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CONFERENCE BOARD ISSUES EXECUTIVE COMPENSATION BEST PRACTICE SUGGESTIONS

On September 17, the Conference Board, arguably the world's leading business network, joined the New York Stock Exchange, the NASDAQ, and other regulatory and business organizations in proposing a wide-ranging series of reforms to strengthen corporate compensation practices so as to restore trust in America's corporations and financial markets. The report[(1)] is the first in a series of three, with the second and third to deal with other areas of corporate governance and accounting/audit issues, respectively.

Background

In response to the recent wide-spread abuses which have rocked America's capital markets and caused a precipitous decline in the public trust, the Conference Board formed the Commission on Public Trust and Private Enterprise. Its twelve members, identified in the Appendix, include business leaders, major investors, former governmental and regulatory officials as well as a professor of business ethics.

Recognizing that some issues cannot be fully addressed by regulation and legislation and that there is a need for corporations to change their own governance practices, the Commission believes that boards of directors must step up to the task to do their part in restoring good corporate governance at America's corporations and revitalizing the basic fiduciary compact between shareholders, boards of directors and management.

The report is structured into seven basic principles with suggested best practices to implement them. While corporations are not legally required to follow best practices, the Commission hopes that they will serve as a beacon.

Reasoning Behind Principles

The Commission identified numerous factors which contributed to the current state of affairs, including:

- The delinkage of executive compensation from the company's long-term strategic and financial goals;

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(1) The full report is available at www.conference-board.org

- The recognition that there is little financial risk in current compensation structures, i.e., the only risk is the lack of a reward;

- Excessive use of stock options accompanied by an unprecedented bull market; and

- Compensation committees not acting in a sufficiently diligent and independent manner to ensure that management is retained in a reasonable and cost-appropriate and effective way.

<u>Principle I – The Compensation Committee's Responsibilities</u>

The compensation committee has primary responsibility for making sure that compensation programs are fair, appropriate, reasonable and relevant vis-à-vis practices at similar companies. The Commission stresses that committees need to be strong and independent, be cognizant of the inherent conflict of interest in management's views on its own compensation, and be held accountable in their decision-making.

Suggested best practices include:

- A committee comprised of only truly independent members

- The committee must be sure that compensation arrangements will not cause behavior that is contrary to the company's best interests or are not designed as a way to circumvent accounting or legal rules or principles

- All aspects of compensation, including contracts, perquisites, etc., should be within the committee's scope of responsibility

- Further, the committee's umbrella should encompass any arrangement for a senior executive officer involving any subsidiary, affiliate or special purpose entity

- In carrying out its responsibilities:

    - The committee chair needs to take an active, lead role and assume "ownership" of committee activities, including being present at shareholder meetings so as to be able to respond to questions;

    - The committee should retain any outside consultants who advise it, and they would report solely and directly to it;

    - Executive sessions should be held as appropriate and the committee should meet whenever and for such purposes as it decides; and

    - Competitive data and prior practices should be considered but should not be primarily determinative of pay actions

Principle II – The Importance of Performance-Based Compensation

The Commission points out that performance-based compensation, properly structured and tied to specific goals, can be a powerful and effective tool in advancing the interests of the corporation.

In designing performance-based compensation in a balanced and cost-effective manner, the Commission suggests that:

- Compensation policies should be tailored to each corporation and its unique needs;
- Performance-based goals should be designed to support and reinforce the corporation's long-term strategic goals; and
- Specific "claw back" provisions should be incorporated in compensation programs to ensure that executives do not benefit from their own wrongdoing.

Principle III – The Role of Equity-Based Incentives

As a statement against the proliferation of stock options, the Commission stresses that the compensation committee should use all equity-based arrangements in a reasonable and cost-effective manner. Specifically:

- It notes that equity compensation, even stock options, can be effective, particularly if designed to support the company's performance goals;
- Compensation plans should be structured after due consideration of the balance between costs and perceived value;
- Broad-based arrangements may serve a desirable purpose; and
- There should be clear disclosure of the dilution and cash costs associated with the maintenance of the company's equity programs.

