C-SUITE

Vol. 2, Issue 1, 2015
Performance Issue

Branching Out

Why companies are favoring formulaic metrics over discretion for determining CEO success

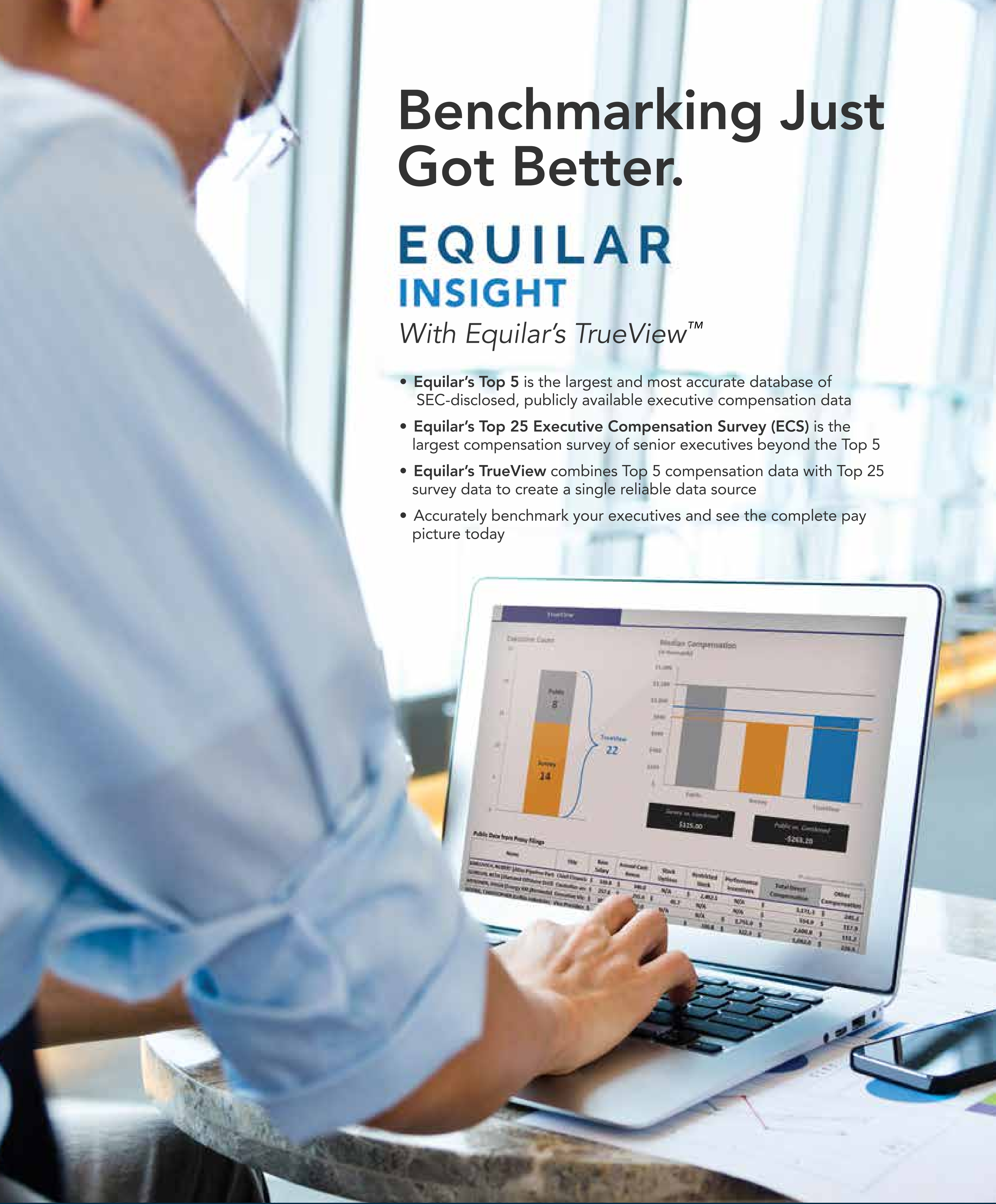
Innovations in proxy design

Seven key strategic planning tasks for boards

Discretion: How should boards approach its application within incentive plans?

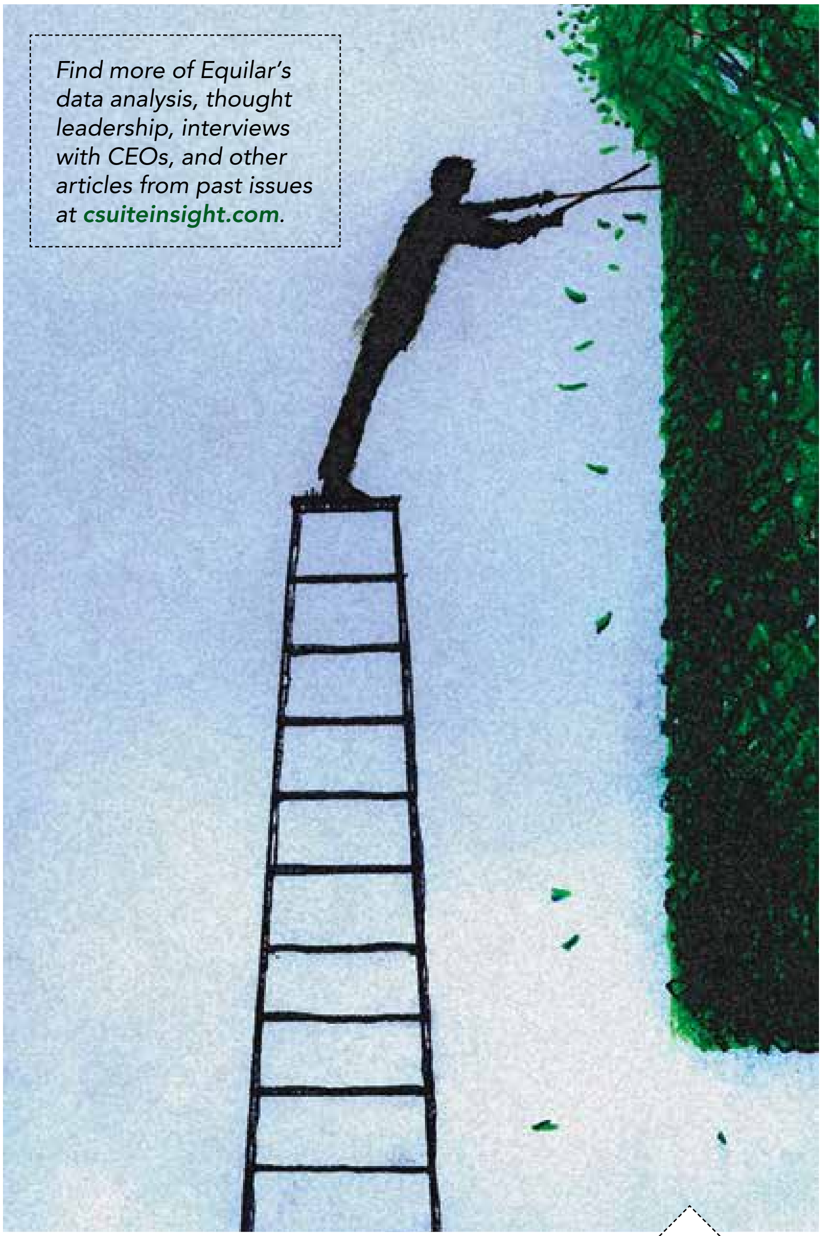
Interviews with Tom Quaadman, John Thompson, and Raymond Milchovich

EQUILAR



C-SUITE Contents

Vol. 2, Issue 1 2015



Find more of Equilar's data analysis, thought leadership, interviews with CEOs, and other articles from past issues at **csuiteinsight.com**.

COVER STORY
04

Branching Out

Why companies are favoring formulaic metrics over discretion for determining CEO success

by Aaron C. Boyd

RRD

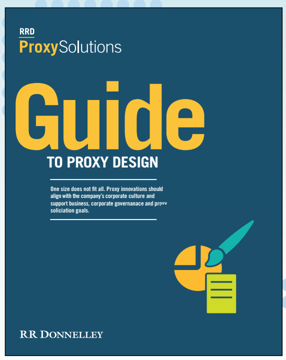
ProxySolutions

Design with a Purpose

Create proxy statements that resonate with your investors

RR Donnelley — The industry leader in proxy statement design, printing, filing, hosting and distribution, working with over 1,900 US companies.

TOOLS

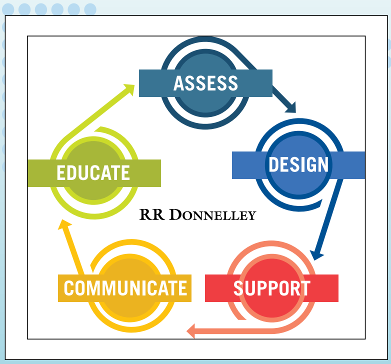


Our Proxy Guide
catalogs over 250 unique examples of layout, design, navigation and content from among our blue-chip client base. We searched through 1,900 proxy statements so you don't have to

KNOWLEDGE

Our Institutional Investor Survey
performed jointly by RR Donnelley, Equilar, and Stanford University reveals what is most important to investors about proxy statements

PLATFORM



Unrivaled resources at your disposal —
world's largest print platform, EDGAR filing expertise, innovative technology and world class service team

Content that Connects

For more information, contact Ron Schneider at ronald.m.schneider@rrd.com

C-SUITE

Publisher
David Chun

Editorial Director
Aaron Boyd

Assistant Editors
Jordan Brooks
Jennifer Estomba
Julie Gramlich
Erin Hansen
Clement Ma

Production Editor
Andrew Conner, GLC

Art and Design Director
Elissa Chamberlain, GLC

Circulation/Distribution
Christopher Chin

Advertising & Sponsorships
Jamie Tassa

Cartoonist
Manoj Vijayan

C-Suite is published by
EQUILAR
1100 Marshall St.
Redwood City, CA 94063
Phone: (650) 241-6600
www.equilar.com

Send address changes and circulation inquiries to the above address.

Publication Management
GLC
glcdelivers.com
GLC

PRINTED IN THE USA EQU-005

Focus on Performance

Equilar's 6th Annual Executive Compensation Summit finds us in Hollywood, Florida at the Diplomat Resort & Spa. Thank you to all the attendees who made the trip to join us. I'd also like to thank all of our speakers, sponsors, and partners who are contributing to this year's agenda focused on industry trends and emerging issues.

Expanding on our calendar of events, I am pleased to announce that Equilar is partnering with NASDAQ to host a Compensation Committee Forum at the NASDAQ MarketSite in New York on October 27, 2015. The Forum will prepare boards and senior HR and compensation executives for the 2016 proxy season. Attendees will gain valuable insights on making pay decisions that align with the long-term strategies for their respective companies.

A central topic of discussion at both events is performance, which we have also explored in this issue of *C-SUITE*. One of the most scrutinized aspects of a company, the challenge lies in aligning how performance is measured by various stakeholders. In this issue of *C-SUITE*, we explore the challenges of determining performance and the implementation of discretion.

Our lineup of feature interviews includes Ray Milchovich, lead director at Nucor and board member at Dow Chemical, who shares his thoughts on corporate governance and the best way for a new director to get up to speed. John Thompson, vice chairman of search firm Heidrick & Struggles' CEO & Board of Directors Practice, discusses what skills boards are looking for in new directors and best practices for CEO succession planning. Additionally, Tom Quaadman, vice president of U.S. Chamber Center for Capital Markets Competitiveness, provides insight on the importance of a consistent global accounting standard and the impact elections can have on job growth.

You will also find thoughts from industry experts, TK Kerstetter of Boardroom Resources and Ron Schneider from RR Donnelley. Furthermore, we asked leading professionals in the field to provide their advice for when a company should use discretion in our "Ask the Experts" feature. Of course, no issue would be complete without Seymour Cash providing his thoughts on what makes a skilled and diverse board.

The *C-SUITE* team has put together a great issue with content that sets the tone for the dialogue at our Summit. Please enjoy and feel free to contact me with your feedback.

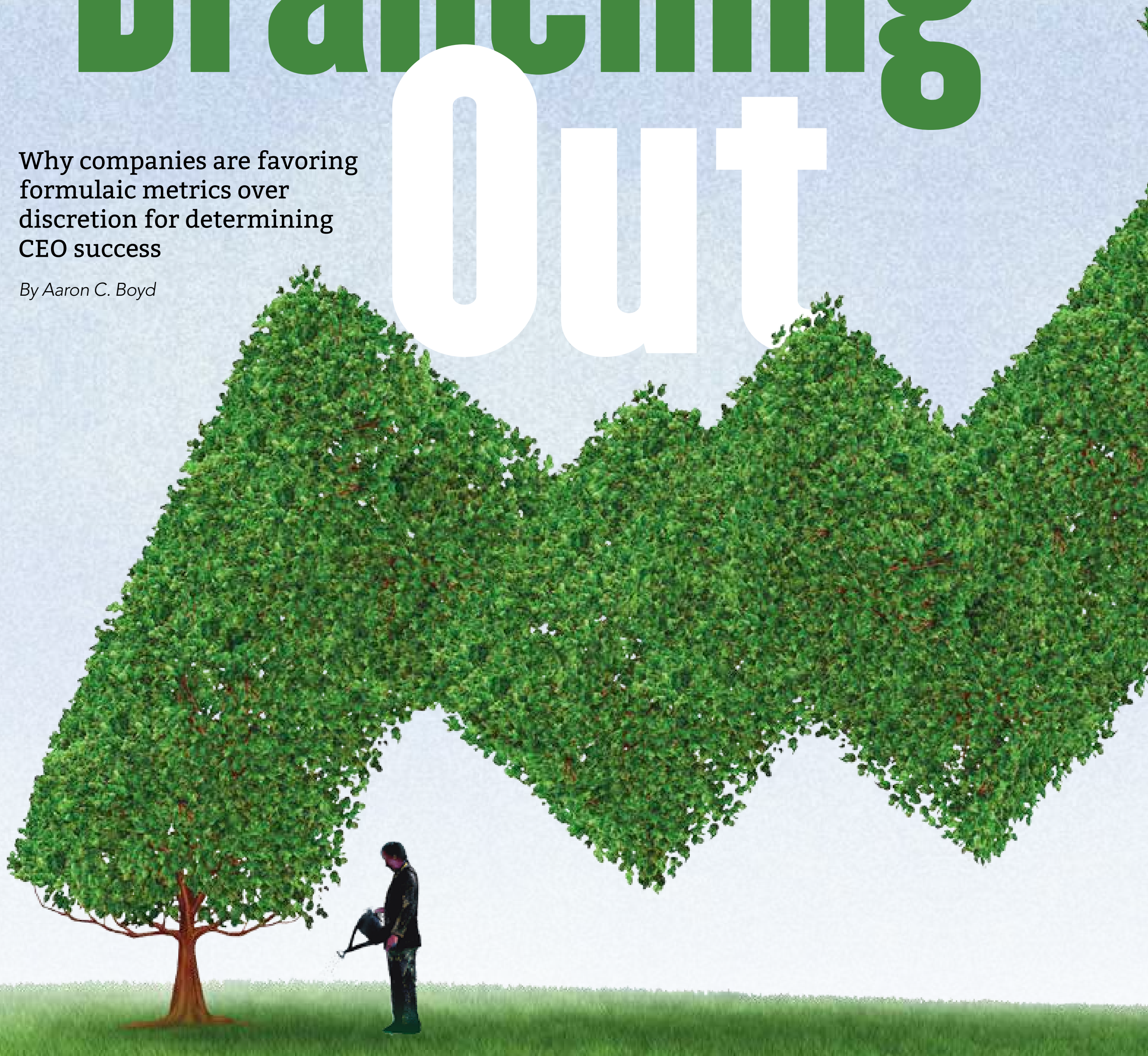
David has led Equilar from a pure start-up since its inception in 2000 to one of the most respected and trusted names in the executive compensation industry.

