IN THEIR OWN WORDS: EXECUTIVE COMPENSATION FROM THE PERSPECTIVE OF THE LARGEST INSTITUTIONAL INVESTORS

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SUMMARY AND KEY FINDINGS

Prepared by the Center On Executive Compensation

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SUMMARY AND KEY FINDINGS

IN THEIR OWN WORDS: VIEWS OF EXECUTIVE COMPENSATION FROM THE LARGEST INSTITUTIONAL INVESTORS

A first-of-its-kind study commissioned by the Center On Executive Compensation (the Center) to identify the perspectives of the nation's largest 25 institutional investors on executive compensation confirms that making broad assumptions about the views of institutional investors on this topic often does not reflect realities, underscoring a need for a thoughtful and reasoned approach to any executive compensation policy changes. Specifically, the study reveals that:

- The majority of large institutional investors do not support a shareholder vote on executive compensation, believing instead that boards should be responsible for compensation decisions and held accountable through greater disclosure and ultimately by shareholders who determine whether to reelect them;
- Large institutional investors are not generally concerned with the level of executive compensation, provided it is clearly and appropriately linked to company results; however, they believe the pay-for-performance link could be further strengthened and unanimously support equity as a form of aligning executives and shareholders' interests;
- One-third of the large institutional investors raised unsolicited concerns over the influence that proxy advisory services have over the proxy voting process, including compensation matters;
- Despite updated SEC disclosure rules, the overwhelming majority of large institutional investors have been disappointed in the rules and how companies have implemented them, especially the lack of clarity in the Compensation Discussion and Analysis. The investors believe there is room for improvement and most believe that it will occur over time. In the meantime, they do not support a "one-size-fits-all" approach to selecting or determining performance metrics, instead preferring multiple performance metrics tailored to measure the achievement of a company's strategic goals.
- Large institutional investors were split on the issue of the independence of executive compensation consultants, with just under half supporting independence and the others divided between disclosure of other relationships with the company and those not seeking any disclosure.

More information on the purpose, methodology and key findings of the study follow.

I. PURPOSE OF THE STUDY

The involvement of certain institutional investors in the executive compensation debate has intensified in recent years with various organizations frequently quoted in the press as representing institutional investors or shareholders generally. However, it was not clear that the positions taken by these organizations were truly reflective of the views of the largest of these institutional investors based on management of U.S. equities.

The Center, which is committed to developing and promoting principled pay and governance practices and advocating compensation policies that serve the best interests of shareholders and other corporate stakeholders, believed this question deserved further analysis. It commissioned a first-of-its-kind study to better understand the views of the country's 25 largest institutional investors, as reported on the *Institutional Investor* magazine website in February 2008.

Because these institutions collectively manage over $6 trillion in U.S. equities—roughly 65 percent of the total of the top 300 institutional investors—and $19.8 trillion in total assets, they carry significant weight. The Center believed that the views of this important shareholder constituency should be better understood and factored into the ongoing national dialogue about how best to inform and structure executive pay practices and the rules and regulations that guide them. Moreover, the Center's members were interested in securing the findings as a part of their individual efforts to expand and enhance their dialogue with shareholders on these topics.

The findings will be made available to senior human resource executives, directors, compensation consultants, law makers and regulators, academics and the media. They will be a part of the Center's effort to contribute a balanced and reasoned understanding of what often can be a complex and highly individualized executive compensation process as debates on the issue take place in corporate America, in the halls of Congress and regulatory agencies, and even in this year's presidential election.

In addition, the Center intends to conduct further research and policy development activities as a result of the study. These activities include:

- Developing a new methodology for explaining the link between actual pay and actual performance that companies can use internally and/or in their executive compensation disclosures;

- Examining new approaches to structuring severance arrangements to ensure that they serve the purpose of recruitment but do not continue in perpetuity; and
- Conducting more research over the structure and operation of mechanisms for obtaining the views of large shareholders.

