2009 NACD
Corporate Governance Conference

Executive Compensation Developments and the Role of the Independent Consultant

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October 20, 2009

Table of Contents

I. Executive Compensation Levels

Target cash opportunities are generally unchanged; actual payouts have declined

- Merit budgets being restored in 2-3% range for 2010
  - Most 2009 salary freezes being lifted
  - But lost value not restored, except for possibly salary cuts
- Target bonuses and threshold-to-maximum opportunities (e.g., 0% to 200% of target) are stable
- Earned 2009 annual bonuses (paid in early 2010) are likely higher after previous year decline
  - The median S&P 500 CEO bonus declined by 21% for 2008
  - Generally, goals were lower in 2009

I. Executive Compensation Levels (cont'd)

2010 long-term incentive ("LTI") grant values likely to be flat to slightly higher following significant reduction in 2009

- Frederic W. Cook & Co. surveyed 113 client companies and determined that 2009 total LTI values (equity and cash awards) were generally down 10% to 15% or more, depending on individual company circumstances
  - Share availability and cost considerations major constraints
- We also compared aggregate equity compensation costs for 150 companies in the first quarter of 2009 versus the first quarter of 2008
  - Median decline in equity grant date value was approximately 60% of median stock price decline
  - Aggregate equity compensation value decreased -25%, while stock prices decreased -41%
    - ♦ Large companies (market cap > $3 billion) reductions were less substantial than small companies
  - In aggregate, median fair value transfer[1] as a percent of market capitalization increased +22%
- With price recovery that has occurred, early 2009 practice is a reasonable guide for 2010

[1] Fair value transfer (FVT) expresses the grant date value of equity awards as a percentage of market capitalization

I. Executive Compensation Levels (cont'd)

Why grant values down but FVT levels up

- Illustration assumes 50% stock price decline and constant outstanding shares
  - If grant value kept constant, company burns through 2x as many shares
  - If shares kept constant, grant value is cut in half

		This Year @ $20	
	Last Year @ $40	**Hold Value Constant**	**Hold Run Rate Constant**
Company Market-Cap	*$4 billion*	*$2 billion*	*$2 billion*
Aggregate Grant Value	*$40 million*	*$40 million*	*$20 million*
*Shares Granted **	*2 million*	*4 million*	*2 million*
Run Rate	*2%*	*4%*	*2%*
Fair Value Transfer/Cost	*1%*	*2%*	*1%*

** Assumes half full-value shares and half options at 33% Black-Scholes value*

II. Executive Compensation Structure

Economy and stock market downturn affecting incentive design…

- Changes taking place in annual bonus plan design
  - Re-examination of metrics to ensure alignment with strategic business objectives
    - Reduced weighting on traditional profit measures
    - Greater focus on cost saving measures, cash flow, working capital
    - Increased use of non-financial metrics (e.g., balanced scorecard) due to limited visibility of future results
  - Companies are widening the payout curve to soften downside and expand the upside
    - Modest payout in difficult environment/protect against windfall if recovery is quick
    - Some companies no longer paying target award opportunity for attaining target goals
- Continued transition in LTI toward more balanced approach
  - Combination of stock options, time-vested restricted stock and performance shares
  - Greater use of time-vested restricted stock at some companies
    - To address the difficulty of multi-year goal setting and retention concerns
    - Trend likely to reverse when market conditions stabilize
  - Some movement to performance cash plans to conserve shares under LTI program

II. Executive Compensation Structure (cont'd)

Economy and stock market downturn affecting incentive design…

- Traditional three-year performance share design is changing
  - Challenge is performance measurement and goal-setting difficulties
  - Some companies using shorter (e.g., 1- or 2-year) performance periods with subsequent time-based vesting tails
  - Movement toward relative goals, including total shareholder return due to uncertain economy
  - Dampening of leverage (e.g., 50%-150% vs. 50% to 200%), especially if portion of award opportunity shifted to time-based restricted stock
- Concern about broad retention has abated, although retaining high performers and critical skills remains a priority
  - More special one-off grants to high-performing/high-potential employees if the retentive value of outstanding grants is low
- Re-pricing underwater options may be considered in hard-hit sectors such as retailing, real estate, financial services, etc.
  - Deterrents include negative stigma and conditions for obtaining shareholder approval
    - Exclude NEOs, economic neutrality, new vesting, surrendered options above 52-week high, etc.
- Few instances of accelerated equity grant-date timing or front-loading future years' grants into current year thus far

