues still being debated following the SEC's revised disclosure rules. Large institutional investors are mixed in their views on this issue.

External Sources Used for Information Related to Executive Compensation

Every single investor interviewed mentioned that they used some external sources for information related to executive compensation. The overwhelming majority used Institutional Shareholder Services (ISS) (ISS Governance Services is a division of RiskMetrics). Many others also used Glass Lewis and some used the Corporate Library, Proxy Governance, and others. Investors used these sources for different reasons, however. Some made clear note that they used the sources for data and background information but not necessarily for strict advice on how to vote. Several went on to suggest that, although they subscribe to the service, they disagree with ISS on many issues. Many used ISS for its proxy voting platform but the investors differed as to the extent to which they followed ISS voting recommendations.

Roughly one-third of the organizations mentioned that they relied heavily on ISS recommendations and were very positive about ISS:

ISS is helpful, I think.

We think they [ISS] do a decent job.

We use [ISS and Glass Lewis] as well. In our industry, we find it the right business practice to use these sources. We read it and we acknowledge it. In some cases we use their research. Compensation is a hot topic and emotional due to some egregious situations. Good governance is key. Compensation done badly is due to a weak board. Good board structure in general is key to a good compensation plan. If you have a good board structure, compensation is not an issue.

We subscribe to Glass Lewis and rely very heavily on their recommendations.

On the proxy voting part, we outsource to ISS. We don't tend to over-ride that.

We have so many stocks, we just can't be into that much detail[ed research and voting] on any one. That is why we outsource this to ISS.

Others subscribed to the service and services of similar organizations but used the information as part of a larger collection of resources and did not particularly rely on recommendations from ISS:

We don't follow ISS strictly but we take a look at their [material]. Sometimes we vote with them and sometimes we vote against them.

We use the ISS model for options but don't necessarily vote according to their recommendations. But it is a good model.

We use research from ISS and Glass Lewis but we use it primarily to create context. We don't follow guidelines except our own, developed by our team. Both [ISS and Glass Lewis] adopt a perspective on compensation. We don't have any other objective sources.

We use some [of the above]. We have our own custom guidelines. Historically we have used ISS. They process our votes through their gateways. We hire them to keep track of [the votes] for us. We have also used them and others once every couple of years [for research]. We like to have a good temperature check and have a separate contract for proxy guideline review and analysis.

We use an incredibly wide range of information; academic studies, investor white papers, blogs, the legal community. We have a diversity of thought and resources. …[We use] compensationstandards.com and Board Analyst by the Corporate Library. We use ISS as a voting platform through which we transmit votes. But, frankly, we could care less about the ISS research. We don't care about scoring but a convenient compilation of data.

Although a vast majority of the institutional investors interviewed use ISS (now part of RiskMetrics Group), it was interesting to see how many were openly critical (roughly one-third) of the power and influence that ISS has. They were asked what sources they used to become informed about issues and were not prompted to give an opinion on the quality or usefulness of the sources.

We use the ISS model for options but don't necessarily vote according to their recommendations. But it is a good model. … [External sources are] becoming too powerful.

We use external sources from a data standpoint but not necessarily an opinion. We disagree with ISS on a lot of things but we are probably a big outlier.

We use ISS as a voting platform through which we transmit votes. But, frankly, we could care less about the ISS research.

They are very influential. ISS is overly influential. ISS has a disproportionate sway in this.

We read [their work] and get caught up. We [try to see] what the drivers are; it's reference. I think ISS has too much power. Too many funds roll their way.

Institutional investors use information from a wide variety of sources in considering executive compensation. Some were openly critical of the influence by some of the sources.

Say on Pay

The discussion on say on pay, a non-binding shareholder vote on executive compensation, was interesting. About half of those interviewed were against say-on-pay proposals for a variety of reasons, including that "the committee has better access to information than we do;" that such a plan may work for large investors but with dispersed ownership it would not; that they would prefer more engagement with directors; or that they would not know what firms would do in the event of a "no" vote. On the other hand, about one-quarter of organizations supported say on pay, with one noting that the threat of the vote could change firm behavior. Finally, the remaining organizations—about one-quarter —had a mixed or neutral view on the subject.

