

INTERNATIONAL ROUNDTABLE ON EXECUTIVE REMUNERATION
SUMMARY OF PROCEEDINGS

September 28, 2005

This Summary of Proceedings consists of two parts: (1) a compilation of the primary points, observations and suggestions that were put forth at the Roundtable and (2) a comprehensive list of action ideas that were generated which relate to the action initiatives.

Summary of Roundtable Proceedings

Keynote Addresses

Primary points in the presentations and ensuing discussions included the following:

- Levels of executive compensation increased from 5% of aggregate corporate earnings in 1993 to 10% in 2003 and had a corresponding negative impact on company value;
- Poor compensation plan structure can dilute management incentives to serve shareholders and create incentives to destroy long-term company value;
- Although roughly two-thirds of CEOs have defined benefit pension plans, the value of those benefits is typically not disclosed. This results in underestimation of executive compensation costs and overestimation of the link between pay and performance;
- Most compensation packages contain a number of provisions which serve to decouple pay from performance. Examples include: (a) large retirement package payments, (b) equity award value increases from market-wide or industry-wide forces, (c) re-pricing of options, (d) sale or hedging of vested stock awards, (e) windfalls from accounting-based valuation increases, (f) gratuitous hello or good-bye payments;
- Moving from option awards to restricted stock does not by itself solve the problem;
- Suggested changes in executive compensation plan design could include: (a) indexing of equity awards to reduce windfalls not associated with the executive's performance, (b) eliminating the ability to time equity sales, (c) pre-sale disclosure requirements, (d) separate vesting and post-exercise holding periods, (e) tying non-equity awards to long-term performance measures, (f) claw-back provisions, (g) eliminating termination payments not tied to the executive's performance, and (h) re-examining use of special pensions for executives;
- Option plans should be dividend neutral, so that executives are not discouraged from paying dividends;
- Independence of directors is not sufficient to make boards accountable to shareholders. Shareholders also need some power to remove directors to encourage directors to better represent shareholder interests;
- Staggered boards undermine director accountability, and research has shown staggered boards are associated with 4-5% lower company value;
- Of the 25 largest corporate frauds, 22 were in the US and were found to be associated with iconic CEOs who earned eight times the equity-based compensation of their peers, were quoted in the press three times more often and had annual company growth targets that were two to three times higher than at peer companies;

- It is not clear whether the exceedingly high levels of executive compensation found at the 25 fraud companies was a cause of the fraud or a marker for an ineffective board that could not provide an adequate check on the CEO's power;
- Corporate governance is about corporate culture and balance of power. Ineffective boards throw off the balance of power;
- Highly successful CEOs are at risk of becoming narcissistic and losing touch with reality;
- Some argue that the absolute level of executive compensation is not as important as aligning compensation with performance, while others argue that excessive levels of compensation are important because they tend to be linked with corporate fraud.

Panel Presentations

Primary points made by the panel on how executive compensation decisions are currently made and in the following discussions included:

- Boards are moving toward directly retaining separate compensation consulting expertise;
- Some question whether compensation consultants can maintain sufficient independence to effectively advise boards when they also work for management;
- CEO hiring practices tend to undermine the board's position in negotiating the CEO's compensation package;
- Poor succession planning and lack of internal leadership development at companies lead to payment of higher compensation to executives when they have to be hired from outside the company;
- Compensation committee members generally lack relevant expertise and need outside assistance from experts to be most effective;
- Compensation plan provisions are often copied from plans at other companies without recognition of differences in circumstances;
- Overlap on boards and compensation committee members who are CEOs at other companies can present conflicts that undermine effective plan development;
- Details of compensation plans are critical to alignment of pay with performance. Plan targets and measures require vigilant board monitoring and oversight;
- Transparency of the board's decision-making process is important to evaluation of both the board's performance and executive compensation plan design;
- It is important to recognize there are differences between accounting, market and true economic performance when designing compensation plans;
- Extra-financial measures of performance, like customer satisfaction and employee turnover rates, should be included in compensation plans;
- Half of the top 1800 public companies in North America have failed to provide a return on invested capital over five years that exceeds their cost of capital. Performance measures should take the company's cost of capital into consideration;
- Compensation plan disclosures in the UK require that cost of capital be included;
- Sufficient information on the comparator groups used in setting compensation levels is rarely disclosed. This undermines shareholders' ability to evaluate plans;

- Letters or contacts from shareholders can provide board members with the opportunity and insight they need to raise the right questions in the board room on compensation plan issues;
- Best practice guidelines can be helpful to institutional investors when engaging with directors about compensation issues.

