Prepare to Perform

Why companies must show performance that proves shareholder value creation

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Be Prepared to Perform

Companies must show performance that proves shareholder value creation

By Dan Marcec

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Executive Compensation Summit

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Each year, Equilar gathers hundreds of executive compensation and corporate governance professionals for a three-day, in-depth event. The only conference dedicated to executive compensation, Equilar's Summit attracts the best and the brightest visionaries in the field to explore the complex and interrelated issues around Say on Pay, pay-for-performance, shareholder outreach, and executive pay.

Compensation Committee Forum

November 10, 2016 | San Francisco, CA

Co-hosted by Equilar and Nasdaq, this forum will arm public company compensation committee members, general counsel, and senior HR and compensation executives with the necessary knowledge to make the right pay decisions that are most relevant to their businesses. Attendees will obtain independent viewpoints, unmatched insights, and noteworthy take-aways to drive long-term strategies to increase shareholder value.

Board Leadership Forum

September 13, 2016 | New York, NY

Co-hosted by Equilar and Nasdaq, this unique event will address investors' increased expectations for transparency around board succession planning and refreshment and how they are voting on boards. Developed for public company board members, general counsel, and corporate secretaries, the Forum will empower participants to build higher performing boards through better evaluations and recruitment, as well as improved engagement with their shareholders.

Webinars

Equilar partners with industry thought-leaders to provide succinct, relevant webinars on a wide range of executive compensation and governance topics. Participate live or on-demand at your convenience! Recent topics have included: board succession planning, the changing landscape of director compensation, avoiding long-term incentive design homogenization, board diversity, and engaging with Glass Lewis.

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Getting to Know Your Shareholders

w’re already halfway through 2016, and it’s been an exciting few months here at Equilar. For those of you seeing this issue of C-Suite for the first time at Equilar’s 7th Annual Executive Compensation Summit, we welcome you.

At this time of year, most companies have completed their annual meetings to address Say on Pay and other shareholder proposals, they’ve re-elected or refreshed their boards, and now they’re out collecting feedback on what matters the most to shareholders. To help in these efforts, we added a major new enhancement to Equilar BoardEdge, our board assessment and recruiting tool.

Our Shareholder Engagement Report provides our clients with the latest data to ensure they have access to the most accurate information for shareholder engagement meetings. Within BoardEdge, you can download and print company summaries neatly organized for meetings, including director and executive changes, voting results from the most recent annual meeting, board benchmarking, CEO succession information, and pay for performance and executive pay.

In this issue of C-Suite, we’re focused on pressing topics for executives and board members as we enter shareholder engagement season. Our cover story is focused on four ways companies should be prepared as they go into these conversations, centered on the idea of proving performance in line with shareholder value.

Our “Ask the Experts” column focuses on the governance issues that will have the most influence on board strategy this year, including input from the Council of Institutional Investors, Ethisphere Institute, Latham & Watkins, Protiviti and Willis Towers Watson. Our one-on-one interviews feature former SEC Commissioner Dan Gallagher on Dodd-Frank’s legacy, as well as Jim Nevels—currently lead director at The Hershey Company and member of several other boards—on how he has seen the director role evolve over the past several years.

In addition, TK Kerstetter weighs in with a column on the two issues that will affect each and every board this coming year. Ron Schneider of RR Donnelley looks back at proxy season and offers suggestions on how companies can better tell their own compensation story—before proxy advisors or activist shareholders tell it for them. And finally, Seymour Cash comes up with a creative solution to board refreshment.

Please enjoy this issue and feel free to contact me directly with any feedback.

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Companies must show performance that proves shareholder value creation

By Dan Marcec

Be Prepared to PERFORM
As another year of shareholder meetings comes to a close, the real work is just beginning. While very few companies are likely to fail their Say on Pay vote—typically about three-quarters of the S&P 500 not only passes, but also receives more than 90% approval on executive compensation from their shareholders—there are a host of other long-term issues facing companies that they will have to address in the coming shareholder engagement season.

Companies were no stranger to shareholder concerns this past year, and some estimates put the number of activist campaigns launched in the U.S. at approximately one per day in 2015. According to a 2016 Davis Polk report, aggregate assets under management for activist investors range from $120 billion to more than $200 billion. In other words, these campaigns can’t be considered small special interests looking to make big noise.

Though the intent of many of the recent SEC rules and regulations has been to increase corporate transparency and shareholder rights—undoubtedly a positive thing for all constituents—some are concerned that this has upset the balance of power. The changes over the past few years have put high demands on boards and management not only to perform well in the face of added scrutiny, but also to appropriately predict and communicate proactively how company performance will play out in both the short- and the long-term.

All of this upheaval has resulted in companies reaching out more to their shareholders. In 2011, just 2% of the S&P 100 disclosed shareholder engagement, increasing to 55% in 2015, according to Equilar research. In the S&P 500, the number of companies disclosing shareholder outreach has doubled, reaching about one-third of that larger index.

On paper, the solution to the tension among companies and their various constituents seems simple: Carefully assess and address all potential shareholder concerns. The application, obviously, is not so straightforward, and writing about outreach in the proxy statement means very little if it doesn’t produce better results and investor relations in real life. Companies must address performance issues and make changes in order to show shareholders return on their investment, and that process starts by engaging with shareholders proactively after annual meetings to understand the hot-button issues and potential trouble spots.

Here are several ways companies will have to prepare for shareholder engagement in the second half of 2016.

**Be Prepared to Show How Pay and Performance Align**

Many expect the SEC to follow through on the proposed rules from Dodd-Frank regarding pay versus performance disclosures this year. While ideally this would make pay for performance universally understandable and easily digestible, it creates further challenges for companies who want to show other definitions of pay and performance, of which there many, in relation to their specific strategies and goals.

According to Equilar research, 252 companies failed their Say on Pay votes at least once within the last five years, and among those, nearly 25% (63 companies) saw their CEOs resign—the average time frame being within a year of the shareholder meeting. In other words, no matter what they disclose,
companies will need to prepare to defend their pay practices and respond to any negative feedback immediately.

Be Prepared to Discuss Pay Equality
Because the SEC’s CEO to employee pay ratio shines a spotlight on income inequality, companies must be prepared to contend with the media and the general public on this issue. Aside from the logistical and cost challenges incurred when this rule goes into effect for the 2018 proxy season—some estimates have put the cost to corporate America at $1.3 billion in the first year and an estimated $526 million each year thereafter—the concept of a uniform figure applying to all companies complicates this issue when it comes to communicating the reasons.

As one attendee of Equilar and Nasdaq’s recent Compensation Committee Forum put it, in the first year companies will be worried about the “four-digit pay ratio,” (i.e., a ratio higher than 1,000:1), unions will love it and use it for negotiations, the media will use it to sell papers and magazines, and a lot of sound bytes will get amplified. But in the near term, investors won’t be able to tell very much until they have a longitudinal view on how it changes year over year and affects executive compensation.

The intended consequences would bring more equitable and transparent pay practices at the executive level and from board and professional compensation committees. However, there will also be a ripple effect to corporate communications strategies both internally and externally, which could distract them from shareholder engagement on this issue.

Be Prepared for Board Assessment
Boards need to be prepared to effectively communicate how they are assessing, recruiting and refreshing their boards on an annual basis, down to the specific candidates they are bringing to the ballot. As the potential for board turnover increases, companies are under pressure not only to replace directors, but also to replace directors with the right people. The SEC has even weighed in on gender and racial diversity on the board, calling it “a priority for 2016.” Boards can expect to see more and more calls from their stakeholders and the public at large to add diversity to their ranks as a signal of better corporate governance.

Diversity in the boardroom is not limited to gender and ethnicity, and it’s not about increasing numbers for the sake of doing so. The concept of “cognitive diversity” is gaining traction, as companies require new skillsets and professional trade skills in order to meet the changing demands of today’s corporate environment.

There’s also no way around it that many individuals in the current generation of executives and board members are on the cusp of retirement. Among S&P 500 companies that have a mandatory board retirement age, the most common is 72. A recent Equilar study found that 45% of all S&P 500 directors are over the age of 61, and another 15% are older than 70.

If boards aren’t prepared with the right executive and director candidates when a succession situation arises—whether due to an emergency, directors forced out through a proxy fight, or for a strategic reason as board members reach age and term limits—they will be facing significant challenges as the pool of qualified director candidates comes in higher demand over time.

Be Prepared to Compete for Shareholders’ Attention
The uptick in shareholder engagement amidst the increase in shareholder activism is a fine balance for companies, who may want to avoid extended exposure to calls for quick decisions on short-term strategic planning. The irony is that in order to avoid this, they have to go out proactively and make sure that their strategic vision is clearly communicated to all their shareholders, especially those that have long-term interests. Even though activism is on the rise, many, if not most, investors are aligned with companies in seeking long-term gains, not just quick returns, and partnering with allied shareholders can help mitigate disruptive forces.

The challenge is finding time with those allied shareholders, many of whom are busy being engaged by other portfolio companies. As an example, a major institutional investor told attendees of the Equilar and Nasdaq Compensation Committee Forum that his firm may meet up to 1,000 companies this year, up from about 800 in 2015, but that would still only account for one-quarter of the companies in which they invest.

