CAPflash
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# 2010 Proxy Season: Changing Practices in Executive Compensation

## Stronger Governance Practices

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### Introduction

Compensation Advisory Partners ("CAP") reviewed 2010 proxy disclosures for a sample of Fortune 500 companies. Our study includes 85 companies, representing seven industry groups. The industry groups we targeted include Consumer Products, Financial Services, Health Care, Insurance, Pharmaceuticals, Retail, and Technology. As described in Issue #7, the companies in our sample are large industry leaders, with median revenue of $25B and median market cap of $37B.

### What We Found

In response to continued focus on executive compensation and recently enacted legislation, many companies are strengthening governance and other pay practices. The most significant change is the assessment and identification of any material risks arising from compensation programs, required by the SEC for all public companies for the first time in 2010. We also see widespread use of clawbacks, continuing focus on reducing perquisites, executive benefits and eliminating tax gross-ups on perks. Companies are reducing supplemental retirement benefits and continue to emphasize stock ownership guidelines and stock retention requirements.

### Compensation Risk Disclosure

The review of material risk arising from compensation programs is an important process, initially required for TARP companies and now required for all public companies by the SEC. Of the 85 companies in our study, 75 companies or 88% make some type of affirmative disclosure related to their assessment of risk in the compensation program. While some companies disclose changes that were made to the compensation programs to discourage risk, none of the companies in our study indicate that their programs can create material adverse risks. The large number of companies including affirmative disclosure in proxy statements is striking, since the disclosure is not required under current rules. Of the 10 companies that did not address compensation risk in their proxy statements, 5 or 50% filed their proxy statements prior to the publication of the SEC's final disclosure rules in December 2009.

Most of the companies make their risk-related disclosures in the CD&A, with the next most common disclosure being in Section 407, the corporate governance section of the proxy statement. The table below summarizes where risk disclosures were made:

| Section of the Proxy Statement with Compensation Risk Disclosure | No. of Cos. | % of Cos. (n = 75) |
|---|---|---|
| CD&A | 39 | 52% |
| Section 407 | 19 | 25% |
| CD&A and Section 407 | 7 | 9% |
| Comp Committee Report or Comp Committee Report and CD&A | 2 | 3% |
| Separate Stand Alone Section | 8 | 11% |

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The type of disclosure varies significantly, ranging from an in-depth description of the process and key safeguards to just one sentence indicating that the company's programs do not encourage excessive risk-taking. 71% of the companies that make risk-related disclosures indicate that a formal risk review was conducted and comment on their assessment. Among these companies, the most common approach to the risk review is collaboration between the Compensation Committee, management and the Committee's independent consultant (20%). The table below summarizes the different approaches used:

| Approach to Compensation Risk Reviews | No. of Cos. | % of Cos. (n = 75) |
|---|---|---|
| Compensation Committee, Committee's Consultant and Management | 15 | 20% |
| Compensation Committee and Management | 10 | 13% |
| Compensation Committee and Committee's Consultant | 9 | 12% |
| Compensation Committee | 7 | 9% |
| Management | 7 | 9% |
| Management and Management's Consultant | 1 | 1% |
| Not Disclosed | 26 | 35% |

29% of the companies do not describe the risk assessment process and only comment on the results of their assessment of the compensation program. A majority of the companies (84%) describe safeguards that are in place to reduce risk-taking. Such safeguards often include:

- Balanced mix of short and long-term pay
- Use of multiple performance metrics
- Vesting requirements for equity vehicles
- Incentive plan caps
- Clawback policies
- Stock ownership requirements
- Committee discretion and oversight

## Clawbacks

The use of clawbacks has increased dramatically in the past few years as a result of SOX and TARP regulations. The policies help alleviate shareholder concerns over managing risk and are viewed as stronger corporate governance. Clawbacks are currently mandated by the SEC for all public company CEOs and CFOs under SOX, for the top 25 executives for participants under TARP, and going forward for executive officers at all public companies as part of the Wall Street Reform and Consumer Protection Act of 2010.

Reflecting broad market trends, a significant majority of our research companies—68 of 85 companies or 80%—maintain some form of clawback provision. For 2009 and 2010, 5 of the 68 companies put a new policy in place and 16 modified existing policies, by expanding the type of compensation that can be recouped, the events that trigger a clawback, or the executives covered.

