



# **Aligning Compensation Decisions with Shareholders Rights**

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**TWST Executive Compensation Conference**

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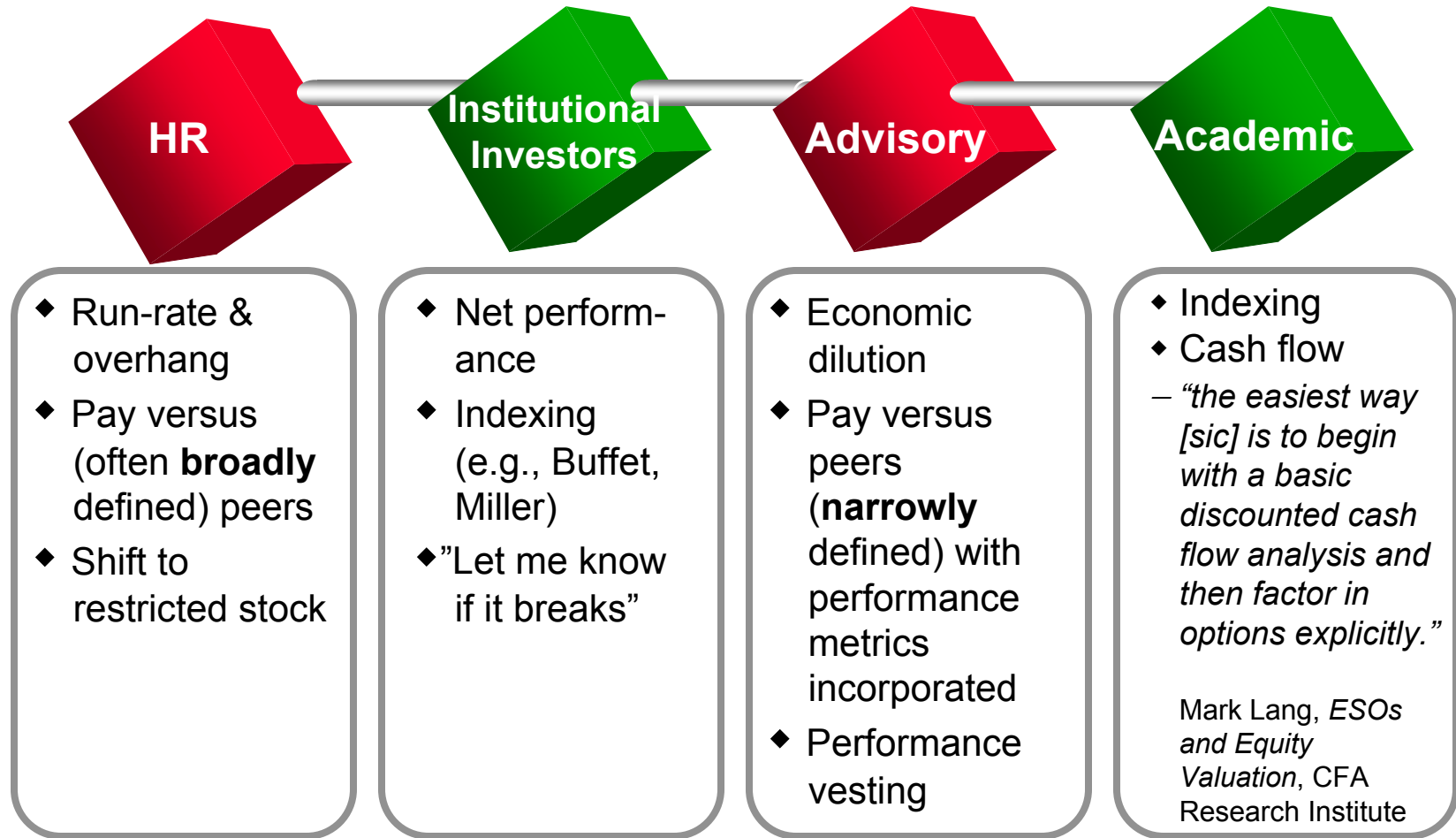
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# After all of the fallout, we are getting back to basics

-  Focus on pay-for-performance
-  Diversity of approaches
-  Good practices and examples