Corporations consistently prepare to deal with unpredictable elements in the economy, and boards are attuned to managing risk for a host of issues. The case of shareholder outreach is no different. The era of activism may represent a shift in process, but it doesn’t have to mean a change of strategy. Straightforward, clear and consistent communication with respect to company goals and expectations among all stakeholders—directors, executives, investors and employees—is more critical than ever.
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Even with its share of detractors, total shareholder return (TSR) is becoming an integral element of executive pay. In 2015, 25.2% of long-term incentive plan performance awards for S&P 500 CEOs were based at least partially on TSR, a figure that has nearly doubled in the last four years. Many executive compensation professionals are concerned about this because they feel that TSR does not appropriately reflect value creation over a short period of time. Since nearly 71% of CEO performance awards are structured in three-year periods—another figure that has increased each year—the concern about tying TSR performance to pay is rising.

A recent Equilar study took a deep dive into long-term incentive plan design for CEOs in the S&P 100, revealing plan details such as the weight assigned to specific performance metrics, as well as performance goal and award payout ranges, to show how public companies balance incentives meant to drive both financial and operational strategy with shareholder value. Effective executive compensation programs aim to align executive pay with measures of company performance, and a well-designed incentive plan achieves this alignment through a rigorous process, including the selection and weighting of performance metrics. While TSR is a prominent part of many executive incentive plans, it is by no means ubiquitous, and companies are weighing many different factors when determining how to pay for performance.

Performance Metric Weightings
Companies commonly assign multiple performance metrics for the payout of one incentive
E*TRADE Corporate Services Commentary

Shareholders, especially institutional investors and advisors, are increasingly interested in how executive compensation is aligned with overall business performance. This has influenced executive compensation design, driving an increased adoption of performance equity plans.

In 2007, fewer than 23% of CEOs in the S&P 500 had long-term performance grants included in their equity compensation mix. By 2014, nearly 70% of companies in the S&P 500 granted performance equity. This significant increase in performance-based equity vehicles over the past several years aligns with the SEC’s adoption of Say on Pay in 2011.

In the most recently reported fiscal year, relative TSR, EPS, return on capital or invested capital (ROC/ROIC), revenue and cash flow were the most popular performance metrics for long-term incentive awards to S&P 100 CEOs. Relative TSR was by far the most often used, assigned to more than 40 performance awards. Each of the other most popular metrics appeared more than 15 times, where no other metrics appeared more than 10 times.

Popularity does not correlate directly to weighting. For example, relative TSR was the most popular metric in terms of prevalence but was weighted less than 25% for about one in five of the CEO incentive awards when it was included. Awards that measure TSR to partially determine payouts, yet do not depend solely on TSR to encapsulate performance, provide incentive to deliver both strong financial or operational performance—critical elements of strategic achievement—and value to shareholders—a fundamental concern of proxy advisors and shareholders.

Along with being the most popular, relative TSR accounted for 100% weighting in nearly one out of every three awards to which it was assigned, more commonly than any other metric. Revenue was weighted between 26% and 50% more often than any metric in the study—76.2% of the time. Most prevalent on the low-end, cash flow was assigned a weighting in the bottom quartile 31.3% of the time.

Graph 1
Most Popular Metrics in S&P 100 Long-Term Incentive Awards: Number of Awards

Typically, a company’s board of directors, specifically the compensation committee, tries to align executive pay with the company’s strategy and to the performance metrics valued by its shareholders, which supports our observation that companies often include several metrics across a single performance grant.

The complexity of administering and accounting for the performance awards appears to rarely influence the overall design of the plan or impact the rate of plan design changes year-on-year. As specific corporate strategies vary and may even change from one year to the next in the same company, individual metrics attached to the long-term performance incentives mirror these shifts and variations.

Performance Ranges

Performance ranges set expectations for the degree to which executives will receive and maximize their payouts. The connection between set performance goals—or targets—and award payouts creates the link between pay and performance. These types of incentive plans inevitably result in portions of executive pay being “at risk,” or variable, meaning that poor performance can result in little or no payout compared to target amounts.

Among CEO performance awards in the study, performance thresholds—or the minimum performance that results in the payout of an award—for long-term incentives were largely above 80% of target performance in 2015. Of the 65 awards that included reported threshold performance, 51 were between 80% and 100%, meaning that in order for these executives to receive any payout, the company would have to hit at least 80% of its target performance goal. The largest grouping of performance thresholds occurred even higher, between 91% and 100%.

Maximums, or the point beyond which higher payouts are no longer achieved, occurred largely in the 101% to 120% of target performance range. Of the awards that included reported maximums, 49 fell within this range, meaning that executives would receive the largest possible award if the company achieved 101% to 120% of target performance.

Payout Ranges

Award payout ranges as a percentage of target amounts were much wider than performance ranges, indicating that incentive plans leverage small, incremental changes in performance into larger changes in award payouts. The most popular threshold as a percentage of target payout for long-term incentives of CEOs in the S&P 100 was 50% in 2015, and the risk of earning 0% of the target award was not uncommon. In other words, if a company did not reach its threshold for company performance, most executives were eligible for at most half of their target payout, and frequently nothing at all.

Maximum payout was most typically capped at 200% of target, with more than half of the awards in the study topping out at twice the target amount. The largest maximum in the study was 300% of target.

Graph 2
Performance Metric Weightings in the S&P 100, CEO LTIP in 2015

E*TRADE Corporate Services Commentary

As highlighted in Equilar’s study, performance ranges, in relation to payout ranges, communicate the importance of specific deliverables to the grant recipients. Performance ranges are typically set so that overachievement is very difficult, but underachieving is relatively easy. This is why we see payouts increase quickly with over-performance.

It’s also important to note there are many factors that play into a company’s consideration when designing payout performance goals. Not only will a company consider past performance and forecast estimates in relation to their peer groups, but also they may weigh industry and market trends, the economic climate, their competitive environment, as well as the regulatory and compliance landscape. This is all done while staying mindful they are ultimately trying to drive shareholder value and ensure executive retention and motivation.

For these reasons, the challenge of setting annual performance goals can be complicated as companies attempt to achieve the proper balance between overachieving metrics and missing the payout ranges all together.

The data and analysis contained in this article has been prepared by Equilar. The commentary, where noted, has been provided by E*TRADE Financial Corporate Services, Inc.

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Creating Progressive Boards in the Age of Activism

Equilar and Nasdaq host Board Leadership Forum

With the rise of activist investors and advocacy groups calling for more transparency and diversity in the boardroom, the focus on board composition and refreshment has never been greater. Boards must clearly demonstrate an ongoing approach to thoughtful evaluation and succession planning, or risk being targeted by activists.

Earlier this year, Equilar co-hosted the Board Leadership Forum with Nasdaq at the Nasdaq Entrepreneurial Center in San Francisco. This feature details the key issues and insightful quotes that highlight actionable insights to help boards establish more robust evaluation processes and succession planning efforts.

Anatomy of a High-Performing Board

Key Takeaways
What makes a good board great? It starts with understanding the right mix of needed skills, but it is also about establishing the appropriate culture that drives engagement, collaboration and effective decision-making. Directors need to come together to set best practices for a well-functioning board and committees, as well as how to establish a strong onboarding process to quickly integrate new directors into the group.

Key Quotes
“It’s important to hear from everyone on the board when doing evaluations, but it’s difficult have everyone engaged in the board meeting. It’s easier in committee meetings to have deep dive sessions to get everyone involved.”

“A typical complaint from the CEO is that the board is trying to be too operational in its thinking. A good percentage is 60-70% strategy and 30-40% operation.”

“When directors are asked to check their own skill sets there’s often a discrepancy. We’ve often found it is better to ask management about directors’ skills.”
Honest Appraisals — Evaluating Directors

Key Takeaways
As investors continue to emphasize the need for board refreshment, the board evaluation process plays a critical role in assessing whether or not your board composition aligns with your company’s long-term strategy. Assessing director tenure and retirement policies and the best processes for board performance is critical. Boards must use these processes to identify gaps in expertise and skill, along with the developing the art of providing constructive feedback and removing poor directors.

Key Quotes
“About one-third of boards have a peer review system, but courage is the missing ingredient. You have to ask other board members for their honest opinions on who the best board members are to find out who the worst ones are.”

“There is no one size fits all for boards, and both quantitative and qualitative analyses with recommendations from outside parties is a winning process to carry forward.”

“Every board should have a two- to three-year board succession plan in place, with an annual review. Board succession planning should be on the board calendar for the first quarter, highlighted by skills matrix development and a gap analysis.”

“The chairman should drive the process and make sure directors are performing. The best boards don’t over-engineer composition, they help each other improve their performance.”

Engaging Shareholders — Key Issues for 2016 Proxy Season

Key Takeaways
Shareholder engagement is on the rise and will only continue as investors seek to better understand a company’s practices and policies. As a result, more companies are taking a proactive approach to communicate how their governance policies align with company strategy and long-term value creation. The most important components of these engagements are preparedness and having the right people in the room. Now more than ever, investors have expectations of communicating with board members. Companies need to better prepare their boards and set policies and protocol for these engagements.

Key Quotes
“Almost every engagement involves some element of compensation—that will not change.”

“There is a generational difference. Older directors are more traditional and have no expectations of dealing with shareholders and may not be as comfortable.”

“Think like an activist, and understand what your activist wants. In fact, having an activist on your board may not be so bad.”

“Shareholder engagement cannot be an ad hoc process. Set the process around your company’s communication with shareholders. Everyone on your board should know the policy/protocol of engaging with shareholders.”

