

Executive Pay in the New Economy: Setting Pay in Troubled Times

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■ Our Speakers

Jim Heim

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Jim Heim specializes in executive and board compensation, compensation strategy, incentive and equity plan design, and competitive analyses.

Theo Sharp

Managing Director

Theo Sharp specializes in incentive plan design, deferred compensation, benchmarking, golden parachute design and evaluation, and the tax and accounting treatment of equity compensation.

Jim and Theo both operate out of our Boston office.

■ Agenda

- How Did We Get Here?
- Methodologies & Research
- Performance vs. Plan & Impact on Pay Decision Making
- Base Salaries
- Bonus Decisions
- Long-term Incentives
- Severance & Security Arrangements
- Variations by Industry
- Management vs. Board Perspectives
- Closing Remarks

“Yesterday’s” Drivers of Change

2002 to 2008

Corporate scandals (Enron/Worldcom/Tyco) - executive compensation visibility

Sarbanes Oxley Act (2002)

FASB - SFAS 123R – Accounting of stock options influencing incentive practices

SEC – New disclosure requirements - mandating “one number” and more transparency of executive and director pay practices

409A – Deferred compensation legislation

ISS/Investor Power – ability to influence proxy votes

- *Increased Board Responsibility and Risk...and Compensation*
- *New Long-Term Incentive Strategies*
- *Deferred Compensation Compliance*
- *Proxy Disclosure and CD&A*
- *Rise of the Investor*

How Did We Get Here?

Today's "Explosion" of Challenges

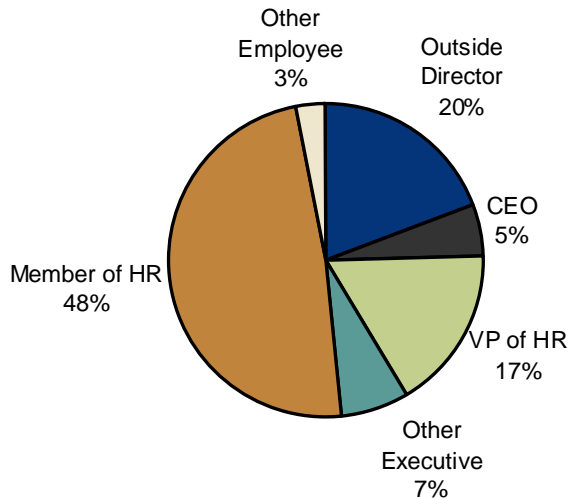
- EESA/TARP/CPP - Government's influence on executive compensation
- Accountability for executives and board members
- Investor scrutiny
- Perception – and misperception of media and shareholders
- The Pay-Performance Time Warp
- Defining "High Performance" in Today's environment
- Economic Influences Beyond Executive's Control



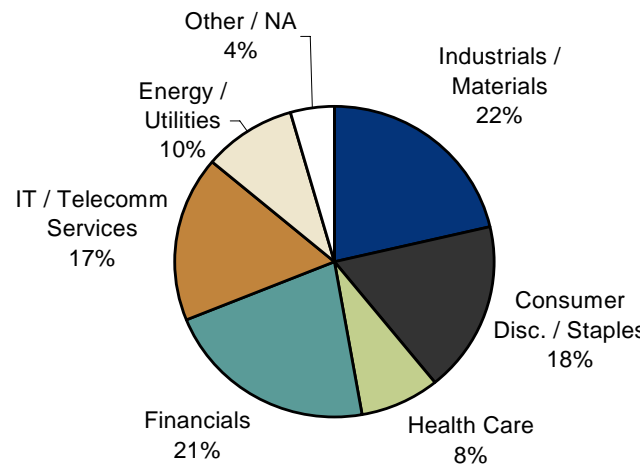
Methodologies & Research

- The PM&P Quick Poll on “Executive Pay in the New Economy” was conducted from late October through early November 2008 and received 410 responses

