Navigating Shareholder Influence: Compensation Plans and the Shareholder Approval Process
by Pamela Brandes, Maria Goranova, and Steven Hall

Executive Overview
Corporate governance research emphasizes the influence of institutional owners on company outcomes such as strategic decisions, organizational structures, and executive compensation. However, little is known about the process companies use to gain support for management-sponsored compensation plan resolutions. This article reviews prior literature linking institutional ownership and compensation practices and investigates the little-studied process of how management tries to work with owners to secure shareholder approval of compensation plans. In addition, it provides brief cases of two Fortune 300 companies (General Mills and PepsiCo) that received positive votes on their compensation plans. The article ends with several recommendations for managers trying to gain institutional owners’ approval of future compensation plans.

Executive compensation has received a great deal of attention in the academic literature and in the mainstream press. Not surprisingly, shareholders are taking note. A recent survey by Watson Wyatt indicates that 90% of institutional investors believe corporate executives are overpaid (Watson Wyatt, 2005). This might explain, in part, the surge in shareholder activism in the past six years, which is mostly focused on executive compensation and boards (see Figure 1; Georgeson, 2000, 2005). The changing nature of ownership in modern corporations from predominantly individual to institutional ownership is giving the institutional investor greater influence over corporate governance issues. Whereas in 1965, institutional owners accounted for less than 20% of the ownership of equities outstanding, current estimates put this figure at 61.3% ($9.3 trillion) of the total value of U.S. equities outstanding (Coffee, 1991; Securities Industry Fact Book, 2002, p. 64), making institutional investors the “most ubiquitous corporate shareowner[s]” (Daily, Dalton, & Rajagopalan, 2003). Researchers are consistently looking more closely at institutional owners, investigating their impact on a variety of corporate activities, including CEO compensation, R&D intensity, innovation, international diversification, corporate venturing, and corporate social performance.

Although the role of institutional investors in mitigating agency conflicts and encouraging managers to undertake decisions that fall in line with owners’ interests is well researched, the firm’s response to investor preferences remains poorly understood. In particular, firms often appear as passive recipients of investors’ influence, and the reverse process, whereby companies actively work with shareholders and their advocates to anticipate and allay shareholders’ concerns, is seldom acknowledged.

In response, this article focuses on two themes. First, we provide a brief review of the literature...
that details the impact of institutional ownership on executive compensation and discusses the variety of mechanisms institutional investors use to gain influence. Hence we revisit the question how do institutional owners influence corporate compensation plans? Second, while prior research on corporate governance has significantly advanced our understanding of the impact of monitoring and the alignment of executives’ interests with those of shareholders (Beatty & Zajac, 1994; Eisenhardt, 1989; Jensen & Meckling, 1976; Tosi, Katz, & Gomez-Mejia, 1997; Zajac & Westphal, 1994), less attention has been devoted to the efforts firms make to improve communication with their shareholders. This issue is even more pertinent in light of recent changes that require shareholder approval of equity compensation plans (Borges & Silverman, 2003). This leads us to our second major question, how do companies work with shareholders to gain approval of corporate compensation plans?

In answering these questions, we highlight the significant players and processes through which companies seek endorsement of their compensation resolutions. Notably, we bring to light the informal processes through which companies confer with owners about their compensation plans, as well as the players involved that have so far remained largely unstudied. For example, while institutional shareholder advisory services such as RiskMetrics Group (the former Institutional Shareholder Services\(^2\) [ISS]) and Glass-Lewis represent important influences on management’s efforts to obtain shareholders’ approval of compensation plans, their role is rarely acknowledged. We then provide cases that demonstrate two companies’ experiences with the shareholder approval process. Finally, we close the article by discussing strategies firm managers could implement to create more effective working relationships with shareholders in the compensation approval process.

### Institutional Owners’ Influence: Effects on the Firm

Institutional investors are organizations such as banks, mutual funds, insurance companies, public and private pension funds, and investment companies (for an excellent review, see Ryan & Schneider, 2002). Their diversity drives differ-

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\(^2\) In January 2007 RiskMetrics Group completed its acquisition of Institutional Shareholder Services (ISS). RiskMetrics modified the name to ISS Governance Services.
ences in terms of their monitoring interests and ability and, consequently, organizational outcomes (Brickley, Lease, & Smith, 1988; Johnson & Greening, 1999; Kang & Sorensen, 1999). While sizable ownership, or blockholding, has emerged as the dominant proxy for the willingness of an investor to bear monitoring costs (Edwards & Hubbard, 2006; Hambrick & Finkelstein, 1995), scholars have pointed to other factors that could help explain owners’ involvement, such as the importance of the firm within the investor portfolio (Ryan & Schneider, 2002), the business ties of the owner to the firm (Brickley et al., 1988), the owner’s propensity to engage in active monitoring (David et al., 2001), and the owner’s temporal horizon (Hoskisson et al., 2002).

Although institutional investors traditionally have been perceived as rubber stamps on managerial decisions, their power has grown rapidly in the past 20 years (Neubaum & Zahra, 2006). Increasingly, we see instances of institutional owners challenging executives’ agendas and seeking to influence target firms’ policies, structure, and governance (Del Guercio & Hawkins, 1999; Gillan & Starks, 2000; Wahal, 1996). Recently, researchers have linked institutional ownership to a wide variety of corporate outcomes, including CEO compensation (David, Kochhar, & Levitas, 1998; Hartzell & Starks, 2003), firm survival (Filatotchev & Toms, 2003), R&D and innovation (David et al., 2001; Hoskisson et al., 2002; Kochhar & David, 1996), international diversification (Tihanyi et al., 2003), corporate entrepreneurship (Zahra, 1996; Zahra et al., 2000), and capital structure (Chaganti & Damanpour, 1991).

