



## Executive Compensation – A New Day in Director Oversight November 13, 2009

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- **June 10 - Obama Administration/Treasury Outlines Broad Compensation Best Practices and Lays Groundwork for More Change**

- Five Broad Principles
- Supports Say on Pay
- Supports Increased Compensation Committee Independence Requirements



**Who's impacted?**

All Financial Institutions / Public Companies

- **July 10 - SEC Proposes New Disclosure Requirements for 2010 Proxy Season**

- Expands Corporate Governance Disclosure
- Changes to Compensation Disclosure
- CD&A Impacts



Public Companies

- **July 31 - House Bill (Corporate and Financial institution Compensation Fairness Act of 2009) approved by the House of Representatives**

- Introduced by Rep. Barney Frank
- Supports Say on Pay
- Proposes Increased Compensation Committee Independence
- Proposes Provisions Relating to Financial Institutions



All Financial Institutions

- **September - Senate Meets on House Bill and SEC Comment Period Ends**

- Final regulations to come this fall/winter



■ **October 22 – Federal Reserve Proposes New Regulations and Oversight of Financial Institution Compensation Practices**

- Unprecedented federal influence on compensation plan design
- Substantial expansion of Board/Compensation Committee role
- Encourages balanced risk-taking incentives
- Requires effective controls and risk management
- Comment period through November 27, 2009

**Who's impacted?**



All Banks supervised by Federal Reserve

■ **October 22 – Special Master for TARP (Kenneth Feinberg) released determinations for compensation packages for 7 exceptional assistance firms**



7 Exceptional Assistance Firms

■ **October 26 – RiskMetrics Releases Draft Policy Updates for Comment**

- Final Policy to be issued in November



All Public Companies



Regardless of specific details to come from the various regulatory proposals, there are several themes that are emerging:

- **Board Accountability and Corporate Governance**
- **Risk Management and Assessment of Pay Programs**
- **Pay for Performance Alignment**
- **Focus on Long-Term Performance**
- **Increased Disclosure and Visibility**
- **Increased Influence of Shareholders**

*Overall increased scrutiny, disclosure and regulation of executive and employee compensation practices and board governance*



## Federal Reserve Proposal – Overview



- **Proposed New Regulatory Guidance Announced October 22, 2009**
  - 30 Day Comment Period
- **Objective**
  - To ensure incentive compensation policies do not encourage excessive risk taking and are consistent with the safety and soundness of the institution
- **Initiating 2 Supervisory Actions**
  - 28 Large Complex Banking Organizations (LCBO) – more comprehensive review and analysis
  - Other Community/Regional Banking Organization – part of normal supervisory review
- **Covered Individuals/Plans - Broader than SEC and TARP covered individuals**
  - **Senior Executives** or others responsible for oversight of organizations' firm wide activities or material business lines
  - **Individual employees** (including non executives), whose activities may expose the institution to material amounts of risk (e.g. traders) and
  - **Groups of employees** who in the aggregate may expose the institution to material amounts of risk, even if no individual employee is likely to expose the bank to material risk (e.g. loan officers as a group)



### ■ **Balanced Risk Taking Initiatives**

- Review the full range and the time horizon of risk to ensure proper balance
- Fix unbalanced arrangements
  - » Risk adjustment of awards
  - » Deferral of payments
  - » Longer performance periods
  - » Reduced sensitivity to short term performance
- Review golden parachute arrangements and termination/CIC agreements.

### ■ **Effective Controls and Risk Management**

- Policies, procedures, and roles to be involved in reviews
- Frequent reviews, reporting and adjustments
- Substance of reviews

### ■ **Strong Corporate Governance**

- Board Involvement (or Compensation/Other Committee) should be actively involved
- Board Composition and Resources (independent Committee and advisors)
- Disclosure (proxy)
- Tailored Governance Programs (size of bank; roles)



## Corporate and Financial Institution Compensation Fairness Act of 2009 (most recent House bill)



- **Introduced by Rep. Barney Frank; Passed House July 31, 2009**
- **Three Major Provisions:**
  - Require **Say on Pay** (i.e. annual, non-binding advisory shareholder vote on pay)
  - Increased Standards Related to **Compensation Committee Independence** at all Public Companies
  - Additional provisions intended to **discourage excessive risks** (for all financial institutions)
- **Proposed Effective Dates**

Requirement	Applicability
Say on Pay/Golden Parachute Approval	Proxies filed on or after six months from the date of rule publication with the practical impact of mandatory Say on Pay likely in 2011
Compensation Committee Independence	Nine months after Act's passage
Disclosure Regarding Independence	For proxies filed one year or more after the Act's passage
Study of Consultant Independence	SEC to complete within two years of Act's passage
Disclosure and Prohibition of Incentives (for financial institutions only)	Federal regulators to issue guidance within nine month's of Act's passage
Financial Incentive Compensation Incentive Study	Comptroller General to compete within one year of Act's passage



### ■ Say on Pay Shareholder Votes

- Requires an annual, nonbinding (advisory) shareholder vote on executive compensation for all\* public companies
  - » Approval would be for compensation as disclosed in Compensation Committee Report, CD&A, tables and support materials for Named Executive Officers (“NEOs”)
  - » Does not create additional liability to directors
- Requires separate advisory vote on golden parachutes during a merger or acquisition
  - » Disclosure of amounts to be received by NEOs as result of Change-In-Control transaction
- Effective Dates: Say on Pay/Golden Parachute Approval would be in effect for proxies filed on or after six months from SEC rule publication (likely to be 2011 proxy season)

