The Compensation of Senior Executives at Listed Companies

A Manual for Investors

CFA INSTITUTE
Centre for Financial Market Integrity

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Introduction

In the financial world, concern about executive compensation typically is limited to whether or not rewards directly correspond to results created by management's decisions or actions. Of equal importance, however, is whether the board of directors or supervisory board (interchangeably referred to as the "Board") of a company (the "Company") has devised a remuneration plan that induces management to act in a manner that is consistent with the interests of shareowners ("Shareowners"). Complete definitions can be found in Appendix B.

For the most part, Shareowners and investors ("Investors") have only the regulatory disclosures mandated in their regions to answer these questions. Although these disclosures have improved in recent years, there is still very little guidance available to help Investors understand how Boards develop and decide on compensation systems for the individuals hired to manage these Companies. With access to more clear and concise guidance, Investors may better determine for themselves whether a Company's compensation process and executive remuneration packages are appropriate. They also may acquire a better understanding of the types of management incentives being created.

The Compensation of Senior Executives at Listed Companies: A Manual for Investors seeks to give Investors the guidance they need to make those determinations about executive compensation. As a supplement to *The Corporate Governance of Listed Companies: A Manual for Investors*, introduced by the CFA Institute Centre for Financial Market Integrity in 2005, this new manual is intended to build awareness of how executives are paid and describe the governance structures that help set compensation plans within Companies. Ultimately, the goal of this manual is to assist Shareowners to make reasoned analyses as to whether the compensation arrangements and strategies used to pay senior managers are fair, transparent, and performance based as well as designed to provide long-term benefits.

The manual is structured in two parts: The first outlines some common corporate governance structures instrumental in setting compensation and describes the purpose and implications of each; the second considers the principal elements of executive remuneration commonly used in most jurisdictions. The second section also describes the reasons each compensation element is offered, how it may influence the actions and decisions of Company managers, and the factors Investors should consider with regard to each. Appendix A provides resources for further study.

This manual does not attempt to describe what Companies should pay senior executives or directors, nor does it seek to give Investors formulas to determine how much to pay specific executives. Rather, the manual takes the perspective that the pay of senior executives is a matter for individual Shareowners to consider on a case-by-case basis. The manual is intended to provide an added metric to their assessment of whether Company board members ("Board Members") are properly monitoring the executive compensation process.

Greater Focus on Compensation Issues

The manual and the specific focus on executive compensation have come about for a number of reasons. First, the growth in executive pay in recent decades has made it incumbent on Shareowners and Investors to understand how much and in what manner Companies are paying senior management.[1] Second, increasingly complex methods used to remunerate these individuals—including cash-based salaries, deferred bonuses, share-based rewards, postretirement benefits, and perquisites—make it more difficult than ever for Investors to fully understand the range and combination of the elements of compensation. Finally, recent changes to the disclosure rules associated with executive compensation have enhanced transparency of such plans, making relevant information more readily accessible for Investors.

[1]A study by Bebchuk and Grinstein (2005) found that the aggregate pay of the five highest-paid executives at U.S.-listed Companies amounted to about 10 percent of those Companies' aggregate earnings. A contrarian study by Gabaix and Landier (2006) suggests that the six-fold increase in CEO pay between 1980 and 2003 was primarily a reflection of the growth in market capitalization of large U.S. Companies over the same period.

Greater scrutiny of Companies as a consequence of their payments to senior executives can affect the reputation of a Company and its officers and directors.[2] Thus, Shareowner value is put at risk if executive compensation awards are perceived to be extraordinary or believed, in rare instances, to be the result of fraud.[3]

Such concerns were highlighted recently when nearly 150 Companies faced formal regulatory scrutiny for the backdating of stock option grants. The personal toll of this matter a year later is that dozens of senior executives and directors have been relieved of their duties, many with prohibitions against ever again taking similar positions at listed Companies. Several individuals also now face criminal prosecution and possible incarceration. On a larger scale, a number of Companies missed quarterly reporting deadlines as a result of the uncertainties caused by backdating, potentially endangering exchange listings and further impairing Shareowner values.

Target Audience for This Manual

This manual is intended to be globally applicable and discusses elements of executive compensation common to all jurisdictions. The discussion is based in many cases on disclosures required by the U.S. Securities and Exchange Commission (SEC) as a starting point for two reasons: First, the relative level of disclosure on executive compensation matters required by the SEC is generally equal to or greater than the transparency required on such matters in most markets; and second, the compensation of senior managers at public Companies in the U.S. market continues to be particularly controversial. In certain cases, compensation levels are multiples of average executive compensation in other markets, thus necessitating greater transparency.

Moreover, the SEC's disclosure requirements for executive compensation were greatly expanded by new rules approved in 2006.[4] These new rules require consolidation of information that Companies already were required to disclose but with improved organization and detail about compensation elements that previously were difficult to track and understand. The new rules also require enhanced descriptions of the rationale used in awarding compensation packages to senior executives. Consequently, the information provided under this new format is, in principle, designed to be more transparent and understandable than in the past. The goal is to make executive compensation disclosures more relevant to and comprehensive for Investors.

The CFA Institute Centre for Financial Market Integrity provides this manual to serve as a resource to help Investors better understand and analyze complex executive compensation plans. It is hoped that with the help of this manual, Investors will have the tools to monitor Companies and Boards for their compensation practices and thus encourage compensation that is commensurate with the level of performance the Company (and its executives) has achieved.

[2] A study by Perry and de Fontnouvell of the Federal Reserve Bank of Boston (2005) indicates that internal fraud events lead to market value declines that are twice as significant as those that occur as a result of external events.
[3] Also see Heron and Lie (2006).
[4] After approving new disclosure rules in August 2006, the SEC amended them prior to introduction, changing the requirements for reporting of stock option grants in the Summary Compensation Table. The final rules require disclosure of just that portion of the current grant and any previous grants that vested in the current year. The original version of the rule required disclosure of the fair value of the full stock option grant in the year of grant; this disclosure remains a required disclosure in a supplementary table.

Governance of Executive Compensation

Companies adopt governance structures to help Shareowners protect their interests from the potentially conflicted positions of senior managers and Board Members. Whereas these governance structures do not permit Shareowners to micromanage a Company in which they have invested, the structures can help Shareowners provide oversight, principally through their voting rights. To vote effectively, however, Shareowners need certain information, such as which Board Members are crafting the compensation plans for executives, what the structure is for determining executive pay, and how those structures have worked in the past.

In the section that follows, we describe the principal governance structures related to executive compensation and illustrate how those structures may influence the methods used to pay senior management.

Compensation Committee

Investors should determine whether the committee established by the Board to oversee executive compensation is independent of the influence of executive management.

Purpose—The compensation or remuneration committee (the "Committee") is responsible for determining both the amounts paid and methods used to pay senior executives. As part of this role, the Committee is entrusted with ensuring that compensation agreements encourage management to align its interests with those of all other owners in the Company.

Implications for Investors—Members of the Committee, like all Board Members, are representatives of the Shareowners of the Company. Therefore, they have a duty to be loyal to Shareowners, behave competently on their behalf, and act in their best interests. If the Committee fails in this task, the Shareowners' primary method of reprimanding them is in the vote for Board Members at each Company's annual general meeting. In some jurisdictions, Shareowners are permitted to submit a nonbinding vote to approve or reject the overall compensation package (please see "Shareowner Approval of Compensation Plans" below).

Investor considerations—Compensation structures that reward long-term profitability and long-term, sustainable growth in Company value are typically considered better for Shareowners than those structures that reward short-term gains in profitability and market value.

To determine whether the compensation Committee is meeting this standard, Investors should:

- Review the Committee's policies and procedures to determine the relative independence and budget authority it has been accorded.
- Pay close attention to the composition of the Committee. A Committee including only outside Board Members without ties to either management or an insiders' group is more likely to devise a compensation package that seeks to align the interests of senior executives with those of Shareowners.[5]
- Review the background of Committee members to determine whether they hold positions at other Companies that may benefit from an increase in compensation for the firms on whose Boards they sit.

[5]See Matsumura and Shin (2006), who found that the "larger the fraction of outside directors appointed by the CEO, the higher CEO pay is."

Compensation Consultants

Investors should determine whether consultants hired by the Board to help develop a compensation plan have any conflicts of interest that may influence the advice they provide.

Purpose—Committees often call on consultants to provide information about how much and in what manner senior executives in similar positions at other Companies of comparable size are paid. These consultants also provide Committee members with updates on changes to tax laws and accounting rules to help them understand how to structure compensation that both rewards management and produces results for Shareowners.

Implications for Investors—Although compensation consultants provide a valuable service to the Committee, their advice and counsel may be conflicted by outside considerations.

