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SUPPLEMENT

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Highlights of The 2nd Annual Executive Compensation Conference

The 2nd Annual Executive Compensation Conference, sponsored by CompensationStandards in cooperation with Harvard Law School's Program on Corporate Governance and Stanford Law School's Program in Law, Economics & Business, was a major success, with 600 attending in person and over 3,000 attending live via video simulcast. In the words of Gibson, Dunn & Crutcher partner John Olson, "the conference (once again) should set the tone for executive compensation discussions throughout America during this coming year." The conference provided practical guidance—with sessions on specific tools that compensation committees should now be using—to implement responsible pay packages.

One theme that emerged over the course of the day was how critical it is for directors who sit on the compensation committee to use the new basic tools now expected of compensation committees when assessing and making decisions on executive compensation, rather than just rely on formulas, surveys and datapoints—and for the entire board to become more involved in the process. Many panelists stressed the importance of understanding and implementing 'internal pay equity' and the use of tally sheets to provide a full picture of total CEO compensation. Other themes stressed throughout the conference included implementing pay-for-performance targets that can't be gamed, requiring top executives to hold options and restricted stock until retirement, and the need for addressing and fixing aspects of CEO compensation.

[Director Liability: After Disney](#)

The stakes at hand and the new expectations for directors were set with a special presentation featuring Delaware Supreme Court Chief Justice Myron Steele, Delaware Vice Chancellor Stephen Lamb and Professor Charles Elson, the Director of the University of Delaware Center for Corporate Governance, discussing the application of Delaware law to director responsibilities and liability today, post-*Disney*. A key takeaway from this session (that was underscored by different panelists throughout the day) was that the information, tools and actions that are expected of directors today—and therefore what courts will look to today—are much different from what existed in the early 1990s.

[John Reed's Opening](#)

The tone for the day was set by John Reed, former Citigroup CEO and NYSE Chairman, who opened the conference with a riveting talk sharing his views on CEO compensation, drawing from his vast experience as both a director and CEO.

Mr. Reed first described why executive compensation is such an important topic—not only because of the public nature of executive compensation—but because it sets the "tone at the top" and speaks to the values of the company.

[The blue text represents hyperlinks on the electronic version posted at www.CompensationStandards.com.]

As with everything else boards do, Mr. Reed emphasized that it is extremely important that executive compensation decisions reflect judgment. Mr. Reed eschewed paying CEOs in the top percentile and using surveys and formulas that have been developed to provide an automated answer. He stressed that directors need to use the information they review as a guide—and only as a guide. Compensation must be tailored to meet the specific situation of the specific company and a board has a responsibility to make judgment calls and to work with the CEO on their goals for the CEO’s total compensation.

He discussed that bonuses should be truly variable, rather than an understanding that the CEO will get paid an expected amount, no matter the level the company operated at or whether other goals were reached. He also focused on stock-based compensation, stating that it should be carefully administered because it is a “blunt instrument” due to the volatile nature of the stock market. As a result, a company may end up providing more compensation to an executive than it intended to.

He said boards need to do a better job of looking back at the value of the equity that they have already delivered to the CEO, giving his own example at Citigroup, where the value of his options ended up to be four or five times greater than either he or the board had targeted to deliver. He called it a “cop out” when boards do not make adjustments to future grants, when the subsequent market value of options previously granted exceeds the amount targeted by the board for the CEO.

Mr. Reed also described why he is uncomfortable with perks. He discussed two drawbacks: First, an executive with a lot of perks veers into the dangerous ground of mixing personal life and work relationship to the company. The line between personal and professional can become fuzzy. Second, because the use of perks is visible within the company, the values of the company can be impaired. A feeling can develop that everyone can live off the company. Mr. Reed believes it is best to have a minimum of perks, if any, with clear delineation between benefits paid and an executive’s personal life. Confusion between who you are as a person and what you do in your work operates to the detriment of the shareholders.

The Directors Speak on Excessive Pay

This session was a highlight of the conference and had everyone in the audience taking copious notes on the challenges that the distinguished directors on the panel—Ken West, Ed Brennan, Warren Batts, Sam Skinner, Michele Hooper and Jim Crown—have faced with CEO compensation, what they have done, and what challenges lay ahead. One theme that emerged from the panel was that recently many positive changes have begun to occur—including the use of tally sheets—but that many changes still need to be implemented.