### ■ Disclosure of Institutional Shareholder Votes

- Any institutional investment manager owning at least \$100 million of equity at some point during the preceding 12 months must annually report any vote it cast on an executive compensation or parachute arrangement, unless such vote would be publicly reported elsewhere

\* Potential exceptions for smaller reporting issuers



- **Stricter Independence Standards for Compensation Committee Members**
  - Board members cannot accept any consulting, advisory, or other fees outside of pay received for Board service
- **Authority of Committee Relating to Compensation Consultants, Counsel and Advisors**
  - Committee to retains sole authority (but not the obligation) to hire, compensate and oversee independent compensation consultants, counsel and other advisors
- **Compensation Consultants, Disclosure and Funding**
  - Any compensation consultant retained by the Committee must be independent within standards to be established by the SEC
  - Proxy filing must disclose whether the Committee retained and obtained the advice of a compensation consultant meeting SEC independence standards. The Act does not include earlier draft language requiring additional disclosure as to why a Committee chose not to hire an independent consultant
- **Study and Review**
  - SEC will conduct a two-year study examining the use of independent consultants by Committees
- **Effective Dates**
  - Independence standards must be met within 9 months after Act's passage, or risk stock exchange delisting. Disclosure regarding independence would be in effect for proxies filed on or after one year from Act's passage



- **Applicability**
  - Applies to “covered financial institutions,” defined as any depository institution, registered broker-dealers, credit unions, investment advisors, Fannie Mae, Freddie Mac and other institutions identified by the Federal Regulator
- **Required Disclosure of Incentive Programs**
  - Must sufficiently disclose to the Federal regulators the structure of **all incentive-based compensation arrangements** sufficient to determine whether they are aligned with sound risk management, account for the time horizon of risk, and meet other criteria to discourage overly risky behavior
- **Prohibition on Certain Incentive Arrangements**
  - Federal regulators will jointly issue regulations prohibiting any incentive arrangements or features determined to encourage risks that could threaten the safety and soundness of the company or have serious adverse effects on economic conditions or financial stability (limited grandfathering of arrangements in place when Act is passed)
- **Exceptions/Clarifications**
  - Covered financial institutions with assets of less than \$1B are exempt
  - Companies are not required to report compensation provided to any individual employee
  - Disclosure is not required if a company does not have incentive-based payment arrangements
- **Study and Effective Date**
  - Comptroller General to study the relationship between compensation structures and excessive risk taking, focusing on 2007-08. Regulations to be completed within nine months of Act’s passage by various federal regulators



## Summary of Proposed SEC Disclosure Requirements – Seven “Enhancements” to Reporting



- **Released July 10, 2009; Comment period ended September 14, 2009**
- **Final rules expected to be effective for any annual meeting that occurs after December 15, 2009 (unless changes are significant)**
  - However, SEC has a long list of open issues/requests for comment
- **Final guidance expected before year end**
- **Discussion of risk management and compensation**
  - New CD&A section will discuss whether the company’s individual components or overall compensation policies for **executives and employees** create incentives that encourage unnecessary risk which would jeopardize the economic viability of the Company ... and how the Company manages that risk
  - Some examples which would warrant Committee attention include:
    - » a business unit that carries a significant portion of the company’s overall risk profile
    - » a business unit with a compensation structure significantly different than other units
    - » a business unit that is significantly more profitable than others within the Company
    - » a business unit where compensation expense is a significant portion of the revenues generated
    - » a compensation program that varies significantly from the Company’s overall risk and reward structure, such as when a bonus is payable upon the accomplishment of a task where the income and risk from that task extends over a significantly longer period



## Summary of Proposed SEC Disclosure Requirements – Seven “Enhancements” to Reporting (cont’d)



- **Reporting of equity awards using grant date value**
  - Compensation tables will reflect full grant date fair value for grants made during the year, rather than accounting accrual during the year (which may relate to current and prior grants)
- **Additional Compensation Consultant disclosures, including fees**
  - If consultant (or any affiliate) played a role in determining or recommending executive and director compensation **and also** provided additional services to the Company, must disclose:
    - » Nature and extent of all additional services provided
    - » Aggregate fees paid for executive or director compensation services
    - » Aggregate fees paid for other services
    - » Whether the decision to engage the consultant for other services was made, recommended, screened or reviewed by management
    - » Whether the Board or compensation committee approved all services provided
- **Director and Director Nominee disclosure:**
  - Specific experience, qualifications, attributes or skills that qualify the person for service on the Board or a specific committee, including the person’s risk assessment skills or other expertise
  - If material, disclosure should cover more than the past 5 years
  - Any public company directorships held at any time during the past 5 years (not just current directorships)
  - Any legal proceedings in which the director or nominee was involved during the prior 10 years (not just 5 years)



## Summary of Proposed SEC Disclosure Requirements – Seven “Enhancements” to Reporting (cont’d)



- **Company leadership structure: Chairman, CEO, Lead Director**
  - Describe the leadership structure and explain why it is appropriate given the Company’s specific characteristics
  - If the same person is CEO and Chairman, discuss whether there is a lead independent director and their specific role
  - Disclose the Board’s role in risk management and the effect that this involvement has on the company’s leadership structure
- **Voting results reported on Form 8-K (rather than 10-Q or 10-K)**
  - Requirement to file results of a shareholder vote within 4 business days
- **Various revisions to proxy solicitation process**

