The Compensation Committee Fundamentals Guide was created for Corporate Board Member’s Board Leadership Program with content provided by FW Cook.
## Table of Contents

**SECTION 1**

### Compensation Committee Responsibilities
- 06 Rules & Regulations
- 08 Key Responsibilities

**SECTION 2**

### Compensation Committee Operations
- 12 Roles & Composition
- 14 Meeting & Agenda
- 16 Onboarding & Increasing Effectiveness

**SECTION 3**

### Methods of Compensation
- 20 Fixed vs. Variable Compensation
- 22 Incentive Plan Design
- 24 Long-Term Incentive Plan Design
- 26 Comparison of Basic LTI Types
- 28 Indirect Compensation

**SECTION 4**

### Peer Group Development
- 32 Selecting Peer Groups
- 34 Peer Group Characteristics

**SECTION 5**

### Director Compensation
- 38 Elements of Compensation
- 40 Director Compensation Levels
- 44 Trends in Director Pay

**SECTION 6**

### Shareholder Engagement
- 48 The Evolving Landscape
- 50 CD&A Strategy
- 52 Conducting Shareholder Outreach

**SECTION 7**

### Regulatory Matters
- 56 Say-on-Pay
- 58 Disclosure Obligations & Listing Rules
- 60 Tax & Accounting Considerations

**SECTION 8**

### Regulatory Matters for Tax Exempt Organizations
- 64 Legislation
- 66 Determining Reasonableness of Compensation
- 68 Best Practices in Exempt Organization Governance

70 Conclusion

73 For More Information
Compensation Committee Fundamentals Guide

The Compensation Committee Fundamentals Guide was created for Corporate Board Member’s Board Leadership Program with content provided by FW Cook.

FW Cook is a nationally recognized executive compensation consulting firm that serves publicly traded and privately held organizations in developing compensation plans for their executives, key employees and non-employee directors. FW Cook’s comprehensive service offerings are designed to help clients attract and retain key employees, motivate and reward them for achieving performance objectives and align their interests with shareowners.

FW Cook adds value to the executive pay programs and processes by closely partnering with directors and companies in the development and administration of meaningful and effective compensation programs that align with the company’s business strategy and culture.

Director Fundamentals Knowledge Center

The Compensation Committee Fundamentals Guide is part of Corporate Board Member’s Director Fundamentals Knowledge Center, an innovative resource for public company boards that provides directors with a multi-faceted learning experience through concise guidebooks and interactive training courses. The goal of the Knowledge Center is to arm new directors with the fundamental training needed to be an effective director from day one.

The Director Fundamentals Knowledge Center consists of the following suite of resources:

- **Director Fundamentals Guide & Training Course**
- **Audit Committee Fundamentals Guide & Training Course**  
  *Content provided to you with support from PwC*
- **Compensation Committee Fundamentals Guide & Training Course**  
  *Content provided to you in partnership with FW Cook*
- **Nominating/Governance Committee Fundamentals Guide & Training Course**  
  *Content provided to you in partnership with Spencer Stuart*
Publicly traded companies are required to have a compensation committee composed of independent directors that is responsible for certain compensation-related actions. The committee’s general responsibility is approval of compensation programs that it believes are in the best interests of the company.
The U.S. Securities and Exchange Commission (SEC), the New York Stock Exchange (NYSE), and NASDAQ Stock Market (NASDAQ) require publicly traded companies to have a compensation committee composed of independent directors that is responsible for certain compensation-related actions. The committee’s general responsibility is approval of compensation programs that it believes are in the best interests of the company.

**COMPENSATION COMMITTEE MEMBER INDEPENDENCE RULES**

The NYSE and NASDAQ generally require that compensation committee members be independent. The determination of independence must be made by the board and publicly disclosed, after considering whether the director has any material relationship that would impair the director’s independence from management in connection with the duties of a compensation committee member. The rules specifically require consideration of the source of compensation received by the director, whether the director is an affiliate of the company and whether the affiliate relationship places the director under control of the company or management. In general, a director will be determined to be independent if the director is a non-management director free from any material family relationship or material business relationship, other than board membership and stock ownership, with the company or management and has been free from any such relationship for three years.

**NYSE LISTING REQUIREMENTS**

Publicly held companies listed on the NYSE are required to have a compensation committee composed entirely of independent directors and have a written charter that addresses its purposes and responsibilities.

*At a minimum, the committee's responsibilities must include:*

- Chief executive officer (CEO) compensation and performance: reviewing and approving corporate goals and objectives as they relate to CEO compensation, evaluating the CEO's performance in light of those goals and objectives and, either as a committee or together with the other independent directors, determining the CEO's compensation based on the performance evaluation;
- Other compensation: making recommendations to the board with respect to non-CEO executive compensation and incentive compensation and equity compensation plans that are subject to board approval;
- Compensation Discussion & Analysis (CD&A): preparing the compensation committee report required by Regulation S-K, which encompasses a review of the CD&A; and
- Annual evaluation of committee performance.

While the NYSE rule only requires the committee to recommend to the board approval of non-CEO executive compensation, the board is permitted to delegate its authority for such actions to the compensation committee.

In addition, pursuant to rules under the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), the committee may, in its sole discretion, retain or obtain advice from a compensation consultant, outside legal counsel or other adviser. The committee shall be directly responsible for the appointment, compensation and oversight of the outside adviser(s), and the company must provide appropriate funding as determined by the committee. Before retaining or receiving advice from an outside adviser, the committee must evaluate certain independence factors with respect to the adviser. While many committees endeavor to retain an independent consultant, the NYSE rule does not preclude retaining a consultant with a real or perceived conflict of interest.
NASDAQ LISTING REQUIREMENTS

Publicly held companies listed on the NASDAQ must have a compensation committee consisting of at least two independent directors.

The company must adopt a written charter, which must specify:

• the scope of the committee’s responsibilities and how it carries out those responsibilities, including structure, processes and membership requirements;
• that the committee shall determine, or recommend to the board for determination, the compensation of the CEO and all other executive officers of the company; and
• that the CEO may not be present during voting or deliberations on his or her compensation.

The NASDAQ rules also contain similar requirements to the NYSE with respect to the committee’s ability to retain an outside adviser, along with the requirement to consider certain independence factors prior to retaining or obtaining advice from an outside adviser.

Independence Factors for Evaluation of an Outside Adviser

1. Provision of other services to the company by the adviser’s employer
2. Amount of fees received from the company by the adviser’s employer, as a percent of the total revenue of the adviser’s employer
3. Policies and procedures of the adviser’s employer that are designed to prevent conflicts of interest
4. Any business or personal relationship of the adviser with a member of the committee
5. Any company stock owned by the adviser
6. Any business or personal relationship of the adviser or the adviser’s employer with an executive officer of the company

The NYSE rule also includes a “catch-all” for any other factors relevant to assessing the adviser’s independence.
Section 1: Compensation Committee Responsibilities

Key Responsibilities

While the SEC and stock exchanges provide for minimum requirements of compensation committees (discussed below), the scope of the committee’s duties has been expanding since the passage of Dodd-Frank in 2010 and associated introduction of mandatory say-on-pay votes in 2011. The committee charter has evolved to encompass strategic oversight of compensation programs, administration of executive pay actions and other related disclosure, regulatory and governance requirements.

Typical responsibilities now include:

- establishing and approving the company’s executive compensation philosophy, including the design and relative mix of pay elements and overall competitive positioning of executive pay relative to market.
- reviewing and approving the corporate goals and objectives relevant to the CEO’s and other executive officers’ compensation and evaluating the performance of the CEO and other executive officers in light of such goals and objectives.
- approving the CEO’s compensation (including salary, incentive-based and equity-based compensation levels); such a review may include input from other independent board members.
- reviewing and approving the compensation of the company’s other executive officers (which could be only Section 16 officers or expanded to a broader group).
- reviewing and approving the companies selected as comparables for competitive market comparisons of the company’s executive (and often director) compensation levels (referred to as the “peer group”).
- approving all employment agreements, severance agreements, change-in-control agreements or any other special benefit/perquisites provided to any executive officers (CEO pay and agreements are sometimes subject to full board approval).
- reviewing and recommending to the board the amount and form of director compensation.
- reviewing the potential risk to the company from its executive and non-executive compensation policies and practices.
- reviewing, approving, overseeing and/or administering policies covering ownership of company stock by executives and directors, hedging or pledging of company stock and recoupment of incentive compensation.
- administering the company’s equity incentive plans, including approval of all stock, option and other incentive awards under such plans.

The committee is typically permitted to and will often delegate authority to management to issue awards below a certain level and in accordance with applicable law and the company’s equity grant policies.

- reviewing and approving, or recommending to the board for its approval, reports on compensation matters required to be included in the company’s annual proxy statement or annual report.
- overseeing proposals to shareholders on executive compensation matters, including advisory votes on executive compensation and the frequency of such votes, incentive and other executive compensation plans, and amendments to such plans and in conjunction with the board or other committees and management, the engagement with proxy advisory firms and other shareholder groups on executive compensation matters.
- appointing and overseeing the work of a compensation consultant, outside legal counsel, or other adviser to the committee.
- reviewing the committee’s performance and adequacy of its charter.

Increasingly, the compensation committee also oversees broad human resources strategy, including management development, succession planning and diversity and inclusion initiatives.
COMPENSATION PHILOSOPHY
The committee should establish a compensation philosophy to serve as a guide for evaluating and making compensation decisions. The philosophy will ideally tie compensation program objectives (e.g., pay-for-performance, shareholder alignment, attraction and retention, etc.) with the compensation vehicles and policies at the company’s disposal (e.g., fixed versus variable pay). It may reference a targeted competitive position for the program versus market or may use market data along with other factors to determine compensation levels, without competitive positioning. An effective compensation philosophy also links the company’s business strategy to its compensation program. The committee should regularly review the pay philosophy to ensure it continues to be appropriate for the stage of business; compensation strategies naturally evolve with development.

The CD&A in the annual proxy statement must include a discussion of the company’s executive compensation philosophy. The philosophy is often a point of emphasis when explaining the committee’s compensation decisions and their appropriateness to shareholders.

DISCLOSURE RULES
SEC and stock exchange rules require extensive disclosure of executive officer and director compensation. Compensation committees are required to prepare the Compensation Committee Report in a company’s annual proxy statement or annual report on form 10-K. The committee report must state whether the committee reviewed and discussed the CD&A with management and based on such review, whether the committee recommended to the board that the CD&A be included in the proxy statement or annual report.
To ensure that compensation programs are effective in supporting a company’s objectives, compensation committees should rely on a set of best practices to form the foundation of the decision-making process.
Roles & Composition

**COMPOSITION**

The caliber and composition of the compensation committee are crucial aspects of committee effectiveness. The makeup of the committee should represent a range of backgrounds, skills and experience, as diversity broadens thinking and enhances dialogue, both of which are critical to the discussion of executive pay.

Compensation committee members should be selected and approved by the full board, following recommendations from the nominating and governance committee. In addition to independence qualifications, the board needs to ensure that each committee member is equipped to make decisions that are in the best interests of the company. During the selection process, careful consideration should be given to the candidate’s background, qualifications and experience. Candidates must be willing to commit the time necessary to make fully informed and thoughtful decisions. They should also demonstrate that they have the resolve to ask difficult questions and be courageous in challenging new proposals or the continued appropriateness of past practices.
ROLE OF THE CHAIR

The compensation committee chairperson is responsible for ensuring that committee meetings run efficiently and that each agenda item receives the appropriate level of attention. The chairperson also serves as the key liaison between the committee and other directors and senior management, and he or she often engages with compensation consultants and other advisers to keep the committee informed on key developments.

In choosing the compensation committee chairperson, the board should seek to select a director with strong leadership skills, including the ability to forge productive working relationships among committee members and with other directors and senior management. The chairperson should also be able to communicate candidly and tactfully with management when reporting the committee’s decisions on sensitive topics such as CEO pay and performance evaluations.
A compensation committee calendar helps ensure that key compensation decisions are made and routine governance duties are completed in a timely manner. Committees typically hold four to seven meetings per year, however, this range could vary depending on the size of the company, the stage in the business cycle, the scope of compensation committee responsibilities, the nature of the compensation arrangements and other factors. As a general rule, the committee should meet with enough frequency to ensure fulfillment of the committee’s oversight and decision-making duties over the course of the year.

The compensation committee should be active in setting the committee calendar each year, as well as individual meeting agendas. The committee should review the calendar periodically to assess progress and modify items as events unfold. A sample calendar is provided below, with agenda items that would typically be addressed at each meeting.