Investor considerations—In reviewing the influence of compensation consultants, Investors should determine:

- Whether the charter for the Committee gives it budgetary authority to retain, terminate, and pay independent consultants. If so, it would indicate that the Committee has a higher degree of independence from management on such matters than a Committee that does not have such authority. It also would indicate that the consultants will recognize that their allegiance is solely to the Committee rather than to management because their services are not paid or influenced by Company executives.
- Whether the consultants are also consulting for management. If so, it could create a conflict of interest and thereby influence their work on behalf of the Committee. Investors should evaluate the type(s) and scope of management services a consultant provides in order to gauge the consultant's independence on compensation matters.
- How the consultants are paid. If they are paid on the basis of a retainer, that could provide reasssurance that the consultants are not encouraging increases in executive compensation to boost the overall value of their own contract. In extreme cases, using executive pay as a factor in determining the consultant's compensation could create a conflict of interest and encourage the consultant to recommend a level of executive pay unsupported by performance or convention.

Shareowner Approval of Compensation Plans

Investors should take advantage of both binding and nonbinding voting mechanisms to register their views on the acceptability of executive compensation plans and senior management pay.

Purpose—Boards that must submit proposed executive compensation packages for review have shown greater concern for creating packages that are acceptable to Shareowners.

Investor considerations—Since the 1990s, the NYSE and the NASDAQ have required listed Companies to submit stock option plans to Shareowners for a vote.[6] In part, this rule recognizes the importance share-based compensation has achieved in executive compensation packages. According to Equilar Inc., an executive-compensation benchmarking company, share-based pay accounted for 59.5 percent of the total pay received by S&P 500 chief executives in 2006.[7]

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[6]Cheffins and Thomas (2001, p. 27) cite New York State business corporation law as also requiring Shareowner approval of stock option plans. To gain tax deductibility under Internal Revenue Code (IRC), section 162(m), "qualified performance based compensation" must be paid based solely on the attainment of one or more preestablished, objective performance targets that are based on goals approved by the Company's Shareholders and that are reratified every five years.

[7]Equilar Inc., summary data on Standard & Poor's 500 CEO Compensation.

Regulators in the United Kingdom, Australia, and the Netherlands have taken this regulation a step further by requiring Companies listed in their respective jurisdictions to submit executive compensation plans to Shareowners for a vote. These votes are nonbinding in the United Kingdom and Australia but binding in the Netherlands.[8] A number of Companies in the United States and Switzerland have voluntarily followed suit by adopting similar nonbinding voting procedures.

In general, these votes are seen as beneficial for Shareowners; many Boards have used such mechanisms to open a dialogue on how, and how much, senior executives should be paid.[9] In reviewing such voting mechanisms, Investors should:

- Determine whether Company Board Members are elected by majority vote or by a plurality vote. The nonbinding votes in the United Kingdom and Australia may owe their success to a majority vote standard for Board Member elections. Most U.S. Companies have a plurality vote system, whereby a Board nominee is elected if he or she receives the most votes, including a minority of votes cast in an uncontested election. Nevertheless, more than 180 U.S. Companies voluntarily adopted some form of majority vote during the 2006 proxy season.[10]
- Determine whether Shareowners have a binding vote on share-based plans that require increasing the number of shares outstanding and review and analyze any proposed plans prior to voting.[11]
- Research the degree of Company ownership held by institutional Investors.[12]

Compensation Discussion and Analysis

Investors should carefully review the compensation report of listed Companies, particularly focusing on understanding the Board's compensation strategy and whether it is consistent with generating long-term, sustainable growth in profitability and market value.

Purpose—The purpose and content of compensation reports vary by market, although in Australia, the United Kingdom, and the United States, they specifically address pay for individual executives and Board Members and the Board's remuneration strategies. In the United Kingdom, a Board Member or the Company secretary must sign all copies of the reports (the "Directors' Remuneration Report to Shareholders") circulated on behalf of the entire Board. In the United States, the report (contained in the annual proxy statement under the heading "Compensation Discussion and Analysis," or "CD&A") must be recommended by the Board and is thus considered "filed" by the SEC, exposing senior management to the risk of criminal penalties for supplying false information.

The CD&A in the United States includes both a narrative discussion of executive compensation matters and a tabular presentation of the different elements of that remuneration. Because of the high degree of transparency incorporated into the new CD&A disclosures, we discuss its two parts in greater detail below.

Narrative discussion of compensation

In this section, the Board describes its strategy and methodologies for paying senior executives as well as discusses the outcomes it hopes to achieve as a result of this strategy. The discussion details employment contracts the Company has signed with senior executives, the kinds of incentives offered, and the performance that will trigger those incentives.

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[8]Institutional Shareholder Services (2007a, p. 6).
[9]New Bridge Street Consultants (2006a) shows that growth in executive compensation in the United Kingdom declined to around 8 percent after growing at twice that rate prior to the introduction of the nonbinding vote.
[10]Institutional Shareholder Services (2006c).
[11]*Delaware Code*, title 8, chapter 1, "General Corporation Law," subchapter 8, section 242.
[12]Hartzell and Starks (2003) found that the higher the holdings of institutional Investors in a Company, the more likely it is that executive pay will be based on performance.

Companies are required to discuss in general terms what benchmarks they use to determine how much executives are paid. However, Companies are not required to disclose benchmarks that are based on products or services under development or that would reveal proprietary information about operational or organization matters of the Company.[13] Consequently, Shareowners may have difficulty identifying and evaluating the mechanisms that determine how much, and under what circumstances, senior executives are ultimately paid. Indeed, it may be impossible to make such an analysis given a lack of key information about performance objectives and award thresholds used within compensation plans.[14]

When reviewing the CD&A, Investors should pay particular attention to the following matters:

Compensation policy—Investors should review the Committee's discussion of rationale for the mix of salary, bonus, share-based compensation, long-term incentives, and perquisites chosen for senior executives.

Share ownership requirements—Some Companies require senior executives and Board Members to personally own and hold shares of the Company. Such requirements may represent a percentage or a fixed amount of compensation for executives. Investors should pay specific attention to the manner in which ownership is acquired—through open-market purchases using the individual's own wealth or through the exercise of stock option awards. They also should review the period of time over which the executives are required to hold the shares. These requirements often are viewed favorably by Investors because they indicate that executives and Board Members have invested personal resources in the Company.[15]

Holding period requirements—Companies that issue share-based compensation may or may not require senior executives and other employees to hold the shares for a specified period of time after the options are exercised. Investors typically support requirements for executives to hold shares after exercise because they are seen as causing management to make decisions and take actions with consideration for their effect on share values and long-term Company performance.

Other benefits—The new tabular presentation (discussed in more detail later) allows Investors to know what Companies award their senior executives in the form of pensions, perquisites, and severance. Investors should review the major terms of such compensation and consider how it may affect executive perspectives and performance.

CEO pay compared with compensation of other senior executives—A comparison between the compensation awarded to the CEO and that awarded to other senior executives in the same Company can provide Investors with insight into the strength of the management team. If the CEO receives a significant portion of the Company's total executive pay, it could lead to succession issues or other potential managerial problems.

Other potential postemployment payments on termination or change of control—This portion of the narrative discussion of postemployment compensation (sometimes presented in a table) includes information about the amounts that the highest-paid named executive officers (NEOs) will receive after voluntary or involuntary departure.[16] The discussion should include information about salary continuation or severance; benefits or perquisites; planned and enhanced pension benefits; and benefits from accelerated vesting of stock options, stock-appreciation rights (SARs), and other share-based benefits. The discussion also is intended to include disclosure of the circumstances that trigger such payments, the manner in which such payments will be made, material obligations of the recipient, and how payments are determined.

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[13]SEC regulation S-K, executive compensation reg. 229.402, item 402(e) and item 402(k).

[14]The State Board of Administration of Florida (2007) states in its white paper that performance objectives should be identified and defined for Shareowners. In addition, the SBA recommends that Companies disclose the explicit award thresholds as well as the proportion of incentive compensation tied to proprietary performance objectives.

[15]The State Board of Administration of Florida (2007) developed a model ownership and retention guideline that recommends that Companies annually disclose to Shareowners which directors and officers are not in compliance with the Company's stock ownership guidelines.

[16]Moody's Investors Service notes that Companies have provided this information three different ways: (1) a separate table for each NEO; (2) a table covering all NEOs; and (3) narrative nontabular disclosures.

Tabular presentation of compensation

Registered U.S. Companies must supplement the narrative discussion of executive compensation strategy (as described above) with tables that give Investors an easy-to-read and easy-to-understand presentation of different components of executive pay.

In total, these disclosures are to include seven separate tables. All but one disclose components of pay awarded over time to each listed Company's chief executive officer, chief financial officer, and the three next-highest-paid named executive officers. The table not related to NEO awards covers the compensation awarded to Board Members during the most recent year. A description of each of the seven tables and the information they provide follows.

Summary Compensation Table (SCT)—This table summarizes compensation awarded during the last three accounting years to each NEO in seven major compensation categories—salary, bonus, stock awards, option awards, nonequity incentive plan compensation, changes in pension value and nonqualified deferred compensation earnings, and all other compensation—as well as a total for all of the components.