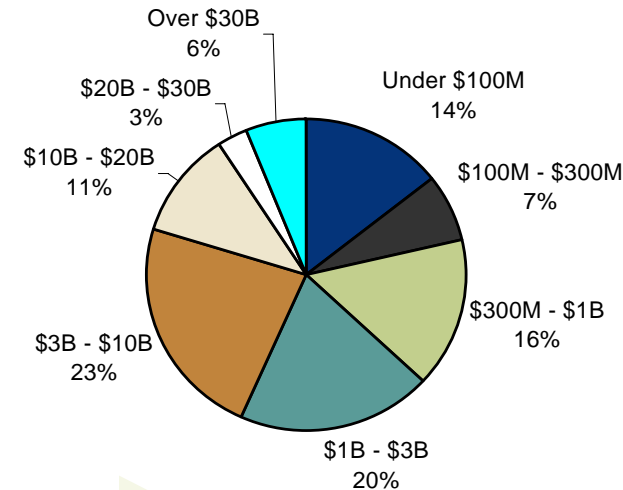
Participants by Role



Participants by Industry



Participants by Revenue

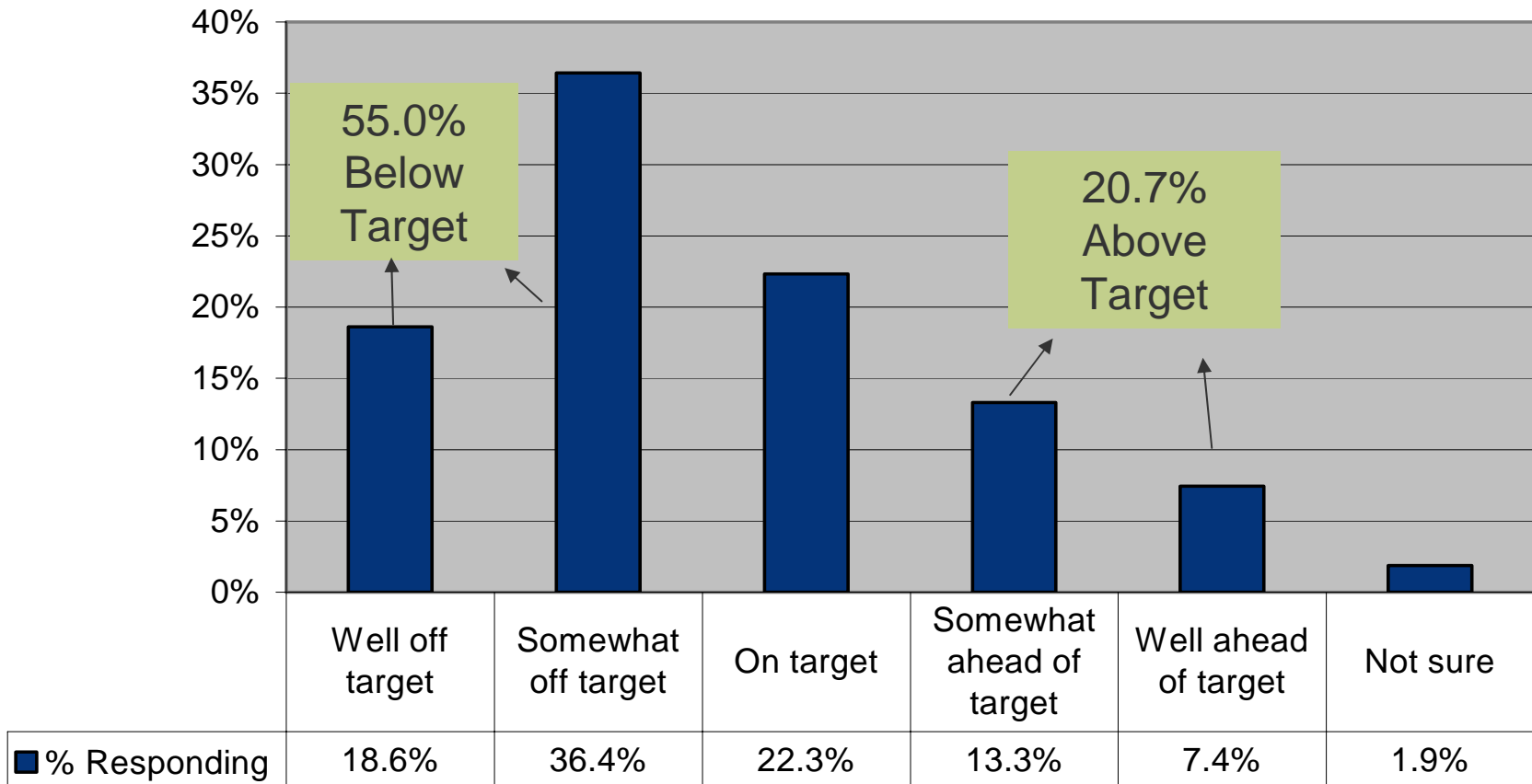


- Topics addressed included:

- Company performance & impact on decision making
- Executive base salary and bonus changes
- Long-term incentives and equity awards
- Severance and security arrangements

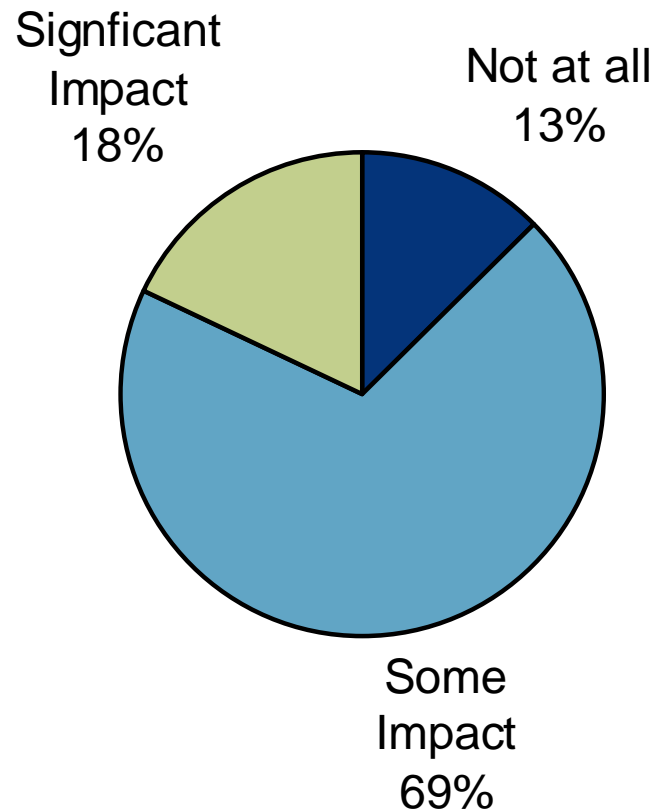
What modifications to pay programs are being contemplated in the wake of financial turmoil?

Assessment of Performance vs. Plan or Budget



Impact of Financial Market Turmoil on Pay Decision Making

“To what extent will recent financial market turmoil impact your pay decision making process over the next 6 months?”



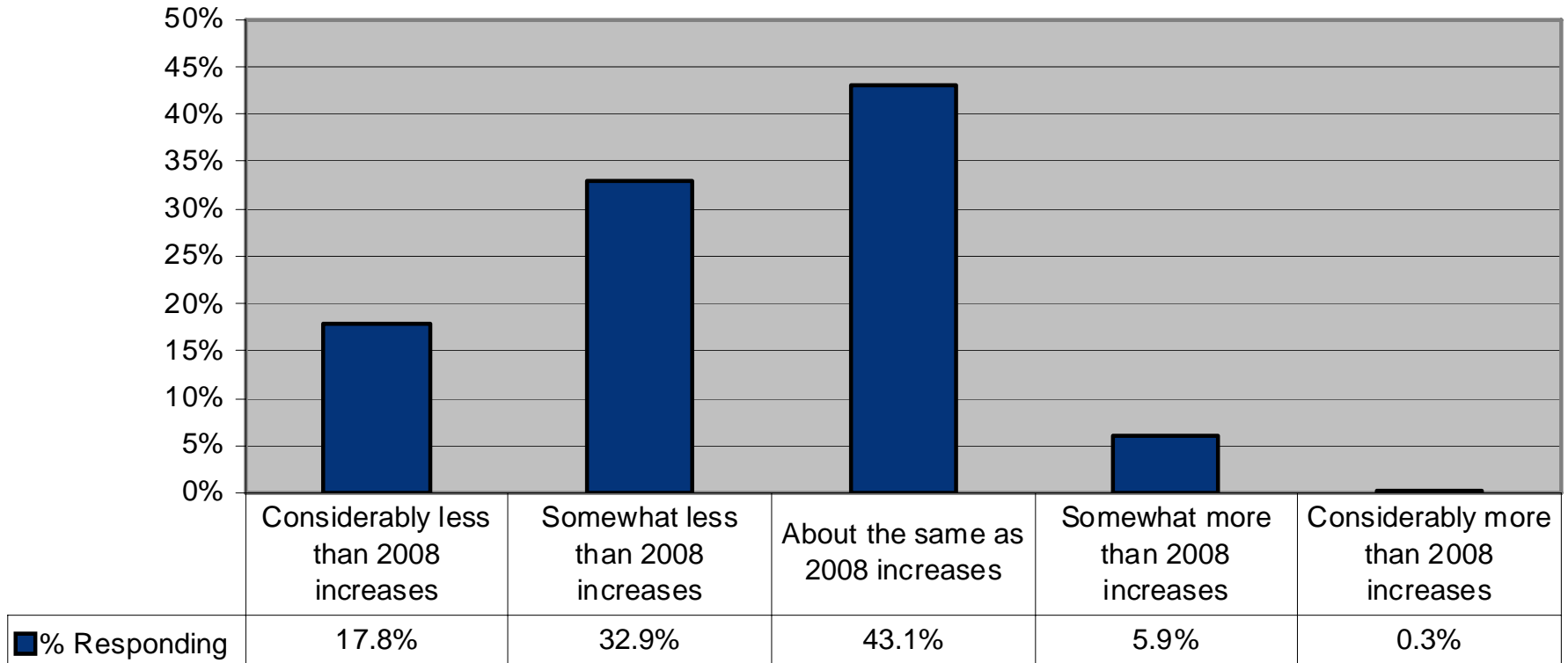
Impact of Financial Market Turmoil on Pay Decision Making

