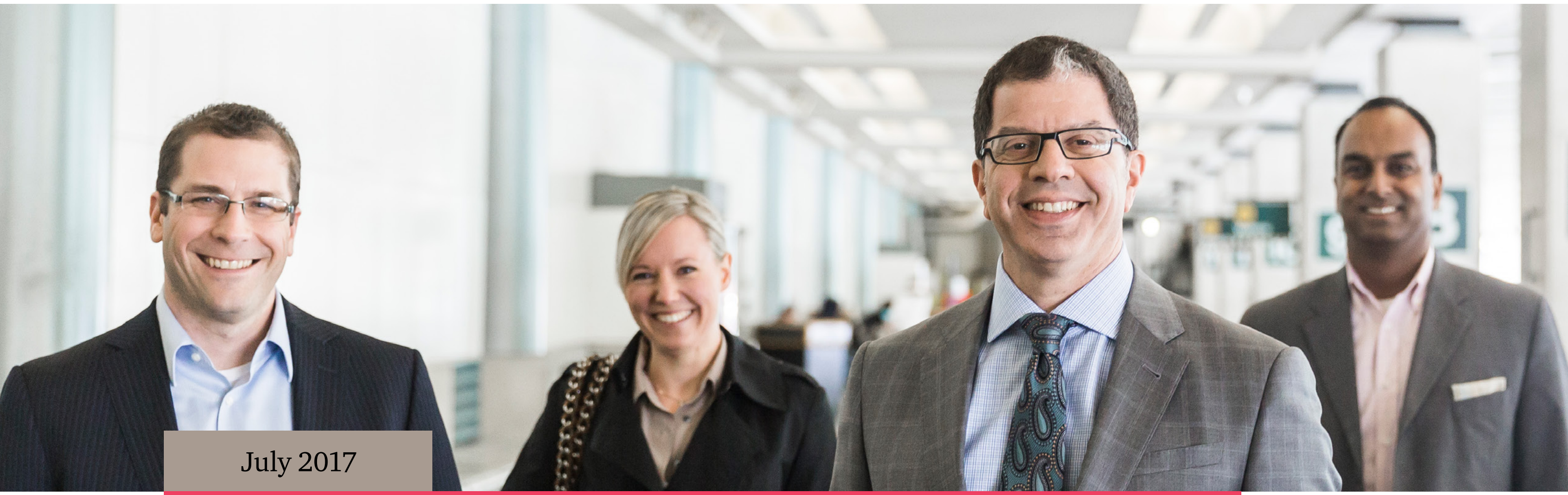
Governance Insights Center
Executive Compensation Series



July 2017

The board's role in structuring an executive compensation package

To oversee executive compensation, board members need to understand what makes a pay package effective for their company.

A compensation package is about much more than just a dollar figure. It's a retention tool, a key benchmark and a shareholder relations issue. When it's done right, it aligns closely with company strategy. Compensation consultants, internal legal and human resources staff and outside counsel all play important roles. But in the end it's up to the compensation committee to get the package right for both the executive, the company and its shareholders.

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Overseeing executive pay requires unique skills as a board-level responsibility because it is so personal for the executives involved, and at the same time requires familiarity with technical rules and a focus on details. While most executives are motivated by much more than just their own compensation, it is a crucial part of keeping an executive fulfilled, rewarded and incentivized in the right way.

But executive pay is not just about keeping executives happy. It's about finding the right balance between what shareholders expect, what the market dicates, what the company requires and what proxy advisors recommend.

Laying the groundwork: the basic elements of a pay package

The variety in different types of compensation vehicles is significant. Figuring out the right components to use, the relative "mix" of each component and how to balance the overall package is a delicate task. And there are no hard-and-fast rules to follow.

In addition, equity awards can be offered in a number of forms, including stock options, time-based restricted stock/units or performance-based restricted stock/units. Each equity vehicle has its own benefits and drawbacks, including tax implications for the company and the executive.