“Say on Pay has been enormously influential, but it’s caused a homogenization of pay practices and fewer pay outliers. The only thing I want homogenized is my milk—we expect pay programs to vary company to company.”
Catalyst for Change — How Investors Are Voting on Directors

Key Takeaways
Investors consider many factors in voting decisions, including perceived director independence, level of expertise, compensation structure, shareholder responsiveness and overboarding. Diversity in the boardroom has also come to the forefront, and boards must address deficits in board composition to eliminate vulnerabilities and enhance the board’s value to shareholders.

Key Quotes
“Every job has an evaluation, but for boards, there is none. Every board should have an evaluation every year, conducted by an independent party.”

“There is very little to no policy around tenure, and boards should have a balance between long tenure for continuity and fresh blood for new ideas. Having too many directors with high tenure is a red flag.”

“Investors will vote against the comp committee members if they fail Say on Pay, and against the audit committee members if they fail to respond to shareholder proposals. Committee rotation is a big emerging concern.”

“Activists have a lot of tools, and the most potent one is to attack the board. This has become mainstream, and boards need the skillset to oversee strategy.”

Planning for the Future — Getting Board Succession Right

Key Takeaways
Everything in the business world is changing—markets, technology, demographics—but boardrooms are not. Shareholders are taking more notice of how directors represent their interests, and a significant increase in proxy access proposals—and approvals—occurring in 2015 has materially changed how boards assess themselves. As a result, more proactive and thoughtful succession has become a necessity to prove the appropriate agility and effectiveness of a board. Without honest conversation regarding the skills of the people in the boardroom, turnover will remain low and change in the boardroom will be sluggish.

Key Quotes
“Very little turnover in the boardroom can be viewed as suspect by shareholders. Boards will be under more pressure to conduct assessments if there is little board refreshment.”

“Establish a culture of turnover from the beginning. If directors go in expecting to leave and have the understanding that it’s okay and not a reflection of their value, they will feel more comfortable stepping down.”

“When you have a board member leaving, make sure you don’t just replace that director’s skill set. Think about the future needs of the board and what skills will be most helpful in driving the company strategy forward.”

Participants at the Board Leadership Forum

- Dan Cooperman, Director, Molina Healthcare; Of Counsel, DLA Piper; former SVP & General Counsel of Oracle Corporation (1997-2007) and Apple Inc. (2007-2009)
- Julie Daum, North American Board Practice Leader, Spencer Stuart
- Cindy Fornelli, Executive Director, Center for Audit Quality
- Joseph Griesedieck, Vice Chairman & Managing Director, Board & CEO Services, Korn Ferry
- Brian Holmen, Senior Executive Compensation Consultant, Hay Group
- Don Keller, Partner, PwC’s Center for Board Governance
- TK Kerstetter, Host, Inside America’s Boardrooms; CEO, Boardroom Resources LLC
- James Kim, Managing Director, Frederic W. Cook & Co.
- Linda Fayne Levinson, Chairman of the Board, The Hertz Corp.; Director, Jacobs Engineering
- Aeisha Mastagni, Corporate Governance, CalSTRS
- Bob McCormick, Chief Policy Officer, Glass Lewis & Co.
- Ann Mulé, Associate Director of the John L. Weinberg Center for Corporate Governance, University of Delaware
- Yumi Narita, Vice President, Corporate Governance & Responsible Investment, BlackRock
- Susan Ness, Director, TEGNA; Former Director, Gannett Co.
- Chad Norton, Senior Manager, Governance & Proxy, Capital Group
- CS Park, Director, Seagate Technology
- Ron Schneider, Director, Corporate Governance Services, RR Donnelley
- Caroline Tsay, Director, Rosetta Stone and Travelzoo
- Lopa Zielinski, SVP & Deputy Corporate Secretary, HSBC
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Win Shareholder Support for Compensation Plans

Equilar and Nasdaq host Compensation Committee Forum

T
oday’s compensation committees—and the members of management who work closely with them—face a formidable task to develop and execute a compensation and benefits program that meets both management’s and investors’ expectations. In a regulatory environment that is becoming more and more complicated, ever-increasing scrutiny from shareholders and proxy advisors means that compensation professionals must be more meticulous than ever.

In April 2016, Equilar joined co-host Nasdaq at the MarketSite in New York City for the second installment of the Compensation Committee Forum. Compensation committee members, consultants and other key advisors provided their expertise to arm participants with the necessary knowledge to make the right pay decisions that are most relevant to their business and best drive their long-term strategy to increase shareholder value. This feature details the key issues and insightful quotes that highlight actionable insights to help compensation planners better processes and strategies to build the most effective pay packages and earn shareholder support while doing so.

Leveraging Resources — How Compensation Committees Can Get the Most out of HR and Consultants

Key Takeaways
Because executive compensation design is a complicated process, it requires multiple stakeholders to make informed decisions that drive results and create shareholder value. Compensation committees must establish the most effective and beneficial relationships with their internal HR and compensation teams and outside compensation consultants and advisors to ensure the committee is prepared to make the best decisions related to executive compensation, talent management and succession planning.

Key Quotes
“Talent has been given plenty of lip service, the idea that ‘people are our most important
Maximizing Shareholder Support for Your Compensation Plan

Key Takeaways
Since Say on Pay passed in 2011, companies have been pressured to become more transparent and forthcoming with the ways that they choose to pay executives, particularly the CEO. Aside from the official vote, shareholder proposals and proxy advisor scrutiny around pay for performance, equity approval and other pay elements often raise red flags.

Key Quotes
“Bad compensation design leads to bad voting outcomes.”

“Management influences TSR, but they don’t control it, at least in the short term. TSR is a good measure for shareholders, but not really as an incentive metric.”

“There are three buckets we pay attention to in proxy statements — pay for performance, transparency around metrics and board oversight. Quality of disclosure, the structure of the process and how you tell your story is important.”

“Presentations in the proxy statements have gotten glitzier and companies are trying to sell themselves. Though it’s a compliance document, the proxy has also become a product brochure.”

Setting the Record Straight — Regulatory and Plaintiffs’ Bar Priorities for 2016

Key Takeaways
Though the SEC has been in a stalemate after losing two commissioners in 2015, compensation-related rules from Dodd-Frank continue to be considered. Mandatory disclosure of the CEO to median employee pay ratio will be required beginning in 2018, and regulations around pay for performance and clawbacks were proposed last year and are expected to be passed once the SEC bench is replenished.

Aside from regulatory concerns, a wave of compensation-related litigation, including several 2015 lawsuits related to director pay, have made headlines and raised eyebrows from the corner office to the boardroom. While the director pay issue seems to have cooled, companies and their boards remain vigilant toward whether there will be another wave of shareholder lawsuits.

Key Quotes
“Ultimately the new pay for performance disclosures will mean much longer CD&As, not only because of the required information but also because of the clarity that will be necessary. All of us are going to read another 10 pages of the CD&A.”

“Using TSR as your financial metric is same thing as teaching to the test.”

“If you target the median in the various markets you operate in, the CEO pay ratio is merely the function of where your employees are located. Companies are market takers not market makers when they go out to set pay. They can’t underpay in a hot market or overpay in a down market.”

“In the first year, the CEO pay ratio will not be comparable across companies. You’re only sharing one piece of information that’s not known — median employee pay, and half your employee population will realize they are below median. Everyone’s worried about the ‘four-digit pay ratio,’ unions will love it and use for negotiations, the media will love it to sell papers and magazines, and a lot of sound bites from this will get amplified. But the real story will be how it is changing after one, two, or three years. Once you get longitudinal, there will be more insights that we can take from it.”
The Canary in the Coal Mine — Why Peer Group Selection and Benchmarking Data Sources are Critical

Key Takeaways
Ever-increasing shareholder scrutiny is forcing boards to make sure their peer groups are appropriate and defendable. Investors’ firsthand perspectives on the peer group selection process offer insights on how to select the most relevant peers and make the most of the process to drive strategic compensation decisions.

Key Quotes
“More than anything, peer groups give us as investors a snapshot of the psychological makeup of the company and management. We use this kind of data as a mirror. It reflects on them who they think they are and who they really are.”

“Most of us don’t create peer groups, we inherit peer groups, and it’s more art than science. As chair of the committee, someone is going to look at your art, and if you can’t take that criticism, don’t be an artist.”

“Should peer groups be the same for executive pay as it for director pay? I think it’s the cleanest. Would be foolish to do otherwise.”

“There are some situations where companies may not pick a peer group—say they compete with divisions at other companies, and they would use surveys to look at the head of a division vs. the CEO. Or if they had gone through a merger or acquisition. But you don’t want to be changing it year over year because that can make it look like you’re changing to fit your compensation objectives.”

Catalyst for Change — Using Incentive Goal-Setting to Help Drive Strategy and Value Creation

Key Takeaways
Establishing goals that support the company’s long-term strategy and shareholder return is a critical component of the executive compensation planning process. While unique to every business, boards can achieve pay and performance alignment while supporting the appropriate level of risk-taking. In addition, forecasting goals in volatile markets and pitfalls to avoid when selecting metrics, as well as evaluating differences various industries and sized companies, are crucial when designing incentive plans.

Key Quotes
“The retail environment has been incredibly competitive with fickle consumers and low overall growth. And the oil and gas industry is obviously facing serious challenges right now. Do you simply say, ‘There will be no incentive pay until or unless the company grows at a minimum rate?’ Or do you believe that the purpose of an incentive plan is to motivate the participants to achieve the company’s objectives and reward them for that achievement, which might not always result in growth?”

