

As We See It

Executive Compensation

Restoring Confidence Without Sacrificing Effectiveness

Restoring confidence in executive compensation programs is critical to preserving the talent and incentives necessary to drive business results that will, in turn, restore confidence in the nation's economy and financial markets. What's at stake in the current crisis reaches far beyond shareholder value and touches all key stakeholders in our collective success – creditors, suppliers, customers, employees and communities.

As We See It, what's required is leadership – not from Washington, but from shareholders' elected representatives on corporate Boards of Directors. Whereas a politician's perspective only allows for reactionary policies for all companies based on ideology, the Board's perspective allows for proactive solutions for each company based on unique circumstances. It is the Board's perspective that promotes a diversity of responsible and effective pay practices, instead of regulatory and legislative mandates that are generally less effective and lead to unintended negative consequences for companies and their shareholders.

We believe based on personal experience that corporate Directors can provide the leadership needed to address the current crisis. They are up to the challenge of providing the vision to pinpoint a destination, judgment to choose the best road forward, and courage to persevere. But time is short: immediate action is required to avert the threat of suffocating government intervention and to breathe life into the economy.

Following are the immediate steps Boards must take to restore confidence in our executive compensation system in a way that preserves its ability to attract, motivate, and retain the best talent to manage through these challenging times.

- **Reduce risk and leverage in the executive pay program.** Much of the controversy over executive compensation centers on whether Wall Street incentive programs that over-emphasized short-term performance may have encouraged "excessive risk-taking." We find other companies maintain a more balanced performance perspective, but there has been a notable increase in the portion of pay being put at risk and the upside opportunities offered relative to target pay. While intended to enhance the link between pay and performance, the combination of more risk-based pay and greater upside leverage may encourage inappropriate risk-taking. We anticipate that these types of risk assessments will lead some Boards to scale back their programs' risk profiles and performance leverage. Boards should resist objections to "takeaways" at the upper end of the reward spectrum.
- **Exercise more rigor in selecting performance measures and setting goals.** Selecting performance measures and setting goals are difficult tasks in any economic environment, and have become even more so with deteriorating economic conditions and limited visibility into near-term performance expectations. Nonetheless, performance measures need to be carefully defined, evaluated, and tested,

and performance goals need to create an appropriate relationship between pay and performance. In order to do this well, Boards cannot simply rely on the annual budget prepared by the company. Boards should obtain independent information regarding the key drivers of value creation for the business as well as multiple perspectives from which to evaluate and set goals, such as historical trends, peer comparisons, analyst estimates, and shareholder expectations. This is the only way for Boards to become truly comfortable with and confident in the selected measures and goals.

- **Link long-term incentives to measures besides stock price.** Stock performance is too volatile and subject to too many externalities to serve as the only basis for equity-based incentive payouts. Programs also should provide opportunities for executives to earn shares based on achieving other critical objectives and results, and require that they own and hold those shares for an extended period (see additional thoughts below on ownership and holding requirements). This approach strengthens performance-linkage and shareholder alignment, while minimizing the effect of grant timing on award value, which has been considerable given the predominant use of stock options. Boards should resist arguments that such programs are less competitive, or unfairly require executives to “earn it twice” through both performance and stock price appreciation, or that share grants should be bigger to offset the greater performance risk.
- **Lengthen performance/vesting periods on equity awards.** Pressure to meet quarterly earnings targets, the rise of day-traders and shareholder activists, and the “get rich quick” days of the tech bubble have all combined to truncate performance horizons for value creation and wealth accumulation. Many organizations now define “long-term” as three years – a limited perspective for assessing a new executive’s

potential, a business strategy’s effectiveness or a new customer’s long-term profitability. Given current economic conditions and relatively poor visibility into near-term performance, companies should consider plan designs that incorporate shorter performance periods (1-2 years), followed by longer vesting periods (3-4 years), resulting in a longer overall performance and retention time frame. Current market practices do not justify maintaining the status quo, and attempts to increase grant levels to offset longer vesting restrictions should be resisted.

