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The Future of Executive Compensation

April 22, 2009

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

The Future of Executive Compensation



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

&

. Answers