

Compensation Standards

Summer 2009

The Executive Compensation Newsletter for Directors and Advisors

Important Reading for CEOs (and Directors) Summer Reading of Lasting Importance

With so much happening right now impacting executive compensation, it is important that we not miss some important big picture reading. The following (most of which are short) are “must reads” for CEOs and directors. [Links are provided in the electronic version of this issue posted on CompensationStandards.com.]

– **Treasury Secretary Tim Geithner’s [Statement on Executive Compensation](#)**—Our lead piece below is devoted to this important Treasury policy statement—and its ramifications to companies, CEOs and compensation committees.

– **Roger Martin’s [“Managers Must be Judged on the Real Score,”](#) and [“Scrap Stock-Based Compensation and Go Back to Principles”](#)**—These two important short pieces on FinancialTimes.com by the Dean of the Rotman School of Management were brought to our attention by Fred Cook.

– **Pepsico CEO Indra Nooyi’s [“The CEO of the Future”](#)**—This thought-provoking speech to the Economic Club of Washington, by one of the most respected CEOs in the country, was also brought to my attention by Fred Cook. In addition to addressing important qualities that CEOs need going forward (particularly the central skill of adaptability), Nooyi focuses on the concept of “performance with purpose”:

Our basic idea was that a company had to marry its performance with its ethical concerns. Its performance and its purpose are not separate entities, they merge. They feed off each other, they need one another. This is a particularly important idea against the backdrop of economic troubles we are in today.

– **Jamie Dimon’s [Letter to Shareholders](#)**—This very perceptive analysis of the environment that brought on the problems we are all dealing with today—and fundamental flaws that need to be addressed—demonstrates that with corporate leaders like Jamie

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Dimon and Indra Nooyi and many other thoughtful, principled, nimble CEOs, our free enterprise system is in good hands. It will, however, take the leadership of so many CEOs, directors, and those of us that advise companies and boards to restore trust and integrity to the system.

– **Joshua Cooper Ramo’s “The Age of the Unthinkable”**—We discovered this excellent new book in early May. Apparently, so did Indra Nooyi. In her words, “The book concludes with the same message I’m giving you today: This is the era of the fox. This is an age in which curiosity and resilience matter more than uncertainty. In uncertain environments, it isn’t any specific asset, intellectual property

or competitive position that matters most. Rather, being adaptable and nimble are the characteristics that will separate the winners from the losers over the long term.”

– **Peter Singer’s “How are We to Live—Ethics in An Age of Self-Interest”**—Closing out our list (and picking up on Indra Nooyi’s point about marrying performance with ethical concerns), we came across Peter Singer’s book this summer on a bookshelf in a vacation house on Santorini. We were impressed with how relevant this fast read, first published in 1993, is to today’s corporate, professional and personal ethics. This should be “must” reading for our colleagues and employees, and the next generation of leadership.

—JMB

The Obama Administration’s Pay Reforms

As we all know, a significant level of public anger has emerged over compensation. The anger is not limited to recipients of bailout money, but has also extended to all public companies and beyond the executive suite. As a result, compensation practices have become a focus of legislators, regulators, shareholders and the public, with a steady stream of reform proposals being advanced in a variety of forums.

With say-on-pay slated to be in place for this upcoming proxy season, anger over compensation policies and practices cannot be ignored. Immediate action is necessary by boards and compensation committees, who must evaluate their overall compensation policies and practices in light of the rapid development of “best practices” that may very well become legislated requirements, and unprecedented shareholder frustration that will result in an increasing level of activism.

Treasury’s June 10 Statement— Don’t Underestimate its Importance

The Obama Administration has sought to advance compensation reforms with the Treasury Department’s June 10 release of broad-based compensation principles, along with specific legislative proposals that are already included in the legislation making progress in Congress. These principles are not limited in their applicability to bailout recipients or financial institutions, and do not (in some cases) only apply to compensation for executives. With the Administration’s broad pay reform principles already taking hold, it is important that directors and CEOs take the time

now to become familiar with the four key principles that will be guiding the Administration’s actions.

To head off more draconian legislative solutions, careful consideration should be given as to how these principles can be implemented quickly, so that companies and their boards will be seen as responsive to shareholder concerns. The Administration’s broad principles address the proper measurement and rewarding of performance, the structuring of compensation to properly relate to the time horizon of risks, the alignment of compensation practices with risk management practices, and the appropriateness of post-employment arrangements for executives in terms of the alignment of these forms of compensation with shareholder interests.

