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Executive Compensation: The Heat is On

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Objectives

- Summarize the current executive compensation environment
 - CEO pay trends
 - Pay/performance alignment
 - Shareholder and regulatory developments
- Outline a framework for evaluating and ensuring that executive pay is responsible and responsive to the current environment



The Current Environment

Executive pay garnering significant attention

Executive pay – Headline Topic

Continued scrutiny includes pay “levels” and pay practices

New SEC disclosure requirements

Shareholders becoming more active on addressing out of line compensation practices and perceived abuses

Increasing number of advisory groups offer opinion on executive compensation plans and programs

Board members and senior management are more accountable for pay issues

Executive pay and shareholder access – subject of Congressional interest and debate



The Four Quadrant Framework

A holistic approach to achieve responsible executive remuneration

- Pay and benefits, set relative to competitive and internal considerations
- Pay design, aligned with business strategy and value drivers
- Employment and severance arrangements

Remuneration

- Performance measurement framework tailored to the company strategy and drivers of value
- Performance targets, set to create an explicit link between pay and performance
- Pay outcomes, reasonable given relative performance

Performance

- Regulatory rules
- Accounting and tax requirements
- Disclosure requirements

Regulations

- Director compensation; Compensation Committee charters and practices
- Shareholder demands and influence
- Transparency and disclosure
- Role of the Committee's consultant

Governance



The Four Quadrant Framework

Current hot topics in executive remuneration

- Executive compensation trends
- Diversification of long-term incentive delivery
- Benefits and perquisites

Remuneration

- Attaching performance conditions to LTI awards
- Linking pay outcomes to key performance drivers
- Validating stretch of incentive plan targets from both internal and external perspectives

Performance

- FAS 123 (R) - Accounting for share-based payments
- 409A - Deferred comp reform
- New SEC disclosure rules

Regulations

- Shareholder proposals and approvals
- Transparency and disclosure
- Compensation committee process
- Careful management of potential equity dilution levels through a focus on run-rate and overhang of equity compensation

Governance



- Executive compensation trends
- Diversification of long-term incentive delivery
- Benefits and perquisites

Remuneration





Remuneration Definitions

- **Total Cash Compensation (TCC) =**
 - Salary + bonus earned for fiscal year
- **Total Direct Compensation (TDC) =**
 - Salary + bonus + value of long-term incentives (LTI) *granted* in the fiscal year
- **Total Compensation (TC) =**
 - TDC + pension values, nonqualified deferred comp (NQDC) earnings and all other compensation
 - Includes the annual increase in pension value, above market NQDC earnings, perquisites and personal benefits, tax gross-ups, etc.



Remuneration CEO Pay

- CEO compensation increased moderately in 2006, while corporate performance was strong, on average

2006 Median Performance

- Increase in annual incentives tracks corporate profitability:
 - Revenue: + 8.9%
 - Net Income: + 14.4%
- Increase in expected value of long-term incentives in 2006 consistent with higher stock prices:
 - 1 year TSR: + 15.1%

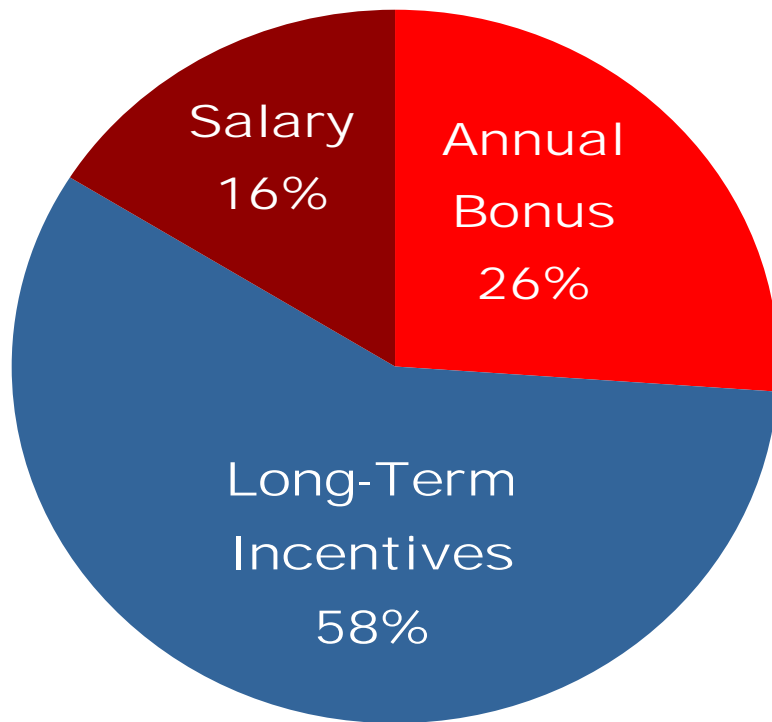
2006 Median CEO Pay

	2006 (\$000's)	% Change from 2005
Base Salary	\$995	+ 4.1%
Annual Incentive	\$1,553	+ 8.1%
Total Annual Comp	\$2,598	+ 7.1%
Long-Term Incentive	\$4,135	+ 8.5%
Total Direct Comp	\$6,549	+ 8.9%



