

Executive Pay – Current Environment & Practical Applications for Directors

NACD – TriCities Chapter

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Agenda

- **Objective and Theme**
- **New Environment for Executive Pay**
- **Critical Alignment in Executive Pay**



Objectives and Theme

Objective

Last month's chapter meeting focused on performance measurement. Thomas Seitz and John Piecuch discussed the importance of **performance measurement** and company health, in understanding the overall performance of the Company and relating this to effective executive compensation programs.

Provide independent directors with current information on executive pay and **equip** them to carry out their jobs in **governing executive pay**

Theme – Alignment

Equipping directors to understand the need for alignment between current executive compensation practices and the expectations of stakeholders in the new environment

We are close to losing the “benefit of the doubt” from the public

We Directors must bring our “A Game” to the process

New Environment for Executive Pay

People have said the Compensation Committee is the next Audit Committee when it comes to scrutiny and liability. Not true:

The average American doesn't know what an audit is...

A blurred background image of an office interior, showing desks, chairs, and people working, overlaid on a dark blue gradient.

New Environment for Executive Pay

New Environment for Executive Pay

Presence of “Executive Compensation” or “Executive Pay” in the media over the last 6 months

Top 50 US Newspapers: 1,373 Articles

Wall Street Journal: 307 Articles

Dow Jones Publications: 1,006 Articles

New Environment – CEO Pay Coming Down?

- Big 3 automakers lower salaries, ditch aircraft
- Big Wall Street firms forgo bonuses?!
- Plummeting equity values challenge companies in delivering LTI values

The invisible floor on executive compensation may be broken

New Environment for Executive Pay

Stronger, More Vocal External Criticism

- Institutions
- Press
- Unions
- Advisory services
- Politicians (nearly unanimous, non-partisan)

- Popular sentiment
- Community becoming more important stakeholder
- New era of haves and have-nots

Expected changes for Executive Pay Environment in 2009

Legislation regulating executive pay

- "Say on Pay"
 - Currently shareholders only have a vote if compensation is on the ballot during proxy season
 - Shareholder advisory vote – non-binding
 - Expect legislation by 2010
- Tax Rules
 - Changes to 162(m) (especially related to financial services industry bailout)
- SEC, proxy disclosure
 - Undue risk
 - Probability of achievement
 - Analysis on pay/performance

Bottom Line: Legislators are going to impose rules to address these issues if left unattended by companies/boards

Expected for 2009

- Increased incidence of stock option repricing/exchange
- Increased dilution through equity awards
- Challenges in run-rate due to option valuations
- Shift to performance based cash LTI
- Lower bonuses
- Lower salary increases
- Shift away from gross ups for golden parachutes

New Environment for Executive Pay

Bottom Line: Investors and other stakeholders are demanding change in executive compensation practices to align with expectations

We have the opportunity to offer change, either

- Lower executive pay – this will happen if nothing changes, or
- **Strengthen the alignment** between executive pay and stakeholder expectations
 - Company performance
 - Employee compensation
 - Coherent and defensible pay strategy

A blurred background image showing an office environment. A person is visible at a desk, and there are various office items like papers and a computer monitor. The image is out of focus, creating a soft, professional atmosphere.

Critical Alignment in Executive Pay

Executive Pay Alignment

Executive
Pay and the
Company's
Business
Strategy

As Compensation Committee members, we must have a firm grasp on the Company's business strategy and bring this to every meeting – top of mind

Executive Pay Alignment

Executive Pay and the Company's Compensation Strategy

- The compensation strategy should be as current and well developed as the company's business strategy → the two should be closely aligned
- The current economic environment will cause many companies to question their business strategies
 - Must review compensation strategy

Executive Pay Alignment

Executive Pay Levels and the External Market

- General market direction
- Competitive market for executive talent
 - Not just peers anymore
- Public perception of executive pay
 - Ask yourself how would this look on the cover of NY Times

Executive Pay Alignment

Executive Pay and Company Performance

- General direction of shareholder prosperity
 - Share the pain; share the gain
- Short-term pay for short-term results
- Long-term pay for long-term results
 - And the relationship between the two
- Proper balance between indirect compensation (e.g., benefits and perks) and performance based pay
 - Avoid big perks when shareholders are not having fun
 - Measure overall Company health

Executive Pay Alignment

Compensation Committees must begin to ask:

What is the critical alignment between this performance measure and the business strategy, health?

What are the potential unintended motivations if we reward for these certain things?

Do our performance measures (and their goals) motivate executive management to take risks that are inconsistent with our risk appetite, profile? Undue risks?

