“A Practical Guide to Compensation Committee Service: Lessons from the Field”

Compensation Advisory Partners

Abstract: Compensation Committees are increasingly under external scrutiny with Say on Pay and the recent threats of related shareholder lawsuits related to Say on Pay. For new and incumbent Compensation Committee members, it is more important than ever that they get things “right”. For many directors, service on the Compensation Committee may be somewhat foreign to them. While they may have interacted with the Committee occasionally as an executive, it is unlikely that Compensation was a primary area of their focus. In order to help Committee members learn from the experience of others, we have created this guide to address key aspects of Compensation Committee service. The guide has been developed based on interviews with current and former Compensation Committee chairs at major U.S. public companies, as well as over 100 years of combined experience as consultants advising Compensation Committees on all aspects of executive and director compensation.

The focus of this guide is not on the technical aspects of Executive Compensation design. Instead, our emphasis is on understanding how effective Compensation Committees structure their activities to effectively address their responsibilities. Not all effective Compensation Committees use the same process or approach, but there are key characteristics that they share. In each chapter, we will reference real experiences from our interviews and our experiences as advisors to illustrate what Committees need to do and need to avoid to get it “right”.

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Chapter 1. Introduction

The role of the Compensation Committee has been continuously evolving and the pace of change has only increased over the past decade. With the bursting of the internet bubble in the early 2000s and the financial crisis of 2008/2009, increased attention has been paid to corporate governance in general, with heightened focus on the potential for compensation programs to create inappropriate incentives for executive management to take on excessive risk or focus on short-term performance at the expense of long-term returns to shareholders.

Corporate governance reforms legislated by Congress and enforced by the SEC have changed the nature of the Compensation Committee. Since the 2010 proxy season, companies have had to disclose the specific expertise that Board and Committee members have that makes them qualified to fulfill their Board service role, as well as why they are appropriate to serve on particular Committees.

The Dodd-Frank legislation of 2009 introduced several new rules that have direct impact on Compensation Committee members. Dodd-Frank mandated that Compensation Committee members meet independence criteria similar to those applied to Audit Committee members. Compensation Committees have become empowered to hire their own advisors and are responsible for reviewing specific independence criteria for the advisors they do employ. To date, the governance reform with the greatest impact on corporate America has been the requirement for Management Say on Pay proposals to be submitted to shareholders for inclusion in a Company’s proxy statement. Management Say on Pay provides shareholders with the opportunity to vote “yes” or “no” on a company’s executive compensation program. While this vote is mandated to be held at least once every three years, the majority of large companies have opted to hold the vote on an annual basis. The vote is non-binding, that is, the company does not need to make changes to its compensation program in response to the vote. However, companies are expected to disclose what response, if any, the company has made to the shareholder vote result. And while the
The vote is non-binding, not responding can create huge reputational risk for Board members.

In practice, companies that have received less than 70%-75% support are viewed by shareholder advisory groups (e.g., Institutional Shareholder Services “ISS” and Glass-Lewis) as having fared poorly on the vote and are expected to make substantial disclosures of changes to their executive compensation programs, improvements in the pay for performance relationship, and the adoption of shareholder friendly compensation practices (e.g., stock ownership guidelines, anti-hedging policies, clawbacks) as well as engage in communications with major shareholders. If they are not viewed as adequately responsive to a poor vote result, ISS and Glass-Lewis may recommend “withhold” votes for Compensation Committee members at the next annual meeting. More disturbingly, companies that have failed to gain majority support for their executive compensation programs have in some cases found themselves as the defendant in shareholder lawsuits (e.g., Beazer Homes USA, Inc., Cincinnati Bell, Inc., and Jacobs Engineering Group, Inc., etc.) claiming that directors have breached their fiduciary duty or that the companies have provided inadequate disclosure for purposes of the shareholder vote. While several of the lawsuits have been dismissed, in other cases (e.g., Martha Stewart Living Omnimedia, Inc., NeoStem, Inc., Applied Materials, Inc. and WebMD Health Corp.), companies have settled with the law firms suing to avoid the cost and nuisance of defending themselves from a potentially embarrassing lawsuit.

In the past, Compensation Committees were criticized for being overly supportive of management. Due to a perceived lack of true independence, there was a perception that Compensation Committees would frequently “rubber stamp” management proposals for their own pay programs. The public perception was that CEO’s were essentially setting their own pay levels by packing the board with cronies who would support whatever was put before them. Highly publicized cases of poor compensation practices including the stock options backdating scandal (e.g., UnitedHealthcare, KB Home), excessive incentive compensation prior to the financial crisis (e.g., Bear Stearns, Countrywide Financial, Lehman Brothers), and excessive pension payments and severance (e.g., Grasso at the NYSE) have
rightly contributed to public and shareholder skepticism about executive pay.

By necessity, Compensation Committees have become much more skeptical of management compensation recommendations. Management knows that whatever compensation program they propose will have to pass muster with a critically-minded Compensation Committee, as well as its independent advisor. As a result, many management teams have become less aggressive in what they propose to Committees and most Committees find themselves balancing the objective of providing management with a compensation program that functions as an effective management tool, while ensuring that the design provisions do not aggravate multiple external and internal constituencies (e.g., shareholders, employees, shareholder advisory groups, the press, etc.).

To go along with the increased scrutiny, is a steadily increasing workload. As the number of items that the Compensation Committee needs to address has grown longer, the demands on the Committee in terms of time commitment and workload have increased. The number of scheduled meetings for a Compensation Committee may range from 4-6 meetings a year, but it is our experience that the average length of a meeting has increased. More time consuming than the meetings themselves, is the preparation for the meetings. In our experience, Compensation Committee materials have become progressively more comprehensive and detailed over time as Committees have increased the rigor of their reviews. For highly regulated financial services firms, Compensation Committee materials can have hundreds of pages covering compensation risk assessments alone.

With this as background, one may ask why would I want to serve on the Compensation Committee of a public company. It is our view that compensation does matter, and service on the Committee does allow a member to make a meaningful contribution to the company. Additionally, a new Compensation Committee member can provide a fresh perspective on existing practices. While the focus of shareholder advisory groups and plaintiff’s attorneys is often on all that can go wrong with executive compensation, we believe that when compensation programs are done right,
they provide the company with a valuable management tool that can help attract and retain top talent, focus management on driving the long-term performance of the company and effectively align the interests of management and shareholders. While Compensation Committee members do not need to be experts in executive compensation, they do need to apply their understanding of the company’s business model and its strategic objectives to ensure that the compensation designs they approve serve to advance the company’s mission.

Compensation Committees help ensure that the Board of Directors carries out its fiduciary duty to shareholders to use their resources in an efficient manner. The goal of the Compensation Committee is not to minimize the cost of compensation to the company. Instead, the Committee needs to make sure that it uses compensation wisely, to get the right kind of executives running the company and focusing them on the activities that will improve the performance of the company and lead to greater shareholder value over time. Many Compensation Committees are also responsible for leadership development and succession planning. A well designed compensation program can aid in leadership development, by supporting the attraction and retention of critical talent, and by maintaining the flexibility required to differentiate pay for employees with high long-term value to the organization.

The Committee needs to be vigilant that the company’s executive compensation program is not going to expose the company to multiple risks. When executive compensation programs go wrong, they can be a source of embarrassment for management and Board members. Compensation scandals can turn into a distraction that diverts management’s and the Board’s attention away from running the business to addressing the external criticism directed at the company by shareholder advisory groups, the press and/or plaintiff’s attorneys.

We are writing this book to provide Compensation Committee members with information that we think will help to make you more effective in your role and make your job a little easier. We try to avoid going too deep into the technical weeds of executive compensation (e.g., tax rules such as 409A, 162(m), 83b election, 10b5-1, etc.). Instead, our focus will be on
the mindsets, activities and processes that lead to successful Compensation Committees. The first part of the book focuses on Compensation Committee processes and requirements. The second part of the book provides an introduction to the material that may come before the Committee over the course of a year and identifies key questions that Committee members should have in mind when reviewing each topic. This section is intended to serve as reference material and we do not recommend trying to wade through it in one sitting.

Our thoughts are informed by interviews with Compensation Committee members that have particularly impressed us over the years, as well as our experiences observing Compensation Committees in action as consultants.

We asked these Committee members to share the benefits of their experience with us.

- What things have worked well for them in their Committee service?
- What do they view as the best practices for setting up the annual calendar, prepping for a meeting, running the meeting, etc.?
- How should a Committee structure its relationship with management?
- How does the Committee deal with differing points of view within the group?
- How does the Committee evaluate its own performance?
- What were the most challenging aspects of Committee service?
- How did the Committee interact with shareholders?

We would like to thank Ed Campbell, Tony Coelho, Lewis Campbell, Peter Haje, Gary Heminger, Charles Hinkaty, Jill Kanin-Lovers, Gil Ray and John McDonnell for sharing their perspectives with us on what makes Compensation Committees most effective. We would also like to thank all of the Compensation Committee members that we have learned from over our
careers, as well as our past and present colleagues. For specific help in putting together these materials, we would like to thank Lauren Peek and Michael Bonner and Joanna Czyzewski for their research assistance, along with other CAP staff members who contributed to the development of our 100 company research.
PART I.

Committee Processes
Chapter 2. Joining the Compensation Committee

Joining the Compensation Committee is very much like taking on a part-time job in a new professional field. Most Compensation Committee members have been exposed to compensation as a topic over their professional careers, at the very least as a participant in executive compensation programs. In the case of CEOs or other managers, they may have had more in-depth knowledge based on experience making compensation decisions, but much of their experience may be specific within the context of their own company.

Like anyone coming into a new role, there is a certain amount of education that a new Committee member will have to take on. At the bare minimum, any new member of the Committee should do a thorough review of the Company’s proxy statement to get a baseline understanding of how the company’s compensation program works and how the company describes the compensation program to shareholders. Beyond the baseline understanding of compensation, new members (particularly new Board members) need to make sure they have a clear understanding of the company’s business and business strategy. Only with this foundational knowledge, can a Committee member begin to assess if the compensation programs that the company has are effective in supporting its business objectives.

Only so much of director orientation can be addressed by self-education. Directors we spoke to said that there is by necessity going to be a period of acclimation upon joining the Committee. “New members need to get the lay of the land” according to Jill Kanin-Lovers, Compensation Committee Chair at Dot Foods and Heidrick & Struggles. Even directors with extensive experience dealing with compensation or serving on other Committees need to get a sense of the new Committee’s culture. Directors interviewed highlight the importance of understanding the “unwritten rules” of how the Committee operates. Does the Committee directly confront difficult issues with management in the room or wait until the executive session to address them? Does the Committee Chair encourage free form discussion among the members or does he limit discussion to the specific
agenda item? Where do different Committee members make the greatest contribution? Tony Coelho, Chairman of the Compensation Committee at Warren Resources, emphasized that new directors, “really need to listen and ask questions” as they work to understand the Committee dynamics.

Two key points of contact can make the onboarding process run smoothly, the Head of Human Resources (or a designee from the Compensation function) and the Compensation Committee Chair. It is critical that management assist in the onboarding process by providing the new member with background material and context on the executive compensation programs and past Committee meetings. Some companies will also include a meeting for the new member with the Committee’s external advisors.

Required Reading / Homework

When joining the Committee, Human Resources should provide the new member with the following information:

1. Company’s Proxy Statement: Reading the Compensation Discussion & Analysis provides the new member with an overview of the compensation program and a view to how the company describes the program to its shareholders

2. Overview of Executive Compensation Program: Management should have a summary document or documents that lay out the following key pieces of information:
   a. Compensation philosophy
   b. Executive salary structure
   c. Annual incentive design
   d. Long-term incentive design, including termination provisions
   e. Executive perquisites and benefits
   f. Executive contracts
g. Change in control agreements
h. Stock ownership guidelines
i. Stock trading rules including anti-hedging
j. Incentive compensation clawbacks

3. Summary of Executive Compensation Benchmarking: Results of any external studies of the competitiveness of executive compensation program vs. market, including information on the peer group

4. Compensation Committee Charter: Publicly available document that lays out the purpose, responsibilities and functions of the Compensation Committee

5. Compensation Committee Annual Calendar: Schedule of meetings and key activities by meeting

The Head of Human Resources should schedule a meeting with the new Compensation Committee member to walk through the compensation philosophy and program. Ideally, the management representative will be a regular participant in the Compensation Committee meetings so he/she will be able to provide broader context on how the company arrived at the current compensation philosophy and program.

*Debrief with Compensation Committee Chair*

Spending time with the current Compensation Committee Chair prior to the first meeting with the Committee is a great opportunity to get a more practical understanding of how the Committee functions. While the written record of the Committee minutes provides a high level summary of what the Committee has been doing, the Chair can provide a more complete context to the new member. Every Committee has its own history and its own dynamics. The Chair can describe the main issues that the Committee has struggled with over time and provide an expectation of what topics the Committee will address in the upcoming meetings.
Every Committee has its own working style. Most committees have a supportive and advisory relationship with management, but depending on the history and the players involved, there could be a more confrontational dynamic with management over compensation levels or the pay and performance relationship. The company may have legacy compensation practices that the Committee is trying to move away from over time. The Chair can give the new member perspective on what the Committee’s collective views on the compensation program are. What works well in the compensation program? What doesn’t work in the Committee’s view? Where have they heard “noise” around the compensation program from shareholders and/or shareholder advisory groups?

Committee Dynamics

The Committee Chair can also provide some basic background on how the Committee members interact with one another and with management. Generally, the Compensation Committee Chair is the point person who interacts most frequently with management, the other Committee members, the Board and the external advisors. The Chair is responsible for setting the agenda for the year and each meeting and making sure that the Committee moves through the agenda in a timely manner during the meetings.

The Chair has a unique perspective to provide background on the strengths and styles of the different Committee members (e.g., who is vocal, who reads the materials in advance, who has strong points of view). He/she can also let the new Committee member in on the meeting structure and dynamics. What does the Committee discuss in front of management and what do they reserve for Executive Session? Do the external advisors participate in executive session?

Formal Training

Some new Committee members find it helpful to participate in formal Board education programs. Training for Committee members and Board members is provided by associations of directors (e.g., The National Association of Corporate Directors, Corporate Board Member). Their training sessions geared to Compensation Committees are generally conducted
by seasoned compensation consultants, attorneys or corporate heads of executive compensation or Human Resources. Training programs serve a dual purpose. They allow Committee members to receive formal education in the topic of executive compensation, but they also allow directors to network with Compensation Committee members from other organizations to share their experience on practices and approaches that have worked in their experience.

Your Role on the Committee

Unless you are the Compensation Committee Chair, you will not have specific responsibilities assigned to you on the Committee aside from reading the materials and actively participating in the Committee meetings. Based on our discussions with Committee members and our observations, we would say that new members have a unique opportunity to make a contribution to the Committee. A critical advantage that new members have upon joining the Committee is that they can provide fresh perspectives, based on their own experiences and points of view. A new member will not be invested in the current approaches to compensation and may be more inclined to question the status quo.

Beyond a different perspective, each new member of the Committee brings unique experience to the Committee. You need to figure out how you can best add value to the Committee. If you have a finance background, you may want to focus extra attention on the company’s selection of performance metrics and the goal-setting process. If you have spent a lot of time managing a large organization, you may offer a strong perspective on leadership development and succession planning. If you have functioned as the CEO of a public company, you may have ideas to offer up about differentiating individual pay with performance. If you have industry expertise, you may be able to offer up views about which compensation practices fit the industry best or information about what the competition is doing. As Charlie Hinkaty, Chair of the Compensation Committee at Prestige Brands said, as a new member you should be “willing to assert yourself, but with the support of facts and data”.
Chapter 3. The Compensation Committee Chair

The best Compensation Committee Chairs understand that while they are in a leadership role, their job is not to make decisions on the compensation design for the Committee as a whole. Instead, their role is to facilitate the process around making compensation decisions to make sure that the Committee has 1) the right information and external advice to make decisions, 2) enough time to consider decisions, and 3) that input is received from all of the Committee members.

Unlike other Committee members who primarily participate at the meetings themselves, the Chair needs to be proactive in interacting with management and the consultant throughout the year from establishing the Committee’s annual calendar to preparation for each individual meeting. It is up to the Chair to determine what areas management will take the lead on and where the Committee will take leadership. The Chair will decide what analyses fall under management’s purview and what should be done by the Committee’s consultant or external legal advisor.

When special circumstances arise (e.g., a CEO transition, a merger or major acquisition), it is up to the Committee Chair to schedule special meetings to address the issue and to work with the Committee’s advisors and management to do the required analyses to support the Committee. In the business as usual mode, the workload of the Chair may only be two to three times as heavy as that of other Committee members. However, when special issues arise, particularly a CEO transition, the workload of the Compensation Committee Chair can be very intense for a period of time.

Keys to Success for a Chair

Communicate Effectively with Management: While the Chair needs to be independent from management and not overly influenced by management in his/her decision making, it is important that the Committee Chair have open lines of communication with the Head of Human Resources and
the CEO. Frequent communication with the Head of Human Resources is necessary to ensure that the calendar for the year addresses the Committee’s needs and that the agenda and materials for each meeting are in place to support the Committee’s activities. Jill-Kanin-Lovers pointed out that this can be a challenge for the Head of Human Resources, “The Head of Human Resources is in a tough spot in terms of being between their boss and the Committee, they need to try to be balanced in their views and objective.” Open communication with the Head of Human Resources about the Committee’s expectations may help to strengthen this relationship.

The Committee may be responsible for the approval of the company’s compensation program; however, it is critical to remember that the compensation program is a valuable management tool to focus management on achieving the company’s business strategy. If the Committee Chair does not have adequate communication with the CEO, the Compensation Committee may end up pushing for a compensation design that is ineffective in addressing the company’s needs, or management may push for a compensation design that is going to be unacceptable to the Committee. In the best run Committees, the Chair has frequent communication with the CEO to understand how the CEO is trying to use compensation to motivate and reward his or her team. Without this communication, the Compensation Committee may be making its decisions in the dark.

**Solicit Input from the Committee:** Effective Committees are not the ones where the Chair functions as a near dictator and the rest of the Committee blindly follow the Chair’s lead. “The culture on the Board carries over to the Committee”, said Ed Campbell, former Chair of the Compensation and Organization Committee at KeyCorp. If the Board is generally assertive in challenging management when there is a difference of opinion, that will likely carry over to the Committee. If the Board tends to defer to management, it is likely that the Committee will tend to defer to management on compensation issues. Still, according to Jill Kanin-Lovers, “the Committee Chair has a lot to do with the culture of the Committee.” The Committee Chair can influence the culture of the Committee by choosing to be directive or inclusive with other Committee members in moving through
the agenda and making decisions. Our view is that effective Chairs are inclusive chairs.

Effective Chairs recognize the need to get input from all the members of the Committee. During Committee meetings, the Chair should pause before any votes or approvals to solicit input from members of the Committee. While most Committee members are not shy to express their views, effective Chairs do not confuse silence with consent. Some members of the Committee are vocal and others are more retiring. The active Committee Chair will work to ensure that each member has an opportunity to ask questions and provide opinions before a vote is taken. Gary Heminger, former Human Capital and Compensation Committee Chair at Fifth Third Bancorp, said, “The Committee Chair can draw people out” and know where particular Committee members are likely to be able to make a valuable contribution to the discussion based on their experiences or background.

For any decisions that are particularly difficult, it is generally best practice to take the vote during Executive Session without management present to facilitate an open discussion among the Committee members. Charlie Hinkaty emphasized that “On all important matters, keep talking until the Committee achieves unanimity.”

Committee Self-Evaluation: As part of the annual process, the Committee is required to do a self-evaluation. The Committee Chair should take advantage of this opportunity to understand the effectiveness of its current processes and gain insight into ways that they could be improved.

Sample Compensation Committee Evaluation

Rating Scale: 1 = Strongly Disagree; 2 = Disagree; 3 = Neither/Agree nor Disagree; 4 = Agree; 5 = Strongly Agree
<table>
<thead>
<tr>
<th>Evaluation Statement</th>
<th>Rating / Comments</th>
</tr>
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<tbody>
<tr>
<td>1. The Committee understands its role and responsibility.</td>
<td></td>
</tr>
<tr>
<td>2. Information provided by management, our consultant and our counsel allows us to</td>
<td></td>
</tr>
<tr>
<td>effectively make decisions.</td>
<td></td>
</tr>
<tr>
<td>3. The length and frequency of each Committee meeting allows the committee to meet</td>
<td></td>
</tr>
<tr>
<td>its objective in a timely fashion.</td>
<td></td>
</tr>
<tr>
<td>4. The Committee is comfortable with the Compensation Committee Charter.</td>
<td></td>
</tr>
<tr>
<td>5. The Committee agrees with the actions taken in the last 12 months.</td>
<td></td>
</tr>
<tr>
<td>6. The Committee understands and is comfortable with the compensation philosophy.</td>
<td></td>
</tr>
<tr>
<td>7. The Committee is comfortable with the executive compensation program and believes</td>
<td></td>
</tr>
<tr>
<td>it will continue to attract and retain top tier talent.</td>
<td></td>
</tr>
<tr>
<td>8. The executive compensation program aligns executive pay with shareholder interests.</td>
<td></td>
</tr>
<tr>
<td>9. The Committee is comfortable with the type and level of compensation and benefits</td>
<td></td>
</tr>
<tr>
<td>the CEO receives.</td>
<td></td>
</tr>
<tr>
<td>10. Management, our consultant and our counsel keep the committee apprised of key</td>
<td></td>
</tr>
<tr>
<td>legislative developments and trends in executive compensation.</td>
<td></td>
</tr>
</tbody>
</table>
Use the Consultant Effectively: Most Compensation Committees have a consultant, but not all Compensation Committees get the most out of their consultant. Some Compensation Committee Chairs use their consultant primarily as a source of market data and technical knowledge about the arcane rules governing executive compensation. Effective Committees engage a consultant that they view as a trusted advisor. Peter Haje, Chair of the Compensation Committee at Time Warner Cable, said, “The Committee needs an independent advisor with whom it can communicate well.” Most Compensation Committee members are business experts with broad understanding of management practices. They may have had a career where they worked for several different organizations across multiple functions. Despite all of their business experience, few directors have knowledge of compensation design and technical issues comparable to that of a compensation consultant.

Compensation consultants have the advantage of spending almost all of their time focused on the area of compensation. While Committee members may have experience with compensation programs at a handful of companies, a typical consultant will have worked with hundreds of companies over the course of a career. The Chair should be willing to admit where the Committee may be out of its depth and ask the consultant not only for information, but for his/her opinion on issues under consideration. Elevating the relationship to a more advisory capacity requires a strong relationship of trust between the Committee and the consultant. If the Committee does not feel it has this kind of relationship with its consultant, they should find a different consultant.

Meeting Preparation: Effective Committee Chairs make it their business to avoid surprises in Compensation Committee meetings. The key to success is ensuring that there is a clear and shared understanding between management and the Committee in advance of the meeting on what will be on the agenda. These days, with few exceptions, Chairs make sure that the management team has walked them through the meeting materials in advance of sharing the materials with other Committee members. The pre-meeting often includes the participation of outside advisors. This walk-through allows the Chair the opportunity to ensure in advance of
the meeting that the materials will effectively address the agenda for the meeting and facilitate any required discussion or approvals.
Chapter 4. The Compensation Committee Charter

The Compensation Committee Charter is a legal document that lays out the responsibilities of the Committee and is required under the listing standards of NYSE and NASDAQ (see the end of the chapter for an example of a Compensation Committee Charter). Companies are required to make the Charter publicly available on the Corporate Governance section of their website. While the document serves a legal function, it is also important from a practical point of view as it lays out the following for the Committee:

- **Purpose of the Committee:** Generally includes establishing and overseeing the Company’s executive compensation program, but in many cases may also include other Human Resources functions (e.g., leadership succession, talent management, diversity)

- **Membership Requirements:** Minimum number of members. Requirement to be independent under the NYSE or NASDAQ, process for election of committee members and Chair

- **Responsibilities:** Typically includes compensation levels for the CEO and other executive officers, severance and employment agreements, supplemental retirement programs and perquisites, CEO performance goals and objectives, compensation risk, review of incentive compensation and equity-based plans, Compensation Committee Report for proxy statement, and director compensation. May also include review of performance for other executives, leadership succession planning and other leadership development activities. For some of these items, the Committee may act in concert with other independent members of the Board.

- **Meetings:** May describe the approximate meeting frequency and who is typically expected to attend Committee meetings

- **Quorum/Voting Rules:** Establishes how many Committee members need to be present to vote and how the Committee can take a vote (e.g., affirmative vote by majority of members, unanimous written consent)
• **Subcommittees and Delegation:** Provides Committee with authority to delegate to subcommittees as it deems appropriate

• **Authority to Retain Advisors:** Provides the Committee with the authority to engage compensation, legal or other advisors. Many companies have added language to address the independence of advisors under the new listing standards due to Dodd-Frank.

• **Committee Charter Review:** Commit to review Charter at least annually and recommend changes to the Board for approval

• **Committee Self-Evaluation:** Committee is required to assess their performance annually

In any case, at a minimum the Charter will need to address the following requirements of the NYSE (or NASDAQ if that is where the Company is listed):

(i) the committee’s purpose and responsibilities - which, at minimum, must be to have direct responsibility to:

(A) review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO’s performance in light of those goals and objectives, and, either as a committee or together with the other independent directors (as directed by the board), determine and approve the CEO’s compensation level based on this evaluation;

(B) make recommendations to the board with respect to non-CEO executive officer compensation, and incentive-compensation and equity-based plans that are subject to board approval; and

(C) prepare the disclosure required by Item 407(e)(5) of Regulation S-K;

(ii) an annual performance evaluation of the compensation committee.
The compensation committee charter should also address the following items: committee member qualifications; committee member appointment and removal; committee structure and operations (including authority to delegate to subcommittees); and committee reporting to the board.

Additionally, if a compensation consultant is to assist in the evaluation of director, CEO or executive officer compensation, the compensation committee charter should give that committee sole authority to retain and terminate the consulting firm, including sole authority to approve the firm’s fees and other retention terms.

NASDAQ generally has the same listing requirements as NYSE although it does not require an annual performance evaluation of the committee.

Most Committee members do not rely on the Charter to guide their day-to-day activities on the Committee. Instead, they tend to rely more on the Committee calendar and the specific agendas for individual meetings as their guide for the Committee’s activities. The responsibility for ensuring that the Committee is fulfilling its responsibilities under the Charter tend to fall on the Committee Chair, with assistance from the Company’s legal staff and human resources staff, along with external advisors. An example of a Compensation Committee Charter for the Coca-Cola Company is provided below.

**The Coca-Cola Company Compensation Committee Charter** (The Coca-Cola Company)

**Purpose**

The Committee has overall responsibility for evaluating and approving compensation plans, policies and programs of the Company applicable primarily to the Company’s Senior Executive Group, which includes all officers of the Company subject to Section 16 of the Securities Exchange Act of 1934, as amended.