Roughly half of those interviewed were quite strongly against the idea of say on pay for a variety of reasons. A selection of the negative reactions is included here.

> *We are not supporting say on pay. It goes against our governance philosophy about the board. If the board is doing a good job there is no reason to consider this. If we see an issue, we would rather withhold votes for compensation committee members. …We have been focused on expanding our engagement. We have increased engagement with … companies by two or three times [in recent years]. We have changed from voters to relationship managers. We identify concerns and reach out to boards of directors. To discuss issues. We do this confidentially. … The committee has better access to information that we do.*

> *I think it's ridiculous. I don't get it. If you don't like it, then don't invest in the company; go somewhere else.*

> *[Most all of us] would say no [to say on pay]. …I would prefer more engagement with directors. We elect directors and they elect management. We will say yes to things but huge pension funds will say no to it.*

> *We have consistently voted against say-on-pay proposals. It is not clear A, what we are voting on and B, what others will vote on. We can have a much more individual discussion and … nuanced discussion. Our view is that engagement is a better avenue. A 100 -share shareholder can't do that but on what basis will they make a decision [to vote on say on pay].*

> *We are not supporters of it as it is currently discussed in the U.S. We just don't support the current form that is based on the numbers in the summary compensation table. We don't think that is the right approach. … We would rather have companies more involved in engagement.*

> *We are not in favor of [an annual nonbinding shareholder vote on executive compensation]. We view it as the prerogative of the board to consider all factors that go into the amount and composition of pay. We view the board as our proxies. Beyond that I think there is a danger in a democratic vote. On the surface it may look like lower pay is better but maybe not in the longer run.*

> *As for say on pay, I am not so excited about it. We should let the compensation committee do it. It's less say on pay and are you setting the right incentives? … You need to set targets that create value. That is the compensation*

committee's job. It isn't an investor's job to say this is how much you should be paid.

In a post-expensing world, we have changed our view of equity compensation plans. In the pre- expensing era cost was an important consideration since it was not on the balance sheet. Post- expensing it is on the balance sheet. So why now do we have to vote on equity compensation plans?

We are generally opposed. Generally we go in line with RiskMetrics and ISS … But the proposals are nonbinding so what's the big deal?

On the other hand, about one-quarter of the large institutional investors interviewed supported say on pay. This is a sampling of their comments and reasons for their support.

I think we would want both [a vote on say on pay and more engagement]. In some cases the company has not been open to us. Just the fact that the advisory vote exists will change behavior.

We don't want to cast a binding vote. But [this is a] good [idea] in light of majority voting standards. I view say on pay as an alternative. [It is] possible that companies will lead good directors since shareholders have no other way to consider pay. …In most cases, management knew it before it became an issue. A lot of times these are self-correcting.

[We] would probably be in favor of [say on pay]. But we do entrust the board to adequately compensate the CEO with shareholders' interests in mind.

[Our] policy is to support them. We have leaned toward supporting say-on-pay proposals. We do have a few portfolio managers who are strongly opposed and prefer to consider board members. …In the UK everyone had to adopt at the same time, which seems fair. So, for example, [a firm that has had a vote] is at a disadvantage relative to others.

If we could come to a collective agreement then I really don't see what companies have to [fear].

I view say on pay as a canary in a coal mine. Maybe that is when engagement should get into high gear. I think say on pay would help us focus the engagement. Let's identify the problem and then ramp the engagement.

About one-quarter of the respondents were mixed or neutral in their view of the say-on-pay debate for a variety of reasons, including that they just did not think the issue was important enough, they were still not yet sure as an organization, or that they preferred to be formally neutral and analyze the issues on a case-by-case basis.

We are abstaining on say-on-pay proposals. In the past, this would have been thought of as [a] negative [vote]. But not now. But if our fund managers wanted a vote on say on pay, we would do it. …We have fund managers and analysts and we don't want to distract them. Don't bother them with whether they like a stock option package.

This has divided us a little bit. The majority sentiment among our portfolio managers is in favor of it. But several have a view that investment managers are

dumb about this. … [There is a] fear that uninformed views may become more dominant. The British say that investors will get smarter and more informed. But in the UK [resources] are more concentrated.

We are really doing [say on pay] on a case-by-case basis. We have voted for and against them.

