

2006 SPECIAL SUPPLEMENT



A Closer Look at Compensation

Results of the 2006 *Corporate Board Member* Executive & Director Compensation Study

IN ASSOCIATION WITH

TOWERS
PERRIN



A Closer Look at Compensation

This year, more than ever before, directors who are responsible for executive and director compensation practices are in the proverbial hot seat. In July 2006, the SEC adopted changes to the rules requiring disclosure of executive and director compensation. The changes come at a time when boards are feeling the pressures of a growing list of responsibilities (and therefore risks) that have expanded their already stretched time commitment.

SEC Chairman Christopher Cox has said, “With more than 20,000 comments, and counting, it is now official that no issue in the last 72 years of the commission’s history has generated such interest.” However, based on the results of the latest survey by *Corporate Board Member* and Towers Perrin, directors don’t seem to be sweating the increased disclosure requirements. In fact, many anticipate very few changes as a result of the new rules.

Is this because companies have already adopted more detailed disclosure practices, or because directors are underestimating the reach of the new rules? The answer, according to Gary Locke, who heads Towers Perrin’s global executive compensation practice, lies somewhere in the middle.

“Compensation committee meetings are rarely perfunctory these days. We’re seeing boards holding more meetings and more executive sessions,” says Locke. “Directors are smarter about the topics they need to address, more committed, and increasingly open to asking the tough questions. The old adages—‘We’ve always done it that way’ and ‘Everyone else does it this way’—are no longer acceptable.”

Locke also says companies are on very different change trajectories. “Some have been working on increased transparency and accountability for several years and feel they have, or soon will have, a good story to tell shareholders and other stakeholders,” he says. “Others are at the beginning of that journey.” Whether they’re facing minor modifications in their practices or a complete overhaul, creating a positive story is imperative, according to Locke. “It not only has to include what a company does in terms of paying senior officers,” he says, “but why the company has chosen that path, and, perhaps most critically, how its compensation plan fits with its stated objectives.”

The *Corporate Board Member*/Towers Perrin “2006 Executive & Director Compensation Study” surveyed close to 500 corporate directors. While the survey included themes that recur year to year, such as compensation and stock options practices, recruiting, and committee pay, it also homed in on some previously unexplored topics, including CEO succession readiness and the effect of the new SEC disclosure rules.

The results of the research are presented here. We hope you will find them informative as you address the many issues facing your compensation committees in the coming year.

New SEC Disclosure Standards

SEC Posts New Disclosure Rules, Directors Anticipate Few Changes

In late July, the SEC approved new executive compensation disclosure standards that require companies to provide (in their proxy statements, annual reports, registration statements, and compensation arrangement reports) a more complete tabular and narrative disclosure of compensation elements for the principal executive officer, the principal financial officer, and the three highest paid executive officers and directors. Companies with a fiscal year ending on or after December 15, 2006 will have to comply with the new rules in their next filing.

Despite the sweeping and dramatic nature of these changes, a surprisingly high 44% of directors responding to our May 2006 survey said they did not anticipate any changes as a result of the new disclosure rules. However, 33% indicated that they did expect to see revisions in the performance standards and/or metrics used in incentive plans. Roughly a quarter (24%) said they would likely revisit the mix of pay or benefits, while nearly the same number (23%) said they foresaw a change in forms of pay (Figure 1).

When asked how they thought the disclosure rules would affect overall pay, more than 75% said they believed there would be no real effect on compensation levels. Only 19% thought the new rules would drive pay down, while a mere 5% believed the rules would result in pay increases (Figure 2).

“The objective is to give shareholders a clear understanding of the basis for executive pay and the information they need to assess whether practices are sound and provide the right direction and focus for the executive team. Whether added disclosure will have any significant effect on pay levels remains to be seen,” says Gary Locke head of Towers Perrin’s global executive compensation practice, who adds, “History has shown that heightened disclosure tends to lead to higher, not lower, pay. So we’ll have to wait to see whether history will repeat itself this time.”

Boards Already Use Tally Sheets to Review and Revise Executive/Director Compensation

In anticipation of the new tabular disclosure requirements, *Corporate Board Member* and Towers Perrin asked directors about their use of tally sheets to track compensation. Just under two-thirds (62%) reported that their companies already use tally sheets, and another 28% plan to do so. Only 10% reported they saw no need for these documents.

Among the survey respondents who have used tally sheets, a third (33%) have taken action regarding overall levels of pay and benefits, while a quarter (26%) have addressed the issue of potential severance or change-in-control payouts.