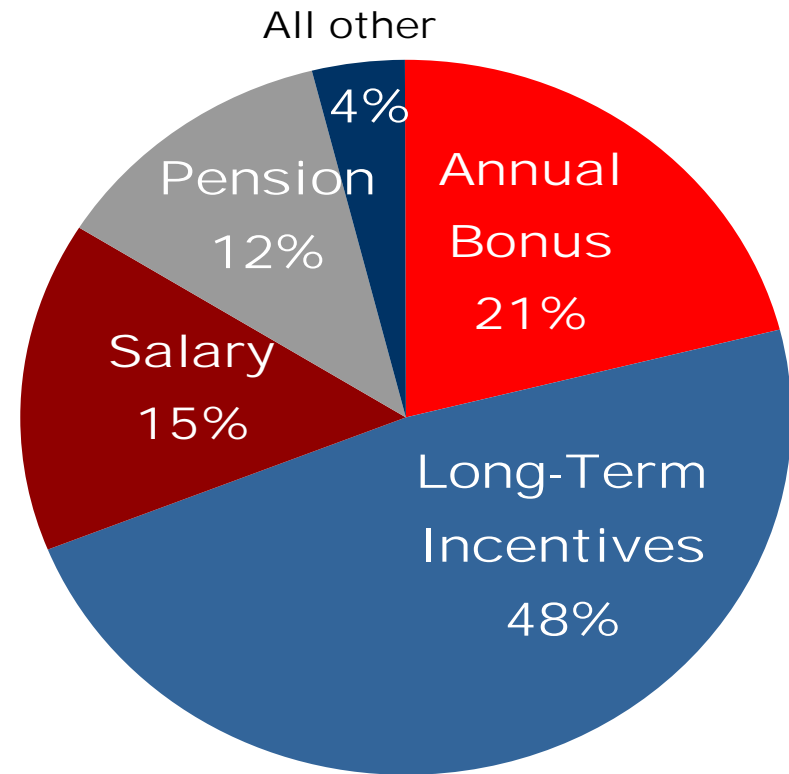
Remuneration CEO Pay Mix

CEO Pay Mix - TDC



\$ 6.5 million median

CEO Pay Mix - TC

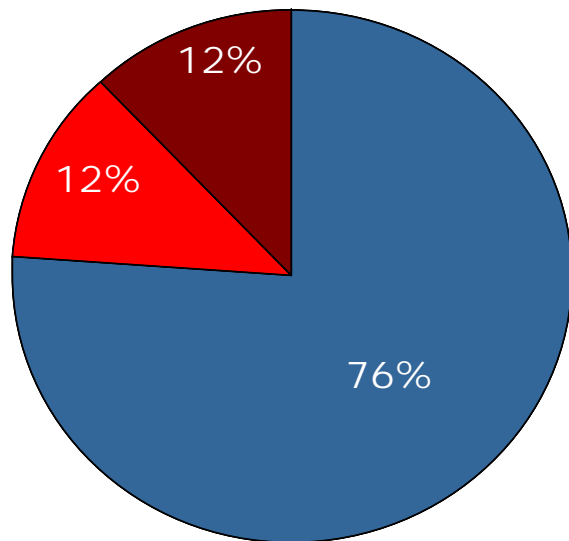


\$ 8.2 million median

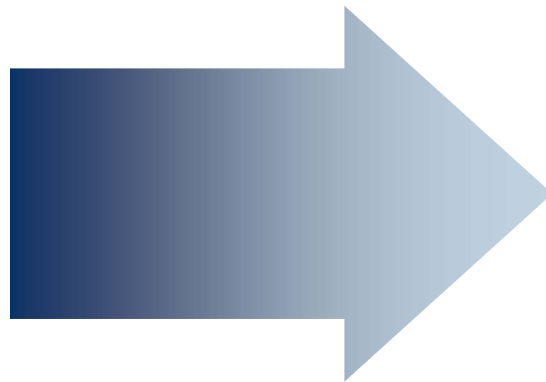
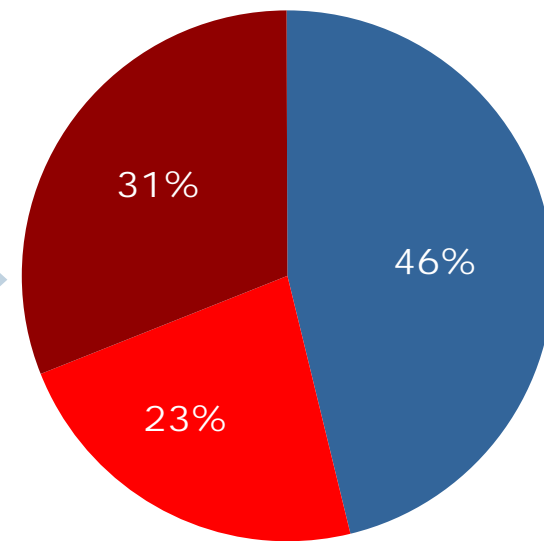


