Contrary to the beliefs of many, a profound transformation has taken place in executive compensation in the past few years, facilitated by compensation committees and brought into focus by the seismic economic and stock market events of late 2008 and early 2009. This sea change has been the result of years of legislative, regulatory and corporate board activity, with participants that include Congress, the Securities and Exchange Commission, the Internal Revenue Service, the major stock exchanges, shareholder advisory services, the media and thousands of outside directors.

The sea change is a positive one, leading to more rational and rigorous executive pay programs, substantially increased performance risk and reductions in the extremes of pay opportunities. Enhanced compensation committee governance has been a major facilitator of the improvements.

More change is on the horizon, due to legislative initiatives and the economic environment, all of it likely to continue these trends. Following is more detail on the changes to date and those expected in the future.

**Increased Performance Risk**

Many changes over the past several years have increased the performance risk of executive compensation. These include:

- Enhanced oversight by Compensation Committees in setting incentive goals.
- Greater compensation committee discipline in evaluating results against goals for short-term and long-term incentive plan payouts. (For example, our consulting experience suggests that few companies adjusted originally established goals due to the economic downturn.)
- Few grants made to make up for the recent decline in value of stock options and restricted stock.
- Little discussion of stock option re-pricings to date, despite an estimated majority of options being underwater.
- More rigor in determining stock option grant dates and less opportunism in granting at market troughs.
- Broad use of stock ownership guidelines, resulting in longer-term holding of stock.
- Growth in the number of anti-hedging policies, which increase the risk of holding company stock.
- Curtailment of accelerated payouts of deferred compensation, eliminating treatment of executives as preferred creditors.
Growth in the number of clawback policies, which increase the likelihood that companies will recoup incentive payouts based on results later determined to be inaccurate.

Constraints on Executive Pay Opportunities
Other changes have limited pay opportunities for executives.
- The introduction of an accounting expense for stock options has led to more attention paid to the grant value of awards and on limiting eligibility to those who can most impact the organization.
- Limits on use of shares for executive incentive grants have led to smaller awards at affected companies.
- The elimination of low-interest loans and loan forgiveness has taken away a means of compensation that was not always visible to shareholders.
- Reductions in perquisites have been effected at many companies.
- Extreme pay practices have generally been reined in, due to more focus on appropriate market data benchmarking practices, questioning of peer group choices, and tougher bargaining when hiring new executives.

Initiatives with Lower Impact
This is not to say that every regulatory initiative has been successful or that it should be. An example of an initiative of dubious effectiveness is the focus on comparisons of CEO pay to the next highest-paid person. Such comparisons are muddied by varied organizational structures, the extremely high impact of CEOs on corporate strategy and results, and the arbitrariness of the comparison.

Coming Initiatives
We expect future regulatory and compensation committee action will focus on the following areas, with the likely impact being further reductions in executive pay opportunities.

Change-in-control (CIC) protections are likely to be reduced as a result of several initiatives, including restrictions on those companies accepting TARP monies and other government bailout assistance, and a negative focus on excise tax gross-ups by shareholder advisory groups.
- The reining in of liberal pay practices is likely to continue as shareholder advisory services expand their lists of targeted pay practices and as compensation committees question old paradigms.
- The corporate cost of each dollar of executive pay is likely to increase through further restrictions on tax deductions.

In addition, recent legislative and SEC proposals are focused on the evaluation of risk at companies and in compensation programs, including those below the NEO level.

An Economic Sea Change
The poor economy and the stock market plunge have ushered in decreases in executive compensation opportunities. This is a major change.

Executive compensation opportunities increased for decades because shareholders were doing well, and because executive roles were increasing in their scope and complexity. The tech boom and bust, and the post-9/11/2001 recession, caused only temporary decreases in pay opportunities.

As the graph below shows, however, the downturn has brought stock prices to where they were in 1996 and was sudden and severe. It also has occurred in a recessionary environment in which prospects for quick recovery seem unlikely. In addition, since so many companies were impacted, the need to make special efforts to retain executives was temporarily reduced in scores of industries.
In addition, lower stock prices require more shares to be granted in order to equal a market-level equity incentive opportunity, and many companies were constrained in their ability to grant more shares in 2009. This resulted in median stock option and restricted stock grants made through April 2009 that were about 20% lower in value than 2008 levels, though the impact varied considerably by industry and level of stock price decline. When performance plan grants are added to equity grants, this impact will likely be muted somewhat.

Another sign that times have changed is that many companies made a zero 2009 base salary increase for executives, but had increases for lower-level employees. In prior years, merit budgets for executives were usually slightly higher than those for rank and file employees.

**Compensation Committee Governance**

The progress noted above in rationalizing executive pay has been a direct result of enhanced compensation committee governance. Such practices as having only independent directors on the committee, having a clear charter, and emphasizing performance-based pay have been put into place at the vast majority of large companies. Others continue to build in prevalence, including having:

- A schedule for reviewing each executive compensation policy.
- A strict code of ethics, compliance, and prudent calibration of risk.

- A clear separation of duties. An example follows:
  “Management is the principal architect of programs that support the business strategy and drive shareholder value. The compensation committee provides oversight and critical review with final authority for approval or change. The Board rigorously reviews, tests, and monitors the program.”

- Operational criteria for compensation committees. Examples follow:
  - Including at least one member well versed in executive compensation.
  - Periodically meeting in executive session.
  - Articulating a sound compensation philosophy easily understood by employees and shareholders.
  - Directly hiring and monitoring the compensation consultant and understanding his or her perspectives, while owning the compensation decisions made.
  - Being the audience for shareholder concerns and the concerns of shareholder advisors.
  This can include:
  - Understanding key shareholder concerns and viewpoints regarding executive pay design, without trying to placate the individual—and often radical or self-interested—views of all shareholders.
  - Periodically communicating to key institutional shareholders the company’s rationale for compensation plan design and decisions.
  - Understanding the proxy voting guidelines of key institutional shareholder advisors and determining to what extent, if any, these guidelines
should be adhered to based on business imperatives.

– Where chairman and CEO roles are one person, having an active lead or presiding director in place with specific responsibilities.
– Electing all board members annually using a majority voting standard. Directors who do not receive a majority of votes should tender their resignation for consideration by the full board of directors.

Further thoughts about governance can be obtained by requesting “Executive Compensation Principles and Best Practices in the United States” from peoplesolutions@hewitt.com.

Summary

Important progress has been made in adding risk and responsibility to executive pay packages and in reducing extreme elements of executive pay opportunity. We expect future regulatory and compensation committee action will build on that, and that the current economic situation will lead to further “pay for performance” alignment in executive pay opportunity.

About Hewitt Associates

For more than 65 years, Hewitt Associates (NYSE: HEW) has provided clients with best-in-class executive compensation consulting services, as well as human resources and outsourcing services. In the executive compensation area, we consult for both compensation committees and management, and design executive pay programs, compile and analyze market data, and provide sound technical expertise. We provide executive compensation advisory services to the compensation committees and executive management of many FORTUNE 500 companies, and to hundreds of mid-cap organizations. Located in 33 countries, Hewitt employs approximately 23,000 associates. For more information, please visit www.hewitt.com.

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