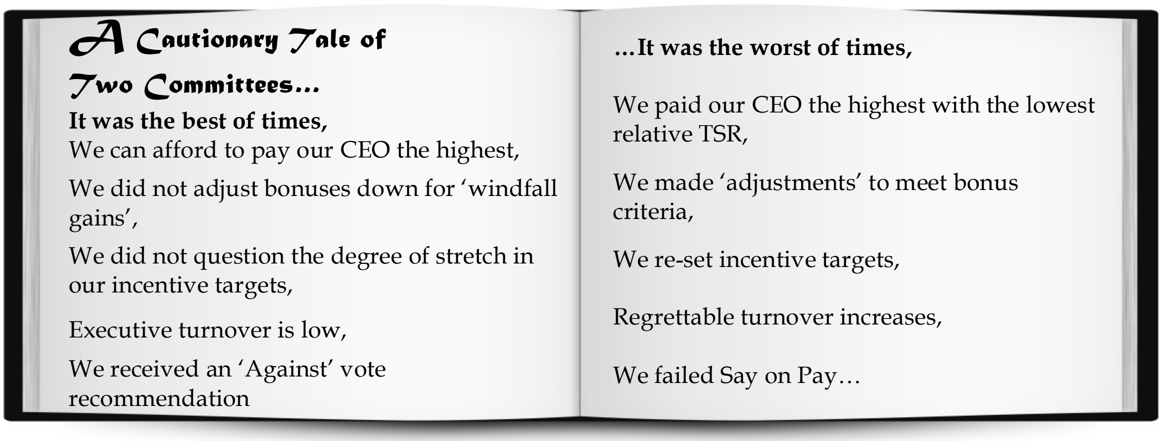

Poor Pay Practices in Good and Bad Times

Most industries are confronted by a variety of compensation challenges, which can be exacerbated in good and bad economies. While many companies have eliminated problematic pay practices (tax gross-ups, stock option repricings, excessive perquisites, and aspirational peer groups) to respond to shareholder and proxy advisor concerns, the greater challenge is to implement compensation programs that reward real and differential performance, and avoid reactionary pay practices that companies may turn to in good and bad economies.

Poor Pay Practices in a Good Economy

In a good period of performance, certain pay practices may fly under-the-radar of shareholders and institutional investors, but Compensation Committees should remain vigilant in assessing the appropriateness of all pay practices including:

- Replacing perquisite, tax gross-up, etc. takeaways with higher salary—this can lead to exponentially higher overall pay as annual incentives, long term incentives and benefits, pensions, and severance are often determined based on salary
- Paying a premium relative to market for fixed and target incentive opportunities—high returns and high operating performance might lead a company to conclude that *target* pay should be significantly above market—however, this approach to pay does not "self-adjust" with changes in performance
- Not using discretion to adjust downward for windfall gains—Committees should be symmetrical in their approach to adjustments and pay should be adjusted downward where results are attributable to factors outside the executive team's ability and mandate to control

Poor Pay Practices in a Poor Economy

During a bad period of performance, retention concerns may lead to poor pay practices including:

- Providing retention grants or other guaranteed payments—in a downward cycle, committees should be cautious and targeted about providing guaranteed payments that reward executives regardless of performance or effort or providing supplemental awards to compensate for programs that did not pay out due to low performance

- Shifting the pay mix to high leverage vehicles like stock options to take advantage of low share prices or shifting pay mix to low risk vehicles like restricted share units—It is significantly more challenging to set appropriate performance targets, particularly in a downward cycle and for the longer term, but Committees should not abdicate this responsibility by moving away from performance contingent long term pay

- Abandoning formula targets for solely qualitative criteria, making adjustments to results to meet criteria, or applying too much upward discretion to meet targets—Lack of performance criteria is particularly likely to result in higher pay in a downward cycle, as it is more difficult to exercise judgment to reduce pay

The Age of Wisdom

There is no "magic bullet" compensation program design for all economies – there may be windfall years and lean years – the goal is not to disconnect pay from external events, but for the Compensation Committee to strike a balance and maximize program efficiency through diversification and over time.

Meridian Comment: To strike a balance, use objective and qualitative assessments and follow clear processes in setting targets and assessing performance. Use goals and targets tied to the business plan, with a focus on key value drivers, a clear understanding of assumptions and an appropriate degree of stretch to recognize shareholder expectations, especially compared to industry peers. Include a regular review of both metrics and strategic performance throughout the year and address deviations from the annual business plan, with incentive plan implications, as these arise. Committees should be disciplined in the application of discretion in determining incentive payouts; if programs are too formulaic, it may be difficult to set appropriate performance thresholds and "targets" or goals might require frequent adjustments; if programs are too discretionary, it may be difficult to hold management accountable for results through compensation.

Take a diversified approach for long-term incentives. Each long-term incentive vehicle works optimally in different performance scenarios, so consider a portfolio approach. For performance-contingent long-term incentives, a balance of absolute/relative and operational/financial metrics helps align realized pay and company performance, while providing reasonable line of sight.

For retention, align compensation within a comprehensive talent strategy; evolve from the historic approach of "pay more to keep them". A common goal of all long-term incentive programs is to "retain" executives so look to regular long-term incentives first, before layering on additional, one-off retention programs.

The ***Client Update*** is prepared by Meridian Compensation Partners. Questions regarding this Client Update or executive compensation technical issues may be directed to:

Christina Medland at (416) 646-0195, or cmedland@meridiancp.com

Phil Yores at (647) 478-3051, or pyores@meridiancp.com

Andrew McElheran at (416) 646-5307, or amcelheran@meridiancp.com

Andrew Stancel at (647) 478-3052, or astancel@meridiancp.com

Andrew Conradi at (416) 646-5308, or aconradi@meridiancp.com

John Anderson at (847) 235-3601, or janderson@meridiancp.com