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The Future of Executive Compensation

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Naples, Florida

Current Environment



- Widely held view is that executive compensation is “out of control”
 - Corporate “misdeeds” (option backdating, etc.)
 - 2006 vintage
 - Now in “sentencing” phase
 - “Egregious” compensation arrangements (e.g., NYSE and others)
 - “Pay for failure” severance deals (Disney, Home Depot, Countrywide, Merrill Lynch, Citigroup, etc.)
- Past attempts to control executive pay include:
 - New proxy disclosure requirements
 - FAS 123R
 - Section 162(m) – million dollar pay cap on deductible compensation

Bank Bailout Bill Executive Pay Limits



New Limits

- Million dollar pay cap becomes:
 - \$500,000 pay cap on deductible compensation
 - No carve-outs for performance-based pay
 - Outcome: Executive pay will cost more in bailout participating institutions due to lack of tax deduction
- Limitations on severance pay
- Elimination of “risky” incentives
- Clawbacks for inappropriate incentives extended to all named executive officers

Auto Bailout Bill – Additional EC Limitations



Additional Limitations

- Auto companies are treated as “systemically significant failing institutions”, or SSFI – most restrictive definition in bank bailout bill
- Additional limitations:
 - No golden parachute payments (read: severance)
 - No bonuses to top 25 executives
 - No corporate planes
- New administration may modify provisions

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Two Likely Key Issues Going Forward

- Bank/auto bailout bill:
 - Could be extended to all companies
 - New limiters could be developed (e.g., \$1 million limitation on non-qualified deferred compensation)
- Revival and implementation of “say-on-pay”
 - Has passed the House – Barney Frank is the House sponsor
 - Stuck in Senate subcommittee – Barack Obama is Senate sponsor
 - Expect passage in 2009 with implementation in proxy statements in 2010



Potential Impact

- Too early to tell in the U.S., but in place in the UK since 2002-2003
- Two key outcomes in the UK:
 - Changes in how Compensation Committee operates:
 - Direct dialogue with institutional investors
 - Designed to ensure at least an 80% yes vote
 - Severance pay redefined as “pay for failure”:
 - Significant reduction in payouts – one times salary is the norm – from previous US-type severance levels
 - Same kind of reductions beginning to happen in the U.S.

Other Future Changes in Executive Pay



- Continued restraint in equity incentives
 - Mega grants will continue to be rare
 - Limitations on shares available are significant when share prices are depressed
- Change in control agreements
 - Pressure on excise tax gross-ups
 - Very negative for shareholders from a cost-benefit perspective
 - Being replaced by hard or modified caps on payouts
 - Double triggers for equity
 - CIC and termination both must take place, similar to requirement for cash payouts
 - Driven by desire to leave performance/retention incentives in place post-transaction