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# Executive Compensation Challenges in the 2008 Proxy Season

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# Agenda

- Executive and Director Compensation in 2008
- CD&A Disclosure Challenges
- Shareholder Compensation Proposals
  - Say on Pay
  - Pay for Superior Performance
- Top 5 Must Do's for 2008 Proxy Season



# Executive and Director Compensation in 2008

# Executive Compensation Trends

- Challenging environment in transition
  - Power shift from Board in response to special stockholder interests and external pressures
- New standards of reasonableness
  - Former “best practices” no longer acceptable
  - Stringent quantitative pay-for-performance standards
  - New internal disparity issue
  - Limit SERPs, perquisites, gross-ups and peripherals
  - Narrow contract terms and CIC payments
  - Reduce severance (“pay for failure”)
  - Broader use of clawbacks
  - Limit equity dilution and value transfer
  - Measure and cap executive wealth; limit 10b5-1 plans

# Executive Compensation Trends

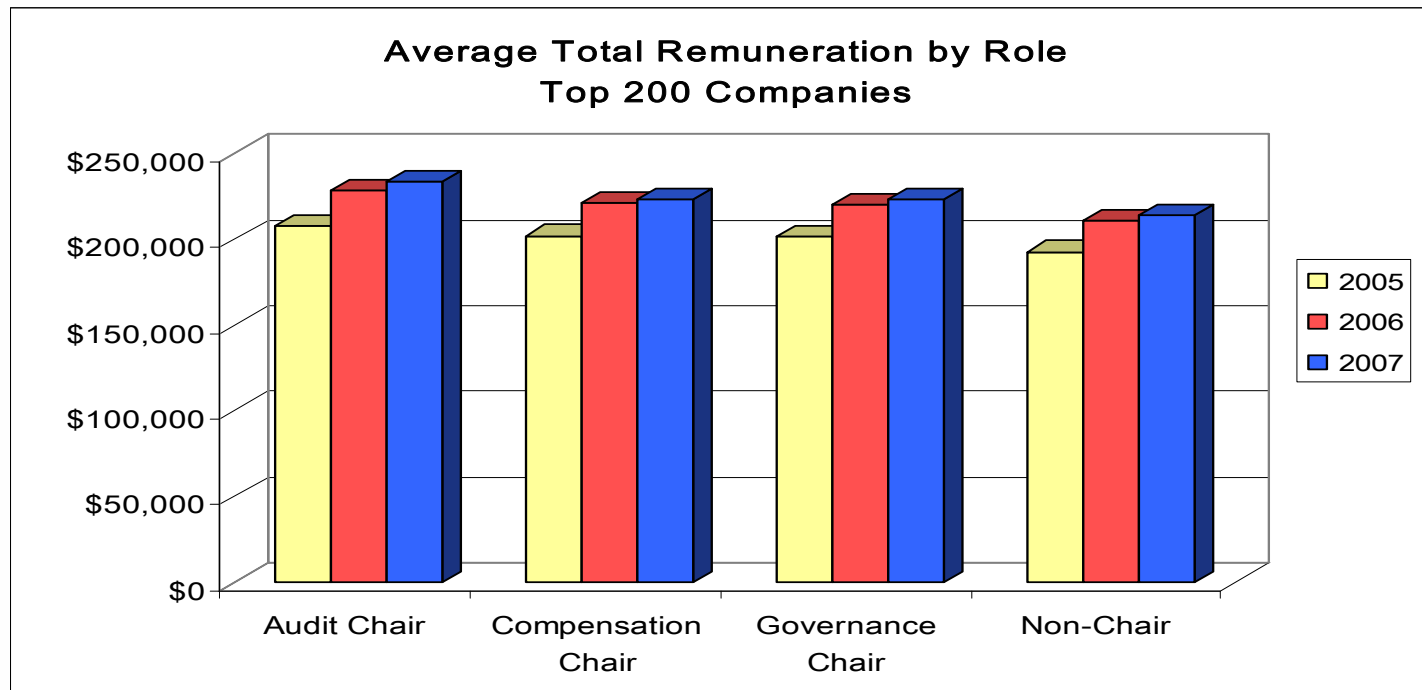
- Difficulty in setting performance measures and defining good performance in uncertain economy
  - Unintended consequences of new SEC disclosure requirements
- Annual incentives now workhorse of pay for performance
  - Increased opportunity as a percentage of base salary
  - Increased leverage
- Continued redesign of LTI architecture
- Retention, recruitment and motivation in face of underwater options and missed LTI goals

