The Focus is on Performance

Companies who link pay and performance are more likely to win shareholder pay provision approval, finds an analysis of the first 100 proxy filings of the Fortune 500

By Yonat Assayag and Russell Miller

April 20, 2011

Well into the 2011 proxy season, the clear emphasis for companies is pay for performance. An analysis of the first 100 Fortune 500 companies to file proxies this year finds a focus on minimizing non-performance-based pay, reinforcing shareholder alignment and improving disclosure to tell the pay-for-performance story.

New federal regulations under the Dodd-Frank Act require companies to hold non-binding shareholder votes on their executive pay programs (say on pay), the frequency of future say-on-pay votes (say on frequency) and golden parachute payments in the event of a transaction (say on golden parachutes). The say-on-pay and say-on-frequency votes are required for all publicly-traded companies with annual shareholder meetings held after Jan. 21, 2011. The say on golden parachutes requirement is effective for proxies filed on or after April 25, 2011. Smaller reporting companies (less than $75 million in public float) are granted a two-year delay until these votes are effective.

As the proxy season progresses and say-on-pay vote results filter in, new learnings for boards continue to surface. One theme is clear: companies that perform, and successfully demonstrate that their pay programs support and drive performance, are more likely to win shareholders’ votes.

Program Changes

This year’s filings indicate that in 2010, companies focused on minimizing non-performance-based pay and enhancing shareholder alignment:

- Excise tax gross-ups: Nearly 40 companies, including companies such as AT&T and OfficeMax, eliminated excise tax gross-ups (either from existing or future arrangements).

- Severance multiples: Three companies reduced severance multiples for the CEO from 3x cash compensation to 2x cash compensation. Six companies have a policy requiring shareholder approval of any payouts greater than 2.99x cash compensation, including one company (Bank of New York Mellon) that adopted the policy in 2010.

- Clawbacks: Of 79 companies disclosing clawback provisions for their named executive officers, 34 adopted or enhanced these provisions recently.

- Ownership guidelines: While CEO stock ownership guidelines of 5x salary is most common among the first 100 companies (45 companies), a growing number of companies are increasing their guidelines beyond 5x. In 2010, six companies increased their guidelines from 5x to 6x, resulting in 24 total companies with guidelines greater than 5x.
The first 100 companies focused their disclosure on their pay-for-performance story:

- Many companies took a “layered” approach and highlighted key program features and the alignment between pay and performance early in their disclosure.
  - Prevalence of executive summaries more than doubled, from 30 companies last year to 64 companies this year. Companies focused their executive summaries on their pay-for-performance relationships, often enhancing disclosure from 2009 through graphical representations of pay and performance.
  - A few companies, including General Electric, took this disclosure a step further by including a summary of the compensation program and why shareholders should vote for it at the very beginning of the proxy statement. This disclosure focused primarily on 2010 compensation decisions and 2010 company performance.

- Several companies, including Kimberly Clark and Lockheed Martin, enhanced their pay-for-performance discussion by adding a comparison of Total Shareholder Return (TSR) vs. CEO pay at the beginning of the CD&A. This level of disclosure may be a preview to the pending pay/performance disclosure requirement under Dodd-Frank, which won’t likely be effective until 2012.

- Some companies have re-introduced the proxy performance graph, which compares the company’s TSR to TSR of an index and peers over a multi-year period and is now required 10-K disclosure. Variations of this performance graph were included in proxy statements for BB&T, Goodrich Corp and Honeywell International.

- While companies discussed their performance in terms of various financial, operating, and stock-based measures, graphical analysis of performance tended to focus on TSR. However, some companies, including Eli Lilly, provided graphical analysis of pay-and-performance based on measures such as revenue and earnings per share growth.

**Vote Results**

Based on the available voting results – which include 30 of the first 100 companies – 89 percent of shareholders, on average, voted in support of executive pay programs. Most of the 30 companies received support from 95-100 percent of shareholders. This trend is consistent with voting results in the broader market, where an average of 93 percent of shareholders have voted in favor of executive compensation.

*Influence of Performance on Say on Pay Votes*

The focus on pay-for-performance in company disclosure is warranted, given that performance, as measured by total shareholder return (TSR), has an influence on the shareholder vote. As shown below, companies with stronger TSR on a 1- and 3-year basis were more likely to get FOR votes from shareholders on their executive compensation programs.

