

# CSUITE

## INSIGHT

# RISK

## THE STATE OF EXECUTIVE COMPENSATION

10 for 2010  
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AND WHY THEY MATTER**

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## LETTER FROM THE PUBLISHER



David has led Equilar from a pure start-up since its inception in 2000 to one of the most respected and trusted names in the executive compensation industry.

# WELCOME TO C-SUITE INSIGHT

**W**E SPEND a lot of time focusing on executive compensation, yet much of our research seldom makes it directly into the hands of the people we focus on (you). More often than not, you come across our findings when *The Wall Street Journal*, the *New York Times*, *Fortune*, *CNBC*, *BusinessWeek*, or other media outlets report on them. Did you read a recent story about TARP, clawbacks, private jet use, retiring CEO pay packages? It's most likely that the data came from our research.

We launched *C-Suite Insight* in the spirit of contributing in a meaningful, editorially independent way to a new dialogue highly focused on simplifying the complexities of executive officer and director compensation, along with tangential perspectives.

Without question, scrutiny is at all-time record levels, as shareholders, politicians, and the media all do their part to keep the pressure on senior executives and board members. In fact, last fall, we hosted two events focused on executive compensation — one in New York and another a week later in Silicon Valley. Both events were oversubscribed and broke fire-code laws, and featured an all-star roster of executive compensation experts, truly the people who are closest to the action when it comes to structuring and analyzing packages.

Now, with the launch of *C-Suite Insight*, we've developed some key feature articles drawn from information we've compiled here at Equilar, and provide some key expert commentary from luminaries across business strategy and marketing. We're also having a little fun along the way.

So enjoy, and please feel free to reach me at any time with your comments. **C**



DAVID CHUN  
CEO, Equilar  
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Joseph A. Grundfest is a nationally prominent expert on capital markets, corporate governance, and securities litigation. His scholarship has been published in the Harvard, Yale, and Stanford law reviews.

## TO PUT IT BLUNTLY, PEOPLE ARE ANGRY

**M**ANY PEOPLE BELIEVE compensation structures were a causal factor in the financial woes of 2008/9. This school of thought suggests that if we simply change executive compensation structures, we will meaningfully reduce the probability that we'll again run into the kind of problem we've just had.

But the uncontested truth is that many different groups of people got it wrong before the crisis, not all of them nearly as highly compensated as top executives. To be sure, executives did not see the train wreck coming. In fact, some of the most highly compensated executives were the same people who lost the most money individually.

Meanwhile, the Boards at these companies did not see the train wreck coming, and neither did the Fed, nor the SEC, nor the armies of bank examiners who were assigned to all these organizations. Yet compensation structures and incentives were very different across these groups.

This suggests that compensation structures may be orthogonal, i.e., unrelated, to the type of problem our economy just encountered. Thus, to me, it is intellectually indefensible to blame the problem on compensation structures. But it is politically popular (and practical) to do so. That is the reality.


To put it bluntly, people are angry. They're angry that unemployment continues to be very high, that aggregate wealth is down, that the economy is hurting. They're angry that while all this is going on, especially in financial services, that some people continue to roll up the truck to collect their very tidy salaries and bonuses.

But if you focus on any specific detail of compensation structures, bailouts, or the current economy, you'll miss the bigger picture, which portrays individual companies, each with its own specific set of challenges, each with its own traditional competitors (and concerns about how new players might change the landscape), each with its own specific circumstances regarding its CEO, how much the CEO is paid, and why.

CEOs and their Boards should not expect much help from the government as they struggle to measure performance accurately in the future. To be effective today at the Fed, SEC, and other government institutions, you have to be political.

After all, it's foolish to expect that any single regulatory agency would be immune from today's highly politicized Congress, which after all, operates just a few blocks from them.

Meanwhile, questions will persist about how Boards and Directors can address concerns about risk control. It behooves CEOs and their Boards to address shareholder and regulatory concerns about compensation directly and forthrightly, while maintaining a focus on the specifics of their particular business.

So I recommend a simple strategy: strive to do what's in the best interest of your company and its shareholders. If you hear suggested approaches that are inimical to your company's health, fight them at every turn. But many times, the only thing shareholders want to know is that you love them and care about them, so sit down with them and talk with them! This is how you will earn your money in the coming year and beyond. 

JOE GRUNDFEST

*W.A. Franke Professor of Law and Business, Stanford Law School; Senior Faculty, Arthur and Toni Rembe Rock Center for Corporate Governance*

# RISK.

AFTER THE MARKET CRACKED, BOARDS AND CEOs FACED INCREASING SCRUTINY OVER EXECUTIVE COMPENSATION. WHAT IS THE STATE OF EXECUTIVE COMPENSATION IN 2010?

BY ROGER STRUKHOFF

**T**he collapse in the U.S. financial services industry in October 2008 was so sudden and precipitous as to bring immediate comparisons to the Great Depression. Such comparisons, whether accurate or not, injected a sense of urgency into business and government executives that probably had not been seen in their lifetimes.

Bush and Obama administration officials have scrambled, members of Congress have bellowed, major shareholders have taken a beating, and top corporate executives in all industries have been reminded of the volatility of public markets and the uncertainty of success, despite their best-laid plans.

The collapse, and subsequent bailouts through the federal government's Troubled Asset Relief Program (TARP), cast a harsh light on executive compensation.

Outsized, non-performance-based bonuses to executives of failing companies received particular scrutiny and criticism, particularly if those bonuses went to companies receiving TARP funds—i.e., taxpayers' money.

The laundry list of common executive perquisites and benefits was also at the receiving end of much renewed outrage, whether it involved corporate jets and car privileges, country-club memberships, home-security systems, or large life insurance policies.

As we enter 2010, more than a year removed from the October 2008 surprise, we enter a new era of close examination of top executive compensation. Yet the fundamentals remain the same:

- It is imperative that companies acquire, develop, and maintain the best in executive talent;
- Competitive pressures among peer companies will never lessen;
- Technological innovation enables companies to change the game quickly and dramatically within many industries;
- Outstanding performance will continue to require outstanding compensation.

Thus, the need to balance risk and reward remains at the top of the executive compensation agenda, whether you are a CEO, other Very Important Top Officer (VITO), compensation committee member, compensation consultant, or major shareholder representative.

Everyone involved in determining executive compensation today must ask, "Is the boardroom table cracked? How badly? How can we fix it? Will we ever return to normal (whatever that means)?"

The following pages offer the insights of several executive compensation experts. They made their remarks in interviews with *C-Suite Insight* and at a seminar sponsored by Equilar Inc. in late 2009 in Santa Clara, CA on the topic of executive compensation.





SCOTT THURM



### THE BIG RULE

Calculating appropriate CEO compensation is a complex task. Yet there is also a very simple rule that you should apply to the final package.

In the words of Wall Street reporter Scott Thurm, Management Bureau Chief, The Wall Street Journal:

**“DON’T DO SOMETHING THAT GETS YOU FEATURED ON THE FRONT PAGE OF THE WALL STREET JOURNAL.”**

(We would add, “Or the cover of Business Week, the lead story on CNN, or on CNBC’s Squawk Box.”)

DAN MARCUS



### PAY FOR PERFORMANCE

What is the best way to address pay for performance?

“Start by defining your terms,” says Dan Marcus, Managing Principal, Semler Brossy Consulting Group.

**“WHAT’S EXPECTED HERE? MINIMAL PERFORMANCE?  
A HOME RUN?”**

“A good forecast of the recovery is more important than performance per se. But it’s more of a crapshoot than ever. So the goal-setting is not really a math problem, it’s more an application of common sense.”

JOHN BORNEMAN



### A MIGHTY WIND IS BLOWING

John Borneman, Senior Vice President, Friend Advisors LLC, urges executives and boards to stick to fundamentals that have worked in the past, before the recent craziness.

**“IF YOU ALWAYS CHANGE WITH THE WIND,  
YOU NO LONGER HAVE A SYSTEM. IT’S BROKEN.”**

GEORGE PAULIN



### ARE YOU LONESOME TONIGHT?

Or, as George Paulin, Chairman and CEO of Frederic W. Cook & Co. says:

**“SOMETIMES SHAREHOLDERS JUST NEED A HUG AND TO BE TOLD THAT YOU LOVE THEM.”**

Don’t we all?



### DO YOU KNOW RISK WHEN YOU SEE IT?

When do you cross the line and venture into excessive risk territory?

Listen to that this comment by Brit Wittmann, Director of Executive Compensation and Corporate Compensation Design, Intel Corp.:

**“YOU CAN DAMAGE YOUR COMPANY’S PRODUCTIVITY IF YOU TRY TO TAKE ALL THE RISK OUT.”**



### TALENT RULES

Risk-taking is also a key factor in determining long-term incentives. As with determining pay-for-performance, figuring the right mix of short- and long-term incentives will vary from industry to industry.

But remember this:

“The starting point and endpoint for determining long-term incentives is competition for talent.”

— Mark Gordon, Principal, Hewitt Associates.

Achieving this drives right to the heart of the risk-takers’ dilemma. How do you pay for the top talent but stay out of the headlines, away from shareholders’ fire, and far away from appearing in front of Congress?

Board members addressing this issue must also remember they have renewed responsibilities to get things right.

As David Larcker, Co-Director of the Arthur and Toni Rembe Rock Center for Corporate Governance at the Stanford University Graduate School of Business, notes:

**“MANY BOARD MEMBERS THINK RISK IS A MANAGEMENT ISSUE, NOT A BOARD ISSUE, AND THAT IS COMPLETELY WRONG!”**



### IT'S NOT PAY *PER SE*

Developing political acumen goes a long way in handling executive compensation.

Farient's John Borneman notes:

**“CONGRESS IS NOT FOCUSED ON PAY, BUT RATHER ON DISCLOSURE, TRANSPARENCY, AND BEING SURE THAT YOU HAVE INPUT FROM SHAREHOLDERS.”**

“Furthermore, shareholders themselves are tolerant if you benefit lower-level employees as well as the top execs.”

DAN SICILIANO



SHARON HENDRICKS



ROBERT MCCORMICK



GRAEF "BUD" CRYSTAL



### SAY ON PAY AND WORSE

Shareholder tolerance has certainly been tested over the past 18 months. The idea that shareholders—particularly the major institutions that often control several million shares of a company—should have more “say on pay” is a notion that seems commonsensical to many people.

Some key points:

### • NEW DISCLOSURE REGULATIONS ACT AS “AN ACCELERANT” WITH RESPECT TO EXECUTIVE COMPENSATION...

says Dan Siciliano, Associate Dean for Executive Education and Special Programs at Stanford Law School.

- Add to that a higher chance that activist shareholders will vote people off corporate boards, and as Sharon Hendricks, Executive Compensation Partner, Gunderson Dettmer, says, companies need...  
**“TO GET RID OF STUFF THAT MAKES PEOPLE MAD.”**
- The reality is that proxy votes seldom remove board members just because major shareholders are mad—in the rare cases that it does occur, it usually involves a controversial acquisition or takeover attempt. But neither say on pay nor proxy removals can be ignored.

As Robert McCormick, Esq., Chief Policy Officer, Glass Lewis & Co., notes...

### “SAY ON PAY IS A BLUNT INSTRUMENT, BUT VOTING OFF A BOARD MEMBER IN PROXY IS EVEN BLUNTER.”

You don’t have to be the sharpest tool in the shed to understand that.

### INDEPENDENCE DAYS

One item that’s been coming up—and won’t go away—is the independence of compensation consultants.

It’s easy to get a little lazy in certain areas—in business one of these areas is overseeing longtime, valued consultants. Oftentimes, an independent compensation consultant will be trusted to do other work for the company, thereby presenting possible conflicts of interest.

As noted compensation consultant Graef “Bud” Crystal says:

### “CLEARLY, THE COMPENSATION CONSULTANT FIRM SHOULD HAVE NO OTHER TIES TO THE COMPANY. PERIOD.”





### SUM IT UP. I'VE GOT A PLANE TO CATCH...

You know your boardroom table got cracked—and maybe badly—during late 2008 and into 2009. You are determined to fix it. You no doubt have too much input from too many parties to make a decision that will please everyone.

If you're a Board member, you know you have to keep your top executives incentivized—the future of your company depends on it. If you're a CEO, you have to be sure the stress you've undertaken with this responsibility is worth it—and that your top team members think it's worth it as well.

After thinking through all the complexities, after grinding through the numbers, and after considering all the options to fix the table...

...perhaps you can take the simple advice offered by Martin Somelofske, Principal and National Practice Leader, Executive Compensation Consulting Practice, Deloitte Consulting:

"Don't be piggish."

After all, it's a boardroom table, not a trough.

## HOW TO EXCHANGE OPTIONS, WIN FRIENDS, AND INFLUENCE PEOPLE

**T**he issue of spreading the wealth through an entire organization is one that's intrinsic to some companies, less so to others.

Specifically, stock options are often used as an incentive to attract employees at all levels and keep them focused on the tasks at hand. Companies in Silicon Valley are most famous for this practice, but are certainly not the only companies who've discovered its uses.

A conference on executive compensation sponsored recently by executive compensation research firm Equilar had a session devoted to this issue, featuring spokespeople from Silicon Valley giant Intel and decidedly non-Silicon Valley titan Starbucks.

The two spokespeople, who were intricately involved with the companies' stock-options plans, discussed the problems they faced after the precipitous stock-market decline in 2008 plunged innumerable options deeply underwater.

Realizing the likelihood of these options coming back above surface was minimal, many companies decided to exchange them. Both of the companies mentioned here represent megabrands, and both are known for setting standards in employee benefits.

Starbucks, for example, offers options through its entire organization, including to part-time baristas at local stores from Main Street to mini-malls. Intel has been famous for its egalitarian approach for decades—everyone gets a cubicle, including the CEO, and everybody needs to be at work on time, or sign a late sheet.

Exchanging the options seemed a logical course of action. But, as the Starbucks spokesperson said, "then we had to do it."

Exchanging options for tens of thousands of people, notifying them of the opportunity, explaining the advantages of doing so versus the benefit of staying the course, and remaining in full compliance sounds like a real job. The trouble is, this job—a one-time, short-term initiative that meant no new hiring—had to be undertaken by existing HR staff, who already had full-time jobs.

As this issue of *C-Suite Insight* was going to press, Wall Street had rallied significantly. Many of the companies that did the right thing by offering options throughout their organizations, and went through the agonies of exchanging them, may now be viewed as having solved a problem that no longer exists.

They may have even cost their companies profitability, given the way options are required to be (controversially) expensed these days—ironically, having the potential to drive stock prices back down.

Such is the Law of Unintended Consequences in business. But timing the market is a fools' game, whether you're an individual investor moving 100 shares at a time, or a Fortune 1000 board voting on long-term employee incentive plans.