### SAMPLE COMPENSATION COMMITTEE CALENDAR

<table>
<thead>
<tr>
<th>ALL MEETINGS</th>
<th>JANUARY</th>
<th>MAY</th>
<th>NOVEMBER</th>
<th>SEPTEMBER</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Discuss and approve minutes from prior meeting(s)</td>
<td>Approval</td>
<td>• Any actions as a result of annual shareholder meeting</td>
<td>Approval</td>
<td>• Approve CEO performance review process</td>
</tr>
<tr>
<td>• Discuss executive compensation current events and recent regulatory changes</td>
<td>Discussion</td>
<td>• Approve peer group and methodology for competitive market analysis</td>
<td>Discussion</td>
<td>• Discuss projected funding of annual bonus plan and long-term incentive payouts</td>
</tr>
<tr>
<td>• Discuss and approve compensation for all new-hire and promoted officers</td>
<td>Approval</td>
<td>• Approve compensation committee consultant(s) and other advisers</td>
<td>Approval</td>
<td>• Discuss expected plan design for upcoming year annual bonus plan and long-term incentive award</td>
</tr>
<tr>
<td></td>
<td>Discussion</td>
<td>• Discuss proxy voting results and investor feedback</td>
<td>Discussion</td>
<td>• Discuss results from competitive market assessment</td>
</tr>
<tr>
<td></td>
<td>• Discuss annual compensation committee activity calendar</td>
<td>• Discuss executive compensation trends and regulatory updates</td>
<td>• Discuss share utilization and share reserve analysis</td>
<td>• Discuss CD&amp;A narrative draft</td>
</tr>
<tr>
<td></td>
<td>• Discuss executive compensation philosophy</td>
<td>• Discuss CEO’s performance relative to goals and objectives</td>
<td>• Discuss executive compensation risk assessment</td>
<td>• Discuss board of directors compensation (every other year)</td>
</tr>
<tr>
<td></td>
<td>• Discuss compensation committee charter (amend as needed)</td>
<td>• Discuss CEO and executive officer succession planning</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Discuss stock ownership relative to guidelines (executives and board of directors)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Discuss CEO and executive officer succession planning</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>MAY</th>
<th>SEPTEMBER</th>
</tr>
</thead>
<tbody>
<tr>
<td>Approval</td>
<td>• Approve funding of annual bonus plan and long-term incentive payouts</td>
</tr>
<tr>
<td>Discussion</td>
<td>• Approve annual bonus and long-term incentive plan designs for upcoming year</td>
</tr>
<tr>
<td></td>
<td>• Approve officer compensation actions (bonus payout, upcoming year base salary adjustment, target bonus and long-term incentive award)</td>
</tr>
<tr>
<td></td>
<td>• Approve CEO goals and objectives for upcoming year</td>
</tr>
<tr>
<td></td>
<td>• Discuss tally sheets for officers</td>
</tr>
<tr>
<td></td>
<td>• Evaluate officer performance for past year (in conjunction with CEO)</td>
</tr>
<tr>
<td></td>
<td>• Discuss upcoming proxy, including CD&amp;A and proxy tables</td>
</tr>
<tr>
<td></td>
<td>• Conduct compensation committee self-evaluation</td>
</tr>
</tbody>
</table>
The compensation committee should develop a regular process for meetings to establish cadence and ensure consistency. The process should allow for adequate time in advance of committee meetings for a discussion of significant items, approval of committee materials and communication and collaboration with management and outside advisers. The process should be tailored to the company and committee’s preference and meeting schedule. Below is a sample timeline outlining the typical lead-up to a meeting.

SAMPLE TIMELINE

**Step One: Discuss Agenda and Assign Tasks**

- 1-2 weeks after prior meeting, key parties (HR, legal, committee chair and consultant) discuss the draft agenda to:
  - identify follow-up items
  - discuss scheduled agenda items for next meeting and
  - identify work to be completed and timeline

**Step Two: Analyses**

- Complete all required analyses with respect to assigned tasks and deliverables
- Develop reports/supporting materials as needed
- Consultant and/or management provide draft materials for HR/legal review

**Step Three: Discuss with Management**

- 2-3 weeks before meeting, present results of analyses and potential alternatives on compensation matters to senior leadership to determine most appropriate direction
- Update materials based on discussions

**Step Four: Socialize, Review Meeting Materials**

- 10-14 days before meeting, partner with HR and committee consultant to present proposals/recommendations to committee chair to determine potential issues and rationale for approach
- Finalize materials based on discussions

**Step Five: Committee Meeting**

- At least 1 week before meeting, finalize materials and distribute
- Set expectations for results
- Monitor progress
- Collect input for next meeting (if needed)
ONBOARDING
Directors joining a compensation committee bring with them different levels of experience dealing with executive compensation matters. Some may have extensive experience from prior committee service, while others may have very limited experience. Regardless of background, there is a certain amount of education that new committee members require to become equipped to serve the needs of the committee. Some of this education can come from reviewing the company’s proxy statement and compensation program documentation. This will help directors to develop a baseline understanding of the company’s compensation programs along with how those programs are communicated to shareholders. In addition, a clear understanding of the company’s business strategy and objectives is essential since compensation is intended to align with and reinforce the business strategy.

Two key points of contact can make the onboarding process run smoothly: the compensation committee chair and an internal designee from human resources, finance or legal. 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. It is also good practice to include a meeting for the new member with the committee’s outside advisers.

A management representative should schedule a meeting with the new compensation committee member to walk through the compensation philosophy and program. Ideally, the management representative will be the head of human resources or a regular participant in the committee meetings so he or she will be able to provide broader context on how the company arrived at the current compensation philosophy and program.
INCREASING EFFECTIVENESS

To ensure that compensation programs are effective in supporting a company’s objectives, compensation committees should rely on a set of best practices to form the foundation of the decision-making process. The following provides a list of recommended best practices that should be used to guide committees in their deliberations related to executive compensation (note that this list is not exhaustive):

**EXECUTIVE COMPENSATION BEST PRACTICES**

- Annual review of the overall compensation programs, including compensation philosophy, in light of changing internal requirements and external market trends and regulatory updates
- Annual review of the previous year’s say-on-pay vote results and whether changes to compensation programs are required to address shareholder concerns
- Annual assessment of the relationship between pay and performance
- Mid-year CEO performance reviews
- Annual review of risks related to a company’s compensation policies and practices
- Review and approval of important decisions spread over two meetings to allow for sufficient discussion and consideration of the proposal and alternatives
- Regular meetings in executive session (with and without the committee’s compensation consultant)
- Periodic rotation of the chair role and committee membership
Compensation committees must determine the right mix of compensation and incentives that best align with their compensation philosophy.
Section 3: Methods of Compensation

Fixed vs. Variable Compensation

Compensation can generally be classified into two categories: fixed and variable. Fixed compensation is not tied to performance and is typically established at the beginning of the year during a company-wide compensation or benefits process. In contrast, the value realized through variable compensation fluctuates based on individual and/or company performance and can sometimes result in forfeiture of the compensation.

FIXED COMPENSATION

BASE SALARY
The core component of fixed compensation is base salary, which is intended to recognize the role, responsibility and tenure of an employee. Base salaries are almost always paid in cash on a fixed schedule and are reviewed annually or biennially for reasonableness (except in the case of a change in role or responsibilities). An appropriate level of base salary should allow for a reasonable standard of living and be substantial enough to mitigate the incentive for excessive risk-taking. (The latter point is most applicable to senior employees whose actions drive company performance.)

INDIRECT COMPENSATION
The other elements of fixed compensation fall into a category often called “indirect compensation.” Indirect compensation generally includes any form of compensation that either does not directly deliver cash or equity or does not provide benefits until a substantial period of time has passed. Types of indirect compensation include retirement benefits, stock purchase plans, health and welfare benefits and perquisites. Indirect compensation is generally determined on a company-wide basis and does not vary between employees, with potential exceptions of enhanced benefits for a select group of senior executives. The types of indirect compensation will be covered in greater detail later in this section.
VARIABLE COMPENSATION

In addition to fixed compensation, nearly all companies provide some form of variable compensation to employees. Variable compensation can be delivered through multiple vehicles, all of which share a common purpose - to incent performance. In the current governance environment, it is critical to align pay delivered to employees with company performance, which is most effectively achieved through well-designed annual and long-term variable compensation plans.

ANNUAL INCENTIVES

Annual incentives (also referred to as short-term incentives or cash bonuses) are intended to motivate employees to achieve near-term objectives. These plans are most commonly based on annual financial, operational, strategic, and/or individual goals. Goals are typically set for a company’s fiscal year, although some companies maintain plans that are based on quarterly or semi-annual goals. Payout, to the extent performance goals are achieved, is provided shortly after the end of the plan cycle, most commonly in cash; a small number of companies pay annual incentives in common stock or time-based restricted stock (most common in the financial services industry). Performance goals are generally weighted more toward company-wide performance for higher-ranking employees and toward individual performance for lower-ranking employees.

LONG-TERM INCENTIVES

Long-term incentive plans are also intended to drive performance, but unlike annual incentive plans, they are oriented over multiple years. The key functions of long-term incentives are to serve as a retention tool, to promote commonality of interest between employees and shareholders, and to tie a portion of compensation to long-term company performance. Long-term incentives can be denominated in cash or equity and are typically delivered over the course of three or more years. Performance-based long-term incentives (i.e., those with specific performance objectives that must be achieved in order for the incentive to vest) are generally reserved for a select group of senior employees who can influence company performance. Time-based long-term incentives (i.e., those which vest based on service alone) tend to reach deeper in the organization, with wide-spread participation most prevalent in high-tech and startup companies. In addition, companies may use long-term incentive grants as an inducement to recruit coveted talent in competitive labor markets or as incremental, on-top awards to recognize exceptional performance or increase the retentive hold on an employee.
## ANNUAL INCENTIVE PLAN DESIGN

There are four main plan types that companies use to deliver annual incentives, each with its own benefits and drawbacks. These plans types are summarized below:

### GOAL-BASED PLAN
- Payouts tied to the degree to which specified performance goals are achieved.
- One or more metrics established, including a weighting for each.
- Ranges of performance outcomes and corresponding payouts are calibrated on a predetermined scale.
- Generally heavily weighted on financial performance.

### FORMULA PLAN (“POOL AND ALLOCATE”)**
- Incentive pool typically funds based on profit performance (e.g., 2% of operating profit).
- Participants are allocated a percentage of the overall bonus pool rather than assigned formal incentive targets.
- Allocation may be proportional, discretionary or a combination.

### BALANCED SCORECARD PLAN
- Combine either of the above plan types with an evaluation of other factors such as achievement of strategic goals (e.g., market share gains, customer satisfaction, employee engagement, safety, etc.) or individual performance.
- Strategic and individual goals, when combined with budget-based plan goals, can either be used as discrete metrics (e.g., 50% of the target opportunity tied to EPS performance and 50% tied to individual performance) or act as modifiers to the payout of the budget-based goal (e.g., 100% of the target opportunity tied to EPS, with a +/- 30% individual performance modifier).
- When combined with formula plans, strategic and individual goals are generally used as modifiers.

### DISCRETIONARY PLAN* 
- Payouts are not formulaic or tied to specific predetermined metrics (no plan is established at the beginning of the year).
- Compensation committee maintains the authority to grant payouts based on a qualitative assessment of subjective criteria at the end of the year.
- Practically speaking, fully-discretionary plans are a “bonus,” not an “incentive.”

*Generally, all annual incentive plans include the ability of the committee to apply some discretion. Shareholders are skeptical of committee discretion and, therefore, companies using discretionary annual incentive plans or making upward discretionary adjustments in their annual incentive payouts should clearly disclose the factors that were considered by the committee when making payout decisions and/or the rationale for the application of discretion in order to mitigate shareholder concern.
SELECTING METRICS
Annual incentive plan financial metrics should reflect the key drivers of company success and, on balanced scorecards, may also consider the key strategic indicators of future success. Metrics and weightings may differ among various business units and between employees based on level and function within an organization. The most common financial metrics used for top executives among large, publicly traded U.S. companies are profitability measures (e.g., EPS, net income, EBITDA, profit margin, etc.), revenue and cash flow.

SETTING PERFORMANCE GOALS
When setting performance goals, committees should consider factors such as the company’s operating plan or budget, historical company and peer performance, and investor expectations. Notably, companies are likely to face criticism if target goals are set below prior year actual performance or if payouts are higher for inferior performance as compared to the prior year (this fact pattern, however, is not always possible to avoid; e.g., for cyclical companies such as those in the pharmaceutical industry); therefore, atypical goal-setting should be explained in a company’s CD&A). Additionally, companies that exceed maximum performance goals for multiple consecutive years are likely to face criticism for a lack of sufficient rigor in their goal setting. Performance goals should also take into consideration target compensation positioning relative to market.

