TOWERS WATSON

Executive Compensation

Bulletin

Survey Finds Companies Sharpening Their Focus on Pay for Performance

By Andy Goldstein, Terri Shuman and Steve Pakela, Towers Watson

August 4, 2010

While average total compensation for executives at the nation's largest companies declined in both 2008 and 2009, a new Towers Watson survey of executive pay practices in midsize and large U.S. companies suggests that the pay trend may be turning this year. Conducted in early June, the survey of 251 companies found that many expect to make modest increases in bonus funding and larger long-term incentive grants in 2010 than last year as a result of improving business conditions and the recovery in share prices.

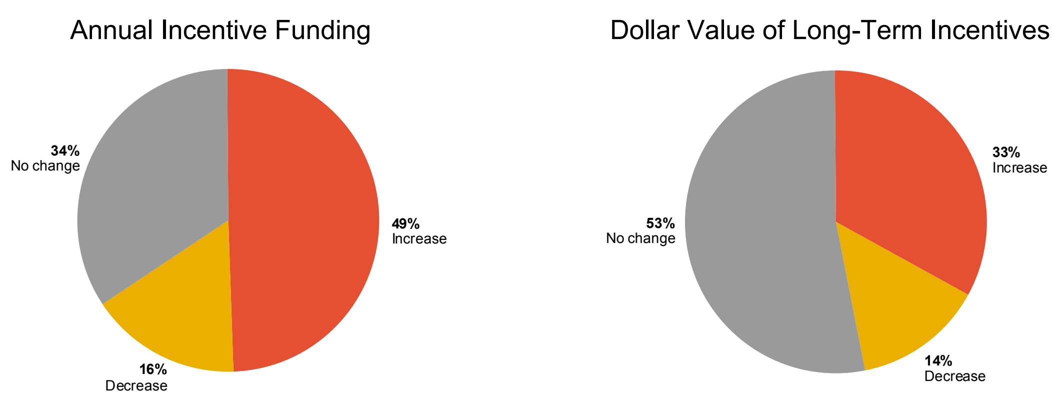
Overall, the survey confirms that most U.S. companies are continuing — if not intensifying — their recent efforts to fine-tune their executive compensation programs and governance processes, respond to shareholder concerns about certain pay practices and, ultimately, strengthen the link between executive pay and performance. Following is an overview of the key survey findings.

For many companies, the economic recovery brings improved financial performance and, thus, more flexibility to make bonus payments and larger long-term incentive grants.

Continuing Caution on the Recovery

For many companies, the economic recovery brings improved financial performance, and thus more flexibility to make bonus payments and larger long-term incentive grants. As *Figure 1* shows, almost half of the companies surveyed expect to increase funding for 2010 annual incentives for executives, while about a third have made or expect to make larger long-term incentive grants (in dollar terms) this year than last.

Figure 1 Trends in Annual and Long-Term Incentives, 2010 vs. 2009



However, the survey responses also suggest that most companies remain cautious about spending in today's fragile economic environment. Of the companies anticipating increased bonus funding, most (53%) are projecting funding increases of 20% or less. Among those making or expecting to make larger long-term incentive grants in 2010, over two-thirds (69%) said the dollar value of their grants will increase by 20% or less.

While many more companies are increasing rather than reducing the dollar value of long-term incentive grants this year, the reverse is true with regard to the number of shares companies are awarding. Many companies have seen a rebound in their share prices since early 2009. As a result, almost half (45%) of the survey respondents expect to award fewer shares under their long-term incentive programs this year than last, compared to only 23% that expect to award more shares.

The survey responses also suggest that most companies remain cautious about spending in today's fragile economic environment.

The survey participants' responses regarding 2010 annual and long-term incentives reflect the unevenness of the recovery and underscore the fact that many companies continue to struggle to regain momentum in a challenging environment. They also suggest that, for the most part, executives are not being made whole for the earlier reductions in incentive compensation.

Getting Incentive Programs Right

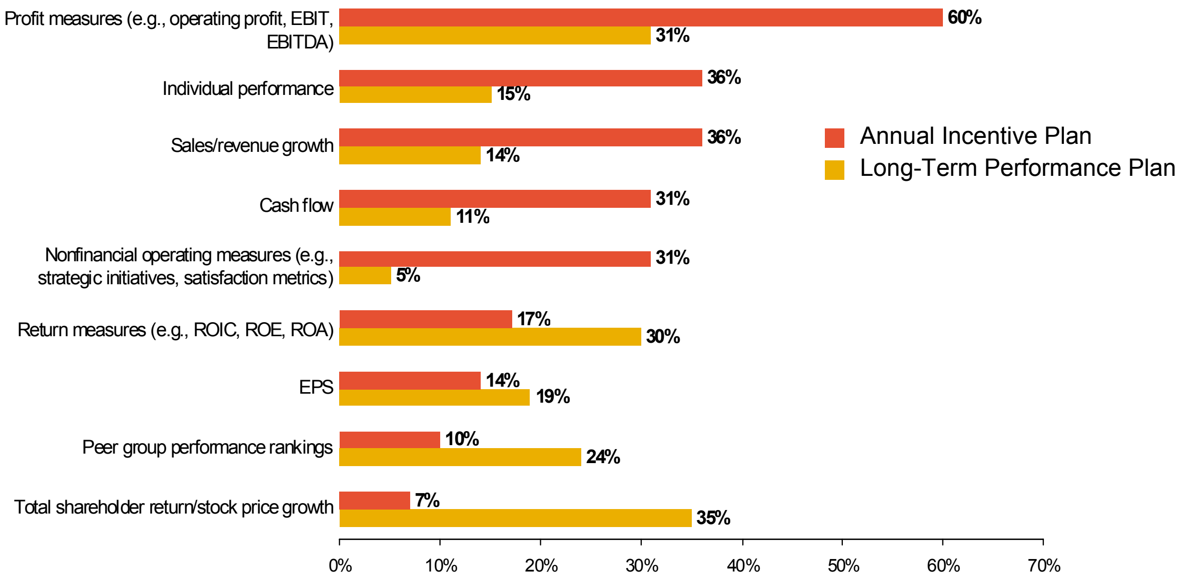
Despite the significant efforts companies have made in recent years to better align their pay programs with business results, there is continuing pressure to fine-tune incentive plan design and calibration. Indeed, two-thirds of the companies in our survey have made at least some changes in their annual incentive programs this year, while slightly over half have made or expect to make revisions in their long-term performance plans.

Across both types of plans, the most common actions were to change performance metrics or increase performance goals. The next most common action was to give compensation committees added discretion to override plan formulas in making incentive payouts. These changes suggest that companies continue to be thoughtful about their incentive programs, refining their performance metrics and target goals to reflect evolving and uncertain business conditions. The findings are consistent with compensation committees' continuing focus on mitigating compensation risk and their growing need to exercise greater discretion to ensure appropriate pay outcomes.

Figure 2 shows which performance measures are receiving added emphasis among those companies reporting changes in measures. Consistent with the focus on pay for performance, the most common shift is putting more emphasis on profit measures, such as operating profit, EBIT and EBITDA. The next most common trend for annual incentives is an increased emphasis on individual performance and revenue growth, as would be expected in an economic upturn.