The upside in the Intel and Starbucks stories (and all stories similar to them) is that moves like this—transparent and designed to help all employees, not just top execs—keep employees engaged and motivated, which is what they were intended to do.



# OWNERSHIP GUIDELINES: EXECUTIVES

Boards Want More Skin  
in the Game...  
Hardship Provisions Help  
in a Pinch, Too

**I**n turbulent economic times, it is important to link executive pay with company performance. Shareholders pay close attention to corporate compensation practices and question company management if the link between pay and performance becomes tenuous.

Equity compensation plans are one of the most effective methods of aligning the incentives of executives with those of shareholders. By granting equity awards that retain value only if share price increases over a prolonged period of time, management can tie a substantial part of overall executive compensation to long-term company performance. Additional conditions relating to equity retention provide a powerful way to properly incentivize executives.



Ownership guidelines and holding requirements are two common methods Boards of Directors use to align the incentives of executives and shareholders. Although they function differently, they have the same goal: building a substantial equity stake for executives in the companies they help manage, and providing a profit motive to improve company performance.

In the case of CEOs at Fortune 250 companies, the median value of target stock ownership levels for CEOs was approximately \$6.1 million in 2008, the latest year for which detailed information is available.

Recent research has examined patterns in the prevalence and design of executive ownership guidelines and holding requirements among Fortune 250 companies for the three most recent years for which detailed data is available. The information in this article is based on that research.

## OWNERSHIP POLICY PREVALENCE

Ownership policy prevalence includes companies that have ownership guidelines, holding requirements, or both. Among Fortune 250 companies with publicly disclosed executive stock ownership policies, it has remained consistent at 81.2 percent in 2008, compared to 82.6 percent in 2007. The prevalence of Fortune 250 companies with publicly disclosed ownership guidelines remained consistent at 78.3 percent in 2008, compared to 78 percent in 2007.

## OWNERSHIP GUIDELINE DESIGN

Executive stock ownership guidelines defining ownership targets as a multiple of base salary are still the most commonly used design model by far, making up 81.9 percent of all ownership guidelines.

As might be expected, the median base salary multiple for ownership guidelines falls from five times base salary for CEOs, down to one times base salary for Vice Presidents.

Presidents of Fortune 250 companies were required to achieve a target level of three times base salary to six times base salary, with the most common multiple being five.

For Fortune 250 companies that specifically disclose target ownership levels for their Chief Operating Officers, the multiple ranged from three to five times. For Chief Financial Officers, the multiple ranged from one to six times. For both of these positions, the 75th percentiles were at four times base salary.

Stock options are less likely to be included in the mix. Among companies with ownership guidelines, 12.2 percent allow options to be applied toward ownership targets, compared with 33.5 percent that explicitly

exclude stock options from ownership levels. Share equivalents and plan shares, on the other hand, are both counted by over 35 percent of companies disclosing a definition of stock.

Among the 85 Fortune 250 companies disclosing holding requirements, 62.3 percent required executives to retain shares before guidelines are met, and 51.8 percent used general holding requirements.

This trend indicates that simply acquiring the target number of shares is no longer sufficient. Companies are increasingly requiring executives to sustain significant equity ownership throughout their terms.

Among the 197 companies with ownership policies, 112 companies disclosed ownership guidelines only, 9 companies disclosed holding requirements only, and 76 companies disclosed ownership guidelines and holding requirements for their executives.

Ownership guidelines typically require executives to achieve pre-determined equity ownership goals within a specified period of time (usually three to five years). Ownership goals are most commonly defined as a multiple of annual base salary, but can also be expressed as a fixed number of shares or the lesser value of the two.

Among companies with ownership guidelines, 35.1 percent explicitly excluded stock options from ownership levels in 2008.

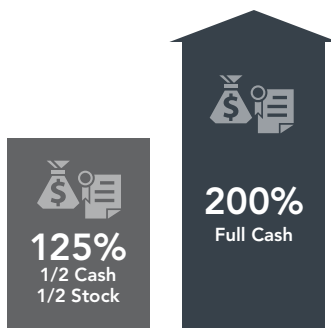
Many executive ownership guidelines specify a set amount of time from when an executive joins the company to when he or she must reach the targeted ownership level, also known as an accumulation period.

Among Fortune 250 companies with ownership guidelines, 78.2 percent of companies disclose the accumulation period under their guidelines. The number of years ranges from two to five, with five years to reach the guideline as the most common amount of time allotted. In 2008, a five-year accumulation period was used by 78.9 percent of companies that disclosed the timeframe given to attain ownership goals.

Along with the ownership guidelines come holding requirements, also known as retention requirements. They typically require executives to retain a certain percentage of the shares they acquire through the exercise of stock options or the vesting of other stock-based awards.

Prior to reaching an ownership guideline target, executives may be subject to an additional holding requirement. These pre-guideline holding requirements force executives to hold a large percentage of the stock and option awards they receive until they reach the stock ownership target.

Any holding requirements that do not specifically relate to building equity ownership prior to reaching the



IF AN EXECUTIVE ACHIEVES  
**125% or more**  
OF THE APPLICABLE  
OWNERSHIP TARGET,  
**PERFORMANCE SHARES**  
**WILL BE PAID HALF IN CASH**  
**AND HALF IN STOCK.**

IF EXECUTIVE  
VICE PRESIDENTS  
AND ABOVE ACHIEVE  
**200% or more**  
OF THEIR APPLICABLE STOCK  
OWNERSHIP TARGET,  
**THEIR PERFORMANCE**  
**SHARES WILL BE PAID**  
**ENTIRELY IN CASH.**

target ownership level are considered general holding requirements. In addition, post-guideline holding requirements specify the percentage of shares executives must retain after they have achieved the targeted share ownership level.

A growing number of companies use holding requirements in lieu of any ownership guideline. For these companies, holding requirements serve as the main and only share retention strategy for executives. Often, such policies will require executives to hold onto all of the equity granted to them until they retire from the company.

As ownership guideline disclosure improves, one area in particular that has seen enhanced disclosure is the definition of the forms of equity included in achieving the targeted level of ownership.

Companies sometimes disclose certain measures that facilitate executive stock ownership, whether in the form of compliance rewards or non-compliance penalties. In addition, many companies have established guidelines on short sales of company stock. There are usually hardship provisions that allow the Board of Directors or other entities to make exceptions for certain cases.

### EXAMPLES OF OWNERSHIP GUIDELINE DESIGN

Ownership guideline design structures are categorized into the following four groups:

- **Multiple of Base Salary.** Most ownership policies require executives to achieve a target ownership level defined as a multiple of their base salary. A good example is provided by Oneok Inc., with a policy that states: “The following minimum share ownership guidelines are established for all officers of the Company, its divisions, subsidiaries and affiliates: Chief Executive Officer, six times; President, five times; COO, CFO, EVP, four times; SVP, Head of Division/Business Unit, three times; VP, two times.”
- **Number of Shares.** The second most prevalent ownership guideline structure defines target

ownership levels for executives as a fixed number of shares. This structure is the least volatile type of ownership guideline because ownership goals do not fluctuate based on stock price. An example of this structure is provided by Praxair Inc., whose policy states: “Significant stock ownership focuses the executives’ attention on managing Praxair as equity owners. Twenty-two executives are currently covered under this stock ownership policy. Individuals are expected to meet the applicable guideline no more than five years after first becoming subject to it.”

- **Mixed Salary and Shares.** An increasing number of companies are designing their ownership guideline policies as a combination of the above two structures, often requiring executives to own the lesser of a multiple of base salary or a fixed number of shares. Although not explicitly stated as such, Travelers Companies Inc. has developed a policy that falls into this general arena, as follows: “We maintain an executive stock ownership policy pursuant to which executives are expected to accumulate and retain certain levels of ownership of our equity securities until termination of employment, so as to further align the interests of management and shareholders. The Compensation Committee developed this policy based in part on analyses provided by F.W. Cook and after an analysis of policies instituted at our peer competitors.”
- **Other.** Two examples of other structures include the use a specific dollar value of shares, or a multiple of base salary plus target bonus. McKesson Corp., for example, has developed a policy that focuses on salary and target bonus: “The Company’s stock ownership guidelines were revised to include the MIP (note: Management Incentive Plan) as a measuring component, such that the ownership requirement is now expressed as a multiple of base salary and target MIP. “The effect of such amendment was to substantially increase the ownership requirement for each of the Company’s executive officers. The ownership requirement for our CEO under the revised stock ownership guidelines is four times his combined base salary and target MIP, whereas each of the Company’s remaining NEOs must achieve stock ownership equal in value to three times his or her combined base salary and target MIP.”

## A GROWING NUMBER OF COMPANIES USE HOLDING REQUIREMENTS IN LIEU OF ANY OWNERSHIP GUIDELINE.

## HOLDING REQUIREMENT DESIGN

When holding requirements are used in tandem with ownership guidelines, they typically apply only to executives who have not yet met their target equity ownership levels. These policies, called pre-ownership guideline holding requirements in this analysis, ensure that executives will retain a significant portion of vested or exercised equity as they build an equity stake in their company.

Among the 85 companies in the Fortune 250 with holding requirements, 62.3 percent require executives to retain shares before guidelines have been met, and 51.8 percent used general holding requirements. Included in these figures are the 14.1 percent of companies that used a combination of both structures.

Illustrative examples of industry practice can be found as they relate to holding requirements as well:

- **Pre-Guideline Holding Requirement.** Duke Energy Corp., for example, has a “policy that prohibits each executive officer, including each named executive officer, from selling shares of Duke Energy common stock acquired through the exercise of stock options until such executive officer is in compliance with Duke Energy’s stock ownership requirements. An executive officer may, however, sell common stock acquired through an option exercise for the limited purpose of paying the exercise price of the stock option and any applicable tax liability.”
- **Pre-and Post-Guideline Holding Requirements.** In this area, Public Service Enterprise Group Inc. provides a good example: “Each officer must retain at least 100%, after tax and costs of issuance, of all shares acquired through equity grants made subsequent to the adoption of the policy, including the vesting of restricted stock or restricted stock unit grants, payout of performance awards and exercise of option grants, until the ownership requirement is met. Once an officer attains his/her required level of stock ownership, he/she must retain 25%, after tax and costs of issuance, of shares until retirement or his or her employment otherwise ends.”
- **General Holding Requirements.** A middle-ground strategy in this area is set out by CVS Caremark Corp., which has a policy that states, “[Long-term incentive plan] awards are delivered 50% in cash and 50% in shares of CVS Caremark common stock. Although the stock is non-forfeitable when

earned, effective with the cycle ending in 2007 the executive is prohibited from selling or trading the shares for two years following the payment date, which encourages stock ownership and further reinforces an alignment of executives’ interests with that of stockholders.”

## SIGNIFICANT STOCK OWNERSHIP FOCUSES THE EXECUTIVES’ ATTENTION ON MANAGING THE BUSINESS.

### COMPLIANCE STATUS

Companies may provide disclosure as to whether executives have achieved or are on track to achieve the established ownership guidelines. Among companies with ownership policies, 70.1 percent have disclosed the compliance status of their executives.

Non-compliance penalties make the consequences for not obtaining the required level of ownership by the end of the target time frame clear. In 2008, of the 197 Fortune 250 companies that disclosed stock ownership policies, 16.2 percent mentioned non-compliance penalties, compared to 16.1 percent in 2007.

Listed penalties included reduction or elimination of annual equity compensation, increased stock retention requirements, mandatory investment of a percentage of bonus into company stock, replacement of cash compensation with equity awards, or reduction of aggregate compensation. Such restrictions remained in effect until executives met their respective ownership goals.

Only 2.5 percent of Fortune 250 companies with stock ownership policies offer incentives for their executive officers to reach their stock ownership goals, and this percentage has been decreasing in recent years. For those companies that use this incentive, cash is king; as with Exelon Corp.: “The form of payment provides for payment in Exelon common stock to executives with lower levels of stock ownership, with increasing portions of the payments being made in cash as executives’ stock ownership levels increase in excess of the ownership guidelines. If an executive achieves 125% or more of the applicable ownership target, performance shares will be paid half in cash and half in stock. If executive vice presidents and above achieve 200% or more of their applicable stock ownership target, their performance shares will be paid entirely in cash.”

United Parcel Service takes a similar approach, and extends it throughout the organization: “To reward management employees for maintaining significant ownership of UPS stock, all 37,000 participants in the Management Incentive Program are eligible for an additional incentive award up to the equivalent of one month’s salary. This portion of the MIP award is also provided one-half in cash, UPS stock or deferred into the participant’s 401(k) or related savings program at the participant’s election, and one-half in restricted stock units. The target level of one month’s salary is the same for all 37,000 participants in the program.”

### HARDSHIP PROVISIONS

Companies disclosing hardship provisions for their executives recently increased by 75 percent among the Fortune 250, with 28 companies in 2008 versus 16 companies in 2007. An example of this policy is provided by the International Paper Co.: “An officer may not sell any shares without Committee approval until he or she reaches the applicable minimum holding requirement and, then, may not sell more than 20 percent of his or her shares per year. Upon the recommendation of the CEO and approval of the Committee (or the Board, in the case of the CEO), an executive officer may be granted an exception to the stock ownership requirement or disposition limit. Exceptions may be granted in cases of personal or financial hardship or other specific emergency need.”

### RESTRICTIONS ON HEDGING

Companies often prohibit executives from participating in insider trading or hedging activities, with 44.2 percent of Fortune 250 companies having ownership policies that also disclosed hedging restrictions. This is seen as a way to ensure that ownership policies effectively align the interests of executives with shareholders.

FedEx Corp. is fairly explicit on the topic: “We generally prohibit all members of management, including the named executive officers, from engaging in certain types of transactions involving FedEx stock that may signal a lack of confidence in FedEx’s prospects or may lead to inadvertent insider trading violations, such as transactions in publicly traded options, short sales, holding stock in a margin account or pledging it as collateral for a loan, and hedging or monetization transactions.”

RRI Energy Inc. is at least as direct and more succinct: “Because short-range speculation in our securities based on fluctuations in the market may cause

conflicts of interests with our stockholders, our Insider Trading Policy prohibits trading in options, warrants, puts and calls related to our securities and it also prohibits selling our securities short or holding our securities in margin accounts.”

PPG Industries Inc. decided to spell out the various behaviors it will not tolerate: “Executives and other employees may not engage in any transaction in which they may profit from short-term speculative swings in the value of PPG’s securities. This prohibition includes ‘short sales’ (selling borrowed securities that the seller hopes can be purchased at a lower price in the future) or ‘short sales against the box’ (selling owned, but not delivered securities), ‘put’ and ‘call’ options (publicly available rights to sell or buy securities within a certain period of time at a specified price) and other hedging transactions designed to minimize an executive’s risk inherent in owning PPG stock, such as zero-cost collars and forward sale contracts. In addition, this policy is designed to ensure compliance with all insider trading rules.”