**Institutional Investor Effects on Compensation**

Anecdotal evidence suggests that large institutional owners stand at the forefront of mitigating conflicts about executive compensation (Bebchuck & Fried, 2004). The extent to which institutional investors can monitor the process associated with evaluating and rewarding CEO performance depends on several factors. Equity-based compensation and awards can dilute shareholders’ ownership rights. In response to such concerns, the New York Stock Exchange and NASDAQ mandated in 2003 that equity-based compensation plans for listed companies be approved by shareholders (Borges & Silverman, 2003). When managers seek investor approval on company compensation plans, institutional investors may use the companies’ proposals as a bargaining lever. As one financial institution manager suggested: “A company may propose a new remuneration package for executives based on, say, an option scheme. We will respond by saying OK, but what about the flowback or added value for us as a result of implementing this scheme?” (Holland, 1998, p. 256).

When such plans do not benefit shareholders, investors may withhold future votes for board members who have authorized them: “We are going to hold compensation committees accountable for giving away shareholders’ money in a way that provides no benefit to us” (Richard Ferlauto, director of the American Federation of State, County, and Municipal Employees [AFSCME], cited in McGregor, 2007, p. 59). Furthermore, executive pay provides a venue for principled monitoring, in which “we are careful to only attempt to influence a firm on matters of principle such as a corporate governance issue,” unlike firm strategy, in which influence attempts mean the financial institution is “trying to second-guess management in its own field of expertise” (Holland, 1998, p. 251). Similarly, Hendry, Sanderson, Barker, and Roberts’ (2006, p. 1113) interviews with institutional investors revealed that though they viewed managers as “dutiful, hardworking fiduciaries, running their companies as best they could in the long-term interests of shareholders,” they believed CEO pay still is influenced by management’s self-interest: “Management needs are often a source of conflict with shareholders. . . . Their requirement for income, for perks, for incentive schemes, for power, for independence of owners, can all create major conflict(s) in relations and stimulate active intervention by us” (Holland, 1998, p. 256).

To attract managerial attention, institutional investors may use a spectrum of interventions,
ranging from “private club” solutions to public confrontation strategies (Holland, 1998). For instance, some shareholders have tried to informally influence corporate decisions, while others have publicly pursued bylaw amendments, “just vote no” campaigns, proxy contests, and shareholder proposals (Thomas & Martin, 1999). Although shareholder resolutions have been described as powerful tools for influencing management (Wilcox, 2001), they rarely garner majority support among voters. For example, only one of 30 resolutions raised by shareholders at Verizon in the past five years received at least 50% of the vote (Dvorak & Lublin, 2006). Even if a resolution passes with a majority, shareholder resolutions remain advisory in nature, meaning boards may ignore these statements of shareholder wishes (The Economist, 2006), which would force sponsors to rely on the publicity that plays out at shareholder meetings and in the business press. Such publicity can threaten executives’ reputations and tenure (Neubaum & Zahra, 2006), as it did in the recent high-profile case of Home Depot’s CEO, who was ousted in part because he refused to have his stock awards package reduced in light of mediocre stock price performance during his tenure (Grow, 2007).

Alternatively, institutional investors can communicate their positions on compensation directly to executives and then resort to more confrontational tactics only if management ignores their interests. Both quiet diplomacy (i.e., private negotiations, letters, regular private meetings [e.g., Carleton et al., 1998; Hendry et al., 2006]) and public activism (i.e., shareholder proposals, proxy fights, publicized letters, and target lists) thus have become increasingly commonplace.

**Empirical Evidence: How Institutional Ownership Affects Executive Compensation**

Empirical research largely supports anecdotal evidence that institutional investors’ involvement reduces executives’ power over the boards that set their compensation (see Table 1). For example, Hartzell and Starks (2003, p. 2366) found that institutional owners with large stakes lower total compensation, thus “acting as a check on pay levels” and “ensuring that management does not expropriate rents from shareholders in the form of greater compensation.” Similarly, Khan, Dharwadkar, and Brandes (2005) found that ownership stakes by the largest owner are negatively related to CEO total pay, but the relationship is opposite for aggregate institutional ownership. Gomez-Mejia and colleagues (2003) found that institutional ownership depresses the long-term income for family CEOs, but Daily et al. (1998) did not find a more general relationship to executive compensation. Outside the United States, Cheng and Firth (2005) found that institutional ownership moderates executive compensation in Hong Kong firms. In addition to linking institutional ownership to total executive compensation, studies have found connections to options repricing (Pollock et al., 2002; cf. Carter & Lynch, 2001), use of stock options (Khan et al., 2005; Ryan & Wiggins, 2002), and perks such as personal use of corporate aircraft (Yermack, 2006).

Furthermore, researchers have pointed at the temporal orientation, pressure sensitivity, and activism of institutional owners. For example, executive compensation is lower in firms where pressure-resistant institutional investors own higher stakes (David et al., 1998), as well as in firms with higher concentrations of active institutions (Almazan, Hartzell, & Starks, 2005). Brandes and colleagues (2006) also found that institutions with longer-term horizons are more likely to expense stock options, thereby improving transparency in executive compensation.

