



IOMA'S COMPLETE GUIDE TO BEST PRACTICES IN PAY FOR PERFORMANCE

Chapter 5: SOLVING THE EXECUTIVE PAY PUZZLE

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How to Create a Successful CD&A

While companies are getting savvier about complying with the Securities and Exchange Commission's (SEC) two-year-old executive-pay disclosure regulations, compensation committees are still seriously challenged by the Compensation Discussion and Analysis (CD&A). Fortunately, there are steps that can help you prepare more transparent and compliant CD&As that will meet the needs of the SEC and your investors, notes Edward Speidel, senior vice president, Radford Surveys + Consulting, (www.radford.com) an Aon Consulting Company and leading provider of market compensation intelligence and consulting to the high technology and life sciences industries. Before joining Radford, Speidel was principal and national executive compensation practice leader for Mellon Human Resources & Investor Solutions (formerly Buck Consultants) and managing director of the Northeast compensation practice for PricewaterhouseCoopers. He is a certified compensation, benefits and equity professional.

In this article, Speidel offers insights into just what the SEC is looking for and provides a comprehensive roadmap for providing it. He also discussed this strategy in a February 2008 Radford webinar, *2008 Proxy Season: New Challenges and Opportunities*.

Four Special SEC Requests

"So much has been happening with executive compensation from a regulatory and legislative standpoint that it can be a bit overwhelming," Speidel acknowledges. "For example, the SEC sent more than 300 letters to companies after the first round of proxies under the new regulations citing issues with the way companies created their CD&As." Also, he adds, if you look at Edgar (www.edgar-online.com) and review companies' SEC filings, you will see that there is much room for improvement.

In analyzing the letters and other SEC comments regarding companies' CD&As, Radford has distilled all the feedback into four "SEC special requests" that companies need to be aware of as they file proxies in the future:

SEC Request 1: Enhanced analysis of executive pay decisions. "Companies need to discuss not only the what but also the how and why of each element of executive compensation," Speidel stresses. For example, you need to provide answers to the following questions:

- *What was actually delivered to the executive?*
- *How did the compensation committee arrive at the amount of each element paid—what process and analytical tools did the committee employ?*
- *Why did the compensation committee pay the actual amount delivered to the executive?*

Keep this in mind: “In particular, you need to justify any payout that was well above or below the stated target as well as any differing payouts made to different executives,” Speidel stresses.

Best practices: Examples of companies that did an effective job of providing a thorough analysis of their executive pay decisions include Schering Plough (which provided a particularly good discussion of equity grants), Dell (which provided a good integration of compensation philosophy and business strategy) and Mindspeed (which gave an effective, detailed description of the performance and pay connection for each named executive officer).

“Last year a lot of companies described their executive pay programs but they did not provide the analysis and language that justified the payouts executives were getting,” Speidel notes. “Be aware that the SEC is dead serious about this issue. They want a particular level of analysis and they want to know the tools used in achieving that analysis as well as the conclusions that were drawn and how and why those conclusions were drawn. Make sure to include exactly how you decided what amounts of pay would be given to what executives, and how the philosophy or the payouts differed for each executive.”

SEC Request #2: Detail benchmarking, tally sheets, and other analytical tools. “The SEC wants to know what level of benchmarking actually occurred,” Speidel says. For example, you need to provide answers to these questions, among others:

- *What peer group did you use?*
- *Did you also use compensation surveys and if so, what were they?*
- *How did you use each tool in reaching a judgment around pay?*
- *What did each tool show?*
- *What judgments did the committee make on the basis of the data?*
- *What specific actions/decisions were taken by the committee as a result of its analysis?*

“For example, if you used a tally sheet and the executive already had a large position in “in the money” stock options, did that influence your decisions about long-term incentives? The CD&A should describe how tally sheets, benchmarking, and summaries of wealth

accumulation factored into the compensation committee's deliberations," says Speidel.

Best practices: Examples of companies that did an excellent job of explaining their use of analytical tools include Google (which provided a clear discussion with detailed tables about who the executives' peers were and how it reached the conclusion of why these were reasonable peers for their company) and Becton Dickinson (which gave a very good discussion of its use of tally sheets).

