

Staying One Step Ahead: The “New” Top Ten Issues in Executive Compensation

Perhaps the best motto for Compensation Committees these days is, “Be Prepared.” Simmering complaints about executive pay tend to come to a boil whenever the economy stumbles; and the past two proxy seasons of expanded disclosure have provided current critics with new ammunition. More than ever, Compensation Committee members can expect and should be prepared to respond in detail to questions about their oversight of executive pay programs.

Among the biggest topics of attention:

1. Say on Pay. The fate of a bill before Congress to mandate a nonbinding proxy vote on executive compensation plans may rest on the November elections. However, shareholders at many companies are not waiting - Say on Pay resolutions were filed by investors at more than 90 companies in 2008 - approximately 50% more than a year earlier.

Proponents argue that giving shareholders a direct voice in pay decisions will force Compensation Committees to do a better job linking pay to performance and reduce instances of excessive pay. Critics respond that mandatory Say on Pay would wrest control from Directors, without providing any direction as to how programs should be changed. Ultimately, they fear that it will put some companies at a competitive disadvantage in attracting and retaining top talent.

However, savvy Boards won't wait for Congress to vote on Say on Pay or for their shareholders to take matters into their own hands through a proxy initiative, in order to prepare for Say on Pay. They will take the time to define Board members' positions on the issue, address potentially problematic aspects of current pay programs, ensure they have good lines of communication with shareholders and avenues for feedback/input, and be prepared to craft a thoughtful response should their company be targeted by investors.

2. Corporate Governance. Many of the biggest personal and financial risks for Compensation Committee members serving in an era of such close scrutiny are the unknowns: embarrassing revelations that can blindside Directors and undermine shareholder confidence. One of the most effective ways Compensation Committees can minimize the risk of being caught off-guard is to focus more closely on the simple basics of sound corporate governance practices and processes.

As a start, Compensation Committee members should address the following questions:

- Is there a Director-driven process for making decisions? Do members or management control the Committee's agenda? How does the Committee ensure it is getting all relevant information?
- Do members truly understand how programs work, especially basic but key points such as how competitive data is used and the sensitivity of payouts to variations in stock price and corporate performance?
- Does the Committee have an easily accessible institutional memory? Is there continuity from meeting to meeting such that new Committee members can be effective immediately?
- Does the Committee regularly evaluate its own effectiveness and the effectiveness of each Committee member? Does the Committee evaluate the effectiveness of its compensation consultant and the governance process in general as it relates to executive compensation?

3. Post-Separation Pay. Some of the most damaging headlines related to compensation in recent years have involved executives, often at financially troubled companies, receiving significant separation packages when they departed. The practice has become even more controversial in light of revised proxy rules, which require detailed disclosure of the value of such awards.

Many companies are reconsidering whether cash-severance for executives is routinely necessary or even appropriate, especially if the executive has been with the firm for several years and has already accumulated significant wealth from the company.

The tide may be turning, slowly. Over the past year, more companies have made or have considered making changes to long-established programs, in some cases by putting a cap on severance multiples based on the number of years the executive has held the position. Companies have also given more consideration to sunset provisions, in which the severance multiple declines as tenure increases.

4. Change-in-Control Pay. A related and increasingly controversial element of executive pay programs is change-in-control arrangements. In an earlier attempt to curb perceived abuses, congress, in 1984, imposed a 20% excise tax on change-in-control payment that exceed three times the average value of an executive's pay over the previous five years. In response, however, many companies began providing gross-ups that essentially reimbursed the executive for any excise tax owed and shifted the tax burden from the executive to the shareholders.

Critics point out that the cost of a gross-up to the company can outweigh the benefits. In some cases, the value of a gross-up can approach millions of dollars, plus the company cannot take a tax deduction on the excess payment. Recently, some institutional shareholders and activist groups have taken the position that a gross-up is a poor and unnecessary compensation practice and are going so far as to recommend "against" votes for Committee members that implement such a practice.

Some shareholder groups are also taking the stance that "single trigger" provisions, which allow equity awards to vest immediately upon a change-in-control, are another example of egregious pay. As a result, "double trigger" provisions, in which the vesting of equity awards accelerate only if the executive is actually terminated following a change-in-control, are considered the best practice.

5. Pay-for-Performance. Pay-for-performance can be difficult to define, but with the drive to improve Board and Committee processes, posing some basic questions can provide a helpful framework for dealing with this complex issue:

- Are performance standards absolute, or evaluated relative to other companies?
- How is "pay" defined - is it on an annual basis or cumulative?
- How is performance defined - is it an increase in total shareholder return, return on investment capital, total revenue, or another metric or a combination of metrics?
- Is performance assessed over the short- or long-term?
- To what extent will changes in stock price or financial performance affect short- and long-term payouts?
- Are performance metrics focused on the most important factors for the company and within the industry?