DETERMINING PAYOUT LEVERAGE
In addition to the selection of metrics and setting of performance goals, committees must determine the annual incentive payout leverage. Almost all annual incentive plans are leveraged, meaning they have a range of potential payouts above and below the target award opportunity. Leverage is typically based on a sliding scale between a threshold goal (below which no payout will occur) and a maximum goal (at which point the payout is capped), with the target goal falling somewhere in between. The chart below illustrates a potential payout curve, with no payout if performance is less than 80% of target, 50% payout (threshold) if performance is equal to 80% of target, target payout if performance is equal to target, and 200% payout (maximum) if performance is greater than or equal to 120% of target.

Payout leverage should be calibrated to the difficulty of the goals and the range of possible performance outcomes. A plan with an especially challenging target may have a low threshold goal to provide significant downside protection, while a plan with a less challenging target may have a higher maximum goal that would continue to serve as a performance incentive even if the target goal were achieved early in the year. Additionally, if a company has the ability to set highly precise performance targets such that the range of potential performance outcomes is narrowly grouped around the target (based on historical precedent), the range between threshold and maximum performance goals should be narrower, resulting in greater changes to payout based on smaller changes in performance, and vice-versa.
Long-term incentives (LTI) are almost always unvested at grant, meaning they are at risk of forfeiture unless specific service and/or performance vesting conditions are achieved. LTI is most commonly provided in the form of equity at public companies but can also be paid in cash. Brief descriptions of the most widely used long-term incentive vehicles are presented below, followed by a comparison of the vehicles based on several key administration considerations.

**TIME-VESTED LONG-TERM INCENTIVES**

**RESTRICTED STOCK**
A form of stock that vests over a period of time (typically three to four years), is subject to transfer limitations until vested, and is generally forfeited upon separation of service. Restricted stock is intended to promote retention as it vests based on service alone and retains some value even if the stock price declines. Restricted stock typically entitles holders to dividends and voting rights.

**RESTRICTED STOCK UNIT (RSU)**
A form of phantom stock (no shares are issued at grant) that is tied to the value of a share of common stock. RSUs are similar to shares of restricted stock, but they can be settled upon vesting in either shares of common stock or cash. Additionally, because receipt of a grant of RSUs does not constitute a transfer of property under Section 83 of the Internal Revenue Code of 1986, as amended (the “Code”), recipients can defer taxation beyond vesting until the grant is settled. Other important ways RSUs differ from restricted stock are that RSUs do not provide voting rights until (or unless) the RSUs are settled in shares, and RSUs do not entitle holders to dividends (although dividend equivalents, paid in cash or reinvested into additional RSUs, may be granted in connection with the underlying award).

**STOCK OPTION**
A share-based vehicle that vests over a period of time (typically three to four years) and provides the recipient with the right to purchase a share of common stock upon vesting at a fixed price (“exercise price”), which is most often equal to the fair market value of the company’s stock on the date of grant, but can also be set at a premium to the grant date stock price. Once vested, the recipient has a period of time to exercise the option prior to expiration (typically seven or ten years after grant). Stock options are intended to reward employees for the increase in company stock price (and therefore shareholder value), as options do not deliver value unless the stock price appreciates above the exercise price.

**STOCK APPRECIATION RIGHT (SAR)**
A share-based vehicle that functions in a manner similar to a stock option but can pay out in either cash or shares of common stock in an amount equal to the value of the stock price appreciation above the grant’s base price.
PERFORMANCE-VESTED LONG-TERM INCENTIVES

PERFORMANCE-BASED AWARDS (STOCK/UNITS/OPTIONS/SARS/CASH)
These are performance-based vehicles that function in a similar manner to their time-vested counterparts but with vesting subject to achievement of performance conditions in addition to service requirements. Performance-based awards are intended to motivate the achievement of long-term operational and/or financial objectives. Examples of commonly utilized long-term performance metrics include total shareholder return (TSR), which measures changes in shareholder value based on the change in stock price and dividends paid, revenue, profit, cash flow, return measures (e.g., ROE, ROIC, ROA, etc.) and strategic objectives. Similar to annual incentive plans, companies may tie the vesting of performance-based awards to one or more performance metrics.

PERFORMANCE GOALS MAY BE SET IN ONE OF THREE WAYS:

1. **Relative to budget**
   Performance is measured relative to budgeted internal goals;

2. **Relative to peers**
   Performance is measured relative to a custom comparator group or an industry or broad market index; or

3. **Relative to absolute benchmarks**
   Performance is measured against pre-established and fixed financial or market goals, which are derived from past and projected performance of a peer group or an industry or broad market index (these goals are generally enduring standards that are not revisited on an annual basis upon grant).

Performance is often measured over three years (which also tends to be shareholder preference), although some companies use a shorter period (or a series of shorter periods). The advantages to performance periods of at least three years are that they are true measures of multi-year performance and they allow for the ability to recover in subsequent years if performance is weak during the initial year. The advantages to annual performance periods (which would typically be followed by an additional vesting period) are that it is easier to set annual goals than goals that cover multiple years and the company is not locked into a particular measure if the strategy or business profile changes.

Similar to annual incentive plans, performance-based long-term awards often provide for a range of payouts above and below the target payout opportunity. Payout opportunities frequently range from 50% of target at the threshold performance level to 200% of target at the maximum performance level, although leverage varies by company. Alternatively, some companies use “hit-or-miss”-style targets that provide for either 100% vesting if the performance target is achieved or complete forfeiture if the performance does not meet the target.
### Comparison of Basic LTI Types

The following table compares each of the long-term incentive vehicles described above based on several key compensation administration considerations.

#### COMPARISON OF BASIC LTI TYPES

<table>
<thead>
<tr>
<th>Consideration</th>
<th>Restricted Stock/Units</th>
<th>Stock Options/SARs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Positive Shareholder Optics</strong></td>
<td><strong>Low</strong></td>
<td><strong>Moderate</strong></td>
</tr>
<tr>
<td>Benefits:</td>
<td>• Build employee stock ownership (assuming stock-settled)</td>
<td>• Align value realized by employees with value realized by shareholders</td>
</tr>
<tr>
<td>Drawbacks:</td>
<td>• Not contingent upon performance condition for vesting</td>
<td>• Not contingent upon performance condition for vesting</td>
</tr>
<tr>
<td></td>
<td>• Retain some value even when stock price decreases</td>
<td></td>
</tr>
<tr>
<td><strong>Retention</strong></td>
<td><strong>High</strong></td>
<td><strong>Varies</strong></td>
</tr>
<tr>
<td>Benefits:</td>
<td>• Retain some value even when stock price decreases</td>
<td>• Provide substantial benefits if stock price appreciates</td>
</tr>
<tr>
<td>Drawbacks:</td>
<td>• None</td>
<td>• Do not retain value if stock price drops below exercise price</td>
</tr>
<tr>
<td><strong>Upside Leverage in Compensation Opportunity</strong></td>
<td><strong>Low</strong></td>
<td><strong>High</strong></td>
</tr>
<tr>
<td>Benefits:</td>
<td>• Value tied to stock price performance</td>
<td>• Options/SARs are granted in multiples of full-value shares to deliver the same fair value, which provides significant upside leverage</td>
</tr>
<tr>
<td>Drawbacks:</td>
<td>• No upside leverage to shares delivered based on performance</td>
<td>• No upside leverage to shares delivered based on performance</td>
</tr>
<tr>
<td><strong>Financial Efficiency</strong></td>
<td><strong>Moderate</strong></td>
<td><strong>Low</strong></td>
</tr>
<tr>
<td>Benefits:</td>
<td>• Generally no expense in the absence of delivered value</td>
<td>• None</td>
</tr>
<tr>
<td>Drawbacks:</td>
<td>• Expense recognition is not tied to operational performance</td>
<td>• Expense recognition is not tied to operational performance</td>
</tr>
<tr>
<td></td>
<td>• Cash-settled RSUs are treated as liability awards and are subject to variable accounting</td>
<td>• Expense is not reversible once recognized, even if underwater options expire</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Accounting cost is often higher than employee perceived value</td>
</tr>
<tr>
<td><strong>Linkage to Stock Ownership Objectives</strong></td>
<td><strong>High (assuming stock-settled)</strong></td>
<td><strong>Moderate (assuming stock-settled)</strong></td>
</tr>
<tr>
<td>Benefits:</td>
<td>• Not subject to forfeiture based on performance requirements</td>
<td>• Greater number of options must be granted relative to full-value shares to deliver the same value, which can result in substantial gains in ownership upon exercise</td>
</tr>
<tr>
<td>Drawbacks:</td>
<td>• No upside leverage to shares delivered based on performance</td>
<td>• No shares are acquired if the options expire underwater</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Potential Dilution to Shareholders</strong></td>
<td><strong>Moderate (assuming stock-settled)</strong></td>
<td><strong>High (assuming stock-settled)</strong></td>
</tr>
<tr>
<td>Benefits:</td>
<td>• No delivery of shares above original number granted</td>
<td>• May not result in any dilution if options are not exercised</td>
</tr>
<tr>
<td>Drawbacks:</td>
<td>• Shares are not subject to forfeiture based on performance requirements</td>
<td>• Greater number of options must be granted relative to full-value shares to deliver the same grant value, which can result in substantial dilution when options are exercised</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Can remain in overhang for up to 10 years</td>
</tr>
</tbody>
</table>
## Comparison of Basic LTI Types

<table>
<thead>
<tr>
<th>Performance-Vested Awards (Stock-Denominated)¹</th>
<th>Performance-Vested Awards (Cash-Denominated)²</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>High</strong> &lt;br/&gt;<strong>Benefits:</strong> &lt;br/&gt;• Contingent upon achievement of performance and service conditions for vesting &lt;br/&gt;<strong>Drawbacks:</strong> &lt;br/&gt;• None</td>
<td><strong>Moderate</strong> &lt;br/&gt;<strong>Benefits:</strong> &lt;br/&gt;• Contingent upon achievement of performance and service conditions for vesting &lt;br/&gt;<strong>Drawbacks:</strong> &lt;br/&gt;• Do not build employee stock ownership &lt;br/&gt;• Value of the payout is not tied to the value of company stock</td>
</tr>
<tr>
<td><strong>Low/Moderate</strong> &lt;br/&gt;<strong>Benefits:</strong> &lt;br/&gt;• Typically has downside leverage such that some payout may occur despite below-target performance &lt;br/&gt;<strong>Drawbacks:</strong> &lt;br/&gt;• No value delivered if performance is below threshold goal &lt;br/&gt;• May serve as drain on employee morale if multiple cycles fail to pay out</td>
<td><strong>Low/Moderate</strong> &lt;br/&gt;<strong>Benefits:</strong> &lt;br/&gt;• Typically has downside leverage such that some payout may occur despite below-target performance &lt;br/&gt;<strong>Drawbacks:</strong> &lt;br/&gt;• No value delivered if performance is below threshold goal &lt;br/&gt;• May serve as drain on employee morale if multiple cycles fail to pay out</td>
</tr>
<tr>
<td><strong>High</strong> &lt;br/&gt;<strong>Benefits:</strong> &lt;br/&gt;• Value tied to stock price performance &lt;br/&gt;• Upside leverage to shares delivered based on performance &lt;br/&gt;<strong>Drawbacks:</strong> &lt;br/&gt;• None</td>
<td><strong>Moderate</strong> &lt;br/&gt;<strong>Benefits:</strong> &lt;br/&gt;• Upside leverage to cash payout based on performance &lt;br/&gt;<strong>Drawbacks:</strong> &lt;br/&gt;• Payout value is not tied to stock price</td>
</tr>
<tr>
<td><strong>High</strong> &lt;br/&gt;<strong>Benefits:</strong> &lt;br/&gt;• Expense recognition is tied to operational performance &lt;br/&gt;• Expense is reversible if performance goals are not achieved (unless market goals are used) &lt;br/&gt;<strong>Drawbacks:</strong> &lt;br/&gt;• Cash-settled performance RSUs are treated as liability awards and are subject to variable accounting</td>
<td><strong>High</strong> &lt;br/&gt;<strong>Benefits:</strong> &lt;br/&gt;• Expense recognition is tied to operational performance &lt;br/&gt;• Expense is reversible if performance goals are not achieved (unless market goals are used) &lt;br/&gt;<strong>Drawbacks:</strong> &lt;br/&gt;• Treated as liability awards and are subject to variable accounting</td>
</tr>
<tr>
<td><strong>Moderate (assuming stock-settled)</strong> &lt;br/&gt;<strong>Benefits:</strong> &lt;br/&gt;• Upside leverage to shares delivered based on performance &lt;br/&gt;<strong>Drawbacks:</strong> &lt;br/&gt;• Below-target number of shares (or no shares) can be delivered based on below-target company performance</td>
<td>None &lt;br/&gt;<strong>Benefits:</strong> &lt;br/&gt;• None &lt;br/&gt;<strong>Drawbacks:</strong> &lt;br/&gt;• No direct alignment to company stock</td>
</tr>
<tr>
<td><strong>Varies (assuming stock-settled)</strong> &lt;br/&gt;<strong>Benefits:</strong> &lt;br/&gt;• Level of dilution is tied to company performance &lt;br/&gt;<strong>Drawbacks:</strong> &lt;br/&gt;• Above-target number of shares can be delivered based on above-target performance</td>
<td>None &lt;br/&gt;<strong>Benefits:</strong> &lt;br/&gt;• No dilution &lt;br/&gt;<strong>Drawbacks:</strong> &lt;br/&gt;• None</td>
</tr>
</tbody>
</table>

¹Reflects performance-vested awards with values that are tied to company stock price and may be paid out in stock or cash
²Reflects performance-vested awards with values that are not tied to company stock price and are paid out in cash
Section 3: Methods of Compensation

Indirect Compensation

RETIREMENT PLANS
There are two principal forms of retirement plans observed in the market – defined contribution and defined benefit:

DEFINED CONTRIBUTION (DC)
DC plans are one form of a retirement plan. The defining feature of a DC plan is that each participant manages his or her own contributions, which are invested in one or more pre-selected investment alternatives offered as part of the plan, with the employees assuming the investment risk. Companies typically provide various investment alternatives and have a fiduciary duty to review them regularly to ensure they are responsible investment choices, but employees have the ultimate say in allocation of their individual contributions. DC pools are funded through a plan formula (e.g., 5% of base salary), with employees often able to determine a contribution percentage up to a certain limit, and companies sometimes offering a match up to a percentage of funds contributed by employees. Examples of DC plans are 401(k) plans, individual retirement accounts, thrift savings plans and certain forms of profit sharing plans.