Interestingly, an almost equal percentage of companies (31%) are focusing on cash flow, indicative of cautious investment and capital spending. The heightened attention to nonfinancial measures reflects the ongoing interest in linking annual incentives to corporate activities, such as strategic initiatives, customer satisfaction, employee engagement and other "citizenship" measures including environmental stewardship, safety and workforce diversity, among others.

Figure 2 Performance Measures Receiving Added Emphasis*



* Data shown are the percentages of those companies that are changing their performance measures for their annual incentives or long-term performance plans.

A sharper focus on performance is also evident in the changing mix of long-term incentive vehicles. Consistent with the gradual trend in recent years to place more emphasis on performance plans and less on stock options, over half (55%) of the companies reporting changes in long-term incentive vehicles are putting added emphasis on performance-based shares. However, two-thirds of the companies surveyed are making or planning no changes in their long-term incentive mix this year.

Addressing Shareholder Concerns

Despite growing shareholder concerns and scrutiny of nonperformance-based compensation, including guaranteed payments under employment agreements and executive perquisites, the survey responses point to most companies continuing to move cautiously in this area. Takeaways of any sort can raise fairness issues for executives with existing employment agreements and also can heighten retention risks in some cases. Only about one in 10 survey respondents report that executive retention is not an issue for their company.

When asked about pay programs such as severance, change-in-control (CIC) protection, employment contracts and supplemental executive retirement plans (SERPs), relatively few of the survey respondents report changes in these programs in 2010. This could be attributed to the fact that many respondents have already made changes over the past few years. Moving away from single-trigger CIC vesting of long-term incentives and eliminating tax gross-ups on parachute payments are the most common areas of change.

Only about one in 10 survey respondents report that executive retention is not an issue for their company.

About a third (37%) of the survey participants report having eliminated or reduced executive perquisites in the past two years. Of these companies that have cut back perquisites over the past two years, almost two-thirds (63%) took no action to replace the lost value to executives. This reflects an overall negative sentiment toward perquisites and the pressure to reduce costs during a time of reduced profits.

Getting Ready for Say on Pay

Under the new financial services reform legislation, all public companies (except for small companies and certain others) will be required to hold periodic say-on-pay votes, possibly beginning as soon as the 2011 proxy season. (See “Executive Compensation Reforms Near Enactment, EC Bulletin, June 30, 2010.) Conducting nonbinding shareholder votes on company pay practices seems certain to intensify the pressure for changes in programs that have been unpopular with investors and proxy advisors. However, based on our survey, it appears that relatively few U.S. companies (12%) feel very well prepared to put their executive pay programs up to a say-on-pay shareholder vote. Another 46% said they were only somewhat prepared.

Many companies are taking a range of actions to prepare for the say-on-pay era. Topping the list among the survey respondents is carefully reviewing executive pay programs to anticipate and address potential shareholder concerns (cited by 69%) , followed by improving company disclosures to better explain the rationale for programs and how pay aligns with performance (60%). Companies are also moving to establish enhanced communications with institutional investors and proxy advisors.

Many companies are taking a range of actions to prepare for the say-on-pay era.

Over half (59%) of the survey respondents believe that proxy advisory firms already have substantial influence on executive pay decision-making processes in U.S. companies. The influence of proxy advisory firms and institutional shareholders on executive compensation programs has increased steadily over the past few years and is likely to increase further in a say-on-pay environment. As a result, companies should be prepared for even closer scrutiny of their executive pay plans and policies, and will need to step up their communication with these groups through direct dialogue and even better proxy disclosure to be assured of strong support.

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Executive Compensation

Bulletin

Mandated Clawbacks Will Create New Tensions Between Executives and the Board

By Marshall Scott and Steve Seelig, Towers Watson

September 7, 2010

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 is widely viewed as the "say on pay" legislation, but its requirement that companies adopt a clawback policy will cause significant consternation and contention in corporate America as such policies are adopted over the next several months — and litigated for years to come. Under the new law, listed companies will be required to "develop and implement a policy regarding clawbacks of erroneously awarded incentive-based compensation" paid to executive officers that would be triggered by an accounting restatement. The law will force virtually every publicly traded company to change the focus of existing clawback provisions, including those developed in response to Sarbanes-Oxley (SOX), from "acts of commission" by executives to recoveries triggered solely because of an individual's status as an executive officer, regardless of whether the acts that led to the restatement were within the executive's control.

This article examines some of the thorny definitional questions the statute raises, any of which the Securities and Exchange Committee (SEC) may resolve via regulation. More troubling, though, are the legal and practical implications companies will need to confront quickly. Most of these are not susceptible to easy resolution, and may only be resolved through litigation. What's more, as with virtually all attempts to regulate executive pay, Dodd-Frank holds the potential for unintended consequences as companies and executives negotiate new pay programs and revisions to existing programs consistent with the statute and sound pay policies.

The law will force virtually every publicly traded company to change the focus of existing clawback provisions.

Background

For most public companies, the new law will impose a clawback design that is different from what they now have in place to comply with SOX or the Troubled Asset Relief Program (TARP) requirements, or what may have been adopted voluntarily. The following table provides a comparison of the clawback rules in SOX, TARP and Section 954 of Dodd-Frank:

	SOX	TARP	Dodd-Frank
When a clawback is triggered	Accounting restatement due to material noncompliance with securities laws as a result of misconduct	Any materially inaccurate performance metric criteria or financial statement (including statements of earnings, revenues or gains) that are later found to be materially inaccurate	Accounting restatement due to material noncompliance with any financial reporting requirement under the securities laws
What is clawed back	Amounts received as incentive-based compensation and profits realized from stock sales	Any bonus, retention award or incentive compensation paid	Erroneously awarded incentive-based compensation (including stock options) in excess of the amount that would have been paid under the accounting restatement
Who is subject to a clawback	CEO and CFO — but not other executive officers — of publicly traded companies	Senior executive officers (five most highly paid) and any of the next 20 most highly compensated employees	All current and former executive officers
Time period covered	Applies to compensation paid within the 12-month period following the misstated financial statement Can be enforced at any time after the payment	Clawback rights must be exercised at any time after the material inaccuracy is discovered unless it is unreasonable to do so (e.g., if the expense of enforcing the rights would exceed the amount recovered)	Applies to compensation paid during the three-year period preceding the date the company is required to prepare the accounting restatement

The key differences between Dodd-Frank clawbacks and those most companies already have in place are that the new law requires clawbacks without any misconduct on the part of the executive, and appears to afford the company no discretion as to whether to enforce the clawback.

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Answers to Commonly Asked Questions About the Dodd-Frank Clawbacks

A host of questions are raised by the statute, which is accompanied by no legislative history to guide regulators and courts in interpreting the clawback provisions. Many of these questions may be resolved via regulations. There is no explicit deadline for the SEC to complete its rulemaking, although it's expected that final rules will be completed before the end of this year. However, it seems unlikely that the listing exchanges will complete the resulting amendments to their rules and gain the SEC's approval of those changes before the 2011 proxy season. Keep in mind that current SEC disclosure rules require companies to articulate their clawback policy in the Compensation Discussion and Analysis portion of the proxy, so companies most likely will be required to disclose their new policies beginning with the 2012 proxy.

