Executive Pay Trends: Looking Forward and Back

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Our nation's top executives found themselves under attack in 2002. As the year opened, businesses were coping with the after-effects of September 11 and a prolonged market slump, while trying to make sense of the Enron debacle—with little clue as to the other allegations about to unfold. By December, the reputations of some of the nation's most lauded executives had been tarnished and the financial survival of several leading companies hung in the balance. Critics charged that overly generous, option-based executive compensation programs had made a mockery of the "pay-for-performance" ideal and some investors clamored for a direct voice in high-level pay decisions. The year ended with double-digit declines in every major market index, capping three straight years of losses at a time when a record 50 percent of all American households owned stock.

As this Annual Report for 2003 is written, positive change is underway. There is unprecedented support for many long-sought corporate governance initiatives. With uncharacteristic speed, regulators and legislators have proposed or enacted a slew of reforms, affecting everything from executive loans, option accounting, shareholder approval of new stock plans and broker voting to proxy disclosure, corporate ethics and Director independence. Mainstream corporations have been voluntarily changing policies and procedures in advance of new mandates and shareholder initiatives. In response to criticism that executive compensation programs were warped by option mania during the long market boom, many companies are re-evaluating how executive pay is earned and delivered.

Regaining credibility and investor confidence in this era of change will fall primarily to Corporate Boards—many of whom find their own performance called into question. A recent survey by our firm of leading fund

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managers revealed overwhelming dissatisfaction with the quality of corporate governance, particularly with regard to executive compensation practices. Many shareholder activists have called for a power shift toward more rigorous Board oversight of top management, a move that would further increase the requirements and time commitments of Board service—along with attendant risk to members' reputations and finances. Small wonder that conscientious Directors view their Board compensation as more akin to combat pay.

We believe these challenges will significantly impact both the level and structure of Board compensation over the next few years. Increases upwards of 20 percent are likely in the 2004 proxy season, with a 50 percent or more overall potential rise over the next several years. In contrast, growth in executive pay may slow as changes are made in the mix of many programs. Perhaps most importantly, compensation programs will start to make greater use of cash and stock incentives that are based on business outcomes, with significant rewards for financial and strategic results that reflect the organization's true long-term health. The expected imposition of new accounting rules will help spur companies to explore alternative ownership opportunities that may be better suited to their organizations than the standard option.

In summary, we see a silver lining in this stormy executive and Director pay environment. Let's look in more detail at some of the developments—many of them positive—that are likely in the coming year.

FORECAST 2003—WHAT'S AHEAD IN EXECUTIVE AND DIRECTOR PAY

On the Executive Front

Executive pay growth will slow in response to business conditions, as well as the sensitivity of shareholders, the public, media, regulators, and legislators to the appropriateness of executive compensation levels and practices.

- Many companies will be forced to reevaluate their practice of *benchmarking* pay levels, which critics contend has fostered the steady rise in compensation. Going forward, such benchmarking will have to correlate pay to performance.

- The outlook for Fiscal 2002 bonuses is brighter than last year, due to more conservative goal-setting following a bleak 2001, when one fifth of CEOs at the nation's 200 biggest companies received no bonus.

The pay pie will be reconfigured starting in 2003 as companies make more disciplined use of stock options, reversing a longtime trend.

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- The goal will be a more balanced approach to motivating and rewarding the creation of long-term corporate value with equity and cash incentives that incorporate business, financial and stock performance measures, rather than focusing so heavily on the stock market.

- Poor market conditions, high dilution, and the likelihood of option expensing will prompt more interest in newly designed equity vehicles and cash LTIPs.

- To illustrate, chip maker Agere Systems Inc. announced in January that it is reducing option grants to its top executives in favor of a cash bonus plan based on market share and profit goals. The move came in response to high dilution and underwater option issues.

- If the proposed elimination of the federal income tax on corporate dividends is passed, companies may revisit the grant of dividend equivalents.

- The near-ubiquitous use of the plain vanilla stock option will start to give way to the design of tailored option programs with performance components and shorter terms.

- More option grants will include a required holding period for after-tax profit shares to avoid "hit and runs" and foster long-term ownership.

- Restricted stock will be a popular and highly effective vehicle to ensure that executives are real owners, rather than optionees. Ideally, grants of restricted stock will be earned on a performance basis and not give-aways.

- Non-option equity awards use fewer shares and result in less dilution, although many plans are bound by the low limits on "full value" awards adopted in prior years to win favor with institutional shareholders.

- More creative use will be made of business-unit-specific incentives, particularly for long-term rewards.