Further, the Administration has proposed targeted legislative initiatives on say-on-pay and compensation committee independence that are quickly gaining momentum in Congress. At the same time, the SEC has now proposed rule changes that would enhance compensation disclosures, particularly with respect to the relationship of compensation to risk and the role of compensation consultants. (All these changes are expected to be in place for this upcoming proxy season.)

Principle #1: Calling for a New “Pay-for-Performance” Paradigm

The June 10, 2009 [statement](#) by Treasury Secretary Timothy Geithner specifically identifies executive

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compensation practices as a factor contributing to the financial crisis. In consultation with SEC Chairman Mary Schapiro, Federal Reserve Governor Daniel Tarullo and a group of experts, the Treasury developed four broad compensation principles that all companies—and in particular financial institutions—must consider. In the Treasury's statement, the first principle states:

Compensation should be tied to performance in order to link the incentives of executives and other employees with long-term value creation. Incentive-based pay can be undermined by compensation practices that set the performance bar too low, or that rely on benchmarks that trigger bonuses even when a firm's performance is subpar relative to its peers.

To align with long-term value creation, performance based-pay should be conditioned on a wide range of internal and external metrics, not just stock price. Various measurements can be used to distinguish a firm's results relative to its peers, while taking into account the performance of an individual, a particular business unit and the firm at large.

The clear import of the first principle is that, while “pay for performance” is an appropriate cornerstone of compensation policies and practices, it does not go far enough as a governing mantra without a closer examination—and calibration—of pay with long-term value creation objectives. In this regard, the Administration is concerned that performance-based compensation which relies too heavily on short-term metrics, including equity value, may create perverse incentives that emphasize short-term gains over the building of long-term value.

This principle calls for a much more nuanced approach to “pay for performance” that requires looking beyond company-specific performance and traditional financial performance measures, such as earnings per share or stock price. In particular, more emphasis on relative performance to peers is called for, with less emphasis on stock price or individual performance measures which, when considered alone, may not provide the appropriate incentives to minimize risk while building long-term value.

The principle calls for a more “diversified” approach to setting performance targets, utilizing “a wide range of internal and external metrics” which should include

measurements that can be used to “distinguish a firm's results relative to its peers.” Such measures may also take into account individual performance, or performance of a business unit or the company as whole.

This principle should cause compensation committees to review the breadth and depth of their performance measures used for incentive compensation programs, which all too often rely on only a few measures that are largely internally focused. Revisiting decisions about target measures should be closely integrated with evaluating the company's strategic focus and the relative contribution of individuals, and in so doing the compensation committee should seek to provide appropriate incentives for employees while at the same time not encouraging undue or excessive risk.

An important element of the principle is that it refers to both executives and “other employees.” This reference is consistent with a broader concern underlying pay reform efforts since the onset of the financial crisis, which recognizes that compensation policies and practices applicable to everyone within a company can be critical in achieving long-term value while minimizing risk. Implicit in the principle is that different performance measures might be appropriate for different levels of employees within the organization, so that the targets for the CEO could be very different from the targets utilized for employees in the sales force.

The principle specifically identifies a practice that is in particular need of attention—benchmarking. The Administration recognizes that too often, companies are relying on external benchmarks to set compensation without properly taking into account company performance relative to peers or performing an internal pay equity analysis. (For more on why and how to implement an internal pay equity analysis, see our [Spring 2007 issue](#) of *Compensation Standards* at pg 2.)

The Administration's identification of benchmarks that cause bonuses to be paid without consideration of subpar company performance relative to peers should cause companies and their compensation committees to revisit their benchmarking practices and broaden their perspective to factor in relative performance targets that are appropriately tailored to creating incentives for employees and executives.

Principle #2: Structuring Compensation to Account for Timing of Risks

The second principle outlined in Secretary Geithner's statement indicates:

Some of the decisions that contributed to this crisis occurred when people were able to earn immediate gains without their compensation reflecting the long-term risks they were taking for their companies and their shareholders. Financial firms, in particular, developed and sold complex financial instruments that yielded large gains in the short-term, but still presented the risk of major losses.