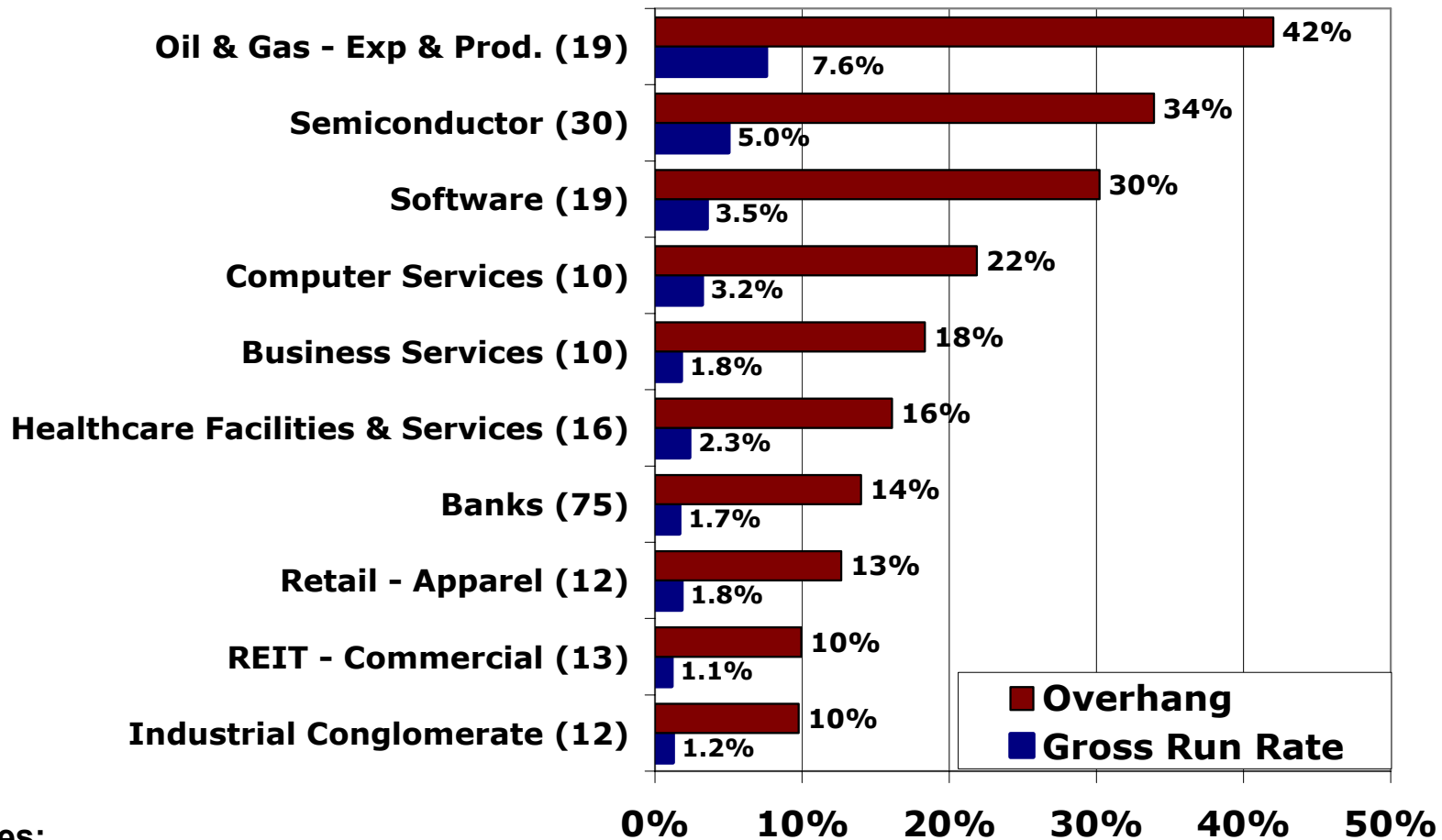
# Shareholder alignment – so many views, so little time...



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# HR professionals benchmark run-rate and overhang against industry standards as one test of alignment

## Overhang and Run-rate by Industry (Averages)



**Notes:**

Overhang = [# of options issued & available] as % of shares

( ) Indicates Sample Size

Source: Aon Consulting, Inc – eComp® Data Services

# Institutional investors are establishing progressive guidelines for pay-for-performance plans

- **TIAA-CREF**

- Equity-based plans should:
  - ◆ Emphasize restricted stock awards
  - ◆ Prohibit or severely restrict “mega grants”
- Adopt performance-based equity plans
- Limit the number of shares to be available for equity programs

- **CalPERS**

- Developed a model to evaluate CEO compensation
  - ◆ Measures against the median of a relevant peer index using various performance metrics
- Stated it intends to vote against:
  - ◆ Plans that do not require performance-vesting
  - ◆ Vesting periods of less than four years
  - ◆ Plans that give greater than 5% of total equity compensation to the top five executives

# The advisory firms are taking different approaches to measuring pay-for-performance

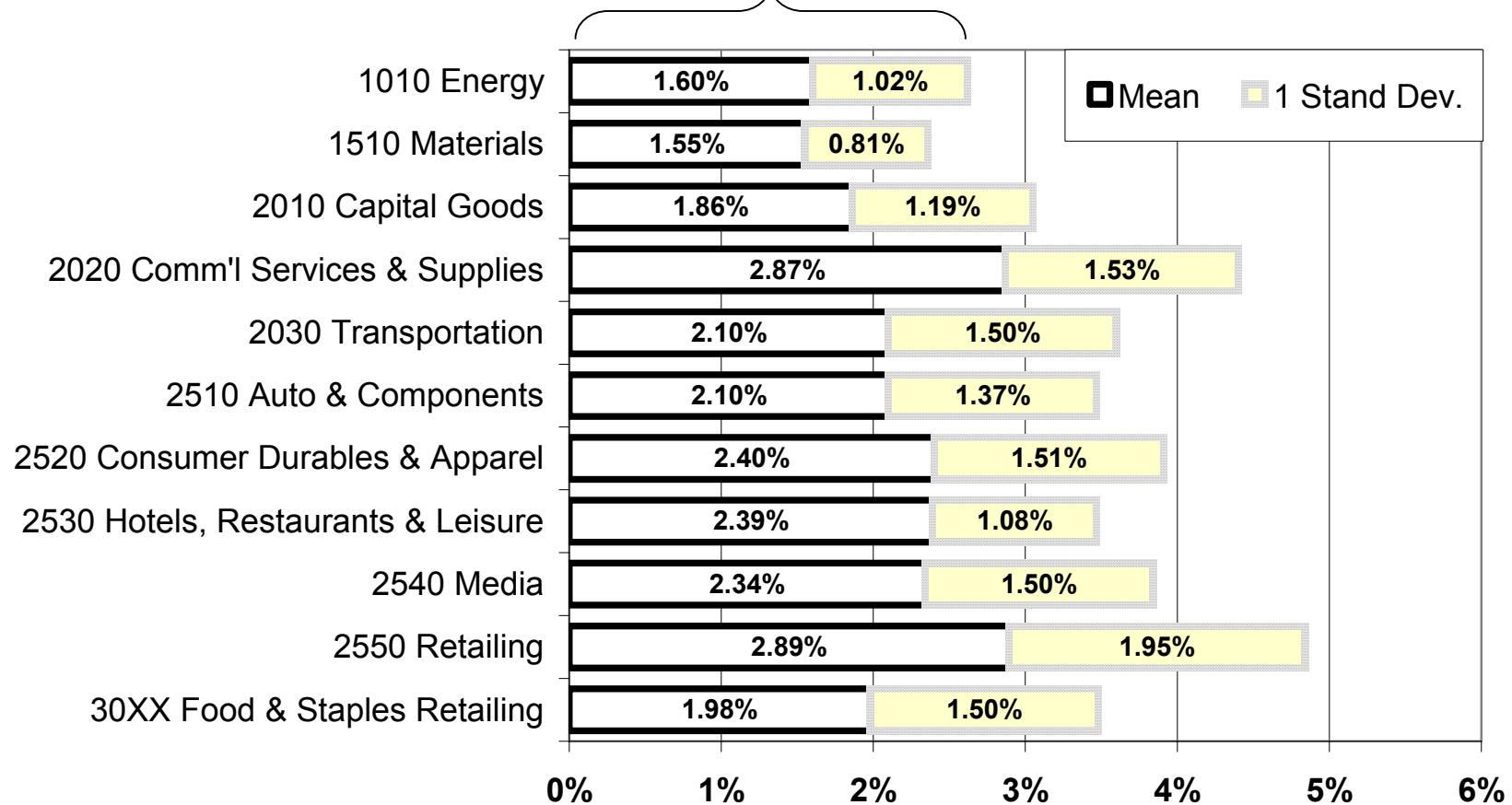
- Institutional Shareholder Services' (ISS) perspective
  - Measures CEO total direct compensation versus one and three-year total shareholder returns
  - Supports the use of performance-based awards
- Glass-Lewis has a *better* approach
  - Looks at percentile rank: relative pay versus relative performance
  - Compares the cost of options to income
  - Evaluates each company on a case-by-case basis
  - Thinks peer benchmarks are important, but also:
    - ◆ Often looks at multiple peer groups
    - ◆ Allows for some variation in pay mix (e.g., above median option cost may be due to lower cash compensation)