I have no clue what you do if it passes. It is a message that the package is out of line.

[As for say on pay] it depends. Right now, we don't want to micromanage. In a broad way we have said we don't want to micromanage compensation. So we haven't really addressed this yet. We have not incorporated a policy. This year we have been having more engagement. Companies have been meeting us. …I think this is a little trendy right now and it will pass. I don't necessarily see that I need to micromanage and vote on what is best left to directors.

Our proxy policies are absolutely company-specific. We [have] voted for some proposasl at one company [and] voted against at another. It depends on the board's credibility. If a management has no record [we] may vote against this.

We are generally in favor of it;, however, we review every one on a case-by-case basis. If we believe disclosure is adequate and performance goals are set then we will not support [say on pay].

The institutional investors discussed some additional issues during our discussion of say on pay. These included topics such as increased responsibility that come with a vote, what shareholders may do in the event of a "no vote," procedural and other issues.

I can see increased risk for say; for the board who owns the liability. …Part of the problem [is what to do in the case of a no vote]. It is a token. But if it's a token vote and they say no, you will have the same next year. [Are you voting for] 30 percent or 50 percent or what?

In some cases the huge unions put pressure. "We want your support on this."

If I vote yes, does that mean I'm okay with 51 percent [of the pay package] or most?

I am not sure what they [would] do [in the case of a no vote] other than call us back and ask what we don't like, since pay is about a mile wide.

As public companies, one of the things is to find out why [there is a no vote]. If you don't then you aren't doing your job. At [X] we disclose our compensation. [Some may] provide a web-site to tell … why [shareholders] voted the way they did. Companies should find means to find out why [shareholders] voted the way they did.

My view is that if there is a no vote, it will be clear what the board will do. Either go back and change it or better communicate.

Companies have not responded well to scandals. Look at Wall Street now. I think a lot of that was brought about by inappropriate compensation policy. …It is the intractable governance dilemma. The advisory vote is really an import from the U.K.

Corporate America is grappling with this whole issue. The SEC has been stringing them along for years. Had the SEC come up with clear guidelines, it would have diffused the whole say-on-pay issue. We have seen the largest companies disclose as much as they can without revealing anything proprietary. They lay out as much as possible with ranges and clawbacks, pension and severance.

The large institutional investors had mixed views on the subject of say on pay. Roughly half were opposed to a non-binding shareholder vote on executive compensation. Only about one-quarter were for such a vote. About one-quarter of the remaining investors had mixed or neutral views.

Severance and Change in Control

There were several opinions on issues of severance and change in control, including that no change-in-control payments should be greater than 2.99 times salary plus bonus; that the public needs to understand that severance and change in control "are two separate issues;" and that severance and change-in-control provisions are fine "as long as it doesn't get out of control."

Several of the investors saw the trade-offs that are inherent in large severance and change-in-control provisions. On the one hand, the company may need to offer a generous package to attract and retain a key executive; on the other hand, they may not want that package to be too generous.

These quotes nicely sum up the feelings of many who were interviewed.

[Severance and change in control] is hard. You have to go back to common sense. You can't mandate integrity. I can see it both ways. I hate it both ways.

You want people to be protected. On the other hand, you don't want it to get out of control.

Is there an efficient labor market for CEOs? Is there an efficient market for executive labor in the United States? [When looking at recruitment of CEOs of a company]: to entice someone, what is the market clearing price, including the severance agreement?

I don't know what to do about it.

When the issue of severance and change in control was raised about one-third of the institutional investors had a negative view, although some of these opinions were qualified.

Severance agreements were supposed to be a bridge between jobs but have become wealth accumulation tools. …We need to be convinced that severance is performance-based. But that isn't always met.

I think the majority view is that [severance and change-in-control agreements] go too far.

I have been a late convert to this question. I always thought it was a rounding error and rare abuse. Now I think there are a lot of hidden risks. There are some shocking and weak provisions in terms of accelerated pensions, etc.

You don't know what the bad ones are [until you see them]. You don't want severance to be pay for failure. But then some is pay to retain the talent pool. But then there are some egregious cases. It is like a sports team. You are making a bet on a star and they sometimes don't work out. And you still have to pay. More disclosure is better. Do some scenario testing and modeling [that says] here's what happens and see if they are reasonable.

