United States Proxy Exchange

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Request for Comment:

Draft Shareowner Guidelines for Say-on-Pay Voting

Released May 12, 2011

This document contains draft guidelines that shareowners can use in making say-on-pay voting decisions to address the problem of excessive CEO pay. We are releasing the guidelines in draft form to solicit feedback from the shareowner community. Because we are doing so in the midst of the 2011 proxy season, shareowners can test the guidelines in actual say-on-pay voting decisions. Please provide your comments, which will be posted to the USPX website, unless you indicate you would rather remain anonymous. The deadline for commenting is June 2, 2011. Based on the feedback we receive, we plan on releasing final guidelines this summer.

Please e-mail comment letters to contact@proxyexchange.org and put "Say-on-Pay Guidelines" in the e-mail header.

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> *... if the stockholder is to regard himself as a continuing part-owner of the business in which he has placed his money, he must be ready at times to act like a true owner and to make the decisions associated with ownership. If he wants his interests fully protected he must be willing to do something of his own to protect them. This requires a moderate amount of initiative and judgment.*
>
> Benjamin Graham and David Dodd, 1934

Overview

Both retail and institutional investors are alarmed by today's outrageous level of executive compensation. In 1965, CEO pay at large companies was 24 times the average worker's wages, according to a study by the Economic Policy Institute. By 2007 this had increased to 275 times the average worker's wage.[1] While growth in executive compensation briefly stalled following the 2008 market crisis, resulting in a ratio of 185-1, it has since rebounded. GovernanceMetrics International sampled large corporations and found that CEO pay jumped 27% in 2010 to a median of $9 million.[2]

The new say-on-pay rules allow shareowners to express an opinion on executive compensation at annual meetings. But to make informed say-on-pay voting decisions, shareowners must first assess the compensation packages boards propose. That is not easy, since those packages tend to be staggeringly complex. Even sophisticated business professionals have a difficult time evaluating them, so how can average shareowners hope to do so?

For shareowners, say-on-pay is a Gordian Knot. If shareowners can reasonably assess compensation packages—untangle the knot—they will have a tool to put the breaks on absurd executive compensation. But how to untangle the knot? Only the very largest institutional investors can afford to pay professional staffers to review the logic of specific executive compensation packages. Even then, their analyses are usually cursory or limited to a small fraction of firms. There are, after all, some 13,000 annual meetings held in the United States each year.

If shareowners believe the vast majority of executives are excessively compensated, then collectively we should vote to reject the vast majority of compensation packages. It is imperative that we avoid a situation where executives pay themselves $10 million, $20 million or $50 million after receiving say-on-pay approval from their shareowners. *If that happens, shareowners will have become part of the excessive pay problem rather than part of the solution*. To avoid that outcome, shareowners must find a way to stand on principle and vote against executive compensation packages at most firms.

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[1] *Ratio of average CEO total direct compensation to average production worker compensation*, Economic Policy Institute: http://www.stateofworkingamerica.org/charts/view/17
[2] CEO pay soars while workers' pay stalls, *USA Today* 4/1/2011, http://www.usatoday.com/money/companies/management/story/CEO-pay-2010/45634384/1

A simple approach would be to vote against all executive compensation packages, but that would be self defeating. If boards know compensation packages will be voted down no matter what they contain, those boards will have no incentive to make changes. Since say-on-pay votes are advisory, they will have no impact.

This document provides guidelines individual and institutional investors can use to easily and objectively assess executive compensation packages and vote against many or most, while not arbitrarily rejecting all. The guidelines reflect input from both individual and institutional investors. The USPX will continue to develop these guidelines, hopefully releasing a new version each spring. In their current form, they are designed to assess compensation at large firms and do not adjust for company size.

To address the Gordian Knot of say-on-pay votes, we recommend shareowners need not attempt a qualitative assessment of the various features of a compensation package. They can simply base their analysis on the total value of compensation paid in the previous year. This solution is in the spirit of Alexander The Great's original solution of cutting the Gordian Knot. Transforming say-on-pay votes from ex-ante to ex-post is straightforward and effective. We discuss strengths and weaknesses of this approach shortly. We believe, for the vast majority of individual and institutional shareowners, it is the only viable solution to the problem.