DEFINED BENEFIT (DB)
DB plans, also known as pension plans, are the other form of retirement plan. The defining feature of a DB plan is that the contribution pool is funded in aggregate, with companies assuming the investment risk. Benefits are determined based on a broad plan formula that may take into account an employee’s years of service, age, and/or average/final salary. The prevalence of DB plans in the market continues to decline as organizations transition to DC plans, which offer employees control of their retirement investments while relieving employers of the associated investment risk.

QUALIFIED VERSUS NON-QUALIFIED
Retirement plans can be structured as qualified or non-qualified plans. Qualified plans are plans that meet the requirements under section 401(a) of the Code and therefore qualify as tax deductible. Under qualified retirement plans, employees are taxed at the time of benefit receipt (i.e., when the employee receives payment under the plan), while employers are taxed at the time of contribution. Qualified plans are subject to regulations under the Code such as limits on contributions under DC plans and limits on payouts under DB plans.

In contrast, non-qualified plans are not subject to the same regulations and, therefore, are not subject to contribution or payout limitations. Non-qualified plans generally provide benefits to employees whose higher earnings would result in contributions above the limitations under qualified plans. These plans are not granted the same tax benefits as qualified plans (e.g., usually employees are taxed upon constructive receipt of the benefit and company contributions are not tax deductible).

Some companies offer a type of non-qualified retirement plan known as a Supplemental Executive Retirement Plan (SERP), which provides benefits to a select group of executives and may use a more favorable plan formula than the broad-based plan.
OTHER INDIRECT COMPENSATION

Employee Stock Purchase Plan (ESPP)
ESPPs allow employees to purchase company stock at a discount (typically 5% to 15%) up to a certain value annually. ESPPs strengthen the alignment of employee and shareholder interests by encouraging employees to build share ownership.

Health and Welfare (H&W) Benefits
Nearly all companies provide certain H&W benefits to employees. These benefits may include medical, dental and vision insurance, short- and long-term disability insurance and accidental death and dismemberment insurance.

PERQUISITES
Some companies provide perquisites, generally only to a select group of executives. Types of perquisites include allowances (e.g., housing, automobile, etc.), financial, tax, or estate planning assistance, physical examinations, personal use of corporate aircraft, and club memberships. Proxy advisory firms and shareholders closely scrutinize companies that provide excessive perquisites; as a result, the prevalence of certain perquisites (e.g., club memberships) has declined materially over the past decade.
Compensation peer groups help companies secure the most relevant competitive data for making market comparisons and assessing pay programs. The peer group should be a meaningful sample of companies of similar size and complexity and with comparable business models.
Compensation peer groups help companies secure the most relevant competitive data for making market comparisons and assessing pay programs. The peer group should be a meaningful sample of companies of similar size and complexity and with comparable business models.

**USE OF COMPENSATION PEER DATA**

Data captured from peer groups have a number of uses, including benchmarking pay levels for executives and non-employee directors, assisting with short- and long-term incentive plan design (setting incentive plan funding slopes, determining mix of pay elements or equity award types, etc.) and evaluating other program features such as severance practices, retirement benefits, perquisites, deferral programs and stock ownership guidelines.

Peer compensation data are also used for aggregate, company-wide equity compensation program comparisons, including burn rate, shareholder value transfer cost and potential dilution overhang accumulated from equity compensation.

In addition, peer groups can (and should) be utilized for financial performance comparisons to help assess alignment between pay and performance. This helps answer questions such as “Do incentive payouts align with relative performance?” and “How are incentive plan goals calibrated relative to peer performance?”

Companies may also use a peer group for incentives where payout is based on relative performance criteria, such as performance shares that are earned for relative TSR performance, although this is often a larger, broader peer group than the primary compensation peer group.
KEY SELECTION CRITERIA

It is important for the selection process to have integrity and avoid the appearance of cherry picking. As a first step, only companies that provide sufficient disclosure of the required data should be considered for inclusion in the group. Most U.S.-based public companies will fit the bill due to various disclosure requirements, but there are exceptions. Smaller reporting companies and emerging growth companies have less burdensome disclosure requirements, so they should be considered carefully before being including in a peer group. Private companies with public debt may have robust enough disclosure and could be considered for inclusion. In addition, foreign-based companies that trade on U.S. exchanges may have the necessary disclosure but should be evaluated in the context of relevance for compensation comparisons (particularly as relates to the domicile of executive officers).

Peer companies should operate in similar industries and have a similar business model. Basic industry classification (e.g., Standard & Poor’s Global Industry Classification Standard, or GICS) may be helpful, but consider if there are companies outside of a company’s own category that may be fundamentally similar. For example, it may be reasonable for a food products company to include size-appropriate beverage and/or household product companies in its compensation peer group.

The peer group selection process should focus on companies that are similar in size, which matters in compensation as it is a gauge of scope and complexity. Primary size metrics are usually revenue and market capitalization value (or enterprise value). However, selection criteria should vary as needed. For example, a REIT should also consider funds from operations, a financial services company might use assets and a drug development company should evaluate the development pipelines of companies being considered for inclusion.

A typical range is 0.5x to 2.0x, or 0.33x to 3.0x, of the subject company’s size for the chosen key size metrics. It is better to start the search process with a wider range to “catch” as many potentially relevant peer companies as possible. Best practice is for the subject company to align at or near median of the final peer group on the key size measures; larger or smaller companies outside of the pre-defined size ranges are sometimes included if they are direct competitors for talent, business or investor capital. A comparator used by Wall Street to evaluate the subject company’s performance may have a very similar business model but may not be appropriate for direct pay comparisons due to size.

In addition to industry, business model and size, a number of other criteria should be considered to arrive at the most similar group of companies. Labor market competitors should be prioritized, but they should be defined for this purpose based on top executive roles, not lower-level roles.

Geography may also factor in, although the market for executive and non-employee director talent is often viewed as a national one. Local talent wars (e.g., in Silicon Valley) may argue for focusing on a certain region, and there are several examples of companies focusing on a specific region while constructing a compensation peer group.

OTHER CRITERIA THAT COULD BE RELEVANT INCLUDE, BUT ARE NOT LIMITED TO:

1. Customer focus (e.g., wholesale versus retail)
2. International complexity of operations
3. Whether there is a manufacturing component
4. Company stage (e.g., recent IPOs may not demonstrate a mature public company pay model and should be carefully examined before inclusion)
5. Required level of research and development
Section 4: Peer Group Development

Peer Group Characteristics

**FINAL PEER GROUP CHARACTERISTICS**

The final peer group chosen should be robust enough in size to yield meaningful results (at least 12 companies, but ideally 15-20 companies so that percentile statistics are not heavily impacted by one or two outliers). The subject company should be positioned as close to the median as possible for the relevant size measures. Further, it is important that the peer group is supported by both company management and the compensation committee. This is critical to confirm before the start of any new compensation benchmarking study so that all parties involved have faith in the relevance of the resulting competitive analyses.

Finally, peer groups should be reviewed annually to make sure current peers remain valid or are modified as needed if there are significant changes to company size or business model (e.g., due to a transformative acquisition).

**SAMPLE PEER GROUP SELECTION PROCESS FOR A U.S.-BASED, PUBLICLY TRADED INTERNET SOFTWARE COMPANY**

- **All Publicly Traded Companies**
  U.S. based and traded on a U.S. exchange (n=10,000+ companies)

- **Industry Focus**
  Concentrate on companies operating in the “Internet Software & Services” industry (n=262 companies)

- **Scope based on Revenue and Market Cap Value**
  Limit to companies within 1/3x - 3x subject company’s $400m annual revenues and $2.4B market cap value (i.e., range of $133M-$1.2B in revenues, and $800M-$7.2B in market cap) (n=41)

- **Final Refinement for Peer Selection**
  Narrow the group down based on following factors:
  (1) exclude recent IPOs,
  (2) geographical focus, and
  (3) positioning subject company near the median in size

- **Final Peer Group**
  (n=16)
PITFALLS
Avoid cherry picking or stacking the peer group with larger or higher-paying companies (or even the perception of it). The selection process should be objective and transparent. The inclusion of “aspirational” peers can attract negative scrutiny from investors and proxy advisory organizations, as peer group selection is sometimes identified as a contributing factor in increasing pay levels. In addition, using outsized peers may have unintended consequences (e.g., larger companies tend to have lower company-wide equity grant rates and may understate market practices for burn-rate and outstanding dilution).

DISCLOSURE CONSIDERATIONS
Publicly traded companies are required to disclose in the proxy statement any peer group used in determining pay levels, as well as the rationale for peer group selection and the process undertaken. Thoughtful disclosure of the peer group and the rationale behind it will provide shareholders with a clear understanding of how the company has defined the market.

OTHER CONSIDERATIONS
While compensation peer groups aim to frame the best possible competitive analyses, it is important to remember that market data may be imperfect and should be interpreted thoughtfully. In some cases, it may be helpful to use more than one peer group. For example, a company may use both a narrow industry peer group and a general industry peer group that is more representative of the company’s size.

A NOTE ON RELATIVE PERFORMANCE PEER GROUPS
Long-term incentives based on relative performance are sometimes granted at public companies. The most common relative measure is TSR, although other measures are sometimes used (e.g., ROE or ROA in banking).

For relative TSR awards, the subject company’s TSR is compared to the performance of a pre-selected group of peer companies (or an index) over a period of time (usually three years). Typically, the relative TSR peer group includes more companies than the regular compensation peer group. This is because the group should be durable over the entire performance period and factors such as M&A may whittle a typical compensation peer group down too much over that time. Usually, at least 30 companies are included in a relative TSR peer group. Some companies make direct comparisons within their own industry and others compare to general industry, such as using the S&P 500. In either case, the size range of the companies used may be wider than the typical size guideline used for the primary compensation peer group. This is because TSR performance is not correlated with company size as closely as pay levels are.
While compensation is typically not a determinative factor in an individual’s decision to serve on a board, companies seek to ensure that their director compensation programs are both fair and competitive.
Elements of Director Compensation

**Section 5: Director Compensation**

Heightened focus on corporate governance guidelines and investor scrutiny have placed greater pressure and demands on directors in terms of their skills, experiences, time commitment and exposure to liability. Similar to executive talent, companies are in search of qualified directors in a highly competitive market and while compensation is typically not a determinative factor in an individual’s decision to serve on a board, companies seek to ensure that their director compensation programs are both fair and competitive.

**ADMINISTRATION OF COMPENSATION**

Non-employee director compensation is typically determined by the board of directors, acting as a whole, or by a designated committee of the board, such as the compensation committee or the nominating and governance committee.

Boards often consult external experts to assist in designing and reviewing the competitiveness of director compensation programs. Consultation with a third-party expert helps provide transparency, legitimacy and credibility in the process and insulate the board from the appearance of being self-serving as its members (and not shareholders) oftentimes approve their own compensation. Annual reviews are becoming common practice for companies to avoid material, single-year pay adjustments that may be out of step with peer group and benchmark compensation.