Others had a more positive view.

[As for severance and change in control] not surprisingly, it depends on the context. A golden parachute that doesn't help shareholders is one issue. But there is also severance as an insurance policy, for the executive and shareholders. It may be good for shareholders if it keeps a key executive in place. Is it priced correctly? The pricing can go to the list of items in good cause. Is the laundry list of things appropriate?

[Severance and change and control should be] fair, not excessive. In the bad old days (10 to 15 years ago) some seemed too big. But one of the values of a free media, if you put it on paper and if it doesn't look right, you see. We really don't have any problems with such issues right now.

The existence of such plans is good. …At a base level, executives are at risk to circumstances outside their control. You want to align their interests with shareholders.

Change-in-control agreements are going to be there and they should be for employee retention. You don't want it to be egregious such that it prevents a deal from being done.

About one-third of the investors specifically addressed limits.

We like them to be limited to 2.99 times salary and bonus for tax reasons. If more it could go to a shareholders' vote. If over that amount then shareholders should have a chance to review it. But again, we tend not to micromanage.

[Change and control is okay] if people stay within industry standards; usually 2.99.

We like to control for 2X base salary including some things like pension. So we want a cap on it.

We don't like packages that are greater than three times base and bonus.

Some of the investors were interested in talking about the difference between severance and change-in-control provisions. The business press sometimes seems to put the two issues into one basket. Some executives have large payouts at the time of a change in control simply due to the fact that they have large accumulated pensions and have had relatively high pay for many decades. Some investors were interested in separating this from simple change-in-control issues.

[Severance and deferred compensation and pension] should be separated.

A lot [of this] has to do with pension and deferred compensation. If it is a pension building and accumulating – those grab headlines and shouldn't.

Many think that deferred compensation is severance and there is a difference.

Where could CD&A be better? – real severance values. More clarity over severance would be good. It makes it easier to do a comparison across companies.

A few of the investors wanted to specifically make clear that provisions for the senior executives were not different from those of the other employees in the firm.

We don't have a problem with acceleration for change in control unless it doesn't cover everyone. …We also don't like grossing up income that wouldn't be grossed up for anyone else.

[Accelerated vesting] is a pretty standard clause. This is one of those where as long as all of the employees benefit, then fine. But if we saw where only the top 15 get acceleration and it is not applied to others, that is not ever anything we would get behind.

Two of the investors noted that change-in-control provisions for the executives could, in fact, work against the interests of the shareholders, as when such provisions for executives can be so lucrative that managers may not act in the interest of shareholders.

Particularly with change in control we want to keep them within reason. We ask a lot about this in mergers and acquisitions. It is obvious in many cases that mergers and acquisitions are self-fulfilling.

Issues of severance and change and control are difficult ones, especially due to the inherent conflict between trying to attract and retain a key executive and trying to avoid paying him or her too much. Several investors thought there should be caps. Some suggested that change-in-control provisions may be out of control. Some also suggested that a clear distinction be made between accumulated pension and change in control.

Equity in Executive Compensation Program Design

Each investor believed in some form of equity compensation to executives for reasons including the alignment of the interests of the managers with those of the shareholders. None came out with a strict formula for the mix of pay but some suggested that they believed this should vary with company industry and size. Some discussed over-use of options and problems with dilution. While this section of the report focuses primarily on equity in executive compensation program design, issues of pay mix, vesting, dilution, luck, and the board of directors also are discussed.

Perhaps not surprisingly, every institutional investor interviewed felt that some form of equity was important as part of a well-designed compensation plan for senior executives. Examples of some of their views are included here.

It's great when managers have equity.

Equity is good. It does show alignment of interest.

We prefer some form of equity for directors and the management team to be aligned with our interest.

At the highest level we want them to think and act like shareholders. We think it is appropriate to have a substantial amount of personal wealth in the firm. But it is hard to tell fund shareholders to have the CEO be completely undiversified.

More equity is better; depends on what the equity is. Sometimes it can be a disincentive – there could be takeover opportunities that could create perverse incentives [from the point of view of the shareholder]. It depends on what industry you are in.