Although influential institutional owners are well positioned to restrain executive compensation levels, they may be even more concerned about pay for performance. Hartzell and Starks (2003) indicated that large institutional owners, as more effective monitors, are associated with greater pay-for-performance sensitivity, i.e., CEOs receive greater rewards for improving shareholder value. Similarly, prior research has associated institutional activism with more salient investor demands and suggested that it relates positively to
Although companies increasingly appreciate the importance of maintaining dialogue with institutional investors (Useem, 1996) and boards may be compelled to take into consideration shareholder views to ensure the passage of a proposed stock option plan (Thomas & Martin, 1999), companies rarely appear as active initiators of this communication. Instead, previous work has largely rationalized the process of owner-management interactions as a “black box,” in which inputs such as ownership preferences or monitoring capabilities lead to firm actions. In answering our second question (i.e., how do companies work with shareholders to gain approval of their compensation plans?), we attempt to peer inside the black box and identify an important, yet currently unacknowledged, process. Specifically, we identify the essential parties and steps of a reverse process, in which managers work with institutional shareholders.

Thus far, companies’ attempts to discern investors’ preferences, such as those disclosed in proxy voting policies, as well as their attempts to work with institutional investors and the groups representing their interests, have gone largely unnoticed, even though we know managers and their firms are active players in the institutional environment and attempt to co-opt institutional investors and/or renegotiate owner expectations.

### Table 1: Institutional Ownership and Executive Compensation

<table>
<thead>
<tr>
<th>Authors</th>
<th>Year</th>
<th>Journal</th>
<th>Findings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Almazan, Hartzell, Starks</td>
<td>2005</td>
<td>FM</td>
<td>Pay-for-performance sensitivity is positively related to the concentration of active institutions</td>
</tr>
<tr>
<td>Brandes, Hadani, Goranova</td>
<td>2006</td>
<td>JBR</td>
<td>Long-term institutional investors prefer stock-option expensing</td>
</tr>
<tr>
<td>Carter &amp; Lynch</td>
<td>2001</td>
<td>JFE</td>
<td>Insignificant relationship exists between institutional ownership and option repricing</td>
</tr>
<tr>
<td>Cheng &amp; Firth</td>
<td>2005</td>
<td>CG</td>
<td>Institutional ownership in Hong Kong moderates compensation but is not linked to pay for performance</td>
</tr>
<tr>
<td>Daily, Johnson, Ellstrand, Dalton</td>
<td>1998</td>
<td>AMJ</td>
<td>Institutional ownership is not related in a systematic fashion to CEO compensation or changes in compensation</td>
</tr>
<tr>
<td>David, Kochhar, Levitas</td>
<td>1998</td>
<td>AMJ</td>
<td>Pressure-resistant institutional owners are related to lower CEO compensation</td>
</tr>
<tr>
<td>Gomez-Mejia, Kintana, Makri</td>
<td>2003</td>
<td>AMJ</td>
<td>Institutional ownership depresses long-term income for family CEOs</td>
</tr>
<tr>
<td>Hartzell &amp; Starks</td>
<td>2003</td>
<td>JF</td>
<td>Institutional ownership concentration is positively related to the pay-for-performance sensitivity of executive compensation and negatively related to the level of compensation</td>
</tr>
<tr>
<td>Khan, Dharwadkar, Brandes</td>
<td>2005</td>
<td>JBR</td>
<td>Institutional ownership affects level of executive compensation, pay mix, and options performance sensitivity</td>
</tr>
<tr>
<td>Pollock, Fisher, Wade</td>
<td>2002</td>
<td>AMJ</td>
<td>Institutional ownership reduces the likelihood of repricing of executive options</td>
</tr>
<tr>
<td>Ryan &amp; Wiggins</td>
<td>2002</td>
<td>FM</td>
<td>Institutional ownership is positively related to stock options for high-growth firms</td>
</tr>
<tr>
<td>Yermack</td>
<td>2006</td>
<td>JFE</td>
<td>Institutional ownership is positively related to CEO’s personal aircraft use</td>
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</tbody>
</table>
(Neubaum & Zahra, 2006; Useem, 1996). For example, CalPERS has been solicited by numerous firms in phone calls, letters, and personal visits from top executives (Hawley, Williams, & Miller, 1994). This influence process is even more important today, as brokers who routinely voted with management in the past cannot vote without explicit voting directions from beneficiary owners (Borges & Silverman, 2003).

**Categorizing Influence Strategies**

From a practical point of view, we suggest that companies’ strategies differ when they attempt to influence the shareholder approval process. We suggest that these strategies vary along two major dimensions (see Table 2). First, companies differ in terms of when they get involved with shareholders—firm actions range from an anticipatory to a responsive stance toward shareholder concerns. Specifically, in attempting to influence shareholders’ opinions on compensation, some companies proactively scan their environments, seeking input from shareholders directly and through the use of hired intermediaries who more closely have their fingers on the pulse of shareholder concerns. Other companies, already largely confident in their compensation approach, feel that communication with shareholders regarding compensation plans is best accomplished after management’s compensation resolutions have been released in company proxy statements.

The second dimension on which we categorize these strategies is the extent to which revisions to companies’ compensation packages are substantive vs. symbolic. For example, Westphal and Zajac (1994, 1998) suggested that companies decouple substance from symbolism in compensation, resulting in higher pay with lower risk for executives while seeming to be responsive to owners. Managers’ influence on these compensation arrangements can be problematic if it dilutes and distorts incentives, leading to reductions in shareholder value and excessive executive compensation (Bebchuk & Fried, 2004). As illustration, Westphal and Zajac (1994, 1998) suggested that organizations adopted long-term incentive plans under the typical rubric of creating incentive alignment between management and owners. However, many of these “adopted” programs were never implemented, denoting a symbolic rather than a substantive response to shareholder demands.