A financial restatement is required in nearly all cases. Further, 48 companies (71% of those with a clawback) disclose that fraud or misconduct are triggering events. Twelve companies (18%) disclose a non-compete/non-solicitation/confidentiality violation as a trigger, and three include improper 'risk analysis' as a trigger.

Based on our review of CD&A disclosures, companies with a clawback include the ability to clawback or recoup the following types of compensation: earned, exercised, outstanding, vested or unvested.

| Compensation Covered in Clawback Policies | No. of Cos. | % of Cos. (n = 68) |
|---|---|---|
| Incentive compensation (cash or equity) | 40 | 59% |
| Annual incentives only | 5 | 17% |

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|---|---|---|
| Equity incentives only | 5 | 17% |
| Deferred cash | 4 | 6% |
| Severance benefits | 1 | 2% |
| 401k plan (company contributions) | 1 | 2% |
| Future compensation | 7 | 10% |
| Company discretion regarding type of compensation to recoup | 10 | 15% |

Note: Percentages add up to greater than 100% due to multiple responses.

Of interest, examples of some of the less common provisions we found include:

- IBM: Expanded clawback provisions by amending the Excess 401(k) Plus Plan to allow the *clawback of Company contributions* made after March 2010
- JP Morgan: Failure to identify, raise, or assess, in a timely manner as reasonably expected, risks and/or *concerns with respect to risks* material to the Firm or its activities, leads to recovery of equity awards for Operating/LOB Management Committee members
- McDonalds: *Awards under the severance plan can be recovered* if the participant engages in willful fraud that causes harm to the company or is intended to manipulate the performance measures that determine award payouts
- Progressive: Limits recoupment to excess bonus payments as a result of incorrect financial results to the *extent that the recovery exceeds the lesser of 5% of the bonus paid or $20,000*

In many cases, it is difficult to determine precisely who the clawback policy applies to. Where such disclosure is clear, we note that 17 companies cover all executives in the recovery of any 'unearned' compensation, regardless of whether the individuals directly caused any inaccuracy leading to a recovery.

A minority of companies tier their clawback policies, with certain parameters applying to Named Executive Officers, and other parameters applying to a broader 'executive' group. In some cases, clawback provisions in long-term incentive awards relate broadly to all eligible award participants.

Many companies did not indicate the time period within which compensation can be recovered after a restatement. Of the 17 cos. that did disclose a time frame for the clawback, the most common is 1 year from the date of restatement, and the range is 1 – 5 years. Three companies indicate that there is no time limit.

Since clawback policies are required by the Wall Street Reform and Consumer Protection Act of 2010 that was recently signed into law, companies will need to review and adopt provisions that align with the new legislation. The law applies to current and former executives who received incentive compensation during the 3 years before the restatement date, with employee misconduct not required as a trigger. SEC guidance is pending.

## Stock Ownership Requirements

Stock ownership requirements continue to be an important tool for aligning executives with longer-term shareholder value. The majority of companies have stock ownership guidelines for their executives, typically expressed as a multiple of salary. While less common, many companies also have stock holding requirements where executives must hold a percentage of net shares from stock option exercises or vesting of restricted shares for a period of time. Within our sample, 17 companies, or 20% made changes to their stock ownership requirements. The most significant change among the companies in the study was the adoption or implementation of more restrictive stock holding requirements. Other changes, such as eliminating or extending the compliance time frame, suspending or decreasing ownership guidelines and changing to a fixed number of shares are responses to the volatility in the stock market.

| Type of Change Reported in 2010 CD&A | No. of Cos. | % of Cos. (n = 17) |
|---|---|---|

| | | |
|---|---|---|
| Newly Adopted/More Restrictive Stock Holding Requirements | 8 | 47% |
| Eliminated/Extended Compliance Timeframe | 4 | 24% |
| Increased Stock Ownership Guidelines | 3 | 18% |
| Newly Adopted Stock Ownership Guidelines | 2 | 12% |
| Suspended Ownership Guidelines | 2 | 12% |
| Decreased Stock Ownership Guideline | 1 | 6% |
| Changed Stock Ownership Guideline from Multiple of Salary to Fixed Share Guideline | 1 | 6% |

Note: Percentages add up to greater than 100% due to multiple responses.

