CAP*flash*
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Early Compensation Trends: 2010 Proxy Season

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2009 was challenging as companies struggled to overcome the difficult economic environment. Now compensation committees are assessing company performance in 2009, making decisions on annual incentive payouts, and determining grants of long-term incentives. Committees are considering how to balance executive rewards with the interests of shareholders, not to mention the governance practices supported by shareholder advocacy groups such as RiskMetrics Group (see page 2 for RMG's list of problematic pay practices).

Based on the dialogue we have seen among compensation committees, we believe the 2010 proxy season will demonstrate that a new level of responsibility has taken hold. Management and committees are struggling to ensure they are doing the right thing when it comes to compensation and that pay is closely aligned with performance. Additionally, some of the incentive program designs and governance practices imposed on financial services companies operating under TARP have had an impact on other industries.

Some of the early trends we are seeing in 2010 are detailed below.

Base Salaries

In 2009, roughly one-third of companies did not give salary increases. Many companies even cut salaries for executives, typically by 5-10%. With the economy showing early signs of a recovery, close to 90% of companies are planning for salary increases in 2010. Merit pools are expected to be lower than pre-recession levels, typically ranging from 2-3%. While many companies are providing salary increases, they will use these smaller pools more strategically, by targeting top performers and highest potential executives, and withholding increases to others.

In the financial services industry, given the impact of TARP and other regulatory initiatives, compensation is being re-mixed. Many financial service firms had increases to rebalance the mix between fixed and variable compensation. This helps avoid any perception that leveraged compensation packages encourage excessive risk-taking. In addition an annual risk assessment is becoming integral to the committee's process across industries (this topic will be covered in the upcoming CAP*flash* on Risk Assessment).

Annual Incentives

Many companies' experiences during two recessions within the last decade have highlighted the challenges with setting targets for incentive plan purposes. Beginning in 2009, many companies have started to incorporate a greater level of discretion in their annual incentive plans.

Companies found that strictly formulaic incentive plans sometimes failed to capture the true quality of the financial performance delivered. Additionally, Committees increasingly want the ability to improve the alignment between pay and performance. Providing for a level of discretion over incentive payouts allows Committees to recognize non-financial factors, individual performance and the challenges management faced in delivering the financial results on a retrospective basis.

For 2009 payouts, we expect to see an increased use of discretion by compensation committees, with more in-depth analysis of the factors influencing payout decisions. This may include a review of multiple financial metrics, analysis of performance relative to peers, strategic and operational results.

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While results will vary by industry, we expect 2009 annual incentives payouts to exceed 2008 levels, when many companies paid zero or below target awards.

Long-term Incentives

In 2009, companies struggled to reconcile collapsing share prices with the need to recognize and reward their top performers and rising stars. Many companies did not grant equity as deeply or as broadly as they had in the past. In many cases, we saw a reduction in long-term incentive awards ranging from 10% - 30%. This decrease was partly due to efforts to manage annual share usage in a year with significantly lower stock prices In 2010, we are expecting grant values to level off or increase slightly as stock prices recover. We also expect to see a continued focus on performance-based long-term incentive plans and a decline in the use of or emphasis on stock options.

In 2010, individual differentiation will continue to be a key theme in long-term incentives as companies continue to manage their share usage and overall expense. The most dramatic examples occur deeper in the organization. At middle management levels, 100% may be eligible for awards, but typically 50%, and in some companies as few as 25%, actually receive awards.

Time-vested restricted stock and "salary stock" has become commonplace for companies operating under TARP. Outside of financial services, however, compensation committees have sharpened their focus on performance, employing a variety of performance-based awards. Shareholders and the various shareholder advocacy groups support these approaches, encouraging the trend.

Pay Mix

In 2009, many companies reviewed the mix of pay they offered. Companies want to ensure there is an appropriate balance between short and long-term compensation as well as fixed vs. variable pay. Within financial services, many companies re-balanced the amounts executives received in salary, annual cash incentives and equity. This rebalancing is intended to align the time horizon of compensation with the risk profile of the company and will vary by industry.

