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The Future of Executive Compensation

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Tampa, Florida

Executive Compensation



Multi-Year View

- 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

Executive Compensation in Today's World



Main Event	Significant Impact	Impact on Executive Pay
Economic Recession	Financial performance declining Limited visibility to the future	Salary increases/ down in 09 Variable pay down in 08 Challenging goal setting for incentive plans
Stock Market Declines	Large daily swings – mostly down Seemingly disconnected from earnings High degree of uncertainty	Underwater stock options Grant rate and shares available challenges Relative measurement?
Government Bailout	Financial rescue (TARP) Auto bailout “Stimulus” package	Direct limits / constraints Mandated “clawbacks” Moderated incentives for risk Extension to all companies(?)
High Profile Fraud	Madoff ponzi scheme Satyam financial fraud The Stanford Group	Eroding confidence Reminder of prior “misdeeds” Focus on process / controls
Democratic Control	Pres. Obama Democratic Congress Growing populist orientation	Say on Pay legislation 162(m) modifications Rising marginal tax rates AIG bonus tiff



Current Outcomes

- Impact on time spent on Compensation Committee matters
- Increased influence of Risk Metrics/Glass Lewis
 - In the Committee meeting room every year with say on pay
 - Need by Committee to sell executive pay package every year to shareholders and institutional advisors
 - Increased focus on “poor pay practices”
- Ever increasing media hype and attention
- Definition of reputational risk - What if you were the AIG Compensation Committee Chair?
 - 82,800 Google hits
 - Probably none of them good
 - Potentially voted out of office in context of:
 - Government appointed trustees with 80% of the vote
 - Pressure from activists to not vote for Chair
 - Not likely “what he signed up for”

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

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Two Likely Key Issues Going Forward

- Extension of bank/auto bailout bill provisions:
 - 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 – Rep. Frank is the House sponsor
 - Stuck in Senate subcommittee – President Obama was 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 and result in lower grant values
- 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



Questions

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. Answers