

ENGAGED DIRECTORS. EFFECTIVE BOARDS.[®]

Strategies for Getting Pay Right: The Science and Art of “How Much”

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Today's Speakers



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Matthew Stinner, Managing Director, Pearl Meyer & Partners
Matt advises clients on compensation strategy and governance philosophy and implementation, as well as all areas of executive and employee compensation.

Melissa Means, Managing Director, Pearl Meyer & Partners
Melissa's expertise includes total compensation strategy, development, incentive compensation strategy and design, market practices benchmarking, and employee pay.

Pay decisions

- Why are they so difficult and such a hot topic

Study of 50 proxies

- How companies describe setting pay
- How companies describe backing up their pay decisions
- Data that could enhance/support pay decisions

Opportunities to enhance pay decision making

- 8 opportunities to consider for better pay decisions

Checklist for making better pay decisions

We've observed thousands of pay decisions:

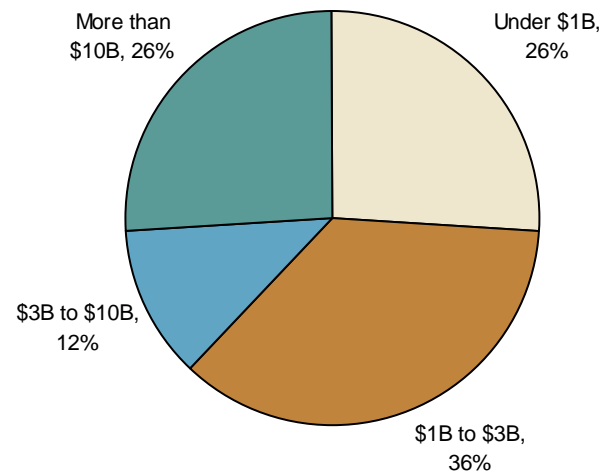
- Complicated dynamics
- Subjective – shades of grey
- Personal biases inevitable – we've all been paid
- Emotional – reflection of value of executives
- Imprecise and subject to significant scrutiny
- Vary by compensation element
- Almost all are trying to do the “right thing,” but sometimes hard to determine how to do the “right thing”

Study of 50 Proxies

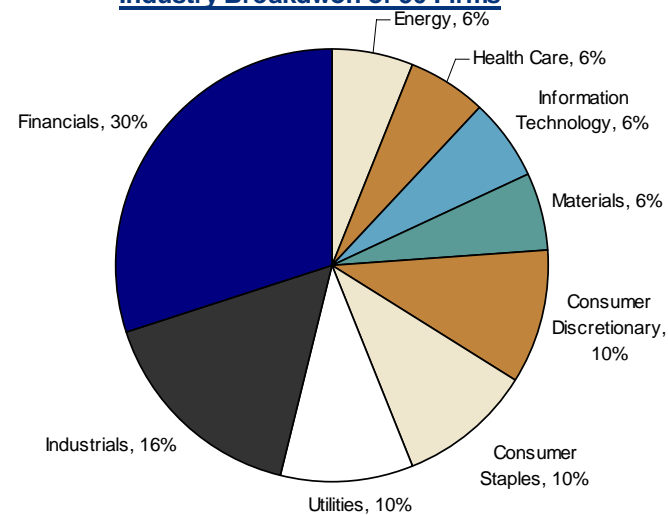
For this Webcast, we reviewed 50 early-filer proxies for:

- Prevalence of pay decision inputs/factors considered
- Pay decision analytics cited
- Peer group selection process disclosure
- Peer group selection criteria cited
- Data regarding pay decision inputs