The economic problems that started in the fall of 2008 have caused companies to change their policies as they try to cope with current conditions. There are two basic tactics in place: suspend ownership requirements until the company’s stock price reaches a higher level, or simply extend the time period in which to reach the ownership requirements.

Aflac provides an example here, in the face of a declining stock price: “The Corporate Governance Committee approved a moratorium for compliance with the stock ownership guidelines at its meeting held in February 2009, based on the significant decline in the Company’s common stock price in early 2009.”

Boeing, on the other hand, a company that has to think in the long term, extended the time period to achieve the ownership requirement from three to five years, noting in the process that “five years is the prevalent market practice and it provides a reasonable goal for new executives to accumulate shares through earned incentive awards and deferrals into stock units.”

It’s no surprise that Fannie Mae had to have a title change in policy as well, to wit: “In January 2009, our Board eliminated our stock ownership requirements because of the difficulty of meeting the requirements at current market prices and because we had ceased paying our executives stock-based compensation.”

That suffices as the final, ironic statement in this discussion, yes? **E**





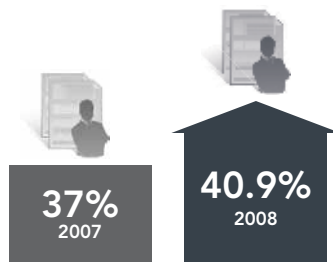
# OWNERSHIP GUIDELINES: DIRECTORS

And Now, Stock Ownership Guidelines  
For the Board...



**O**WNSHIP GUIDELINES AND holding requirements encourage top executives and directors to develop a sizable equity stake in the companies they help manage. They generally establish stock acquisition goals to be achieved within a specified period of time. On the back side, holding requirements call for the individuals involved to retain a certain percentage of shares acquired through the exercise or vesting of stock options, restricted stock, and other equity awards.

Furthermore, in a current business environment where it behooves companies to be transparent about compensation policies, it's been found that about four in five public companies have disclosed they have ownership guidelines in place for directors. Around 20 percent also stipulate holding requirements.



## Compliance Disclosures Status of Directors

PERCENT DISCLOSED  
AMONG COMPANIES WITH  
OWNERSHIP GUIDELINES

(as reported in 2009)

### DIFFERENT PATHS TO THE SAME PLACE

As the prevalence of ownership guidelines at Fortune 250 companies has increased, the level of disclosure regarding such policies has also improved.

One area in particular that has seen enhanced disclosure is the definition of what counts as ownership under a company's director ownership guidelines. In 2008 (as reported in 2009), 65.6 percent of Fortune 250 companies with ownership guidelines provided disclosure about the forms of equity included toward achieving the targeted level of ownership.

On the other hand, stock options are rarely counted toward stock ownership for director ownership guidelines. Among companies with ownership guidelines, only 2.7 percent disclose that options are applied toward ownership targets, compared with the 14 percent of companies that explicitly exclude stock options from ownership levels.

Deferred shares and stock equivalents are counted as stock ownership by 45.2 percent of companies with guidelines. Among the 122 companies that provide disclosure about their definition of stock, 68.9 percent of companies include deferred shares or stock equivalents in calculating director ownership levels.

The prevalence of companies that defined ownership guidelines as a multiple of the annual retainer decreased from 57.5 percent in 2007 to 57 percent in 2008, the most recent year for which complete data is available. In addition, the prevalence of companies that disclosed ownership guidelines as a fixed number of shares increased from 27.1 percent in 2007 to 27.4 percent in 2008. In 2008, 4.3 percent of Fortune 250 companies with ownership guidelines had policies that did not fit any of the common design structures. These companies either did not disclose the level of required ownership, or defined the target ownership level using a combination of more than one type. Such companies typically require directors to own the lesser of a multiple of the annual retainer or a fixed number of shares.

### EXAMPLES OF OWNERSHIP GUIDELINE DESIGN

- **Multiple of Annual Retainer.** A good example is provided here by The Goodyear Tire & Rubber Co., which has a policy that states, "Guidelines specify that a director must accumulate and hold a number of shares equal in value to five times the annual cash retainer within five years of the later of the effective date of the program or the date of election as a director."
- **Fixed Number of Shares.** Count TRW Automotive Holdings Corp. among the companies that fix the number of shares in its guidelines: "The independent directors are expected, over a period of five years from the date they are elected as a director, to acquire and hold a total of eight thousand (8,000) shares of our common stock. Unvested restricted stock units do not count toward satisfying these requirements..."
- **Fixed Dollar Value of Shares.** A simple variation on the above approach is to require a fixed-dollar, rather than fixed-share, approach, as illustrated by PG&E: "Directors are encouraged to own a significant equity interest in the Corporation within a reasonable time after election to the Board. A director should own shares of the Corporation's common stock having a dollar value of at least \$200,000."
- **Combination.** Chevron is among the companies that prescribes a combination of retainer and shares for its directors: "The Board expects all Directors and executive officers to display confidence in the Corporation by ownership of a significant amount of stock. The Board has structured its compensation to strive to result in ownership of at least 7 times the annual cash retainer amount or 15,000 shares of stock or stock units after five years of service as a Director."

Holding requirements, although not as widely implemented with directors as they are with executives, do provide another way to encourage director stock ownership. The prevalence of holding requirements at Fortune 250 companies reached 19.2 percent in 2008, an increase from 16.9 percent in 2007.

Also known as retention requirements, holding requirements typically require non-employee directors to retain a certain percentage of the shares they acquire through the exercise of stock options or the vesting of other stock-based awards.

TODAY, THERE IS ENHANCED  
DISCLOSURE ABOUT THE DEFINITION OF  
WHAT COUNTS AS OWNERSHIP FOR DIRECTORS.

This analysis categorizes holding requirements into the following groups:

- Prior to reaching an ownership guideline target, directors may be subject to an additional holding requirement. These pre-guideline holding requirements force directors to hold a large percentage of the stock and option awards they receive until they reach the stock ownership target.
- Many companies disclose the use of both ownership guidelines and holding requirements but do not relate the retention level in the holding requirement to achieving an ownership goal. Directors must comply with both the holding requirement and the ownership guideline.
- A growing number of companies use holding requirements in lieu of any ownership guideline. For these companies, holding requirements serve as the main and only share retention strategy for directors. Often, such policies will require directors to hold on to all the equity granted to them until they retire from the Board.

Looking at the numbers, research has found that among those Fortune 250 companies with holding requirements, 41.3 percent maintained both general holding requirements and ownership guidelines. Another 32.6 percent of Fortune 250 companies with holding requirements had pre-guideline holding requirements.

In 2008, a small percentage of the Fortune 250—only 2.2 percent of the companies with holding requirements—had post-guideline requirements. Post-guideline requirements typically require directors to hold a specific number or value of shares in addition to the ownership threshold. The remainder of companies, 23.9 percent, used holding requirements alone as their ownership policy for non-employee directors.

Within these guidelines, 32.6 percent of director holding requirements at Fortune 250 companies were designed to be in effect only prior to the satisfaction of ownership guideline targets. Once ownership goals are met, these holding requirements are no longer active.

Companies often implement holding requirements in conjunction with ownership guidelines, and some holding requirements have different retention obligations before and after the achievement of equity ownership goals set by ownership guidelines.

## EXAMPLES OF HOLDING REQUIREMENT DESIGN

- **Holding Requirement Only.** Deere & Co. provides an example in this area, stating, “While a director, restricted shares and RSUs (restricted stock units) may not be sold, gifted or otherwise disposed. Directors may lose their restricted shares and RSUs if their service is terminated for any reason other than retirement, disability or death. The restricted period for restricted shares and RSUs ends when the director retires from the Board, becomes permanently and totally disabled, dies, or if there is a change in control of Deere.”
- **Pre-Guideline Holding Requirement.** Valero Energy Corp. provides a good example of this policy: “Until such time as the director reaches his or her share ownership guideline, the director will be required to hold 50% of the shares of Common Stock received upon lapse of the restrictions upon restricted stock and upon exercise of stock options (net of any shares utilized to pay for the exercise price of the option and tax withholding).”

IN A CURRENT BUSINESS ENVIRONMENT WHERE IT BEHOOVES COMPANIES TO BE TRANSPARENT ABOUT COMPENSATION POLICIES, IT'S BEEN FOUND THAT **ABOUT FOUR IN FIVE PUBLIC COMPANIES HAVE DISCLOSED THEY HAVE OWNERSHIP GUIDELINES IN PLACE FOR DIRECTORS.**

## COMPLIANCE STATUS

Companies may provide disclosure as to whether directors have achieved or are on track to achieve the established ownership guidelines. Among companies with ownership guidelines, 40.9 percent disclosed the compliance status of their directors in 2008 compared to 37 percent in 2007.

Though few companies disclose non-compliance penalties for directors (4.3 percent of Fortune 250 companies with ownership guidelines in 2008), such policies help clarify the consequences of not reaching the required level of ownership. The non-compliance penalties found below subject directors to additional holding requirements and/or force directors to receive cash fees in the form of stock.

For example, guidelines from Bristol Myers Squibb Co. state, “If the minimum requirement has not been met, a non-employee director is required to defer 25% of his or her compensation into the Company’s stock fund under the Company’s deferred compensation plan for non-employee directors until such ownership requirement is met.”

Another example is provided by Caterpillar: “In the event a director fails to achieve or maintain the required stock ownership levels, such director’s compensation from the Company will be paid one-half in restricted stock units and one-half in cash until the target ownership level is achieved.”

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### HARDSHIP PROVISIONS

Research has also found that while the prevalence of Fortune 250 companies disclosing director compliance status and non-compliance penalties have remained relatively constant over the past two years, companies disclosing hardship provisions for their directors increased 37.5 percent, with 33 companies having them in 2008.

This may, of course, indicate that companies are allowing their directors time to reclaim ownership status after declining stock prices caused many of them to fall below the ownership threshold set forth by the guidelines.

Here’s an example from Aetna: “It is understood that if Directors temporarily do not meet this guideline because there has been a significant drop in the price of the Company’s stock, they would have a reasonable period of time to acquire additional shares of stock necessary to meet the guidelines.”

Cardinal Health takes a similar view, and clearly spells out why: “In light of the decline in our stock price and the equity markets in general as discussed earlier in this proxy statement and the potential impact of the Planned Spin-Off, if completed, on the value of the equity holdings of our named executives in the Company, the Board has determined that current executive officers and directors should have until June 30, 2012 to satisfy these Guidelines.”

The guidelines from Sysco Corp. are worded a bit more delicately and extend beyond the prevailing market conditions: “There may be instances where abiding by these stock ownership guide-

lines may place an undue hardship on a director or executive officer, although it is anticipated that such instances will be rare. The Chairman of the Corporate Governance and Nominating Committee will make the final decision as to developing an alternative to these stock ownership guidelines for such a director or executive officer that reflects the intent of these stock ownership guidelines and the individual’s personal circumstances.”

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### HEDGING RESTRICTIONS

As with executives, Fortune 250 companies don’t want their directors to hedge their bets. The idea is that restrictions on hedging help ensure the effectiveness of ownership policies at aligning the interests of directors with shareholders. As far as their specific policy in this area goes, 9.7 percent of Fortune 250 companies with ownership policies disclose hedging restrictions.

Community Health Systems Inc. provides a good example: “Pursuant to the Company’s Policy Concerning Securities Trading, applicable to all members of the Board of Directors, officers, and other key employees, any short-term trading, short sales, transactions in puts, calls, or other derivative securities, hedging transactions, and margining or pledging with respect to the Company’s securities are strictly prohibited.”

We’ll leave the final words to Jabil Circuit, which has thought this through in detail: “Our insider trading policy prohibits directors, employees and certain of their family members from purchasing or selling any type of security, whether issued by us or another company, while aware of material non-public information relating to the issuer of the security or from providing such material non-public information to any person who may trade while aware of such information. We restrict trading by our officers and directors, as well as other categories of employees who may be expected in the ordinary course of performing their duties to have access to material non-public information, to quarterly trading windows that begin at the close of business on the second trading day following the date of public disclosure of the financial results for the prior fiscal quarter or year and end on the first calendar day of the third fiscal month of the fiscal quarter.” **C**

## Q&amp;A

## Graef "Bud" Crystal on the current state of executive compensation

**G**raef "Bud" Crystal has worked as a compensation consultant for more than 20 years, has authored more than 1,600 articles for Bloomberg News and every major newspaper you can name, and has served as Adjunct Professor of Industrial Relations and Organizational Behavior at the Haas School of Business at the University of California-Berkeley.

Bud has built a reputation as a clearheaded, provocative commentator who is not afraid to be openly critical of true excesses in top executive compensation packages.

Among the six books he has authored, his 1991 work, *In Search of Excess: The Overcompensation of American Executives and What Are You Worth?*, offers not only a nice play on words on the classic Tom Peters book, *In Search of Excellence*, but an in-depth review of how we should really be thinking about executive compensation.

**C-Suite Insight** had the chance to pick his brain a bit about the current state of executive compensation, and here's what he told us...

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**C-Suite Insight:** Let's start with the big view: how has the executive compensation landscape changed over the past 30 years or so?

**Bud Crystal:** Leaving aside the current furor going on in Congress, we can start by first saying that bonuses are still bonuses. There's not a huge change here. But long-term incentives (LTIs) 25 or 30 years ago were mostly all options, with occasional free shares and special plans. Today, options have fallen out of favor quite a bit.

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**CSI:** Any particular reason why?

**Bud:** Well, sure. Executives over time learned how to game the system—if they think the market is soaring,

they love options, but if the market's going down, they become more averse to them. Today, free shares have become much more popular—ironically so in Silicon Valley, where people used to think that only wimps don't take stock options.

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**CSI:** Well, you could always re-price them...

**Bud:** Right, companies used to re-price options at the drop of a hat. But today, even companies in Silicon Valley are using more free shares than they used to.

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**CSI:** So how does all this fit into today's demands for performance-based plans?

**Bud:** Hmm, performance-



based plans—I designed the first one in the world myself in 1968—but I didn't have the sagacity to call it a performance-based plan! But the design for the concept was mine, whatever that's worth.

At the time, no one had a performance plan that paid off based on how your company's total return matched up against a peer group. Of course, 25 to 30 years ago it was very hard to get data on total returns, as there obviously was no Bloomberg or Yahoo Finance, for example.

But as we know, academics will tell you that the only fair way to pay top executives is to pay them not just because the stock price rises, but [based on] how it performs against peers.