Primary points made during the panel presentations and ensuing discussion on evaluation of compensation plans included the following:

- Sixty US public companies over the last five years lost \$700 billion in market value and destroyed \$485 billion in economic profit while paying their top five executives an average of \$40 million each, aptly illustrating the pay without performance problem;
- A McKinsey survey found that 55% of directors have no meaningful process to evaluate CEO performance;
- Based on proxy statement disclosures, 85% of US companies have no compensation metrics to hold executives accountable for business performance beyond three years, even though most company enterprise value is based on market expectations for future growth;
- Executive compensation seems to be based primarily on performance of operational duties already reflected in the stock price rather than related to meeting longer-term enterprise business strategy metrics associated with the executive's value added;
- The current compensation process relies heavily on surveys that do not take differences in business and innovation complexity between companies into account. This results in apples to oranges comparisons;
- Broad based and ongoing shareholder engagement with independent directors will be required to make real progress on compensation plan problems;
- Shareholders may be their own worst enemy because they have generally failed to do their homework when they engage with companies on compensation issues;
- Shareholders may need to involve experienced directors on their side of the interaction to be credible in company engagements on executive compensation;
- Some companies consistently produce bottom quartile performance over the long-term, with billions of dollars of value being destroyed, while paying their executives top quartile compensation, and shareholders continue to vote for the compensation committee members at those companies. This raises questions about the use of pay for performance and validity of related disclosures at those companies;
- Focus lists and multi-level shareholder engagement strategies based on pay for performance compensation issues could be an effective tool;
- Some believe that publicity can be an effective tool to get boards to address compensation problems, while others see it as self-defeating because it could foreclose dialogue opportunities with boards;
- Enhanced disclosure on compensation is needed, and we may be in a relatively short window where advocacy with the SEC on greater transparency could be effective;
- Institutional investors send mixed messages to companies when we seek alignment of pay with long-term strategic goals but pay and evaluate our own portfolio managers in ways that encourage them to pressure companies for short-term results. Part of the

solution may have to be making changes in the way plan sponsors compensate and engage with their own portfolio managers;

- Analyses of compensation plans should include stress testing to determine results under different scenarios, such as extraordinary company economic performance or CEO termination for underperformance;
- The present value of all compensation and benefits should be calculated and disclosed;
- Internal fairness, or pay equity, between different management levels of a company based on their unique value added should be part of the pay for performance compensation plan evaluation process;
- Many see combination of the CEO and board chair in the same person as a conflict of interest when it comes to board actions on executive compensation;
- Equity awards have tended to be given as an add-on to compensation rather than in place of a reduction in other compensation plan components;
- Shareholders need to also engage with compensation consultants to encourage better integration of company strategic plans and pay for performance into the compensation plan;
- There is not a one-size-fits-all solution to executive compensation plan design questions, and “check the box” approaches may be counterproductive;
- The increasingly short tenure of CEOs has produced a shortening window of time for executives to build personal wealth and has been a factor in pushing compensation levels up, though a longer-term pay for performance focus and better succession planning could counteract this trend;
- Pay for performance compensation plan metrics, performance periods and targets must be selected carefully because they can be powerful drivers of both positive and negative behaviors;
- Plans should be monitored so they are not gamed. For instance, short-term targets may be met by divesting of valuable company assets or foregoing capital improvements and targets may be met though performance is consistently deteriorating, albeit from higher levels.

Primary points made during the panel presentations and ensuing discussions on strategies for filling information gaps included the following:

- Regulation S-K requires that all compensation to the top five officers be disclosed and, while most companies are in literal compliance, many fail to report in a meaningful and transparent manner;
- Shareholders should regularly send a letter to the compensation committee chair whenever disclosure has been inadequate to ask for the information that is needed to evaluate the company’s compensation plan;
- If sufficient data is not voluntarily disclosed, shareholders have the ability submit a request to review the company’s records and, if access is not granted, to seek a court order authorizing an inspection;
- There is a strong argument under Delaware law that shareholders can pass a binding bylaw resolution requiring enhanced executive compensation disclosures;
- A request for company information will be more effective if it is followed up with a meeting with the independent directors;

- Compensation plan analysis is complex and time consuming and requires collection of data from various sources, including the proxy statement, financial statement footnotes, 8-Ks, 10-Ks and 10-Qs;
- There is great inconsistency between companies in terms of the extent and quality of disclosure;
- In the UK, compensation committee reports are now submitted to the shareholders for approval. This has improved transparency and fostered dialogue between shareholders, compensation consultants and compensation committee members, but it has not solved all compensation problems;
- US investors have been fragmented in their approaches to compensation issues and related company engagements, with different investors expressing different preferences. We would benefit from development of general agreement on at least high level best practices.

