Executive Compensation **January 2010**

Risk management continues to be a primary focus of the US Securities and Exchange Commission and the US stock exchanges. Rules for completing Proxies filed on or after February 28, 2010 by some companies were released by the SEC on December 16, 2009 after a 4 to 1 vote of SEC members.

Those rules contain guidance that *compensation related risk disclosure* for some filers on or after 2/28/10 will have to include a conversation in the Compensation Disclosure and Analysis of the Proxy about any compensation plan (whether executive compensation or broad based plan) that creates incentives that can affect the company's risk levels. This move on the part of the SEC takes risk reporting that has been completed by public companies in the Management Discussion & Analysis portion of the proxy and requires some filers to comment on the risk compensation plans (beyond the named executive officers) create in the company.

The SEC provides examples of what could be considered "risky compensation plans" including plans in business units more profitable than others, plans in business units that carry significant portion of the company's risk profile and business units where compensation costs account for a significantly high percentage of revenues.

The SEC requirements to report compensation related risk does not apply to publicly held companies with less than a $75m million public float. According to 2006 SEC Release No. 33-8819, approximately 42% of an approximate 11,900 US filers had a public float below $75 million.

It is our estimate that a good number of mid-market, mid-western public companies would fit into this demographic and, as such, would not be required to report compensation related risk in their Proxy.

Although a good number of public and, clearly, private companies, will not be required to report compensation related risk, it is our opinion that the board of directors and senior management team seek facts and discuss risk levels that may be present in some of their compensation plans including sales compensation plans.

Further, the SEC reversed its practice of requiring reporting the value of equity awards using financial statement expense values. Starting with filings on or after February 28, 2010, the value of current year grants will be in accord with FASB ASC Topic 718 (formerly known as FASB Statement 123R). Generally this new rule confirms what most public companies are already doing – that is, reporting the value of awards in current year real time.

Along with this rule change, the SEC now allows the reporting of the value of performance based awards to be based on the probable outcome of the performance condition – generally, the target objectives set for allowing ownership of the awarded equity. This ruling provides companies greater latitude in reporting the value of awards that are based on the judgment of the Board of Directors of the company reaching targeted performance levels.

Finally, the SEC now requires the reporting of professional fees of compensation consultants for services *other than compensation consulting* that are greater than $120,000 per annum. This ruling speaks directly to larger professional service firms that offer both compensation consulting and other consulting services that affect the performance and/or reporting of the company.

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It is our opinion that all companies whether public or private and, regardless of annual revenue levels, can benefit from reviewing their compensation plans in these three areas noted in the December 16, 2010 rules finalized by the SEC.

Risk

Risky compensation plans are those that promote the wrong behavior. For example, if the future mid-term strategy of a company is to maximize net income, the sales and management compensation plans would be risky if the weight of earning high incentive bonuses is overwhelming given to increased revenue regardless of its potential profitability. Not focusing on profitable revenue could result in taking on costly higher risk business.

Use of Performance Based Equity Awards

In the past seven years equity or stock plans whether in public or privately held companies have moved away from the use of awarding equity in stock options to awarding full value equity with time and/or performance objectives for ownership. Use of performance based vesting or lapsing (in the case of restrictions for ownership) provides companies in these uncertain times to encourage employees and board directors to clearly concentrate on performance objectives required for profitable sustainability.

Use of Compensation Consulting Services

The 12/16/10 ruling on reporting higher costs of professional services other than compensation consulting costs had an immediate impact on the consulting practices of Towers Watson and other, larger consulting firms. Expert consultants in larger firms have terminated from the larger firms to set up compensation consulting firms focusing only on compensation planning. This unintended consequence of the SEC ruling may create less opportunity for larger consulting firms to provide compensation consulting services.

Summary for the Start of 2010

The levels of risk and how businesses manage risk will continue to be a major focus of the US Executive and Legislative arms for the next few years. The concerns over regulation and control of business voiced by the current US Administration will continue to cast a major shadow over any recovery in markets.