6. Expanded SEC Disclosure Rules. Now in its second year, the SEC's heightened standards for reporting of executive compensation programs remain a work in progress. While this year's disclosures were better in some respects over the year before, there is still much room for improvement. For example, criticism by the SEC that many 2007 disclosures were overly long and hard to understand produced little improvement in 2008, according to a recent study by Pearl Meyer & Partners of 50 early filer companies. The study found that at the median, firms' Compensation Discussion & Analysis sections were actually 13% longer than the previous year, while the median number of pages swelled by nearly one-third. Similarly, tests of readability suggested no progress toward meeting the SEC's "plain English" standard.

Further, the study suggested that while more companies opted to disclose performance goals this year, a significant number of firms opted not to disclose this information. Of the firms that did not disclose performance goals, few made the argument that disclosure would result in competitive harm to the company. It is anticipated that the disclosure of performance goals will remain an SEC focus, along with the disclosure of how compensation decisions are made and why.

Of note, in a related Pearl Meyer & Partners study of companies' views of the 2008 proxy disclosure process (2008 "Proxies that Make the Grade" report), companies indicated that concerns about how programs will be perceived by investors have prompted design changes to short- and long-term incentive programs.

Both the 2008 "Proxies that Make the Grade" and "Early 50 Filers" reports are available for download at www.pearlmeyer.com.

7. Benchmarking and Setting Pay. Compensation Committees recognize that it is no longer sufficient to tell shareholders a CEO deserves above-market pay just because he or she is talented and hard to replace. Good governance demands that compensation decisions are defensible and not made in a vacuum. However, under the intense scrutiny of shareholders, there can be a tendency for Committee members to rely too heavily on competitive market data. Committees should avoid “chasing the data” and feeling compelled to mark to market just because their company’s general philosophy is to target, for example, the 50th percentile. The talent market is a place where the value to the beholder is determined by more than price alone. Rather than relying entirely on competitive data, Committee members can and should use good business judgment and take into account factors such as the executive’s experience, skills, and contributions, the company’s performance relative to its peers and whether the business model, organizational structure, and executive’s responsibilities are truly comparable to the peers/market. These perspectives can point to the need to adjust pay in either direction, upwards or downwards.

8. Internal Equity. Expanded disclosure has put a spotlight on internal equity, giving shareholders more insight into the gaps that may exist between the CEO’s pay versus that of other named executive officers. Further, more detailed proxies have opened executives’ eyes to what their superiors and peers in other companies are paid. Boards that ignore major and unexplained differences in pay risk losing top talent, causing rifts among executives, and receiving negative shareholder attention.

9. Consultant Independence. There are two main aspects of the consultant independence issue: one is the reporting relationship of consultants with Committee members and management; and the other is the types of services provided to the company. The consultant independence issue was a major focus in the recent Waxman Congressional hearings on executive compensation. Corporate governance experts, institutional investors, CEOs of large companies, and compensation consulting firms testified in front of a House subcommittee regarding the role of consultants in setting executive pay and efforts to prevent and manage real and perceived conflicts of interest. Company Boards have taken notice and have begun to stress this issue in order to avoid the potential of a “front-page” effect. In a study of recent proxy filings, some interesting statistics were found regarding how companies are disclosing the relationship they have with compensation consultants:

- In both 2007 and 2008, 90% of companies said their compensation consultant was retained by the Compensation Committee, rather than by management.
- 12% of companies in 2008 specified that their compensation consultants were independent, provided only compensation-related services to the company and had no conflicts of interest - up slightly from 7% in 2007.
- About 81% of the firms provided a description of their compensation consultants’ services, up from 73% in 2007.

10. The "How Much is Too Much?" Issue. No one has come up with an absolute point at which an executive is universally said to be overpaid. Generally, investors have not objected to executives being handsomely rewarded, provided they spread the wealth in the form of increased shareholder value. The most notorious pay scandals have typically involved unusually high compensation provided when shareholders saw relatively little benefit, either because the results achieved weren't significant or impressive results were later discredited. Generally speaking, Compensation Committees have a good sense of whether pay packages being provided are disproportionate, or truly in line with the value the executives have provided to the company and its shareholders.

While examples of egregious pay still do exist, two relatively easy ways Committees can minimize the frequency of these instances is by implementing and following sound corporate governance practices and regularly examining the competitiveness of executive pay programs and practices. In combination with competitive assessments, other ways Committees can reduce the risk of excessive pay is by examining executives' wealth accumulation and conducting "forward looking" analyses - such as an economic impact analysis - where potential payouts for executives are modeled out based on projected or assumed corporate performance and stock price appreciation.



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