CORPORATE BOARD MEMBER MAGAZINE
FARIENT ADVISORS PARTNERING FOR PERFORMANCE

ALL EYES ON EXECUTIVE COMPENSATION

Results of the 2009 *Corporate Board Member*/Farient Advisors Study of Executive Compensation Practices

OVERVIEW

In the summer of 2009, *Corporate Board Member* and Farient Advisors, an independent executive compensation consulting firm, teamed up to survey U.S. compensation committee members on the challenging issues for the year ahead. Specifically, the research aimed to determine whether heightened attention on risk management has affected how companies are structuring their executive pay policies, and, if so, what steps compensation committees plan to take to address those issues. The research also focused on compensation committees' competencies, their relationship with management, and the support they feel is needed to perform their duties.

The survey comes at a time when all eyes seem to be on compensation and the impetus to pass reform legislation has reached a fever pitch. In addition to questions surrounding appropriate levels of pay, other hot buttons this year include say on pay, tax gross-ups, clawbacks, executive employment agreements, and severance arrangements—leaving no shortage of fodder for ongoing governance discussions and debate. In this environment, many directors are working harder to balance the need to remain competitive against the use of excessive and inappropriate remuneration and to guard against compensation practices that encourage unnecessary risk.

COMPENSATION PRACTICES AND RISK

Despite the overarching legislative and regulatory issues that hang in the balance, the vast majority of compensation committee members surveyed (83%) aren't worried about the current pay plans they have in place for their top employees (Figure 1). Robin A. Ferracone, founder and executive chair of Farient Advisors, says this finding is consistent with her observations over the past year. "By and large, board members are not worried about executive compensation in the companies in which they are involved. However, they are worried about the high-level abusive practices they see in the market," she says. In fact, she notes, the levels of executive pay may be masking deeper issues. "Interestingly, I have seen studies that cite that investors are more concerned about the lack of performance and pay alignment than about the absolute levels of executive pay."

While compensation committee members surveyed indicate a relative comfort level with their present plans, they are nonetheless looking closely at their organizations to make sure they have best practices in place going forward. The first step is to make the issue of risk a priority on the meeting agenda. Nearly half said their compensation committee has put an evaluation of whether compensation encourages excessive risk taking on their formal agenda. Thirty-eight percent of those have had at least one discussion on risk (Figure 2).

In terms of actions taken by compensation committees thus far, 80% of responding directors indicated their company has not altered their executive compensation

Figure 1

Do you believe there is an issue with the level of executive pay in your company?

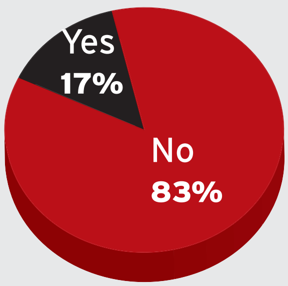


Figure 2

Has your compensation committee put a formal item on its agenda to evaluate whether the executive compensation program encourages excessive risk taking?

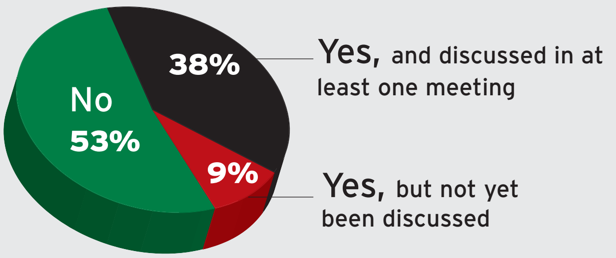


Figure 3

How likely is each of the following to cause executive pay alignment issues?

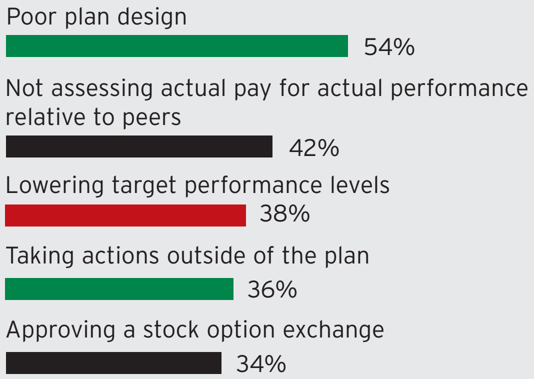
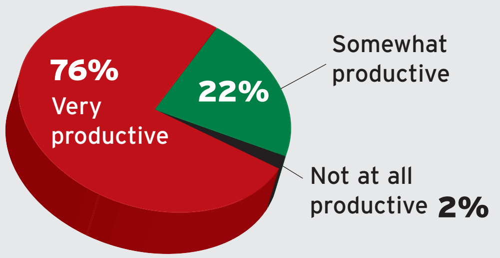


Figure 4

How productive would you characterize your compensation committee's relationship with management?



program to mitigate any possible effect on risk taking. One in five respondents indicated they have made specific changes to their programs, such as basing compensation incentives on long-term performance or on profit instead of revenue, adding the ability to use clawbacks if necessary, placing caps on incentive pay, using modified earnings per share (EPS) as a performance measure, and offering restricted stock as incentive pay.