The values reported for option awards in the SCT reflect only the amounts reported as an expense in the income statement under Financial Accounting Standard (FAS) 123(R). In general, this includes only that portion of the value of the option that vested during the most recent year. To determine the total value of all current compensation and future incentives awarded to each NEO during the year, Investors must replace the 123(R) values in the SCT with the total grant-date fair value of option awards found in the Grants of Plan-Based Awards Table (see below).

The "all other compensation" column discloses the amounts received by each NEO in the form of perquisites, tax reimbursements, discounted securities, termination plans, defined-contribution plans, insurance premiums, and other pay. Perquisites exceeding $10,000 must be identified separately in footnotes to the SCT, and the value of any such benefits worth more than $25,000 or 10 percent of total perquisites must be individually disclosed (some Companies make these disclosures in a separate table).

Grants of Plan-Based Awards Table—This table provides three primary categories of information about stock option grants, including:

- Option value—full fair value of option awards as of the grant date;
- Estimated future payouts—estimated value of threshold, target, and maximum future payouts of both non-equity- and equity-based incentive plans awarded to each NEO during the past year; and
- The number of shares involved—the threshold, target, and maximum future payout in number of shares under equity incentive plan awards as well as the number of shares underlying other stock awards and option grants.

Outstanding Equity Awards Table—This table summarizes the cumulative equity awards given and outstanding to each NEO. It provides summary information about:

- Outstanding option and stock awards granted to each executive;
- The number of shares underlying those awards;
- The exercise prices and expiration dates of the option awards; and
- The market value of both vested and unvested stock awards, although it does not provide market values for the outstanding stock option holdings of each NEO, leaving it to Investors to calculate the value of those awards outstanding from prior years.

Option Exercises and Stock Vested Table—This table specifically discloses those option and stock awards that NEOs exercised during the past year. The number of shares acquired on exercise of option awards or vesting of stock awards is disclosed along with the value realized.

Pension Benefits Table—This table provides details on the cumulative postretirement benefits that each NEO has accrued with the Company. The information provided includes the plan name, the number of years of credited service, the present value of the accumulated benefit, and the payments made by the Company during the last fiscal year.

Nonqualified Deferred Compensation Table—This table describes those elements of compensation that are related to pay that is deferred (typically tax free) by the executive until retirement. It discloses the relative contributions of both the executive and the Company during the last year, a summary of the aggregate earnings of the fund during the last year, a description of any withdrawals or distributions made during the last year, and the aggregate balance outstanding at the latest fiscal year-end.

Summary Director Compensation Table—This table provides much of the same information about Board Members as the SCT provides about NEOs—fees paid to the Board Member, stock and option awards, nonequity incentive plan compensation, changes in value of pension and nonqualified deferred compensation earnings, all other compensation, and total compensation for the year—except that the directors' table covers only the prior year.

Investor considerations

When reviewing a Company's compensation report, Investors should:

- Familiarize themselves with the major elements of the employment agreements between Companies and senior executives. U.S. Companies typically include these agreements in their annual proxy statements in the year the agreements are adopted, although further discussion on such matters may also be found in the new CD&A. When reviewing such agreements, Investors should consider four key elements:

  Contract term—Increasingly, Companies are moving toward shorter-term contracts or no contracts at all with their CEOs. In Australia, for example, employment agreements typically last no more than two years and increasingly contain no fixed term. Contracts in the United Kingdom typically cover no more than one year, and CEOs at a number of high-profile U.S. Companies, including ExxonMobil Corp., Pfizer Inc., Citigroup Inc., and Bank of America, no longer have employment contracts.

  Severance terms—If included, these terms outline what the NEOs would receive on departing the Company, including such cases as when the executive is dismissed "for cause." It also should indicate whether the metrics that determine severance amounts are objective.

  Accelerated vesting—The contract should state whether the vesting of stock option awards, pensions, or other deferred compensation accelerates in the case of a change of control.

  Change-in-control triggers—The contract should indicate whether change-in-control provisions are triggered solely by a change in ownership or whether additional developments, such as a loss of employment for the executive or a substantial change in job duties, are needed to activate the severance package.
- Determine if the Company has a succession plan for its CEO.[17]
- Review, in U.S. disclosures, all elements of an executive's compensation package and not just the summary total number. Review of the different elements of pay will provide information such as the following:

  Stock option grants—The fair value of all stock option grants awarded to NEOs during the past year, together with the grant dates and exercise prices for those awards (found in the Performance-Based Awards Table); and

  Outstanding equity awards—The cumulative outstanding equity awards held by NEOs as shown in the Outstanding Equity Awards at Fiscal Year-End Table. This table will alert Investors to the degree of dilution they can expect in the future as a consequence of executive compensation.
- Review the narrative portion of the CD&A to understand how pay will be determined in the future.

[17]Institutional Shareholder Services (2007a) notes that "many experts see better succession planning as the antidote to excessive executive compensation."

- For German Companies, determine whether their Shareowners have waived the requirements to fully disclose the fixed and variable components of individual remuneration for senior executives as well as severance arrangements with both senior management and Board Members.[18]

Share Ownership Disclosures and Discussion

Investors should review disclosures about the current and cumulative awards of share-based compensation granted to senior executives and Board Members and the share holdings of significant insiders to determine the degree of control each group has over the affairs of the Company.

Purpose—These disclosures are intended to give Investors an understanding of both the degree to which management is vested in the welfare of the Company and the manner in which that ownership is created. They also give Investors information about who the significant owners of the Company are, permitting them to determine whether an owner's presence may affect the Board's independence.

Implications for Investors—The required disclosures relating to share ownership issues cover three primary topics: (1) ownership by senior executive officers and related family members; (2) ownership by Board Members and related family members; and (3) ownership by other insiders, such as significant Shareowners, cross-ownership agreements, or so-called golden shares that give their owners—often governments—a percentage of the votes disproportionate to their financial investment in the Company.

Investor considerations—When reviewing these disclosures, Investors should:

- Determine whether senior executives own shares in the Company. Investors believe that such ownership makes it more likely that management will adopt a perspective similar to that of other Shareowners.
- Review the share ownership disclosures about Board Members to determine whether they have interests that are similar to those of the Shareowners they represent. These disclosures should also indicate the manner in which these individuals acquired their interests—whether as part of a personal investment, as part of a required share-purchase program, or through a Company-sponsored stock option program.

Related-Party Transactions

Investors should investigate whether the Company has outside business relationships with members of the Board, executive management, or other insiders because these relationships may affect the pay awarded to senior executives.

Purpose—Companies often have relationships with individuals who serve as Board Members. In many cases, these relationships are useful because these individuals have special skills, such as legal or financial expertise or knowledge about supplier relationships, that the Board and senior management can draw on.

Implications for Investors—Although potentially useful to Companies, the existence of business relationships between Board Members and management or between Board Members and significant insiders could indicate the existence of conflicts of interest for the loyalties of the affected Board Members. In particular, a conflict of interest could impair the judgment of such Board Members as it relates to executive compensation.

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[18]Institutional Shareholder Services (2007a) reports that German Companies can waive these requirements for up to five years if three-quarters of the Shareowners attending the annual general meeting vote against making such disclosures. In the first half of 2006, 94 Companies received Shareowner exemptions from disclosures, in large part because each of the Companies involved had a single large Shareowner or Shareowner group that had a controlling stake in the Company.

Investor considerations—When considering the implications of related-party transactions, Investors should, at a minimum, determine:

- Whether the Company has an ethical code and, if it does, determine whether that code covers the extent to which Board Members are permitted to engage in business activities with the Company.
- Where available, the existence and magnitude of related-party transactions and the number of parties involved in them in the most recent fiscal year.[19]

[19]French Companies are required to obtain an auditor's special report on related-party transactions and submit the report to Shareowners for approval at the annual general meeting. Related-party information is required by U.S.-listed Companies in the new proxy disclosures.

Elements of Compensation

The differences in the way Companies pay their senior executives reflect the diverse priorities of individual Boards, the business models of individual Companies, and the various approaches that senior executives take to achieving long-term growth in earnings and market value. Nevertheless, the means used typically share elements, including traditional cash-based salary and bonus; noncash perquisites; share-based awards—including stock options, grants of shares, and Stock Appreciation Rights—and postretirement benefits, such as pensions, deferred compensation, perquisites, and severance packages.

In the following section, we consider these different elements and how they may influence management perspectives and, ultimately, investor returns. In the United States and Canada, Investors can find information about these elements in the annual proxy statements. In a number of other countries, including Australia, Germany, Hong Kong (for Companies listed on the stock exchange of Hong Kong's main and growth enterprise markets), and the United Kingdom, Investors should look to the audited financial statements for information about executive compensation.

Cash-Based Compensation

Salary

Investors should consider whether the nonperformance, cash-based elements of executive compensation are appropriate for the type of Company in question and the abilities of the executives involved.

Purpose—Salary is typically the base cost the Company must pay to retain the executive services of an individual for the position. In effect, it is the guaranteed portion of the compensation package and is not subject to performance-based variability.