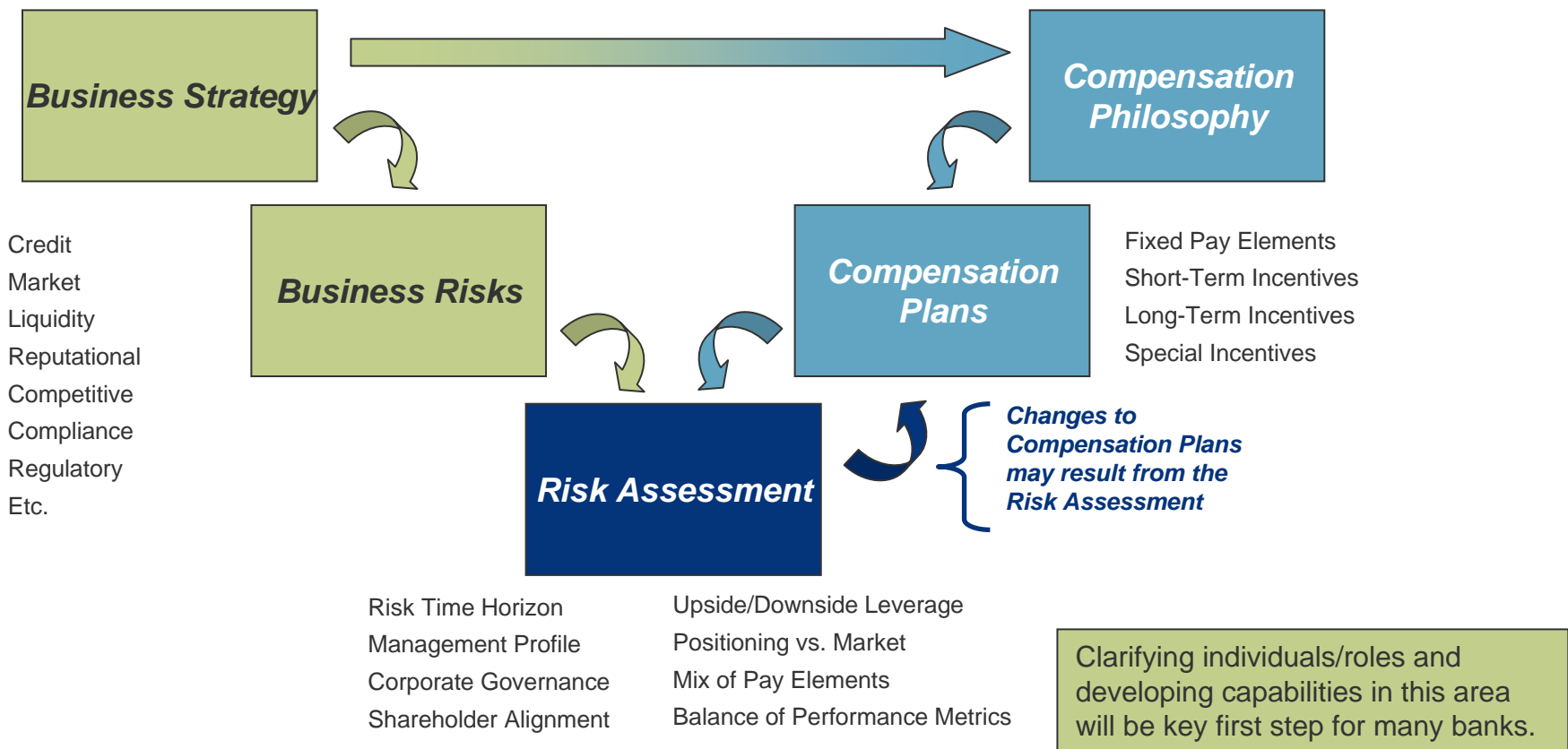


## Compensation “Best” Practices Should Embrace

- **Risk Management**
  - Ensure compensation programs do not motivate unnecessary or excessive risk taking (all employees, not just executives)
  - Implement controls, process, design features to mitigate risk taking
- **Long-Term Horizon of Performance and Rewards**
  - Reward based on the long-term value and soundness of the institution
  - Review mix, leverage and design features to ensure a long-term view of performance
- **Pay for Performance**
  - Ultimately ensure pay and performance are aligned
  - Use appropriate balance of performance measures
  - Reward short and long-term performance in appropriate balance
- **Limited Focus on Perquisites and Benefits**



- Understanding of the business strategy and risks should be the starting point for assessment
- Knowledge of compensation plans is also needed to evaluate the risk-reward interaction





## LOWER RISK

## HIGHER RISK

### MIX

At least half of compensation in base salary  
 Most of compensation paid based on long-term, sustained performance



Majority of compensation in incentive pay  
 Most of compensation paid based on annual, short-term results

### MEASURES

Balance of performance measures:

- Financial, operational, quality
- Short and long-term
- Bank and Individual
- Absolute and relative
- Formula and discretion



1 (or few) performance measures  
 1 (or few) performance perspectives (e.g. all top line metrics without accounting for quality)  
 Same performance measures used for short and long-term incentives

### DESIGN FEATURES

Cap/maximum payout  
 Appropriate performance-payout curve  
 Multi-year performance period (or hold back/deferral if focus on short-term)  
 Discretion allowed  
 Clawback  
 Ownership/holding requirements



No cap/unlimited upside  
 Threshold/target set too high  
 Quarterly or single year performance without some focus on longer-term  
 Formulaic calculation  
 No clawback  
 No ownership/holding requirements



