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Short- and Long-Term Incentive Design Criteria Among Top Companies: *Study Highlights*

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The Securities and Exchange Commission ("SEC") requires that in their annual proxy statements, public companies disclose the specifics of their executive compensation policies in clear language for investors. This requirement has developed from the assertion by the SEC that if executive compensation performance targets are central to a company's decision-making process, these targets must be disclosed. In order to investigate what (and how much) is being shared in annual proxy statements about executive pay packages and how incentive pay is designed, Arthur J. Gallagher & Co.'s Human Resources & Compensation Consulting Practice has conducted a study of the 2015 annual proxy statement disclosures for 200 of the top U.S. companies (based on revenue and market capitalization). This is the seventh consecutive year it has conducted this in-depth analysis for the top 200 public companies.

INTRODUCTION

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Proxy advisory firms such as Institutional Shareholder Services ("ISS") and Glass Lewis review compensation-related disclosures as part of the proxy reviews. It is through these reviews they are able to provide governance-related reports to their investor clients. Incomplete or unclear disclosures can affect their Say on Pay ("SOP") recommendations and the message they send to investors.

ISS includes a number of factors as part of their qualitative review of pay for performance. The completeness of disclosure and rigor of

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performance goals are two of eight areas they review. Other areas include the ratio of performance- to time-based equity awards, the overall ratio of performance-based compensation, the company's peer group benchmarking practices, financial and operational performance, realizable pay compared to granted pay, special circumstances, and any other factors deemed relevant. In considering the qualitative merits of a compensation program, Glass Lewis will highlight any compensation-related decisions or features that may be detrimental to shareholders' interests, as well as any important information that has not been clearly provided.

Public companies continue to be under constant pressure to include in their proxy filing complete pay-for-performance disclosures such as minimum, target, and maximum performance goals and corresponding payout levels.

The SEC rules require that all performance measures and goals be released and compared with actual results for both short- and long-term incentive plans. There are four broad issues for publicly traded companies relating to performance-based compensation, which are as follows:

- Selection of short- and long-term performance measures that have been approved by shareholders (i.e., contained in incentive and equity plans);
- Adequate disclosure of performance goals (measures and levels) in the proxy filing;
- Review of the risk associated with performance plans and appropriate proxy disclosure; and
- Clawback of incentive payouts if financial statements have been restated, causing the performance goals to not be met (included in Dodd-Frank, regulations issued but final rules pending).

In order to investigate what (and how much) is being shared in annual proxy statements about executive pay packages and how incentive pay is designed, Arthur J. Gallagher & Co.'s Human Resources & Compensation Consulting Practice has conducted a study of the 2015 annual proxy statement disclosures for 200 of the top U.S. companies (based on revenue and market capitalization). This is the seventh consecutive year we have conducted this in-depth analysis for the top 200 public companies.

This study provides a behind-the-scenes look at how incentives are being structured to connect pay and performance. Because incentive compensation comprises the bulk of executive pay packages at publicly-traded companies, boards of directors and senior management are continually searching for the right performance measures to balance rewards with financial, stock price and operational performance as well as non-financial and individual performance.

The following sections detail some highlights of this year's study:

SHORT-TERM INCENTIVE PLANS

Umbrella Plans

Of the 200 companies reviewed this year, 61% of companies with short-term incentive plans ("STIPs') indicated the use of "umbrella" STIP plans (also referred to as "inside/outside" plans or "plan within a plan"), which along with prior year results, were the highest in the past five years. Companies with these types of plans often disclose fewer performance metrics than companies without these plans, in part due to the inclusion of more qualitative rather than quantitative measures in these types of plans. Similar to other performance-based pro-

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grams, umbrella plans must follow specific guidelines in order to qualify as performance-based compensation that is in compliance with Internal Revenue Code 162(m) and thus tax deductible.