Implications for Investors—Although salary is not based directly on the performance of the Company or the executive over a given period, it does reflect an expectation of performance from the executive. For example, Investors would likely be willing to provide a higher salary to an individual who has led Companies that have performed well than to someone whose tenure at a Company coincided with poor performance.

Investor considerations—When considering the appropriateness of the salary component of executive compensation, Investors should:

- Determine whether the mix of salary to performance-based elements of executive pay is appropriate relative to the type of Company in question and the performance of the executive.[20]
- Consider local tax laws. For example, U.S.-based Companies cannot deduct more than $1 million in non-performance-based cash compensation to any one employee for income tax purposes. As a consequence, salary typically does not constitute a significant portion of U.S. executives' overall pay.
- Determine whether executives have chosen to defer non-performance-based compensation. Such deferrals boost the value of postretirement benefits while limiting the immediate tax consequences for the Company. The Company would deduct the expense for the amount deferred (up to the $1 million maximum in the United States) but at a discounted rate equal to its assumed present value at the time of deferral. This reduces current compensation expense on the financial statements, although it creates a long-term liability for the Company in the amount deferred, which will grow until payment is made.

[20]Murphy (1998) found that U.S.-based executives receive a lower percentage of their total pay in the form of salary (32 percent) compared with executives in the United Kingdom (59 percent) and elsewhere.

Bonus

Investors should investigate how the Board determines bonus awards and whether the determinants reward outstanding performance.

Purpose—The purpose of a bonus—also referred to as a "variable cash incentive award" in some cases—is to reward employees for implementing Company principles and turning managerial know-how into superior Company performance. The metrics used to determine performance-based compensation, including bonuses, will vary according to the role the individual plays in the Company.

Implications for Investors—As share-based remuneration has become common, bonuses have become a less important component of performance-based compensation. Moreover, the link between bonuses and performance is blurred, and in a number of cases, bonuses are paid to senior executives even if the Company's performance has suffered. Often, the performance objectives and award thresholds are not disclosed to Shareowners.

Investor considerations—In general, bonus awards are determined by a measure of earnings growth beyond a specified target measure. For example, if the Board's target growth in earnings or cash flow is 5 percent and the Company grows by 8 percent, the Board may award a percentage of the incremental growth above the target to senior executives as a bonus.

Owing to the potential magnitude of the incremental gain in earnings that Boards may share with senior executives as bonus awards, Investors should:

- Determine whether the criteria and benchmarks that management must reach to share in the incremental growth in earnings are disclosed to Shareowners and, if so, determine whether those criteria are based on objective targets or are established by the Board. Objective performance-based goals may include growth in earnings, cash flow, or earnings per share that surpasses that of the Company's peers, exceeds its capital costs, and beats market expectations. Discretionary criteria may include such attributes as leadership skills.
- Check to see if the goals the Company uses to determine bonus awards are the same as those it uses to measure its overall performance in public statements, such as the annual report or quarterly earnings reports.
- Check to see if the goals the Company uses to determine bonus awards are similar to those it uses in long-term incentive compensation plans, which may create redundant and less efficient management incentives.
- Consider whether performance metrics rely solely on near-term growth in share price or on net income because such measures may lead some executives to influence the Company's financial reports to ensure their targets are met.
- Review whether senior executives and Companies have chosen to defer bonus awards and the effects such deferrals may have on compensation expense and long-term liabilities for the Company.
- Ascertain whether the Company has so-called claw-back provisions to recover performance-based compensation paid to senior executives on the basis of financial reports that are later restated.

Share-Based Compensation

Beginning in the early 1990s, performance-based compensation replaced non-performance-based cash pay at U.S. Companies as the primary component of total executive remuneration. In part, this shift was triggered by outcry over executive pay. Legislators responded by writing tax laws that penalized what were considered excessive salaries to senior managers while encouraging performance-based rewards, such as stock options. These legislative initiatives coincided with suggestions—from compensation consultants and academics—that Companies adopt pay strategies based on the issuance of stock options as a way to align the interests and perspectives of management with those of Shareowners.

Adding to the interest in stock options was a decision by accounting authorities to exempt out-of-the-money stock option awards from inclusion as an expense in GAAP-based financial statements. Therefore, increasing the option component relative to salary and bonus meant that a smaller portion of the cost of executive compensation would appear in Companies' income statements.[21]

There were two primary problems with these early efforts. First, most option plans were awarded based primarily on increases in share prices without distinguishing between growth created by management initiatives or a general rise in the market. Second, because the cost of stock option grants was not included as an expense on the income statements of issuers, Shareowners were left largely in the dark about true stock option costs.

The result was that senior executives often benefited, regardless of their own policies and actions. Also, Companies effectively underreported what they were paying their senior managers and, therefore, overstated net income. Moreover, some executives were able to take advantage of the inconsistency in reporting to post higher return ratios and thus receive even more options.

Ultimately, the cost of these accounting omissions was borne by the Shareowners, many of whom bought shares at prices inflated by overstated earnings. Adding to the costs, Shareowner interests were diluted by the issuance of additional shares to senior executives at discounted prices.

Recent research shows that poorly structured option plans did not, in fact, always encourage the types of decisions or behaviors that were expected of senior executives in the early 1990s. In some particularly egregious cases, senior executives were found to have manipulated and falsified the performance reported to Shareowners to produce an artificial increase in their Companies' share price. The false reports led to higher share prices that enabled executives to sell their securities at a significant profit over what might have occurred had the actual performance been reported.[22]

Increasingly, Companies and their Boards are altering the performance requirements for the vesting of their stock option and other share-based awards. Executives are judged not only by the share-price performance and profitability of their Companies but also against the results of their chief competitors. Moreover, Companies have revised the thresholds for performance-based awards to make very high compensation awards attainable only as the result of superior performance.

Another problem with these early plans is that stock option grants were sometimes backdated. Researchers began noticing a correlation between the dates on which stock option awards were granted to senior executives and the dates on which the issuing Companies' shares reached a periodic low point, making the early distortions of stock option awards even worse than initially believed.[23] It was eventually determined that some Companies had retroactively issued stock options to senior executives and Board Members to coincide with dates on which their share prices were at a low point without disclosing such information to the market. At least one Company dated the granting of its stock option awards to before the awards had been approved by its Board and Committee.

The purpose of this "backdating" in many cases was to enhance the returns of the recipients. However, when uncovered at 150 (principally U.S.) Companies, the practice was seen as taking advantage of other Shareowners and ultimately led to the dismissal of many of the

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[21]In 1993, CFA Institute, then known as the Association for Investment Management and Research, published a white paper, *Financial Reporting in the 1990s and Beyond*, in which we advocated strongly for the expensing of stock options; see pages 47 and 48. Companies, in contrast, argued that assigning a value to stock options was imprecise and, therefore, should not be attempted. This argument ignored the magnitude of such off-book expenses.
[22]Bebchuk and Fried (2005a).
[23]Heron and Lie (2006).

executives and Board Members involved as well as to the recall of some of the option awards. It also caused the SEC to launch a number of investigations into Companies thought to have engaged in the practice.

The extent of the backdating that occurred has caused the SEC to amend its executive compensation disclosures to require greater transparency about the grant dates of such awards. These disclosures, together with changes incorporated as part of the Sarbanes-Oxley Act of 2002, are expected to eliminate many of these types of abuses in the future.

Four other important changes since 2001 have helped reduce the occurrences of many of the most egregious problems involving stock option grant awards. First, accounting standard setters in most major markets have adopted rules requiring Companies to show the estimated cost of their stock option awards as an expense on the income statement. This change has had the effect of imposing greater transparency and, therefore, greater scrutiny of the aggregate cost of option-based compensation. Second, as a result of the more transparent accounting treatment of such awards, many Companies have switched from issuance of stock options to other forms of share-based remuneration.[24]

Third, greater regulator-mandated transparency of executive compensation matters, including share-based compensation, has increased Shareowner attention to the issue of executive pay. This change combined with the fourth change—permitting Shareowners to voice their opinion either on a nonbinding basis (as in the United Kingdom and Australia) or on a binding basis (as in the Netherlands) on whether the compensation awarded to senior management is acceptable—has helped to introduce greater discipline into executive compensation.[25]

The upshot of these changes is that senior executives are increasingly required to meet strict performance guidelines to fully monetize their pay packages. Although it is expected that these changes will lead to a better alignment of the interests of management and Shareowners, they are relatively new, and it will take time and further study before researchers will know for certain the results of such initiatives.

In the next section, the elements of share-based compensation are reviewed and analyzed. These elements include stock options, long-term incentive plans, SARs, and restricted shares.

Stock options

Investors should review and analyze the terms and conditions applicable to stock options granted to senior executives to determine what incentives underlie the plan and the potential payout of the awards.

Purpose—Stock options are issued to give employees and, in particular, senior executives an incentive to "act like owners" of the Company. The purpose of stock options is to guide employees toward behavior that will generate higher share values, thereby benefiting all Shareowners, including themselves.

Implications for Investors—The granting of stock options creates an expense that appears on the income statement of the Company, incrementally diluting the percentage of ownership of all other Investors. Boards issue stock options with the hope that aligning management's interests with those of Shareowners will produce expected gains in share price and cash flow, more than offsetting any attendant costs.