The mix of pay across various components was discussed with many of the investors. This included base pay, bonus, non-equity incentive, stock, options, perquisites, and other forms of compensation. It is not surprising that there was variation in views with no prescribed formulae and that views would differ by industry.

We don't specify a level of composition or makeup. Nor do we have an approach to restricted stock or options.

Stock makes more sense than options. There is more egregious use of options.

We don't have an institutional view [on equity in executive compensation programs]. … We don't have an institutional view of [the mix of pay]. Even those big pay packages, critics haven't attributed that to the performance of the company. …My personal view is that less base pay is better. I feel that we are in a place where there is a view [by many] that there is a magic formula.

Companies should have equity policies. Companies shouldn't have unintended dilution…The [optimal mix of pay] depends on the individual company.

We don't have a target mix of compensation. The more senior the executive, the more heavily weighted to equity.

We don't have a programmatic percentage for [mix of pay].

We don't have any magic formulas [for pay mix]. What you are frankly starting to see is greater emphasis on restricted stock and less on incentive stock options. And still see non-qualified stock options for employees. But we have no guidelines on X% of this or that.

Whether it is restricted stock or options, I am not sure it matters. If those equity grants are given they should be seen in the context of total compensation so they are not just given away.

Vesting was discussed with a sub-set of the respondents. While some preferred performance vesting, others strongly believed in time vesting for reasons they discuss below.

We [consider a mix of vesting types] but not entirely time vesting to maintain incentive value.

[As for time and performance vesting] time sort of appeals to us. One of the purposes of executive compensation is to have stability of the management team and hopefully working for the long term. But who can argue with aligning pay with performance? We would not be fans of punishment for a bad quarter. We don't want executives to think in a short time frame. We want them to think in a three-to-five-year time frame.

[As for dilution] we would like to have a more sophisticated proprietary solution to this. We often follow ISS but make some exceptions. Companies hate it but the world is moving to performance vesting. I'd rather see time.

With regard to the stock compensation piece, the longer it takes to vest the shares the better. Now, we don't have a cap on that. ... This also goes to the board members. There is surprisingly low ownership of boards. That should be raised.

It would be great if there was performance vesting.

[Time vesting is like a] lottery ticket on the passage of time.

Whenever it vests, there should be a three-year holding period on the other side [even if the person has retired].

Should vest over time. Maybe some performance shares in there. The amount may increase or decrease relative to performance.

In the context of equity in executive compensation plan design, a few of the investors discussed dilution.

We have withheld a lot of votes when there is a lot of dilution.

From a dilution standpoint, we like restricted stock.

We do have burn rate and dilution guidelines that we follow. We have urged against new programs where the burn rate is too high. We have never been in favor of repricing underwater options.

We look at [dilution] depending on the sector, you have to have enough stock to go through a few pay cycles. …If you are forced to use cash and not issue shares you are in a tough situation in some industries.

As a shareholder, we want to limit dilution. But we haven't really thought in detail about this. We don't have a strong view as a firm. We want it to be transparent and reported.

Two investors brought up the idea of luck and the fact that executives could profit from a general rise in the market.

Equity is good if handled in appropriate ways. …There is a widespread view that stock options are overused. In particular, a lot of people are being rewarded for luck. …[There is an issue with] supercharged [equity]. Ten mega grants are a problem.

The type of equity, we might have something to say. But there are many factors that go into a stock price that are out of an executive's control. What if it happens to be a bull market? Did the executive do that? [X Company] is in the news right now. We think they have been doing a terrific job. Earnings are up by more than double but the stock price hasn't gone up that much. You can get that in other ways, say bonus on earnings growth.

In the interests of aligning the views of executives with those of shareholders, every investor interviewed felt that some form of equity in executive compensation design was important.

The Role of Compensation Consultants

In nearly every interview conducted, the role of the compensation consultant in executive compensation in the United States was discussed. In particular, there was a focus on the independence of the compensation consultant. In May of 2007, the heads of major executive compensation consulting companies received a letter from Rep. Henry A. Waxman, the Chair of the United States House of Representatives Committee on Oversight and Government Reform. That letter stated: "The Oversight Committee is conducting a preliminary inquiry into executive compensation practices, including the role played by executive pay consultants. … Shareholders and investors have expressed concerns that a compensation consultant's ongoing business relationships with a company could compromise the independence of the advice the consultants provide to the company's board about executive compensation." The consulting firms were then asked to provide the committee for details on revenues generated through executive compensation services and all other services to the 250 largest companies in the United States over a five-year period.

