

T · H · E I · S · S · U · E BAROMETER

Volume 18, Number 5

December 2005

Executive Pay: Rewarding Talent in Times of Reform

Executive pay has been publicly—and often critically—probed from every angle over the past few years. Regulators, lawmakers, shareholders, labor activists and the media have increasingly turned their attention to the size and composition of executive compensation packages. And the results of their investigations have many calling for stepped up reform and greater transparency in the way that those at the corporate helm are rewarded.

With considerable momentum already underway, signs point to 2006 as being a year of change in the way that executive performance is measured and how executives and board members are paid.

To delve deeper into emerging aspects of the compensation issue, *Barometer* invited **Tim Ranzetta**, president and COO of Equilar, Inc.—a leading independent provider of executive and board compensation analysis solutions—as guest expert for the 15 December teleconference. **Hank Boerner**, managing director - New York, Rowan & Blewitt; **Jeremy Frearson**, head of global issues (CAPI), Shell International; and **Brit Wittman**, director of human resources, Cisco Systems also joined the conversation to share their insights on the issues confronting executive pay and outlook for its future.



Tracking Trends in Executive Compensation

Barometer: Tim, what are some of the trends in executive compensation?

Ranzetta: Equilar analysis earlier this year found that S&P500 CEO pay rose 10.2% in 2004, an increase to \$8.05 million. One of the major drivers was an increase in bonuses, which rose 28.5%. The major factor there was the particularly strong earnings growth in 2004—in excess of 20 percent. As well as stock market performance being up, stock options still continue to form a significant component of long-term pay.

Many companies are shifting long-term compensation away from a stock option dependent strategy to a more diversified approach where they provide other vehicles such as restricted stock. There are a couple of reasons for this. The obvious reason is FAS 123R—the new accounting standard that companies are required to comply with at their fiscal year end. Most calendar companies will be adopting it January 1, 2006. They will now have to report an expense on their income statement to reflect the value of the options that they are granting.

Another issue is institutional investor sensitivity to dilution rates. These investors have made their disdain very clear for

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companies that are diluting them considerably by granting large numbers of options on an annual basis.



Radar Blip: The chief executives of America's 500 biggest companies got an aggregate 54% pay raise last year. Total compensation: \$1.5 billion. That easily outpaces 2003's eight percent pay raise. Main reason: stock gains. Aggregate stock gains accounted for 53% of total compensation versus 39% a year ago.

— *Forbes Magazine, May 9, 2005*

The trend is towards a more diverse pay structure. Options are fragile instruments and once prices see a substantial drop, they lose all their value. They are used for retention purposes, but they lose all their retentive value when the executive believes they are never going to have any value. By mixing them with restricted stock an executive can retain some value even in a down market.

Barometer: Is the dot.com bust part of the reason we're seeing early action and leadership on executive compensation reform from tech companies?

Wittman: Silicon Valley, and tech companies in general, have relied on stock options more heavily than other industries, which worked for quite a while. Cisco, for example, doesn't have pension plans, deferred compensation, executive "perquisites," SERPS or split-dollar life insurance. It has simply been base and bonuses and options for 100 percent of the employee population. Options form a very significant part of the overall compensation package. So when options need to be reduced going forward, or their value has dropped significantly, obviously a company like Cisco is going to have to respond much more quickly than say, General Motors, where options represent a small portion of the overall package.

Boerner: I think that executive compensation is probably the number one lightning rod for the coming proxy contest season. A recent S&P report on U.S. executive

2004 CEO COMPENSATION ANALYSIS

	S&P500 Companies — 2004	Small Cap Companies — 2004
Total Direct Compensation (TDC)	\$8,046,288	\$1,521,561
Salary	\$980,000	\$494,184
Bonus	\$1,500,000	\$288,369
Value of Stock Options	\$3,032,304	\$349,345
Restricted Stock (see note)	\$2,629,825	\$407,400
Long-Term Incentive Plan Payouts (see note)	\$1,562,486	N/A
Median Market Capital	\$11.1 Billion	\$561 Million

Notes:

Total Direct Compensation has been calculated for each individual CEO by summing salary + bonus + restricted stock + option awards + LTIP payouts. The TDC number provided in this chart is the median of the TDCs for all CEOs in the study.

Small Cap companies include CEOs at 202 companies in the S&P 1500 with market capitalization under \$1.0 billion that have filed their fiscal year 2004 proxy.