Balancing pay components

Fixed (such as salary) vs. *Variable (such as bonus)*

Fixed (such as salary)
- Guarantees a minimum level of income
- Is not tied to performance

Variable (such as bonus)
- Potentially offers more upside if performance is strong
- Risks lower payouts if performance is weak
- Usually linked to company, business unit and/or individual performance

Insights
- Use of individual factors (in addition to company or business unit performance metrics) is increasing
- Salary increases are declining in favor of increasing variable compensation

Cash vs. *Equity*

Cash
- Can be fixed for variable based on a performance metric

Equity
- Ties executive pay to shareholder value
- Often subject to vesting or holding restrictions that encourage retention

Insights
- Value of equity depends on the market, which can result in a mismatch between the individual's performance and the value realized through the award

Short-term vs. *Long-term incentives*

Short-term
- Establishing performance targets is simpler in the short-term
- Easier to motivate executives with a shorter performance period

Long-term incentives
- May align better with the company's long-term strategy
- Increased retention value since the executive usually must remain employed during the entire period to earn the award

Insights
- "Long term" usually means just three years, though options may be exercisable for up to 10 years
- Calibration is key—if it becomes clear early in the performance period that performance is unlikely to be met, awards lose their retentive value; metrics that are too easy may not provide proper incentives

Current benefits vs. *Deferred benefits (such as pensions)*

Current benefits
- Predictable and easily measurable

Deferred benefits (such as pensions)
- Provides retirement security to executive at a deferred cost to the company

Insights
- Qualified defined benefit pension plans are increasingly rare
- Company defers tax deduction for non-qualified deferred compensation

Employment agreements

The employment agreement is a basic building block of many executive compensation packages. But there is no rule or law requiring it. In fact, only about a quarter of the CEOs at Fortune 200 companies have an employment agreement.[1] Whether an employment agreement makes sense depends on the needs and the expectations of the executive, and of the company.

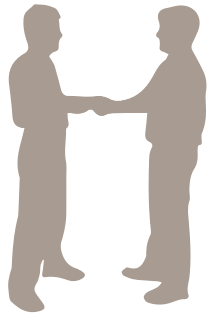
Setting expectations from the start can give both parties a degree of certainty. Both have a picture of what the relationship should look like. And hopefully, that picture is consistent.

Deeper insights:

Employment agreements often provide severance benefits if the company terminates the executive's employment before the end of the contract—unless he or she is terminated for "cause." Negotiations on what precisely constitutes cause in the contract can be difficult. Neither side typically wants to dwell on the risks, but a lot of money is perceived to be at stake. In the past, it was rare for public company executives to be terminated for cause. According to Strategy&'s 2016 CEO Success Study, CEO dismissals related to ethical lapses have been on the rise: from 3.9% during 2007-2011, to 5.3% during 2012-2016.

Some common items covered in employment agreements:

- Title, role and reporting relationship(s)
- Change in control arrangements (definitions and provisions)
- Elements of compensation: salary, target cash and equity incentive opportunities
- Employment termination arrangements (definitions and provisions)
- Dispute resolution
- Benefit plans coverage
- Post-employment restrictions



1. Study conducted by Equilar, a board and executive data provider, based on calendar year 2015.

Some executives expect an employment agreement. It demonstrates that the company views them as a valuable member of the team. Other companies choose not to use formal employment agreements at all, even for their CEO. This may be a function of the type of company and the formality of their internal structure. For example, companies in certain industries may have employment agreements with every top-level executive. But a newer start-up technology company that grew out of someone's basement a few years ago may not have any, because it wasn't a part of the natural growth cycle of the company. And some companies may have employment agreements only in exceptional circumstances (e.g., a senior, mid-career hire).

Even with an employment agreement, executives cannot be forced to work, and usually cannot be made to pay large penalties if they choose not to work. For this reason, employment agreements are often more beneficial to the executive than to the company, and directors should consider whether they make sense at their company. In states where agreements not to compete can be used, these provisions can balance out the benefits of an employment agreement.

A lack of employment agreements doesn't mean that executives are not entitled to any benefits or protections. Instead, benefits like bonuses, equity awards and severance would come from plans covering a group of employees. This often gives the company more flexibility. The terms of an employment agreement usually can't be modified without the executive's consent, but most benefit plans give the company the right to make unilateral changes.

Deeper insights:

Equity compensation plans are key for motivating and retaining employees. Granting equity to employees helps to align their interests with shareholders. But those grants can also dilute the shareholders' interests. Some companies use share buybacks to manage the dilutive effect of the compensation plans, which also has other capital allocation ramifications.