David Chun
CEO and Founder, Equilar
dchun@equilar.com

Branching Out

Why companies are favoring formulaic metrics over discretion for determining CEO success

By Aaron C. Boyd



How do you know if someone performs well? This seems like a basic question. One that company boards are asked throughout the year, but especially at the end of the fiscal year when bonuses are determined. Yet it seems like each year, it becomes harder and harder to state with certainty and reward accordingly. What happened, and what can boards do about it?

The majority of pay for an executive now typically comes from equity awards, while yearly discretionary bonuses have been replaced by annual incentive plan payouts. Incentive plan bonuses serve the same function as the traditional year-end bonus. They differ, however, because instead of the compensation committee determining the appropriate level of pay at the end of the year while factoring in all the circumstances, the typical plan requires metrics and goals to be chosen at the beginning of the year. A payout is made at the end based on achievement measured against a formula. These incentive plans typically offer little in the way of flexibility and place a big emphasis on getting the metrics and goals right at the beginning of the year. The important difference is that performance is now determined based on outcomes, not behavior.

How Is Performance Determined?

Carefully.

Companies spend considerable amounts of time studying indicators to determine which provide an accurate reflection of how well the company has performed or how successful it will be in the future. Hundreds of leading and lagging indicators are used by outside investors to accurately predict where the company's stock price is moving. Quarterly earnings statements are dissected, presentations are made, analysis is given, and investor reports are created—all for the purpose of assessing the state of the firm. All of that noise makes it hard to boil down the numbers to form an opinion, which is why only a handful of metrics are viewed as critical.

Brief History of CEO Bonuses

Bonuses for executives go back much further, but in 1993, section 162(m) of the United States Internal Revenue Service (IRS) was made law. That section eliminated the tax-deductibility of pay above $1 million unless the compensation was performance-based. The original purpose was to prevent oversized executive compensation packages. To the dismay of the proponents of the IRS law, the opposite effect occurred. Executive pay grew at an even faster rate.

Fast-forward 15 years to the financial crisis, and many people had the same expectation about pending legislation to curb executive pay. Admittedly, many of the current rules passed have been successful at curbing pay only at Wall Street financial institutions, or at least successful in lowering it from the highs in 2006. However, CEO pay has continued to grow, and the median pay for CEOs is at an all-time, non-inflation-adjusted high.

The most popular metric used is total shareholder return (TSR). Since the goal of companies is to bring returns for investors, growing the value of the company is an end goal. While TSR is great from an investor's standpoint to assess a firm's performance relative to other possible investment decisions, it carries with it a lot of other factors. Macroeconomic financial situations, such as increasing interest rates, play a huge role in certain companies' stock prices, while others are impacted by commodity prices, for example, for oil or precious metals. TSR over a one-year period can often provide unreliable results reflective of more outside circumstance than internal achievement.

Net income and earnings per share (EPS) are other highly popular metrics used to determine the health and outlook for a company. Referred to as the bottom line, these metrics illustrate whether a company is profitable, which is the ultimate test of a company's viability. These measures do have their detractors who claim these numbers can be more a reflection of a company's financial and accounting creativity than true performance. They also may not provide a good view of how the company will do in the future.

Companies may also be able to determine success using measurements not found on the operating statement. New stores opened, factories built, and product quality, to name a few, are all other metrics to be successful that also have implications for the future.

Many companies are moving to a more diverse set of metrics recognizing that no one number can accurately demonstrate all the facets of what a company has done throughout the year. Boards have the challenge of determining the right mixture of financial and non-financial goals. The next challenge is figuring out who is actually responsible for those goals.

Who Gets the Credit? Who Gets the Blame?

President Harry Truman was famous for the sign on his desk that read, "The Buck Stops Here." President Truman understood that, no matter what part he actually played in the outcome of something, as a leader, it was his responsibility to be accountable. This sentiment often rings true when it comes to company leaders. Leniency is not usually given to the top executives when results do not meet expectations. Quarterly earnings are missed. Revenue targets are too high. Growing expenses are hung around the neck of the CEO, regardless of circumstance.

It is the double-edged sword of being a leader. Success is attributed when things go well. Blame is assigned when things go poorly. The irony is that as CEOs are held responsible for success and failure, their companies become bigger, requiring more people to be successful while also creating more places for things to go wrong.

If we learned anything from the bear market of 2008 and 2009, it's that factors beyond one person's, or even one company's, control can significantly impact how an organization succeeds. Certainly, some companies deserved blame for their role in the market downturn, but many more were put in unfortunate situations that required layoffs and cutbacks because credit dried up, the economy was suffering, and people cut back on spending.

As was mentioned earlier, performance is now often assessed based on results and not behavior. A CEO may execute to the plan perfectly, but commodity costs, disruptive technologies, new competitors, or macroeconomic financial hardship may cause targets to be missed. This has led to an increase in the use of relative metrics that compare results against those of other companies—measures done to account for factors affecting similar companies, but is still based on a formulaic approach.

What Happened to Discretion?

The shift to a formula-based bonus has precipitated the decline of the use of discretion for year-end payouts. Not only does the use of discretion threaten tax-exempt status, but it is viewed unfavorably by outsiders. These aspects build to make a case for the near extinction of positive discretion, the upward adjustment of bonuses, while very little wiggle room exists for payouts to be adjusted after the fact.

In order for a bonus plan to qualify for the 162(m) IRS provision, positive discretion must be excluded from the terms of the incentive plan. Negative discretion is allowed, giving compensation committees the flexibility to reduce or eliminate a payout, but not increase it. If a company wants to ensure an executive is not prevented from receiving a bonus due to external factors, the compensation committee is actually incentivized to design the bonus plan in a way that makes positive discretion unnecessary.

Another big factor in the decline of discretion is the disapproval of those outside the boardroom. Many institutional investors have a negative take on positive discretion. BlackRock states in its voting guidelines that "overreliance on discretion or extraordinary pay decisions to reward executives, without clearly demonstrating how these decisions are aligned with shareholders' interests" will likely result in a negative Say on Pay vote.

There is also a perception that the proxy advisory firms, namely ISS and Glass Lewis, will give a negative recommendation if the positive discretion exists in the plan. Glass Lewis recently clarified its voting guidelines to state that it is not unequivocally against use of discretion, but does require clear disclosure explaining the reason for the decision and how it fits into a pay for performance model. In addition, ISS lists the use of discretionary pay components as a problematic pay design issue in its most recent compensation policy. Glass Lewis states that the awarding of a discretionary bonus as a replacement for failing to achieve an incentive plan payout is a cause for it to issue a negative recommendation.

The media and watchdog groups also typically disapprove of the use of positive discretion. They may not have direct influence through the use of an actual vote, but they often have the biggest megaphone and will highlight companies that use these types of adjustment.

> CEOs are held responsible for success and failure, their companies become bigger, requiring more people to be successful while also creating more places for things to go wrong.

The Future of Discretion

So where do we go from here? Will positive discretion reach ultimate extinction as I referred to earlier? Will boards ever be able to reclaim the use of their best business judgment to determine how much a CEO receives without fear of reprisal from the media or shareholders?

The short answer is probably 'No.' But there is a silver lining to the recent decline. Over the last few years, as companies have moved even further away from the use of discretion, it has exposed the limitations of the formulaic incentive plans. A company cannot predict everything, and choosing metrics and goals at the beginning of the year doesn't do away with the need for a holistic review at the end of the year. With disclosure around compensation growing every year, companies have a greater platform with which to explain the reasoning behind their actions, thereby bringing outsiders into the minds of the compensation committee. Shareholder engagement has grown over the last few years, which is resulting in a greater understanding between stock owner and the company. This is leading to more trust, which, in turn, is providing greater freedom to the compensation committee to use its judgment as long as they provide an explanation.

Board members must be careful about exercising discretion, though. Thoughtfulness is the name of the game for compensation committees as they discuss the best way to approach altering an incentive payout. Disclosure is great, but no matter how good the relationship with investors, there needs to be a compelling reason for the use of discretion and a clear benefit to using it. More information is available every day to properly assess performance from a million different angles, but there also appears to be a growing number of voices willing to share their opinion on a company's decision to use its best judgment.

Discretion may never regain its lofty place in the pay package of a CEO, but it appears that its use does not garner as negative a reaction as it once did. Should companies be allowed to use more discretion? I'll leave that up to you.

Women on Board

Examining the success of gender diversity goals for the corporate boardroom

C·S +

Please contact Dan Marcec at dmarcec@equilar.com for more information. The contributing authors of this paper are Garret Sturgis, Senior Research Analyst, and Kuljit Singh, Research Analyst.

In recent years, the topic of gender diversity in corporate boardrooms has made its way to the forefront of governance discussions. Advocates of gender diversity on boards state that diverse backgrounds lead to an inclusive and collaborative environment that is essential to good governance, better financial performance, increased innovation, and improvements in opportunities for women.

Background

In December 2009, the desire for greater diversity in board composition culminated in the SEC mandating that companies disclose the director nomination process for considering diverse candidates. The SEC Commission's comments on the issue were as follows:

> "We are adopting amendments to Item 407(c) of Regulation S-K to require disclosure of whether, and if so how, a nominating committee considers diversity in identifying nominees for director. In addition, if the nominating committee (or the board) has a policy with regard to the consideration of diversity in identifying director nominees, disclosure would be required of how this policy is implemented, as well as how the nominating committee (or the board) assesses the effectiveness of its policy. We recognize that companies may define diversity in various ways, reflecting different perspectives. For instance, some companies may conceptualize diversity expansively to include differences of viewpoint, professional experience, education, skill, and other individual qualities and attributes that contribute to board heterogeneity, while others may focus on diversity concepts such as race, gender, and national origin. We believe that for purposes of this disclosure requirement, companies should be allowed to define diversity in ways that they consider appropriate. As a result we have not defined diversity in the amendments."

Other countries have addressed the issue of gender diversity on boards through more proactive approaches, including the establishment of quotas requiring a specific percentage of women on boards. While the United States has not implemented a quota, many American companies are taking an active role in increasing the number of women on boards. Organizations such as The 30% Club and 2020 Women on Boards are advocacy groups calling for greater gender diversity in the boardroom.

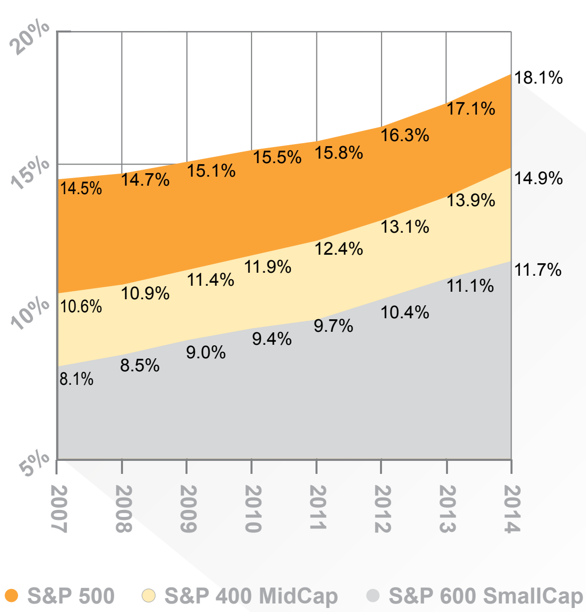
Methodology

For the following analysis, the current S&P 1500 index was used as a baseline to analyze company director data between 2007 and 2014. Information was gathered to compare differences across a number of areas for men and women serving on boards.

Female Directors at S&P 1500 Companies

In 2007, the percentage of female board members at S&P 1500 companies was 11.3%. That number has been slowly increasing over the past eight years, reaching 15.0% in 2014. The graph below separates the S&P 500, S&P 400 MidCap, and S&P 600 SmallCap indices and highlights how gender diversity has increased over the past eight years.

Graph 1
Female Directors At S&P 1500 Companies



Board Composition

Female directors in all three indices are younger on average than their male counterparts and have shorter tenure. The difference in age between women and men has remained fairly consistent over the years. The table below provides information about age, tenure, and whether directors are outsiders, insiders, or affiliates. Outside directors have no material interest or connection with the company outside of his or her role as a director. Inside directors are employed by the company, one of its subsidiaries, or have over 50% beneficial ownership in the company. Affiliated directors are deemed to have some material interest in the company. Examples include directors that are related to employees of the company, former employees of the company, employed by customers or suppliers, founders of the company and are no longer employed, receiving consulting fees from the company, or have over 5% ownership in the company.

Table 1
S&P 500 Director Statistics

YEAR	GENDER	PERCENTAGE	AGE	TENURE	OUTSIDER	INSIDER	AFFILIATE
2014	Female	18.1%	60.3	7.9	94.5%	3.0%	2.5%
	Male	81.9%	64.0	9.3	82.5%	13.2%	4.3%
2007	Female	14.5%	64.5	7.0	89.4%	3.4%	7.2%
	Male	85.5%	68.9	8.9	70.7%	16.5%	12.8%

Table 2
S&P MidCap 400 Director Statistics

YEAR	GENDER	PERCENTAGE	AGE	TENURE	OUTSIDER	INSIDER	AFFILIATE
2014	Female	14.9%	59.9	7.3	93.3%	4.3%	2.3%
	Male	85.1%	63.1	10.3	80.4%	15.0%	4.6%
2007	Female	10.6%	63.5	6.8	88.0%	5.4%	6.6%
	Male	89.4%	68.3	9.5	68.6%	18.4%	12.9%

Table 3
S&P SmallCap 600 Director Statistics

YEAR	GENDER	PERCENTAGE	AGE	TENURE	OUTSIDER	INSIDER	AFFILIATE
2014	Female	11.7%	59.3	7.1	92.5%	4.7%	2.8%
	Male	88.3%	63.2	10.5	79.4%	16.1%	4.5%
2007	Female	8.1%	62.7	6.1	84.4%	6.8%	8.8%
	Male	91.9%	67.7	9.5	65.6%	18.8%	15.5%

In the last eight years, the percentage of outside directors has increased for both women and men. However, there is a larger percentage of outside female directors than their male counterparts. In addition, there is a larger percentage of inside male directors.

Largest Change in Percentage of Females on Boards

Certain companies in the S&P 1500 have made steady efforts to add more women to the board. The tables below highlight companies that had the largest difference between the percentage of women on the board in 2007 versus 2014.