Two somewhat different plan designs are evident. The plan design found most often involves creating a bonus pool usually based on a percentage of an income measure ("outside plan"). Sixty-four percent (64%) of umbrella plans use this approach. Each executive covered under this plan is allocated a percentage of the pool, which represents the maximum allowable payout to each person. Actual payouts are based on an "inside plan" which often includes a combination of financial/formulaic performance measures with corresponding threshold, target and maximum levels, and qualitative individual or discretionary goals. Because the outside plan is based on a financial measure that is approved by shareholders and meets the other 162(m) requirements, these individual/discretionary amounts are considered performance-based and therefore are tax deductible.

To qualify for 162(m) deductibility, an executive's payment must be below the disclosed maximum amount, and the sum of payments to all executives must be less than or equal to the pool amount. Additionally, a reduction in one executive's amount cannot result in an increase to another executive's payment. Once the pool and individual amounts have been established, only negative discretion can be used to adjust the payout amounts.

The second plan type used by 36% of companies with umbrella plans involves establishing a financial hurdle or hurdles which must be achieved before bonus payments can be made. These hurdles are designed to cover the amounts necessary to pay bonuses to the top executives. The actual bonus pool is usually a multiple of salaries of those executives participating in the plan. As described above, performance and individual goals can be created for determining the actual payment amounts. Because there is an overarching financial hurdle or threshold and payment limits established for the executives, this type of plan would qualify for 162(m) tax deductibility.

Figure 1: STI Umbrella Plans—Percent of Companies

Number of Measures	*2015*	*2014*	*2013*	*2012*	*2011*
Hurdle	22%	21%	21%	20%	16%
Pool	39%	39%	38%	37%	34%
TOTAL	61%	60%	59%	57%	50%

Individual Objectives in STIPs and Use of Discretion in Non-Umbrella Plans

Many companies use individual performance measures in their STIPs. Of the 199 companies with STIPs, 27% included individual, specific objectives for one or more named executive officers (NEOs) excluding the CEO. Twenty-four percent (24%) of CEOs had individual objectives. Individual objectives can be based on a combination of financial and non-financial measures. Of the CEOs that had individual objectives in 2015, 56% had a separate weighting for individual objectives ranging from 10% to 50%; for other NEOs, 57% had a weighting between 10% and 50%. In other cases, the final award was based on an adjustment to a calculated, formulaic amount using discretion or a predetermined plus and minus range.

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Discretion, excluding negative discretion related to umbrella plans, was used at 64% of companies with STIPs in 2015 to determine at least a portion of the bonuses paid to executives. This was an increase from 61% in 2014 but similar to 63% in 2013.

Discretion can reflect individual performance or overall company performance relative to the industry, recognize special contributions, or be based on other factors that the CEO or compensation committee deem valuable to the company. The use of discretion is not related to the use of individual objectives, although these practices can overlap.

Setting STIP Targets

The median year-over-year increase in target goals (target over prior year target) for 2015 was again 4%, matching 2013 and 2014. Thirty-seven percent (37%) of target performance goals were set at levels that were lower than the prior year actual results, and 31% of goals were below the prior year target value.

The difference between the 25th percentile to 75th percentile target change remains quite narrow, with a difference of 13 percentage points (-2% to 11%) in 2015, down from 20 points in 2012 (see Figure 2).

Figure 2: Strength of Targets

Percentile	2015		2014		2013		2012	
	Target Change (%)	Target Over Prior Year Results (%)	Target Change (%)	Target Over Prior Year Results (%)	Target Change (%)	Target Over Prior Year Results (%)	Target Change (%)	Target Over Prior Year Results (%)
25th	-2%	-5%	-2%	-6%	-3%	-4%	-2%	-4%
Median	4%	2%	4%	3%	4%	4%	6%	4%
75th	11%	9%	14%	7%	11%	9%	18%	9%

Pay for Performance

An examination of 2015 short-term incentive payouts relative to target indicates there was an increase in the percentage of NEOs that were paid above target. Among companies that reported short-term incentive payouts in 2015, 62% of NEOs were paid at or above target levels as compared with 63% in 2014, 60% in 2013, and 62% in 2012.