Specifically, the directors underscored several areas that were discussed throughout the day: directors must use their own judgment, rather than solely rely on experts and surveys; internal pay equity should be a basic practice; directors need to view surveys or other datapoints with a critical eye, to understand the source and bias of the information; succession planning needs to be focused on; the “rock star” CEO mentality needs to be discarded; and directors should analyze what the executive group is costing the company, as a percentage of profits, to help directors better understand how the group is performing. It was also made clear that making necessary changes to CEO pay needs to be a cooperative effort with open discussions and the full involvement, support and leadership of the CEO.

The Consultants Speak on What You Need to Do Now

This panel provided candid guidance about where executive compensation has gone astray—and how to bring it back into line.

Pearl Meyer of Steven Hall & Partners discussed where we have *all* gone astray and the new responsibilities of compensation committees, including re-examining assumptions underlying current executive

compensation programs; testing compensation philosophy and policies based on corporate mission, strategy and performance; and adding it all up under varying scenarios.

She also candidly acknowledged that until a few years ago, even consultants did not appreciate how large the retirement and severance components (and perks) had become because these were not part of the compensation consultant's responsibility. As a result, compensation recommendations and decisions were made without taking into account the additional huge amounts that had, in fact, become part of many CEOs' total compensation.

Mike Halloran of Mercer Consulting addressed several problems with SERPs and severance arrangements that many companies still need to address. George Paulin of Frederic W. Cook & Co. focused on restricted stock grants and the mistakes that many companies are making right now (including compensation committees overlooking the dividend income that needs to be factored in, *e.g.*, the extra \$3.2 million per year that Exxon Mobil's CEO now receives).

Douglas Friske of Towers Perrin called attention to a very important area that companies have only now begun to focus on: the wealth accumulated from past equity grants. After compensation committees are presented with these numbers, they often have what Mr. Friske dubbed an "ah ha" moment. That, in turn, causes directors to focus on whether there is any longer a need for, or corporate purpose served by, retirement and severance provisions in those situations where several lifetimes' worth of wealth and 'security' have already been provided.

[Readers should take note of the [excellent materials](#) that were posted accompanying this and several other sessions.]

JPMorgan Chase CEO Jamie Dimon's Candid Luncheon Speech

At last year's Executive Compensation Conference, luncheon speaker SEC Corp Fin Director Alan Beller used the platform to deliver his memorable message, serving notice that the SEC was taking aim at executive compensation disclosures. This year, luncheon speaker JPMorgan Chase CEO Jamie Dimon delivered an equally significant speech, putting forth his views on executive compensation.

Mr. Dimon started by noting that there is a lot of angst and anger around executive compensation these days and acknowledged that it is somewhat justified.

Mr. Dimon shared his approach for how to set an executive's compensation. Rather than rely on surveys, which in his opinion are "misused to ratchet compensation," he believes directors should ask: what job function(s) does the executive perform, does the executive perform the whole job, is the executive doing the job at an "A" level, what is the value of the job to the company, and did the company do well? Mr. Dimon also said that unknowns—such as SERPs—should be capped to keep a rein on compensation and that executives "should pay out of their own pocket for their own stuff." However, when a company does provide a perk, it needs to also provide full and fair disclosure.

Mr. Dimon then discussed how important internal pay equity is—sometimes more important than external benchmarks. He said that it is important to have open conversations about compensation, so executives can see compensation across the company. With respect to severance, Mr. Dimon provided a novel disclosure guideline: companies should disclose the GAAP cost of the severance and the amount of the check that will be written to the executive. He also reiterated that different circumstances will require different arrangements, so comparison of severance plans across companies does not work.

While it would be impossible to lay out all the important points made by Mr. Dimon, he also touched on a number of other compensation issues: tally sheets are essential for a board and boards should focus on total compensation; the more senior an executive is, the more stock that executive should own and retain—and a significant portion (75% "after tax") of all equity granted to the top level executives

should be held for the duration of the executive's employment (as has been the case at JPMorgan, Bank One, Citigroup and many other companies); CEOs should evaluate themselves to the full board; boards should meet without the CEO; CEOs should decline pay increases that are not justified; and compensation should not include things like accomplishing a merger without some evaluation of the quality of the merger.