Remuneration CEO LTI Mix

2002



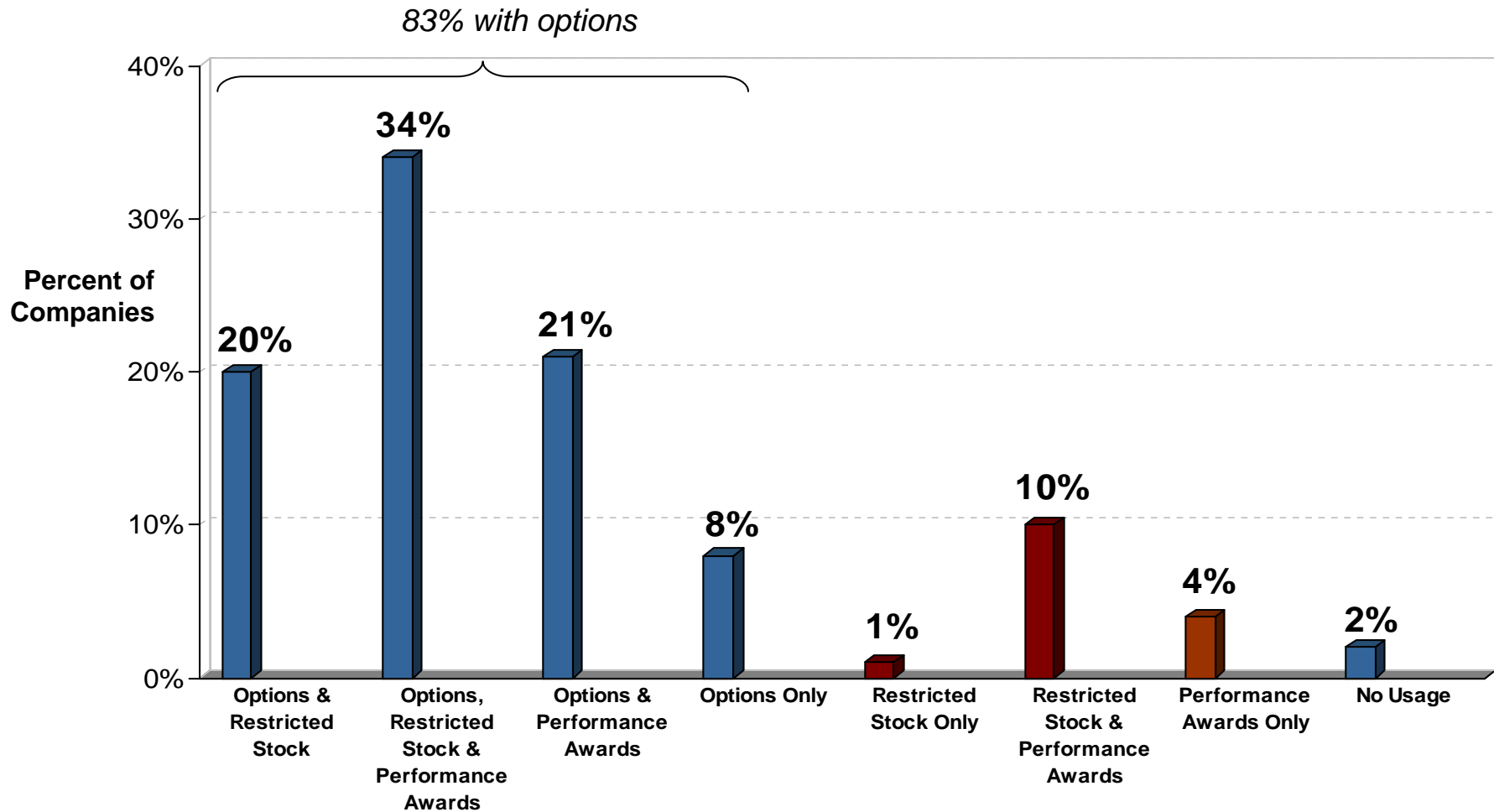
2006



- Stock Options
- Restricted Stock/Cash
- Performance Awards



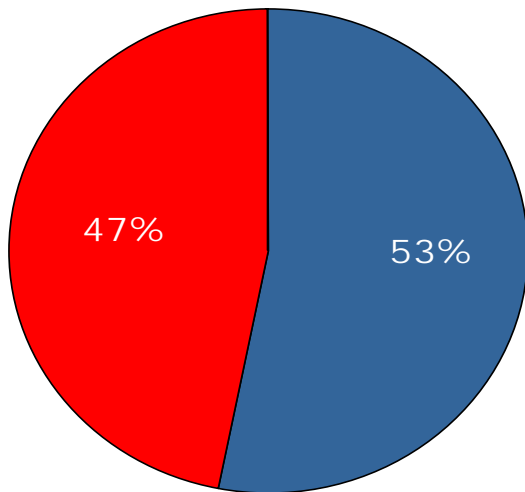
Remuneration Types of LTI Vehicles Used for CEO



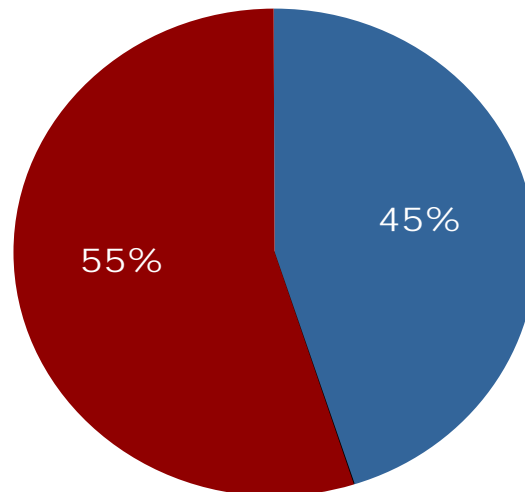


Remuneration CEO Average LTI Mix in 2005 by Program Type

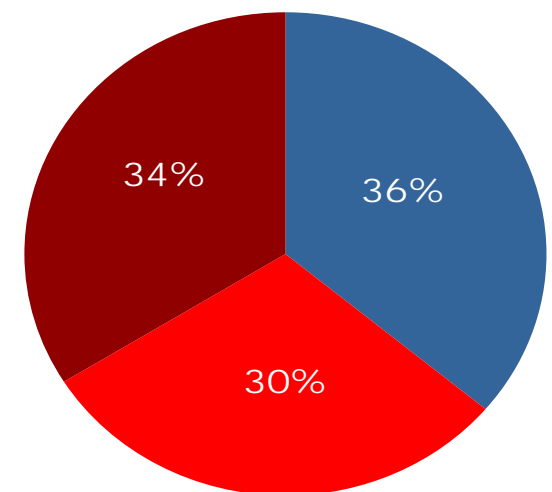
Options &
Restricted Stock



Options &
Performance Awards



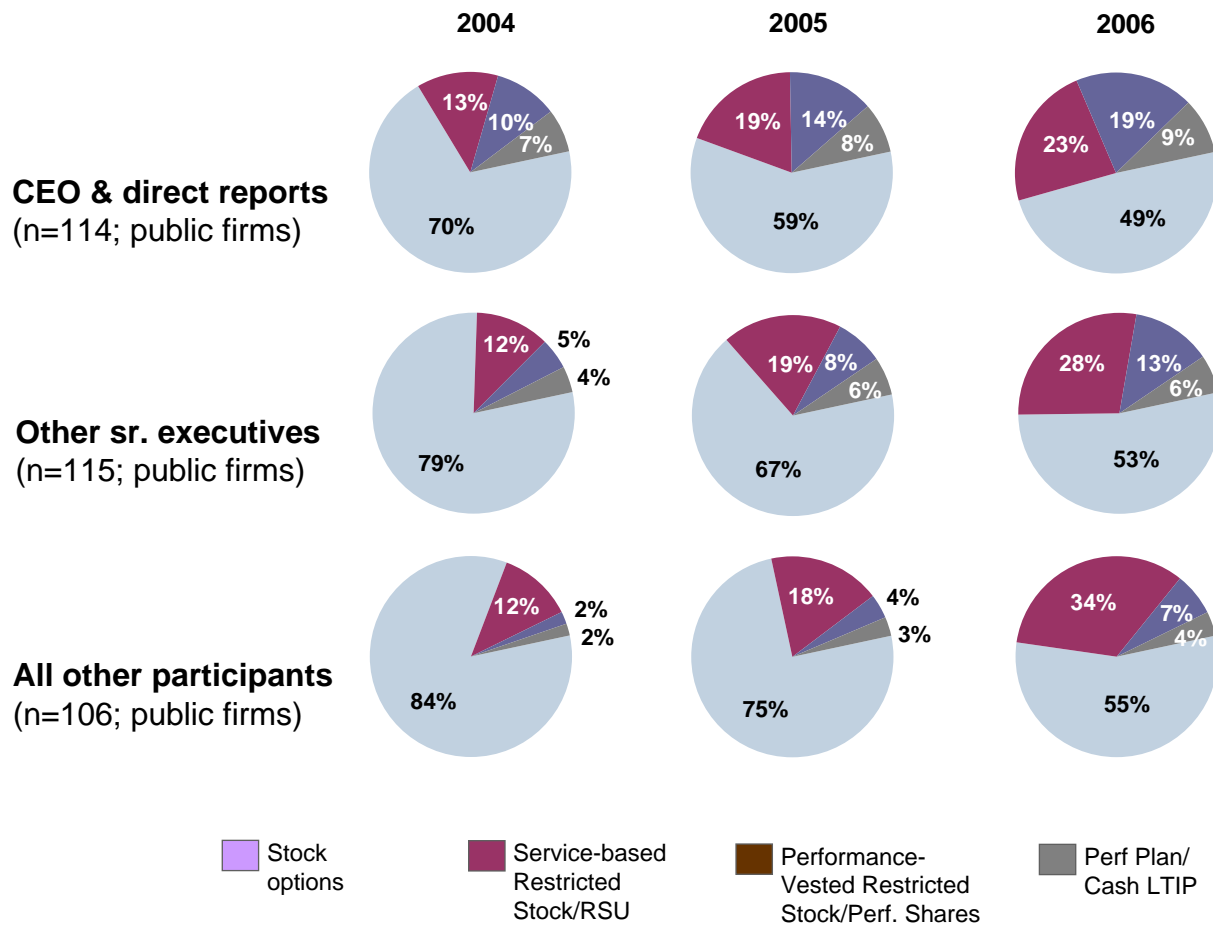
Options,
Restricted Stock &
Performance Awards



