

## Top 10 Executive Compensation Issues in the New Economy

Compensation Committees have entered virtually unknown territory. Historically, pay programs for senior executives have always drawn fire when the economy goes into a slump. But the worldwide financial meltdown has fueled an unprecedented level of outrage and activism on multiple fronts – most notably, in moves by legislators, the SEC and Treasury to directly limit management pay at the multiple financial institutions that have accepted government funds. Without question, these developments will have sweeping ramifications for pay programs at *all* public companies. More than ever, every Compensation Committee should be scrutinizing every nuance of every executive compensation program with an eye not only to whether its practices are effective and appropriate, but to how programs will be perceived within and outside the organization.

We've taken a look at 10 key issues related to plan design and corporate governance that Boards will be grappling with in the coming year, with recommendations for best practices and pitfalls to avoid:

- 1) Considering "Optics"
- 2) Corporate Governance
- 3) Say on Pay
- 4) Assessing Risk in Compensation Plans
- 5) Addressing Underwater Options
- 6) Pay Programs in a Down Economy
- 7) Selecting Measures and Setting Goals
- 8) Managing Career Compensation
- 9) Stock Ownership Guidelines
- 10) Peer Group Selection

### (1) Considering "Optics"

In addition to ensuring that pay programs are competitive and effective, companies should be mindful of how they will be perceived by others – what is commonly referred to as program "optics." The perspective of shareholders has never been more acute, given significant reductions in shareholder wealth, outrage over executive compensation at many financial services organizations receiving government bailouts, and growing support for giving shareholders a direct voice on compensation programs via a Say on Pay proxy vote. Employees' perceptions also become critical when organizations take such steps as reducing their workforce, eliminating salary increases, reducing 401(k) benefits, etc.

The challenge is to eliminate any design features that are not justifiable and address elements that, while appropriate, are at risk of being perceived negatively – all without sacrificing the compensation program's competitiveness or effectiveness. This is best accomplished by taking a holistic perspective and having the courage to do what's right for your business, as opposed to "following the herd." The following seven practices can enhance program optics:

- *Minimize perquisites.* Executive perquisites are a very small percentage of total compensation value, but a huge driver of shareholder and employee dissatisfaction. We recommend eliminating executive perquisites that generally lack a legitimate business purpose and that other employees must cover on their own, such as *personal* use of a corporate aircraft; a car allowance and/or company car; club dues; and tax preparation services. In contrast, executive perquisites with a potentially legitimate business justification include *business* use of a corporate aircraft; a home security system; or a periodic physical exam.

- *Minimize tax gross-ups.* Paying an executive's tax bill will never be viewed positively by shareholders or employees. Moreover, gross-up provisions incurred when change-in-control payments trigger excise taxes can entail significant added expense to the company. We generally advise against the use of gross-ups, with the possible exception of relatively new executives who stand to be significantly hurt by the excise tax "penalty." There are two reasons: their basis, or W-2 history with the company, will be artificially low, while the value of their accelerated equity vesting will be artificially high, given the likelihood of having received inducement equity awards at hire with limited time for exercise and/or vesting.
- *Rationalize severance.* Executive-level severance is now the veritable poster child for egregious compensation. While severance has a legitimate purpose, companies always should carefully review eligibility, potential payouts, and the conditions under which severance would be provided. To ameliorate concerns about severance programs, more companies are excluding executives at later stages in their careers, reducing benefit formulas and levels, and redefining contract terms such as "Cause," "Change-in-Control," and "Constructive Discharge." A challenging case that should be addressed is abysmal performance that falls short of the definition of "Cause."
- *Perform "dynamic pay modeling."* The best way to avoid embarrassing compensation optics is to incorporate a forward-looking analysis in the program design process. Reviewing potential outcomes under various performance scenarios at the time the program is being adopted helps avert "surprises" when compensation is earned, delivered, or disclosed.
- *Embrace transparency.* The litmus test for any compensation decision is whether it will withstand the light of day when reported in the proxy's *Compensation Discussion and Analysis (CD&A)*. By embracing full transparency and considering disclosure implications at the time decisions are made, optics issues can be minimized.
- *Improve shareholder relations.* Including shareholders in the executive compensation process can help avert negative reaction to formal compensation disclosures. Engage in regular dialogues with large shareholders to increase their understanding of compensation programs, particularly in advance of a new share request or of being subject to a Say on Pay shareholder vote. While we are likely to get Say on Pay in the near future, it is a blunt instrument and not a substitute for proactive communications with key shareholders on executive compensation issues.
- *Retain independent and experienced consultants.* In a rapidly changing environment, a seasoned executive compensation consultant adds value and credibility to the compensation process. Given the perception that executives wield excessive influence over the process of determining pay, the Compensation Committee should retain an independent consulting firm that has no other business relationships with the company. Eliminating the potential for a highly visible conflict within the overall governance process makes it less likely that decisions and programs will be questioned down the road.