Table 4
S&P 500 Largest Change In Percent Of Females On Boards

COMPANY	2007 - FEMALE DIRECTORS	2014 - FEMALE DIRECTORS	CHANGE
Interpublic Group of Companies	11.1% (1 of 9)	44.4% (4 of 9)	33.3%
Netflix	0.0% (0 of 7)	28.6% (2 of 7)	28.6%
Procter & Gamble	14.3% (2 of 14)	41.7% (5 of 12)	27.4%
Kellogg	15.4% (2 of 13)	40.0% (6 of 15)	24.6%
KeyCorp	12.5% (2 of 16)	35.7% (5 of 14)	23.2%

Table 5
S&P MidCap 400 Largest Change In Percent Of Females On Boards

COMPANY	2007 - FEMALE DIRECTORS	2014 - FEMALE DIRECTORS	CHANGE
Jack Henry & Associates	0.0% (0 of 7)	37.5% (3 of 8)	37.5%
Williams-Sonoma	10.0% (1 of 10)	40.0% (4 of 10)	30.0%
United Natural Foods	14.3% (1 of 7)	40.0% (4 of 10)	25.7%
HCC Insurance Holdings	0.0% (0 of 11)	23.1% (3 of 13)	23.1%
Deckers Outdoor	11.1% (1 of 9)	33.3% (3 of 9)	22.2%

Table 6
S&P SmallCap 600 Largest Change In Percent Of Females On Boards

COMPANY	2007 - FEMALE DIRECTORS	2014 - FEMALE DIRECTORS	CHANGE
Pinnacle Entertainment	0.0% (0 of 9)	25.0% (2 of 8)	25.0%
E.W. Scripps	16.7% (2 of 12)	40.0% (4 of 10)	23.3%
Sonic	0.0% (0 of 8)	23.1% (3 of 13)	23.1%
NetGear	11.1% (1 of 9)	33.3% (3 of 9)	22.2%
Koppers Holdings	0.0% (0 of 7)	22.2% (2 of 9)	22.2%

Organizations that Support Gender Diversity on Boards

The United States has not implemented any gender diversity quotas, but some organizations have been proactive in increasing the number of women on boards. One organization, the Thirty Percent Coalition, is a U.S. organization that seeks to realize a goal of 30% women on boards by 2015. A British organization called The 30% Club, which recently launched a chapter in the United States, established a goal of reaching 30% women on the Financial Times Stock Exchange 100 boards by the end of 2015.

In order to achieve these goals, the organizations provide several tools for women to become board members. By providing workshops for women on career advancement, writing letters to companies advocating for gender diversity improvements, and assembling a database of female leaders, the organizations are working diligently to reach their targets.

Another organization called 2020 Women on Boards seeks to increase the percentage of women on U.S. company boards to 20% or greater by the year 2020. It runs the 2020 Gender Diversity Directory, a database of public and private companies, which categorizes companies based on gender composition of boards. The methodology awards companies on the following scale:

1. Winning (W) = >20% Women
2. Very Close (V) = 11-19% Women
3. Token (T) = 1 Woman
4. Zero (Z) = 0 Women

Stanford University sponsors the Stanford Women on Boards Initiative that seeks to increase the representation of female alumnae on boards. It has taken proactive measures to promote gender diversity such as:

- Promoting programs that provide opportunities for networking connections and educational enhancement
- Establishing a community forum for Stanford women on boards and prospective board candidates
- Providing guidance to women seeking to enhance their qualifications for board service

International Quotas on Gender Diversity in Corporate Boardrooms

A number of countries have chosen to implement quotas on the percentage of women required on boards. Most rules are limited to companies based on size, employee count, or status as publicly traded companies. The table below includes countries that have either considered quotas or have implemented quotas.

Gender diversity on boards will continue to be a topic of discussion in the years to come. While there has been an increase of women on boards in the S&P 1500 over the past eight years, advocacy groups and governments will continue to drive initiatves for more females on corporate boardrooms. CS

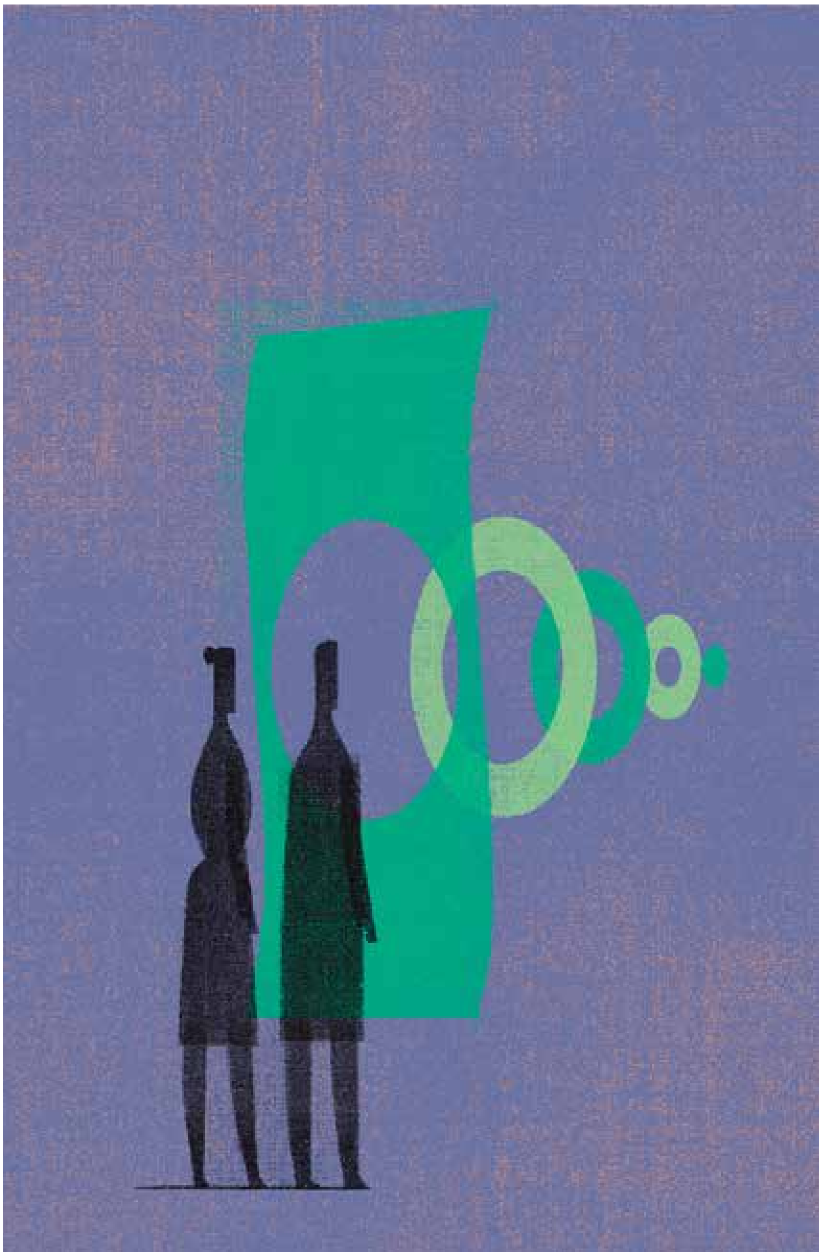
Certain companies in the S&P 1500 have made steady efforts to add more women to the board.

Table 7
International Gender Diversity Quotas

COUNTRY	QUOTA PERCENTAGE	REGULATION
Norway	40%	In December 2003, Norway passed a 40% quota for public companies. Since most firms did not comply, the law became compulsory in January 2006. Firms that did not comply by January 2008 would be dissolved. Some companies changed their corporate structure to avoid the quota system, and full compliance was achieved in 2009.
Belgium	33%	Belgium set a quota that at least 33% of the board of directors of state-owned and publicly traded companies should be women. If a company failed to comply, each director's appointment made in violation of the quota would be nullified.
Iceland	40%	In September 2013, Iceland required companies with over 50 employees to meet a quota of 40% women.
Italy	33%	In 2011, Italy passed legislation requiring public companies and state-owned companies to have at least 33% women on their boards by 2015. If a company failed to comply, the board would eventually be dissolved.
France	40%	Publicly-listed companies in France with more than 500 employees, or more than 50 million euros in revenues, must reserve at least 40% of their director positions for women within six years of 2011.
Spain	40%	In 2007, Spain passed a non-binding quota of 40% female directors by 2015 on boards of public companies, and firms with more than 250 employees. There are no penalties for companies that do not comply. However, those companies must provide an explanation of why they failed to reach the quota in their annual report.
Malaysia	30%	Malaysia enacted a quota of 30% for new appointments to boards.
Brazil	40%	Brazil's quota of 40% applies to only state-controlled firms.
Australia, England, and Sweden	N/A	Australia, England, and Sweden have threatened to impose quotas if firms do not appoint more female directors voluntarily.
Germany	30%	In 2014, Germany passed legislation that all boards must be comprised of at least 30% women by 2016 or the seat for a departing director would be left vacant.
European Commission	40%	The European Commission mandated that by 2020 the number of seats on non-executive boards of publicly traded companies should be held by 40% women.

Zeroing in on a Number

How companies gauge and reward individual performance in the annual incentive plans of S&P 500 CEOs



C·S +

*For more information or to request the full report, please visit **Equilar.com** or contact Dan Marcec **dmarcec@equilar.com**.*

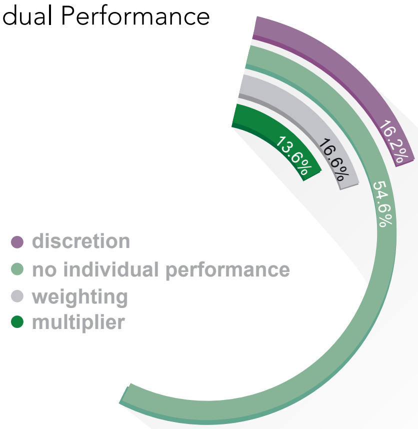
Annual incentive plans, which typically represent 20–25% of total direct compensation for chief executive officers (CEOs), are a key component of the compensation program that companies can use to promote greater alignment between executive pay and company performance. These plans generally consist of cash bonuses paid early in the fiscal year based on the achievement of performance goals set by the compensation committee for the previous fiscal year. The annual incentive opportunity is often expressed as a target percentage of base salary with corresponding threshold, target, and maximum levels of performance. The actual level of performance will then result in a corresponding threshold, target, or maximum level of payout.

In designing annual incentive plans, companies are careful to establish plan features and specific performance criteria that will provide optimal incentives to executives and ensure the appropriate responsiveness of any payout to performance over the measurement period. While these plans traditionally contain an assortment of weighted financial (i.e., cash flow, EBITDA) and non-financial (i.e., safety, customer satisfaction) metrics that will vary among companies due to the nature of the business and external market conditions, a number of companies also incorporate an individual performance element into the plan. In order to illustrate how companies design plans to account for individual performance, Equilar analyzed the annual incentive plans of CEOs at S&P 500 companies with fiscal years ending between July 1, 2013 and July 1, 2014.

Individual Performance

Within the S&P 500, 46.4% of companies factor individual performance in some form into the CEO's annual bonus plan payout. The remaining 54.6% of companies have either an annual plan based on achievement of weighted financial and/or non-financial metrics with no individual performance component, or do not have an annual non-equity incentive plan for the CEO. The three ways in which companies can factor individual performance into annual incentive plans are through the application of weightings, multipliers, or discretion. Weightings, which indicate what percentage of the annual bonus plan payout is dependent on individual performance, are used at 16.6% of companies. Multipliers, which specify that the individual performance score be multiplied by the corporate performance score, are used by 13.6% of companies. Last, 16.2% of companies use a form of discretion in which the executive's individual performance is a consideration but ultimately has no formal weighting or multiplier effect on the payout. In these cases, the board has the authority to increase and/or decrease payouts based on individual performance using its discretion.

Graph 1
Individual Performance

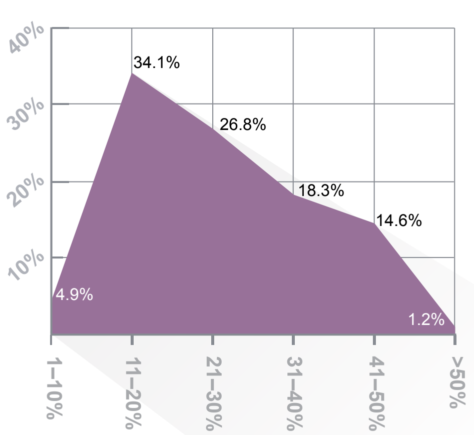


Individual Performance Weightings

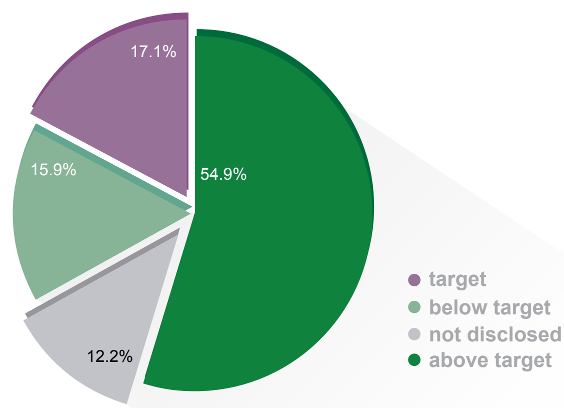
Assigning a weighting is the most common way for companies to incorporate individual performance into an annual incentive plan. While individual performance weightings among companies ranged from a low of 2% to a high of 75%, nearly a third of companies choosing to use a weighting selected 20%. It follows that the effect of individual performance on total payout will be more significant in plans that assign a larger weight to individual performance.

Additionally, the majority of companies (54.9%) using an individual performance weighting disclose payouts above target, at a median payout of 118% of target. Payouts at target and below target for individual performance are not nearly as prevalent, with companies disclosing these payouts at 17.1% and 15.9%, respectively. Last, 12.2% of companies do not disclose payout versus target for the individual performance component in cases where a weighting is disclosed.

Graph 2
Individual Performance Weighting Distribution



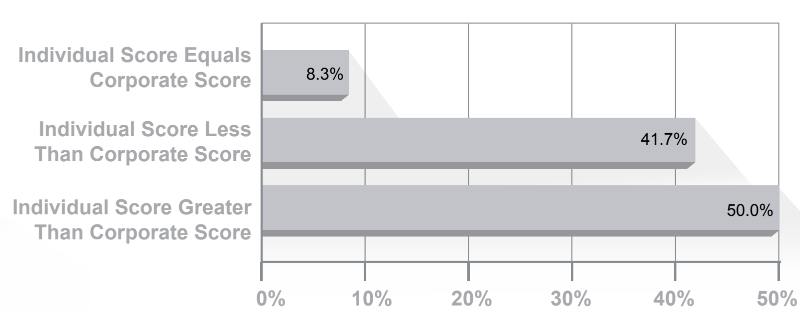
Graph 3
Individual Performance Weighting Payout vs. Target



Individual vs. Corporate Performance Scores

An interesting point of comparison exists between the individual performance payout versus target and the corporate performance payout versus target. There were 72 companies that provided a payout versus target figure for both a weighted individual performance score as well as a corporate performance score. At exactly half of these companies, the individual performance score exceeded the corporate performance score.