- Stock Options
- Restricted Stock
- Performance Awards



Remuneration Changes in LTI Mix



- Across all employee groups, stock option value has shifted from 70% or more of the LTI mix to about 50% of the mix.
- The greatest shift away from option use has been at levels below senior executives.
- Use of restricted stock (service or performance vested) has seen an upswing across all groups, and now accounts for about 40% of the LTI mix (compared to 15% - 20% in 2004 depending on the employee group).
- While service-based restricted stock is still used, performance-vested restricted stock or performance shares have gained prominence, particularly for senior executives and above.



Remuneration Changes in LTI Strategy

Job Groups	LTI Eligibility	LTI Vehicles (Prevalence)				LTI Value
		Stock Options	Service-Based Restricted Stock/RSU	Performance-Vested Restricted Stock/Perf. Shares	Perf Plan/Cash LTIP	
Executive	=	↓	↑	↑	=	=
Management	=	↓	↑	↑	=	↓
Professional	↓	↓	↑	N/A	N/A	↓
Office/Clerical/Technical	↓	↓	=	N/A	N/A	↓



- **Attaching performance conditions to LTI awards**
- **Linking pay outcomes to key performance drivers**
- **Validating stretch of incentive plan targets from both internal and external perspectives**

Performance





Performance Use of Performance-based LTI

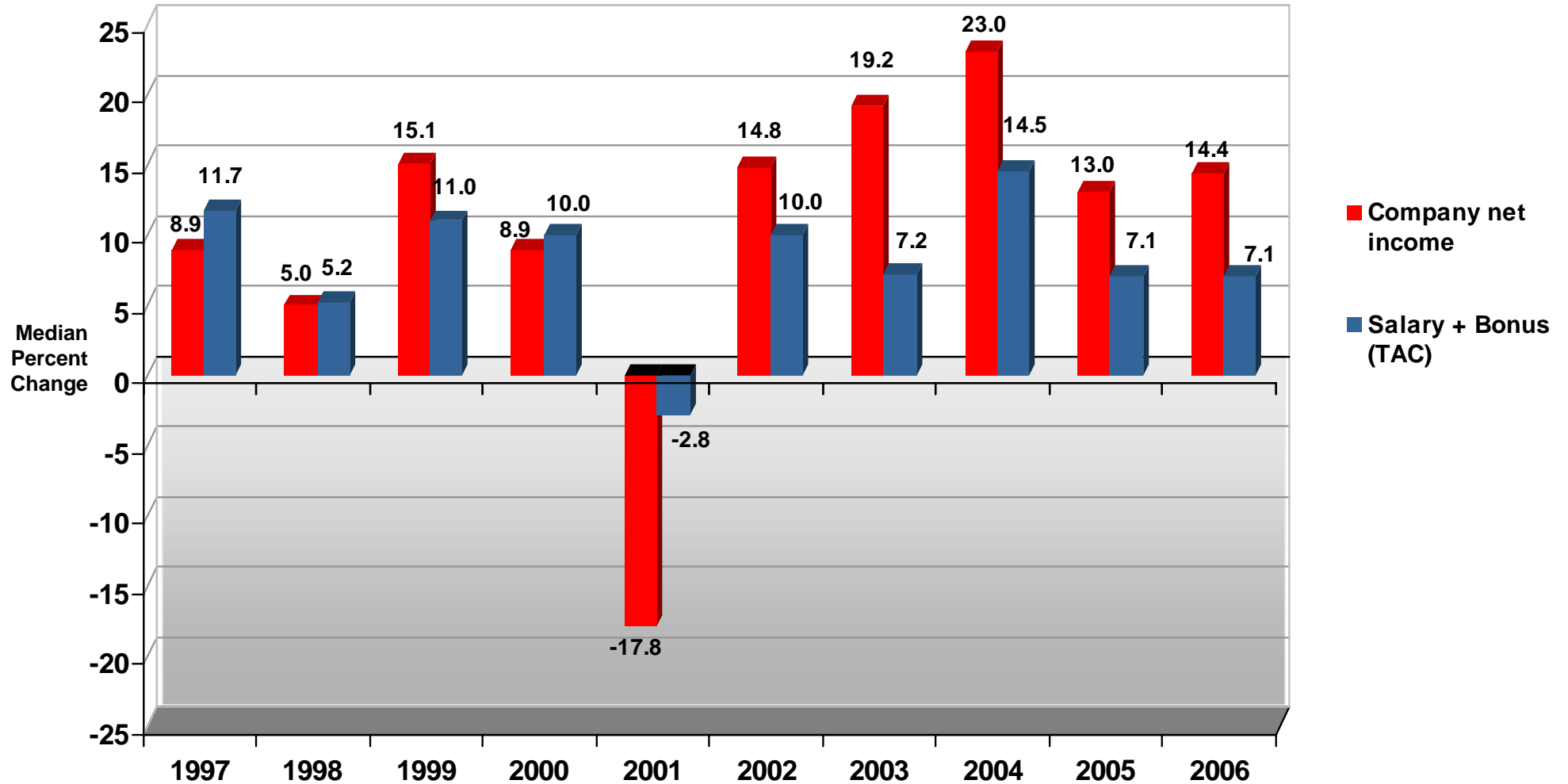
	2002	2006
Performance Based LTI	31%	69%
Performance Equity	20%	53%
– Performance Restricted Stock	1%	25%
– Performance Shares	14%	32%
– Performance Stock Options	5%	2%
Performance Cash/Units	12%	23%