We propose two general tests shareowners can apply in making their say-on-pay voting decisions. To address perceived opposition to any sort of hard cap for executive compensation, we have made it possible for users to calibrate either test to reflect their own opinion about what level of executive compensation is reasonable. Both tests are simple and objective. Shareowners should choose one or the other test and use it consistently.

The first test is based on a ratio of executive compensation to median worker compensation. For example, a shareowner might elect to vote against compensation packages of any firm at which that ratio exceeds 100 over the previous year. Another shareowner might choose to vote against any for which that ratio exceeded 20.

The second test is based on median executive compensation. For example, one shareowner might choose to vote against compensation packages of any firm at which executive compensation exceeded that median in the previous year. Another might vote against compensation packages of any firm if executive compensation exceeded 90% of that median in the previous year.

If shareowners decide against voting "no" on say-on-pay for a particular firm, then they have the option of voting "yes" or abstaining. We leave this decision to shareowners. Some might adopt a policy of always voting "yes" or always abstaining in this circumstance. Some might make the decision on a case-by-case basis.

If, based on one of these tests, shareowners choose to vote "no" on say-on-pay at a given firm, we also recommend that they vote against board members on that firm's compensation committee.

These guidelines are designed to address only the problem of out-of-control executive compensation. Our tests can be combined with analyses that address other issues. We suggest that shareowners with the resources to perform such analyses first apply one of our tests to screen out compensation packages that are *prima facie* excessive. They can then perform their own additional analyses to assess if compensation packages that were not screened out are unacceptable based on the additional criteria. In this way, even the largest institutional investors can incorporate our guidelines into their say-on-pay voting decisions. We encourage them to do so.

Lake Wobegon and the Ever-Widening Pay Gap

Onerous SEC proxy solicitation rules maintain a community of entrenched board members who rarely run in contested board elections. Most are executives themselves or have social or financial relationships that align their interests with those of executives. They have a clear interest in ever rising executive compensation. Corporate governance failures help maintain a clubby atmosphere at board meetings, where there is a strong sense of "you scratch my back and I'll scratch yours."

Boards typically hire compensation consultants, lawyers, and academics to advise them on compensation issues. While the purpose of this advice is ostensibly to help "optimize" compensation packages and align them with the interest of shareowners, their effect has been to provide legal and political cover for boards to approve ever more exorbitant compensation packages.

The aggregate compensation paid by public companies to their top-five executives during the period 1993-2003 totaled about $350 billion, and the ratio of this aggregate top-five compensation to the aggregate earnings of these firms increased from 5 percent in 1993-1995 to about 10 percent in 2001-2003.[3] We find this to be a dangerous, unsustainable trend that could re-purpose the nature of the firm.

Compensation consultants and large institutional investors who believe the sky is the limit have produced a vast literature on executive compensation that so dominates discussion on this issue that shareowners need to step back and question the implicit assumptions that underlie that discussion.

These assumptions drive what Rachel M. Hayes and Scott Schaefer have called the "Lake Wobegon effect".[4] Lake Wobegon is a fictional Minnesota village[5] where "all the children are above average." Obviously, it is impossible for all members of a group to be above average within that group. Despite that impossibility, there is a quality of Lake Wobegon at play within most corporate compensation committees. Here's how:

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[3] Bebchuk, Lucian A. and Grinstein, Yaniv, The Growth of Executive Pay. Oxford Review of Economic Policy, Vol. 21, Issue 2, pp. 283-303, 2005. Available at SSRN: http://ssrn.com/abstract=906403. In a May 3, 2011 email, Bebchuk indicates they are in the process of updating these figures.

[4] Rachel M. Hayes and Scott Schaefer (2008). CEO Pay and the Lake Wobegon Effect, *Journal of Financial Economics*.

[5] Invented by radio humorist Garrison Keillor.

No firm wants to admit to having executives who are below average, so they seek to compensate their executives at an above-average level. They survey executive compensation at corporations in their "peer group" and then set compensation packages that are above-average for that peer group. Of course, all executives cannot be compensated above-average, so the average rises as most companies pay their executives above the average. Hence, the Lake Wobegone Effect. The result is rapidly-rising executive compensation.

