

# ON POINT

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## **PM&P on Compensation Planning: Looking Ahead to Executive Pay Practices in 2012**

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## Presenter



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## About this presentation

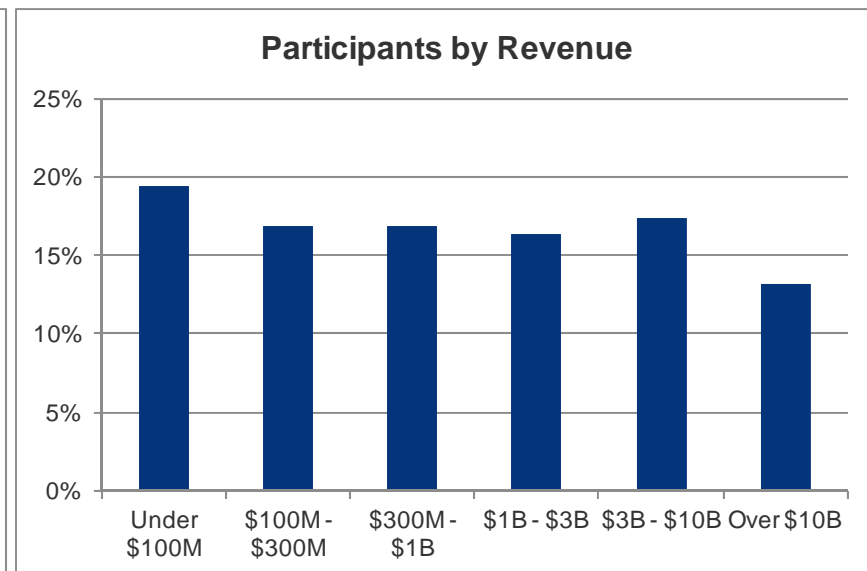
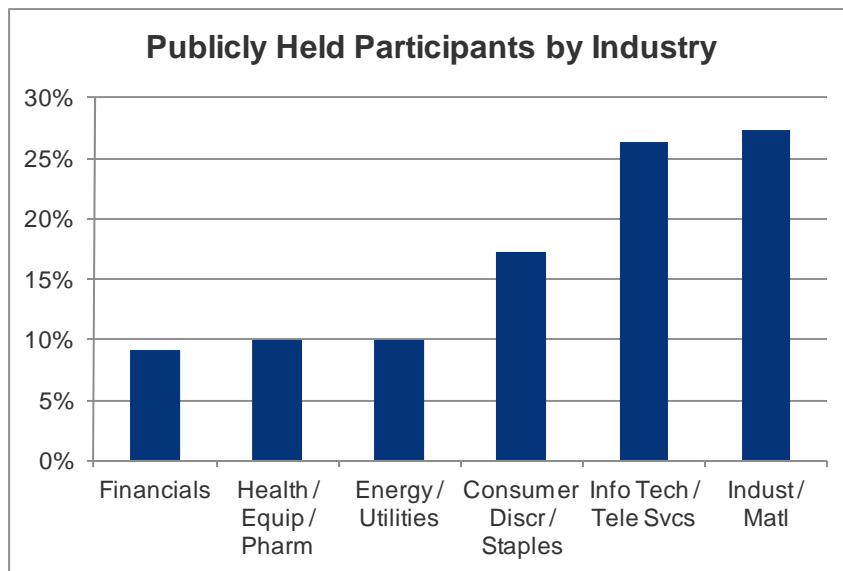
- Effective pay decisions:
  - Drive execution of the company’s unique business strategy, while recognizing company-specific challenges and opportunities
  - Consider broader economic trends
  - Are constrained by an ever-evolving regulatory environment
  - Are informed by – but not beholden to – broader market practices for compensation
- The executive pay environment is dynamic, and a better understanding of how others are reacting to these changes will lead to better decisions
  - The ***PM&P on Compensation Planning: Looking Ahead to Executive Pay Practices*** survey series investigates how executive compensation continues to evolve in response to these developments
  - Our goal in this presentation is to summarize some of the survey’s key findings and (more importantly) explore the “why” behind these companies’ decisions

## The current environment for executive pay decision-making

- There is an increasing focus on linkage of pay with performance
  - Key influences are Say on Pay, enhanced SEC disclosure requirements, new ISS protocols
  - Competing definitions of both “pay” and “performance”
  - Increasingly sophisticated approach to both performance metric selection and goal-setting
  - Companies are conducting these evaluations more frequently than in the past
- It is difficult to balance “performance” and “retention” in an environment with such volatile markets and heightened pay scrutiny
  - What tools do we have to retain executives when performance misses the mark?
  - How do we set long-term goals when we have no reliable long-term forecast?
  - How do we (and should we) replace the value attributable to “problematic” pay programs?
  - What to do when relative performance is strong but we miss budget? And vice versa?
  - How do we convince shareholders our programs are “right” when they’re “different”?