Note: Some companies use multiple plans, so numbers do not add to the totals



Performance

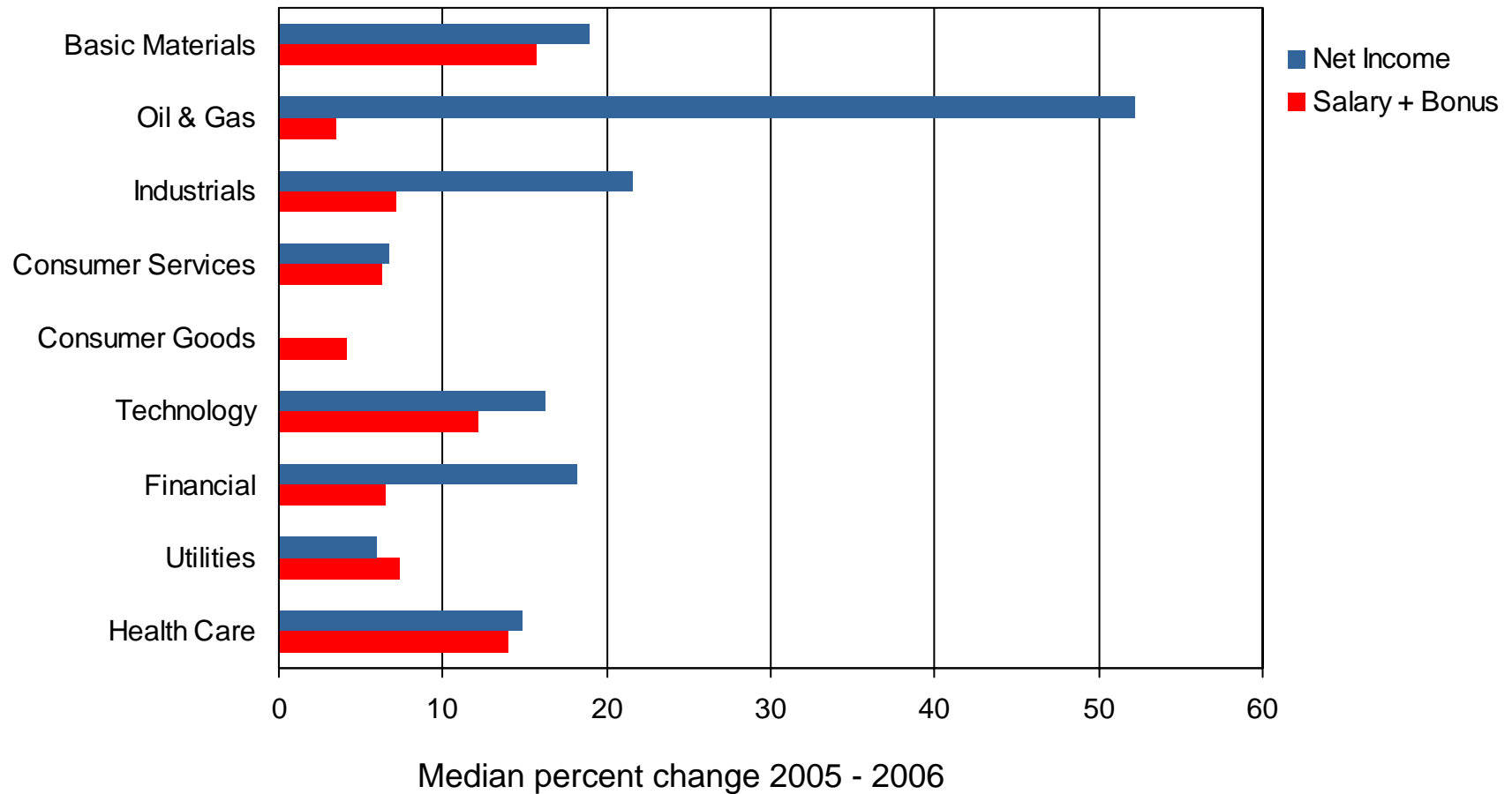
Change in salary + bonus compared to corporate profits





Performance

Corporate profit growth exceeded salary + bonus gains in 7 of 9 industry groups



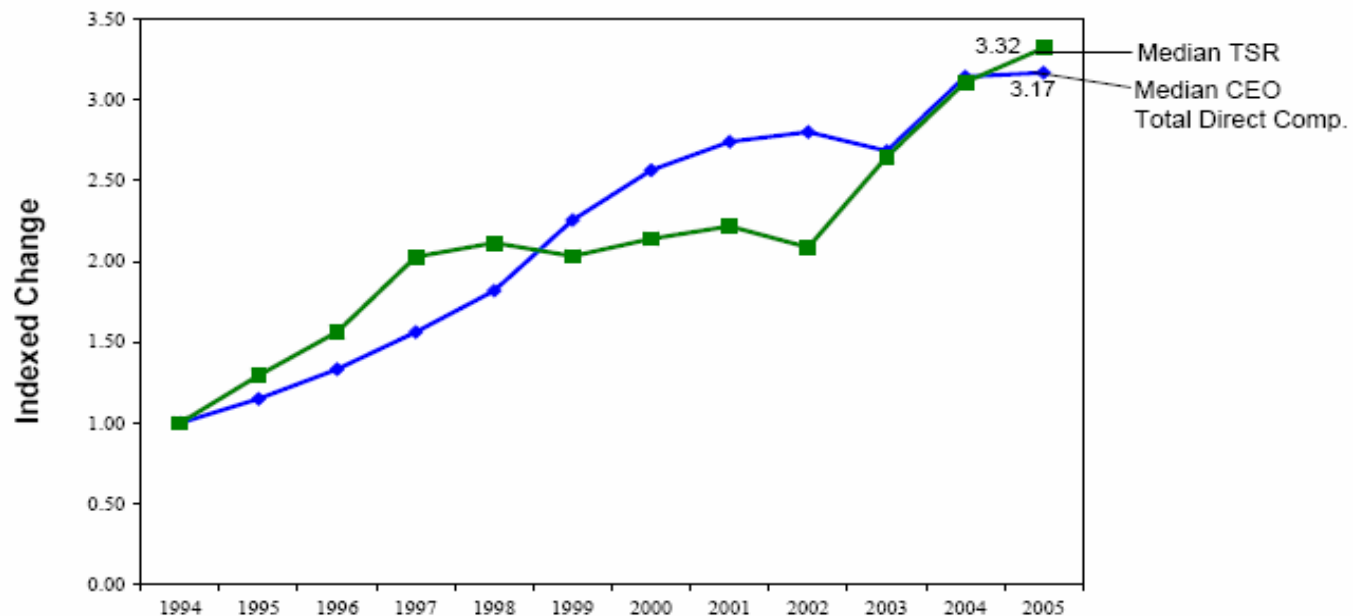


Performance

The Link Between TDC and Performance

- Over a ten year period from 1995-2005, median total compensation for CEOs in Mercer's 350 database increased 9.6 percent per year.
- This tracks closely with the 9.9 percent median annual shareholder returns over the same ten-year period, and the 8.8 percent annual growth in median total market capitalization.