Following are questions we expect the SEC to address during the regulatory process:

- **Who are executive officers?** Dodd-Frank says the new clawback policy will apply to "executive officers," which appears to adopt the definition of Section 3(7) of the Securities Exchange Act. This definition includes presidents, vice presidents (division or function), others who perform similar policy-making functions and executives of subsidiaries who also perform policy-making functions — a much broader group than the named executive officers in the proxy. Among other grandfathering questions, the SEC will need to define an effective date to determine whether companies' clawback policies under Dodd-Frank must apply to any former executive officers, including those who departed before the law's effective date (July 21, 2010).

- **What is material noncompliance?** This is a threshold question companies must answer before even considering the question of what constitutes incentive compensation. For example, a change in accounting standards would seem not to trigger the clawback. However, a change in how an auditor interprets accounting standards might trigger a clawback, even where there were no actual issues regarding whether the company had adequate controls in place over its financial system. Clearly, Congress recognized that not all financial restatements would require clawbacks. The SEC may very well leave this determination up to the discretion of the company in enforcing the clawback policy.

- **Who may or must enforce the refund obligation?** Under Sarbanes-Oxley, the SEC enforces any clawbacks for material noncompliance with securities law as a result of misconduct. Under Dodd-Frank, however, it appears that the company is required to enforce the clawback pursuant to its policy. The question then becomes whether this enforcement would be a board or compensation committee responsibility, or one that falls to the company itself.

- **Can discretion be exercised in enforcing the clawback?** Under the TARP guidelines, companies are not required to exercise a clawback if it's unreasonable to do so — for example, if the expense of enforcing the clawback would exceed the amount likely to be recovered. The new law is silent on the use of discretion. The SEC might decide that since any compensation recouped would be an asset of the company, companies should be permitted wide discretion in exercising their right to seek recovery. But granting discretion to enforce clawbacks could pose other issues. For example, if a committee or board does not act or fails to pursue a claim vigorously, could a shareholder bring a derivative action to enforce the clawback? This would provide a new avenue for challenging a company's compensation practices.

When companies would be required to make their clawback policies first enforceable is a fundamental question under the new law.

- **Would existing contracts be grandfathered?** When companies would be required to make their clawback policies first enforceable is a fundamental question under the new law. Would existing employment or equity award contracts be grandfathered? Would the clawback apply to compensation paid from the date the policy is made effective, regardless of contract terms? SEC guidance will be needed on these issues.

- **What compensation is subject to being clawed back?** The statute provides that regardless of when the restatement takes place, the compensation subject to recovery is measured for the three-year period before the restatement is “required.” The SEC may interpret this to mean that a restatement is “required” as of the date the financials are stated incorrectly. This presumably would mean that if, in 2017, a company decides to restate its 2014 financials, the clawback would apply to compensation paid for 2011, 2012 and 2013.

  If the SEC interprets the statute this way, it would be possible that an executive could lose out on equity gains many years later. Expanding on the example above, suppose an executive exercised stock options during 2017 that were granted during 2011 based on strong share price performance totally unrelated to the erroneous financial statements. Will the SEC interpret the statute to require that any gains earned on those options be clawed back, or will the agency create a narrower rule that somehow ties the amount to be clawed back directly to the erroneous financial statement?

  What’s more, how would the amount to be clawed back be determined? It’s conceivable that the SEC could craft a rule that determines the amount to be clawed back based on the gross (pretax) amount received by the executive. This could create some difficult tax issues that might not be resolved in the executive’s favor under the current tax code (i.e., the possibility of any tax refund is beyond the statute of limitations).

- **How is incentive compensation defined?** Incentive compensation comes in all shapes and sizes, often with some portion measured based on financial measures and some based on nonfinancial or qualitative measures (e.g., customer satisfaction). The SEC may craft regulations that permit the company to separate the elements of compensation that are incentive compensation from those that are not, based on how they are defined by company policy. As for stock options, the SEC may define the amount subject to clawback based on the grant date being within the three-year period before the erroneous financials were issued. Alternatively, the SEC could create a mechanism to adjust the grant-date exercise price to reflect the erroneous financials.

- **Would the SEC regulate indemnity clauses?** With the advent of the golden parachute, excise tax under Sections 280G and 4999 of the tax code, many companies adopted “gross up” provisions designed to make executives whole for any excise tax incurred at a change in control. The SEC will need to address the possibility for similar "make whole" treatment in its Dodd-Frank clawback regulations. Specifically, the SEC will need to decide if it has the legal authority to prevent companies from entering into similar agreements to indemnify executives whose compensation is clawed back due to no fault of their own. Even if the SEC determines that it lacks the authority to prohibit such indemnifications, companies would need to disclose the existence of these agreements in their proxy statements.

- **What about compensation in mergers and acquisitions?** Applying a clawback following an M&A transaction poses added complications in that it’s common for the two organizations and their auditors to have very different notions of proper financial statement presentation. This raises the question of whether executives of the acquired entity should have an exclusion period under the clawback rules for restatements originating before the transaction or for a limited time after.

Possible Unintended Consequences

As with other laws seeking to regulate executive pay, the Dodd-Frank clawback requirement seems certain to have some unintended consequences. One source of potential problems will be how the requirement for a clawback policy as an exchange listing requirement interacts with existing employment agreements or stock award contracts governed by state law. Unlike federal pension law, the Dodd-Frank statute does not preempt state contract law. However, as a practical matter, a company would have little choice but to impose a clawback provision or risk being delisted (or, possibly, seeking an injunction to avoid delisting).

This will create an inherent conflict between the company's interests and those of the executives because few, if any, existing employment contracts, compensation plans or award agreements include a clawback provision based on a no-fault financial restatement. And, going forward, executives will be well aware that incentive compensation will be subject to potential clawbacks, and will endeavor to negotiate employment agreements that minimize the downside. It's too early to predict how this tension will play out, and it's always possible that executives will simply accept the clawback policy without much debate. But it's equally possible there may be significant changes in executives' demands during employment contract negotiations and in the discussions that take place at the time of a restatement as executives seek protection from the possibility of losing a portion of their pay. Here are just some of the issues companies may confront:

- **Will executives seek a quid pro quo for existing agreements?** Companies will need to be prepared for immediate negative reactions from executives with no responsibility for preparing the financial statements. The question is whether these executives will seek some quid pro quo in the form of enhanced compensation opportunities to balance against the risk of a no-fault clawback. Executives may also seek more fixed pay or to base more of their incentive compensation on nonfinancial performance measures that would not be subject to a clawback. Complicating matters might be how broadly "good reason" termination triggers are defined in existing agreements, since adoption of a Dodd-Frank clawback policy could trigger a walk-away right for some executives. This would give the executive additional leverage to negotiate new compensation plan terms.

Going forward, executives will be well aware that incentive compensation will be subject to potential clawbacks and will endeavor to negotiate employment agreements that minimize the downside.

- **What might happen when a clawback provision is exercised?** Putting aside the legal question of whether a clawback can be enforced under state law, companies seeking to enforce clawback provisions may find themselves having to make retention awards, such as time-based restricted stock, to retain or compensate innocent executives. If the SEC prohibits indemnities in such cases, these retention grants would likely need to be structured to be clearly attributable to future services rendered.