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[24]Just 38 percent of FTSE 100 Companies included stock option grants in their share-based remuneration plans during 2006, down from nearly 61 percent the year before. In contrast, long-term incentive plans providing either grants of whole free shares or the matching of executive share purchases were used by nearly 95 percent of FTSE 100 Companies during 2006, of which 59 percent were issued exclusively.

[25]New Bridge Street Consultants (2006a) estimates that the rate of growth in director pay for U.K. Companies declined to around 5 percent during 2006 from a peak of around 14 percent per annum in 2001.

Investor considerations—Employee stock options give the employee the right to purchase shares of a Company at a set price over a specified period of time. When analyzing a Company's stock option program, Investors should:

- Determine whether performance objectives and award thresholds are adequately disclosed to Shareowners.
- Review and analyze the basis for awarding stock options to determine whether it encourages and rewards future performance for those executives who are key to long-term Company performance.
- Determine whether the Company has a claw-back provision to recover compensation in cases of restated financial reports, under what conditions such recovery is initiated, and which Company employees are covered by the requirements.
- Consider the valuation method used by the Company. The method used can affect the amounts reported as expense on the income statement and as share-based compensation in the compensation report. The most common valuation methods are:

  Lattice model—based on a range of alternative price paths that the underlying asset might follow until the option matures;

  Black–Scholes model—a so-called closed-form model in that it assigns a value to an option based on a number of assumptions relating to the option, the share price, and interest rates; and

  Market-based models—based on the sale of similar instruments to third-party Investors. Many analysts believe that, relative to other models, these models tend to understate the expense.
- Consider all the assumptions used by the Company in valuing its stock option grants. U.S. and international accounting rules require Companies to disclose their assumptions[26] with regard to:

  Weighted-average share price—This number compares the number of shares traded over a specified period of time with the prices at which they traded during that same period. The value calculated influences the overall fair value estimate of the granted option.

  Exercise price—This number reflects the price at which the executive is permitted to purchase the shares. A lower exercise price relative to the market price on the exercise date creates more profit for the executive as well as more dilution for other Shareowners. Investors also should determine whether the Company can reprice the options (which lowers the exercise price after granting) or reload the options (which issues new options to replace expired ones) without Shareowner approval.

  Expiration date—Stock option awards typically allow the owner to exercise the vested portion of the option at any time during a specified period. Investors should determine whether the options have set expiration dates or whether they are so-called evergreen options that never expire.

  Expected volatility—The potential for price increases and decreases is known as volatility. Options are more valuable if there is a greater chance that the price of the underlying shares will increase in value. Consequently, the higher the volatility assumed by the Company, the higher the calculated value of the option and vice versa. Companies are allowed flexibility in selecting the volatility assumption used. Investors should compare a Company's volatility assumptions with readily available stock price volatility measures. Investors also should determine whether there are significant changes in the Company's volatility assumptions from one year to another and whether those changes coincide with changes in reported metrics.

[26]FAS 123(R) issued by the Financial Accounting Standards Board and IFRS 2 issued by the International Accounting Standards Board contain the relevant disclosure rules regarding valuation of share-based compensation.

Option life—The likelihood that the price of shares underlying a stock option award will exceed the exercise price increases the longer the option is allowed to exist. Consequently, the value of a 10-year option will have a greater opportunity to rise than the value of a 90-day option. Companies are granted flexibility in these assumptions, which can affect valuations. When valuing stock option grants, Investors should analyze the manner in which assumptions about option life change from one year to another and determine whether the assumptions match the actual life of option awards over time.

Vesting requirements—Vesting is how employees obtain ownership of stock options. In the past, most vesting was based solely on the passage of time. For example, options that vested equally over five years gave employees ownership of 20 percent of the options each year. That, in turn, gave them the right to exercise those options at set prices until expiration. Increasingly, though, Companies are requiring employees to meet specified performance-based metrics before their options can vest.

Expected dividends—Companies that award stock options to employees often permit the option holders to receive any dividends on the underlying shares that are approved by the Board, even if the employees have not exercised the options.

Risk-free interest rate—This factor estimates the financing cost for purchase of the stock and helps determine the arbitrage opportunities arising from exercising the option. The higher the interest rate assumption, the higher the value of the option, and vice versa.

- Determine the effective grant date of the options. This is typically the date on which the Company, with Board approval, officially makes option grants to Company employees. Investors should determine whether the Company has a set schedule for awarding stock options to senior executives or whether the awards are given on an ad hoc basis. As noted above, some Companies retroactively had set the grant dates of their executive stock options to coincide with price nadirs as a way to enhance the compensation of Company executives and Board Members.
- Analyze the potential dilution resulting from executive stock option grants and how that dilution compares with competitors' plans over a period of time.[27] The Company can affect dilution by the means it uses to finance its stock option grants. In general, there are three primary mechanisms through which a Company meets its stock option obligations:

  Purchasing the shares in the open market—Typically, the Company would purchase its own shares in the open market through publicly announced stock repurchase programs. Such programs have the effect of temporarily reducing the supply of shares on the market, thereby increasing the value of those remaining. If the shares are repurchased to fund the expected exercise of employee stock option grants, that may over time negate a portion or all of the gain in share value from the repurchase program.

  Issuing unregistered shares—Unregistered shares have to be registered with the regulatory authority before the holder can trade them. This requirement has the effect of reducing the pace of potential dilution. The registration terms are included in the option agreement, which Investors should review.

  Issuing newly authorized shares—Issuing newly authorized shares is the most dilutive method of funding stock option grants and is a common feature of new executive compensation and stock option programs. Such programs typically require a Shareowner vote to approve the increase in shares outstanding.
- Review the performance targets to determine their purpose and their reasonableness. Some performance targets determine whether and how many stock option grants senior executives should receive. Other targets relate to the vesting of previously granted options. Increasingly, targets are relative to those of the Company's competitors and are based on factors such as earnings per share growth, cash flow growth, return on equity, total Shareowner return, market value growth, or some combination thereof.

[27]The State Board of Administration of Florida (2007) states that total dilution should not exceed 1 percent to 2 percent per year and should not exceed industry medians over a three-year period.

- Determine how soon the Company permits executives to exercise and sell their options after vesting. Senior executives who are able to liquidate their option holdings soon after vesting may reduce or even eliminate the shared interest between the executives and Shareowners that the option grant was intended to create.
- Determine whether the stock option grants will trigger tax consequences for the Company. At- or out-of-the-money stock option grants do not create immediate tax liabilities in the United States for either the Company or the executive. However, when the options are exercised, they immediately create a current income tax liability for the executive. Some Companies provide a tax "gross-up" to senior executives that covers employees' tax arising from the difference between the exercise price and the market price at exercise.
- Understand how U.S. disclosure rules affect what Companies report. The value reported by U.S. Companies in the SCT reflects only that portion of all current and outstanding option grants that were exercised by the NEO or vested in each reporting year. This also is the amount that the Company will include under compensation expense on its income statement for the NEO.

  Proxy disclosures may not capture all significant option grants or even the largest grants in any given year. For example, if the sixth-highest-paid executive were to receive an initial stock option grant that begins vesting in two years but has an aggregate present value that is greater than the amounts received and vested by the five highest-paid NEOs, the Company would not have to report the grant in the SCT, the supplementary Grants of Performance-Based Awards Table, or the Grants of All Other Equity Awards Table. Indeed, it is possible that the Company would never have to report the award if the amounts vested in the future did not end up exceeding the cumulative earned and vested awards of other NEOs.

Long-term incentive plans

If the Company uses long-term incentive plans to reward senior executives, Investors should determine what kind of performance is rewarded and whether the Company matches share purchases made by the executives.

Purpose—There are two primary goals of long-term incentive plans (LTIPs). One is to offer executives a higher reward in return for long-term performance. The second is to help align the interests of executives with those of other Shareowners through share ownership.

Implications for Investors—LTIPs have become the most common form of incentive-based compensation used in some jurisdictions, such as the United Kingdom. There are two primary types of LTIPs: The first awards shares to executives on the basis of meeting a specified performance target ("performance share plans"); the second matches the shares purchased by the executive ("share matching plans").[28] By awarding shares rather than options, Companies are able to create a direct link between executives' performance and the benefit they receive.

Investor considerations—When reviewing LTIPs, Investors should:

- Recognize that share-matching plans encourage share ownership by senior executives but do not reward the executive for performance. In most cases, however, executives pay for their shares with the earnings from bonus payments.
- Establish what performance conditions are required for performance share plans in order to determine whether the thresholds require superior performance.[29]
- Determine what conditions are required for executives to achieve full vesting of their LTIP awards and what percentage of the award vests at the maximum vesting level.

[28]New Bridge Street Consultants (2006a).

[29]According to New Bridge Street Consultants, total Shareowner return (TSR) is the most common performance measure used for U.K. Companies in LTIPs, although an increasing number combine TSR with earnings per share and a return measure, such as return on equity or return on capital employed.