**A reactive shift to one-size-fits-all metrics (e.g., dilution caps and bottom-line governance statistics) will not serve investors in the long-run**

# However, companies can't ignore the recently introduced ISS run-rate thresholds

ISS 2005 Run-Rate "Thresholds"  
Russell 3000 (GICS 1000 - 3030)

Threshold for Energy:  
 $1.6\% + 1.02\% = 2.62\%$



**Note:** ISS sets the "threshold" equal to (i) the industry average plus (ii) one standard deviation. If a company's three-year average run-rate is greater than this threshold, it is considered excessive. See [Appendix](#) for remaining thresholds.

# There are seven practices that your company can use to align its compensation programs with shareholder rights

1

**Establish a pay-for-performance linkage**

2

**Select LTI vehicles to match Company strategy**

3

**Understand competitive positioning on burn-rate and compensation levels**

4

**Scrutinize compensation package from an investor perspective**

5

**Emphasize ownership**

6

**Establish Board structure and policies that support good governance**

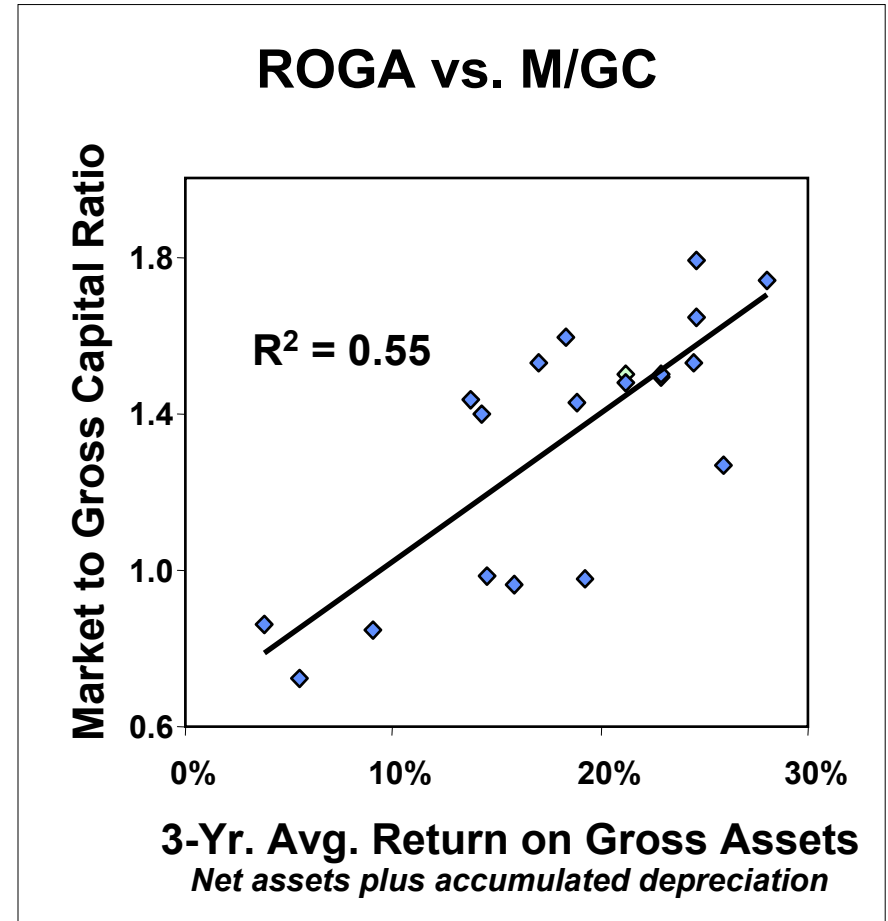
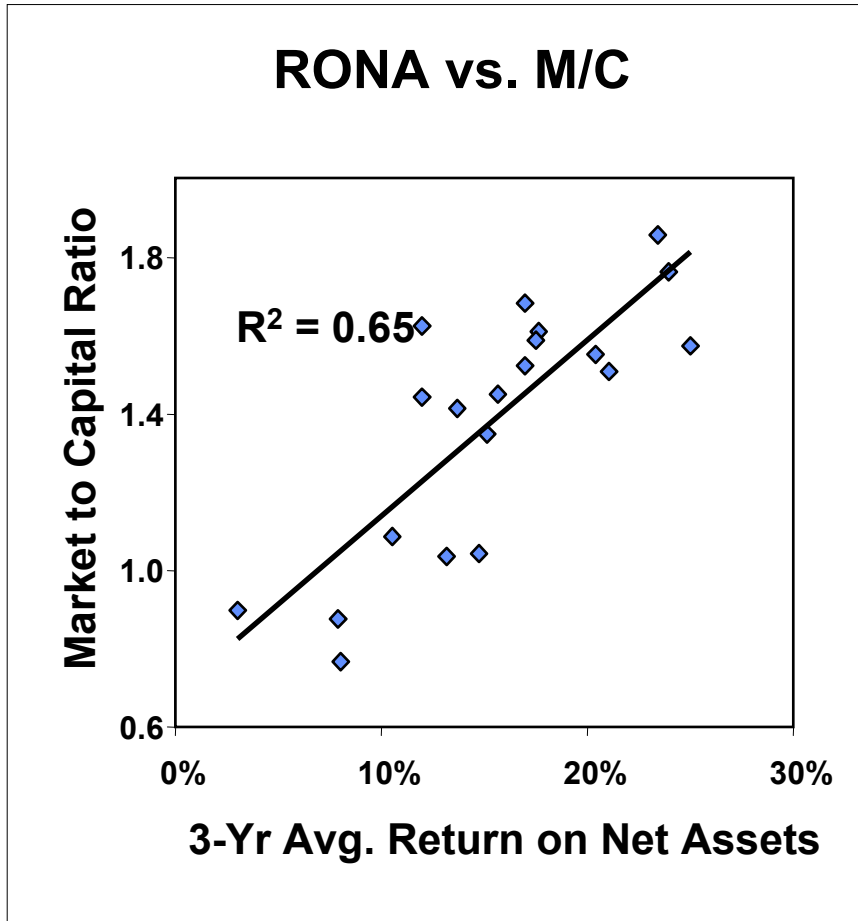
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**Provide clear and complete Compensation Committee reports**