- **How might incentive compensation designs change?** Once the Dodd-Frank clawback rules take effect, companies and compensation committees may feel pressure to change the design and structure of compensation programs to subject executive officers to less clawback risk. Possible changes could include:

  - A pay mix that skews to a reduced emphasis on incentive compensation (and stock options) and to more salary, time-based restricted stock or deferred compensation

- The use of more discretion (either implicitly or explicitly) in delivering pay (for example, annual grants of time-based restricted stock could be issued at the discretion of the compensation committee, which may be informed, but not determined by, actual performance; such an approach might be preferred where the company is otherwise reducing the percentage of incentive compensation in its pay mix and adding a performance-based component to its restricted grant practices)

- Basing incentive compensation more on operational performance, rather than financial performance (one approach might be to increase levels of incentive compensation that are not financially based so as to assure a viable level of bonus income [e.g., target] based on nonfinancial operational goals or metrics)

- Banking bonuses based on financial measures so that companies hold back compensation that could be subject to a clawback (but note that "bonus banks" have been slow to catch on even in financial services, despite support for the concept from industry regulators; for this reason, companies might need to consider providing a matching contribution, perhaps subject to vesting conditions and paid in company stock, as a sweetener to executives required to defer payments)

- Greater use of debt, or debt that is convertible into equity, in the compensation structure

- **What might newly hired executives ask for?** Newly hired executives who are wary of the accuracy of the financial statements of a new employer may request more guaranteed compensation, rather than accepting financially based incentive compensation or stock options upon accepting a new job. These individuals may demand some time to learn the organization and get comfortable with the company's accounting practices before agreeing to traditional incentive compensation.

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Executive Compensation

Bulletin

Answers to Common Questions About How Dodd-Frank Levels the Playing Field for Consultant Independence

By Doug Friske, Paula Todd and Steve Seelig, Towers Watson

July 15, 2010

In addition to ushering in the say-on-pay era in the United States and making other significant changes in the legislative framework for executive compensation and corporate governance in public U.S. companies, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) opens a new and more constructive chapter in the debate about the independence of advisors to compensation committees. Specifically, Dodd-Frank expands the recent focus on multiservice consulting firms to a broader range of executive compensation advisors (including lawyers retained by compensation committees) and a wider array of potential conflicts of interest. (For more on the new say-on-pay requirement and other provisions of Dodd-Frank, see "Executive Compensation Reforms Near Enactment," EC Bulletin, June 30, 2010.)

The legislation requires compensation committees to closely examine all potential and actual conflicts of interest that could arise with any advisor that they hire. Such potential conflicts go well beyond the assessment as to whether the consulting firm that employs the compensation committee's executive compensation consultant also provides other services to the corporation. These so-called "other service" conflicts are the only type of potential conflict that may require companies to disclose their consulting fees under the current Securities and Exchange Commission (SEC) proxy disclosure requirement that took effect earlier this year.

Dodd-Frank opens a new and more constructive chapter in the debate about the independence of advisors to compensation committees.

Under Dodd-Frank, no category of advisors to board compensation committees is automatically exempt from potential conflicts, nor are there any "safe harbors" for specific categories of advisors (e.g., boutique executive compensation consulting firms that, by definition, provide no other services to their clients). In fact, the legislation stipulates that future SEC requirements must be "competitively neutral among categories of consultants, legal counsel, or other advisors and preserve the ability of compensation committees to retain the services of members of any such category…"

With this broader focus, compensation committees should no longer be tempted to take a "one size fits all" approach to thinking about the potential conflicts of their executive compensation advisors. In selecting consultants, compensation committees should look for advisors that are most appropriate for their own particular needs. Such needs include the reputation and resources of the consulting firm (including data, global reach and other factors), as well as the qualifications, experience, personal chemistry and availability of individuals who will work directly with the committee. In short, committees should evaluate all conflicts that could potentially get in the way of the consultant providing fully objective advice — and then determine whether and how any such conflicts can be mitigated.

Following are answers to some of the most common questions companies have been asking about the legislation's implications for consultant independence and the selection of executive compensation advisors.

Q1. What potential conflicts are covered by the legislation?

A1. Beyond the "other services" potential conflict that has been the main focus of the SEC disclosure rules regarding consultant independence, the legislation specifically identifies several other sources of potential conflicts:

- A *fee concentration conflict*, in cases where a single client represents what might be considered a significant percentage of a consulting firm's revenues
- A *relationship conflict*, involving business or personal relationships between the advisor and any member of the compensation committee
- An *ownership conflict*, where an individual consultant or the consultant's firm has an ownership interest in the client

This list is not intended to be exhaustive, and the legislation does not distinguish in any way between these different categories of potential conflicts (e.g., putting more emphasis on one type of conflict than another). Other potential conflicts could arise in particular instances.

Q2. Does Dodd-Frank attempt to regulate these potential conflicts?

A2. Not really, except by requiring compensation committees to have a process for evaluating potential conflicts via disclosure. Companies are required to disclose in their proxy statements:

- Whether the compensation committee retained or obtained the advice of a compensation consultant
- Whether the work of the compensation consultant raised any conflict of interest and, if so, the nature of the conflict and how it is being addressed

Note that no evaluation of potential conflicts or disclosures are required for consultants retained by or limiting their advice to a company's management.

Perhaps even more important than the legislation's list of potential conflicts is its explicit acknowledgment that it is possible for compensation committees and their advisors to mitigate conflicts by adopting policies and procedures to ensure the objectivity of the executive compensation advice.

Q3. How can potential conflicts be mitigated? How does Towers Watson help clients in this regard?

A3. Perhaps even more important than the legislation's list of potential conflicts is its explicit acknowledgment that it is possible for compensation committees and their advisors to mitigate conflicts by adopting policies and procedures to ensure the objectivity of the executive compensation advice. This means that no category of advisor has to be ruled out simply as a result of a potential conflict.

Towers Watson has long maintained formal procedures to ensure the objectivity and independence of our advice to clients. These procedures have proven effective across the full spectrum of consulting relationships. All of our consultants are required to follow these policies so that the advice and counsel we provide are not compromised in any way, irrespective of the number of client relationships we might have or services we might provide to a particular client. We require our consultants, under our Code of Business Ethics and Conduct, to notify Towers Watson of any potential conflicts of interest discovered during the course of their work.

To avoid the appearance or reality of conflicts arising from Towers Watson providing executive compensation services to a company's board of directors or compensation committee if the firm also provides other services to the company, our executive compensation consultants who work directly with the compensation committee do not have explicit cross-selling goals or receive incentive compensation that directly relates to selling other services to a company's management. Further, these committee consultants are not allowed to serve as account director or client relationship manager for the client, or be involved in account planning activities.

Towers Watson has long maintained formal procedures to ensure the objectivity and independence of our advice to clients.

In addition, our peer review and other quality assurance processes are designed to ensure that our advice is appropriate and impartial. And we strive to be transparent regarding all of our business relationships with each client and allow for reasonable procedures to manage these relationships.

Concentration conflicts aren't an issue for Towers Watson because, given our size (with more than $3 billion in annual revenue), no single client represents more than a fraction of a percentage of our aggregate revenue. No client is in a position to threaten the financial security of our firm if we fail to provide the advice they want.

Finally, ownership conflicts are avoided because Towers Watson's Code of Conduct and Ethics also imposes limitations on an individual consultant's transactions and investments in the stock of a client for which the consultant has recently performed services.