## **(2) Corporate Governance**

Executive compensation governance is especially critical in the current environment, because it strongly influences how shareholders judge a Board's overall effectiveness. We recommend the following six practices and processes:

- *Enhance the decision-making process.* A well-planned process begins with a Committee Charter that clearly defines its purpose, responsibilities and the delegation of its specific authorities from the Board – for example, which recommendations or changes require approval from the full Board. There should also be in place a clearly defined compensation strategy that addresses the objectives of the program, targeted compensation levels, mix of compensation, and the inputs used to make compensation decisions, such as performance, survey data, tenure, etc. Finally, there should be an annual compensation calendar that specifies deadlines for various work to be performed over the course of the year, who is responsible for that work, and who will report findings and recommendations to the Compensation Committee. Adequate time also should be allowed for discussion and review; generally, we recommend presenting information twice to the Compensation Committee – the first time for members to review, digest and question, and a second time prior to approval of any subsequent recommendations and changes. Whenever possible, the Committee Chair should review materials

before they are distributed to the rest of the Committee to help keep meetings on track, and to identify issues that may be particularly sensitive from the Committee's point of view.

- *Adopt a holistic view to avoid overcompensating.* The Committee must thoroughly understand the ramifications of every decision made in regard to the compensation program, including all associated payouts. The combined value of all elements of compensation – base salary, bonus, long-term incentives, perquisites, deferred compensation, severance and change-in-control arrangements – should be both reasonable and aligned with the company's and shareholders' interests.
- *Anticipate and avoid the potential risks associated with pay programs.* Committees can improve their understanding of pay decision outcomes by performing "forward looking" analyses. These include an economic impact analysis (in which potential payouts for executives are modeled out based on projected or assumed corporate performance and stock price appreciation), or a wealth accumulation analysis (which compares the wealth built up over an executive's career to the value created for shareholders). Such tools assess whether the resulting payout from a compensation decision made today makes sense; if programs have the desired performance orientation; and whether the mix of opportunities provides an appropriate pay-for-performance alignment.
- *Continually strive for improvement.* The Committee should regularly evaluate its own performance – as well as that of individual members, the compensation consultant, and the overall governance process. All Directors should attend formal Director education programs on an ongoing basis to interact with peers who may face similar situations and learn of new approaches to existing problems. Finally, Committees should maintain a formal "on-boarding" process to get new members more quickly up to speed and actively involved in decision-making.
- *Avoid perceived conflicts of interest.* Compensation Committees today must avoid not just real conflicts of interest, but even the appearance of conflict. As a general practice, consulting firms engaged in the review and recommendation of executive compensation programs should be retained directly by the Board or Committee, which also should authorize and oversee all work performed on its behalf or for management.
- *Be proactive about anticipating issues.* Compensation Committees should devote one meeting annually exclusively to a discussion of the company's compensation strategy and programs in the context of the current and expected future business environment.