# 1. Establish a pay-for-performance linkage

- Develop compensation programs based on Company strategy and measures that truly reflect Company performance
  - Thoroughly test the correlation between proposed measures and overall company performance
- Minimize the use of ambiguous and subjective metrics in pay plans
- Use absolute and/or relative performance targets
- Spend as much time on target-setting as you do on selecting performance measures
  - Budgets aren't always appropriate targets
- Back test actual pay vs. performance and scenario test for future

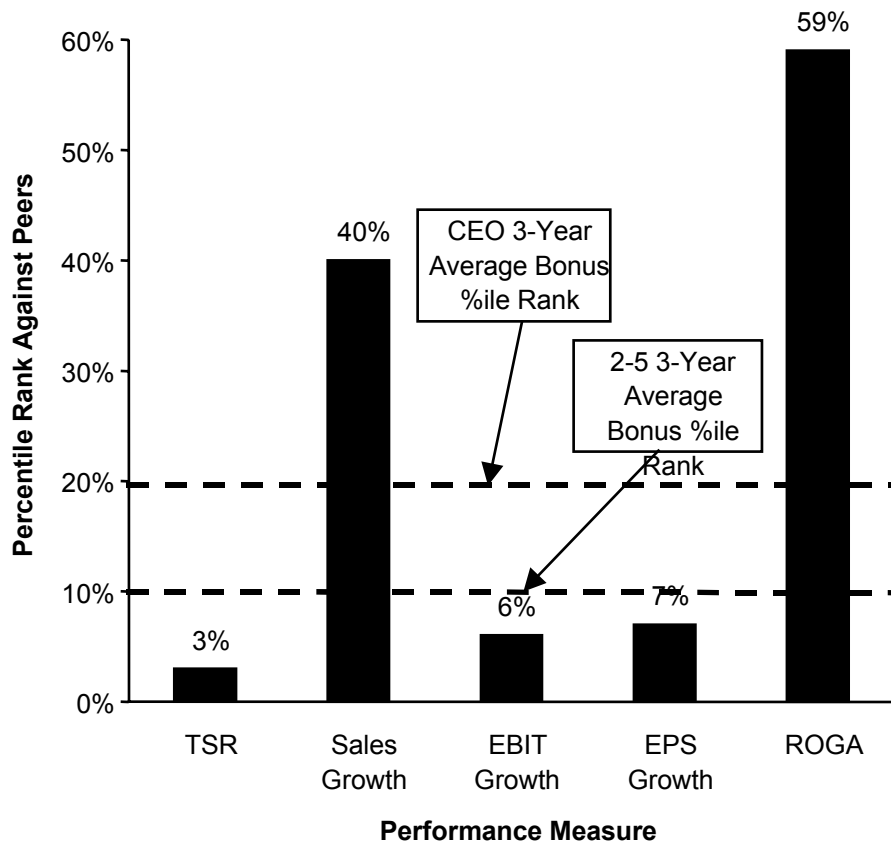
# One way to identify performance measures is to look at correlation with Company performance