“Companies with well-defined long-term corporate strategies struggle the least with economic uncertainty.”

The Compensation Committee Forum rings the closing bell at Nasdaq following the event.
The Art of Storytelling — Selling Your Compensation Plan to Shareholders

Key Takeaways
Shareholder engagement continues to be one of the hottest topics in board governance. As a result, directors need to establish proactive outreach to investors, including the right timing, who is involved and what makes meetings the most useful.

Key Quotes
“Say on Pay has created much more open dialogue, not just discussing ‘what’ but also ‘why’ as companies try to balance the tension.”

“Over the past year, we’ve met with somewhere in the order of 800 companies, in 2016 that might hit 1,000. If you’re just getting in touch with us at the time the proxy is out, there’s not much you can do to change the facts. Tell your best story first in the proxy, which serves as a primary starting point for investors.”

“Comp committee members have a tough job if you fail Say on Pay. We got an unexpected red flag from ISS, caught on our heels, and realized we needed to do something. So we went out on the road and set up personal meetings in the offices of 40 of the top 43 institutional shareholders. We took no materials and wanted to hear them. Every single one of those were prepared to tell us things, and I heard some really interesting comments that were not compensation related but good for me to hear as a board member.”

Participants at the Compensation Committee Forum

- Cambria Allen, Corporate Governance Director, UAW Retiree Medical Benefits Trust
- Glenn Booraem, Principal, Vanguard
- John Borneman, Managing Director, Semler Brossy Consulting Group
- John Cannon, Partner, Shearman & Sterling
- Doug Chia, Executive Director, The Conference Board Governance Center
- David Fitt, Partner, Pay Governance LLC
- Alan Guarino, Compensation Committee Chair, The Chef’s Warehouse Inc.
- Drew Hambly, Executive Director, Corporate Governance, Morgan Stanley Investment Management
- James Johnson, Compensation Committee Chair, Ameren Corp. and Energizer Holdings; Director, Edgewell Personal Care and Hanesbrands
- Ken Julian, Vice President, Human Resources, Thor Industries
- Michael Keehner, Compensation Committee Chair, Oppenheimer Holdings Inc.
- Chip Lawrence, Compensation Committee Chair, Apache Corp.
- Peter Lupo, Managing Director, Pearl Meyer
- Kelly Malafis, Partner, Compensation Advisory Partners
- Kathryn Neel, Principal, Frederic W. Cook & Co.
- Judy O’Brien, Compensation Committee Chair, Ciena Inc.
- Timothy Olson, Senior Corporate Counsel & Corporate Secretary, Northwestern Energy
- Lyndon Park, Vice President, BlackRock Investment Stewardship
- Ron Schneider, Director, Corporate Governance, RR Donnelley
- Bryan Smith, Senior Vice President, Global Head of Human Resources, Nasdaq
- Jan Suwinski, Compensation Committee Chair, Thor Industries
- Charlie Tharp, EVP, HR Policy Association; Senior Advisor Research and Practice, Center On Executive Compensation
- Marc Ullman, Partner, Meridian Compensation Partners
Managing the Merger

The significance of compensation data and analysis in corporate transitions

By Amit Batish

Merger and acquisitions (M&As) tend to be complex and time-consuming processes that require vast resources and exceptional levels of attention. In 2015, there was a total $3.8 trillion worth of M&A spending in the United States—the highest amount ever for a single year, according to Bloomberg—and that number may be surpassed in 2016. According to an Ernst & Young study conducted last October, 59% of executives expected to pursue acquisitions in the next year—a six-year high. Globally, in 2015, companies announced over 44,000 transactions with a total value of more than $4.5 trillion.

With increased M&A activity comes challenges for companies managing these sensitive transitions. Companies undertaking these transactions will have a variety of issues to address, particularly from shareholders, and will continue to face a delicate balance of incentivizing and retaining their top management talent, if they are able. With any change in control (CIC), such as a merger or acquisition, shareholders will focus on the details of the transaction and scrutinize them from many angles. Thus, it becomes crucial to adequately approach any obstacles associated.

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Obviously, there are a number of critical challenges requiring resolution to effectively ensure a smooth transition in any M&A deal. While working through the array of legal and financial issues—such as analyzing previous financial statements to forecast financial conditions and resolving any filed or pending litigations against the target company—which typically assume top priority, there also awaits the tall task of dealing with the executives involved. A decision must be reached on which employees will remain on board with the newly established organization and which employees will not.

Consequently, with that discussion follows the matter of compensation packages. There are many incentives that could drive the design of a compensation package, including employee motivation. In fact, many organizations may choose to address the issue of new talent motivation through compensation plans, particularly with executives.

Executive compensation structures take many different forms and require high attention to detail. For example, in some cases of inversion, a “merger of equals” umbrella may form, where companies of similar size combine with expected cost or revenue synergies. In these scenarios, executives may be awarded for their ability to create these synergies. Equilar identified six transactions among the S&P 500 since 2010 in which both the target and parent CEOs remained with the combined company and one or both of them received a special merger-related award, taking the form of either a synergy award, a retention grant or a special recognition bonus.

Additionally, larger M&As may require a more thorough approach. To better analyze deals of this nature, Equilar examined transactions valued above $1 billion and completed since 2010, identifying synergy metrics in either the surviving company’s annual incentive plan (AIP), or within a special one-time bonus plan. Among 15 transactions, it was revealed that four companies used synergy as a weighted metric in the AIP and 12 granted special synergy awards, which ranged in value from a target of $62,500 to a target of $30 million, while median value was $1.7 million.

Regardless of whether the deal may be a merger or acquisition, one of the biggest challenges of M&A pay structures is comparing the two organizations’ compensation plans, benefits and other policies related to pay and deciphering whether one particular plan is superior to the other or whether a completely new plan ought to be put in place going forward.

In terms of payments and payouts, executive compensation pay components break down to equity, cash and other benefit provisions embedded within employee contracts. Working through the different executive compensation plans requires a thorough analysis, where factors such as previous pay levels, industry and previous/new peer groups might be significant drivers taken into consideration in the decision-making process. However, without the right data and information in place, making an informative decision that is also in compliance with legal codes becomes an unclear task.

A prime example of how the appropriate data may be desired in these types of situations lies within CIC payments to executives in recent years. According to an Equilar study of M&As involving companies with more than $5 billion in revenue, the median potential CIC payment made to an executive was below $20 million between 2007 and 2014. In fact, in 2014, median potential payments for the four CIC situations that year were just $5.5 million. This information might come as a surprise to many as the number might be lower than expected—especially since high-profile mergers have yielded upwards of $50 million or even $100 million or more for some executives. However, each merger or acquisition is a case-by-case scenario trend that may not be applicable to all companies.

**Graph 1**

Median Change-in-Control Payouts for Companies

A thorough statistical breakdown of the type or size of companies that receive a payout and the amount, if any, would allow companies to make the appropriate pay decisions in situations like CICs.

Regardless of the change taking place at a respective organization, having clear data and a concise analysis on hand is crucial in making an insightful and well-thought out decision, particularly for matters dealing with compensation.
As proxy season comes to a close each year, compensation specialists face the tall task of compiling significant amounts of newly reported executive compensation data as a benchmark to establish pay packages for their executives. This is not a simple task. Compensation committees, human resources analysts, general counsels, corporate secretaries and consultants must come together to assume the responsibility to formulate a pay scale that motivates and retains executives while creating shareholder value and return.

This process requires both objective data and strategic analysis, and oftentimes, companies may choose to rely on compensation surveys in addition to publicly reported data on the Top 5 paid employees from proxy statements for a better understanding of trends and practices throughout their particular industries.

An executive compensation survey is a collection of data submitted by companies on key executive officers, typically conducted on a yearly basis. Data of this nature is time-sensitive because compensation packages should be reviewed and updated frequently due to changes in the scope of

Pulling Back the Curtain

Your executive pay survey may be costing you too much

By Amit Batish

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executive roles and responsibilities, changes in the marketplace, and evolving shareholder concerns. Survey data consists of the pay elements involved in executives’ compensation packages at each participating company, including base salaries, stocks, and performance incentives and bonuses. Surveys are normally conducted by survey vendors, but can also be organized by individual employers themselves. And while some companies may be hesitant to give away private compensation data to a survey, many survey organizers will allow only participating companies to view survey results, providing an added incentive to submit.

Among the many uses, surveys can be a critical resource to display executive pay rankings, establish an understanding for compensation paid and depict key pay trends. But the chief value of compensation surveys rests in their ability to help companies understand how their executive pay compares to the market, and more specifically their peers. In many cases, Top 5 proxy data is not sufficient enough for companies to accurately benchmark their executives and may result in a pay bias.

Outside of the Chief Executive Officer and Chief Financial Officer, the highest paid executive positions are often different across companies. Take, for example, a company that recently hired a new Chief Marketing Officer (CMO). If the compensation team responsible for developing the new CMO’s pay package uses only Top 5 proxy data to determine the pay package, then there will be a significantly high probability of that company overpaying market value, as most companies do not include the CMO in Top 5 proxy data. Survey data is crucial in scenarios of this nature, as it takes a greater sample size and complements Top 5 proxy data for a more complete and accurate pay picture.

To address this dilemma, each year, Equilar conducts a Top 25 Survey that highlights the pay trends of participating company’s Top 25 paid employees. The Survey has collected information on more than 1,700 public and private companies in its database since inception. One of the benefits of participating in a survey with such a large sample size is that it allows companies to accommodate any sample size error that arises in benchmarking solely against Top 5 data. In essence, the survey helps show the complete pay picture, including those “hard-to-benchmark” positions outside of the Top 5 executives.