# Board Compensation Trends

- Redesigned pay for redefined jobs
  - Diminished pool of traditional CEO candidates
  - Other senior officers with applicable expertise sought
  - Increased responsibilities and oversight accountability
  - Greater time/commitment required
  - Reputational risk; threat of withhold vote
- Pay differentials by industry narrowing due to competition for limited number of qualified candidates
- Board pay grew at faster compound rate (11%) than executive pay in recent years
  - Slowdown in 2007 to less than 5% as total approaches \$250,000 among Top 200
  - Not current issue among stockholders, activists or media

# Director Total Remuneration

- Total remuneration varies based on individual director role on committees
  - Range of \$214,000 to \$233,000



# Lead Independent Director Trends

- Increasing prevalence and role for Lead/Presiding Director, as well as non-Executive Chair
  - Prevalence among S&P Super 1,500 Companies
    - 45% have separate Board chair – up 4% in 2007
    - 53% have Lead/Presiding Director – down 4% in 2007
      - Over 85% among Top 200
  - Among Top 200 companies
    - Lead Directors receive, on average, a premium of \$30,500 over Board fees paid to directors
    - Non-Executive Chairs receive, on average, a premium of \$235,000 over Board fees paid to directors

# ISS Guideline Trends

- Increasingly stringent requirements
- Expanding purview
  - Over additional aspects of compensation and corporate practices
  - Passage of pending legislation and/or shareholder proposals for “Say on Pay” would bring executive compensation under annual oversight by ISS and other proxy advisory firms

# ISS 2008 Guidelines

- New guidelines for 2008 proxy season
  - Withhold vote on compensation committee members, CEO and potentially entire board in event of poor practices
  - Current list of 11 “poor practices” expanded to include following additional 11, for total of about 22
    - Egregious employment contracts
    - Excessive perquisites
    - Huge bonuses without justifiable performance or proper disclosure
    - Changed performance metrics
    - Egregious pensions/SERPs
    - Overly generous new CEO hire packages
    - Excessive severance and/or CIC provisions/payments
    - Poor disclosure
    - Internal pay disparity
    - Option backdating
    - Other excessive payouts or poor practices

# ISS 2008 Stock Plan Guidelines

- Stock plan approval
  - Six new multipliers for ratio of full-value stock grants to options based on volatility
  - Weighted average shares outstanding vs. year end as denominator in dilution calculation
  - Revised burn rate table with 22 industry categories
  - Consideration of following factors for companies with high overhang costs
    - Five-year and one-year TSR; peer performance
    - Size, length of holding period, exercise price and remaining period for in-the-money options and underwaters
    - Vesting provisions
    - Distribution to NEOs
    - Dilution
    - Compensation practices

# Compensation Committee Use of Outside Advisors

- New governance standards and proxy disclosure
  - Independent compensation consultant to committee unaffiliated with other service providers to company
  - Trusted outside advisor
  - Resource for trends, technical matters and program design/review/updates
- Experience indicates need for independent or assigned internal legal counsel to be available at committee meetings
  - Compliance requirements
  - Resource for immediate resolution of legal issues
  - Accurate and complete minutes



# CD&A Disclosure Challenges

## 2008 CD&A Issues

- SEC reaction to 2007 proxy disclosure
  - Comment letters
  - SEC observations
  - John White speech
- Two main themes:
  - **More analysis is needed in CD&A**
  - **Manner of presentation is important**

