

Summary of International Roundtable on Executive Remuneration Articles

September 28, 2005

Article 1: Unassailable Executive Pay Demands a Whole New Set of Rules

Sibson Consulting - April 2005

Summary:

An executive pay plan that fails the test of “soundness,” may emphasize competitiveness, costs and pay delivery but be unable to motivate executives to achieve the business strategy. Many of the executive compensation programs that are surveyed by Sibson appear to merely follow conventional wisdom about “good” pay design: that is, they just copy typical practice or those of purported industry leaders. Such “borrowed” plan designs frequently do not deliver as expected because they fail to embrace a company’s unique needs and circumstances. As demonstrated, the key to creating a “company-centric” design is to reflect a company’s unique design objectives; take into account business characteristics, talent characteristics and performance and rewards strategy, and of course, be consistent with legal and cost constraints.

Article 2: Remuneration: Where we’ve been, how we got to here, what are the problems, and how to fix them

Michael Jensen and Kevin Murphy - July 2004

Summary:

This paper introduces a conceptual framework for analysing remuneration and incentives in organisations and provides history, analysis and over three dozen recommendations for reforming the system surrounding executive compensation. The paper shows how traditional plans encourage managers to ignore the cost of capital, manage earnings in ways that destroy value, and take actions to deceive investors and capital markets. A new concept is introduced - the Strategic Value Accountability issue. This is the accountability for making the link between strategy formulation and choice and the value consequences of those choices - basically the link between internal managers and external capital markets. The critical importance of this accountability, its assignment, and its implications for performance measurement and remuneration have long been unrecognised and therefore ignored in most organizations. Finally, the authors analyse the complex relationships between managers, analysts, and the capital market, the incentives firms have to manage earnings to meet or beat analyst forecasts, and shows how managers playing the earnings-management game systematically erode the integrity of their organization and destroy organizational value.

Article 3: McKinsey on Finance: Perspectives on Corporate Finance and Strategy

McKinsey - Summer 2005

Summary:

The five articles in this paper focus on:

1. Measuring long-term performance:
Earnings per share and share prices aren't the whole story—particularly in the medium and long term.
2. How to escape the short-term trap:
Markets may expect solid performance over the short term but they also value sustained performance over the long term. How can companies manage both time frames?
3. The view from the boardroom:
A McKinsey survey of directors shows that they're tired of playing defense.
4. The value of share buybacks:
Companies shouldn't confuse the value created by returning cash to shareholders with the value created by actual operational improvements.
After all, the market doesn't.
5. Does scale matter to capital markets?
Simply getting bigger won't produce a higher valuation multiple.

Article 4: The Economics of Short-Term Performance Obsession

Alfred Rappaport - May/June 2005

Summary:

Most CEOs champion the goal of maximizing shareholder value but without embracing the essential determinant of value—risk-adjusted, long-term cash flows. Instead, they are obsessed with Wall Street's earnings-expectations machine and short-term share price. Sacrificing the company's long-term prospects to meet quarterly earnings expectations in an attempt to temporarily boost the stock price represents the antithesis of sound shareholder-value management. A driving force for such behavior can usually be traced to executive compensation schemes. One proposal put forward for consideration is the implementation of a performance discounted indexed-options plan with extended time horizons which do not reward under-performing executives simply because the market is rising.

Article 5. Getting what you pay for: linking executive remuneration to responsible long-term corporate success

Henderson Global Investors and USS - February 2005

Summary:

Investors expect companies to structure their remuneration in ways that support the delivery of durable long-term value growth. The UK companies reviewed in this paper recognise that in order to do this, remuneration systems need to provide incentives focused not just on their ultimate financial goals, but also on the means by which those goals will be achieved. They are therefore integrating areas such as customer satisfaction, employee issues, the environment and health and safety into executive remuneration schemes, alongside financial performance measures. The innovations described in this document stand out against a background of remuneration schemes and structures that generally display little diversity, particularly with regard to the narrow range of performance measures they use, which are usually financial. The companies reviewed are

at the forefront of initiatives to tailor their remuneration arrangements more closely to the operational requirements of implementing their strategies.

Article 6: Scandal fallout: tougher evaluation of CEO pay

Christian Science Monitor – March 2005

Summary:

This article focuses on some US companies which are beginning to introduce extra-financial criteria to assess performance for executive compensation purposes. One example highlighted is to award restricted shares that vest only when the company reaches specified financial or operational goals. In a 2004 survey undertaken by an executive pay strategist of 26 mid-size and large New England companies, 30 to 40 percent of performance based bonuses had a link to extra-financial measures, such as project results, customer satisfaction or personal goals.

Article 7: The New DNA of Corporate Governance – Strategic Pay for Future Value

The Corporate Governance Advisor – May/June 2005

Mark Van Clieaf and Janet Langford Kelly

Summary:

Most enterprise value is based on market expectations of future growth, but 85% of companies fail to set performance targets to encourage management pursuit of long-term value. Future value can be generated by both current operations and new growth or innovation, and the mix varies between companies and sectors. Boards should assess how much of a company's stock price and enterprise value is tied to future growth or innovation and determine the complexity and levels of executive capability required to achieve long-term strategic goals. Compensation levels for executives should be based on the level of work and level of executive capability required at a company, rather than its size. The "level of work" analysis described in the article uses factors such as the (1) degree of innovation for which the role is accountable, (2) planning time horizon involved, (3) complexity of capital or assets assigned to the role, and (4) intricacy of stakeholder groups it must manage. Incentive compensation should also reflect accountability for achieving key performance indicators that are aligned with strategic goals and show the executive's unique contribution. Long-term incentive compensation triggers should be based on sustained performance over several years and involve a further vesting period to ensure positive momentum toward strategic goals is maintained.