- Recognize that the compensation expense created by LTIPs is smaller than the expense created by stock options for an equivalent benefit, except for Companies with significant share-price growth. In the United Kingdom, for example, the median maximum annual benefit for performance share plans is 150 percent of an executive's salary, compared with 200 percent for option plans.
- Ascertain whether the Company uses more than one LTIP plan or combines LTIPs with stock options; Investors should determine the aggregate awards granted under each plan.
- Determine whether senior executives benefiting from LTIPs are restricted as to when they can sell their shares.
- Verify whether the Company prohibits the use of derivative instruments by senior executives to hedge the economic risk of ownership. If not, it could undermine the goal of awarding shares to the executives.
- Determine whether the Company has a claw-back provision to recover compensation in cases of restated financial reports and whether those provisions survive termination of the executive or a change of control in the Company.

Stock-appreciation rights

If the Company uses SARs to compensate senior management, Investors should determine what performance-based provisions are tied to the assumption of the rights.

Purpose—SARs attempt to create incentives for senior managers that are similar to those created by stock options or restricted stock but without the dilutive effects of issuing options or shares.

Implications for Investors—SARs are structured so that an executive is entitled to a cash payment equal to the gain in the share price over a specified period of time.

Investor considerations—When reviewing SARs, Investors should:

- Review the proxy statements and supporting documentation to determine whether the valuation criterion used by the Company closely tracks the quoted price of the Company's publicly traded shares.
- Recognize that because SARs represent a claim only on the appreciated share price rather than on the shares themselves, no dilution of shares owned by existing Shareowners results from this form of compensation.
- Determine whether the award of SARs depends on management performance or on a general increase in industry or overall market share prices.
- Determine whether the Company has a claw-back provision to recover compensation in cases of restated financial reports.

Restricted shares

If the Company awards senior executives with restricted shares, Investors should scrutinize the provisions for awarding those shares and determine the holding period requirements they impose.

Purpose—Restricted shares represent a current ownership interest in the shares of the Company by the executive but with restrictions that control the executive's ability to sell the shares. Often, this control is accomplished by awarding shares that are not registered with the regional regulatory authority and, therefore, not tradable.

Implications for Investors—These plans are similar to traditional stock option plans except that the exercise price on restricted stock is effectively zero. Consequently, the number of shares underlying restricted stock awards is typically smaller than the number of shares underlying stock options. As is the case for cash bonuses and most share-based compensation, the granting of restricted shares is typically performance based.

Investor considerations—When considering restricted share plans, Investors should:

- Recognize that unlike options, the valuation of restricted shares does not require complicated calculations. Rather, their value should track the publicly reported value of the shares as listed on a public stock exchange.
- Be aware that depending on the source of the shares issued by the Company, restricted shares typically do not create significant dilution issues for existing Shareowners. This is because, in part, the shares are issued at the then-prevailing price. By comparison, when an executive exercises options, the value of the underlying shares is higher than the exercise price and in some cases much higher, a difference that dilutes the value of other Shareowners' holdings.
- Realize that the restriction on selling may come as the result of issuing shares that are not registered with the relevant securities authority. In the United States, SEC rules permit the gradual registration of these shares over time.
- Understand that research has shown that Companies that use restricted shares to compensate their senior management are more likely to pay dividends on their shares and less likely to engage in share repurchases.[30]
- Recognize that the Company incurs an expense from the granting of restricted shares at the time of grant.
- Determine whether the Company has a claw-back provision to recover compensation in cases of restated financial reports.

Perquisites

Perquisites paid to senior executives often went unnoticed in the past until some event—a divorce, bankruptcy, or a fraud case—brought them to the public's attention. The new SEC compensation disclosure rules for U.S. Companies, which require the disclosure of perquisites if the value exceeds $10,000, make these costs more transparent.

Although the use of Company assets, such as planes, for personal reasons makes headlines and can divert a CEO's focus, most perquisites given to senior executives relate to more ordinary matters,[31] such as:

- Life, medical, or liability insurance
- Relocation/living expenses
- Transportation, including aircraft usage and automobile allowances
- Club memberships
- Tax reimbursements
- Security services
- Financial planning, including tax and legal services
- Debt forgiveness

The upshot of the new SEC disclosure rules is that Investors are now provided with more and better information about the magnitude and types of perquisites awarded to management than they were before. Disclosures on perquisites are part of the Supplemental All Other Compensation Table.

Investors should review the value and types of perquisites offered to senior executives in order to determine the merit of the rewards and to consider their effect on Company financial performance as well as their potential effect on managerial performance.

Purpose—Among the motivations cited for offering perquisites to senior executives and Board Members is that the benefits enhance the security of these individuals and in the case of certain perquisites, enhance productivity by reducing the amount of unproductive time spent traveling. Another reason often cited is that the Company can acquire certain assets more cheaply than the executives could if they were to purchase such assets on their own, thus enabling the Company to maintain or enhance compensation at lower cost.[32]

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[30]Jolls (1998) finds that this practice could cause Investors to determine that restricted shares are more likely to create a perspective among senior executives that is similar to that of other Shareowners.

[31]Schwab and Thomas (2004) analyzed 375 employment contracts of executives originating between 1984 and 2003. The benefits most commonly sought in CEO employment contracts were supplemental executive retirement plans, pensions, and financial advice. These items are discussed in the section on postretirement benefits.

[32]Yermack (2005).

Implications for Investors—Perquisites awarded to senior executives may not only provide specific benefits to individual executives but in certain cases may also benefit the Companies that offer them. For example, executives of an automobile Company can aid its marketing efforts by driving the latest models. In other cases, however, the return to the Company may not be as apparent.[33]

Investor considerations—When reviewing perquisites awarded to senior executives, Investors should:

- Consider the investment in equipment and personnel that the Company must make to provide perquisites, such as planes, tax reimbursements, and living expenses.
- Determine whether the perquisites are used primarily for business-related purposes or for personal reasons.
- Take into account the potential headline risk arising from the negative publicity associated with poor judgment in the awarding or use of perquisites by senior executives.
- Determine whether the Company provides a tax gross-up to senior executives to effectively pay the tax owed as a result of the perquisite or option exercise, thereby significantly increasing the cost to the Company for providing such benefits and compensation.[34]
- Determine whether the Company has made any loans to executive management or to Board Members. Although Company loans are prohibited in some markets, they remain a regular feature in most markets, particularly in Asia.[35]

Postemployment Benefits

Pension plans

Investors should determine what type of pension plan or plans the Company offers to its senior executives and consider both the potential magnitude of the pension liabilities they create and the incentives they give to management.

In most jurisdictions, there are two primary types of pension plans: defined benefit and defined contribution. Defined-benefit plans provide recipients with a fixed monthly income. Depending on the structure, the plan could provide this benefit solely to the retiring executive or, in many cases, to the executive's surviving spouse after the death of the executive. Because it is difficult for Companies to determine how long an individual will live after retirement, the extent of these payments remains largely undetermined.

Companies that provide defined-contribution plans, in contrast, contribute to accounts created on behalf of each employee that, together with funds contributed by the employees, are invested. These contributions often are based on a percentage of the executives' salaries. The performance of these combined investment funds determines the amount of income available to the retired employee. Therefore, Companies that provide defined-contribution plans do not have the type of open-ended liabilities that are created by defined-benefit plans.

[33]Yermack (2005) relied on the relevant disclosures of Companies that complied with the SEC rules. He found that shares of a Company fall, on average, 1.1 percent after disclosure of the aircraft perquisite and subsequently underperform market benchmarks by 4 percent annually. Companies that disclose this information also are more likely to report accounting write-offs and earnings results that are below analyst expectations.
[34]A tax "gross-up" in this case is a payment made by a Company to cover the tax expense incurred by an executive as a consequence of some other form of compensation. Examples include an excise tax on severance packages, tax liabilities on noncash perquisites, or travel reimbursements for long-term overseas assignments.
[35]Loans to insiders in the United States were proscribed by the Sarbanes-Oxley Act of 2002.

Each of these plan types is considered in more detail below.

Defined-benefit plans

Purpose—These plans are intended to provide the beneficiary with a specific benefit per payment period after retirement.

Implications for Investors—The "defined" benefit refers to a set amount that the Company pays to the beneficiary each period, the total liability for which cannot be known until the death of the executive and/or the executive's spouse.

A number of factors determine the level of the benefit an executive will receive following retirement or departure, including the number of years the executive worked for the Company and in senior management; the average compensation received—or, in many cases, the target compensation—in the executive's final years of service; the age of the executive; and depending on the type of pension offered, the age of the executive's surviving spouse.