The Committee shall have the powers and authorities vested in it by stock option, restricted stock, incentive, and other compensation plans of the
Company. With regard to plans designed and intended to provide compensation primarily for the Senior Executive Group, the Committee shall have the power to approve, modify or amend all non-equity plans, modify or amend all equity plans, and shall recommend adoption of equity plans to the Board.

Committee Membership

The Committee shall consist of no fewer than three members. Each member of the Committee shall meet the independence requirements of the New York Stock Exchange and the Company’s Corporate Governance Guidelines.

The members of the Committee shall be established and removed by the Board. A majority of the members shall constitute a quorum.

Committee Authority and Responsibilities

1. The Compensation Committee will measure the Chairman of the Board’s and the Chief Executive Officer’s performance against each of his or her goals and objectives pursuant to the Company’s plans and, after considering the full Board’s evaluation of his or her performance, determine the compensation of the Chairman of the Board and the Chief Executive Officer. The full Board will review the Compensation Committee’s actions. In determining compensation, the Committee will consider the Company’s performance and relative shareholder return, the compensation of chief executive officers at comparable companies, the awards given to the Chief Executive Officer in past years, and such other factors as the Committee deems relevant.

2. The Committee shall review and approve compensation of all Senior Executive Group members at appropriate time periods. The Committee shall take account of the Chief Executive Officer’s recommendation and evaluation of each individual’s performance, the Company’s overall performance and comparable compensation paid to similarly-situated executives in comparable companies.
3. The Committee shall have the sole authority to retain, oversee and terminate any compensation consultant to assist in the execution of the Committee’s responsibilities, including without limitation, the evaluation of the Chairman of the Board’s, Chief Executive Officer’s, Senior Executive Groups’ and other senior executives’ compensation, and shall have authority to approve the consultant’s fees and other retention terms. The Committee shall also have authority to obtain advice and assistance from internal or external legal, accounting or other advisors.

4. Prior to the retention of a compensation consultant or any other external advisor, and from time to time as the Committee deems appropriate, the Committee shall assess the independence of such advisor from management, taking into consideration all factors relevant to such advisor’s independence, including factors specified in the New York Stock Exchange listing standards. The Committee shall ensure that any disclosure required by the rules and regulations of the Securities and Exchange Commission or the New York Stock Exchange related to the foregoing is included in the Company’s proxy statement.

5. The Committee shall approve and review employment agreements, severance arrangements, retirement arrangements, change in control agreements/provisions, and any special or supplemental benefits or perquisites for Senior Executive Group members.

6. The Committee shall review and discuss the Compensation Discussion and Analysis (the “CD&A”) required to be included in the Company’s proxy statement with management, and, based on such review and discussion, determine whether or not to recommend to the Board that the CD&A be so included. The Committee shall also produce an annual report of the Committee for inclusion in the Company’s proxy statement.

7. The Committee shall annually review the potential risk to the Company from its compensation programs and policies, including any incentive plans, and whether such programs and policies incentivize unnecessary and excessive risk taking.
8. The Committee shall oversee the Company’s (i) submissions to shareowners on executive compensation matters, including advisory votes on executive compensation and the frequency of such votes, and (ii) engagement with proxy advisory firms and other shareowner groups on executive compensation matters. The Committee also shall review the results of such advisory votes and consider any implications.

9. The Committee shall review and approve the creation or revision of any clawback policy allowing the Company to recoup compensation paid to employees.

10. The Committee shall oversee the Company’s policies on structuring compensation programs to preserve tax deductibility where appropriate. To the extent the Company provides for performance-based compensation subject to the requirements of Section 162(m) of the Internal Revenue Code, the Committee shall establish and certify the attainment of performance goals, as required by Section 162(m).

11. The Committee may form and delegate authority to subcommittees, including management subcommittees, when appropriate, and may require that any such subcommittee periodically present to the Committee a summary report of actions taken.

12. The Committee shall make regular reports to the Board.

13. The Committee shall periodically review and reassess the adequacy of this Charter and recommend any proposed changes to the Board for approval.

14. The Committee shall annually review its own performance.
Chapter 5. The Annual Committee Process

In order to ensure that the Committee effectively executes its responsibilities under the Charter, Compensation Committees establish an annual calendar outlining the timing of key activities over the course of the year. The Committee calendar is typically a joint product developed by management and the Compensation Committee Chair as the timing of Committee decision-making needs to fit into the annual compensation cycle of the Company. The Compensation Committee will typically have 4-6 scheduled meetings over the course of the year, so part of the function of the Calendar is to logically allocate the Committees activities across the different meetings.

The Calendar. The outline below lays out what the Compensation Committee calendar could look like for a sample Committee operating on a calendar fiscal year and holding five meetings per year. There is a great deal of variation in Committee calendars across companies, depending on the number of meetings held each year and the responsibilities under the Charter. The example below focuses on core activities that all Committees will address over the course of the year. There are other activities that the Committee will have more flexibility in scheduling and typically are assigned to meetings where the agenda is lighter (e.g., employment agreements, the Committee Charter, the Committee self-evaluation, the Consultant’s evaluation). A best practice is also to include an Executive Session of the Committee at each meeting.
Sample Committee Calendar

**Meeting 1**

**Timing:** January / February  
**Location:** Company Headquarters  
- Close out compensation for prior year:  
  - Review financial performance results for annual and, if any, long-term incentive plan cycles  
  - Approve overall annual incentive plan funding and individual payouts for select executives  
- Preliminary review of proxy statement including the Compensation Discussion and Analysis (CD&A)  
  Approve program design changes in annual incentive and long-term incentive design

**Meeting 2**

**Timing:** February / March  
**Location:** Company Headquarters  
- Establish opportunities for current year  
  - Approve individual salary increases for executives  
  - Approve annual incentive design including:  
    - Individual incentive opportunities  
    - Performance measures and weightings  
    - Performance goals  
    - 162(m) compliance  
  - Approve long-term incentive design including:  
    - Individual incentive opportunities  
    - Vehicle mix  
    - Design features (e.g., vesting, term)  
    - Long-term performance plan design:  
      - Performance measures and weightings  
      - Performance goals  
      - 162(m) compliance

- Final review of proxy statement and CD&A
Meeting 3

**Timing:** April/ May/ June

**Location:** New York City

- Review actual compensation and performance for prior year relative to the peer group
- Review pay-for-performance relationship for prior year, relative to peers
- Review compensation philosophy
- Review Compensation Committee Charter
- Review executive share ownership vs. guideline requirement

Meeting 4

**Timing:** July/ August / September

**Location:** Company Headquarters

- Review of executive compensation trends
- Review compensation peer group
- Receive update on financial performance for in-progress incentive plan cycles

Meeting 5

**Timing:** October/ November/ December

**Location:** Company Headquarters

- Review executive compensation programs
  - Competitiveness of pay levels
  - Annual incentive design
  - Long-term incentive design
  - Other program features, as necessary (e.g., stock ownership guidelines, clawbacks, executive agreements, severance / CIC arrangements, etc.)
- Review tally sheets
- Approval of base salary increase budget for next year
- Risk assessment of compensation programs
- Performance updates on performance incentive plans
- Committee self-evaluation
- Annual review of external advisors
Committees try their best to plan for all of the activities that they know they will have to address over the course of the year in advance. That said, it is important to leave room for time to cover unexpected events. While some events are difficult to predict, it would be surprising for nothing unanticipated to arise during the year. Changes in senior management, major transactions and regulatory developments are just some of the unanticipated events that may need to be squeezed into the Committee’s calendar. A certain degree of flexibility is needed to address these events. In some cases, the Committee may need to convene for additional meetings or conference calls to address special topics. It is also important to give Committees ample time to make decisions. The Committee may react adversely when management is asking the Committee to approve major changes the first time a topic is presented to them at a meeting.
Chapter 6. Committee Meeting Processes

While the processes for Committee meetings tend to be more informal, having effective processes in place is critical to the success of each meeting. Without adequate preparation prior to each meeting, things can easily go awry.

A best practice is for the Compensation Committee Chair to review a draft agenda developed by Human Resources well in advance of the meeting, either by email or over a conference call. The objective should be to clearly lay out the answers to the following questions:

- What is scheduled to be covered in the meeting based on the Annual Committee Calendar?

- Are there any additional topics that need to be discussed based on recent developments (e.g., terminations, new hires, regulatory developments, etc.)?

- What is for review or informational purposes?

- What will require formal Committee action or approval?

- How much time should be allotted to each topic and for the Committee meeting in total?

Sample Meeting Agenda

<table>
<thead>
<tr>
<th>Time</th>
<th>Item</th>
<th>Agenda Item</th>
<th>Committee Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>9:00 AM</td>
<td>1</td>
<td>Approve minutes of last Compensation Committee Meeting</td>
<td>Approve</td>
</tr>
<tr>
<td>9:05 AM</td>
<td>2</td>
<td>Review executive management changes</td>
<td>Review</td>
</tr>
<tr>
<td>9:15 AM</td>
<td>3</td>
<td>Discuss executive compensation pay assessment</td>
<td>Review</td>
</tr>
<tr>
<td>Time</td>
<td>Item</td>
<td>Agenda Item</td>
<td>Committee Action</td>
</tr>
<tr>
<td>-----------</td>
<td>------</td>
<td>-----------------------------------------------------------------------------</td>
<td>------------------</td>
</tr>
<tr>
<td>9:45 AM</td>
<td>4</td>
<td>Review recent trends in executive compensation</td>
<td>Review</td>
</tr>
<tr>
<td>10:15 AM</td>
<td>5</td>
<td>Review potential peer group changes</td>
<td>Review</td>
</tr>
<tr>
<td>10:35 AM</td>
<td>6</td>
<td>Review new hire and promotion equity grants below the CEO level</td>
<td>Review</td>
</tr>
<tr>
<td>10:45 AM</td>
<td>7</td>
<td>Review annual status of employee benefits plan</td>
<td>Review</td>
</tr>
<tr>
<td>11:15 AM</td>
<td>8</td>
<td>Executive Session</td>
<td></td>
</tr>
</tbody>
</table>

Committee Composition and Meeting Attendance

Composition of the board Compensation Committee is an important step toward achieving an effective Committee. Compensation Committees are typically composed of 3 - 5 board members with different, yet complementary backgrounds and skills. The Committee should have representation from an active senior executive, an academic, an industry expert, etc., as appropriate. Some companies often include a current (or recent) member of the Audit Committee on the Compensation Committee to provide additional perspective on financial goals and results. If the Compensation Committee is composed of members with different backgrounds it will allow for more comprehensive and fully vetted discussions.

Compensation Committee meetings typically involve participants from management, external advisors and all of the Committee members. Management participants typically include 1-2 representatives from Human Resources (e.g., Head of HR, Head of Compensation and Benefits) and 1-2 representatives from Legal (e.g., General Counsel and/or Corporate Secretary). The CEO will also frequently attend Committee meetings. Other members of management (e.g., CFO, Chief Risk Officer, Business Unit leaders) may join a portion of the meeting to discuss specific topics (e.g., financial performance objectives, compensation risk review, talent
reviews), on an as needed basis. Upon occasion, additional Board members may be invited to attend Compensation Committee meetings, but generally this is not the case. Also, in financial services, it has become common to have at least one joint meeting annually with members of the Compensation Committee and Risk Committee participating to discuss the risk implications of the company’s incentive compensation programs.

Most committees will have external advisors present for all or a portion of the meeting as well. It is common that 1-2 representatives from the Committee’s consultant participate in each meeting. If the Committee has engaged external legal counsel they often participate in meetings as well, particularly where a need for their specific expertise is anticipated. Depending on the nature of the subject matter under discussion, the external advisors may take the lead in presenting material for portions of the Committee meeting, but their primary role is to provide perspective on topics under discussion (e.g., market practice, effectiveness of different approaches to meet specific objectives, identify potential tax, legal or accounting issues). In cases where management engages its own compensation consultant, management’s consultant may also be invited in for a portion of the meeting to present to the Committee, though it is less common for management’s consultant to participate in the Executive Session of the Committee. Effective Committees make it a practice to test ideas with the external advisors and proactively ensure that the Committee has addressed any potential issues with the topic under discussion.

**Meeting Materials**

Management and the Committee’s compensation consultant work together to prepare meeting materials, depending on whether the agenda items are the primary responsibility of management or the Committee’s consultant. Independent of who is developing the materials, whenever possible the goal should be to review draft materials for the meeting with the Compensation Committee chair at least one and a half to two weeks prior to the Committee meeting date. This timing is critical to ensure that the meeting materials can be made available to Committee members at least one week prior to the Compensation Committee meeting. In the past, paper copies of Committee materials were provided to Committee members,
but an emerging trend is to deliver the materials electronically to dedicated iPads provided to the directors. Electronic delivery allows the Company to update materials without having to physically redistribute them to Committee members and avoids encumbering committee members.

Given the busy schedules of Committee members, providing them with adequate time to review materials in advance of Committee meetings dramatically enhances the productivity of committees. Meetings can be conducted much more effectively if all of the members have reviewed the materials in advance of the meeting. This allows for the scarce time available to the Committee to be dedicated to points of clarification and discussion of issues, rather than reading through the written materials. In addition, Charlie Hinkaty shared that when Committee members receive material late, “it gives the impression that management is springing it on them.”

Based on our interviews with Committee members and our experience, Committee meeting materials need to effectively summarize a great deal of information. As Ed Campbell related to us, “Management and the advisors can’t just provide data to the Committee, materials have to provide a conclusion.” Ideally, the Committee should be provided with an Executive Summary that effectively lays out the issue, findings, conclusion and rationale for the conclusion in one to two pages. The Executive Summary can be complemented by a longer report with supporting data, but the expectation should be that the long form report will mostly be used as a pre-read and the meeting will focus on the Executive Summary.

**Meeting Management**

At the start of the Committee meeting, the Chair will typically call the meeting to order and begin by asking for approval of the Minutes from the prior Committee meeting. The Chair is responsible for ensuring that the Committee works through the agenda in a timely manner, while ensuring that there is adequate discussion of each topic and that there is an opportunity for Committee members to gain clarity on the issues and voice their points of view. Lewis Campbell believes it is important to hear each member’s view point and will proactively ask each member for their
point of view to ensure a fulsome discussion. The agenda will typically involve some materials which are being provided to the Committee for review and discussion and other materials that require a Committee vote. Depending on the preferences of the Chair, votes can be taken during the Committee meeting or delayed until the end of the meeting when the Committee meets in Executive Session without management present. Generally, when decisions are going to be made about issues where the management team has a direct economic stake, it is preferable to vote during the Executive Session of the Committee so the members have an opportunity to discuss without input from management.

The length of a Committee meeting will typically vary with the agenda for the meeting, but also on the practices and approach of different companies. Some companies regularly address all required business in one-hour sessions. Other Committees we have worked with typically have three hour meetings. In most cases, the meeting length is a function of the working style of the Committee. Some Committees delve deep into the issues in each meeting, others rely on a thorough pre-reading and count on management and the Committee Chair to surface any issues that require longer discussion. In almost all cases, year-end meetings where key compensation decisions for the year are made typically run longer.

**Executive Sessions**

Executive Sessions are a critical part of any Committee meeting. They allow Committee members the opportunity to meet without members of the management team present to discuss sensitive topics (e.g., CEO compensation) and to conduct critical votes. At the beginning of the Executive Session, members of the management team are typically excused from the room. The Committee members and their external advisors remain in the room for the beginning of the Executive Session. The Committee uses this part of the Executive Session as an opportunity to ask the advisors if they have any issues or concerns that they would like to raise relating to any of the topics that surfaced during the meeting. If any compensation decisions related to the CEO are up for discussion, they will receive input from external advisors at this point. Once the external advisors have had the opportunity to share their views, they are frequently asked to leave.
Once alone, Committee members will take the opportunity to review any decisions made in the Committee meeting, take votes on any decisions that were pushed back to the Executive Session to allow for additional discussion and discuss any upcoming issues that the Committee may want to add to its going forward agenda. The Executive Session is also the most likely time for members to discuss their own performance evaluation, the performance evaluation of the external advisors and to make a change in their external advisors.

In many Committee meetings, the Executive Session may not seem necessary due to the nature of the items under discussion. However, directors we spoke with believe that the Executive Session is critical. As Peter Haje said, “Always have Executive Sessions...if after a meeting anything is bothering one of the members, they will share their views in the Executive Session.” Executive Sessions can serve a very real function of allowing Committee members an opportunity to raise concerns. Below are several examples of issues that may come up in an executive session, but are difficult to discuss with management present:

- Committee feels management is trying to “force” them into making a hasty decision, without providing adequate opportunity for the Committee to discuss
- The Committee has concerns about the performance of the company or specific executives and would like to discuss potential implications for compensation
- Concerns that management may not be adequately sensitive to shareholder concerns
- Concerns about executive retention

In fact, some Committees will even schedule an Executive Session without management present at the beginning of the meeting to allow Committee members to air their concerns before reviewing issues with management. While not all Committees use this approach, those that do find that it helps to ensure that the Committee and management work through
issues during the course of the meeting and the Committee does not have to wait until the end of the meeting to find out about members’ concerns.

From a governance perspective, having an executive session at every meeting helps to maintain a record that the Committee members were provided with an opportunity to express their views independent of management at each meeting. It also helps to avoid raising concerns among management that “something is up” when Committee members meet in Executive Session.

**Post-Meeting Process**

Following each Committee meeting, the Committee Chair will typically need to debrief with management (e.g., Head of HR, Corporate Secretary) to ensure that any topics discussed or decisions made during the Executive Session are included in the meeting minutes. In addition, it provides an opportunity for management and the Committee Chair to ensure that they have a shared understanding of the items approved at the meeting and any next steps for additional work that were identified.
Chapter 7. External Advisors

Under the Dodd-Frank legislation and the listing standards for the NYSE and NASDAQ, Compensation Committees are empowered to hire external advisors to assist them in managing their responsibilities. The legislation requires companies to provide funding for the Committee to pay an external advisor if the Committee decides to use one. Before engaging any consultant, the Committee is required to conduct a review of the independence of the consultant it uses (though not required to use an independent advisor).

Compensation Consultants

Why Use a Consultant?

It is a testament to the complexity surrounding the issue of executive compensation that the overwhelming majority of Compensation Committees use a consultant. On the surface, the decision on how much to pay a company’s senior executives may seem simple enough. However, there are multiple advantages to including a consultant as part of the process:

- **Third-Party Independence:** If management is left alone to develop recommended compensation levels and design, their self-interest would encourage them to propose relatively high compensation levels and low performance standards. The use of a third-party advisor helps to ensure that the information used as the basis for establishing recommended pay levels and performance standards does not have a bias in favor of management. Since consultants are engaged by the Committee, their incentives tend to be more closely aligned with the Committee members.

- **Experienced Advisory:** Experienced consultants have worked with hundreds of clients over their careers. It is likely that situations that may be new to the Compensation Committee are familiar to the consultant. A strong consultant will have learned from past experiences and can share that knowledge with Committee members to provide assurance when making decisions.
• Competitive Information: Through past client experience and firm resources, consultants have the ability to provide detailed information on competitive practices to the Committee. While competitive data should not be the primary basis for Committee decision-making, it is a valuable input and can provide comfort to Committee members that designs they are implementing do not deviate from common market approaches. In the words of Jill Kanin-Lovers, the consultant “needs to keep you smart.”

• Technical Expertise: The design of executive compensation programs requires knowledge across multiple disciplines, including tax, accounting, SEC disclosure rules and insider trading. In addition, it is critical to have an understanding of the financial drivers of business success. While Compensation Committee members may excel in the understanding of business strategy and financial performance, it is unlikely that they will have adequate technical knowledge to navigate the intricacies of executive compensation design on their own.

• External Cover: The reality of the business world today is that there is no shortage of external criticism of corporate decision-making. The recently adopted mandatory “Say on Pay” proposals have served as the basis for shareholder lawsuits and executive compensation has long been a popular topic for the business press. The use of a consultant allows the Committee to demonstrate to external critics that they tried to “cover all bases” in developing the compensation program. In the event of a lawsuit, if the Committee has used a consultant, they can point to independent, third-party advice as an input into their decision-making.

Typical Consulting Arrangements

The nature of the arrangement with the consultant and the level of workload required factor into how much a consultant will be paid. In our experience, an annual consulting engagement with a Compensation Committee could cost as little as $50,000 if the role of the consultant is primarily to just review and comment on data and recommendations developed by management (and/or its consultant) with occasional meeting attendance. In other cases, the consultant reports to the Committee, but works with management to develop recommendations. In these cases,
fees can range from $100,000-$500,000 depending on the complexity of the company’s compensation programs and decision-making processes. Most consulting firms will charge clients based on the hours required to complete the work and hourly billing rates of the consultants serving the clients, similar to law firms. Consultants will generally provide an estimate of fees for the year associated with anticipated work steps.

**Consultant Independence**

Over the past 5-10 years, Committees have become more concerned about the independence of the consultant. In the past, compensation consultants were often engaged by management and would be brought in to discuss management recommendations with the Compensation Committee. As external scrutiny of executive compensation increased, there was a push to make sure that the consultant reported directly to the Compensation Committee, rather than to management, to reduce the risk that the consultant would feel obliged to support management recommendations in order to remain engaged by the Company.

Throughout the 1990s and into the 2000’s, the majority of executive compensation consulting arrangements were with large, multi-service Human Resources consulting firms (e.g., Towers Watson (created by the merger of Towers Perrin and Watson Wyatt), Hewitt, Mercer). Over time, shareholder advisory firms, certain institutional investors and the press raised concerns about a potential conflict-of-interest for these firms. They posed the question, “Would the compensation consultant with annual fees of $150,000 really be willing to confront management on executive compensation if it put annual pension benefit consulting fees of $3-$5 million at risk?” The presumptive answer was that there was a potential conflict of interest for these firms. As a result, over the past 5-10 years, many large companies have switched from using multi-service consulting firms to working with boutique consulting firms that only provide executive compensation consulting advice.

Concerns about consultant independence culminated in the Dodd-Frank legislation which requires Committees to consider the following six independence factors when engaging a consultant:
Criteria | Assessment
---|---
Does the consulting firm receive any revenue from XYZ Company for services other than executive compensation consulting? | 
Percent of revenue potential estimated fees represent as a percent of the consulting firm’s 2013 revenue? | 
Does the consultant have any personal relationships with members of the Board of Directors or executive officers at XYZ Company? | 
Does the consultant have any business relationships with members of the Board of Directors or executive officers at XYZ Company? | 
Does the consultant directly own any shares in XYZ Company? | 
Does the consulting firm have a written policy for managing conflicts of interests? | 

The Committee is not required to hire an independent consultant. If the Committee does determine that a conflict of interest arises for the consultant, the Company needs to disclose how the conflict was addressed. To avoid the perception of a conflict of interest, it is likely that most Compensation Committees will avoid working with consultants that give unsatisfactory responses for any of the six questions.

**Single Consultant vs. Dual-Consultant Model**

Two compensation consulting models have developed that are seen in the market: 1) a single consultant reporting to the Committee Chair and working for the Committee and with management, 2) two consultants, one directly engaged by the Committee and one working directly for management.

**Single Consultant Model.** In this structure, a single consulting firm addresses all executive compensation consulting needs. The consultant
works with the Human Resources team, as appropriate, ensuring that Compensation Committee Chair approves of any services performed.

**Dual Consultant Model.** The management consultant works closely with the Human Resources team and management to design incentive programs, benchmark the executive compensation levels for positions below the most senior executives, assists with executive compensation disclosure, and addresses the Company's other data needs. The Committee consultant's responsibilities typically include attending Committee meetings, reviewing proposals prepared by management, benchmarking senior executive compensation, providing an overview of market trends, working with the Committee Chair to ensure good governance, considering shareholder optics and best practices. There is significant variation in the market in the division of responsibilities between the two consultants. The table below provides a detailed breakdown of the work steps allocated to each consultant.
<table>
<thead>
<tr>
<th>Consultant to the Committee</th>
<th>Consultant to Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Advise on compensation philosophy and overall positioning for senior executives</td>
<td>• Propose appropriate compensation philosophy tied to related business and talent objectives</td>
</tr>
<tr>
<td>• Review recommendations on peer groups</td>
<td>• Recommend peer groups based on business and talent competitors</td>
</tr>
<tr>
<td>• Prepare proxy data for CEO (possibly other NEOs)</td>
<td>• Prepare proxy and survey data for executives, excluding CEO</td>
</tr>
<tr>
<td>• Advise on amount and mix of pay for CEO and prepare alternatives for review by Chair and/or Committee</td>
<td>• Support HR in crafting pay recommendations for Covered Executives and senior management, excluding the CEO</td>
</tr>
<tr>
<td>• Review management’s recommendations on compensation for other executives in advance of Committee meeting and advise Chair and/or Committee on appropriateness of recommended amount and mix of pay</td>
<td>• Support HR in developing proposals on design of annual and long-term incentive plans</td>
</tr>
<tr>
<td>• Review management’s recommendations on design of annual and long-term incentive plans</td>
<td>• Prepare tally sheets, if requested</td>
</tr>
<tr>
<td>• Provide Committee with an assessment of Covered Executive pay vs. Company performance</td>
<td>• Advise HR on amount and mix of pay for executives below the Covered Executive level</td>
</tr>
<tr>
<td>• Review tally sheets</td>
<td>• Research executive compensation issues for HR</td>
</tr>
<tr>
<td>• Review proxy statement disclosure, specifically CD&amp;A, on behalf of the Committee</td>
<td>• Support HR/Legal as necessary in drafting the proxy statement</td>
</tr>
<tr>
<td>• Advise on market trends related to executive compensation</td>
<td>• Advise on non-executive compensation issues</td>
</tr>
<tr>
<td>• Advise Committee on relationship between executive compensation and risk</td>
<td>• Conduct risk review on compensation program</td>
</tr>
<tr>
<td>• Review and recommend board of directors compensation</td>
<td></td>
</tr>
<tr>
<td>• Attend Compensation Committee meetings and executive sessions, as requested</td>
<td></td>
</tr>
</tbody>
</table>
The dual consultant model is relatively new and has mainly been adopted by the largest companies with the greatest concerns about the perception of a conflict of interest. For most companies, it is viewed as duplicative to have two consultants work on the topic of executive compensation. The table below summarizes key advantages of each of the alternative models.