Companies should seek to pay top executives in ways that are tightly aligned with the long-term value and soundness of the firm. Asking executives to hold stock for a longer period of time may be the most effective means of doing this, but directors and experts should have the flexibility to determine how best to align incentives in different settings and industries. Compensation conditioned on longer-term performance will automatically lose value if positive results one year are followed by poor performance in another, obviating the need for explicit clawbacks.

In addition, firms should carefully consider how incentives that match the time horizon of risks can extend beyond top executives to those involved at different levels in designing, selling and packaging both simple and complex financial instruments.

Hold-Through-Retirement Policies

Perhaps one of the most significant compensation concerns to be highlighted by the financial crisis has been the mismatch between the timing of performance-based compensation payments and the realization of risk related to the employee's or executive's activity. In effect, the Administration is expressing a concern that compensation is received for performance before the full effects of that performance have "come home to roost." This inherent mismatch can cause the focus of executives and employees to be oriented toward the short-term when bonuses or other forms of compensation can be maximized, while ignoring the long-term, risk-adjusted returns arising from their efforts.

This principle highlights one of the most simple, yet effective, means for addressing the mismatch—requiring executives to hold their equity awards for a specified period of time. Unfortunately, many policies creating stock ownership requirements do not require holding for a period long enough to adequately address the mismatch and focus executives on long-term value creation. That is why so many mainstream

compensation consultants are now recommending that companies consider implementing a "hold-through-retirement" policy for top executives, specifying that those executives retain a significant portion of their equity awards for a period extending at least two years after retirement, so as to ensure that their interests are aligned with those of shareholders—and focused on the long term—throughout their careers. (For more on implementing hold-through-retirement policies, see the excellent piece in the [Special Supplement](#) to the January-February 2009 issue of *The Corporate Executive*.)

In that connection, companies that grant restricted stock or restricted stock units should not overlook the importance of a long-term hold. The model that Exxon Mobil has in place is particularly well suited for top level executives at a broad range of companies: Requiring that 50% of the grant be held for the later of 10 years from grant or retirement, thus ensuring a long-term focus. (For more on Exxon Mobil's approach, see the [September-October 2008 issue](#) of *The Corporate Executive* at pg 2.)

A further change to compensation programs being advocated now in light of this principle is a shift from annual incentive bonus plans toward more long-term incentive bonus plans (*e.g.*, rather than setting bonuses based on annual results, implementing a three-year or five-year plan that reassesses bonuses on an annual basis based on "stretch" performance measures driven by relative performance—and that "banks" bonuses earned until completion of the performance cycle).

A key to ameliorate the mismatch between pay and the time horizon of risk and to provide more significant incentives for long-term performance is to require that a meaningful portion of bonuses be converted to restricted stock with an Exxon Mobil "later of 10 years from grant or retirement" hold. "All upside with no risk of downside" can no longer be a philosophy behind an incentive compensation plan in light of this principle.

The principle discusses structuring incentive programs to avoid explicit clawbacks (note, for example, how Exxon Mobil holds the 50% portion until the time period is satisfied, thus obviating the need for difficult enforcement or clawback mechanisms). We do not, however, think that the Administration is rejecting the notion of effective clawback policies. Over the last few years, companies have been increasingly

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adopting clawback provisions, but now is the time for companies to reconsider their existing policies or to adopt new policies that go beyond the old “restatement” limitation.

Prior to the financial crisis, the focus of clawbacks was on recovery of compensation in the event of a restatement and/or financial fraud. In light of issues arising in connection with the financial crisis, the focus has increasingly been on clawbacks (or other mechanisms) that can address the mismatch between short-term performance-based compensation and long-term performance, as well as conduct that may ultimately be seen as detrimental to the company.

In designing effective clawback policies, it is critical to determine who is covered by the policy and the specific triggering events that would require repayment. In terms of who is covered, it is important to establish the extent to which an executive officer’s responsibility for the triggering event is to be considered. Enforcement is often a difficult question for clawback policies, so structuring compensation in a way that ultimately avoids having to invoke a clawback, while retaining a clawback as the ultimate tool for recovery, remains the optimal solution.