Mr. Dimon also made the point that CEOs are not greedy, they are motivated by many other human factors (including fear) and that compensation committees and advisors should not be intimidated about having open discussions with CEOs. Mr. Dimon's words are backed by action. While at Bank One, he gave back a \$7 million SERP and rejected other compensation that the board had granted. He also took it upon himself to purchase two million shares with his own money, "tying himself to the mast."

A message worth repeating from these and other insights conveyed by Mr. Dimon during his talk is that directors should not be afraid to have open discussions with their CEOs, and consultants should not be cynical or intimidated about pointing out to compensation committees areas where excesses have gotten built into a CEO's total compensation. CEOs may well be more responsive to corrective actions than is commonly thought.

What Now Needs to Be Disclosed in the Proxy Statement

The afternoon sessions began with an important panel with Ron Mueller of Gibson Dunn and Mark Borges of Mercer focusing on this year's upcoming proxy statement disclosures—particularly the information that those directors whose names go under the compensation committee report need to focus on and question more closely. Because space will not permit an adequate summary of this session, readers are encouraged to view the tape of this session and the accompanying materials posted on CompensationStandards.com. [Those responsible for drafting compensation disclosures—as well as all directors who sit on compensation committees—should be aware that Ron Mueller and Mark Borges will be providing the latest proxy disclosure guidance in two important upcoming webcasts in January.]

How to Implement Pay-for-Performance Targets that Can't Be Gamed

Renowned author and Harvard Law School professor Lucian Bebchuk provided an insightful overview of paying for performance. As one example of the stakes involved, Professor Bebchuk found that, comparing the early 1990s to the early 2000s, compensation levels for the top five executives increased from 5% of the aggregate corporate earnings to 10% of aggregate earnings. Thus, if compensation levels could be reduced without weakening incentives (as Professor Bebchuk believes it can), the effect on firm value could be significant.

Diane Doubleday of Mercer Consulting and Don Delves of The Delves Group discussed the top performance measurement and board oversight mistakes they find in pay for performance structures, including just using one measure, not "stress-testing" the performance metrics, managing the program inconsistently year-over-year and not taking a "holistic" approach to plan design, so that all incentive plans have goals that are aligned.

Mark Van Clieaf closed out this excellent session by providing an analysis of real-world pay-for-performance programs, finding that the best programs clearly define the CEO/NEO level of work and accountability beyond the short term and publicly disclose performance metrics, performance periods and pay-for-performance policies.

How to Devise the Appropriate Tally Sheets

A highlight of the conference was the panel on "How to Devise the Appropriate Tally Sheets." Although many compensation committees are now utilizing tally sheets setting forth all the components

of the CEO's compensation, tally sheets are still a work in progress at many companies—with much room for improvement.

Mike Kesner of Deloitte Consulting and Pearl Meyer of Steven Hall & Partners described the essential elements of a “proactive” tally sheet, including the need to summarize the impact of current and past decisions, project future outcomes under various stock price appreciation and equity grant scenarios, and include pension accruals and projections. They also called attention to areas (and overlooked factors) where many tally sheets can be deficient, providing examples of comprehensive tally sheets they developed. [Note that the CompensationStandards website has become the central repository for a variety of [tally sheets](#).]

The panelists provided their own candid observations and guidance on the important question of what to do when a compensation committee, upon seeing all the components of the CEO's compensation and all the numbers added up, has a “Holy Cow” moment.

Key “action items” for directors reviewing tally sheets:

- Ask for “what if” calculations under various total shareholder return scenarios and future equity grant levels;
- Consider renegotiating/ratcheting back severance multiples, future equity awards, and pension accruals;
- Review the impact of changing the pay philosophy/targets on future equity awards and wealth creation;
- Revise/restrict “gross up” language in change in control provisions; and
- Consider how much is enough—and then add (a) caps and/or (b) offset provisions. For example: (a) SERPs need caps; (b) severance can be 2x salary, but no more than, *e.g.*, \$5 million.

A suggestion was put forth by Mike Kesner: Add a provision to the CEO's retirement plan benefits so that the ultimate payments factor in the wealth accumulated from prior equity grants—for example, “the sum of equity and retirement plan benefits not to exceed, *e.g.*, \$15 million.” (Therefore, if the wealth accumulated from prior grants were to exceed the targeted retirement benefit, there would be no ‘need’ for any additional retirement payments.) This suggestion, which was well received, furthered the point made during the earlier Consultants’ Panel about the need for compensation committees to factor in the wealth accumulated over the years from stock options and restricted stock.