S&P 500 CEO analysis includes 299 companies that have filed their fiscal year 2004 proxy.

Value of stock options calculated by Equilar using a standardized Black-Scholes methodology.

All numbers provided are median values. Restricted stock and LTIP payout medians based only on those CEOs receiving such an award or payout.

Source: *Equilar 2004 CEO Compensation Analysis*

pay levels warns that compensation is not going to moderate, it's going to escalate way above inflation. They warn corporations that pay policies will be cranked into their credit risk rating.

Their comment is that if you look into how the Board handles executive compensation, you have a window into how independent it is, how much it is beholden to management and if it is well governed. That's my phrasing, not theirs. Board competence is a major factor in setting the risk profile, which will directly affect the cost of capital. And when you're talking about executive compensation versus rank and file, the cost of capital going up reflects a risk to everyone in the enterprise. Perhaps you could say it's a case of excessive pay for the benefit of a few.

Barometer: Jeremy, from a European perspective, what trends are we seeing in executive compensation?

Frearson: I have been listening with some fascination. It is a different perspective. Traditionally pay levels in the U.S. are considerably higher than those in Europe for chief executives and directors. The figure of \$8.05 million that was quoted earlier certainly sounds high. From the point of view of an oil company, given that oil prices are high, people do look closely at the salaries senior directors are getting. But I would think if you were looking at the listings today, the Shell senior directors are on the lower end of the listing.

Pressures on Pay and Emerging Expectations

Barometer: Can we shift now, to some of the pressures being exerted on companies for their payment practices. What are some of the different expectations that are emerging?

Ranzetta: There are some early adopters given the fact that it's become a lightning rod issue. We're seeing some companies take a more proactive approach to

implementing what I would define as more shareholder-friendly compensation practices – stock ownership guidelines for executives and directors and more disclosure of pay practices in compensation committee reports. Equilar analysis found that roughly 54.9% of the Fortune 500 had such ownership guidelines in place, 14.1% had holding requirements in place.

“We’re seeing some companies take a more proactive approach to implementing what I would define as more shareholder-friendly compensation practices.”

Some of the issues during the dot.com period were situations where executives exercised options and sold the stock just ahead of a downturn in the overall economy, so there was a sense that they were cashing out ahead of other investors. What holding requirements do is require executives to exercise their options and then hold the stock for one, two or four years. It might be that they hold all of their stock until they achieve the ownership guidelines.

There has also been a move toward more disclosure of pay practices in compensation committee reports. We completed an analysis earlier this year of 100 companies to discern whether disclosure was actually changing. In addition to the median length of these reports growing 11.9% to 1,522 words, we also found that about 14 of 100 companies made dramatic changes to their disclosure and moved away from the typical “boilerplate” language.

“There has also been a move toward more disclosure of pay practices in compensation committee reports .”

There is also more of a movement toward linking performance criteria to equity grants. So if you're going to provide restricted stock, start shifting away from

time-based to achieving certain targets. Whether it's earnings per share growth or total shareholder returns, these criteria ensure that you're outperforming your peer group before you receive that stock.

Barometer: A number of years ago CALPERS came up with a solution in a contract with

“Microsoft moved away from stock options to an entire dependence on restricted stock and performance awards. One of the performance criteria they utilize in determining these awards is customer satisfaction.”

the HMO, Pacificare, where compensation was linked to patient satisfaction. Is this happening elsewhere?

Ranzetta: Microsoft also made one of the more dramatic moves about three years ago. They moved away from stock options to an entire dependence on restricted stock and performance awards. One of the performance criteria they utilize in determining these awards is customer satisfaction.

Boerner: There are people at the top under performing and being rewarded in the view of shareholder advocates and some institutions. In the case of CALPERS, the pension fund asked Pacificare to unwind \$345 million in bonuses that were part of a merger plan.

Carl Icahn, the famous corporate raider,

“Pay for non-performance is actually one of the larger issues that shareholders and shareholder advocates are wrestling with at the moment. The big problem is that nobody has defined performance.”

recently addressed a New York crowd and said what he's been seeing is “survival of the unfittest.” We've set Darwinism on its head by rewarding poor or mediocre performance.