FIGURE 1

Do you anticipate any changes in the following areas due to the SEC’s proposed disclosure rules about the process for setting executive pay?

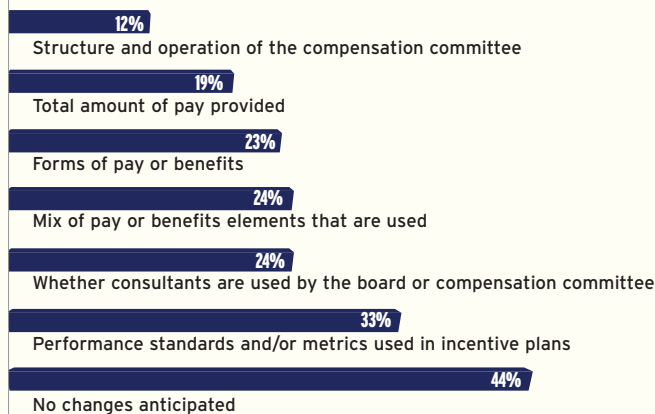


FIGURE 2

In general, how do you believe the proposed disclosure rules will affect executive pay practices?

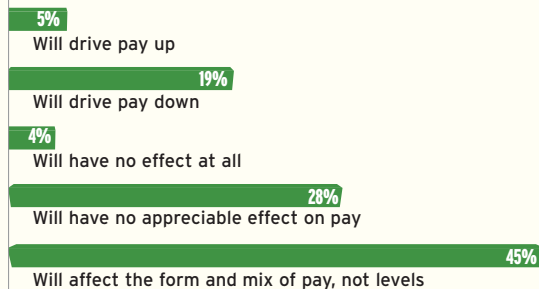
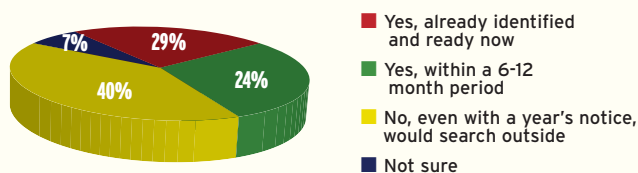


FIGURE 3

If your company needed to replace its CEO, would it have a viable internal candidate?



As Towers Perrin's Locke notes, "Well-designed tally sheets can aid boards and compensation committees in their decision-making process by supplying various sorts of user-friendly information. They can be especially useful for assessing the level and mix of pay, as well as the sensitivity of changes to one pay element on another element."

Succession Planning/Recruiting

CEO turnover rates have increased over the past several years. More than 75% of respondents attributed the higher turnover rates to external pressure to replace CEOs viewed as underperforming. Approximately half said that pressure comes from the board, while nearly a quarter said it comes from shareholders and hedge funds.

Many Companies Unprepared for CEO Succession

One of the most disturbing findings in the study is that companies appear unprepared for succession at the top. Only about a quarter of the responding directors (24%) said their companies have identified and prepared a viable internal succession candidate—meaning they would be ready in the event they needed to replace their CEO. And while another 29% indicated they could identify and prepare such a candidate given six to 12 months' notice, a full 40% said that even with a year's notice, they would not be able to find an internal candidate and would need to search outside the company (Figure 3).

"Failure to groom a ready successor for senior roles can be a costly and risky mistake," Locke says. "It can force companies to retain an underperforming executive for far longer than they should or to recruit someone from outside—often at added expense from recruitment fees and other buyouts. While a sudden change in top leadership will likely create some disruption no matter what, having a capable individual ready to step in can dramatically minimize that disruption and put operations on a steady keel very quickly."

"Unfortunately, this trend hasn't improved even with increased focus in recent years," says TK Kerstetter, president of *Corporate Board Member*. "This is one of the most critical duties that a board has, and directors need to overcome CEO disinterest or their own board's malaise to get an effective succession plan in place."

The survey also showed that 68% of respondents believe that if they hired a new CEO, his or her pay (excluding any recruitment fees or buyouts) would be equal to or less than that of the current CEO (Figure 4).

Executive and Board Compensation Issues

Compensation Practices Deserve a Closer Look

In the wake of the increasingly heated commentary about CEO pay practices in the last few proxy seasons, the new SEC regulations, and the demand for increased transparency, it's not surprising that directors broadly believe there should be greater scrutiny of executive compensation practices.

A resounding 88% of responding directors believe that U.S. companies should take a fresh look at their compensation practices. Far fewer, however (58%), admit their prescription for other U.S. corporations is a necessary remedy for their own company.