**Identifying the Players in the Shareholder Approval Process**

Before we move to our two mini-cases, we highlight the cast of players who move on and off stage over the time of the shareholder approval process.

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**Table 2**

**Conceptual View: How Firms Interact with Institutional Investors Regarding Compensation**

<table>
<thead>
<tr>
<th>Timing</th>
<th>Nature of Company Response</th>
<th>Substantive</th>
<th>Symbolic</th>
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<tbody>
<tr>
<td>Anticipatory</td>
<td>Preempt shareholder concerns by undertaking compensation policies that shareholders deem desirable</td>
<td>Ex: Voluntary expensing of stock options (Brandes, Hadani, &amp; Goranova, 2006)</td>
<td>Ex: Announce, but do not implement, voluntary expensing of stock options</td>
</tr>
</tbody>
</table>
The process has evolved into a consultative one. Acting on behalf of the organization are human resource (HR) departments, particularly senior members of the compensation function and vice presidents of HR. This group is assisted by other members of the organization, including those employed in investor relations, legal and finance departments, top management, and even company controllers. Boards and the subset of directors who constitute the compensation committee represent the interests of shareholders. Furthermore, institutional owners take great interest in the compensation process; in a letter to companies in which Vanguard has substantial equity interests, the large mutual fund claimed it was pleased with its “ability to influence, in appropriate situations and in an appropriate manner, the structure of compensation programs” (Vanguard, 2002). Many institutional investors also rely heavily on proxy advisory resources, such as Glass-Lewis and ISS, for voting advice and recommendations. Compensation consultants such as Mercer and Hewitt and Associates provide benchmarking data to compensation committees, assist in compensation plan designs, and report to boards (Watson Wyatt, 2005).3 Finally, proxy solicitors (e.g., Georgeson, D. F. King, Morrow, etc.) assist companies in the preparation and tabulation of proxies, actively encourage owners to vote, and may provide consulting services to companies regarding owners’ preferences.

**Case Studies**

We now turn to the experiences of two companies—General Mills and PepsiCo—to illustrate the shareholder approval process. These companies’ approaches although not identical had similarities—the main one being their communication with institutional investors regarding their compensation plans. This is something that few companies do, but we expect more companies to adopt similar strategies in the future.

**General Mills**

In compensation circles, General Mills is a leader and an innovator (Bryant, 1998). The company was a pioneer in linking pay to performance, one of the first companies to put virtually all employees on an incentive pay program, and at the forefront of providing periodic all-employee stock option grants (Davis, 2006). It also developed a very innovative approach that allows most professional employees the opportunity to receive a supplemental stock option grant in lieu of a merit increase.

Before shareholders’ approval of its 2003 stock plan, General Mills had a strong ownership culture, including several all-employee stock option grants and ownership guidelines for executives and the board (General Mills, 2003). As an example of the company’s commitment to its ownership culture, its 2003 proxy statement indicated that it “believes that broad and deep employee ownership effectively aligns the interests of employees with those of stockholders and provides a strong motivation to build stockholder value” (General Mills, 2003, p. 21). The company’s extensive and unique use of equity incentives led to a burn rate (i.e., total number of equity awards granted in any given year divided by the number of common shares outstanding; Frederic Cook and Co., 2004) of 4.2% in 2002, which the company wanted to reduce to 1.6% (General Mills, 2003). Its stock option overhang (i.e., potential shareholder dilution)5 was “slightly above 17% . . . higher than average for the consumer products industry” (General Mills, 2003, p. 27). It also was running low on shares allocated for incentive plans and knew it would need shareholders’ authorization for more at its annual meeting in September 2003 (Davis, 2004).

As General Mills considered its future incen-

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3 Recent concerns center on whether compensation consultants’ independence suffers when a consultant simultaneously offers services related to executive compensation and other HR consulting. A Watson Wyatt report based on a survey of institutional investors finds that 67% of these investors “favor having independent consultants report to the compensation committee.”


5 Stock option overhang is a “measure of potential dilution from stock compensation plans equal to the number of shares in outstanding grants plus those remaining available for grants divided by common shares outstanding” (World at Work, Advanced Concepts in Executive Compensation Programs [C6A] Glossary, p. 15). High levels of overhang can dilute shareholder value, in conflict with the interests of shareholders.
tive plan, it remained cognizant of what was going on in the compensation and corporate governance domains. Recent corporate scandals in other industries suggested more scrutiny of compensation programs in the future, and an ever-growing threat indicated that stock option expensing would become mandatory, which would eliminate the accounting advantage options provided over other equity-based rewards (General Mills, 2003). At the same time, proxy voting advisers, such as Glass-Lewis and ISS, had become increasingly vocal in advising clients about how investors should vote their company proxies to protect their interests. Nearly all of General Mills’s 75 largest institutional shareholders subscribed to ISS’s and/or Glass-Lewis’s voting recommendations services (Davis, 2004). “Within this context, the company realized it had to change the way it dealt with its stock plan design, its proxy disclosure, and the shareholder vote” (Davis, 2004).

Before designing its 2003 approach to stock compensation, the company contacted three of its 10 largest shareholders to understand their views of the company’s past practices and learn in general terms what they would like to see in a new stock compensation plan. These investors, long-term owners of the firm, were familiar with the company and its reputation as a leader in compensation practices. They also seemed appreciative of the company’s attempts to engage in dialogue and understand their perspective. A major theme that emerged from these discussions was the need for the company to communicate the various aspects of the plan clearly and effectively to the investment community, as well as why the plan was appropriate given not only the overall compensation environment but also the firm’s specific situation and history. This communication later emerged in the form of the company’s very elaborate proxy disclosure regarding the plan, which detailed why particular aspects were in the shareholders’ best interests. No further contact was made with these three investors until after the proxy had been released.