Changes in CEO Pay vs. Total Shareholder Return



(1) Mercer 350 database; continued Incumbents only



Performance Highlights of Pay and Performance

- Pay and performance alignment continues to strengthen

	<u>2006 TSR</u>	<u>Change in Profit</u>	<u>Change in TDC*</u>
75th percentile	26.0%	40.6%	28.0%
Median	15.1%	14.4%	8.9%
25th percentile	3.0%	-6.0%	-8.7%

** Total Direct Compensation = salary + bonus + grant value of long-term incentives*

- Relative performance: Over 40% of companies now use comparisons against peers in their long-term performance plans (80% of these use TSR)



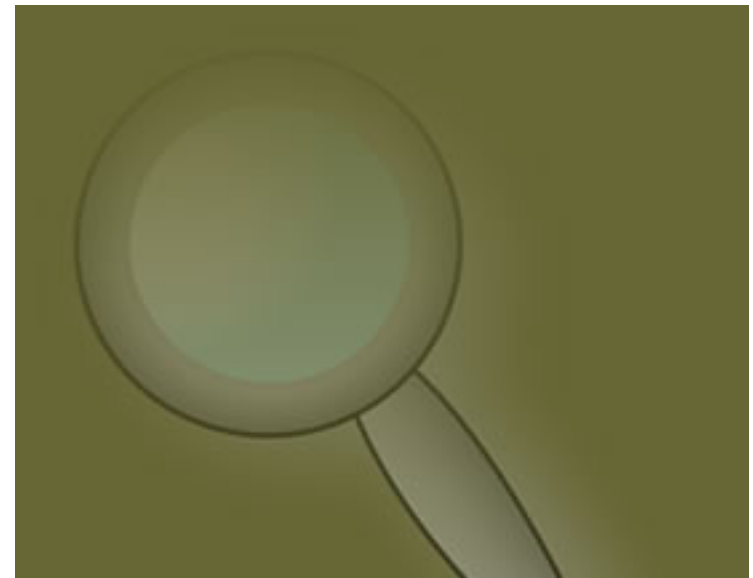
Performance Areas for Future Improvement

- **Link total compensation more closely to performance – directionally is not strong enough in today's environment**
 - More focus on performance conditions attached to LTI vehicles
 - Reconsider elements that are not performance-related, such as SERPs, preferential deferred compensation, and perquisites
 - Minimize pay for failure
- **Create transparency regarding performance measures, targets and achievement**
 - Clear rationale behind selection of performance measures (beyond EPS and TSR)
 - Balanced focus on growth and returns
 - Integrated short-term and long-term incentive programs
 - External testing of internally set targets (not just financial budgets)
 - Greater use of relative performance measurement
 - Explicit guidelines for making adjustments



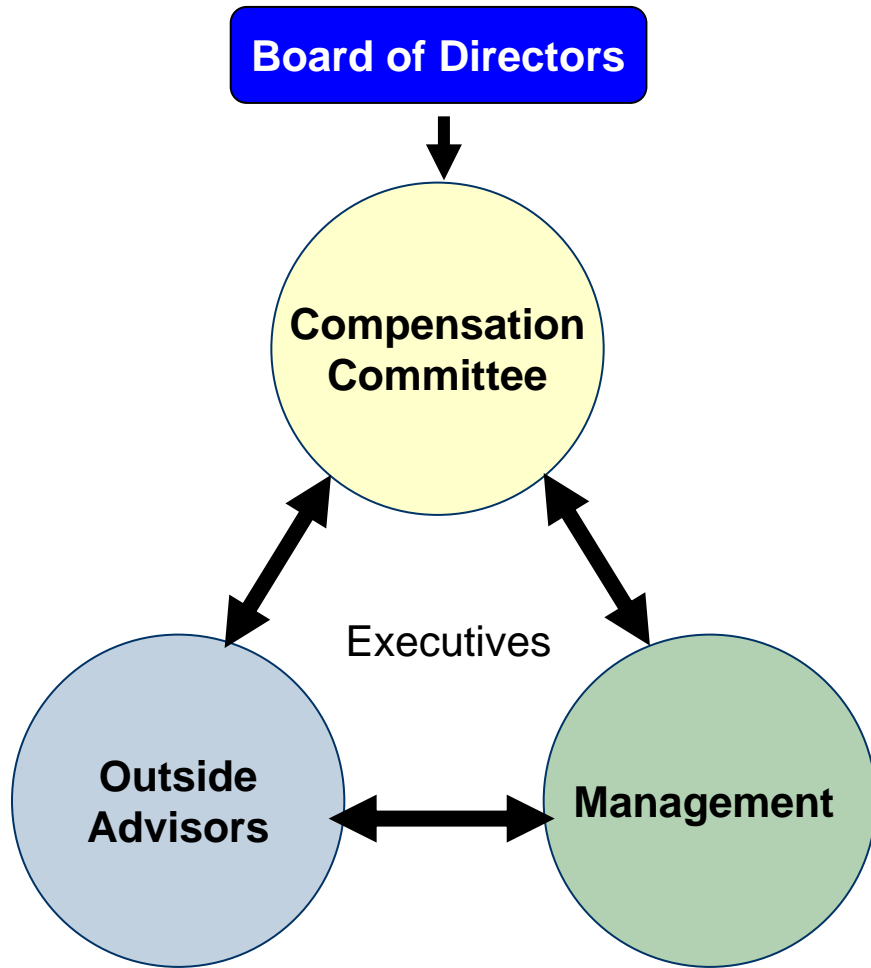
- Shareholder proposals and approvals
- Transparency and disclosure
- Compensation committee process
- Careful management of potential equity dilution levels through a focus on run-rate and overhang of equity compensation

Governance





Governance Model of Effective Governance



Outside Influences

Active Investors

CalPERS
TIAA-CREF
AFL CIO
S.W.I.B.

Proxy Advisors

ISS
Glass-Lewis
Proxy Governance, Inc.

Regulators

SEC
Congress.