Investor considerations—Investors should analyze the magnitude of the accumulated pension benefits and benefits from nonqualified and deferred compensation awards relative to share-based awards.[36] Also, when reviewing the potential cost of a defined benefit awarded to a Company's executives, Investors should recognize that:

- These plans create long-term liabilities for Companies because they are responsible for ensuring the payment of the benefits after the executive retires, regardless of how long the executive or, in many cases the executive's spouse, survives after retirement.
- Pension benefits typically are not based on Company performance.
- Companies base their contributions to pension funds on projections of how the investment of plan assets will perform between the date of contribution and the payment of benefits and on the expected life span of the executive and his/her spouse following retirement.
- Companies may credit senior executives with additional years of service at the time of their retirement to boost the final payout under their plan's formula.
- Under defined-benefit plans, Companies absorb all of the investment risk associated with the investment of the funds set aside for the pension.
- In the United States there are two types of defined-benefit plans: qualified and unqualified. Qualified plans meet the tests required for tax deductibility of contributions that limit the pension any beneficiary may receive. Unqualified plans supplement qualified plans for highly paid senior executives. Contributions to unqualified plans are not tax deductible for the issuing Companies. The tax on income earned from invested retirement assets for the executive is deferred until the executive retires. Companies may provide annual gross-ups to retired executives to pay the income tax owed on unqualified pension plans.

Defined-contribution plans

Purpose—These plans contribute money to investment funds created for the executives, who may take the investment funds with them when they leave the Company.

Implications for Investors—These plans require Companies to make contributions to an investment fund on behalf of executives during their employment with the Company. For Investors, an important element of these plans is that they do not create any long-term obligations for the Companies to make annual payments to the executives after retirement.

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[36]Bebchuk and Jackson (2005) indicate that the magnitude of such benefits often exceeds even generous incentive-based stock option awards, causing senior management to act more like a fixed-income investor than an equity investor and, therefore, behave more cautiously with respect to long-term investments. This view is not universal; some believe that executives may act in a riskier manner if they have a safety net to protect them against losses.

Investor considerations—When analyzing Companies that offer defined-contribution plans, Investors should recognize that:

- Defined-contribution plans are becoming the principal means by which Companies provide pensions to their employees.
- Such contribution plans avoid the long-term liabilities associated with defined-benefit plans.
- Such plans shift the investment risk to the executive and away from the Company.
- Because these plans are effectively owned by the individual beneficiaries, the beneficiaries are not creditors of the Company in the same way that beneficiaries of defined-benefit plans are. As a consequence, executives with these plans may have less concern that investments in research and development, new products, or other capital-intensive activities will reduce the Company's ability to fulfill its pension obligations when the executives retire.
- Companies are better able to budget for and prepare to meet their obligations to defined-contribution plans because of the predictability and limits on contributions.
- Companies often match employee contributions—including those of many nonexecutive employees—up to a certain percentage of annual compensation.
- In the United States, there are two types of defined-contribution plans: qualified and unqualified. The difference is the same as with defined-benefit plans: Company contributions to qualified plans are tax deductible, and contributions to unqualified, supplementary plans for highly paid executives are nondeductible.

Where to find information about executive pension plans—The new SEC-mandated executive compensation disclosures create greater transparency relating to pension plans. Following is a list of those tables in the CD&A section of an annual proxy statement that include information about pension awards to senior executives.

- Summary Compensation Table—specifically in the postretirement awards included in the "all other compensation" column;
- Supplemental All Other Compensation Table;
- Pension Benefits Table; and
- Potential Payments on Termination or Change in Control Table—specifically in the columns labeled "salary continuation or severance"; "benefits or perquisites"; "pension benefits"; and "enhanced pension benefits."

Severance packages

Investors should review and analyze senior executives' employment agreements and related proxy disclosures to determine the potential payouts offered in severance packages.

Purpose—Executive severance packages—also called "golden parachutes"—can help Companies recruit CEOs because they insulate senior executives from the risk of a loss of control or employment as a consequence of a Board decision. Such packages also make clear to management, the Board, and to Shareowners the severance terms effective upon the executives' departure.

Implications for Investors—Historically, a severance package involved a cash payment equal to a certain percentage of an executive's salary. Currently, a severance package, like an overall compensation package, is likely to include a number of different elements, such as perquisites, enhanced pension or enhanced pension benefits, and accelerated vesting of share-based awards.

Investor considerations—When considering the provisions and magnitude of executive severance packages, Investors should:

- Determine whether the Company will provide severance benefits to an executive as a consequence of negotiations with the Board. These negotiations may occur at the time the executive is hired or, less frequently, after the executive is an employee.
- Ascertain whether an executive severance package may act as a de facto anti-takeover device. By making severance packages particularly lucrative for management and the Board, some Companies hope to make potential acquirers reluctant to launch a hostile takeover without consultations with management or the Board. The difficulties created for potential acquirers by such packages can reduce both the market value and potential takeover value of the Company's shares.
- Determine whether the Company will owe severance benefits to executives who are terminated "for cause," such as for misconduct or gross mismanagement.
- Understand how severance payments are determined. Typically, they are based on a multiple of salary and bonus. Tax law in the United States imposes a 20 percent excise tax on severance payouts that exceed three times the average pay—including salary, bonus, and stock option grants—of the NEO prior to departure. According to Institutional Shareholder Services, most large U.S. Companies use a multiple of between two and three times, whereas in most other jurisdictions, the multiple is between one and two times.
- Investigate whether change-in-control provisions in the severance package of a senior executive include such benefits as accelerated vesting of stock options and postretirement benefits. Furthermore, Investors should determine whether such benefits are triggered solely by a change of control or whether the executives also must suffer either a loss of employment or a substantial change in job duties.

Where to find information about severance packages—In the United States, the new SEC executive compensation disclosure rules provide information about the potential cost of severance benefits in the Potential Payments on Termination or Change in Control Table located in the Company's annual proxy statement. The first column of this table specifically addresses salary continuation or severance payments, but the remainder of the columns in this table also relate to severance payouts to senior management.

Postemployment perquisites

Investors should determine the type and magnitude of perquisite benefits the Company is obligated to provide to senior executives after retirement.

Purpose—These awards are designed to reward executives for past service on behalf of the Company and Shareowners. They may take the form of long-term medical benefits, continued provision of club memberships, and continued use of Company assets—such as aircraft, cars, homes, and personnel.

Implications for Investors—These awards are typically determined either as part of negotiations between the Board and the executive involved or as a unilateral award offered to the executive in return for exemplary service to the Company and Shareowners.

Investor considerations—When reviewing the existence and potential cost of postemployment perquisites, Investors should recognize that:

- Boards often feel obligated to continue rewarding perquisites to senior executives after retirement in return for exemplary performance.
- By using Company assets for nonproductive activities, such awards may impair the ability of successor management teams to produce similar results in the future.

Where to find postemployment perquisite information—Investors in U.S.-listed Companies can find relevant information about the cost of postretirement perquisites in the Potential Payments on Termination or Change in Control Table of the Company's annual proxy statement.

Board Compensation

Board Member compensation

Investors should review the magnitude of compensation provided to Board Members and the manner in which they are compensated.

Purpose—Compensation awarded to Board Members serves as both a reward for their time and an inducement to encourage them to act as Board Members.

Implications for Investors—Board Member compensation often includes many of the same elements as that of executive management. Both receive share-based awards, and both often receive perquisites. Whereas senior executives are paid a salary to retain their services, Board Members receive directors' fees in return for their services.

Investor considerations—When reviewing Board Member compensation, Investors should:

- Review the manner in which Board Members are paid to determine what elements the Board has ascertained are best suited for remunerating themselves. In general, Board Members do not have the same motivations as senior management and, therefore, may require different incentives.
- Review how the Board determines the manner and magnitude of its own pay. Such decisions pose inherent conflicts of interest, and the means by which the Board seeks to mitigate these conflicts may provide indications of its ethical direction.

Where to find information about Board Member compensation—Companies in most jurisdictions provide information about the compensation awarded to Board Members either in their annual proxy statements or their annual reports.

Required share ownership

Investors should determine whether Board Members are required to own shares and, if so, the manner in which they fulfill such requirements.

Purpose—The point of ownership requirements is to give Board Members a perspective similar to that of the Shareowners they are elected to represent.

Implications for Investors—Requirements that Board Members own shares of the Company are intended to align the perspectives of Board Members with those of the Shareowners that they are elected to represent. The rationale is that changes in the Company's value will affect the personal wealth of the Board Members in the same way that it affects the wealth of other Shareowners. However, if the shares are acquired through share-based compensation programs, the wealth tied to the fortunes of the Company is supplemental to the individual's financial well-being and thus may not achieve its intended goal.

Investor considerations—When reviewing Board Member compensation, Investors should:

- Determine whether Board Members are required to continue to own a certain number of shares of the Company until they resign.
- Review the manner in which Board Members acquire their shares. There are two primary means of share acquisition for Board Members: direct purchase using personal funds or through the receipt of share or stock option grants. The manner in which such ownership is acquired may influence the perspective of individual Board Members. One who purchases shares using his or her own funds would feel any loss in value in the same way that an outside Shareowner or investment fund beneficiary would. Reduced value in shares acquired through share grants does not represent a direct loss of personal wealth.