The company also contacted the corporate services arm of ISS, which, for a fee, measures how a compensation plan would fare according to ISS’s proprietary Shareholder Value Transfer (SVT) model. The model estimates the cost of a proposed compensation plan by assessing “the amount of shareholders’ equity flowing out of the company as options are exercised,” plus the cost of voting power dilution (VPD) (ISS, 2005). The company “worked very closely with ISS to help them understand [the] unique reasons why [General Mills’s] overhang and run rates were high . . . [and] where we were heading with run rate and overhang” (Davis, 2004, p. 34).

In three different areas of the proxy statement, the company meticulously disclosed the elements and rationale behind its plan while showcasing its long history of ownership and previous equity incentive plans. General Mills also described its selective stock buyback policy, used to reduce the dilutive effects of equity incentives. The plan included several emerging best practices supported by shareholders. For example, the company would prohibit executive loans related to option exercises (such loans are no longer permitted for named executive officers under the Sarbanes-Oxley Act of 2002), nor would it permit the compensation committee or board of directors to (a) materially change the number of shares associated with the plan, (b) issue options at less than fair market value, (c) permit repricing of outstanding options, or (d) amend the maximum number of shares permitted for any one recipient, without first having obtained shareholder approval. Other shareholder-friendly aspects highlighted included (a) eliminating the (shareholder-unapproved) 1998 Employee Stock Plan, (b) prohibiting reload options, and (c) requiring at least four years for vesting. The plan also suggested a desire to “lower share usage by shifting long-term incentive grants

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6 At the time, Institutional Shareholder Services ran two separate business units. ISS Proxy Research and Voting Solutions provided voting recommendations and “corporate governance solutions that enhance the interaction between shareholders and companies, in order to help shareholders manage risk and drive value” (www.issproxy.com/institutional), whereas ISS Corporate Services, Inc., (ICS) was a “stand-alone, wholly owned subsidiary of ISS” that provides “a suite of services designed to help companies advance their corporate governance standards in the post–Sarbanes-Oxley era” (www.isscorporateservices.com). Although ICS “has historically been managed as a separate division of ISS, operating with a staff completely apart from ISS’ core institutional services division,” some members of the business press note a potential conflict of interest in simultaneously “setting governance standards and helping clients meet them.” See R. Hershey, “A little industry with a lot of sway on proxy votes.” New York Times, June 18, 2006.
to a blend of stock options and restricted stock from solely stock options . . . [which would] further reduce overhang, while keeping compensation levels competitive with our industry peers” (General Mills, 2003, p. 27).

Serving as the proxy solicitor, Georgeson Shareholder Communications, Inc., helped in the “preparation, printing, and mailing . . . for a fee of $17,500 plus their out-of-pocket expenses” (General Mills, 2003, p. 38). Georgeson also consulted with General Mills to help it better understand the compensation-related voting patterns of the 50 largest investors in the company. The proxy solicitor provided contact information for institutional investors and whether they used ISS/Glass-Lewis voting recommendations. With this information, General Mills attempted to contact its 50 largest institutional shareholders after the release of the proxy to “discuss the plan, our past, our future, and answer questions” (Davis, 2004, p. 34). The vice president of HR and/or head of investor relations conducted these phone calls. Discussions with the investors typically were brief (15 to 30 minutes), and investors who agreed to speak with the company generally were very knowledgeable about the company’s proposed compensation plan. When the proxy was released publicly, General Mills also mailed a copy to ISS and Glass-Lewis.

The company observed that it had a short window (only a few weeks) between the release of the proxy and the voting deadline and knew, according to its proxy solicitor, that most voting occurs toward the end of the voting period. Approximately a week before the company’s annual meeting, Glass-Lewis and ISS issued their voting recommendations to their clients: The 2003 plan had received the support of both ISS and Glass-Lewis, and then earned an 87% affirmative vote from shareholders.

**PepsiCo**

In 2003, PepsiCo management needed shareholder approval for its compensation plan. PepsiCo recognized the fever pitch reached as a result of corporate scandals and media attacks on incentive compensation, as well as the reality of regulations regarding disclosure and expensing (Scherb, 2004). As an innovator and leader in compensation design, PepsiCo had a long history of employee stock ownership; its well-reputed, broad-based Sharepower Global Ownership Program had existed since the 1980s (Scherb, 2004). However, three additional factors added to the urgency associated with the company’s 2003 compensation plan. First, the company had recently changed CEOs. Second, an internal survey of PepsiCo executives suggested that they “perceived the value of stock options [as] lower than the Black-Scholes value” (i.e., the actual cost to the firm of providing the incentive) (Scherb, 2004, p. 5). This perception was worrying, as the Financial Accounting Standards Board (FASB) was contemplating accounting changes that would require companies to take a charge for options, thereby creating a disconnect between the cost of providing the incentive and employee preferences. Third, the survey suggested that PepsiCo employees had “concerns about [the] financial security and stock market stability” associated with their equity awards (Scherb, 2004, p. 5).

In September 2002, with the backing of the CEO and the senior team, the company took proactive steps in accordance with emerging practices in compensation and corporate governance, including stock ownership guidelines that required “certain senior executives and directors [to] own PepsiCo stock worth between two times and eight times base compensation” and an “exercise and hold” policy, both considered shareholder-friendly actions (PepsiCo, 2003, p. 7). The core

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7 This is roughly comparable to the average solicitation fee for S&P 500 clients of $11,075 for the 1996-98 proxy season, as reported by Bethel & Gillen (2000).