### **(3) Say on Pay**

The significant losses experienced by investors, combined with controversy over recent Wall Street bonuses, retention payouts and severance arrangements, have renewed interest in requirements for a non-binding shareholder vote on executive pay programs.

Say on Pay debuted in the United States in 2006 when the American Federation of State, County, and Municipal Employees (AFSCME) filed shareholder proposals that sought a referendum on executive compensation. Since 2006, more than two dozen U.S. companies have voluntarily agreed to put forth management proposals for an advisory shareholder vote on executive compensation. However, the number of companies providing a Say on Pay advisory vote has significantly increased this year, as public companies receiving funds from the Troubled Asset Relief Program (TARP) are required to include a non-binding Say on Pay vote in their proxy statements filed on or after February 17, 2009.

Proponents of Say on Pay argue that an advisory vote will give shareholders an effective mechanism to express dissatisfaction with a company's executive compensation practices, similar to the voting mechanisms already in place in the UK. Critics respond that Say on Pay has significant shortcomings, among them that holding an up/down referendum on highly complex executive compensation programs will give corporate Boards little practical insight into shareholders' views on pay. They also are concerned that generally speaking, investors may lack the expertise or inside company information needed to appropriately evaluate pay decisions for individual executives.

Nevertheless, momentum for Say on Pay appears to be growing and it may not be long before it is a requirement for all companies and not just TARP recipients. If so, 2009 executive compensation decisions may be subject to Say on Pay votes during the next proxy season. We recommend taking proactive steps to prepare for a future Say on Pay vote and minimize the likelihood of an unfavorable outcome, including:

#### Knowledge

- Make sure the Committee is making pay decisions for 2009 in the context of a potential Say on Pay vote in 2010.
- Determine how comfortable members are with taking a position vs. following “best practices” that may not make sense for your company.
- Understand your institutional shareholders’ views on Say on Pay and whether they are likely to follow recommendations from proxy advisory firms like RiskMetrics Group.
- Stay abreast of the results of Say on Pay proposals at other companies.
- Partner internally with investor relations, legal and senior management on a multi-disciplined approach toward Say on Pay. Also draw upon the experience and expertise of external advisors across the various disciplines.

#### Disclosure

- Review your proxy CD&A and related tables to ensure executive compensation disclosure is clear, complete, and not subject to misinterpretation.
- Consider whether your proxy disclosure is consistent with other public documents (e.g., 10-K, annual report, press releases, etc.), especially with respect to key business goals, risks, and competitors.

#### Program Review

- Identify any perceived “poor pay practices” in your executive compensation philosophy and program design.
- Review market benchmarking practices, particularly with respect to selection of appropriate peer group(s).
- Conduct an analysis to ensure there is a strong link between executive pay and performance.
- Conduct a risk assessment to ensure incentive programs do not motivate “unnecessary and excessive risk-taking.” Consider additional checks and balances such as caps on bonus payouts and clawback provisions.
- Consider the use of stock ownership/retention guidelines to strengthen the long-term alignment between executives and shareholders.
- Establish a plan for any changes to the compensation program resulting from the Program Review. For example: what changes should be made, when changes will be implemented, how changes will be communicated to employees and any relevant external parties, etc.
- Articulate the company’s rationale for any perceived “poor pay practices” that you have decided not to change and develop an approach for addressing investor questions, should concerns arise.

### Shareholder Outreach

- Establish an effective shareholder communication strategy, including a process for gathering feedback on executive compensation programs. Consider how to differentiate the approach for your Top 20 institutional shareholders.
- Establish a strategy for communicating with employee shareholders, including unions where applicable.
- Review the company's bylaws to determine how abstentions would count in a Say on Pay vote. Abstentions can be a determining factor in vote outcomes, but changing the bylaws on abstentions could negatively affect other types of shareholder votes.

Finally, despite the visibility of Say on Pay and the benefits of the proactive steps outlined above, common sense still suggests that sustained, superior performance can offset the concerns of most shareholders.