# Analysis

- How and why
  - Disclose how the compensation committee analyzed compensation information and why its analysis resulted in specific forms and amounts of compensation for each named executive officer (“NEO”)
  - Disclose the material qualitative and quantitative factors considered for each NEO’s base salary, bonus award and equity award
  - Explain why the amount of each NEO’s base salary, bonus and equity award was appropriate

## 2008 Hot Button Issues: Performance Measures and Targets

- Most widespread comment in SEC comment letters
- General rule
  - Disclose performance measures and targets
- Two exceptions
  - Materiality
  - Competitive harm
- Competitive harm corollary
  - Degree of difficulty disclosure

# Performance Measures and Targets: Materiality Exception

- Materiality
  - Determine if performance measures or targets are material
    - Plan design
    - Prior year's targets vs. current year's targets
    - Operational targets vs. financial targets
  - If not material, no need to disclose
  - If material, analyze whether disclosure would cause "competitive harm"

# Performance Measures and Targets: Competitive Harm Exception

- Competitive Harm
  - Target levels need not be disclosed if involve “*confidential trade secrets or confidential commercial or financial information, the disclosure of which would cause competitive harm.*”
  - Same standard as confidential treatment request (no request required)
  - SEC has indicated it views competitive harm exception narrowly
  - Be able to demonstrate, specifically, how target could be used by competitor to harm company
  - Documentation considerations

# Performance Measures and Targets: Competitive Harm Corollary

- Result of competitive harm finding
  - If measures or targets not disclosed due to competitive harm, disclose difficulty or likelihood of achieving targets
    - Context is important
    - Historical perspective may be helpful
    - Why was target set at specific level
    - Description of terminology

# Performance Measures and Targets: Final Thoughts

- **Target Disclosure**
  - If disclosed, include description of metrics, target levels and description of how the company or individuals performed against targets – quantify
  - Explain why the Board selected the performance measures and the targets (and the reasons for any changes)
  - Put the targets in context – how does the target focus management and what are the benefits
- **Discretion**
  - Explain the extent to which discretion can be used to adjust awards
  - If discretion was exercised, quantify the adjustment and explain what factors it was based on

# Performance Measures and Targets: Final Thoughts

- **Close the pay for performance loop**
  - Disclose actual payouts and tie them back to targets and actual performance results
- **Corporate reaction**
  - Published reports indicate that fewer than one-half of companies intend to disclose 2007 performance goals

# 2008 Hot Button Issues: Benchmarking

- **Benchmarking**
  - Second most prevalent comment in SEC comment letters
  - How were benchmarks or other comparative information used?
    - Identify specific peer group companies
    - How did comparison affect specific compensation decisions
  - Discuss where actual compensation fell with respect to benchmark (specific targeted and actual percentiles)
    - Discuss any discretion – explanations of payouts that fall outside of targeted percentiles
  - Some confusion by SEC regarding the term “benchmarking”
    - Benchmarking = individual company data
    - Use of aggregate survey data not benchmarking

# 2008 Hot Button Issues: Peer Groups

- **Peer groups**
  - Explain the basis for choosing the specific companies
  - Discuss and justify differences in benchmark/peer groups used
  - Potential red flags for investors
    - Wide differences between the performance of the company and the peer group companies
    - Unexplained changes to the peer group
    - Different peer group for setting compensation levels vs. performance measurements
  - Standards for selecting peer group companies
    - Size
    - Industry
    - Performance
    - Circumstances; challenge

# Manner of Presentation

- Style and Readability
- Write for your audience (investors, corporate directors and executives and the business and financial press)
- Clear, high-quality writing, in plain English
- Executive summary
- Roadmaps – Titles/subtitles
- Visual formatting – tables, charts, text boxes, coloring, shading, bullets
- Make disclosure easier to follow
  - Explain technical terms in layman terms
  - Enhance required tables with supplemental columns or new tables

# CD&A Disclosure Challenges & ISS

- New ISS policy for 2008
  - “Poor” CD&A disclosure may trigger “Withhold” vote recommendation for compensation committee, CEO and even entire board
  - The hot points for 2008
    - CEO role in setting compensation
    - Past performance targets and methodology
    - Benchmarking/peer group disclosure
  - What will ISS add for 2009?



