Council of Institutional Investors
The Voice of Corporate Governance

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Top 10 Red Flags to Watch for When Casting an Advisory Vote on Executive Pay

For investors, the advent of advisory shareowner votes on executive compensation — at more than 300 companies in 2010 — is an opportunity and a challenge. These votes can be catalysts for shareowner discussions with directors and management about pay concerns, including the structure and size of executive compensation. But they also oblige shareowners to analyze compensation in a thoughtful way.

Many investors, however, lack the time and resources to do deep dives on compensation at each of the hundreds of companies in their portfolios. They need rules of thumb to identify executive pay programs that are ticking time bombs. Poorly-designed incentives can promote excessive risk-taking and get-rich-quick mentalities — key contributors to the financial crisis.

Accordingly, the Council has developed the following list of red flags to help members target companies where pay deserves careful scrutiny and where dialogue may be most urgent. The list was crafted by Council staff after a thorough review of Council policies and comment letters on executive compensation, checklists developed by other organizations and the recommendations of 15 pay experts who briefed members in a series of teleconferences in 2009.

The list is a guide to problematic pay practices but is not meant to be exhaustive. Web links to additional resources for evaluating executive pay are provided at the end.

1. Stock Ownership and Holding Policies

- Do top executives have paltry holdings in the company's common stock and can they sell most of their company stock before they leave?

Senior managers who don't own much company stock may not be guided by what is in the best interest of long-term shareowners. Executives who can cash their stock out quickly may be emboldened to take excessive risks that pump up short-term gains at the expense of long-term value creation. Compensation committees should ensure that top executives own a meaningful position in the company's common stock, after a reasonable amount of time, and that they hold a significant portion of their equity-based compensation for a period beyond their tenure.

2. Clawbacks

- Does the company lack provisions for recapturing unearned bonus and incentive payments to senior executives?

Strong clawback policies may discourage a CEO from taking questionable actions that temporarily lift share prices or accounting numbers but ultimately result in a financial restatement.

3. Performance Drivers

- Is only a small portion of the CEO's pay performance-based?
- Is the company's disclosure of pay-related risk management controls and procedures non-existent, vague or suggestive of weak oversight by the board?
- Is the CEO's annual bonus based on a single metric?
- Is long-term incentive pay also linked to the same target?

To promote long-term shareowner value creation, a majority of senior executive compensation should be based on performance, and pay-related risk should be properly disclosed, managed and overseen by the company and the board. A mix of metrics that support the business strategy makes it harder for a CEO to game the result than if just one metric is used (and check your wallet if EPS is the sole metric because it is relatively easy to manipulate). Diverse metrics also discourage executives from focusing on one goal while ignoring others. Using the same metrics for short- and long-term incentive pay rewards executives twice for the same performance.

4. Perquisites

- Are executive perks excessive?
- Do they seem unrelated to legitimate business purposes?

Lucrative special perks can be a sign that the board is in the CEO's pocket. They can also harm employee morale.

5. Internal Pay Equity

- Is there a wide pay chasm between the CEO and those just below?

This can indicate poor succession planning and a weak compensation committee. It can also demoralize promising senior managers. Many compensation experts draw a line at CEO pay that is more than three times that of the next layer of executives.

6. Stock Option Practices

- Did the company reprice underwater options for executives, thereby shielding them from downside risk?
- Did the CEO receive options that vest after a period of time, with no performance requirements? A rising market or sector can lift the share prices of all players, even those performing poorly relative to peers. To isolate management's contribution to stock price performance, stock options should be indexed to a peer group or should have an exercise price higher than the market price of common stock on the grant date and/or vest on achievement of specific performance targets that are based on challenging quantitative goals.

7. Performance Goals

- Did the CEO get a bonus even though the company's performance was below that of peers? Incentive pay is supposed to motivate executives to deliver superior, sustainable returns exceeding those of peers. A company that rewards below-median performance is likely to get it.
- Does the company disclose performance goals? Investors cannot evaluate the rigor and pay-for-performance alignment of pay programs without knowing the targets that the CEO was shooting for.

8. Post-employment Pay

- Does the company guarantee severance payments to executives who leave as a result of poor performance—whether they are terminated, resign under pressure or the board fails to renew their contract?
- Are change-in-control payments (including a large slug of options that vest upon the control change) so lucrative as to incent executives to sell the company even if that is not in the best interests of shareowners?
- Do retired executives get perquisites? That can be a sign of a board that is in thrall to the CEO; top executives are usually paid well enough to cover the costs of their own retirement.

- Does the company make payments beyond earned or vested compensation upon the death of executives?
- Do supplemental executive retirement plans (SERPs) use guaranteed or above-market rates of return or add phantom years of service or other sweeteners that are not available to other employees?

Lavish post-employment compensation can hurt morale, the company and shareowners.

9. Compensation Policy and Philosophy

- Is the Compensation Discussion & Analysis confusing, vague or incomplete?
- Does the narrative focus on the whats and hows, with short shrift to the whys?
- Does the disclosure fail to explain how the overall pay program ties compensation to strategic goals and the creation of long term shareowner value?
- Does the company's list of pay peers leave you scratching your head, and does the company do a poor job of explaining and justifying its process for selecting pay peers?

Investors need to understand whether and how the executive pay program encourages superior, sustainable, long-term shareowner value creation. A company that does not make a cogent, convincing case may have a muddled pay program and a compensation committee that is not doing its job. Also, a company's choice of pay peers can have a major impact on the size and structure of compensation—investors must take care that the pool of peers is legitimate and not designed to pump up pay for executives.

10. Compensation Adviser Independence

- Does the firm advising the compensation committee earn much more from services provided to the company's management than from work done for the committee?

Consultants who count on lucrative actuarial or employee benefits business from senior management may be inclined to recommend overly-generous pay packages for those executives. Helpfully, the SEC now requires proxy disclosure of all fees paid to the compensation committee's consultants if the consultant or its affiliates earns more than $120,000 for work performed for the company beyond executive and director compensation services. Disclosure must be broken down between: (1) aggregate fees for executive and director pay consulting; and (2) aggregate fees for other services.

Additional Resources

- *California State Teachers' Retirement System*. Principles for Executive Compensation. http://www.calstrs.com/INVESTMENTS/PrinciplesExecutiveCompensation.pdf

- *Conference Board*. Report of the Task Force on Executive Compensation. http://www.conference-board.org/pdf_free/ExecCompensation2009.pdf

- *Council of Institutional Investors*. Executive Compensation Policies. http://www.cii.org/policies
- *Railpen Investments and PIRC Limited*. Say on Pay: Six Years On – Lessons from the U.K. Experience. http://www.pirc.co.uk/publications/SayonPay.pdf
- *RiskMetrics Group.* Evaluating U.S. Company Management Say on Pay Proposals. http://www.riskmetrics.com/docs/2009EvaluatingSayOnPay
- *The Corporate Library*. Say on Pay: How to Vote "Yes" or "No." http://info.thecorporatelibrary.com/say-on-pay-how-to-vote-yes-or-no/Default.aspx?RewriteStatus=3&utm_campaign=Say-on-Pay&utm_source=TCL-homepage
- *TIAA-CREF*. Policy Statement on Corporate Governance. http://www.tiaa-cref.org/pubs/pdf/governance_policy.pdf