Analyzing Equilar’s TrueView can better explain this concept. TrueView is a service that blends Top 5 proxy data and Equilar’s Top 25 Survey data for a thorough analysis following SEC disclosure guidelines. For example, the Chief Human Resources Officer (CHRO) position is another hard to benchmark role since it is more often than not outside the Top 5 highest paid executives. Yet, these roles are becoming more prominent in many organizations as corporate culture becomes a higher priority with each passing year.

According to an Equilar report, in 2014, the median total compensation of S&P 500 CHROs in proxy statements was $320,864 greater than the median total compensation of CHROs within this group of companies based on TrueView data—$2.0 million as compared to $1.7 million. (See Figure 1.) The difference further supports the idea that Top 5 data alone may provide a relatively small sample size for many executive positions, resulting in a significant bias in pay analyses.

Graph 1
HR Executive Median Compensation at S&P 500 Companies, 2014

The general counsel (GC) position at S&P 500 companies provides another example. While far more GC executives appear in proxy data than CHROs—about 80% of the sample in Equilar’s annual GC pay study were in the Top 5—the pay difference shows why companies often use supplemental data beyond what’s in public filings. According to Equilar data, GCs that were among the Top 5 highest-paid executives at S&P 500 companies earned a median $2.2 million in 2014, compared to $2.0 million for those in the Top 25 Survey. While less of a contrast than the CHROs, a $200,000 difference remains significant.

The use of the objective data that comes from compensation surveys can be crucial for executive benchmarking purposes. By mitigating potential pay biases, compensation plan designers have a better sense of appropriate pay levels that can ensure executive motivation and retention while meeting the demands and expectations of shareholders.
Corporate boards have been dealing with the challenges of overseeing corporations since approximately 1811 when a New York statute provided that “the stock, property and concerns of such company shall be managed and conducted by trustees, who, except those for the first year, shall be elected at such time and place as shall be directed by the bylaws of the said company.”

As corporations and corporate law evolved, governance challenges persisted in various forms. Skip ahead to the much more recent past, particularly to 2002 and the introduction of the Sarbanes-Oxley Act. Fresh off the meltdowns of Enron and WorldCom, Sarbanes-Oxley was considered monumental corporate legislation at the time, and served as a wake-up call to boards to ensure proper focus on financial reporting and board responsibility among other major issues.

It is safe to say that regardless of what era you pick over that 200-plus year period since the concept of corporate boards was introduced, you will find unique challenges faced by public company boards of all industries. So what makes the experiences of today’s times different than those faced by our corporate director predecessors? At their roots, most required similar strategic problem-solving skills and allegiance to the shareholders whose interests they represented, but even between today and 14 years ago when Sarbanes-Oxley was enacted, the speed at which problems escalate has accelerated, and the scrutiny of everyone evaluating how you handle them has been amplified. The lights are much brighter on how corporate directors govern themselves, which raises the bar for boards’ due
diligence significantly. With that slice of history and broader context to set the table, let’s look at two major issues looming large on the plates of today’s boardroom leaders.

**Cyber Risk and Data Security**

I’m sure if I had lived during The Great Depression, I would have a better appreciation for the corporate challenges of the 20th century. But I dare say that after they publish the business history of the 21st century, cyber crime and its related business disruption will command a big part of it. Corporate boards really haven’t had to face a challenge like cybersecurity in the past. Even if there is a rare person on the board whose career was centered on data protection, I’m sure they couldn’t have foreseen the current level of state-sponsored espionage and a hackers’ underworld that would make organized crime proud of the fear and disruption they can cause. Therein is the challenge to today’s boards. How do you protect critical company information and data from criminals and hackers whose whole purpose is to steal and disrupt your business … especially in an area where most directors don’t have much history or experience?

It is a classic bad news/good news story! The bad news is you don’t know who the enemy is, where and what device they might choose to attack, and often you don’t know you’ve been hacked. The good news is you don’t have to be a cybersecurity expert as a board member to do a good job as a corporate director. This cybersecurity issue is being discussed everywhere, and you can stay up to speed by paying close attention. If you haven’t yet absorbed the steps boards should take to mitigate their company’s cyber risk, then you just might be that director living under a rock. And if you haven’t taken steps on how to react when you have a cyber breach, then you probably have one foot either in the courtroom or maybe out the door during the next proxy season. Chances are good that some part of your business is going to be hacked if you haven’t had a breach already. How you are prepared as a board to handle your corporate affairs immediately after an attack will truly expose how effective your board is. As my friend the late Bill Seidman used to always say … “When the tide goes out, we’ll get to see who is swimming without a bathing suit!”

**Shareholder Engagement**

The idea and implementation of shareholder engagement is also looming large over all boards. Each company is different either by the expertise and skill sets of existing board members, the quality of their internal investor relations teams, demands and/or requests by their current shareholders, and finally the attitudes of the CEO and board members about engaging at all. Institutional investors and activists seem laser focused when poorly governed or troubled companies also display an attitude of little disclosure, transparency or the need to have their independent directors talk to anybody. It is safe to say that all companies and their boards are searching for the right roadmap or formula on how best to conduct shareholder outreach.

Even if you don’t know where to start, the good news here is that you can earn engagement points with investors without putting your directors at risk of being in awkward positions with clever investors. It might take some creativity, but you can arrange one-way outreach scenarios that give shareholders comfort that you recognize their importance to the process and that your board wants to communicate regularly. This might include board member videos where you introduce directors and discuss goals for committees on your website like the Microsoft board introduced several years ago. Or you may want to send an invite to shareholders to submit questions for the compensation or audit committees and then do a one-way webcast where the committee chair, lead director or non-executive chair answers shareholders’ questions and discusses other topics they feel might be informative for investors. In both of these examples, shareholders appreciate the board reaching out, yet directors are able to reach out in a controlled environment.

These two challenges require solutions, but as fate would have it, creating solutions to problems is what most directors excelled at their whole career and got them on the board in the first place. Yes, communications of all types now occur at break-neck speed, but much like in other decades or centuries, boards and their management teams will figure out how corporations can overcome today’s challenges.

I’ll leave you with a little tip that kept me motivated as a board member when times got challenging and I was at risk of losing focus. Just remind yourself why serving on a board is so important by remembering this simple phrase: “What we do as board members today … can improve our shareholders, employees and communities tomorrow!”
In recent years, we have seen companies use virtually every permutation of these varied pay and performance definitions to demonstrate pay for performance alignment. However, companies are not the only ones telling their executive compensation story, and they are competing with other messengers that may obscure communications to their shareholders.

Who Is Telling the Pay for Performance Story?

1. **Companies.** An increasing percentage of companies is discussing pay for performance in their proxies, and a smaller but also increasing percentage of companies is including one or more pay for performance graphs in their proxies. (Graphs 1 & 2)

2. **Proxy Advisors.** Both ISS and Glass Lewis compare CEO pay to peer company TSR, one difference being ISS employs GICS/industry group peers while Glass Lewis uses Equilar Market Peers, an algorithm that objectively determines peer groups by matching companies based on who they choose as their peers, and who chooses them as peers.

3. **Investors.** Each year more institutional investors, many of whom subscribe to one or both major proxy advisory services, also run their own pay for performance analyses, often using Equilar or other third-party data. This past year, RR Donnelley, Equilar and Stanford University jointly surveyed 64 institutional investors, with a combined $17 trillion in assets under management. These investors indicated that two of the top three topics of interest to them are pay for performance alignment and performance metrics. The third main topic is director independence—though that is not exclusively related to executive pay, many investors scrutinize compensation committees based on how their pay decisions align with company performance.

4. **The U.S. Securities and Exchange Commission (SEC).** In April 2015, the SEC proposed a new rule which, if and when approved, would require companies to show the relationship over a period of years between the pay of certain senior-level executives and the company’s TSR. Each company would also be required to compare, over the same period of time, its TSR

Tell your best pay for performance story, or others may tell it for you

By Ron Schneider

**RR DONNELLEY**
with that of a company-selected peer group. Given the potential new rules on the horizon, it is quite possible that 2017 proxies will feature yet another way to demonstrate alignment of pay versus performance.

**Telling Your Story for Maximum Impact**

**Context matters.** Many of the proxy voters and governance heads at the largest institutional investors report that inclusion of some industry and business context at the beginning of the proxy is helpful to them. Some have even referred to this as a “mini CD&A.” Consider these readers to be governance generalists who have limited time and resources to research companies or their IR stories, as opposed to the portfolio managers responsible for making the ultimate buy/sell decisions. Despite this, these voters still want to vote in a thoughtful manner. To assist them in doing so, each year we are seeing more companies provide critical industry/business context in their proxies, whether in robust CEO and/or board chair cover letters, in proxy summaries or in the CD&A.

**Explain how pay supports strategy.** As you review your selection and disclosure of performance metrics, you may also want to review your company’s past IR messaging that influenced the initial investment decision. If IR disclosures identify certain value drivers, yet performance metrics in the proxy do not seem in sync with or supportive of these value drivers, investors may conclude “you told us X is important, yet you appear to be paying for Y.” Beyond disclosing metrics, companies should indicate why certain metrics are selected and why they are appropriate and incentivize the behaviors intended to drive shareholder value.