# It is important to test bonus and short-term cash (STC) compensation payouts against key performance measures

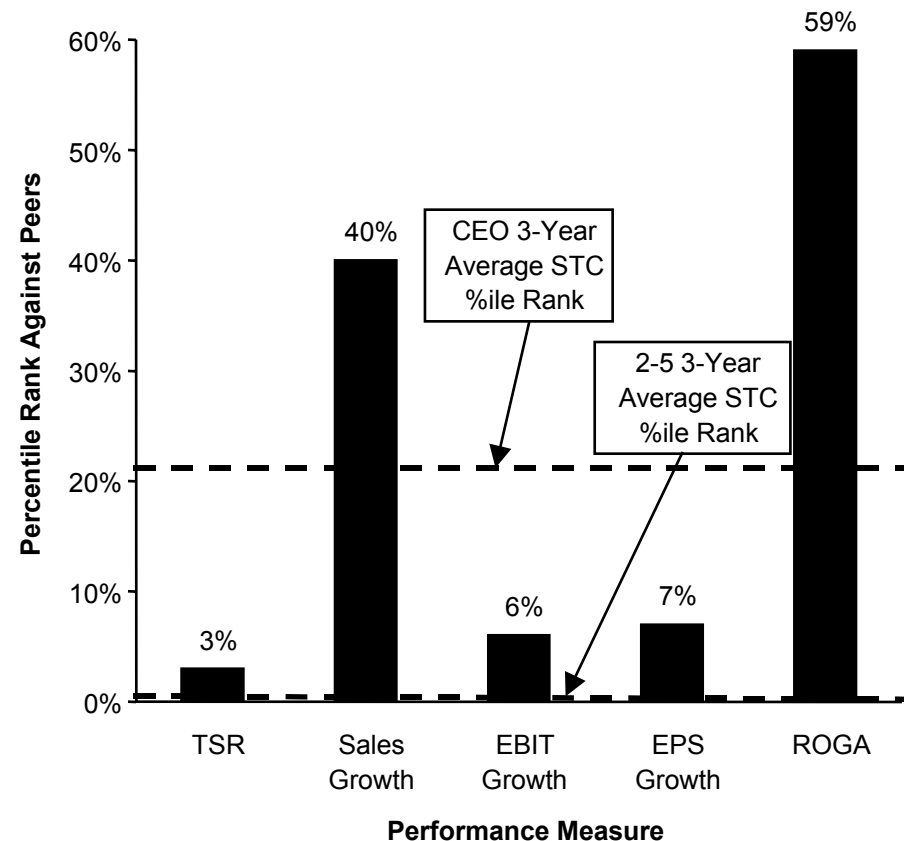
## Pay-for-Performance Calibration

3-Year Average Bonus vs. 3-Year Performance

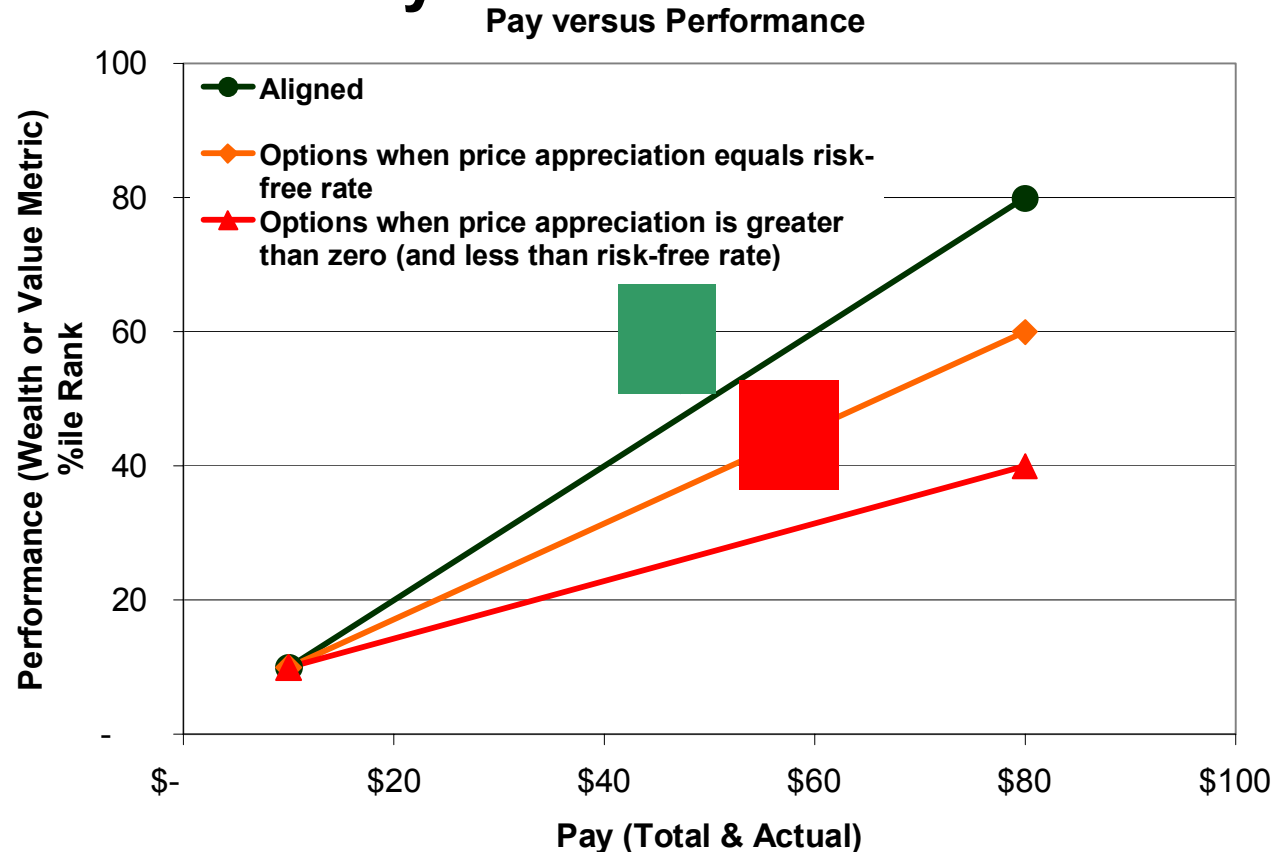


## Pay-for-Performance Calibration

3-Year Average STC vs. 3-Year Performance



# The pay-for-performance philosophy is straightforward but the timeframe and performance metrics will vary



Alignment is when *relative* total pay outcome tracks with *relative* performance outcome ranked relative to a peer group(s) or benchmark