Ed Woolard's Compelling Words

A major highlight of the conference was the memorable presentation by Ed Woolard, Jr., former CEO and Chair of E.I. DuPont Nemours and Co. and current Chair of the NYSE's Compensation Committee (which was also the focus of an October 23 *New York Times* [article](#)). Mr. Woolard's talk served as the lead-in to the important session on internal pay equity.

In his presentation, Mr. Woolard dispelled four myths of executive compensation: (1) that CEO pay is driven by competition (instead, outside consultant surveys have ratcheted CEO compensation); (2) that compensation committees are truly independent (the board should have its own outside consultant, who should not have contact with management); (3) that CEOs “create wealth” when the stock price rises (a tide lifts all boats); and (4) that CEOs should have large severance packages (“no one else gets paid for failing”).

Mr. Woolard's main message focused on internal pay equity. Mr. Woolard described why he urged the board at DuPont to adopt internal pay equity—tying CEO compensation to the executives heading

the company’s business functions—and how DuPont implemented the program (which is still in effect today), not only to address excessive CEO compensation (which was already burgeoning in the early 1990s), but also to maintain company culture and values.

Mr. Woolard ended by reminding the audience that everyone—CEOs, directors, lawyers and consultants—has a responsibility to restore trust and to regain the respect of the public. He asked compensation committees to “seriously consider implementing internal pay equity.” He offered a challenge to CEOs to say “we’re going to do internal pay equity.”

Why—And How to—Implement Internal Pay Equity

Mr. Woolard’s compelling talk was followed by the panel on “Why—And How to—Implement Internal Pay Equity” headed by Fred Cook of Frederic W. Cook & Co. Jesse Brill, Conference Chair, introduced this session observing that—just as tally sheets were the common sense tool that compensation committees embraced and implemented over the past year—internal pay equity will be the major tool implemented by compensation committees during this coming year. Strong support for boards to implement internal pay equity came from the Directors’ Panel earlier in the day, where the directors underscored the importance of internal pay equity, not only as a way to address fairness of the compensation at the top, but to set the tone and culture of a company.

As Mr. Woolard and other panelists pointed out, internal pay equity provides an objective benchmark that compensation committees can look to instead of chasing survey numbers that have years of distortions baked into them.

Blair Jones of Semler Brossy provided practical guidance on how to task a company’s HR to conduct an internal pay equity “audit” in order to ascertain where unintended gaps may have originated, including:

- Looking back over time to determine when (and why) each component of the CEO’s total compensation was added to the mix and seeing how gaps were created versus other executives;
- Hypothesizing how you would expect the ratios for your company to turn out based on organization structure, operating style, business situation and history. (Ultimately, these hypotheses could be evolved into philosophy statements); and
- Testing whether the actual ratios are consistent with these hypotheses. If they are not, examine what influences over time have prevented the outcomes you expected, and then take the necessary steps to get back to the company’s core compensation philosophy.

Finally, Fred Cook responded to cynics of internal pay equity by addressing the criticism that internal pay equity will cause a growth in everyone’s compensation rather than a decrease in the CEO’s. Fred stated that even if this were to happen (which he did not necessarily accept), it could still have the beneficial effect of creating a more equitable culture at companies.

[At the NASPP Conference following the Executive Compensation Conference, there was a 75-minute session that provided a lot of important follow-up guidance and detail on implementing internal pay equity and tally sheets (including [wealth accumulation tables](#)) with Mike Kesner of Deloitte, Joe Rich of Pearl Meyer & Partners, Doug Friske of Towers Perrin and Myrna Hellerman of The Segal Company/Sibson Consulting. Because of the importance of this session and the accompanying materials—particularly [an internal pay equity total compensation worksheet](#)—we have now posted an [audio archive](#) of the session and accompanying materials on the CompensationStandards web page containing the Executive Compensation Conference archive.]

Realistic Fixes

Jesse Brill pointed out that three areas where internal pay equity audits would reveal gaps that will need to be addressed will be: (1) stock options and restricted stock grants, (2) retirement and SERP provisions, and (3) severance provisions. He also pointed out that there are fixes that he believed respected CEOs would understand and get behind.

