EXECUTIVE COMPENSATION

A 2013 Opinion Survey of Compensation Committee Members

Overview

NYSE Governance Services, Corporate Board Member and Pay Governance LLC collaborated in the fall of 2013 to survey the opinions of compensation committee members at U.S. publicly traded companies to tap into their views regarding the state of executive pay. Specifically, the survey sought to ascertain what compensation committee members believe about compensation policies and design; the effects on corporate governance of compensation policies and compliance regulations; the alignment of executive pay and shareholders' interests; the effectiveness of proxy disclosure; and the impact on say on pay votes of proxy advisors. In addition, the research investigated what actions companies have taken, or anticipate taking, as a result of any say on pay challenges. The following report highlights the key findings and summary analysis from this study, which comprises 323 compensation committee member survey responses.

Positive or Emerging Developments

The survey demonstrated a number of positive developments and emerging trends. It shows that compensation programs at U.S. publicly traded companies continue to become more aligned with shareholders' interests in the wake of the implementation of Dodd-Frank regulations. Despite arguments to the contrary posed by some proxy advisory firms, some institutional investors, and shareholder activists, most compensation committee members believe that the vast majority of shareholders support their executive pay programs and thus have shown their support via positive say on pay votes over the last three years. This affirms that compensation committees and boards are setting up pay plans that are successfully aligned with shareholders' interests. The following are a few key findings that further support this view.

Executive pay programs and shareholder alignment are healthy. Most compensation committee members (80%) believe the design of executive pay programs are working well to motivate the executive team and improve the

performance of the company and 70% agree they create alignment with shareholder interests (Figure 1). This finding is consistent with separate Pay Governance research that has demonstrated that most companies have realizable pay aligned with TSR. Of the types of structures that provide alignment, 90% agree performance share plans using performance vesting have the greatest degree of alignment, including both those using operating/financial metrics (88% agreement) and relative TSR (81% agreement).

Shareholder support is evident. Nearly three quarters (73%) of compensation committee members believe today's executive pay programs have won the endorsement of shareholders and gave high marks to the quality of shareholder communication in the CD&A, which is an important tool used to win shareholder support. Specifically, directors surveyed say the CD&A effectively communicates company pay philosophy (81%), incentive program goals (78%), compensation objectives (78%), and rationale (76%). Separate research on 2013 say on pay votes by Pay Governance has shown that the shareholders at 98% of more than 2,000 companies endorsed their executive pay programs.

Say on pay votes have had impact. As a result of the past three years of say on pay voting, public companies have taken many steps to improve their pay plan design and communications. These include actions such as improving their proxy disclosure (82%); reviewing incentive plans to ensure they are challenging enough (71%); shifting their pay mix from time-based plans to performance-based programs (65%); and changing severance plans (57%) (Figure 2). Looking ahead, directors told us the most likely actions planned for the future are to conduct and disclose a realizable pay-for-performance analysis (39%); to increase shareholder outreach (30%); and to implement relative TSR as a performance share metric (24%) (Figure 3).

Figure 1

Compensation committee members agree that executive pay amounts and design at most U.S. companies

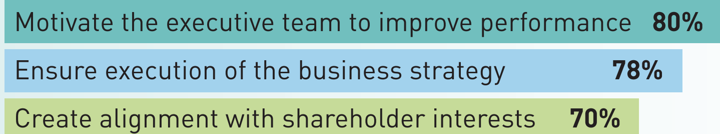


Figure 2

Top five changes made as a response to say on pay challenges

1. Improving proxy disclosure
2. Ensuring incentive plan goals are sufficiently challenging
3. Shifting pay mix to performance based
4. Changing severance plan
5. Increasing weight of performance shares

Figure 3

Top five actions companies are planning to take

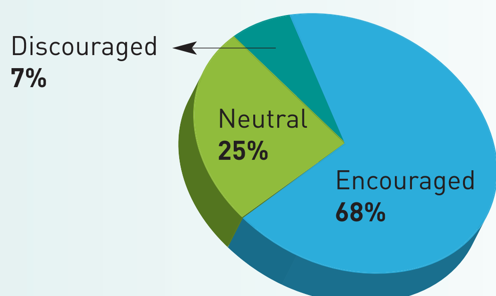
1. Conduct a realizable pay for performance analysis
2. Increase shareholder outreach
3. Implement relative TSR metric
4. Increase weight of performance shares
5. Re-examine changes to market positioning

Challenges Ahead

Even with all that has been accomplished with regard to pay/performance alignment, a number of challenges exists that boards and management will need to address in the months and years ahead. Some of these challenges may be resolved through additional shareholder outreach and action; others are less clear, and may in fact depend on the test of time to determine whether systems and actions currently being implemented will result in a more stable, positive compensation environment. The key challenges identified by the survey results are outlined below.

Figure 4

Have proxy advisors (e.g., ISS and Glass Lewis) encouraged the usage of pay for performance plans?



How have proxy advisors affected the alignment of pay for performance?

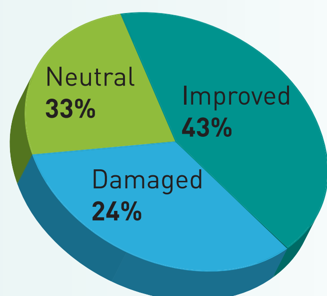


Figure 5

Do you agree or disagree that say on pay has resulted in the following?