**PAY PHILOSOPHY**

Distinct from executive compensation programs, which are designed to reward executives for successful execution of business strategy, align pay with company performance and recruit, retain and reward top talent, director compensation programs are designed to emphasize oversight of management and align directors’ interests with those of shareholders without compromising director independence, encouraging excessive risk taking or promoting director entrenchment. In recognition of these philosophical differences, director compensation programs should be structured differently and are generally simpler in design, have fewer components and lack incentive-based opportunities found in executive compensation programs.
ELEMENTS OF DIRECTOR COMPENSATION

Directors typically receive a mix of cash and equity compensation with a slightly greater weighting on equity, with the percentage delivered in equity generally increasing with company size. Tying a material portion of director compensation to equity reinforces the director’s role as an elected agent of shareholders and strengthens the alignment of interests between the two parties.

Pay components typically found in director compensation programs:

<table>
<thead>
<tr>
<th>CASH</th>
<th>EQUITY</th>
</tr>
</thead>
<tbody>
<tr>
<td>▶ Annual Board Retainer</td>
<td>▶ Annual equity award (stock options, restricted</td>
</tr>
<tr>
<td>▶ Per-Meeting Fees</td>
<td>shares/RSUs, deferred shares/DSUs, unrestricted</td>
</tr>
<tr>
<td>◆ Board meetings</td>
<td>common stock)</td>
</tr>
<tr>
<td>◆ Committee meetings</td>
<td>▶ Initial equity award (i.e., upon initial election</td>
</tr>
<tr>
<td>▶ Additional Committee Retainers</td>
<td>to the board: stock options, restricted shares/RSUs,</td>
</tr>
<tr>
<td>◆ Committee chair service</td>
<td>deferred shares/DSUs, unrestricted common stock)</td>
</tr>
<tr>
<td>◆ Committee member service</td>
<td></td>
</tr>
<tr>
<td>▶ Additional Retainers for Board Leadership</td>
<td></td>
</tr>
<tr>
<td>◆ Board chair service</td>
<td></td>
</tr>
<tr>
<td>◆ Lead/presiding director service</td>
<td></td>
</tr>
</tbody>
</table>

It should be noted that variations of these components and their delivery exist across industries and companies. For example, some companies pay no meeting fees or only pay meeting fees in excess of a certain number of board/committee meetings; some companies base the size of equity awards on fixed dollar values, while others base it on a fixed number of shares; and some companies permit directors to elect to receive their cash compensation in the form of additional equity. Companies may also provide fees for temporary ad hoc committees or other special circumstances, including CEO search efforts and transaction- and litigation-related activities.

In addition to the elements listed in the table above, directors are generally reimbursed for travel and other business-related expenses, including travel for spouses in connection with board meetings. Some companies also provide additional benefits for directors, including life and travel insurance, discounts on company products and services and matching charitable contributions up to a certain dollar amount. However, benefits and perquisites for directors have decreased significantly over the last decade given external scrutiny of such practices and are now typically aligned on the same basis as those provided to the broader company employee population, if any.
COMPENSATION LEVELS

Unlike executive compensation, which exhibits greater variability between companies, director compensation tends to reflect less differentiation, with clustering of pay close to benchmark medians. For example, in 2017, median non-employee director compensation at large-cap companies was $274,000, with 25th and 75th percentiles 17% below and 11% above median, respectively. Additional compensation provided for committee chair and lead director service exhibits similar clustering and tends to fall within a fairly narrow range in terms of dollar amount. Additional compensation for the non-executive chairperson of the board generally has greater variability, given the relative uniqueness of the position, which is highly role- and company-specific. A summary of 2017 findings on director compensation levels is illustrated on the pages that follow.

LARGE CAP MEDIAN DIRECTOR PAY LEVELS

Core Director Total Compensation
$274,000

Additional Leadership Pay

Audit
$25,000
Compensation
$20,000
Nominating/Governance
$15,000
Non-Executive Chair
$143,340
Lead Director
$30,000
### DIRECTOR PAY LEVELS - EXHIBIT I

#### 2017 Core Director Pay Levels ($000)

<table>
<thead>
<tr>
<th></th>
<th>Cash Retainer</th>
<th>Equity Award</th>
<th>Total Comp</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Small-Cap</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>75th Percentile</td>
<td>$50,000</td>
<td>$87,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Median</td>
<td>$50,000</td>
<td>$70,000</td>
<td>$125,000</td>
</tr>
<tr>
<td>25th Percentile</td>
<td>$36,000</td>
<td>$60,000</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Cash Retainer</th>
<th>Equity Award</th>
<th>Total Comp</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Mid-Cap</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>75th Percentile</td>
<td>$85,000</td>
<td>$125,000</td>
<td>$202,000</td>
</tr>
<tr>
<td>Median</td>
<td>$86,966</td>
<td>$125,000</td>
<td>$160,000</td>
</tr>
<tr>
<td>25th Percentile</td>
<td>$50,000</td>
<td>$96,415</td>
<td>$135,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>Cash Retainer</th>
<th>Equity Award</th>
<th>Total Comp</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Large-Cap</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>75th Percentile</td>
<td>$108,000</td>
<td>$172,000</td>
<td>$274,000</td>
</tr>
<tr>
<td>Median</td>
<td>$150,000</td>
<td>$202,000</td>
<td>$274,000</td>
</tr>
<tr>
<td>25th Percentile</td>
<td>$108,000</td>
<td>$172,000</td>
<td>$227,000</td>
</tr>
</tbody>
</table>

### Source
Source: FW Cook 2017 Director Compensation Report
Section 5: Director Compensation

Director Compensation Levels

**DIRECTOR PAY LEVELS - EXHIBIT II**

2017 Additional Committee Leadership Pay ($000)

<table>
<thead>
<tr>
<th>Small-Cap</th>
<th>Mid-Cap</th>
<th>Large-Cap</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit</td>
<td>Comp</td>
<td>Nom/Gov</td>
</tr>
<tr>
<td><strong>AUDIT</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>75th Percentile</td>
<td>$20,567</td>
<td>$26,115</td>
</tr>
<tr>
<td>Median</td>
<td>$16,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>25th Percentile</td>
<td>$10,000</td>
<td>$16,000</td>
</tr>
<tr>
<td><strong>COMPENSATION</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>75th Percentile</td>
<td>$15,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Median</td>
<td>$12,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>25th Percentile</td>
<td>$10,000</td>
<td>$15,000</td>
</tr>
<tr>
<td><strong>NOMINATING/GOVERNANCE</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>75th Percentile</td>
<td>$10,000</td>
<td>$15,000</td>
</tr>
<tr>
<td>Median</td>
<td>$10,000</td>
<td>$12,000</td>
</tr>
<tr>
<td>25th Percentile</td>
<td>$7,500</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

Source: FW Cook 2017 Director Compensation Report
**DIRECTOR PAY LEVELS - EXHIBIT III**

2017 Additional Board Leadership Pay ($000)

<table>
<thead>
<tr>
<th>Pay Level</th>
<th>Non-Executive Chair</th>
<th>Lead Director</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Small-Cap</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>75th Percentile</td>
<td>$101,750</td>
<td>$18</td>
</tr>
<tr>
<td>Median</td>
<td>$50,000</td>
<td>$70,000</td>
</tr>
<tr>
<td>25th Percentile</td>
<td>$28,750</td>
<td>$20,000</td>
</tr>
<tr>
<td><strong>Mid-Cap</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>75th Percentile</td>
<td>$150,000</td>
<td>$25</td>
</tr>
<tr>
<td>Median</td>
<td>$112,000</td>
<td>$25,000</td>
</tr>
<tr>
<td>25th Percentile</td>
<td>$70,000</td>
<td>$20,000</td>
</tr>
<tr>
<td><strong>Large-Cap</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>75th Percentile</td>
<td>$192,500</td>
<td>$30</td>
</tr>
<tr>
<td>Median</td>
<td>$143,340</td>
<td>$30,000</td>
</tr>
<tr>
<td>25th Percentile</td>
<td>$95,000</td>
<td>$25,000</td>
</tr>
</tbody>
</table>

Source: FW Cook 2017 Director Compensation Report
TRENDS

Low- to mid-single-digit percentage increases in director compensation have occurred in 2016 and 2017, consistent with historical trends.

From a structural perspective, companies are shifting away from the per-meeting fee model in favor of higher annual cash retainers. The absence of meeting fees simplifies administration, promotes efficiency and communicates that attendance at meetings is an expected part of board service.

With respect to equity awards, the general industry trend has been away from stock options in favor of full-value awards with short or immediate vesting terms. This shift in approach creates immediate ownership that aligns directors’ interests with those of shareholders and avoids the asymmetry in payout outcomes that can occur with appreciation awards. Full-value awards may be denominated on a fixed-share or fixed-value basis, though the trend has been toward fixed-value in order to facilitate consistency in year-to-year expense and avoid volatility in reported compensation due to changes in share price.

STOCK OWNERSHIP GUIDELINES

The majority of public companies have adopted stock ownership guidelines that require directors to hold a meaningful amount of equity in the company as long as they are serving on the board. This governance practice strengthens the alignment of director interests with those of shareholders. The guidelines may be stated in terms of a fixed number of shares or a fixed dollar value. However, the most common practice is a multiple of the annual board cash retainer, generally between three and five times (with the latter considered to be a governance best practice), to be attained within a specified timeframe, most commonly three to five years after initial election to the board. Some companies structure their guidelines in terms of a holding requirement, stating that directors must retain all or a portion of net after-tax shares until a specified ownership level is achieved or until termination of board service.
SCRUTINY OF DIRECTOR COMPENSATION AND RECENT LITIGATION

In recent years, director compensation programs have come under greater scrutiny from shareholders and proxy advisory firms. To address this, many companies have adopted shareholder-approved annual limits on non-employee director equity and/or total compensation in their stock incentive plans. Companies have adopted these “meaningful” limits to mitigate the potential for shareholder litigation by having potential strike suits thrown out at the “motion to dismiss” phase according to the “business judgment” standard rather than be forced to defend the case on the “entire fairness” standard.

However, a recent December 2017 ruling in *In re Investors Bancorp, Inc. Stockholder Litigation* determined that stock plans containing limits on director compensation levels but providing discretion to the board to set their own pay could be subject to the “entire fairness standard” in the event of a shareholder lawsuit (and not allow for a motion to dismiss). This recent development has given some experts pause as to the value of a shareholder-approved limit that does not include a specific amount or formula for director awards. That said, at this time, it would appear that the presence of a reasonable shareholder-approved maximum limit, coupled with strong board processes in establishing that limit and frequent (i.e., annual) reviews of the program by an independent compensation consultant, would provide the company with at least a “first line of defense” in the event of litigation.

In November 2017, Institutional Shareholder Services (ISS) announced that it will include excessive non-employee director compensation in its review of companies’ problematic pay practices, which is significant as this is the first time director compensation has entered the ISS compensation policy lexicon. ISS will issue adverse vote recommendations for board members responsible for approving or setting non-employee director compensation when there is a pattern (i.e., two consecutive years or more) of excessive pay magnitude (i.e., 95th percentile or above of the appropriate “industry segment”) without a compelling rationale or other mitigating factors.

In light of the increased scrutiny surrounding director compensation, it is becoming increasingly important for companies to include the rationale for director pay decisions, both in terms of amounts and general program structure, as well as any governance policies in their annual proxy statements.
The passage of the Dodd-Frank Act and the introduction of say-on-pay in recent years has stimulated a new wave of engagement between public companies and their shareholders.
Historically, public companies engaged directly with their shareholders on executive pay matters in a limited way. The engagement often focused on topics such as a company’s strategy and/or financial performance and was limited to earnings calls, investor roadshows and annual meetings. In situations in which shareholders had differing views from a company, they would:

- submit shareholder proxy proposals for companies to adopt policies or practices that aligned with their views,
- “vote with their feet” by selling shares to voice their displeasure, or
- confront the board directly or withhold votes from directors at the annual shareholder meeting.

However, these tactics changed with the passage of Dodd-Frank in 2010 and the introduction of say-on-pay in 2011.

55%

More than half (55%) of directors say their board had direct engagement with investors outside of regularly scheduled earnings calls and the annual meeting in 2017.

Source: Corporate Board Member 2017 Shareholder Engagement Report

Of those, 76% report having in-person meetings.