In the current climate, even those companies that have already adopted clawback policies need to reevaluate those policies. The triggering events may be too narrow and fail to deal with circumstances where it turns out that, after compensation decisions have been made, an executive had engaged in conduct that ultimately causes harm to the company and its shareholders. In this regard, companies should consider whether recovery of any annual or long-term incentive compensation paid to executives (not limited to the amounts where payout or vesting has been deferred) may be necessary in situations where recovery reflects the longer term results of the executive’s performance, which may not be fully known or understood immediately following the completion of the performance period.

Further, many companies are considering whether the board or compensation committee should have broad discretion to recover compensation in the event that the executives engage in conduct that is detrimental to the company, with such conduct including, but not limited to, the need for a restatement of results, a significant financial loss, actions, decisions or strategies that were not in the company’s long-term best interests, or other reputational harm to the company.

Principle #3: Aligning Compensation Practices with Sound Risk Management

In the third principle, Treasury Secretary Geithner targets the consideration of risk in compensation practices, stating:

At many firms, compensation design unintentionally encouraged excessive risk-taking, providing incentives that ultimately put the health of the company in danger. Meanwhile, risk managers too often lacked the stature or the authority necessary to impose a check on these activities.

Compensation committees should conduct and publish risk assessments of pay packages to ensure that they do not encourage imprudent risk-taking. At the same time, firms should explore how they can provide risk managers with the appropriate tools and authority to improve their effectiveness at managing the complex relationship between incentives and risk-taking.

As with Principle #2, this principle focuses on the relationship between compensation and risk. Echoing a requirement already applicable to TARP recipients, the Administration calls on compensation committees to factor risk assessments into compensation decisions and provide transparency on the risk elements through disclosure of the results.

The SEC has proposed rules requiring more discussion in the Compensation Discussion & Analysis of the role of risk in compensation decision making, and the relationship of risk to compensation philosophies for the organization as a whole (and not just the CEO, CFO and highest paid executive officers). In fact, the SEC has said in the release proposing these rules that disclosure of the extent to which companies perform such a risk assessment is already required with respect to the executive officers named in the compensation disclosure, under the principles-based standards of the Compensation Discussion & Analysis.

As a result of this principle and the SEC’s proposed (and existing) disclosure requirements, boards will need to evaluate their policies regarding risk management, and calibrate the policies as necessary to make sure that they properly relate to compensation decisions and the board structure. This process will typically involve:

- Taking an inventory of risks by consulting with management and other employees of the organization (including a risk officer if the company has one), evaluating pay packages and the circumstances with

respect to particular business units, and examining existing policies and procedures relevant to risk;

- Making sure the appropriate persons on the board and within the organization are paying attention to risks and have the authority to address the risks; and
- Documenting policies and decisions in the context of risk so that they can be accurately described in the company's SEC filings—including an analysis of how identified risks have impacted compensation policies and practices.

A Heads Up: In connection with the risk assessment obligation, boards should not overlook the need to examine their CEO's and top level executives' long-term incentive compensation plans—particularly stock options and restricted stock grants—to address the need now for adding 50% hold-through-retirement policies to counter the short-term temptations inherent in most option and restricted stock grants. This should be expressly addressed in the CD&A risk discussion.

Principle #4: Reexamining Post-Employment Compensation and SERPs

The fourth principle of the Treasury statement focuses on the extent to which golden parachutes and supplemental executive retirement packages are properly aligned with shareholder interests, stating:

Golden parachutes were originally designed to align executives' interests with those of shareholders when a company is the potential target of an acquisition. Often, they have been expanded beyond that purpose to provide severance packages that do not enhance the long-term value of the firm. Likewise, supplemental executive retirement benefits can make it more difficult for shareholders to readily ascertain the full amount of pay due a top executive upon leaving the firm.

We should reexamine how well these golden parachutes and supplemental retirement packages are aligned with shareholders' interests, whether they truly incentivize performance, and whether they reward top executives even if their shareholders lose value.

This principle voices a concern that companies should have already been considering: Are provisions that provide for payments upon the termination or retirement of an executive appropriate and aligned with

shareholders' interests? In this regard, termination of employment provisions in employment agreements that provide for "golden parachute" benefits are often entered into as a means of addressing competitive concerns when executive officers are recruited, by providing a level of protection to those individuals in order to address the risks associated with moving to a new position.

