

EXECUTIVE COMPENSATION

The New Long-Term Incentive Portfolio

by Russell Miller

Contentious debates and numerous regulatory changes have sought to address the perception that some shareholders remain in the dark about executive compensation packages. Yet, these discussions often obscure an equally important executive pay issue: the emergence of new performance-based long-term incentives (LTI) that are part of an overall LTI portfolio.

The stock option backdating controversy and the U.S. Securities and Exchange Commission's (SEC's) new rules on executive compensation disclosure are only the most recent forces contributing to a profound shift in executive compensation design. A 2005 accounting rule change concerning stock options, negative perceptions of stock options following the dot-com bubble and mounting shareholder pressure regarding equity usage are also significant drivers of change in the design of executive compensation plans. All of these factors are causing forward-looking companies to embrace a more sophisticated assortment of LTI vehicles.

This article provides a clear-eyed breakdown of the current executive compensation landscape while paying close attention to the ways in which trends are impacting the long-term incentive mix. Given the heated opinions surrounding executive compensation, forthright and well-balanced

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Key Takeaways

1 External market pressures affecting executive compensation design are real and have staying power.

2 Designing an effective executive compensation plan requires companies to balance the following objectives: shareholder alignment, pay for performance, attraction and retention, and the assessment of cost vs. perceived value.

3 A new long-term incentive (LTI) portfolio with performance-based LTI vehicles can help achieve that balance.

assessments of key issues are increasingly useful to design planners, who must keep in mind that:

- 1) The pressures affecting executive compensation design are real and have staying power;
- 2) Designing an effective executive compensation plan that can withstand those pressures requires the balancing of numerous objectives; and
- 3) A new long-term incentive (LTI) portfolio that includes performance-based LTI vehicles can help executive compensation plan designers achieve the appropriate mix.

Striking the right balance is difficult: Critics often focus on specific components of sophisticated plans without fully considering how the overall program is designed to balance numerous interconnected, and sometimes conflicting, demands.

This frank review is based on our experience working with HR executives, compensation committee members and other influencers of executive compensation design across all industries.

A LIGHTNING-ROD ISSUE – WITH LEGS

Executive compensation has long qualified as a "lightning rod" issue. In recent months and years, however, the lightning has struck much more frequently, and it shows no sign of diminishing.

Not long ago, debates about the amounts and makeup of CEO pay flared up during each proxy season and then subsided until the subsequent proxy season rolled around. That calm stretch has vanished. The uproar around stock option backdating marks only the latest in a long string of hot-button executive pay issues featured prominently in the business press virtually every day.

While meeting business objectives continues to be the most critical factor in designing executive compensation plans, it has also become important to ensure that the plans hold up under the glare of the executive compensation spotlight. Consider the following e-mail exchange (which we've made anonymous) that took place at a large, publicly traded company:

From: Comp Committee Member
 To: Comp Committee Chair
 Subject: Executive Compensation Program

The design is right on the mark vis-à-vis our strategy. We can tighten up the performance definitions, and we also may want to consider including a stock price test.

From: Comp Committee Chair
 To: Comp Committee Member
 Subject: RE: Executive Compensation Program

Great, we're all on the same page. And I'm confident that the design can withstand a front page article.

In no way were these board members trying to appease journalists or other watchdogs. Rather, the exchange reflects a sound response to the heightened scrutiny of executive compensation. The two compensation committee members are committed to doing the right thing: putting forth a plan that satisfies shareholder objectives, regulatory requirements, corporate governance standards and business objectives.

At the same time, these two individuals clearly understand that it is impossible to prevent a

plan from being parsed in the business pages and by shareholders. Their exchange reflects a mindset other executive compensation plan designers are also embracing:

"We want to do what we believe is right. We understand that executive compensation is a hot-button issue, and we understand that our plan could show up on the front page. Whether or not that comes to pass, we want to be able to stand behind our plan and feel confident and comfortable that our plan satisfies all of its objectives."

DRIVERS OF CHANGE

The authors of that e-mail demonstrate a firm understanding of the factors currently shaping executive compensation design. Those factors – which include shareholder, regulatory, governance and business considerations – can be difficult to balance. The best way to do so is by understanding the dynamics at play within each factor:

Shareholder Pressure

Still smarting from the widespread use of stock options and the growth in executive compensation levels over the past decade, shareholders are pressuring boards and executive teams to reduce the use of shares in equity compensation plans and increase the use of performance-based compensation.

