



A DIRECTOR'S PERSPECTIVE...

Dear Friends,

On March 23, 2010 Drexel's Center for Corporate Governance* held its 2010 Directors Dialogue, a one-day interactive discussion with a small group of leading executives, directors and academics focused on challenges in the boardroom. I am a member of the Advisory Council and chaired this year's program. The theme of this year's dialogue was Risk: Opportunity or Disaster—A Boardroom Dialogue featuring two interactive sessions, a distinguished panel of stakeholders including members from the SEC and RiskMetrics, and a keynote address by Jack Brennan of the Vanguard Group. The executive director of the center, Dr. Ralph Walkling, asked if I would also moderate the session on executive compensation and has encouraged me to distribute my thoughts. The comments below outline my discussion. I hope you find them useful.

Regards,

Raj,

Opening remarks for session on Executive Compensation

I have no doubt that Executive Compensation is of interest to all of us in our roles as board members politicians, regulators, media, the public at large, unions, employees and of course the executives themselves.

While Executive Compensation has always been a topic of interest, it seems to have taken a life of its own in the last decade or so.

Factors contributing to this are:

- Compensation is perceived to be excessive: the gap between the average worker and CEO has been widening for the last quarter century from 40 times of average worker to over 400 times,
- The perception is that there is at best a weak link between Pay and Performance. This belief gets supported when CEOs receive generous separation packages for non-performance or when they are fired.
- The widely held belief is that the compensation structure (salary, annual and long term awards) promotes a focus on short term results and excessive risk taking.

These sentiments have become even stronger since the most recent financial meltdown. No wonder that this topic consistently ranks among the top three priorities for Boards today.

* For more on the Center, please visit <http://www.lebow.drexel.edu/Centers/CorpGov/index.php>

Let me add few of my own observations that I believe have contributed to escalation in Executive Compensation:

- Intense competition for executive talent in an ever demanding business environment,
- Failure of succession planning leading to external recruiting for CEOs and Senior Executive positions. External recruiting is not always a panacea but is always expensive. There are numerous exceptions where external hires have been very successful. Examples include Lou Gerstner at IBM, Larry Bossidy at Honeywell, Ed Breen at Tyco and Mark Hurd at HP. There are, perhaps, more cases where it hasn't worked out so well.
- Unintended consequences of Rules, Regulations and Bull Markets of 80s and 90s
 - Cap on cash salary of \$1million (reg 162m)
 - Accounting rules for stock options (in the past no expense was recognized at the time of the grant, this has now changed)
 - Time based equity vesting (options and restricted shares) without any performance metrics (relative to peers or absolute) combined with the bull market. A rising tide lifts all boats resulting in large increases in executive wealth across the board.
- Weak Board and Compensation Committee oversight (this is clearly changing)
- Peer Group selection bias towards larger and higher paying companies and targeting compensation at the top end of the peer group,
- Insufficient Investor/Shareholder Oversight (both the Directors and CEOs are generally sensitive and responsive to Shareholder/Investor concerns),
- Tone at the Top (setting 'easy to achieve' targets, changing performance metrics mid stream, repricing options, too many subjective performance measures, etc)

In short there is clearly an increasing trust gap that needs to be addressed and corrective actions taken.

In Spring 2009 The Conference Board convened a task force co-chaired by Bob Denham and myself to address this issue. The Task Force Advisory Group and Team members included Directors, Academics, Compensation experts, CEO, institutional shareholders and Governance experts.

At the outset we recognized that new regulations will come from various agencies as the Federal Reserve, Treasury, SEC and others respond to political pressure and the public outcry to rein in executive compensation. However, our belief is that while the government has an important role to play in modernizing the regulatory framework, trust in our corporate institutions can only be fully restored if private sector institutions themselves take meaningful action.

Meaningful actions in this context means taking the necessary steps that will do the most to restore trust and confidence.

On September 21, 2009 the task force laid out Five basic principles for companies to follow:

1. Be very clear about how your compensation supports your long term strategy, properly incorporates risk, and pays only after performance has actually been delivered.
2. Assure that the compensation you are delivering is affordable over long term and that you are getting your money's worth from your compensation programs (measure actual payouts against performance).
3. Stop using compensation vehicles (and entrenchment devices) that conflict with fundamental notions of fairness and pay for performance, unless compelling justification is present. These practices include golden parachutes, multi-year guaranteed contracts, over generous severance arrangements, golden coffins, poison pills, staggered boards and gross ups etc.
4. Proactively demonstrate credible board oversight of executive compensation.
5. Make sure your compensation programs are understandable and effectively communicated to shareholders-and when the questions arise, make sure that boards and shareholders are able to engage in meaningful dialogue (beyond 'say on pay' which is an advisory vote).

These five principles are intended to reflect the current environment and take into account risk and uncertainty more clearly. There is a stronger emphasis on transparency and dialogue as well as greater clarity on controversial practices. However, the five principles are not prescriptive and recognize that one size does not fit every situation.

We should all be encouraged by the attention that this topic is receiving from all interested parties and continue to proactively make the changes necessary to close this trust gap.



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