Regardless of whether respondents were referring to their own company or to U.S. companies in general, they were fairly consistent in what should come under scrutiny. Topping the list is the design of long-term incentives. Following closely behind are the choice of performance metrics, reliance on benchmark data, the design of annual incentives, and the use of stock options (Figure 5).

FIGURE 4

If your company had to recruit a CEO candidate from outside, what do you anticipate the new CEO's pay level would be (excluding any recruitment fees or buyouts)?

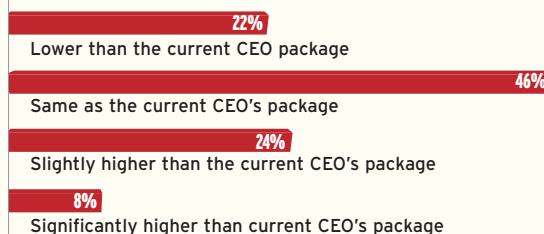
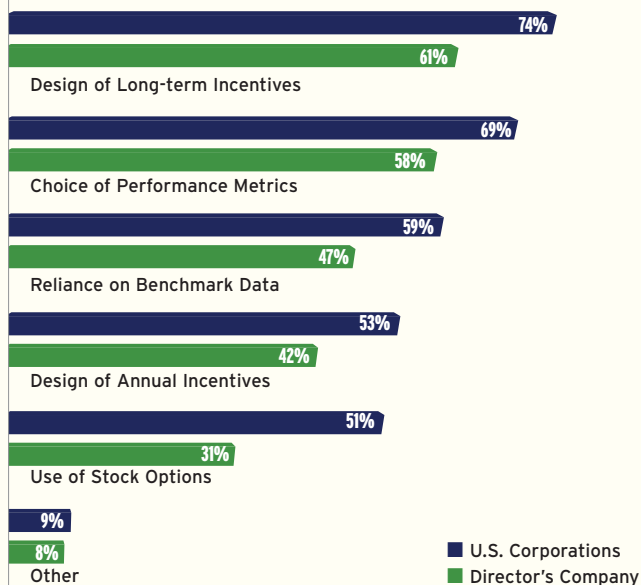


FIGURE 5

Which of the following compensation practices deserve a fresh look in U.S. corporations in general, and in your particular company?



Stock Option Grants Continue to Decline

Nearly half of the directors said stock option grants have decreased for senior executives, directors, and employees. Most of the remaining respondents said their rate of option grants had remained the same. Very few (between 10% and 15%) reported an increase. These results are consistent with those from the 2005 survey, which also showed a decline in the prevalence of stock option grants (Figure 6).

Support Growing for Bonus Clawbacks

An overwhelming number of directors (77%) said that in the event a company is required to restate earnings or other financial results, it should forcefully reclaim, or claw back, bonuses or incentive payments that are no longer justified by the new earnings. Another 17% indicated they did not think the company should seek to recoup its losses, because it wasn't practical to do so. Only a handful (6%) responded that bonus clawbacks are inappropriate (Figure 7).

"While clawbacks can present some practical challenges, they can be invaluable in some instances to prevent inappropriate windfalls and preserve an incentive program's integrity. The strong support we see in these results affirms the performance-oriented mindset of today's boards," says Locke. "If earnings need restating and a prior bonus turns out to be inappropriate largesse, recalibrating that bonus to reflect the change in earnings clearly signals the company's commitment to alignment of pay to performance, regardless of the administrative complexities involved."

Stock Ownership Requirements

Companies Satisfied with Stock Ownership Requirements

Given the emphasis placed on stock ownership as a critical means of aligning management and shareholder interests, it's interesting that only a little more than half of the respondents said their companies had stock ownership requirements. Of that group, 46% reported they require key officers to hold a specified amount of stock during their tenure, either as a dollar amount or as a multiple of pay, while about 12% said they require key officers to retain a specified percentage of the stock they acquire during their tenure. Still, 39% said they had no specific policy regarding stock ownership (Figure 8).

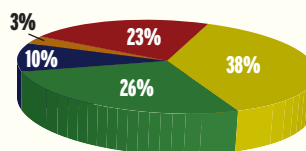
On the whole, directors seem satisfied with stock ownership at their companies. Roughly three-quarters said that both senior officers and outside directors at their company own enough company stock. "Stock ownership has been a key issue in executive compensation circles for almost two decades," notes Locke. "Virtually all companies and boards agree in principle that senior officers should have a substantial, long-term investment in company stock to align their financial interests with those of shareholders. And we've seen a strong and steady growth in executive ownership over this period."