A recent study[6] identified a subset of S&P 500 companies with high pay not aligned with high performance. Data revealed that these companies choose as peers corporations that are larger and more successful than themselves. The selections appear to be based on aspirations and not reality. On top of that, boards of these companies recommended compensating their CEOs an average of more than double, or 103 percent above the median, of their already-skewed peer groups.

During the first decade of the new millennium, executive compensation reached unprecedented levels. Yet corporate performance, as measured by the S&P 500, was abysmal. If compensation is linked to ability, as supporters of CEO pay maintain, why are our corporations not performing better? Any link between incentive compensation and performance is poor or nonexistent. Pay for performance is probably driven more by a perceived need to work around Section 162(m) of the Internal Revenue Code, which is supposed to limit non-performance-based pay, than it is by any real evidence that pay for performance yields better results. We aren't getting more value from the executives who run America's businesses; they have just gotten better at securing outrageous pay. Average shareowners suffer directly, due to the drag executive compensation has on investment returns, and indirectly, due to the social costs as America becomes a two-class society of "haves" and "have-nots."

If shareowners want to use say-on-pay to slow or reverse the Lake Wobegone Effect, they cannot look to proxy advisory firms or the largest institutional investors for guidance. Neither has indicated interest in that goal.

ISS, a subsidiary of MSCI, dominates the proxy advisory industry. Glass Lewis is a distant second, and there are a few niche firms. These are for-profit firms whose advice to clients is designed to preserve or grow their business. Not surprisingly, their approach to say-on-pay tends to be the safe one of recommending "no" votes on only a fraction of the most outlandish pay packages. This avoids the controversy a large number of "no vote" recommendations might engender but still gives their clients the impression they are adding value.

In a handful of interviews the USPX conducted with the largest institutional investors, we found little evidence they were concerned about skyrocketing executive compensation. Interviewees were primarily focused on structuring compensation packages to "incentivize" executives. We found strong opposition to the idea they should attempt to cap executive compensation at any particular level or address the fact that CEO pay is rising far quicker than the average pay of other workers. The attitude appeared to be that a "sky's the limit" approach to executive compensation would facilitate possible "sky's the limit" executive performance and "sky's the

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[6] *Compensation Peer Groups at Companies with High Pay*, released by The Investor Responsibility Research Center (IRRC) Institute and PROXY Governance Inc.

limit" gains to shareowners. This is the very attitude cultivated by the compensation consulting industry.

Mechanics of Say-on-Pay

Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") mandates advisory shareowner votes on executive compensation. The SEC issued final rules[7] on January 25, 2011. These require three types of votes:

1. A say-on-pay vote to approve compensation packages for senior executives, as described in the corporation's proxy materials;

2. A frequency vote at least once every six years for shareowners to advise how often—annually, biannually or every three years—they would like to have a say-on-pay vote;

3. In the event of a merger, acquisition, consolidation, proposed sale or other disposition of substantially all a corporation's assets, a separate advisory vote to approve certain "golden parachute" compensation arrangements.

In all three cases, votes are advisory only. They do not bind a corporation or its board.

The SEC's final rules allow smaller companies—those with a public float of less than $75 million—to postpone say-on-pay and frequency votes until annual meetings on or after January 21, 2013. This temporary exemption does not apply to golden parachute votes.

For frequency votes, the USPX recommends shareowners vote for annual say-on-pay votes. We recommend that they vote against all golden parachute payments. The rest of this document recommends guidelines for say-on-pay voting.

Each corporation's say-on-pay vote applies collectively to the compensation packages of all "named executives". These are a corporation's CEO and most highly paid executives. The compensation packages are described in the corporation's proxy materials, which are issued in advance of each annual meeting. You can access proxy materials on-line through the company's investor relations website, the SEC's EDGAR database or at MoxyVote.com.

Proxy materials provide much information. For say-on-pay, narrative of compensation, data tables, and Compensation Discussion & Analysis ("CD&A") sections are all relevant. Mostly, they provide a qualitative narrative, but they are required to include a table with actual numbers. Called the Summary Compensation Table, this indicates an actual dollar value for each component of compensation received by each named executive in the prior year. The SEC specifies valuation methodologies for each form of non-cash compensation. Figures are summed for each named executive to give total compensation figures for the year.