We also reviewed how STIP target levels are set relative to the prior year target to see if decreasing the target value resulted in companies more able to exceed target. We found that companies with reduced targets from the prior year achieved above target performance for a given measure at a lower rate as compared to companies that increased performance targets (57% vs. 62%). In 2014 the results were reversed (63% vs. 58%).

Here are a few additional findings.

- Sixty-one companies, or 31% of all companies with STI plans, included one or more measures with a lower target than the previous year. As noted above, 31% of all measures for all companies had lower target values.
  - Excluding discretionary plans, some of which include measures with targets but no weights, the percentage increases to 36%.
- Finally, when looking at all disclosed STI measures, 64% had target

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values greater than prior year target values, while 63% of targets were set above prior year actual results. Five percent of target values did not change from the prior year.

Number of Performance Measures

Most companies include multiple measures in their STIPs (Figure 3). In 2015, 80% of companies with STIPs used two or more financial measures in their plan design, which has steadily increased from 68% in 2010. When financial and non-financial measures are included, 90% of companies use two or more measures, with the highest prevalence in the category of "6 or more measures."

Figure 3: Short-Term Incentive Plan Financial Measures

Number of Measures	2015*	2015	2014*	2014	2013*	2013	2012	2011	2010
1	10%	20%	10%	18%	13%	21%	27%	29%	32%
2	21%	35%	19%	34%	17%	31%	35%	33%	32%
3	19%	28%	19%	30%	18%	29%	25%	22%	23%
4	12%	12%	10%	10%	12%	12%	9%	7%	9%
5	8%	2%	10%	6%	10%	5%	2%	5%	2%
6 or more	30%	3%	31%	2%	30%	2%	2%	3%	2%
Weighted Average	5.16	2.51	4.98	2.62	4.76	2.52	2.32	2.35	2.28

* Includes non-financial measures

Type of Performance Measures

Earnings per share ("EPS") was the most common single measure used by the companies in the study that disclosed their performance measures. Thirty-eight percent (38%) of companies with non-discretionary STIPs used EPS in 2015, which is lower than last year (40%).

Ninety percent (90%) of companies disclosing specific measures and metrics used at least one type of an income-based measure in 2015, which is lower than last year (93%). This category includes EPS, net income, operating income, EBITDA, EBITDA margin, etc.

Other common measure groups used in 2015 included revenue (42%), cash flow (33%), and capital efficiency ratios (21%, which was slightly lower than last year's 24%).

Total shareholder return (TSR), the most commonly used measure in a long-term incentive plan ("LTIP"), is not often used in a STIP. We found only 2% of companies with STIPs used TSR in 2014 and 2015 as one of the performance measures.

For companies disclosing measures, the use of non-financial measures (such as customer satisfaction, production goals, and new business market share) were disclosed at 50% of companies, relatively consistent with previous years.

Thirty-seven percent (38%) of companies with STIPs and LTIPs used one or more of the same measures in both incentive programs, which is slightly more than 37% in 2014. See Figure 4 for a summary of STIP performance measures.

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Figure 4: STIP Performance Measures

Performance Measure	*2015*	*2014*	*2013*	*2012*
Income: EPS, net income, EBIT/EBITDA, operating income, pretax income, EBITDA margin	90%	93%	91%	90%
Total Shareholder Return: Stock price appreciation plus dividends (relative and absolute), stock price	2%	2%	5%	3%
Capital Efficiency: Return on equity, return on assets, return on investment, return on capital, economic value added	21%	24%	24%	25%
Revenue: Revenue, revenue growth	42%	42%	40%	35%
Cash Flow: Cash flow, cash flow growth	33%	34%	33%	29%

LONG-TERM INCENTIVE PLANS

Stock Option Grants Continue to Recede

The shift away from appreciation awards (stock options/stock appreciation rights ("SARs")) and towards performance awards that are earned based on achieving performance goals continued in 2015 for the seventh consecutive year. Also, for the sixth consecutive year, the prevalence of grants of performance-based awards exceeded the prevalence of time-based appreciation awards and the gap continues to grow.