Anticipated impact varies with performance...

| All Firms | | To what extent will recent financial market turmoil impact your pay decision making process over the next 6 months? | | | |
|---|--------------------------|---|--|---|-------|
| | | Not at all | Some impact on decision making process | Significant impact on decision making process | Total |
| Please indicate your assessment of your company's performance for the year as compared to plan or budget. | Well off target | 7.1% | 51.4% | 41.4% | 100% |
| | Somewhat off target | 8.1% | 74.3% | 17.6% | 100% |
| | On target | 17.9% | 73.8% | 8.3% | 100% |
| | Somewhat ahead of target | 20.0% | 74.0% | 6.0% | 100% |
| | Well ahead of target | 21.4% | 60.7% | 17.9% | 100% |
| | Not sure | 16.7% | 83.3% | 0.0% | 100% |

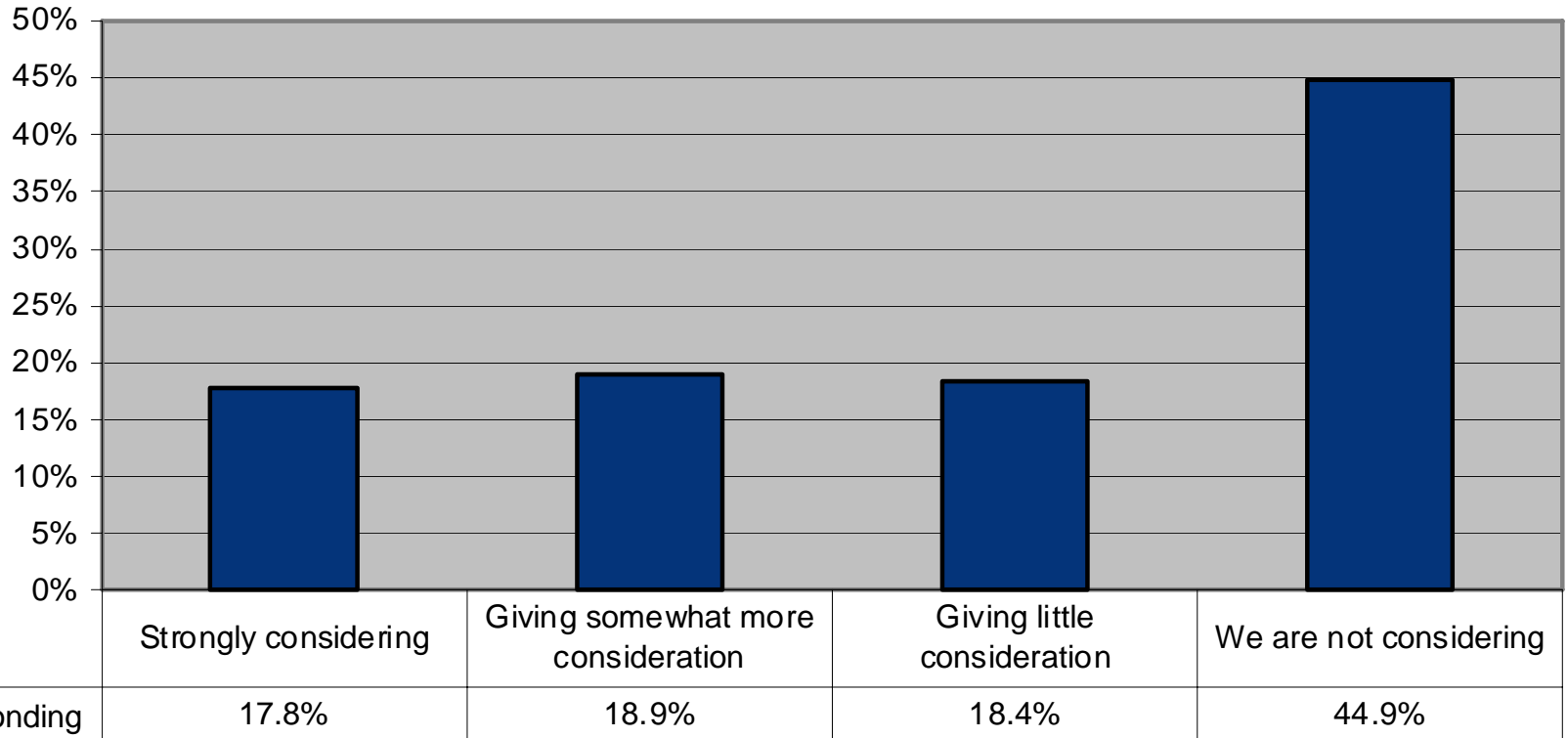
Base Salaries: Anticipated Increases

Anticipated Executive Team Base Salary Increases for 2009



■ Base Salaries: Contemplating a Freeze?