Q4. What does the legislation say about the role of compensation consultants?

A4. Dodd-Frank clearly stipulates that compensation committees should be allowed — but not required — to retain compensation consultants, legal counsel and other advisors. Within reason, the legislation requires companies to pay for such advisors.

At the same time, however, hiring a consultant does not affect the compensation committee's ability or obligation to exercise its own judgment in the fulfillment of its duties. And committees aren't required to follow the consultant's advice or recommendations. Clearly, while Congress seems to see executive compensation consultants as playing an important role for many companies, it's by no means analogous to the legally required role played by company auditors who must approve the company's financial statements.

Q5. What are the next steps?

A5. The legislation gives the SEC one year to develop rules to be adopted by the New York Stock Exchange and other listing exchanges to help define how compensation committees will evaluate the independence of their advisors. Exchanges are allowed to exempt a category of issuers from the requirements (e.g., smaller issuers) and to exempt "controlled companies" (i.e., in which a single individual, group or issuer holds more than 50% of the voting power). Dodd-Frank also calls for the SEC rules to include appropriate procedures for an issuer to have a reasonable opportunity to avoid delisting as a result of this requirement.

Given the one-year requirement, these new rules should take effect by the 2012 proxy season — and possibly by 2011 if the SEC acts quickly. In preparing guidance, the legislation stipulates that the SEC rules must be "competitively neutral" among categories of consultants, legal counsel and other advisors to preserve the ability of compensation committees to retain the services of members of any such category.

Finally, the SEC has two years after enactment to submit a report to Congress on the use of compensation consultants and the effects of using consultants. Presumably, the SEC will examine how the use of different types of consultants affects pay levels and designs.

In preparing guidance, the legislation stipulates that the SEC rules must be "competitively neutral" among categories of consultants, legal counsel and other advisors to preserve the ability of compensation committees to retain the services of members of any such category.

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With Say on Pay Looming,

Companies Move to Further Tighten the Link Between Executive Pay and Performance

Amid growing concern about executive retention, most U.S. companies remain focused on shareholder perceptions and the alignment between executive pay and business performance in the economic recovery.

Executive Summary

Recent years have been marked by unprecedented pressure on executive compensation as companies struggled to overcome economic and market turmoil and growing shareholder and government activism on the pay front. While average total compensation for executives at the nation's largest companies declined in both 2008 and 2009, a new Towers Watson survey of executive pay practices in midsize and large U.S. companies suggests that the pay trend may be turning this year.

- Many companies expect to make modest increases in bonus funding and larger long-term incentive grants in 2010 than last year as a result of improving business conditions and the recovery in share prices.
- Following a couple of years of widespread salary freezes/reductions and smaller or nonexistent bonuses at many organizations, the vast majority of companies say they are likely to address executive retention issues at least to some extent as the recovery picks up speed.
- At the same time, it's clear that most companies are taking a thoughtful and cautious approach to changing their executive pay programs.
- Overall, the survey shows that most U.S. companies are continuing — if not intensifying — their recent efforts to fine-tune their executive compensation programs and governance processes, respond to shareholder concerns about certain pay practices and, ultimately, strengthen the link between executive pay and performance.
- More than two-thirds of the responding companies are making changes this year to their annual incentive plans, while slightly over half are making changes to their long-term performance plans. The most common changes in both annual and long-term plans are refining performance metrics and setting tougher performance targets.
- Relatively few of the 251 companies responding to the survey believe they're fully prepared to put their pay practices to a shareholder vote, as the new financial services reform legislation will require. It seems certain the "say on pay" requirement will only intensify the pay-for-performance imperative.

"Most U.S. companies are continuing — if not intensifying — their recent efforts to fine-tune their executive compensation programs and governance processes."

About the Survey

Towers Watson's Executive Compensation Flash Survey was conducted online between June 7 and June 14, 2010. A total of 251 U.S. organizations responded to the survey, primarily midsize and large companies spanning a broad range of industries. Over 80% of the responding companies report annual revenues exceeding $1 billion, and over 40% have more than $5 billion in annual revenue. Senior human resource professionals and executives at the director level and above made up the bulk of the survey respondents.

Rewarding Improved Performance

For many companies, the economic recovery brings improved financial performance, and thus more flexibility to make bonus payments and larger long-term incentive grants. As *Figure 1* shows, almost half of the companies surveyed expect to increase funding for 2010 annual incentives for executives, while about a third have made or expect to make larger long-term incentive grants (in dollar terms) this year than last.

However, the survey responses also suggest that most companies remain cautious about spending in today's fragile economic environment. Of the companies anticipating increased bonus funding, most (53%) are projecting funding increases of 20% or less. Among those making or expecting to make larger long-term incentive grants in 2010, over two-thirds (69%) said the dollar value of their grants will increase by 20% or less.

While many more companies are increasing rather than reducing the dollar value of long-term incentive grants this year, the reverse is true with regard to the number of shares companies are awarding. Many companies have seen a rebound in their share prices since early 2009. As a result, almost half (45%) of the survey respondents expect to award fewer shares under their long-term incentive programs this year than last,

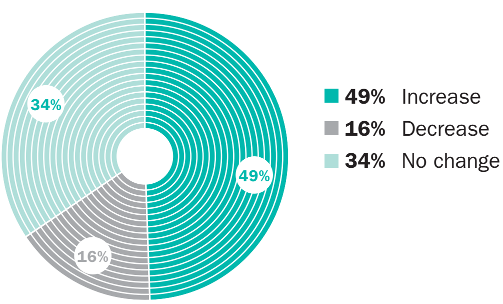
> "For many companies, the economic recovery brings improved financial performance and thus more flexibility to make bonus payments and larger long-term incentive grants."

compared to only 23% that expect to award more shares. Over half (53%) of those awarding fewer shares expect reductions of 20% or less in the number of shares granted. Of those awarding more shares, the vast majority (79%) report that the number of shares they're awarding is likely to increase by 20% or less. This suggests that companies are willing to increase the value of long-term incentive awards provided to executives, but are more likely to accomplish this by leveraging a higher stock price than by increasing the number of shares granted.

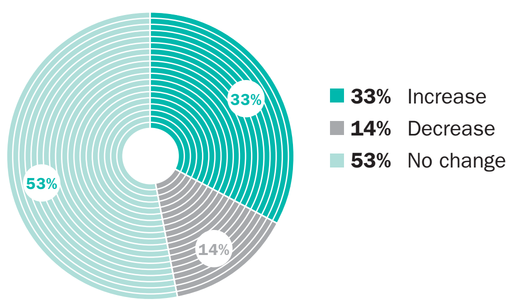
These findings regarding 2010 trends in annual and long-term incentives reflect the unevenness of the recovery. They underscore the fact that many companies continue to struggle to regain momentum in a challenging environment. They also suggest that, for the most part, executives are not being made whole for the earlier reductions in incentive compensation.