Graph 4
Individual vs. Corporate Performance Score



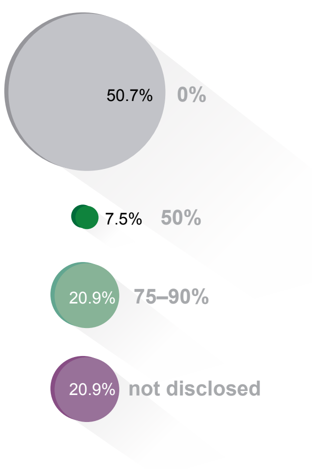
Individual Performance Multipliers

Multipliers, while not as prevalent as weightings, are also a useful means by which companies can integrate an executive's individual performance with some level of discretion. A multiplier consists of both threshold and maximum levels for the individual performance component. Using these two parameters, the board will then determine the actual adjustment to apply to an executive's corporate performance score in an effort to increase or decrease any payout.

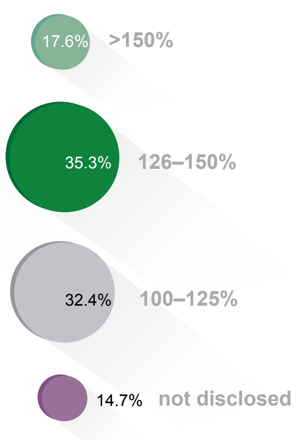
Discretion

Companies can also choose to account for individual performance within an annual incentive plan by offering the board some form of discretion to increase or decrease an executive's payout. The vast majority of companies employing discretion in annual incentive plans do so with both downward discretion and upward discretion; however, there are companies that will grant discretion in only one direction.

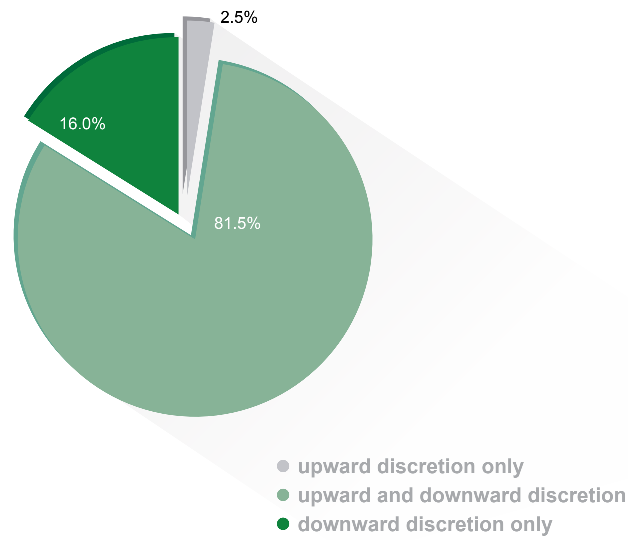
Graph 5
Individual Performance Threshold Multipliers



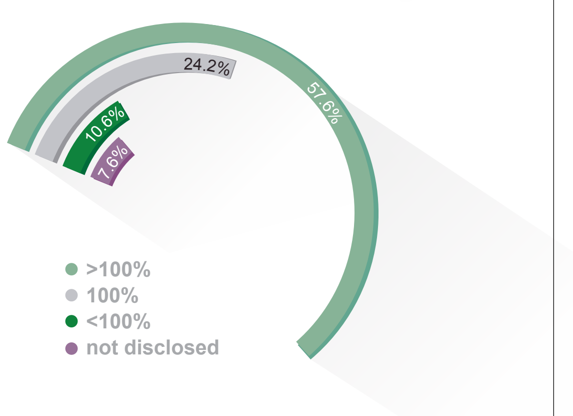
Graph 6
Individual Performance Maximum Multipliers



Graph 8
Discretion Type

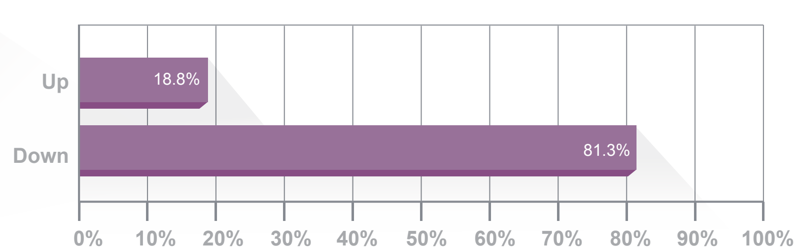


Graph 7
Individual Performance Multiplier Actual Adjustment



Of the 81 companies with discretionary individual performance components, 32 companies exercise discretion in making an actual adjustment to the individual performance component. Of these companies, only 6 made a downward adjustment to the payout. CS

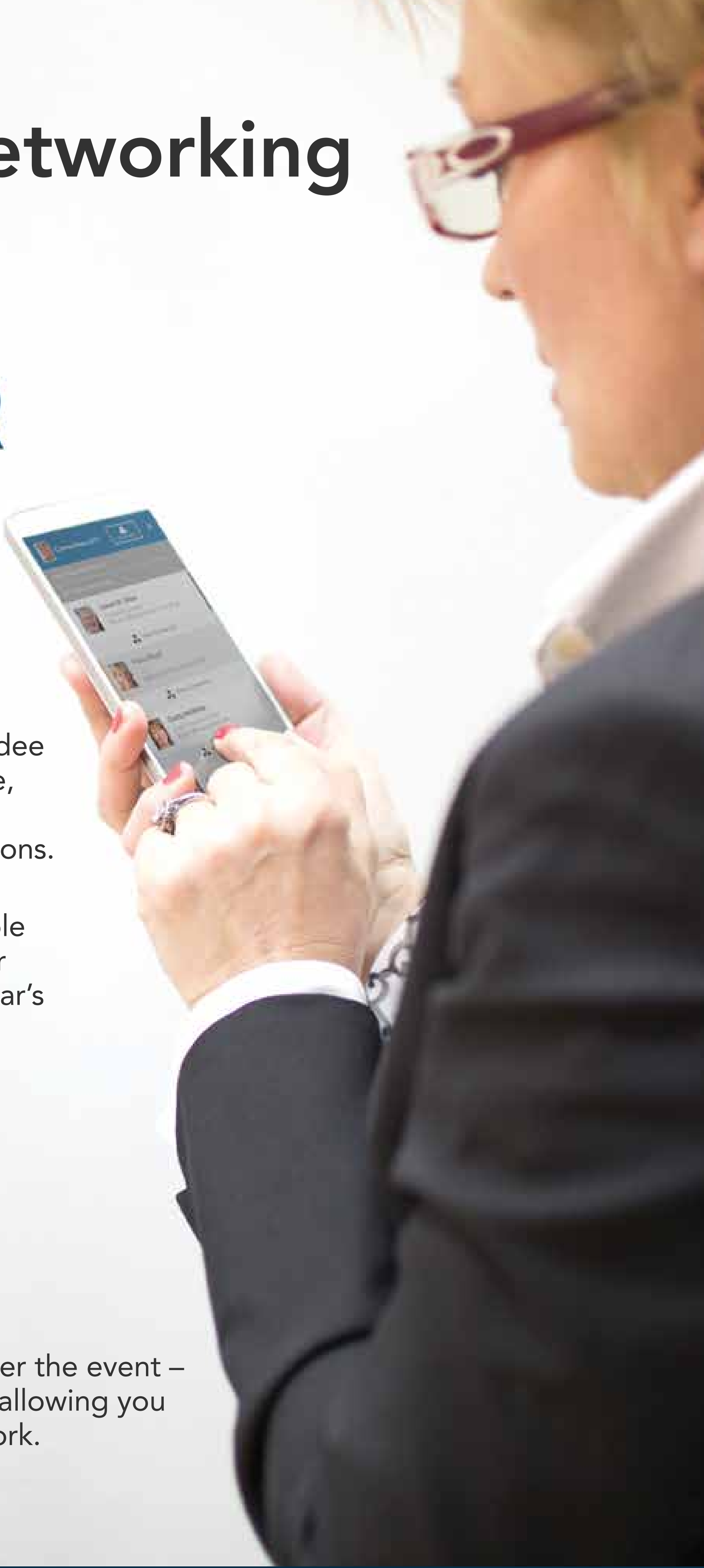
Graph 9
Actual Discretionary Adjustments to Individual Performance



Meaningful Networking Made Easier

EQUILAR ENGAGE

the next level in executive connection



Static nametags and conference attendee lists are transformed into an interactive, rich set of executive profiles that highlights commonalities and connections.

Executives can quickly search for people they want to interact with and discover connections they share based on Equilar's sophisticated relationship mapping.

- Easy to access
- Mobile friendly
- In-depth attendee profiles

Your access to Engage doesn't end after the event – all of your events become connected, allowing you to leverage a growing executive network.

(877) 441-6090 | www.equilar.com

EQUILAR

A Fresh Take

Reaching shareholders through innovations in proxy design

C·S +

*For more information, please contact Dan Marcec **dmarcec@equilar.com**. The contributing authors of this paper are Kuljit Singh and Tiffany Chen, Research Analysts, and Garret Sturgis, Senior Research Analyst.*

Over the past decade, the Securities and Exchange Commission (SEC) has implemented numerous changes concerning the proxy disclosure requirements to which public companies are subject. This has been especially true for the Compensation Discussion & Analysis (CD&A) section, which describes in detail a company's executive compensation program and compensation governance practices. Using data from the past six years, Equilar looked into the proxies of S&P 100 companies to identify relevant disclosure trends and highlight significant changes in both the design and content.

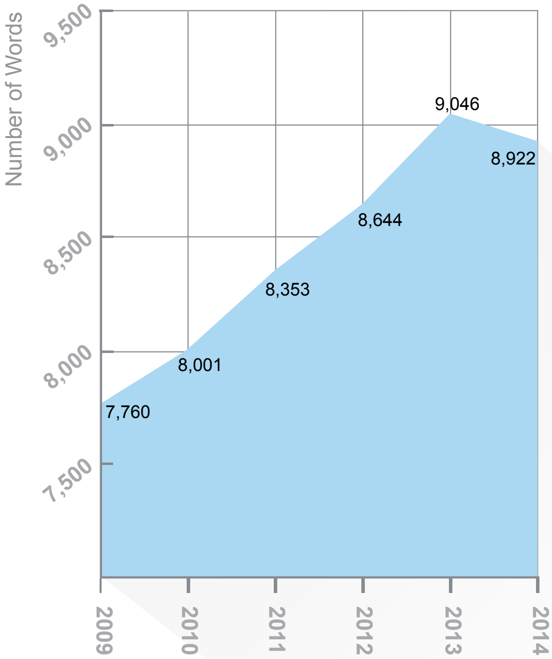
Proxy design has played a large role in enhancing the proxy. Features such as color, graphs, and additional content are used to strengthen the proxy statement and have had a rapidly increasing presence over the past five years. The components that will be examined are word count, use of color, use of additional graphs, alternative pay visuals, and the CD&A Table of Contents.

Word Count

The length of the Compensation Discussion & Analysis section of proxies has steadily increased from 2009 to 2013, growing by an average of 321 words each year. However, there was a slight dip from 2013 to 2014, in which the average CD&A word count for S&P 100 companies dropped from 9,046 words to 8,922 words. The average word counts for proxies filed in 2009, 2010, 2011, 2012, 2013, and 2014 were 7,760, 8,001, 8,353, 8,644, 9,046, and 8,922 respectively. Overall, CD&A word count has increased 15.0% from 2009 to 2014 in S&P 100 companies. A factor causing these increases is the addition of sections to the CD&A, such as proxy summaries and executive summaries.

In the upcoming 2015 proxy season, it is likely that word counts in the CD&A section will continue to increase. Visa has grown its word count from 5,176 words in 2009 to 13,969 words in 2014, demonstrating a significant increase in length. Companies like Amgen, however, have decreased their CD&A word count from a massive 18,332 words in 2009 to 13,713 words in 2014.

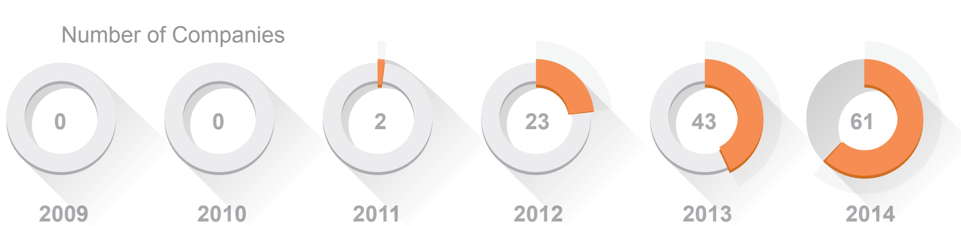
Graph 1
S&P 100 CD&A Word Counts



Proxy Summary

As proxy statements continue to increase in length, several companies have provided summaries of their proxies. To meet the expectation that some shareholders will not read the entire proxy statement, companies have responded by including proxy summaries in an effort to highlight key topics. Companies hope that shareholders will read at least a summary to get an understanding of compensation programs and internal corporate governance. Proxy summaries were not included in any S&P 100 proxy statements in 2009 or 2010. However, 2011 brought the first two disclosures of proxy summaries, and 2012 through 2014 saw an exponential increase in the inclusion of proxy summaries.

Graph 2
S&P 100 Proxy Summary Inclusion



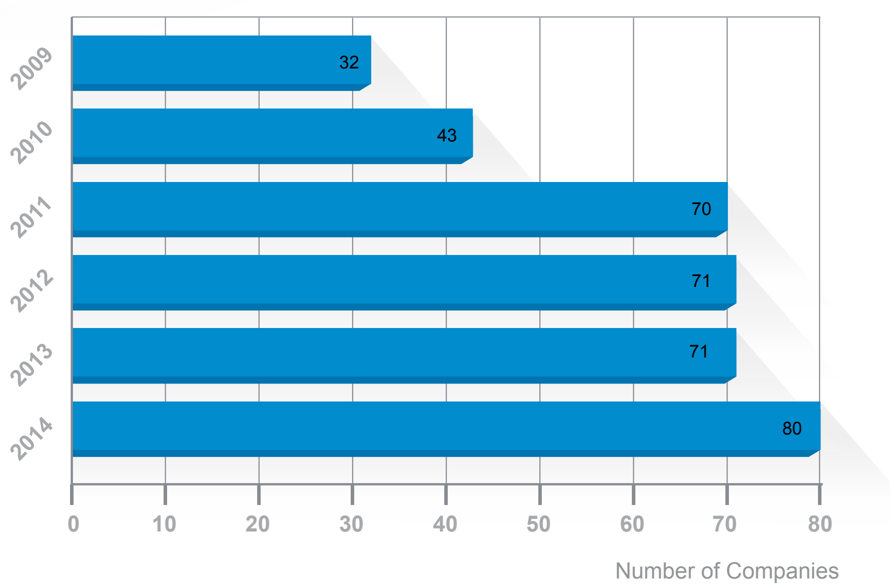
The page length of these proxy summaries ranged from one page to 11 pages for S&P 100 companies over the past four years. The most common page length of proxy summaries was three pages, and the average page length has increased from 3.13 pages in 2012 to 3.60 pages in 2014. Companies are trying to incorporate more topics in proxy summaries, and as a result, proxy summaries are getting longer.