- **Maintain meaningful and reasonable stock ownership and holding requirements.** The combination of ownership requirements and holding periods is a critical element of governing executive compensation over time. Ownership requirements prevent the executive from selling below a meaningful ownership level. Holding periods promote a performance perspective beyond vesting and, in some cases, past retirement. Without these policies, the effectiveness of the entire equity compensation program is in jeopardy. Boards should push for the adoption of these policies, even if initially resisted due to other restrictions already imposed on “insider” sales transactions or that such requirements will materially reduce the perceived value of the program to executives.
- **Eliminate perquisites.** Executive perquisites are a relatively small component of executive compensation, yet raise a disproportionate amount of ire from stakeholders. Any perquisite that simply pays for something an executive would otherwise purchase on his or her own should be eliminated. This includes relatively common perquisites such as company cars, country club dues, tax preparation services or personal use of a corporate aircraft. Perquisites are justifiable only if they can provide direct tangible benefits to the company. Attempts to maintain perquisites based on competitive practices or executive “status” should

be dismissed. Attempts to monetize their value and increase other pay components should be resisted.

- **Eliminate tax gross-ups.** Everyone must pay the taxes applicable to them by law, and executives should be no exception. Shifting part of their tax burden to shareholders is generally unfair and inappropriate, regardless of whether that tax is “reasonable” or what competitors provide to their managers. An exception might be made for paying the excise taxes owed by a recently hired executive following a change-in-control. In such situations, the executive may have an unusually low earnings basis in the first few years of employment (given the absence of vesting and exercise activity) and therefore be unduly penalized relative to other executives. However, any such gross-up should include a “sunset” provision stating when it expires.
- **Adopt clawback policies and procedures.** Any incentive payouts that were based on financial results that are subsequently restated, and therefore were never truly “earned,” should be returned to the company. This applies whether the restatement was caused by fraud, negligence, or simply a misinterpretation of accounting principles, and regardless of whether the recipient was directly responsible for the error. Boards should reject arguments that clawbacks are unfair, overly restrictive, or too difficult to draft. But they should use discretion in how and when to invoke a clawback to ensure the benefits exceed the cost and to mitigate any undue hardships.
- **Use a defensible peer group and benchmark against the 50th percentile.** Benchmarking is a classic “garbage-in, garbage-out” process. Ideally, the companies selected for peer groups should be in the same or similar industry, of similar size, with similar economics (e.g. margins, profitability) and at a similar stage in the business cycle. Comparator companies should range within one-half to two-times the size

of your organization, which should also fall around the 50th percentile of the peer group. The 50th percentile should be the primary point of comparison to avoid a ratcheting effect (from every company aiming to exceed the 50th percentile of pay) and because most peer groups are too small to provide statistical accuracy at the 75th or 90th percentile. Boards should resist tendencies to compare against meaningfully larger companies or to target pay above the 50th percentile in order to “attract top talent.”

- **Embrace disclosure as an opportunity to “tell your story.”** Too many CD&As have a lot of words about executive compensation, but not much information – the fault of a disclosure process that focuses on compliance rather than communication. It is unfortunate that Boards that devote significant time, energy, and resources to developing thoughtful pay programs often give relatively little thought to what will be shareholders’ prime source of information about those programs. Rather than simply adhering to minimum regulatory requirements or replicating prior year disclosures, Boards should take an active role in crafting key messages and story lines that accurately and persuasively reflect their thinking and judgments about executive compensation. With the increasing likelihood of “say on pay” in the near future, there’s too much at risk not to make the most of disclosure.

The flip side of crisis is opportunity. Boards should seize this moment to exercise responsible leadership and restore confidence in our executive compensation system. Failure to act will lead to the imposition of further regulatory or legislative mandates that threaten the effectiveness of our organizations to create value for all stakeholders.



About Pearl Meyer & Partners

For 20 years, Pearl Meyer & Partners (www.pearlmeyer.com) has served as a trusted independent advisor to Boards and their senior management in the areas of compensation governance, strategy and program design. The firm provides comprehensive solutions to complex compensation challenges for companies ranging from the Fortune 500 to emerging high-growth companies. These organizations rely on Pearl Meyer & Partners to develop programs that align rewards with long-term business goals to create value for all stakeholders: shareholders, executives, and employees. The firm maintains offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston and Los Angeles.

For more information on how PM&P can help you create comprehensive compensation solutions, please visit our website www.pearlmeyer.com or contact the PM&P office nearest you.



www.pearlmeyer.com

NEW YORK

570 Lexington Avenue
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA

One Alliance Center
3500 Lenox Road, Suite 1708
Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

BOSTON

132 Turnpike Road, Suite 300
Southborough, MA 01772
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE

3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO

123 N. Wacker Drive, Suite 1225
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON

Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LOS ANGELES

550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com