II. METHODOLOGY

To conduct the study, the Center turned to Kevin F. Hallock, Professor of Labor Economics and of Human Resources Studies and Director of Research at the Center for Human Resource Studies at Cornell University. Starting in March 2008, Professor Hallock conducted one-on-one interviews with senior representatives from 20 of the largest 25 institutional investors on a range of issues currently dominating the national discourse on executive compensation. These representatives were the heads of the organization or the chairs or senior members of the institution's proxy committee and involved with corporate governance and executive compensation.

III. SUMMARY OF KEY FINDINGS

The following summarizes the top three executive compensation concerns as identified by the institutional investors as well as the Study's other findings.

A. Top Three Issues: Large institutional investors are most concerned about: (1) ensuring pay-for-performance, followed by (2) preserving the Boards' role to set compensation and being able to "trust" and rely on compensation committees, and (3) seeking greater clarity in company's pay disclosures and the SEC's requirements.

1. Pay for Performance: Pay for performance dominated the list of investor concerns, with the majority feeling that there is room for improvement in how performance is measured and disclosed relative to pay. These investors believe that current executive pay levels are not too high so long as they reflect performance and shareholders also have benefited. Certain other findings in the study confirmed and supported this view:

   - multiple performance metrics should be used so that it is more difficult for companies to "manipulate" the results;
   - some form of equity should be included in the pay package to more strongly align executive and shareholder interests;

- a long-term view (3-5 years) is better than a quarter-by-quarter outlook when it comes to evaluating shareholder value.

2. The Board's Role: The majority of these investors did not support the adoption of "say on pay," which requires shareholders to have an annual nonbinding vote on executive compensation, with most instead preferring that the Board set compensation and be held accountable through greater transparency and, ultimately, shareholder votes on whether to reelect the Board. The composition of a board's compensation committee was deemed important and something they "look at."

3. Disclosure: Despite the U.S. Securities and Exchange Commission's updated executive compensation disclosure requirements, the majority of these investors expressed disappointment in the clarity of disclosures, both the compensation discussion and analysis ("CD&A") and the compensation tables. The investors believe that there is still room for improvement and some indicated that it will come over time. Rather than relying solely on the CD&As or the tables, these investors utilize a wide variety of sources when considering executive compensation, including meetings with company managers and analyses from other entities (such as RiskMetrics and Glass-Lewis), and many only turn to the CD&A if some sort of outlier is identified through their quantitative analysis.

B. Large institutional investors do not have a shared view on all executive compensation issues. While they agree about some issues, such as pay for performance and rejecting "say on pay," they are almost evenly split on others, such as the necessity of maintaining the independence of the compensation consultant and disclosure of performance targets.

1. Issues on Which Large Institutional Investors Generally Agreed. Almost in unanimous agreement, surveyed investors coalesced around issues including:

   - *Level of Executive Compensation*. Seventy-five percent were not concerned with the level of executive pay, as long as it was clearly linked to performance and investors understood the link.
   - *Disclosure*. The institutional investors were disappointed in the SEC's disclosure rules and believed that company implementation of the rules needs to be improved. Investors found the CD&A overly wordy, legalistic and jargony, and the

tables difficult to understand. Given that most companies have had only two years at most of filing proxies using the new rules and the SEC is still in the process of interpreting how it will enforce them, some indicated that they expect clarity will improve over time.

- *Equity Compensation*. Equity should be included as part of a well-designed executive compensation plan because, as one investor put it, "at the highest level we want [executives] to think and act like shareholders."
- *Performance Metrics*. Investors believe that multiple metrics should be used in measuring performance to ensure that the pay is aligned to specific company strategies and to minimize the potential that incentive targets could be manipulated.