Section 953(b) of Dodd-Frank mandates the SEC amend its executive compensation rule (Item 402 of Regulation S-K) to require disclosure of the:

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[7]Say on Pay Final Rules. http://www.sec.gov/rules/final/2011/33-9178.pdf

1. median total annual compensation paid to all employees other than the chief executive officer;

2. the total annual compensation paid to the chief executive officer; and

3. the ratio between these two amounts.

The SEC has scheduled this rulemaking for later this year, with hopes that it will take effect prior to the 2012 proxy season. However, corporate interests are lobbying to have this provision revoked. Congress is considering legislation to do so.[8]

Cutting the Gordian Knot With Ex-Post Assessment

Dodd-Frank envisions shareowners voting on pay packages ex-ante—for the upcoming year. This means they won't be voting for dollar figures but for compensation schemes, which are a convoluted mix of base pay, possible bonus payments, equity grants, equity options, retirement benefits, severance arrangements, tax gross-ups and perks, such as personal use of corporate jets. To these are added mind-numbing vesting requirements, restrictions, performance hurdles and clawback provisions that supposedly align executives' interests with those of shareowners. Descriptions of such pay packages can run for pages of impenetrable prose. Any reasonable assessment would require at least a spreadsheet model to perform "what-if" analysis to determine the magnitude of executive compensation under various scenarios for the firm's stock price and other "performance metrics" to which compensation is linked.

Christoph Pereira, deputy general counsel at General Electric, helps write GE's annual pay disclosures, but he jokes about standing over a trash can when reading proxies for the other stocks he owns. "The last thing I want to read is a 40-page proxy full of algorithms or a Kafkaesque description of process", he says. "In the Twitter age, people want to know: Is this a good number based on what you've done for me lately?"[9]

With say-on-pay, Dodd-Frank has handed shareowners a Gordian Knot. If they can untangle it, they may have a tool to put the breaks on out-of-control executive compensation. But how to untangle it? How should retail investors and institutional investors who lack the resources of the largest institutions assess executive compensation packages? The USPX advocates a simple solution: shareowners can base say-on-pay voting decisions, not on the convoluted pay packages boards propose for the upcoming year, but on the dollar value of total compensation reported in the Summary Compensation Table for the past year. That number provides a simple and accessible metric on which to base voting decisions. With this approach, shareowners will essentially tell boards "we can't hope to assess the convoluted pay packages you propose, but based on last year's total compensation, we think your approach to compensation is" … "reasonable" or "unreasonable". This will be meaningful feedback—arguably the most

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[8]See H.R.1062—Burdensome Data Collection Relief Act at http://thomas.loc.gov/cgi-bin/query/z?c112:H.R.1062:
[9]A Chance to Veto CEO's Bonus, *The Wall Street Journal*, January 29, 2011. http://online.wsj.com/article/SB10001424052748703399204576108680208010522.html

reasonable feedback most shareowners can hope to give. But the approach may raise some concerns, which we shall now address.

One possible concern might be that this is inconsistent with the intent of Dodd-Frank. Congress envisioned shareowners voting on pay packages ex-ante, so why should they be voting on them ex-post? The obvious answer is that Congress and boards serve citizen-shareowners and not the other way around. Congress, through the drafting of Dodd-Frank, and boards through the drafting of impenetrable compensation packages, have set shareowners an impossible task. It is as if they asked shareowners to jump 100 feet in the air. Rather than ignore such an absurd request, we are recommending that shareowners do something similar but possible. Maybe they can jump two feet in the air.

Another possible concern is that good compensation packages may be voted down. The most likely scenario is of a board that pays a CEO lavishly one year but proposes a more reasonable compensation package the next year. If shareowners base their say-on-pay voting decisions on the previous year's compensation, they may vote down the new, more reasonable package. The obvious solution to this is communication. Boards need to understand that shareowners are approving compensation packages ex-post, and there will be a year's delay between any board proposing a reasonable compensation package and shareowners acknowledging it in their say-on-pay votes.