- **Compensation practices should be adjusted to**
  - Consider risk horizon and timeframe of results/rewards
  - Place more focus on longer term, sustainable performance
    - » Adjust the “mix” of total compensation to focus more on long-term performance; enhance long-term incentive timeframes/vesting
  - Ensure reward periods match the timeframe required to determine whether a decision/action was successful
    - » If not, change design features to allow for better alignment
- **Short-term incentive techniques**
  - Holdbacks/deferrals – portion of annual award contingent on sustained future performance
  - Payment in stock – pay part (or above target) payouts in stock
  - Shifting mix to long-term
- **Long-term incentive techniques**
  - Extended vesting of awards (i.e. longer periods)
  - Performance vesting of restricted stock
  - Stock ownership and retention guidelines
  - Hold until or past retirement requirements



- **Ensuring PFP is a complex balancing act**
  - Economic environment
  - Influences out of control of management (e.g. stock price, rates)
  - Optics and perceptions - media/public/shareholders
  - Disclosure limitations
  - Regulatory mandates
  - Piecemeal view
  - Contradicts risk mitigation (i.e. no risk pay is the opposite of pay for performance!)
  
- **BALANCE is the key to effective pay for performance**
  - Short-term and long-term
  - Absolute and relative
  - Financial, operational, strategic
  - Bank, team and individual
  - Formula and discretionary
  - You want ALL of these in aggregate – not in each plan
  
- **Review performance in aggregate and over a longer period of time (stress test) and understand potential range of outcomes for performance and pay**



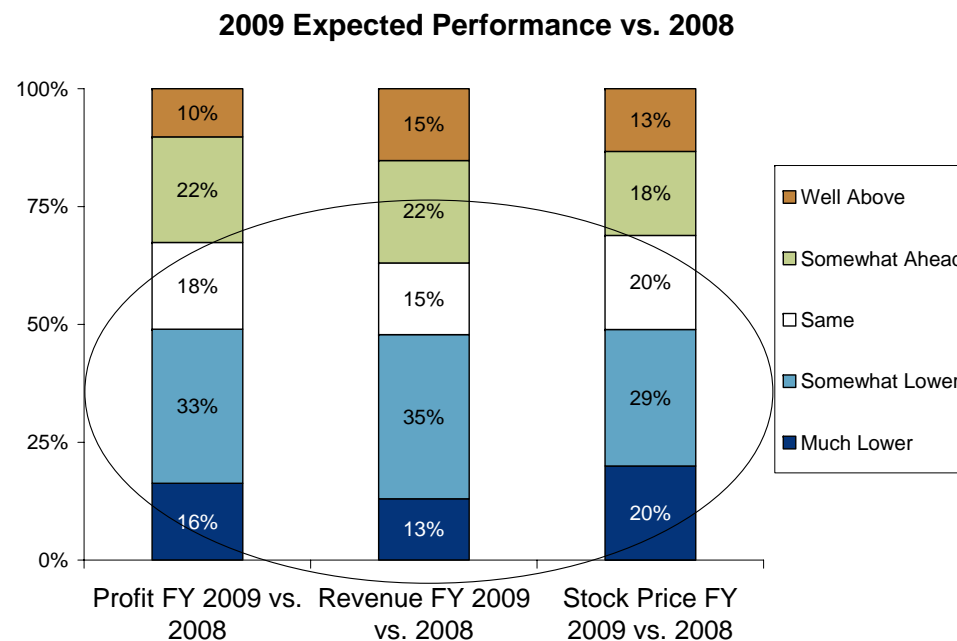
- **Stay Informed**
  - The best starting point is education and information; understand what may be coming, implications and what changes may be appropriate going forward
- **Develop Processes, Define Roles**
  - Establish process for assessing incentive plan risk and ongoing reviews/compliance
  - Review governance practices in light of pending legislation (independence, process, disclosure)
  - Clarify roles of management, Compensation Committee, Board
- **Review Compensation Program and Incentive Plans**
  - Review total compensation programs and incentive plans in particular to ensure they do not motivate and reward inappropriate risk taking
  - Ensure compensation focuses on driving sustained, long-term performance that supports your unique business goals and strategies
  - Ensure performance is measured using a balanced portfolio of performance measures
  - Ensure total compensation program is clearly aligned with both company business strategy and interests of shareholders
- **Prepare for Future – Disclosure and Regulatory Reviews**
  - Begin evaluating last year's proxy statement and CD&A to assess areas where additional/better/different disclosure may be required
  - Begin to set up risk assessment processes, structures, controls



## Expectations for 2009 & 2010



- More than 50% of surveyed financial service companies now expect performance to be the same or lower than 2008

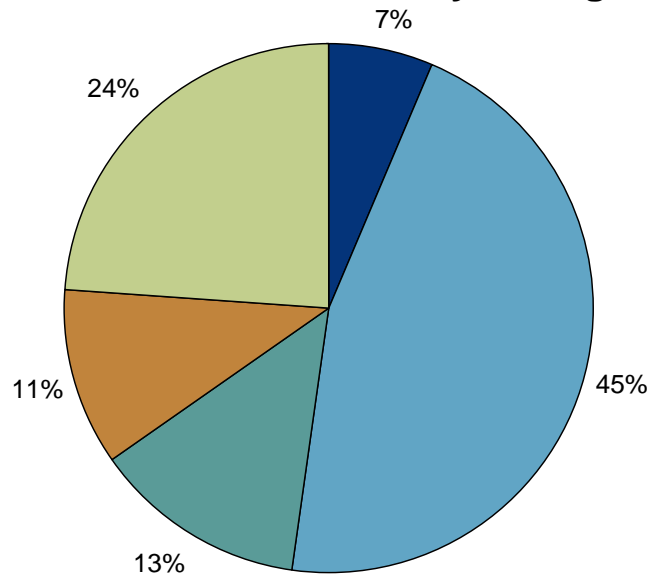


- However, more than 75% expect performance to be the same or better than their peers
- More than 65% of companies expect performance to be the same or better than budget