2. Issues on Which the Institutional Investors Had Differing Views. Institutional investors were not monolithic in their views on executive compensation and governance. Some areas in which their views were split into two or three categories included:

- *Say on Pay*. The majority of institutional investors did not support say on pay -- a nonbinding shareholder vote one executive compensation. The largest share of investors – about half – indicated they opposed the adoption of "say on pay" resolutions, which require an annual nonbinding vote on executive compensation for a variety of reasons. Investors' comments explaining their reasons for this conclusion include that "the [compensation] committee has better information than we do," that "engagement [with the Board] is a better avenue," and that say on pay would not work well under the U.S. system of dispersed ownership. Only about one-quarter of the firms interviewed supported a shareholder vote. Another quarter had "mixed views."
- *The Use of Proxy Advisory Services*. Nearly all institutional investors indicated that they used proxy advisory services, with a good number using the services for research, rather than for their voting recommendations. In addition, in unsolicited comments, a third of those interviewed expressed concern over the influence that advisory services have over the proxy voting process, particularly RiskMetrics, which holds the largest share of the market.
- *Compensation Consultant Independence*. Views of the institutional investors split into three parts on this subject. About one-quarter of the institutional investors interviewed had no concerns with consulting firms providing executive

compensation advice and performing other work for the company. One-quarter believed that the dual role could be provided with appropriate disclosure, and just under half believed that independence was essential.

- *Disclosure of Performance Targets*. One third of investors interviewed opposed disclosure of incentive plan performance targets, one third supported disclosure, and another third had mixed views. One conclusion that can be drawn from these results is that there is an incomplete understanding of the competitive harm that could result if certain confidential incentive targets that are closely related to business strategy are required to be disclosed.

3. Issues on Which Investors Had Divergent Views. Investors had a mix of views on the following issues:

   - *Severance and Change-in-Control*. Many investors interviewed recognized the purpose behind severance and change-in-control provisions. However, several also expressed concern that these provisions were too large in some cases, or that it was difficult to express a general sense of whether they are good or bad because they are specific to the contexts and circumstances at individual companies.
   - *Executive Retirement Plans*. Roughly one-fifth of investors interviewed believed that companies should pay the market rate for retirement and about the same number believed that executives should receive the same retirement arrangement as other employees. A good number of comments in the interviews focused on equity grants provided to executives changing companies to make them whole for retirement and other benefits lost as a result of the switch.

IV. COMPARISON OF INSTITUTIONAL INVESTOR FINDINGS VERSUS ACTIVISTS' VIEWS

In his report, Professor Hallock concludes that though further study is needed, it ***"[appears to] 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."***

The differences are most notable in the following three areas:

- Support for Say on Pay
- Level of Executive Compensation
- Performance Metrics/Targets

The Center believes that additional research is warranted to understand the differences in institutional investors' views on these issues.

V. CONCLUSION

This study confirms that making broad assumptions about the views of institutional investors on executive compensation often does not reflect realities. Overall, the views of the largest institutional investors support the notion that the current system of corporate governance, in which the board compensation committee sets executive compensation levels, is working. It also demonstrates that investors expect compensation plans that are tailored to the company's competitive position and strategic goals and that undue influence by proxy advisory services could harm such approaches.

In sum, the Center believes that the study lends support to its position that a thoughtful approach to policy changes involving executive compensation is essential. The largest institutional investors not only carry substantial influence because of their size, but their primary motivation is to maximize returns for their investors. Thus, their views should be given careful consideration as the dialog over executive compensation and deliberations over public policy changes continue.

Appendices

- Appendix A: Largest 25 Institutional Investors
- Appendix B: Center On Executive Compensation Action Items
- Appendix C: Sample Institutional Investor Quotes From the Study
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- Appendix E: Interview Guidelines
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APPENDIX A

LARGEST U.S. INSTITUTIONAL INVESTORS BASED ON U.S. EQUITIES UNDER MANAGEMENT

As Ranked by Institutional Investor Magazine

1. Fidelity Investments
2. Barclays Global Investors
3. Capital Group Companies
4. State Street Global Advisors
5. Vanguard Group
6. AXA Group
7. Wellington Management Company
8. Legg Mason
9. T. Rowe Price Group
10. Mellon Financial Corp.
11. Northern Trust Global Investments
12. JP Morgan Asset Management
13. BlackRock
14. TIAA-CREF
15. Goldman Sachs Group
16. Morgan Stanley Investment Management
17. Franklin Resources
18. Prudential Financial
19. Janus Capital Group
20. Dodge and Cox
21. Amvescap
22. UBS Global Asset Management
23. MetLife
24. Davis Selected Advisors
25. Old Mutual Asset Management