# Shareholder Compensation Proposals

# Selected Shareholder Compensation Proposal Results

	# Voted		"For" as % of Outstanding		"For" as % of Votes Cast	
	2006	2007	2006	2007	2006	2007
<b>ALL EXECUTIVE COMP.</b>	<b>92</b>	<b>161</b>	<b>21</b>	<b>23</b>	<b>29</b>	<b>31</b>
Say on Pay	4	39	29	29	39	39
Link Pay to Superior Performance	16	34	22	21	29	29
Add Perf. Criteria to Equity Award	5	16	25	24	37	32
Golden Parachutes	17	12	36	37	50	50

Note: Data limited to S&P 1500 companies

## Impetus for Surge in These Proposals in US

- Mounting concern of investors, press, politicians and general public about executive compensation
  - Partly due to front-page over-the-top excesses
  - But also due to examples of eye-popping pay in years of anemic company performance
- Option back-dating scandal has fueled fire
- Subprime mortgage and credit market mess and slowing economy haven't helped

# Typical Say on Pay Proposal

- Most common Say on Pay proposal is for advisory vote on executive compensation
- Example: Verizon Communications
  - “**RESOLVED** , the shareholders of Verizon hereby request that the Board adopt a policy that includes, as a voting item in the proxy statement for each annual meeting, an advisory resolution, proposed by Verizon’s management, to approve the compensation of the named executive officers (“NEOs”), set forth in the proxy statement’s Summary Compensation Table (the “SCT”), and the accompanying narrative disclosure of material factors provided to understand the SCT....”

## Say on Pay Origins

- Advisory vote on executive compensation modeled after system in UK--also adopted in Australia and Sweden
  - Advisory vote required by law in these countries
- In UK, advisory vote on Director's Remuneration Report
  - Report discusses company's policy on executive pay for following year and future years and discloses details of executive pay for prior year
  - Roughly comparable to US CD&A

# UK Experience with Say on Pay

- Studies on UK experience found advisory vote
  - Sparked annual consultation between companies and institutional investors representatives
  - Transformed compensation practices
    - Toughened performance metrics
    - Trimmed severance to one-year's salary
  - Reigned in executive pay increases
  - Strengthened hand of proxy advisory services
- However, UK market very different from US
  - Relatively few large institutional investors and companies
  - Two large umbrella organizations in UK with stature
- Is UK experience even relevant in US?

# Say on Pay in the 2007 Proxy Season

## Shareholder Say on Pay proposals

- 39 voted at S&P 1500 companies vs. 4 in 2006
- 39% average support – about 40% in 2006

Passed		Received Majority of Votes But Did Not Pass		Close	
	%		%		%
Activision	69	Clear Channel	50.02	Apple	46
Blockbuster	57	Valero Energy	53	Bank of New York	47
Ingersoll Rand	57			Merck	49
Motorola	51.8			Occidental Petroleum	48.4
Par Pharmaceuticals*	56.8				
Verizon*	50.2				

\* Board subsequently adopted Say on Pay policy.