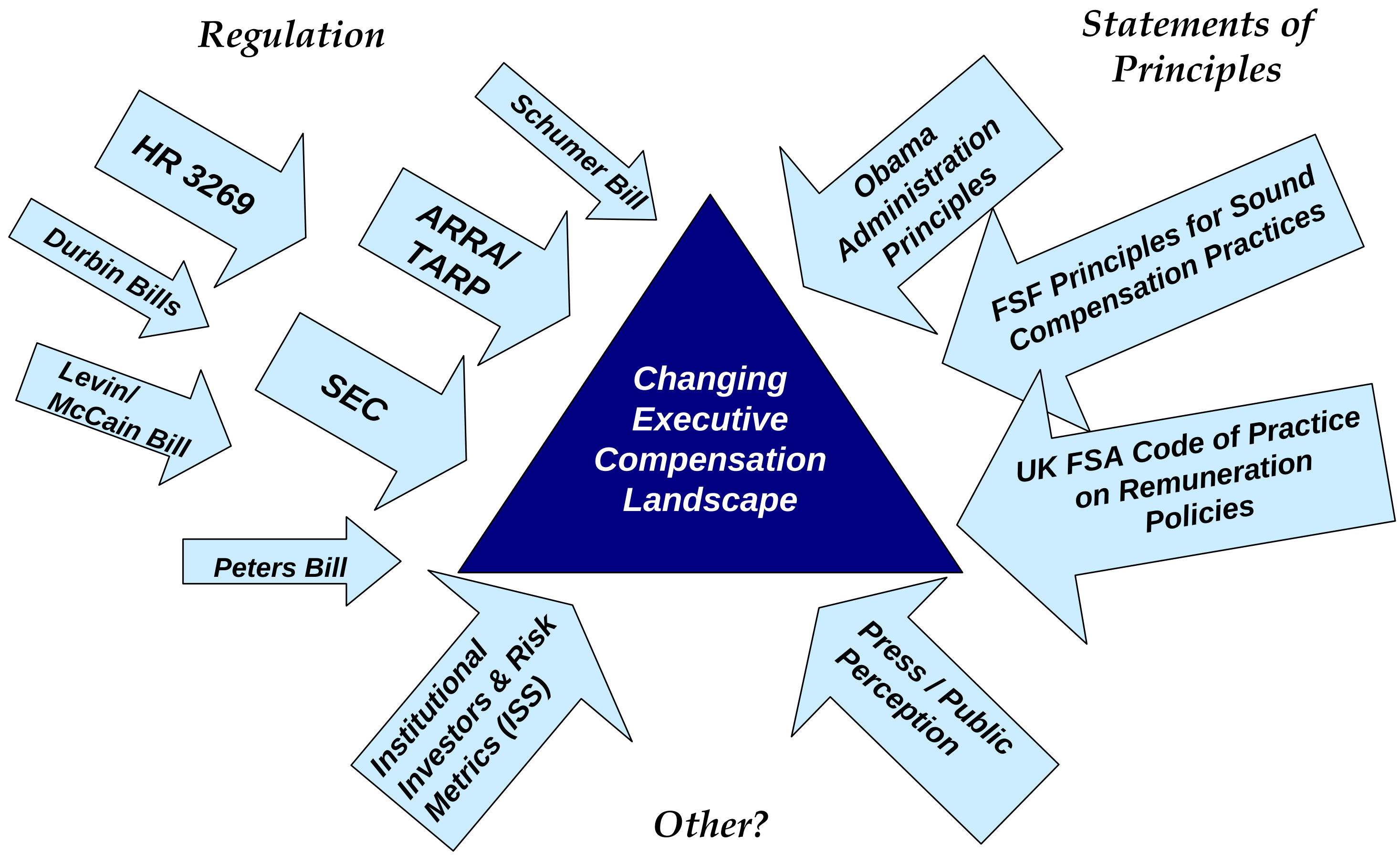
II. Executive Compensation Structure (cont'd)