Our advice on 2010 compensation planning has been and remains to focus on objectives that are not aggressively above target, realizing that the normal values based management practiced by a number of our clients will be negatively affected by the US and global political climates in the next two years.

Several of our clients have been successful converting debt to cash and equity in the last 24 months. By focusing on objectives set reasonably above target and keeping dry powder in 2010 for equity awards, expected or unexpected super growth can motivate and be rewarded with award of greater equity that will respond to the intelligent deployment of cash.

Asked if our advice is to be relied on, our normal response is “depends on how successful the board sets strategic limits and the executive staff executes operational plans –“!

An addendum to advice on setting annual cash performance and long-term incentive goals against strategic objectives seems to be needed on a daily basis as 2009 comes to an end.

Last month, a piece that follows this piece, made clear that the direction of the US Federal Reserve and the US Treasury Department in advising and directing executive compensation guidelines for companies listing on US exchanges is focusing on Board of Directors' responsibility to insure senior management is aggressively managing risk. We point out in the piece that follows that this focus on managing risk takes the long view in that more strict adherence to long-term performance is expected by both the US Federal Reserve and the US Treasury Department.

RiskMetrics Group Policy Statement for 2010

Not that executive compensation should be dictated by US Federal agencies and departments; the fact of the matter is that a significant watchdog of the governance and compliance of US exchange listed companies is not letting up its diligence. On November 19, 2009, RiskMetrics Group issued its policy updates and FAQs for the 2010 production of Form DEF 14A – definitive proxy statements, for performance during 2009. Following behind US Federal Reserve and US Treasury Department announcements emphasizing managing risk, the RiskMetrics policy updates are no surprise.

RiskMetrics takes a stronger position of recommending for or against a company's pay practice based on a "more nuanced and less formulaic look at whether CEO pay increased or decreased by how much and what accounted for the change". In concluding this more nuanced look for the 2010 Proxy Season, RiskMetrics includes a review of CEO pay increases relative to total shareholder returns (TSR) over the last five (5) years in addition to the already established review of the connection between pay increases and TSR trends over a one and three year period. If the company's TSR is in the bottom half of the company's peer group in any of these timeframes, RiskMetrics will take a very serious look at CEO pay increases year over year to determine causes for increases, if any.

RiskMetrics continues to emphasize the need for ultra transparency and definition of performance metrics and goals, including adjustments made if non-GAAP metrics are used. If a "cure" for an earlier award of company equity that did not meet RiskMetrics' standards is needed, at least fifty percent (50%) of shares granted as an award for 2008 (not value of the award) must be performance based. According to RiskMetrics, the definition of "performance based" is a premium of 25% or greater above the price of a share of stock at the time of grant. Further, RiskMetrics policies dictate that, if a company grants equity early in 2010 for performance in 2009, they will scrutinize the value of the award relative to performance of the company to the point of matching grants to performance using any supplemental tables in the Proxy that declare number of shares, stock price at grant and terms of the grant at the time of the award.

RiskMetrics lists several problematic pay practices they will be looking for as they review Proxies for their recommendations. Again, no surprises; however, nonetheless, their presentation of policies that define problematic pay practices requires that Compensation Committee's take heed of the following practices:

1. Employment contracts with multi-year guarantees for salary levels

2. Large cash bonus payouts without clear and concise connections to results

3. New hire packages that provide “make whole” provisions

4. Perquisites that don’t make common sense – including buyouts of homes using company coffers

5. Excessive severance and CIC provisions that appear to pay for past poor performance or “make up” for restrictions to receiving awards during the normal tenure of the executive

6. Large and unexplainable pension or supplemental executive retirement plans that account for added years of service or include performance-based equity awards in the payment schedule

7. Tax reimbursements for executives’ tax liabilities for use of perquisites, airplanes, etc.

8. Re-pricing or replacing underwater stock options on a favorable basis that damages investor holdings or don’t comport to common sense guidelines and dividend payments on unvested performance shares

9. Use of awarded shares of stock as hedges on future performance including the use of cashless collars, recognition of forward sales or other conditions where value does not compare to the level of award

10. Internal pay disparities where senior executives are receiving egregiously higher levels of cash and equity payments than the next level down

Finally, RiskMetrics continues to pursue their interest in supporting a say on pay proposal that makes transparent executive pay in a way that shareholders can understand and make a rational vote on the content of the company’s executive pay packages.