Ranzetta: Pay for non-performance is actually one of the larger issues that shareholders and shareholder advocates are wrestling with at the moment. The big problem is that nobody has defined performance. That's

what's triggered a large round of attempts to control something that hasn't been defined. The irony is that shareholder advocates are pushing for restricted stock, which is pay for non-performance. But they don't see it that way because it reduces dilution. It's the more immediate solution to some of the shareholder issues.

Barometer: Currently there are a number of regulatory and legislative reforms in the executive pay pipeline, such as the Frank Bill and some SEC initiatives. What sort of impact are they expected to have?



Radar Blip: In 2006, Congressman Barney Frank (D-Mass) will seek passage of the Protection against Executive Compensation Abuse Act. It calls for an amendment to the SEC Act requiring additional disclosure of executive pay to shareholders.

Ranzetta: I think that the way this is going to play out is that the SEC is going to take the bull by the horns here. The Barney Frank Act (House Financial Services Committee) probably won't go that far, as Mr. Frank even admits.

The SEC has proceeded to take action with some pretty high profile cases with General Electric regarding the disclosure of Jack Welch's retirement benefits and Tyson's Food, regarding the benefits and “perquisites” paid to Chairman Donald Tyson that hadn't been adequately disclosed.

SEC Chairman Christopher Cox recently said, “Today's regulatory regime permits obfuscation or worse when it comes to executive compensation. The notorious abuses, such as never-before-disclosed exit payments, are the byproduct of this leaky regime.”



There is talk that “sunshine is the best disinfectant.” Does full disclosure guarantee that excess or abuse is not present?

The SEC is drafting rules that would require companies to tally up salary, bonus, stock and option awards and roll all benefits into a single figure. I think one of the things Cox is lining up behind is this “one number” concept. It may also require companies to make changes to the narrative section of proxy reports to better spell out the objectives of compensation programs.

Barometer: What are some of the key areas that institutional investors and groups like Institutional Shareholder Services (ISS) are focusing on?


 **Radar Blip:** Institutional Shareholder Services (ISS) is a provider of proxy voting and corporate governance research services to approximately 33,000 institutional and corporate clients worldwide. Visit ISS at www.issproxy.com.

Ranzetta: ISS represents the interests of institutional investors. They have identified several new areas of focus and I will describe three to them which touch on executive compensation.

In 2006, if you don’t include Tally Sheets showing all elements of compensation, they’re going to put in cautionary language, which to some extent is a slap on the wrist. However, in 2007, if you don’t provide full disclosure of Tally Sheet figures ISS will potentially withhold votes against your compensation committee or vote against your equity plans. They’ll also look at company performance over one, three and five years. If the company is at the bottom of the list, they may use that information to vote against the directors. ISS have given themselves some latitude to evaluate these performers on a case-by-case basis.


Wittman: The thing to remember about ISS is that they service institutional shareholders, but they also work for companies. They consult on things like equity programs for a fee and will tell you

what sorts of changes you have to make for them to approve the plan. They’ve become a lot more popular lately because of shareholder activism. I think the real danger is that they’re going to solve for the median – the middle. For the most part if you follow their formula you’re going to wind up with a very vanilla program.

 **Radar Blip:** Equilar analysis found that 2.7-2.8 percent of equity plans are voted down by shareholders in a given year.

Ranzetta: The other major piece here is performance. The top paid person in Silicon Valley last year, based on the *San Jose Mercury News* Executive Compensation Survey, was Terry Semel, chairman and CEO, of Yahoo. He exercised his options and sold shares worth close to \$230 million in value. So you read the story and wait for the outcry and it never happens. It was hard for investors who have held the stock to get too upset since the price had risen over 300% since Semel joined the company in April, 2001.

Boerner: The American public would not object to a lot of things related to compensation if stock prices and corporate performance were high and if we weren’t downsizing and shifting jobs offshore.”

 **Radar Blip:** S&P500 stock prices have risen more than 59% since the bottom in early 2003, but clearly public trust in business is not making the same recovery. Many people still link excessive pay packages to one of the core conditions leading to scandal.

—Equilar, Inc.

Ranzetta: There was a Roper study that came out recently trying to identify U.S. institutions and to what extent they were considered very trustworthy. At the bottom of the list were CEOs. Only two percent

found CEOs to be very trustworthy, even lower than the trustworthiness of the media at four percent.