Governance

Hallmarks of Today's Corporate Governance Landscape

- **Greater influence of institutional shareholders and proxy advisors on compensation programs**
 - Tougher to gain approval of new plans
 - Larger impact of shareholder proposals on plan design
 - Compensation Committees held accountable
- **Transparent compensation design, decision-making, and rationale**
 - New SEC disclosure rules
 - Median market pay positioning – let performance drive ultimate payouts
- **Greater board involvement in senior executive pay decision-making**
 - More deliberations
 - Validation of pay alignment with business strategy
 - Review of performance measures and targets to ensure company is paying for the right performance and the right amount of performance



Governance Shareholder Proposals

- **2007 Proxy Season shaping up to be record year for proposals**
 - Fueled by high-profile compensation issues
- **New Proposals for 2007**
 - Option Policies
 - Report on Committee advisor independence
- **Modification of 2006 Proposals**
 - “Say on Pay” – seeking advisory vote on compensation package
 - SERP calculations / formula
- **Prior Year Proposals which Received Strong Support**
 - Pay for Superior Performance
 - Performance equity
 - Shareholder Approval of CIC and Severance Payments
 - Recoupment / Clawback Policies
- **Other Proposals**
 - E.g., capping certain compensation, eliminating options, two-thirds of board approval for CEO pay



Governance Shareholder Proposals

ISS 2007 Proxy Season Watchlist*

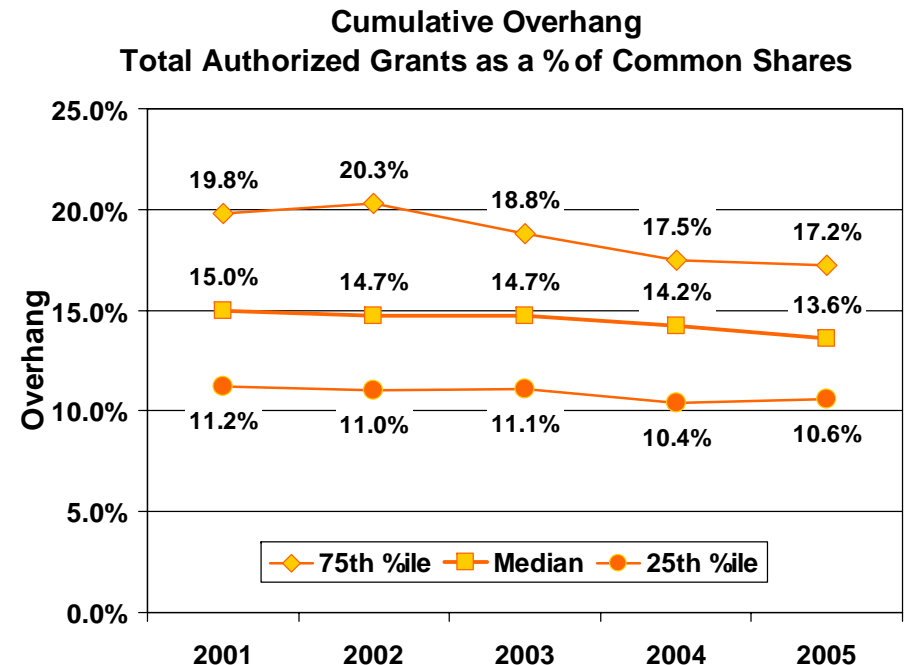
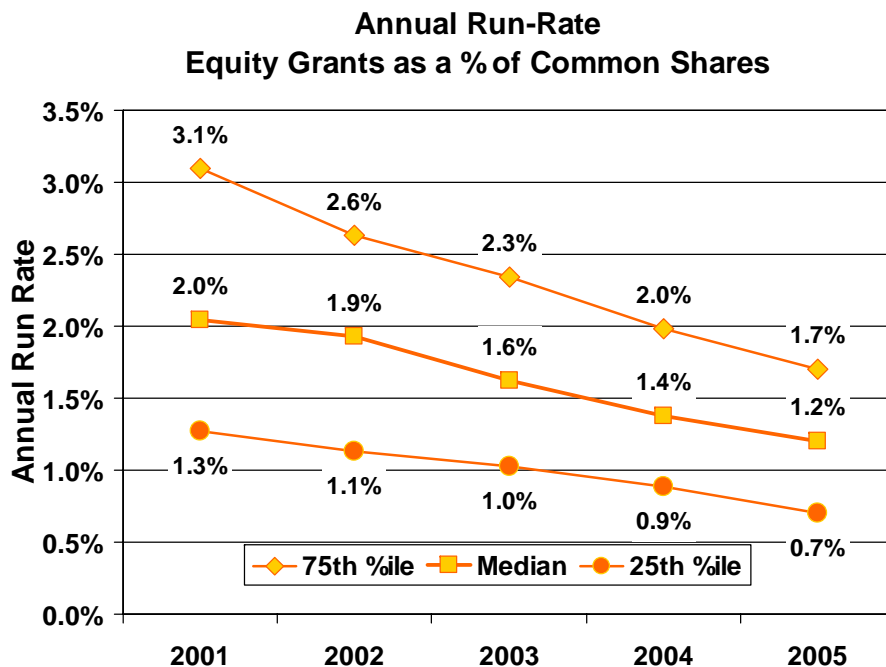
	Proposals Pending	Proposals Voted	Proposals Withdrawn	Proposals Omitted	Proposals Tracked (Total)
Governance – Board Issues					
Require majority vote to elect directors	58	3	75	4	14
Proxy access	1	1	1	0	3
Independent board chairman	34	4	3	4	45
Governance – Executive Pay Issues					
Supplemental executive retirement plans	14	0	6	0	20
Link pay-to-performance	40	2	16	1	59
Advisory vote on compensation	45	0	9	10	64
Reform option grant practices	6	0	5	0	11
Award performance-based stock options	12	1	0	2	15
Recoup unearned bonuses	10	0	1	0	11

* As of March 30, 2007; Source Institutional Shareholder Services © 2007



Governance Management of Overhang and Run-Rate Levels

- **Run rates and overhang are dropping**, a function of accounting impact and increased institutional shareholder focus on equity usage
- Use of **multiple vehicles** (replacing stock options with other vehicles) and **performance measures** (e.g., performance-contingent or performance-accelerated vesting)
- **Reduced eligibility/participation levels**





Governance

Enablers of Developing Sound Executive Pay Practices that Stand up to Shareholder Scrutiny

- Clearly articulated compensation philosophy, strategy and program rationale
- Appropriate link of pay to performance
- Regular review of all compensation elements
- Well defined decision-making processes and oversight by Compensation Committee
- The right balance between shareholder, company and employee interests
- Communication strategy with key shareholders and their advisors



- **FAS 123 (R) - Accounting for share-based payments**
- **409A - Deferred comp reform**
- **New SEC disclosure rules**

Regulations



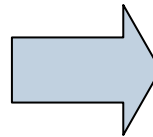
Regulations

FAS 123 (R) - Accounting for share-based payments

FAS 123 (R)