- Stock appreciation rights exercisable for stock, which entail the same accounting cost as options under FAS 123, will help reduce insider sales into the market, avoid broker-assisted cashless exercises and conserve plan shares.

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- A major consideration will be managing the costs associated with the expected passage of new option accounting rules in mid-2004.

- The depth of participation in stock option programs will be trimmed at many companies. Fewer companies will grant options world-wide.

- Companies with a large number of underwater options and shares available may take advantage of the hiatus before the new rules take effect to make multi-year option grants in 2003.

Underwaters will continue to be a troubling issue at many companies.

- Ongoing concerns over dilution, executive retention and potential accounting expense will drive some companies to "swap out" their underwater options. In many cases, shareholder approval will be sought.

- But institutional shareholder ire, combined with likely shareholder approval requirements, will cause some companies to continue ignoring out-of-the-money options.

- Much will depend on the economy and job market. Underwaters may need to be addressed more forthrightly when the job market heats up.

FAS 148 may trigger a new wave of voluntary adoptions of FAS 123 in 2003.

- After the initial wave of FAS 123 voluntary adopters—mostly large, prominent companies for which the option earnings charges were not meaningful—new adoptions slowed to a trickle.

- Under FAS 148, effective for fiscal years ending after December15, 2002, a company that adopts FAS 123 after 2003 cannot use the "prospective method" for transitioning to FAS 123. Potential loss of this "least expensive" transition method may push a new group of companies to voluntarily adopt FAS 123 in 2003.

Company relations with shareholders will be different in 2003.

- Institutional shareholders are increasingly voting against management proposals on compensatory plans. In some cases, their ire drives them to vote against specific Board candidates as well.

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- Expect more instances in which record "no" votes are registered or plans are voted down.

- The SEC-mandated "overhang" disclosure is expected to show heavy use of non-shareholder-approved stock plans.

- Though a proposed SEC rule requiring shareholder approval of any repricing has not yet passed, it adds to growing pressure on companies to seek such approval voluntarily.

Given investor sensitivity, more companies will initiate full disclosure, valuation and periodic review of contract terms.

- Perquisites will be closely scrutinized and a genuine business rationale will be required for any remaining special executive benefits. Where not truly needed, companies will be sensitive to symbols of executive excess. Companies as diverse as Roadway and Bank One recently eliminated perquisites such as split-dollar life insurance and automobiles.

- Failure to comply with a company's code of ethics will be included as a "for cause" reason for dismissal, as companies focus on corporate culture, values, and conduct.

- There will be a decline in single trigger change-in-control protection, in response to investor concerns about high payouts for the continuously employed.

- Amidst uncertainty about stock values and the absence of wealth creation through equity participation, executives will seek additional security for their retirement years through improved SERPs. But overly generous SERPs, often granted in response to declining equity values and as recruitment and retention aids, will be less common as disclosure becomes more rigorous.

Companies will deal with a host of unresolved questions raised by the ban on executive loans under Sarbanes-Oxley.

- With a prohibition on loan extensions, companies will have to forgive or require repayment of loans that come due. Payback will be problematic where the value of an executive's underlying stock is no longer sufficient to cover the loan.

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- The ban on loans for option exercise or equity purchase will doom major programs for executive stock acquisition.

- But broker-assisted cashless option exercise programs will survive, avoiding the loan restriction by delivering shares to the broker only after receiving the exercise price and allowing the optionee to choose a broker.

- Once FAS 123 becomes mandatory or is voluntarily adopted, stock SARs will also be used to avoid the problem of financing option exercise.

- Rather than provide relocation loans, companies may offer interest offsets or taxable sign-on bonuses that are recoupable if new executives leave within a stated period.

Clawbacks will be utilized more aggressively by companies to disgorge signing bonuses from executives of brief tenure, as well as bonuses and option profits from those who join the competition or violate other restrictive covenants.

Share ownership retention ratios will become more prevalent, with executives asked to demonstrate continued faith in their companies' future well-being by holding a set percentage—usually 50 percent up to 75 percent—of after-tax option gains and restricted share grants.

On the Board Front

Corporate governance—particularly Director independence—are the watchwords of the new era.

- New investor service scoreboards will offer shareholders a detailed comparison of corporate governance practices by company.

- Board process will become more standardized in terms of schedules and procedures.

- Companies will need to adopt or amend their Compensation and Nominating Committee charters to comply with proposed new NYSE and Nasdaq rules.