Since 2009 when the prevalence was about even, performance-based awards have increased to nearly 30 percentage points higher than stock options/SARs (95% vs. 61%). Nonetheless, appreciation awards are still more prevalent than time-based restricted stock even though the gap has narrowed over time as time-vested share grants have declined moderately. For example, in 2008, the difference in prevalence was 34 percentage points (82% vs. 48%), but in 2015 the difference was just 9 points (61% vs. 52%).

The collective use of performance-based awards (which includes performance shares/units, performance-based restricted stock, performance stock options, premium stock options, and long-term cash plans) totaled 95% in 2014 and 2015, up from 93% in 2013, 88% in 2012, 82% in 2011 and 77% in 2010. On the flip side, the prevalence of stock option/SAR grants, in total, has declined steadily from 82% in 2008 to 61% in 2015.

We attribute the steep shift from appreciation awards to performance awards to the impact of SOP and the influence of ISS, particularly their classification of time-based stock options as non-performance-based grants. See Figure 5 for further details.

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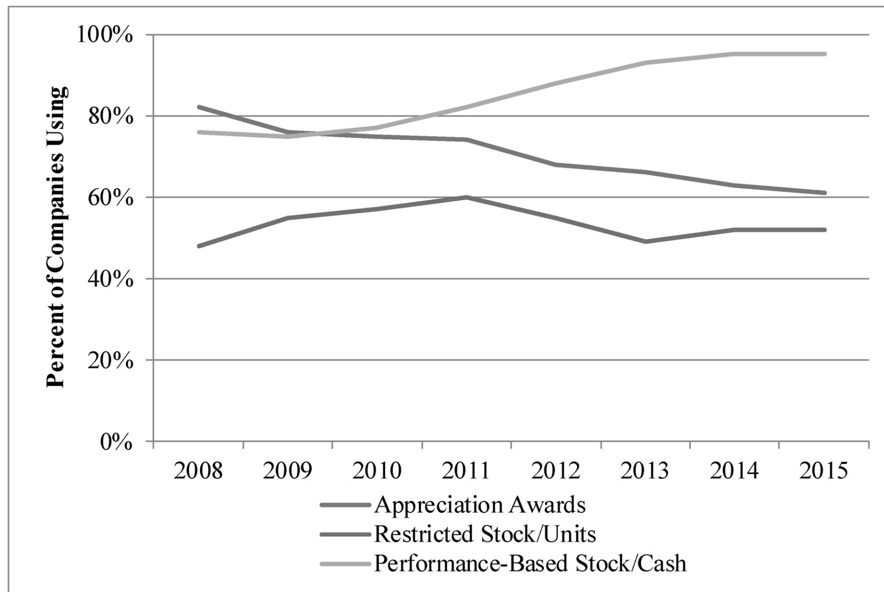
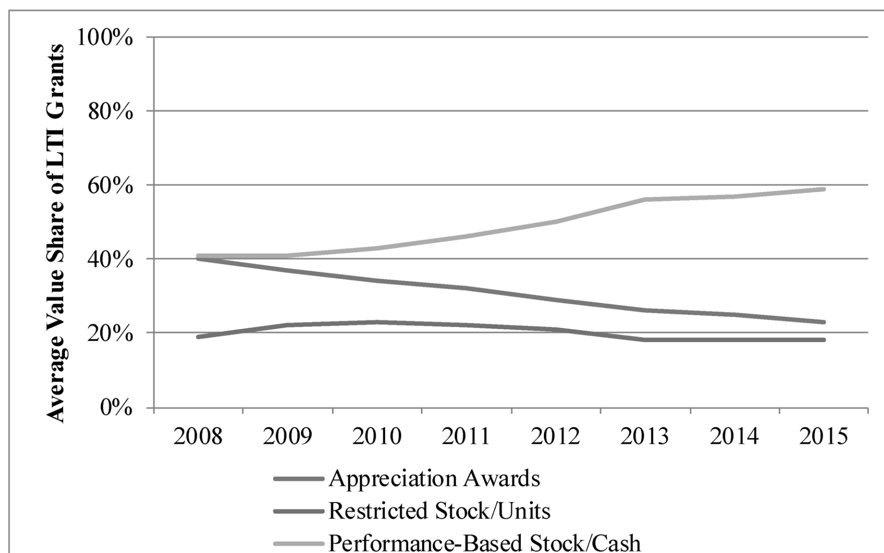
Figure 5: Prevalence of Use