Keeping track with tally sheets

Total compensation can be tough to measure. What is the value on any given day of different forms of equity? The grant may or may not vest, and no one can predict what the stock price will be if, and when, the grant is eventually settled. Future pension benefits can also be difficult to value, especially when paid as a lifetime benefit after retirement.

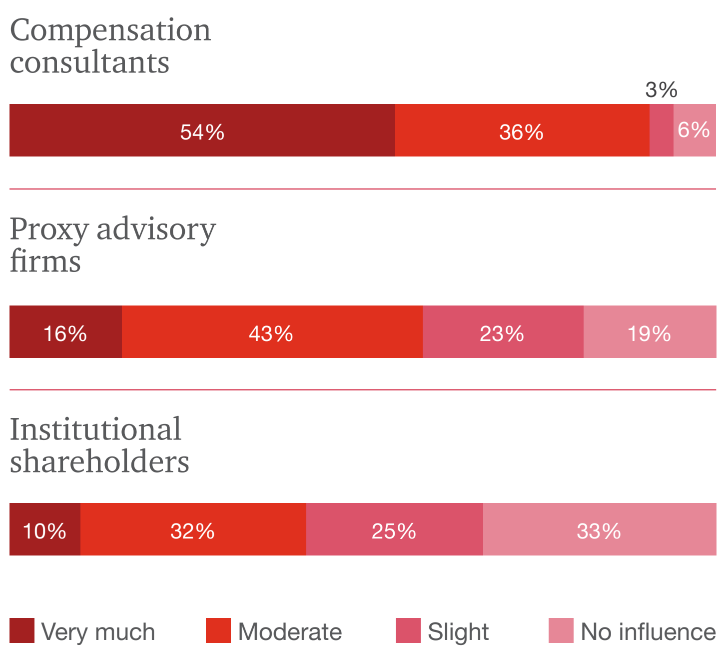
Tally sheets can help compensation committees get their arms around these numbers in a way that looking at proxy statement disclosures cannot. Tally sheets give a full picture of each executive's total pay, broken out by type (e.g., cash, equity, pension). They may include best-case and worst-case scenarios of bonus and equity pay-outs to demonstrate the range of possibilities. And they provide both "annual" and "accumulated" views across all elements of executive compensation.

As discussed in our prior module on legal and regulatory requirements, directors have a fiduciary duty to exercise due care in setting pay. Using tally sheets can be a good way for them to exercise due care and fulfill this duty.

The role of consultants

Compensation consultants are key players in the benchmarking discussion. When PwC asked almost 900 public company directors who is driving executive pay, compensation consultants came out on top. Over 90% of respondents said that the consultants had at least a moderate influence over the board's decisions, with more than half saying they had a great deal of influence.

Directors say consultants have the most influence on executive compensation



Note: Charts may not all add to 100% due to rounding
Q: Rate the level of influence that the following have over your board's decisions on executive compensation:
Base: 792-819
Source: PwC, *2016 Annual Corporate Directors Survey*, October 2016.

Consultants can support compensation committees in a number of ways: including providing a view into compensation levels, incentive design, governance trends and pay-for-performance relationships across the company's peer group, as well as creating tally sheets.

The best compensation consultants do more than just summarize publicly-available information gleaned from peers' proxy statements. They will help a compensation committee define the programs and metrics that most closely align with the company's overall strategy. They also identify pay trends and spot potential issues in a company's pay practices early. And they know which pay elements shareholders may find confusing or problematic, enabling them to give advice on how to respond and/or tweak the programs.

For compensation consultants, defining the peer group—finding those companies that are reasonably comparable—is critical. But competitive data is an input to decisions, not a substitute for decisions themselves. It is the role of the compensation committee to decide what is right for the business, rather than just where their executives fit amongst their peers at other companies. The information compensation consultants provide is useful, but it represents just one data point in the decision-making process.

Deeper insights:

The SEC adopted rules in 2015 that require public companies to disclose the ratio of their CEO's total pay as compared to the total pay of the company's median employee, starting with their 2018 proxy statements. In February 2017, the SEC sought comments about whether the rule should be delayed or whether it poses any "unexpected challenges" to companies. Whether it will still go into effect remains uncertain, but companies should be prepared in the event that it does. Many institutional investors remain keenly focused on the issue, and a group of more than 100 investors and investor organizations representing $3 trillion in collective assets under management sent a letter to the SEC in March 2017 urging the commission to maintain the original effective date for the rule, emphasizing the importance of the disclosure.