NOTE: List of top 25 Institutional Investors as ranked by *Institutional Investor Magazine* based on year-end 2006 numbers, as listed on its website as of February 2008. Year-end 2007 rankings were released after the study was completed.

APPENDIX B

CENTER ON EXECUTIVE COMPENSATION RESEARCH PROJECTS BASED ON REPORT'S FINDINGS

In response to the Professor Hallock's Study of the largest institutional investors on executive compensation, the Center On Executive Compensation has identified the following research projects designed to reinforce pay for performance and responsible compensation practices.

Develop a New Methodology for Explaining the Link Between Actual Pay and Actual Performance

Most large institutional investors interviewed in the study identified pay and performance alignment as a primary concern, with many of those seeking better disclosure of the pay for performance link. The Center seeks to develop a methodology that compensation committees can use to measure whether there is a strong correlation between company performance and executive compensation. The methodology would compare total shareholder return and actual total pay, as opposed to "total compensation" as disclosed in the summary compensation table, which is not based on realized amounts. The "actual pay" would be determined by cash compensation and the realized and unrealized gains on vested equity held by the executive over a period of years and compared to the increases in stock price during the same period. This would enable boards and, where disclosed, shareholders to determine whether a true link exists, thus enhancing comparability.

Develop and Promote a Standard on Clawback Policies in the Event of Financial Restatement

The institutional investors interviewed sought clear indications that the board and compensation committees are paying for performance. Over the past year, there has been considerable discussion about the need for boards of directors to recoup incentive compensation when the company has engaged in fraud or has otherwise restated earnings. Some activists have opined that clawbacks should apply in the event of extraordinary shareholder losses.

In keeping with its pay for performance principles, the Center believes that clawback policies should apply in the event of all material restatements that, if the actual results had been known prior to the payment of incentive compensation, would have resulted in the Compensation Committee approving a lower payout. Correspondingly, restatements affecting the financial results that determine bonuses and equity payouts would prompt a recoupment of the portion of incentive payouts that were based on the misstated earnings. The Center will be working to more fully articulate its position on clawbacks this fall.

Identify New Approaches to Structuring Severance Arrangements to Ensure That They Serve the Purpose of Recruitment But Do Not Continue in Perpetuity

Several large institutional investors expressed concern over the practice of providing large cash severance arrangements, especially as part of senior executive pay

CENTER ON EXECUTIVE COMPENSATION RESEARCH PROJECTS (Continued)

packages, where the executive has been with the company for several years. While severance arrangements play a legitimate role in recruiting new executives from outside the company, these amounts are often called "pay for failure" if the executive is forced to depart and the severance arrangement is triggered. This reaction is even more pronounced where the executive is also receiving substantial vested equity upon departure. The Center seeks to develop best practices and policy proposals that encourage companies to adopt severance arrangements for newly hired senior executives that sunset as equity awards vest. This keeps severance aligned with its true purpose--to encourage an executive to join a new company.

Develop Mechanisms to Increase Communication Between Companies and Large Institutional Investors.

In light of the conclusions reached in this report, it is clear that greater communication between large companies and large institutional investors on executive compensation would help both parties understand the perspective of the other. The Center will explore ways to help companies provide a structure that facilitates communication with their largest shareholders.

