

The Conference Board Governance Center Working Group: Pay for Performance



Defining Realized and Realizable Pay

- Conference Board convened a group of experts in compensation and corporate governance to create a conceptual framework to encourage greater consistency in the disclosure of supplemental measures of pay.
 - ✓ Consistent, principles-based non-proprietary definitions
- Three lenses:
 - ✓ Summary compensation table: what the compensation committee intended to pay, as measured by the accounting value of stock awards
 - ✓ Realized pay: what was actually received during the performance period
 - ✓ Realizable pay: the “walk away” value as of a point in time



The Conference Board Governance Center Task Force on Investor Engagement



Task Force of Corporate Directors, Directors of “Traditional” Investment Firms and Activist Hedge Funds

- Engagement: a positive result of Say on Pay
- In January Task Force will release:
 - ✓ White paper
 - History of balance of power in corporate governance
 - Trends influencing the current allocation of power
 - Key issues in the current corporate governance system and the current state of debate on those issues
 - ✓ Recommendations of the Task Force on key issues
 - ✓ Guidelines for Investor Engagement
- This presentation will briefly summarize the white paper findings on trends influencing the current balance of power and key issues



Trends: Increasing Influence of Institutional Investors

- Concentration of ownership in institutional form
 - ✓ Over 70% of larger corporations owned by institutional investors
- Institutional investors vote
 - ✓ 90% voting rate as compared with 30% voting rate for individuals
- Federal regulation empowers shareholders to have a larger role in corporate governance
 - ✓ “Say on Pay” -- investors advisory vote on executive compensation
 - ✓ SEC expands investors’ rights to provide advisory votes on ordinary course of business decisions if they have a policy implication
 - ✓ SEC approves NYSE rule to eliminate broker’s discretion to vote shares for management that are held by individuals who don’t vote
 - ✓ SEC adopts rules to encourage institutional investors to vote
 - ✓ SEC approves proxy rules which have the unintended effect of decreasing the vote of individual investors



Trends: Increasing Influence of Institutional Investors

- Changes in corporate governance standards increase investor rights
 - ✓ Adoption of majority vote rule for election of directors
 - ✓ Elimination of take over defenses
 - All directors stand for re-election annually (eliminate staggered boards)
 - Standing poison pills eliminated
 - Elimination of super-majority vote requirements for fundamental issues
 - Increase in rights to vote by written consent
 - Increase in rights to call a shareholders' meeting
- Rise in activist investors who influence corporate strategy
 - ✓ Increase in assets under management
 - ✓ Increase in investments by pension plans in activist funds
 - ✓ Increasing traction with traditional investors to effect changes in board composition through short slate proxy contests or negotiations



Trends: Increasing Influence of Proxy Advisors

- Proxy Advisor influence on voting
 - ✓ Academic studies— influence ranges from 6% to 38%
 - ✓ Interim vote results— companies cite evidence of 20% to 30%
 - ✓ Equivalent to major investor “block holder” influence on voting
 - ✓ Indirect influence when boards change policies in anticipation of vote
- Causes of increased proxy advisor influence on institutional investors:
 - ✓ Complexity of Say on Pay vote
 - ✓ Complexity of proxy statements and annual reports
 - ✓ Compressed time period in which to make voting decisions
 - ✓ Desire to keep investment overhead costs low
 - ✓ Rise of traders indifferent to corporate governance; share lending
 - ✓ Hyper-diversification of institutional investors
 - ✓ Size of institutional firms and expansion into global markets
 - ✓ Endorsement of reliance by SEC staff



Trends:

Prevalence of Shareholder Primacy Model

- The sole purpose of a corporation is to maximize the wealth of its shareholders
 - ✓ Prevailing model for corporate governance in the U.S. in recent years
 - ✓ After financial crisis it came under question—does this focus actually increase shareholder value? Or, does it encourage too much risk taking at the expense of sustainable value?
 - ✓ Public distrust of business leaders who manage for Wall Street at expense of employees and communities
- Stakeholder model of corporate governance or “triple bottom line” prevalent outside of the U.S.
- Evolving model:

An optimally balanced system of corporate governance is based on the premise that serving the interests of major constituencies of corporations—customers, employees, creditors, suppliers, communities and the environment—is essential to maximizing shareholder value.



Trends: Growing concern with executive compensation and income inequality

- Equity compensation granted to align interests of managers with shareholders increases the magnitude of executive compensation, resulting in rising income inequality
 - ✓ Unintended consequence
- Increasing gap between executive compensation and compensation of average employees serves as a lightning rod and invites skepticism of business leaders
- Public concern over executive compensation leads to more federal attempts to indirectly constrain compensation
 - ✓ CEO pay ratio
- Implicit view that boards are ineffective at properly setting executive compensation puts some executive compensation oversight in the hands of shareholders
 - ✓ Say on Pay



Current State of Corporate Governance

- Unsettled position with respect to roles and responsibilities of directors, management and shareholders in corporate governance
- Federal regulation expanded the rights of shareholders at the same time that regulators acknowledge the central role of the board, through mandates designed to strengthen the effectiveness of board oversight
- Shareholders have unprecedented levels of influence on corporate decision-making, but may not always have the capacity or resources to exercise that influence
- Proxy advisors have significant influence on shareholder voting and their role is under review by Congress and the SEC
- Management frequently finds itself judged based on swings in the stock market, and there is significant concern that the focus on stock prices results in a bias toward short-term gains over long-term value.



Some Questions For the Future of the System

- Have we reached the right balance of shareholder power?
- Should proxy advisors be subject to regulatory oversight?
- Is short-termism a cause of concern, and if so what is the solution?
- Will further attention to board processes and composition result in better governance?
- Will changes to voting mechanics improve corporate governance?
- Do federal rules-based governance mandates undermine the benefits of principles-based state corporate law?
- What new challenges are presented by vote decoupling, high speed trading and “hyper” portfolio diversification?



Some Questions For the Future of the System

What is the optimal balance of power between investors, directors and managers of public corporations?

What gaps are there between an optimal balance and the current status?