Revenue of 50 Firms Included in Analysis

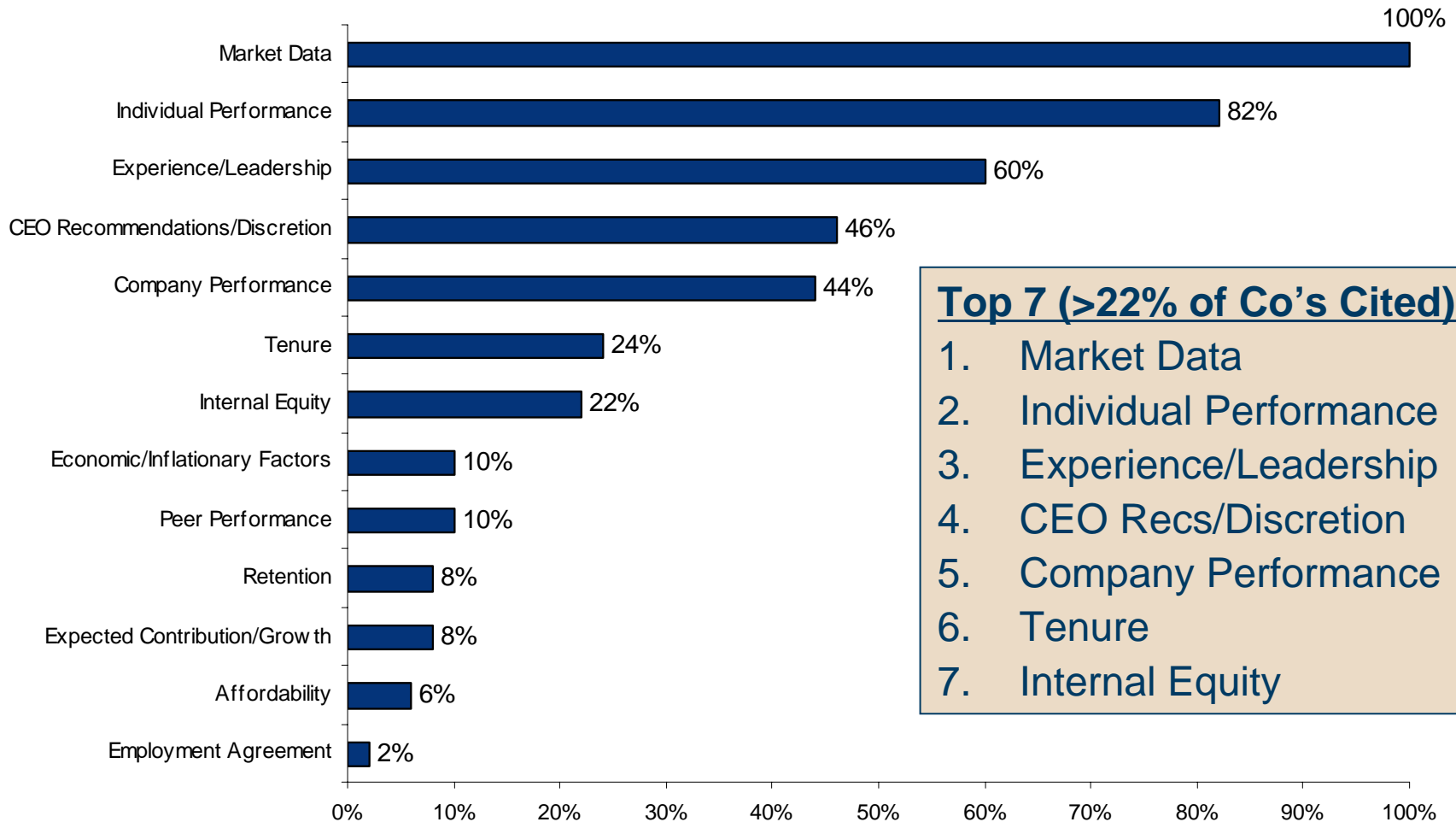


Industry Breakdown of 50 Firms



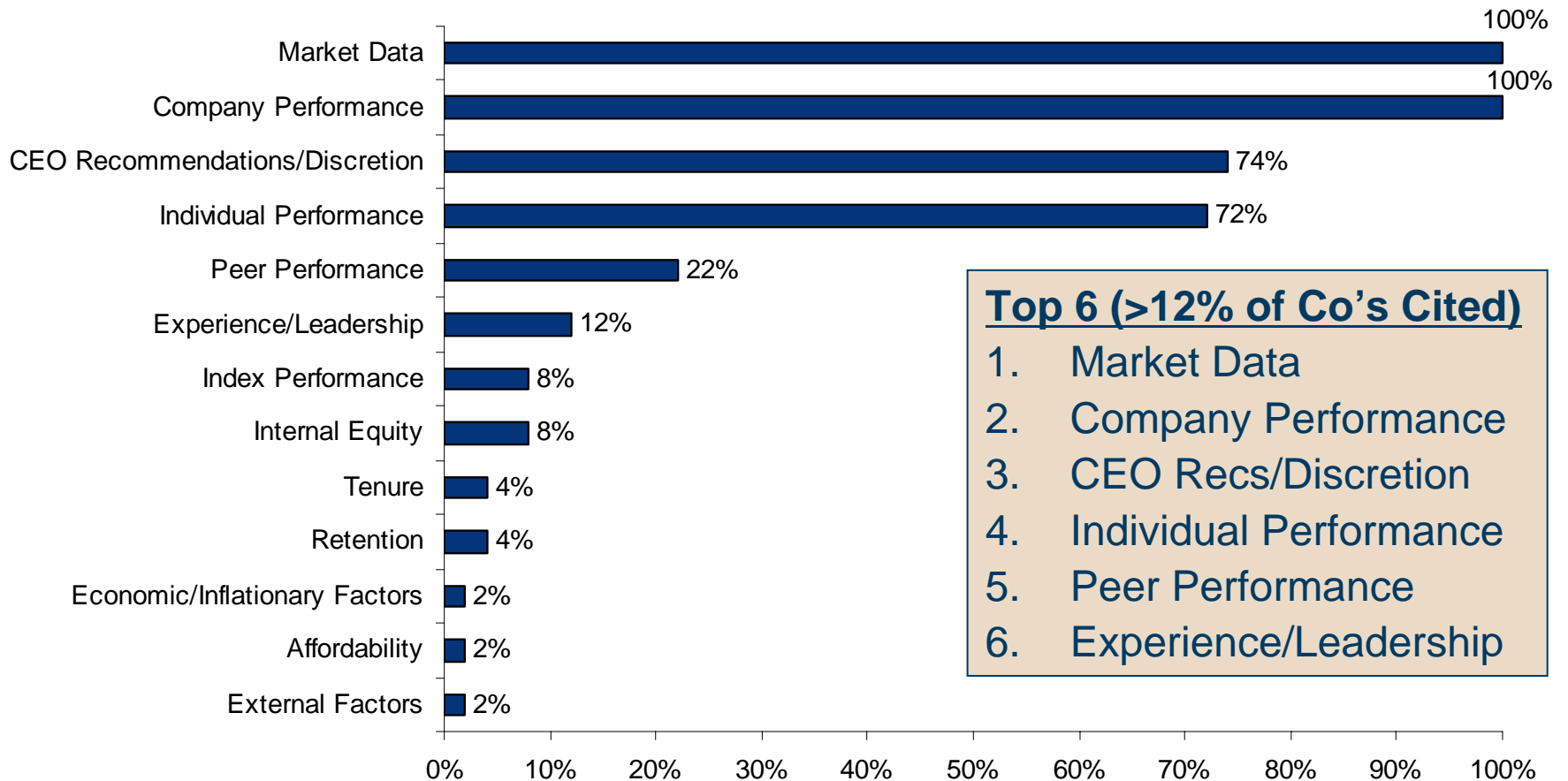
Base Salary Decision Inputs

Disclosed Factors Considered in Determining Base Salaries



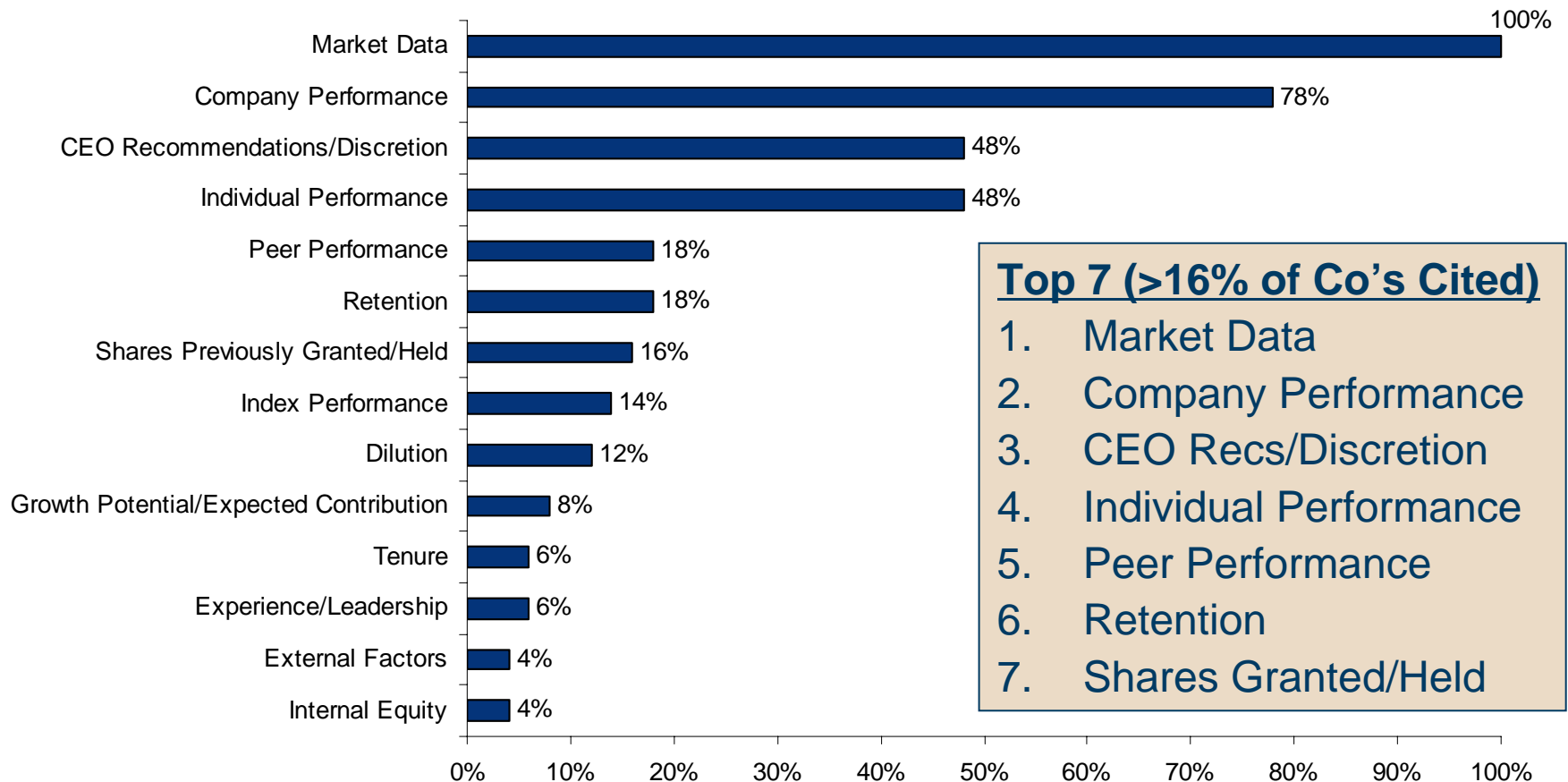
Annual Bonus Decision Inputs

Disclosed Factors Considered in Determining Short Term Incentives



Long-Term Incentive Decision Inputs

Disclosed Factors Considered in Determining Long-Term Incentives



Inputs Into Pay Decision Process

18 Inputs Cited



Pay Decisions – Quality Inputs

Potential Inputs

- Market Data
- Individual Performance
- Company Performance
- Discretion
- CEO Recommendations
- Retention
- Internal Equity
- Executive Potential
- Equity Held
- Wealth Accumulation
- Affordability
- Dilution
- Tenure
- Peer/Index Performance
- Experience/Leadership
- Contractual Clauses
- Economic/Inflationary Factors
- External Factors



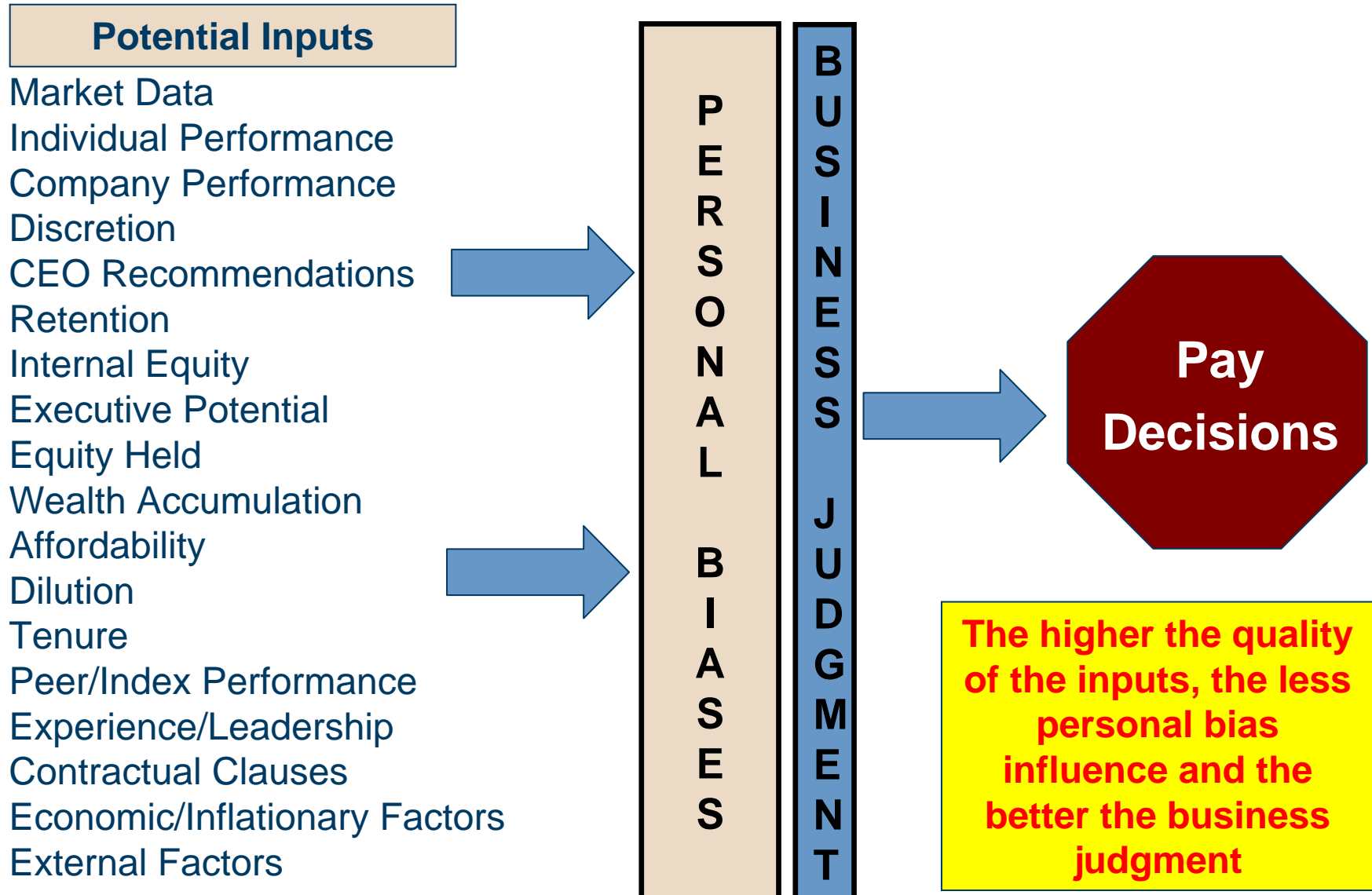
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**Pay
Decisions**

Pay Decisions – Poor Quality Inputs



8 Opportunities to Improve Pay Decision-Making

- 1. Review the pay decision inputs cited in the proxy**
- 2. Adopt a holistic view to pay decisions**
- 3. Enhance pay decision process**
- 4. Improve pay decision input quality**
- 5. Provide structure for subjective pay decision inputs and document results**
- 6. Improve competitive market analysis quality**
- 7. Improve peer group selection/review process**
- 8. Improve knowledge of potential pay decision outcomes**

Opportunity #1: Review Pay Decision Inputs in Proxy

With two years of CD&A history, now's a good time to re-evaluate pay decision inputs cited in the proxy

- Is each input for each compensation element really used?
- What's a realistic number of pay decision inputs to consider?
- Is there an opportunity to limit the inputs to what's really important?
- Do the inputs considered align with the compensation strategy?