Improved proxy disclosure

Agree	**63%**
Neutral	**18%**
Disagree	**18%**

Improved shareholder outreach

Agree	**51%**
Neutral	**27%**
Disagree	**21%**

Reduced nonperformance-based pay

Agree	**44%**
Neutral	**31%**
Disagree	**26%**

Improved pay for performance alignment

Agree	**41%**
Neutral	**33%**
Disagree	**27%**

Improved executive pay programs

Agree	**34%**
Neutral	**33%**
Disagree	**33%**

Impact of proxy advisors is mixed. Opinions on the impact of proxy advisors is a mixed bag among directors surveyed, who were mostly neutral on proxy advisors' effect with a few exceptions. More than half (56%) believe proxy advisors have improved the quality of disclosure and 68% agree proxy advisors have encouraged pay for performance—although only 43% believe they actually improved pay for performance alignment (Figure 4). Another 64% say they have had an impact on the implementation of policies such as limiting hedging and pledging. Nevertheless 34% agreed that proxy advisors have damaged the ability for companies to set appropriate pay levels that motivate and retain executives.

Mixed views on the benefit of say on pay. Directors are hard-pressed to state whether three years of say on pay has produced tangible benefits on governance. Two-thirds (63%) say it has created improved proxy disclosure and just over half (51%) agree it has improved shareholder outreach, but in general, directors are lukewarm. Less than half (44%) agree say on pay has had a positive effect on corporate governance, and just a third (34%) believe there has been a positive effect on executive pay programs overall (Figure 5).

Say on pay outcomes and actions. Once the votes are counted each year, boards have many issues to consider. Depending on the vote allocation, some decisions are clear cut; others are less clear. The majority (74%) of those surveyed agree that a say on pay vote garnering 70% or less should trigger a strategic review of executive pay programs; 64% of directors say a vote of less than 70% shareholder approval should mandate some type of change (Figures 6 and 7).

Compensation committee challenges. Overwhelmingly, compensation committee members reported being challenged with responsibilities related to both technical and philosophical aspects of the job (Figure 8). The top challenge noted by nearly two-thirds (62%) of directors was the ability to determine appropriate incentive pay, followed close behind

by balancing pay for performance with retention (57%) and ensuring the rigorous nature of incentive plans (57%). Finally, more than half of compensation committee members selected succession planning (52%) as a real concern for their members.

More disclosure on the CEO/employee pay ratio is not the answer. Although only 44% believe pay systems are clearly understood by key stakeholders, a mere 18% agree that the SECs new rules on disclosure of CEO/employee pay ratios will improve corporate governance. In discussions with institutional investors, Pay Governance has found that most agree that disclosure of the CEO ratio is of limited value to investors.

Summary

Many actions taken by U.S. public companies regarding compensation plan and design since the advent of say on pay are continuing to: align executives and shareholders' interests; provide clearer and more useful disclosure; and create pay policies that encourage better company performance. While there will always remain a natural tension in motivating and retaining top executive talent and creating shareholder value in a "say-on-pay" world, it does appear that boards are working to find the right balance for these sometimes competing interests. While many challenges still remain, such as choosing the right incentive metrics, determining optimal incentive compensation plans, and the influence of proxy advisory firms, the trends elucidated from the 2013 survey demonstrate that tangible momentum is occurring at the board level of U.S. public companies.

Methodology

The survey questionnaire was sent electronically in August/ September, 2013 to a total of 5,884 directors from the Corporate Board Member and Pay Governance databases, most of them on compensation committees. A total of 322 surveys were opened and 73% were completed fully. The median company had revenue of approximately $2 billion. Separate analysis showed that committee members at both large and smaller companies had similar observations.

Figure 6

What level of shareholder support in a say-on-pay vote should *require a strategic review* of executive pay programs?

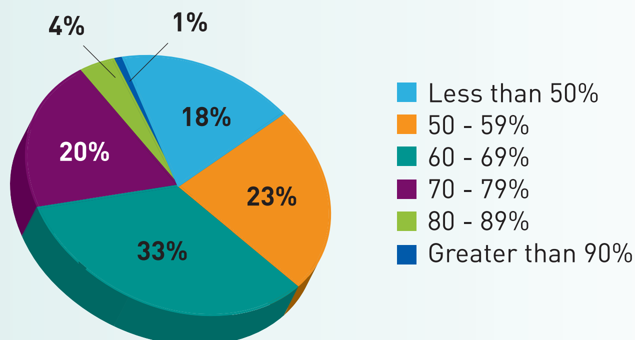


Figure 7

What level of shareholder support in a say-on-pay vote should *mandate change* to executive pay programs?

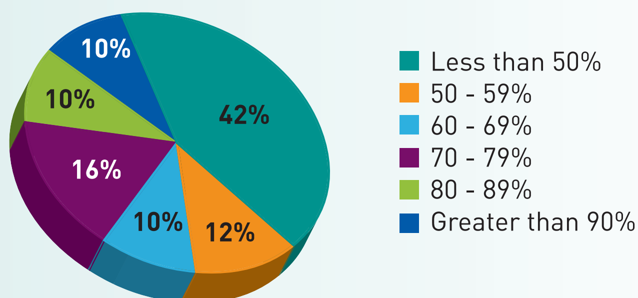


Figure 8

Top five compensation committees issues

1. Determining appropriate incentive pay
2. Balancing pay for performance with retention
3. Ensuring rigor in incentive plans
4. Succession planning
5. Peer group development

For more information please contact us at: info@paygovernance.com or visit our website: www.paygovernance.com; (215) 569-8500.

For information from NYSE Governance Services, contact editor@boardmember.com or visit us at www.boardmember.com; (800) 452-9875.