Are you considering freezing your executive team's base salaries in 2009?



■ Base Salaries: Considerations

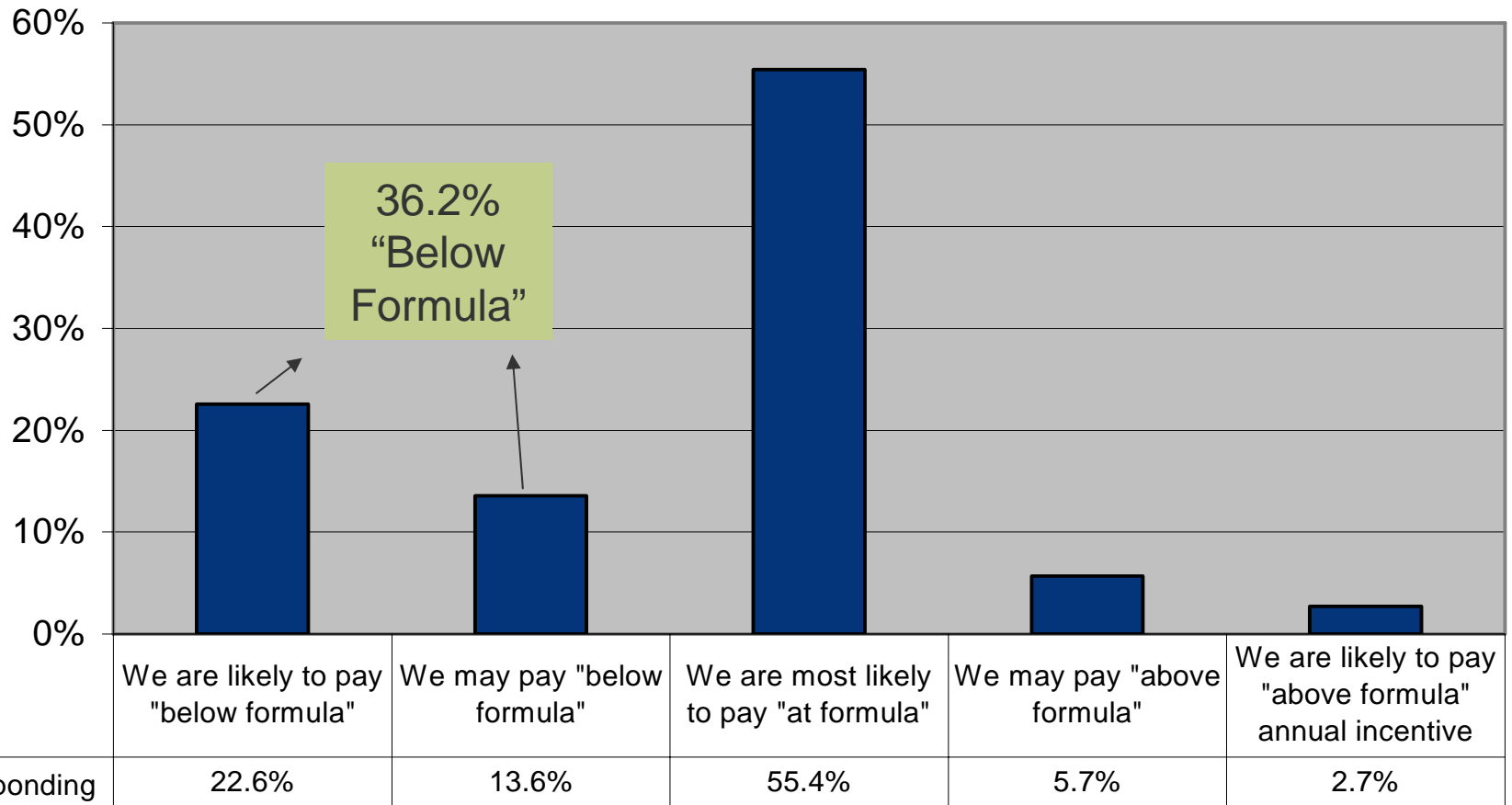
- **Are numbers material enough to matter?**
- **Not the year to “catch up”.**
- **Stick to the process.**

■ Bonus Decisions: Context

- **Presumably financial performance is down year-over-year at bulk of firms.**
- **“Per formula” bonus payouts should also drop.**
- **Will Boards exercise discretion to feather actual payouts up or down?**

Bonus Decisions: Survey Results

Which statement best describes whether you may exercise discretion in determining this year's incentive payout?



■ Bonus Decisions: Considerations

- **Alternatives to negative discretion.**
- **Executive perspective.**
- **Short-term vs. long-term.**