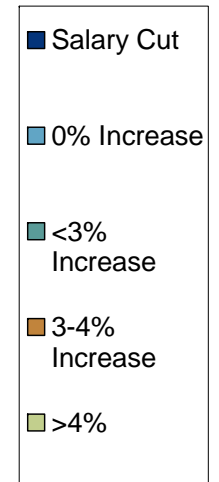
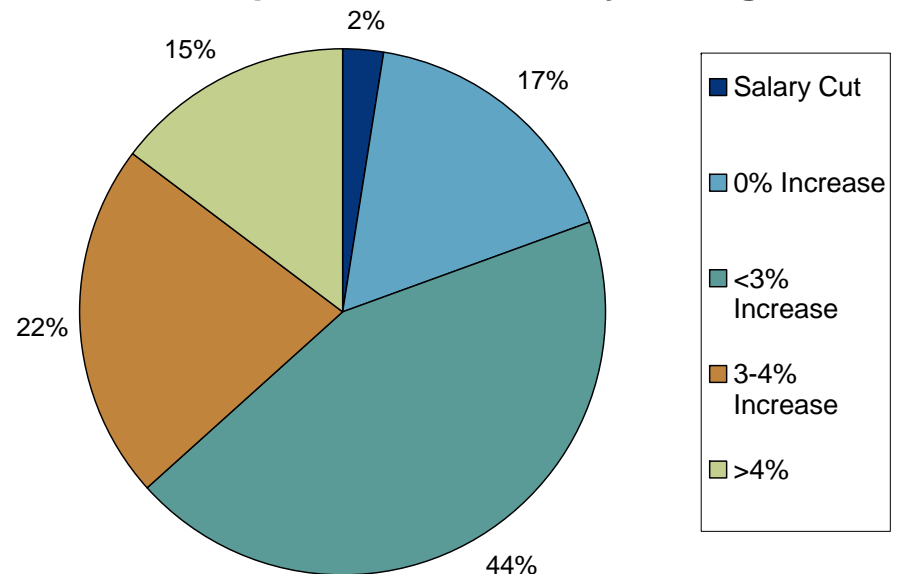


- 52% of companies froze salaries or reduced salaries in FY 2009 as compared to 70% among general industry
- Future prospects look brighter, with 81% of companies considering salary increases and 15% expecting salary increases of over 4%

**FY 2009 Executive Salary Changes**



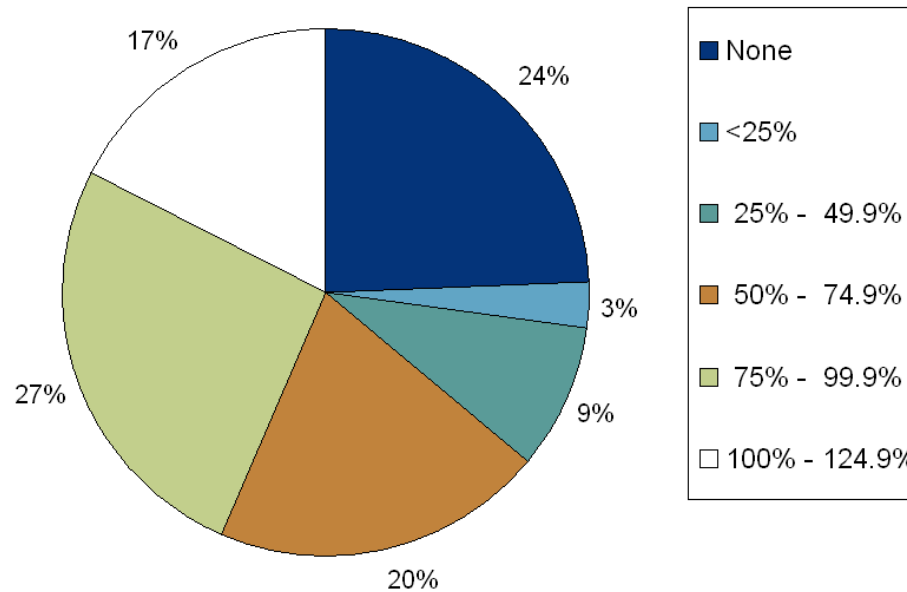
**FY 2010 Expected Exec. Salary Changes**





- Nearly 25% of companies expect to pay no or de minimis bonuses this year
- Only 17% anticipate paying at or above target