Rep. Waxman mentioned the concern that some consulting firms provide executive consulting services to large U.S. companies while also providing other services (e.g. benefits administration, compensation design, etc.) to those same companies. The concern is that a consulting firm may feel pressure to be generous in making executive pay recommendations to keep the other consulting business which is, in many cases, substantially larger than the executive compensation business. Most of the institutional investors were asked about this.

Given the interest by the House committee and the discussion in the business press, it is very interesting that less than half of those interviewed on this issue thought that the firm providing advice to the board on executive pay should have no other relationships with the firm. In fact, one-quarter indicated that they had no real problem with consultants providing executive compensation and other services to the board simultaneously. Nearly another quarter indicated that they weren't that concerned about this issue as long as relationships were properly disclosed. Two of those interviewed said they had no formal policy but were working on one. They said:

We are such a litigious society and so quick to impute conflicts of interest. We don't have any definitive positions on this yet. The fact of the matter is that this is a cosmetic measure with respect to company A, consultant M must decide to represent the compensation committee and management at company B. You will get a way of approaching executive compensation that will be speaking out of both sides of their mouth. They will have to specialize. They tend to characterize what they do as not advocacy. We need to benchmark against the industry.

That's my sense of how [consulting] firms perform their work. Maybe they are acting like advocates. It doesn't sound like advocates to me.

The trade-off is that yes, you want them to be independent but yes, you want them to have enough information to actually advise.

Again, about one-quarter of those interviewed saw no serious conflict.

I guess for us, the key thing is if the firm is not beholden to management, it doesn't matter to us what the relationships are. If there is a pristine lack of relationship but the advice doesn't assist directors in making sensible decisions [that is a problem].

We understand the rational along the lines [of having an independent compensation consultant]. Having said that, we don't see the need for a hard and fast rule. There is a desire to please for any company. This is true for a siloed product versus and multi-faceted company.

I think the whole [idea of having an independent compensation consultant] is a red herring. I don't see it as the same kind of conflict as audit.

I understand all the arguments. On the other hand, we are all [adults]. I think the board has to make the decision.

Others (nearly one-quarter) didn't see a big problem so long as there was complete disclosure.

Well, that is a little tricky. We don't have a firm stance on that but clearly if there were other business or contracts with the board or board members, that should be disclosed. This is not like audit firms.

[As for an independent compensation consultant] I would say it is not important. We just want the issues to be transparent and disclosed.

If you [required firms doing executive compensation consulting to have no other relationships with the firm] they would probably exit the business since they make so much more elsewhere. But they should report to the committee and the board. And they should disclose their relationship.

It is notable that fewer than half of those interviewed about this felt that consultants to boards on executive compensation should be completely independent. A sampling of their responses include:

It is our policy that [the firm providing advice to the board on executive pay should have no other relationships with the firm]. Anything that could impair their objectivity should be avoided.

I have been surprised. Managers say of course they are independent. I agree that they [should be independent]. Investment managers really care about this.

This doesn't rise to the same level as the audit firm. But if there is some agenda other than the best independent advice [it could be problematic]. Best practice would be to have an independent compensation consultant.

I work in an industry that is rife with conflicts of interest. I think the compensation consultant should be completely independent.

It will be interesting to see what happens in the future with the issue of independence of consultants providing advice on executive compensation. The institutional investors interviewed were certainly not in agreement on this issue.

Retirement Plans for Senior Executives

There were many different views on retirement plans, although the majority favored some sort of plan. This set of interviews began by asking respondents about their general feelings about retirement plans for senior executives. About one-fifth immediately gave what might be characterized as "pay the market" responses. A similar proportion of respondents specifically stated that retirement benefits for senior executives should not be much different than those for other employees.

The issue of equity grants for mid-career hires was also discussed in this section. Some executives speak of the stake they may be giving up from their former employer when they move to a new job. Respondents had a diversity of views, including those who were fine with the idea, those who mentioned that this must be done on a case-by-case basis, and those who felt that executives should be pressed to prove what they are giving up before being made large grants on taking a new position. Others added that the magnitude of the coverage from such retirement grants could taper away as time in the new job increases.