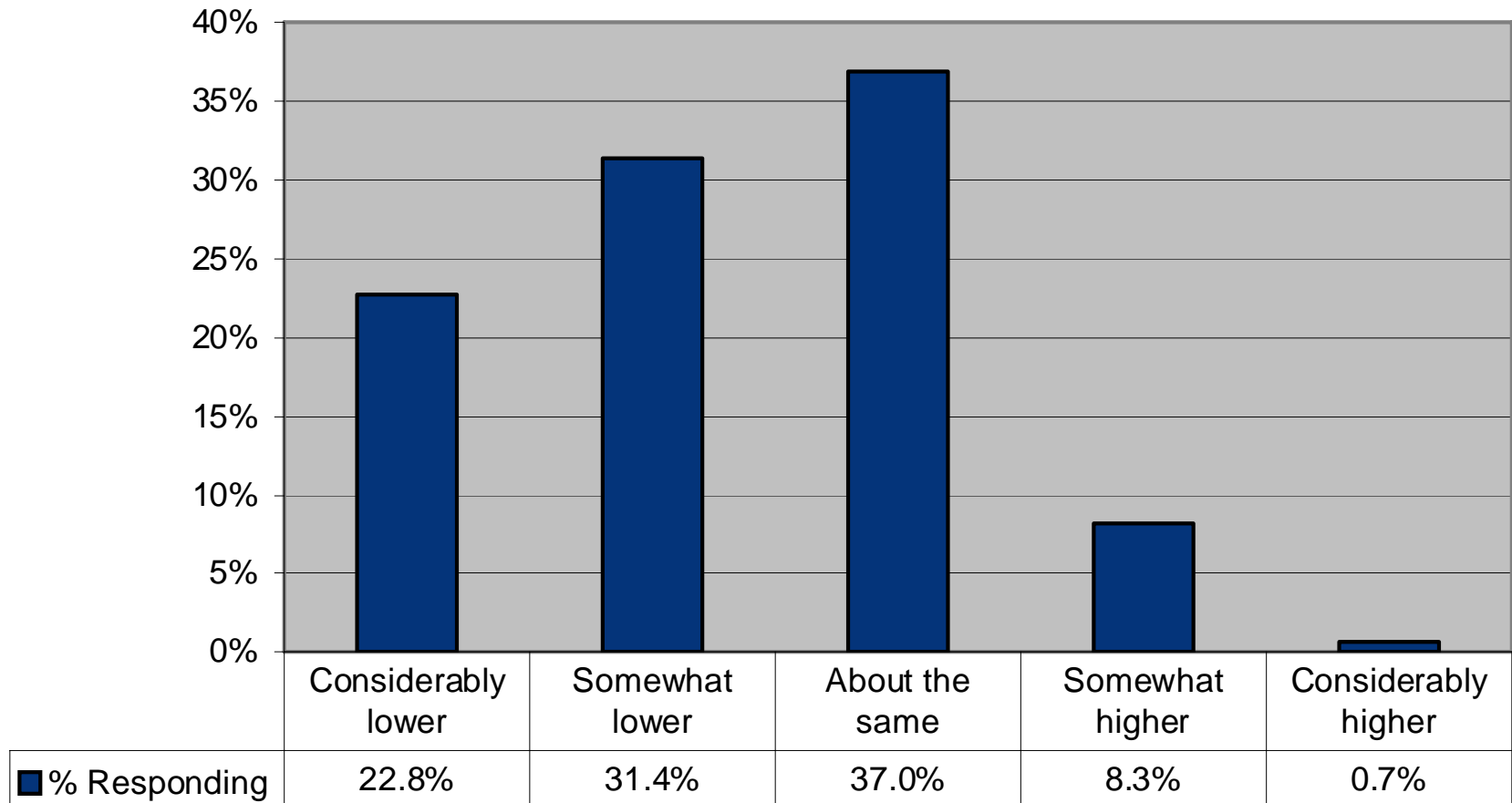
Long-term Incentives

- Share prices are down
- Will companies grant more shares to compensate for depressed share values?
- Example:

| | 2008 Grant | 2009 Strategies | |
|----------------------------|-------------|-----------------|-----------------|
| | | Match Value | Match Burn Rate |
| Price | \$10.00 | \$5.00 | \$5.00 |
| Black-Scholes (per option) | \$4.00 | \$2.25 | \$2.25 |
| Options Granted | 1,000,000 | 1,777,778 | 1,000,000 |
| RSUs Granted | 500,000 | 1,000,000 | 500,000 |
| Total Shares | 1,500,000 | 2,777,778 | 1,500,000 |
| Fair Value of Options | \$4,000,000 | \$4,000,000 | \$2,250,000 |
| Fair Value of RSUs | \$5,000,000 | \$5,000,000 | \$2,500,000 |
| Total Fair Value | \$9,000,000 | \$9,000,000 | \$4,750,000 |
| Common Shares Outstanding | 50,000,000 | 50,000,000 | 50,000,000 |
| Burn Rate | 3.00% | 5.56% | 3.00% |