The longest proxy summary, from Abbott Laboratories' (ABT) 2014 proxy, was 11 pages long and provided sections discussing their spinoff of AbbVie, financial highlights, governance highlights, executive compensation program highlights, and other topics. In contrast, 16 proxies from 2011 to 2014 had only single page proxy summaries. Norfolk Southern (NSC) was one such company. They included only a list of their proposals with their recommendations and the location for their annual meeting. Other companies' proxy summaries ranged in length and most included proposal recommendations along with governance and executive compensation highlights.

CD&A Navigation

At the beginning of the CD&A, companies have the ability to provide an executive summary prior to discussing each element of executive compensation. Similar to proxy summaries, executive summaries enable companies to disclose a snapshot of their executive compensation for shareholders who are unable to read the entire CD&A. The majority of companies in the S&P 100 disclosed an executive summary in their most recent proxy, a significant increase from six years ago, as displayed in the graph below.

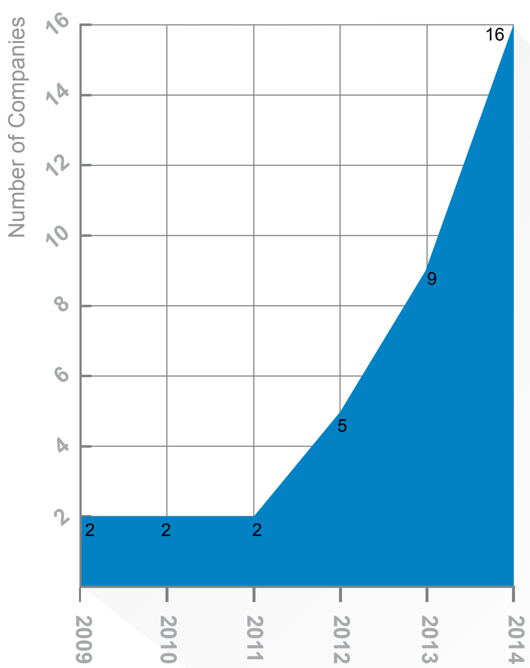
Graph 3
S&P 100 CD&A Executive Summaries



Topics frequently discussed in executive summaries include: Financial Highlights, Total Shareholder Return, CEO Compensation Highlights, All Named Executive Officers' Compensation Highlights, and Response to Say on Pay. The rest of the CD&A discusses the individual elements of compensation, making the executive summary an opportunity for companies to provide disclosure on their company success (or lack of success) and share how executive compensation was paid in response.

Companies have increasingly added a Table of Contents specifically for the CD&A in their proxy statements. The prevalence of a CD&A Table of Contents in S&P 100 companies increased from two companies in 2009 to 16 companies in 2014. The CD&A Table of Contents is a tool to preface the CD&A and provide a general overview of the sections. Sections include: Executive Summary, Compensation Objectives and Strategy, Compensation Principles, and Shareholder Engagement on Executive Compensation, to name a few.

Graph 4
S&P 100 CD&A Table of Contents

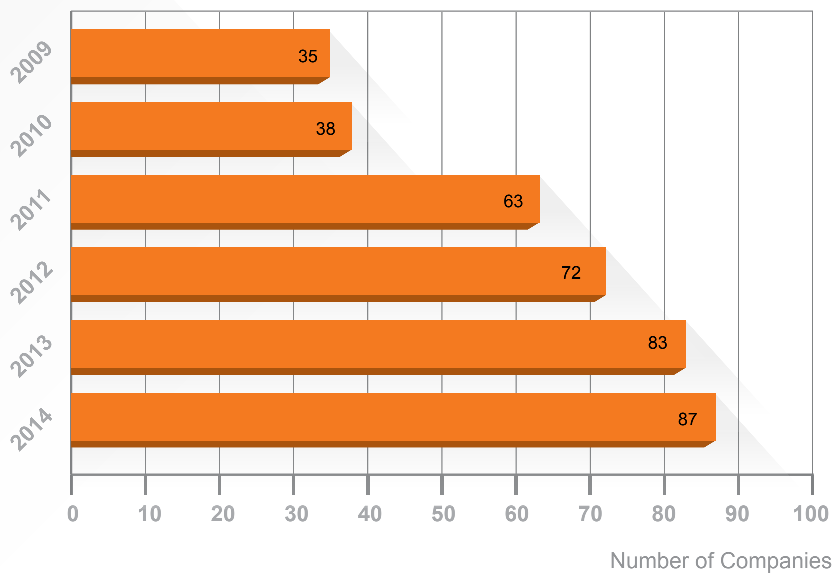


Additional Graphs

In recent years, companies have incorporated visual aids into their proxy to supplement the filing. The number of companies that used additional graphs has increased significantly over the past six years, from 35 companies in 2009 to 87 companies in 2014. Some examples of graph topics include alternative pay, total direct compensation pay mix, revenue growth/operating income growth, and total compensation versus total shareholder return.

Several companies disclosed additional graphs within the CD&A in addition to those required by the SEC. These additional graphs add variety to company proxy statements and describe pay practices more thoroughly. As the 2015 proxy season approaches, companies are more likely to include additional graphs for the optimal proxy disclosure.

Graph 5
S&P 100 Supplemental Charts & Graphs



Deluge of Data

Why shareholders are dissatisfied with CEO compensation and disclosure

Only 38% of institutional investors believe that corporate disclosure about executive compensation is clear and easy to understand.

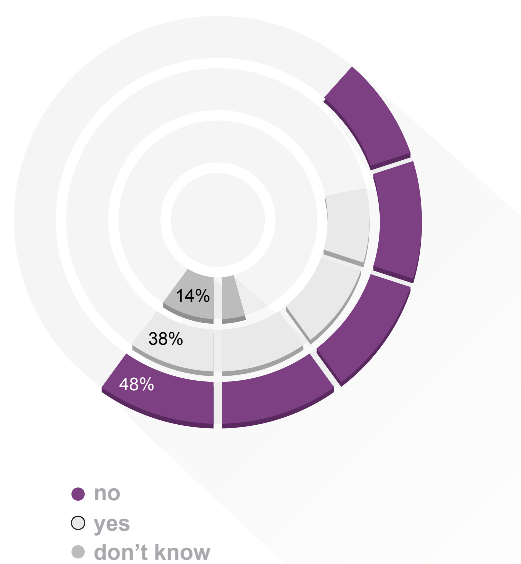
"Shareholders want to know that the size, structure, and performance targets used in executive compensation contracts are appropriate," says Professor David F. Larcker of the Stanford Graduate School of Business. "Our research shows that, across the board, they are dissatisfied with the quality and clarity of the information they receive about compensation in the corporate proxy. Even the largest, most sophisticated investors are unhappy."

"With new pressure from activist investors and annual 'Say on Pay' (SOP) votes, it is more important than ever that companies explain to their shareholder base why the compensation packages they offer are appropriate in size and structure," says Aaron Boyd, director of Governance Research at Equilar.

"Investors are noticing the wide range in quality and clarity among various companies' proxies. They want companies to communicate and explain, rather than simply disclose," adds Ron Schneider, director of Corporate Governance

Graph 1

In general, do you believe that information about executive compensation is clearly and effectively disclosed in proxy statements?



Services at RR Donnelley Financial Services. "This represents a significant opportunity for many companies to improve the clarity of their proxies."

In the fall of 2014, RR Donnelley, Equilar, and the Rock Center for Corporate Governance at Stanford University surveyed 64 asset managers and owners with a combined $17 trillion in assets to understand how institutional investors use the information in corporate proxies to make voting and investment decisions.

Investors Are Deeply Dissatisfied with Compensation Disclosure

Less than half (38%) of institutional investors believe that information about executive compensation is clear and effectively disclosed in the corporate proxy. Responses are consistently negative across all elements of compensation disclosure. Sixty-five percent say that the relation between compensation and risk is "not at all" clear. Forty-eight percent say that it is "not at all" clear that the size of compensation is appropriate. Forty-three percent believe that it is "not at all" clear whether performance-based compensation plans are based on rigorous goals.

Significant minorities cannot determine whether the structure of executive compensation is appropriate (39%), cannot understand the relation between compensation and performance (25%), and cannot determine whether compensation is well-aligned with shareholder interests (22%). "Corporations must do a better job of articulating the rationale behind plan design," says Mr. Boyd. "It is not enough that disclosure in the Compensation Discussion & Analysis (CD&A) section of the proxy meets regulatory requirements. Companies should take renewed effort to be clear and concise in explaining their choices."

Investors Rely on Only a Small Fraction of Information Provided in Proxies

Fifty-five percent of investors believe that a typical proxy statement is too long. Forty-eight percent believe that a typical proxy is difficult to read and understand. Investors claim to read only 32% of a typical proxy, on average. They report that the ideal length of a proxy is 25 pages, compared to the actual average of 80 pages among companies in the Russell 3000. "Lengthy disclosure does not necessarily equate with clear and digestible disclosure, and can actually impede rather than improve shareholder understanding of governance choices," observes Mr. Schneider. "Plain English language which is well-organized and easily navigated, coupled with simple design elements to draw the reader to key content, are much more effective in conveying information."

Investors are most satisfied with disclosure relating to director nominee descriptions and qualifications, director independence, and shareholder-sponsored proposals. They believe that disclosure relating to pay ratios (the ratios of CEO pay to median employee pay and CEO pay to other named executive officer pay), corporate political contributions, corporate social responsibility and sustainability, and CEO succession planning are least clear.

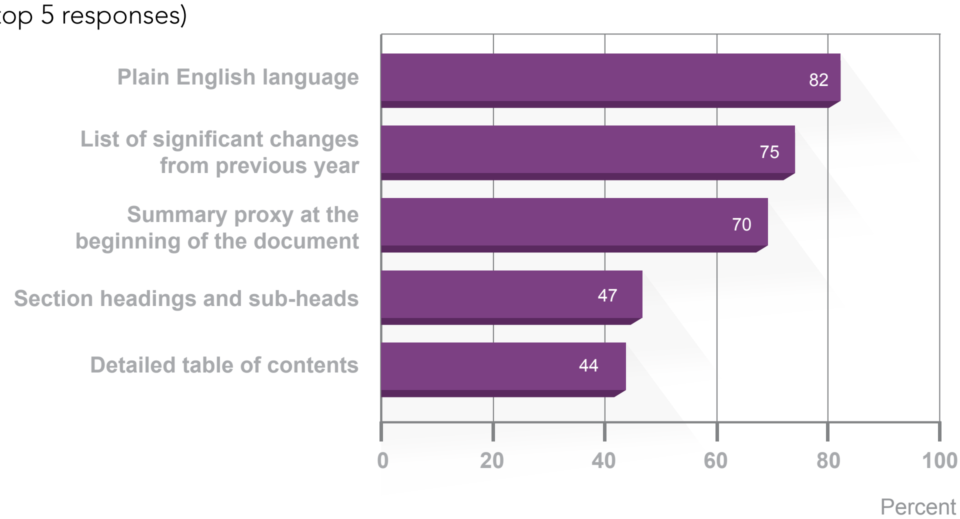
Investors Believe the Proxy Voting Process Is a Valuable Exercise ...

Eighty percent of investors believe that proxy voting increases shareholder value. Their confidence level that proxy voting increases value averages 7.2 on a scale of 1 to 10, with nearly a quarter of respondents (24%) assigning a confidence level of 10. Institutional investors are most likely to read the summary section of the proxy (if included), total compensation tables, and disclosure on long-term incentive plans. Investors also highly value a table highlighting significant changes from the previous year. For proxy voting decisions, investors rely most heavily on disclosure relating to pay-for-performance alignment, performance metrics used in compensation plans, and director independence.

In addition to proxy statements, investors are most likely to rely on internal policies or analysis (73%), third-party proxy advisors (63%), and direct engagement with the company (58%) to make voting decisions.

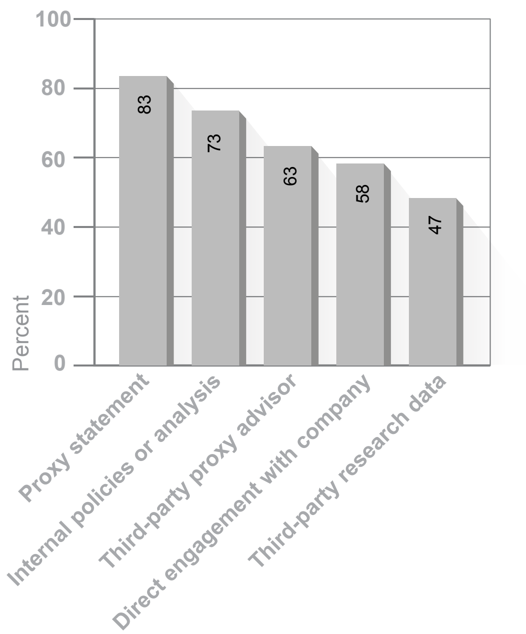
Graph 2

Which of the following elements make proxy statements easier to read or navigate? (top 5 responses)



Graph 3

What information sources does your organization rely on to make proxy voting decisions? (top 5 responses)



… However, Portfolio Managers Are Only Moderately Involved in Voting Decisions

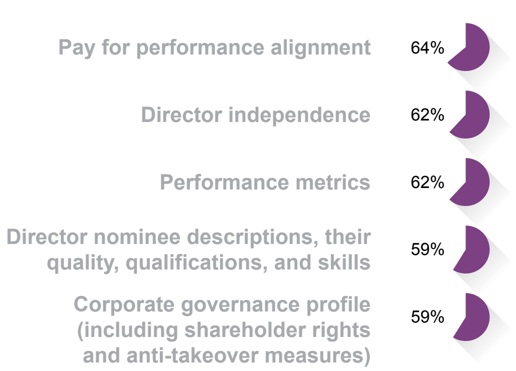
Seventy-six percent of institutional investors report that portfolio managers are involved in voting specific proxy items for the companies their organization is invested in. However, among those portfolio managers that do participate in voting decisions, the level of engagement is very low. A typical portfolio manager is involved in only 20% of voting decisions. Among large institutional investors with assets under management (AUM) greater than $100 billion engagement is even lower: Portfolio managers are involved in only 10% of decisions.

Portfolio managers who participate in voting tend to weigh in on major issues: mergers and acquisitions (89%), director nominations in a contested election (82%), executive compensation "Say on Pay" (75%), and proposals to approve or amend equity compensation plans (70%).

Two-thirds of respondents (68%) report that portfolio managers are involved in establishing their firm's proxy voting guidelines.