…and other factors driving a rebalancing of risk and rewards…

- Perks and special benefits being downsized and refined
  - Personal aircraft use and tax gross-ups are primary current focus
- Severance and change-in-control programs being reviewed and modified
  - Reduction in benefit levels, eliminate tax gross-ups, other fine-tuning
- Claw back policies for accounting restatements attributable to management fraud or misconduct becoming widespread
  - 34% of S&P 500 companies have formal policies
  - Anticipate broader application to cover restatements even when no executive fraud or misconduct
- Ownership guidelines based on multiple of salary are being re-examined in light of lower stock prices
  - Some eliminating compliance deadline
  - Retention policies becoming more common
  - Changes in valuation methodology at some companies

III. External Influences on Executive Compensation

Influence is multi-directional and comprehensive…



Leading to changes in compensation design and practice, management/Board engagement with, and influence of, institutional shareholders, and responsibility levels and time commitment for Compensation Committee

III. External Influences on Executive Compensation (cont'd)
Changes expected to SEC proxy and governance disclosures…

- Pay-Risk Disclosure
  - Disclose in CD&A how compensation policies for employees generally (including at subsidiaries) affect risk if material, and how company manages that risk
  - Disclose board's role in risk management
- Summary Compensation Table (and Directors Table) – Equity Values
  - Replace FAS123R accrual value with grant date fair value in stock and option columns
- Consultant Conflicts
  - Disclose fees paid to compensation consultant if the firm or an affiliate provides other services
- Director Nominees
  - Describe "particular skills, attributes and qualifications" that qualify nominees to serve
- Leadership Structure
  - Explain why the company has chosen to combine or split Chairman and CEO roles

III. External Influences on Executive Compensation (cont'd)

Treasury recently released five executive compensation principles…

Applicable to all U.S. public companies

- Properly measure and reward performance
  - Use a wide range of internal and external metrics, not just stock price
- Account for the time horizon of risks
  - Avoid over-emphasis on short-term financial performance that could undermine the long-term health of the enterprise
- Align compensation practices with sound risk management
  - Conduct and publish pay-risk assessments
- Examine whether golden parachutes and SERPs align the interests of executives and shareholders
  - Not required to eliminate, but re-examine need for such arrangements
  - Require non-binding vote on golden parachutes in proxy solicitation materials for change in control transactions
- Promote transparency and accountability
  - Require advisory "say on pay" vote
  - Enhance independence of compensation committees and their advisors

III. External Influences on Executive Compensation (cont'd)

TARP rules may expand to other companies by law or "best practice…

- Mandatory Say on Pay
- Deduction limits (annual cap of $500,000 for proxy officers and no performance-based exclusions)
- Cap on severance pay (three times five-year average W-2, all-in)
- Recoupment or claw back policies
- Risk assessment certified by independent compensation committee
- Executive stock ownership retention requirements
- Restrictions on non-business related perks, including "excessive or luxury expenditures"

Many of these requirements included in pending legislation and regulatory initiatives

III. External Influences on Executive Compensation (cont'd)

Say on Pay currently looks weak but may pack a strong punch…

- Likely to become mandatory in 2010 or 2011
  - If in 2010, not likely effective until mid-year or later (e.g., six months after SEC final rules)
  - Gives calendar year companies a "pass" for 2010
- Vote tallies on existing Say on Pay (~ 300 companies) so far overwhelmingly in support
  - Even among poorly performing TARP companies or if "against" recommendation from RiskMetrics
  - 2009 tallies supported by unfamiliarity among retail investors and broker discretionary vote
- Change could be on the horizon…and Say on Pay could quickly become meaningful
  - Elimination of broker discretionary vote on uninstructed shares would shift power to proxy advisory firms and activist investors (~10% to 15% of shares at some companies)
  - Companies with significant "poor pay practices" likely to become targets
- Substantial "against" votes creates challenges even if majority in favor
  - Potential embarrassment to Board and management
  - Pressure to open dialogue with investors to identify and address deficiencies
- A majority "against" vote would have significant ramifications
  - Pressure to make major changes to compensation program to address "poor pay practices"
  - Failure to do so likely to result in a withhold vote recommendation at next election
  - If coupled with majority voting requirement and elimination of broker discretionary vote, could result in Board members failing to be reelected