### **(4) Assessing Risk in Compensation Plans**

Among the more nuanced challenges facing companies receiving TARP funds is a requirement to create and oversee a process to ensure incentive plans do not encourage “unnecessary and excessive risk-taking” – an assessment for which Congress did not provide substantive guidance. However, we consider understanding risk in the context of pay-for-performance, to be a best practice that will be critical to the long-term success of *all* institutions.

Ideally, performance-based incentives should motivate *appropriate* risk-taking without encouraging or rewarding *excessive* risk. Every Compensation Committee should encourage its executives to take the kinds of reasonable risks that can result in real innovation, business improvements and outstanding shareholder returns. As part of their assessment process, we recommend that all companies, whether TARP participants or not, ask the following questions:

- *What risks could threaten the institution's value?* The Compensation Committee should have a thorough understanding of the company's strategy, risk profile and potential business risks, and how they are being addressed by management. The senior risk officer (SRO) should be able to clearly explain how key risk areas could directly or indirectly affect performance and executive payouts.
- *Do incentive plan metrics reflect the institution's business strategy?* Performance and awards under the compensation program should fit the institution's overall business strategy and support the desired risk profile. One potentially “risky” performance measure in the incentive plan would not, in itself, necessarily drive executives to “unnecessary and excessive risk taking.” For example, the inherent riskiness of loan growth can be mitigated by internal credit and quality controls, as well as by limits on payouts under related performance incentives.
- *Are the leverage and ratio of incentive compensation appropriate?* Both the amount of the incentive opportunity, as well as the proportion of total compensation based on performance, should be thoroughly understood. For example, basing 90% of an executive's total compensation on the achievement of specific performance goals is more likely to drive risky behaviors than a program that is 50% incentive-focused.
- *Is the full range of upside/downside payouts under our incentive plans understood?* Potential payouts should be projected under all possible performance scenarios, including threshold, target and maximum performance. Additionally, equity/long-term incentive awards should be calculated under best, realistic and worst case stock price/payout scenarios (although this is more difficult in an uncertain economy). At a minimum, Committees should be comfortable that maximum payout opportunities under the best performance scenario are reasonable and unlikely to motivate excessive risk-taking.
- *Do plans have protection/controls to avoid excessive risk-taking?* Do incentive plans allow unlimited upside opportunity, or define maximum awards? Does a single performance measure drive a majority or even all of the incentive rewards, or is there a balanced “portfolio” of performance measures? Best practice calls for basing plans on multiple performance perspectives. The Committee should examine

any performance measures that are significant drivers of total compensation, particularly if the same measures are used in both short- and long-term plans and might thereby over-emphasize those aspects of performance.

- *Do plans focus executives on long-term performance that aligns with shareholder interests?* A powerful way to protect companies and their shareholders is to maintain a long-term view of performance that reduces the likelihood that executives will take undue risks. Among the tools to do so:
  - Stock ownership and retention requirements such as “hold to retirement” and “hold past retirement.”
  - Limited or zero severance for poor performance, which may require changing some existing employment agreements and/or eliminating equity acceleration for certain types of terminations.
  - Holding back a portion of annual incentive awards pending sustained performance results (i.e., long tail).
  - Paying incentive awards above a certain level, such as target, in restricted stock or unvested deferred compensation.
- *How does performance compare to industry/peers?* In addition to comparing performance against a business plan, results should be assessed on a relative basis. Particular attention should be paid to performance that is dramatically above or below industry/peer group levels – both of which are red flags of potentially inappropriate risk-taking that warrant a closer look.
- *Do the plans allow the Committee to exercise discretion?* No compensation program can predict all possible situations. Sometimes, it is more appropriate that common sense prevail over formula-driven award payouts.