<table>
<thead>
<tr>
<th>One Compensation Consultant</th>
<th>Dual Compensation Consultants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Avoids concerns over “dueling consultants”</td>
<td>Typically management’s consultant has limited interaction with Committee</td>
</tr>
<tr>
<td>Easier to manage limited resources – since one firm is less expensive than two firms</td>
<td>Management would normally work with its consultant but actually present the material at Committee meetings</td>
</tr>
<tr>
<td>Given the rise of boutique firms, the perception of a conflict of interest is avoided</td>
<td>In this case, Committee’s consultant can develop more into an “auditor” role, rather than a partner</td>
</tr>
<tr>
<td>One consultant can develop a more holistic view of the company, its strategy, goals and culture, since it interacts with all parties – the Compensation Committee, senior management, HR and other support functions</td>
<td>Avoids any possible perception of a conflict, provided the Committee’s consultant does not provide other services to the Company</td>
</tr>
</tbody>
</table>

What to Look For in a Consultant?

Most consultants that you interview will have adequate experience to provide you with the technical advice that you require and will come from a firm with significant resources to provide required market data. It is likely that the differentiator will instead come down to your views of how the consultant will interact with the Committee and management.
<table>
<thead>
<tr>
<th>Topic Area and Description/Rationale</th>
<th>Information typically requested</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Company Experience</strong></td>
<td>• Brief overview of the firm</td>
</tr>
<tr>
<td></td>
<td>• Description of consultant’s</td>
</tr>
<tr>
<td></td>
<td>background and experience</td>
</tr>
<tr>
<td></td>
<td>as it relates to the work</td>
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<td>annual and long-term incentive</td>
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<td><strong>Consulting Team</strong></td>
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<td>consulting team provide:</td>
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<td><strong>References</strong></td>
<td>• Provide three Compensation</td>
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<td>Committee Chair references</td>
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<td>with the following information:</td>
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<td>▪ Company for which the</td>
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<td>individual is the Committee</td>
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<td></td>
<td>▪ Summary of scope of work</td>
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<td>▪ Length of relationship</td>
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</table>
### Potential Conflict of Interest

Alerts the Committee to any potential conflicts of interest prior to engaging a consultant

- Highlight any potential conflicts of interest that could result from this engagement including the SEC factors
- Provide the firm’s conflict of interest policy

### Pricing

- Provide total anticipated consulting fees work steps outlined in this request for proposal

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**General positives in a consultant will include the following:**

- **Willingness to speak up when consultant is uncomfortable with decisions the Committee is making or management is recommending**

- **Creativity in helping the Committee think through solutions to difficult challenges**

- **Preparedness in advance of meeting so can address issues efficiently and anticipate Committee questions**

- **Flexibility to think “on the fly” as new issues surface in the course of the meeting**

- **Ability to engage different points of view while maintaining objectivity**

- **Proactivity in keeping the Committee Chair aware of emerging issues between meetings**

- **Effectiveness in facilitating decision making**

Similar to the Compensation Committee Chair, while part of the role of the consultant is to provide information and expertise, the other function of the consultant is to facilitate decision-making and bridge the gap between
differing points of view. In order to fulfill this role well, the consultant needs to be trusted by the Committee members and management and has to be able to relate to their concerns. Directors we spoke to indicated that one of the key challenges for a consultant is balancing the relationship with the Committee with the relationship with management. For example, Peter Haje said, “an open and candid relationship between the consultant and people in the company is critical and it has not worked well when there was a poor relationship between management and the consultant.” Consultants who fail to recognize the importance of an effective working relationship with management may find that their relationship with management quickly becomes adversarial. For most Committees, it is a much easier decision to change compensation consultants than to change the management team. On the other hand, if the consultant is perceived as being “too close” to management, the Committee may come to question whether or not the consultant is providing objective, independent advice.

Much like management and directors, consultants will generally be most effective if they always keep in mind that their ultimate client is the company’s shareholders and that all three key parties (i.e., management, the Board and the consultants) should all be acting in the interests of the company’s shareholders. As part of the Committee’s annual process, they should incorporate an evaluation of the effectiveness of the relationship with the consultant.

Sample Compensation Consultant Evaluation

| Rating Scale: 1 = Well Below Expectations; 2 = Below Expectations; 3 = Meets Expectations; 4 = Exceeds Expectations; 5 = Well Exceeds Expectations |
### Evaluation Statement

<table>
<thead>
<tr>
<th>Evaluation Statement</th>
<th>Rating / Comments</th>
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<tbody>
<tr>
<td>Overall, how would you rate the consultant’s relationship with the Committee?</td>
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<td>Did the consultant respond to your requests, questions and concerns effectively and</td>
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<td>in a timely manner? Were there any problems and, if so, in what way?</td>
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<td>Did the consultant communicate effectively during the engagement? Did the consultant</td>
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<td>listen and ask effective questions? How would you rate the usefulness and quality of</td>
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<td>the consultants’ input? In what ways could the consultant improve?</td>
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<td>Does the Committee feel the consultant made appropriate use of market data? Did it</td>
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<td>meet the needs of the situation?</td>
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<td>Does the consultant have a strong understanding of your business, short- and long-</td>
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<td>term issues, compensation philosophy and programs? Were recommendations presented</td>
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<td>with the business context in mind?</td>
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<td>Did the consultant provide the Committee with a proper context for any recommenda-</td>
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<td>tions? Were recommendations presented to include a governance, regulatory and share-</td>
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<td>holder perspective?</td>
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<td>Were the work and recommendations presented effectively? What can be improved?</td>
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<td>Did the consultant interact with management (on the Committee’s behalf) effectively?</td>
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<td>Should any revisions be made to how interactions occur going forward?</td>
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### Legal Advisors

In many cases, the Compensation Committee does not view it as necessary to have an independent legal advisor reporting directly to the Committee. Instead, the Committee often relies on the company’s internal legal staff and management’s external counsel to provide the Committee with legal advice. However, there are certain situations where it is critical for
the Compensation Committee to have its own advisors and some Committees have determined that it is worthwhile to retain a legal advisor to attend all Committee meetings and serve as a sounding board between meetings.

There are times when the Compensation Committee needs to work on confidential projects and does not want to share information with the management team. In particular, when recruiting a new CEO or determining compensation arrangements for a departing CEO, it is critical to obtain external legal advice to ensure objectivity.
PART II.

The Basics of Executive Compensation Design
Chapter 8. Compensation Objectives

In this part of the guide, we will provide an overview of the basic activities that fall under the purview of the Compensation Committee. To assist you in your role as a Committee member, we have identified key questions that you should ask or make sure have been addressed related to each topic.

Compensation Objectives

Most public companies share the same core compensation objectives in some form or other:

- Align the interests of management with those of shareholders
- Pay-for-performance
- Ensure that compensation functions as an effective incentive
- Attract and retain required talent to execute the business strategy
- Manage the risk associated with compensation

Some companies may have additional stated objectives that complement these four objectives (e.g., manage compensation cost, ensure internal equity within the company, etc.), but in most cases compensation design is founded on the above objectives.

It is difficult to argue with any of these objectives. What is important for you to understand as a Compensation Committee member is that there are trade-offs among different objectives that make it a challenge to fully address all objectives at the same time with each element of the compensation program. For example, the objective of aligning management with shareholders can conflict with the desire to attract and retain required talent. To enhance the alignment of management’s interests with those of shareholders, we ideally would tie a great deal of management’s compensation to the stock price movements over the long-term. However, managers will generally prefer immediate cash compensation over an equal amount of long-term stock-based compensation, as it is less vari-
able and more tangible. Said in other words, cash compensation tends to be most effective in meeting the objective of attracting top talent, while stock-based compensation is most effective in aligning managements’ interests with those of shareholders and potentially retaining executives.

There is also often a similar trade-off between alignment with shareholders and pay-for-performance. To meet the objective of pay-for-performance, it is often preferable to pay management based on the financial results of the company which tend to be a “truer” measure of management performance than stock price movements, especially over the short-term. However, paying management based on financial performance, rather than stock price can result in different outcomes for management than shareholders. In an “up” market stock price appreciation may outpace financial performance, in a “down” market the reverse relationship may hold.

Part of the role of a Compensation Committee member is to review the compensation program holistically and ensure that it is effectively balancing the different compensation objectives. This requires a great deal of judgment as it is challenging to assess how effective different forms of compensation are in addressing each of the objectives and it is not always clear what the appropriate balance among objectives is.

Key Questions for Committee Members to Ask:

- How does the design change help to align management with the interests of shareholders?
- How do proposed design changes impact the pay for performance relationship at the company?
- How does the design help us to attract and retain the talent we need?
- How does the design impact the risk associated with our compensation programs?
Chapter 9. Compensation Philosophy

In order to help achieve the company’s compensation objectives, Compensation Committees typically will develop a compensation philosophy to guide their decision-making. The compensation philosophy describes high level principles rather than prescribing specific design details, but does provide direction on key aspects of compensation design. Below is an overview of the main elements of a compensation philosophy and how Compensation Committees establish them.

- **Target Pay Positioning**
- **Definition of Competitive Market**
- **Pay Mix**
- **Internal Equity**
- **Pay-for-Performance Relationship**

**Target Pay Positioning**

A target pay positioning statement provides the Compensation Committee with a guideline about how competitively to pay their executives. Committees can develop a target pay positioning for each element of compensation (e.g., salary, bonus, and long-term incentives) or may just state a target positioning for overall target total direct compensation (i.e., the sum of base salary, annual target bonus and long-term incentives). The target pay positioning pertains to the target pay opportunity for the executive, rather than the actual level of compensation delivered based on performance results.

The most common approach is market median target pay positioning (i.e., at the level that half of the competitive market provides a greater pay opportunity and half of the competitive market provides a lesser pay opportunity). The rationale for this approach is that if the competitive market is appropriately defined, there is no need for the company to set target pay levels above or below those of the typical competitor. It is critical to remember that the target pay positioning relates to target pay opportunities and actual pay realized will vary from target based on the company’s
performance. Executives with target pay opportunities set at the market median level will have the opportunity to earn actual pay above (or below) market median levels based on performance.

<table>
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<th>Target Total Compensation Pay Philosophy</th>
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<td>At Median</td>
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<td>Above Median</td>
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A minority of Compensation Committee’s will establish a premium pay positioning (see above chart) under the compensation philosophy (i.e., target pay levels to be above the median). IBM, for example, has a premium pay positioning philosophy for executives. In 2013, the company cited that “… the Company’s philosophy is to generally consider a range from the 50th to the 75th percentile of the market for cash and total compensation for IBM job roles compared to jobs of similar size and complexity at companies within our benchmark group. Data from companies at the 50th percentile of our benchmark group serves as the reference point for job roles in our lines of business. Most of our lines of business are large enough to compare to the size of stand-alone companies within this group. Data at the 75th percentile of our benchmark group serves as the reference point for our enterprise-wide job roles. Revenue for companies in this group is similar to revenue for IBM as a whole.” Other reasons for a premium pay positioning include the following:

- **Challenges in Attracting Talent:** The company may have difficulty attracting the desired talent due to its geographic location (e.g., rural area), challenging business conditions, or a difficult work environment.

- **Requires Premium Talent:** Company may feel that their current talent is superior to that of the market and that in order to attract and retain that level of talent they need to pay more than comparable firms.

- **Firm Outperforms Market:** Company may have demonstrated levels of performance that consistently exceed the market. As a result, their performance objectives may be set at higher levels than competitors and target pay levels should be aligned with the targeted performance levels.
Unsurprisingly, a premium pay philosophy tends to be popular with executive management. Unfortunately for executives, shareholder advisory firms and some institutional shareholders tend to raise concerns when they see companies set target pay opportunities above the market median. They will be skeptical of any rationale that the company uses to justify a premium pay positioning and will closely examine the actual relationship between pay levels and performance for companies with a premium pay position. If as a Compensation Committee member, you find that the company needs to adopt a premium pay position, you should be prepared to be criticized by shareholder advisory groups. Even less common than the premium pay position is a company that has a discount pay positioning (i.e., targets pay levels below the market median). Where this is the case, the company may have a mix of pay that is different from other firms in the market. For example, the firm may have target base salary and bonus levels that are above market median and as a result decide to have long-term incentives and total direct compensation opportunities that are below median. Alternatively, the company may provide a generous Supplemental Executive Retirement Plan (SERP) and feel that target total direct compensation does not need to be competitive with the market median because of the above market retirement benefits provided. In other situations, for example a turnaround company with near-term cash constraints, cash compensation for executives may be positioned well below median, with the company providing above median or top quartile equity-based, long-term incentive compensation to reward executives for successful completion of the turnaround.

The target pay positioning statement should generally be stated as where the company expects to target pay opportunities for its executives on average. There are a number of valid reasons why the pay levels for a given executive may vary from the market median value:

- Any value within +/- 15% of the market median is essentially at the market median from a statistical perspective. Market median values are drawn from peer group or published survey data and can be expected to vary over time. It is an error to view this data with too high a degree of precision

- Executives may have responsibilities that are substantially greater (or smaller) than those of the most relevant competitive benchmark position
(e.g., finance executive who oversees legal and human resources vs. a finance executive without additional responsibilities)

- Executives may have long or short tenure in the role
- Executive may be a consistently high performer over a long period of time in the role
- Position may be viewed as more or less important within your organization than in the broader market
- Specific retention concerns

A Compensation Committee can tie its hands and limit its ability to exercise judgment if the target pay positioning statement is too rigid or is applied dogmatically. It should be viewed as a guideline, rather than a hard and fast rule. As Gary Heminger stated, “Don’t be so prescriptive that there is no flexibility, give yourself an opportunity to adjust up or down” for specific circumstances that may not fit into a dogmatic approach to median pay positioning.

**Key Questions for Committee Members to Ask:**

- Do we position pay at market median? If not, what is our rationale for the current approach?
- Has our target pay positioning been the basis for external criticism? Do our critics have a point?
- Does our company conform to our target pay positioning on average or are we systematically high or low relative to what we target? If we are high or low, should we rethink our target pay positioning?
- Where individual executive’s pay differs from the target, are we comfortable with the rationale?

**Definition of the Competitive Market**

Closely related to the target pay positioning statement is the definition of the competitive market. The target pay positioning statement provides a
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guideline on where to position pay relative to the market, but the definition of the competitive market is needed to determine just what the company views as its market for executive talent.

The most important input in determining the competitive market is identifying the type of companies with which your organization competes for executive talent. Which kind of firms do you go to when you are looking to recruit executive talent? What firms do you tend to lose executives to when they decide to leave? For most roles, this will likely lead you to a list of firms within your industry or in related industries.

For executive roles, it is important to think of firms with comparable scale to your own firm. While Radio Shack may try to recruit retail management from Apple, it is not appropriate to compare compensation levels for senior executives across two organizations with such different scale. The most commonly used measure of scale is revenue. Within a particular industry, revenue is a good indicator of scale, however, across industries, profitability and/or market capitalization should be considered as well. For a very low margin business (e.g., a retailer or a wholesaler), revenue may overstate the scale and complexity of executive roles. We will address the definition of the competitive market in more detail when discussing peer groups in Chapter 10.

Key Questions for Committee Members to Ask:

- Are these companies comparable to us in terms of size (e.g., revenue, assets, profits, market capitalization)?

- Are there criteria that are critical other than size (e.g., global, branded, etc.)

- Do we lose talent to these firms/attract talent from them?

- Is there anything about the makeup of our competitive market that may skew the pay data to be high or low?
Pay Mix

Relatively few companies make an explicit statement about the precise percentage of pay expected to be delivered as salary, annual incentive and long-term incentives. However, almost all public companies will state that variable, at-risk pay (i.e., annual incentives and long-term incentives) will be the majority of pay for senior executives and will represent a higher portion of total pay for the CEO and the most senior executives than for other employees.

For the CEO, a market median target pay positioning for each pay element (salary, annual incentive and long-term incentives) will typically result in a pay mix that results in more than 50% of total direct compensation delivered in the form of long-term incentives. In fact, for CEOs of large companies, the typical pay mix is close to 15% base salary, 20% annual incentive and 65% long-term incentives. Within the market, the mix of pay elements will vary, depending on the perceived importance of near-term and long-term performance and the goals of the company.

Beyond the target pay mix across different elements of pay, the company may have a philosophy about the mix between cash compensation and equity-based compensation. While most public companies deliver 100% of their long-term incentive compensation in the form of equity-based compensation, other companies either denominate or settle a portion of their long-term incentives in the form of cash to address executive concerns
about liquidity and exposure to stock price volatility (i.e., emphasizing the objective of attraction and retention of executives over alignment with shareholders).

Of a high degree of interest to shareholder advisory groups is the mix between performance and non-performance-based pay. For example, Institutional Shareholder Services (ISS) will tend to view salary, time-vested restricted stock and time-vested stock options as non-performance based pay. They will only view annual bonus plans, or performance plans with explicit performance criteria required to vest in awards as performance-based pay. Many companies will address this by indicating which elements of the compensation program the Compensation Committee views as performance-based. In many cases, Compensation Committees view stock options as inherently performance-based, as the stock price has to increase for the options to have any value.

**Key Questions for Committee Members to Ask:**

- How does our pay mix compare to market?
- To the extent it does vary from market, is the variance consistent with our compensation philosophy (e.g., more/less pay at risk, more/less cash)?

**Internal Equity**

Internal equity is currently a hot topic with critics of executive pay levels. Many observers have noted a significant disparity between the pay levels of the CEO and other senior executives and between the CEO and rank and file employees. As a result of concerns about pay disparities, Congress added a requirement to the Dodd-Frank legislation for companies to disclose the ratio of the pay of the median employee to the pay of the CEO.

As a practical matter, most Compensation Committees are more focused on ensuring that pay levels are competitive with the external market than they are with the relative levels of pay for employees that are fulfilling different functions within the company. It is hard for Committees to understand the relevance of comparisons between the pay levels of a CEO and a bank teller or sales manager. Each position requires fundamentally
different skills and experience and as such they are paid very differently in the labor market.

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**CEO Pay Ratio**

*Based on an initial proposal from the SEC to implement section 935(b) of the Dodd-Frank Act, companies will be required to disclose in their proxy statement the ratio of the pay of the CEO to that of the median employee of the company. While most Board members and compensation consultants view this ratio as a figure with very little relevance to compensation decision-making, certain legislators and activist investors pushed for its inclusion in the Dodd-Frank Act and worked behind the scenes to accelerate the SEC’s implementation of the rules for the required disclosure. While the stated rationale for the requirement is that the ratio may be useful information for shareholders to assess how the company pays its employees, it seems that the underlying intent for the rule is to “shame” corporate boards for paying CEOs significantly more than other employees and to place the most scrutiny on the companies with the biggest discrepancies between the pay of the CEO and the median employee. In practice, numerous factors will influence the ratio that have very little to do with how competitively a company’s employees are paid (e.g., industry, company size, nature of workforce, degree to which company outsources, geographical makeup of workforce, percentage of part-time employees, etc.). As a result, the CEO pay ratio will be hard to interpret.*

*Unfortunately, the CEO pay ratio will also be challenging to calculate as most companies have a limited capability to identify the pay levels for the median employee, particularly companies that operate in multiple countries. The table below provides a summary of the key provisions of the proposed rules.*
Summary of Requirements

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<tr>
<th>Area</th>
<th>Requirements</th>
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<tbody>
<tr>
<td>Employees Included</td>
<td>All employees (includes part-time, temporary, non-U.S., etc.) employed at fiscal year end</td>
</tr>
<tr>
<td>Definition of Compensation Used to Identify Median Employee</td>
<td>Companies have discretion to determine an approach as long as it is a reasonable estimation of annual total compensation, as it would appear in the Summary Compensation Table (e.g., W-2 earnings, salary plus bonus, salary plus bonus plus long-term incentives, etc.)</td>
</tr>
<tr>
<td>Method for Calculating Median</td>
<td>Companies can use the total population or representative statistical sampling of the employee population</td>
</tr>
<tr>
<td>Annualized Compensation</td>
<td>Companies can annualize pay for full-time workers who are employed for only part of the year, but cannot annualize pay for seasonal, part-time or temporary workers</td>
</tr>
<tr>
<td>Definition of Compensation for Ratio</td>
<td>Summary Compensation Table definition (includes salary, bonus, equity awards, non-equity incentive compensation, change in pension value and all other compensation)</td>
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Where Compensation Committees do (and should) pay more attention to internal equity is among members of the senior executive team. At times, positions within your company may be challenging to benchmark externally because of differences in your organizational structure from what is typical in the broader market. In these cases, competitive data may be a less important input into decision-making than the relative importance of the positions to your organization. The Compensation Committee and executive management need to use their judgment to determine that certain jobs should be paid comparably even when the competitive market pay data may suggest that they should be paid differently.

A recent development is that ISS has begun to incorporate the ratio of the CEO’s pay to the pay of the next highest paid executive into the compensation quadrant of its QuickScore governance tool. While the results of this
tool do not factor directly into ISS’ vote recommendation on a company’s Say on Pay Proposal, the results include an indicator of concern about the compensation program. Shareholder advisors and some institutional shareholders view a high ratio between the CEO’s pay and the pay of the next highest paid executive as a potential indicator that the company may have challenges in CEO succession, as the high difference in pay levels may signal that there is not a strong successor in place.

**Key Questions for Committee Members to Ask:**

- *Is the ratio between our CEO’s pay and other senior executives (e.g., the CFO) comparable to the ratio in the competitive market? If not, why?*

- *Are the direct reports to the CEO paid at similar levels? If not, why (e.g., differences in market data, differences in responsibilities)?*

- *Are executives with comparable responsibilities (e.g., business unit leaders) paid at similar levels? If not, why (e.g., differences in scope of business unit, additional responsibilities)?*

**Pay-for-Performance**

Much like beauty, pay-for-performance is in the eye of the beholder. Depending on how performance is defined, how pay is defined, what is used as the basis for comparison and what time period is examined, people can arrive at very different conclusions about the nature of the pay-for-performance relationship. In the current environment, getting the pay-for-performance relationship “right” is the most important aspect of the pay philosophy and one of the most challenging areas of compensation design.

In terms of pay philosophy, most companies will simply state that they intend to have pay levels move with the performance of the company (i.e., higher pay levels when performance is strong, lower pay levels when performance is weak). Some companies will take this approach a step further and add in a component of relative performance (e.g., state that they expect pay levels to be in the bottom quartile when performance is in the bottom quartile and for pay levels to be in the top quartile when performance is in the top quartile). Most of the challenges related to mainte-
nance of the pay-for-performance relationship come in its implementation, rather than in the philosophy statement.

**Key Questions for Committee Members to Ask:**

- Have we committed to a pay-for-performance approach in our compensation philosophy?

- Do we define performance on an absolute or relative basis or some combination?

- Can we demonstrate that we are complying with our compensation philosophy in how we set performance goals and determine actual pay levels?
Chapter 10. Peer Groups

Building off of the definition of the competitive market in the compensation philosophy, most Compensation Committees use a peer group to benchmark pay and/or performance levels for the most senior executives in the company (CEO, CFO and three highest-paid executive officers other than the CEO and CFO). The peer group that the company selects is intended to reflect the competitors for talent for senior executive roles, and also considers who the company competes with for customers and capital.

Most companies select peer companies based on comparability in terms of industry and/or other business characteristics, along with business scope:

- **Industry Comparability**: Operate in the same industry narrowly defined (e.g., auto manufacturing) or more broadly defined (e.g., durable goods manufacturing). Global Industry Classification (GIC) codes and Standard Industrial Classification (SIC) codes are frequently used to help companies screen for peer companies.

- **Business Characteristics**: When a company is challenged in finding peers that are direct industry peers, or in a highly concentrated industry, they may expand the search to companies that share key business characteristics (e.g., consumer goods companies, global companies, professional service firms, asset intensive businesses, highly cyclical or sensitive to commodity prices, highly regulated, etc.).

- **Company Scale**: Peer companies are typically targeted to be similar to the company in size at median. A common rule of thumb is to look at companies with revenue from 0.5x to 2.0x the company in terms of revenue (or assets for financial services companies). Companies may expand beyond this size range to include peers that are viewed as particularly important competitors for talent. Alternative and/or secondary criteria may also be used (e.g., market cap, profit margin) to supplement revenue.
The peer group is important in that it serves as the basis for establishing target executive compensation levels and also can be used as way to test the pay and performance relationship. If a company is going to get the pay and performance relationship calibrated correctly, it is ideal to use a single peer group for pay and performance comparisons. That way, the company can demonstrate that the percentile positioning of its compensation levels is aligned with the percentile positioning of its performance. A key challenge is that sometimes the companies that are relevant for pay comparisons may be less relevant for performance comparisons. In cases where the use of multiple peer groups is required, the rationale for the use of more than one peer group and how each peer group is used should be clearly disclosed in the company’s CD&A.

Companies are often criticized for “gaming” the makeup of their peer group to try to increase target pay levels. These criticisms are largely based on companies including much larger companies in terms of revenue or market cap in the peer group. At times, this criticism is well founded. Pay levels systematically increase with company size. When developing a peer group, a key principal to keep in mind is that the median revenue among the peer group should be close to the revenue level of the company.

For companies that target pay levels above median, it can also be important that the range of size among the peers not be too large, as inclusion of peers that are larger than 2x the size of the company may have a limited impact on the median revenue and median compensation levels among the peer group (particularly if the peer group also includes some companies that are significantly smaller than the company), but may have a significant impact on the 75th percentile compensation levels.

Many times management will feel that there are significantly larger companies in the industry (e.g., > 3x the company’s revenue) that should be included in the peer group as they may be a source of talent for the company or may potentially recruit the company’s talent away. In many cases, it may be appropriate to use these companies for purposes of assessing pay practices, but it can be problematic to use them to benchmark compensation levels (though in isolated cases/industries there may not be a
better alternative). While it is reasonable to be aware of the compensation practices of larger companies, including them in the calculation of summary statistics can skew the findings and will potentially make the company a target for external critics.

Another important perspective to understand on peer groups is that the two largest and most influential shareholder advisory firms (ISS and Glass-Lewis) each have their own approaches to defining peer groups for your company. They will use the peer groups that they develop to conduct their own assessments of the competitiveness of your company’s pay levels and the alignment of the CEO’s pay levels with the company’s performance on an absolute and relative basis.

ISS peer group development continues to evolve from year to year and their current approach uses the company’s self-defined peer group as a key input into their selection criteria. They tend to take a strict approach to excluding any companies from the peer group that are < 0.4x the revenue (or assets for financial services companies) of the company or more than 2.5x the revenue (or assets) of the company. ISS will select a peer group that contains at least 12 companies (though a typical minimum is 14) up to a maximum of 24 companies.

Glass-Lewis’s peer group methodology depends on the social networking theory. They use a scoring methodology to identify which companies use the target company as a peer and how many of the peers use one another as peers. The companies identified as having the most and strongest connections to the client are selected as the peers.

ISS and Glass-Lewis’ peer groups will each overlap with your company’s self-identified peer group to some degree, but there likely will be differences. It is helpful to know the degree of difference to assist in anticipating where ISS and Glass-Lewis may identify misalignments between pay and performance based on differences in the peer groups used.
Below is an illustration on developing a peer group:

**Peer Group Selection**

- 10,000+ Companies
- ~ 600 Cos.
- 50 Cos.
- 15 Cos.