## Participants in the survey represent companies of all sizes and industry

- The 190 participants ranged from Fortune 500 members to not-for-profits and emerging high-growth companies, with 150 who responded as company managers and 40 who responded as board members of their company
- 58% of participants represent publicly traded companies, while 36% represent private, membership and mutual organizations. 6% of respondents are from not-for-profit or government entities



## Executive base salary changes

Perspective	Executive Team Base Salary Increase									
	Not Sure	Cut or Freeze	0% - 2%	2% - 3%	3% - 4%	4% - 5%	5% - 6%	6% - 7%	7% - 10%	>10%
<b>All Companies</b>										
FY11	1%	18%	8%	17%	31%	11%	6%	2%	3%	3%
Expected FY12	7%	10%	7%	26%	32%	9%	5%	1%	1%	1%
<b>Above Peer Performers</b>										
FY11	4%	12%	4%	16%	32%	18%	2%	4%	2%	6%
Expected FY12	8%	6%	4%	16%	38%	18%	2%	2%	4%	2%
<b>Below Peer Performers</b>										
FY11		25%	19%	13%	22%	3%	16%	3%		
Expected FY12	9%	6%	16%	44%	13%	3%	9%			

Key: 30% - 45% 18% - 29% 9% - 17% 3% - 8% 0% - 2%

## Modifications to annual incentive program design and payout levels

Perspective	Expected Annual Incentive Payout as % of Target								
	0% - 25%	25% - 50%	50% - 75%	75% - 100%	100% - 125%	125% - 150%	150% - 175%	175% - 200%	>200%
All Companies	11%	5%	12%	30%	31%	7%	2%	1%	1%
Above Peer Performers	9%	4%	11%	21%	34%	13%	4%	2%	2%
Below Peer Performers	17%	4%	29%	25%	25%				

Key: 25% - 35% 17% - 24% 10% - 16% 4% - 9% 0% - 4%

Perspective	Perceived Difficulty of "Target" Performance Goals as Compared to Prior Year								
	FY10 Responses			FY11 Responses			FY12 (Expected) Responses		
	Softer	Similar	Tougher	Softer	Similar	Tougher	Softer	Similar	Tougher
All Companies	6%	49%	41%	4%	44%	49%	4%	44%	42%
Above Peer Performers	2%	42%	53%	4%	37%	59%	2%	41%	50%
Below Peer Performers	8%	62%	31%	11%	56%	33%	11%	48%	33%

Key: 50% - 65% 40% - 49% 30% - 39% 10% - 29% 0% - 9%

## Long-term incentive programs – consider stock market volatility

- One would expect:
  - Higher award values in 2011 vs. 2010
  - Rosier outlook in first half of 2011 vs. second half of 2011



## Expected FY12 LTI awards

Perspective	Anticipated FY12 LTI Value Grants To Executives					
	Unknown	Considerably lower than FY11	Somewhat lower than FY11	About the same as FY11	Somewhat higher than FY11	Considerably higher than FY11
All Companies	17%	5%	8%	49%	21%	1%
Above Peer Performers	13%	3%	5%	49%	28%	3%
Below Peer Performers	33%	7%	13%	33%	13%	

Key:

40% - 50%

25% - 39%

10% - 24%

0% - 9%

## Expected FY12 mix of LTI instruments

Perspective	Expected Mix of 2012 LTI			
	Stock Options / SARs	Time-Vested Restricted Stock or RSUs	Performance Shares / Units / Options	Cash-Based Plans / Other
All Companies	24%	23%	27%	26%
Above Peer Performers	32%	18%	28%	22%
Below Peer Performers	25%	30%	31%	13%
Smallest Companies (Under \$100M in Revenue)	42%	31%	6%	22%
Largest Companies (Above \$10B in Revenue)	14%	32%	34%	20%
<b>Key:</b>	<b>40% - 45%</b>	<b>30% - 39%</b>	<b>15% - 29%</b>	<b>0% - 14%</b>

## Severance and Change-in-Control payments

Perspective	Treatment of Unvested Equity Upon a Change-in-Control				
	Acceleration of unvested equity is at Board's discretion	Partial acceleration upon CIC (single-trigger)	Partial acceleration only if CIC is followed by job loss (double-trigger)	Full acceleration upon CIC (single-trigger)	Full acceleration only if CIC is followed by job loss (double-trigger)
FY10	14%	5%	10%	33%	38%
FY11	14%	3%	11%	31%	40%
FY12 (Expected)	15%	3%	12%	29%	41%