Article 8: Myths of Executive Compensation – Returning to Basic Principles of Pay for Performance

The Corporate Governance Advisor – September/October 2005

Mark Van Clieaf and Janet Langford Kelly

Summary:

Sixty of the lowest decile of Russell 3000 companies lost a total of \$700 billion in market value and had \$485 billion in cumulative negative economic profit over the five years ending in 2003, while paying their executive officers \$9 to \$12 billion in total direct compensation, not including pension benefits. Common executive pay practices fail to

establish links with business strategy, organizational structure and long-term performance. The article discusses four myths of executive compensation, making the following primary points:

1. Total shareholder return (TSR) and earnings per share (EPS) can become disconnected from intrinsic company value for significant periods of time, are subject to manipulation, do not reflect return on invested capital and can encourage executives to focus on short term factors at the expense of building long-term value;
2. Stock options and time-vested restricted stock awards do not necessarily create alignment with long-term interests of shareholders and can incentivize executives to pursue risky, short-term strategies, reward them for industry-wide or market-wide trends unrelated to their own effectiveness and have often been used to merely inflate compensation levels;
3. Executive compensation surveys often do not reflect market pay levels because of comparability problems in selection of peers and variations in levels of work or executive capabilities between peer group companies;
4. Money is not necessarily the key driver for executive retention, and the authors cite several examples where executive compensation at companies was adjusted downward without loss of personnel.

Pay for performance principles require a compensation plan design that reduces incentives to maximize short-term performance at the expense of long-term growth; reflects the real level of work and accountability of the executives in meeting strategic company goals; involves absolute and relative measures of intrinsic value creation over three to five years (or longer); takes into consideration the amount of executive wealth already awarded; is reasonable in the context of company economic profits and free cash flow over three to five years; is consistent with competitive pay levels for appropriately matched positions outside the company; and is equitable in the context of the company's internal compensation structure.

Article 9: The Dilemma of the Successful CEO

The Boston Consulting Group 2005 – Kees Cools

Summary:

After studying the 25 largest world-wide cases involving corporate fraud since 1998, the author concluded that bad corporate governance per se was not the cause of the scandals. Instead, he attributes the frauds to excessive stock option awards, creation of celebrity CEOs and setting of unrealistic growth targets (due to the CEO's growing narcissism and need to protect his or her immense position in the company's stock). These iconic CEO's were cited in the press more than three times more often than their counterparts. The author refers to other studies showing that narcissism is an occupational hazard for successful and charismatic CEOs. To prevent similar future frauds, his recommendations include eliminating excessive compensation awards and instilling an ethical corporate culture that will help to keep narcissistic leaders from becoming CEOs.

Paper 10: Good Governance Guidelines for Principled Executive Compensation

Canadian Coalition for Good Governance – June 2005

Summary:

The Working Paper sets for and describes the following guidelines for principled executive compensation:

1. The compensation committee should be composed entirely of independent directors;
2. Compensation committees should employ external advisors to provide both independent perspective and expertise;
3. A compensation committee should test linkage of pay to performance to ensure that total pay packages vary significantly with outcomes;
4. Executives should be required to build and maintain significant equity in the company and may be required to hold their position for a period beyond retirement;
5. All facets of the compensation regime, including post retirement benefits, should be completely, accurately, understandably and timely disclosed.

It also contains sample best practice formats for compensation disclosures, including CEO “look back – total take” and pay for performance disclosures, and recommendations for selection of performance measures and review of different scenarios to determine potential maximum payouts, including with retirement benefits and under various termination scenarios.

Article 11: Executive Compensation: Bridging the Gap between What Companies are Required to Disclose and What Stockholders Really Need to Know

By Stuart Grant, Megan McIntyre and Brian Rostocki, Grant & Eisenhofer
September 2005

Summary:

The article describes Delaware and SEC legal requirements for disclosure of executive compensation awards, noting that item 402 of SEC Regulation S-K essentially requires that all compensation to the top five officers (including the CEO) must be disclosed. Furthermore, Item 402(k) requires that the compensation committee describe the specific rationale for the compensation paid and how it relates to company performance, including the quantitative and qualitative measures on which the CEO’s compensation was based. While almost all companies are in literal compliance with these requirements, many fail to report in a meaningful manner and creatively categorize perks and other compensation as business expenses.

The authors suggest that shareholders could use what are called “books and records requests” to examine company records in order to obtain full information on compensation, though the courts have imposed confidentiality orders prohibiting sharing of some compensation information with other shareholders. In addition, shareholders could propose mandatory bylaw resolutions to require better company disclosure. While Delaware law is not settled on the matter, there is a strong argument that shareholders can pass enforceable bylaws requiring enhanced executive compensation disclosure.