8 That is, investors were approached about plan specifics after the proxy was disclosed. Companies cannot solicit a vote before the actual shareholder vote takes place, in line with regulation FD, which we discuss in the Managerial Recommendations section of this paper.

9 This case relies on information provided by David Scherb, former Senior Vice President of Compensation and Benefits, PepsiCo, in D. Scherb and P. Chingos, “Getting Dramatic Shift to Occur in Your Compensation Strategy,” presented at the annual meeting of World at Work, May 24, 2004, in Boston. It also synthesizes information gained during an interview with Greg Smith, Senior Manager, Global Compensation, PepsiCo, November 20, 2006.
project team consisted of the vice president of compensation and benefits, a team of PepsiCo compensation professionals, and a compensation consultant (Mercer), supported by the offices of the controller and the legal and finance departments. November 2002 saw a meeting of the core project team with the compensation committee of the board of directors and the CEO. At this pivotal meeting, the compensation consultant provided a presentation focused on PepsiCo’s third-quartile pay, which matched the third-quartile performance among 19 of its peers over the previous three years. Also on the agenda was the company’s compensation philosophy, which affirmed that the company would “achieve its best results if its executives act and are rewarded as business owners” and that owners needed to have “skin in the game” so they would “take higher personal risks for higher rewards” (Scherb, 2004, p. 11).

The company then sought input from executives through informal (staff meetings, business reviews) and formal (survey) channels. The survey, conducted by the compensation consultant, found that base pay was considered the compensation aspect most likely to “influence [employees’] day-to-day behavior,” according to 55% of employees, whereas stock options were ranked most likely by only 10% (Scherb, 2004, pp. 13–14). Furthermore, 85% of employees remarked that they would “appreciate more choice in how they received their compensation (i.e., cash vs. options),” despite the additional pay complexity (Scherb, 2004, p. 15).

In turn, the company created a new executive pay plan that incorporated suggestions from the firm’s leadership, market information, and employees. The specifics go beyond the scope of this paper, but it included aspects such as granting employees a choice of options versus restricted stock units (which have less risk for recipients), enhanced bonus awards (again, more cash, less risk), and other cash bonuses (Scherb, 2004, pp. 16–17). In addition, the company maintained its broad-based global equity program but reduced the size of grants, reallocating value from options to retirement programs (and thereby adding additional compensation stability) (Scherb, 2004). Finally, PepsiCo hired ISS’s Corporate Services group to model the expected SVT associated with their proposed plan, but it failed to meet ISS’s SVT standards, which meant ISS would recommend a no vote—though ISS had previously given PepsiCo high overall governance scores, both within the S&P and among players in its industry (Scherb, 2004). PepsiCo’s plan may not have met the SVT model standard because of its strong support of the use of broad-based options, which, though consistent with the company’s compensation philosophy and ownership culture, could have led to dilution levels over ISS’s SVT cap (Smith, 2006).

These results represented an important turning point in the shareholder approval process and led the company to launch a more intensive shareholder approval campaign. PepsiCo conducted its own research on institutional investors’ backgrounds and preferences regarding compensation plans and found that its 50 largest shareholders not only held 50% of ownership voting rights but also that 80% of them subscribed to the voting recommendations provided by ISS’s Proxy Research and Voting business unit (Scherb, 2004). PepsiCo next sought the counsel of its proxy solicitor, Georgeson, to validate its own research into owners’ preferences and vote projection analysis. Knowing that so many investors would be looking to ISS for voting recommendations and that the plan did not meet the SVT model, PepsiCo’s compensation staff attempted to “set realistic expectations for board members” regarding the upcoming shareholder vote by suggesting that the “vote may be closer than in the past” (Scherb, 2004, p. 20). In order to overcome the ISS voting recommendation, PepsiCo contacted its top 75 shareholders regarding the compensation plan (Smith, 2006).

In late March 2003 the company released its compensation plan to the public in its proxy statement and soon after approached institutional shareholders, some by phone and some in person, to communicate the objectives of the proposed compensation plan clearly. In these communications, PepsiCo discussed issues of dilution and
equity run rates and plans for controlling them in the future—issues that would likely influence how the company’s largest investors would vote. Specifically, two-person teams of PepsiCo employees (from the HR or investor relations departments) used “scripted talking points” that were “tailored for each institution based on [PepsiCo’s] research” and emphasized the company’s unique position in terms of its broad-based ownership culture (Scherb, 2004, p. 21).

On May 7, just a few short weeks after the release of the proxy, the plan was approved by 68% of those voting, despite ISS’s negative recommendation. PepsiCo noted that 16 institutional investors that it had expected would vote no actually ended up voting for the plan, perhaps due in part to the extensive campaign the company had undertaken (Scherb, 2004, p. 22).

The Shareholder Approval Process: Comparing the Cases

Similarities. Having kept up with current trends, both companies remained very aware of the changing compensation environment and the importance of communicating with their shareholders. In addition, both General Mills and PepsiCo used their HR and investor relations functions extensively—primarily to exploit their compensation expertise, understanding of market conditions, and recognition of how to communicate the benefits of the companies’ plans to shareholders. Although most companies use proxy solicitors to identify and solicit votes, these firms employed additional support from their provider to gain a sense of the voting record of their largest institutional owners, whom both expressly attempted to enlist. Their efforts to contact all of their largest institutional owners in the few weeks between the proxy’s release and the companies’ annual business meetings represented huge undertakings.