**CSI:** And how do you mix the various ingredients into a fair plan?

**Bud:** A lot of companies are using three basic ingredients: stock options, free shares, and LTIs based on earning-per-share (eps) growth. If the stock goes up quickly, the exec may win on stock options, but may lose over the long-term if eps is just not there.

That said, a good predictor for whether someone is being overpaid is to ask, how many

LTIs does he or she have? If their plan is overloaded in all three areas, they can't lose and will most likely be overpaid.

I've faced situations where I've persuaded companies to cut way back on the options, to make room for the LTIs, for example. But it's a hard sell to get people to cut back anywhere.

**CSI:** So how about cutting back on those big bonuses that seem to draw so much attention?

**Bud:** Well, you can have a big bonus plan, but rather than having it in free stock, make a lot of it held hostage for three years. If you have bad results, then debit the amounts.

**CSI:** Do you mean a "negative bonus"? That must be a popular idea...

**Bud:** It's hard to have a negative bonus. I've tried selling that over the years, and it's a tough sell. But I don't mean we take money away; the exec never loses money. But yes, in a bad year you'll eat into the bonus that was "earned" the year before. Over a three-year period, for example, the total bonus

may net out to zero, but it will never be negative.

**CSI:** Theory aside, how should companies start addressing the issue of executive compensation today?

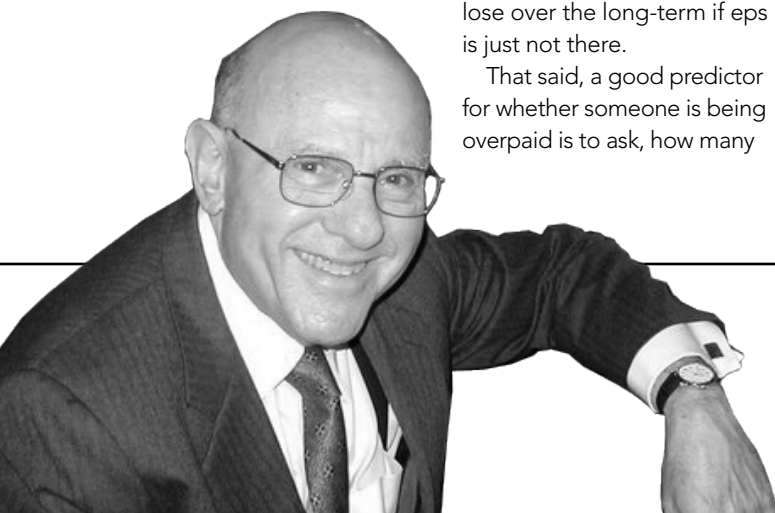
**Bud:** One thing you can do is employ that term "stress test" that has become popular. You can address the whole pay package to stress testing.

Address issues such as, "Let's not assume we're going to have steady growth, let's have thousands of scenarios, various stock prices, various earnings scenarios, etc. What's going to happen under a variety of different circumstances?"

**CSI:** And this is a start to addressing the risk in the equation? Don't the more complex plans actually increase the risk of overpaying for poor performance?

**Bud:** All this concern about risk came up when the Wall Street firms failed [in 2008]. I don't think the bonus plans caused the problems. In fact, as we know, some of the Wall Street CEOs were the biggest losers, losing over a billion dollars in personal wealth in some cases.

Then, in my opinion, there's this generational problem.



**A GOOD PREDICTOR FOR WHETHER SOMEONE IS BEING OVERPAID IS TO ASK, HOW MANY LTIs DOES HE OR SHE HAVE?**

When (most of) these CEOs went to business school, a stunning invention in those days was the four-function calculator. So they never understood all this new stuff, like derivatives and Black-Scholes modeling.

Beyond a certain age, these folks think of “black shoals” as what the Exxon Valdez fiasco caused. So, a lot of these 60+ execs lost control of their own ships. I mean, you’d like to think a CEO knows more than anyone about a business, but this wasn’t always the case.

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**CSI:** Yeah, but some things never change, right? Like the desire of top executives to be well-compensated.

**Bud:** Sure, and there are some basic things you can always do. For example, boards should talk about real long-term incentives, not flash-in-the-plan, one-year incentives. Yet many companies let people start exercising after only one year. How can you call that a long-term incentive?

I would say you don’t exercise any of it for five years. I won’t let you choose the time of exercise either, because that is merely opportunistic.

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**CSI:** What else?

**Bud:** Well, clearly, the compensation consultant firm should have no other ties to the company. And having CEOs on the comp committees is just asking for the

opportunity to overpay the company CEO. Statistical analyses have been done that show there is a highly significant correlation to the extent of a CEO being overpaid when there are CEOs on the comp committees.

he imposed cuts, and then he was wondering if he went too far. It’s all political theater.

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**CSI:** So does it come back to the shareholders to force change if they want it?

## WE KNOW THAT TOP EXECS ALWAYS FIGURE THEY’RE ENTITLED TO A LOT OF MONEY, UNTIL SOMEONE STOPS IT.

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**CSI:** Some would say that there is also a correlation between the public outcry about executive pay and the poor economy; as soon as the economy gets better, everyone will forget. What’s your opinion of that statement?

**Bud:** Once the coast is clear, people go back to what they were doing before. The public right now wants a “Joan of Arc” moment where someone gets burned at the stake. But the public has the memory span of a gnat, you know.

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**CSI:** So is what pay czar Kenneth Feinberg is doing in trying to limit compensation going to be effective in the long term?

**Bud:** These pay controls never work; they eventually collapse. The public is bloodthirsty, so Kenneth Feinberg has responded to a lot of political pressure. And it doesn’t help that he’s now expressing remorse; a sense of penance doesn’t help his own cause. First

**Bud:** Sure, but they rarely do it. So many of these big funds talk a big game, but they don’t follow through, even though in my opinion, they have a fiduciary duty to their beneficiaries.

Really, if you manage significant shares, and you find a company’s abusing the process, you need to call them and tell them you are selling your stock. That will get their attention. Panic the board about the possibility of them getting sued, and they’ll put some pressure on the CEO.

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**CSI:** You think so?

**Bud:** Well, we know that top execs always figure they’re entitled to a lot of money, until someone stops it. And some CEOs push the envelope more than others, knowing that the squeaky wheel does get the grease. And so many boards are like papier maché figures. So progress in this area is measured in millimeters per decade. ■

# Q&A

**George Paulin** is CEO of Frederic W. Cook & Co. From his office in Los Angeles, he works with clients in a variety of industries and locations. We managed to catch him one morning after he returned from a day trip to New York.



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**C-Suite Insight:** The subject of risk is unavoidable right now. But is it being overemphasized? Is it too hot an issue?

**George Paulin:** It's a hot issue, of course, primarily because of the financial services companies and the TARP bailout. Before the economic meltdown in late 2008, it was not as actively considered, nor was it considered a front-burner issue.

In the financial services industry, it's been hard to separate out the role that the actual business risk played versus the compensation risk per se. This is what everybody's still struggling with right now.

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**CSI:** Do you think that FSI is uniquely risky in this respect?

**George:** Yes, this is because banks and other financial institutions are intermediaries and in the business of transferring different types of risk. That aside, it's always best to design comp programs to be reasonable competitively, and to support business strategy.

So, if there's a high-risk business strategy and the incentives are appropriate to support that strategy, then the risk is in the strategy and the compensation program should be designed to mitigate the risk. The methods that companies are talking about now to mitigate risk

are better-balanced short- and long-term measurement periods, more compensation paid in stock versus cash, requirements to hold a portion of the company stock into retirement, avoiding over-reliance on a single performance measure, and avoiding pay for failure, so there is a penalty for taking risks that are not successful.

**CSI:** Well, let's follow that thought. TARP-funded companies are under tremendous scrutiny with regard to their exec compensation practices. And the Obama administration's pay czar, Kenneth Feinberg, has rolled out different compensation rules. Is there a spillover effect for companies other than FSI companies, and is this fair?

**George:** No, I'm not really seeing a spillover from Feinberg and TARP. The spillover is coming more from the new SEC disclosure rules that require companies to discuss compensation risk in their proxy statements, if it is potentially material. And in order to determine if there is potentially material compensation-related risk, compensation committees are going to have to first understand the business risks inherent in the strategies, and then how the compensation

programs either dampen or magnify the risk in their structure and policy.

My sense is that most companies outside of financial services and a few other industries with relatively high inherent business risk will conclude that there isn't material compensation-related risk. This will be especially true where some or all of the risk mitigants I mentioned earlier are in place. Where they are not, we will see more companies adopt them, and this will be the spillover effect.

**CSI:** Assume that things continue to settle down in terms of the economy. Will we still be having conversations like this—about the relationship of executive compensation and risk—two years from now?

**George:** Yes, I think so. Actively thinking through the risk-related design considerations is a worthwhile thing to do.

**CSI:** And what has been your recent experience in discussions with your clients?

**George:** As we've gone through this process, it has been helpful in identifying elements in comp programs that might have unintended consequences.

**CSI:** And sometimes those unintended consequences are big, unpleasant newsmakers. What general advice do you have for companies to keep bad news about them off of the front page of *The Wall Street Journal*?

**George:** My thinking on this is very simple and straightforward. When the compensation committee in a large public company is making decisions on executive compensation, they always need to apply two tests, repeated over and over. The first is, "Is this a reasonable action in terms of competitiveness?" The second is, "Is this an appropriate action in terms of supporting the business objectives and strategy of the company?"

**CSI:** And that implies that companies can still be aggressive...

**George:** Sometimes there are actions that are at the high end, but are important and supportable. You have to do what's in the interest of long-term shareholders, but you also need to justify why. I am not justifying "outlier" actions, but it's important to have a rationale. A big potential risk for the American economy, in general, from all of this is "one-size-fits-

## I WOULD NOT WANT TO SEE EVERYBODY IS IN THE SAME BOX, AND NOT ALLOWING COMPANIES TO DIFFERENTIATE THEMSELVES FOR COMPETITIVE ADVANTAGE.

all” executive compensation where there is no ability to differentiate in financial-reward systems for competitive advantage.

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**CSI:** So comp committees should still differentiate from the competition if it's in the best interests of the company.

**George:** Absolutely. I'm hoping that all say on pay, the rules that institutional investors and their advisors apply, etc., don't result in everybody paying the same.

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**CSI:** What do you think about how activities in Washington will affect compensation?

**George:** There is some good. Look at the changes to proxy disclosure rules as an example. There are three elements.

The first is the change to the Summary Compensation Table, where equity grant values will be the amounts attributable to the year being reported, as opposed to the accounting value of old

grants that become vested during the reporting year. The old way never made sense because you couldn't pay on performance for the year. Now, it will be easy for financial-statement users to do this, which is necessary if they are serious about say-on-pay voting.

Second, the risk discussion is now in the proxy, and it's a good thing for comp committees to spend some time talking about how the comp program relates to risk. The third element relates to consultant independence. To the extent investors believe that potentially conflicted consultants could be a factor in what they perceive as excessive pay or too much pay for corresponding performance, then the financial statements would allow them to make a better-informed conclusion. I support this disclosure based on the released rules.

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**CSI:** And there's nothing negative?

**George:** There will be problems with clarity, and

too much information, and boilerplate legalese. One of the negatives is that it adds more disclosure. But really, the three disclosure changes, in terms of direct effect, are positive.

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**CSI:** You mentioned say on pay. Is it just going to be part of everyone's world from now on?

**George:** Everybody expects it in 2011, and everybody is getting ready for it. The CD&A will become (in effect) a marketing document, a selling document to explain the executive compensation program. A lot more thought will go into the disclosure, and by implication, hopefully, into the decisions that have to be disclosed.

The big question is will say on pay really open up and improve the dialog about executive compensation between companies and investors? I think this dialog is already open and I'm not sure that say on pay will add much, but I'm not opposed to it. **C**





# HOW TO MAKE MORE AS A CEO: CHANGE COMPANIES

## S&P 1500 CEO New-Hire Analysis Reveals Better Pay for Outsiders

**T**HE BEST WAY to get a raise is to make yourself available and appealing to a competitor. This conventional wisdom holds true whether you spend your business day in front of a computer, on an airplane, or playing shortstop.

Or does it? The answer is yes, at least when it comes to CEO compensation, according to recent Equilar research.

To examine compensation differences between chief executives hired internally versus those hired externally, a new report from Equilar compared the pay of these two groups to the compensation of tenured CEOs in place for at least two full years.

The results are from research conducted for the years 2007 and 2008—one can assume that the same pattern will hold true in 2010, as it seems to be a tendency in both up and down economies.

Focusing on overall pay levels, restricted stock awards, and stock option grants, it was found that CEOs hired from outside a company continue to earn more in their first year than CEOs who are promoted from within.

For example, at large-cap companies (S&P 500), externally hired CEOs received a median total compensation package of approximately \$13.5 million in 2008, or 74.3 percent more than CEOs with at least two years of tenure, who made approximately \$7.7 million. Internally promoted CEOs made less than both groups in 2008, pulling in a median pay package of approximately \$7.4 million.

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### METHODOLOGY

The survey comprised a review of data for 1,229 companies in the S&P 1500 index with executive compensation data reported for fiscal years ending between April 30, 2008 and March 31, 2009. This group of companies includes CEOs in place for at least two full years, as well as newly hired CEOs. The total population of companies is segmented in tables on the opposing page.

Throughout this analysis, total compensation is calculated as the sum of base salary, discretionary bonuses, the target value of short-term cash bonuses, restricted stock awards, stock option awards, the target value of long-term cash and equity incentives, and all other compensation.

Base salaries for CEOs joining a company mid-year are annualized, but all other elements of compensation, including bonuses, are measured on an as-reported basis. Compensation for internally promoted CEOs includes a blend of compensation levels before and after promotion to the CEO position.

Founders are excluded from the analysis. Values for all equity awards represent the grant-date value of new awards as reported by the company in the Grants of Plan-Based Awards Table.