Opportunity #2: Adopt a Holistic View

Reviewing all compensation and benefits together provides a more complete picture of true pay

- Consider all elements of compensation together
 - Base, bonus and long-term incentives
 - Security arrangement (severance, vesting acceleration, etc.)
 - Executive benefits and perquisites (SERPs, NQDC, etc.)
- Consider macro issues as well
 - FAS expense
 - Dilution
 - Institutional shareholder and regulatory guidelines

Opportunity #3: Enhance Pay Decision Process

Thorough, well-planned process

- Annual compensation calendar
- Committee involved in setting agenda
- Committee input into peer group prior to market analysis
- Agree on pay decision inputs and importance of each
- Provide timely information
- Schedule pre-meetings to review issues
- Provide adequate time to deliberate and decide
- Consider twice, decide once

Opportunity #4: Improve Pay Decision Input Quality

**Improving the quality of pay decision inputs can help
Committees make better business judgments**

Examples:

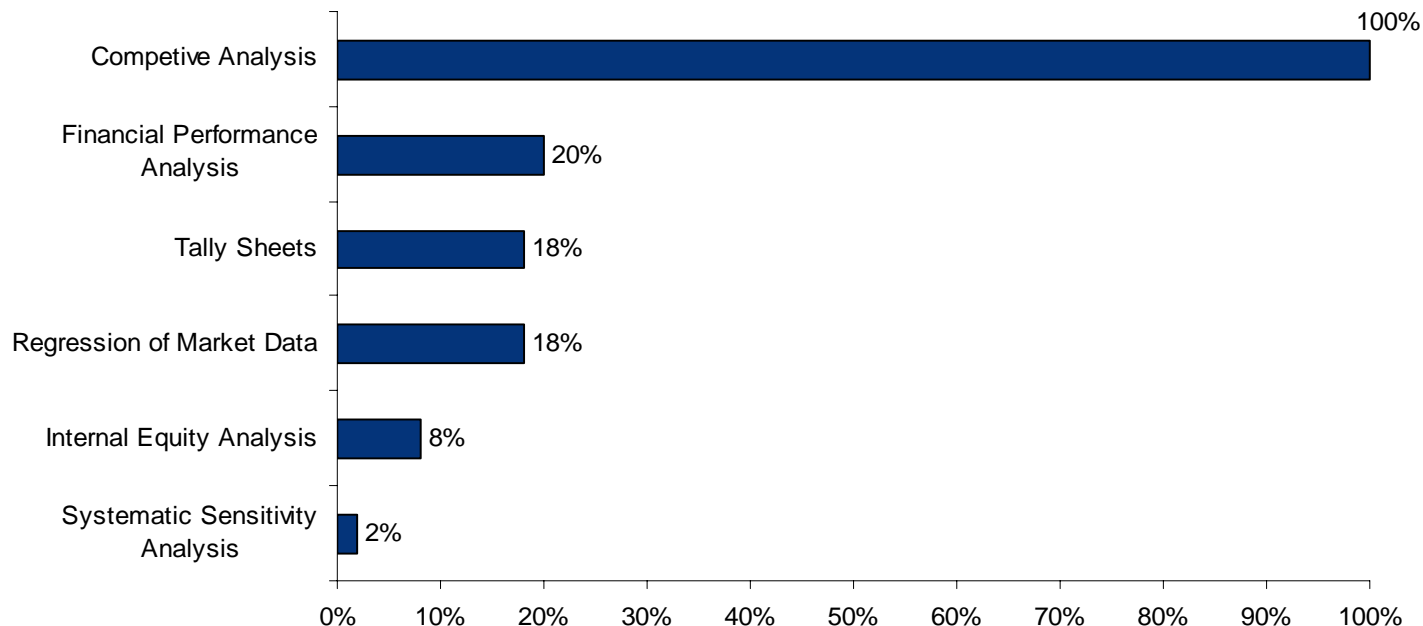
- Retention
- Company performance
- Internal equity
- Tenure

Opportunity #4 (cont.): Improve Pay Decision Input Quality

Generally limited analysis behind inputs

- Often information is anecdotal
- Opportunities missed to make subjective inputs more objective
- Subjective inputs often not documented

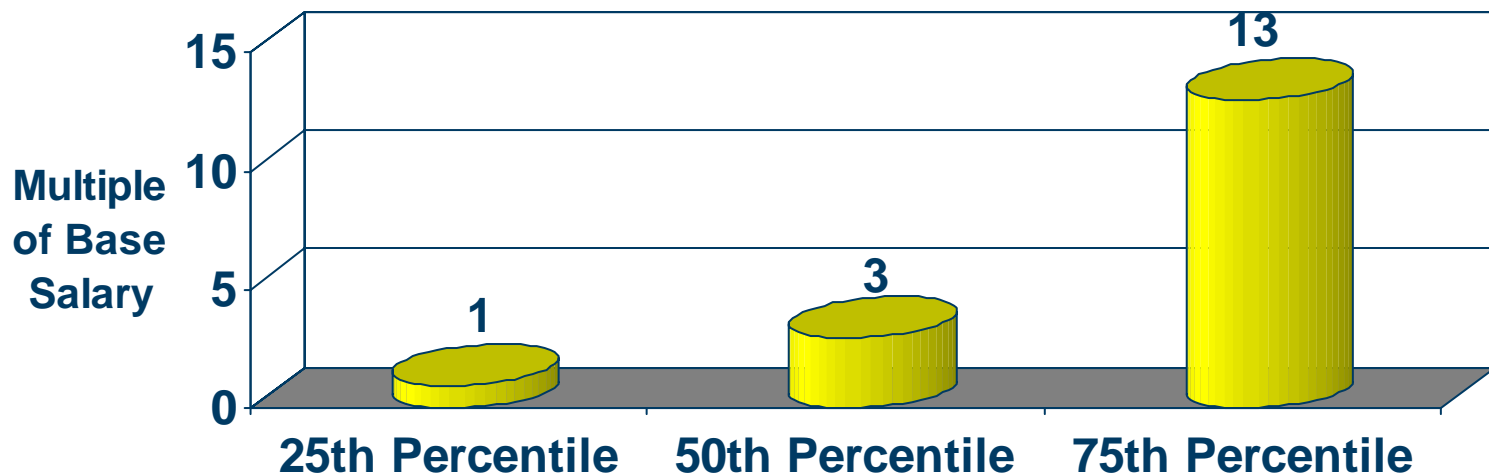
Types of Analyses Performed by 50 Early Filers



Opportunity #4 (cont.): Pay Decision Input - Retention

- Frequently subjective and anecdotal
- Simple opportunity to add objective input to subjective input
- 13 to 1 difference in retention quality from 75th to 25th percentile