RiskMetrics’ recommendations for companies not meeting their standards could be an adverse vote recommendation for returning directors serving on the compensation committee to the board.

The need to be more aware of RiskMetrics’ 2010 policies is heightened as the US Securities and Exchange Commission carries through with its declaration for “deeper dive” reviews of Proxy statements supplemented by the SEC requesting restatements versus replies to SEC comments.

The Preferred Approach

Compensation committees are advised to complete their work from an approved strategy with clear objectives that have well documented performance goals clearly linked to both cash and equity awards. Committees need to insure that their review of 2009 performance is done in a manner understandable by all shareholders and that the gauges set for 2010 performance are tied to reporting mechanisms fully translatable to all shareholders.

The balance Compensation Committees need to strive for is improved conditions of their companies countered by talented executives committed to shareholder goals.

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Executive Compensation **November 2009**

This month, the Wall Street Journal reported that the Bank of America Board of Directors may be having difficulty meeting expectations of talented candidates to fill the post of Kenneth D. Lewis, President and CEO. Sources reported by the Wall Street Journal indicate that part of the reason for the difficulty is the cap on annual cash salary imposed by the US Treasury's Kenneth Fienberg, Special Master for Executive Compensation. In a Harvard Business Review At Large article published this fall, Karen Dillon put forward the argument that the battle over executive pay is not happening just under the spotlight in Washington. Rather, she purports that the damage done by financial services companies' pay practices will plague all public companies for months ahead and vocal shareholders are taking on the job of calling attention to director responsibilities for executive compensation.

We would advise that the challenges surrounding managing executive compensation are well beyond Washington D.C. and well beyond public companies. In a late night interview with Charlie Rose this month, Warren Buffet, CEO of Berkshire Hathaway, Inc. admonished board members in financial services companies that the onus is clearly on them to focus on the right things in managing compensation. His admonishment was directed not only at a board's fiduciary responsibility but also the responsibility of the board to manage risk more closely.

It is no surprise to us that the US Federal Reserve last month issued proposed guidance for sound incentive compensation policies at banking institutions that is centered on managing risk. The level of risk needed to reach compensation targets has, by several estimates, been decreasing over the last ten years. At the same time, the level of executive compensation in some companies continues to far exceed Peter Drucker's advice of 20 times the lowest paid employee by some 13X upward to 300 times the lowest salary. This imbalance, coupled with the high level of scrutiny on executive compensation has created a "perfect storm" of concern.

Along with the US Federal Reserve guidance, US Treasury suggestions that were issued in the spring of this year for setting compensation policies in US firms accepting Troubled Asset Relief Program (TARP) advocate awarding long-term equity compensation versus short term awards of cash or deferred cash compensation. The US Treasury suggestions put forth by the Treasury Secretary signaled to companies using TARP funds that they should focus on long-term results versus short term results. The US Treasury's guidance speaks about adjusting long-term equity awards to longer vesting and lapsing periods, encouraging companies to increase their stock ownership guidelines and compelling executives to hold awarded equity through to retirement.

Put together, the message coming from the US Federal Reserve and the US Treasury is that boards of directors must be more cautious as they seek shareholder and investor support in making cash, deferred cash and long-term equity compensation awards.

Boards of Directors are chartered with three major responsibilities to monitor; strategy, risk and CEO performance. Unlike a number of regulators and accrediting agencies that are responding to this most recent challenge with new regulations and legislation, the US Federal Reserve and the US Treasury have chosen to combine risk management with managing CEO compensation in their guidance as a way forward from this challenge.

