CAPflash
CAP Compensation Advisory Partners Newsletter | Issue #23 | Sep 30, 2011

2011 Proxy Season: Changing Practices in Executive Compensation

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Stronger Governance Practices

Introduction

Compensation Advisory Partners ("CAP") reviewed 2011 proxy disclosures for a sample of Fortune 500 companies. Our study includes 111 companies, representing ten industry groups. The industry groups we studied include Aerospace & Defense, Automotive, Consumer Goods, Financial Services, Healthcare, Insurance, Manufacturing, Pharmaceuticals, Retail, and Technology. The companies in our study are large industry leaders, with median revenue of $27.2B and median market cap of $29.6B. This CapFlash, along with our August 10, 2011 CapFlash, continues to explore changes in executive compensation observed in our research.

What We Found

In response to increased pressure from shareholders and proxy advisory firms, as well as recent Say on Pay legislation, companies continue to monitor their executive compensation programs. In the past, companies would re-evaluate their programs every 2-3 years. Given today's intense scrutiny of executive compensation, we are seeing companies and compensation committees re-evaluate their programs annually. New governance standards include completing the annual risk assessment and implementing updated clawback policies. In addition, companies have removed excise tax-gross ups from change in control benefits and perquisites, continue to emphasize stock ownership guidelines and stock retention requirements, and have reduced supplemental retirement benefits.

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Compensation Risk Disclosure

Clear and explicit disclosure of the compensation risk assessment process is becoming standard practice, especially after the recent economic downturn and passage of SEC rules on enhanced compensation disclosure. Of the 111 companies in our study, 105, or 95%, make some type of affirmative disclosure on risk assessment in the most recent proxy. Similar to 2009, none of the companies disclosed that their incentive programs create material adverse risks.

Most companies make their risk-related disclosure in the CD&A of the proxy statement, with the corporate

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governance section of the proxy statement ranking as the second most common place for this disclosure. The table below summarizes where risk disclosures were made:

Section of the Proxy Statement with Compensation Risk Disclosure	2010		2009	
	No. of Cos.	% of Cos. n=105	No. of Cos.	% of Cos. n=75
CD&A	49	47%	39	52%
Corporate Governance Section (Section 407)	25	24%	19	25%
CD&A and Corporate Governance Section (Section 407)	14	13%	7	9%
Separate Stand Alone Section	11	10%	8	11%
CD&A and Compensation Committee Report	4	4%	2	3%
Compensation Committee Report	2	2%	n/a	n/a

Responsibility for completing the risk assessment process varies by company. Of the companies disclosing a risk assessment, 35 companies (33%) had management and the compensation committee working together to conduct the assessment, while 17 companies (16%) reported that the compensation committee worked alone to conduct the assessment. One change we noted is that this year 95% of companies disclosed who conducted the risk assessment versus only 65% last year. The table below provides further detail on which groups were involved in the compensation risk review:

Approach to Compensation Risk Reviews	2010		2009	
	No. of Cos.	% of Cos. n=105	No. of Cos.	% of Cos. n=75
Management & Compensation Committee	35	33%	10	13%
Compensation Committee	17	16%	7	9%
Compensation Committee & Consultant	15	14%	9	12%
Management	13	12%	7	9%
Management, Compensation Committee & Consultant	12	11%	15	20%
Management & Consultant	8	8%	1	1%
Not Disclosed	5	5%	26	35%

Clawbacks

Despite the SEC's delay in proposing policies to recoup executive compensation under Dodd-Frank, companies have been proactively adopting clawback policies. Even though clawbacks are mandated by the SEC for all public company CEOs and CFOs under SOX and for the top 25 executives in TARP participants, companies have implemented their own clawbacks to obtain broader protection.

A significant majority of our research companies – 89 of 111 (80%) – maintain some form of clawback provision. For 2010, 17 of the 89 companies adopted a new clawback policy and 10 modified existing policies by expanding the type of compensation that can be recouped, the executives covered or the events that trigger a clawback. The majority of companies are awaiting final SEC regulations, however, before making comprehensive changes to update existing policies.

Similar to our findings in 2009, a financial restatement is required to trigger a clawback in nearly all cases (74 companies or 83% of those with a clawback). Further, 66 companies (74% of those with a clawback) disclosed that misconduct is a triggering event and 45 companies (51%) disclosed fraud 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.