Corporate Innovations in Executive Compensation

Wittman: In its 20 year history, Cisco has never had a pension plan or “perquisites.” The decision was made early on that all employees would share ownership. The way they defined that was through stock options. Rather than reserving options for executives, they decided to share them across the entire employment population. At that time it was a couple of hundred people, but the workforce grew relatively quickly. The reason the compensation plan is successful is that we’re making employees owners.

The problem for some companies is that plain vanilla options are essentially free from accounting perspective like no other equity program is. So, options became highly popular - more than they should have, probably. The companies relying on granting options were often wildly successful. From a competition and retention standpoint, they felt they had to grant options to be able to attract and keep people.

Barometer: Do you see any new forms of compensation that are highly innovative and satisfactory to stakeholders?

Wittman: Restricted stock is becoming much more popular. I think there’s going to be a backlash against it because restricted stock has a value even with a declining stock price. There is no link between pay and performance with time-based restricted stock. However, you can implement performance restrictions rather than just time restrictions. So, there probably is a way to use restricted stock appropriately to create

“There probably is a way to use restricted stock appropriately to create an ownership mentality - with less dilution for shareholders - and still deliver value.”

an ownership mentality - with less dilution for shareholders - and still deliver value.

The other thing I see happening, certainly at Cisco, is a change in employee demographics, which drives different desires and behaviors. It’s a lot easier for a company where you have a large equity stake with no pension plan or “perquisites” - just relatively bare bones benefits. The philosophy is that this is, for all intents and purposes, a “start-up” environment, even though it’s a large revenue company. With the demographic shift away from single, male programmers of 15 years ago to employees with family responsibilities, it’s now becoming harder to attract people with high risk but potentially high reward packages.

The Road Ahead for Executive Pay

Barometer: What specific issues need executive attention now?

Boerner: The first thing is shareholder reaction to abuses, which come in two forms. One is fraud - CEOs stuffing their pockets while telling shareholders that everything is rosy. That definitely has to be taken care of and a lot of things have been put in place to address that issue, including Sarbanes-Oxley.

The second is back to our original issue: how much is too much? If you are performing, how much of that performance are you entitled to? As long as you’re providing shareholder returns, should there be a cap on potential earnings?

Ranzetta: Disclosure rules will be changing—the only question is form and timing. Investors will quickly tire of restricted stock and will demand more performance-based requirements before equity is awarded. Also, expect them to demand more information on what the actual performance metrics are. Executive compensation will continue to be a front-page issue; it’s not going away. Expect more shareholder activism and debate over proforma accounting will reach a crescendo later this year as companies start to disclose on their income statement the expense of their stock options.

So much focus is on the negative because there are a lot of examples of that. But to the extent where companies think that their compensation strategies are exemplary, they should highlight them.

As examples of compensation leadership, we can look to pay equity at Whole Foods where a salary cap limits executive compensation to 14 times the average total of all the company's full-time team members, as well as salary or bonus givebacks where several technology executives took \$1 in salary during difficult times.

Intel is a good example of a company where stock options are broadly distributed. From 2000 to 2004, only 1.2 percent of all options granted went to its top five most highly compensated executive officers.

Best Buy's example of sharing option awards with rank and file employees is another positive example of compensation practices. That's one of the things people often miss with this topic. Compensation policies can set the tone within an organization. Employees perceive executive

pay as being emblematic of the type of organization they work for. When done properly, it can have a beneficial impact on a company's culture. Southwest Airlines and JetBlue in the airline industry provide some good lessons with low fares and low executive pay levels relative to their peers.