Roundtable Action Ideas for Shareowners

Engage Policy Makers on Executive Compensation Transparency

- Better disclosure should include executive compensation plan information on all targets and performance measures including:
 - Peer groups, with the rationale for selection and job matching/benchmarking, as well as explanation of variations from the peer group used for total shareholder return comparisons
 - Target and maximum payouts based on the incentive plans
 - Transfer rate from options to performance shares
 - Internal pay equity and compensation calibration within organisations
 - Total present value of all compensation components, including pension disclosure
 - Total compensation overview in a user friendly format
 - Reporting of information in a non-formulaic and non-boiler plate format, with performance metrics, measurement periods, targets and individual performance justifications for payouts
- Important information hidden in footnotes should be incorporated into main body
- Ensure integration of information and not just additional information silos
- Qualitative targets should be disclosed as well as quantitative targets – including those based on delivery of strategic objectives
- Although disclosure focuses mind and behaviour of the CEO, disclosure on its own could be meaningless without pre-determined pay for performance criteria
- Compensation should be calculated based on various scenarios, like sale of the company, termination of the CEO without cause, etc.
- Collective engagement with the SEC is needed to provide early input into their deliberations

Better Analysis of Compensation Plans and Proposals

- Executive accountability for adding value (pay for performance) against strategic goals and responsibility matched positions, rather than merely identifying peer company compensation levels
- Connection of compensation awards to sustained performance and creation of long-term value
- Payouts under different scenarios, including change in control and termination
- Extra-financial criteria are undervalued by analysts, investors and companies
- Value of company not necessarily reflected in balance sheet and may vary from economic or market value
- Role of analysts in looking and reporting on these issues
- Is pay reflecting current performance or the value created by predecessors?
- Explore the possibility of a shareholder-appointed compensation consultant with demonstrated pay for performance expertise
- Work with proxy advisory services and other analysts in developing models and metrics for pay for performance
- Engage with mainstream analysts to ensure appropriate analysis of executive accountability and pay for performance is incorporated into reports

Practice Principles for Executive Compensation Plans

- Avoid fragmentation (i.e., high level principles/best practice/metrics)
- Shareholder role in approving plans as in the UK and The Netherlands?
- Focus on plans which change behaviour
- Identify right performance metrics and performance measurement periods
- Link to strategic objectives and executive accountability for adding value
- Compensation scorecard to evaluate pay for performance
- Subjective components – individuals' contributions
- Compensation peer group selection based on job and responsibility matching
- Extra financial targets such as customer satisfaction, employee retention, environmental compliance, ethical risk to name brand
- Explain process for evaluating strategic objectives
- Link to sector specific and/or company specific issues (e.g., R&D and tech solutions)
- Accounting and economic performance vs market performance
- Measures that reflect real value creation over time
- Explore the possibility of a shareholder-appointed compensation consultant with demonstrated pay for performance expertise
- Develop and circulate measures, metrics and templates encapsulating above criteria

Focus List Development and Company Engagement

- Succession planning/performance appraisals
- Focus on credible and knowledgeable compensation committees
- Professional development for directors

- Board diversity
- Conflicting messages coming from investment houses – governance people vs portfolio managers
- Focus on list of companies to send signal to market based on pre-determined criteria
- Proactive approaches to sectors and companies with recommendations for remuneration strategies – based on above categories
- Confidence of value in informed collaboration
- Vote against directors on compensation committees where there are problems
- Inspection of books and records of corporation
- Lawsuits (selective) – signals to be sent
- Mandatory by-laws
- Precatory resolutions
- Collective engagement with companies, including interaction with compensation committee members, with enhanced analysis that avoids “check the box” approach

Evaluation of Portfolio Manager Mandates and Practices

- Seek participation of best practice managers, the CFA Institute and others to review how investment management agreement compensation provisions impact portfolio companies
- Consider how plan sponsors could most effectively interact with portfolio managers on executive compensation issues
- Develop guidance for investors on best practices for external and internal portfolio managers that does not undermine the ability of portfolio companies to meet governance expectations

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