Stock Options: Two ways to address large accumulated gains of stock options and restricted stock (where, for example, today's median annual stock option grant is now more than two times what in 1998 was a huge one-time mega grant) are: (1) implement [hold-til-retirement](#) provisions for past as well as future grants, as many savvy companies are now doing; and (2) focus on, and return to, the purpose of equity grants: when you reach a sufficient level of [carried interest](#), as Fred Cook, John Reed and other respected leaders have advocated, additional grants may not be necessary or appropriate.

Retirement and Severance: As was suggested, in addition to caps, where a CEO has already accumulated several lifetimes' worth of wealth and security from previous equity grants, there is no *need* for retirement or severance provisions. As suggested, compensation committees can set a target for accumulated wealth at retirement (say, \$15 million) and have retirement payments kick-in to cover any shortfall between accumulated equity gains (realized and unrealized) and the targeted wealth accumulation amount.

One key theme from this session was that, by using internal pay equity as a guidepost, a partnership between a respected CEO and a responsible board can indeed implement these and other necessary changes and send a message that will resonate.

Conference Takeaways

The conference closed with five takeaways to implement:

- *All* directors, not just those on compensation committees, need to get up to speed. Four items that every board member should read are: (1) [Ed Woolard's talk](#), (2) [Fred Cook's talk](#), (3) [the September-October 2005 issue](#) of *The Corporate Counsel*, with the latest specific guidance for directors, and (4) [the key tools](#) a director needs to get up to speed (which, together with the above three 'must-reads,' are posted, for ease of access, on the right hand column of CompensationStandards.com under the caption [Catch Up Now](#)).
- Add to the next compensation committee meeting agenda: "implementation and review of the results from the basic tools that compensation committees should now be utilizing: (1) [tally sheets](#), (2) [internal pay equity](#), and (3) [stock option gains/accumulated wealth tables](#)."
- Have a follow-up meeting to take necessary actions like: (1) revamping your stock compensation grant practice, (2) adding hold-til-retirement provisions, and (3) fixing or capping/offsetting severance and retirement (and wealth accumulation) provisions.
- Have that open discussion with your CEO, referring perhaps to Ed Woolard's talk and the examples of CEOs who have now taken meaningful steps. (See [CEOs That Have Set an Example](#) on CompensationStandards.com.)
- The final takeaway was actually a request that each of us do our part. Please keep us apprised of what you are doing so we can continue to be a central resource for others and so that we can continue to add examples of boards and CEOs implementing responsible changes.

And Much More...

It is impossible to truly convey the wealth of information delivered at the conference; the above is only intended to be a brief snapshot. The panels described above included far more guidance than we

have been able to describe here. Other critical panels included Fred Cook and John Olson's guidance on [What Compensation Committees Should Now Be Doing](#); Mike Melbinger and Tim Sparks' respectful, practical pointers on [How to Fix Outstanding CEO Pay Packages and Agreements](#) (and their list of [20 Action Items](#)) and a sobering session on [What Institutional Investors are Now Focusing On](#). Those that missed this groundbreaking conference can access the [video and audio archive of each session](#)—and the invaluable [supporting materials](#)—at CompensationStandards.com. [If your company or firm is not yet a member of CompensationStandards, to enable you to view the sessions and access the accompanying materials, just take advantage of the [no-risk trial](#).]

Access to the Conference Video/Audio Archives and Materials

Because we are receiving so many requests from companies seeking permission to provide to their directors (and CEOs) portions of the just completed 2nd Annual Executive Compensation Conference (and the accompanying materials), we have decided to facilitate the broadest possible access to the entire Conference video/audio archive and materials: All 2006 subscribers to Compensation Standards (including those that enter trial subscriptions) with *FIRMWIDE* subscriptions will have unlimited access to the Conference video/audio archives and materials—without any additional charge. And those with single subscriptions or single location unlimited subscriptions will be able to gain ongoing access for all of 2006 for only \$95 and \$295, respectively.

Our hope in doing this is that even more companies and firms will benefit from the responsible guidance provided and implement practices that will restore the public trust and help regain the respect for all of us who are in positions of responsibility and leadership. We encourage you to enter Firmwide subscriptions so that outside directors, as well as other key participants in the compensation process will be able to access the important guidance and tools and ongoing compensation committee practice developments, that have become essential to those fulfilling fiduciary responsibilities.

Please use the form below to take advantage of the no-risk trial (or go to CompensationStandards.com to do so online and gain immediate access).

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