Figure 1. Trends in Annual and Long-Term Incentives, 2010 vs. 2009

Annual Incentive Funding



Dollar Value of Long-Term Incentives



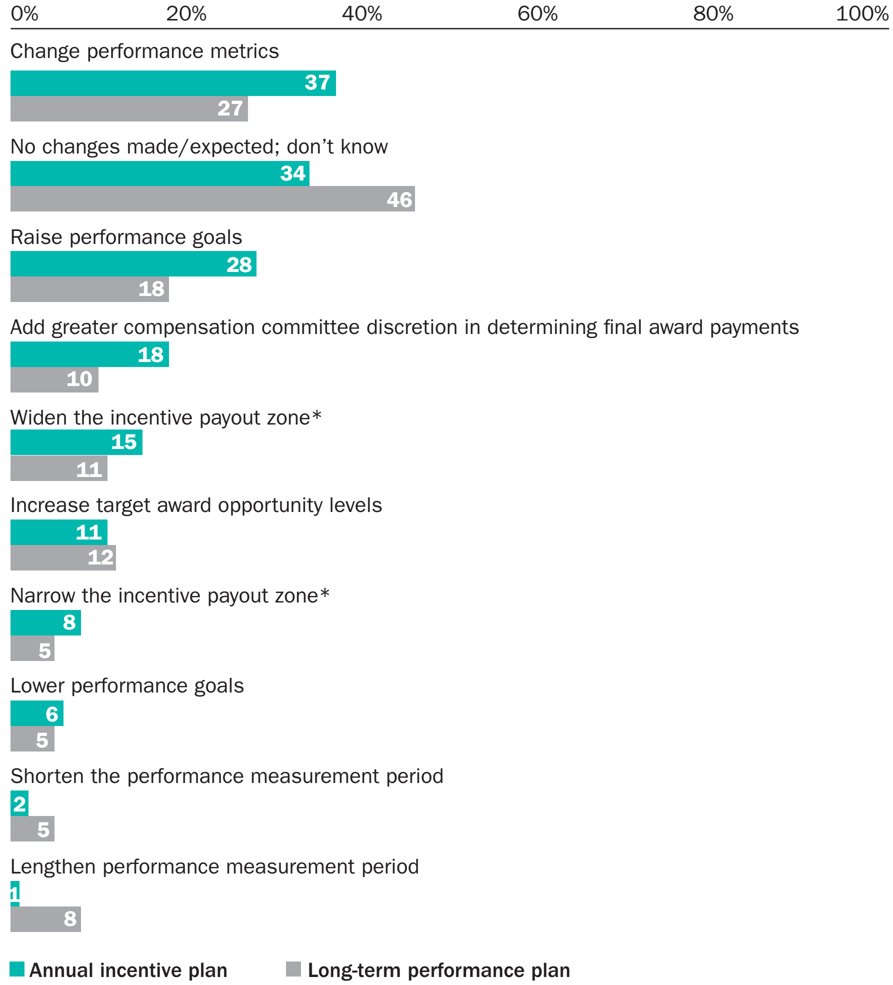
Ensuring Incentives Reward the Right Performance

Despite the significant efforts companies have made in recent years to better align their pay programs with business results, there is continuing pressure to fine-tune incentive plan design and calibration. Indeed, two-thirds of the companies in our survey have made at least some changes in their annual incentive programs this year, while slightly over half have made or expect to make revisions in their long-term performance plans.

> "The most common actions were to change performance metrics or increase performance goals."

As *Figure 2* shows, across both types of plans, the most common actions were to change performance metrics or increase performance goals. The next most common action was to give compensation committees added discretion to override plan formulas in making incentive payouts. These changes suggest that companies continue to be thoughtful about their incentive programs, refining their performance metrics and target goals to reflect evolving and uncertain business conditions. The findings are consistent with compensation committees' continuing focus on mitigating compensation risk and their growing need to exercise greater discretion to ensure appropriate pay outcomes.

Figure 2. Changes in Annual Incentives and Long-Term Performance Plans



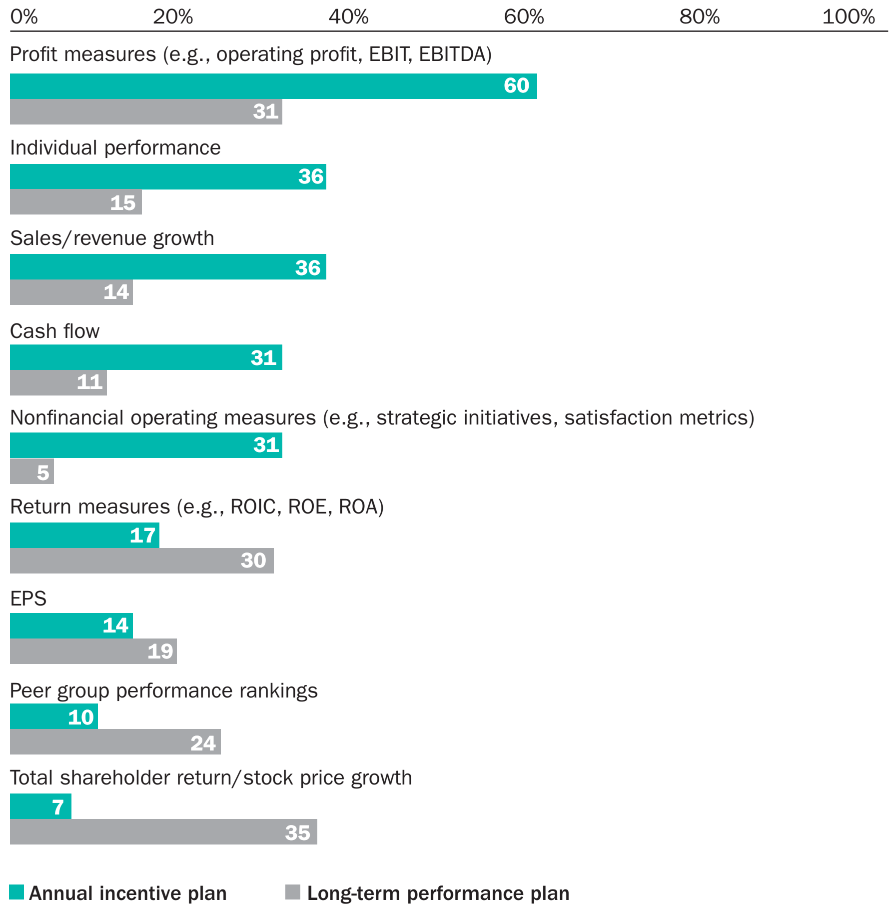
*Payout zone is the performance range (minimum and maximum) around the target goal to earn an award. An example payout zone around the target goal would be 80% at the minimum or threshold level, to 120% at the maximum performance level.

Figure 3 shows which performance measures are receiving added emphasis among those companies reporting changes in measures. Consistent with the focus on pay for performance, the most common shift is putting more emphasis on profit measures, such as operating profit, EBIT and EBITDA. The next most common trend for annual incentives is an increased emphasis on individual performance and revenue growth, as would be expected in an economic upturn. Interestingly, an almost equal percentage of companies (31%) are focusing on cash flow, indicative of cautious investment and capital spending. The heightened attention to nonfinancial measures reflects the ongoing interest in linking annual incentives to corporate activities, such as strategic initiatives, customer satisfaction, employee engagement and other "citizenship" measures including environmental stewardship, safety and workforce diversity, among others.

"A sharper focus on performance is also evident in the changing mix of long-term incentive vehicles."