## Perquisites

Companies continued to reduce perquisites in 2009, building on a trend that has been evident for several years. 16 of 85 companies or 19% of the sample made a change to perquisite programs. A number of companies also eliminated tax gross-ups on perquisites, responding to widespread criticism of this practice.

| Type of Change Reported in 2010 CD&A | No. of Cos. | % of Cos. (n = 16) |
|---|---|---|
| Reduced perks | 11 | 68% |
| Eliminated tax gross-ups on perks | 10 | 63% |

Note: Percentages add up to greater than 100% due to multiple responses.

The most common reduction in perquisites – seen at 6 of 11 companies (38%) that reduced perquisites—involved curbs on personal use of corporate planes by senior executives. Examples include:

- Eli Lilly: No longer allows executive officers to use company planes for travel to outside board meetings
- Genworth Financial: In 2009, suspended all incidental personal use of corporate aircraft
- MetLife: CEO is no longer required to use the company plane for personal travel
- Morgan Stanley: CEO entered into an aircraft time-sharing agreement with the Company and has since fully reimbursed the Company for the cost of his personal use of the Company aircraft up to the maximum amount permitted by federal aviation regulations
- PNC Financial: Required certain executives to pay for all personal trips on corporate aircraft
- Sara Lee: Terminated all use of its corporate aircraft

## Severance And Change In Control Benefits

Given the economic and governance climate, change in control severance benefits have garnered a great deal of attention in recent years from shareholders, advisory groups and the media. In response, program changes have gained traction.

14 of our 85 research companies, or 16%, disclosed changes for 2009/2010 in most recent proxy CD&As consistent with what we are seeing in the broad market:

| Severance and CIC Program Changes | No. of Cos. | % of Cos. (n = 14) |
|---|---|---|
| Removed excise tax gross up feature<br>- For current participants<br>- For future participants (new hires/ promotions) | 6<br>2<br>4 | 43% |
| Changed equity vesting from single to double trigger | 3 | 21% |
| Reduced overall severance and CIC benefits | 2 | 14% |
| Changed definition of pay (bonus) for severance calculation | 2 | 14% |
| Reduced number of eligible participants | 1 | 7% |
| Eliminated executive CIC agreements, introduced exec severance plan | 1 | 7% |
| Increased excise tax cutback threshold above IRS limit | 1 | 7% |
| Eliminated pension supplement | 1 | 7% |
| Reduced benefit continuation period | 1 | 7% |
| Adopted new CIC plan | 1 | 7% |

Note: Percentages add up to greater than 100% due to multiple responses.

Program changes in 8 companies impact current participants and in 6 companies changes apply to new participants only. Five of the 14 companies making changes are in the pharma industry and three are in health care.

## Executive Retirement Benefits

Several companies—9 of 85 or 11% of our sample—made changes to executive retirement benefit plans. The most common approach was to reduce supplemental retirement benefits. This might involve closing SERPs to new participants, freezing future benefit accruals or modifying or capping the formula used to calculate benefits.

| Type of Change Reported in 2010 CD&A | No. of Cos. | % of Cos. (n = 9) |
|---|---|---|
| Froze DB SERP benefits | 4 | 44% |
| Scaled back DB SERP benefits | 2 | 22% |
| Enhanced supplemental DC benefits | 2 | 22% |
| Added retiree medical coverage | 1 | 11% |

Note: Changes to qualified plans available to all employees are not captured here.

## Conclusions

In 2009 and 2010, companies continue to reevaluate – and modify – pay and governance practices. Risk assessment disclosure represents the biggest expansion in disclosure requirements. Another trend that emerged is the widespread use of clawbacks. Meanwhile, reductions in perks, change in control severance benefits, and executive retirement benefits, elimination of tax gross-ups, and enhanced stock ownership guidelines continue trends that have been evident for several years. These are all shareholder friendly developments that should improve the alignment between executive compensation and shareholders. We expect companies to continue to re-examine their programs as shareholders continue to demand good governance practices.

***Please contact us at (212) 921-9350 if you have any questions about the issues discussed above or would like to discuss your own executive compensation issues. You can access our website at www.capartners.com for more information on executive compensation.***