In terms of investor and regulator red flags, clawback provisions—the ability to recapture executive incentive pay in the event of wrongdoing—have been a serious concern. Not surprisingly, compensation committee members felt the absence of such provisions in the event of a financial restatement created the highest likelihood of encouraging executives to take excessive risks. The following factors were rated by compensation committee members as those most likely to encourage executives to take excessive risks:

- No clawback provision for subsequent financial restatements
- An annual incentive plan with significant upside potential
- Aggressive financial goals
- No holding period for stock required through stock incentive plans
- Financial performance measures that encourage financial leverage

In another analysis of the presence of risk factors, one in four compensation committee members (24%) said their company would be very likely to use special mechanisms outside the normal compensation plan to retain key executives in the wake of poor performance. However, about half (51%) of those responding say it is unlikely that they would turn to such mechanisms.

PERFORMANCE ALIGNMENT

In addition to risk analysis, one of the ongoing challenges for compensation committees is the need to structure plans that create a positive alignment between executive pay and long-term corporate performance goals. When problems with alignment between pay and performance arise, the most likely cause, according to 54% of our respondents, is poor compensation plan design (Figure 3). Forty-two percent of directors also cited the failure of the compensation committee to assess actual pay for performance relative to peers as a root cause. Compensation committees' lowering of target performance levels and taking action outside of plan parameters are two other significant factors mentioned by responding directors as having an effect on alignment issues.

Although compensation committees typically make appropriate and defensible decisions, "over time, the cumulative effect of modifying, adding, and making exceptions to compensation programs can actually dampen the degree of alignment between performance and pay," notes Todd M. Gershkowitz, senior vice president of Farient Advisors, who says this "hidden" effect is the primary problem facing boards and compensation committees in terms of aligning performance and pay. "The best way to address this problem is for companies first to understand the current degree of performance and pay alignment that exists and, going forward, to test the potential impact on alignment of any future compensation decisions before they are approved," he explains.

Farient's Robin Ferracone agrees. "It is critically important for compensation committees and managements to agree, in both philosophical and concrete terms, on what performance and pay alignment means. What will happen to alignment if it comes into conflict with retention objectives, particularly when performance is low? How will the compensation system and our alignment philosophy help us reward in the good times and bridge through the lean times? All of these issues should be anticipated and dealt with in advance—not in the heat of battle."

While the topic of management performance is by far one of the most difficult issues for compensation committees to grapple with, the survey demonstrates that the majority of compensation committees feel they have a healthy working relationship with management. More than three-quarters of those surveyed (76%) characterized their relationship with management as "very productive" (Figure 4). Survey data shows that the likelihood of having a productive relationship between the two entities increases as the revenue size of the company increases. An additional 22% see the relationship as somewhat productive, while only 2% find the relationship not at all productive. Overall, the survey found that the more productive the relationship between management and the compensation committee, the less likely directors are to believe that there is an issue with the level of executive pay in their company.

THE RIGHT BALANCE OF OVERSIGHT

With regard to shareholder and regulatory concerns, 37% of survey respondents indicated that improving disclosure to include pay rates under different performance and risk exposure scenarios is the solution most likely to temper investor concerns regarding executive compensation. Forty percent believe that requiring publicly traded corporations to separate the duties of chief executive and board chair is the most appropriate corporate governance action to remedy excessive payouts.

Other responses deemed appropriate actions by more than a third of respondents include requiring directors to be subject to annual shareholder votes, requiring directors to receive a majority of votes cast by shareholders to remain on the board, and requiring formal shareholder approval for any compensation programs that are not based on performance.

While some directors appear to be open to increased disclosure, many are skeptical about additional intervention. Three-fourths of those surveyed believe that legislation that invites government involvement in setting compensation policies poses a threat to the long-term health of their company (Figure 5). Moreover, 59% of responding directors believe that legislation that invites investors' involvement in the compensation approval process also would pose a threat to company viability. A deeper analysis of the data shows that the strength of this threat increases as the size of the company increases.

Finally, we asked respondents about the compensation committee skills they felt were necessary to provide adequate oversight as well as the need for resources such as customized tools and training and the need for outside consultants. Forty-three percent of respondents said financial acumen is the most important skill compensation committee members should possess to carry out their responsibilities effectively. Decision-making skills were rated as the second most important (25%), followed closely by technical skills (22%).

To bolster those skills, many compensation committee members believe they would benefit from specialized training; however, most respondents (84%) say their companies neither provide nor require formal compensation committee training (Figure 6). Fully half (50%) of respondents from those companies think their organization should provide or require such training. To that end, in-boardroom training is viewed as the most effective method to help them better perform their duties by half of the respondents. Likewise, the majority (53%) believe that compensation committees need additional analytic tools to assess risk-taking behavior as well as pay relative to performance.

THE NEED FOR OUTSIDE ASSISTANCE

Respondents affirmed their reliance on compensation consultants to provide additional perspective and tools, with 85% indicating their company had employed the services of a compensation consultant within the last 12 months. The survey indicated that the ability to give an objective opinion was the highest-rated criterion (97%) to consider when hiring a compensation consultant, followed closely by independence of the firm (89%) and industry knowledge (79%).