<table>
<thead>
<tr>
<th>% of Votes FOR</th>
<th>n=</th>
<th>1-Yr</th>
<th>3-Yr</th>
</tr>
</thead>
<tbody>
<tr>
<td>0% - 50%</td>
<td>2</td>
<td>-13%</td>
<td>-13%</td>
</tr>
<tr>
<td>50% - 70%</td>
<td>3</td>
<td>-8%</td>
<td>-9%</td>
</tr>
<tr>
<td>70% - 90%</td>
<td>3</td>
<td>20%</td>
<td>-2%</td>
</tr>
<tr>
<td>90% - 100%</td>
<td>22</td>
<td>23%</td>
<td>-1%</td>
</tr>
</tbody>
</table>
Moreover, all companies in the first 100 with positive TSR on both a 1- and 3-year basis received at least 95 percent of votes cast in favor of the executive compensation program.

Failed Say on Pay

Two companies in the first 100 (Jacobs Engineering and Hewlett-Packard) did not receive majority shareholder support of their executive compensation program. Although not Fortune 500 companies, three additional companies failed to receive majority support from shareholders. Below are the say-on-pay vote results for these companies:

<table>
<thead>
<tr>
<th>Company</th>
<th>FOR</th>
<th>AGAINST</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ameron International</td>
<td>42%</td>
<td>58%</td>
</tr>
<tr>
<td>Hewlett-Packard</td>
<td>49%</td>
<td>51%</td>
</tr>
<tr>
<td>Jacobs Engineering</td>
<td>45%</td>
<td>55%</td>
</tr>
<tr>
<td>Shuffle Master</td>
<td>45%</td>
<td>55%</td>
</tr>
<tr>
<td>Beazer Homes</td>
<td>46%</td>
<td>54%</td>
</tr>
</tbody>
</table>

*Note: Votes are as a percentage of votes cast FOR or AGAINST (excludes abstentions and broker non-votes)*

Interestingly, one company (Hemispherx Biopharma) stated that shareholders voted in favor of say on pay. However, based on the company’s voting guidelines, abstentions count as “AGAINST” votes, in which case the company would not have received majority support. Regardless of how the votes are tallied, shareholders are expecting improvements to the executive pay program.

Responding to Proxy Advisor Recommendations

Some companies have proactively engaged with shareholders following AGAINST recommendations from proxy advisory firms (e.g., ISS and Glass Lewis). Notable among these companies in the first 100 were Disney and Hewlett-Packard, who filed supplemental materials following ISS’s negative recommendation. Disney was successful in obtaining shareholder support for the executive compensation program, while Hewlett-Packard was not. One of the key issues in ISS’s recommendation against Disney’s program was its excise tax gross-ups, which Disney ultimately chose to eliminate, potentially after engaging with key shareholders. ISS’s primary issue with Hewlett-Packard’s executive compensation program was on the new CEO’s employment arrangements. However, Hewlett-Packard focused its supplemental filing on ISS’s criticism of their director election process, which may have been a more pressing issue given that Hewlett-Packard has a majority vote standard for director elections. Although these supplemental filings didn’t work in every case, the success for some companies provides evidence that pay-for-performance disclosure can influence the shareholder vote.

Shareholder Preference for Annual Say-on-Pay

It appears that say on pay will become an annual event for most companies. Among early filers, a significant number of companies had recommended triennial votes. However, the votes that are in (for 30 companies) indicate shareholders’ clear preference for annual say on pay:

- While only 12 of 30 companies actually recommended annual say on pay, 26 received majority shareholder support for annual votes.
- Three of the four companies who did receive support for biennial or triennial votes (Hormel Foods, Tyson Foods, Franklin Resources) are family-controlled companies.
Shareholder preference for annual say on pay has influenced the later filers among the first 100 to recommended annual votes, as shown below:

![Bar Chart: Say-on-Frequency Recommendations Among First 100](chart.png)

### Conclusion

For the first 100 companies, this year’s proxy season is ultimately about performance and aligning the pay program with performance. A renewed focus on performance not only translates to shareholder approval but also supports the creation of sustainable, long-term shareholder value.

Yonat Assayag and Russell Miller are partners at ClearBridge Compensation Group, an independent executive compensation consulting firm based in New York City. Lauren Arey and Kristine Meyer assisted with the research and analysis. They can be reached at vassayag@clearbridgecomp.com, rmiller@clearbridgecomp.com, larey@clearbridgecomp.com and kmeyer@clearbridgecomp.com