Shareholders have put forth a strong case that companies need to better manage their "run rates" or "burn rates" (terms that refer to the number of shares granted to employees each



year.) They have also pressured companies to reduce their "overhang," which refers to the total amount of shares outstanding and reserved for future grants to employees. The message from shareholders is clear: *Equity usage skyrocketed in the 1990s. It shouldn't go any higher.*

The influence of shareholder interest groups, such as Institutional Shareholder Services (ISS), The Corporate Library and Glass, Lewis & Co., has grown much stronger in recent years. Many of those groups advise institutions that hold large amounts of a company's shares how to vote on items put to shareholder votes each year. For example, an institutional shareholder group may recommend that a client votes to approve a stock option plan, but only if the board and the company also agree to lower the current run rate or overhang rate, or promise that they will not re-price the company's options.

When it comes to determining the right LTI portfolio, off-the-shelf solutions are usually off the mark.

Ultimately, shareholders are demanding compensation plans that are more performance-based. The key challenge lies in selecting performance measures that align with the business strategy, thereby fostering a pay-for-performance relationship that sustains shareholder value creation over the long term.

New Regulatory Demands

Individuals charged with designing executive compensation plans must understand and comply

with a rash of new and complex regulations, including the following:

- Internal Revenue Code Section 409A, which is part of the American Jobs Creation Act of 2004, established new rules for the design and tax treatment of deferred compensation.
- Financial Accounting Standard (FAS) 123-R, which took effect in 2005, completely changes how stock options are accounted for (as an expense now.)
- New executive compensation and option grant disclosure requirements recently adopted by the SEC affect how executive compensation is reported in proxy statements.

Corporate Governance Scrutiny

These regulations, the events that contributed to their creation and other, related incidents have contributed to a much greater focus on corporate governance. Companies need to have strong governance practices and demonstrate the right "tone at the top" to investors, regulators, their own employees and other stakeholders.

Corporate directors are keenly aware that their counterparts at companies stung by governance failures were criticized for being "asleep at the wheel." Directors and the executives who work closely with them understand that shareholders, regulators and other stakeholders are holding them accountable to the highest level of corporate governance possible.

The new governance ideal emphasizes disclosure and transparency. The new ideal also means that many directors are asking challenging questions of executives and spending more time ensuring that the board's oversight is as exhaustive as possible.

Scrutiny of governance practices by shareholders and regulators also has greatly increased, and has contributed to changes in executive compensation practices. For example, many corporate boards have voluntarily created stock ownership guidelines for executives to help ensure that executive compensation (and therefore executive decision-making) aligns with shareholder interests.

As recently as five years ago, stock ownership guidelines existed at less than half of large U.S. publicly traded companies. Today, approximately two-thirds of those same companies have implemented stock ownership guidelines.

Balancing Business Objectives

While the nature and intensity of external pressures on executive compensation plan designers have changed, so have the ways in which designers use components within the plan to meet business objectives.

Executive compensation plan designers must weigh:

- Shareholder alignment needs;
- Pay-for-performance needs;
- Attraction and retention needs; and
- Evaluations of the actual cost vs. the perceived value of incentive vehicles.

While stock options still pay for performance through stock price appreciation, the extent to which they address other business objectives is less certain. For example, at companies with a flat

Pitfalls to Avoid

As the pressure bearing down on executive compensation designers has intensified in recent years, new pitfalls have cropped up. Human resources (HR) executives and compensation committee members should steer clear of the following stumbling blocks:

1 Following the leader.

Each business must contend with a unique set of challenges. Each company's compensation plan should reflect and address those unique circumstances.

2 Overreacting to external pressure. Criticism from shareholders, shareholder interest groups, the media and other stakeholders may be legitimate, but critics often don't consider the complete picture. An effective executive compensation plan must balance numerous objectives, some of which can be at odds with each other. Relevant criticism should be addressed, but not in a way that neglects or impairs other objectives.

3 Letting one objective obscure others. Effective executive compensation plans balance a host of objectives. Focusing too much of a plan's design on meeting any single objective can prevent the plan from addressing other equally important needs.



or decreasing stock price, options may not address attraction and retention objectives because the perceived value of stock options may have diminished. During the 1990s, most executives and managers viewed stock options as gold. But the ensuing recession and uncertain nature of the current market have diminished the value of stock options as an attraction and retention tool for many companies.

Prior to FAS 123-R, stock options were relatively simple to evaluate: there was no need to calculate their cost, assess their perceived value and reconcile those figures. However, while stock options reward executives for a rising stock price, they do not possess a downside risk for executives. The value of the options to the executive is the same (zero) if the share price is

"underwater" by a penny or \$20 below the exercise price. While options provide an appropriate pay-for-performance relationship in an environment of declining stock, alignment with shareholders can be compromised.