Of those compensation committee members who had engaged the services of a consultant in the last 12

Figure 5

Compensation committee members rated the following as posing a strong threat to the long-term health of their companies:

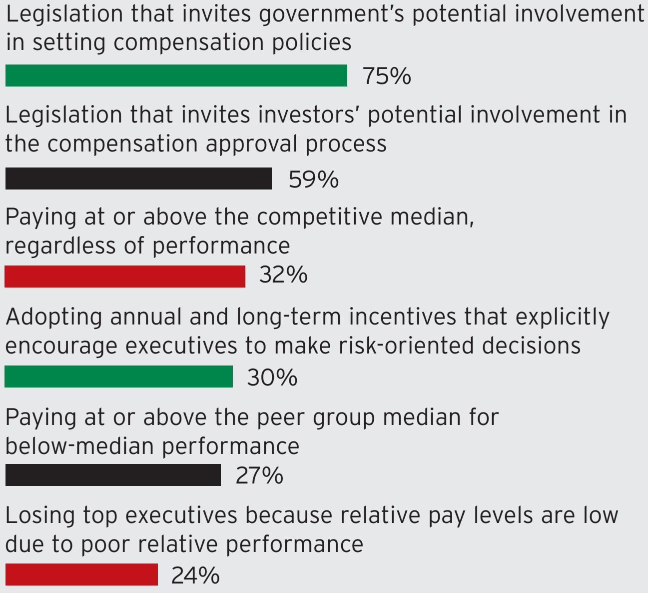
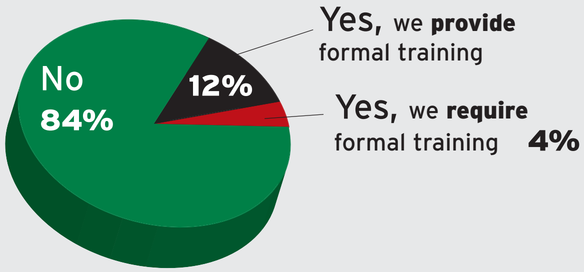


Figure 6

Does your company provide or require formal compensation committee training?



months, 90% indicated it is very important that the compensation consultant be held directly accountable to the compensation committee, and another 9% find that somewhat important. Nearly 80% indicated that it is equally important for a compensation consultant to both provide data and be a strategic adviser to the compensation committee.

Furthermore, 52% of those who have recently worked with a compensation consultant are completely satisfied with the data provided to their compensation committee and another 44% are somewhat satisfied. Meanwhile, 37% of these respondents indicated they are completely satisfied with the strategic advice and/or sounding board services offered to the compensation committee by their consultant, half are somewhat satisfied, and 10% are not at all satisfied with this service.

CONCLUSION: BEST PRACTICES

Overall, compensation committees are rising to meet the challenges facing them, as the spotlight continues to shine brightly on executive pay practices and risk management. As the year continues to unfold, and as directors consider what foundational concepts need to be addressed in 2010, Farient Advisors' Todd Gershkowitz offers the following best practices to consider:

- Establish where your company stands with regard to alignment and risk.
- Make a commitment to enhancing alignment and mitigating excessive risk taking by testing the potential impact of decisions before they are approved.
- Be proactive about engaging in dialogue with shareholders and sharing with them where the company stands on alignment and risk and how it is addressing any issues in this regard.

Farient Advisors' Robin Ferracone adds, "There are three potent things to watch out for that companies can easily gloss over. The first is to make sure that pay systems and actions do not turn the company into a pay outlier that makes compensation look egregious under any circumstances. The second is to watch out for ad-hoc actions that can unduly enrich executives, particularly when they are on the way out. This may mean not only lucrative severance arrangements, but also a plus-up in bonus, for example, for a retiring executive to enhance the defined benefit payout stream. Finally, I find the timing of rewards versus performance to be one of the richer areas for inquiry. Are performance and vesting periods really rewarding for sustained performance, not just temporary blips? Are the long stock-option windows (the period between vesting and expiration) in most option plans allowing recipients to benefit from secular run ups in the stock market rather than sustained company performance? In my opinion, these are the types of issues that will need to be addressed to avoid the next wave of hysteria."

As compensation committees begin to discuss these critical issues, *Corporate Board Member* and Farient Advisors will continue to monitor the changes occurring in regulations, the reforms inspired by shareholders, and the best practices embraced by well-governed companies. We thank all compensation committee members who participated in the survey, and by doing so, helped the larger community of directors by providing benchmarks for future analysis and guidance.

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Founded in 2007 by Robin Ferracone, Farient Advisors LLC is an independent, full-service executive compensation and performance advisory firm. With offices in Los Angeles, New York, and San Francisco, Farient provides insight on executive pay, performance, and governance processes. Farient Advisors partners with its clients to proactively help them address their executive compensation and performance issues, but also retains its independence, ensuring that the consulting services the firm provides serve the long-term best interests of its clients' shareholders. For more information, visit **www.farient.com**.

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