**Selection Criteria**

- Public Companies
- Industry Relevant
- 0.5x – 2.0x Client Revenues
- Business Mix

**Key Questions for Committee Members to Ask**

- *Is our peer group comparable to us in terms of size based on revenue? Is the answer substantively different for other measures of size (e.g., market cap, net income, EBITDA)?*

- *Is the range in size among our peers wide or narrow (e.g., what is the difference in the median and 75th percentile revenue)?*

- *Are there any large or small peers that may be skewing the competitive findings? If so, how can we address this issue?*

- *Are all of the peers equally relevant for financial performance comparisons? Would it be helpful to look at a subset of our most direct competitors for financial performance comparisons?*

- *What is the degree of overlap between our self-defined peer group and the peer groups used by ISS and Glass-Lewis?*
Chapter 11. Annual Incentive Design

Annual incentive (or bonus) design is a complicated topic that could easily serve as the basis for an entire book on its own. For our purposes, we will focus on the information that is needed to ask informative questions about the annual incentive design to help ensure it does not raise any major concerns. Our discussion focuses on the incentive plan primarily as it relates to the most senior executives in the company.

Target Annual Incentive Opportunity

Most annual incentive plans will have a target annual incentive opportunity assigned to each executive (or employee) participating in the plan. The target amount is expected to be earned if the company achieves its objectives at the planned level of performance and/or the individual meets his objectives at the expected level of performance. The target annual incentive opportunity is most often defined relative to base salary (e.g., 50% of base salary), though in some circumstances it is set as a dollar amount (e.g., $50,000).

As discussed under the compensation philosophy, annual incentive target opportunities are often established with reference to the market median (e.g., the market median annual incentive opportunity for a comparable role or the amount of annual incentive required to result in market median target total cash compensation). It is typical that the target annual incentive opportunity as a percent of base salary will be highest for the most senior executives with the greatest ability to impact overall financial results of the company. The table below provides an illustrative scale for annual incentive opportunities:

<table>
<thead>
<tr>
<th>Executive Level</th>
<th>Base Salary</th>
<th>Incentive % of Base Salary</th>
<th>Annual Incentive $</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO</td>
<td>$1,000,000</td>
<td>100%</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>COO</td>
<td>$600,000</td>
<td>80%</td>
<td>$480,000</td>
</tr>
<tr>
<td>EVP</td>
<td>$450,000</td>
<td>70%</td>
<td>$315,000</td>
</tr>
</tbody>
</table>
### Executive Level Base Salary

<table>
<thead>
<tr>
<th>Executive Level</th>
<th>Base Salary</th>
<th>Incentive % of Base Salary</th>
<th>Annual Incentive $</th>
</tr>
</thead>
<tbody>
<tr>
<td>SVP</td>
<td>$300,000</td>
<td>60%</td>
<td>$180,000</td>
</tr>
<tr>
<td>VP</td>
<td>$200,000</td>
<td>40%</td>
<td>$80,000</td>
</tr>
</tbody>
</table>

It is critical to understand that target annual incentives represent an opportunity to be earned, assuming a given level of performance, but that the actual payout is expected to vary from target based on performance outcomes.

A minority of companies (approximately 10% of the CAP 100) have purely discretionary annual incentive designs without the concept of an annual incentive target. This structure is most common in financial services firms. In this context, companies and employees tend to look back at historical average incentive payouts as the basis for establishing expectations about the bonus opportunity.

**Key Questions for Committee Members:**

- How do our annual incentive opportunities compare to market?

- If our annual incentive opportunities are significantly above/below market, are our performance goals demonstrably more difficult/less difficult than those of other companies?

- In the absence of target annual incentive opportunities, how do our employees gauge how their performance will translate into compensation outcomes?

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1 Compensation Advisory Partners (“CAP”) reviewed proxy disclosures for a 100 company subset of the Fortune 500 representing a cross-section of nine industry groups. The industry groups included: Automotive, Consumer Goods, Financial Services, Health Care, Insurance, Manufacturing, Pharmaceutical, Retail, and Technology.
Annual Incentive Payout Range

The annual incentive payout range is the range of potential payouts that an executive (or employee) can receive based on performance. The most common structure is as follows:

- **Threshold Payout: 25% - 50% of target annual incentive opportunity**

Maximum Payout: 150% - 200% of target annual incentive opportunity

<table>
<thead>
<tr>
<th>Threshold Payout as a % of Target</th>
<th>% of Cos.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Range</td>
<td></td>
</tr>
<tr>
<td>&lt; 25%</td>
<td>27%</td>
</tr>
<tr>
<td>25% &lt; 50%</td>
<td>27%</td>
</tr>
<tr>
<td>50%</td>
<td>32%</td>
</tr>
<tr>
<td>50% &lt; 75%</td>
<td>3%</td>
</tr>
<tr>
<td>75 &lt;100%</td>
<td>11%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Maximum Payout as a % of Target</th>
<th>% of Cos.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Range</td>
<td></td>
</tr>
<tr>
<td>100% &lt; 150%</td>
<td>2%</td>
</tr>
<tr>
<td>150% &lt; 200%</td>
<td>21%</td>
</tr>
<tr>
<td>200%</td>
<td>58%</td>
</tr>
<tr>
<td>200% &lt; 250%</td>
<td>3%</td>
</tr>
<tr>
<td>&gt; 250%</td>
<td>17%</td>
</tr>
</tbody>
</table>

The threshold payout level is established to indicate that below a certain level of performance, no incentive payout is warranted. While a minority of companies initiate bonus payouts at 0% of target, many companies have a threshold payout of 25% - 50% of target to ensure that the incentive paid is a meaningful amount of money.

Companies have annual incentive maximum amounts to help manage the overall cost of the incentive program, limit the risk of a windfall annual incentive payout due to unanticipated events and to limit the possibility that executives will take on inappropriate risks in order to earn out-sized payments in a given year.
Key Questions for Committee Members to Ask:

• How do our threshold and maximum payout levels compare to market norms? If they are substantively different, what is the rationale?

• Are our performance objectives at threshold and maximum appropriately calibrated to the incremental decrease or increase from the target annual incentive?

Performance Measures

Before diving into the role of performance metrics in the annual incentive plan, it is worthwhile to briefly discuss the different categories of performance measures used by companies:

• Operational/Strategic Measures: These tend to be measures of the success of the company or individuals in achieving operational improvements (e.g., fewer product defects, higher levels of customer satisfaction, less manufacturing downtime) or executing strategic initiatives (e.g., implementation of a enterprise resource management platform, completion of an acquisition/divestiture, new product launch, etc.)

• Financial Measures: Includes measures of top-line (e.g., revenue growth) and bottom-line growth (earnings per share growth), profitability (e.g., operating margin), financial returns (e.g., return on equity, return on capital), cash flow or economic profit

• Stock Price Measures: Includes stock price appreciation or total shareholder return

If we think of these measures along a spectrum, the achievement of operational/strategic measures is expected to lead to improved financial performance which will in-turn lead to improved stock price performance. For annual incentive plans, most companies use financial measures as the basis for corporate and/or business unit performance measures and operational/strategic measures as the basis for individual performance measurement (where used).
Annual Incentive Plan - Corporate Performance Metrics

<table>
<thead>
<tr>
<th>Metric</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>EPS</td>
<td>33%</td>
</tr>
<tr>
<td>Other Profit Metrics*</td>
<td>33%</td>
</tr>
<tr>
<td>Revenue</td>
<td>32%</td>
</tr>
<tr>
<td>Cash Flow</td>
<td>24%</td>
</tr>
<tr>
<td>Op Income</td>
<td>23%</td>
</tr>
<tr>
<td>Return Metrics**</td>
<td>16%</td>
</tr>
<tr>
<td>Industry Specific</td>
<td>9%</td>
</tr>
<tr>
<td>Strategic</td>
<td>8%</td>
</tr>
</tbody>
</table>

* Other Profit Metrics include EBIT/EBITDA, Economic Profit/EVA, Net Income, and Pre-tax income.

** Return Metrics include Return on Invested Capital, Return on Equity and Return on Assets.

*Source: CAP 100*

Why don’t companies use stock price measures in the annual incentive plan? While stock price measures are great for aligning executives with shareholder interests, they do not send a clear message to executives or other employees about what the company needs to achieve on an operational or a financial measure to deliver results. Also, an annual performance period is difficult for setting a stock price objective and assessing performance, as market volatility may have a larger impact on the company’s stock price performance over a single year than the results that management achieves.

While stock price and/or total shareholder return are seldom used in annual incentive plans, it should be noted that many external critics of executive compensation are frustrated when annual incentive payouts do not decrease significantly in periods where the company’s stock price falls or significantly lags the broader market. It is important to keep in mind that
the annual incentive is only one part of the executive compensation program and there are other long-term elements of the pay program that will be much more sensitive to the stock price performance of the company.

Financial measures are used as the basis for assessing corporate and business unit performance because they are results-oriented metrics that over the long-term should lead to increases in shareholder value. They are also measures that management can influence more directly over an annual period than stock price. Management knows that they can increase return on capital by increasing revenue, decreasing costs or reducing the amount of capital in the organization. It is challenging to identify how specific decisions or actions they take will move the stock price within the course of a year.

Operational and strategic measures are less likely to be used at the corporate level for a couple of reasons. Often, success or failure on these measures is not necessarily a shared responsibility across all executives, but may only be within the span of control of a subset of executives. In addition, corporate and business unit financial measures tend to be used as the basis for funding incentives and operational and strategic measures may be used only for allocating incentives among different individuals in the plan. In a sense, financial metrics are self-funding in that the incremental dollars of profitability fund incremental incentive payments. With operational and strategic measures, there is no guarantee that they will result in an improvement in financial results, let alone an increase in stock price. As a result, most companies are reluctant to base substantial amounts of annual incentive funds on the achievement of operational or strategic measures, without the anticipated return.

With that as background, it is expected that the Company will select performance measures for the annual incentive plan that will translate into increased shareholder value over time. It is often the case that the Committee wants to ensure that the performance measurement framework sends balanced messages to management about what performance is important. For example, if only a return measure is used, there may be an excessive focus on cost and capital reduction as the way to improve performance at the expense of top-line growth. As a result, many companies
that use a return measure in their annual incentive plans, use a revenue growth or earnings growth measure as well to help reduce the risk that returns are improved at the expense of growth. Ultimately, the measures selected should be linked into the company’s business strategy and how value is created in the business.

Practical considerations also factor into the selection of performance measures for an annual incentive plan. In our experience, using more than three or four measures in the annual incentive can dilute the message about what performance is most important. A performance plan with ten performance measures will have an average weighting for each measure of 10% of the overall annual incentive. While this approach may give an executive a clear checklist of performance requirements, it does not prioritize the key results that will be most important from an investor’s perspective. By concentrating on a few key measures, the executive has some leeway in determining how to achieve the result and can focus on the activities that he/she feels will be most critical to improving results.

Another practicality that factors into the annual incentive design is whether or not the measure fits the specific organization. A measure like Economic Profit has a strong theoretical basis and advocates for the measure will say that it is highly correlated with shareholder value creation over the long term. For most mature businesses, economic profit is a theoretically sound measure of business economics. However, economic profit is a complex measure to communicate and understand. Beyond that, many aspects of achieving an economic profit result (e.g., capital allocation, capital structure) may be out of the control of most annual incentive plan participants. It may also be challenging to measure something like economic profit at the business unit level, particularly if some physical capital is shared by different parts of the business. Similar arguments frequently apply to return measures like return on assets or return on invested capital.

To use certain measures, an organization needs to be committed to training and confident in the financial knowledge of their employees. If the typical manager only impacts invested capital through working capital, then using a working capital measure like working capital turnover in combina-
tion with operating profit may be better than explicitly measuring economic profit. The diagram below outlines some key questions to keep in mind when considering alternative performance measures.

![Performance Metric Diagram]

It should also be noted that the financial performance measures used for purposes of annual incentive plan calculations may vary from GAAP measures disclosed in the company’s financial statements. The reason for these adjustments is that there may be items that impact the financial statements that were either not anticipated in the budgeted numbers used in the annual incentive plan or are viewed as one-time items outside of the usual operations of the company. Below is a list of common adjustments made to financial measures (e.g., EPS, Free Cash Flow, Return on Net Assets) in annual incentive plans:

- Any changes in accounting standards or treatments that may be required or permitted by the Financial Accounting Standards Board and
the Securities and Exchange Commission, or adopted by the Company after the goal is established;

- Effect of changes in laws, regulations or tax rules and treatments;

- The gain or loss from the sale or discontinuance of a business segment, division or unit and the budgeted, unrealized operating income for this business segment, division or unit;

- Restructuring and severance costs pursuant to a plan approved by the Board of Directors and/or CEO;

- Gains or losses from litigation or claims, natural disasters and terrorism and fraud or potential fraud investigations;

- Results from an acquired business and costs related to the acquisition including earn-out payments, interest expense and the EPS impact from the issuance of stock related to the acquisition;

- Extraordinary items as defined by GAAP or non-recurring items;

- Effect of changes in foreign currency exchange rates from the rates assumed in the budget;

- Write down or impairments of assets that exceed $__________;

- Termination or loss of license, lease or long-term contracts;

- Stock based compensation costs to the extent not included in the budget;

- The EPS impact of unbudgeted share repurchases and other changes in the number of outstanding shares, and the corresponding impact those repurchases and changes have on interest expense;

- Unplanned capital expenditures that exceed $__________ in expense;

- Unplanned or out-of-period charges or credits.
Deciding on what exclusions should be made for purposes of determining annual incentive performance is frequently a contentious area. Companies are frequently criticized for excluding items that adversely impact performance while not backing out positive impacts. In our experience, the best approach is to agree in principle up-front to the type of items that will be excluded from the calculation of the measure, with the intention of making similar adjustments for both negative impacts (e.g., restructuring costs, asset write-down) and positive impacts (e.g., gains on sale, legal settlement). In any case, the Committee should reserve the right to apply negative discretion in the event that they feel management should be held accountable for an item that might otherwise be excluded from the calculation.

**Key Questions for Committee Members to Ask:**

- Are the performance measures appropriate for measurement over a one-year time period or is it better measured over the mid-term/long-term?

- Do the performance measures used in the annual incentive plan provide us with a basis for assessing how well we are doing in achieving our business strategy? Will they potentially distract executives from achieving the strategy?

- Do the performance measures emphasize certain aspects of the strategy at the expense of others (e.g., encourage inventory turnover at the expense of increased revenue)?

- Are these measures long-term drivers of improvement in the stock price or correlated with stock price movement over time?

- Are our financial measures calculated on a GAAP basis? If not, what are the adjustments from GAAP accounting and why do we make them?

- Do the metrics in the annual incentive plan complement the performance focus in the long-term incentive plan?
Performance Goals

Selecting the right performance measures provides executives with a message on what aspects of performance are most critical. The performance goals let executives know what level of performance is expected. Most companies will establish a target level of performance that will correspond to a target annual incentive payout. As a result, for appropriate pay-for-performance calibration, it is critical that the target level of performance be set at the expected level of performance (i.e., about a 50% chance of achieving above that level and a 50% chance of achieving below that level).

The overwhelming majority of companies set their annual incentive performance objectives based on the company’s business plan. As a result, the degree of rigor in establishing the business objectives will have a strong impact on the company’s pay-for-performance relationship. If the company sets an aggressive plan that is unlikely to be achieved, it is likely that they will underpay relative to performance. If the company sets a relatively conservative plan, with a high probability of achievement, it is likely that they will overpay relative to performance.

A key challenge in goal-setting is that the company is trying to predict the future and there is often a great deal of uncertainty around financial projections, including macroeconomic factors, changes in the prices of the factors of production, regulatory decisions, etc. As such, it is challenging to assess the accuracy of plan goals at the time they are set. Companies that take goal-setting seriously should assess the plan goals from multiple perspectives (e.g., the company’s past performance on the measure, industry peers past performance on the measure, analyst expectations for the company and its peers) to test the difficulty of the plan. If the plan departs from historical performance and analyst expectations, there may be reason for concern that the goals are not well calibrated.

A minority of companies avoid the goal-setting question by assessing annual performance on a relative basis vs. peers. Few companies go this route because of three challenges:
a. **Data Availability:** Due to the timing of public disclosures of financial performance information, it is challenging to calculate relative performance in the time-frame required.

b. **Performance Comparability:** Comparing financial performance across companies is challenging. Growth measures (e.g., EPS growth) can be problematic due to scale issues (e.g., a $0.05 increase in EPS for one company may represent a 5% increase while it represents a 100% increase for a company coming off a poor base year). Even return measures like ROIC have challenges as companies may want to adjust for differences in capital structure, goodwill or non-operating items.

c. **Peer Relevance:** It may be challenging to identify a group of companies that are comparable in terms of business model and relevant for financial performance comparisons.

Under today’s disclosure requirements, companies are expected to disclose their annual incentive performance goals and actual performance results in the proxy statement’s Compensation Discussion & Analysis (CD&A) as part of their explanation of how the annual incentive payouts for the fiscal year were determined. Directors should anticipate external criticism from shareholder advisory groups if the performance objectives do not appear to be robust (e.g., decline relative to goals or actual performance from the prior year, significantly lag competitor performance levels) or the performance goals are achieved, but the company’s TSR or financial performance was weak on a relative basis.
Key Questions for Committee Members to Ask:

- How do the performance goals compare to last year’s performance? If they are not an improvement over the prior year, why is performance expected to decline?

- How do the performance goals compare to analyst expectations? If there is significant variance from analyst expectations, what is the reason?

- How confident is the company in achieving its business plan? Does the company have a history of meeting its business plan and lagging peer performance levels or missing its business plan, but exceeding peer performance levels?

- If relative performance goals are used, are the financial comparisons being done on an “apples-to-apples” basis? Are all of the peers equally relevant for performance comparisons?
Internal Revenue Code Section 162(m)

*In 1992, the Internal Revenue Code 162(m) was enacted. The intended purpose of the law was to not allow companies to take a tax deduction on any compensation above $1M made to the four highest paid executive officers (excluding the CFO) that was not performance-based. In order to qualify as performance-based under 162(m), compensation needs to meet several requirements:*

- Compensation is paid solely on account of the attainment of one or more pre-established, objective performance goals
  - Pre-established means established in writing by the Compensation Committee no later than 90 days after the performance period start, assuming the outcome is uncertain
  - Objective means that a third party with knowledge of the facts could determine whether the goal is met
- Performance goal must state, in terms of an objective formula or standard, the method of computing the payment if the goal is achieved
- Discretion can only be applied to reduce, and not increase, compensation payable for performance goals
- Performance goals are determined by a compensation committee of the board of directors comprised solely of 2 or more outside directors
- Material terms of the performance goal must be disclosed and approved by shareholders before payment
- The compensation committee certifies that the performance goals and any other material terms were satisfied before payment*
While the number of requirements described above may lead you to believe that 162(m) compliance is difficult to achieve, as a practical matter, compliance can be achieved relatively simply. Many companies adopt what is referred to as an “umbrella pool” incentive structure where they set up a 162(m) compliant incentive formula that will fund an amount expected to be greater than the maximum award to the individual (e.g., 1% of earnings is expected to fund $5 million, but the executive’s bonus maximum is $2 million). The Committee can then apply negative discretion to the funded amount to arrive at the bonus they want to pay to the executive officer. For long-term incentive compensation, stock options are generally going to be treated as performance-based under 162(m) so long as they are made subject to a shareholder approved plan. Restricted stock units are not performance-based unless vesting is subject to the achievement of 162(m) compliant performance criteria. From your perspective as a Committee member, the key question related to 162(m) to be asking for any incentive arrangement is: “are we able to maintain tax deductibility of the award?” If the answer is no, the Committee should receive an explanation of why the company decided to not maintain the tax deduction.

Performance Ranges

Most companies have a performance range around target that is used as the basis for determining the actual incentive payout relative to the target annual incentive payout. In the typical structure, a threshold performance level and a maximum or superior performance level are established that correspond to the threshold incentive payout and the maximum incentive payout. The table and chart below describe the typical structure:

- **Wide Performance Range**: 80% - 120% of planned performance level
- **Narrow Performance Range**: 90% - 110% of planned performance level
For performance measures where a relatively low level of variability is anticipated (e.g., top-line revenue), the threshold performance level should likely be set relatively close to the target performance level (e.g., 97.5% of plan) and maximum will be close to target as well (e.g., 102.5% of plan). For performance measures that are expected to be more variable from year to year or in more volatile businesses, a much wider performance range could be used (e.g., threshold at 70% of plan, maximum at 130% of plan).

A rule of thumb for establishing performance ranges is that the threshold level of performance should be set so that the company expects to achieve it 80%-90% or of the time and the maximum (or superior) performance level should be achieved 10% - 20% of the time. It should be noted that these probabilities are in themselves just the company’s best guess at the range of outcomes. To the extent possible, analyses of the historical variability of the company’s own and peers’ performance on the measure can be used to as an input in determining the performance range.

It is common to expect a symmetric performance range above and below target. This makes sense if the variability in performance is similar above or below the planned level of performance. If the performance range is
not symmetric, management should provide a sensitivity analysis to the Committee explaining why the asymmetry makes sense. As a Committee member, you should be skeptical if the performance range is wide between the threshold performance level and target performance level and is narrow between the target performance level and maximum/superior performance level, particularly if there is significant upside opportunity in the payout.

**Key Questions for Committee Members to Ask:**

- *How variable has the company’s performance been over time? Out of the past ten years, how many times has performance come out above the maximum level, below the threshold level?*

- *If performance falls below the threshold level, will the company still need to pay annual incentives at some level to retain key employees? If so, would it be better to have a wider payout range?*

- *Is there anything about the current environment indicating the future performance may be more or less variable than historical performance?*
Chapter 12. Long-term Incentive Design

If annual incentive design could serve as the basis for a book of its own, then long-term incentive design could be a multi-volume set. Long-term incentive design raises complicated questions about accounting, tax treatment, shareholder approval, plan administration and governance. Fortunately, Compensation Committees have the management team and external advisors to help in addressing the technical aspects of long-term incentive design. For our discussion of the topic, we will provide a brief overview of the different vehicles and how they address the company’s compensation objectives, with only brief forays into the more technical aspects of long-term incentive design.

Long-term Incentive Opportunity

Most companies have an overall target compensation structure composed of base salary, target annual incentive and an annual grant value of long-term incentives. As the base salary and annual incentive are generally denominated in cash, it is straightforward to put a monetary value on them. For simplicity, most companies will also establish a dollar value for long-term incentives, often equal to a multiple of base salary (e.g., 150% of base salary) or a dollar amount (e.g., $500,000).

Similar to annual incentive opportunities, long-term incentives are often tiered by executive level, with the most senior executives having the highest percentage of their total pay in the form of long-term incentives.

<table>
<thead>
<tr>
<th>Executive Level</th>
<th>Base Salary</th>
<th>LTI % of Base Salary</th>
<th>LTI $</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO</td>
<td>$1,000,000</td>
<td>350%</td>
<td>$3,500,000</td>
</tr>
<tr>
<td>COO</td>
<td>$600,000</td>
<td>200%</td>
<td>$1,200,000</td>
</tr>
<tr>
<td>EVP</td>
<td>$450,000</td>
<td>150%</td>
<td>$675,000</td>
</tr>
<tr>
<td>SVP</td>
<td>$300,000</td>
<td>100%</td>
<td>$300,000</td>
</tr>
<tr>
<td>VP</td>
<td>$200,000</td>
<td>50%</td>
<td>$100,000</td>
</tr>
</tbody>
</table>
Long-term Incentive Mix

Among public companies, there are three long-term incentive vehicle categories that are in wide use:

- **Stock Options or Stock Appreciation Rights (SARs):** Provides value to executives based on appreciation in the stock price, subject to vesting criteria

- **Restricted Stock or Restricted Stock Units (RSUs):** Provides executives with the full-value of a company share, subject to vesting criteria

- **Performance Plans:** Function like an annual incentive plan, but with actual performance measured and/or award vested over a multi-year period of time
  - **Performance Shares:** Target opportunity denominated in shares
  - **Performance Cash/Units:** Target opportunity denominated as a cash value or units with a value established independent of the stock price

Most of the CAP 100 use at least two of the above vehicles, with 30% using all three of the vehicles.

Prevalence of Typical LTI Vehicles Granted to Executives
The average mix among the three vehicles is as follows among CAP 100 companies:

![Executive LTI Mix](image)

While use of stock options and performance shares are commonly used for senior executives, lower level executives and individual contributors are more likely to receive a higher portion of their LTI in the form of time-based restricted stock.

<table>
<thead>
<tr>
<th>Employee Level</th>
<th>Performance-based LTI</th>
<th>Stock Options</th>
<th>Time-based Restricted Stock/Units</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executive Officers</td>
<td>53%</td>
<td>28%</td>
<td>19%</td>
</tr>
<tr>
<td>SVP</td>
<td>35%</td>
<td>30%</td>
<td>35%</td>
</tr>
<tr>
<td>VP</td>
<td>25%</td>
<td>30%</td>
<td>45%</td>
</tr>
<tr>
<td>Sr. Director</td>
<td>10%</td>
<td>25%</td>
<td>65%</td>
</tr>
<tr>
<td>Director / Manager</td>
<td>0%</td>
<td>20%</td>
<td>80%</td>
</tr>
</tbody>
</table>

Source: CAP 100 and CAP Proprietary survey of general industry companies
Determining the Number of Shares to Grant

To determine how many stock options, restricted shares/RSUs, or performance shares to grant to employees, the target LTI opportunity is typically first divided into component parts. For example, an executive with a $1,000,000 annual LTI target opportunity and a vehicle mix of 25% stock options, 25% time-vested RSUs, and 50% performance shares would expect to receive a grant value of $250,000 in stock options, $250,000 in time-vested RSUs and $500,000 in performance shares. The executive’s target long-term incentive values then need to be converted into a number of shares for each of the vehicles.

Stock options are usually assigned a dollar value per option based on an option valuation model (e.g., Black-Scholes or binomial). This amount is typically thought of as a percent of the current market price of the stock, as an option value will always be less than a price of a share of company stock. Since the company has to account for stock options in its income statement, most companies have moved to use the accounting value of stock options as used for disclosure purposes in converting target option values into the number of options to grant. For example, if the company’s stock price on the date of an option grant was $20, a representative stock option Black-Scholes value could be $5.00 (or 25% of the stock price value on the date of grant). In order to provide $250,000 in stock option value, the company would need to grant 50,000 stock options.