Key: 35% - 45%      30% - 34%      15% - 29%      0% - 14%

Perspective	Provisions for 280G Tax Attributable to Golden Parachute Payments				
	Full Gross-Up	Modified Gross-Up	Other Gross-Up	Best After-Tax	Scale Back
FY10	35%	22%	3%	8%	32%
FY11	32%	24%	3%	11%	32%
FY12 (Expected)	18%	24%	3%	15%	39%

Key: 35% - 39%      25% - 34%      15% - 24%      0% - 14%

### Definitions

Full Gross-Up	Company pays excise tax and additional payments to keep executive "w hole"
Modified Gross-Up	Company pays excise tax only if payments exceed safe harbor by a certain amount
Other Gross-Up	For example, capped to a set dollar amount or company pays initial excise taxes only
Best After-Tax	Company cuts back payments only if executive receives greater after-tax benefit than if the excise tax were paid by the executive
Scale Back	Cut back parachute payments to safe harbor

## Top Compensation Committee Agenda Items for 2012

Perspective	Compensation Committee Agenda Items for 2012			
	Will be Reviewed in 2012	Likely to be Reviewed in 2012	Not Likely to be Reviewed in 2012	Will Not be Reviewed in 2012
Prepare for New SEC Disclosure and Governance Requirements	46%	21%	15%	18%
Validate Alignment of Relative Pay / Performance	45%	30%	19%	6%
Peer Group Composition and Basis for Selection	44%	15%	26%	15%
Be Aware of How ISS Will Evaluate Your Pay Program	43%	15%	23%	19%
Challenge Long-Term Incentive Program Design	39%	25%	23%	13%
Assess Impact of SOP and SOF Vote Results	37%	14%	24%	25%
Balance Traditional "Target" Pay Analysis with Forward Looking Sensitivity Analysis	26%	29%	30%	15%
Discuss Role of Discretion in Executive Pay Programs	23%	34%	34%	8%
Assess Policies Regarding Executive and Outside Director Share Ownership	22%	20%	35%	22%
Revisit Executive Compensation Governance Building Blocks	19%	29%	34%	18%
<b>Key:</b>	<b>40% - 46%</b>	<b>25% - 39%</b>	<b>15% - 24%</b>	<b>0% - 14%</b>

## Focus: Prepare for new SEC disclosure and governance requirements

Upcoming Dodd-Frank Provisions	
Provision	Description
<p><b>Compensation Committee Independence and Authority</b>  <i>Effective July 16, 2011</i>  <i>SEC to issue final rules prior to Dec 2011 (Likely to be effective for 2012 proxy season)</i></p>	<p>The Act directs the SEC to adopt Compensation Committee independence standards</p> <p>The Committee may in its sole discretion engage outside counsel, and the Company must provide appropriate funding</p>
<p><b>Compensation Committee Advisors</b> (Consultants and Legal Counsel)  <i>Effective July 16, 2011</i>  <i>SEC to issue final rules prior to Dec 2011 (Likely to be effective for 2012 proxy season)</i></p>	<p>No absolute requirement that the advisors to the Compensation Committee be independent</p> <p>However, Compensation Committees must assess the independence of their Advisors, based on suggested factors to be articulated by the SEC</p>
<p><b>Clawback Policies</b>  <i>Effective date unclear but likely 2013 proxy statements</i>  <i>SEC to issue proposed rules 2<sup>nd</sup> half of 2011</i></p>	<p>Companies must implement and disclose policies for recouping payments to current and former executive officers based on financial statements that are subsequently restated (this is an expansion of the Sarbanes-Oxley clawback provisions)</p>
<p><b>Enhanced Disclosure in Proxy (four areas)</b>  <i>Effective date unclear but likely 2013 proxy statements</i>  <i>SEC to issue proposed rules 2<sup>nd</sup> half of 2011</i></p>	<ol style="list-style-type: none"> <li>1. <u>Pay-for-performance</u>: the relationship between compensation actually paid to executives and the company's financial performance</li> <li>2. <u>Internal equity ratio</u>: the ratio between the CEO and median employee's pay</li> <li>3. <u>Hedging policies</u>: whether employees and Directors are permitted to purchase financial instruments to hedge or offset a decrease in the firm's stock price</li> <li>4. <u>Role of COB/CEO</u>: why the roles of the Chairman and CEO are combined or separate</li> </ol>