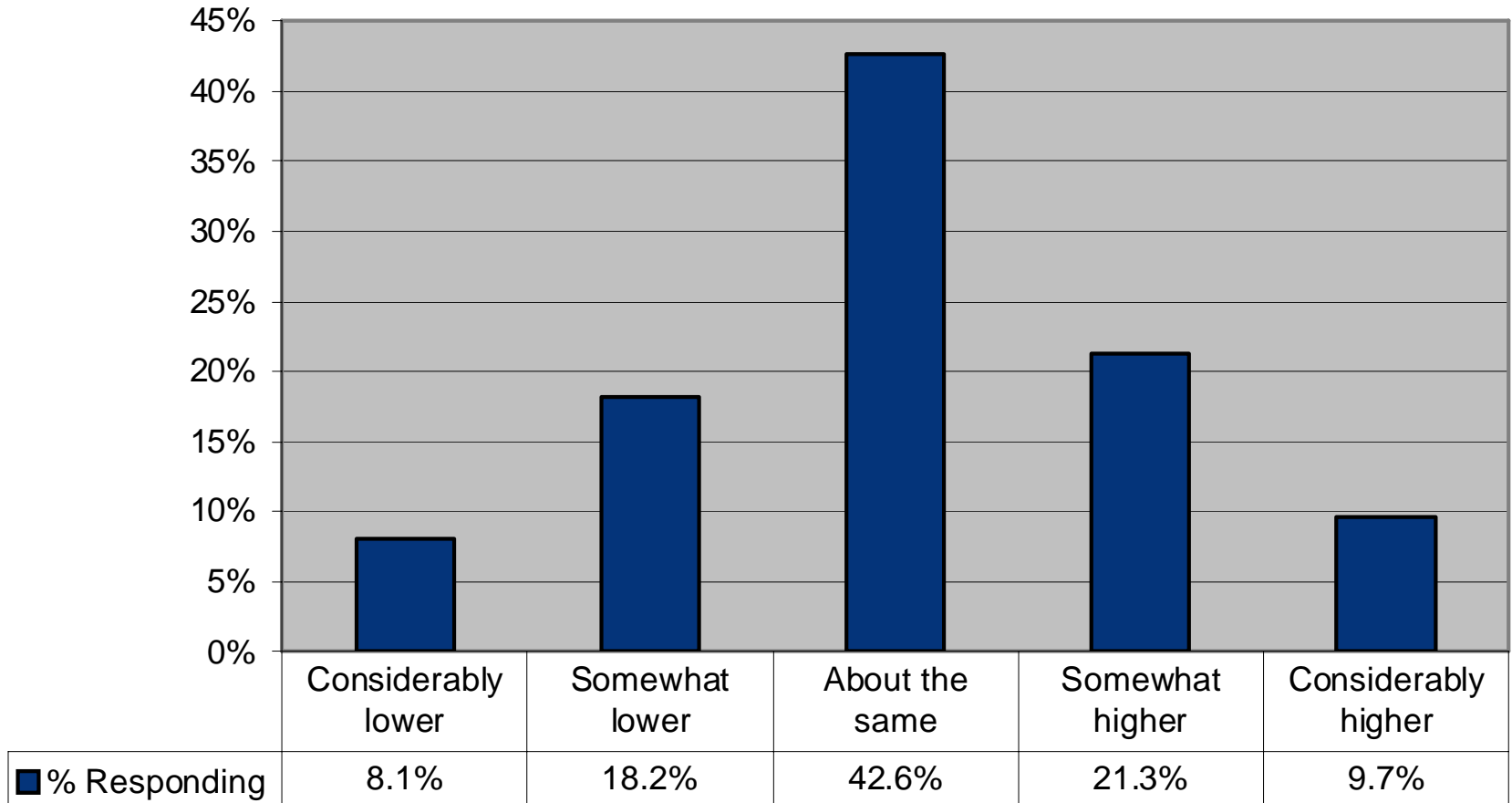
Long-term Incentives: Value May Drop

Economic Value of this Year's Award, Relative to Last Year's



Long-term Incentives: Burn Rates Steady

This Year's Burn Rate, Relative to Last Year's

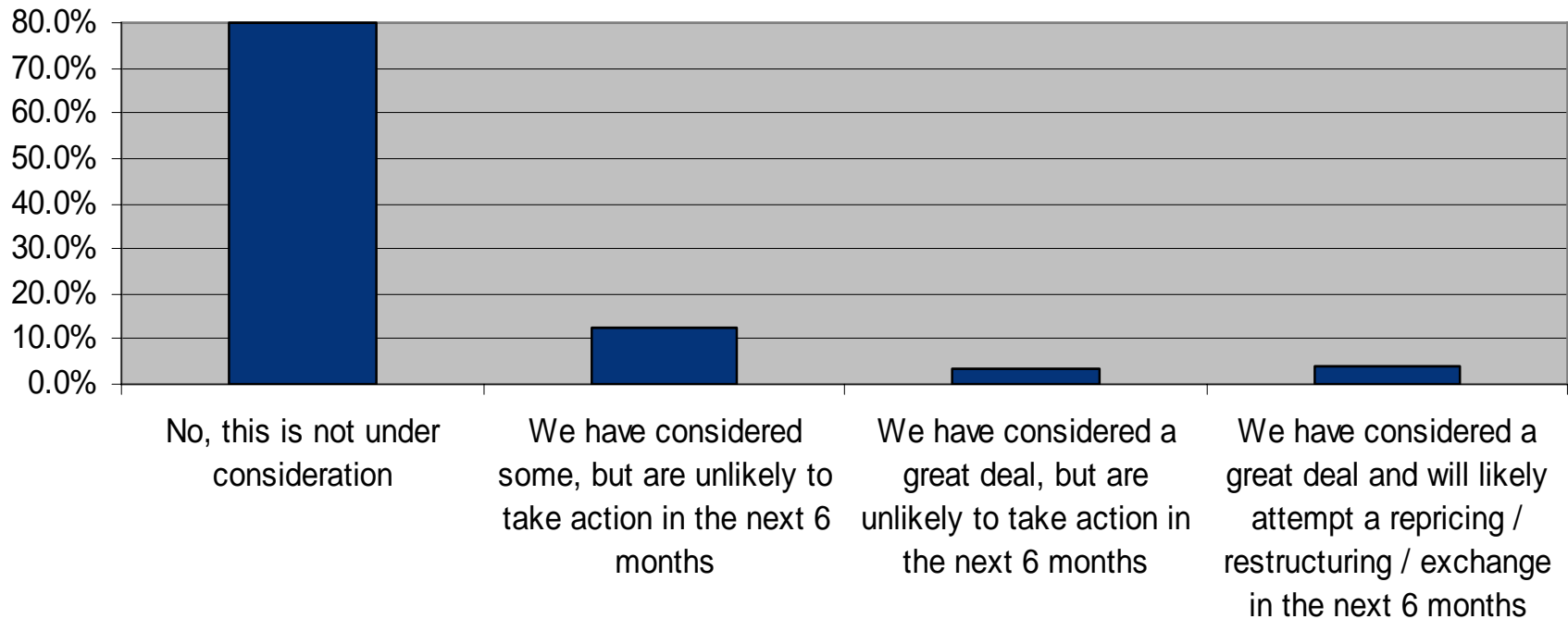


Long-term Incentives: Alternative Grant Methodologies

- **Stick with the value methodology.**
- **Grant a constant number of shares or a constant percentage of shares outstanding year-over-year.**
- **Use an average price (say, 400 days).**
- **Something more intuitive than scientific that is in the middle.**
- **Fewer shares but less risk (more time-based grants).**

Long-term Incentives: Option Exchange Considerations

Is Your Organization Considering Repricing or Restructuring Stock Options?