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### OVERVIEW AND THE TRENDS WITHIN

In large-cap companies, S&P 500 chief executives in place for at least two full years in 2008 received

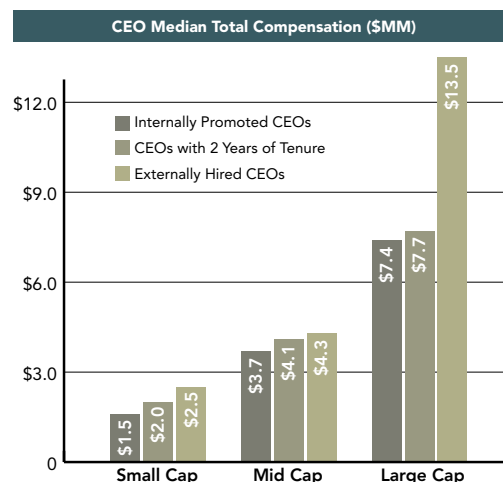
Small Cap				
Segment	Number	Prevalence	Median Revenue (\$MM)	Median Market Cap. (\$MM)
Companies with a CEO in place for at least two years	401	85.1%	\$645	\$507
Companies with a new CEO promoted from within	45	9.6%	\$722	\$385
Companies with a new CEO hired externally	25	5.3%	\$502	\$341
All companies	471	100.0%	\$650	\$484

Mid Cap				
Segment	Number	Prevalence	Median Revenue (\$MM)	Median Market Cap. (\$MM)
Companies with a CEO in place for at least two years	305	92.4%	\$1,898	\$1,810
Companies with a new CEO promoted from within	14	4.3%	\$1,538	\$1,070
Companies with a new CEO hired externally	11	3.3%	\$1,261	\$1,399
All companies	330	100.0%	\$1,880	\$1,744

Large Cap				
Segment	Number	Prevalence	Median Revenue (\$MM)	Median Market Cap. (\$MM)
Companies with a CEO in place for at least two years	375	88.2%	\$7,911	\$7,052
Companies with a new CEO promoted from within	39	9.2%	\$7,626	\$6,198
Companies with a new CEO hired externally	11	2.6%	\$3,572	\$5,080
All companies	425	100.0%	\$7,670	\$6,976

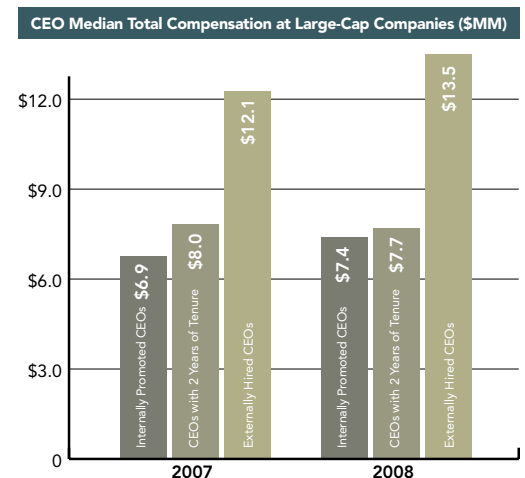
a median total compensation package of approximately \$7.7 million. Meanwhile, for CEOs hired externally, the median compensation in 2008 was approximately \$13.5 million.

CEOs promoted from within a company lagged behind both groups, receiving a median total compensation package of approximately \$7.4 million. A similar pattern held true at mid-cap and small-cap companies. The following chart displays median total compensation levels (in millions) for external hires, internal promotions, and tenured executives in all three major segments of the S&P 1500 index:



In 2008, S&P 500 chief executives in place for at least two full years received a median total compensation package of approximately \$7.7 million, a nearly 3.8 percent drop from 2007's \$8.0 million. Meanwhile, for CEOs hired externally, the median compensation grew by approximately 11.6 percent, to \$13.5 million.

For executives internally promoted to CEO in 2008 compared to 2007, the median total compensation increased approximately 7.2 percent. The following chart displays median total compensation levels (in millions) for external hires, internal promotions, and tenured executives in the S&P 500 index for 2007 and 2008:



Quite often, equity awards are a key driver in the differences between pay levels for internally promoted CEOs and externally hired CEOs. For example, while the premium enjoyed by external hires over tenured CEOs at large-cap companies in median total compensation was 74.3 percent, external hires received a median option award that was 232.2 percent larger than the median option award for tenured CEOs.

## THE FACTS BEHIND THE FINDINGS

Equilar's research on 1,229 companies in the S&P 1500 index with executive compensation data reported for fiscal years ending between April 30, 2008 and March 31, 2009 generated significant statistical information that gives a clear, detailed picture of the CEO compensation scene at companies of all sizes. The research also enabled the establishment of a few key facts:

### Higher Pay for External Hires.

In 2008, externally hired chief executive officers received the highest median total compensation package in all three segments of the S&P 1500 index. CEOs hired externally at large-cap companies enjoyed the largest premium in pay, receiving a median pay package that was 74.3 percent larger than the median pay package for tenured CEOs at the same companies.

Mid-cap companies paid the smallest premium for outside talent, paying 6.7 percent more to externally hired CEOs. Small-cap companies paid a 25.8 percent premium for external hires versus tenured CEOs.

### Lower Pay for Internally Promoted CEOs.

CEOs promoted from within a company received the lowest median total compensation in 2008 in all three segments of the S&P 1500 index. But the gap in pay between internally promoted CEOs and tenured CEOs was typically much smaller than the gap between tenured CEOs and externally hired CEOs.

At large-cap companies, CEOs promoted from within received a median compen-

sation package that was 4.8 percent smaller than the median pay package for tenured CEOs. The gap was 8.9 percent at mid-cap companies and 19.2 percent at small-cap companies.

### Companies with Lower TSR Tend to Hire from Outside.

In each of the three main segments of the S&P 1500 index, median three-year total shareholder return for companies that hired a CEO from outside was lower than for companies that internally promoted a CEO. Additionally, companies with tenured CEOs had the highest median three-year total shareholder return in each segment of the S&P 1500 index.

### Smaller Companies Tend to Hire from Outside.

In each of the large-, mid-, and small-cap segments, companies hiring CEOs externally had lower median revenues than companies with tenured CEOs or CEOs promoted from within. Additionally, small-cap companies had the largest number of external CEO hires in 2008, representing 5.3 percent of CEOs, versus 3.3 percent at mid-cap companies and 2.6 percent at large-cap companies. This trend is particularly interesting when you consider that

externally hired CEOs receive significant premiums over all other executive groups.

### Less Is Still More for Internally Promoted CEOs.

Although internally promoted CEOs made less in median total compensation than tenured CEOs or CEOs hired externally, they usually made much more in their first year as CEO than they did in the year before.

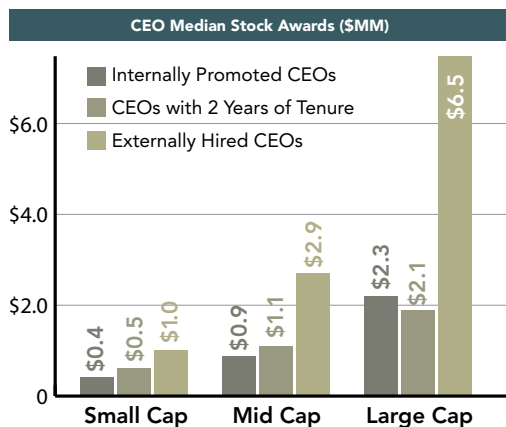
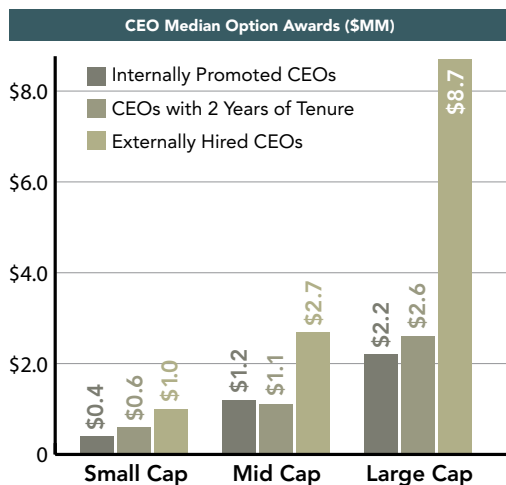
At large-cap companies where data is available, median pay for CEOs promoted from within jumped by 54.3 percent from the year before they became CEO. In total, 83.8 percent of internally promoted CEOs at large-cap companies received a pay increase. The increase in median compensation was 32.6 percent at mid-cap companies, where 66.7 percent of internally promoted CEOs received a raise.

At small-cap companies, median compensation rose by 34.9 percent, and 81.0 percent of internally promoted CEOs made more than they did in the previous year.

### COO Position Acts as Best Stepping Stone to CEO.

In all three segments of the S&P 1500 index, over 35.0 percent of all executives promoted to CEO from within a company held the chief operating officer position in the year before they became CEO. The next most prevalent stepping stone positions were Division Head, in large- and mid-cap companies, and CFO in small-cap companies.

The premium for stock awards among the same group was 214.1 percent. To illustrate these trends, the following charts display median option and stock awards (in millions) for external hires, internal promotions, and tenured executives in all three major segments of the S&P 1500 index:

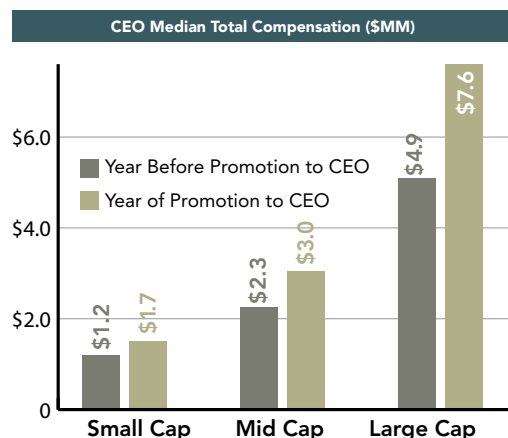


A uniquely interesting finding was that the median value of option awards for internally promoted CEOs at mid-cap companies exceeded the median value of option awards for tenured CEOs in the same segment of companies, whereas the median value of stock awards for internally promoted CEOs in the same segment was less than the median value of stock awards for tenured CEOs.

However, the situation is reversed at large-cap companies. For small-cap companies, equity awards for tenured CEOs were usually larger than awards for promoted CEOs.

As previously noted, CEOs promoted from within a company typically make less than tenured CEOs, and much less than CEOs hired from outside a company.

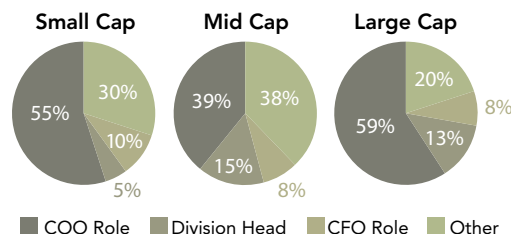
However, this does not mean that promoted CEOs do not receive a significant raise when they ascend to the top of the corporate ladder. When data was available, we compared compensation for promoted CEOs in the year they became CEO to the year before they became CEO. Among large-cap companies, promoted CEOs received a 54.3 percent raise.



### STEPPING STONES

In 2008, among all segments of the S&P 1500 index, approximately 53.1 percent of CEOs promoted from within their company held the chief operating officer title in the year before their promotion. This percentage was highest among large-cap companies, where 59.0 percent of internally promoted CEOs were a COO in the year before.

Among mid-cap companies, the percentage of CEO positions going to COOs was lowest, at 38.5 percent. In addition, chief financial officers represented 8.1 percent of CEO promotions in the S&P 1500 index. The chart below displays the breakdown of roles held by internally promoted CEOs in the year prior to their promotion, in all three major segments of the S&P 1500 index. **C**



# Q&A

“I’ve guided my clients to make decisions that are fully informed and transparent. If they want to be aggressive with compensation, in a way that doesn’t follow the crowd, they need a good rationale.”

**Blair Jones** has been an executive compensation consultant since 1991. She has worked extensively across industries, including healthcare, retail, professional services and consumer products, and has particular depth of expertise working with companies in transitional stages. Prior to joining SBCG, Blair was the practice leader in Leadership Performance and Rewards at Sibson.

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**C-Suite Insight:** Why is risk such a burning issue right now?

**Blair Jones:** Risk is a hot issue for a couple of reasons. First, no one wants to repeat the events of the past year and a half. So we must closely examine the culture and behaviors that enabled people to take the type of extraordinary risk that endangers the interests of shareholders, employees, and the general public.

Second, the SEC will require companies to disclose the extent to which any of their compensation programs are reasonably likely to have a material adverse effect on the company. This new requirement means that every company will need to assess the potential for their compensation programs to encourage inappropriate risk-taking on an annual basis. This places a major spotlight on this issue.

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**CSI:** And companies, specifically their boards, don’t know how to respond?

**Blair:** I’d say that companies are interested because they want to know how to respond. The CEOs and Boards want to be sure that they are being responsible.

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**CSI:** But risk varies from industry to industry and company to company.

**Blair:** Yes, the truth is, risk is a bigger issue at certain companies than at others. Risk is very prominent in financial companies, for example. But all companies should be evaluating the relationship between their business risk and their compensation risk.

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**CSI:** By that you mean...

**Blair:** Two things: first, does compensation risk exacerbate the business risk? Examine the financial, operational, regulatory and compliance, and reputation factors. For example, take a company whose manufacturing or products carry environmental risk, and the potentially big regulatory fines that go with it. This company does not





WE CAN USE A SILICON VALLEY METAPHOR. LOOK AT THE COMPENSATION PLAN AS HARDWARE. THE REAL RISK HERE IS THAT EVERYONE FOCUSES ON THE HARDWARE. BUT SO OFTEN, IT'S THE CULTURE—THE SOFTWARE—THAT CAUSES THE PROBLEM.

want its compensation program to encourage its people to lose sight of environmental risk in their pursuit of other objectives.

Second, are there elements of the compensation program design that could drive unintended behaviors? For example, is a program design too short-term-oriented in nature, such that employees might be encouraged to make short-term decisions that might later harm longer-term results? If there are elements that could encourage unintended behaviors, are there mechanisms within the compensation program to mitigate that risk (e.g., counterbalancing goals, clawback policies, bonus deferral)?

By looking at risks from both perspectives, companies can get both a "top down" and "bottom up" view.

**CSI:** But the best-laid plans...

**Blair:** Well, most companies will find they have responsible pay programs—with obvious features such as stock ownership guidelines, clawback guidelines, and shareholder-friendly policies that provide protection and alignment with shareholder interests.

However, for those that don't, now is their chance to identify opportunities to improve their programs so they will be less likely to run into big problems. The point is not to avoid risk taking altogether, but for programs to encourage prudent (rather than reckless) risks.

**CSI:** How can shareholders help drive this effort toward responsible pay plans and risk mitigation?

**Blair:** Shareholders want to invest in companies with good enterprise risk management systems. As such, they underscore the importance of strong risk assessment processes. At the same time, shareholders need to understand that the solutions to mitigate unnecessary risk are varied. They should not expect "one size fits all" solutions on the compensation front. Too much prescription around risk mitigation solutions ignores the unique business characteristics and challenges and could impair pay and performance alignment.

**CSI:** Even to the extent that all companies are feeling a spillover effect from the strictures placed on TARP recipients, for example?

**Blair:** Yes, there's a governance spillover because boards would prefer not to ever face TARP-type regulation. As an example, clawbacks are required among TARP companies; so non-TARP companies are instituting them, too. They want to get ahead of the game.