**Expected FY 2009 Bonus vs. Target**



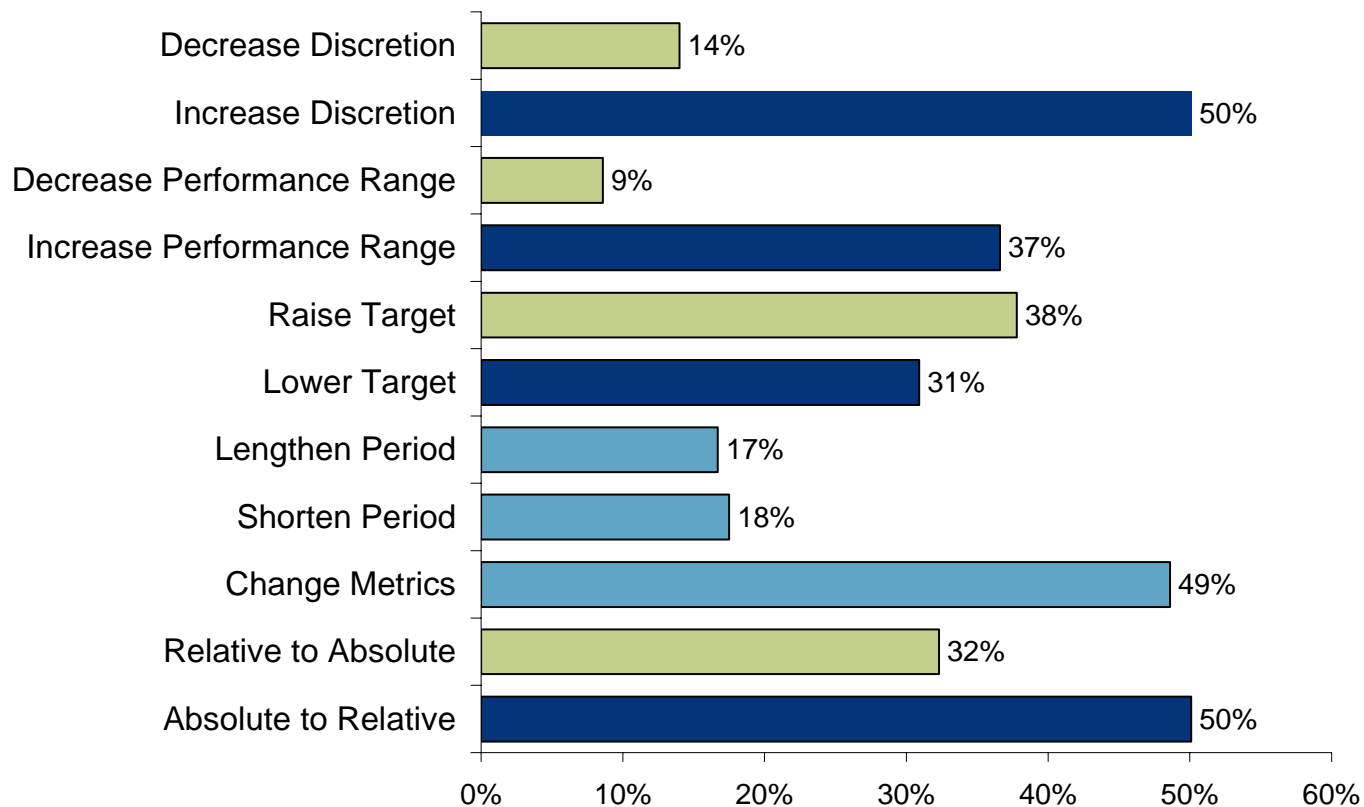


## Annual Incentive Plan Modifications – Financial Services Companies



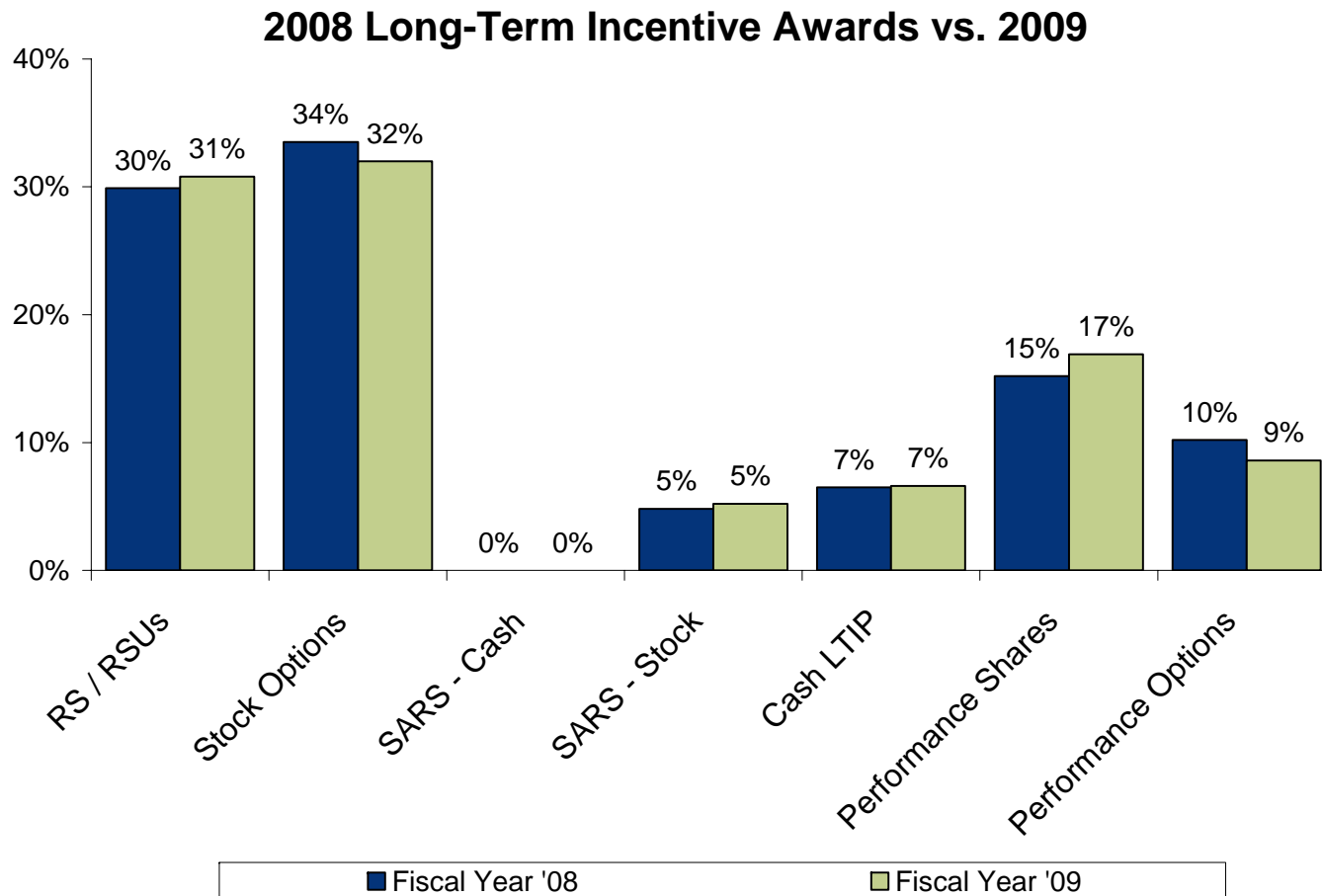
- A significant number of companies contemplated or modified plans in 2009 or expect to relook at incentive plan design in 2010