Clawbacks

Clawback provisions for annual and long-term incentives are becoming more common across industries. This is another example of a practice required by TARP spilling over into general industry. Clawbacks come in a variety of flavors. Some require employees to forfeit or reimburse compensation for a period of time if an executive engages in conduct that results in a restatement of financial results. Other clawbacks are fashioned more broadly, allowing companies to recoup compensation if results deteriorate over time for any reason. Providing for clawbacks helps further align pay and performance and mitigates the potential risks of executives making short-term decisions that have a detrimental impact on the company over time. Some companies, especially in financial services, are increasing

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RiskMetrics Group Problematic Pay Practices

While not a complete list, RMG views the following as problematic pay practices:

- Multi-year guarantees for salary increases, non-performance based bonuses, and equity compensation;
- Including additional years of unworked service that results in significant additional benefits, without sufficient justification, or including long-term equity awards in the pension calculation;
- Perquisites for former and/or retired executives, and extraordinary relocation benefits (including home buyouts) for current executives;
- Change-in-control payments exceeding 3 times base salary and target bonus; change-in-control payments without job loss or substantial diminution of duties ("single triggers"); new or materially amended agreements that provide for 'modified single triggers' (under which an executive may voluntarily leave for any reason and still receive the change-in-control severance package); new or materially amended agreements that provide for an excise tax gross-up (including "modified gross-ups);
- Tax reimbursements related to executive perquisites or other payments such as personal use of corporate aircraft, executive life insurance, bonus, etc;
- Dividends or dividend equivalents paid on unvested performance shares or units;
- Executive using company stock in hedging activities, such as "cashless" collars, forward sales, equity swaps or other similar arrangements; or
- Repricing or replacing of underwater stock options/stock appreciation rights without prior shareholder approval (including cash buyouts and voluntary surrender/subsequent regrant of underwater options)

the use of deferred compensation to make it easier to recoup compensation later, if the need arises.

Stock Holding Requirements

The requirement to hold stock for a period of time following vesting or exercise of options has become increasingly prevalent over the last few years, although still not a majority practice. Companies with such requirements generally ask executives to hold 50% to 100% of net shares for a period of one to three years, or even to retirement or beyond for a minority of companies. Stock holding requirements continue to be a focus for companies as they are viewed as another practice to mitigate risk in compensation programs. Stock ownership guidelines, most often expressed as a multiple of base salary, are common for most companies. Some companies are re-evaluating their stock ownership guidelines and denominating the guideline in shares as opposed to a multiple of salary as a response to the volatility in the market.

Change in Control Protections

Pressure from shareholder advisory groups and activist investors are leading to reductions in change in control protections. As companies review their programs, many are committing to eliminate gross-ups on 280(g) excise taxes going forward. Some of these companies are grandfathering this provision for existing participants, while select companies are eliminating them completely for all participants. A few companies are asking executives with contractual rights to gross-ups to waive them. These companies recognize that gross-ups are a red flag in the current environment and acknowledge that the potential cost to the company, or acquiring company, far exceeds the benefit to the executive. As companies eliminate the gross-up feature, some provide the executive with the choice to receive the full amount of their change in control benefits and pay the excise tax themselves or reduce the benefits to a level just below the level which would trigger the excise tax payment.

In addition to eliminating gross-ups, more companies are moving to double-trigger vesting on equity following a change in control (i.e., executive must be terminated without cause or terminate for good reason following the change in control).

Summary

The magnitude of the economic crisis increased the level of scrutiny of executive compensation practices over the past two years to unprecedented levels. The actions we have seen companies take in 2009 have been greatly impacted by the environment. As companies release their proxy statements in the next few months, we will get a better sense of the final decisions, but we believe that both senior leaders within companies and compensation committees are supporting a new level of responsibility and accountability.

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