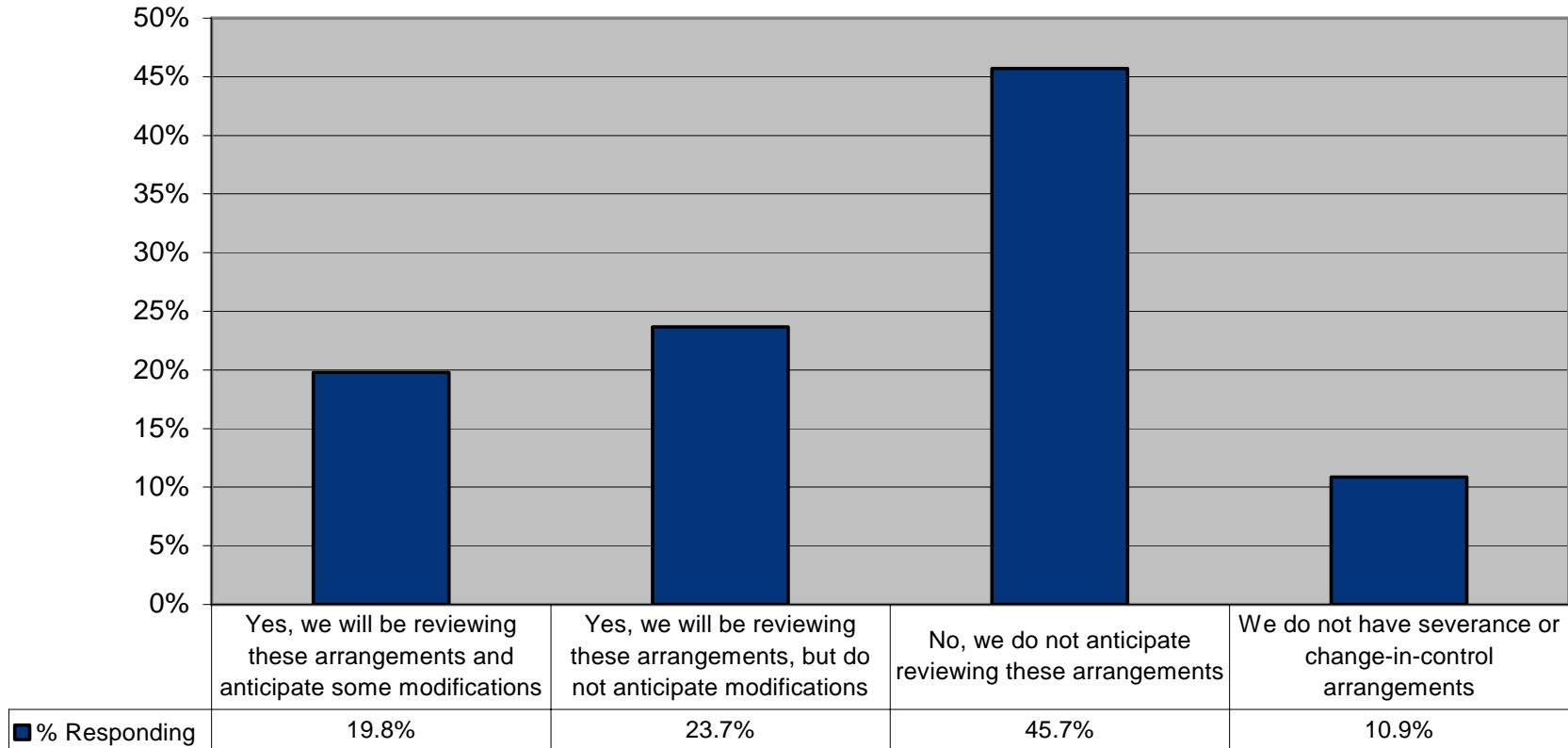


Long-term Incentives: Option Exchange Considerations

- **Its not clear where the bottom is.**
- **The vast majority of companies will need shareholder approval in order to implement a repricing/restructuring.**
- **Tender offer rules cost time and money.**
- **From 2009 RiskMetrics Group Governance Policy Updates:**
 - “...RMG will not view market deterioration, in and of itself, as an acceptable reason for companies to reprice stock options and / or reset goals under performance plans”
- **“Only” 4% of respondents indicated they will likely attempt an exchange during the next 6 months**
 - Equals 16 firms out of a sample size of 371
 - Extrapolate to Russell 3000...might we see over 100 exchange programs?
 - RMG tracked a total of 78 proposals submitted to shareholders between 2003 and 2007...less than 16 per year

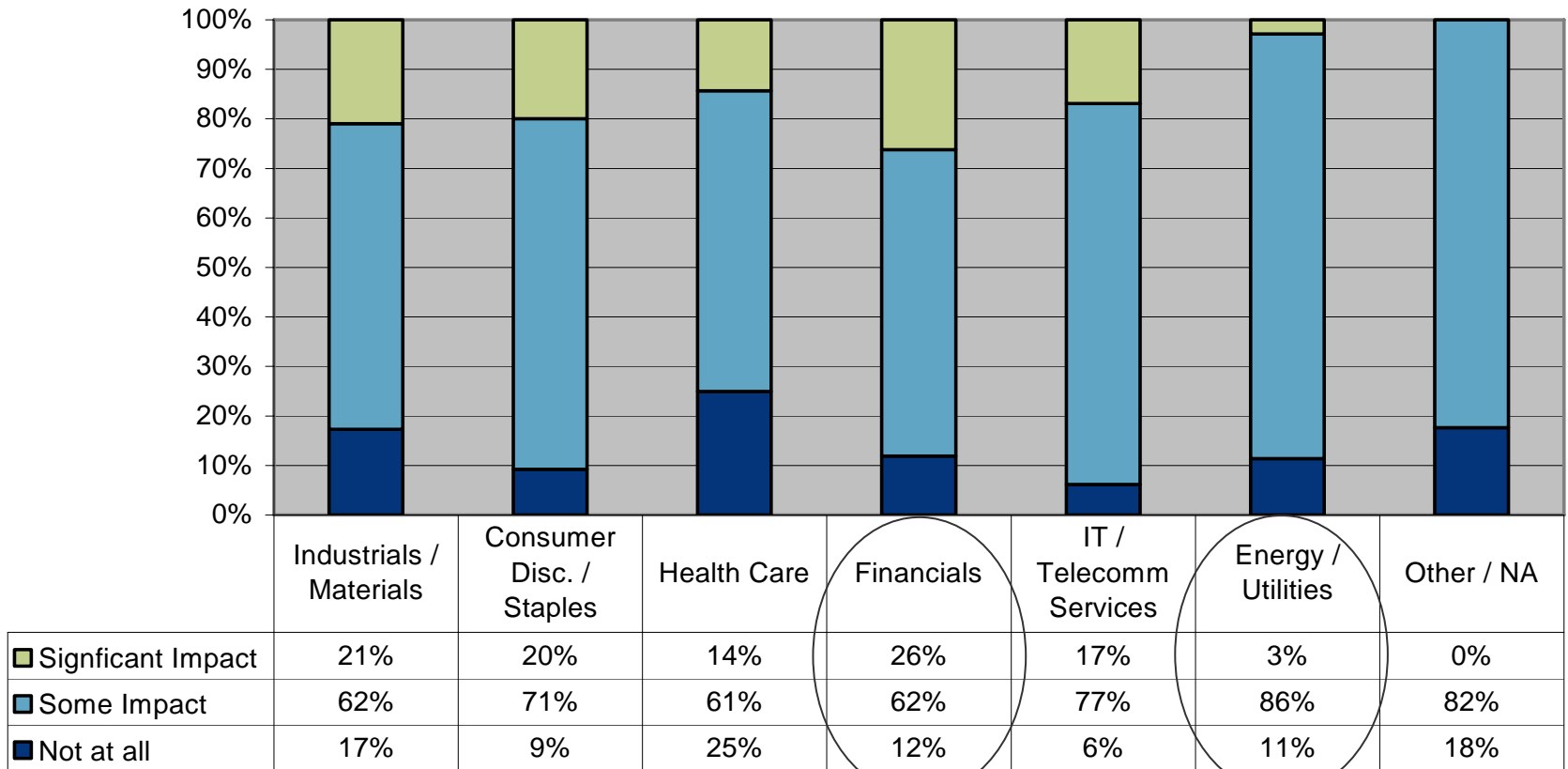
Severance & Security Arrangements: Under Review

Do you anticipate reviewing your executive severance or change-in-control arrangements during the next 12 months?