### Actions Contemplated in 2009 or 2010





- For 2009 relatively few companies modified their mix of equity



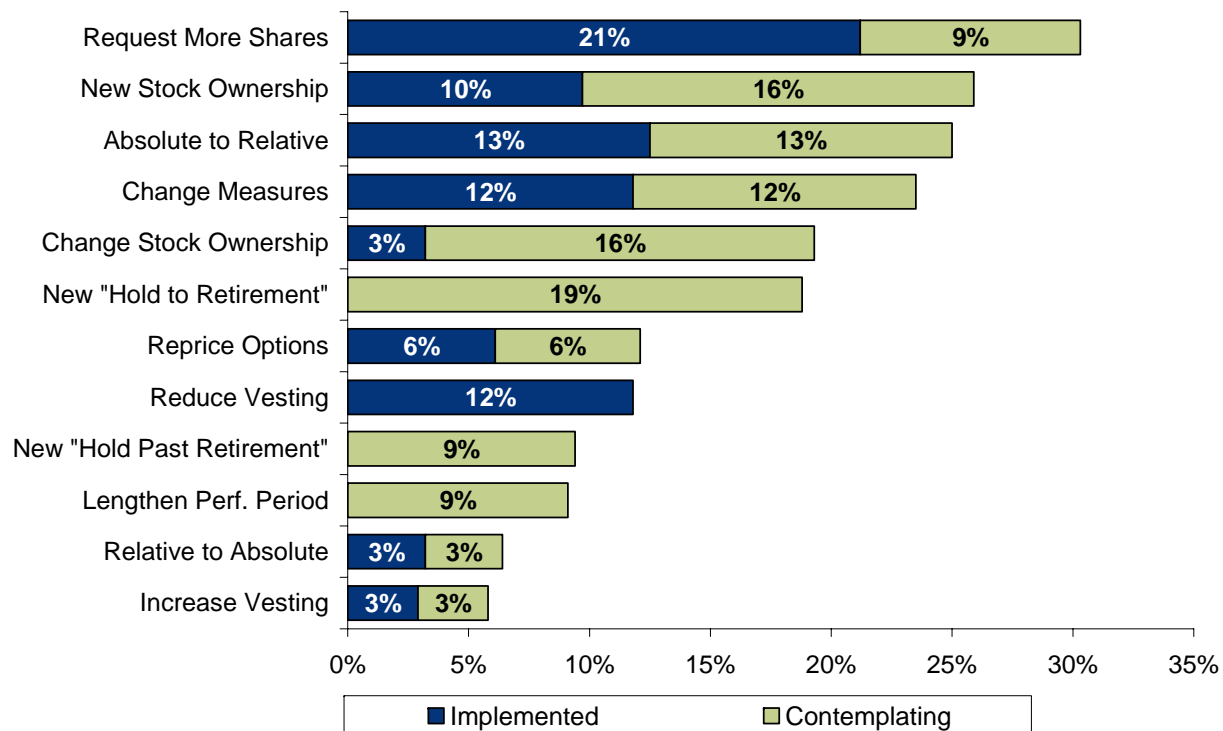


## Long-Term Incentive Awards – Financial Services Companies



- Expectations of future long-term incentive awards plan design indicate moderate change
- Ownership guidelines continue to increase with refinement and companies are considering hold requirements