All too often, these provisions do not "sunset" when the executive has been with the company for a sufficient amount of time to accumulate wealth under the company's plans that offsets the risk of termination due to a merger or other event. Further, when these provisions are put in place, the compensation committee and the shareholders may not get the full picture of the company's obligations, because neither gets a "walk-away" number aggregating all of the amounts that an executive is entitled to upon the occurrence of specific termination events.

In light of this principle, compensation committees should analyze and reassess all of the termination and change-in-control arrangements, as well as supplemental retirement benefits, to determine whether they are necessary and appropriate under the company's current circumstances and the circumstances of the individual executives.

This type of review should occur at least annually. In the course of conducting this analysis, the committee should review wealth accumulation estimates included in tally sheets, as well as the aggregate value of all compensation that would result in the event of each triggering event under the termination and change-in-control arrangements—in other words the total "walk-away" number under the relevant arrangements.

It is instructive that Treasury Secretary Geithner singled out the importance of providing full walk-away numbers in proxy disclosures: "disclosures typically failed to make clear in a single place the total amount of 'walk-away' pay due a top executive, including severance, pensions, and deferred compensation."

The walk-away numbers analyzed by the compensation committee should be disclosed to shareholders in the proxy statement, and must not be based on a "static" analysis. Rather, the walk-away value should include not only unvested equity grants, but also previously exercised grants and projected future grants based on the assumption that they will be made on the same basis as the most recent award. Pension benefits (including benefits from supplement plans)

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should also be projected out as well in computing the walk-away numbers.

A Heads Up: It is clear that Treasury, the SEC and institutional shareholders will be looking for clearly set forth full walk-away numbers in this year's proxy statements. And perhaps more importantly, they undoubtedly will be expecting a discussion in the CD&A analyzing whether the payments and amounts “are aligned with shareholders’ interests, whether they truly incentivize performance, and whether they reward top executives even if their shareholders lose value.” [For more on what this analysis should look like, see the [“Wealth Accumulation/Full Walk-Away Amounts” chart](#) posted on CompensationStandards.com—and see the model CD&A disclosure that David Lynn, former SEC Chief Counsel, is preparing for the upcoming special issue of *Proxy Disclosure Updates* which will be posted on CompensationDisclosure.com. To access this important issue, those that many not yet be subscribers are encouraged to take advantage of the enclosed no-risk trial or go to CompensationDisclosure.com.]

The Administration’s Legislative Proposals

As part of announced compensation principles, the Administration noted areas where it could seek to promote accountability and transparency through legislation targeted at shareholder input into the compensation process and the role of compensation committees and their advisors. In furtherance of these goals, the Administration recently delivered draft legislation to Congress that would require enhanced compensation committee independence for listed public companies, as well as advisory votes on executive compensation. The concepts of this legislation have already been incorporated into a bill entitled H.R. 3269, the [“Corporate and Financial Institution Compensation Fairness Act,”](#) which was approved in the House on July 31, 2009.

The Administration’s proposed legislation would direct the SEC to adopt rules requiring the national securities exchanges to adopt strict listing standards for the independence of compensation committee members that closely track the provisions applicable to audit committee members adopted as part of the Sarbanes-Oxley Act of 2002. In addition to requiring the highest level of independence, the listing standards would need to provide that compensation committees have authority and funding to retain consultants and counsel, and that such consultants and counsel also be independent from management.

The Administration’s proposed legislation would also require that all public companies soliciting proxies or consents for an annual meeting provide for a separate advisory shareholder vote on the compensation of executives as disclosed under the proxy rules. An additional non-binding vote would be required for any compensatory arrangements of executive officers relating to mergers, acquisitions and similar extraordinary transactions when proxies or consents are solicited in connection with such a transaction.

Given that these legislative proposals have already cleared the House and appear to be gaining momentum in the Senate, companies and their compensation committees must begin preparing for the prospect of a say-on-pay vote for executive compensation. Now is the time for compensation committees to take the Administration’s four principles to heart in upcoming meetings and act to implement the policies outlined above. In addition, compensation committees must consider the issues shareholders will be analyzing when making voting decisions on compensation policies, including:

- the quality of the executive compensation disclosure;
- the link between pay and performance, including whether compensation programs factor in appropriate performance measures and take into account the time horizon of risk;
- the presence of—and justification for—employment agreements, severance and change-in-control provisions, as well as supplemental retirement benefits;
- pay disparities among executives;
- perquisites; and
- the presence of critical compensation policies, such as internal pay equity, meaningful clawbacks and a hold-through-retirement policy.