This step is appropriate not only in the financial services industry including national, regional and local banks, but in all companies public and private. Managing risk and taking the long view is an old fashioned phenomenon in service during the 1960s and 1970s when companies would reward success that fit within risk appetites and be significantly above thresholds needed to insure returns expected by shareholders and investors. In 1973, the relatively new Chairman and CEO of GE, Reginald H. Jones, advocated for rewarding senior executives incrementally on their ability to produce results ten to fifteen percent greater than GE's cost of capital and their ability to manage all major projects well within risk parameters set by the GE Board of Directors.

Returning to this level of concern about managing risk relative to award thresholds requires that boards of directors more closely combine their risk management programs with the process of setting executive compensation performance metrics and award guidelines. This process should be a fairly straight forward and painless exercise for boards with active risk management programs and processes for setting compensation metrics and award guidelines.

We recommend five steps to boards of directors which will allow them to get their hands around these moving targets.

1. **Review the charter of the Compensation Committee** – confirming that the Committee has oversight for CEO performance and is empowered to understand and use the risk management plan in setting compensation metrics and award guidelines. Insure the charter gives the Committee responsibility for recommending a compensation philosophy that combines the risk appetite of the company with a compensation mix that accounts for balanced awards and responsible wealth accumulation.

2. **Review the Risk Management Plan** – First, insure a risk appetite is set, is being monitored and is being used in all capital and operational cost decisions. Typically, risk appetites are affected primarily by two dimensions, frequency of occurrence and business impact. Second, insure current risks are identified and placed into a framework that displays the probability of an occurrence and the impact such occurrence may have. In the corporate enterprise risk management arena, these risks are typically in four categories: 1) controllable and uncontrollable outside conditions; 2) processes; 3) tangible assets; and, 4) intangible assets. Third, insure decisions made in the organization are made on a risk-adjusted basis, thereby providing that the level of performance that is measured is adjusted for approved risk levels. As an example, adjust performance against an internal rate of return goal by adding a discount for a high risk appetite or a premium for a low risk appetite.

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3. **Do not use comparative salary survey data for benchmarking** – insuring that all performance metrics that are set by the board of directors for awarding compensation compare absolute performance of the company year over year. Using commercially prepared salary surveys and proxy data of peer group companies to influence awarded levels of compensation detracts from the focus of a board on managing risk and on long term results of the company.

4. **Set cash and long-term equity compensation awards using longer horizons with differing currencies** – insuring that the moral hazard of compensating for short term results by awarding unwarranted compensation as wealth accumulation is avoided. Setting cash awards using banked cashed bonuses and "fifth quarter" plans provides boards of directors with assurances that audited and sustainable performance meeting standards of auditing standards for going concerns corroborate their award decisions. Compensation committees should consider using longer vesting or lapsing periods for long-term equity compensation and consider use of unit performance awards earned each year that minimum performance goals are met. Consideration could also be given to awarding performance units with premiums set as multiples of share price resulting in greater or lesser ownership of beneficially owned shares at vesting depending on the increase or decrease in value of the company over the vesting period.

5. **Establish a mid-year report on compensation to be shared with shareholders and investors** – using the metrics set at the beginning of the year as a basis for the report. Include a discussion on mid-year adjustments to performance metrics that occur in the normal course of a year. Include also a prognosis of performance over the long-term horizon on which the board of directors has set long-term compensation goals. This report does not need to be voluminous nor replicate a year-end report. The report can be a one page update from the chair of the board of directors that communicates and informs.

Going forward into 2010 and beyond, boards of directors in companies of all sizes whether public or private would benefit from a review of the processes they use to set executive compensation. We find in advising boards and committees that the years 2008 and 2009 have allowed for more review since the need to retrench and review annual and long-term performance has been greater.

Our hope for you is that the speed of recovery in 2010 and beyond will create a greater need to be more exact in aligning executive compensation with your company's strategy.

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