DIRECT ENGAGEMENT WITH INVESTORS

Which individuals in your company have investors engaged with directly?
(Respondents were asked to select all that apply)

<table>
<thead>
<tr>
<th>Role</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO</td>
<td>85%</td>
</tr>
<tr>
<td>Chair or lead director</td>
<td>60%</td>
</tr>
<tr>
<td>Other director(s) designated</td>
<td>34%</td>
</tr>
<tr>
<td>Corporate Secretary or GC</td>
<td>25%</td>
</tr>
<tr>
<td>Other</td>
<td>32%</td>
</tr>
</tbody>
</table>

Source: Corporate Board Member 2017 Shareholder Engagement Report
SHAREHOLDER ENGAGEMENT IN THE EARLY YEARS OF SAY-ON-PAY

The introduction of Say-on-Pay in 2011 stimulated a new wave of engagement between public companies and their shareholders, as it gave shareholders a more direct voice for engaging with their portfolio companies on executive pay issues. During the early days of Say-on-Pay, the CD&A of the annual proxy statement was seen as the only tool for communicating with shareholders on executive compensation issues. The shareholder “engagement” process, if any, was primarily reactive. In situations in which a company received an “against” Say-on-Pay recommendation from the proxy advisory firms, companies would typically issue a supplemental filing explaining why the proxy advisers “got it wrong” and urging shareholders to support management’s Say-on-Pay proposal. Some companies would also engage in direct dialogue with their largest shareholders to improve the likelihood of a favorable say-on-pay vote outcome.

INVESTORS’ EVOLVING VIEW ON STEWARDSHIP IS CHANGING THE ENGAGEMENT PROCESS

In recent years, shareholders’ expectations around the engagement process have changed due to an evolving view among certain influential institutional investors. The perspective of some of these investors is that in order to be good stewards of their clients’ capital, they should actively engage with their portfolio companies to help influence sustainable growth. This philosophy is emerging at both actively and passively managed investment funds. Some index funds are taking the view that since they are constrained in their ability to sell a company’s stock, they are truly a long-term shareholder and need to be especially engaged.

Some shareholders have expressed that they no longer want outreach to be a one-off occurrence. Rather, they expect the opportunity to have an open and continuous dialogue with their portfolio companies. As a result, some institutional investors are allocating more time and resources to help facilitate engagement with filers, and more companies are conducting proactive shareholder outreach to engage with shareholders on executive pay and governance issues, rather than waiting to react when faced with a potential negative Say-on-Pay vote outcome.
USING THE CD&A AS AN EFFECTIVE MEDIUM FOR ENGAGING SHAREHOLDERS

The CD&A remains one of the most effective mediums for public companies to engage with shareholders on executive compensation. Over the past several years, the CD&A has evolved from a SEC compliance document to one of the most effective tools for communicating with shareholders.

**Characterized by:**
- Compliance orientation
- Rigid flow, organization
- Legal jargon
- Boiler plate language
- Vague, directional messaging
- “Check the box” coverage of SEC rules

**Characterized by:**
- Less compliance orientation
- Evolving content
- Supplemental tables
- Defensive tones addressing Say-on-Pay questions
- Increased density, length
- “Check the box” coverage of proxy advisory firm policies

**Characterized by:**
- Telling a company’s unique story
- Informing on industry and company context
- Innovative order
- Addressing investor topics of interest
- Improved transparency
- Bringing the reader inside the decision process
- Informative tone - less jargon
- Enhanced use of graphics
- Addresses rigor of goals
- Shorter, more concise
- Realizable pay, alignment between pay and performance
CD&A BEST PRACTICES

As part of the CD&A’s evolution, several best practices have emerged. These best practices include the following:

**Telling a Company’s Unique Story**
Companies have started providing key contextual information that influences the company’s pay program design and administration. This could include providing an overview of industry conditions that have negatively affected the company’s performance; outlining the company’s unique business model, which makes peer comparisons difficult; or describing the company’s strong performance to set the backdrop for high incentive plan payouts.

**Address Investor Topics of Interest First**
The first couple pages of the CD&A are “prime real estate” and should be treated as such. When writing the CD&A, a company should outline the topics that are most important in that year for shareholders to understand and address those items first. For example, many companies utilize the first few pages to present the company’s business highlights and achievements during the year that support the pay decisions discussed later in the CD&A. However, in a year after receiving low shareholder support for Say-on-Pay, a company could utilize this portion of the CD&A to demonstrate responsiveness to shareholder concerns (e.g., shareholder outreach efforts and changes to compensation programs as a result of outreach efforts).

**Improved Transparency**
Investors and proxy advisory firms want filers to be transparent about the purpose, administration and results of a company’s pay programs. At a minimum, this includes disclosing the metrics used within the incentive plans and the company’s performance against these metrics. Companies looking to effectively communicate their pay programs should focus on bringing the reader inside the decision-making process. To accomplish this, companies can outline the process they follow for setting goals, demonstrate that the established goals are rigorous and provide the business rationale for any use of discretion or for special/unique compensation actions (e.g., retention awards).

**Making the Document Easier to Read**
To be an effective medium for communicating with shareholders, the CD&A needs to be easy to read. An easy to read CD&A will focus on being concise, incorporating tables to effectively organize topics and using graphics to “show, not tell” the reader critical information.
In developing a company's shareholder outreach program, the company and the compensation committee should assess the following questions.

1. When to Conduct Shareholder Outreach?
Shareholder outreach can be conducted in either a reactive or proactive manner. Reactive shareholder outreach occurs in response to negative criticism of a company's pay programs. This could happen immediately after receiving an “against” Say-on-Pay recommendation from proxy advisory firms or after a company receives low shareholder support for its Say-on-Pay proposal. Proactive shareholder outreach occurs before a company has received criticism of its pay programs and is an ongoing effort by a company to inform shareholders about its pay practices and to solicit feedback. It could be part of a larger “roadshow” to solicit feedback on all areas of a company’s corporate governance practices.

In recent years, an increasing number of shareholders have expressed a desire for outreach to be proactive and to occur outside of proxy season, when they have more capacity to engage in conversations with their portfolio companies.

2. Which Shareholders Should Be Contacted?
Once a company has decided to engage in shareholder outreach efforts, it then needs to determine which shareholders to contact. Every company’s shareholder base looks different, but at a minimum, a company should evaluate the list of its five to ten largest shareholders. The investor type (e.g., index fund, hedge fund, actively managed fund, etc.) and size of the investment should be taken into account when choosing which shareholders to contact.

When a company has identified the shareholders with which it wants to engage, it then needs to identify who is responsible for voting the shares at the respective fund. In some cases, this will be the portfolio manager; in other cases, there will be a specific governance/portfolio engagement team that votes the shares.
What Should Be Discussed?
Prior to meeting with shareholders, a company should identify the specific topics it wants to cover. When discussing executive compensation and governance, a company should be prepared to address the following:
- rationale behind the company’s compensation philosophy and compensation strategy;
- specific circumstances that influenced the administration and execution of the company’s compensation programs; and
- proxy advisory firms’ view of the company’s compensation programs.

As part of the preparation process, a company should also research each of the investors it plans to meet with to understand their voting policies (e.g., do they vote lock-step with a proxy adviser, do they have their own voting policies, etc.).

Who Should Be Involved in the Engagement Efforts?
Companies need to identify which stakeholders from the company should be involved in the engagement process. The topic of discussion will likely drive who should be involved. Management should look to include participants across functions. This could include representatives from legal, human resources, investor relations or finance.

In discussions of executive compensation, a company should also look to involve select members of the board of directors (e.g., the lead director, non-executive chairman of the board or potentially the chair of the compensation committee).
In designing executive compensation, the compensation committee should be mindful of numerous regulatory and compliance considerations that can affect the implementation, operation and optimization of compensation programs.
Section 7: Regulatory Compliance Considerations

Say-on-Pay

In designing executive compensation, the compensation committee should be mindful of numerous regulatory and compliance considerations that can affect the implementation, operation and optimization of compensation programs. Some of the key considerations are highlighted in this section. Because the regulatory and compliance aspects are complex and constantly evolving, it is critically important for compensation committees to receive current advice from the relevant subject matter experts.

SAY-ON-PAY

“Say-on-Pay” was enacted by the Dodd-Frank Act and became effective for annual shareholder meetings after January 21, 2011. Under the rule, at least every three years, shareholders must be provided with a separate, nonbinding vote (Say-on-Pay) on approval of compensation of the named executive officers disclosed in the company’s proxy statement. Shareholders must be provided with a separate, nonbinding vote at least every six years on whether the Say-on-Pay vote should occur annually, every two years or every three years (Say-on-Pay Frequency). Shareholders must also be provided with a separate, nonbinding vote on golden parachute compensation in the event of the company’s acquisition, merger, consolidation, sale or other disposition of assets (Say on Golden Parachute).

The Say-on-Pay, Say-on-Pay Frequency and Say on Golden Parachute votes are advisory only and are not binding on the company. However, a failed Say-on-Pay vote and challenged outcomes (i.e., less than strong majority) create pressure to open dialogue with investors on executive compensation and make passing Say-on-Pay in future years more challenging. In addition, if meaningful improvements are not made, proxy advisory firms may recommend voting “against” the re-election of compensation committee members in future years.
PROXY ADVISORY FIRM ASSESSMENT PROCESS

When developing vote recommendations on Say-on-Pay proposals, each of the major proxy advisory firms—ISS and Glass Lewis—evaluates a company’s executive compensation program on a holistic basis. Both firms use the alignment between pay and performance (i.e., “pay-for-performance”) as the foundation of their analysis:

- ISS focuses solely on the CEO and measures performance based primarily on the company’s TSR performance, with a supplemental evaluation that compares CEO pay and financial performance (metrics vary by industry).

- Glass Lewis focuses on all executive officers named in the proxy and measures performance based on a multifaceted proprietary model, which includes TSR and financial performance.

Companies with strong alignment are generally expected to receive a “for” vote recommendation unless:

- the absolute magnitude of CEO pay is deemed to be excessive;
- the company maintains “problematic pay practices;” and/or
- performance goals are determined to lack “rigor.”

Companies with weak alignment are subjected to a higher degree of scrutiny and are more likely to receive an “against” vote recommendation, especially if there are problematic pay practices or other policies that are deemed to be inconsistent with a pay-for-performance culture.

EXAMPLES OF PROBLEMATIC PAY PRACTICES

Problematic pay practices include:

- repricing or replacing of underwater stock options/SARS without prior shareholder approval (including cash buyouts and voluntary surrender of underwater options);
- excessive perquisites or tax gross-ups, including any gross-up related to a secular trust or restricted stock vesting;
- new or extended agreements that provide for:
  - change-in-control (CIC) payments exceeding three times base salary and average/target/most recent bonus,
  - CIC severance payments without involuntary job loss or substantial diminution of duties (“single” or “modified single” triggers),
  - CIC payments with excise tax gross-ups (including “modified” gross-ups)
- multiyear guaranteed bonuses;
- a single or common performance metric used for short- and long-term plans;
- lucrative severance packages;
- high pay opportunities relative to industry peers;
- disproportionate supplemental pensions;
- mega annual equity grants that provide unlimited upside with no downside risk; and
- lack of responsiveness to low Say-on-Pay support.
## SEC Disclosure Obligations

The SEC imposes various executive compensation–related disclosure obligations on public companies. The key obligations are summarized below:

<table>
<thead>
<tr>
<th>FORM</th>
<th>DISCLOSURE DESCRIPTION</th>
</tr>
</thead>
</table>
| **Proxy Statement:** Compensation Discussion & Analysis (CD&A) | • The compensation committee must review and approve for inclusion in the annual proxy statement CD&A  
• The CD&A is a “principles-based disclosure” that should explain all material elements of “named executive officer” compensation  
• Named executive officers generally consist of the CEO, CFO and the three other highest-paid executive officers as of the end of the company’s fiscal year  
• As a result of Say-on-Pay, the CD&A has become an important marketing tool |
| **Proxy Statement:** Compensation Tables | • Unlike the principles-based approach of the CD&A, the SEC has prescribed a variety of tabular compensation disclosures to be included in the proxy statement  
• The most important of these tables is the Summary Compensation Table, which provides disclosure of the salary, bonus, equity awards, benefits and perquisites and all other compensation paid to the named executive officers for the immediately preceding three years  
• Other required tables include: Grants of Plan-Based Awards, Outstanding Equity Awards at Fiscal Year End, Option Exercises and Stock Vested, Pension Benefits, Nonqualified Deferred Compensation and Director Compensation |
| **Proxy Statement:** Compensation Risk Disclosure | • In addition to the CD&A, the SEC rules require a discussion and analysis in the proxy statement of risks of compensation policies and programs for all employees if such risks are “reasonably likely to have a material adverse effect on the company” (as described in more detail below) |
| **Proxy Statement:** Consultant Conflict of Interest | • A discussion is required in the proxy statement if the compensation consultant’s work has raised any conflict of interest and, if so, describe the nature of the conflict and how it is being addressed |
| **Proxy Statement:** CEO Pay Ratio | • Disclosure is required of the ratio of (i) median annual total compensation of all employees other than the CEO (set to “1”) to (ii) the reported annual total compensation for the CEO  
• Disclosure is required for fiscal years beginning on or after January 1, 2017 (i.e., 2018 proxy filings) |
| **Form 8-K:** Disclosure of Executive Officer Agreements | • A Form 8-K must be filed describing key terms of any material compensatory plan, contract or arrangement (excluding nondiscriminatory, broad-based plans) with the company’s executive officers  
• A Form 8-K must be filed within four business days after the company enters into or materially modifies such compensatory plan, contract or arrangement |
| **Section 16 of Securities Exchange Act of 1934** | • A Form 3 is used to report the initial beneficial ownership by officers and directors of the company’s securities and is filed within 10 days after a person becomes an officer or director  
• Ongoing transactions in company securities by officers and directors are reported on Form 4 within two business days  
• In order to avoid “short-swing profit” restrictions, the compensation committee (or a subcommittee) comprised solely of nonemployee directors should approve equity awards to officers subject to Section 16 |
COMPENSATION RISK ASSESSMENT