CEO Unvested In-the-Money Equity Value as a Multiple of Base Salary



Opportunity #4 (cont.): Pay Decision Input – Comp. Performance

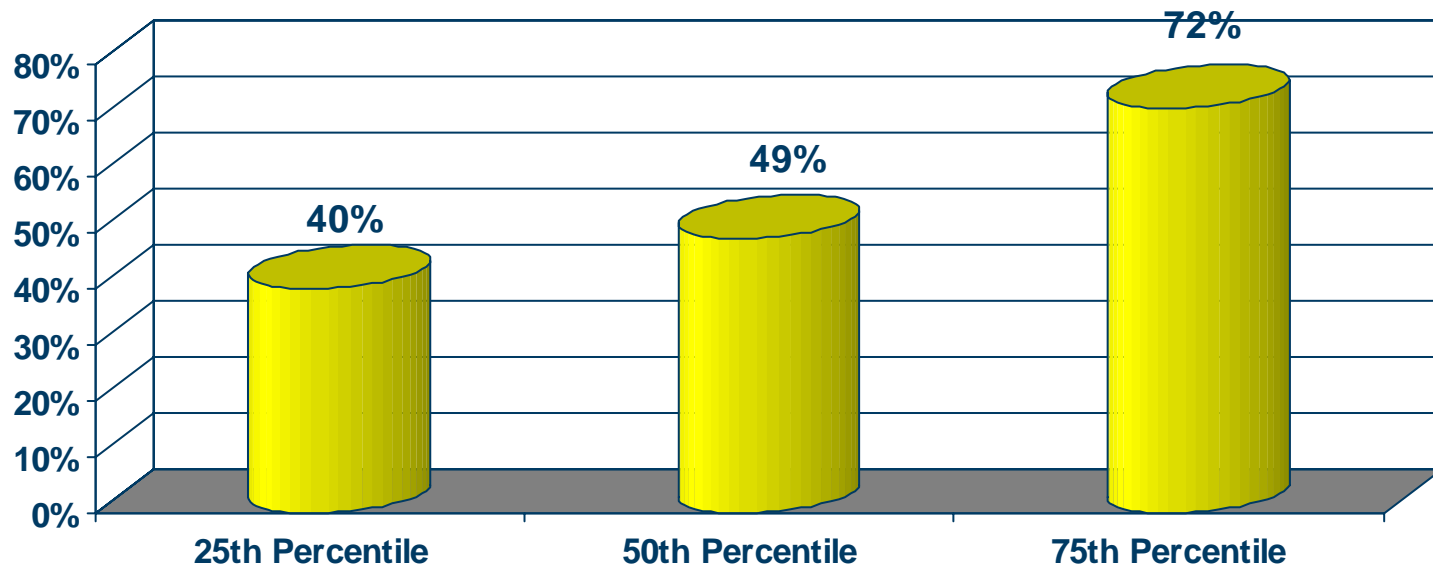
Company performance cited as input 100% of time for annual bonus

- Goal setting process critical
- Understand the metrics
- Understand the interrelation between the metrics
- Understand how the proposed goals fit:
 - Versus guidance
 - Versus budget
 - Versus prior year
- Understand magnitude of potential payments vs. true company performance
- Maintain discretion

Opportunity #4 (cont.): Pay Decision Input – Internal Equity

- Frequently subjective and anecdotal
- Simple opportunity to add objective input to subjective input
- The 2nd highest paid total pay as a percent of CEO total pay ranged from 40% at the 25th percentile to 72% at the 75th percentile

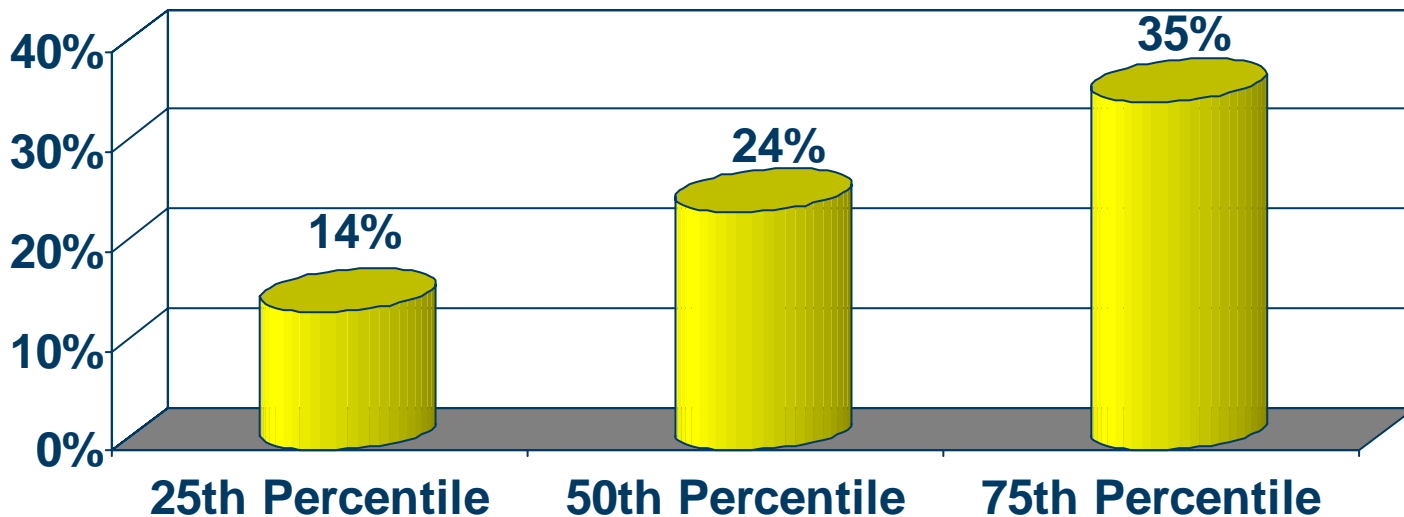
#2 Executive Total Pay as a Percent of CEO Total Pay



Opportunity #4 (cont.): Pay Decision Input – Internal Equity

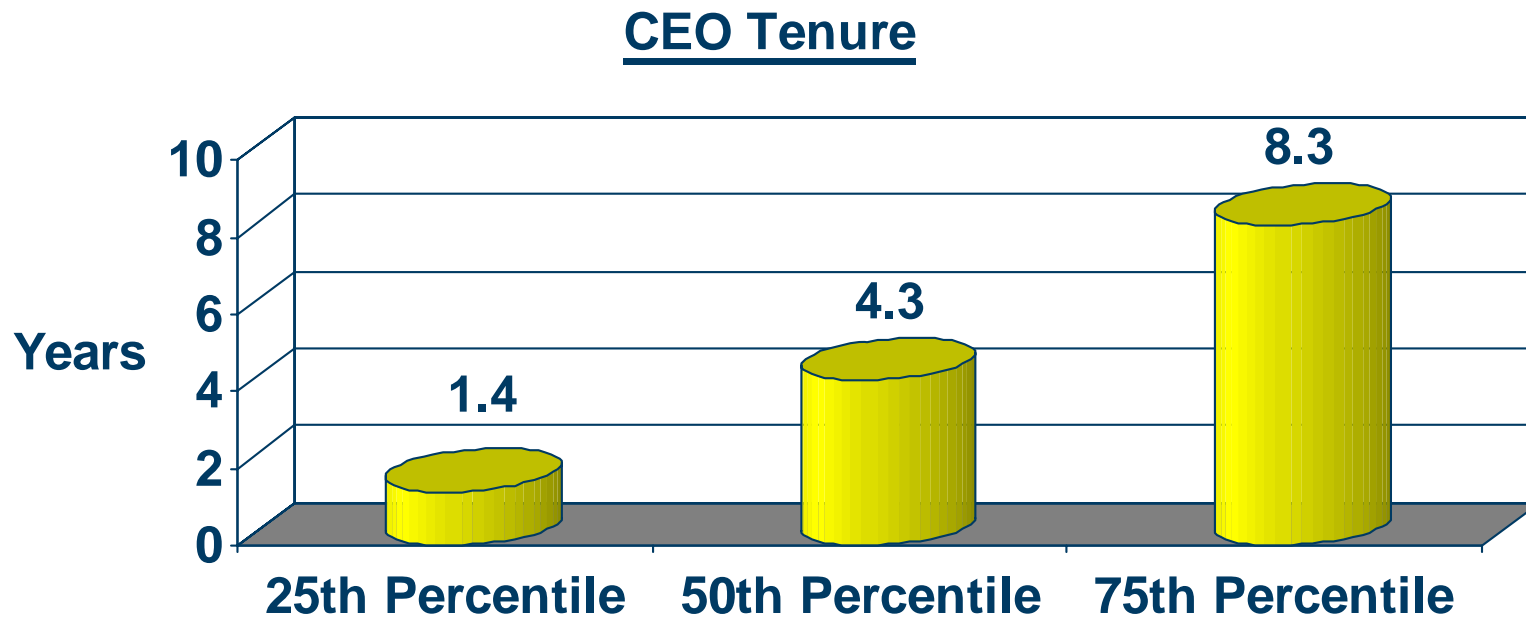
- LTI example – Top 5 FAS expense as a percentage of total company expense
- Can look at any element of compensation in same context
- 75th percentile is more than double the 25th percentile