- If all the Exchange proposals and other recommendations are adopted, at a minimum, Boards also will elect non-CEO Chairs or lead/presiding Directors; maintain codes of ethics; obtain shareholder approval of all equity plans; and, for Directors themselves,

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have guidelines for independence, share ownership and regular performance reviews.

The Board relationship will evolve from one of CEO domination to CEO accountability.

- More retiring CEOs are transitioning into the Chairman position.
- Board pay programs will be structured to accommodate additional compensation for lead Directors and new designs for non-CEO Chairs and non-executive Chairs.

Director pay will climb steeply in 2003, starting with an expected 20 percent hike, which will be disclosed in 2004 proxies, as companies overhaul their Board compensation programs in an effort to reflect the newly heightened commitment, time requirements, and risks of Board service. Within five years, pay levels could easily swell by as much as 50 percent to 100 percent.

Board pay will become more individualized to reflect members' differing responsibilities and backgrounds. Broader use will be made of committee member fees and Chair retainers to reflect the fact that Board business increasingly is conducted at the committee level, particularly audit and compensation matters. Differentiation will be less of an issue at Boards that regularly rotate committee memberships.

Compensation Committees will scrutinize pay programs to an unprecedented extent.

- Rather than "leaving the details" to management, Directors will turn to outside consultants, question tactics as well as policy, request more data, and generally insist that management justify proposed performance targets and payouts.
- More activist Compensation Committees may offer better oversight—or turn out to be a mixed blessing.
- Some members may be tempted to try to micromanage pay programs.
- One solution would be to have Compensation Committees set clear parameters to guide management regarding the scope of their oversight and the information they require.

The laws of supply and demand will mean tougher recruitment challenges at the Board level.

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- New exchange rules specifying committee member experience and/or independence requirements will force some current members to step down and narrow the pool of qualified new candidates.

- Fewer CEOs will be available for directorships as companies seek to avoid exposing their top executives to the new time demands and reputational risk of Board service.

- Boards increasingly will recruit second-level executives and candidates from the worlds of academia and public service. Nominees with financial expertise, such as CFOs and controllers, will be in high demand. Similarly, other functional officers such as senior human resource executives may be sought out for their professional or technical expertise.

Use of stock options in Board compensation programs will decline in favor of full value grants that provide an immediate ownership component.

- There is a growing view that Director options may be contrary to the long-term perspective considered appropriate for Boards.

- Experienced Directors will avoid programs that hold them to the same annual pay-for-performance standards as management.

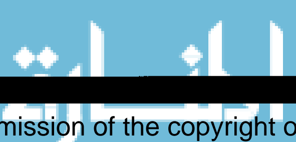
- As the use of full value grants increases, so will the prevalence of Director share ownership/retention guidelines.

On the Regulatory/Political Front

On the Accounting Side

On the accounting side, the Financial Accounting Standards Board (FASB) will move toward adoption of a global accounting standard. While APB 25 accounting for options has survived past attacks, the deathwatch is underway.

- In November 2002, the FASB solicited comments on the proposed International Financial Reporting Standard (IFRS) on "Share-based Payments" being developed by the International Accounting Standards Board (IASB). Like FAS 123, the IFRS presumes that options and equity awards have a fair value that should be reflected in a company's income statement.



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- Companies will now focus on how the IFRS differs from FAS 123 in treating forfeitures and accounting for income tax benefits of equity awards and the timing of any transition to the new standard.

- FAS 148 further signals imminent change, by providing an incentive for more companies to voluntarily adopt FAS 123 this year.

On the SEC and Governance Side

On the Securities and Exchange Commission (SEC) and governance side, we expect that after the embarrassing departure of Chairman Harvey Pitt, the SEC will try to re-establish itself as part of the corporate governance solution, rather than part of the problem. A key step in 2003 is the release for public comment and eventual adoption of the NYSE and NASDAQ corporate governance proposals, under which:

- Boards need a majority of independent Directors.

- Audit, Nominating/Corporate Governance, and Compensation Committees must be wholly independent and adopt charters delineating their responsibilities, with the authority to retain consultants and counsel.

- Boards must adopt new standards of independence for all members, with even stricter standards of independence (and, in some cases, expertise) for Audit Committee members.

The SEC is poised to adopt the NYSE and NASDAQ proposed rules requiring shareholder approval of nearly all equity compensation plans for the 2004 proxy season.

- The SEC may limit "grandfathering" of existing non-shareholder approved plans that would have been allowed under the proposals.

- The new rules may also forbid repricing of underwater options (including quasi-repricing exchanges) without shareholder approval.

At the same time, it will become tougher for companies to gain shareholder approval of compensation plans.