## Focus: Validate the alignment of relative pay and performance and re-calibrate as necessary

Key Consideration	Comments
<b>Choose the right peer group</b>	<ul style="list-style-type: none"> <li>• Group will ideally exhibit a similar financial/operational profile</li> <li>• In selection of peers, may consider operating leverage, exposure to market cycles, mix of revenue, R&amp;D expense</li> </ul>
<b>Define what performance captures your strategic objectives</b>	<ul style="list-style-type: none"> <li>• TSR is common, but highly susceptible to vagaries of the market</li> <li>• Consider providing balance with an analysis of metrics in your short- and long-term incentive programs, as well as metrics considered important by investors</li> </ul>
<b>Compare realizable pay against performance</b>	<ul style="list-style-type: none"> <li>• Comparing performance with pay opportunities (ISS protocol) is flawed</li> <li>• More meaningful comparison is to realizable pay, which includes actual paid amounts (bonuses) or amounts that can be realized (e.g., in-the-money stock option values)</li> </ul>
<b>Re-calibrate as necessary</b>	<ul style="list-style-type: none"> <li>• Do performance metrics and goals need adjustment to correct misalignment?</li> </ul>

## Focus: Peer group composition and basis for selection

*Until recently, the use of peer groups was mostly limited to the assessment of marketplace pay opportunities, and focused on similarly sized companies within the same industry. More nuanced selection criteria may be more effective in assessing issues such as difficulty of incentive plan goals or reasonableness of performance metrics*

Key Consideration	Comments
<b>Does the group include companies that shareholders might consider inappropriate?</b>	<ul style="list-style-type: none"> <li>• Revenue and market cap within 1/2 to 2x of the company</li> <li>• Similar industry (GICS, SIC or NAICS)</li> </ul>
<b>Does the company have unique characteristics that should be reflected in the peer group?</b>	<ul style="list-style-type: none"> <li>• Varies by industry and maturity</li> <li>• May consider operating leverage, revenue diversity, end customers, international focus, R&amp;D investment, beta</li> </ul>
<b>What is the proper way to utilize the peer group?</b>	<ul style="list-style-type: none"> <li>• Increased disclosure requirements and proliferation of data services have created new opportunities for in-depth analysis of pay/performance alignment, goal difficulty and incentive metric correlation</li> <li>• Don't lose sight of traditional benchmarking activities: pay levels, pay mix, prevalence and design of various benefits/perquisites</li> </ul>

## Focus: Be aware of how ISS will evaluate your program

***New methodology for 2012 includes three analyses focused on relative and absolute measurement of company TSR and CEO pay:***

Description	Analysis Details
<b>Relative Alignment</b> TSR and CEO pay are analyzed to determine the pay-performance alignment within the ISS-developed peer group	<p><u>Analysis 1: Relative Alignment between CEO Pay and TSR:</u></p> <p>The degree of alignment between the company's TSR rank and the CEO's total pay rank within the peer group is measured over 1-year and 3-year periods (weighted 40/60, to put more emphasis on the longer term)</p> <ul style="list-style-type: none"> <li>Note that per discussions with ISS, the current thinking is to apply the weight to the actual 1- and 3-year TSR and CEO pay to determine overall TSR and CEO pay rank</li> </ul> <p><u>Analysis 2: CEO Pay Multiple:</u></p> <p>The multiple of the CEO's total pay is compared to the peer group median, which may identify cases where a high performing company may nevertheless be overpaying</p>
<b>Absolute Alignment</b> Company TSR performance and CEO pay are analyzed in terms of long-term alignment	<p><u>Analysis 3: TSR and CEO Pay Trend over 5 Years</u></p> <p>The degree of alignment between the trend in the CEO's pay and the company's TSRs over the prior five fiscal years – i.e., the difference between the slope of annual pay changes and the slope of annualized TSR changes during the prior 5-year period</p>

- Relative Alignment and Absolute Alignment may be weighted 50/50 in this portion of the analysis
- Companies that demonstrate strong or satisfactory alignment will generally receive a positive recommendation (in the absence of other pay-related issues), while companies demonstrating weak alignment will receive further qualitative review to determine a final vote recommendation

*The new methodology replaces the current approach consisting of an initial test based on 1- and 3-year TSR relative to a company's 4-digit GICS; if both 1- and 3-year TSRs are below median then ISS would further scrutinize CEO pay and performance alignment*

Thank You! If you have any questions after the event,  
please contact:

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Please join us for our next webcast:

***Change-in-Control Agreements After Say on Pay***

Tuesday, December 13<sup>th</sup> at 2pm ET

Dan Wetzel and Margaret Black

Please register at [www.pearlmeyer.com](http://www.pearlmeyer.com)