## **(5) Addressing Underwater Options**

Between January 2008 and April 2009, approximately 110 companies submitted proposals to their shareholders or filed a tender offer for an option exchange. These programs are intended to restore some equity value to employees left holding underwater options in the wake of the economic downturn. However, companies should carefully consider whether an option exchange is the best and most effective approach for their own underwater problem. Critical questions to ask include:

- *Is the timing right?* If the company's share price drops after the exchange, the new options provided in the exchange could also end up underwater, leaving employees no better or even worse off, with little motivational or retentive impact.
- *Is there high turnover now, or potentially?* Many shareholders facing significant equity losses will question the fairness of allowing employees to recoup value by turning in underwater options. An option exchange should be considered only to address an imminent risk of significant turnover and lost motivation in the absence of drastic action, and after other alternatives have been explored.
- *Does the exchange address investor concerns?* Investor approval is more likely if the proposed exchange includes “shareholder friendly” features, such as excluding executives and Board members from the program and prohibiting any surplus shares from being added to the plan for future grants.
- *Is it worth it?* Option exchanges entail significant time and administrative effort, from the preparation of employee communications and proxy proposal to the tender offer and CD&A proxy disclosure. Substantial expense also may be incurred by grants of new options, restricted stock, or cash awards, as well as additional fees for accounting, legal, valuation and compensation experts.

If the administrative burdens, costs, and potential negative shareholder reaction to an option exchange outweigh the advantages, alternative approaches would include:

- *Migrating to an annual award schedule.* Rather than limiting awards to new hires, promotions and “special events,” annual grants essentially reload employees each year with at-the-money options, triggering a fresh vesting schedule that promotes retention.
- *Making a supplemental grant of new at-the-money options, with appreciation capped at the exercise price of the underwater options.* Like annual equity awards, this approach creates a motivational and retention “bridge” between the current share price and the exercise price of the underwater options.
- *Utilizing more restricted stock or performance-based restricted stock grants, in lieu of options.* Because they are immediately in-the-money, full-value shares can be an effective way to boost morale and retention.
- *Offering a choice of equity vehicles, such as a menu of stock options, restricted stock, or performance-based restricted stock.* Tradeoffs could be made in terms of the different equity value provided by each instrument.
- *Increasing target cash incentive opportunities and reducing or eliminating equity awards for non-executive populations.* ESPPs may be a better approach if the goal is to foster employee ownership.
- *Accelerating “deep” underwater options.* Under FAS 123(R), accelerating the vesting of a deep out-of-the-money award is not a substantive modification and any unrecognized compensation cost associated with the award can be recognized over the remaining original vesting period. While such a strategy does not eliminate the underwater option problem, it may be viewed positively by employees and restore some of the retentive capability of the awards. Because FAS 123(R) does not provide guidance on determining when an award is deep out-of-the-money, companies are strongly recommended to consult their accounting advisers.

## **(6) Pay Programs in a Down Economy**

Challenging economies put pressure on expense control and cash management, even as companies must incentivize high performers and minimize retention risks. A good initial approach to executive salaries is to focus on more moderate increases, targeted to managers whose current pay is below-market. If the economy worsens, salary freezes are the next course of action, with salary cuts reserved for extreme circumstances.

For annual and long-term incentive programs that are generally working well, consider some tweaks:

- *Widening the gap between threshold and maximum performance.* Goal-setting is more difficult when business results are less predictable. A greater differential can help ensure the company does not underpay executives when the economy takes a turn for the worse, or overpay when it recovers.
- *Changing incentive plan metrics.* Wholesale changes should be considered only if business and economic conditions fundamentally change, given the importance of the interaction of annual and long-term incentive plan metrics. For example, cash management can be adopted as a metric if such an approach would help satisfy bank covenants.
- *Providing more long-term incentives in time-vested restricted shares.* If sufficient shares cannot be granted to match the previous year’s long-term incentive value, restricted shares can help bridge the gap. They are generally perceived as more valuable and provide more of a retention hook.