**Compensation explained “at a glance.”** Compensation is an admittedly complex and multi-layered topic, with its key elements typically described in detail over 10 to 15 pages of narrative in the CD&A. Not every reader is looking for the same information, and a layered or cascading approach, which goes from broadest overview to full detail, may be useful.

We are also seeing more companies employ one-page elements of compensation tables, identifying each principal pay element, its rationale/purpose, how this type of pay is earned (including any specific performance metrics), and even page references indicating where each element is subsequently discussed at length. The key is to make the proxy easily accessible and digestible for a broad range of readers.

**Text versus graphic/visual presentation.** Important information contained in sections of dense text can easily be overlooked. By definition, visual treatments draw the reader’s eye and are more likely to be located and digested. For instance, if you are describing a process, perhaps this information should take the form of a timeline. If you are listing peer companies or best practices, tabular or checklist formats may be most desirable. Similarly, call-out boxes, graphs, shading (for emphasis) and other design elements can further draw the reader to whatever content you consider most important.

**Conclusion**

While non-binding in nature, Say on Pay votes are not inconsequential. In addition, meeting SEC proxy disclosure requirements does not automatically mean you are meeting the informational needs and expectations of a majority of your investors. A good practice is to review not only the proxies of the governance leader companies that constantly innovate, but also of your peer companies.

While proxies are growing in terms of word length, with some of this additional length attributable to expanding SEC requirements, for many companies much of the added length comes from the all-important context or story-telling—the “why” in addition to the “what” of your company’s story. This additional context is critical in helping investors better understand the environment in which you operate, which in turn helps them to make more thoughtful, company-specific voting decisions.
Influential Corporate Governance Issues
What will have the biggest influence on board strategy in the second half of 2016?

Kenneth Bertsch was named Executive Director of the Council of Institutional Investors in March 2016. He has more than 30 years of experience across a wide range of investment, consulting, management and corporate governance roles. He most recently served as a Partner at CamberView Partners, and previously was President and CEO of the Society of Corporate Secretaries & Governance Professionals. Before that, he held various positions at Morgan Stanley Investment Management, Moody’s Investors Service, TIAA and the Investor Responsibility Research Center.

Internal Board Assessment and Strategy Evaluation
Board composition is at the top of the investor wish-list in the U.S. this year, with implications for board discussion of strategy. Many investors are concerned about director tenure, especially on boards with limited recent turnover. U.S. boards on average have longer tenure than we see in some other markets, creating particular concern about boards that have unusually long tenure even within the U.S. context. In the view of these investors, there should be regular renewal to bring fresh perspective into the boardroom.

Many investors also would like confidence that board nominating committees are thoughtful about the optimal mix of skills and background, and in particular how this may change as the business evolves. In many industries facing complex challenges, this suggests there be outside, independent directors with strong and demonstrable subject matter knowledge and experience. Investor confidence requires a thoughtful process of director succession planning and search, and clear explanation. In this view, subject matter expertise from an independent perspective is vital to board discussion of strategy.

Finally, investor focus on boardroom diversity, particularly in gender and ethnicity, is on the rise. In the view of many investors, diversity fosters stronger board decision-making. We have not yet seen much focus on age diversity, but with (1) rapid economic change, (2) the fact that U.S. boards that are significantly older on average than a decade ago, and (3) higher director retirement ages than in the past, we may see some pressure to consider recruitment of younger directors. I could see this combined with more widespread adoption of term limits (as seen recently at General Electric) so that appointment of younger directors does not eventually lead to even longer board tenure.
Company Culture Across the Organization

Every business is looking for the edge that will help them outperform the competition, or trying to find the panacea for its performance woes. Today, that edge comes from driving an ethical culture across the organization. It’s something that all top-performing boards will need to address throughout the year.

A number of high-profile troubles at major companies in recent months have highlighted what happens to a company as a result of a skewed culture. The scandal that came from Volkswagen’s emissions reporting fraud led to numerous investigations on how a bad culture leads to outright cheating at the company. At VW, these perceptions trickled down from the top, across the organization. With better board oversight, this culture likely could have been discovered and nipped in the bud before it became the scandal it is today.

It’s worth noting that having an ethical culture is not just about risk mitigation, it also gives companies an edge. In fact, Ethisphere has found that share price of the publicly traded companies recognized as the 2016 World’s Most Ethical Companies consistently outperform other major indices, including performing 3.3% higher than the S&P 500 last year, and even greater outperformance as compared to the MSCI ACWI. Similarly, other research has found that portfolio managers today actively review a company’s governance practices when deciding whether or not to invest. Rivel Research for example has found that CSR is cited as an important investment driver by 22% of portfolio managers, a number that has steadily increased for the past few years.

None of this can happen without clear leadership and engagement from the board and the rest of the executive committee. The message is clear: Boards must get involved in strengthening their companies’ culture if they want to stay ahead of the game.

Ty Francis is Executive Vice President and Group Publisher at the Ethisphere Institute, where he is responsible for long-term strategy and revenue production across Ethisphere’s full suite of events, research and publishing business.

Previous to his current role, Ty most recently served as Vice President and Publisher of NYSE Governance Services, a division of the New York Stock Exchange, where he was the chief revenue driver for the commercial side of its Corporate Board Member magazine and events business. In 2014, Mr. Francis was appointed as a Business Advocate in the USA, by The Right Honorable Carwyn Jones AM, First Minister of the Welsh Government to further Welsh culture, business and promote it as a premium place to invest. Ty also serves as an advisory board member for Women in the Boardroom Inc., a company committed to advancing women in their careers and into the boardroom.
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NASDAQ® CORPORATE SOLUTIONS DIRECTORS DESK® is an online board portal designed to provide public, private, and non-profit boards and leadership teams with greater governance management, engagement and insight throughout the organization. Purposely built and designed with multiple security features, our centralized and efficient Directors Desk software simplifies the sharing of critical information via the web or tablet apps, helping you make meetings anywhere more productive.
Paul Conley is a Director in Willis Towers Watson’s Minneapolis office, and is the Western Region Leader for the firm’s Executive Compensation practice, as well as a member of the global executive compensation leadership team. He joined the firm after serving as Director of Compensation for Multifoods. Paul has over 25 years of experience, including the design of board, executive and employee compensation programs. Currently, Paul advises several Fortune-ranked companies as well as a number of the nation’s largest private companies across a range of industries.

Paul has co-authored and contributed to a number of publications, including The Total Rewards Handbook and The Talent Management Handbook. Paul received his bachelor’s degree in psychology from St. John’s University and his master’s degree in industrial relations from the University of Minnesota. His certifications include CCP (Certified Compensation Professional) and SPHR (Senior Practitioner in Human Resources).

Recruiting and Retaining Executive Talent
As we look toward to the latter half of 2016, one of the key issues we see commanding more of boards’ time is talent risk. Despite the business challenges many companies are facing in the current economy, it’s still a highly competitive market for senior leadership talent. This is true for companies or industry segments that are performing well and those currently doing less well.

Some industries are doing quite well, and the competition for talent in those sectors can be fierce, requiring boards to pull all of the talent management levers in the toolkit. Notably, high performers within high-performing industries are the most sought-after talent and retaining them can be a significant challenge. Compensation offerings need sufficient leverage to reward for top performance.

Alternatively, in industries that are struggling, retention risk becomes heightened as companies find themselves constrained from a compensation standpoint. There is a tension between pay for performance alignment and retention. Retention sometimes requires rewarding “at-risk” executives despite company performance, and that creates negative optics internally and externally.

When you think about the various governance responsibilities of corporate directors, succession planning and talent management are certainly key ones. As part of these responsibilities, boards have to consider both the talent needs underlying the company’s business strategy as well as how to attract, retain and motivate that talent. Compensation is, of course, a critical tool at the board’s disposal for carrying out the talent strategy, but it’s not the only tool. Boards also need to consider how pay fits into executives’ broader career trajectory as part of a comprehensive talent management framework that also includes performance management, leadership assessment and developmental opportunities.

We expect to see boards in a number of industries devoting more attention to this tension as the year progresses. But, talent risk seems certain to be a key strategic issue for boards in many sectors of the economy.
Steve Hobbs is a Managing Director in the San Francisco office of Protiviti and is the global leader of the firm’s Public Company Transformation solution. He has more than 30 years of experience providing business consulting and financial reporting services to clients in various industries, primarily technology and consumer products companies. Prior to joining Protiviti in 2006, Steve was a partner at KPMG for three years and spent nearly 20 years at Arthur Andersen, where he was also a partner. He holds graduate and undergraduate degrees from the Marriott School of Management at Brigham Young University.

Steve has served on the board of directors at three companies, one as Chairman and two as Audit Committee Chair, and has served more than 100 public companies, especially boards and senior management, during his career, providing guidance in corporate governance, financial reporting and numerous business transformation issues.

Regulations and Risk Heighten Board Oversight

One of the most significant governance issues is regulatory change and heightened regulatory scrutiny. Protiviti and North Carolina State University’s ERM Initiative conduct an annual global survey of board members and C-suite executives on the top risks likely to affect their organizations. Regulatory concerns have topped the list of risks for organizations in each of the four years of the study, with an increased rating this year.

The cost of regulation and its impact on business models remain high in many industries. Compliance costs are embedded within prices consumers must pay and affect employee compensation. Depending on the industry, regulation and its high costs can contribute to an uneven playing field in the global marketplace that can affect a company’s competitiveness and lead to lower levels of economic growth. As a result, business leaders must make investment and hiring decisions in the face of the uncertainty imposed by continued and, in some cases, heightened regulatory mandates.