Differences. The importance of companies communicating to shareholders about their compensation plans is underscored by PepsiCo’s ability to obtain a positive vote on its plan, even though it did not receive the sanction of ISS. However, the PepsiCo vote was closer than the General Mills vote, which suggests that institutional investors still subscribe to the recommendations of organizations such as Glass-Lewis and ISS and wait to hear their recommendations before voting. Recall that General Mills’ proxy solicitor suggested that many investors would vote quite late—within the last week or two of the voting process—which matches the time that ISS and Glass-Lewis release their voting recommendations. It remains to be seen whether companies can continue to gain shareholder approval of compensation plans when they lack the sanction of these groups.

Perhaps the strong backing of PepsiCo’s plan by top management; survey evidence suggesting that employees wanted less at-risk pay; and the company’s extensive comments about equity burn rates, dilution, and need for broad-based incentives to sustain its ownership culture were sufficient to persuade enough investors to carry the plan through. Furthermore, the company (and therefore, many of its institutional investors) had enjoyed solid recent performance, which may have positively affected the interactions between the firm and its shareholders. For example, in its 2003 annual report, PepsiCo noted: “Over the past four years, we’ve grown faster than both the S&P 500 and our industry group. We improved on that strong record in 2003: volume grew 5%, division net revenue 8%, division operating profit grew 10%, total return to shareholders was 12%” (PepsiCo, 2003, p. 1).

Managerial Recommendations

Having detailed how owners affect executive compensation and introduced the roles and process of how organizations attempt to secure shareholder approval, we offer recommendations to managers wanting to facilitate future compensation approval processes. We include some observations from our case studies and the business press as illustrations.
Communicate Clearly and Carefully with Shareholders

The importance of management communicating with shareholders on compensation issues without “resorting to boilerplate disclosure” has been underscored by recent revisions of disclosure rules (SEC, 2007). Related to the topic of clarity in communications, both PepsiCo and General Mills management recognized the need to “emphasize and re-emphasize shareholder friendly aspects of compensation” in their compensation resolutions (Scherb, 2004, p. 8). General Mills’s management did so by providing a very clear proxy statement that detailed aspects of the compensation plan as well as the rationale behind the various elements. Both companies undertook extensive efforts to contact their largest institutional owners. In these communications PepsiCo explicitly addressed issues of dilution and equity run rates, as well as the firm’s plans for controlling them in the future.

When attempting to persuade investors of the merits of company compensation practices, managers may not disclose information that has not already been disclosed to the market at large. In line with Securities and Exchange Commission (SEC) Regulation FD (Fair Disclosure), PepsiCo suggested that there be “communicat[ion] with key shareholders early and often [but only] where allowed [emphasis added]” (Scherb, 2004, p. 8). In fact, Regulation FD was enacted because companies were “disclosing important nonpublic information, such as advance warnings of earnings results, to securities analysts or selected institutional investors [emphasis added] or both, before making full disclosure of the same information to the general public” (SEC, 2000, p. 2).10

Be Alert for Shifting Preferences Among Investors and Their Advocates

Managers must be attentive to the hot buttons of investors and their intermediaries. Keeping up with institutional investors’ changing priorities can be a challenge. ISS’s preferences regarding equity compensation have evolved significantly just over the past decade. Between 1997 and 2001, ISS put forward its SVT model (e.g., ISS, 2005; McGurn & Ranzetta, 2006) and issued voting recommendations on management compensation resolutions solely on the basis of whether it deemed the costs of a plan reasonable compared with a standard based on the firm’s industry, market capitalization, and the best of its peers (ISS, 2005). The second stage (2002–03) reinforced this cost method but also included concerns about stock option repricing, which became a litmus-type test for institutional shareholders that felt that repricing can reward poor management performance while jeopardizing pay for performance. In the third stage (2004), ISS added another consideration: greater concern about pay for performance. Finally, in the last stage (2005–06) ISS focused even more on pay for performance but also on stock option burn rates (i.e., the annual rate at which shares are used for compensation purposes). Specifically, ISS wanted management to “commit to an annual burn rate equal to the mean plus one standard deviation of its GICS (Global Industrial Classification Standard) for the next three fiscal years” (McGurn & Ranzetta, 2006, p. 19). More recently, ISS has developed formulas that compensation plans must meet before it will recommend a yes vote. In fact, during the 2007 proxy season ISS recommended against 38% of equity pay plans, compared to 30% in 2006 and 31% in 2005 (RiskMetrics, 2007).

In summary, managers who are uninformed about the opinions of institutional investors and their intermediaries on compensation components may fail to incorporate aspects of compensation design that are anathema to shareholders. Management that overlooks shareholder concerns may encourage contentious

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10 Specifically, “the regulation provides that when an issuer, or person acting on its behalf, discloses material nonpublic information to certain enumerated persons (in general, securities market professionals and holders of the issuer’s securities who may well trade on the basis of the information), it must make public disclosure of that information” (www.sec.gov/rules/final/33-7881.htm#P12_1308).
votes and heightened scrutiny of future compensation plans.