→ Debate about options

Performance Measurement

Last month, we heard about the importance of performance measurement

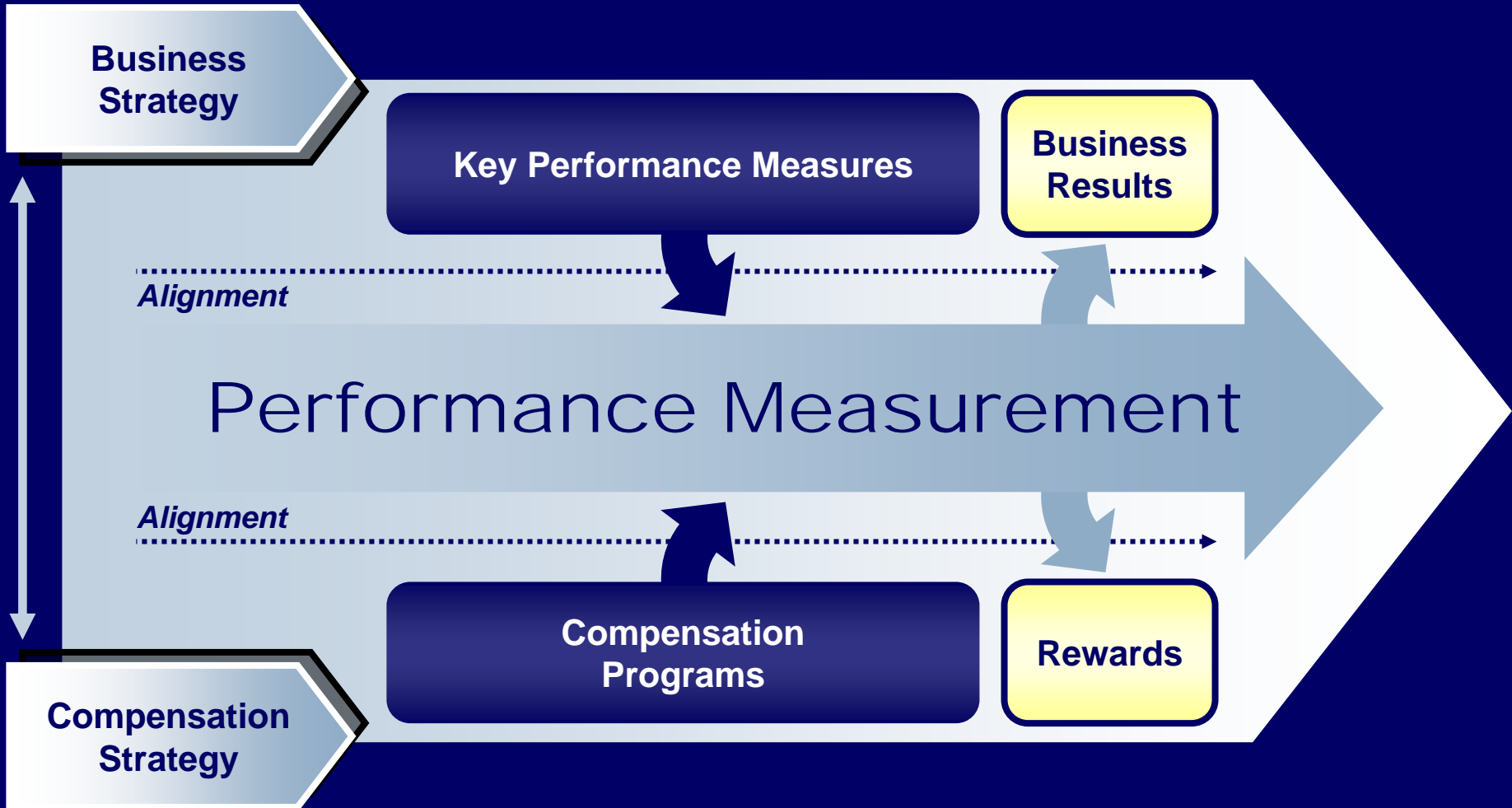
Boards must critically assess information they receive to fully understand how well the company is performing vs. business strategy

The health of the Company



Compensation Committee must understand alignment between critical performance indicators and the Company's incentive compensation programs

Performance Measurement - Alignment with Pay



Performance Measurement

- Performance measurement facilitates **Alignment between Business Results and Rewards**
- Directors need to understand the alignment
- Management and advisors must facilitate this alignment and provide **succinct information** to support

Executive Pay Alignment

Too often the full Board of Directors hears the message of company objectives that the Compensation Committee doesn't deal with.