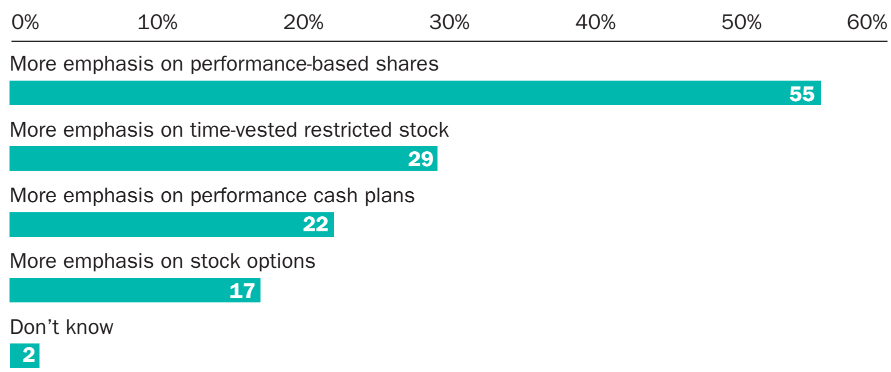
A sharper focus on performance is also evident in the changing mix of long-term incentive vehicles. Consistent with the gradual trend in recent years to place more emphasis on performance plans and less on stock options, over half (55%) of the companies reporting changes in long-term incentive vehicles are putting added emphasis on performance-based shares *(Figure 4)*. However, two-thirds of the companies surveyed are making or planning no changes in their long-term incentive mix this year.

Figure 3. Performance Measures Receiving Added Emphasis*



*Data shown are the percentages of those companies that are changing their performance measures for their annual incentives or long-term performance plans.

Figure 4. Most Common Changes in Long-Term Incentive Vehicles*



*Data shown are based on the subset of companies (33%) making changes.

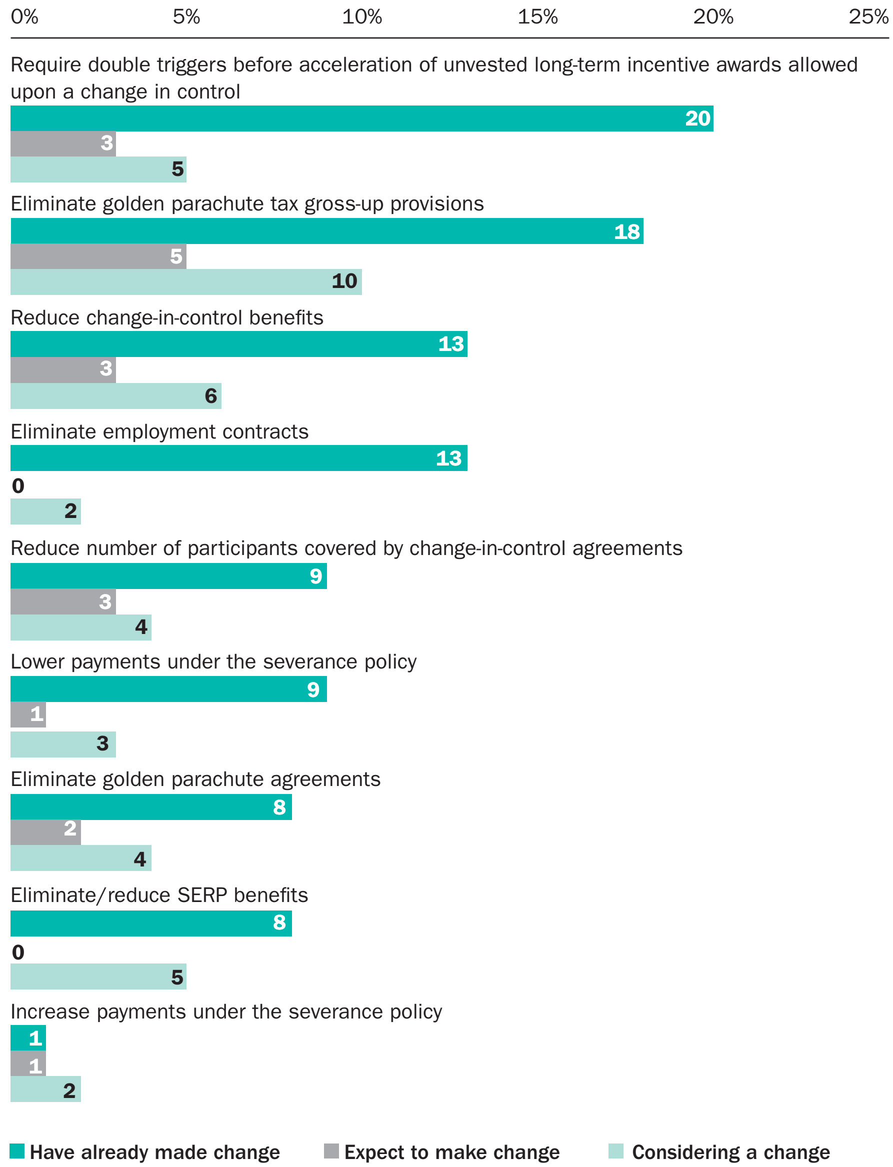
Reductions in Perks, Parachutes and Other Reward Programs

Despite growing shareholder concerns and scrutiny of nonperformance-based compensation, including guaranteed payments under employment agreements and executive perquisites, the survey responses point to most companies continuing to move cautiously in this area. Takeaways of any sort can raise fairness issues for executives with existing employment agreements and also can heighten retention risks in some cases. Our survey confirms that companies are paying more attention to retention issues in the recovery, with only about one in 10 respondents reporting that executive retention is not an issue for their company.

"Moving away from single-trigger CIC vesting of long-term incentives and eliminating tax gross-ups on parachute payments are the most common areas of change."

Figure 5 shows the changes companies are making or considering with regard to pay programs such as severance, change-in-control (CIC) protection, employment contracts and supplemental executive retirement plans (SERPs). As noted, relatively few companies report changes in these programs in 2010, which could be attributed to the fact that many respondents have already made changes over the past few years. Moving away from single-trigger CIC vesting of long-term incentives and eliminating tax gross-ups on parachute payments are the most common areas of change.

Figure 5. Other Expected Changes in Executive Pay Programs



Although many companies have been rationalizing perquisites for some time now, about a third (37%) of the survey participants report having eliminated or reduced executive perquisites in the past two years. Of these companies that have cut back perquisites over the past two years, almost two-thirds (63%) took no action to replace the lost value to executives. This reflects an overall negative sentiment toward perquisites and the pressure to reduce costs during a time of reduced profits. Of those replacing lost value, increasing executives' base salary was the most common approach, followed by making one-time cash or stock payments and introducing cash allowances.