Summary of Executive Compensation Considerations

Governance of Executive Compensation

- Investors should determine whether the Committee established by the Board to oversee executive compensation is independent of the influence of executive management.
- Investors should determine whether consultants hired by the Board to help develop a compensation plan have any conflicts of interest that may influence the advice they provide.
- Investors should take advantage of both binding and nonbinding voting mechanisms to register their views on the acceptability of executive compensation plans and senior management pay.
- Investors should carefully review the compensation report of listed Companies, particularly focusing on understanding the Board's compensation strategy and whether it is consistent with generating long-term, sustainable growth in profitability and market value.
- Investors should review disclosures about the current and cumulative awards of share-based compensation granted to senior executives and Board Members and the shareholdings of significant insiders to determine the degree of control each group has over the affairs of the Company.
- Investors should investigate whether the Company has outside business relationships with members of the Board, executive management, or other insiders because these relationships may affect the pay awarded to senior executives.

Elements of Compensation

- Investors should consider whether the non-performance, cash-based elements of executive compensation are appropriate for the type of Company in question and the abilities of the executives involved.
- Investors should investigate how the Board determines bonus awards and whether the determinants reward outstanding performance.
- Investors should review and analyze the terms and conditions applicable to stock options granted to senior executives to determine what incentives underlie the plan and the potential payout of the awards.
- If the Company uses long-term incentive plans to reward senior executives, Investors should determine what kind of performance is rewarded and whether the Company matches share purchases made by the executives.
- If the Company uses stock-appreciation rights to compensate senior management, Investors should determine what the performance criteria are for assuming those rights.
- If the Company awards senior executives with restricted shares, Investors should scrutinize the provisions for awarding those shares and determine the holding-period requirements they impose.
- Investors should review the value and types of perquisites offered to senior executives in order to determine the merit of the rewards and to consider their effect on Company financial performance and their potential effect on managerial performance.

Postemployment Benefits

- Investors should determine what type of pension plan or plans the Company offers to its senior executives and consider both the potential magnitude of the pension liabilities they create and the incentives they give to management.
- Investors should review and analyze senior executives' employment agreements and related proxy disclosures to determine the potential payouts offered in severance packages.
- Investors should determine the type and magnitude of perquisite benefits the Company is obligated to provide to senior executives after retirement.

Board Compensation

- Investors should review the magnitude of compensation for Board Members and the manner in which they are compensated.
- Investors should determine whether Board Members are required to own shares and, if so, the manner in which they fulfill such requirements.

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Appendix A
Executive Compensation
Official Positions and Resources

Issue: **Executive Remuneration Policy**

Position: *Executive remuneration should be explicitly linked to the Company's long-term financial and operating performance.*

Rationale: Creating this link between executive compensation and fundamental performance will serve to better align executive and Shareowner interests.

Issue: **Shareowner Approval of Executive Remuneration Policy**

Position: *Companies and their Boards of directors should submit their executive remuneration policies to Shareowners for a vote regarding its approval.*

Rationale: Granting compensation to corporate executives and directors can create a significant conflict of interest for the Board of directors. This conflict can occur if individual directors might benefit from an overall rise in executive compensation or if management is able to use Company assets to benefit Board Members. Subjecting such policies to Shareowner review and approval will help to mitigate such potential abuses.

Issue: **Share-Based Compensation**

Position: *Shareowners should have a right to approve or reject any share-based compensation plans for management and directors as well as other share-based plans that have the potential to dilute Shareowners' holdings.*

Rationale: Such requirements recognize the right of Shareowners to exercise their voice on corporate governance matters that have a direct and substantial effect on their interests.

Further details online

www.cfainstitute.org/centre/positions/

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Appendix B
Definitions

Corporate Governance

Corporate governance is the system of internal controls and procedures by which individual Companies are managed. It provides a framework that defines the rights, roles, and responsibilities of different groups—management, Board, controlling Shareowners, and minority or noncontrolling Shareowners—within an organization. This system and framework is particularly important for Companies with a large number of widely dispersed minority Shareowners.

At its core, corporate governance is the arrangement of checks, balances, and incentives a Company needs to minimize and manage the conflicting interests between insiders and external Shareowners. Its purpose is to prevent one group from expropriating the cash flows and assets of one or more other groups.

In general, good corporate governance practices seek to ensure that:

- Board Members act in the best interests of Shareowners;
- The Company acts in a lawful and ethical manner in its dealings with all stakeholders and its representatives;
- All Shareowners have the same right to participate in the governance of the Company and receive fair treatment from the Board and management, and all rights of Shareowners and other stakeholders are clearly delineated and communicated;
- The Board and its committees are structured to act independently from management, individuals, or entities that have control over management and other non-Shareowner groups;
- Appropriate controls and procedures are in place covering management's activities in running the day-to-day operations of the Company; and
- The Company's operating and financial activities, as well as its governance activities, are consistently reported to Shareowners in a fair, accurate, timely, reliable, relevant, complete, and verifiable manner.

How well a Company achieves these goals depends, in large part, on the adequacy of the Company's corporate governance structure and the strength of the Shareowner's voice in corporate governance matters through Shareowner voting rights. The success of the Board in safeguarding Shareowner interests depends on these factors.

This manual focuses on these areas as a means of evaluating the corporate governance practices of Companies.

Independence

A number of new national corporate governance codes and exchange-based rules prescribe factors to consider in determining the Independence of Board and Board committee Members. Generally, to be considered Independent under these codes and rules, a Board Member must not have a material business or other relationship with the following individuals or groups:

- The Company and its subsidiaries or members of its group, including former employees and executives and their family members;
- Individuals, groups, or other entities—such as controlling families and governments—that can exert significant influence on the Company's management;
- Executive management, including their family members;
- Company advisers (including external auditors) and their families; or
- Any entity that has a cross-directorship relationship with the Company.

Board Members

The term "Board Member"—in some jurisdictions called "directors"—in this manual refers to all individuals who sit on the Board (defined below), including Executive Board Members, Independent Board Members, and Non-Executive Board Members.

Executive Board Members. This term refers to the members of executive management. In a Unitary Board, or Committee System, Executive Board Members also serve as part of the Board in a Unitary Board structure. In a Two-Tier Board, these individuals would only be part of the Management Board. These individuals are not considered Independent.

Independent Board Members. An Independent Board Member refers to an individual who meets the qualifications listed under "Independence."

Non-Executive Board Members. Non-Executive Board Members are neither Executive Board Members nor Independent Board Members. Individuals in this category may represent interests that may conflict with those of other Shareowners. Non-Executive Board Members may include Board Members who are affiliated with individuals or entities that have control over management, who are part of a cross-directorship arrangement with another listed Company, or are representatives of labor organizations.

Board

The term "Board" in this manual refers to both the Supervisory Board—or a Board of Corporate Auditors in Japan—in countries with a Two-Tier Board structure as well as the Board of Directors in countries that use a Unitary Board. In most cases, corporate structures take the form of one or the other of these, but in some countries, such as in France and Japan, Companies have the option of choosing which of the two structures they wish to use.

Two-Tier (Dual) Board

Common in some parts of Europe, particularly in Germany, the Netherlands, Austria, and Denmark, the Two-Tier Board structure has two elements, the Management Board and the Supervisory Board, both of which are described further below.

Management Board. The Management Board consists exclusively of executive management and is charged with running the Company on a daily basis and setting the corporate strategy for the Company, in consultation with the Supervisory Board. Its Members do *not* sit on the Company's Supervisory Board.

Supervisory Board. The Supervisory Board is charged with overseeing and advising the Company's Management Board and includes only Independent and Non-Executive Board Members.

Corporate Auditors System. In Japan, the Two-Tier Board structure is called the "Corporate Auditors System" and is used by most large Japanese Companies. It includes a Board—including either Independent Board Members or Non-Executive Board Members who are elected by Shareowners and are responsible for business decisions—and a Board of Corporate Auditors—consisting of corporate auditors, including at least one full-time corporate auditor, and at least half the Members must be outside auditors. These corporate auditors are elected separately by Shareowners and are charged with auditing the performance of the Board.

Unitary Board

In a Unitary Board structure, the Board may include Executive, Non-Executive, and Independent Board Members. It oversees and advises management and helps set corporate strategy, although in many jurisdictions it does not engage in corporate decision making, except in matters such as mergers, acquisitions, divestitures, and sales. Jurisdictions increasingly require Independent Board Members to compose at least a majority of the Board.

Committee System. The Committee System is the Unitary Board structure in Japan, which uses a Board consisting of Executive Board Members, Independent Board Members, and Non-Executive Board Members. The system gets its name because the Board must establish three committees—the audit, nominations, and compensation committees—all of which must have at least three members, a majority of whom are either Independent Board Members or Non-Executive Board Members.

Company

The Company is the firm in which the Shareowners have an ownership position and in which Investors are considering an investment.

Investors

This term refers to all individuals or institutions who are considering investment opportunities in shares and other securities of the Company.

Shareowners

The term "Shareowners" is distinguished from the term "Investors" by referring only to those individuals, institutions, or entities that own shares of common or ordinary stock in the Company in question.

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