Some respondents thought that it is an artifact of the market system that executives are able to negotiate retirement packages at the time they are hired. Often they are giving up a lot from their previous positions and negotiate that they be made whole.

A retirement plan or package is perfectly appropriate in terms of retention and compensation over a long period of time …Well, I don't think there is anything wrong with earning more after they leave. …I find it hard to argue that [X] should not have gone far out of its way for luring him from [Y]. They just basically had to make him whole. I am cautious about being overly prescriptive on this. You have to be accept that they will not take the job otherwise.

[Retirement accounts] have to be case by case. We have tried pretty hard not to put absolute limits. If there are big numbers, tell us in the CD&A why it makes sense.

It is part and parcel of getting someone.

Some respondents went out of their way to mention that retirement plans for senior executives should not be materially different than those for other employees. Clearly the size of the packages will end up being larger, but this is based on the fact that executives earn more on an annual basis throughout their careers.

We are skeptical unless they are like plans that others get. It really undermines pay for performance. SERPS are challenging.

Retirement plans should be about replacement. …We don't favor supplementary benefits that aren't provided to other managers. We want

companies to think, what are we trying to do? It ought to be about income replacement. Some of this [(large grants)] is not income replacement.

An important focus in this section was the issue of grants for mid-career hires. There was a lot of heterogeneity in these discussions. Some were perfectly fine with the idea of mid-career hires. Others mentioned that this must be done on a case-by-case basis. Finally, a few felt that executives should be pressed to prove what they are giving up.

[The view of grants for mid-career transition] is an interesting issue. I don't have a problem with it. Companies need to be in a position to recruit. But any firm will need to recruit at sometime with some seniority. Presumably you are attracting someone who is pretty good.

[X] hired [Y with a generous package] but it was a Hail Mary pass [to get an extraordinary top executive as a last effort] to avoid bankruptcy.

[Grants for service elsewhere] is one of those things you need to look at on a case-by-case basis. Unfortunately, if the board falls in love with somebody and doesn't factor that from a cost/benefit standpoint. The reality is if the bet pays off then great. But if it blows up it blows up big since you have to give him that to get rid of him. …I am not a raging fan of employment agreements. But we may need one to get someone into place. In that context something in the one to three year context should be [okay]. A renewal with three to five years or so is of questionable value.

It doesn't mean that executives shouldn't be made whole. I'd like executives to prove how much they are losing.

It depends on what I am giving up. If I go somewhere else are they going to make me whole? The incentive systems in public companies are really different from private equity. There, performance metrics are different from public companies; here is what it costs. Just the present value of a number stream…[As for grants for past service] it is up to the board to disclose that. If that's what it takes, they have to tell [us] that. If it doesn't work out, we should be [upset with] the board again. … [As for grants for past service, would it be better to offer] 40 [million or] 10 [with the possibility of] 100?

[As for grants for past service] I would focus on middle management, not senior executives. Perhaps it should be a larger at middle management and less at senior management. It is not one size fits all. The CEO may not be in need of retirement. There is a lot more mobility in the workforce than there used to be. The basic question is whether it is ever needed. 401(k) plans tend to be very mobile…Nobody is going to react well to 50 or 100 million. That just doesn't read very well and there is no need for it.

We have nothing against [mid-career grants]. That's just a function of the marketplace. We don't want individuals to be chained to their companies. But nothing is guaranteed.

We have nothing against deferred compensation. Most corporations, if they are offering deferred compensation, it is pretty far down the line, not just the top people.

Two of the large institutional investors interviewed didn't focus much on this issue at all.

We don't tend to take a position on details [of retirement plans]. The last time I remember a big to-do on retirement plans and deferrals was [company A]. The comp committee from 10 years prior set the metrics. The person had compensation beyond anyone's expectations. Is that an issue for the current compensation committee who had nothing to do with setting this? The committee hadn't been looking at the value as it was increasing over time. They didn't set the metrics but didn't do a good job monitoring. Again, our aim is to evaluate the committee.

To be honest, I don't focus on this much.