A third possible concern is that voting decisions based on the dollar value of past compensation cannot reflect—and hence will be silent on—whether or not a proposed compensation package appropriately aligns executive compensation with performance. Our voting guidelines do not attempt to make such assessments, focusing on the more important issue of the overall level of compensation. While it is not the purpose of this document to debate the merits of "pay for performance" schemes, we question their legitimacy. While pay for performance may be an admirable ideal, implementation to date has enriched executives with no discernible benefit to shareowners. Nevertheless, our guidelines can be integrated with assessments of the structure or incentives of a compensation package. Later in this document, we will describe such integration. We emphasize, however, that only the largest of institutional investors are likely to have the resources to make additional, qualitative assessments.

Ratio Tests for Say-on-Pay Voting

The first of the two say-on-pay tests we recommend is a ratio test based on the ratio of executive compensation to median worker compensation.

At the turn of the 20th Century, legendary financier J.P. Morgan thought the ratio of CEO to average worker pay should not exceed 20. In his book *Managing in the Next Society*,[10] management guru Peter Drucker concurred: "I have often advised managers that a 20-1 salary ratio is the limit beyond which they cannot go if they don't want resentment and falling morale to hit their companies."

[10]2002, p. 150

When and if the Dodd-Frank mandate that corporations disclose the ratio of CEO to median worker compensation goes into effect, shareowners can use that ratio in making say-on-pay voting decisions. They will simply vote against any corporation's pay package if that ratio exceeded a specified value.

In the interim, the USPX is proposing an alternative ratio that shareowners can calculate on their own. For any corporation, this has the dollar value of the highest paid executive's total compensation (found in the Summary Compensation Table) in the numerator and the Bureau of Labor Statistics (BLS) national median annual wage in the denominator. If the ratio exceeds a specified threshold, vote no on say-on-pay at that firm.

The BLS reported the 2009 national median annual wage as $33,176.[11] To apply a ratio test in 2011, first decide on a threshold value you think is reasonable. Then refer to the Summary Compensation Table in a corporation's proxy materials. Identify the executive that received the highest total compensation. Usually, this will be the CEO. Divide that person's total compensation by $33,176. If the result exceeds your threshold value, vote "no" on say-on-pay for that firm.

What is a reasonable threshold value? The USPX takes no stand on this issue. Each shareowner should settle on a threshold he or she thinks is reasonable. Shareowners could follow the lead of J.P. Morgan and Peter Drucker and adopt a threshold of 20. That would have them voting against virtually all compensation packages, at least at medium or large firms. As discussed in the next section, median CEO compensation at large firms in 2010 was $9 million, so a threshold of 270 would have shareowners voting down compensation packages at about half of large corporations. A threshold of 450 would ensure a "yes" vote on most compensation packages.

Median Tests for Say-on-pay Voting

A shortcoming of ratio tests is their dependence on a threshold value whose selection may seem arbitrary. If shareowners believe executive compensation is out of control and want to vote down compensation packages at many firms, a simple alternative is to vote against compensation packages at any firm where a named executive earned more than the median CEO compensation in the past year.

In 2010, median CEO compensation for S&P 500 corporations was $9 million.[12] Shareowners can use that figure to apply a median test in 2011.

A shortcoming of the median test is that it is not a sustainable way to assess executive compensation for the long-term. If widely adopted, over many years, it would tend to drive executive compensation ever downward. A ratio test, by comparison, will tend to drive

[11] At http://www.bls.gov/oes/2009/may/oes_nat.htm#00-0000, the BLS reported for 2009 a $15.95 median hourly wage and 2,080 average hours worked. Multiplying, we obtain $33,176 as an estimate for median annual wage.
[12] Source: Equilar. Analysis draws on recently filed proxy data for 303 chief executives at 302 companies in the S&P 500. All companies studied have had CEOs in place for at least two full years. By selecting only incumbent CEOs, the study avoids distortion from new-hire awards and more accurately tracks year-over-year changes in compensation. The companies included in this report ended their most recent fiscal year between June 30, 2010 and January 31, 2011.

compensation downward only while the ratio of executive to average worker compensation remains above a chosen threshold. It is for this reason we are offering shareowners the choice between a ratio test or median test.

Another problem with a median test is that, with it, shareowners will still be voting to approve half of compensation packages even though those packages may be excessive. A solution to this problem is to adopt a percentage-of-median test. For example, shareowners might base their voting decisions, not on median CEO compensation, but on, say, 75% of median CEO compensation. What percentage is reasonable? The USPX does not take a position on that.