Locke says there is far less agreement about how to promote ownership and whether ownership programs should be formal or not. On one side are companies and boards that believe senior management has a responsibility to invest along with shareholders and that overt stock ownership requirements signal that commitment and ensure compliance. On the other side are those who say it's intrusive for a company to impose an investment

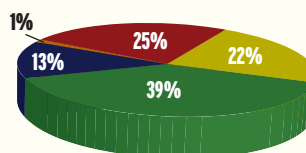
FIGURE 6

To what extent has the level of stock option grants changed as a component of compensation for the following groups of people?

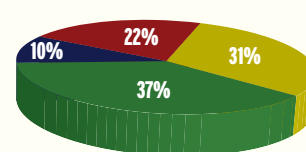
Senior Executives



Directors



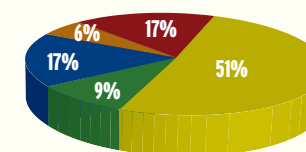
Employees



■ Significant Decrease
■ Some Decrease
■ No Change
■ Some Increase
■ Significant Increase

FIGURE 7

If a company has to restate earnings or other financial results, do you believe it should seek to recoup any excess bonus or other incentive payments not justified by the restated results?



■ Yes, for senior officers only
■ Yes, for senior officers/ anyone responsible for restatement
■ Yes, for all award recipients
■ No, not practical
■ No, not appropriate

approach on management and that individuals should have the freedom to make their own decisions. Advocates of this view would expect executives to align themselves with shareholders by investing in the company anyway—because it’s the right thing to do, without being forced to do so by formal requirements.

Is one approach better than the other? “Not really,” says Locke. “The right answer depends very much on the company and the individuals involved. Unfortunately, there’s no magic formula for ensuring the top team will make the right decisions from the perspective of longer-term stock growth, and their level of ownership can be an inhibiting factor as much as a supporting factor because it changes the risk/reward ratio for them in ways that aren’t always obvious.”

Directors’ Issues

Personal Risk and Time Contribute to Reluctance to Serve on Boards

Time and risk remain the biggest issues that appear to keep people from serving on boards. When asked what factors could affect their company’s ability to attract and retain qualified outside directors today, versus five years ago, more than 85% of respondents cited personal liability. More than half of this group said it’s a major concern, while the remainder judged it a minor concern.

Time requirements was a close second, with just over 80% of directors indicating that it is a major or minor concern. Pay had the least effect on the ability to attract and retain directors, with 46% citing it as a minor concern and only 17% rating it as a major concern (Figure 9).

“Sometimes directors’ dissatisfaction with pay is more about [their] concern that they don’t have sufficient amounts of D&O insurance to cover their liabilities,” Locke notes. “At the end of the day, no amount of pay is going to make up for an unacceptable amount of risk, which is why risk is the central issue today and is likely to stay that way for some time to come.”

Some respondents noted additional sticking points in their efforts to recruit and retain outside directors, including location, directors downsizing the number of boards on which they serve, limits on the number of board seats active CEOs are allowed to hold, and reluctance to serve in a post-Sarbanes-Oxley environment.

Some Committee Chairs and Members Deserve Additional Pay

Despite the lack of emphasis put on pay generally, directors rated several board positions as deserving of extra pay. Nearly all respondents (97%) said audit committee chairpersons deserved more pay, and 68% said members of that committee should be paid more. Roughly 80% of respondents also supported extra pay for compensation committee chairmen, but far fewer (30%) supported extra pay for compensation committee members.

Slightly more than half indicated that chairpersons of nominating/governance committees deserved additional pay, but again, far fewer (14%) felt the same way about those committees’ members (Figure 10).

Compensation Committees Better Prepared, But Need More Training

The statistics show companies and boards are taking education to heart in ensuring boards can effectively meet their expanded roles. Directors rated the skills and backgrounds of compensation committee members at the companies where they serve on boards. This year’s results are somewhat more positive than last year’s, with 49% (up from 41% last year) reporting that their compensation committee members have the skills and background to perform capably.