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Compensation Subject to Clawback	No. of Cos.	% of Cos. n=89
Prior annual incentive	81	91%
Prior LTI	79	89%
Future annual incentive	20	22%
Future LTI	14	16%

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

Of the type of compensation that is subject to a clawback, clawbacks of both cash and equity are equally prevalent.

While the majority of companies do not explicitly state who their clawback policy applies to, it is clear that coverage extends to the NEOs at 83 companies (93%).

A minority of companies (18 companies or 20%) indicate the time period which compensation can be recovered after a restatement. Of the 18 companies that disclosed a time frame, the most common is 1 year from the date of restatement and the range is 1-3 years.

It is apparent from reviewing CD&A disclosure that most companies are waiting for the SEC to rule before modifying their current policies. Companies will need to develop and implement a policy to provide for recovery of compensation that aligns final rules issued by the SEC. The proposed rules apply to both current and former executives and cover all incentive compensation within 3 years of a financial restatement (with or without intentional misconduct). It is unlikely that companies will make final modifications to their policies that apply to the 2012 proxy season, since the SEC is not expected to issue final rules until the first half of 2012.

Stock Ownership Requirement Changes

Companies continue to monitor their stock ownership requirements in order to align executives with shareholders. This year 25 companies (23%) initiated a change with respect to stock ownership or stock holding requirements. The most prevalent change was an increase in stock ownership guideline levels, with 12 of the 25 companies (48%) disclosing an increase. This is likely attributed to a recovery in the economy as well as stock prices, and increasing pressure from regulators and proxy advisory firms. Other common changes were 24% of companies added a new stock holding requirement and 20% modified or added a penalty for non-compliance. Further detail on changes made to executive stock ownership guidelines are below:

Changes made to Executive Stock Ownership Guidelines	2010		2009	
	No. of Cos.	% of Cos. n=25	No. of Cos.	% of Cos. n=17
Increased	12	48%	3	18%
Added holding requirement	6	24%	n/a	n/a
Modified penalty for non-compliance	5	20%	n/a	n/a
Changed to multiple of salary	2	8%	n/a	n/a
Increased holding requirement	2	8%	n/a	n/a
Decreased holding requirement	2	8%	n/a	n/a
Newly adopted	1	4%	10	59%
Decreased	1	4%	1	6%
Adopted mandatory holding of shares through retirement	1	4%	n/a	n/a

Note: Percentages add up to greater than 100% due to multiple changes by several companies.

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Stock Ownership Requirements Detail

For companies disclosing shares counted toward ownership requirements, it is interesting to note that one-third of companies count unvested restricted stock towards meeting the guidelines, since companies expect executives to vest in these shares. However, only 6% count vested/unexercised options and 5% count unearned performance shares since these shares are viewed as being subject to greater risk. See below for further detail:

Shares Counting For Guideline Requirements	No. of Cos.	% of Cos. n=99
Shares directly owned	55	56%
Unvested RS	33	33%
Shares in 401(k) plan	33	33%
Shares indirectly owned	29	30%
Shares purchased on open market	29	29%
Not disclosed	29	29%
Deferred Compensation	25	25%
Vested but unexercised options	6	6%
Unearned performance shares	5	5%
Unvested options	1	1%

Note: Percentages add up to greater than 100% due to multiple types of equity counted by various companies.

Among CEOs, most companies (82%) express their guidelines as a multiple of base salary and 17% of companies express their guidelines in fixed share amounts. The fixed share approach is more prevalent among financial services and technology companies.

The median guideline for all company CEOs in our study sample is a 5x multiple of base salary or a fixed share guideline of 150,000 shares. The median value of these guidelines is $6,700,000.

CEO Stock Ownership Guidelines (n=99)	Prevalence	25th Percentile Level	Median Level	75th Percentile Level
Multiple of Base	82%	5.0x	5.0x	6.0x
Fixed Share	17%	100,000	150,000	300,000
Fixed Value	1%	$5,000,000	$5,000,000	$5,000,000
Total Value	-	$5,389,894	$6,700,000	$8,600,000

15% of companies disclose some type of penalty for non-compliance with stock ownership guidelines. The most common penalties disclosed include mandatory payment of a portion of the annual bonus in stock and requiring executives to hold shares after an option exercise or the vesting of stock awards.