## 2. Select long-term incentive vehicles to match Company strategy

- Different award vehicles drive different behaviors
- Consider performance-based vehicles
- Balance options with vehicles that have more of a medium to long-term horizon

# Companies select appropriate LTI vehicles based on strategic considerations

<u>Strategic Considerations</u>	<i>Plain Vanilla</i> <u>Stock Options</u>	<i>Plain Vanilla</i> <u>Restricted Stock</u>	<u>LTIP</u>	
			<u>Stock</u>	<u>Cash</u>
Is simple to understand	●	●	◐	◐
Links payout to stock price performance	●	◐	◐	○
Focuses on financial or strategic goals	○	○	●	●
Provides significant leverage	●	◐	●	◐
Links executive interest to shareholder interest	●	●	◐	◐
Promotes retention	◐	●	◐	◐
Encourages stock ownership	◐	●	●	○
Exposes executive to risk	◐	○	◐	◐

*Completely Satisfies Objective*
 *Partially Satisfies Objective*
 *Does Not Satisfy Objective*

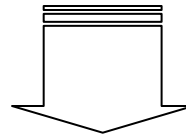
### 3. Understand competitive positioning on total compensation levels and burn-rate

- Benchmark executive compensation levels and practices, and burn rates periodically to understand competitive positioning
- Do the right thing for the Company regardless of competitive practice
- Regarding burn-rates:
  - Use a rough estimate of economic dilution <sup>(1)</sup>
  - Don't blend in restricted stock simply to reduce the number of shares used

(1) Economic dilution = [(options issued & available) + full value shares]/equity market capitalization

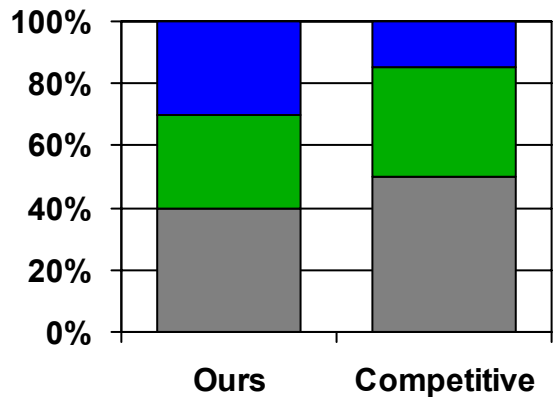
# Economic dilution is evaluated in the context of strategy and total compensation

Economic Dilution



Business Strategy

Competitive Total Pay Mix



- Long-term
- Annual Bonus
- Salary

## 4. Scrutinize compensation package from an investor perspective

- Establish claw back on bonus payments if earnings are overstated
- Reset change-of-control (COC) compensation
  - Reward only for stock price increase
  - Avoid “pay-for-failure” severance packages and technical COCs
- Understand how maximum payouts are earned and what the total company liability is in a “maximum payout” scenario

## 5. Emphasize ownership

- Establish mandatory stock ownership guidelines for executives
- Include exercise and hold provisions in stock option plans

## 6. Establish Board structure and policies that support good governance

- Calibrate Director pay to reflect level of effort, and to provide an appropriate balance of cash and equity
- Show investors how compensation signals proactive governance
- Establish a formal process by which the Board and Committees evaluate their own performance annually
- Eschew summary governance statistics

**Vivient Consulting has developed a self-evaluation tool for Compensation Committees.  
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## 7. Provide clear and complete Compensation Committee reports

- Write Compensation Committee reports that clearly describe the spirit and intent of executive pay programs
- Describe peer universe, performance metrics, and pay level determination
- Have Committee members write it, not attorneys
- Specify “degree of difficulty” in achieving performance
- Disclose detail of new employment contracts

# Intel's Compensation Committee report goes beyond boilerplate language

- Discusses role and responsibility of the Committee, including structure and process
- Provides a detailed compensation philosophy
- Discusses peer group, pay positioning, and different methodologies to set executive compensation
- Provides detail on performance-based compensation plans
- Explains why Intel used stock options vs. restricted stock and determination of grant amount and vesting schedules
- Includes special sections on stockholding guidelines and personal benefits

# In the future, there will be a continued focus on the relationship between pay and performance

- Dilution will continue to be a key measure
- Pay-for-performance nature of your compensation program must be communicable and saleable
- Shareholders want more disclosure
  - Don't finish with plan re-design and internal communication
  - You may get a lot of market purchase with a specific, tailored external message that explains the pay-to-performance features of your plan(s)