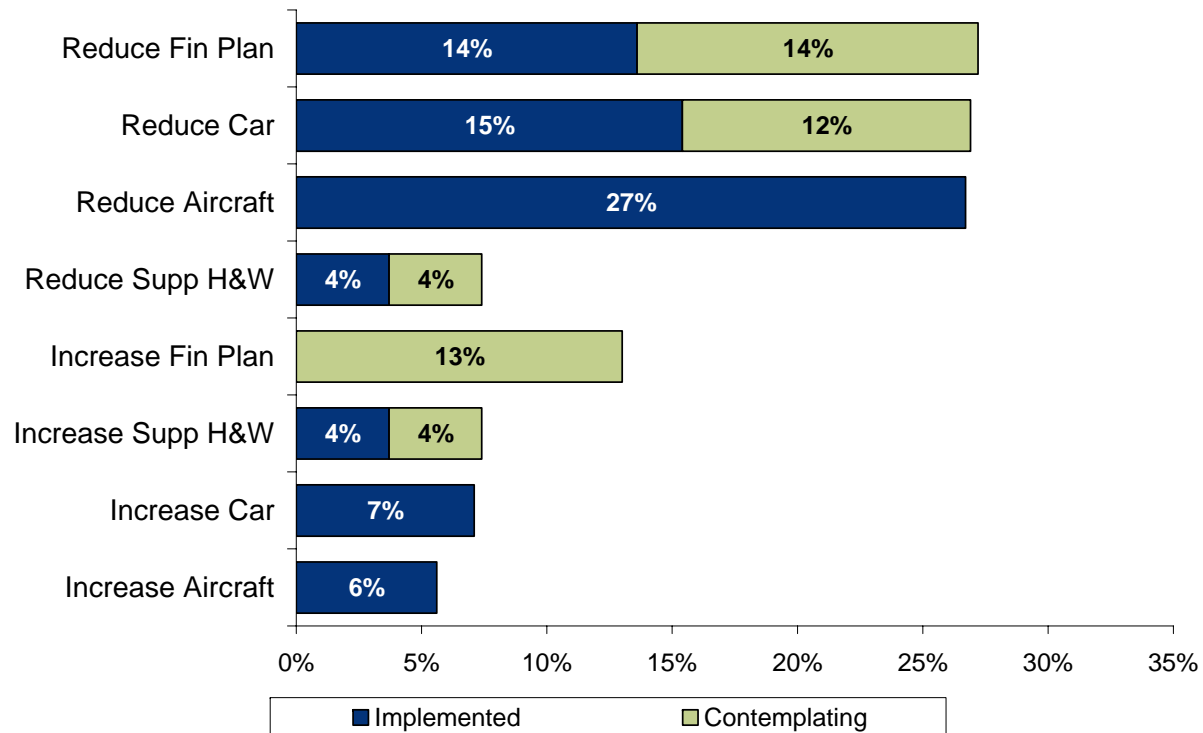
### Implemented and Contemplated Changes to LTI / Ownership





- Companies continue to implement and contemplate reductions to perquisites

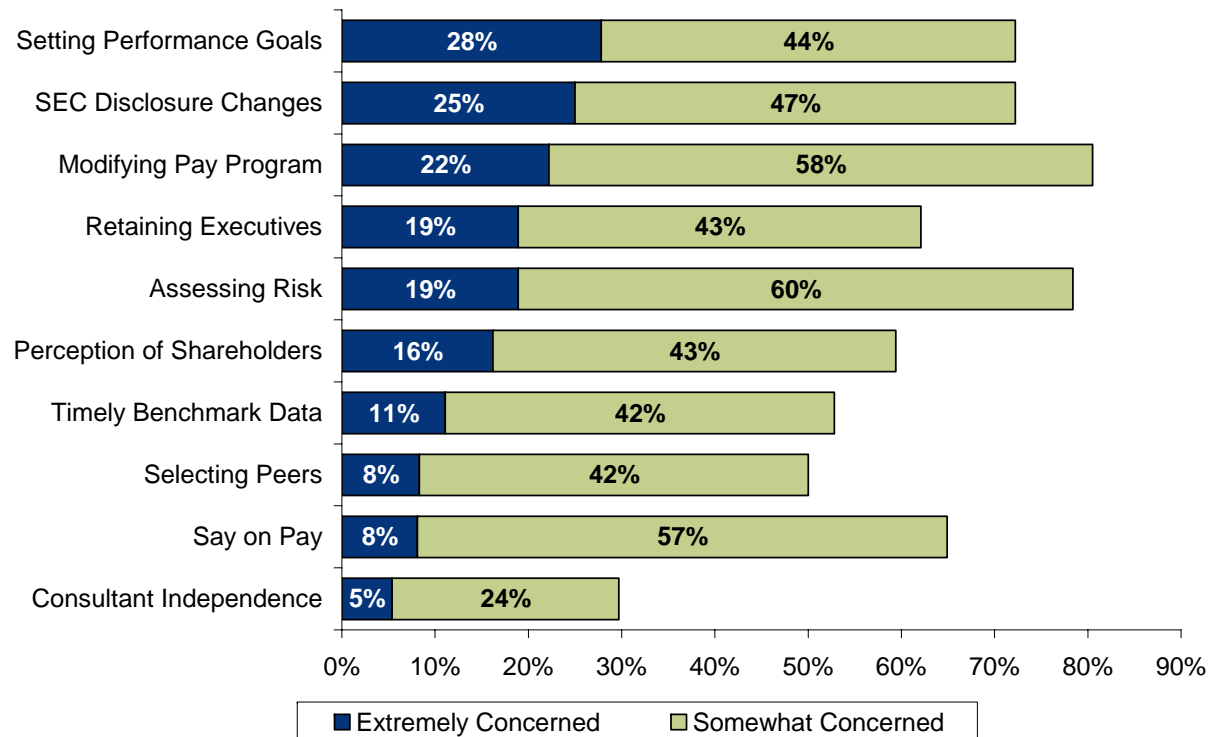
**Implemented and Contemplated Changes to Perq's**





- Concerns focus on risk assessment and goal setting, and pay plan flexibility
- Regulatory changes generally perceived as lower concern

### Areas of Concern for Upcoming Year





# QUESTIONS?

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