- The SEC probably will approve the NYSE and NASDAQ-proposed elimination of "broker non-votes" on all such proposals, with brokers permitted to vote only as directed by the shareowner.

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- The SEC has adopted a new rule requiring mutual funds, other institutional investors and investment advisors to adopt and publish guidelines on how they will vote shares held in their accounts, including votes on compensation proposals. Mutual funds and institutional investors must publish their actual votes and explain any deviation from their guidelines.

- The SEC is advising public companies to take actions that alert regulators when they are confronted with material non-compliance with securities laws.

- A recent Enron court case also threatens to impose liability on professionals when their actions assist companies in law-breaking.

Disclosure issues also seem certain to heat up.

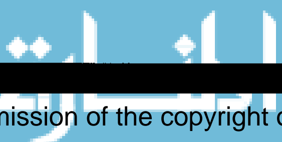
- The SEC's new "overhang" table is debuting for most companies this Spring, showing the total shares reserved for future equity awards and shares subject to outstanding options and rights, including the number of shares reserved without shareholder approval.

- After two decades of ignoring perquisites and post-retirement benefits, disclosure of Jack Welch's valuable package from GE prompted an informal SEC investigation. The SEC probably will question the categorization of non-cash executive benefits for business purposes rather than personal use (such as exclusive use of apartments), disclosed valuation of perquisites (such as using low IRS valuations for personal use of company aircraft) and internal accounting procedures for perquisites.

- Complaints about deferred compensation may lead to new disclosure proposals, although only a minority of deferral plans provide for the lavish returns cited in the media. Disclosures that obfuscate supplemental pensions and change-in-control arrangements may also be ripe for change.

Companies should expect no help from SEC staff in clarifying the anti-loan provisions of Sarbanes-Oxley, which seem to ban certain split-dollar insurance policies and have raised concerns on broker-assisted cashless exercises.

- Congress may offer relief on split-dollar issues, but Republican leaders say they won't push in the face of Democratic opposition.



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More change may be on the way regarding Form 4 reporting and short-swing profits liability exemptions.

- The SEC will complete the conversion to all-electronic filing of Forms 3 and 4 (and the now nearly useless Form 5) this year.

- The SEC may have to reconsider its exemption under Rule 16b-3 for non-compensatory transactions between a company and a Director or Officer. A federal appeals court recently held that the Rule applies only to compensatory transactions, which may be sensible, but is fundamentally at odds with the SEC's view of its own rule.

Congress will seek to remedy perceived compensation abuses. Tax shelter schemes pushed in recent years by accounting firms will be one target, although since the scandal involving Sprint executives, such plans have effectively been killed.

On the Tax Side

On the tax side, we expect that under golden parachute tax rules, the IRS now values option vesting acceleration upon a change in control at a theoretical "Black-Scholes" value, rather than based on the option's "in-the-money" value. Companies are now considering automatically cashing out such options to limit excise tax costs to the optionee or, if a gross-up is provided, to the company.

Compensation Committees are reviewing the cost of gross-up provisions in change-in-control agreements, which are costly under the golden parachute tax rules.

The proposed tax deduction for dividends, if adopted, could lead to a shift away from a "growth" to an "income" approach for larger companies; over the long term, this would change the way equity is used in compensation.

LOOKING BACK AT 2002—THE PAST YEAR IN REVIEW

Top 200 CEO Pay Growth Slows for Second Year

As reported in 2002 proxies, CEO total remuneration grew approximately 3 percent in 2001, to an average $11.87 million.

- Salary rose 10 percent, to $1.1 million, while bonuses for Fiscal 2001 performance fell 20 percent, to $1.7 million.

- Long–term incentives were relatively unchanged, at $672,000.

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- Restricted stock rose 9 percent, to $1.3 million, while options continued to dominate chief executive compensation, rising 9 percent in value, to $7.0 million.

- Options, on average, accounted for 59 percent of CEO pay.

At the 163 companies that had the same chief executive in both 2000 and 2001, CEO pay dropped slightly compared to the previous year, to $11.56 million.

Mega Grants More Common Than Ever, but Decline in Size and Value

A record 131 Top 200 CEOs received "mega option grants" (option grants with a face value of $10 million or more), but average grants plummeted by approximately one third in size and value, respectively, to 951,088 shares and $33.54 million.

Grants were affected by the market downturn and investor concerns about high overhang, with an absence of the gargantuan stock option grants seen in recent proxy seasons.