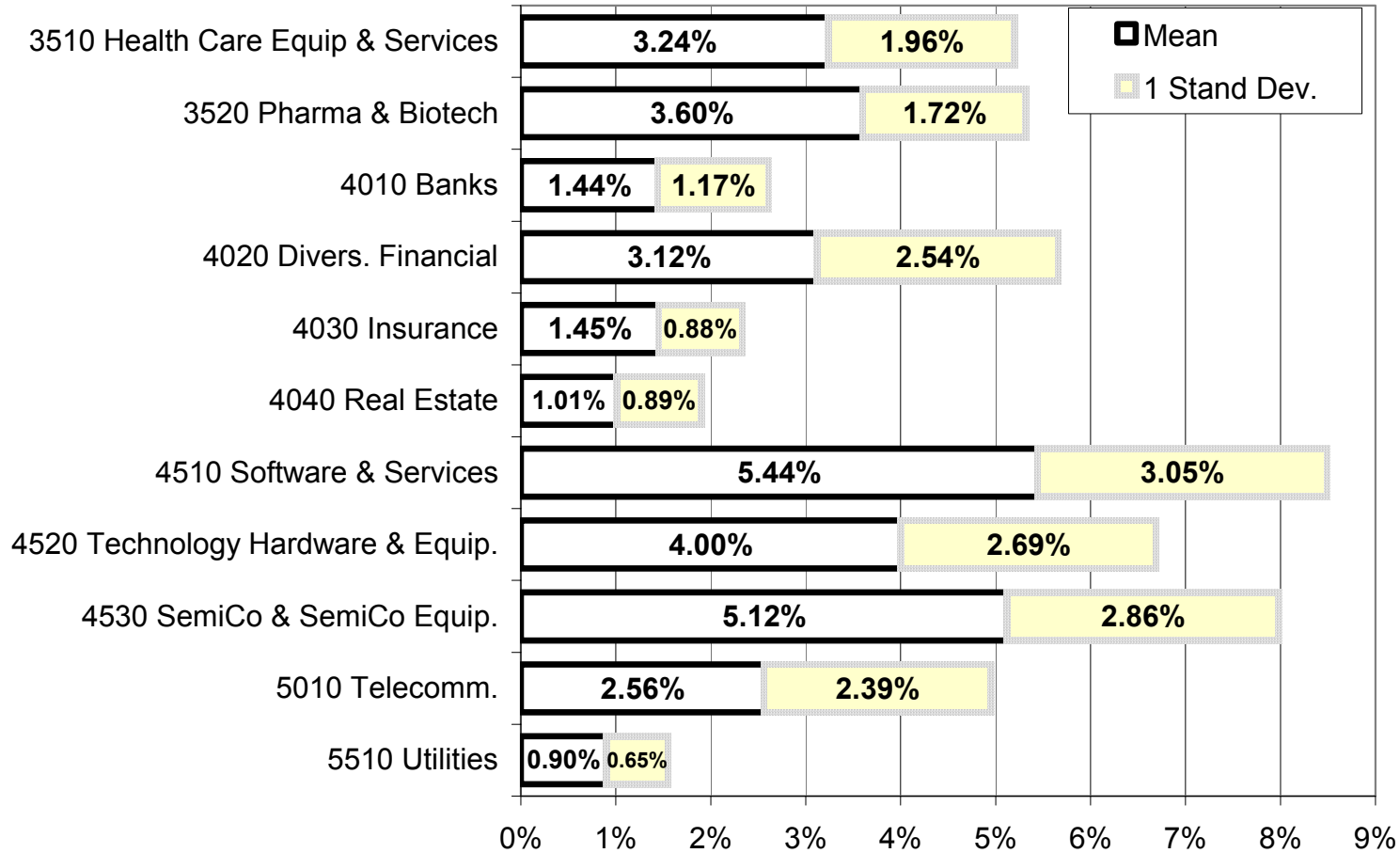


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# Appendix

# APPENDIX: ISS Run-rate (Burn Rate) Thresholds

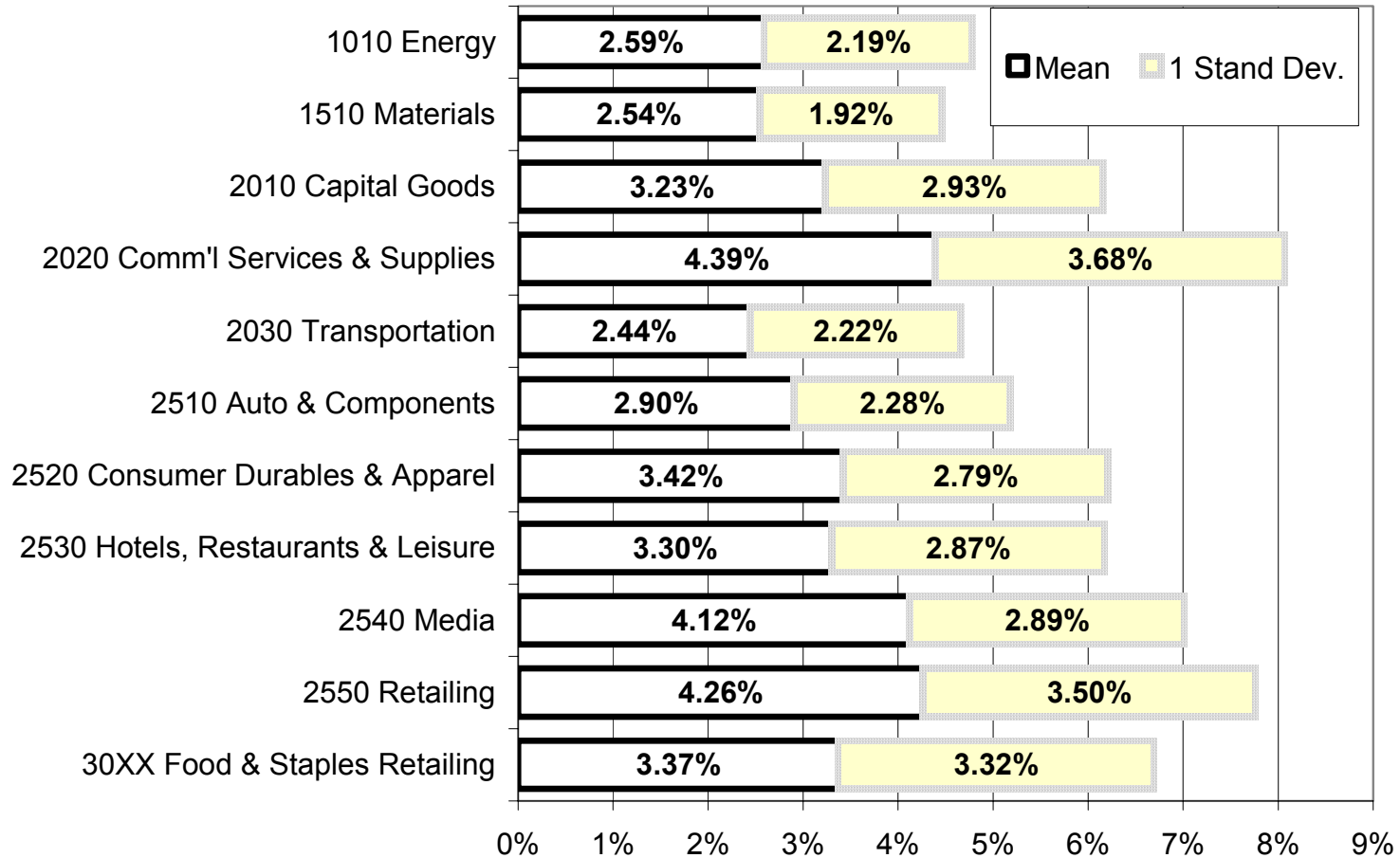
ISS 2005 Burn Rate Thresholds  
Russell 3000 (GICS 1000 - 3030)