In December 2009, the SEC adopted rules regarding disclosure of any “compensation policies and practices for its employees [which] are reasonably likely to have a material adverse effect on the registrant.” The rules were adopted in the wake of the financial crisis and in response to concerns that incentive compensation plans contributed to the crisis by rewarding short-term revenue-generating activities without regard to the potential risks or how such designs might impair long-term company value. Although the SEC has emphasized that determining which situations may require additional disclosure will depend on the particular company and its compensation programs, the rules provide (nonexclusive) examples of situations that could trigger disclosure:

- if a business unit carries a significant portion of the company’s risk;
- if compensation is structured in a significantly different manner than in other units;
- if a business unit is significantly more profitable than other units;
- if compensation expense is a significant percentage of a unit’s revenues; or
- if compensation policies and practices vary significantly from the overall risk and reward structure of the company, such as where bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time.

The SEC rules are principles based and therefore do not impose any formal requirements on the risk assessment process. Technically, no risk disclosure is required under the SEC rules unless the compensation programs do, in fact, present a material adverse risk to the company. However, proactive “negative” confirmation (i.e., disclosure that no material risks were found to exist), together with a summary description of the risk assessment process, has become virtually universal in proxy statements, and the absence of such disclosure is likely to draw scrutiny from both the SEC and investors.

PENDING ITEMS UNDER THE DODD-FRANK ACT

As of the date of publication, the following three executive compensation related items are still pending rule-making under the Dodd-Frank Act:

<table>
<thead>
<tr>
<th>HEDGING POLICY</th>
<th>PAY-FOR-PERFORMANCE</th>
<th>CLAWBACK POLICY</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Who</strong></td>
<td><strong>Who</strong></td>
<td><strong>Who</strong></td>
</tr>
<tr>
<td>• Covers employees, officers or directors or any of their “designees”</td>
<td>• Disclosure reflects compensation of proxy named executive officers</td>
<td>• Covers current and former Section 16 executive officers</td>
</tr>
<tr>
<td><strong>What</strong></td>
<td><strong>What</strong></td>
<td><strong>What</strong></td>
</tr>
<tr>
<td>• Disclosure of permitted and prohibited hedging transactions</td>
<td>• Tabular disclosure of “actual pay” for the company and TSR performance for the company and peers over five years</td>
<td>• Requires policy providing for recovery of excess incentive-based compensation received during the three-year period preceding a financial restatement</td>
</tr>
<tr>
<td>• Disclosure only—does not require companies to prohibit hedging</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Where</strong></td>
<td><strong>Where</strong></td>
<td><strong>Where</strong></td>
</tr>
<tr>
<td>• Proxy statement</td>
<td>• Proxy statement</td>
<td>• Proxy statement/Form 10-K</td>
</tr>
<tr>
<td><strong>When</strong></td>
<td><strong>When</strong></td>
<td><strong>When</strong></td>
</tr>
<tr>
<td>• Proposed 2/9/15</td>
<td>• Proposed 4/29/15</td>
<td>• Proposed 7/1/15</td>
</tr>
<tr>
<td>• Timing of final rule-making not yet announced</td>
<td>• Timing of final rule-making not yet announced</td>
<td>• Timing of final rule-making not yet announced</td>
</tr>
</tbody>
</table>
The Tax Cuts and Jobs Act (H.R.1), which was signed into law on December 22, 2017, eliminates the long-standing corporate tax deduction for “performance-based compensation” in excess of $1 million paid to a company’s top five “covered employees” under IRC Section 162(m). As a result of the repeal:

- all compensation above $1 million per year that is paid to each “covered employee” will no longer be deductible (subject to limited exceptions for certain pre-existing binding agreements that were in place as of November 2, 2017),
- the CFO will now be automatically included as a “covered employee,” along with the CEO and the next three highest-paid executive officers (other than the CEO and CFO),
- any individual who is a “covered employee” during any year beginning after December 31, 2016, always will be designated as a covered employee (i.e., once covered, always covered),
- all compensation paid to such individuals will be covered, i.e., payments after termination and death will be nondeductible.

IRC Section 162(m): Non-deductibility of Compensation in Excess of $1 million

IRC Section 409A was enacted in 2005 in the aftermath of the Enron debacle to address perceived abuses by senior executives of deferred compensation programs. Section 409A strictly, and often inflexibly, regulates time and form of payment of “nonqualified deferred compensation.” If a nonqualified deferred compensation plan does not meet the requirements of Section 409A, amounts deferred will be subject to current income taxation (or if later, when vested), as well as increased tax equal to:

- an additional 20% of original deferral and on any earnings credited on deferral; and
- interest at the underpayment rate plus 1% on the tax that should have been paid on the amount of the original deferral and any related earnings.

It is important to note that IRC Section 409A defines “nonqualified deferred compensation plan” very broadly and can include severance compensation, certain equity-based compensation and nonqualified retirement plans.

IRC Section 409A: Onerous Deferred Compensation Rules

IRC Section 280G prohibits a deduction for “excess parachute payments” paid to a disqualified individual that is contingent on a change in ownership or control of the company. There is a limited but important safe harbor for parachute payments that do not exceed 2.99 times the disqualified individual’s base amount (i.e., the average annual compensation over the lesser of the most recent five taxable years preceding the year in which the CIC occurs or the number of years of actual employment with the company).

If a disqualified individual receives parachute payments which exceed the safe harbor amount:

- the disqualified individual must pay a 20% excise tax on any parachute payment in excess of the base amount, and;
- the company is prohibited from deducting such amount.

IRC Section 280G: Golden Parachute Rules
ACCOUNTING CONSIDERATIONS

To optimize the financial impact of compensation programs, the compensation committee should also consider the accounting implications of the program.

ASC Topic 718 (formerly referred to as FAS 123R) applies to accounting of stock-based compensation. Compensation cost of equity instruments is equal to the fair value of the award at grant, which is to be accrued over the vesting period.

- Equity instruments are generally awards that are to be settled in stock, such as stock options, restricted stock, restricted stock units and performance shares or units.
- The fair value for a stock option must be based on a valuation model (e.g., Black Scholes) that incorporates all “substantive characteristics” of the option.
- Performance awards denominated and settled in stock are accounted for in one of two ways:
  - “performance conditions”—if the performance criteria are based on financial, operational or strategic goals, the expense is based on the stock price at grant and the actual number of shares earned; or
  - “market conditions”—if the performance criteria are based on stock price, total shareholder return, or other similar measures, either on an absolute or relative basis, the expense is based on the grant date fair value using a valuation model and is not adjusted for actual performance.
- Compensation cost of liability instruments—i.e., awards that are expected to be settled in cash (e.g., cash-settled SARs, long-term cash awards)—is based on the fair value of the award over the vesting period and is marked-to-market to reflect changes in the company’s stock price until the liability is settled.
- The fair value of an award on the applicable measurement date is reduced by the amount, if any, that the employee pays for the award (or base price at grant of an award of SARs).

As noted in the introduction, the regulatory and compliance aspects of executive compensation are complex and evolving, and it is critically important that compensation committees receive thoughtful and comprehensive advice from qualified subject matter experts.
Compensation committees of tax-exempt organizations must be aware of compensation-related regulatory matters and avoid common pitfalls.
INTERMEDIATE SANCTIONS LEGISLATION

Tax-exempt organizations are prohibited from using their income for the benefit of “insiders” and private individuals. An exception to this prohibition is the payment of reasonable compensation. In the past, violation of the “private inurement/private benefit rule” resulted in loss of the organization’s tax-exempt status. Because this sanction was so severe, it was not widely utilized and had not been an effective tool for the IRS. Thus, the IRS sought legislation providing for a less onerous “intermediate sanction” while retaining the ultimate sanction of revoking tax-exempt status.

The Taxpayer Bill of Rights 2, signed into law in 1996, enacted new penalty taxes applicable to Code Section 501(c)(3) and 501(c)(4) organizations that engage in “excess benefit transactions.” These rules are embodied in Code Section 4958 and applicable Treasury regulations, commonly referred to as the “Intermediate Sanctions” legislation. When the Affordable Care Act was passed, qualified nonprofit health insurance issuers were added to the statutory definition of applicable tax-exempt organizations. Similar rules and potential for penalties on excessive compensation apply to private foundations under Code Section 4941 which prohibits “self-dealing.”

An “excess benefit transaction” is any economic benefit provided to a “disqualified person” at other than fair market value or involving the payment of compensation that is found to be unreasonable. A “disqualified person” is any person in a position to exercise substantial influence over the affairs of the organization, such as officers, trustees and directors. Penalties assessed by the IRS may include:

- a tax on the recipient equal to 25% of the excess benefit, which increases to 200% if the violation is not corrected within the allowable timeframe, by repaying the excess to the organization;

- a tax can also be imposed on the organization’s trustees, directors or officers (the “organization managers”) who approved the arrangement, if they did so knowing it to be excessive; and

- the tax on organization managers is 10% of the excess benefit up to a maximum of $20,000 per transaction, applied on a joint and several basis.
REBUTTABLE PRESUMPTION OF REASONABLENESS

There is a “safe harbor” of sorts for those who follow certain strict procedures designed to ensure that compensation provided to disqualified individuals is reasonable and oversight is provided by an independent governing body. Payments provided to disqualified individuals under a compensation arrangement are presumed to be reasonable if the following three conditions are satisfied:

• The compensation arrangement is approved by an authorized governing body of the organization (e.g., independent members of the board or a committee comprised entirely of independent directors) who are free of any conflict of interest with respect to the proposed transaction.

• The authorized body relies upon “appropriate data as to comparability,” e.g., compensation paid by similarly situated organizations (both taxable and tax-exempt as applicable) for positions of similar roles and scope of responsibility, prior to making its determination.

• The authorized body adequately documents the basis for its determination, including the terms of the transaction and the date it was approved, the members of the authorized body who were present in discussion, the comparability data obtained and relied upon, and any actions taken with respect to members of the authorized body who had a conflict of interest and how such conflict was handled.

If these requirements are satisfied, the compensation paid is presumed to be reasonable, unless the IRS can demonstrate otherwise on the basis of “sufficient contrary evidence.” Determining the reasonableness of compensation can be a complex process, and governing boards need to understand how reasonableness is determined in the event of a third-party review by regulators, typically the IRS or a state attorney general.
The IRS defines reasonable compensation as “the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances (See Treasury Reg. Section § 53.4958-4 regarding excess benefit transactions).” Compensation committees of tax-exempt boards must take great care in ensuring the market data relied upon meet these criteria. Otherwise, the IRS can exclude such data due to lack of comparability and thereby eliminate any rebuttable presumption protection the board thought it had achieved (see “2013 IRS Colleges and Universities Compliance Project”).

**2013 IRS COLLEGES AND UNIVERSITIES COMPLIANCE PROJECT**

In 2013, the IRS finalized its findings from its examination of 34 colleges and universities concerning unrelated business income and compensation.

The study found that approximately 20% of the examined institutions—including those that engaged compensation consultants—were determined to have failed to secure the rebuttable presumption for the following reasons:

- The college/university “peer group” included institutions that were not determined to be comparable based on at least one of the following factors: location, endowment size, revenues, total net assets, number of students and selectivity.
- Compensation studies provided by the college/university did not document the selection criteria for the schools in the surveys provided and did not offer an explanation as to why those schools were deemed comparable.
- The compensation surveys relied on for comparability data often did not specify whether amounts reported included only salary or other types of compensation to equal total compensation, as required by Code Section 4958.