Stock Options Valuation

The Black-Scholes model was developed by Fischer Black and Myron Scholes and applied to stock options by Robert C. Merton. The model allows for calculation of the value of stock option based on the following assumptions: 1) stock price on the date of grant, 2) stock option exercise price, 3) risk-free interest rate, 4) stock price volatility, 5) option term and 6) dividend yield of the stock. The model was built for European Style stock options where there is no ability to exercise the option prior to expiration of the term. In many cases, the Black-
Scholes model provides an accurate estimate of the value of a stock option, though for stock options that are significantly in-the-money (i.e., the stock price is above the exercise price) or options where there is a high dividend yield, using a binomial option pricing model is superior, because the binomial model allows for the possibility of the exercise of a stock option before the end of the option term (American Call options). For your purposes, the key things to understand are how the different inputs impact the valuation, as laid out in the table below.

<table>
<thead>
<tr>
<th>Input Factor</th>
<th>Input Change</th>
<th>Option $ Value</th>
<th>Explanation / Theory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock Price</td>
<td>↑</td>
<td>↑</td>
<td>Higher stock price produces higher option value, since it increases the potential dollar gain for a given percentage of stock appreciation.</td>
</tr>
<tr>
<td>Exercise Price</td>
<td>↑</td>
<td>↓</td>
<td>The more one pays for the option, the lower the potential gain. If the stock price is constant, a higher exercise price creates a premium-priced option while a lower exercise price creates a discounted option.</td>
</tr>
<tr>
<td>Dividend Yield</td>
<td>↑</td>
<td>↓</td>
<td>Theory says total shareholder return (“TSR”) equals stock price appreciation plus dividends. Therefore, the higher the dividend portion of TSR, the lower the stock appreciation and the lower option value (since options typically do not pay dividends). Payment of dividends is viewed as a decrease to stock price.</td>
</tr>
</tbody>
</table>
### Impact of Inputs to Option Valuation

<table>
<thead>
<tr>
<th>Input Factor</th>
<th>Input Change</th>
<th>Option Value</th>
<th>Explanation / Theory</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock Price Volatility</td>
<td>↑</td>
<td>↑</td>
<td>Volatility measures variation in absolute movement in TSR. Since options cannot be worth less than $0, higher volatility provides more upside opportunity with no additional downside risk.</td>
</tr>
<tr>
<td>Option Term to Exercise or Expected Life</td>
<td>↑</td>
<td>↑</td>
<td>The longer the life of the option, the more time available for the stock price to increase.</td>
</tr>
<tr>
<td>Risk-Free Rate</td>
<td>↑</td>
<td>↑</td>
<td>The risk-free rate impacts the size of the “investment” necessary to pay the exercise price. The higher the interest rate, the lower the upfront cost necessary to cover the liability of the option exercise price at the end of the term.</td>
</tr>
</tbody>
</table>

The accounting value for time-vested restricted stock is determined based on the closing stock price on the date of grant. In order to provide $250,000 in value with a stock price of $20.00, the company would need to grant 12,500 shares of time-vested RSUs to an executive. To smooth out stock price volatility, companies may use an average stock price over a period of time (e.g., 10 trading days) leading up to the date of grant to determine the number of shares. In these cases, the value used to determine the number of shares to grant will not be equal to the accounting value of the shares and as a result, the value of the grant as communicated to the employee may differ from the value disclosed to shareholders.

The accounting value of performance shares or long-term cash plans will in most cases be equal to the target number of shares granted times the closing stock price on the date of grant. This means that in order to provide an executive with a target value of $500,000 at a stock price of $20.00, the company will grant the executive 25,000 shares. It should be noted that when the performance measure is based on the compa-
ny’s stock price (e.g., in a performance share plan based on relative total shareholder return), the determination of the accounting value will be more involved and will likely be different than the closing stock price on the date of grant.

**LTI Vehicles: Stock Options**

Stock options used to be the most prevalent long-term incentive vehicle and continue to be used by the majority of large companies as a long-term incentive for senior executives. Why did stock options become a prevalent form of long-term incentive? Investors viewed stock options as a way to achieve the goals of pay for performance and alignment with shareholders through a single long-term incentive vehicle. Options are inherently performance-based in that the executive can only realize value from the stock options to the extent that the stock price at the date of exercise exceeds the exercise price which is typically set to be equal to the market price on the date of grant. In other words, executives only realize gains from stock options to the extent that they increase the stock price for shareholders. Another practical advantage of stock options is that the company and the board do not need to set specific goals or in other words to attempt to predict future results. The implicit goal is to increase the stock price and the more it increases, the more value executives receive. Through the bull market of the 1990’s stock options increased in prevalence and CEO compensation levels increased dramatically. Another historical advantage of stock options is that they did not impact earnings on the income statement due to the accounting treatment for stock options at that time. As a result, stock options were a LTI vehicle that helped to align management with shareholders, pay for performance, and all at no accounting cost to the company.

Why did companies move away from stock options in the late 2000’s? Several forces combined to push companies away from stock options. The bursting of the internet bubble in the early 2000’s started the move away from stock options. While options were enormously popular in a bull market when stock prices were increasing, in a bear market, many stock options were underwater (i.e., the exercise price was well above the current market price) and provided little or no motivational value to management
to increase the stock price. The trend away from stock options was given a “push” in 2004 with the publication of accounting standard FAS123R, now ASC 718, which required that stock options be expensed on the income statement. Once stock options were put on an equal footing with other long-term incentive vehicles, it became less compelling for companies to continue to use them to such a large extent.

Following both the internet bubble and the financial crisis of 2008/2009, critics of stock options raised concerns about the asymmetrical incentives of stock options. Stock options align management and shareholders on the upside, but an executive is less sensitive to incremental declines in the stock price below the exercise price. In fact, when an option is well underwater, executives potentially have incentives to take risks with low expected returns, but high variability in results. As a result, shareholder advisory groups view a LTI program that is overly dependent on stock options as potentially putting the company at risk of losses or in extreme cases bankruptcy by encouraging executives to take on risky strategies.

While it was not a major driver of the move away from stock options, the options “backdating” scandal of the 2000’s also harmed the reputation of stock options. Many investors and other observers formed the impression that executives were using options as a tool to line their pockets rather than reward for performance.

Today, stock options continue to be used, in most cases in combination with a performance plan or time-vested RSUs. Companies are more likely to use stock options when the management team is optimistic about the future stock price appreciation, the company has difficulty establishing multi-year performance objectives, and the option cost is viewed as comparable to the perceived value of the award. Certain industries that are viewed as high growth (e.g., biotechnology, software) may be more likely to use stock options as a major component of the LTI program.

**Key Questions for Committee Members to Ask**

- Would using stock options send a signal to shareholders that the company is optimistic about the stock price?
• Do the management team and other LTI plan participants value stock options highly or do they have concerns about stock price appreciation and/or volatility?

• Are a significant number of stock options from past grants underwater?

**LTI Vehicles: Time-Vested Restricted Stock/Restricted Stock Units (RSUs)**

Time-vested restricted stock continues to be used by the majority of large public companies. It is frequently criticized as “pay for pulse” or a “giveaway”, as no performance criteria need to be achieved in order for executives to realize value from restricted stock. This is largely a valid criticism. If Compensation Committee’s only goal was to ensure that the company has a strong pay-for-performance relationship, it is hard to argue that restricted stock belongs in an executive compensation program. In fact, unlike stock options and most long-term performance plans, grants of time-vested restricted stock do not qualify for tax deductibility under IRC Section 162(m) because the IRS does not classify them as performance-based. As a result, when the restricted stock vests (or units are settled), the company will not be able to deduct the value of the restricted stock from it income to the extent that total non-performance based pay to the executive exceeds $1 million in the year of vesting/settlement. To preserve tax deductibility under 162(m), some companies have established a minimal performance-based hurdle for the vesting of what are otherwise time-based restricted stock grants. In disclosing these grants, the company may explicitly state that the performance hurdles are there to address tax deductibility concerns, rather than to bolster the pay-for-performance relationship.

Despite concerns about their efficacy from a pay-for-performance perspective, time-vested restricted stock is very effective in attracting and retaining talent and is an excellent tool for aligning management with shareholder interests. From the perspective of an executive, unvested restricted stock sends a strong signal that if you stay with the company, you will accumulate wealth. The amount of wealth will move with the stock price, but it is unlikely that it will decrease significantly unless market conditions
or company performance are very poor. Restricted stock serves as a handcuff to keep executives with the company.

From a shareholder’s perspective, restricted stock has the advantage of focusing management not just on increasing the stock price of the company, but on avoiding reductions in the stock price. This is a key difference between stock options and restricted stock; restricted stock encourages management to limit the downside risk to the company. Concerns about risk mitigation, along with a desire to attract and retain talent, can serve as the rationale for including restricted stock in the LTI program.

When companies use time-vested restricted stock, it is used in three different ways:

- **Part of Annual LTI Program:** Included as part of the annual LTI program (typically less than 1/3 of the total value provided to executives), and vesting over 3-5 years. For example, if a CEO receives $3,000,000 of LTI value each year, $1,000,000 might be provided in the form of time-vested restricted stock cliff vesting at the end of 3 years.

- **Sign-on Grant Upon Hire:** Special, one-time grant of restricted stock upon hire to help attract the executive to the company and retain the executive for a period of time. Often serves the dual purposes of making the executive “whole” for forfeited equity from a prior employer and providing the executive with an initial equity stake to encourage alignment with shareholders.

- **Special Grants of Restricted Stock:** Some companies do not include time-vested restricted stock as part of their ongoing, annual long-term incentive program. Instead, they use targeted grants of restricted stock to support the retention of executives that are viewed as at risk of being recruited away. Under this approach, restricted stock is typically an “addon” to an already market competitive compensation program and can be the basis for external criticism of the company’s pay practices if used too often.
Restricted Stock vs. Restricted Stock Units (RSUs)

Some companies use restricted stock, others use RSUs. What’s the difference and why would I use one vehicle rather than the other? Restricted stock is a grant of property, with restrictions on the vesting of the property. RSUs are a promise to deliver property at a future date in time. The key differences are that restricted stock entitles the executive to the dividends on the shares during the vesting period and the right to vote the shares during the vesting period. With RSUs, the executive does not have the right to vote the shares or receive dividends during the vesting period since no shares are issued until the date of settlement (which may be different than the vesting date). However, some companies will provide payment of dividend equivalents (a cash value equal to the dividends paid on shares that is typically accrued over the vesting or deferral period and paid out when the RSUs are settled). If you do not receive dividends or get to vote the shares, why would you use RSUs? The key advantage of RSUs is that they provide flexibility to defer the receipt of shares (and taxation) that is not feasible with restricted stock. In addition, the company can choose to settle RSUs in cash or in stock, though there will be accounting implications for this decision.

Key Questions for Committee Members to Ask

- Has the company been challenged in attracting executives into the company?

- Has the company had difficulty retaining executives? Has compensation been cited as an issue in any unwanted executive departures?

- In the event that the company’s stock options are underwater and/or one or more performance plan cycles are unlikely to pay out, does the company have effective retention tools in place?
• Does the stock price tend to be volatile (e.g., in a cyclical industry) where stock price movements are often driven by factors outside company control?

• Has the company been criticized by shareholders or shareholder advisory groups for excessive use of time-vested restricted stock or a weak pay-for-performance relationship?

**LTI Vehicles: Performance Plans**

Performance plans are similar to annual bonus plans, except that performance and/or vesting is typically determined over a multi-year time frame rather than within a single year. These plans have become increasingly popular over the past five to ten years, as they tend to be well received by executives and shareholders. Executives like performance plans because they can be customized to the specific objectives of the company and shareholders like them as they have a more explicit pay-for-performance structure than stock options or time-vested restricted stock.

Another reason for the attractiveness of performance plans is the flexibility that they have in accommodating a multitude of design objectives. Plans designs vary over the denomination of awards (cash vs. shares), performance period, performance measures, absolute vs. relative measurement, vesting period and the form of payment. Companies can tailor these designs to meet their specific strategic objectives and context. While there may be some redundancy with the design decisions for annual incentive plans, we will review the key design decisions involved in performance plans and highlight the differences from annual incentive plans.

**Denomination of Award**

While annual incentive plans are generally denominated as a cash opportunity, performance plans can be denominated as a cash/cash unit target or a share/share unit target. Share/share units are the most common design (approximately 80% of the CAP 100). Why use cash? Cash performance plans focus the executives on the achievement of the specific performance objectives identified under the plan, and insulate executives from the impact of stock price movements. While this may not support the
objective of alignment with shareholders as effectively as a share-based plan, cash payouts tend to be favored by executives as they do not need to sell shares to realize value from these awards. Given the insider trading rules that restrict an executive’s ability to sell shares and the scrutiny that investors apply to insider sales, a cash-based plan has obvious advantages. Since stock options and time-vested restricted stock are both stock denominated, performance plans are frequently the only cash-based long-term incentive for publicly traded companies. In addition, companies that have had high levels of shareholder dilution from stock-based compensation may have a preference for a cash-based long-term incentive, as they do not need shareholder approval to fund shares for awards.

Why use shares? Share-based plans are more common than cash-based plans because denoting the award in shares helps to align executives with shareholders while also encouraging pay for performance through the plan design. While executives may generally prefer cash, denoting the plan in shares allows for greater upside opportunity as the executive can benefit not only from outperforming relative to the pre-established performance criteria and thereby earning more shares, but from stock price increases. The same is true on the downside.

Key Questions for Committee Members to Ask

- Do we have adequate shares available under our shareholder approved plan to fund awards if delivered in shares? Will it reduce the number of years of long-term incentive plan awards that we can make under the existing reserve?

- Are executive plan participants’ liquidity constrained? Would they benefit substantially from a plan design feature that improves liquidity?

- Do executives have enough “skin in the game”?

Performance Period

The decision on the performance period is frequently inter-related with the selection of performance measures. Overwhelmingly, (approximately 80% of performance plans) use a three-year performance period. For com-
panies that use financial performance metrics, this usually aligns with the length of time that the companies project future performance in their mid-term/long-term financial plans. For companies that use stock price-based metrics (e.g., total shareholder return (TSR)), there is not an obvious reason for a three-year performance period to be used, but it remains the most common practice. Very few companies use performance periods that extend beyond three years. For financial performance objectives, this is likely due to the difficulty to make long-term projections. For stock-price based measures, the performance period is likely selected to ensure that the award feels tangible to executives. Given the diminished role of stock options in LTI designs, there may be pressure over time to lengthen performance periods for relative TSR plans given the emphasis most shareholders place on long term performance.

A minority of companies, approximately 10%, use a one year or two year performance period and typically will have additional vesting of two to three years on the award to ensure that executives cannot get paid until at least three years from the grant date. The rationale for this approach is that the companies do not have confidence in projecting out financial performance objectives for three years. Additional vesting beyond the performance period is added to assure shareholders that the award is intended to reward for the long-term, even if the performance objectives are short-term in nature. Shareholder advisory firms frequently prefer that companies commit to multi-year performance goals and view 1-year goals as problematic, particularly if they overlap substantially with the annual incentive performance goals.

**Questions for Committee Members to Ask**

- Does the company have a credible mid-term financial plan that can be used as the basis for setting long-term performance objectives?

- What is the appropriate period of time to assess whether or not management is making progress on achieving its strategic objectives?

- Will the program be externally credible with the performance period we have selected?
Performance Measures

In contrast to annual incentive plans, where companies rarely use stock price as a performance measure, in long-term performance plans relative total shareholder return (TSR) is the single most common performance measure (used by 39% of CAP 100 companies). While many companies use TSR as a measure, financial performance measures (e.g., Revenue, EPS, ROIC) are the most common category. Most companies use 2-3 performance measures in combination with one another.

* Return Metrics include Return on Invested Capital, Return on Equity and Return on Assets.

** Other Profit Metrics include EBIT/EBITDA, Economic Profit/EVA, Net Income, and Pre-tax income.

Companies that use TSR will in most cases establish performance goals relative to other companies, as it is very difficult to predict what level of absolute performance will be viewed as strong performance over a multi-year period. Relative TSR plans tend to be well received by shareholders, as outperforming a group of competitors in terms of stock price performance is an indicator that the company was a better investment than alternatives over that time period. From an executive perspective, relative
TSR can be viewed positively as it helps to insulate management from movements that affect all companies under comparison and rewards for the company’s relative performance. While in an “up” stock market, it may be harder to earn large payouts under a relative TSR plan than under a stock option plan, in a “down” stock market executives can earn payouts in a relative TSR plan, when stock options would likely be underwater.

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**Accounting: Market Conditions vs. Performance Conditions**

For accounting purposes, a market condition is an award that depends on stock price-based measures (e.g., stock-price appreciation, total shareholder return) and a performance condition is an award that is subject to internal financial performance metrics. These awards differ dramatically in how they are treated for accounting purposes. For a market condition, a model is used to determine the probable payout of the award and hence its expected value at the date of grant, not unlike a stock option. For example, to determine the cost of a relative TSR performance share grant, a Monte Carlo simulation model is used to determine the fair value based on the expected value for the award. This value is “locked-in” as of the date of grant if the award is settled in stock and cannot be adjusted based on actual performance relative to the market condition. In contrast, awards with a performance condition “lock in” the value per share on the date of grant, but the number of shares expensed can be “trued up” the number of shares actually earned based on actual performance. Some companies find the fact that you cannot reverse the expense for a market-based award if the award is not earned frustrating as they are recognizing an expense, when the participant received no value.

The key challenge in implementing a relative TSR plan is identifying the right group of companies to compare to. Since two of the main goals are to reward executives for outperforming alternative investments and
to insulate management from external factors, a natural starting point is to identify companies that are viewed as viable investment alternatives or impacted by similar market conditions. Companies that meet these criteria can be identified by looking at who investment analysts compare the company to and by identifying which companies have had stock price movements that are highly correlated with movements in the company’s stock price. For companies with a clear set of industry competitors or a well-defined industry index, this is likely the best set of companies for TSR comparisons. Companies with few direct industry competitors may either decide not to use relative TSR as a metric or may select a broad market index (e.g., the S&P 500) as the basis for comparison. However, some may criticize using a market index as movements in stock price relative to the broad market can be driven by sector performance, as opposed to company-specific performance.

Companies that use financial performance metrics in their long-term performance plans, will generally use the performance measures that they view as most clearly aligned with shareholder value creation over the long-term. These performance measures will be embedded in the company’s strategic plan and viewed as keys for long-term success. For capital intensive industries, a return measure like return on net assets or return on invested capital may be used in combination with an earnings measure like net operating profit or EPS. For high growth industries, the performance measures may be revenue growth and operating margin. Multiple measures are often used to recognize that there may be tradeoffs between different objectives (e.g., growth at any cost vs. profitable growth).

The key advantage of using financial performance objectives has over using relative TSR plans is that financial performance objectives are generally viewed as being more within the control of management. A 3-year EPS goal provides management with a clear message about what the Compensation Committee is expecting from them in terms of performance. Management can think through the specific activities that can contribute to improved earnings. With a relative TSR plan, there is no clear goal. It is much more challenging to identify the decisions and activities that will contribute to outperformance in the stock market. As such, relative TSR
plans are less effective at driving management decisions and are better as a way of aligning management pay with an outcome for shareholders.

Questions for Committee Members

- What are the best measures of the company’s success in achieving its mid-term business strategy?

- What measures do investment analysts focus on in evaluating our company’s performance?

- Do most senior executives understand how they can impact performance on the measures under consideration? Are there alternative measures that are easier to understand and still accurately capture the economics of our business?

- Is there a credible basis for establishing mid-term performance goals on performance metrics? If not, can we assess our performance relative to peers?

Absolute vs. Relative Measurement

Similar to annual incentive plans, the majority of companies set long-term performance plan goals to be equal to the performance levels in the company’s mid-term or long-term business plan. Where companies have extreme difficulty in setting multi-year goals, a few alternative approaches are available:

- Use of a Performance Standard: Companies can set their performance to be based on growth from current levels based on a long-term standard for the industry (e.g., EPS growth of 10%) or based on a long-term industry standard of performance (e.g., ROE of 12%). This avoids an internal negotiation with management about the level of difficulty of the goal. While this approach may be effective over a long-time period, it may be challenging for any one performance cycle as it does not take market conditions into consideration.
• **Relative Performance Assessment:** Instead of establishing an up-front goal for a multi-year performance period, the goal can be established relative to other companies, to a market index or the companies that compose the index. While this does not take into consideration the absolute level of performance, it does implicitly correct for market conditions.

Relative performance measurement can be challenging for financial measures as it is sometimes difficult to provide “apples to apples” comparisons. The most common financial measures assessed on a relative basis are financial returns or profit ratios (e.g., return on equity, return on capital, operating margin, etc). As mentioned earlier, total shareholder return is also frequently measured on a relative basis.

When TSR is measured on a relative basis, the majority of companies use percentile rank among the comparator companies as the basis for the comparison. This is a relatively straightforward approach, as the companies payout relative to target will be tied to the company’s relative performance (see table below):

<table>
<thead>
<tr>
<th>Performance</th>
<th>Percentile Rank</th>
<th>Shares Earned as a % of Target</th>
</tr>
</thead>
<tbody>
<tr>
<td>Below Threshold</td>
<td>&lt;25th %ile</td>
<td>0%</td>
</tr>
<tr>
<td>At Threshold</td>
<td>25th %ile</td>
<td>50%</td>
</tr>
<tr>
<td>At Target</td>
<td>50th %ile</td>
<td>100%</td>
</tr>
<tr>
<td>At Maximum</td>
<td>75th %ile</td>
<td>150%</td>
</tr>
<tr>
<td>Above Maximum</td>
<td>&gt;75th %ile</td>
<td>150%</td>
</tr>
</tbody>
</table>

Performance and corresponding payout levels are generally interpolated between threshold and target and target and maximum. A similar approach can be used for financial measures. A key issue in implementing this approach will be the treatment of companies that exit the peer group due to bankruptcy or acquisition. The “rules” for how to handle companies that exit from the peer group should be defined in the beginning of
the performance period to avoid any uncertainty or potential legal and accounting issues.

An alternative approach, which can be difficult to calibrate, and may overly rely on large cap index constituents is to set goals relative to the performance of a market index itself (e.g., the S&P 500), rather than the component companies of the index. This approach is much less common than the approach discussed above. Below is an example of what performance goals might look like for this approach:

<table>
<thead>
<tr>
<th>Performance</th>
<th>Annualized TSR Performance vs. Index</th>
<th>Shares Earned as a % of Target</th>
</tr>
</thead>
<tbody>
<tr>
<td>Below Threshold</td>
<td>5% or more below</td>
<td>0%</td>
</tr>
<tr>
<td>At Threshold</td>
<td>2.5% - 5% below</td>
<td>50%</td>
</tr>
<tr>
<td>At Target</td>
<td>2.5% below – 2.5% above</td>
<td>100%</td>
</tr>
<tr>
<td>At Maximum</td>
<td>2.5% - 5% above</td>
<td>150%</td>
</tr>
<tr>
<td>Above Maximum</td>
<td>&gt;5% above</td>
<td>150%</td>
</tr>
</tbody>
</table>

**Questions for Committee Members to Ask**

- Do we have a credible basis for establishing long-term performance goals? Is there a risk that we will overpay or underpay if we do a poor job of projecting market conditions?

- Is the preferred measure readily used for relative performance comparisons?

- Is there a good group of companies or a market index available to use for relative performance comparisons?

- Should we use the same peer group for performance comparisons that is used for pay comparisons?
Absolute Performance Goals: Performance Calibration

The challenges faced in setting performance goals for a multi-year performance plan are similar to those for an annual plan, but are complicated by the heightened degree of difficulty in projecting business conditions over a multi-year period. Depending on the business environment, making projections for business performance for one year may be difficult, let alone three years. Still, the clear message that multi-year business objectives send to management about what the company is trying to achieve is so compelling that a majority of companies with performance plans set multi-year financial goals.

When looking at performance over a multi-year period, there are two main different ways to assess performance:

- **Point to Point Growth**: For example, establish a growth goal for the 3-year period. For example, if EPS in 2013 was $1.50, the company may say that they want to grow EPS by $0.15 per year to $1.95 by 2016. This approach effectively puts all of the focus on the final year of the performance period and implicitly assumes that performance in the intermediate years of 2014 and 2015 will be progressing toward the 2016 level. The downside of this approach is that performance in 2014 and 2015 could be poor, but the plan will pay out well so long as 2016 performance is strong.

- **Cumulative Performance**: In contrast to Point to Point Growth, setting a cumulative performance goal requires summing the goals for each period in the plan to come up with a three-year total level of EPS (e.g., $1.65 + $1.80 + $1.95 = $5.40). In this structure, each year of the performance period matters in evaluating 3-year performance, not just the final year of the performance period. The downside of this approach is that there may appear to be a pay for performance disconnect if performance is strong in the first two years of the performance period and then declines in the third year. In this situation, there could be a meaningful plan payout, even though performance looks average in the final year.
Similarly, for multi-year measurement of a return measure (e.g., return on equity), performance can either be assessed based on the level of attainment in the final year of the three-year performance period or on the basis of the average result on the performance metric over the full three-year period.

**Questions for Committee Members to Ask**

- *Is it better to focus management on getting to an aspirational level of performance by the end of the performance period or should we assess management based on their performance throughout the entire performance period?*

**Form of Settlement**

Most often, awards that are denominated in cash are settled in cash and awards that are denominated in shares are settled in shares. However, there are times where the form of payment will be different than the form of denomination. At times, in order to facilitate executive compliance with ownership guidelines or to conserve cash, awards that are denominated in cash will be settled (or partially settled) in shares. At other times, awards denominated in shares will be settled all or partially in cash in order to conserve shares or to facilitate the payment of taxes. It should be noted that while the change in the form of settlement will not have any impact on the incentives that the executive has while the award is outstanding, it can have a meaningful impact on how the awards are treated for accounting purposes.
Equity-Grant Accounting: Share-Settled Grants vs. Cash-Settled Grants

With share-based grants of equity, the accounting treatment for grants that are settled in shares is different from the treatment if they are settled in cash. This difference applies to stock-settled performance shares vs. cash-settled performance shares, but also to stock-settled RSUs vs. cash settled RSUs and stock-settled stock appreciation rights (SARs) vs. cash-settled SARs. Share-settled awards are generally treated as a fixed accounting expense. This means that the company is able to “lock-in” the expense per share based on the stock price as of the date of grant. While the company may “true-up” the expense for the number of shares that ultimately vest due to a financial performance condition or time-based vesting, the expense will not be changed for subsequent movements in the stock price.