**CSI:** They want to be sure they're exemplars of good governance.

**Blair:** There has been an emphasis on good governance for a few years because of Sarbanes-Oxley, but now it's intensified. In this environment, boards and manage-

ment teams have found they must pay more attention to shareholder groups. This is particularly true since shareholder concerns have bled into the public concern as well.

I've guided my clients to make decisions that are fully informed and transparent. So if they've performed well, and want to be aggressive with compensation in a way that doesn't follow the crowd, they need a good rationale.

**CSI:** So it behooves boards today to put things out there in plain view and not try to hide anything.

**Blair:** If you disclose as little as possible and are convoluted in your reasoning, you are going to hurt yourself. You're much better off being open about what you're trying to achieve.

**CSI:** What role does creating the right peer group play in all this?

**Blair:** Most companies have always compared themselves to peers, but the bar has been raised regarding selecting the right peers. I would caution CEOs and boards to be practical about constructing a peer group and to understand the limitations. For example, for at least one-third of companies, there are comparable companies but no true peers. I have a client that is partly in wholesale and partly in retail; there are a number of retailers and wholesalers of their size, but no 'peer' has the exact same business mix. I have another

client in consumer products whose business is more volatile than any peers because of their high volume of international business. In these cases, peer comparisons have some relevance as stakes in the ground, but there are points at which the comparisons become strained because of the unique client circumstances.

**CSI:** So what do you do? What do you tell them?

**Blair:** You put stakes in the ground. You must be aware of what companies in your peer group are doing, but you can't follow data blindly. Let the peer group inform your approach, not dictate it. Yet, as mentioned earlier, if you step outside the box and do something very different, you need to be guided by a compelling rationale.

**CSI:** Sounds like a lot of work.

**Blair:** Yes, it is a lot of work. The more rigorous the compensation committee's process, the better programs it will have, and the better-aligned compensation will be with the true business need and with shareholder interests.

Committee members often sit on multiple boards, so it may be hard for them to stay cognizant of all the issues at a particular company. Therefore, practitioners must get the right information in front of comp committee members and encourage analysis and discussions from the right angle. Then committees can

feel confident that they're making the right decisions, and not exposing themselves unnecessarily.

**CSI:** But I'll go back to my comment about best-laid plans...

**Blair:** So let me make a further point. We can use a Silicon Valley metaphor. Look at the compensation plan as hardware. The real risk here is that everyone focuses on the hardware, while so often, it's the culture—the software—that causes the problem. Does a company have a culture where people can't bring bad news to the CEO, for example? Or a culture where people hide things systemically? A compensation program goes wrong when it's paired with the wrong culture.

Boards owe it to their companies not to implement a program if the cultural dynamics aren't there. If the capabilities of the people or the alignment is not right, then the program is going to fail, and that's a recipe for risk.

**CSI:** What can you do to address this situation?

**Blair:** When designing compensation programs, look at things holistically: consider the business priorities and whether top management and the board are in agreement on these; consider whether you have the right capabilities on the team as well. Only then can a well-designed compensation program achieve full impact. ■

# TEN FOR '10

## THE C-SUITE INSIGHT TOP 10 ISSUES FOR 2010

During the past several months, as the editorial content for this launch issue of *C-Suite Insight* came into focus, it became clear that The Big Issues affecting the *C-Suite* in the still-churning wake of the financial services meltdown of 2008-9 comprise a cross-section of overarching socio-political topics and more granular, business-oriented “shop talk.”

The overarching stuff includes a general public outrage over salaries and bonuses paid to failing companies, particularly those companies that received TARP funding. It also includes much political hot air, as members of Congress parade before the cameras with righteous indignation and promises “to do something” to those businesspeople who “just don’t get it.”

Limitations on salaries, elimination of bonuses, cutting of luxe perks, and a new spirit of shareholder activism all resonate through today’s echo chamber of 24-hour TV coverage, online newspapers and magazines, and the blogosphere.

Meanwhile, an army of compensation consultants works away from the cameras (and away from the politicians), meeting with top executives and boards to dig down into the nitty-gritty of ownership guidelines, clawback policies, how to define “long-term,” and how to create rational peer groups.

From reading and analyzing news articles and research reports, conducting interviews for this issue of *C-Suite Insight*, and things we overheard, we were able to come up with a list of Top 10 Issues for 2010—our Top 10 for '10—as presented here.

1

**Transparency.**

Eschew obfuscatory, opaque convolution. Keep it clear, simple, and direct.

2

**Exposure of Comp Committee Members.**

There’s a difference between golden handcuffs and real ones.

3

**Salary Reductions and Reinstatements.**

It’s OK, really. Even a measly \$500 an hour is good work if you can get it.

4

**Say on Pay.**

Remember, it’s just a “say.” You’re still in charge.

5

**Elimination of Gross-Ups and Other Perks.**

Please, no whining.

6

**Clawbacks.**

Returning a bonus may be the least of someone’s worries if they’re facing a stay at The Greybar Hotel.

7

**Severance/CIC.**

Would you settle for a silver parachute? Or maybe a bronze one?

8

**Ownership Guidelines.**

Get some skin in the game! Read more in this issue.

9

**Performance Periods and LTI Metrics.**

Repeat after me: One year is not long-term.  
One year is not long-term. One year...

10

**Peer Group Definition.**

A tough topic subject to manipulation. Like when Tootsie Roll (\$496M revenues) called Kraft (\$42B revenues) a peer (per an article in The Wall Street Journal).



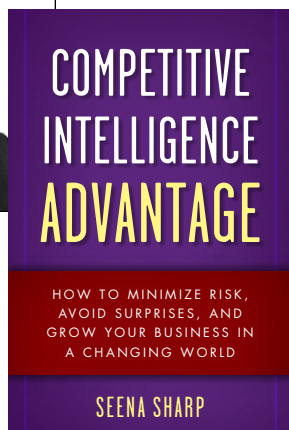
# SHARP INSIGHTS ABOUT BUSINESS DECISIONS AND COMPETITIVE INTELLIGENCE

## Interview with **Seena Sharp**

**S**eena Sharp is a long-time practitioner and writer on the topic of Competitive Intelligence (CI), and heads Sharp Market Intelligence ([www.sharpmarket.com](http://www.sharpmarket.com)) from her office in the Los Angeles area. She is the author of the new book, *Competitive Intelligence Advantage: How to Minimize Risk, Avoid Surprises, and Grow Your Business in a Changing World*, published by Wiley.

In the book, she drives home the point that companies will make good decisions, the first time, when they are based on good input. She explains what CI is, why data is not intelligence, and why competitor intelligence is a weak sibling to competitive intelligence. She advises about when to use CI, how to find the most useful information and turn it into actual intelligence, and how to present findings in the most convincing manner.

Almost 10 years ago, Seena outlined 10 myths about CI that are still highly relevant, so you'll find them in the accompanying sidebar. More recently, *C-Suite Insight* interviewed her about the book and her current thoughts. This is how it went:



**C-Suite Insight:** Could CI, or a better use of it, have helped cushion the fiasco within the financial services industry?

**Seena Sharp:** Absolutely, and it could still be helping, because this is no time to make poor decisions. To the extent these companies and their executives use CI, they will make better decisions; they will understand the changes that are occurring, including the many opportunities that exist but are unknown.

**CSI:** But so many people missed it and apparently didn't see the meltdown coming. Even with good CI, how much of this disaster could have been averted?

**Seena:** There was certainly a willful element to all this. It's not so much that people missed it; they either ignored, dismissed, or underestimated the warning signs. But the warning signs were there. A great number of people in positions of power in business and government knew what was going on. Everyone knew about the so-called "liar loans," to name just one example.

**CSI:** Yet a lot of people lost their jobs and lost a lot of money in all this...

**Seena:** Well, the people in government who missed it didn't get fired. And you still see major bonuses being paid to executives at many of these financial companies



that received TARP funding. So, in my opinion, people were not really held accountable.

**CSI:** Well, let's say there will be more accountability today and in the future. What should companies be doing with CI?

**Seena:** The basic rule is this: If you don't pay attention to problems and opportunities, another company will. Someone else will take the opportunities that you miss.

making any kind of decision. That means not only today's competitors, but customers, suppliers and distributors; what's happening with technology, government and industry regulation, demographics, cultures, and societal changes.

Not all of these things will affect every industry, of course. But when customers come to buy your product or service, they're (at least) subliminally considering some of these additional issues.

**Seena:** You might, but so many companies—at least at the executive level—are convinced that they know better. But they usually have only an internal perspective, and this is one of the most damaging things they can do. They do not have a broader, macro view.

**CSI:** And that broader view must include smaller companies as well...

**Seena:** Sure, and you can't underestimate that aspect, because all companies start small. Even Microsoft and Google started small!

SO HERE'S AN OPPORTUNITY FOR CEOS TO SAY...

**"I'M ONLY GOING TO TAKE A MILLION IN SALARY, AND WE'LL HIRE ANOTHER 50 PEOPLE WITH THE MONEY I'M NOT TAKING."**

**CSI:** In your writing and consulting, you like to point out that these companies who might eat your lunch aren't always the most obvious competitors.

**Seena:** Right! Remember, using CI effectively means paying attention to what's going on—not only in your industry, but also outside your industry—and what's going to affect you.

**CSI:** So you can't just look at your competitors.

**Seena:** Yes, there is a very big distinction between competitive intelligence and competitor intelligence.

Competitor intelligence is actually a subset of competitive intelligence. It encompasses all the areas you have to consider when you're

**CSI:** And even your competitors aren't always who you may think...

**Seena:** Most businesses only consider their direct competitors as competitors: companies in their industry, and furthermore, of a similar size. But what you think your competition is may be substituted by an indirect competitor, even one from a totally different industry.

A point I want to make here is that customers—whether B2B or B2C—view the marketplace very differently than executives view it. Customers don't care about your company or your competitors; they only care about what company can satisfy their needs.

**CSI:** You would think companies would be more aware of this today.

**CSI:** Those two are primarily consumer companies. You said this applies to B2B as well?

**Seena:** In the world of business-to-business, companies buying products and services are not concerned with the size of a potential vendor as much as "Can you provide what I need in my timeframe and budget, and with quality work?"

If this were not true, then there wouldn't be any small suppliers for the automotive industry, or any other business, really. It applies to every industry.

**CSI:** What are some examples of business leaders who effectively use CI, and who can be disruptive as a result?

**Seena:** Take a look at Richard Branson. He has businesses in 200 different industries, and he selected these industries because they didn't see changes coming.





## TEN MYTHS ABOUT **COMPETITIVE INTELLIGENCE**

### **MYTH #1**

***Competitive Intelligence and Market Research are the same.***

**In Fact:** Market research is widely defined as primary research, with results from surveys, questionnaires or focus groups. In contrast, competitive intelligence draws on a wide variety of sources and captures what is occurring today rather than what respondents say, with different expectations from the results.

### **MYTH #2**

***Competitive Intelligence and Competitor Intelligence are the same.***

**In Fact:** Competitive and competitor are not synonyms. Competitive intelligence targets anything in the business universe that affects the ability to compete. This includes knowledge of what's changing with suppliers, distributors, customers, technology, regulations, and competitors.

Competitor intelligence focuses on one or more specific competitors, and is an important subset of competitive intelligence. Competitor intelligence includes monitoring and understanding competitors. However, it cannot stand on its own because tracking only the competition is the surest way to develop tunnel vision and be blindsided by significant marketplace changes.

### **MYTH #3**

***Data, Information, and Intelligence are the same.***

**In Fact:** Data is raw material. It's numbers or facts presented in a vacuum. Information, on the other hand, is data in context. Intelligence is information that has been analyzed and suggests actions, strategies, or decisions. Intelligence reveals critical information or insight and implications beyond the data.

### **MYTH #4**

***Competitive Intelligence is spying.***

**In Fact:** Besides being illegal and unethical, dirty tricks like phone taps, dumpster diving, and surveillance are simply unnecessary in competitive intelligence because an estimated 95 percent of the information you want is publicly available.

That other 5 percent? Access to a competitor's truly proprietary information—such as customer lists, pricing, intellectual

property—wouldn't be valuable for long because the most successful companies are constantly creating new ways to satisfy their customers. Covert operations are just not part of the competitive intelligence job description.

### **MYTH #5**

***There's no information on private companies.***

**In Fact:** As *X-Files* fans knew, the truth is out there. The amount and type of information available varies by company and industry, and directly correlates to the media interest in that company or industry, as well as support from the industry. Some private companies generate as much ink as their publicly held counterparts, and even the most private companies cannot escape the efforts of a determined investigative reporter.

Information on private companies appears in unexpected places, too. Some U.S. private companies provide SEC-type financial information, for example, while all companies in some countries are required to file financial documents.

### **MYTH #6**

***The best industry information comes from my industry.***

**In Fact:** If only the business world were so orderly! Trade publications and associations do provide valuable information about an industry. But the flipside is that their perspective can be insular and narrow. The interrelationships between competitors, suppliers, distributors, and customers has created an environment where non-industry viewpoints are as essential as those from the industry.

Trade information needs to be balanced by an outside view, such as respected general business publications and publications that cover industries indirectly related to your business. Articles from these non-industry journals often detail needs, changes, gaps, potential problems, substitute products, ancillary issues, and valuable insights that none of the competitors are addressing.

### **MYTH #7**

***Information is free.***

**In Fact:** Despite the wealth of free information on the World Wide Web, there is still no such thing as a free lunch, or free valuable information. After all, if you can find something easily and for free, everyone else can as well!

*continued on next page*

Acquiring information of value requires an expenditure of time, money, or both. Even with initial web searches, there is an inevitable cost, whether the information is gathered by a salaried or contracted employee, or a professional researcher.

The proliferation of information today frequently prompts executives to assume specific information is relatively easy to find and, therefore, very inexpensive. How many times have you said or heard, "I know I read it somewhere," or "I only need a few statistics," or that all-time favorite, "You should be able to find that in five minutes."

In reality, the desired information will be buried somewhere; the purported source will be incorrect; and the specific information won't be identified by a simple keyword search. Finally, more and more free sources are moving (or seeking a way) to a fee-based model.

#### MYTH #8

##### ***Information costs too much.***

**In Fact:** This is the flipside to Myth #7. I have to ask, "Compared to what?" Making a huge, expensive blunder in the marketplace?

Everything necessary to run a successful business has a price tag. From raw materials to real estate, computers to coffeemakers, personnel to paper clips—everything has a cost.

Information is the raw material of good decisions. Profits result from making good decisions, avoiding mistakes, and minimizing risk. So the cost (in time or money) of obtaining information must be appropriate to the purpose. A decision requiring significant outlay of resources, such as entering a new market, targeting a new customer base, purchasing equipment, or exploring an acquisition or merger, requires an in-depth investigation.