Top 5 FAS Expense as a % of Total Company FAS Expense



Opportunity #4 (cont.): Pay Decision Input - Tenure

- When reviewing market data and citing tenure as pay decision input, does Committee know tenure of peer group?
- CEO tenure in our study ranged from 1.4 years at the 25th percentile to 8.3 years at the 75th percentile



Opportunity #5: Structure Subjective Pay Decisions

Many very subjective inputs

- Individual performance
- Executive potential
- Experience/leadership
- Discretion

Thorough documented review process

- Require back-up and ratings for executives
- Conduct thorough, documented CEO review
- Rate executive potential – tie to succession planning process
- Document reasoning for use of discretion

Opportunity #6: Pay Decision Input - Market Analysis

100% indicated that a competitive analysis of market data was used in pay decisions

Quality of market analysis varies – key opportunities for improvement:

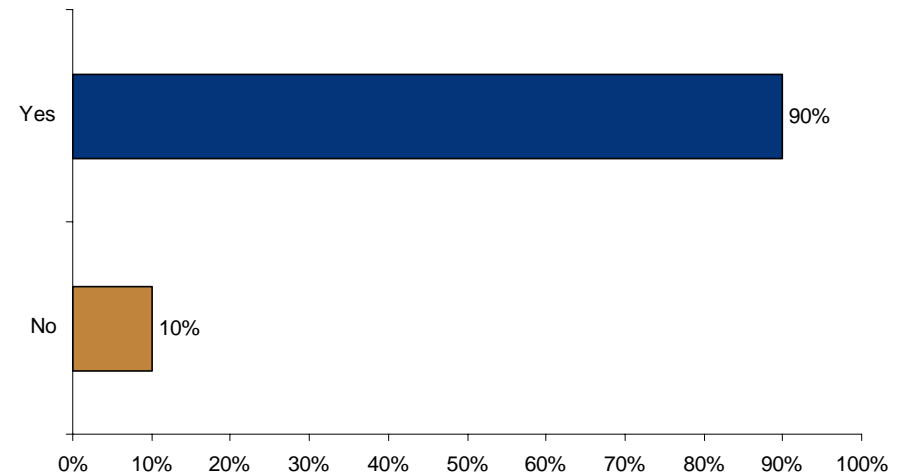
- Survey selection
- Peer Group selection
- Long-term incentive decisions (smoothing, 3-year average, etc.)
- Treatment of multiple data sources – composites
- Sample size issues
- Effective use of regression analysis

Opportunity #7: Peer Group Selection

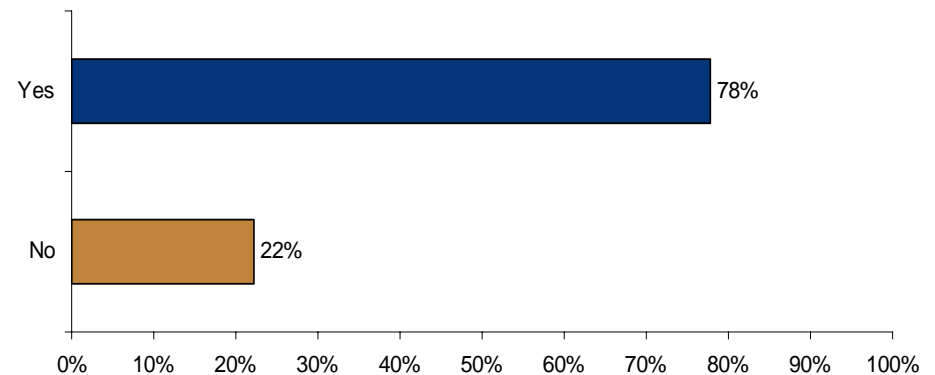
Key points on Peer Group (PG) selection

- Often hotly debated
- Misunderstandings around PG use drive poor selections
- Reasonable minds can disagree on appropriate PG
- Selection process critical to show Committee was informed/involved to make reasonable business judgment