Executive Pay Alignment

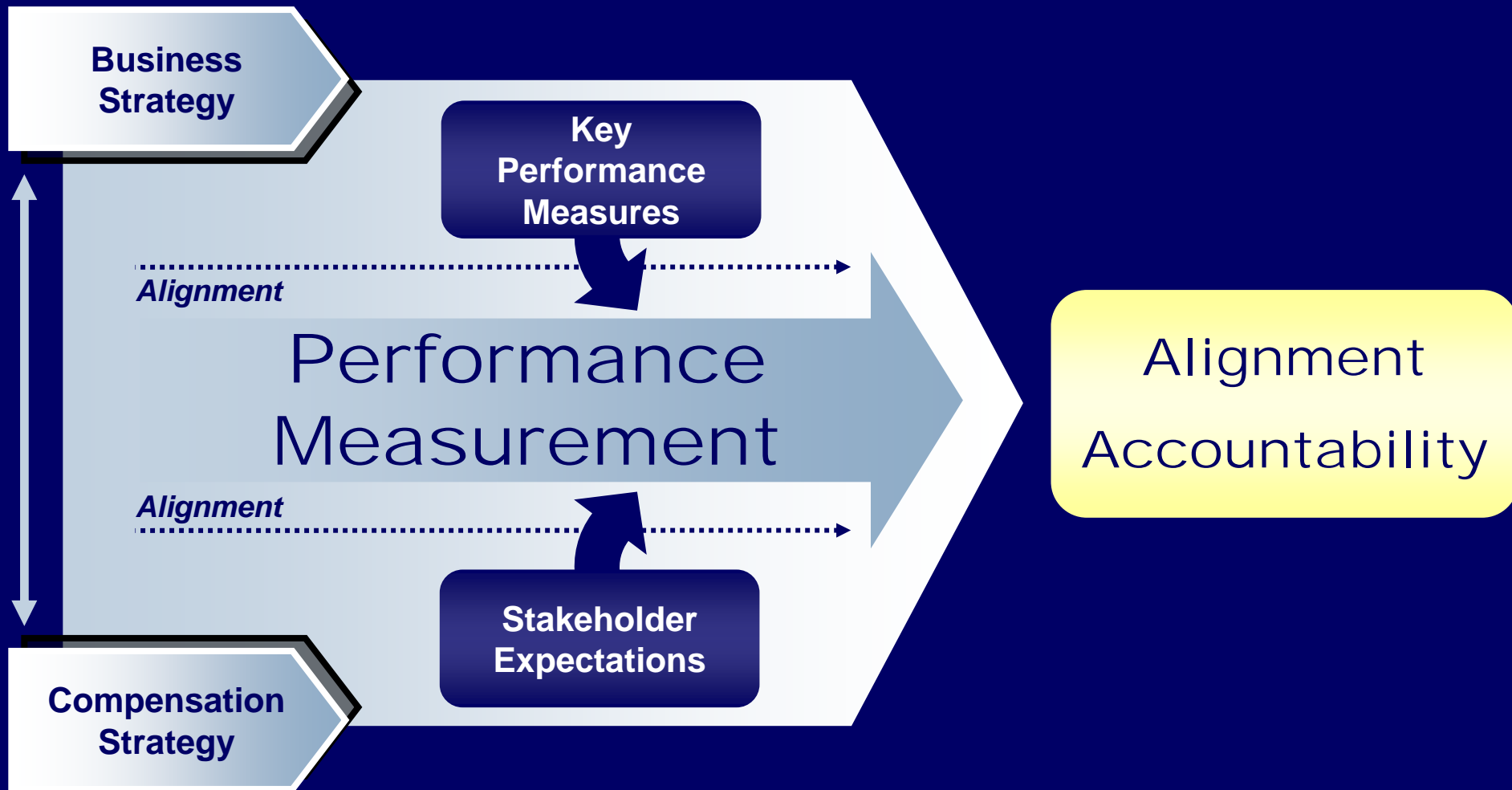
Directors often have to deal with two sets of critical performance measures. Why?

Not all critical performance measures are “compensible” or appropriate for inclusion in incentive plans (e.g., health of company)

Not all incentive plans are kept up to date with changes in the business/market

Many compensation plan measures “summarize” or capture a multitude of business performance measures

Need for Change - Alignment & Accountability



Next Up...

John Riley

- Lead Director and Compensation Committee Chairman for Baker Hughes
- Director and Compensation Committee Chairman for Allstate
- Director and Compensation Committee Member for Westlake Chemical