Who *are* your peers? (The SEC wants to know)

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Subjects	Executive compensation, peer groups, market analysis, benchmarking, proxy disclosure
Bottom Line	New proxy disclosure rules and the corporate governance environment dictate a thorough process for developing a peer group (or groups) for competitive benchmarking, and it is a daunting task.

Executive Summary

The SEC's recent challenge to companies regarding the extent and quality of proxy disclosure of executive pay practices and process raises a number of issues – and the peer group issue is high on the list. A company's identified peer group – who is in it, how it was determined, and how it was used in pay analysis – was identified as a key concern by the SEC. Compensation Committees must have a structured, data-based, and well-documented process for determining the basis of competitive comparisons. A data-intensive, iterative process is critical for meeting disclosure and governance responsibilities.

The SEC has indicated that 350 companies will be challenged on their proxy disclosures – and this may just be the "Phase I" group

The Issues

- The SEC reportedly contacted approximately 350 companies indicating a **deficiency in their proxy statement** disclosure regarding executive pay. The group is apparently biased toward larger companies rather than degree of shortcoming as the names disclosed include such firms as Pfizer, Coca-Cola, General Electric, and American Express.
- While the SEC seems to be focusing on the big fish what does that mean for smaller fish in the pond in those same industries? Will the SEC start "batch processing" and **target groups** of firms with disclosure weaknesses **based on criteria other than size and name brand recognition?**
- The **first year** under the new disclosure rules was **a year of ground-up development, speculative drafting, and hopeful submissions**. Some companies merely revised the previous Compensation Committee Report into the new Compensation Discussion and Analysis ("CD&A") section. Others decided that only 500 words or as much as 40 pages were required to tell their pay story.
- The full list of companies will not be released until later this year and in the meantime we thought it would be useful to see **how many companies provided information about the peer group they used** as a basis for evaluating and structuring their executive pay program. Beyond the disclosure requirements, peer group analysis is an important element of the pay governance process.

Multiple issues were targeted by the SEC's comments, and peer group development and disclosure are a key issue

Our review of 135 high-performing public companies reveals that 30% did not disclose their peer group or explained that their process does not include referencing a peer group

The Research

We selected a sample of 135 companies using our CompAnalyst Executive peer group development tool. We delved below the group of largest "mega-cap" companies (over $100 billion in market capitalization), examining companies in three market capitalization categories:

- Large Cap ($20 billion to $100 billion)
- Mid Cap ($5 billion to $20 billion)
- Small Cap ($1 billion to $5 billion)

We included all industry sectors and focused on those companies that significantly outperformed their market cap category average on a 3-year total shareholder return metric.

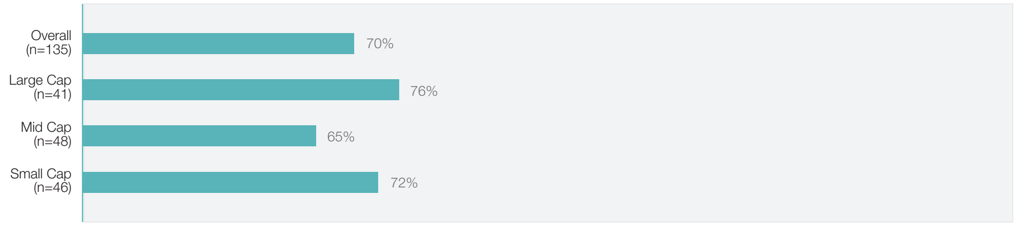
As companies attempt to meet governance and disclosure obligations in a complex business environment, we found a remarkably wide range of approaches used to answer the question **"how does our pay compare?"**

The Data

Here are some observations from the research:

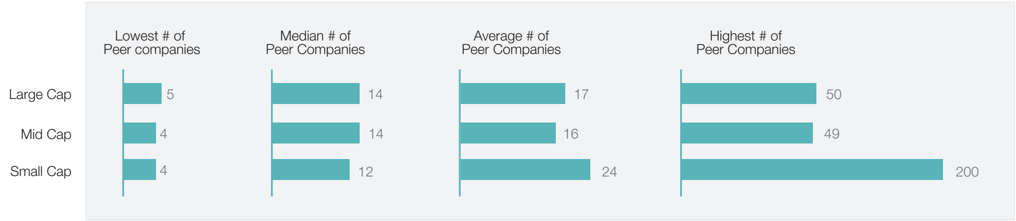
1. Of the 135 companies reviewed, 30% did not disclose the use of a peer group for purposes of benchmarking total compensation of executives. There is no pattern related to market cap category so it does not appear that company size and relative level of resources are dictating who does or does not choose to develop a relevant peer group for pay analysis purposes.

Percentage of Companies Reporting a Peer Group



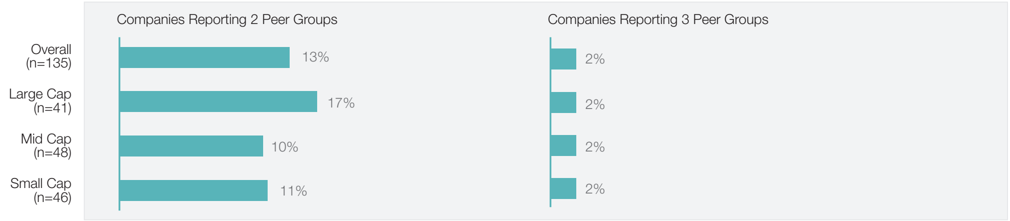
2. In the studied group, some companies reference a peer group of as few as 4 companies while others as many as 200. Some reference labor competitors; others, business competitors; and still others a broad index based only on industry classification.

Number of Companies Referenced in Peer Group



3. Interestingly, 17 of the 135 companies (13%) referenced two different peer groups and 3 companies referenced three different peer groups. Again, there was no relationship to company size.

Percentage of Companies Reporting More Than 1 Peer Group



Notably, many companies that did not reference a peer group indicated their competitive comparisons were based on a single survey provided by a consulting firm. We will be interested to see the SEC's response to this method of relying on a constrained peer group determined by self-selected participation. We believe this "outsourcing" of the peer group development process to a biased sampling could be problematic, and is inconsistent with the diligent peer group development process used by the majority of companies.

The Challenge

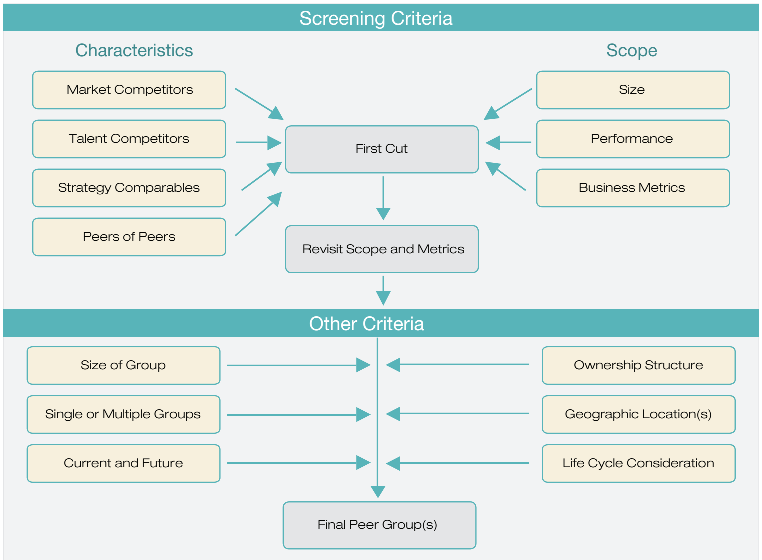
If the SEC extends their scrutiny and comment to the peer group issue in more companies, our analysis indicates that many, regardless of size and sector, will have some additional work ahead of them – either in response to an inquiry this year or proactively for proxy development next year.