Yet when it comes to governance and oversight, there certainly are other issues affecting board strategy. Other concerns include economic conditions restricting growth opportunities, succession planning and the ability to attract and retain top talent, and insufficient resources to address cyberthreats, privacy and other information security risks.

Another critical risk calling for effective board oversight is the rapid speed of disruptive innovations and new technologies potentially outpacing the organization’s ability to compete. Whereas disruptive innovations may have once taken a decade or more to transform an industry, the elapsed time frame is compressing significantly, leaving very little time for reaction. As boards have come to understand, sustaining a business model in the face of digitally enabled competition requires constant innovation to stay ahead of the change curve.

Most certainly, these issues impact the board’s oversight agenda. The ones with the biggest influence in the second half of 2016 are likely to vary by industry.
Institutional Investor Focus on Long-Term Value Creation

Boards no doubt will face governance issues and challenges of many kinds in the coming months, but I believe that the governance issue which will (and deserves to) have the broadest and deepest influence on boards in the second half of 2016 is preparing to live with the intensified focus by large institutional investors on long-term value creation, and its many implications.

While institutional investors have become increasingly active on the governance front in recent years, in 2016 it has become crystal clear that they:

• are concerned with the destructive impact on their funds’ investment returns from activists who militate for short-term payoffs and companies which unduly focus on beating quarterly earnings estimates;
• have embraced long-termism as a theme which organizes and unifies their thinking on a broad range of governance issues; and
• will be even more aggressive in asserting their agendas in the 2017 proxy season.

This development is bolstered by strong fund flows into indexed investment funds, which have given institutional investors more muscle and a business imperative to use it for the benefit of their investors and growing their own businesses.

The impact of long-termism on governance practices can be seen in recent letters to boards and public statements made by BlackRock, Vanguard, State Street Trust and others, and a detailed exegesis is provided by BlackRock’s Q1 report, aptly titled “Building Connections for the Long-Term.” In this report, BlackRock discusses its views and company engagement practices in the first quarter of 2016 on governance and other issues and describes nine cases, which demonstrate how building long-term value intersects with issues such as the independence, composition and competence of boards, management succession, capital allocation, executive compensation, legal compliance, and oversight of regulatory and business risks.

Boards are on notice and need to study these letters and reports, assess their companies’ strategies and governance practices and prepare to proactively engage on them before institutional shareholders (or even worse, short-term activists) come calling.
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Dodd-Frank’s Legacy on the SEC

An Interview with Dan Gallagher, former SEC Commissioner

With hundreds of rules already passed and dozens of other rules in the proposal stages, mandates from the Dodd-Frank Wall Street Reform and Consumer Protection Act became an immersive deliberation topic for the Securities and Exchange Commission over the past seven years. Dan Gallagher, now president of Patomak Global Partners, served as a commissioner for the agency from 2011 until 2015. He spoke with C-Suite about the past, present and future of the agency and its relationship to executive compensation and corporate governance.

In what ways did Dodd-Frank influence the SEC’s operations over the past five years, and what will be its lasting legacy?
In your view, what challenges did Dodd-Frank present the Commission?

Daniel Gallagher: I’ve given dozens of speeches on this exact topic, but in a nutshell, for almost six years now, Dodd-Frank has dominated the agenda of the SEC. It was a massive piece of legislation—2,300 pages, or 30 to 40 times larger than Sarbanes-Oxley. Despite its length, Dodd-Frank wasn’t exactly prescriptive—it mostly gave broad mandates for rulemaking to supposedly independent agencies. Many of these rulemakings are just political and have nothing to do with the financial crisis, and these mandates put the agency at 20, 30, 50 times the normal rulemaking rate. There is only so much Commission bandwidth, and it really pushed—and still is pushing—the agency to the extreme.

Dodd-Frank only amended the existing federal securities laws, it’s not like it started everything over, and there are still 75 years of federal law for the SEC to administer. Yet it has dominated the agenda. There were three different chairmen during my time in the SEC, and each of them chose to prioritize Dodd-Frank over other blocking-and-tackling, mission-critical responsibilities.

Why did the agency choose to prioritize it?

Gallagher: Dodd-Frank is a single-party piece of legislation, so the SEC is implementing a political document. Key terms were not negotiated between the parties in Congress, and the Commission had to resolve those on its own. Take for example, the conflict minerals

Single-party legislation is not meant to last. Without bipartisanship you are subject to the ebb and flow of the election cycle.
disclosure rule. While the ultimate goal may be laudable, no sane human being is going to argue that conflict minerals had anything to do with the financial crisis. The fact that it was even in Dodd-Frank tells you something right there.

There are still a third of the rulemakings left to do, and it’s going to continue to dominate the SEC for years to come.

**Several rules related to executive compensation—including pay versus performance, clawbacks, and of course, the CEO pay ratio—were either proposed or passed last year. What are your thoughts on these rules and how they will affect companies and the markets?**

**Gallagher:** Like I said about Dodd-Frank generally, these are theories that directly come from vested political interests. Pay ratio is probably the best example, where organized labor was patting itself on the back for including it with no legislative history. AFL-CIO has talked about it on its website as something to “shame” corporations.

We could have done this with a safe harbor where you choose a number—say 1,000 to 1—instead of implementing the rule unilaterally and creating significant costs that companies, investors and shareholders have to bear. The rule states that investors would view the CEO pay ratio as material when casting say on pay votes, and there’s no evidence of that. In fact, it will harm investors as they bear the cost of compliance. For example, if the pay ratio applied just to U.S. employees, that would have cut 90% of the cost.

**What about pay versus performance?**

**Gallagher:** The question on pay for performance is whether the information given to investors is the right kind of information or even understandable. Instead of spending more time with these questions and thinking about whether the rule makes sense, there was a drive to get it proposed.

We know there is a big debate about TSR [total shareholder return], and we received a lot of negative public comments about it. Given the heated debate we had before it was proposed and the comments coming from a wide range of market participants, I don’t think the Commission will proceed with the rule the way it was proposed, and the agency will take those comments into account because it’s so clearly an issue.

**That’s interesting. We’ve heard that the rule passing is imminent, and that it is likely to pass as proposed.**

**Gallagher:** We probably won’t see a final rule this year. It’s already difficult to get things done with three members now, and it’s doubtful you’ll get a full slate in there this year to get it done.

Just like everything else, it will come down to the election, who’s going to be in leadership at all the agencies, and what the White House will think of the rules. There’s only a few months until November, and the chairman usually leaves when the administration changes. If you have a conservative SEC chairman, I can tell you the first task would not be to prioritize this.

That’s why single-party legislation is not meant to last. Without bipartisanship you are subject to the ebb and flow of the election cycle. Sarbanes-Oxley—while it has created its own problems—stands in such stark contrast because it was almost the exact opposite of Dodd-Frank, getting just a couple of “no” votes in all of Congress.

**Let’s step aside from Dodd-Frank for now and to the SEC’s core duties. What are the main challenges you see public companies facing in the changing regulatory environment? What hindrances are in place now that the SEC could help mitigate?**

**Gallagher:** If you go back about 10 years, there was a debate about the competitiveness of U.S. capital markets—New York vs. London. You had economic leaders getting together talking about issues like plaintiffs’ litigation and Sarbanes-Oxley, but the financial crisis hit so these discussions got put on the shelf. The economy was devastated, and now all these restrictions and mandates have come out, and—though the JOBS Act has helped over the last few years—here we are with IPO numbers that are still much lower than they should be.

So why is it so bad? We never addressed the real issues. There is rampant class-action litigation, legacy Sarbanes-Oxley issues, complaints about auditors getting back to micromanagement because...
they are getting beat up by PCAOB, and 404b debates. Factor in shareholder activism on top of that—and don’t get me wrong, there is good and bad activism—but if you add bad activism to bad legislation to bad market practices and bad rulemakings, it’s more daunting today than it was 10 years ago. People don’t talk about this much, but with the accretion of all these things, you almost wonder why a company would go public.

In industrial history, going public was the ultimate goal, the end game for capitalists who want to create investment opportunities. Now I don’t think it’s the same.

What does that mean for the public markets?

Gallagher: Ironically, it does the opposite of what all the interest groups who push for all these restrictions say they want. It drives investment opportunity solely to the rich. A company who is not going to IPO has millionaire investors rather than the regular Joe. The idea behind the public markets is to democratize investment opportunity.

How have investors been affected by post-financial crisis regulations?

How have shareholder rights and shareholder activism changed the landscape for the long-term investor?

Gallagher: We’ve seen the large investment funds grow massively, the asset management industry is ballooning, and the amount of money in passive funds is vast. At least among the top tier, they’re doing a lot more. There is scrutiny about over-reliance on proxy advisory firms, and we’re seeing the large institutional investors bring in staff to resource corporate governance research so they don’t just rely on ISS and Glass Lewis anymore. That’s terrific, and it needs to stretch down to lower tiers of the asset management industry. In an era of activism and politically charged decision-making, I don’t see policymakers—at least outside of Congress—stepping up to address the issues, and you need the markets to step up and handle them.

Is the SEC seriously considering issues that will affect boardroom operations, such as diversity, term limits, compensation caps, etc.?