Top-performing executives and those considered high retention risks may need special attention in a down market. Although it is generally not good practice to institute ad-hoc or additional salary increases, these program tweaks may be appropriate:

- *Set aside money (e.g., 20% of the target pool) for awards to high performers and retention risks, if threshold performance levels are not met under the annual incentive plan.*
- *Grant additional shares to higher performers and retention risks following a poor performance year.* Many companies are reluctant to adopt this approach since even a thoughtful and well designed plan to

communicate the payout results may not satisfy executives who receive a reduced or zero incentive award.

## **(7) Selecting Measures and Setting Goals**

While every company needs to follow a disciplined process suited to its unique business situation in deciding measures and goals for performance-based pay programs in this troubled economy, some general trends and practices are emerging:

### Selecting Performance Measures

- *More robust analysis of “value drivers.”* Company-specific, peer group, and industry analyses can help identify specific measures of performance that correlate most closely with creating meaningful, long-term shareholder value.
- *More customized measure definitions.* More companies are moving beyond purely GAAP definitions of financial performance to adjust or incorporate performance measures that are more within management’s control. These “adjusted” definitions often exclude non-operating and/or non-recurring items that are not necessarily appropriate variables for determining short-term or long-term incentive awards. Making these adjustments at the *beginning* of the performance period ensures objectivity and limits the need for subjective changes at the *end* of the performance period.
- *More focus on cash flow measures.* As many companies enter “survival mode,” targets related to working capital management, debt coverage, and operating cash flow are complementing or replacing traditional profitability and return measures.
- *More consideration of purely “discretionary” short-term incentive plans.* Formula-based programs face the challenges of poor visibility into 2009 performance, plus continued SEC pressure to disclose forward-looking performance goals. While taking a totally discretionary approach to executive incentives might work for some companies in the near term, it is generally not a viable strategy, given the push for greater transparency.

### Setting Performance Goals

- *Consider shareholder expectations of forecasted growth in evaluating short-term and long-term business plans and goals.* This is especially important because share prices often move in response to how performance compares with expectations. This perspective is especially important for long-term incentive plans, which are intended to reward only sustainable increases in shareholder value.
- *Incorporate a relative measurement framework.* With limited visibility into outcomes for 2009 and beyond, some incentive programs are utilizing an appropriate peer group or index for comparison purposes. However, key stakeholders may not view being “best of the worst” as an appropriate performance target.
- *Establish “enduring standards” vs. annual budgets.* Maintaining performance standards year-over-year can address concerns about the annual budgeting process and separate incentive targets from annual budget expectations. An example would be a fixed targeted earnings growth rate, or return on capital, that represents an enduring standard for shareholder value creation in the industry. This approach eliminates any incentive to “sand bag” the budget, but may render performance expectations unrealistic over time. The best approach in a rapidly changing global economy may be a hybrid: an “enduring standard” that is reviewed every few years.
- *Set “self-adjusting” multi-year targets.* When long-term goal-setting is difficult, companies can choose to automatically adjust performance targets annually. The objective is a multi-year measurement period, in which each year’s results affect future year requirements so that pre-determined goals don’t go stale. For example, actual vs. target performance in Year 1 would automatically adjust the initial Year 2 target up or down accordingly (i.e., if the company achieved 105% of the Year 1 goal, the Year 2 goal would increase 5%). Alternatively, a constant growth rate could be applied to each year’s actual performance result.

Because measure selection, measure definition and goal-setting are the building blocks of the risk/reward profile of the executive compensation program, the end of the planning process should include an overall risk assessment. Involve the Board's Audit Committee to help ensure that measures and goals are not construed as promoting "excessive risk-taking" by executives.

## **(8) Managing Career Compensation**

Most companies assess a static year's compensation (or average compensation over a series of years) relative to external benchmarks. In isolation, this fails to consider that compensation should change over an executive's career and that external benchmarks are position-specific, rather than incumbent-specific. The compensation value of a given *position* should be balanced by what is valuable and appropriate for that particular *individual*.