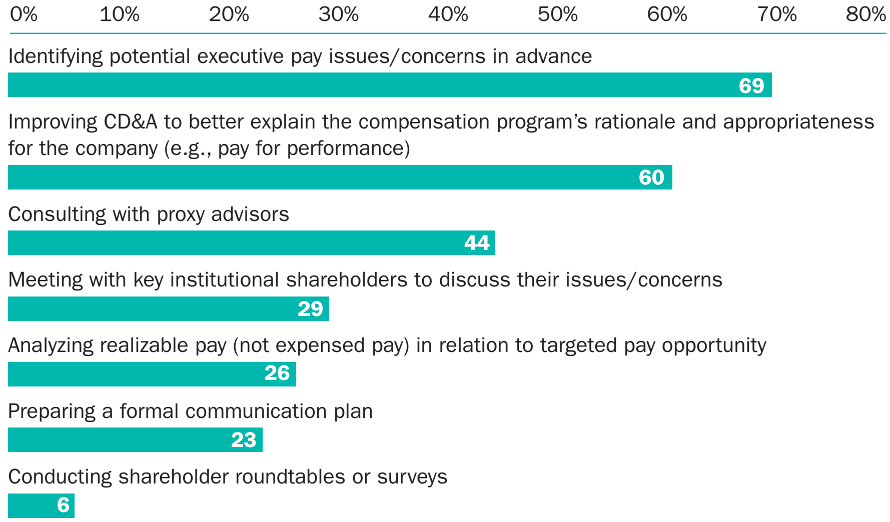
Readiness for Say on Pay

Under the new financial services reform legislation, all public companies (except for small companies and certain others) will be required to hold periodic say-on-pay votes, possibly beginning as soon as the 2011 proxy season. Conducting nonbinding shareholder votes on company pay practices seems certain to intensify the pressure for changes in programs that have been unpopular with investors and proxy advisors. However, based on our survey, it appears that relatively few U.S. companies (12%) feel very well prepared to put their executive pay programs up to a say-on-pay shareholder vote. Another 46% said they were only somewhat prepared.

Figure 6 shows the steps companies are taking to prepare for the say-on-pay era. Topping the list is carefully reviewing executive pay programs to anticipate and address potential shareholder concerns, followed by improving company disclosures to better explain the rationale for programs and how pay aligns with performance. Companies are also moving to establish enhanced communications with institutional investors and proxy advisors.

Over half (59%) of the survey respondents believe that proxy advisory firms already have substantial influence on executive pay decision-making processes in U.S. companies. However, 42% said guidelines established by proxy advisory firms have had no or minimal impact to this point on the design of their executive compensation programs.

Figure 6. How Companies Are Preparing for Say on Pay



"Under the new financial services reform legislation, all public companies (except for small companies and certain others) will be required to hold periodic say-on-pay votes, possibly beginning as soon as the 2011 proxy season."

The influence of proxy advisory firms and institutional shareholders on executive compensation programs has increased steadily over the past few years and is likely to increase further in a say-on-pay environment. As a result, companies should be prepared for even closer scrutiny of their executive pay plans and policies, and will need to step up their communication with these groups through direct dialogue and even better proxy disclosure to be assured of strong support.

Managing Compensation Program Risk

While no companies this year disclosed that their pay programs pose material business risks, it's clear that most survey participants are taking compensation program risk management seriously. New Securities and Exchange Commission rules require companies to assess their pay programs, disclose if those programs pose material risks and, if so, describe steps taken to mitigate pay risk. As *Figure 7* shows, most companies are taking action on many fronts to better manage program risks.

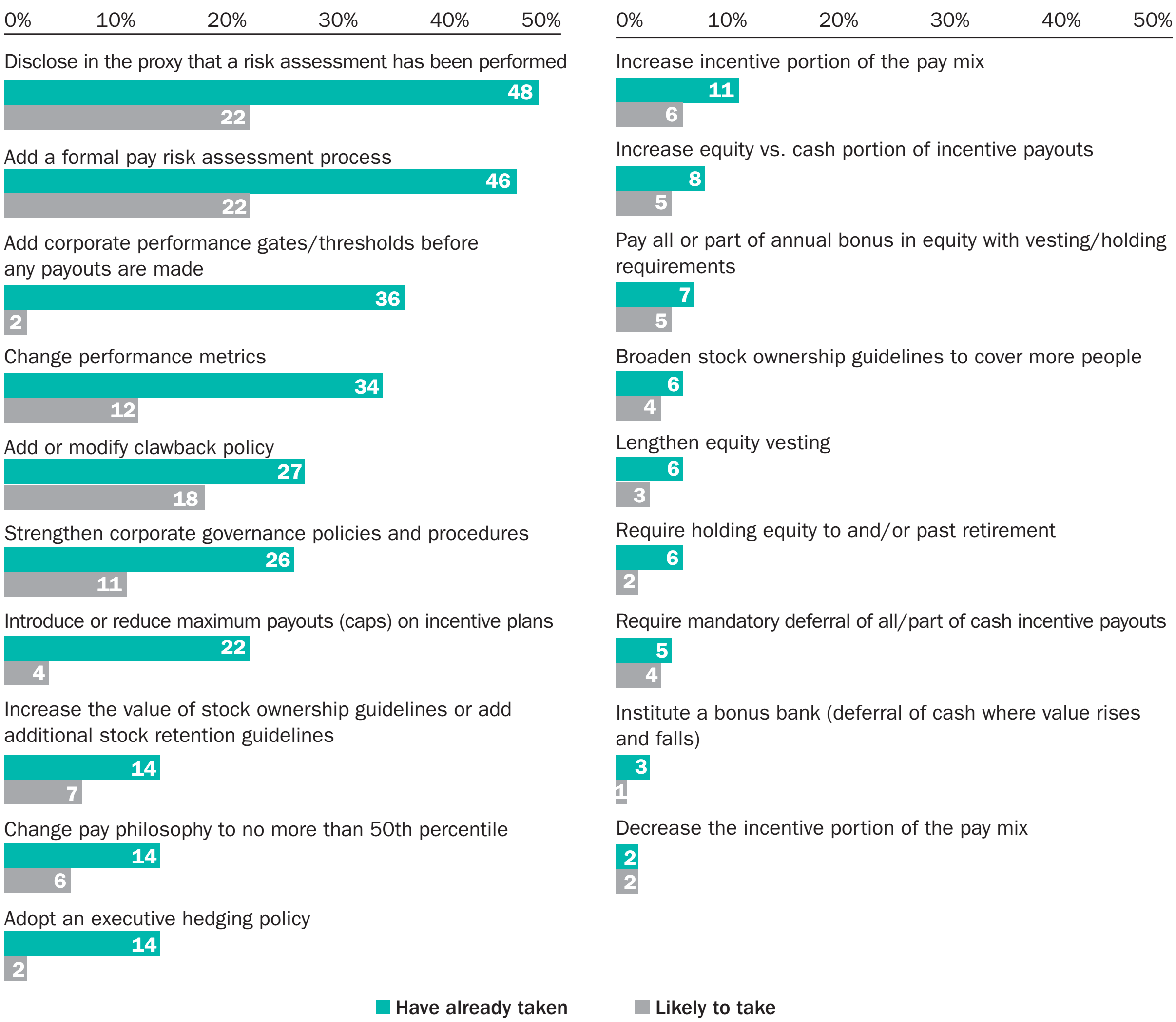
More Information

To learn more about the survey and how Towers Watson helps companies mitigate compensation risks and strengthen the links between executive pay and performance, please contact your local Towers Watson consultant.

About Towers Watson

Towers Watson is a leading global professional services company that helps organizations improve performance through effective people, risk and financial management. With 14,000 associates around the world, we offer solutions in the areas of employee benefits, talent management, rewards, and risk and capital management.

Figure 7. Company Actions in 2010 to Manage Pay Program Risks



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