In addition to the decrease in prevalence of appreciation awards, the value provided in the form of stock options/SARs is also declining. In 2008, an average of 40% of the total LTI value was provided in the form of appreciation awards, 41% in performance-based awards, and 19% in time-based restricted stock/units.

By 2015, the average of Top 200 performance-based awards had increased to 59% of the total LTI value with a corresponding decrease in stock options/SARs (with time-based restricted stock/units remaining relatively flat). See Figure 6.

Figure 6: Average LTI Mix



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PERFORMANCE-BASED LTIPS

Pay for Performance

Of the companies that disclosed long-term incentive performance and payout information, the percentage that were paid at or above target was 61% in 2015, up slightly from 60% in 2014, 57% in 2013 and 52% in 2012.

Number of Performance Measures

It is most common to have two performance measures in a performance-based LTIP. The use of just one measure continues to decline in practice. As shown in Figure 7 below, the number of companies using one measure has declined from 46% in 2009 to 24% in 2015. The number of companies using two measures reached a high in 2015 of 44%.

Figure 7: Long-Term Incentive Plans

Number of Measures	2015	2014	2013	2012	2011	2010	2009
1	24%	29%	28%	37%	39%	41%	46%
2	44%	43%	40%	35%	35%	39%	37%
3	22%	21%	22%	21%	22%	15%	14%
4 or more	10%	7%	10%	8%	5%	5%	3%
Weighted Average	2.08	2.11	2.19	2.07	1.88	1.86	1.73

Type of Performance Measures

Of the 95% of companies with performance-based LTIPs, TSR is the most commonly used performance measure, with 56% of LTIP plans using TSR in 2015, down slightly from 57% in 2014. This measure had steadily increased in use over the past few years, from 46% in 2011, to 51% in 2012 and 55% in 2013. TSR is usually used as a relative measure that compares company performance to a peer group (56%) or composite index (39%). Five percent (5%) of companies used both a composite index and a peer group for measuring comparative performance. Twenty percent (20%) of companies using TSR used the S&P 500 index as a benchmark, and an additional 13% used an S&P 500 industry index. Sixteen companies (8%) with LTIPs used a TSR-based modifier to adjust the final performance result, with seven of these companies using the S&P 500 index as the relative measure. As recently as 2012, only 5% of TSR usage was as a modifier.

Similar to STIPs, some type of income measure is commonly used in LTIPs. Fifty-one percent (51%) of companies with LTIPs used at least one measure of income in 2015, up from 49% in 2014 but less than the 53% prevalence in 2013. Of the income measures, EPS is still used most often, with 58% prevalence in 2015 as compared to 57% in both 2013 and 2014.

Forty-seven percent (47%) of the companies used a capital efficiency measure in 2015, which has increased from 40% in 2012. The use of revenue measures remained the same in 2015 as in 2014 at 20%, up from 18% in 2013. This was just below the high of 21% over the last six years. See Figure 8 for a summary of LTIP performance measures.