Principle IV – Creating a Long-Term Focus

As woven through the Commission's other identified principles, the fourth principle is that compensation policies should be structured to encourage key executives and directors to acquire and hold a meaningful equity position in the company on a long-term basis. This stake should, if supported by the company, be provided in a reasonable and cost-effective manner.

In furtherance of this:

- Meaningful stock ownership guidelines should be implemented for both senior management and directors; and

- Any stock delivered through compensation plans or otherwise received as fees, etc, should be subject to minimum holding periods.

Principle V – Accounting Neutrality

In a move which Andy Grove, Intel's Chairman disagreed with, the Commission called for the expensing of stock options. The Commission wants the FASB and the IASB to move expeditiously in addressing this issue, including the development of a uniform method to value options. Further, the Commission believes that compensation decisions should be based on the appropriateness and effectiveness of the compensation structure, rather than simply accounting implications.

Principle VI – Shareholder Rights

Shareholders should have the final say in determining how much dilution they may suffer as a result of equity compensation programs. This should be accomplished by requiring that:

- All stock plans would need to be approved by shareholders; and

- Material modifications of existing arrangements, including stock option repricings, would also need to be subject to shareholder approval.

Principle VII – Transparency and Disclosure

Finally, the Commission notes that everyone's best interests are served by full and understandable disclosure of executive compensation and that such policy is needed to reassure the public that management is not engaged in behavior involving stock taking advantage of insider information.

Identified best practices include:

- Disclosure of the effects of equity-based compensation plans on EPS and the extent to which future value will be transferred to executives and employees, including the overhang of outstanding stock options, should be conspicuous;

- Executive officers should be required to give public advance notice of their intention to sell company stock; and

- There should be prompt and full public disclosure of new executive employment agreements.

Comments

The Commission has done a service to the community in identifying the principles that boards of directors, in general, and compensation committees, in particular, should follow in their future decision-making. The action steps into which these principles translate are really quite simple in concept, but will take strength and conviction in carrying out. Boards and compensation committees should take a step back and with a clean sheet of paper look at three things:

- The board's and committee's corporate governance practices, including scope of responsibility, adequacy of the information it receives from the company, its policies and practices, its willingness to be independent and not take the view that the "tie goes to the runner," i.e., management, whether to use an independent advisor, etc.;

- The "how" of compensation, including all structures, plans, contracts, special "one-offs," executive benefits and perquisites, etc., to ensure that they are the most appropriate for the company and in support of the company's long-term growth and success; and

- The "how much" of compensation, i.e., what is the total opportunity being delivered to employees, and to correlate that with the increased value being realized by shareholders.

Shareholders, the financial markets and the public at-large now demand that boards exercise the utmost level of independence and scrutiny and, at this early writing, it appears that most directors are up to the challenge.

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This letter is intended to alert compensation professionals about developments that may affect their companies. General questions applicable to corporate governance or the other issues discussed in this letter may be addressed to Jeff Kanter in our New York office at 212.986.6330 or by email at jmkanter@fwcook.com. This letter and other published materials are available on our website, www.fwcook.com.

Appendix

Members of The Conference Board's Commission on Public Trust and Enterprise include:

- **Peter G. Peterson**, Chairman of The Blackstone Group, former Secretary of and Chairman of the Federal Reserve Bank of New York
- **John W Snow**, Chairman, CSX Corporation and former Chairman, Business Roundtable
- **John H. Biggs**, Chairman, President and CEO, TIAA-CREF
- **John C. Bogle**, Founder and former Chairman, Vanguard Group, Inc.
- **Charles A. Bowsher**, former Comptroller General
- **Peter M. Gilbert**, Chief Investment Officer, State Employee's Retirement System, Commonwealth of Pennsylvania
- **Andrew S. Grove**, Chairman of Intel Corporation
- **Ralph S. Larsen**, former Chairman and CEO of Johnson & Johnson, former Chairman of The Business Council
- **Arthur Levitt Jr.**, former SEC Chairman and former Chairman of the American Business Conference
- Professor **Lynn Sharp Paine**, John G. McLean Professor of Business Administration, Harvard Business School
- Former Senator **Warren B. Rudman**, Paul, Weiss, Rifkind, Wharton & Garrison
- **Paul A. Volcker**, former Chairman of the Board of Governors, Federal Reserve System