Obtaining reliable market comparability data can be challenging for tax-exempt organizations based on size, scope of operations, recruiting patterns and other factors. Program services offered by public charities are mission specific, which needs to be considered. Also, for smaller organizations, compensation levels are more likely to be impacted by regional pay levels, and external data sources for tax-exempt executive compensation are not as prevalent as for-profit data sources.

As such, in determining what constitutes fair and reasonable compensation, within the parameters defined by the intermediate sanctions legislation, compensation committees should challenge themselves to address the following reasonableness criteria beyond mere comparability data:

**MARKET DATA SELECTION.** The compensation study obtained by the board should contain robust data, scoped to relevant size, and include compensation provided by “similarly situated” organizations, both taxable and tax-exempt, for “functionally comparable” positions. For example, a university should establish a market range representative of other higher education institutions with similar operating budgets, student enrollment, endowment value and/or selectivity. All relevant factors selected should be thoroughly justified and documented.

Tax-exempt organizations are not precluded from using market data from for-profit companies, as long as the rationale for the use of such data is valid and transparently documented. Board-approved compensation philosophies are useful in this regard, because they establish internal consistency when reviewing the reasonableness of compensation levels for all executives, not just disqualified individuals.

**CHARACTER AND CONDITION OF THE ORGANIZATION.** Not all organizations are created equal. Consider any unique factors about your organization that can be difficult to benchmark to market on an equivalent basis. For example, an organization with a budget that is 10 times other “like enterprises” is likely not competing for talent in the same talent pool. The organization’s operations are likely more complex and require “peer comparisons” that are more comparable to its own size and complexity, or if true peers are limited, consider setting compensation higher in the range to account for such differences.
**FACTORS THAT THE IRS WILL CONSIDER IN DETERMINING THE REASONABLENESS OF COMPENSATION**

- Compensation levels paid by similarly situated organizations, both taxable and tax-exempt, for functionally comparable positions;
- The availability of similar services in the geographic area of the applicable tax-exempt organization;
- Current compensation surveys compiled by independent firms; and
- Actual written offers from similar institutions competing for the services of the disqualified person.

**QUALIFICATIONS, SKILLS AND EXPERIENCE OF THE INCUMBENT.** Similarly, the scope of responsibility and complexity of the position, as well as the qualifications, skills and experience of the incumbent should be taken into consideration. A position that requires above-average skills and experience that is not easily found in the marketplace, or may be very difficult to replace if the incumbent left, may reasonably command a higher market value.

**INTERNAL CONSISTENCY.** The 2013 Massachusetts Public Charities CEO Compensation Review conducted by the state attorney general noted that “it did not see evidence that the committees examined regularly considered the reasonableness of the CEO’s compensation when compared with the compensation paid to other members of the organization’s workforce or discussion about how the CEO’s compensation related to or advanced the charitable mission of the organization.” While these factors are not required to establish the rebuttable presumption safe harbor, they can support the organization’s narrative as to why it is critical to the organization’s mission to retain the CEO at current compensation levels and why it is reasonable to position pay above the typical market median in reasonable situations.

**EVALUATING COMPENSATION IN ITS ENTIRETY.** The 4958 regulations require that compensation must be considered in its entirety when boards or committees review and approve compensation for purposes of establishing the rebuttable presumption. This includes fixed (salary) and non-fixed (bonus) compensation, deferred compensation, and other taxable compensation or benefits to be treated as imputed income to the executive.

For non-fixed compensation that is subject to a cap, the committee should consider whether the maximum compensation opportunity it is approving to be paid (assuming the requirements for maximum payout are met) would be reasonable.

Finally, an executive can be considered a disqualified individual in the last year of employment and as such, all post-employment benefits, including severance arrangements and any other benefit extended to the executive, should be reviewed and evaluated against market practices.
Best Practices in Exempt Organization Governance

In our experience, the most pro-active and effective compensation committees serving on nonprofit boards engage in the following practices:

- Establish an independent compensation committee, reporting to the full board.
  Establish a compensation committee charter with sound corporate governance procedures including a standing calendar, use of executive sessions and annual CEO performance reviews, among others.

- Adopt a comprehensive compensation policy statement.
  The policy should be revisited every one or two years to ensure it remains in alignment with the organization’s mission, vision, values, and strategic objectives.

- Develop effective incentive arrangements.
  Align pay with organization performance, mission and values. For nonprofit organizations, use quantifiable metrics whenever possible, with clear line of sight as to how the metrics support the overall mission.

- Regularly evaluate executive compensation levels and make sure the “rebuttable presumption” of reasonableness is established. Obtain comparability data from multiple independent sources whenever possible. Organizations with low-risk compensation arrangements (e.g., below average salaries and limited deferred compensation arrangements) may not need to conduct assessments annually. Similarly, when the market has not moved significantly, the committee may rely on studies from the prior year to make pay decisions.

- Avoid any appearance of conflict of interest.
  Work through outside counsel where necessary to maintain privilege. Document incidents were a potential conflict of interest may occur and note that the individual was excluded from any meeting, discussion or votes pertaining to his or her compensation.

- Maintain well-documented minutes for all board or committee meetings.
  Make clear that the rebuttable presumption process was met by providing documentation of what terms were approved, the rationale for the decision, who was present, who was recused, how the members voted and where the committee requested additional information, if any, to guide its decision-making process.

2017 TAX CUTS AND JOBS ACT AND IMPACT ON TAX-EXEMPT COMPENSATION

The Tax Cuts and Jobs Act passed in 2017 is the most significant tax reform impacting tax-exempt organizations since 1986. While prior versions of this bill would have had an even greater impact on nonprofits, the final version imposes a 21% excise tax on the sum of (1) remuneration paid in excess of $1 million to the top five highest compensated employees (a “covered employee”) by an applicable tax-exempt organization for the taxable year, plus (2) any excess parachute payment paid to any covered employee. The employer will be responsible for this tax, not the recipient.

Unlike Section 4958, this new excise tax provision applies to any organization exempt from taxation under 501(a) or Section 115, farmer cooperatives and select political organizations.

The remuneration that would be taxable includes all gross income, including income paid under 457(f) deferred compensation arrangements, but excludes payments from qualified retirement plans (e.g., 403(b) or 457(b) plans). It will, however, exclude any compensation paid for medical services, thereby excluding medical professionals from the additional tax.

The provision also states that compensation from any related organization to the applicable tax-exempt entity will be included, and the tax obligation is shared in the same ratio as the compensation provided.

Similarly, the excise tax on the excess parachute payment will not include qualified retirement plan payments or payments to a licensed medical professional, and it will not apply to individuals who are not highly compensated.

Tax-exempt organizations with outstanding deferred compensation arrangements and severance arrangements for any of the highest compensated employees are encouraged to review the current arrangements and determine if they are likely to exceed the $1 million threshold and trigger the new 21% excise tax. Planning may be useful over several years to mitigate this tax if possible.
PITFALLS FOR THE UNWARY

Tax-exempt organizations with more complex compensation arrangements should pay attention to common pitfalls that could result in failing to satisfy the rebuttable presumption rules and/or trigger an examination for excessive compensation:

- **Signing bonuses that are not justified as to their purpose.**
  Tax-exempt organizations face the same challenges as for-profit companies when recruiting a candidate from their current employer—there is sometimes a large opportunity cost being forfeited and occasionally a large one-time bonus is required. Such terms need to be justified based on what is being forfeited at the prior employer. Justify the rationale for the signing bonus further with a clawback provision if the executive does not remain with the organization for a set number of years.

- **Supplemental deferred compensation needs to comply with both Code Section 457(f) and 409A rules.**
  For tax-exempt organizations, deferred compensation is immediately taxed when it is vested and is no longer subject to a “substantial risk of forfeiture”, even if the amount is to be paid at a later time. Tax-exempt boards are advised to work closely with counsel to ensure compliance with all deferred compensation rules.

- **Incentive compensation should be based on written performance objectives.**
  Objectives should be established at the beginning of each year and approved by the board, and then measured as to the actual performance outcomes at the end of each year. Large bonuses that serve no valid business purpose or are not performance-based, carry a significant risk upon examination.

- **Above market retirement benefits.**
  The rate at which retirement benefits are being accrued annually needs to be considered when determining the reasonableness of total compensation.

- **Ensure severance arrangements are reasonable.**
  Severance arrangements need to be considered when opining on the reasonableness of total compensation arrangements for an executive. In general, severance arrangements for tax-exempt organizations are more conservative than for-profit practices.

- **Beware of upcoming vesting events related to deferred compensation, and required reporting requirements.**
  Form 990 reporting rules require prior deferred compensation to be reported as taxable income in the year that it is paid—board members should be aware of how deferred arrangements will be reported to avoid surprises.

- **Minimize “one-off” deals for the CEO to the extent possible.**
  This can create a significant internal consistency problem if the CEO receives a material benefit not otherwise provided to other employees, and his or her total compensation arrangement is found to be excessive.
Conclusion

The compensation committee is primarily responsible for establishing and maintaining the compensation program for the company’s executive team, ensuring that it is appropriately tied to performance, and in the best interests of the company and its shareholders. Compensation committee members may also be tasked with evaluating the executive team’s performance, overseeing broader human resources strategies, including succession planning and inclusion initiatives, and setting director pay programs.

KEY TAKEAWAYS

Operations and Best Practices

• The compensation committee should comprise members with a diverse set of backgrounds, skills and experience, and meet all independence requirements.
• The company’s proxy statement and compensation program documentation, together with the compensation committee’s charter, are great starting points for new committee members to get up to speed on the company’s compensation objectives and philosophy.
• Each year, the committee should perform a thorough review of the company’s overall compensation programs to ensure pay-for-performance alignment and consistency with evolving market best practice standards and investor expectations.

Compensation Methods and Design

• Most executive compensation plans have both fixed (typically established at the beginning of the year) and variable compensation (incentives tied to performance) components.
• Peer group selection should be based on industry, business model and size, but could include geography, customer focus and company stage.
• Director compensation programs have fewer components and tend to favor annual cash retainers and full-value awards with short or immediate vesting terms. Directors are also often required to own a certain amount of equity in the company to ensure alignment of interests with those of shareholders.
• Compensation committees often consult external experts to assist with the design of compensation programs, both at the executive and board levels. This ensures compliance with regulations as well as competitiveness and objectivity.
Shareholder Engagement, Say-on-Pay and Compliance

• Since 2011, shareholders have had a more direct voice for engaging companies on executive pay issues and many have come to expect an open and continuous dialogue.

• The CD&A is an effective way to engage with shareholders on executive compensation, and it should provide context and transparency, address investors’ topics of interest and be concise and easy to read.

• While nonbinding, Say-on-Pay, Say-on-Pay Frequency and Say on Golden Parachute are three ways shareholders can voice their agreement or disagreement with a company’s compensation programs.

• The SEC imposes various executive compensation-related disclosure obligations on public companies, including risk disclosure and CEO pay ratio—among many others.

• Compensation committees generally work with subject matter experts to ensure the company remains in compliance with all legislation, regulatory requirements and tax and accounting considerations.
The information in this guide is by no means exhaustive. If you wish to dive deeper into the topics in this guide, we encourage you to visit FW Cook’s website, where you can find more information and also request a meeting for your board or compensation committee. We also recommend that you discuss questions and issues with your company’s general counsel or corporate secretary.

CONTACT FW COOK

Daniel Ryterband  
CEO & Head of New York Office  
212.299.3715  
daniel.ryterband@fwcook.com

George Paulin  
Chairman & Head of Los Angeles Office  
310.734.0112  
george.paulin@fwcook.com

Steven Harris  
President & Head of Atlanta Office  
404.439.1002  
steve.harris@fwcook.com

CONTACT CORPORATE BOARD MEMBER

Scott Budd  
Managing Director  
203.889.4981  
sbudd@chiefexecutive.net

Leigh Townes  
Program Director  
615.592.1213  
ltownes@chiefexecutive.net
FW Cook is an independent consulting firm specializing in executive and director compensation and related corporate governance matters. Formed in 1973, FW Cook has served more than 3,000 companies of diverse size and business focus from its offices in New York, Chicago, Los Angeles, San Francisco, Atlanta, Houston and Boston. FW Cook currently serves as the independent advisor to the compensation committees at a substantial number of the world’s leading companies. Learn more at: www.fwcook.com

Corporate Board Member, a division of Chief Executive Group, has been the market leader in board education for 20 years. The quarterly publication provides public company board members, CEOs, general counsel and corporate secretaries decision-making tools to address the wide range of corporate governance, risk oversight and shareholder engagement issues facing their boards. Corporate Board Member further extends its thought leadership through online resources, webinars, timely research, conferences and peer-driven roundtables. The company maintains the most comprehensive database of directors and officers of publicly traded companies listed with NYSE, NYSE Amex and Nasdaq. Learn more at: www.BoardMember.com