APPENDIX C

VIEWS OF THE LARGEST INSTITUTIONAL INVESTORS, IN THEIR OWN WORDS

Issue	Investor Quotes	Page
Say on Pay	“We are not supporting say on pay. It goes against our philosophy about the board.” “It is not clear A, what we are voting on and B, what others are voting on. We can have a much more individual discussion and nuanced discussion” [with the Board]. “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.”	Page 18 Page 19 Page 20
Pay for Performance	“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.” “We have no objection to executives making a substantial amount when investors make a lot, too. . . . We worry about tarring thousands of executives for the behavior of a few.”	Page 5 Page 5
Role of the Board and Compensation Committee	“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.” 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.	Page 6 Page 6
SEC Disclosure Rules	The compensation discussion and analysis is “too much information and legalese that has not achieved its intent.” “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.” “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.”	Page 13 Page 13 Page 13
External Sources/Proxy Advisory Services	“On the proxy voting part, we outsource to ISS. We don’t tend to override that.” “We use the ISS model for options but don’t necessarily vote according to their recommendations [External sources are] becoming too powerful.” “I think ISS has too much power. Too many funds roll their way.”	Page 17 Page 18 Page 18

Issue	Investor Quotes	Page
Metrics and Performance	“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 single metric. What we often learn when we engage with a compensation committee is that they have a lot more information than we have.”	Page 10
	“We don’t want to micromanage or opine on what the metrics ought to be since they vary by industry.”	Page 10
	“This really should be a board decision that has objective and subjective [components] and is not just formulaic”	Page 10
Executive Pay Levels	I have no problem with paying a lot if executives add value."	Page 8
	“Across the board we would say that we disagree that CEO pay is too high.”	Page 8
	“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.”	Page 8
Disclosure of Metrics/Targets	“If you disclose the way in which your senior officers are being paid, you are in some ways disclosing the strategy of the firm.”	Page 15
	“[There are] probably mixed concerns about whether [targets] disclose competitive risks. My personal view is that this is overstated.”	Page 15
	“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.”	Page 16
Severance and Change-in-Control	“You want people to be protected. On the other hand you don’t want it to get out of control”	Page 22
	[Severance and change-in-control] is hard. You have to go back to common sense.”	Page 22
	“Change-in-control agreements are going to be there and they should be for employee retention.”	Page 23
Equity	“We prefer some form of equity for directors and the management team to be aligned with our interest.”	Page 24
	“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.”	Page 24
Compensation Consultant Independence	“[As for the independent compensation consultant] I would say it is not important. We just want the issues to be transparent and disclosed.”	Page 28
	“I understand all the arguments. On the other hand, we are all [adults]. I think the board has to make the decision.”	Page 28
	“Best practice would be to have an independent compensation consultant.”	Page 28

APPENDIX D

ABOUT THE AUTHOR

Kevin F. Hallock is Professor of Labor Economics and of Human Resource Studies and Director of Research at the Center for Human Resource Studies (CAHRS) at Cornell University in Ithaca, NY. This year he is serving as the Chairman of the Cornell University Financial Policy Committee. In addition to his posts at Cornell he is a Research Associate at the National Bureau of Economic Research (NBER) in Cambridge, Massachusetts and a Senior Fellow on Executive Compensation, Board Compensation and Board Practices at The Conference Board. He also serves on WorldatWork's Executive Rewards Advisory Board.

At Cornell he has recently taught courses on designing compensation plans, on Finance for HR Managers, and on the effects of Job Loss on companies. He has written extensively on executive compensation in the for-profit and non-profit organizations. One recent project, using stock option exercise information, estimates the value employees place on options and the cost of the options to firms.

Kevin's work has been discussed in various national publications such as the Wall Street Journal, The New York Times, Barron's, Business Week, Time Magazine and Newsweek. He is the recipient of the Albert Reese Award for the Best Dissertation on Labor Economics from the Industrial Relations Section at Princeton University and the John Dunlop Outstanding Scholar Award from the Labor and Employment Relations Association. Kevin earned his Ph.D. in economics from Princeton University.