Stock Holding Requirements Detail

Having stock holding or stock retention requirements in addition to stock ownership guidelines is a growing trend. In our sample of 111 companies, 30 companies (27%) disclose some type of stock holding requirement. Over half of the 30 companies have a stand-alone stock holding requirement. This type of requirement is most prevalent among financial services companies in place at 75% of financial services companies.

Most of these companies (46%) require executives to hold equity after vesting or exercise for 1 year. Holding shares until retirement (33%) is the second most prevalent holding period, although it is relatively rare. 70% of companies disclose that the equity to be held is the net after-tax shares retained by the executive after

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option exercise/equity vesting. See below for further detail:

Definition of LTI subject to Hold	No. of Cos.	% of Cos. n=30
RS/RSUs	25	83%
Options	22	73%
Performance Shares	12	40%
Net after tax shares	21	70%

Note: Percentages add up to greater than 100% due to some companies requiring that multiple forms of equity be held.

Holding Requirements - Period subject to Hold	No. of Cos.	% of Cos. n=24
1 year post exercise/vest	11	46%
Retirement	8	33%
Other	4	17%
2 years post exercise/vest	1	4%
Post-Retirement	1	4%
Not disclosed	1	4%

Note: Holding requirement only for companies with stand alone holding requirement. Percentages add up to greater than 100% due to two companies requiring different holding periods for CEO and other NEOs.

Perquisites

With enhanced disclosure requirements, pressure from proxy advisory firms and mandatory Say on Pay proposals, the trend of reducing perquisites has continued in 2010. 20 of 111 companies (18%) disclosed making a change to perquisite programs. Similar to 2009, the most prevalent change was elimination of perquisites.

Type of Change Reported in 2011 CD&A	No. of Cos.	% of Cos. n=20
Eliminated perquisites	11	55%
Eliminated tax gross-up on perquisites	8	40%
Changed perquisites	3	15%
Reduced perquisites	2	10%

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

Among companies eliminating perquisites, the most common (in 6 of 11 companies) involved eliminating personal travel on the corporate aircraft or use of company automobile/automobile allowance. 3 of 11 (27%) curbed home security benefits.

Severance and Change in Control (CIC) Benefits

We continue to see companies modifying CIC provisions at an increasing rate. 36 of our 111 research companies (32%) disclosed changes for 2010/2011 in their most recent proxy filings, which is a significant increase from last year's findings, where 16% of companies disclosed changes:

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Severance and CIC Program Changes	2010 No. of Cos.	2010 % of Cos. n=36	2009 No. of Cos.	2009 % of Cos. n=14
Removed excise tax-gross up	26	72%	6	43%
- For current participants	19		2	
- For future participants (new hires / promotions)	7		4	
Adopted double trigger vesting of equity	13	36%	2	21%
Reduced overall severance and CIC benefits	9	25%	2	14%
Reduced enhanced CIC Benefits	7	19%	n/a	n/a
Eliminated enhanced CIC Benefits	3	8%	n/a	n/a

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

Similar to findings last year, healthcare and pharmaceutical companies continue to lead other industries in making changes to their severance and change in control benefits.

Executive Retirement Benefits

19 of 111 companies (17%) made some type of change to executive retirement plans or SERPs, an increase from 2009 where 11% of companies disclosed a change. The most prevalent change we saw in 2010 was enhancement of the defined contribution plan, which was changed by 7 of the 19 companies, or 37%. Other changes made by companies included modifying or reducing the retirement plan and limiting the defined benefit SERP.

Changes made to Retirement Program / SERP	No. of Cos.	% of Cos. n=19
Enhanced defined contribution plan	7	37%
Modified/reduced retirement plan benefit	4	21%
Limiting DB SERP provision	2	11%
Froze retirement plan	2	11%
Added retiree medical	1	5%
Froze SERP	1	5%
Eliminated employer contribution to nonqualified plans	1	5%
Capped employer contribution on deferred compensation plan	1	5%

Conclusions

In 2010 and 2011, companies continue to reevaluate their pay and governance practices. The prevalence of clawback policies – even though the SEC had not issued rules at the time proxies were filed, and has subsequently delayed the rule-making process – was notable. Meanwhile, as we saw in our 2009/2010 study, reductions in perquisites, 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 modifications to executive compensation practices align executive compensation more closely with the interests of shareholders. With the majority of the company's shareholders approving annual Say on Pay voting, we expect companies to re-examine their programs annually. By closely monitoring governance trends, companies may receive higher support on Say on Pay voting in the future.

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.