Variations by Industry: Anticipated Impact

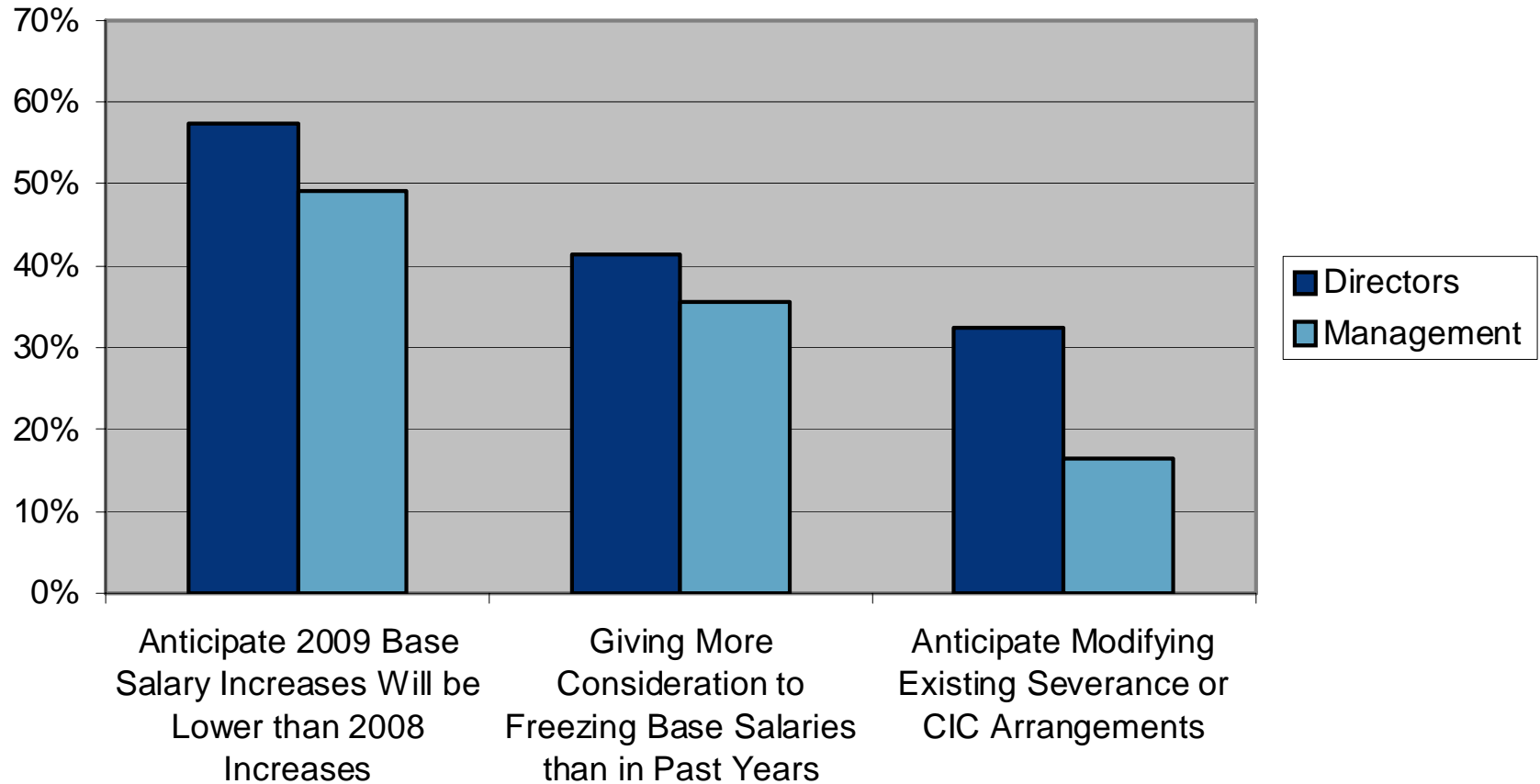
Impact of Recent Financial Market Turmoil on Pay Decision Making Process over the Next 6 Months



Variations by Industry: Specific Modifications under Contemplation

| % Agreeing with the Following Statements: | Industry | | | | | |
|--|------------|-------------------------------|----------------------------------|-------------------------|-------------|--------------------|
| | Financials | Info Tech / Telecomm Services | Consumer Discretionary / Staples | Industrials / Materials | Health Care | Energy / Utilities |
| We are strongly considering freezing base salaries | 23.8% | 23.4% | 19.0% | 16.3% | 10.7% | 2.9% |
| We are likely to pay "below formula" bonuses | 26.2% | 26.2% | 27.0% | 22.8% | 10.7% | 8.8% |
| We are anticipating modifications to our severance or change-in-control arrangements | 24.4% | 25.0% | 16.1% | 20.0% | 18.5% | 15.6% |

Boards Tougher on Pay



- **Age of Transparency**
 - Consider shareholder / media optics
 - Consider SEC disclosure implications

- **Heightened Risks for Boards**

- **Balance:**
 - Pay-for-performance and retention of executives
 - Risk-to-reward relationships
 - Short-term and long-term goals

Closing Remarks: Executive Compensation Governance

| | |
|--|--|
| STRUCTURE <ul style="list-style-type: none">• Checks and Balances• Roles and Responsibilities of Key Players• Documentation | KNOWLEDGE <ul style="list-style-type: none">• Understanding of plan components, metrics and potential pay outcomes• Training and Education• Quality Advisor Support |
| PROCESS <ul style="list-style-type: none">• Meeting Prodecures• Objective pay decision inputs• Selection and management of advisors | COMMUNICATION <ul style="list-style-type: none">• Internal communication protocols among key governance constituencies• External communication protocols (media, institutional shareholders) |

■ Thank You!

A copy of these slides will be posted by tomorrow at pearlmeyer.com/settingpay.

The audio archive will be available for download on the site on Thursday.