Source: Frederic W. Cook & Co., Inc.

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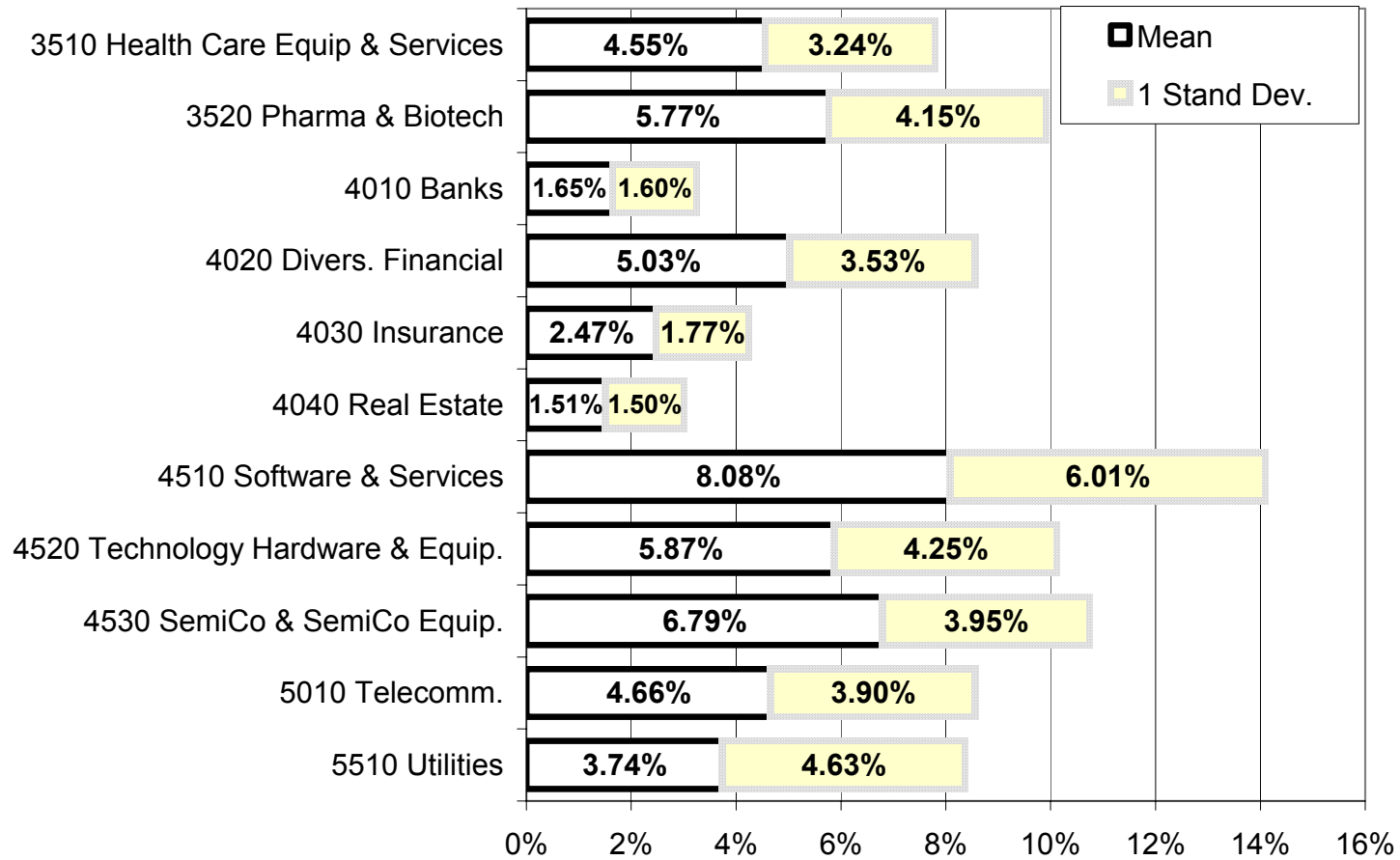
ISS 2005 Burn Rate Thresholds  
Non-Russell 3000 (GICS 1000 - 3030)



Source: Frederic W. Cook & Co., Inc.

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