In contrast, with a grant of cash-settled shares, the award is subject to liability accounting. This means that the accounting expense associated with the award will be “trued-up” each quarterly reporting period based on movements in the stock price and the ultimate amount expensed will be based on the actual value of the award at the time of settlement. This can create significant variability in the expense if the stock is volatile.
Examples of Performance Share Designs

- **Financial Metric Performance Share Plan:** Shares are earned based on level of performance relative to pre-established financial goals over a 3-year period (e.g., 3-year return on invested capital (ROIC))

<table>
<thead>
<tr>
<th>Performance Level</th>
<th>3-year Average ROIC</th>
<th>Payout vs. Target Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum</td>
<td>≥12.5%</td>
<td>200% of target</td>
</tr>
<tr>
<td>Target</td>
<td>10%</td>
<td>100% of target</td>
</tr>
<tr>
<td>Threshold</td>
<td>7.5%</td>
<td>50% of target</td>
</tr>
<tr>
<td>&lt; Threshold</td>
<td>&lt;7.5%</td>
<td>0% of target</td>
</tr>
</tbody>
</table>

*Shares will be interpolated for performance between threshold and target and target and maximum*

- **Relative TSR Performance Share Plan:** Shares are earned based on relative TSR performance vs. an index (e.g., S&P 500 index) or a custom peer group.

<table>
<thead>
<tr>
<th>Performance Level</th>
<th>Performance Requirement</th>
<th>Payout vs. Target Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximum</td>
<td>≥75th percentile</td>
<td>200% of target</td>
</tr>
<tr>
<td>Target</td>
<td>50th percentile</td>
<td>100% of target</td>
</tr>
<tr>
<td>Threshold</td>
<td>25th percentile</td>
<td>50% of target</td>
</tr>
<tr>
<td>&lt; Threshold</td>
<td>&lt;25th percentile</td>
<td>0% of target</td>
</tr>
</tbody>
</table>

*Shares will be interpolated for performance between threshold and target and target and maximum*

**Termination Treatment of Long-Term Incentive Compensation**

A fundamental characteristic of most long-term incentive awards is that employees are supposed to vest in their awards over time. In fact, one of the key objectives of a long-term incentive design is to encourage execu-
tives to stay with the company over time and to make it costly for employees to leave the organization or to be recruited away. If employees leave, they will either walk away from any unvested awards or the company that recruits the employee will have to make the employee “whole” for forfeited awards through the provision of sign-on grants.

With that said, the treatment of vested and unvested long-term incentives upon an executive’s termination of employment often varies depending on the circumstances around the termination event. Generally, companies are more likely to have plan provisions that allow for continued vesting post-termination, pro-rata vesting or accelerated vesting when the reason for termination is perceived to be less within the control of the employee and are more likely to call for forfeiture of unvested long-term incentives when the decision to leave is more within the control of the executive or is due to an executive’s failure to perform.

In practice, this means that executives who terminate due to death, disability or retirement are typically treated more generously than executives who voluntarily leave the company or are terminated by the company with or without cause. Treatment upon retirement may be less generous in companies that provide for an earlier definition of retirement, as someone who retires at age 55 may be viewed as making a more elective decision to retire vs. an executive who retires at age 65.

When a company experiences a change in control, they tend to take a more lenient view of accelerated vesting of equity. In the past, it was common for all unvested equity to become vested upon the completion of a change in control. The rationale for this approach was that the change in control was an opportunity for shareholders to liquidate their investment and employees should share in that treatment. Also, for most employees the change in control falls into the category of an event that is outside of the employee’s control. More recently, companies have been under pressure from shareholder advisory firms and institutional investors to move to a “double trigger” approach for equity acceleration following a change in control. That is, executives will receive accelerated vesting on their unvested equity only if they are terminated (typically within one to two years following a change in control) or if the acquiring company does not
assume the unvested equity of the acquired company. Proponents of double trigger vesting argue that this more conservative approach to equity vesting makes the company more attractive to potential acquirers and provides the continuing entity with a tool (in the form of unvested equity) to retain employees following the acquisition.

The table below provides an overview of prevalent practices for the treatment of equity upon termination:

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Stock Options</th>
<th>Time-Vested Restricted Stock</th>
<th>Performance Plans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Death</td>
<td>Vested: Between 3 years and remaining term to exercise</td>
<td>Most common to accelerate vesting</td>
<td>Mixed practice between pro ration and full vesting; paid out based on actual achievement</td>
</tr>
<tr>
<td></td>
<td>Unvested: Most common to accelerate vesting</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disability</td>
<td>Vested: Between 3 years and remaining term to exercise</td>
<td>Most common to accelerate vesting or provide continued vesting</td>
<td>Mixed practice between pro ration and full vesting; paid out based on actual achievement</td>
</tr>
<tr>
<td></td>
<td>Unvested: Most common to accelerate vesting</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Normal Retirement</td>
<td>Vested: Between 3 years and remaining term to exercise</td>
<td>Most common to accelerate vesting or provide continued vesting</td>
<td>Mixed practice between pro ration and full vesting; paid out based on actual achievement</td>
</tr>
<tr>
<td></td>
<td>Unvested: Most common to accelerate vesting</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Early Retirement</td>
<td>Vested: 1 year to exercise</td>
<td>Mixed practice between forfeiture, pro ration and continued vesting</td>
<td>Mixed practice between pro ration and forfeiture; if pro rate, paid out based on actual achievement</td>
</tr>
<tr>
<td></td>
<td>Unvested: Most common to forfeit</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
### Scenario	| Stock Options	| Time-Vested Restricted Stock	| Performance Plans
---|---|---|---
Involuntary Termination (without cause)	| Vested: 3 months to exercise
Unvested: Most common to forfeit	| Forfeit	| Forfeit
Voluntary Termination	| Vested: 1-3 months to exercise
Unvested: Most common to forfeit	| Forfeit	| Forfeit
Involuntary Termination (with cause)	| Vested: Forfeit
Unvested: Forfeit	| Forfeit	| Forfeit
Involuntary Termination (without cause) following a Change in Control	| Unvested: Most common to accelerate	| Accelerate	| Accelerate; Mixed practice between paying based on actual achievement and target performance

**Key Questions for Committee Members to Ask:**

- Is our termination treatment consistent with peer practices?
- Are our termination provisions viewed as “fair” by employees? By shareholder advisory groups?
- Do our termination provisions undermine our ability to retain executives as they near retirement age?
Chapter 13. Executive Perquisites

Perquisites

In the past, executive perquisites were viewed as an acceptable form of recognition offered to the most senior executives of a company. Perquisites signal to executives that they have “made it” and provide in-kind compensation that makes an executive’s life easier. Many perquisites provided to senior executives also served a legitimate business purpose that benefitted the company, for example:

- **Company Car**: Facilitates frequent travel involved in certain executive roles. Recognizes that a significant portion of the hours logged by the executive will be in service to the company.

- **Personal Use of Corporate Aircraft**: Supports executive security and allows executive to work and travel more efficiently than with commercial air travel. Personal use of the corporate airplane is often limited to the CEO and the company frequently has a security policy that requires the executive to use the corporate aircraft for all travel (business and personal).

- **Club Membership**: Membership in a club allows the executive to network with potential clients and/or business partners and could be beneficial to the company.

- **Tax Planning**: Helps to ensure that the executive will pay taxes in a timely manner and avoid any embarrassment associated with failing to file a return or filing an inaccurate return.

Despite the potential business rationale for the provision of perquisites, many Compensation Committee members have concluded that for the most part they do not want to be in the business of providing perquisites to executives. Perquisites are unpopular with shareholders and shareholder advisory firms and can potentially be divisive within a company. Shareholders view perquisites as a form of non-performance based compensation. Critics of perquisites wonder why rank and file employees are
expected to use their own funds to pay for certain services, but the most highly paid executives in the company receive a subsidy.

As a result of the criticism of executive perquisites, we have seen a dramatic decline in the prevalence of perquisites over the past five to ten years. Many major companies have eliminated some or all perquisite programs. Where companies maintain perquisites, they are often legacy programs that the company is required to maintain due to contractual commitments to current employees. In such cases, companies may “grandfather” the executives receiving the perquisites and not provide them to new employees.

The practice of providing a “gross-up” payment to the executive to cover the cost of taxes on perquisites is viewed as even worse than the perquisites themselves by many shareholders. For example, ISS labels gross-up payments as an egregious pay practice. As a result, very few companies continue to “gross-up” their remaining perquisites.

As companies have eliminated perquisites, they have often offset the reduction by providing a salary increase to executives. When doing so, the company should not assume that they need to make up for the cost of the perquisites on a dollar for dollar basis, as executives may value a cash payment more than the lost perquisites and increases to base salary often result in indirect increases to target bonus and long-term incentive opportunities, as well as retirement benefits.

The table below provides data on the value of perquisites to CEOs and CFOs among CAP 100 companies. Note that companies are required to disclose the incremental cost to the company of perquisites unless the total value to an individual is less than $10,000, an amount viewed as de minimus. Where the total cost of perquisites exceeds $10,000 the perquisites must be separately identified by type in the footnotes to the Summary Compensation Table.
### Perquisite Value

<table>
<thead>
<tr>
<th>Percentile</th>
<th>CEO</th>
<th>CFO</th>
</tr>
</thead>
<tbody>
<tr>
<td>75th Percentile</td>
<td>$247,342</td>
<td>$48,776</td>
</tr>
<tr>
<td>50th Percentile</td>
<td>$99,874</td>
<td>$21,357</td>
</tr>
<tr>
<td>25th Percentile</td>
<td>$35,488</td>
<td>$2,086</td>
</tr>
</tbody>
</table>

**Key Questions for Committee Members to Ask:**

- *Do we still provide perquisites to our executives? If so, why?*

- *Is there a compelling business rationale for continuing to provide any perquisites?*

- *Is there any reason why the company could not eliminate the perquisites and replace them with a base salary increase?*
Chapter 14. Executive Retirement Benefits

Most companies have qualified retirement plans to provide employees with a source of income when they retire. These plans are “qualified” in the sense that they receive for preferential tax treatment that is not available to other forms of compensation, provided IRS regulations are met. One of the key requirements for qualified plans is that they be made available to all employees. Another aspect of qualified plans is that there are limits to the amount of money that can be contributed to the plan annually or be counted towards determining the benefit accrued under the plan.

The two most common types of retirement benefits are defined contribution plans and defined benefit plans. A defined contribution plan is an arrangement where employees are eligible to save a portion of their current compensation for retirement and receive additional contributions from the company. When people think of defined contribution plans, they primarily think of 401(k) plans. Under a standard 401(k) design, the employee is provided with the opportunity to contribute a percentage of salary and/or bonus into their own 401(k) account. The company will typically make a contribution into the account, often defined as a percentage match of the employee’s contribution (e.g., 50% match of the employee’s contribution up to a maximum match of 3% of the employee’s salary). In some cases, companies will contribute on behalf of employees without requiring the employee to make their own contribution to the plan.

Most companies will provide employees with a choice of investment options within the 401(k) plan, often consisting of an interest-bearing account pegged to a federal treasury rate, mutual funds, and/or company stock. In the past, many companies directed their match into company stock, however, following several high profile corporate collapses (e.g., Enron), this practice is no longer popular. An important benefit of an account within a qualified plan is that, while the company is responsible for administering the accounts, the funds in the accounts belong to the employees (once vested) and are portable when the employee leaves the company. In addition, the 401(k) assets are not treated as assets of the company and as such, are not subject to creditor claims in a bankruptcy.
A defined benefit plan is an arrangement that provides employees with a pre-established amount of income after they stop working. Under these plans, the company bears the investment risk, making them potentially more expensive than defined contribution plans. For example, if plan assets do not appreciate sufficiently to cover the cost of the promised benefits, the company will be required to increase contributions. Due to the greater expense associated with defined benefit plans, many companies have closed plans to new participants or terminated plans by ending future benefit accruals. As a result, defined contribution plans have become the core retirement vehicle for most employees.

In defined benefit plans, the amount of the annual benefit will be a function of three factors: employee’s salary or annual cash compensation over a period of time (e.g., last five years of employment), the number of years of service the employee had with the company, and the age of the employee at retirement. A typical formula might determine an employee’s benefit as 1% of final average salary and bonus for each year of service, up to a maximum of 40 years of service. Final average salary and bonus could be the average earned over the last three to five years of service prior to retirement. For a long-service employee, a retirement plan with this structure could provide the employee with retirement income equal to 40% of salary and bonus.

If the employee retires early, the size of the benefit will be reduced to reflect the additional years the employee will receive benefits and potentially to penalize the employee for retiring before the full retirement age under the plan. Defined benefit plans generally provide the benefits as an annuity, with the payment of benefits ceasing upon the death of the retiree (and his/her spouse if the plan provides a survivor benefit). This effectively insures the employee against the risk of not knowing how many years he/she will survive beyond the retirement date. Alternatively, some companies will provide a “lump-sum” option that provides the employee with the option to receive the actuarial present value of the retirement benefit upon retirement. In this case, employees are responsible for investing the lump-sum value post-retirement and they bear the risk of outliving their funds. Amounts in qualified defined benefit plans are not subject to
forfeiture in the event of a bankruptcy and are generally insured (within limits) by ERISA.

As mentioned earlier, there are limits on qualified plans to ensure that excessive benefits are not provided to high income employees. At present, the maximum individual contribution for a defined contribution plan like a 401(k) is $18,000, with an additional “catch-up” contribution of $6,000 available to participants age 50 or older. The maximum compensation included in a benefit formula for a defined benefit pension plan is $265,000. Because of these limits on qualified plans, many companies have added non-qualified plans targeted at the executive population called supplemental executive retirement plans (SERPs). SERPs provide benefits to high income employees beyond the qualified plan limits. These plans can serve one of two purposes:

- **Restoration Plans:** Mirror the qualified plan that all employees of the company receive, but provide for the continuation of benefits beyond the caps on contributions/benefit formulas under the qualified plans

- **Supplemental Benefits:** Provide special benefits to executives beyond the benefits provided to other employees at the company

While SERPs are frequently criticized by shareholder advisory firms, the rationale for providing a restoration plan to executives is sound. The benefits provided under restoration plans simply maintain the same structure as the qualified plan, as if the qualified plan limits on maximum contributions or allowable compensation did not exist. In this sense, these plans are not really providing executives with something extra that is not available to other employees. Instead, restoration plans put them on similar footing relative to other employees, but recognize their higher income levels.

When criticism of SERPs may be more justified is when special benefits are made available to executives that are not available to other employees. Several varieties of these arrangements exist:

- **Additional Service Credit:** At times, senior executives that join a company later in their careers may be credited with additional years of service
under the SERP. Generally, the rationale for providing the additional service credit is to make-up foregone benefits from a prior employer or as a carrot for recruitment. Additional service credit can be very valuable to an employee and can lead to large amounts reported by companies in the Summary Compensation Table (SCT) disclosure of the change in pension value.

- **Enhanced Benefit Formula:** Occurs when the company has a more generous benefit formula for executives under the SERP than employees receive under the qualified plan. For example, an executive could receive 1.5% of compensation for each year of service under the SERP vs. 1% of compensation under the qualified plan.

- **Enhanced Contributions:** Companies may make larger contributions on behalf of executives than for employees under the qualified plan.

- **Frozen Qualified Plan/Unfrozen SERP:** In some cases, to manage plan costs, companies may freeze the qualified plan, so that new participants are not allowed to enter the plan or to limit future benefit accruals for existing participants, but allow executives to continue to accumulate benefits under the SERP.

- **LTI Included in Benefit Calculation:** In rare cases, companies will include the value of cash long-term incentive payouts in the definition of compensation for purposes of calculating the pension benefit.

From the perspective of Committee members, SERPs can be a challenging aspect of compensation to manage. The value of a SERP can be substantial; many examples of SERPS in the tens of $ millions for CEOs with long service or significant years of service exist. The methodology used to determine the present value of the benefits relies on actuarial calculations that can be volatile from year to year. At times, executives with a large SERP may appear overpaid due to changes in the discount rate used to calculate the pension value, rather than the accumulation of incremental benefits. In addition, the value of SERP benefits is somewhat difficult to benchmark as the values for different CEOs will depend on their specific circumstances.
circumstances, including age, tenure, and compensation, as well as on the differences in the designs of the SERP programs.

We recommend caution when implementing any new SERP arrangement with executives. SERPs are generally viewed by shareholder advisory firms and shareholders as a form of non-performance based pay that insulates executives from performance accountability. Where long-term executive retention is the goal, the use of long-term equity-based incentives, rather than a SERP, is preferred by Committees and shareholders. In addition to the concerns already raised, SERPs constitute deferred compensation subject to complicated tax rules under IRC Section 409A. SERPs also are subject to greater risks. Unlike qualified plan assets, assets held in a SERP will be subject to general creditors in the event of a bankruptcy.

If your company has an active SERP program, it is critical to understand how changes to the compensation of senior executives will impact the value of the SERP. Because SERPs often depend heavily on final compensation, changes in compensation can have a very large impact on the present value of the SERP.

Beyond SERPs, other forms of executive benefits include supplemental life insurance, supplemental health insurance, supplemental disability insurance and executive physicals. Most forms of supplemental executive benefits have fallen out of favor and, in most cases, Compensation Committees will be better off if the executive purchases these benefits on their own. The one exception is the executive physical which is a relatively low cost benefit that can contribute to the health of senior executives by encouraging physical exams at regular intervals.

**Key Questions for Committee Members to Ask:**

- Do our SERPs restore benefits to executives beyond qualified plan limits or provide benefits beyond what rank and file employees receive? If so, why?
• What forms of compensation are counted towards retirement benefits under the SERP? Salary? Bonus? Other? How will changes in compensation impact the present value of the SERP benefits?

• For new hires, is restoration of SERP benefits from their prior employer necessary? Could we replace the value of the SERP with a different, more performance-based form of compensation?

• Are any other executive benefits provided? What is the business rationale? What is the value of these benefits?
Chapter 15. Deferred Compensation

Traditional deferred compensation arrangements provide executives with an opportunity to defer taxation on a portion of compensation for a pre-established period of time. In order for compensation to be deferred, the executive may not have “constructive receipt” of the compensation and the compensation must be subject to a “substantial risk of forfeiture.”

In layman’s terms, constructive receipt means that the compensation is available to the executive without meaningful restrictions. Similarly, a substantial risk of forfeiture exists when the compensation is contingent on future service, on the occurrence of an event or if the deferred compensation plan is unfunded and unsecured. In short, this means that there must be some meaningful risk to executives that they will not be paid. For example, if the deferred compensation plan is unfunded and unsecured, any assets would be part of the general assets of the company, subject to the claims of creditors. In turn, the executive would be a general creditor of the company in the event that the company became insolvent. So while deferred compensation is inherently at risk, executives may not view the risks as greatly concerning, unless insolvency is viewed as a real possibility.

There are several reasons that executives defer compensation. First, companies credit deferred compensation with interest and may allow the executive to choose from a broad choice of investment vehicles within the plan. Executives can benefit from interest compounding on pre-tax amounts since income taxes are not paid until the end of the deferral period. In addition, executives may defer compensation because they expect to face a lower marginal tax rate when they receive the deferred funds at some pre-established time in the future. Lower tax rates could result from anticipated changes in the tax regime or differences between the executive’s current and future income levels. Finally, some executives defer the receipt of non-performance-based compensation (e.g., base salary, or time-vested RSUs) to avoid exceeding the 162(m) $1M limit on deductible compensation.
In order to implement a deferred compensation plan, your company will have to establish administrative policies covering multiple aspects of the program that address key questions, including:

- **Eligible executives**: Decide how eligibility for the plan will be established. Determine if the plan will be limited to executives with a certain level of annual income or limited to a particular employee salary grade or level.

- **Eligible compensation**: Establish what compensation can be deferred (e.g., up to 50% of salary, 100% of annual incentive, RSUs, PSUs).

- **Investment options**: Determine how deferred funds will be invested. Alternatives are for interest credits to be pegged to a market interest rate, to the performance of company stock, investment options under the 401(k), or credited with a fixed rate of return.

- **Election timing**: Set up processes around deferral elections, by type of vehicle (e.g., timing of deferral election, deferral form, differences across vehicles).

- **Payment timing**: Identify the timing of the payment of funds that are deferred (e.g., fixed number of years after employment ends, upon termination of employment, or a specified date(s), etc.).

- **Form of payment**: Establish whether deferred amounts will be paid in cash or paid in shares of company stock (particularly for share-based deferrals of RSUs and PSUs).

- **Funding**: Determine a strategy for funding the deferred compensation obligation by setting aside funds for the plan, funding with company-owned life insurance, or using a “pay as you go” approach. Note that assets earmarked to pay for deferred compensation must remain general assets of the company subject to the claims of creditors to avoid current taxation of deferred compensation.

- **Executive protection**: Decide if the company will use a “rabbi trust” or “springing rabbi trust” to ensure that the company funds deferred compensation payments in the event of a merger or acquisition of the com-
pany. Assets deposited in a rabbi trust will be paid to deferred compensation plan participants by the trustee, protecting the executive from the risk that the company reneges on the promise to pay deferred amounts. A springing rabbi trust is an arrangement pre-funded with a minimal amount of cash prior to a change of control. Upon a change of control, the trustee is instructed to deposit a larger amount (i.e., the money “springs” into the trust) sufficient to pay at least 100% of the deferred compensation obligation.

From the company’s perspective, deferred compensation has benefits and costs. The company delays taking a tax deduction, thereby increasing current taxes, until the deferred amounts are actually paid out. On the positive side, the company preserves cash in the year of deferral and can use those funds for other purposes (or to fund future deferred compensation payments). If the company chooses not to fund deferred compensation balances, there may be large cash requirements triggered by the retirement of key executives. Finally, there will be some administrative cost involved in managing the program.

Shareholders generally do not object to deferred compensation arrangements where the major objective is beneficial tax planning. However shareholders will object when deferred compensation arrangements are used to provide supplemental compensation to executives by paying above-market interest or by making company contributions to executives’ deferred compensation accounts. Above market interest must be reported in the Summary Compensation Table of the proxy statement and company contributions are reported on the Nonqualified Deferred Compensation Table in the proxy.

Even in cases where deferred compensation consists solely of amounts that would have been paid currently if the executive had not elected to defer, there can be a degree of “sticker shock” when an executive leaves the company with a large deferred compensation balance. In these situations, it is critical to clearly disclose that these amounts were earned by the executive over a number of years and do not reflect severance paid at termination. Even with clear disclosure, the company runs the risk deferred compensation balances will be described by others as a form of executive
severance. We recommend that the Committee include the full deferred compensation balance in a tally sheet that is reviewed at least annually, in addition to proxy statement disclosure of non-qualified deferred compensation, to avoid surprises. Finally, deferred compensation arrangements are subject to Internal Revenue code section 409A which is a complex enough topic to require its own chapter.

**Key Questions for Committee Members to Ask:**

- What are the financial implications of our deferred compensation program? What is the anticipated size of the long-term liability?

- What investment options will be made available to executives participating in the plan? Will any “above-market” interest be paid?

- Is the design unnecessarily complex? Are there aspects that could be simplified?
Chapter 16. Internal Revenue Code (IRC)  
Section 409A

No discussion of deferred compensation would be complete without touching on IRC Section 409A, the section of the federal tax code that governs the treatment of deferred compensation. This legislation was developed as a response to Enron’s bankruptcy, one of the largest corporate bankruptcies ever. In the Enron case, the company dismantled a deferred compensation plan, making payouts of large cash balances to participating executives right before the company’s bankruptcy filing. Meanwhile, rank and file employees were hurt badly when the stock price cratered.

Section 409A was enacted to try to prevent similar situations by limiting the ability of executives to access deferred compensation balances. Since IRC Section 409A became effective in 2005, implementing a deferred compensation program has become much more complicated and the risk to executives of non-compliance because of administrative or design errors is now much larger. The bottom-line is that if companies fail to comply with 409A, all deferred compensation can be subject to current taxation along with penalties and interest for late payment of the taxes. In addition, an executive can be penalized with a 20% non-deductible excise tax on the deferred compensation, due in addition to regular income and payroll taxes. As a result, with any form of deferred compensation (which can include non-qualified deferred compensation plans, SERPs, restricted stock unit plans, phantom equity plans, and long-term cash plans) the company should conduct careful analysis to identify whether the award will be subject to 409A and, if so, whether the award design and payment timing comply with 409A.

Key things to keep in mind for 409A include the following:

- Stock options and restricted shares are generally exempt from 409A

- Performance plans that pay out before the 15th day of the end of the tax year are excluded from 409A due to the short-term deferral exception
Deferral elections generally need to be made prior to the beginning of the year of the award

Executives are limited in their ability to modify any deferral elections; re-deferrals must extend for at least 5 years beyond the originally scheduled payment date

With 409A as the tax law governing deferred compensation, effective plan administration has become critical to ensure that employees participating in deferred compensation schemes are not subject to tax penalties. Attorneys practicing in tax law can point to numerous cases where 409A has been violated due to administrative errors in implementing the design. Simplicity of design and of processes can make administration easier. In reviewing these plans, it is critical to make sure that all parties agree that the company will be able to effectively administer the design.

Key Questions for Committee Members to Ask:

- Is this compensation arrangement subject to 409A?
- Have appropriate legal/tax professionals reviewed the arrangement?
- Has the company ensured that the terms of the award and deferral elections comply with 409A?
Chapter 17. Employment Agreements and Executive Severance

The employment of many senior executives is governed by an employment agreement.

Employment agreements normally define the terms and conditions governing an executive’s employment, including:

- **Term of employment and contract renewal provisions;**
- **Position, title, and reporting relationship;**
- **Minimum compensation opportunities, including base salary, target bonus opportunity and eligibility for long-term incentives;**
- **Vacation, executive benefits and perquisites; and**
- **Severance protection in the event of termination.**

When an executive is hired, the terms of an employment agreement may require extensive negotiation. This often results in locking the company into commitments that are difficult to unwind. If the company unilaterally eliminates certain benefits or otherwise changes the terms of employment, the executive may be eligible to receive severance from the company, by triggering the agreement’s “Good Reason” termination provision (i.e. the executive can quit claiming that the company effectively terminated his employment by materially changing employment terms).

Another issue with individual employment agreements is that they can result in different treatment among the executive group based on the timing of when they join the company, as well as the individual executive’s aggressiveness in negotiating the terms of employment. Provisions that may be acceptable to the company for one executive, may be problematic if provided to many executives. However, once one executive establishes the precedent for a particular provision, other executives will likely negotiate for similar treatment. Employment agreements in effect with
executive officers are required to be filed with the SEC so the terms are public knowledge.

For these reasons, we suggest that companies avoid entering into employment agreements with executives whenever possible. Instead a preferred approach is to use an executive severance policy to cover all similarly situated executives under comparable terms. The most critical protection that an employment agreement provides is protection in the event that the employee is terminated or constructively terminated through a material reduction in responsibilities or compensation. Severance policies provide this protection to senior executives, but provide the company with flexibility to change the program without obtaining the consent of participants. A severance policy also reduces the likelihood of executives negotiating for more at termination. Shareholder advisory groups and other external observers tend to be highly critical when companies make special payments to terminated executives.

Another approach is to have a standard form of employment agreement that provides a consistent, basic level of protection for all executives at a particular level within the company. This can allow the company to avoid negotiating unique provisions. In addition, if the employment agreement is structured so that it expires after a fixed term or contains a notice period that allows the company to revisit the terms, the company retains a degree of flexibility.