Therefore, an important element of pay decisions is where your executives are in their careers, how their compensation arrangements will change over time, and what additional program analyses will inform your decision-making process. Below are some examples of compensation elements that should evolve and additional analyses that support effective decision-making.

### Compensation Elements that Change Over Time

- *Employment contracts.* Contracts are most useful when an executive joins the company and issues such as title, role, reporting relationship, compensation and termination benefits must be addressed. Any special "inducement" or "buyout" arrangements for new hires also must be put in writing. An employment contract is harder to justify after three to five years, when a simple severance and/or change-in-control (CIC) agreement can suffice.
- *Severance/CIC agreements.* These agreements provide a degree of financial protection while a terminated executive is seeking comparable employment. However, there is less justification for providing significant protection to senior executives who have a cushion of accumulated wealth and may even be ready to retire from the work force.
- *Compensation levels and mix.* A new and relatively young executive interested in wealth accumulation is likely to prefer an attractive long-term incentive opportunity to a fully competitive base salary. Conversely, a longtime executive nearing retirement, who has substantial wealth accumulation and a shorter time horizon, probably is more interested in an above-market base salary than additional long-term incentives.
- *Long-term incentive grant mix and provisions.* Early in their careers, employees tend to value compensation programs with a relatively high risk/reward profile, such as a long-term incentive mix focused on 10-year stock options with four-year vesting. Those closer to retirement usually prefer the lower risk/reward profile offered by a grant of service-based restricted stock, which the younger workers would view more as a "takeaway."

### Additional Supporting Analyses

- *Executive stock ownership.* In addition to executive pay levels, the Committee should compare the peer group's level of beneficial stock ownership. If there is a significant difference in the comparator firms, a different pay level or mix may be preferable to using market data. For example, significant owners often receive relatively less annual equity grant value than a new executive.
- *Carried equity values.* The value of an executive's potential equity stake includes direct stock ownership, in-the-money outstanding stock options and non-vested shares. Changes in value over time reflect the sensitivity of executive rewards to shareholder value and point to the level and mix of equity awards likely to have the greatest impact. For example, executives with significant outstanding stock options, but relatively low carried equity value, might be given proportionately more service-based stock to balance their mix of performance and retention incentives.

- *Retention ratios.* Executives who join the organization at different times receive different equity awards at different grant prices, potentially producing a spread of retention ratios among the team. Unvested carried equity value provides marginal retention strength, and expressing this non-vested value as a percentage of base salary can reveal its relevance to the executive. Harmonizing or improving these retention ratios may require providing slightly different long-term incentive mixes among executive team members or relative to their peers.

## **(9) Stock Ownership Guidelines**

Most executive equity requirements are expressed as a fixed multiple of compensation value, with the result that many executives are having difficulty meeting minimum stock ownership guidelines as share prices decline. There are multiple considerations for companies in addressing this issue:

- What types of shares to count towards ownership requirements – personal shares, qualified plan shares, restricted shares, performance shares, etc.
- The right number of levels and the right multiple for each level.
- How much time to give executives to meet guidelines.
- Whether the guidelines force executives to exercise options earlier than desired.
- Whether and how the requirements should be enforced.
- Whether a significant drop in stock prices would create undo hardship by forcing executives to acquire and/or hold more shares in a relatively short period.
- Whether an executive who acquired more stock to meet the guidelines might be left holding excess shares, once prices recover, that he or she might otherwise have invested differently.

Rather than a value-based equity standard, some companies express ownership as a fixed number of shares. Although less volatile than the value approach, a share approach can still complicate an executive's ability to meet guidelines in down economic cycles. An emerging approach that calls for valuing shares only at the time of acquisition has some advantages, but may still burden an executive in a prolonged economic downturn.