NEW LTI MIXES

According to U.S. public company filings, the use of traditional, time-vested stock options among large companies decreased by roughly 15 percent between 2002 and 2005. To be sure, traditional stock options remain a useful component of an effective LTI portfolio. Stock options continue to be used by most public companies, with more than 80 percent continuing to rely on stock options as a component of their LTI mix. During this same period, the use of time-vested restricted

the NEW LTI portfolio

Stock Options

PROs:

- Pay-for-performance
- Align with shareholders (upside only)

CONs:

- Dilution/overhang
- No downside risk
- Perceived value vs. cost

Restricted Stock

PROs:

- Attraction & retention
- Align with shareholders (upside & downside)
- Efficient share usage

CONs:

- Lack of performance orientation ("pay-for-pulse")
- Less leveraged upside

Performance Awards

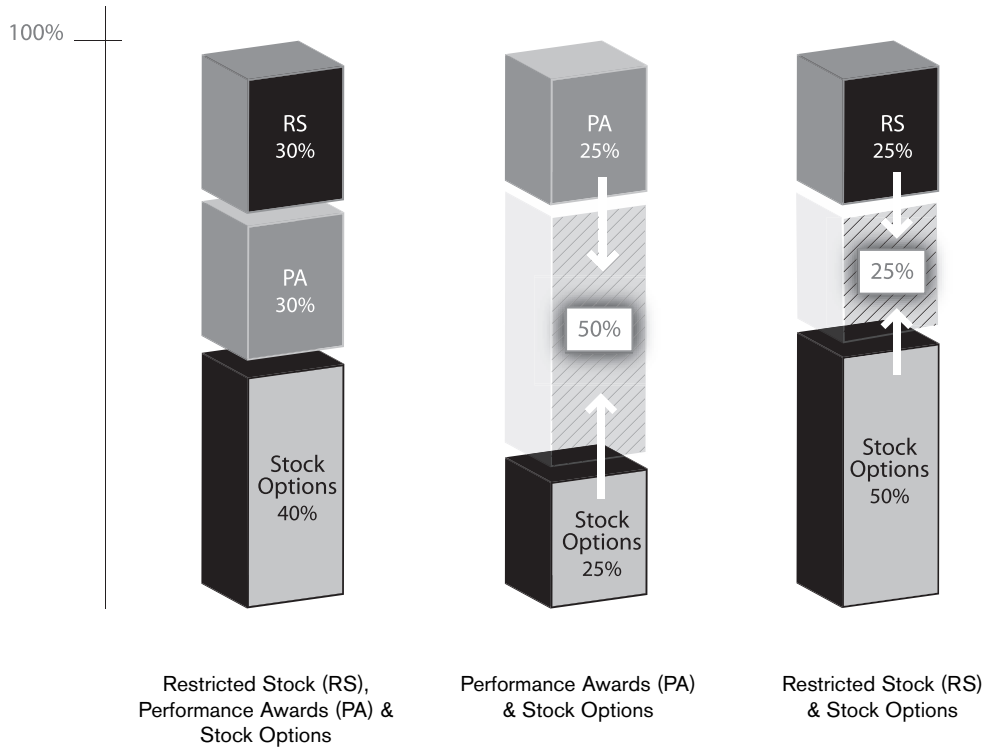
PROs:

- Balances: pay-for-performance, attraction & retention
- Align with shareholders (upside & downside)
- Link to key corporate goals

CONs:

- Goal-setting challenge
- Stretch goals may diminish attraction & retention

LTI Mix



stock awards at large companies increased by slightly more than 15 percent, although their use is showing signs of hitting a plateau.

Among recent changes to LTI strategy, one of the most noteworthy shifts is the surging interest in performance awards, where awards are earned based on the achievement of multi-year performance hurdles. In the past three years the use of these performance awards by large companies has grown by close to 20 percent. This growth represents a larger increase than any other form of

long-term incentive. Today, about half of large public companies use performance awards (delivered in shares or cash) in their LTI portfolios. During the next two to three years we project that figure will soar to 75 percent or more.

Performance awards can be blended with other LTI vehicles, such as stock options and restricted stock, to balance various business objectives. The combined value of these awards deliver the desired total LTI opportunity. The mix of value by vehicle varies by company. (See chart above for the most common range of LTI mixes in use today.)

CONCLUSION:*A Framework for the Future*

Each LTI vehicle possesses its own strengths and weaknesses. The most appropriate mix of LTI vehicles varies by company; each company has a unique set of circumstances that requires a tailored executive compensation plan. When it comes to determining the right LTI portfolio, off-the-shelf solutions are usually off the mark.



Russell Miller is the co-practice leader of Korn/Ferry International Executive Compensation Advisors, and is based in New York.

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Korn/Ferry International Executive Compensation Advisors offers boards of directors and senior management objective advice to ensure that executive compensation programs align with shareholder value, business strategy and strong governance practices.

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