With action now, compensation committees can avoid the negative consequences of appearing unresponsive in the face of such overwhelming government support of compensation reforms.

Clawbacks: SEC Finally Uses Its Sarbanes-Oxley Authority

In mid-July, the SEC announced an [action](#) to clawback bonuses and stock profits from a former CEO under Section 304 of Sarbanes-Oxley. The SEC asked the U.S. District Court of Arizona to order the former CEO of CSK Auto Corporation, Maynard Jenkins, to reimburse the company for more than \$4 million that

he received in bonuses and stock sale profits while the company was committing accounting fraud. This is the third Enforcement action that the SEC has brought regarding CSK's alleged accounting shenanigans, which resulted in two restatements (one of them charges four of the company's executives with wrongdoing, but not the former CEO).

Although this is not the first Section 304 action from the SEC, it's the first one where the "clawee" isn't alleged to have violated the securities laws. The SEC has brought very few 304 actions since the provision was enacted seven years ago, mainly because of the uncertainty over what constitutes the "misconduct" required by the provision.

There is no requirement in Section 304 that the CEO or the CFO from whom the reimbursement is sought have any involvement in the events that necessitated the restatement. Indeed, the statute doesn't require any showing of wrongdoing or fault at all. And remember there is no private right-of-action under 304—only the SEC can enforce it.

So what type of "misconduct" did the SEC find here? For starters, the SEC's press release refers to the CEO as the "captain of the ship." Did the SEC decide that the captain is responsible for the ship and that alone is enough to find "misconduct?" We don't think so.

Based on a cursory reading of the SEC's complaint, we believe the SEC found that the captain engaged in some "misconduct," but that misconduct didn't amount to a violation of the securities laws. There's not a lot of meat in the SEC's allegations to explain what role the former CEO actually had in the accounting fraud, leaving the SEC open to criticism. But maybe that's the SEC's point—that merely being the captain of the ship while rampant fraud occurs on your watch is "misconduct" enough. We've posted memos analyzing this case in the [CompensationStandards.com "Clawback Policies" Practice Area](#).

At a minimum, the SEC's action seems like a wake-up call to CEOs and CFOs of companies that have had restatements due to some accounting misconduct: you are not safe, the SEC may come after you. And hopefully, this action will spur companies to attempt to enforce their own clawback policies (Equilar reports more than 64% of the Fortune 100 now have them; compared to just 17% in '06). We're not aware of any company that ever has (although it's possible it has happened behind closed doors). We imagine companies sometimes deal with situations where it's not clear if their own clawback policy—or Section 304—applies. Or if it does apply, whether it's prudent to seek recapture from the executive (weighing cost/time of litigation; indemnification issues, etc.).

Rather than decide to just move on and not do anything, it's time to put teeth into those clawbacks as we wrote about in the article from our Winter 2008 issue of *Compensation Standards* entitled "[Ten Steps to a Clawback Provision with "Teeth."](#)"

Treasury's Mark Iwry and SEC's Deputy Director Shelley Parratt to Speak!

We're very excited to announce that Treasury's Mark Iwry, Senior Advisor to Treasury Secretary Geithner, and the SEC's Deputy Director Shelley Parratt have joined our All-Star cast and will serve as the keynotes for our upcoming pair of Conferences: "[6th Annual Executive Compensation Conference](#)" and "[4th Annual Proxy Disclosure Conference](#)."

Now that Congress is moving on say-on-pay (and other compensation-changing initiatives), you need to [register now](#) to attend these critical conferences and get prepared for a wild proxy season by using the enclosed form or going to [CompensationStandards.com](#). Remember that these Conferences are paired together—so you automatically get to attend both Conferences for the price of one. They will be held November 9-10th in San Francisco and via Live Nationwide Video Webcast. See you there.

—JMB/BR

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Compensation Standards is tailored for the busy director, quarterly issues that do not overload directors with useless information—rather, this newsletter provides precisely the type of information that directors desire: practical and right-to-the-point. Plus, each issue includes timely compliance reminders to help directors avoid inadvertent violations (which also help advisors with their compliance tasks).

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