Disclosed Using a Peer Group

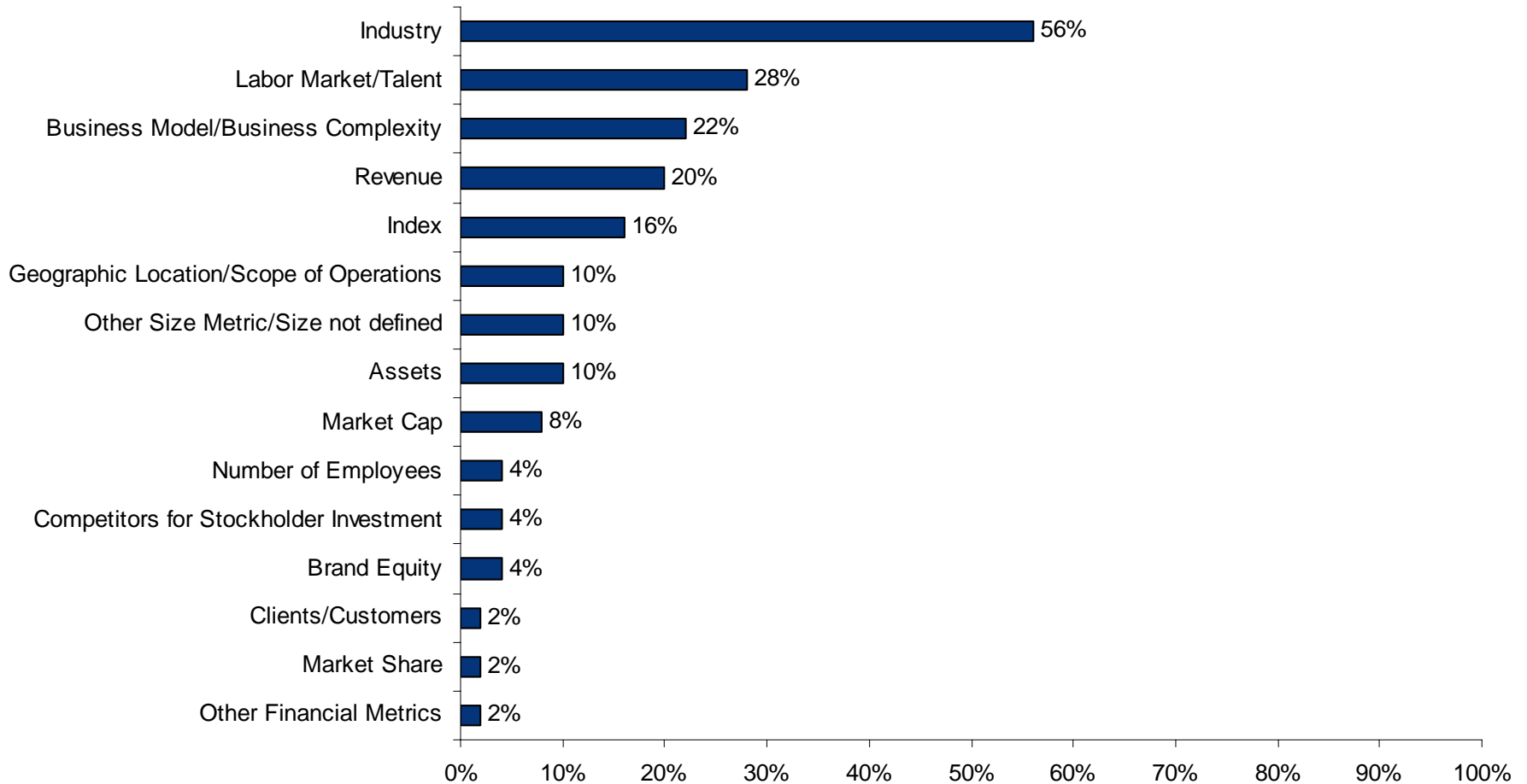


Discussed Peer Group Selection Criteria



Opportunity #7 (cont.): PG Selection Criteria Prevalence

Criteria Disclosed in Peer Group Selection



Opportunity #7 (cont.): Peer Group Use

Peer Group typically used for:

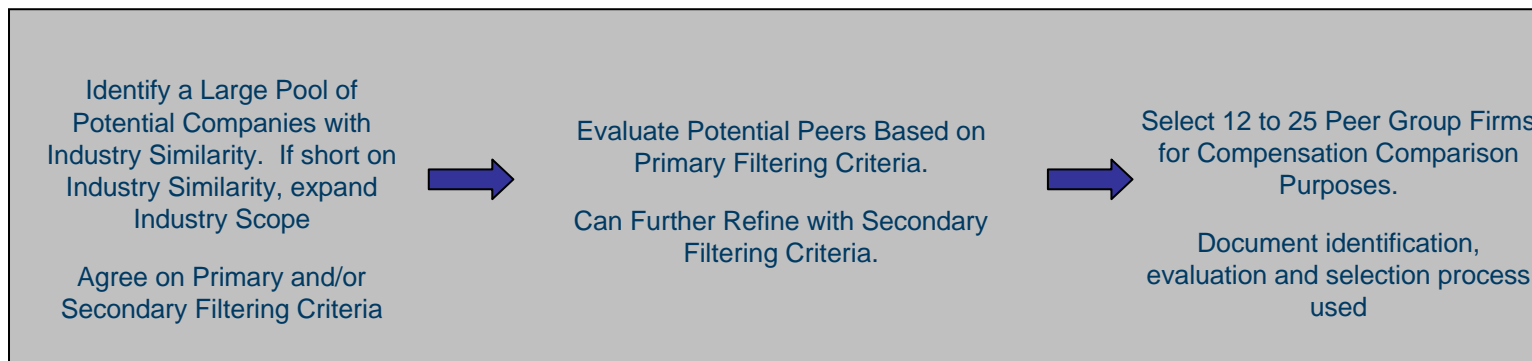
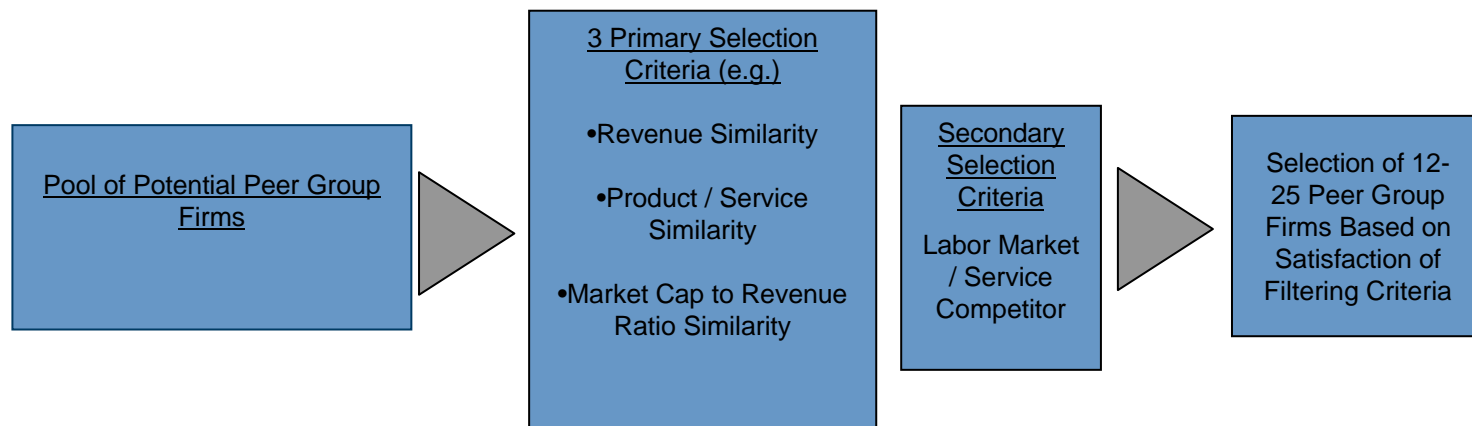
- Pay comparison for top 3 to 5 executives
- Macro-analyses around key areas such as:
 - Relative dilution (annual and overall)
 - Relative FAS expense
- Can also be used for security arrangement competitive analyses, competitive pay practices, and performance-based plans relative performance assessments
- Data should be put in context for Committee:
 - How did pay comparators perform relatively speaking
 - Typically look at revenue growth, profitability and shareholder return metric, but should customize accordingly

Opportunity #7 (cont.): Rules-Based PG Selection Process

Step 1: Identification

Step 2: Evaluation

Step 3: Selection



Opportunity #8: Potential Pay Outcomes

Dynamic, not static, pay modeling

- Illustration of compensation potential over period of years
- Most current analyses look at one year's worth of compensation data, not what pay could be given:
 - Potential company performance
 - Potential stock performance
- Simulate potential results of a compensation program
- Serves as an alternative way to review appropriateness of executive pay

Opportunity #8 (cont.): Dynamic Pay Modeling

Dynamic pay modeling helps assess:

- Whether payouts that could result from a compensation decision today make sense
- Whether a program has the appropriate performance-orientation
- If there is too much focus on company vs. stock price performance or vice-versa
- If incentive opportunities are appropriately aligned (pay vs. performance achievement)
- If the current compensation mix is appropriate
- If incentive programs, as designed, support the business strategy

Opportunity #8 (cont.): Dynamic Pay Modeling Example

1.) Is this too much compensation for a CEO performing between the 10th - 20th percentile for company and stock price performance?

2.) Is this an appropriate amount of compensation for a CEO performing at the 50th percentile for company and stock price performance?