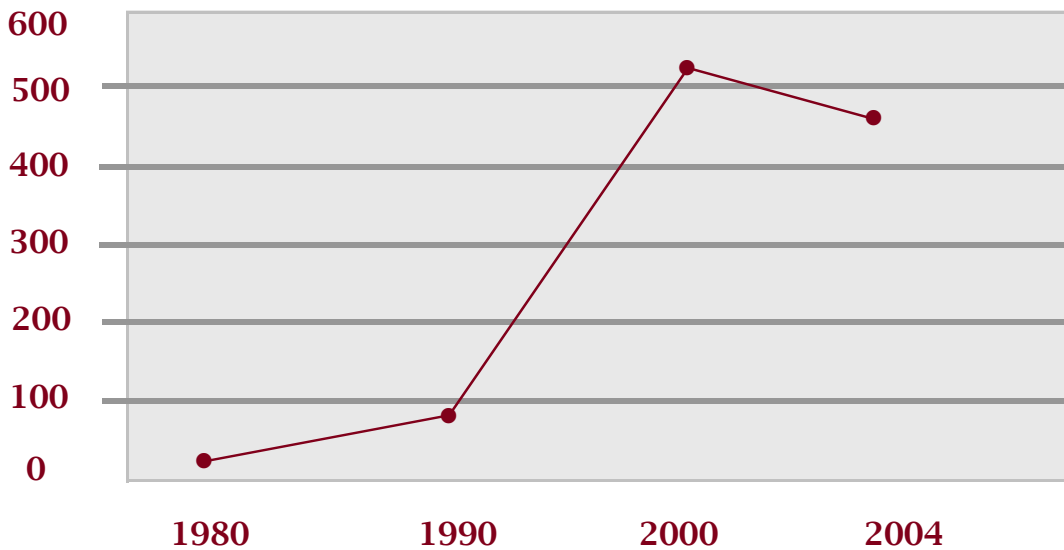
"To the extent where companies think that their compensation strategies are exemplary, they should highlight them."

Equilar is a compensation research firm that focuses on executive and Board of Director pay, specifically the information discussed in filings made by companies to the SEC on their top five executives and Board of Directors.

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LONG-TERM TRENDS IN CEO AND WORKER PAY



Average hourly worker to CEO pay ratios

Source: Business Week

Coming Attractions: Privacy & Nanotechnology

During January, *The Issue Barometer* will participate in the following special events that will form the basis of our next two editions:

- On 11 January, Privacy & American Business will present *The Privacy Year in Review: Trends and Projections*. Led by **Dr. Alan Westin** and **Robert Belair**, the review will examine “the full spectrum of federal privacy legislation in play during 2004-2005 that will likely shape the actions of the upcoming Congressional session. Topics addressed will include security breach notice language and other security standards, Social Security number privacy language, freeze file language and data broker language.” For details, visit www.pandab.org.

Based on the P&AB presentations and our own research, *Barometer* will hold an Emerging Issues teleconference at 11 a.m. EST on Thursday, 19 January to discuss implications and actionable steps forward regarding privacy expectations.

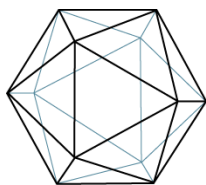
- The Washington Academy of Sciences will present a *Forum on Nanotechnology — An Interdisciplinary Effort* on 17 January. After attending, *Barometer* will present key findings along with additional analysis during an Emerging Issues teleconference that will take place at 11 a.m. EST on 2 February 2006.

Members of the Issue Management Council will receive invitations to these conversations via e-mail. For additional information or to participate as a speaker in the teleconferences, contact us at barometer@issueactionpublications.com.

Publisher and Editor: Teresa Yancey Crane
Contributing Editor: Linda Fischer

Production: Judith K. Dimsey and Kathy Sauer
Circulation: Hazel C. Coupar

The Issue Barometer was founded in 1986 by Rafael D. Pagan, Jr. Published monthly, it is designed to inform business, government and other opinion leaders of the objectives and activities of issue-oriented organizations, thereby initiating dialogues to resolve issues. The opinions that appear herein do not reflect the position of the *Barometer*. Subscription rates are US\$257 annually. Single copies are US \$30 each. Address all editorial and subscription correspondence to: Issue Action Publications, Inc., 207 Loudoun Street, SE, Leesburg, VA, USA, 20175; tel: (703) 777-8450. Reproduction of this newsletter without publisher's written permission is an actionable violation of copyright laws. ISSN 0882-7966. For more information on IAP products, see www.issueactionpublications.com.



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A primary goal at the Issue Management Council is to provide you with the practitioner forums and collegial exchange that help you identify emerging issues before they reach a crisis threshold. One of these collegial exchanges takes place as a monthly teleconference, which combines research and member collaboration on emerging issues. *The Issue Barometer*, attached here with our compliments, is then mailed to all IMC members as one of many benefits of membership.

You are invited to join the list of potential participants on this robust and lively discussion panel by becoming a member of the Issue Management Council. Read this *Issue Barometer*, then visit the IMC website at www.issuemanagement.org. All of the many advantages of membership in the Council can be found there, as well as on the accompanying list. We encourage you to act now to join this dynamic group of progressive corporate leaders.

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