The range of available information and/or the difficulty of obtaining it is truly a mystery to those outside the competitive intelligence profession. Executives need to be made to understand that competitive intelligence is, in fact, the least expensive part of most transactions. When properly used, information is an investment.

#### MYTH #9

##### ***Not every decision requires Competitive Intelligence.***

**In Fact:** OK, I'll confess, there's a bit of truth to this one. But remember, the decision to skip the competitive intelligence process must be weighed against the ultimate cost of a wrong or bad decision.

If a company can afford the cost—in time, effort, and money—or if a tight timeframe precludes adding competitive intelligence to the equation, then the gamble may be worth it.

Yet, in most cases, CI enhances the chances for success. Growing a business, expanding offerings, attracting new customers, or selling in new or different channels are highly competitive activities.

Being a profitable player involves posing a threat to other companies and creating a visibility that may prompt an existing or emerging competitor to go after your business. Because the cost of competitive intelligence is only a fraction of any decision cost, it should be part of the plan in most cases.

#### MYTH #10

##### ***Competitive Intelligence is a waste of time.***

**In Fact:** Decision makers who don't want to make an investment in competitive intelligence deserve an "A" for arrogance. While they correctly assume they know their business, they are dead wrong about assuming they can't learn anything of value from outside sources.

In reality, decision makers are most knowledgeable about the past, and most confident about the information and decisions that brought about their present successes and experiences. So yesterday!! However, the rate and complexity of change in the marketplace steadily decreases the value of historical information.

As for the future, few decision makers have the time to methodically and creatively think about where their industry is headed. If they're working in global and/or downsized organizations, they're too busy handling multiple projects and putting out fires.

Timelines aside, management also needs information with one or two degrees of separation from their core business. In fact, the most valuable competitive intelligence counters, rather than confirms, what the company believes.

He started by selling records, then expanded that into making recordings, then created his own label. But his genius is for business, not just music. So he's in the airline-travel business, railroads, media, cosmetics, wedding gowns, energy, stem-cell research, health care, etc.

You should never fool yourself into thinking that someone won't see a gap or opportunity in your industry, or you might see Richard Branson coming in and taking over!

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**CSI:** Well, he's well-known to be a unique figure...

**Seena:** Sure, but he does it right. And here's another example: Warren Buffett. He started small, and he buys a lot of small companies. Even today, most of his companies are small companies that most of us had never heard of when he bought them. But he is successful because he does his due diligence with CI every time.

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**CSI:** As we go through the year 2010, what Three Big Rules of CI do you encourage top-level execs to remember?

**Seena:** Well, the public is absolutely furious at executives drawing huge amounts of money. They should read what is being said, and not just in their industry. As President Obama said, "They just don't get it."

So here's an opportunity for CEOs to say, "I'm only going to take a million in

salary, and we'll hire another 50 people with the money I'm not taking." They should stop being oblivious, and realize that there are ramifications beyond executive compensation. People want less and less to do with that whole industry, frankly.

Executives should also realize there is a new generation coming into the workforce and buying products and services, one with a totally different view of business than that of Gen-X or Baby Boomers. This Gen-Y demographic cohort is much more into doing good, volunteering, and corporate social responsibility. They are looking for companies that reflect their values.

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**CSI:** Executives don't make it to the top level without having a certain willfulness, a certain resoluteness in what they think and do. How do you get these points across to this audience?

**Seena:** I like to think of it as a situation that is very much like Sherlock Holmes building a case. You're not going to convince someone with the first clue, or the second one, or even the third or fifth sometimes.

When you're trying to convince executives of something that's contrary to what they think, it takes numerous attempts. You have to remind them how you presented good evidence last week, last month, and before that. When you present new evi-

dence, you have to reinforce the previous evidence.

Over time, they'll begin to pay attention to you. And they'll see from elsewhere, from other sources, that what you say has legs. As they see other examples of what you're talking about, they'll begin to notice the value of what you are saying.

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**CSI:** Executives are the primary readers of this magazine. Now that you have their attention, what else do you want to say to them?

**Seena:** Executives are expected to be leaders, which means they not only have to stay current, but ahead of their current and potential future competitors. They need to make smarter decisions, and recognize that the information on which they base their decisions is constantly changing.

I'd pose questions about a decision they made that didn't turn out, and I'm sure I could tell them it was because they didn't do their due diligence. They didn't have the most current, useful information, and made a decision based on outdated, insufficient, or erroneous information.

Bad decisions not only mean a loss of revenue. They mean a lost opportunity, and a loss of morale. On the other hand, if you use CI, you'll make far better decisions, seize the opportunity of change and market shifts, and minimize risk. **C**

# IF HE HAD THE EAR OF THE PRESIDENT, “I’D TELL HIM TO LOOK AT HISTORY”

Interview with **Charlie Tharp**



**Dr. Charles Tharp** is Executive Vice President for Policy at the Center for Executive Compensation, located in Washington, DC. Charlie is also an lecturer at the School of Industrial and Labor Relations, Cornell University. He has more than 25 years of corporate experience, including key human resource positions with General Electric, PepsiCo, Pillsbury, CIGNA and Bristol-Myers Squibb, where he served as Senior Vice President of Human Resources.

**W**e were very interested in learning his views on risk, especially as to how the activities of the Obama administration and Congress might affect things.

**C-Suite Insight:** Let’s talk about risk as a hot topic right now.

**Charlie Tharp:** I was the moderator at a recent executive compensation seminar in New York, and yes, risk was a hot topic. It is so because there is a widely held belief—whether factual or not—that incentive compensation motivated the excessively risky behavior that helped fuel the financial crisis in late 2008.

**CSI:** You sound skeptical...

**Charlie:** Well, the discussion is about how the design of incentive arrangements motivated traders and others to pursue certain business strategies and they did this presumably to get payouts from their incentives. Given that the business strategy turned out to be much riskier than was initially assumed, the fact that executives had highly leveraged incentives tended to accentuate the risk inherent in the business strategy.

So it is not merely the incentive arrangement that is

problematic, but rather the combination of a risky business strategy with a highly leveraged incentive program that turned out to be a toxic cocktail.

**CSI:** And too much of that cocktail led to TARP and TARP-funded companies, which are now under scrutiny with regard to their executive compensation practices. What is to be learned from this?

**Charlie:** The first effect of TARP on all companies is that boards are interested in the topic of risk and are asking themselves, “What are those things that could represent inordinate risk in our incentive programs, and how do we mitigate them?”

**CSI:** Is it fair if companies other than TARP-funded companies are receiving added scrutiny?

**Charlie:** Heightened attention is not a bad thing in that it causes companies to revisit their overall compensation design to ensure it is achiev-

ing the desired impact on company performance without exposing shareholders to excessive levels of risk.

But the key is that most companies don't have programs that really encourage excessively risky behavior. By and large, most big companies have well-thought-out plans without uncapped payouts that represent a balanced approach to motivating the accomplishment of near-term objectives and sustaining long-term growth and profitability.

The risk we saw in some of the products in the financial services industry is different from the product mix and risk profile found in general industry.

**CSI:** But it behooves all companies to take a look at their exec-compensation practices.

**Charlie:** Sure, companies are starting again to look at the mix of pay. Most big non-financial companies have about 60 to 70 percent of senior executive compensation based on long-term incentives, with many of the long-term incentives heavily weighted toward stock-based compensation.

**CSI:** And LTIs vary, of course.

**Charlie:** Yes. The links of the long-term performance period will vary dramatically between industries, as will the overall mix of compensation. For example, within the pharmaceutical and oil industry, the product development and performance cycle may

be very long, indeed perhaps as long as 10 to 15 years, and the orientation of incentives is similarly very long-term.

But generally, companies have three-year performance cycles on their long-term plans. Then, they reward a new cycle each year. Three years overlapping provides a nice continuation of long-term focus while reinforcing the accomplishment of intermediate performance objectives.

**CSI:** Are all these companies really looking at risk, then?

**Charlie:** The degree of risk is not as great for all of them, but paying attention to the relationship between incentives and risk is still important, and boards are increasingly discussing how best to mitigate the potential risk in incentive plans.

Common areas of focus when attempting to mitigate risk are share ownership guidelines for executives, mix of pay, clawbacks, and the increased emphasis on long-term incentives. These help mitigate the potential that incentives may encourage excessively risky behavior.

**CSI:** What role will the Obama administration and Congress end up playing with respect to executive compensation over the long term?

**Charlie:** First of all, we've just gone through a very unusual situation, with the government becoming a major stakeholder and investor in the troubled companies that participated in a government

## Mitigating Risk

**CSI:** How do boards mitigate inordinate risk in incentive programs?

**Charlie:** We have an eight-point checklist of questions we suggest that boards explore when reviewing their incentive arrangements:

1. Do the performance criteria and corresponding objectives represent a balance of performance and the quality and sustainability of such performance?
2. Is the mix of compensation overly weighted toward annual incentive awards, or is there a balance of annual and long-term incentive opportunities?
3. When compared to a carefully chosen peer group, is the relationship between performance and incentive plan payouts within the range of competitive practices?
4. Is there a relationship between performance criteria and payouts under the annual incentive award consistent with targeted performance under the long-term incentive awards?
5. Are the long-term incentive performance measures or equity devices overly leveraged and thereby potentially encourage excessively risky behavior?
6. Is there a requirement that a meaningful portion of the shares received from incentive award payouts be retained by the participants?
7. Has the Board of Directors adopted a recoupment policy which provides for the clawback of incentive payouts that are based on performance results that are subsequently revised or restated and would have produced lower payouts from incentive plans?
8. Does the Compensation Committee discuss the concept of risk when establishing incentive performance criteria and approving incentive payouts?

*We provide a lot of detail in answering those questions at our website. You can find it at [www.execcomp.org](http://www.execcomp.org).*



bailout. It's also unique in that the government is now involved in the day-to-day design of pay. [Fortunately] this is a short-term issue, as Kenneth Feinberg, the Special Master, has stated he doesn't see his job as an ongoing role.

Having said that, there are various bills being proposed that would have a longer-term impact. Certainly the Schumer, Frank, and Dodd bills all fall into this category, since in addition to the proposed changes to corporate governance, they also contain various limitations on executive compensation.

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**CSI:** So here's the big question: if you had the ear of President Obama, what would you say to him?

**Charlie:** I would tell him to look at history. The history of government intervention in executive pay has not been helpful, and we have learned that the substitution of government mandates for the recent judgment of the Board of Directors has led to unintended consequences.

Look at Section 162(m) of the IRS code as an example. [Note: This section limits the tax deductibility of executive compensation to \$1 million per covered executive, with an exception for performance-based compensation.] Its practical result meant that the salaries of virtually all CEOs jumped to a million dollars, and a significant portion of the executive pay package was shifted to stock options, which are deemed

to be "per se" performance-based compensation, and therefore exempted from the million-dollar cap.

There is serious debate by critics of executive pay as to whether this shifting compensation mitigated risk or increased it. Any time the government intervenes, it usually has unintended consequences.

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**CSI:** So what specific things would you tell the President?

**Charlie:** The first thing he should do is let compensation committees of boards do their job. It's really the board that has confidential information about all the issues relating to executive compensation, including succession plans and business strategy, for example.

But he could make sure they are independent, and that they're getting independent advice and that there continues to be transparency and clear disclosure about the process as to how pay is determined and the relationship between the pay and performance.

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**CSI:** And what role should shareholders play?

**Charlie:** The most important role for shareholders is the selection of the Board of Directors. The Board of Directors are the fiduciaries who help monitor the action of management and run the company in the best interests of all shareholders. While it's rational for shareholders to express their views about the performance and qualifications of

the Board of Directors, it does not necessarily follow that shareholders should have a voice in the determination of executive pay.

They don't really have the information to make a rational decision about the appropriateness of compensation, and to substitute the views of generally uninformed shareholders for that of a dedicated and knowledgeable compensation committee is not in the best interests of companies and is counter to the long-established roles of shareholders and boards.

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**CSI:** But doesn't shareholders' desire here stem from the idea that boards don't have anything else to curb them?

**Charlie:** Compensation committees operate under the requirements of independence as established in the NYSE rules and the disclosure rules promulgated by the SEC. My observation is that compensation committees are becoming more independent and are seeking expert advice from independent consultants to help them in the area of executive compensation. Shareholders should certainly expect compensation committees to be independent and to have an in-depth understanding of the business strategy and how pay links to performance. This should be a key consideration when shareholders vote for directors.

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**CSI:** Who should serve on compensation committees?

**Charlie:** Frankly, corporate executives, especially sitting and retired CEOs, have the best perspective on business strategy and the linkage between effective compensation design and performance. Academics understand the theory of compensation and have research expertise, but they don't have the practical expertise of how to make these connections work in the business setting. In the compensation committee, companies need someone who understands business, someone who understands what it takes to drive performance.

Go back to what a board does. It does two things: it serves as a fiduciary on behalf of shareholders by monitoring the behavior of management, but it also provides advice and counsel to senior management, so in this respect, a CEO [on the board] is very useful.

**CSI:** When, if ever, will things settle down?

**Charlie:** Let's remember that even when the market was doing well, there were always issues around compensation. It's a populist issue and always will be. There are many more voters making \$50,000 a year than \$5 million; therefore, the view that compensation is too high is a very easy political issue to leverage. But to the extent to which unemployment lessens, the market improves, and foreclosures slow down, there should be less attention to executive compensation and efforts to vilify incentives.

**CSI:** But it will never go away entirely.

**Charlie:** I have been involved in executive compensation for more than 30 years, and I can't remember a year when executive compensation wasn't a hot issue. It's always a bit of a hot button because it grabs popular attention, is an easy agenda for politicians, and sells newspapers.

**CSI:** But it's not as if these issues aren't real...

**Charlie:** There are certainly cases of companies providing levels of compensation that are hard to justify and that don't seem to be linked with performance, and in these cases we have had the government react with regulations or legislation, such as 162(m) or 409A. There always seem to be outliers that get political and popular attention.

**CSI:** Speaking of newspapers, what advice do you have for companies to keep unhappy stories about them off of the front page of *The Wall Street Journal*?

**Charlie:** There are a few things they can do.

First, they have to do a better job in explaining pay for performance. Today, it's hard to tell what someone makes because so much of what is required to be disclosed is a mix of accounting expense and the actual pay someone makes.

Companies have to show the accounting expense of equity awards, the Black-Scholes [value], so it is

incumbent upon companies to report what actual pay is and how the level of actual pay corresponds to performance. So I would advise companies to tell their pay-for-performance story, rather than letting someone else say what their executives presumably made, which is often the mixing of apples and oranges in terms of actual compensation and accounting expense for equity awards.