Option Profits Fall

Top 200 CEO option exercises plummeted in average value by more than one-third in 2001, to $4.77 million, compared to $7.40 million in 2000. (The 2000 average does not include a record $706.1 million option exercise gain by Oracle CEO Larry Ellison.) For the third straight year, fewer Top 200 CEOs exercised options—down from 100 in 2000 to 87 in 2001.

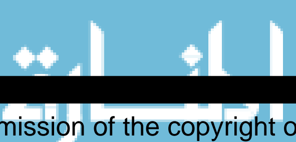
Total realized remuneration (gains realized on options exercised during the year) as reported in 2002 proxies fell 19 percent, to $10.14 million, compared to $12.49 million in 2001.

Beneficial Ownership Values Hit

The market slump hit Top 200 CEO equity holdings, with average ownership value declining approximately one-third, to $64.2 million (averages exclude the 10 highest and 10 lowest CEO values).

- CEO interest as a percentage of the outstanding was little changed, averaging 1.10 percent.

- Direct stock holdings were unchanged at .44 percent of the outstanding, but down sharply in dollar value to $46.1 million, compared to $64.0 a year earlier.



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- The paper profits on both vested and unvested options dropped sharply, to $14.7 million and $3.4 million, respectively.

- Sixteen CEOs had zero value in their vested options as of the 2002 proxy filing, including 11 with no value in any outstanding options.

More Equity Set Aside for Pay Plans, but Companies Hand Out Less

For the first time in seven years, shares granted for equity incentives at the 200 largest US companies declined as a percentage of outstanding shares, averaging 2.5 percent of outstanding shares, compared to 2.7 percent the previous year.

A record 16.7 percent of outstanding shares were allocated—or set aside—for equity pay plans, up slightly over the prior year's 16.3 percent.

Surge in Stock Options' *Pro Forma* Impact on Earnings

The estimated *pro-forma* hit to earnings from stock options nearly doubled in 2001, to an average 13.5 percent. The *pro forma* footnote will become obsolete under the expected accounting charge for the cost of employee stock options.

Mutual Fund Managers Weigh in on Pay Issues

In a direct survey by Pearl Meyer & Partners in 2002, leading mutual fund managers overwhelmingly expressed dissatisfaction with Board oversight of executive compensation.

- 90 percent of respondents said company pay practices are a factor in their investment decisions at least some of the time, while 70 percent described current CEO pay levels as excessive.

- In contrast, 58 percent of fund managers in a 1998 survey responded that they considered executive pay levels when investing and only one-third regarded CEO pay as too high.

Director Pay Stagnates

Most Boards held off making substantive changes to Director pay programs in 2001, pending the outcome of a variety of legislative and regulatory proposals, from Sarbanes-Oxley to new stock exchange listing requirements.

- Board remuneration at the largest 200 US companies was up less than 1 percent to $154,012.

- The equity portion of Director pay more than doubled in value over the

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past five years, compared to a 7 percent increase in cash compensation.

- The healthcare industry reported the highest average Director remuneration of the 21 industry groups studied, averaging $241,262, followed by average Board pay of $201,491 in the diversified financial and brokerage industry.

A 2003 Proxy Season Preview

Pearl Meyer & Partners' third quarter survey of senior executive pay at selected multi-billion dollar US companies provides an early look at what can be expected in 2003 proxies to be issued this spring. Among the findings, which include salary, annual bonus, long-term incentives, and stock option value are the following:

- CEO average 2002 total remuneration rose 2 percent over 2001.

- CFO compensation dropped 1 percent.

- Top Legal Officers saw the biggest drop of the surveyed executives, down 3 percent.

- Top HR Executive compensation was flat, following a 7 percent decline in 2001.

- Top Information Technology Officers, for the third consecutive year, saw a double-digit pay increase, up 10 percent.

Technology officers were the only executives surveyed to report increases in every pay component.

NOTES

Statistical information cited above was drawn largely from the following research conducted by Pearl Meyer & Partners.

- Studies of proxy statements issued through August 31, 2002, and comparable annual reports of the 200 largest U.S. industrial and service companies for data on:
- CEO compensation
- Director compensation
- Company stock allocated to compensation plans
- The value of CEO beneficial share ownership and option value
- Share ownership guidelines
- A direct mid-2002 survey of 33 highly ranked mutual fund managers (ranked 4- or 5-star by Morningstar or included in Morningstar's Source Book of selected funds)
- A direct survey during the third-quarter of 2002 of senior executive compensation in 63 industrial and service companies with average revenues of $26 billion
- Shareholder return analysis at the 200 largest U.S. companies for the five years ending 12/31/01

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