Finally, a few investors noted that more should be done to consider the potential size of retirement contracts once they are completed. One suggested that more detailed simulation exercises be done when the contracts are negotiated to help avoid very large packages that were never intended to pay out so richly.

We should be looking at just the present value of [deferred compensation]. …Retirement benefits used to not be on the radar.

[Retirement plans for executives] need to be reasonable in light of the level of service and performance. …SERPS should be reasonable and not enhance retirement inappropriately.

Given new disclosure requirements, more emphasis will be placed on retirement packages in the future. The large institutional investors interviewed are not in complete agreement on this issue.

Other Issues

Investors discussed a number of other issues that did not necessarily neatly fit into one of the eleven categories above.

It was interesting that some institutional investors thought that actually setting executive pay was difficult and others thought it was quite simple.

My view is it is a very difficult job to set CEO pay. I am a big sports guy. The great ones, you can hardly pay them enough, even if it seems like a lot to the man on the street. The poor ones are probably paid way too much even if the nominal amount doesn't seem unreasonable. I like the American system much better than the European system of executive pay. We think the system attracts and retains people who are essential; making large business a career decision that they take rather than another. Alternatives to how American companies do this don't really appeal to us. …In some sense we use a lot of facts and circumstances but what we do is not hard. We think about what we want them to do and how do we get them to do it and is it aimed at value creation?

The whole issue [of setting executive pay] is frustrating. The technical aspects are hard for people to get.

As noted above, the level of detail at which investors study executive compensation in publicly held companies varies widely. Some look very carefully at the issue; others give it much less attention. Several noted that the real goal was to look for things that were not the norm. An example of that view is the following statement:

Our goal is to look for outliers. We really see the say-on-pay approach as counterintuitive to our general philosophy of electing competent board members to manage this on our behalf. We tend to avoid opining on social consequences of top executive pay relative to employees or the U.S. relative to other markets. We make decisions within the context of each market. We look at U.S. companies relative to other U.S. companies.

Only one mentioned labor unions but it was a provocative comment:

[You must] consider the fact [that] campaigns against executive compensation have largely been driven by labor issues.

One thought that the idea that executive compensation is a hot topic today but interest will fade.

This is the topic du jour. Governance structure period is where we should [be focused]. I think if we have a strong board, you don't have this issue. …We don't like to vote for members who serve on more than three boards.…[There is a large pool] of untapped board members [including academics].

Several discussed the issue of selecting peer groups appropriately.

How big or small or appropriate are the peer groups? Some are mixing and matching to get desired results.

One mentioned the issue of relative pay:

They would all do it for less, but not less than the next guy.

Investors also discussed whether there was an efficient market for executive labor. This was often in the context of setting pay and thinking about issues such as lucrative severance agreements that may have been necessary to attract an executive in the first place. One executive summed-up the feeling of many with this remark:

Why do people pre-suppose that this is not an efficient market in executive labor?

There are many more potential issues for discussion. A sampling of those that were discussed by only a few of the investors is included in this section.

Concluding Thoughts

From March through June of 2008, 22 representatives from 20 of the largest 25 institutional investors in the United States as listed in the most recent list of *Institutional Investor* magazine were interviewed for this project. Many things were learned from these discussions. Chief

among them is that it is perfectly clear that not all investors have the same views on issues of executive compensation. No doubt, there were some issues in which there was universal agreement, including the idea that top executives in publicly held firms in the United States should have their own interests in line with those of shareholders.

This report is based on a sample of representatives of very large institutional investors in the United States. It is important to keep in mind that it is not a random sample and the views of those few organizations that were not interviewed is not known. That said, a wide variety of very large investors were interviewed and a synthesis of their views is included in this report.

One issue that seemed quite clear in the study of investor responses is that they all have a common goal of earning money for their clients. It was also clear that most evaluate prospective firms for investment by considering a wide variety of factors, including (for many) executive compensation.

Although this issue is not studied in particular in this report, it may be the case that some of the strong views held by activist institutional investors are not generally held by the majority of or even very many of the largest institutional investors. A more in-depth analysis of the views of large institutional investors (perhaps with a formal structured survey) and an analysis of the differing views of activist investors and large investors is left for further study.

About the author

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