Graph 4

Which of the following sections of the proxy does your firm read and rely on to make voting decisions? (top 5 responses)



Proxies Are Less Frequently Used for Investment Decisions

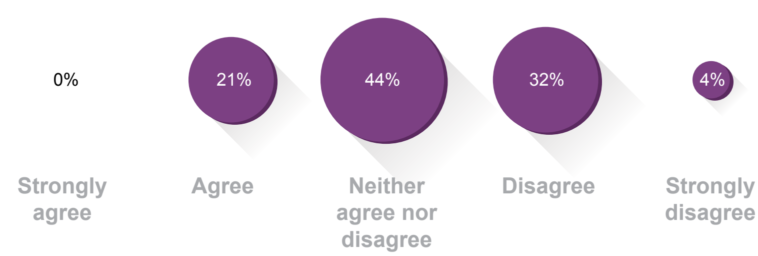
Fifty-nine percent of investors use proxy information for investment decisions. In making investment decisions, they rely most heavily on disclosure relating to performance metrics used in compensation plans, pay-for-performance alignment, the corporate governance profile of the firm (including shareholder rights and anti-takeover measures), and risk oversight.

Investors Are Lukewarm that "Say on Pay" Leads to Tangible Improvement

A slight majority (54%) of shareholders believes that proxies allow them to make informed votes on executive compensation ("Say on Pay"). A similar percentage (58%) believes that "Say on Pay" is effective in influencing or modifying pay practices.

Graph 5

To what extent do you agree with the following statement "CEO compensation among our portfolio companies is clearly linked to performance?"



Complaints about disclosure might be related to dissatisfaction with pay practices in general. Only one-fifth (21%) of institutional investors believe that CEO compensation among companies in their portfolio is appropriate in size and structure. Twenty-one percent believe that CEO compensation among companies in their portfolio is clearly linked to performance. Only a quarter (26%) are able to understand the payouts that executives stand to receive under long-term performance plans.

"These are significantly negative perceptions of executive compensation," observes Professor Larcker. "'Say on Pay' is having some effect, engaging shareholders in a discussion about plan design. However, investors are still frustrated with pay levels overall and whether the packages awarded today are justified." CS

Time for an Upgrade?

Investors are interested in Pay for Performance, but many current proxies don't adequately address the topic

By Ron Schneider

RR DONNELLEY

Many institutional investors have been focused on executive compensation—particularly CEO pay—for years, even prior to the near-universal adoption of Say on Pay votes in the U.S. in 2011. While some investors focus on the absolute amounts and related trends, most are more interested in understanding how these pay plans work, and how the resultant pay outcomes align with relevant measures of executive and company performance. In fact, the number one question investors would like answered is, "How does the executive pay program support company strategy?"

Say On Pay Votes Often Influenced by Murky Disclosure

Ron Schneider is Director of Corporate Governance Services at RR Donnelley, and can be reached at ***ronald.m.schneider@rrd.com***.

In fact, in assisting certain companies with their post-meeting engagement efforts following less than stellar Say on Pay votes, I have heard investors—when confirming that they had voted against—indicate that a major driver of their negative votes was not pay per se, but rather their concerns about the relevance and rigor of performance metrics for short- and/or long-term incentives. Such comments ranged from "We didn't understand their relevance or appropriateness given your industry" to "They appeared to be lay-ups." Other investors indicated they had experienced difficulty locating these disclosures or had missed them entirely—generally in cases where they were disclosed in dense text and not highlighted in an easier to locate tabular format.

Consider the situation where a proxy advisory firm has issued negative Say on Pay or equity plan vote recommendation. Many institutional investors use proxy advisors primarily as data aggregators or screening tools and seek to vote thoughtfully and independently, doing so typically in the final week or two prior to the annual meeting. When they either cannot quickly locate key information to support a positive vote—or when they do and it isn't clear and compelling—they probably are not going to have the time or inclination to call a company up and ask you for clarification (i.e., provide that "second bite at the apple"). Rather, they may simply vote against and move on to their next portfolio company's proxy.

Investor Interest in Performance Measures Is High

Both the initial RR Donnelley investor survey about proxy statements conducted in 2013 and the more recent and expanded investigation, conducted jointly by RR Donnelley, Equilar, and Stanford University's Rock Center for Corporate Governance, confirmed that performance metrics is one of two topics investors most highly scrutinize in company proxies (the other being director independence, skills, and qualifications).

The survey results provide strong support for the importance of companies explaining their pay plans, how they work and the resultant pay outcomes clearly and credibly. This not only can help secure voting support for Say on Pay, but also can improve the companies' investment appeal. To highlight a few questions from the recent joint survey:

When asked "Which of the following sections of the proxy does your firm read and rely on to make voting decisions? (select all that apply)," the top three responses out of 20 available choices were:

- Pay for performance alignment – 64%
- Director independence – 62%
- Performance metrics – 62%

When asked "Which of the following sections of the proxy does your firm read and rely on to make investment decisions? (select all that apply)," the top three responses out of 20 available choices were:

- Performance metrics – 40%
- Pay for performance alignment – 34%
- Corporate governance profile (including shareholder rights and anti-takeover measures) – 33%

That is what investors report they are most interested in. So how do they grade company proxy disclosures on these key topics?

Investor Reactions to Key Topic Disclosures Are Mixed

When asked "On average, how clearly and effectively is information disclosed in the following sections?" the results were less than stellar.

- Performance measures: 13% chose "very," 79% chose "somewhat," and 8% chose "not at all"
- Parsing this topic further, when asked whether performance-based compensation plans are based on rigorous goals:
- 6% chose "very," 52% chose "somewhat," and 43% chose "not at all"*

These results represent investor views of average or "typical" U.S. company proxies. Clearly, many companies are already doing a superior job of clearly communicating how their pay plans work, how they support company strategy, and why the resultant pay outcomes are appropriate. In the event of negative proxy advisor recommendations on Say on Pay or equity plan proposals—because they are providing investors with the information and ammunition they need to make thoughtful, company-specific voting decisions—these companies may fare better at the ballot box than companies with more opaque disclosures.

For other companies, this wide variance in the quality and clarity of company disclosures provides them with an opportunity to upgrade their compensation disclosures going forward in order to better meet their investors' informational needs. Questions they can ask themselves include:

- Is the level and clarity of our disclosures about performance metrics, weightings (if used), and target levels of performance on par with those of our peer companies? If so,
- Is the information easily found, whether through a listing in the table of contents, a location under a relevant subject matter heading, or a display in a tabular or other eye-catching format? And most important,
- Are we making it easy for investors and others to understand our pay plans, how they support company strategy, and thus, why they deserve investor support? CS

C·S +

To read more of Ronald Schneider and RR Donnelley's proxy analysis, visit ***csuiteinsight.com/author/rschneider***.

* does not total 100% due to rounding

Strategy Building

The seven key strategic planning tasks boards should be a part of and how to incorporate them into your process

By TK Kerstetter

BOARDROOM RESOURCES LLC

What is the board's role in strategy? Anyone who has served on a public company board has asked himself or herself this question. It is a question that has been asked and debated for decades by the profession's best, yet we still struggle finding a common answer on what could be considered a best practice. One thing that we can all agree on is that directors want more time on board agendas to discuss strategy. In my 18 years at Corporate Board Member and as Chairman of NYSE Governance Services, we never had an annual board survey where directors haven't ranked more time to discuss strategy as the top response to "What do directors want to spend more time on?" So why don't boards just add strategy topics as part of their agendas? The truth is … it's not as easy as it sounds. Typically, board meetings are filled with so many regulatory or legal "must-dos" that carving out constructive time for deep strategy discussions is rare.

Before we deal with the issue of how the board's strategy discussions should occur, let's first understand what the director's contributions should be. The board's role is for its members to contribute their advice and experience to key portions of the planning process, including confirming that the organization's tactical and financial goals meet the mission, the CEO's vision, and the investors' expectation for growth in shareholder value. Also a key aspect of the board's oversight role with respect to the company's strategic direction is to ensure that the business plans have identified the risks inherent in conducting operations and then actively monitoring management's execution of approved strategic plans.

Getting Specific with the Strategic Plan

So … realizing that the beginning of this article looks at strategy and the board's strategic planning responsibilities from 30,000 feet, the value of this column is to provide some answers. The following are specific planning tasks that I believe are part of the board's role in strategy and strategic planning.

TK Kerstetter is the CEO of Boardroom Resources LLC and is a second generation pioneer of governance thought leadership and board education.

1. **Mission —** Boards need to contribute to the initial formation of the mission and its review for validity each year. The mission outlines the primary work and purpose of the company.
2. **Vision —** The vision is the CEO's view of the company's strategic direction. There can only be one vision, but the board of directors needs to sign off that it meets the mission and can contribute to long-term shareholder value.
3. **Situational Analysis —** This is the exercise of understanding the competitive and regulatory environment. Simply put … it is getting your arms around where you are today and what hurdles exist to get you to where you want to be.
   A thorough situational analysis includes:
   - a review of your competition, industry (or industries), and regulatory/political environment;
   - a projected economic forecast of all regions and countries where you currently operate or plan to do business;
   - a technological impact study of how related innovations and risks will affect your operations;
   - a SWOT analysis that will review current strengths, weaknesses, and threats;
   - a comprehensive financial and capital allocation report that includes a financial peer group comparison;
   - and any meaningful survey information from internal employee cultural research.

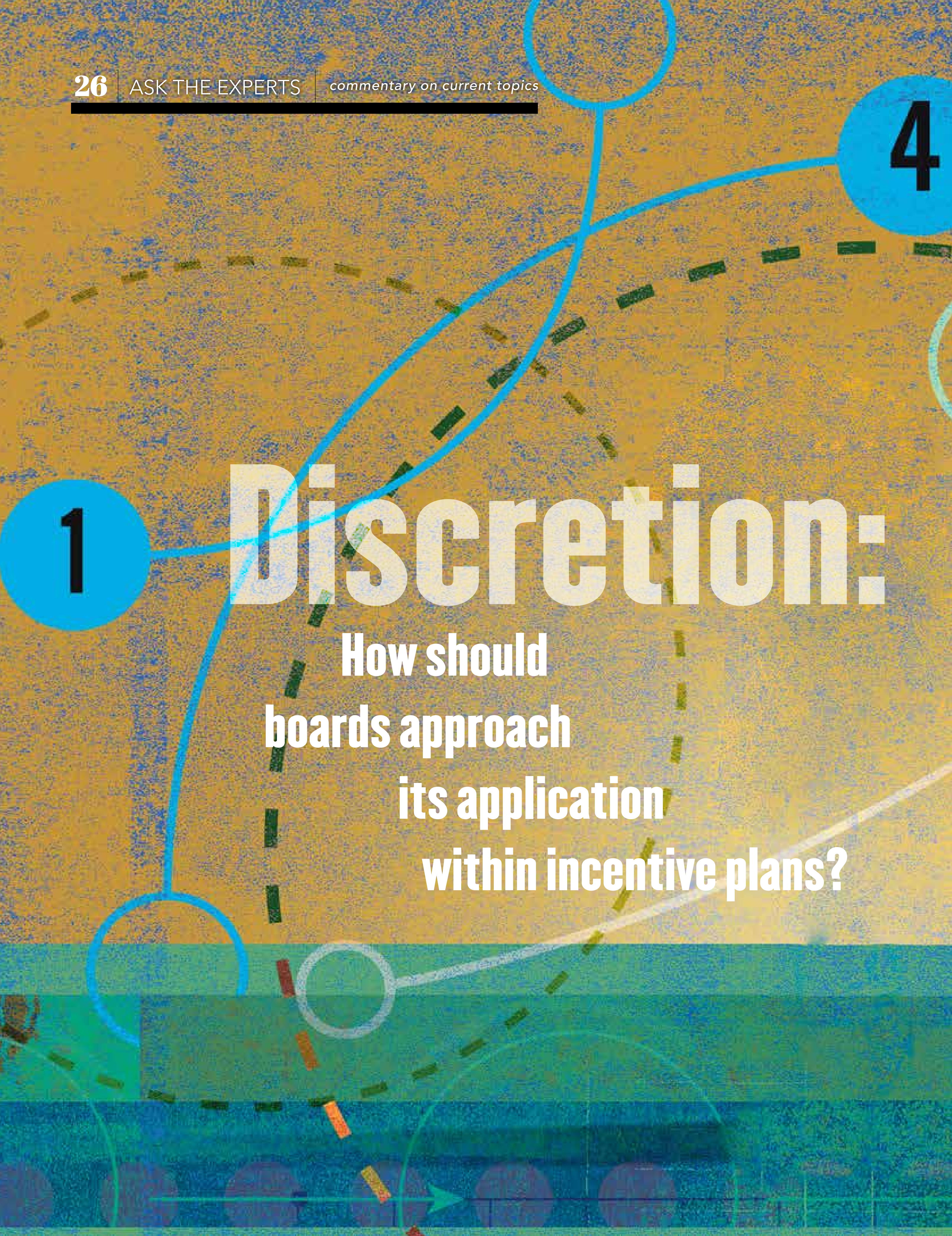
   The shareholder and proxy adviser analysis is important for the board to do, but I prefer doing that type of review outside of the strategic planning process.
4. **Qualitative and Quantitative Goal Setting —** Companies can do goal setting from the bottom-up, the top-down, or even a hybrid approach. Regardless, some goals will literally fall out on the table from the situational analysis, and the board needs to sign off on any corporate goals developed. This is where a director's experience and probing questions can be very important.
5. **Strategic Plan Tactics and Business Plans to Reach Corporate Goals —** This is the meat of the planning process, and it seems best for the board to step aside here and let management do its job. Certain directors with relevant experience may be asked their opinions depending on the relationship they have with officers throughout the organization, but basically, a director shouldn't be involved in this business unit and senior management function.
6. **Presentation of Plan and Budget —** The board needs to sign off on the entire plan and budget and ensure that compensation plans are structured to motivate the desired behavior and result.
7. **Plan Execution and Key Performance Indicators Review —** The board is responsible for conducting at least quarterly reviews of the plan's performance, discussing what has changed from earlier environment forecasts, and assisting in determining whether changes in the plan are warranted. Plans must be flexible to adapt to changing conditions, but management still must be held to a high level of accountability.

While I would never profess to be able to delineate all of a board's planning responsibilities in this single article, this summary does get into the specifics of a board's role in strategy, at least as it relates to the strategic plan. Because enterprise risk analysis is part of the strategic planning process, it can be argued that the role of the board in strategy is the second most important oversight fiduciary duty that it has next to ensuring it recruits and retains the right CEO for the company.

> "The board's role is for its members to contribute their advice and experience to key portions of the planning process.