In a related finding, directors also see slightly less need for training for compensation committee members. Last year, 44% of respondents reported that their committee members had a solid background in compensation issues, but required some additional training. This year, that percentage dropped to 38%. Very few

FIGURE 8

Stock Ownership Requirements for CEO and Senior Leaders

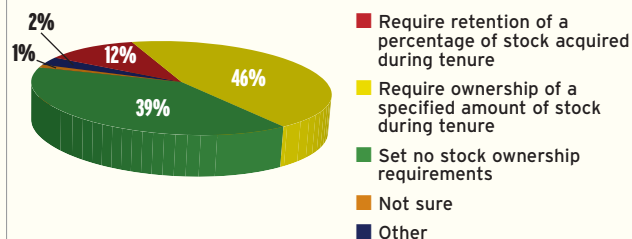
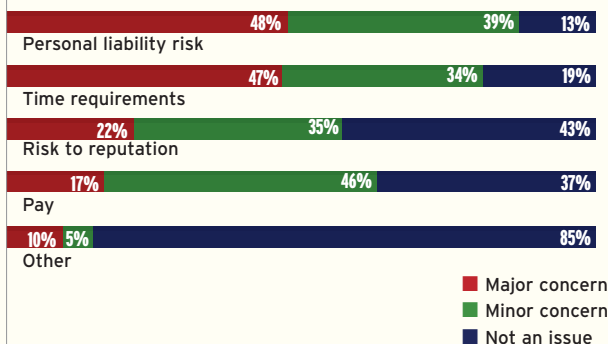


FIGURE 9

Which issues affect your company’s ability to attract and retain qualified outside directors today?



directors (12%) believe their compensation committee members require extensive training.

Compensation Committee Members Want Periodic Updates on Trends and Issues

Directors identified some tools, besides formal training, that would make compensation committee members more effective. At the top of their list are periodic updates on trends and issues in executive compensation (in general and within the company's industry), with 74% of directors finding that useful. Tally sheets came in second (cited by 58%). User-friendly, premeeting materials (distributed with adequate time to digest prior to the meeting) made a close third (cited by 54%). Less-effective approaches were structured orientations for new members (cited by 39%), and premeeting discussions between committee chairs and management (cited by 35%). (Figure 11).

"Premeeting discussions can significantly shorten the time needed for regularly scheduled committee meetings. The meetings can be with HR as well as consultants," says Kerstetter of *Corporate Board Member*.

Also, as Gary Locke points out, "Given the complexity of the executive compensation environment today and the pace of change, committee members need an effective way to keep up with developments. I've never seen a committee that didn't gain important insights from a well-prepared tally sheet or a thoughtful update on trends and issues. And with all that the committee is expected to do these days, how can it expect to function well without useful meeting planning and pre-reading? In our experience, however, the right way to do this largely depends on the committee's composition, skills, and time availability."

Summary

Many companies are already taking steps toward greater accountability and transparency. Compensation committees are getting more training, using tally sheets, and finding other tools to make their work more effective. Succession planning is an important responsibility that should not fall by the wayside as demands increase on directors' time. One thing is clear: The SEC's new disclosure standards will soon have everyone taking a closer look at executive and director compensation in an effort to assuage investors' concerns about the integrity and performance of their corporations.

FIGURE 10

Which individuals should receive extra pay?

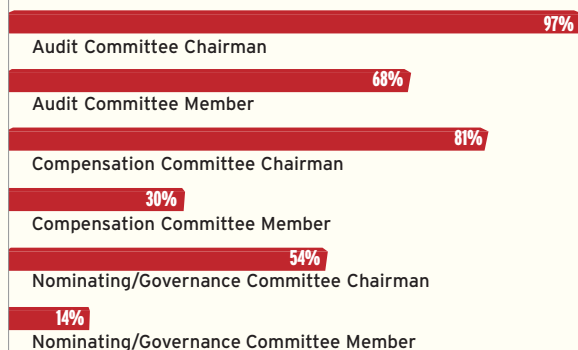
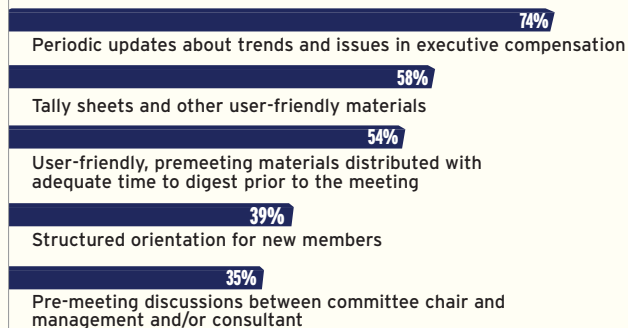


FIGURE 11

Besides formal training, what other actions would help to make compensation committee members more effective?



CORPORATE
BOARD MEMBER
MAGAZINE



**TOWERS
PERRIN**

Corporate Board Member
5110 Maryland Way, Suite 250
Brentwood, TN 37027
www.boardmember.com

Towers Perrin
100 Summit Lake Drive
Valhalla, NY 10595
www.towersperrin.com