Second, companies need to take a hard look at the perquisites they provide and explain to shareholders the purpose behind these benefits and how they help add value. Some of the areas of heightened criticism are perquisites such as personal use of company aircraft, which is generally driven by security concerns for the safety of the CEO.

Of course, not all perquisites can easily be justified as providing benefits to shareholders, and the company should take a hard look as to whether such perquisites should be continued. One word of advice for compensation committees is to adopt the view of everything in moderation.

When any part of a pay package is far over the top, then you're just asking for someone to question why. Balance all the parts, create a balanced program based on sustainable performance, and I don't think you'll end up in *The Wall Street Journal* in a story about executive compensation. ■

# PERKS AND BENEFITS: WHAT WILL PLAY IN PEORIA?

Equilar Research from Fortune 100 Proxies  
Finds Most Perks Intact, If Reduced



**E**xecutive compensation is in the public eye as never before. Benefits and perquisites have received special scrutiny. With the U.S. government working to limit overall compensation—including benefits and perks—for companies that received Troubled Asset Relief Program (TARP) funds, we can expect a spillover effect to all public companies.

Equilar has announced its *2010 CEO Benefits and Perquisites Report* against this backdrop. Areas covered in the report include financial planning and related services, flexible perquisite accounts, personal and home security, personal use of corporate aircraft, and tax reimbursements (or “gross-ups”).

## COMPANIES ARE ACTING QUICKLY

This article highlights the findings of Equilar’s report, which is primarily based on proxy filings from Fortune 100 companies in 2008, the most recent year for which data is available. This article also includes data on executive retirement benefits, and provides specific examples from a cross-section of industries.

Many companies are now working at full speed to amend their compensation programs. In 2008, 29.2 percent of Fortune 100 companies indicated they would eliminate some executive perquisites that year or by the start of 2009.

As far as specific perks are concerned, more than 50 companies in the S&P 500 index either reduced or eliminated tax reimbursement programs for their executives in the first few months of 2009. The use of corporate aircraft (whether for business or personal use) is another perquisite in the bull’s eye today.

According to the Equilar research, “other” compensation dropped 2.3 percent in 2008, and should be expected to drop further this year. This was after an increase of 6.5 percent in 2007. The median value of other compensation for Fortune 100 CEOs was thus \$348,101 in 2008, versus \$356,175 in 2007.

Yet personal use of corporate aircraft rose dramatically in 2008, up 28.9 percent to a median value of \$141,477 from \$109,743 in 2007. Operating costs could have been a factor here, given the oil-price bubble in mid-2008. This perk’s prevalence ticked upward 4.5 percentage points, from 74.7 to 79.2 percent.

The accumulated pension benefit remained very strong in 2008, with 74.0 percent of companies reporting they had one in place for the CEO, with a median value of \$10.7 million. The median was up from \$10.3 million in 2007.

On the other hand, nonqualified deferred compensation plan balances fell in 2008, to a median value of \$3.6 million from about \$4.8 million the prior year. A total of 82.3 percent of Fortune 100 companies reported a non-qualified deferred compensation plan balance for their CEO.

## FINANCIAL PLANNING A MIXED BAG

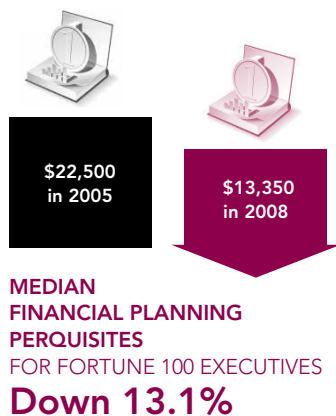
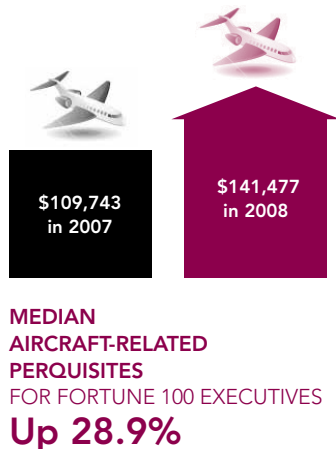
Financial planning remains an important perk for top executives, although the median value of this perk among Fortune 100 CEOs dropped 13.1 percent in 2008 to \$13,350, down from \$15,575. This continues a trend from the time this perk hit a peak of \$22,500 in 2004.

The value here principally concerns the cost of personal financial planning, but may also include tax preparation, corporate financial planning, and personal legal services. It does not include gross-ups.

A typical disclosure is provided by Safeway, as follows: “We make available to our executive officers the services of a financial planning firm. The firm offers services, paid by us; valued at \$15,000 for the executive’s first year with the firm, and \$10,000 for each year after the first year. The executive is responsible for income taxes on any services provided through this program. Some executives, including [our CEO], have decided not to participate in this program.”

A thought process common throughout the Fortune 100 is shown in this excerpt from Travelers Companies Inc.: “The Compensation Committee believes it is important to provide financial counseling to senior executives to help them maximize the benefits they realize from the various elements of compensation...the use of a single financial counseling firm by most of our senior executives helps our Human Resources Department improve senior executives’ understanding of the benefits.”





On the other hand, Caterpillar Inc. and ConocoPhillips were among the companies that discontinued a financial planning benefit in 2008.

### FLEXIBLE PERKS INCREASING

One smaller trend that might get lost in the big picture is the idea of flexible perquisite accounts, which were reported by 8.4 percent of Fortune 100 companies, a 33-percent rise when compared to the 6.3 percent of companies providing this perk during the previous year. The value held steady, at a median of \$35,000, down less than one percent from the year before.

### PERSONAL SECURITY IS NO JOKE

Moving on to a more visible—and controversial—area, the report saw an amazing rise in the median value of personal and home security perks in 2008: They rose to \$64,348, more than double the 2007 median of \$29,291.

This perk can draw bemused looks from commentators, who often seem to view personal and home security as a responsibility of the individual. But several disclosure examples outline the seriousness of this category.

Witness this disclosure from Dell Inc.: “For Mr. Dell this security includes personal security as well as residential security and is provided pursuant to a separate Board-authorized security program. The Board believes that Mr. Dell’s personal safety and security are of vital importance to the company’s business and prospects and, therefore, that these costs are appropriate corporate business expenses. Nevertheless, because these costs can be viewed as conveying personal benefits to Mr. Dell, they are reported as perquisites in this column.”

An even harder line is drawn by Exxon Mobil Corp.: “The Company does not consider any such security costs to be personal benefits since these costs arise from the nature of the employee’s employment by the Company; however, the disclosure regulations require certain security costs to be reported as personal benefits. For (the CEO), the amount shown includes \$34,060 for car, \$57,513 for personal security driver, and \$122,182 for residential security. The remainder is for mobile phones and other communications equipment for conducting business in a secure manner.”

### THE \*!\*&\$ CORPORATE JET UNDER SCRUTINY

Personal security is one thing. Personal use of corporate aircraft is another, and represents possibly the most visible and controversial aspect of CEO compensation overall. The mystique of flying has not abated since the idea of the “Jet Set” came about half a century ago, and corporate aircraft remain the most visible symbol of power and wealth in society.

In 2008, the median value of aircraft-related perquisites for Fortune 100 chief executives rose to \$141,477, an increase of 28.9 percent over the 2007 median of \$109,743.

From 2007 to 2008, the prevalence of Fortune 100 companies reporting the personal use of corporate aircraft by CEOs rose from 74.7 percent to 79.2 percent. Overall, the prevalence of personal aircraft usage has increased from 2004 to 2008, and along with median value, has reached its highest level in the last five years.

Although the median value of CEO aircraft perquisites fell from 2006 to 2007, prior years of data show that the median value of aircraft-related perquisites has increased at an annualized rate of 12.2 percent from 2004 to 2008.

Gross-ups continued to be part of this picture as well. Among the 7.3 percent of Fortune 100 companies that disclosed a dollar amount for tax reimbursements for aircraft use, the median gross-up was \$9,936. This represents an increase of 25.7 percent from 2007, when the median gross-up was \$7,902.

Will this change dramatically in 2010? Despite the negative publicity generated by auto company CEO’s tone-deaf use of corporate aircraft to attend Congressional hearings in 2008, the value of top executives’ time will no doubt continue to weigh in favor of their use.

The key questions will revolve around how much of this use is truly for business versus truly personal, and whether gross-ups to the CEO will continue for a perk that is not cash-based.

Here is a frank disclosure from Safeway Inc. on this topic: “Based on the analysis of an independent security advisor, our Board has directed that [the CEO] will ordinarily use Company aircraft for all air travel, both business and personal, including his immediate family when they are accompanying him... Other executive officers are discouraged from mak-



ing personal use of the corporate aircraft, either by taking personal trips or by having non-business passengers accompany them on business trips.”

On the other hand, Pfizer Inc. has chosen to set a specific threshold for the entire executive team: “Pfizer ELT (executive leadership team) members are eligible to use the aircraft for business purpose... (and) may be accompanied by his/her spouse or partner...all spouse/partner travel is considered personal use and is subject to taxation and disclosure...approximately 20 hours of personal use per calendar year for each type of aircraft (helicopter and plane) are generally allowed for use by each ELT member.”

Pfizer also takes a hard line with respect to the SEC view of the situation: “The Committee considers these costs to be necessary, security-related business expenses rather than perquisites, but per the disclosure regulations we report the incremental cost of aircraft usage for personal travel.”

The disclosure from Travelers Companies Inc. illustrates that, because security (not lifestyle) is the prime rationale for travel on a corporate jet, this is not a simple issue: “(Our) security policy...requires that the CEO use Company aircraft for all business and personal air travel...the CEO is responsible for all taxes due on any income imputed to him in connection with his personal use of Company transportation other than travel taxed as commuting costs and spousal travel related to our business...we also on occasion provide transportation on Company aircraft for spouses of the named executive officers who accompany the named executive officers on trips related to our business but which spousal travel, under SEC rules, may not be considered to be directly and integrally related to our business. We reimburse the named executive officers for any tax liabilities incurred with respect to spousal travel related to business.”

Even so, some companies have chosen to buckle on this issue. Witness the disclosure from Sears Holdings Corp.: “After significantly restricting the use of our corporate aircraft, we have undertaken a process to sell our corporate jets in fiscal 2009.”

And finally, a few words from General Motors Corp., which became the center of the storm when its CEO (along with other automotive CEOs) made his ill-starred trip to Washington, D.C.: “On December 31, 2008, the Corporation entered into the UST

Loan Agreement which requires we take all reasonable steps to divest of any private passenger aircraft or any interest in such aircraft, and prohibits the leasing of private passenger aircraft. As a result, beginning January 1, 2009, [the CEO and a few other top executives] are now permitted to fly first class for international and domestic flights, and Automotive Leadership Group (ALG) members are permitted to fly business class for international and coach class for domestic flights.”

The new GMC LLC that recently emerged takes the same approach: “Upon becoming a TARP participant, all personal and business travel on company aircraft ceased.”

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## MORE ON GROSS-UPS

The gross-ups extend to other perks, of course, but there was a 21-percent drop in this area in 2008, driving the median value down to \$27,163 from \$34,396. This occurred as the percentage of CEOs receiving gross-ups of some kind continued its steady rise over the past several years, reaching 59.4 percent in 2008.

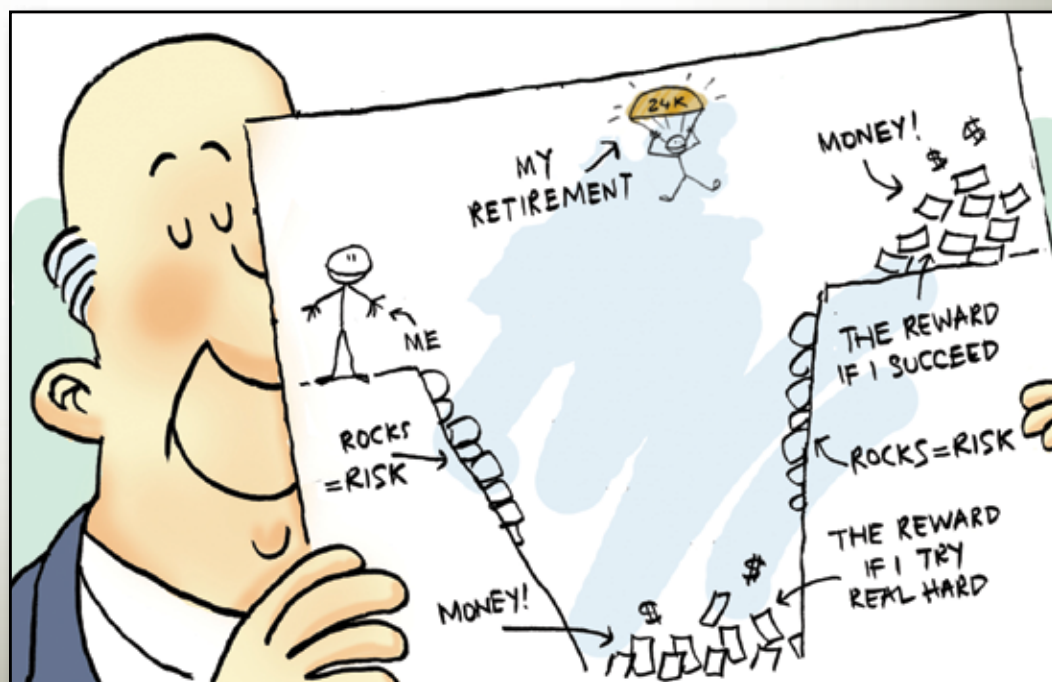
The Fortune 100 proxies also provide data on many other executive benefits and perquisites, including automotive and parking expenses, club dues, annual physical exams, matching charitable contributions, and corporate housing.

Disclosures on this topic, which will undoubtedly become more sensitive in the current overall economic environment of “jobless recovery,” are straightforward.

Deere & Co. provides a typical example, with a note that the car washes are now gone: “Miscellaneous perquisites include...car washes, participation in a staff retreat which included spouses in fiscal 2007, spouse attendance at a board meeting in fiscal 2008, and drive-by surveillance and response to alarms of certain Named Executive’s residences by Deere’s Corporate Security Staff. Company-provided car washes have been discontinued for fiscal 2009.”

Bottom line: You’ll just have to do some things yourself. But if the benefit relates to primary compensation (such as financial planning or life insurance) or security, it will probably last, through 2010 and beyond. 

## MEET \$EYMOUR CASH



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**DIRECTORS' COLLEGE** is the nation's premier executive education program for directors and senior executives of publicly traded firms. This RiskMetrics (ISS) accredited curriculum addresses a broad range of problems that confront modern boards, including the board's role in setting business strategy, techniques for controlling legal liability, the challenge posed by activist investors, and dramatic new changes in the rules governing the election of corporate directors.

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