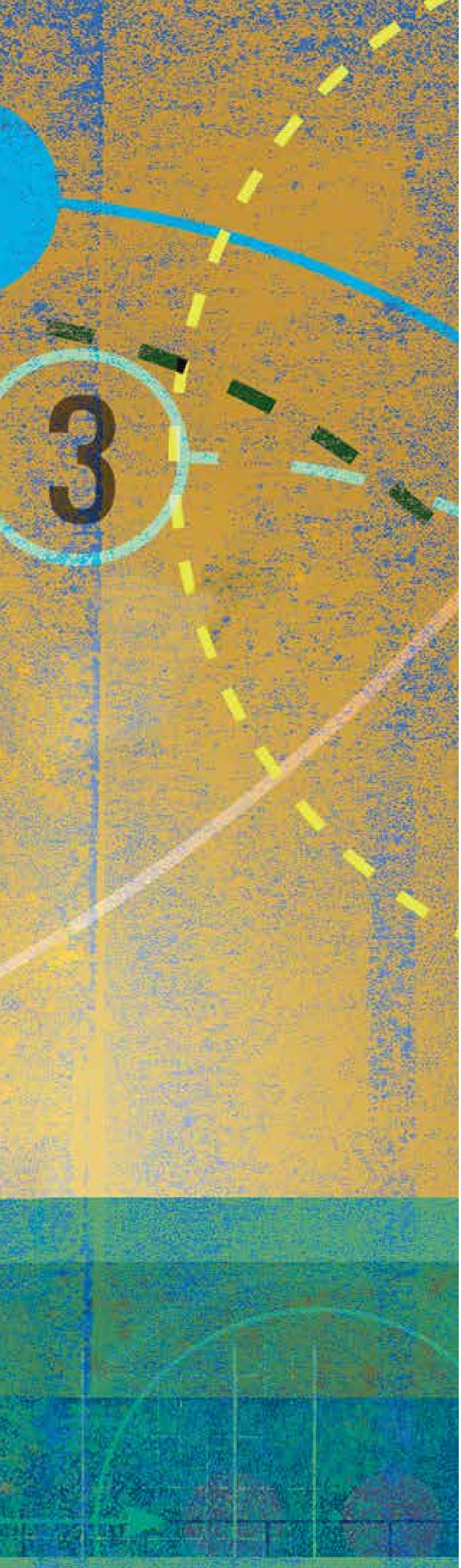
To Retreat or Not Retreat

Now back to the actual strategy discussions and the when, where, and how they are conducted. I can only say that there are many options. I know boards that have strategy committees and deal with strategy in every quarterly board meeting. I also know boards that don't intentionally plan strategy on their agenda because they do a two-day off-site planning retreat where they can devote uninterrupted attention to the company's direction and strategies. Each company and board must decide what works best for them. If you are a board member and your board isn't doing anything to participate or approve strategy and the strategic planning process at your company, I would quickly check the organization's D&O policy. I say that because the first question you will get from one of the judges at the Delaware Court of Chancery is, "Did you as a board member review and approve the company's direction and planning process?" Good luck if the answer is no! CS



Discretion:

How should boards approach its application within incentive plans?



BRIAN ROBBINS
Partner
SIMPSON THACHER & BARTLETT LLP

Brian D. Robbins is a Partner in, and Head of, Simpson Thacher's Executive Compensation and Employee Benefits Practice. He has extensive experience in the areas of executive compensation, employee benefits, and ERISA, and routinely advises the firm's corporate clients in connection with compensation and employment matters as well as the firm's M&A and public company advisory practices. He has represented numerous high-profile senior executives with regard to the negotiation of employment and termination agreements.

In the years following the financial crisis, we have witnessed intense focus on performance metrics and risk taking in federal legislation and increased scrutiny of performance metrics, as well as the development and implementation of performance-based compensation arrangements at public companies by corporate governance organizations such as Institutional Shareholder Services Inc. (ISS) and Glass Lewis & Co. (Glass Lewis). In addition, public companies have long operated under Section 162(m) of the Internal Revenue Code, which concerns executive officers who receive compensation in excess of $1 million but fail to meet the requirements of "qualified performance compensation" under those rules. Furthermore, many private companies, particularly those expecting to go public, have adopted performance-based compensation metrics and designs similar to those in place at public companies.

While ISS and Glass Lewis encourage the exclusive use of objective performance metrics and frown on public boards and compensation committees awarding compensation when these criteria are not met, there are circumstances when the use of discretion may be appropriate. Notable examples would include unanticipated market changes, strategic transactions, personnel changes resulting in reallocation of responsibility, or other changes in circumstance that warrant rewarding the management team for increasing shareholder value. Many public companies provide for this ability within the confines of the "qualified performance-based compensation" requirements under IRC Section 162(m), for example, by creating minimum performance goals that must be met to earn a maximum bonus, but with the expectation that the bonus amount will be reduced to reflect actual performance.

While creating performance-based compensation programs designed to pay bonuses only upon the achievement of pre-established objective performance goals is desirable (and clearly a market trend), ultimately, the board and compensation committee may choose to balance this with the desire to retain flexibility to react to unexpected events and even to compensate management for more "subjective" performance criteria.

SUSAN STEMPER
Managing Director
PEARL MEYER & PARTNERS

Susan Stemper is a Managing Director at Pearl Meyer & Partners, advising Boards and management on executive compensation, including strategy, compensation program design, pay-for-performance, IPO/transaction/M&A, communication and disclosure, and related governance. Susan advises public and private companies across several sectors, including emerging and growth technology and biotech companies. In addition to her experience in consulting, she has served in corporate compensation leadership roles.

Applying discretion shouldn't be a third-rail issue. Even with strong, structured performance and pay alignment, boards regularly use discretion to approve financials, other numeric metrics, or exclude a now-private peer from relative TSR calculations. Discretion is also used for non-quantitative goals, such as succession or organizational effectiveness. In each case, it helps determine results within the plan.

Discretion is also needed to assure appropriate payouts when the plan did not—or could not—anticipate certain events. Perhaps the strategic plan changed and the team refocused. A well-executed spinout may be right for the long term, but cause a significant miss on current-year goals. Further, while a goal may have been achieved on paper, how it was met may undermine other critical objectives. In these and similar cases, discretionary adjustments (up or down) may be needed to align pay with performance.

Boards should develop a process to assess results and determine whether adjustments are warranted. This creates a familiar approach when discretion is needed. Boards should:

Reduce surprises:

- Adopt apples-to-apples principles for financials; document treatment of accounting changes, M&A budgets, effect of

SARAH GOLLER
Senior Manager
Fund Financial Services
VANGUARD

Sarah Goller is responsible for Vanguard's corporate governance program and oversees daily operations of governance and proxy voting matters for Vanguard investment portfolios. Her position involves assisting Vanguard's Proxy Oversight Group with policy decisions, managing a team of governance analysts, and ensuring accurate execution of Vanguard's global voting and engagement program. Sarah's team meets regularly with company representatives, including portfolio company directors and executives, on matters such as executive compensation, director elections, and Vanguard's corporate governance philosophy.

Prior to her current role, she worked as an analyst in the Portfolio Review Department, which is responsible for overseeing Vanguard's 100-plus mutual funds, assessing fund performance, and monitoring Vanguard's external advisors. Sarah has also worked in Vanguard's Corporate Strategy and Advice Services Departments. She is a graduate of the University of Notre Dame and is a CFA charter holder.

Two of Vanguard's primary principles regarding executive compensation are "pay for performance" and "pay within reason." These joint principles reflect our expectation of reasonable consistency in compensation among companies that are comparable when considering their size, complexity, industry, and performance. We also expect that most of executive pay will be driven by objective, quantitative goals that will create long-term value for our shareholders.

We've also seen a number of boards apply discretion effectively. For example, we've spoken to a number of companies that apply limited discretion in response to a company's risk profile or cyclicality. We've also communicated with boards that exercised discretion when a company is in a turnaround

foreign exchange changes, etc.
- Understand what events might break the pay and performance link.
- Monitor the plan throughout the year, and discuss potential issues with management.
- Deal with the unplanned.
- Understand facts and circumstances and how well executives addressed the situations.
- Model alternatives to best align payout with performance, including the loss of tax deductibility.
- Clearly communicate decisions and rationale to participants, other directors, and stockholders.

A well-designed incentive plan reduces the need for ad hoc adjustments and should be the starting point. Boards should not shy away from exercising business judgment: reality requires discretion.

situation and goal-setting is more difficult. Finally, a number of compensation committees exercise negative discretion in response to litigation or regulatory matters that may be difficult to predict.

At the end of the day, it's most important that we understand how the compensation committee approaches these decisions. We expect that pay will generally reflect a company's performance over time, and this is more difficult to assess when a company doesn't use quantifiable metrics. As a result, we need to understand how the board assesses performance. Specifically, what are its criteria, agreed to at the beginning of the year, that determine the final pay decision? Companies shouldn't underestimate the importance of thorough disclosure and other shareholder communications to convey how they've prudently used discretion.

ROBERT B. LAMM
Of Counsel
GUNSTER

Bob Lamm is Of Counsel to Gunster, Yoakley & Stewart, P.A., Florida's Law Firm for Business, and serves as co-chair of the firm's Securities and Corporate Governance practice. He rejoined Gunster in 2014, having been a shareholder from 2000 to 2002.

In addition to his role at Gunster, Bob is an Advisory Director of Argyle, which advises corporations on the effective communication of corporate governance, and he serves as a Senior Advisor to Deloitte's Center for Corporate Governance.

From 2008 to 2013, Bob was Assistant General Counsel and Assistant Secretary of Pfizer Inc. His previous experience includes service as Vice President and Secretary of W. R. Grace & Co., Senior Vice President – Corporate Governance and Secretary of CA, Inc., and Managing Director, Secretary and Associate General Counsel of FGIC Corporation/Financial Guaranty Insurance Company.

In most contexts, using discretion is considered a good thing; among other things, it implies trust and the exercise of judgment. However, when used in the context of determining executive compensation, our legal and regulatory system has looked askance at the use of discretion for at least the last 20+ years. In particular, with the enactment of Section 162(m) of the Internal Revenue Code in 1993, compensation committees became increasingly locked into using quantitative metrics and discretion became permissible only when applied negatively—i.e., when the committee reduced compensation below the amount indicated by the application of the metrics in question.

However, particularly at a time when companies and investors alike are increasingly concerned with issues such as diversity, sustainability, and compliance—"softer" issues that are not easily susceptible to quantitative metrics—I would argue that positive discretion is a good thing. Negative discretion may "punish" executives for subpar performance in these softer areas, but it doesn't incentivize executives to excel, or even to "do the right thing," where these areas are involved. Rewarding executives for outstanding achievements in diversity, sustainability, compliance, and other areas would give them reasons to exceed expectations and outperform peer companies (i.e., competitors) and might just provide a reason to launch a race to the top.

I've yet to find a company that says "we aren't going to comply with Section 162(m) because we value discretion over deductibility," but maybe now is the time for some brave souls to go there.

BRIAN HOLMEN
West Region Practice Leader for Board Solutions
HAY GROUP

Brian Holmen is the West Region Practice Leader for Board Solutions at Hay Group in its Los Angeles office. Brian works with Boards of Directors and management to design and implement cash and equity incentive programs for directors, executives, and employees, including deferred compensation arrangements, severance arrangements, change-in-control arrangements, and employment agreements. He also addresses corporate governance issues associated with director and executive programs.

In my experience, it is difficult for a Compensation Committee to establish objective performance metrics that account for all of the variables that may occur over a long time horizon. To comply with Section 162(m) of the Internal Revenue Code, long-term incentive (LTI) grants often include a laundry list of adjustments that will be made to reflect unpredictable events, such as litigation costs, foreign exchange gains or losses, or reorganization and restructuring programs. Despite the effort to account for these events, unforeseen developments may still render an LTI grant worthless, as we all learned in 2008. For this reason, I believe that Compensation Committee discretion to adjust performance awards remains an important tool in LTI design.

To comply with Section 162(m) while giving Compensation Committees flexibility to adjust awards, I am a proponent of 162(m) "umbrella" plans. Under a common umbrella plan design, a Compensation Committee approves one or more objective performance metrics that, if achieved, will fund the bonus pool with a maximum amount that may be paid to each participant. Under the plan, the Compensation Committee establishes separate objective and/or subjective performance metrics that determine the actual amount of the bonus pool that will become payable to each participant. To the extent the actual amount that becomes payable to each participant is less than the maximum amount allocated to the bonus pool for that participant, the Compensation Committee exercises negative discretion to reduce the maximum amount.

For many companies, the flexibility in design makes this an attractive alternative to traditional 162(m) plans. A company that implements such a design must consider how to describe the arrangement in its proxy and how to socialize the arrangement with participants.

ANA M. FLUKE
Senior Manager
ERNST & YOUNG LLP

Building a better working world

Ana M. Fluke is a Senior Manager in the Human Capital practice at Ernst & Young LLP. Based in Cleveland, Ohio, she provides advisory services focusing on human resources, compensation/executive compensation, and benefits issues. With over 15 years of experience, Ana supports both public and private companies on the design, implementation, and operation of their executive compensation philosophy and strategy and the programs to support that strategy. She is a Certified Compensation Professional through WorldatWork™.

With continued scrutiny on executive compensation and the emphasis on pay for performance, boards generally use discretion only if there are unexpected business or market events or a fundamental change in the business. Ideally, the incentive plans should have challenging but realistic goals, which should result in payouts that are reflective of the company's performance. However, circumstances will arise that require discretionary adjustments to awards, whether positive or negative, and the board has a duty to carefully consider all of the facts to determine if an adjustment is necessary, as well as understand the ramifications of applying that discretion. Those ramifications could include tax and accounting consequences, disclosure requirements, and employee, shareholder, and public perception issues.

As boards consider making discretionary adjustments, they need to consider all elements of performance and the unique facts and circumstances that may require a discretionary adjustment to the award payout. Also, the board may wish to consider applying discretion in a manner that falls outside of the incentive plan to help mitigate the potential ramifications. Regardless, we recommend that boards proactively develop guiding principles outlining those circumstances when discretion may be considered in incentive payouts, as well as outside the incentive plans. The guiding principles should also address how much awards can vary from the calculated amounts when discretion is applied. This will help boards determine when and how to apply discretion to incentive awards in a consistent manner.

An interview with

Tom Quaadman

Tom Quaadman is the vice president of the U.S. Chamber Center for Capital Markets Competitiveness. The Center advocates legal and regulatory policies for the U.S. capital markets to advance the protection of investors, promote capital formation, and ensure U.S. leadership in the financial markets. Tom develops and executes strategic policies to implement a global corporate financial reporting system, address ongoing attempts of minority shareholder abuse of the proxy system, communicate the benefits of efficient American capital markets, and promote an innovation economy and the long-term interests of all investors.

Prior to joining the Chamber, Tom was chief of staff to Congressman Vito John Fossella Jr. (R-NY) from 1997 to 2008. In that capacity, he helped establish the Republican Policy Committee Task Force on Capital Markets, Economic, and Information Security to develop a legislative program on economic competitiveness.

Tom graduated cum laude from New York Law School and is a graduate of the College of Staten Island. He is a member of the New York and Connecticut state bars. Tom and his wife, Tara, and their children, Creighton and Alexandra, reside in Alexandria, Virginia.

Tom, tell us about the U.S. Chamber of Commerce and your role there. What are the main goals you and the Chamber want to accomplish?

Tom Quaadman: The Chamber is the largest trade association in the world, and we represent every type of business and industry. The Chamber, throughout its 102-year history, has worked on many issues of importance to the business community. In 2007, the Chamber established the Center for Capital Markets Competitiveness (CCMC) to advocate for financial regulatory reform and focus on issues related to capital formation, corporate governance, financial reporting, and risk management. While the 2008 financial crisis and the subsequent response broadened the number of issues we work on, the core mission remains the same.

My job is to help craft policy positions for the Chamber in these areas, develop strategies to implement them, and advance these positions before domestic and international policy makers.

Serving 3 million businesses must be tough. Many of them probably have competing interests. How does the Chamber handle this and serve all of its members?