Percentiles		Company Performance								
		10%	20%	30%	40%	50%	60%	70%	80%	90%
Stock Performance	10%	\$4,084,083	\$4,375,795	\$4,586,193	\$4,765,970	\$4,934,003	\$5,186,054	\$5,455,719	\$5,771,316	\$6,208,875
	20%	\$6,611,269	\$6,902,975	\$7,113,373	\$7,293,150	\$7,461,184	\$7,713,234	\$7,982,900	\$8,298,497	\$8,736,056
	30%	\$8,433,544	\$8,725,250	\$8,935,648	\$9,115,425	\$9,283,459	\$9,535,509	\$9,805,175	\$10,120,772	\$10,558,331
	40%	\$9,990,611	\$10,282,317	\$10,492,714	\$10,672,492	\$10,840,525	\$11,092,575	\$11,362,241	\$11,677,838	\$12,115,397
	50%	\$11,445,963	\$11,737,669	\$11,948,067	\$12,127,845	\$12,295,878	\$12,547,928	\$12,817,594	\$13,133,191	\$13,570,750
	60%	\$12,901,316	\$13,193,022	\$13,403,420	\$13,583,197	\$13,751,231	\$14,003,281	\$14,272,947	\$14,588,544	\$15,026,103
	70%	\$14,458,383	\$14,750,089	\$14,960,487	\$15,140,264	\$15,308,297	\$15,560,348	\$15,830,014	\$16,145,610	\$16,583,169
	80%	\$16,280,658	\$16,572,364	\$16,782,762	\$16,962,539	\$17,130,572	\$17,382,623	\$17,652,288	\$17,967,885	\$18,405,444
	90%	\$18,807,838	\$19,099,544	\$19,309,942	\$19,489,719	\$19,657,753	\$19,909,803	\$20,179,469	\$20,495,066	\$20,932,625

3.) Is this an appropriate amount of compensation for a CEO performing between the 80th - 90th percentile for company and stock price performance?

Opportunity #8 (cont.): Dynamic Pay Modeling Example

4.) Is an incremental change in potential TDC of 9.7% (btw the 30th and 70th percentile for company performance only) enough incentive to drive executive behaviors on company performance?

5.) Is enough of the TDC package driven by company performance?

Percentiles		Company Performance								
		10%	20%	30%	40%	50%	60%	70%	80%	90%
Stock Performance	10%	\$4,084,089	\$4,375,795	\$4,586,193	\$4,765,970	\$4,934,003	\$5,186,054	\$5,455,719	\$5,771,316	\$6,208,875
	20%	\$6,611,269	\$6,902,975	\$7,118,373	\$7,298,150	\$7,461,184	\$7,718,234	\$7,982,000	\$8,298,497	\$8,736,056
	30%	\$8,433,544	\$8,725,250	\$8,935,648	\$9,115,425	\$9,283,459	\$9,535,509	\$9,805,175	\$10,120,772	\$10,558,331
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	70%	\$14,458,383	\$14,750,089	\$14,960,487	\$15,140,264	\$15,308,297	\$15,560,348	\$15,830,014	\$16,145,610	\$16,583,169
	80%	\$16,280,958	\$16,572,364	\$16,782,762	\$16,962,539	\$17,130,572	\$17,382,623	\$17,652,288	\$17,967,885	\$18,405,444
	90%	\$18,807,838	\$19,099,544	\$19,309,942	\$19,489,719	\$19,657,753	\$19,909,803	\$20,179,469	\$20,495,066	\$20,932,625

6.) Is an incremental change in potential TDC of 67% (btw the 30th and 70th percentile for stock price performance only) an appropriate amount of incentive to drive executive behaviors?

7.) Is an appropriate amount of the TDC package driven by stock price performance?

Opportunity #8 (cont.): Dynamic Pay Modeling Example

Percentiles		Company Performance								
		10%	20%	30%	40%	50%	60%	70%	80%	90%
Stock Performance	10%	\$4,084,089	\$4,375,795	\$4,586,193	\$4,765,970	\$4,934,003	\$5,186,054	\$5,455,719	\$5,771,316	\$6,208,875
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8.) Is the mix between company and stock price performance appropriate?

9.) Does this compensation program have a true pay-for-performance orientation?

10.) What behaviors does this type of compensation program drive?

Checklist to Better Pay Decisions...

- Review pay decision inputs in proxy for accuracy
- Adopt holistic view for pay decisions
- Review effectiveness of the pay decision process
- Review pay decision inputs for quality improvement opportunities
- Enhance structure around subjective pay decision inputs and document
- Review competitive market analysis for opportunities for improvement
- Review peer selection process to ensure it is objective and rules-based
- Consider dynamic pay modeling

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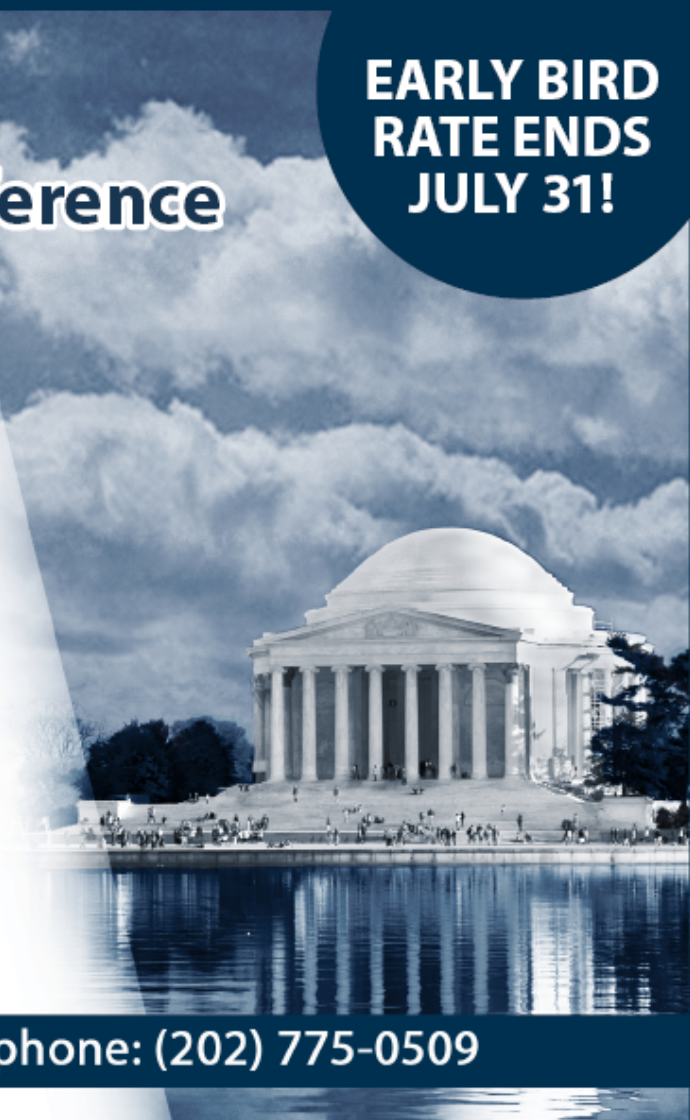
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Wednesday, August 13, 2008 – 2:00 pm ET

Maintaining Effective Incentives in a Volatile Market

Presenters:

Mike Esser, Managing Director, Pearl Meyer & Partners

Dan Wetzel, Managing Director, Pearl Meyer & Partners

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