Executive severance benefits are typically provided in two scenarios: (i) termination by the company or by the executive for good reason and (ii) actual or constructive termination in connection with a change in control (CIC). Severance is generally not provided if the executive resigns for no reason or without good reason, at retirement, death or disability, or in cases of termination for cause.

Executive severance benefits that apply for termination by the company or by the executive for good reason frequently include the following components (Source: CAP Change-in-Control / Severance study):

- Cash severance paid in regular payroll installments:
- CEO: 1x-2x base salary or 1x-2x base salary plus target bonus

- Other Named Executives: 1x base salary or 1x base salary plus target bonus

- Actual bonus prorated for service during the year of termination

- 1-2 years of benefit continuation, normally limited to health and life insurance coverage for a period that frequently matches the cash severance period

Companies frequently include various covenants that limit the executive’s ability to compete or solicit employees and customers after termination. Common covenants include confidentiality provisions, non-compete and non-solicitation provisions, non-disparagement and agreement by the executive to participate in investigations for fraud or other malfeasance after employment ends. Finally, companies require the executive to sign a release before severance is made available to reduce the likelihood of litigation.

Executive severance benefits that apply for termination in connection with a change in control (CIC) severance protection is often more generous for senior executives, on the theory that shareholders may be receiving a premium in the transaction and that the executive is losing his job through no fault of his own. Typical components include (Source: CAP Change-in-Control / Severance study):

- Cash severance paid in a lump sum:
  - CEO: 3x base salary plus target bonus
  - Other Named Executives: 2x-3x base salary plus target bonus

- Actual bonus pro-rated for service during the year of termination

- Accelerated vesting of equity and other long-term incentives

- 2-3 years of benefit continuation, or the cash equivalent for a period that frequently matches the cash severance period
Change in control benefit payments are known as “golden parachutes.” Under Section 280G of the Internal Revenue Code, parachute payments include all payments made within one year of a change of control that are contingent on or accelerated by the change in control. If the total parachute payment is more than 2.99 times an executive’s base amount (5-year average W-2 income), the payment is an excess parachute payment according to the IRS. Any excess parachute payment is subject to a 20% nondeductible excise tax, in addition to regular income and payroll taxes, on any parachute payments that exceed the base amount. Payments triggered by the change in control can include cash severance, but also the value of the benefit from accelerated vesting of equity or long-term performance plan and benefit continuation. There is a complicated methodology that the IRS requires be used to calculate the value of parachute payments.

In order to insulate executives from the cost of the excise tax penalty, an additional payment was often promised to the executive to pay for the excise tax and incremental excise and income taxes on the payment. These “excise tax gross-ups” can be very expensive for companies. For example, if an executive is subject to a 40% income tax and a 20% excise tax, then the payment required to fully gross-up an executive will be 2.5 times the value of the 20% excise tax. In addition, any payment that is deemed to be an excess parachute payment is not tax deductible for the company.

Shareholder advisory groups have strong views about severance payments, often viewing them as non-performance-based pay or “pay for failure”. Largely as a result of input from the shareholder advisory firms, companies have been reducing change in control severance and eliminating practices that are viewed as unfriendly to shareholders. Practices that are going away include:

- Cash severance triggered solely by the occurrence of the change in control without a termination of employment (i.e., a “single trigger” benefit)

- Cash severance pay multiples that include any form of long-term incentive compensation in the definition of pay (e.g., 3x [base salary plus target bonus plus cash LTIP target])
• *Excise tax gross-ups*

• *Additional service credit for retirement benefits*

In the past, it was common to provide an “excise tax gross-up” as part of the CIC severance benefits for senior executives (see technical sidebar for a discussion of the topic). Excise tax gross-ups are unpopular with shareholder advisory groups. For example, ISS has made it part of its “Say on Pay” voting policy that they will recommend against the pay plan of any company that puts an excise tax gross-up in a new or materially modified contract. While many company’s still have grandfathered contracts or severance arrangements with excise tax gross-ups, very few companies incorporate them into new arrangements.

In place of the excise tax gross-up, many companies have moved to an approach where they give the executive a choice. The executive can opt to take the entire parachute payment and pay any excise taxes due without help from the company or cap the payment just below the level that triggers the excise tax gross-up, if that maximizes the payment’s after-tax value. This approach optimizes the after-tax payout to the executive and reduces the risk that the company loses its tax deduction on severance pay.

Another approach which is seen less frequently is for the company to employ a “hard cap” and limit the parachute payment to avoid the excise tax. This approach guarantees that any severance payments will be tax deductible to the company, but is much less generous to the executive.

**Key Questions for Committee Members**

• *Are any of our executive officers covered by employment contracts? If so, is there a standard form or do the contracts vary by executive?*

• *In the absence of employment contracts, is an executive severance policy in place? What benefits are provided?*
• Is it possible for the company to “unwind” the employment contracts over time without triggering a severance payment for “good reason” termination under the agreements?

• Do any of our employment contracts or severance arrangements provide for excise tax gross-up?

• Do any of our employment contracts provide for cash severance payments of more than 3x pay?

• Are we doing anything more for the executive than what we are contractually obligated to do? If so, do we have a strong rationale for why it is in the interests of shareholders?
Chapter 18. Compensation Policies that Support Good Governance

Since the financial crisis began in 2008, US public companies have made great efforts to improve corporate governance. The corporate governance reforms included in the Dodd-Frank Act of 2010 accelerated the movement by requiring shareholders to approve executive compensation on a non-binding advisory basis, beginning in 2011. Companies worked to strengthen their compensation policies as a way to increase shareholder support of Say on Pay proposals. Certain executive compensation program elements quickly evolved from “nice to have” status to “expected”. In this section, we summarize five common policies that enhance the alignment of executives with shareholder interest and support strong governance.

Stock Ownership Guidelines

CEOs and other senior executives receive the majority of their compensation in the form of company stock. Stock ownership guidelines have been established by 91% of companies in the CAP 100 to ensure that executives hold on to a pre-defined level of the company’s stock over the course of their tenure with the company. Shareholder advisory firms and institutional shareholders support ownership guidelines, viewing ownership of company stock as a way to align management with shareholders. Most Compensation Committee members also support the use of stock ownership guidelines, but recognize that executives may have some desire to diversify their interests out of company stock over time.

Most stock ownership guidelines share certain characteristics, as summarized below:
### Stock Ownership Guideline Feature

<table>
<thead>
<tr>
<th>Stock Ownership Guideline Feature</th>
<th>Market Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Basis for Requirement</strong></td>
<td>Majority of companies define ownership as a multiple of base salary (80% of CAP 100)</td>
</tr>
<tr>
<td></td>
<td>Minority of companies define as a number of shares (~20%) or as a dollar amount (~1%)</td>
</tr>
<tr>
<td><strong>Requirement</strong></td>
<td>CEO: 5x-6x salary is most common (approximately 80% of CAP 100)</td>
</tr>
<tr>
<td></td>
<td>Other NEOs: 2x-3x salary is most common</td>
</tr>
<tr>
<td><strong>Time to Comply</strong></td>
<td>5 years to comply is the most common (from date of hire or promotion to executive role or for any increase in guideline)</td>
</tr>
<tr>
<td><strong>Shares Counted Toward Compliance</strong></td>
<td>Shares owned outright</td>
</tr>
<tr>
<td></td>
<td>Shares held in company benefit plans</td>
</tr>
<tr>
<td></td>
<td>Unvested time-vested restricted stock or restricted stock units (in some cases on a net of tax basis)</td>
</tr>
<tr>
<td></td>
<td>Unvested performance shares and unexercised stock options typically do not count toward compliance</td>
</tr>
<tr>
<td><strong>Assessment of Compliance</strong></td>
<td>At least annual testing of compliance</td>
</tr>
<tr>
<td></td>
<td>Many companies use an average stock price over a period of time (e.g., average for the year)</td>
</tr>
<tr>
<td><strong>Consequence if not in Compliance</strong></td>
<td>Most companies expect executives to comply, but do not have formal consequences for non-compliance</td>
</tr>
<tr>
<td></td>
<td>Most common “penalty” is to require that all or a portion of shares (net of taxes) vesting be held until guideline is achieved</td>
</tr>
</tbody>
</table>

In practice, most executives are able to comply with ownership guidelines over a 5-year period without making any purchases in the open market. This is particularly true for companies that deliver a substantial portion of their long-term incentives in restricted stock or performance shares. Companies that use stock options as the primary long-term incentive may inadvertently encourage early exercise of stock options if they require executives to comply within 5 years.

When a company experiences a severe decline in the stock price, executives may fall out of compliance with the ownership guidelines. Commit-
tees are often lenient in assessing compliance as long as executives do not fall out of compliance due to the sale of shares.

**Key Questions for Committee Members**

- *Are our stock ownership guidelines consistent with the levels of peers?*

- *Do our compensation programs deliver adequate shares so that executives will not need to purchase shares to achieve the guideline?*

- *Are our executives all in compliance with the ownership guidelines? If not, do the executives not in compliance still have sufficient time to achieve compliance?*

- *What are the consequences of failing to achieve the ownership guideline within the specified compliance period?*

**Stock Holding Requirements**

Stock holding requirements are similar to stock ownership guidelines. They require an executive to hold all or a portion of the shares delivered at vesting of full-value shares or at exercise of stock options for a defined period of time. Stock holding requirements arose out of concerns that executives may have incentives to “pump and dump” a company’s stock. That is, they may take actions that lead to a short-term increase in the company’s stock and immediately sell shares before the market recognizes that the shares are overvalued. In theory, this makes sense for stock options, since the executive has the ability to time the stock option exercise, but it is harder to make the case that stock holding requirements are necessary for full-value shares, where executives do not control the timing of vesting.
Key features of stock holding requirements include the following (Source: CAP 100):

<table>
<thead>
<tr>
<th>Stock Holding Policy Feature</th>
<th>Market Practice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares to be held</td>
<td>Typically applies only to net shares (i.e., net of any shares used to satisfy the option exercise price or taxes on the shares)</td>
</tr>
<tr>
<td>Applies to</td>
<td>Most include option exercises</td>
</tr>
<tr>
<td></td>
<td>Some include vesting of restricted shares</td>
</tr>
<tr>
<td></td>
<td>Some also apply to payouts of performance shares</td>
</tr>
<tr>
<td>% of Shares Held</td>
<td>50% is the most common, but some companies have 25% or 100% of net shares</td>
</tr>
<tr>
<td>Period of Time</td>
<td>Most companies have 1-2 year holding requirements</td>
</tr>
<tr>
<td></td>
<td>A few companies require the shares to be held until retirement</td>
</tr>
</tbody>
</table>

Similar to stock ownership guidelines, shareholder advisory firms view stock holding requirements as an effective shareholder alignment tool, preferring that companies adopt these policies, even if they already have stock ownership guidelines. Many Committee members and executives view stock holding requirements as redundant, if ownership guidelines are already in place. Approximately 50% of CAP 100 companies disclose a holding requirement. Among the few (9%) companies in the CAP 100 that do not disclose ownership guidelines, 55% disclose a holding requirement. Some shareholders and advisory groups have promoted the concept of holding requirements until retirement. While this concept has not caught on to date, there are a minority of companies, particularly in the financial services industry, who have implemented this approach.

**Key Questions for Committee Members**

- Will stock holding requirements encourage executives to retain company stock beyond current holding levels?
- Will stock holding requirements improve shareholder advisory views on our compensation program?
• How are stock holding requirements viewed by executives? Would adopting guidelines meaningfully change executive behavior?

• How do stock holding requirements align with our stock ownership guidelines?

Clawbacks

A clawback provision provides the company with the ability to recoup previously paid compensation to executives if a triggering event takes place. Sarbanes-Oxley mandated that incentive compensation for CEOs and CFOs would be subject to clawback by the SEC in the event financial results are restated due to misconduct. The Dodd-Frank legislation includes a clawback that would apply to all Executive Officers in the event of a financial restatement that would have led to a reduced incentive payment. A key distinction between the Sarbanes-Oxley clawback and Dodd-Frank rule is that the Dodd-Frank clawback does not require executive misconduct to trigger the clawback. To date, the SEC has not taken action to implement the clawback requirement under Dodd-Frank; however, approximately 95% of the CAP 100 have implemented some form of clawback.

<table>
<thead>
<tr>
<th>Clawback Policy Feature</th>
<th>Market Practice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Triggering Event</td>
<td>Most common approach is financial restatement (approximately 85% of Fortune 250 companies) and/or misconduct (75% of companies) that would have impacted incentive payments. Some companies include violation of restrictive covenants (e.g., non-solicitation or non-compete agreements) as a triggering event.</td>
</tr>
<tr>
<td>Applies to</td>
<td>Among larger companies, typically applies to both annual and long-term incentive plans</td>
</tr>
<tr>
<td>Period of Time</td>
<td>One to three years is the most common period that companies look back to take back compensation</td>
</tr>
</tbody>
</table>

The underlying rationale for a clawback is that incentive payments based on inaccurate financial statements have not been earned fairly by executives and should be returned to the company, particularly in cases where
the restatement was due to executive misconduct. This rationale is compelling and is accepted as reasonable by most Compensation Committee members. In addition, most shareholder advisory firms support the use of clawbacks.

While the rationale for clawback policies is sound, in practice they are seldom used to recoup compensation from executives. It is often challenging to determine how much an executive was “overpaid” due to a financial restatement, particularly when the value of equity-based compensation is not directly linked to a company’s financial statements. There may also be legal barriers to recovering compensation from executives.

**Key Questions for Committee Members**

- **Should we adopt a clawback?**
- **If yes, what triggers are best? Do we require misconduct? Do we include employment covenants?**
- **If we adopt a clawback policy, who will be responsible for informing the Committee of the occurrence of a triggering event?**
- **Who will be responsible for determining the amount of incentive compensation that needs to be clawed back?**
- **How much discretion will be available to determine how a clawback will be applied?**

**Hedging**

Hedging is a sophisticated technique where an investor attempts to limit losses created by stock price in a given security by taking an offsetting position, such as short sales, put options or futures. Only a very few years ago, hedging of company stock by executives was mentioned rarely when discussing executive compensation. This changed since Dodd-Frank and the proxy advisory firms focused on hedging. Among CAP 100 companies, approximately 90% disclosed anti-hedging policies in 2013 compared to only 45% in 2012.
Most Committees have assumed that executives would not hedge equity-based compensation, by selling company shares short or using other strategies to protect themselves from decreases in the value of the company’s stock. However, the Dodd-Frank legislation requires that companies disclose whether or not their employees or directors were allowed to hedge their interests in company stock. While the Dodd-Frank legislation did not fully define what would be viewed as a hedging transaction, companies that have implemented policies have generally taken a broad approach in prohibiting all hedges on the company’s stock.

Committees have generally embraced anti-hedging requirements as they help ensure that equity-based compensation aligns the interests of management with those of shareholders. Most agree that allowing executives or directors to hedge their positions in company stock is not viewed positively.

Key Questions for Committee Members to Ask

- Do we have a policy prohibiting the hedging of company stock? If not, why?

- Does our hedging policy apply to all employees and directors? If not, which employees does it apply to?

Pledging

Pledging of company shares occurs when an executive uses shares as collateral for a margin loan or other financial transaction. In its 2013 policy statement, ISS indicated that significant pledging of company shares could serve as the basis for recommending a withhold vote for directors. ISS’ concern stems from a risk that executives may need to sell pledged shares to satisfy their obligations and that would undo the positive incentive effects of using equity as a shareholder alignment tool or limit executives’ ability to comply with ownership guidelines. Forced sales of company stock could also cause the executive to violate insider trading rules. In 2013, approximately 60% of CAP 100 companies disclosed their pledging policies in the annual proxy statement.
While pledging of shares was not a widespread practice in corporate America, several high-profile cases involving company founders who owned large blocks of stock received negative publicity. In addition, the prospect of a withhold vote for directors encourage companies to take share pledging seriously. As a result, in 2013, we saw a significant uptick in companies stating that they prohibit management and directors from pledging company shares.

Key Questions for Committee Members

- Do we have a policy prohibiting the pledging of company stock? If not, why?

- Do any executives or directors currently engage in pledging transactions?
Chapter 19. CEO Pay

One of the most significant responsibilities of Compensation Committees is to establish CEO compensation packages. In our experience, Committees work hard to strike a balance between the need to offer attractive compensation opportunities and the need to appease potential critics.

Employees and the press often criticize CEO pay for being too high in an absolute sense or relative to the pay levels of the typical worker. Shareholders and shareholder advisory firms tend to focus their criticism on the pay and performance relationship. For them, the primary concern is whether or not the CEO’s pay was appropriate in the context of the company’s performance. They will raise concerns when the CEO’s pay appears to increase or stay the same when the company’s performance declines. They also may criticize the Committee or Board if they find that its CEO is paid more than industry peers, but the company has not outperformed peers. Institutional shareholders will look beyond the amount of pay and also criticize the forms of pay. Was too much of the CEO’s pay delivered in salary or cash compensation relative to equity? Did the CEO receive too much pay that did not move with performance (e.g., perquisites, retirement benefits)? Was the CEO’s long-term incentive plan too conservative (e.g., mostly restricted stock) or too risky (e.g., mostly stock options)?

With all of the criticism of CEO pay, it may seem impossible to have a “bullet-proof” CEO pay program. That is probably true. However, a well-thought out process for addressing CEO pay can help to limit the amount of criticism directed at compensation.

Process

The Chair of the Compensation Committee normally takes the lead in overseeing CEO pay. For much of the Committee’s work, management may take a very active role in working with the Committee, but management rarely participates in setting CEO pay. For CEO pay decisions, the Committee Chair will rely more heavily on the input of its compensation consultant to understand market compensation levels and pay practices. However,
the ultimate judgment on what to pay the CEO is a decision the Committee needs to make.

The timing of the Committee’s decisions on CEO pay is aligned with the timing of pay decisions for other executive officers in most cases. The key difference is that any recommendations that are specific to the CEO (e.g., target pay levels, actual incentive payouts, etc.) are discussed in executive session by the Committee, without members of management present. The materials are most often prepared by the Committee’s compensation consultant, with input from the Compensation Committee Chair. The consultant can facilitate the decisions on pay by informing the Committee of competitive pay for the CEO as suggested by the market data, the company’s compensation philosophy, as well as the company and CEO’s performance.

Key steps in the annual CEO pay cycle include the following:

**Beginning of the Year:**

- **Establish target pay levels for the CEO** (e.g., base salary, target bonus, target cash compensation, long-term incentive grant value, target total direct compensation)
  - Assess competitiveness of current pay levels relative to peer group target compensation levels
  - Assess current pay levels relative to compensation philosophy (e.g., how positioned vs. target pay positioning)
  - Identify whether or not there is a need to increase CEO’s target pay opportunity based on current compensation positioning
  - Identify whether the Committee’s perspective on the CEO’s sustained performance would serve as the basis for adjusting CEO target pay levels up or down

- **Establish CEO’s individual and strategic performance objectives for the year** (often done with input from the full Board of Directors)
**Year-end:** Determine annual incentive payout and long-term incentive payouts

- Assess company’s *performance relative to annual and long-term incentive plan objectives*
- Assess CEO’s *performance relative to individual and strategic objectives*
- Determine CEO annual incentive payout, potentially adjusting size of payout based on Committee’s assessment of CEO’s performance
- Approve long-term incentive payouts for the CEO
- Estimate outcomes of ISS and/or Glass-Lewis CEO pay-for-performance tests based on anticipated proxy statement disclosure of CEO compensation

**Following Year-End:** Assess CEO’s actual pay relative to actual performance (over multiple timeframes)

- Assess actual CEO pay for fiscal year relative to actual pay among peers
- Assess actual performance on key measures relative to peers
- Assess percentile pay relative to peers vs. percentile performance relative to peers (see diagram below)

A robust process for assessing the pay and performance relationship is a critical part of whether the Committee fulfills its responsibilities effectively. Our preferred approach is discussed in the following section.

A formal review of the CEO’s pay levels relative to peers, as well as an assessment of how financial performance compares to the same sample of companies, is a valuable tool to test whether the company’s actual pay practices are consistent with the pay philosophy. This is also an important indicator of whether the financial goals established for the company contain sufficient rigor.
The diagram shown below summarizes the results of the pay-for-performance assessment. Four quadrants are displayed, with the upper right quadrant showing the sweet spot: above median performance and above median pay relative to peers. The diagonal lines mark the 25th and 75th percentiles on each axis. In most instances, a position within these guidelines is desirable.

Many Committees are becoming more sophisticated in how they view the pay and performance relationship and are looking at pay and performance over a three to five year time-frame to recognize the majority of CEO compensation is based on long-term performance. When looking at compensation over a multi-year time-frame, Committees often shift their focus from the grant value of long-term incentives to the “realizable” value of long-term incentives. Realizable pay can be calculated a number of different ways, but in all its variations, the key difference is that the long-term incentives are revalued as of the end of the period under review to capture the most critical driver of CEO compensation levels – changes in a company’s stock price since the grant date.
Below are several approaches to assessing the CEO pay and performance relationship:

- **Absolute Assessments:**
  - Change in SCT pay vs. change in TSR over a 1-year or 3-year period
  - Change in realizable pay vs. change in TSR over a 3-year or 5-year period
  - Change in realized pay vs. TSR over CEO tenure

- **Relative Assessments**
  - Compensation percentile vs. performance percentile
  - Compensation may be defined as SCT pay, SCT pay excluding change in pension value and all other compensation, realizable pay, or realized pay
  - Performance is frequently based on TSR, but can be based on financial performance on key metrics that are important to the Committee

**ISS Approach:**

As a key component of its recommendations to institutional shareholders on how they should vote on management Say on Pay proposals, (ISS) assesses CEO pay using three quantitative tests:

- **Relative Degree of Alignment:** Compares percentile rank of the company on the 3-year average summary compensation table (SCT) pay of the CEO relative to peer group CEOs against 3-year total shareholder return percentile ranking relative to the peer group. If the pay percentile ranking is well ahead of the TSR performance percentile ranking, ISS may have concerns

- **Multiple of Median:** Assesses the relationship between the 1-year SCT pay of the CEO and the median of SCT pay of peer group CEOs. If the
company’s pay is well above the median of the peer group (e.g., >2x), ISS may have concerns.

- **Pay-TSR Alignment:** This test compares the trend rate in a company’s CEO’s total compensation with the value of a $100 investment (in the Company) over the prior five-year period. If the pay trend is not aligned with the TSR trend, ISS may have concerns.

Many Committees will review simulations of ISS’ quantitative pay-for-performance tests in advance of filing proxy materials to understand if they are likely to receive an against recommendation on Say on Pay based on ISS’ quantitative analysis of the CEO’s pay-for-performance relationship. If a company raises concerns on the quantitative tests of performance, ISS will evaluate numerous qualitative aspects of the company’s compensation program before determining its recommendation on the management Say on Pay proposal.

**Glass-Lewis Approach:**

Similar to ISS, Glass-Lewis conducts a quantitative assessment of the relationship between pay and performance. The Glass-Lewis performance assessment looks beyond TSR to include financial measures of performance. Similar to ISS, pay is defined as Summary Compensation Table pay. Glass-Lewis will assign companies an A-F rating based on the degree of alignment in the pay and performance relationship. Companies with an A rating have a performance percentile above their pay percentile; companies with a C rating have aligned pay and performance percentiles; companies with an F rating have a pay percentile above their performance percentile. Glass-Lewis will evaluate the pay and performance relationship for the CEO and all other Named Executive Officers disclosed in the proxy statement.

**Key Questions for Committee Members to Ask**

- How well does the CEO’s actual pay levels align well with the company’s performance relative to peers over 1-year and over longer periods? Have we heard any comments?
• Does the actual pay reflect the leadership and strategic stewardship of the company?

• Do we expect ISS or Glass-Lewis to raise concerns about the CEO’s compensation?

• Do any Committee members have any concerns about the compensation program for the CEO?

• Have we received any shareholder proposals that touch on CEO compensation? Any publicity?

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**Realized and Realizable Pay**

Many companies have concluded that the required Summary Compensation Table (SCT) disclosure of executive pay levels is ineffective for purposes of comparing pay and performance. The key limitation of SCT pay is that mixes actual payments to executives (e.g., salary, bonus payouts, long-term cash plan payouts) and pay opportunities that will vest and be earned over time (e.g., the grant date fair values of stock options, restricted stock, and performance share awards). Since equity-based pay is such a large portion of CEO pay, it is the most critical form of pay to examine when looking at the pay and performance relationship. If we look at SCT pay, then we are missing how the pay and performance relationship plays out over time for the most significant part of CEO pay.

To correct for this serious shortcoming of SCT pay, most Compensation Committees will also evaluate the realized pay of the CEO over time, as well as the realizable pay. Realized pay is akin to the “take home” pay for the CEO and is similar to W-2 gross income. It includes the CEO’s base salary, short-term and long-term cash incentive payouts in (or for) a given year, the value realized upon stock option exercises, the value realized upon the vesting of restricted stock, and performance share plan payouts. Some analyses will also include the
value of other forms of compensation for a given year (e.g., perquisite values, pension contributions).

Realizable pay is the potential value that an executive could realize at a point in time if the executive “cashed in” on all outstanding long-term incentives granted over a period of time, plus the salary and bonus paid to the executive over that period. Realizable pay has become popular because it demonstrates how the potential pay an executive could earn changes over time with movements in the stock price. It is generally easier to use for comparisons across companies, because it is less dependent on the timing of executive stock option exercise decisions and the timing of equity vesting than realized pay. Many Compensation Committees make it a practice to review realizable pay on a relative basis compared to peers and a small minority of companies have begun to include the results of these comparisons in their proxy statements.
Chapter 20. The Proxy Statement and Compensation Discussion and Analysis

In the past, the proxy statement discussion and disclosure of executive compensation was viewed largely as a legal compliance document. Corporate legal departments generally took the lead in drafting the materials, with support from the compensation function in assembling the information required for the compensation tables. As a result, proxy statements were often challenging to read. Technical language and jargon was used frequently and the bare minimum level of disclosure required to comply with regulations was often provided.

With the advent of the management Say on Pay vote, companies now view the proxy statement, particularly the Compensation Discussion and Analysis (CD&A), as a critical communications document. Rather than a compliance document, the CD&A and supporting materials in the proxy statement are the means for the company to make the case that its executive compensation program is effective in supporting pay for performance, aligning management’s interests with those of shareholders and retaining key executives. As a result, companies have been working to modify their disclosure to make proxy statement more user friendly and better communications documents.

Below is a brief summary of some of the key developments in proxy statements, with a focus on the CD&A.