Gallagher: As a threshold matter, the federal government should have no role in corporate governance. Unlike Europe or other countries, we historically have decided to leave corporate governance generally to the states. The trend now, however, is toward more involvement by the SEC—I’ve referred to it as the federalization of corporate governance. So we see a lot of rhetoric about pay practices and boardroom composition, but I don’t think the SEC should have the authority to write rules in these areas, and there is also a reluctance among those who purport to care for the agency to throw it into that social or political fight.

What’s your prediction for the second half of the year in the SEC? Do you have any advice for the new commissioners?

Gallagher: It’s funny, I come at it a little differently. It’s always better to have a full complement of commissioners, but you always hear about the government getting nothing done—well to me, for the last seven years, some of what has been done has been bad, and the idea of doing less bad is a good thing.

In other words, this could be a good opportunity for the agency to take a breath, step back for a moment, and realize that Dodd-Frank had nothing to do with the actual causes of the financial crisis. We’ve already missed most of the rulemaking deadlines by years—it’s like a kid getting their homework in late. At this point, you might as well get it right. Take your time, be deliberative and proceed at a pace that allows you to focus on the core work. Focus on the state of the U.S. equity markets, bubbling problems in corporate fixed income markets and facilitating capital formation. Maybe a big, deep breath is what everyone needs.
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Defining Characteristics of Today’s Directorships

An Interview with Jim Nevels, Lead Director, The Hershey Company

Directorship is becoming more and more complex. Increased rules, regulations, scrutiny from proxy advisors and the mounting pressure to engage shareholders mean that much more time and attention is required of board members than any point in corporate history. C-Suite spoke with Jim Nevels, Lead Director at The Hershey Company, as well as a director at First Data Corporation and WestRock Company, about how the director’s role has changed and what board performance means in today’s corporate environment.

How has the director’s role changed in recent years? In what ways are expectations for board service evolving?

Jim Nevels: Things have changed so dramatically since I first joined the Tasty Baking board in 2005, but there are several examples that stand out to me the most. First and foremost is risk oversight, starting with the notion of separating risk management from audit, for example, and the significant rigors and demands Sarbanes-Oxley placed on audit committees and how they would assess risk. Then you move from the idea of general risk to what’s a concern for every company—cyber risk. That became front of mind just in the past five years after we’ve seen the major disruptions cyber crime has caused in corporate enterprises.

More broadly, the power of that little handheld device that you have in your pocket has changed the tenor of the boardroom. It can take a picture, it can go on the internet, it can blog, it can do all kinds of interesting things that may be good or potentially not so good for a corporation. It all comes back to being more and more aware of what can affect your company quickly and significantly.

Similarly, why and how do think the definition of “board performance” has changed?

Jim Nevels: Board performance is judged differently now because of the rapidity and warp speed at which information can move. Nimbleness of boards and their ability to respond quickly in conjunction with management is at a premium. All the while, with all the nimbleness needed, you have to ask how you also maintain the appropriate line between management and governance. I am a strict believer in observing that line because the action and reaction of a corporation is dependent on it.

For example, my natural tendency would be to focus on pension funds because that’s what I do in my regular daily business. But the more important question and the perspective a board member must bring is what will the enterprise look like three, five, 10 or 15 years out. It’s really hard not to focus on how the pension fund fared quarter to quarter—those are the things management is charged with. For the board, it’s a question of how we keep a long-term view in a rapidly moving environment.
That’s a great point. How has the notion of short-term and long-term shareholder return changed in the era of activism?

**Nevels:** There is this idea out there that directors should “think like an activist.” If you’re the director, you have to do that. Well, how does an activist think? Commitment to shareholder value is the starting point, and then serving multiple constituencies. For the board, figuring all that out in the short, intermediate and long term is the rub. The real conundrum is how to maximize shareholder return over a reasonable amount of time without debilitating a corporate organism longer term.

Whether it’s corporate governance or it’s your local school board, it’s good to operate “in the sunshine” and entertain detractors who may have a good point. Sometimes they don’t, and sometimes they do, but we definitely need to be aware of issues that activists bring. Quite frankly, they’re not just financial activists. They have provided input that has changed corporate boardroom behavior, and that’s a good thing.

As a director serving multiple companies, what are the challenges of serving on multiple boards? What advice do you have for multi-boarded directors in terms of how to manage their time and duties to multiple companies?

**Nevels:** There was a time years ago when there were people on double-digit boards. Those days are over and frankly should be. But as long as you can be adequately prepared to discharge that responsibility, which includes attendance at board meetings, that can be the self-regulating mechanism.

I also believe that it can be a good thing to serve on more than one board. You can have incredible a-ha moments bringing one idea to another board. You build transformational knowledge that is impactful across industrial segments. My advice would be don’t bite off more than you can chew, and be intellectually curious.

We’re hearing calls from shareholders, proxy advisors and other stakeholders for more regular board assessment and refreshment. Is regular refreshment a good or bad thing for the board? For what reasons?

**Nevels:** I think it is essential. It becomes very important to have that annual assessment because it gives an insight to a board’s effectiveness. You have to take the opportunity to look at the qualities and skills of board members and the needs at the company. For example, do you think that 20 years ago, cybersecurity was on anyone’s grid as a necessary talent? Even 10 years ago?

A corporation is a living organism, and it adapts itself by sustaining in the world around it. I think it becomes important to ask if a 65-year-old director is old? I thought it was old when I was 20, but now at 64 I don’t. Do I think that as one approaches 70, is that a reasonable retirement age? You can always say there are exceptions. There are 100-year-olds that can run circles around me. The question is whether it is tenable to have a high percentage of people at a given age able to be functional contributors.

That’s what boards do. They drive consensus around those issues, and hopefully they do so with intelligence and integrity. We rent...
these positions, we don’t own them. Some may disagree—and I respect them if they do—but I strongly believe that.

In your experience, is this easier said than done? How difficult is it to conduct an honest evaluation of your own performance inside the boardroom?

Nevels: The issue boils down to this. There is no person or group of people who are indispensable to service. If you have a group of directors who retire all at the same time, and you have all this history and institutional memory walking out the door, that’s the board’s fault, because it’s their responsibility to draw on talent and to renew and refresh itself. If there is a tilting in age, then shame on us for not bringing on new people.

If you’re a consumer products or goods company, that’s a fast moving business with many different constituencies, and it certainly makes sense to have gender diversity, ethnic diversity and intellectual diversity on the board. The people I know in the technology industry are younger than me by a lot. They are in their 30s and 40s. Should we be making time and making room? Anyone who says that ‘I have so much experience that I am indispensable’ is a flight of hubris I will not engage in. You have to have the intelligence and the integrity to know when it’s time to step down, and to work with your colleagues on the board to drive a consensus.

Board diversity has also become a major area of focus in the assessment/refreshment/succession conversation. Why is diversity important for a board—whether that means age, tenure, gender, ethnicity, independence or skill sets? How does diversity influence board performance—qualitatively and quantitatively?

Nevels: The challenges have decreased over time as we grow and we develop and change. As we look at the classic grid and ask what are the areas of expertise that you want, there is nothing like intellectual diversity. It’s stimulating, it’s great. If we look at people’s life experiences, there are insights that gender and ethnic diversity can bring to the table, and that is conjoined around skill sets. If you have a person that is not filling a skill set, then why are they sitting in the boardroom? We are at a time in this country’s history where there are people of all diverse backgrounds that can do this job.

What do you see as the most critical issue on any board’s agenda in 2016, and looking toward next year?

Nevels: This year especially it will be around the appropriate metrics to evaluate the financial health and progress of a company. What are the ways in which a company and its board and management will be evaluated in potentially a slow growth environment? It spills over to questions about compensation. What if you’re leading the pack in an industrial segment but are not growing year over year? That’s a real conundrum—if you’re charged to retain talent, and we know it’s all about talent, how do you base compensation?

I also think that how we look at and examine the sensitivity and sensibilities around global social responsibility will be another issue. And the one that continues to linger is the issue of cybersecurity and risk. There has to be uneasiness, and if you’re not uneasy you’re not going to vigilant. You can’t comprehend what the next curveball is going to be and which way it’s going to break.
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<th>Annual Executive Pay Decisions</th>
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<th>Disclosure and Other Shareholder-Related Actions</th>
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CFOs Are in the Money

As this issue of C-Suite hits your desk, another proxy season is on the books, and the high season for annual shareholder meetings is underway. Aside from voting on who will return to the boardroom, the Say on Pay vote will be one of the most anticipated—and pored over—topics of conversation at these meetings.

Indeed, shareholders, proxy advisors and regulatory agencies are demanding more transparent executive pay disclosures, which has inevitably led to an increase in length and depth of information in the Compensation Discussion and Analysis (CD&A) section of companies’ annual proxy statements. In the past five years, word count for the average CD&A has increased 8.4%, up from 8,416 words in 2011 to 9,121 words in 2015 among S&P 100 companies (Figure 1). As you can see in Figure 2, the longest CD&As run more than twice that long, and even though a few companies have significantly shorter executive pay disclosures, even several of the five shortest were submitted at nearly 5,000 words.

To counteract the ballooning text required to accurately explain how pay relates to company performance, companies are using more summary and visual information to draw readers’ eyes, such as tables of contents and summaries for the CD&A section as well as compensation program checklists that explain visually what companies “do” and “don’t do” when it comes to pay practices. (Figures 3 & 4)

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Source: Equilar
For more information on Equilar’s report, Innovations in Proxy Design, featuring commentary from Pay Governance and RR Donnelley please visit [equilar.com/proxy-design](http://equilar.com/proxy-design).
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