- Options have an expense (value determined using an option pricing model such as Black-Scholes, fixed at date of grant)
- Value of restricted stock, RSUs*, SARs* and performance shares fixed at the date of grant
- Expense can be reversed if shares don't vest (unless using market-based performance conditions)
- ESPPs considered compensatory unless purchase price no more than 5% below stock price on date of grant
- Tighter valuation assumptions – use most likely values, not lowest values

** If settled in stock*



Implications for Plan Design

- “Levels the Playing Field” in design
 - Greater focus on ROI and “best fit” rather than “best practice”
 - More diversity in LTI delivery
 - Shift toward full-value shares, especially at lower levels
 - Balance cost with perceived value to recipients and alignment with shareholder interests
 - Introduction of choice
- Efforts to control expense
 - Reduction in eligibility, size and frequency of broad-based grants
 - Changes to plan design (ESPPs, option terms)



Regulations

409A Deferred Compensation Legislation

- **Section 409A added by American Jobs Creation Act of 2004**
 - Reforms rules governing nonqualified deferred compensation (NQDC)
- **Effective for deferrals on or after January 1, 2005**
 - Compensation earned and vested on or before December 31, 2004 is grandfathered
- **Statute is very broad and penalties for noncompliance are steep**
 - Applies to all employees, directors, and independent contractors
 - Applies to corporations, tax-exempt entities, churches, and governmental entities
- **Statute has application beyond traditional deferred compensation arrangements**
 - Equity awards
 - Severance payments
 - Other post-termination compensation arrangements (e.g., benefits continuation)
- **The IRS released final 409A regulations on April 10, 2007**
 - Documentary compliance by 2007 year-end



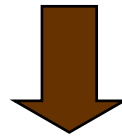
Regulations

The New SEC Disclosure Requirements

SEC Disclosure Requirements

Compensation Discussion & Analysis (CD&A)

- Comprehensive narrative on all compensation arrangements and material factors behind decisions and data in tables
- Focus on rationale for programs, not just summary description
- Replaces old Compensation Committee Report, but is *different*



Summary Compensation Table

- CEO, CFO, next 3 highest paid executive officers (+ poss others)
- 3-year view of total compensation
- Supplemented by additional tables

Total compensation defined, along with officers covered

Exercises and Holdings of Previously Awarded Equity

- Focus on prior year grants of equity-related interests
- Includes recent realization of gains in these interests

Tracking of equity grants and realized value over time

Post-Employment Compensation

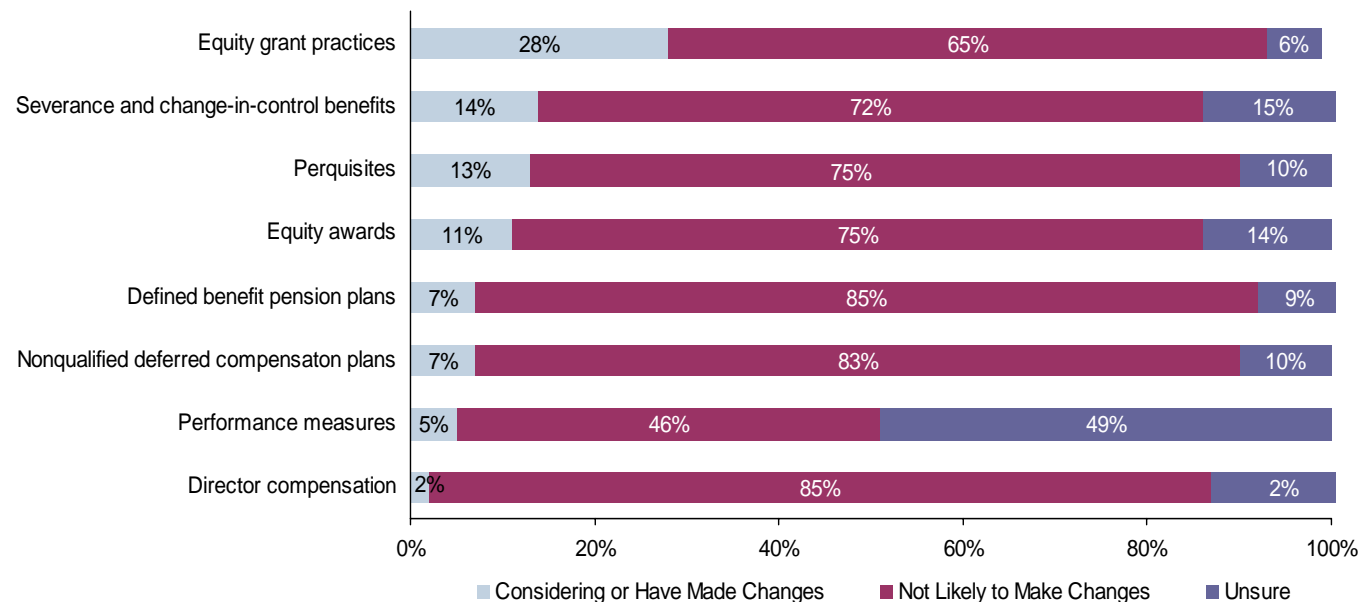
- Retirement and other post-employment benefits
- Includes benefits payable on change-in-control

Require reasonable estimates for uncertain future values



Regulations Changes Being Made or Considered, because of New SEC Disclosure Requirements

- The most frequently cited program changes being made or considered are to equity grant practices
- While few firms are currently changing their performance measurement plan, almost half are unsure of future changes. And, 19% are considering or decided to retain their current measures but *not* disclose them
- We expect to see deeper exploration of program changes in 2007 – with 2006 being used to assess the rules' impact





Regulations Regulatory Prospects

- **“Say on pay” proposed legislation would require public companies to let shareholders have a non-binding vote on the pay packages of top officers.**
 - The bill, which was approved by a 37 to 29 vote by the U.S. House Financial Services Committee on March 28, would take effect in 2009.
 - Moves on to House for full vote and possibly Senate; prospects uncertain
- **SEC Disclosure improvements may be sought**
 - Withholding of performance targets criticized
 - Complexity of CD&A
 - Grant value vs accounting value of equity
- **Proposed cap on annual amount of NQDC deferrals – one proposal would place limit to lesser of \$1 million or individual’s average annual compensation over previous 5 years**
- **Examine potential changes to broaden scope of 162(m)**
- **SEC mulling new shareholder access rules**



A Look Ahead



A Look Ahead

- Executive pay will remain in the news
- More rigorous alignment of pay and performance
 - To assess and ensure pay for performance, investors may push for more disclosure of performance targets
- Use of performance contingent LTI will gain momentum
- More disclosure changes likely
 - Value of equity awards
 - Guidance on CD&A content
 - Clarification on performance target disclosure
- Continued shareholder and regulatory action



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