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Figure 8: LTIP Performance Measures

Performance Measure	*2015*	*2014*	*2013*	*2012*
Income: EPS, net income, EBIT/EBITDA, operating income, pretax income, EBITDA margin	51%	49%	53%	52%
Total Shareholder Return: Stock price appreciation plus dividends (relative and absolute), stock price	56%	57%	55%	51%
Capital Efficiency: Return on equity, return on assets, return on investment, return on capital, economic value added	47%	46%	44%	40%
Revenue: Revenue, revenue growth	20%	20%	18%	20%
Cash Flow: Cash flow, cash flow growth	13%	12%	13%	12%

Plan Design

Eighty-seven percent (87%) of performance-based grants included the common design of threshold/target/maximum performance and payout levels. Thirteen percent (13%) of grants used a performance hurdle or capped the payout at target.

Performance Period Length

Seventy-five percent (75%) of performance periods reported were three years in length, which is up from 69% in 2014. Twenty percent (20%) used one-year performance periods, down from 27% in 2014. Twenty-one percent (21%) of these plans added two or more additional vesting years to get to at least three years of vesting. Also, for those companies using one-year performance periods, over half (57%) of them set performance goals annually over a three-year period.

WILL SELECTION OF PERFORMANCE METRICS SHIFT WITH ISS' NEW POLICY UPDATES?

On Nov. 8, 2016, ISS announced updates to its pay-for-performance evaluation of U.S. public companies, effective Feb. 1, 2017.

For many years prior to this update, ISS focused on TSR as the sole financial metric in its quantitative pay-for-performance screens. In particular, the relative degree of alignment (RDA) test compared the percentile ranks of a company's three-year average CEO pay and three-year annualized TSR with those of the ISS-determined peers.

Starting in February 2017, ISS will determine relative financial performance for six new metrics, as compared to that of the company's ISS peer group. The actual weighting on each metric (which will vary by industry) is yet to be disclosed by ISS at the time of writing this article.

These six additional financial measures will supplement ISS' continued use of TSR as a key metric for assessing corporate performance in the context of evaluating executive compensation. These new measures are as follows:

1. Return on equity;
2. Return on assets;
3. Return on invested capital;
4. Revenue growth;
5. EBITDA growth; and
6. Cash flow (from operations) growth.

This broader view of a financial performance may more appropriately capture the linkage between actual compensation earned and underlying financial performance. Public companies should be prepared to model their financial performance using these additional measures relative to their ISS-defined peer groups.

Indeed, it will be interesting

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to see in our next annual study how companies have updated their performance measure usage in light of this new development. In LTIPs, TSR as a performance measure has steadily increased in use over the past few years, but by 2015 had started to level off. With TSR no longer the standalone measure in ISS' pay-for-performance evaluation, we expect to see further increases in the use of the six new measures, while TSR continues to stagnate. In addition, we will likely see a further decrease in the number of companies relying on just one performance measure in either STIPs or LTIPs. With this more holistic ISS view, companies may be encouraged to consider more performance measures when building performance-based pay programs that align company performance and shareholder interests.

Companies will need to consider whether any of these six new measures should be factored into their compensation plans if not already in place. Moreover, it is likely that company management and the compensation committee will be discussing the appropriateness of each of the six measures just as they do now in assessing peer group companies disclosed by proxy advisors.

CONCLUSION

Outside advisors, lawyers and consultants play a substantial role in the process of setting and describing performance measures and goals, because designing the appropriate compensation package for senior executives is a difficult process. The unique environment of the company and the individual needs of executives must be considered as compensation programs are designed. In addition to these considerations, public scrutiny of executive pay decisions and practices complicates the overall process of setting executive pay.

As proxy advisors continue to raise the governance bar, companies continue to grapple with the expectations of management and the demands of investors. We believe this paper will be useful in communicating the current market standards in both short-term and long-term incentive design practices, enabling companies to stay ahead of outside pressures.

Our full study of 2015 Short- and Long-Term Incentive Design Criteria Among Top-200 Companies is available now. To request a complimentary copy, please contact Molly Kyle, Manager of Business Development & Marketing with Arthur J. Gallagher & Co.'s Human Resources & Compensation Consulting Practice (molly_kyle@ajg.com).

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