**Clarify Pay-for-Performance Issues for Shareholders**

Managers must continually evaluate the extent to which pay matches performance and must communicate to shareholders the steps they have taken to ensure that pay and performance are in alignment. Previously, some institutional shareholder resolutions tried to encourage pay for performance through extremely prescriptive pay restrictions. For example, the United Brotherhood of Carpenters and Joiners of America, one of the largest pension funds, previously issued what it called “Common Sense” resolutions that restricted/capped pay (Plitch & Whitehouse, 2006). However, when these resolutions failed to garner much support, Carpenters changed its strategy, so its recent proposals regarding DuPont, Mattel, PepsiCo, and Bank of New York did not stipulate pay restrictions but instead proposed making awards contingent on outperforming competitors (Plitch & Whitehouse, 2006). Managers who fail to articulate the relationship between pay and performance in their compensation plans risk the reproach of such investors and their intermediaries. In fact, in 2004, ISS issued “cautionary notes” to 230 firms whose compensation plans had tenuous links between pay and performance.

Managers who refuse to acknowledge the importance of pay for performance for shareholders also risk drawing the ire of institutional shareholders when it’s time for board elections and/or re-elections. Although offering no specific guidelines as to what is “excessive” compensation, in 2005 ISS recommended withhold votes at more than 75 firms for board candidates who had previously authorized “excessive” bonuses, options, and/or severance pay (McGurn & Ranzetta, 2006, p. 13). In the same vein, two Pfizer corporate directors recently received withhold votes of approximately 21%—levels virtually unknown in the domain of corporate governance (Morgenson, 2006). More recently, investors have started to withhold votes for board candidates who have ignored shareholder resolutions approved by the majority of owners in prior periods (RiskMetrics, 2007). In summary, some institutional owners blame mismatches between management pay and performance on a lack of oversight by board members and may voice their displeasure by voting down management’s board candidates. Management must ensure that board candidates have a sincere commitment to issues such as pay for performance or risk prickly board elections that may be played out in the business press or at shareholder meetings.

**Increase Transparency Regarding Pensions, Severance, and Perquisites**

Managers are under increasing legal and institutional owner pressure to more thoroughly disclose post-employment compensation. This compensation can result from (a) retirement (i.e., pensions and other deferred compensation) or (b) the end of an employment relationship (i.e., dismissal, changes in control). Managers must be aware that institutional owners and their advocates are concerned with incomplete disclosure of post-employment payouts and/or payouts that are misaligned with performance. For example, ISS suggested that it is not the mere presence of “golden handshakes” (severance agreements) that engenders its ire, but that severance plans that go beyond 299% of annual compensation should be put to shareholder vote (McGurn & Ranzetta, 2006, pp. 34–35). Clear management disclosure about these arrangements is essential, as this better informs investors and assures them that there isn’t any “hidden” compensation.

The SEC recently required “the disclosure of

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11 Under Pfizer’s election rules, candidates who receive less than 50% support among those votes cast must submit their resignation to the board, but the board still maintains discretion over accepting the resignations. In other words, the vote is only advisory.

12 Severance payouts in excess of 299% will generally result in unfavorable tax treatment under Sections 280G and 4999, which can result in lost tax deductions to the company that are believed to hurt shareholders.

13 An analysis of the Fortune 100 by Equilar suggested that the median compensation multiplier in the case of (disclosed) CEO severance arrangements was two times base plus bonus compensation; for executive job loss resulting from a change in control, it was a multiplier of three (McGurn & Ranzetta, 2006, p. 35).
perquisites and other personal benefits unless the aggregate value of such compensation is less than $10,000 . . . [a level that] is a reasonable balance between investors’ need for disclosure of total compensation and the burden to track every benefit [emphasis added]” (SEC, 2006). As an example of this increased disclosure, Merck management claimed in its 2006 filings that the aggregate value of company reimbursement for financial/tax planning, the use of company planes, reimbursements for home security, and physical examinations by the company staff was less than $50,000 for each of its executive officers (McGurn & Ranzetta, 2006, p. 28; Merck, 2006). Freescale Semiconductor indicated that it would not cover its CEO’s tax burden for the 50 hours of company aircraft time he is allowed for personal use but would cover his income tax expense associated with allowing his wife to travel with him on business-related trips (Freescale Semiconductor, 2006). For most investors it is less the presence of particular perquisites that upsets them but rather their excessive use or declines in company performance after their implementation (McGurn & Ranzetta, 2006, p. 26). Consequently, management must ensure that perquisites are within acceptable ranges and commensurate with performance levels. Clearly, disclosing “appropriate” compensation can engender shareholder trust regarding post-employment compensation that may carry over to other aspects of compensation.

Limitations and Conclusion

We recognize that the generalizability of our two cases and our managerial recommendations may depend on factors such as firm performance and size. For example, performance represents an important criterion when institutional investors select compensation activism targets, and firms with above-average performance may be able to garner greater institutional investor support for their compensation plans. Firm size may be an important predictor of how much investor activism management may anticipate; large firms may be better able to work with shareholders’ demands, in that they can expend more resources, such as talent and experts, to address them. In contrast, smaller firms may have to rely on less-formal processes to address institutional owners’ concerns.

Some question why institutional owners, with their massive, diversified portfolios invested in hundreds if not thousands of firms, would bother to get involved with firms’ compensation arrangements. After all, institutional owners are not experts in compensation design, and disgruntled investors can vote with their feet by taking their investments elsewhere. However, if owners note an increasing percentage of mismatches between pay and performance among the firms in their portfolios, they may raise compensation resolutions, create voting guidelines on compensation, consult intermediary voting advisory services, vote down or offer up their own board candidates, and/or demand change in the amounts and/or disclosure of compensation. Insightful management must anticipate or respond to institutional shareholder feedback using the arsenal of internal and external support detailed in this article to ward off public criticism, or worse, negative shareholder votes, regarding company compensation plans.

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