## Say on Pay in 2008

- Activists smell a winner—expect about 100 Say on Pay proposals in 2008
  - 90 filed to date
- ISS policy supports Say on Pay shareholder resolutions
- Companies with majority voting cannot afford to ignore troublesome shareholder proposals like Say on Pay
  - If approved, company has the option of adopting or risk losing board members
- Even if company does not have majority voting today, may in future

## The Dark Side of Say on Pay

- Executive compensation sparks high emotions
  - Tensions between activists and companies
  - And between boards and managers
- May be difficult for boards to please both constituencies
- Transfer of leverage from boards to ISS

# Avoiding Say on Pay Proposals

- Try not to stimulate a proposal by adopting aggressive executive pay packages
  - Most companies will not receive a Say on Pay proposal in near future
- If company has received a proposal, best option now is for board to enter into dialogue with sponsor if feasible
  - Goal is to keep proposal off annual meeting agenda
  - Offer informal consultation process between compensation committee and top institutional holders
  - Could promise to retool pay practices
- If negotiation fails, remaining option is try to defeat proposal at annual meeting
  - No “silver-bullet” arguments
  - Absence of significant pay “misdeeds” likely best friend

## ISS Say on Pay Guidelines

- ISS recently published Say on Pay guidelines
- ISS guidelines are “principles-based” rather than prescriptive
- Wildcard is how ISS will apply guidelines in practice
  - Boards that are uncertain how ISS will assess its pay practices will likely request an audience with ISS
  - Alternative is to seek blessing from significant institutional holders

## If Your Company Adopts Say on Pay

- Learn from UK experience
  - Consult with key shareholders and ISS before any advisory vote
    - Like it or not, ISS will be Compensation Committee's "partner"
    - Compensation will have to pass muster under ISS guidelines
  - Refashion pay policies to gain ISS/shareholder support
- What if shareholders vote "No on Pay"?
  - Likely means company did not heed lessons from UK
  - Meeting ISS compensation guidelines and addressing pay issues in advance of next annual meeting will be key to avoid withhold vote campaign against Compensation Committee

## Pay for Superior Performance: Typical Proposal

- Most common Pay for Superior Performance proposal asks Board to adopt pay plans that
  - Sets compensation targets for annual and long-term incentive pay at or below a defined peer group median
  - Delivers a majority of target long-term compensation through performance-vested equity awards
  - Establishes performance targets for defined financial metric(s) against peer group
  - Awards annual and performance-vested, long-term incentive compensation only when company's performance exceeds peer group median performance

## Pay for Performance in 2007 Proxy Season

- 34 Pay for Superior Performance shareholder proposals voted in 2007 proxy season vs. 16 in 2006
- In 2007, pay for performance proposals came close to receiving a majority of votes cast at the following companies
  - Mattel - 46.8%
  - PerkinElmer - 42.2%
  - Progress Software - 44.9%

## Pay for Performance in 2008

- Likely to be most common executive compensation proposal after Say on Pay
- ISS policy generally supports Pay for Performance shareholder resolutions (theoretically analyzed on case-by-case basis)

# The Dark Side of Pay for Performance

- Company fights so hard on this battle that it loses the compensation war
- Risk that ISS will micromanage implementation of performance pay under threat of a withhold vote campaign against compensation committee
  - Rejecting composition of peer groups
  - Pronouncing compensation targets too generous
  - Declaring performance metrics too soft
- Little wiggle room when failure to achieve performance targets is beyond management's control

# Avoiding Pay for Performance Proposals

- Ensure pay plan has following elements
  - Annual and long-term awards are in large part performance driven
  - Performance hurdles are meaningful
- As noted earlier, disclosure is key
- Alternatives if receive a Pay for Performance proposal
  - Negotiate with proponent
  - Consider pre-emptive implementation
    - Modify pay plans in line with ISS guidelines
  - Fight the proposal on grounds of:
    - Prior implementation
    - Proposal too detailed and too prescriptive

## Top 5 Must Do's for 2008 Proxy Season

1. Carefully assess company's pay plans and practices against ISS voting policies and guidelines
  - Try to eliminate non-complying elements
2. Carefully prepare and review the CD&A in light of latest SEC positions
3. Pick your fights over pay carefully and strategically – avoid Say on Pay if at all possible, even if it means accepting a less intrusive shareholder proposal
4. Compensation committee should retain its own independent compensation consultant
5. Compensation committee should have an experienced attorney, either inside or outside, who attends all meetings and provides support to the committee

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