APPENDIX E

Interview Guidelines

Kevin F. Hallock

Survey Outline: I am Kevin Hallock, a Professor of Labor Economics and Human Resource Studies at Cornell and I do research on executive compensation, among other areas. I am trying to determine the views of America's largest institutional investors on the subject of executive compensation for a project I am working on that is funded by the Center On Executive Compensation. While I may disclose information from specific responses I will keep the identity of each of the individual respondents confidential, and will not attribute specific responses to any specific organization. I expect that the interview will take approximately 30-40 minutes.

1. What is your view of the issue of executive compensation today and what are the top three issues that are of concern to you at this time?
2. What is your view of the overall level of executive compensation?
3. What is your view on the alignment of pay and performance? Why?

   How do you measure/compare pay and performance when analyzing executive compensation?

   a. What are the important/best metrics in considering pay for performance?
   b. Should pay be capped even in instances of extraordinary performance?
   c. Does your view change if pay is "out of line" with performance? Why?
4. What is your view on the new SEC disclosure rules generally?
   a. Has the new CD&A given you/institutional investors greater insight into the rationale for pay?
   b. Do you look at the CD&A for other purposes (e.g. to discern business strategy)?
   c. What is your view of the usefulness of the Tables?
   d. What is your view of the length of disclosure?

5. What is your view of disclosure of performance metrics and targets?

    a. What is your view of the disclosure and usefulness of performance metrics and targets in the CD&A? Is the disclosure useful? Why?

    b. (Do you want to see the performance targets to assist in understanding the company's compensation program? Do you want to see the performance targets to assess the company's expected performance for reasons unrelated to pay?)

    c. Do the potential negative consequences of performance target disclosure concern you (companies eliminating targets, changing company-specific targets to reported targets, the effects on firm performance of such changes etc.)

6. What external sources to you use to become informed about the issues relating to executive compensation?

    a. Do you rely on specific sources (including reports, websites, webcasts, articles, services, institutions)? If so, which ones? How often is this reviewed?

    b. Do you have a particular focus on any of the following?: Institutional Shareholder Services (ISS), The Council of Institutional Investors, Glass, Lewis and Company, The National Association of Corporate Directors, the Conference Board or the Corporate Library?

    c. If so, how do you use their research and/or recommendations?

7. What is your view of "say on pay," that is an annual nonbinding shareholder vote on executive compensation?

    a. Would you favor a vote on pay? Is the vote a burden?

    b. In lieu of a vote, would you prefer more engagement with management on pay and how so? How often?

    c. What about more engagement with management generally? Who else should be part of that conversation?

    d. Could the vote lead to fiduciary exposure that is not wanted?

    e. Should say on pay be mandated by legislation or by stock exchange rules so that it applies to all or none?

    f. In the event of a "no" vote by shareholders, what should the board do then?

8. What is your view of severance or change in control agreements?
    a. What do you consider when you hear “severance”? Severance or previously agreed amounts?
    b. Is it an issue that severance multiples are larger inside the US than elsewhere?
    c. What is your view of the new disclosure requirement for severance and change in control?
    d. What is your view of accelerated vesting in terms of change in control or severance?

9. What is your view of the use of equity in executive compensation program design?
    a. What is your view on the use of equity in terms of the effect on dilution?
    b. The mix of pay? Do you want executives more heavily weighted toward one type of pay (e.g. salary, bonus, non-equity incentive, stock, options, restricted stock, performance-based equity, etc.) in the pay package?
    c. The use of time versus performance vesting? Does it depend on the vehicle?

10. What is your view of the role of the compensation consultant?
    a. Is it important to you that the firm providing advice to the board on executive pay have no other relationships with the firm? Why or why not?

11. What is your overall view of retirement plans for senior executives?
    a. What is your view on the level of retirement amounts for executives?
    b. What is your view on the issue of grants for past service for mid-career hires?
    c. What is your view of deferred compensation? Does it differ depending upon the circumstances for payout (retirement versus termination?)

12. Is there anything else you think is important or relevant to executive compensation that we have not yet discussed and does your organization have written guidelines or opinions on these issues that I may read?