SEC Request #3: Describe the interplay of the various elements of executive pay. "The CD&A should not only explain each element of executive pay in isolation, but also discuss how the delivery of one element may have impacted decisions about the other elements of pay," Speidel explains. Questions to answer here include:

- What is the targeted level of overall compensation versus the market?
- What does the compensation committee target in terms of long-term versus short-term pay and fixed versus variable compensation?
- How might the pay mix vary between the CEO and other executives?

Best practices: Examples of companies that did a good job in describing how their various pay elements interrelated were Apple (which effectively explained the role of cash versus long-term incentives) and Dell (which provided a good explanation of why it was moderating base pay to provide more short-term incentives).

"What the SEC wants to know here is, why did you choose to focus on variable pay versus fixed pay, long-term incentives versus short-term incentives, etc.? How does the way you made your choices tie into your philosophy as a company? What is it about the particular stage of development your company is at that caused you to use this element of pay in this type of approach?" Speidel points out.

SEC Request #4: Disclose material performance targets. "This is the most important—and potentially sticky—area because it addresses your metrics around short-term and long-term incentive plans," Speidel notes. "Companies should disclose their material performance targets in both short-term (bonus) and long-term 'performance-based' comp plans, unless any omission can be justified under the 'competitive harm' standard.

"Basically the SEC has said that if a given performance target is material to your pay program, it should be disclosed unless it is a confidential trade secret or financial information whose disclosure might cause competitive harm. If a material metric is omitted under this standard, you need to explain the unique characteristics of the industry or the metric that would make disclosure to competitors harmful. Also, you need to disclose in detail the level of difficulty of achieving the target level of performance and you must use a context that is amenable to easy comprehension—for example, comparing to last

year's performance.

"A lot of companies are reluctant to comply here," he continues. (See box: Divulging Proprietary Information Causing Concern.) "Almost none of the CD&As we reviewed included this type of detail. Although SEC rules did provide an out—competitive harm—the SEC was not satisfied with what they saw in the CD&As for 2007. Companies were either silent or made a boilerplate assertion of competitive harm. You have to provide a cogent case for why and how disclosing these metrics would cause competitive harm."

The bottom line: The SEC really wants to see these metrics—or in the absence of actual targets they want to see at least some discussion of how difficult those metrics would be

Divulging Proprietary Information Causing Concern

Radford's Edward Speidel reports that there has been a great reluctance on the part of companies to divulge proprietary information in their CD&As. At issue is pay-for-performance, a major area of interest and concern for investors, who for years have pushed for more performance-oriented programs using short- and long-term incentives that are based on specific company metrics. Response letters (letters written by companies in response to the SEC's Comment Letters containing questions for companies regarding their disclosure filings) that were reviewed by Radford consultants clearly indicated that the regulations have left many companies concerned that providing this information may lead to unintentionally disclosing proprietary information in the process.

"Many companies believe it's difficult for them to disclose corporate metrics around short- and long-term incentive plans," says Speidel. "Companies that resist this year, however, will be asked to provide a convincing case for why and how it would be competitively harmful to disclose this information, especially information already reflecting results that are publicly disclosed."

Faced with the need to explain the rationale for each material element of their executive compensation programs, companies are using their upcoming CD&A reports as a starting point and re-evaluating whether they contained sufficient executive compensation disclosure information and the "why" and "how" behind the decisions in rewarding executives. "While many companies did a good job with their CD&As in 2007, there were also many that missed the mark and probably received a free pass," Speidel points out. "Those who choose not to follow the true intent of all the rules this year are going to find themselves being challenged by the SEC and other corporate governance agencies much more than in previous years."

Good advice: Public companies should outline the lessons they learned from the previous proxy season and begin the implementation process for the next proxy season as early as possible. Radford advises the following key action items:

- Make it clear that you understand the vulnerabilities of your current compensation program and have acted to make them more performance oriented and shareholder friendly.
- Use "plain English" as opposed to boilerplate content or legal jargon, explaining the reasons behind payments to executives and not just the amounts.
- Review and incorporate important feedback from investors.

Step for success: Do your homework. "I'm always surprised by the number of internal human resources, legal and compensation professionals I speak to who have never picked up the corporate governance quotient that Institutional Shareholder Services (ISS) of Risk Metrics distributes each year," says Speidel. "It's very important that you take the time to read it, understand what ISS is saying about your company from a governance and practices perspective, and factor these issues into pay discussions with your compensation committee."

to achieve. For example, you could provide a discussion of how often threshold, target and maximum targets have been reached over the last one, two or three years.