That some companies find it necessary to construct three different peer groups while others merely reference a single survey database shows a disparity of practices that we believe will evolve. It may be valid to reference a single survey source when an industry is narrowly-defined and all potential peers – from any perspective – participate in that survey, but that is a rare situation.

More likely, given the proliferation of market segments and business models, a company must carefully determine who their peers are to allow a valid competitive comparison. Because company size increasingly has more effect than industry sector on executive pay, a company must decide whether "size" means revenue, market capitalization, number of employees, enterprise value, global dispersion, capital intensity, labor intensity, and/ or other factors. The SEC believes that investors want to know what each company thinks about this, how it affects the methods used and amounts paid to executives, and how they arrived at that decision. Even if a company is privately-held, a nonprofit organization or a hybrid entity such as a joint venture, good corporate governance dictates that the same standards apply.

Recommendations

The peer group development process has grown to be a significant part of the executive compensation evaluation and design process, as it should be. Peer group development is hard work, particularly as companies' business models become more complex. Compensation Committees have a responsibility for ensuring that competitive comparisons are rooted in a meaningful benchmarking process. Benchmarking is meaningless, however, if the benchmarks are inappropriate. As validated by the SEC commentary, it is something that investors want to know. We think there is a basic process that should be followed, tailored to each company's situation as summarized in the adjacent chart:



1. **Start with a broad cut:** The executive labor market is diverse. The CEO of a home improvement products retailer just became CEO of a US auto manufacturer while a competing US auto manufacturer hired an airplane manufacturing divisional executive as CEO. A company should consider all industry sectors from which they have recruited executives and lost executives, understanding what business characteristics led to those moves. Compensation for some executive positions is much less industry-specific than sometimes assumed.

2. **Define scope:** Starting with a comprehensive measure such as revenue or market cap, define a range that is perhaps 50% to 200% of your company's. Did that produce 3 peers or 80 peers? It is not necessary to analyze 80 companies' data but with the technology tools available it is little incremental work if a peer group that large is deemed appropriate.

3. **Understand scope metrics:** Differences in business models can be significant. A young fabless semiconductor company might be a business competitor of a mature fully-integrated firm with comparable revenue but the latter might have 5 times the number of employees and have physical plants in 10 countries. Does it matter or is managing a virtual organization more complex than being "under one roof?"

4. **Consider other metrics and characteristics:** Seemingly similar companies may be substantially different in terms of ownership structure, life cycle stage of the business, geographic scope of operations, and business strategy. The selection process need not be purely quantitative.

5. **Consider "pay level peers" as well "pay practice peers":** Our ongoing research confirms that scope, across sectors, may dictate pay levels, but industry norms, across all size companies in an industry, may dictate pay practices.

6. **Iterate:** No amount of data and analysis should replace good business judgment. The Compensation Committee ultimately has the responsibility to "do what's right" and each company will have considerations unique to its situation. How else can one firm decide that 5 peers are the "right" amount while another decided it was 75? It is completely valid to decide that all of the processes and criteria used resulted in the inclusion or exclusion of a certain company as a peer. Also, exclusion because "they're just not like us" may very well be valid; however, the organization should disclose the reason(s) for the exclusion if the excluded company is one that investors would expect to be included. An Internet company in San Jose is not a movie studio in Hollywood even though they might be "media companies" with similar financial and operational characteristics. They might be peers, they might not be.

Takeaway

To ensure integrity in the process, no compensation data should be presented during the peer group construction process. Final sign-off on the group should occur before the Compensation Committee sees the pay data. If the data resulting from a well-constructed peer group tells an unexpected story about marketplace pay practices and levels, there may be significant changes indicated for the company's existing executive pay program. Alternatively, a thorough explanation of why there is such divergence would be warranted. That is what Compensation Committees are paid to decide, and while they are not easy decisions, they are necessary ones – according to the SEC.

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