Abstaining Is an Option

If shareowners decide against voting "no" on say-on-pay for a particular firm, this does not mean they must vote "yes". They can always abstain. We leave the decision to shareowners. Some may adopt a policy either of always voting "yes" or always abstaining in this circumstance. A better approach is to decide on a case-by-case basis. Shareowners can modify one of our tests to aide them in doing so. To use the ratio test as an example, a shareowner might vote "no" on say-on-pay if the ratio of executive-to-worker compensation exceeds 100, abstain if it is between 20 and 100, and vote "yes" if it is below 20.

Caution: Leaving a ballot item blank is not the same as abstaining on that item, at least not in corporate elections. Corporations treat a non-vote as granting them discretionary authority to vote that item as they see fit. To abstain on an item, you must physically select the box marked "abstain".

Coordinated Voting for Compensation Committee Members

No matter how you vote on say-on-pay—"yes", "no" or "abstain"—we recommend you cast an identical vote for each member of the compensation committee. A list of compensation committee members can be found in a firm's proxy materials.

This policy reflects the fact that, even before say-on-pay, shareowners had the ability to express an opinion on a firm's executive compensation practices. If they didn't like those practices, they could vote against members of the compensation committee. Actually, voting against compensation committee members is more effective than voting "no" on say-on-pay. Because it threatens committee members' seats on the board, it will gain more attention.

Abe Friedman, former global head of corporate governance and responsible investing at BlackRock and Barclays Global Investors, argues that voting out five compensation committee chairs and putting their pictures in the *Wall Street Journal* will accomplish more than say-on-pay votes granted by Dodd-Frank.[13] We agree. Executive compensation is in crisis. Shareowners need to increase the pressure on boards, and they can do so by voting against *both* say-on-pay and compensation committee members.

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[13] Video: *Abe Friedman on CEO Pay*, http://corpgov.net/?p=6249

Company Size

Executive compensation correlates with company size. This is especially true at the CEO level. For example, we have already indicated that median CEO compensation at large firms was $9 million in 2010. At medium and small firms, comparable numbers are $4.3 million and $2.2 million.[14]

In their current forms, our proposed ratio and median tests are designed to address excessive compensation at large corporations. This is especially true of the median test, which is based on median CEO compensation at large corporations. The tests can be applied to corporations of any size. However, they will indicate "no" votes at fewer small and medium sized corporations.

We anticipate that future releases of the tests will incorporate adjustments for firm size. In the mean time, we encourage shareowners to experiment with their own adjustments and report the results to us. We will consider such results in our design of future versions of the tests.

Integrating Other Analyses

The purpose of the USPX voting guidelines is to identify compensation packages that should be rejected based only on their size. Rejected packages are deemed so large as to be unacceptable irrespective of the firm's performance, executives' perceived contribution, or any other factors. Accordingly, the mere fact that a package is not rejected by one of the tests does not mean it necessarily deserves a "yes" vote. For shareowners without the means to perform additional analyses, we recommend a "yes" vote for such packages only because, in the absence of a justification for doing otherwise, a "yes" vote seems reasonable.

Only the largest institutional investors are likely to have the means and ability to perform additional analyses, but we encourage them to do so. These might identify unique circumstances at a firm; take into account performance at the firm; or assess incentives built into compensation packages. Such additional analyses should be applied only to packages that were not screened out by one off our tests. The goal should be to identify packages that deserve a "no" vote based on criteria other than absolute magnitude of compensation.

Contact Information and Credits

We welcome feedback, which we will incorporate into future versions of these guidelines. Please send comments to contact@proxyexchange.org, and put "Say-on-Pay Guidelines" in the e-mail subject line. Letters will be posted to the USPX website, unless you indicate you would rather remain anonymous.

This document was prepared by a drafting committee of USPX members: Brett Davidson, Glyn Holton, Jim McRitchie and Steven Towns. It reflects discussions with individual and institutional investors. We thank Equilar for their help providing compensation data.

[14]Source: Equilar. The result for medium sized firms draws on recently filed proxy data for 265 CEOs at 262 companies in the S&P 400. The result for small firms draws on recently filed proxy data for 385 CEOs at 383 companies in the S&P 600. All companies studied have had CEOs in place for at least two full years.