III. External Influences on Executive Compensation (cont'd)

Voting guidelines of proxy advisory firms and activist investors driving change…

- "Poor pay practices" could result in "withhold" or "against" vote recommendation for re-election of Compensation Committee members or Say on Pay resolution
  - Higher year-over-year CEO pay when relative one- and three-year total shareholder returns are in bottom half of peers (RiskMetrics "CEO Pay Disconnect")
  - Measures/goals changed, replaced, or cancelled without valid performance rationale and clear disclosure
  - Internal pay disparity where CEO is high versus others in proxy
  - Excise tax gross-ups in new and amended change-in-control agreements
  - Change-in-control benefits without loss of employment, e.g., single-trigger equity acceleration
  - High costs relative to peers for auto allowances ($100,000 guideline) and personal use of corporate aircraft ($110,000 guideline)
  - Tax reimbursements (i.e., gross-ups) for imputed income on executive perquisites
  - Re-pricing or restructuring underwater stock options without shareholder approval
  - Miscellaneous "poor-pay provisions" including evergreen employment contracts, supplemental executive retirement plans, above-market interest credited on deferrals, dividend equivalents paid on unvested restricted/performance shares, perks continued for former employees, etc.

IV. What Should Companies do to Prepare?

1. Have a strong and well designed program
   - Aligned with business strategy and long-term performance
   - Simplicity is better than complexity
2. Avoid red flags
   - Be aware of potential criticisms by advisory firms and shareholders; address pro-actively
   - Avoid “poor pay practices” -- especially those with modest economic value but significant governance impact
3. Convert the CD&A from a legal document to a "selling" document
   - Describe program in the best light, particularly alignment with strategy and performance
4. Expand dialogue with interested shareholders to solicit input and support
5. Take steps to enhance corporate governance related to executive compensation
   - Periodic risk assessment of overall compensation system
   - Independence of Compensation Committee, as well as skills and experience of members
   - Independence standards for consultants and other advisors

V. Compensation Committee Advisors
Independence and objectivity are critical concerns…

- Committee should retain sole authority to hire/fire independent consultant
- Committee should retain authority to approve advisor's fees, determine the nature and scope of its services, and evaluate its performance
- Advisor should be expected to work directly on behalf of the Committee and in cooperation with (but not for) management
- Advisor should be free of economic relationships or other factors that may impair independence and objectivity
  - Required to disclose any potential conflicts that could cause independence and duty of loyalty to be questioned
  - Prohibited from undertaking projects for management except at the request of the Committee chair and in the capacity as the Committee's agent
  - Projects for management generally defined as anything outside of the Committee's oversight or unrelated to executive compensation
- Responsibilities should be carefully defined to ensure clarity in expectations

V. Compensation Committee Advisors (cont'd)

Responsibilities have evolved from passive to proactive…

1. Advise the Committee chair on setting agenda items for Committee meetings
2. Review supporting materials in advance of each Committee meeting; raise questions/issues with management and the Committee chair, as appropriate
3. Attend Committee meetings as requested
   - Review Committee meeting minutes for meetings attended by the consultant.
4. Review total compensation philosophy, market peer group, and target competitive positioning for reasonableness and appropriateness
5. Be on call to the Committee chair for advice on or review of management proposals as requested
6. Undertake special projects that are directly in support of the Committee's Charter
7. Review total executive compensation program and advise the Committee of plans or practices that might be changed to improve effectiveness

V. Compensation Committee Advisors (cont'd)

And relationships will continue to evolve…

8. Provide market data and recommendations to the Committee on CEO and senior officer compensation
9. Provide advice on the design of variable incentives, including the selection of performance metrics and payout ranges
10. Review Compensation Discussion & Analysis ("CD&A") and related tables for the proxy statement each year
11. Review any significant executive employment or severance agreements in advance of being presented to the Committee for approval
12. Periodically review the Committee's charter and recommend changes
13. Proactively advise the Committee on best-practice ideas for Board governance of executive compensation and areas of concern and risk in the overall program