Use of Executive Summary

In our view, the executive summary is the most important section of the CD&A. It provides the company with an opportunity to boil down its compensation decisions in the relevant year to the essentials. Even though the SEC does not require an executive summary, most companies have adopted this approach. While each company has a different compensation program, well written executive summaries of the CD&A share the same structure:
- **Company Performance**: Provide a written or graphic summary of the performance of the company. Address total shareholder returns and key financial performance metrics (e.g., performance on metrics used in the annual incentive and long-term incentive plan). Companies can also include important strategic (e.g., product launch, business acquisition) and operating achievements (e.g., cost reductions, succession planning) from the year.

- **Incentive Compensation Payouts**: Describe how the company’s performance impacted annual incentive and long-term incentive plan payouts (e.g., above plan financial performance led to above target annual incentive payouts). If performance fell short of expectations, demonstrate that there was an associated impact on pay.

- **Target Compensation Levels**: Describe how the Committee arrived at target pay decisions for the executive team, referencing the company’s pay philosophy.

- **Compensation Design Changes**: Highlight any changes to the company’s annual or long-term incentive design, or any other executive compensation changes and provide the reason for why the change was made.

- **Highlight Positive Program Features (“What We Do/What We Don’t Do”)**: Inform shareholders of positive aspects of the program (e.g., ownership guidelines, stock holding requirements, anti-hedging policy) and negatives that are absent from the program (e.g., excise tax gross-ups, single trigger vesting of equity following change in control, excessive perquisites).

**Assist the Reader**

Proxy statements used to read like legal documents. Anyone who has ever read a proxy statement knows that the legal style of writing is not necessarily meant to ease understanding.

The SEC has encouraged companies to use plain English in describing their compensation programs and companies have taken this to heart. There is a lot of jargon specific to the field of executive compensation and
it should be avoided. Below is an example of how some jargon can be eliminated from disclosure:

*Legalese:* “To ensure compliance with IRC Section 162(m), our Compensation Committee established an umbrella plan that insured an initial level of funding of 0.5% of net income for each Named Executive Officer, other than the CFO who is not a Covered Employee under IRC Section 162(m)”

*Plain English:* “In order to make sure that incentive payments to our executives were tax deductible for the company, we established a maximum annual incentive payment to each executive equal to 0.5% of net income.”

As part of the move to clearer communication, companies have tried to aid the reader by breaking up long blocks of text and calling out the topic under discussion more clearly. In addition, many companies have introduced tables and graphics to enhance the readability of the proxy statement.

**Key Questions for Committee Members**

- *Does the Executive Summary clearly tell the company’s pay for performance story?*

- *Does the CD&A tell the reader why we did what we did or just what we did?*

- *Are there opportunities to condense the document?*

- *Can we avoid unnecessary jargon and use plain English?*
Chapter 21. Director Compensation

Oversight of director compensation can fall under the purview of the Governance and Nominating Committee or under the Compensation Committee depending on the individual company’s approach to Committee responsibilities. Whichever Committee oversees director compensation, the issues will be the same. Establishing director compensation is inherently a little awkward, as the directors are responsible for establishing their own pay levels.

Director Compensation Philosophy

To date, director compensation has not been subject to the same level of external scrutiny as executive compensation. There are likely two main reasons for this: 1) director compensation levels in absolute terms, are modest relative to executive compensation levels, 2) director compensation programs are not highly leveraged. Much of the controversy surrounding executive compensation stems from concerns about the pay-for-performance relationship or excessive levels of non-performance based pay. Director compensation is generally not designed to explicitly link director pay levels to performance, aside from paying directors in the form of company equity. While in the past, directors used to often have non-performance based pay in the form of perquisites, insurance benefits or retirement plans; today’s director compensation programs do not generally include significant amounts of non-performance based pay. Unlike executives, directors are generally not participants in retirement plans or covered by severance arrangements. Due to concerns about potential litigation based on excessive director compensation some companies have established limits on director compensation particularly in their shareholder approved process.

To effectively manage director compensation programs, the key objectives that Committees focus on are 1) aligning the interests of directors with those of long-term shareholders and 2) attracting and retaining qualified directors to serve on the Board. In practice, the first objective is addressed by ensuring that a meaningful portion of director compensation (50% or more) is delivered in the form of company equity and often deferred until
the director retires from the board. With this kind of compensation structure, directors can accumulate a meaningful ownership level over time and are expected to have a financial incentive to act in the long-term interests of shareholders, consistent with their responsibilities as directors or stewards of the company.

To address the second objective of attracting and retaining qualified directors, most companies ensure that they establish a competitive target pay positioning for directors. The majority of companies use the same peer group for establishing both director compensation and executive pay levels. This may seem somewhat counterintuitive, as directors are typically drawn from a broader array of backgrounds than executive talent. However, most companies opt to use the same peer group for executive and director pay as it sends a message that directors are being treated comparably to executives. Similarly, if executive pay is targeted at the median of the peer group, most companies will target director pay at the median as well to ensure that management does not feel that directors are more generous with their own pay than the pay of executives.

**Director Compensation Design**

Director compensation program design is simpler than executive pay, but can have a number of different elements and may depend on the role a director serves on the board. When we think about director pay, we think about it in the following buckets:

- **Compensation for Board Service**
- **Compensation for Committee Service**
- **Compensation for Committee Leadership**
- **Compensation for Board Leadership (Non-Executive Chair/Lead Director)**

**Compensation for Board Service**

Compensation for board service consists of elements of pay that all directors will receive, without regard to committee service or leadership roles.
The most common pay elements for board service are the annual retainer (can be delivered in cash, shares or a combination of both), board meeting fees, and an annual equity grant.

In the traditional model of director pay, a director would receive an annual retainer in cash (e.g., $60,000), Board meeting fees (e.g., $1,500 per meeting), and an annual equity grant (e.g., $75,000). Assuming a Board had 10 meetings a year, this would result in total compensation of $150,000 for Board service.

Over the past, 5+ years, many large companies have moved to simplify their director compensation programs by eliminating Board meeting fees and/or potentially Committee meeting fees and providing a single retainer divided between cash and equity. For example, a single annual retainer of $150,000 may be delivered $75,000 in cash and $75,000 in deferred equity shares.

Many companies will provide directors with the option to defer receipt of all or a portion of any annual cash retainer and meeting fees until they leave the board. This can provide directors with a useful means of managing their tax liability.

Equity compensation for directors is almost always provided in the form of shares or stock units. In the past, companies frequently provided directors with stock options, but stock options have been heavily criticized for incentivizing excessive risk-taking. Pay critics would prefer that directors be paid in shares out right so they are focused on increasing the value of the stock price while being mindful of downside risk. Similarly, very few directors participate in long-term performance plans, as they might be conflicted in establishing goals for such plans and assessing performance levels.

Equity grants for directors are most often established as a targeted annual dollar value which is converted into a number of shares at the time of grant (often the annual meeting date). In many cases, the directors are granted stock units that are immediately vested, but are deferred and settled when the director leaves the board. The rationale for this approach
is that a vesting requirement is not critical to retain directors and the company wants to use equity primarily to align directors with shareholders over the long-term.

Compensation for Committee Service

Under the traditional model of director compensation, all members of a committee would receive a fee for participation in meetings (e.g., $1,500 per meeting). The rationale for this approach was that the number of meetings held was a good proxy for the committee workload and time commitment. Historically, the Audit Committee tended to have more meetings than other committees and often had a heavier workload. In years where the committee had more meetings, compensation would rise and in years of lower activity, compensation would fall. In addition, board members who serve on multiple committees may be paid differently from members who serve on only one committee. A minority of companies provide a committee service retainer, in lieu of committee meeting fees.

As mentioned under Compensation for Board Service, many large companies have decided to eliminate Board and committee meeting fees, along with Board meeting fees. For many of these companies, the rationale is that over time all board members will make similar contributions through board and committee service and, even if not in attending a meeting in-person, directors will review materials and provide input prior to meetings, and they would rather have equitable compensation for all board members. However, even among these companies they generally differentiate compensation for committee or board leadership roles.

Compensation for Committee Leadership

Most boards recognize that serving as the Chair of a committee is a significant step up in terms of responsibility and workload from serving as a committee member. The Chair will typically spend more time working with management or outside advisors to develop meeting agendas and reviewing meeting materials and may be called upon to vet ideas with other committee members in advance of meetings or occasionally interact with shareholders. The typical form of incremental compensation for Com-
mittee Chairs is a supplemental retainer to recognize their additional role. The Audit Committee tends to receive the highest incremental compensation of the committees, followed closely by the Compensation Committee. The table below provides typical retainers among Fortune 100 companies.

<table>
<thead>
<tr>
<th>Percentile</th>
<th>Audit</th>
<th>Compensation</th>
<th>Finance</th>
<th>Governance</th>
</tr>
</thead>
<tbody>
<tr>
<td>75&lt;sup&gt;th&lt;/sup&gt;</td>
<td>$25,000</td>
<td>$20,000</td>
<td>$20,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>50&lt;sup&gt;th&lt;/sup&gt;</td>
<td>$25,000</td>
<td>$18,000</td>
<td>$15,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>25&lt;sup&gt;th&lt;/sup&gt;</td>
<td>$15,500</td>
<td>$14,250</td>
<td>$10,000</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

**Compensation for Board Leadership**

Depending on the company’s management structure, non-executive board leadership roles can be one of the following:

- **Non-executive Chairman**
- **Lead director (fixed individual)**
- **Lead director (rotating)**

**Non-executive Chairman Compensation**

In companies where there is not a combined Chairman and CEO, the Non-Executive Chairman serves as the leader of the Board. Given the expansive responsibilities of a Non-Executive Chairman (e.g., has authority to call Board meetings, chairs Board meetings, shapes Board agendas, can represent organization externally), the compensation levels for Non-Executive Chairman are often close to 2x that of a typical director. The market range of compensation for this role is broad reflecting the differences in the scope of the role at different companies.
Total Board Compensation (Cash + Equity) | Total Non-Executive Chair Compensation | Total Non-Executive Chair Comp (as a multiple of total board comp)
---|---|---
75th Percentile | $257,000 | $500,000 | 2.04x
50th Percentile | $235,000 | $435,000 | 1.73x
25th Percentile | $200,000 | $300,000 | 1.44x

### Lead Director Compensation

In companies where there is a combined Chairman and CEO role or an Executive Chairman, the Lead Director role is responsible for leading the executive sessions of the Board outside of the presence of the CEO. In most companies, a single director is charged with the role of functioning as the Lead Director for all executive sessions, in other companies, different directors may take on the role in different meetings. In cases where a single director is charged with the role, they are typically provided with additional compensation to reflect their responsibilities.

The incremental compensation for a Lead Director is typically provided in the form of a supplemental retainer, with the amount of compensation comparable to what is provided to the Chair of a major committee (e.g., Audit or Compensation).

#### Lead Director Compensation: Fortune 100

<table>
<thead>
<tr>
<th>25th Percentile</th>
<th>50th Percentile</th>
<th>75th Percentile</th>
</tr>
</thead>
<tbody>
<tr>
<td>$23,750</td>
<td>$25,000</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

### Director Stock Ownership Guidelines

To help to ensure that directors have a meaningful financial stake by which their interests are aligned with the interests of the company’s shareholders, many large companies have established director stock ownership guidelines. In practice, most directors find it relatively easy to comply with these guidelines given that a substantial portion of their annual compen-
sation opportunity is provided in the form of company equity. The table below summarizes the typical elements of director stock ownership requirements.

<table>
<thead>
<tr>
<th>Program Element</th>
<th>Market Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basis for Requirement</td>
<td>Majority of companies define as a multiple of annual retainer  &lt;br&gt;Minority of companies define as a number of shares or as a dollar amount</td>
</tr>
<tr>
<td>Requirement</td>
<td>3x-5x annual retainer is common</td>
</tr>
<tr>
<td>Time to Comply</td>
<td>5 years to comply from joining the Board</td>
</tr>
<tr>
<td>Shares Counted Toward Compliance</td>
<td>Shares owned outright  &lt;br&gt;Unvested restricted stock or restricted stock units (in some cases on a net of tax basis)</td>
</tr>
<tr>
<td>Assessment of Compliance</td>
<td>Annual testing of compliance  &lt;br&gt;Many companies use an average stock price over a period of time (e.g., average for the year)</td>
</tr>
<tr>
<td>Consequence if not in Compliance</td>
<td>Most companies expect directors to comply, but do not have formal consequences for non-compliance</td>
</tr>
</tbody>
</table>

**Key Questions for Committee Members to Ask**

- *Is our compensation philosophy (e.g., peer group, target pay positioning) for director compensation consistent with our approach for executive compensation? If not, why?*

- *Could our director compensation program be improved through simplification?*

- *Does our director compensation adequately recognize the contributions of Board members who take on leadership responsibility?*

- *Does our director compensation program provide a high enough proportion of compensation in the form of company stock?*
Chapter 22. Compensation Risk Review

In 2009, the SEC created a new disclosure requirement for companies requiring them to disclose material risks arising from the compensation programs for all employees. The rationale for this new risk disclosure requirement was the perception that certain forms of compensation arrangements (e.g., uncapped bonus plans, stock options, commission plans) could create incentives for management to expose the company to risk in the hopes of getting outsized returns. It should be noted that while the disclosure requirement is triggered only when material risks are identified, all companies are required to assess the risks from their compensation programs in order to determine whether there is a likelihood of material risks arising from such programs.

Since 2009, there have been almost no examples of companies disclosing that their compensation programs raise meaningful risk concerns. To date, most companies instead disclose that the company has reviewed the risk of its compensation programs and determined that the compensation programs do not generate a meaningful risk for the company.

What does this mean for you as a Compensation Committee member? In practical terms, it should mean that some time prior to the filing of your annual proxy statement, the company should provide the Committee with a risk assessment of the company’s compensation programs. This is most often done by a company’s HR and risk staff, or in conjunction with outside compensation advisors. Critical to this assessment is ensuring that the compensation program does not encourage employees (individually or as a group) to make decisions or actions that will expose the company to significant risk. Most companies address this concern by demonstrating that their compensation programs balance different performance measures over different time-frames. Additionally, they demonstrate that there are supporting design features and operational and governance processes to help ensure that undesirable behavior from a risk perspective will not result in outsized compensation payments. There are a wide variety of approaches used to conduct the risk review, but they tend to incorporate several key features as summarized in the table below.
<table>
<thead>
<tr>
<th>Aspect</th>
<th>Description</th>
<th>Purpose</th>
</tr>
</thead>
</table>
| **Summarize Plans**         | • No. of participants  
• Time-frame  
• Performance Measures  
• Total Spend  
• Low/Median/Max payouts | • Ensure that Compensation Committee knows relative scope of the various compensation plans                                                                                                             |
| **Pay Mix Analysis**        | • % of pay delivered as salary, bonus, and LTI vehicle (at target and based on actual pay)  
• Broken out by employee level/area of the business | • Demonstrates degree of balance in compensation program across different measures and different time-frames  
• Demonstrates how pay mix varies with employees ability to impact performance                                                                 |
| **Risk Mitigating Design Features** | • Identify in aggregate or by plan aspects that mitigate risk (e.g., bonus caps, multiple measures, deferrals, ability to exercise negative discretion, stock retention requirements, stock ownership guidelines, clawbacks, etc.) | • Ensures Compensation Committee that plan has “built-in” risk mitigators that reduce the likelihood of risky behavior resulting in outsized compensation |
| **Internal Controls**       | • Process for calculating performance results for plans and determining payouts  
• Auditing process  
• Potential conflicts of interests in control functions, if any | • Ensures Compensation Committee of accuracy of plan payouts and addresses concerns about self-interested parties biasing results                                                                  |
| **Plan Governance**         | • Role of control function staff not participating in plan in design process  
• Role of Compensation Committee in approving plan designs and overall payouts | • Provides comfort to the Committee that there is adequate oversight of plans up-front in the design process and at year-end in determining payouts |
For most Compensation Committees, the compensation risk review tends to be addressed in a brief discussion, as most companies have few risk concerns related to compensation. However, for Compensation Committee members operating in the financial services industry, the risk review can involve significant time and effort, as these companies are subject to considerable regulatory scrutiny. Because of the severity of the financial crisis, and the view that inappropriate incentive compensation design contributed to undesirable employee behavior, large financial services companies (primarily banks) have been required to change processes around incentive compensation design significantly.

At this point, it is unclear if the type of regulatory scrutiny around compensation and risk applied to the financial sector will ever be applied to other industries, as most industries do not have the same potential for systematic risk as financial services.

**Key Questions for Committee Members to Ask**

- *Do participants in the design play a critical role in assessing performance and determining payouts? If so, what controls are in place to ensure that they act in the company’s interests?*

- *Do we have any uncapped incentive payments? If so, what processes are in place to avoid windfall compensation for participants in these plans?*

- *What ability do we have to reduce incentive compensation payments or recover payments already made in the event that an executive has engaged in inappropriate risk-taking?*
Chapter 23. Leadership Development and Succession Planning

In our interviews with directors, several pointed out that the responsibilities of their committees in many cases have expanded beyond compensation to include oversight of leadership development, succession planning and/or employee diversity. In fact, many Compensation Committees have been renamed to incorporate Human Resources, Human Capital or Organization into the name of the Committee to recognize the Committee’s broader role in human capital management.

In some ways, it is a natural fit for leadership development and succession planning to fall under the purview of the Compensation Committee. Two of the key compensation objectives, the attraction and retention of talent and ensuring pay-for-performance, are each critical to the company’s leadership development and strategic planning. Given the role of the Compensation Committee in overseeing the compensation design and in reviewing the CEO’s assessment of his direct reports’ performance, the Compensation Committee is well informed about the strengths and weaknesses of the senior executive team and what compensation structures are in place to support their retention.

Where the Compensation Committee does have oversight of leadership development and succession planning, significant time will be dedicated over the course of the year to talent reviews and a current understanding of the succession plans. Talent reviews are frequently conducted for each area of the organization and typically cascade down from the top of the organization (e.g., the CEO may conduct a talent review of each of his direct reports, the General Counsel will provide a talent review of the legal function, identifying potential successors to the General Counsel role, as well as second level legal succession candidates). The goal of the talent review should be to identify what the strengths of the current staff are, as well as where there are needs to further develop current staff or recruit externally to supplement existing staff. The talent review also feeds directly into succession planning by identifying those individuals that may
be potential successors to more senior executives, as well as their development needs before they are ready to move to the next level.

Several directors pointed out to us that leadership development and succession planning is an area where members of the existing management team may feel somewhat conflicted. For example, a CEO has an obligation to the organization to identify those employees that may be able to function as a suitable replacement for he or she in the near-term and long-term. Identifying and developing a strong successor can yield great benefits for the organization at the time that a CEO transition occurs. Unfortunately, from the perspective of the CEO, identifying a successor is likely a lower priority. By identifying and developing a strong candidate to succeed him, the CEO may be helping the Board and the company, but is harming his own job security. If the Board knows that the company has a strong succession candidate, they may be more likely to terminate the CEO or accelerate any transition plans if the company's performance is weak. When it comes to the management team that supports him, the CEO may have a stronger incentive to identify and develop succession candidates, but his management team will likely be more conflicted about the benefits of identifying successors to potentially replace them in their own roles.

With this as context, it is critical that the Board takes leadership development and succession planning seriously, as they are the group that has the most to lose if the process does not work well. As discussed earlier, when Boards have to look outside of the company to find a successor for the CEO, it typically costs the company more money and is likelier a riskier transition. Turnover below the CEO level is similarly expensive and can be disruptive to the functioning of the management team.

When the Board makes leadership development and succession planning a priority, it can become a priority for the CEO and the management team as well. If management understands that their individual performance assessment will include an evaluation of the progress they have made in developing and implementing a succession plan, they will pay attention to it.
In our experience, we have found that Compensation Committees that take leadership development seriously dedicate significant time to the effort and incorporate one of two processes:

- **Annual meeting (typically in the summer):** Dedicated to leadership development and succession planning across the organization
- **Periodic reviews:** Review of talent within a functional area (e.g., Finance, HR, etc.) of the organization at each meeting of the Committee

During the course of the year, Board members often get exposure to the senior management team to contribute to executives’ development, as well as gain better ability to assess future executive talent within the organization.

From a compensation perspective, it is also critical to periodically review the equity holdings of senior management to understand what the company has in place in terms of unvested equity value that serve as “handcuffs”, that will increase the cost to the executive of voluntarily leaving the organization or the cost to another organization to recruit the executive.

Beyond leadership development and succession planning, some Committees also have responsibility for oversight of employee diversity. In these cases, it is common for management to provide the Committee with periodic reports on employee demographics by different areas of the organization, such as:

- **Female percentage of employee population overall and by level of the organization**
- **Minority percentage of employee population overall and by level of the organization**

Ideally, management provides the Committee with some sort of benchmarking of the above percentages. There are several perspectives that should be of interest to the Committee, to the extent available:

- **Changes in demographics over time**
• Comparison to relevant benchmarks (e.g., typical representation in the industry/profession)

• Comparison to company’s own long-term goals for diversity

**Key Questions for the Committee Members to Ask**

• What are the Compensation Committee’s responsibilities for the oversight of leadership development and succession planning?

• How will management support the Committee in fulfilling our leadership development and succession planning responsibilities?

• What is our plan if the CEO suddenly departs the organization? Our CFO? Our General Counsel? Etc.

• Does our current level of employee diversity expose us to potential criticism? Legal action?
Chapter 24. Conclusions

While executive compensation is an area that is subject to considerable external scrutiny and any Compensation Committee is potentially at risk for criticism of decisions they make, it is our view that executive compensation is a key tool that when used correctly can help an organization achieve its goals. When the pay design goes astray, pay levels can become a distraction for members of the Board and the management team.

Key Lessons

Our position as compensation advisors has provided us with a unique vantage point to view the evolution of the role of the Compensation Committee. While in the past, the Compensation Committee may have been too closely aligned with management, today’s Committees take their independence and objectivity seriously. What many critics of executive compensation practices fail to understand is that even with the best intentions, it is almost impossible to design an effective compensation design that will not be criticized by someone. Compensation Committees have to balance competing objectives in compensation design and have to be able to prioritize the concerns of the many different constituencies that will weigh in on the compensation design, whether their input is solicited or not.

Some of our peers in the consulting profession have raised concerns that executive compensation practices run the risk of evolving over time to a “one size fits all” approach. They fear that due to the disproportional influence of shareholder advisory firms on executive compensation design, Compensation Committees will cave to compensation designs dictated by the policies of the shareholder advisory firms. For example, since ISS uses total shareholder return (TSR) as a key component in its pay and performance model, there is a risk that Compensation Committees may move to long-term incentive designs that pay out based on relative TSR to help ensure that their compensation program has pay and performance alignment under ISS’s quantitative tests. Similarly, a Compensation Committee that is overly concerned with ISS may select peers based less on their own definition of the competitive market for talent and more on the basis of who ISS views as the right peers.
Our view is that these fears are overstated. We agree that ISS and Glass-Lewis tend to evaluate compensation programs using a “one size fits all” approach that may fail to recognize that different organizations may have very good reasons for using compensation designs that do not comply with their policies. However, in our experience, Compensation Committees function as an effective protector against the prescriptive policies of shareholder advisors. Most of the Committees we see in action recognize that ISS and Glass-Lewis are influential over a portion of the company’s shares, but in most cases influence the voting of a minority of shareholders. The Committee understands that doing something only for the purposes of pleasing ISS can significantly diminish the effectiveness of the compensation program in achieving its objectives as an overall management tool.

For example, many companies continue to use the same performance goals in their short-term incentive plan and long-term performance plan. ISS and Glass-Lewis each view this as a problematic pay practice that they consider putting excessive weight on a single performance measure. However, Compensation Committees recognize that while ISS and Glass-Lewis may have a point in certain circumstances, there are plenty of situations where using a single measure for the short-term and long-term performance plan makes a great deal of sense. For example, many companies that use economic profit as a performance measure will use it in both the annual and long-term performance plans. Organizations that use economic profit effectively understand that using other performance measures will dilute the company’s focus on its true definition of performance. Compensation Committees in such an organization would need to work to ensure that other aspects of the compensation program address the concerns of shareholder advisors.

Successful Committees do a great job of balancing the concerns of the different constituencies. They will pick their battles with shareholder advisers or with management over fundamental principles that the Committee views as critical to the compensation design. Wisely, Committees will cede ground on more minor points that may be the Committee’s preferred
approach, but will help the Committee to win other battles with management or shareholder advisers.

**Looking Forward**

If we scroll forward to what the next few years hold for Compensation Committees, we expect to see a continued movement toward more effective review and refinement of the pay and performance relationship. We expect that it will be standard practice for Compensation Committees to do an annual look-back on prior year compensation to see how well the company’s pay levels aligned with the company’s performance. While many Compensation Committees review this kind of information today, we expect to see a higher degree of sophistication in the Compensation Committee’s review with compensation reviewed not just from the perspective of Summary Compensation Table compensation, but also from the perspective of realizable pay. We also expect Committee’s to review the pay and performance relationship over a three year or five year period, in addition to a year over year look at compensation changes. Sophisticated Committees will review the company’s performance from multiple perspectives beyond Total Shareholder Returns to examine top-line and bottom-line growth as well as financial returns on capital.

While a retrospective review is important for understanding how well the pay program has worked in the past, in order to ensure the program works well going forward, the selection of performance measures linked to strategic objectives and shareholder value creation will be critical. Compensation Committees need to ensure that management uses performance measures in the annual and long-term incentive designs that effectively measure success against strategic objectives and implementation of such objectives.

Beyond selecting the right performance measures, the Committee and management have to work together to make sure that the goals are set at the right level. Many companies rely heavily on an internal budgeting process to establish performance objectives. This approach can lead to goals that fall short of external expectations for performance. Management and the Compensation Committee should review shareholder expectations for
performance along with peer historical performance levels to assess the rigor of budgeted performance levels. Shareholders are likely to be underwhelmed if the company achieves its internal performance objectives, but falls short of industry standards and shareholder expectations. Setting performance goals with adequate rigor will be a leading contributor to appropriate pay for performance connections in the future, along with incentive vehicles that provide appropriate linkages to shareholder value creation.

To date, the annual say on pay vote has been a non-issue for most companies with very high approval rates. However, there has been an enhanced focus on shareholder outreach and engagement with shareholders around the subject of executive compensation. We expect this trend to continue in the future. At times, committee chairs will be called upon to speak directly with shareholders to explain the rationale for the company’s compensation decisions. This type of communication, when combined with the clear disclosure in the CD&A can help to keep the say on pay vote a non-issue.

We hope that this book has provided some helpful guidance in terms of Compensation Committee processes that can help you be successful in your Committee service. In addition, we believe that it can serve as a valuable reference tool to provide you with a baseline understanding of key aspects of compensation design.
Please contact us at (212) 921-9350 if you have any questions about the issues discussed above or would like to discuss your own executive compensation issues. You can access our website at www.capartners.com for more information on executive compensation.