Best practices: Northrop Grumman (which provides a good example of a way to not disclose actual targets but still provide a meaningful discussion that helps shareholders better understand their incentive compensation program) and Biogen/dec (which did disclose their threshold and maximum targets for short-term incentives).

What Investors Are Looking for in the CD&A

It's wise to keep in mind what your investors are looking for as you prepare your CD&A statements, Speidel stresses. Here are the factors you want to include in your CD&As to keep your investors happy:

Performance linkages. "You want to make sure your compensation plan is performance based and explain in the CD&A how your plan promotes long-term value creation for shareholders," Speidel says.

Suitability/appropriateness for your company. "Investors want to know how the plan is related to your company's business strategy. Explain how the plan is customized to suit your company's size, industry, performance, and competitive position," he advises. "Also, investors want to know how the compensation plan is suited to your company's particular stage of growth."

Clarity and comprehensiveness. "Make sure the information is clear, complete and understandable. Your plan's metrics, hurdles, and goals must be clearly and specifically disclosed and understandable. They must make sense and clearly articulate a coherent compensation philosophy that is appropriate to the company and clearly understood by directors," Speidel notes.

The bottom line: "Investors are going to be asking, 'Does this pay program avoid abuses?' and the most important question, 'Are we convinced?' You must make a convincing case that executive compensation is linked to the performance of your company and encourages executives to maximize shareholder returns," he stresses.

"It's not enough to have your lawyers sit down and write boilerplate copy. The CD&A must provide investors with a meaningful explanation of how your compensation philosophy advances the business objectives of your company."

Key HR/Compensation Action Items

According to Radford, here is a good roadmap for preparing your CD&As:

Identify any current areas of vulnerability in your compensation programs, processes, and/or disclosure practices. "Understand where your programs, processes and practices might be vulnerable to SEC and investor scrutiny and make the necessary

adjustments," Speidel advises.

Understand any distinct disconnects between pay and executive performance. Fill those gaps so that you can provide a sound discussion of your company's well-linked pay-for-performance philosophy and practices in your CD&A.

Assemble a team (internal and external) early and coordinate efforts. "Involve HR/compensation, finance, accounting, investor relations, legal, and any other appropriate internal experts to lend their expertise to the process of creating your CD&A," Speidel advises.

Understand your institutional base. "Understand your investors and their unique policies and perspectives on executive pay. Also, understand their policies regarding share requests," he suggests.

Review last year's CD&A in the context of SEC comments. Learn from past mistakes. If you make the same mistakes again, there will be no more "free passes," Speidel warns. There could be enforcement or other negative consequences for CD&A shortfalls in the future.

"If you are not meeting the rules this year there will be many more challenges by the SEC and others. Make your pay program discussion very content-oriented in terms of how your pay decisions are made. Enhance transparency wherever possible. And if you had to make reforms to any aspect of your pay program, explain this." Investors will react positively when they see that companies are aware of what needs to be changed, willing to make the needed corrections and open about discussing what they did.

Review any other feedback you've received about your CD&As. "Look at feedback from investors, proxy advisors, the ISS or any other sources. Incorporate that feedback into the preparation of your CD&A," Speidel recommends.

Provide a roadmap for the reader. "Make sure your CD&A includes an executive summary, good titling, and a clear flow within the document," Speidel advises. "In the executive summary, list a comprehensive review of your pay program and each of the elements in executives' compensation packages.

"Very few companies—perhaps 15 percent—provided executive summaries last year. This year so far, upwards of 40 percent are including executive summaries. CD&As are getting more concise and more content rich."

Consider what you can do to help your compensation committees. "Compensation committees are in the hot seat. You can help them in a number of ways," says Speidel.

"Understand the ways in which your current compensation program lacks leverage. Eliminate disconnects in terms of payouts, excessive severance, and change-in-control

arrangements. Know who your investors are, understand their concerns about equity plans and executive pay, and be aware of their hot buttons.”

Think of your CD&A as a marketing vehicle. “Your CD&A should serve as a vehicle for marketing your company’s highly effective, well-conceived pay practices,” Speidel points out. “Tell your story in a positive, credible way.

“One of the biggest mistakes companies make is treating their CD&A as a legal document. Yes, the CD&A does create liability, but you can use it in a much broader way to say positive things about your company’s approach to compensating its executives.”