Under another, more simple standard, executives would be required to retain all or a portion of their equity-based compensation shares for a stated period – for example, 25% to 50% of all shares received, net of taxes, for a period of five years. This approach offers multiple advantages:

- It eliminates the issue of what constitutes a “share” under the guidelines.
- The number of shares held is directly related to the level of incentive compensation.
- There's no need for enforcement rules.
- The guidelines are unaffected by share price fluctuations.
- There's no need to review who is out of compliance and the associated consequences.
- New hires need not ramp up their stock holdings to meet guidelines.

## **(10) Peer Group Selection**

Companies must list the firms used for the benchmarking process under expanded proxy disclosure rules, and these new details are receiving close shareholder scrutiny. Peer groups serve multiple purposes in compensation planning, providing: a comparison of absolute pay levels; a perspective on relative financial and shareholder return performance; and an evaluation of design issues such as pay mix, performance metrics, severance and contractual provisions, and equity use.

To ensure that appropriate and defensible peer groups are selected, we recommend that companies:

- *Follow a rules-based approach.* Picking a peer group can be highly subjective absent a well-considered, consistent process. An appropriate approach would include identifying the factors for selection of peer companies (e.g., revenue, product/service similarity) as well as establishing appropriate parameters and tolerances to evaluate the “similarity” of each factor (e.g., 1/3 to 3x the company's revenue).
- *Select similar size firms.* Company size often serves as a proxy for comparing job complexity and scope between executives with the same title at two different firms. Ideally, your own firm should be around the median of the peer group. Revenue generally offers the strongest correlation with pay levels, although total assets often prove more relevant for industries such as banking. While market capitalization may also be an important “size” factor, companies should be careful about using it as the primary factor because its high volatility may result in annual changes to the composition of the peer group.
- *Pick firms with product/service similarity.* Product/service similarity is a significant predictor of both pay levels and pay practices, due to underlying industry financials, life cycles, risk profiles, transferability of executive skills, etc. Alternatively, “like” industry firms can be used if companies are mindful of any differences with direct competitors in terms of financial performance, choice of pay vehicles, and actual pay levels.
- *Revisit the peer group annually, but avoid major overhauls.* Maximizing peer group consistency over time avoids drastic swings in the compensation data, better illuminates emerging compensation trends, and demonstrates that firms were not cherry-picked to produce favorable comparisons. If a major overhaul is necessitated by significant changes in size, merger & acquisition activity, or other factors, it should be based on the same rules-based approach used in the initial selection process. Leniency may be exercised for “borderline” companies that are just outside the group's revenue or market capitalization criteria.
- *Be cautious about including non U.S.-based firms.* Inclusion of foreign-based companies in the peer group may be warranted in some cases. We are seeing rapid changes in terms of disclosure and regulations outside the U.S. and executive portability is increasing, while shareholders sometimes criticize firms for comparing themselves only to U.S. companies as a way to justify high pay levels. However, inclusion of foreign-based companies is complicated by multiple factors: data still is generally less available in most countries outside the U.S.; the labor market for top U.S. executives remains generally U.S. based; and other countries' pay practices can vary dramatically because of local customs, regulations and requirements.
- *Include 10-20 firms in your Peer Group.* RiskMetrics Group (RMG) has found that 57% of S&P 1,500 companies have between 10 and 20 companies in their peer group, which is generally sufficient to minimize the impact of outliers when analyzing market data. A much larger group is often less comparable in size and industry and results in significant additional expense for data collection, while a much smaller peer group may not provide adequate data to reach valid conclusions.
- *Consider the peer group put together by RMG.* For its annual Proxy Research Reports, RMG creates a peer group for each company that is used as the basis for its compensation analysis and proxy voting recommendations. RMG's peer groups usually consist of 8 to 12 firms, based generally on revenue and the General Industry Classification Standard (GICS) code. RMG's methodology may not provide an appropriate group if a company lacks enough similarly sized peers within its GICS code. However, given the advisory firm's voting influence, companies should give consideration to RMG's choices in putting together their own peer groups.

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