Preparing for the unknown: change in control issues

A change in control of a company can be a life-changing event for its executives. They might have a new business line, new responsibilities, a new boss or they might even lose their role at the company. Many companies address the risk for executives by providing special benefits in the event of a change in control. The intent is to help keep executives focused on a potential transaction involving such a change in control. Without the protections, executives might not be motivated to get the deal done and perhaps work themselves out of a job.

These benefits usually pay out if the executive loses his or her job after the change in control—a so-called "double trigger." Double trigger benefits also sometimes pay out if the executive quits for good reason. Good reason covers the times when the executive still has a role after the transaction, but the job is fundamentally changed, such as with a diminished title, duties, or a reduction in pay.

Some change in control benefits are structured as a "single trigger" that pays out after the transaction, whether or not the executive keeps his or her job. Single trigger agreements are sometimes cast as a windfall to the executive, and are not popular with shareholders or proxy advisory services. However, they can sometimes serve as a vital retention tool.

Shareholders weigh in

Shareholder perspectives are also an important aspect of structuring executive pay packages. Shareholders frequently want to discuss executive compensation as part of their engagement with the company, including how the company's plans work, what behaviors they are encouraging and how they tie to the company's strategy.

Telling your story

SEC disclosure rules require that a public company's annual proxy statement include a discussion of executive compensation, including the objectives of the program, what it is designed to reward and why the company chooses to pay each element. But in recent years, proxy statements have become more than just required disclosure. It's also a chance to tell the company's story on compensation. In its own words, the company can describe how the pay package ties to the overall strategy and why its compensation decisions are the right ones for the company.

Compensation committee members can add value to a proxy statement by reviewing it carefully and looking for ways that the disclosure can be improved—perhaps by expanding on certain areas, or by simplifying the language.

Shareholders also have a chance to weigh in since say on pay rules adopted in 2011 have required regular advisory votes on executive pay. Shareholder support of executive pay tends to be strong, but even risk of a low say on pay vote can spur proactive shareholder engagement and get companies thinking about how their pay practices are being received.

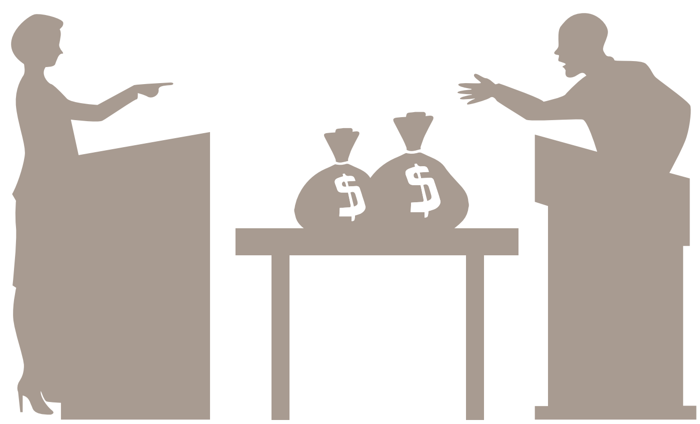
Controversial pay practices

Institutional shareholders and the proxy advisory firms have identified a number of what they consider to be controversial pay practices. These are practices that they believe promote bad behavior, or are the wrong use of corporate resources, and could lead to poor say on pay support. During a time when no company wants to fail a say on pay vote, these practices have been moving out of the mainstream.

By crafting the right executive pay programs, a strong compensation committee can ensure that executives are aligned on key strategic goals, that high levels of pay occur when shareholders realize superior value creation and that the company has a clear path forward.

Pay practices commonly viewed as controversial

- Single trigger change in control benefits—benefits that automatically pay out upon a change in control, whether or not the executive keeps his or her job
- Perquisites such as club memberships
- Excise tax gross-ups
- Internal pay inequity—a large difference between the pay of the CEO and the other top executives
- Adjusting the price of underwater options



Other "Executive Compensation Series" topics include:

- ***Boards, shareholders and executive pay***
- ***Legal and regulatory requirements***
- ***Tax matters: what should the board be thinking about?***
- ***Accounting and financial reporting in executive compensation***

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