Quaadman: While there are issues with competing interests, there are fundamental issues that are common to private businesses in a free enterprise system. Businesses must have efficient capital markets in order to operate and grow. Businesses must also have access to opportunity in order to develop into larger businesses, and through reasonable risk taking, also have the right to fail. Through that lens, there is more that unites than divides the business community. That is the sweet spot that allows us to be a vocal and effective advocate for our members.

> While there are issues with competing interests, there are fundamental issues that are common to private businesses in a free enterprise system.

One of your big goals is to help develop policies to implement a global corporate financial reporting system. Tell us why this is so important and what progress you've made.

> Many of the issues that I work on have traditionally been non-partisan. However, recently, we have witnessed a willingness to sacrifice the public good on the altar of political gamesmanship.

Quaadman: That we all live in a global economy is not a cliché. It's a reality. We have multi-national businesses that operate in dozens of countries and Main Street businesses in the United States that export overseas or rely on foreign companies as suppliers. While many of our financial firms operate overseas, European and Asian banks are important players in the United States and provide liquidity for American businesses.

As a result, trade has exploded and capital is no longer hemmed in by borders. Consequently, cross-border coordination and cooperation between regulators is integral for such a system to work. Additionally, common financial reporting languages are important for investors and businesses in this global environment. We were on a path toward achieving such a system, but the 2008 financial crisis and other bumps in the road have either made for uneven progress or for accounting convergence to stall.

Ultimately, the marketplace will help to drive progress, and with the deepest capital markets, the United States will remain the key player in such efforts.

In your bio, it states that you're responsible for, among other things, addressing ongoing attempts of minority shareholder abuse of the proxy system. We've seen the impact of shareholders grow over the last several years. Why is this an important issue? What should be done to fix this?

Quaadman: The public company model, as developed in the United States, has been the greatest wealth and job creator in world history. Yet since the burst of the tech bubble, we have seen a steady and consistent decline in the number of public companies in the United States. When entrepreneurs such as Michael Dell say that they will never again operate a public company, then you know we have real trouble.

The question is "why?"

As always, there are several answers. The SEC has been unwilling or unable to modernize corporate disclosures and delivery systems to meet the needs of a 21st-century marketplace. Financial stability initiatives, such as Dodd-Frank and Basel III, have reduced the role of market making, which is critical to public company capital formation. And we have also seen the corporate governance systems used to advance political goals and agendas unrelated to corporate management and growth. The Manhattan Institute recently found that union-sponsored shareholder proposals and contested director elections are concentrated in industries with ongoing labor organizing campaigns.

This tyranny of the minority incentivizes investors to put their money where they can get a solid return without the hassle. Unfortunately, when decisions like that are made, investors, workers, and businesses lose out.

We have a chance to make sure that the corporate governance system is a fair one that represents the interests of a corporation and the majority of its shareholders on a long-term basis. However, if we do not achieve this goal, we will all be hit with the economic cost. Clear rules of the road that are fairly enforced are an important part of that solution.

> "Young businesses—rather than small businesses in general—represent the most reliable, consistent source of job creation.

> That we all live in a global economy is not a cliché. It's a reality.

In a blog post in June of 2014, you raised concerns regarding proxy advisors, particularly their conflicts of interests. The Chamber also released a best practices report for proxy advisory firms in 2013. In your post, you mention the possibility of the SEC regulating these firms. What kind of regulation do you think is necessary?

Quaadman: The guidance released by the SEC in June 2014 was an important first step in creating oversight over proxy advice. Many firms use proxy advisory firms as one set of data to use in determining how to vote their shares. However, academic studies have also demonstrated that the two advisory firms that dominate the field hold significant sway over a substantial portion of shareholder votes and develop voting policies and recommendations with little or no transparency or process.

> "When entrepreneurs such as Michael Dell say that they will never again operate a public company, then you know we have real trouble.

What are the best practices for companies in dealing with proxy advisors?

Quaadman: The SEC guidance is a start to addressing some of the flaws in the system by requiring disclosure of conflicts of interest and ensuring that advice correlates with the economic interests of clients. This past January, the Chamber released a white paper on how business should interact with proxy advisory firms under the new SEC oversight regime. The white paper can be found on our website.

You previously worked as chief of staff for a congressman, where you helped pass the Investors Capital Markets Fee Relief Act. What was it like serving in Congress and dealing with this issue? What were the challenges you faced in getting this passed while working for the government?

Quaadman: During the 10+ years I had the pleasure of working on Capitol Hill, I learned a great many lessons. However, the biggest lesson I learned was that you have to work with people on both sides of the aisle if you want to get something done. The Investors Capital Markets Fee Relief Act was an example of how bi-partisanship can get a seemingly difficult issue over the finish line. You can only get things done if you are willing to communicate and try to bridge philosophical differences through consensus building.

How has that experience helped you with your position at the Chamber?

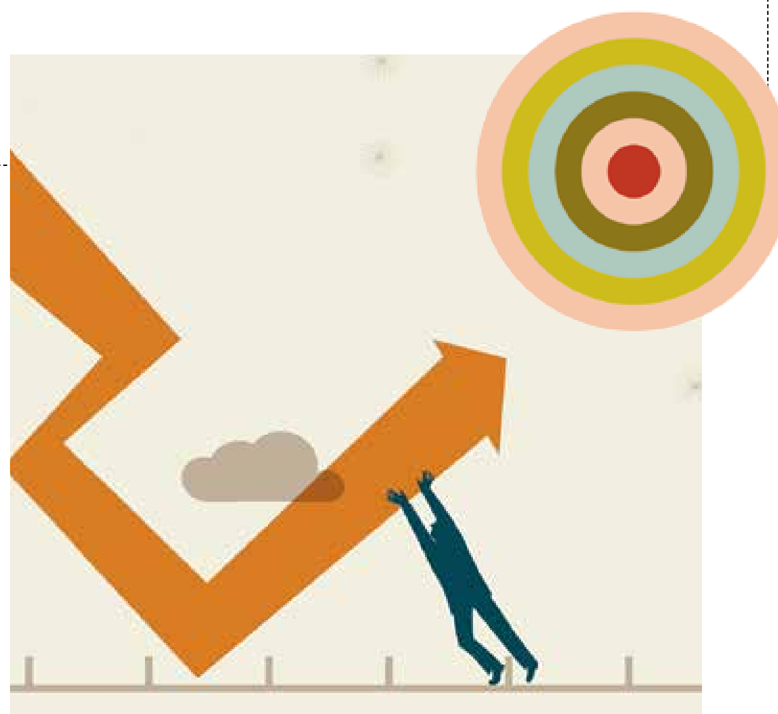
Quaadman: Many of the issues that I work on have traditionally been non-partisan. However, recently, we have witnessed a willingness to sacrifice the public good on the altar of political gamesmanship. We may have been able to get away with that in the past when the United States was the unquestioned economic king of the global hill, but that position is increasingly being threatened, and we have to compete. We must recognize that and act accordingly.

We're starting to see the Presidential race ramp up with more people joining the race. What impact do you see the upcoming elections having on corporations? Are there issues that will likely be a hot topic? What effect will this have on any legislation that is trying to be passed?

Quaadman: The Chamber gets involved in House and Senate elections, but not the presidential. Nonetheless, elections have consequences. Since 2008, the long-term economic growth rates are turning downwards for the first time, imperiling the standard of living for future generations. New research shows that the country's rate of new business creation has dropped by more than 30 percent during the recession and has been excruciatingly slow to bounce back. The consensus among economists is that young businesses—rather than small businesses in general—represent the most reliable, consistent source of job creation. Small business, historically, creates about two-thirds of our nation's net new jobs. Small firms employ almost half of the private sector workforce, and they make up about half of our nonfarm gross domestic product. They are a major source of both innovation and economic stability, not to mention opportunity for upward mobility.

So we need to have an honest debate on how to encourage growth and job creation. We need to push for an agenda that builds upon the JOBS Act to spur IPOs, understand the cumulative impacts of regulations to address areas of over-reach, and finally, streamline our New-Deal era regulatory system so that businesses have clear and understandable rules of the road in a 21st-century economy.

> "Staying on the sidelines won't make things better, and the next several years will determine if we can get things back on track. Not easy to do, but as the old saying goes, you have to be in it in order to win it.



> The biggest lesson I learned [on Capitol Hill] was that you have to work with people on both sides of the aisle if you want to get something done.

Any final thoughts you would like to share with our readers?

Quaadman: It is critical for business leaders to pay attention to issues that can impact their businesses and advocate for their interests before the ink is dry on a law or regulation. Too often, political interests seek to increase their power base or push agendas unrelated to the overall economic well-being. As a result of the Dodd-Frank Act, we have provisions that allow a new entity, the Financial Stability Oversight Council, to have the power of life or death over businesses, and the Federal Reserve to become the largest life insurance regulator. Additionally, we have new disclosures, such as pay-ratio or conflict minerals that may make people feel good, but provide no useful information to investors and increase the clutter that turns investors away from public companies. Those are just four issues in a 2,000-page bill.

Staying on the sidelines won't make things better, and the next several years will determine if we can get things back on track. Not easy to do, but as the old saying goes, you have to be in it in order to win it. CS

An interview with

John Thompson

HEIDRICK & STRUGGLES

John Thompson serves as Vice Chairman, Global CEO and Board Practice at Heidrick & Struggles. He is recognized as one of the most respected CEO and Board consultants in the nation, having completed over 200 CEO searches in the last 26 years. His public company clients have included Akamai Technologies, Apple, Brocade, CA Technologies, CSC, Dell, Disney, DirecTV, Google, Intuit, McAfee, McGraw Hill Education, Oracle, Polycom, Salesforce.com, SAP, SRI, Univision, and Verifone.

John has been active in working with both public and private boards in recruiting new directors as well as serving as an advisor on major board restructuring projects. His recent directorship clients include Adobe, Autodesk, Coherent, Corning, Dell, DirecTV, Flextronics, GE, Google, Juniper Networks, Nielsen, NIKE, Salesforce.com, SanDisk, Seagate, SunEdison, and Western Digital.

In 2010, John was the first recipient of Heidrick's Global "Lifetime Achievement Award." John joined Heidrick & Struggles in 1989 as a Partner and previously was a Partner with a regional executive search firm. He was formerly the Corporate Director of Organization Development for Atari and previously employed with The Williams Companies as Corporate Director of Organization Development. He serves on the Advisory Board of the Stanford Institute for Economic Policy Research.

John received a BA in economics and an MBA from Virginia Tech.

You're currently the Vice Chair of Heidrick & Struggles' Global CEO and Board of Directors Practice. Tell us about your current role and what your top priorities are in helping companies.

John Thompson: At Heidrick, we do director and executive-level search, but more and more we are helping boards with CEO succession—helping them to assess internal candidates and outside candidates via a continuous and comprehensive mapping process of identifying high-quality executives who might be able to be a successor candidate in either a planned or emergency scenario.

Interesting. Has this shift toward CEO succession affected your relationship with your clients?

Thompson: Our business has morphed into focusing on developing broader relationships with companies. In many cases, we have ongoing retainer relationships with companies so that we can be more helpful to them on a consistent and regular basis. This allows us to have a much deeper relationship with our client companies so that we can effectively advise on critical, strategic issues.

As you mentioned, there has been a growing emphasis on CEO succession planning. With your experience in this area, can you offer any insight into important skills and/or characteristics companies typically look for in a candidate? Have those changed over the years? Are there any that are becoming more important or less important?

Thompson: Characteristics that have become increasingly more important include agility of thought—that is, having a real mental agility and a nimbleness. Being self-aware, authentic, genuine, and relatable are also important for engendering trust, building a followership, and establishing connections with stakeholders.

Of course, domain expertise is always important, and while boards may think they are willing to take someone who does not have the relevant domain experience, the reality is very few do when it comes down to it. One example of this is Dave Calhoun at Nielsen, who had no real media experience, but he had the soft leadership skills mentioned above to quickly diagnose what was going on and then to make the necessary leadership and strategy adjustments to effectively drive the transformational changes to further empower the business.

In your opinion, what can most boards improve upon in the succession planning process? From a strategic point of view, are there any general words of wisdom you can offer to all companies, regardless of their present succession planning needs?

Thompson: Succession planning is one of the most, if not the most, important priorities and responsibilities of any board.

Boards should think about implementing a board mentoring process and program for internal candidates. This is something all companies can do. In theory, a board will assign a director mentor who would build a relationship with and work with the identified internal candidate. This relationship would serve two major and very helpful purposes. One, it would allow for the board to really assess the strengths and development areas of the internal candidate via real-time, practical interactions and one-on-one experience. Second, this type of program would also allow internal top talent an opportunity for coaching by statured, experienced executives. This can also be helpful in retention as employees are more likely to stay if they feel senior management/the board is making an investment in their careers.

In summary, it is a very mutually beneficial and symbiotic relationship, with the key being that this is an ongoing and continuous process that will be hugely valuable to the long-term health of the company, the immediate responsibilities of the board and the development, and the retention and morale of the internal candidate.

Characteristics that have become increasingly more important include agility of thought, being self-aware, authentic, genuine, and relatable are also important for engendering trust, building a followership, and establishing connections with stakeholders.

With the rising number and popularity of corporate transactions in the past few years, what is important to consider in the midst of a merger or spin-off compared to a more typical situation?

Thompson: A robust plan allows you to have a qualified and pre-vetted candidate ready—it is important to have people identified and assessed because if you have to recruit somebody, it can be problematic and a lengthy process. Especially in a merger or spin/separation situation, pre-planning is very important. Being able to tell people—employees, investors, customers, suppliers, really any stakeholder—who the CEO is will reduce some of the anxious feelings. This will allow for a smoother transition and less disruption to the business.

A key tool in effective succession planning, especially in a merger or separation event, is the ability to determine quickly what competencies you need in the new CEO and at the board level. We help clients very quickly realize what they need, what gaps they currently have and what gaps they may have post the corporate event by creating a matrix of key competencies and comparing the existing leadership and board, as well as other internal/external candidates, against those. This helps the current board effectively determine what is needed moving forward—what new board profiles are required from a composition perspective, how many additional seats need to be filled, etc.

Can you touch upon some of the challenges you have faced in these types of situations and what are best practices?

Thompson: In a spin/separation situation, the board needs to think carefully about how to tackle building the new company board. We see two common approaches.

The first approach is to separately recruit for each new board just prior to the separation. While this approach seems the most straightforward, it can be difficult to attract potential directors to a new public board without the opportunity to become familiar with its operations,

“Succession planning is one of the most, if not the most, important priorities and responsibilities of any board.

governance structure and processes. Directors will often need an NDA to review appropriate detail, and they will have to build rapport almost immediately, in addition to getting to know the company while simultaneously dealing with the challenges created by the separation.

The second approach is to temporarily expand the current board until the separation event and then allocate the board members appropriately. While this approach may require more pre-planning and a larger advance time, it affords new directors the opportunity to get to know the company, the governance structure, their peers, and the culture—which often translates into more informed decisions regarding allocation and board composition being made at the right time. Also, the new independent board members can assist with decisions on related party transactions, assets, debt, and other costs between the separated companies, which can minimize risk.

Not to focus completely on CEO searches, you also help companies find the right directors to serve on the board. What skills do you see as different or similar for a successful director compared to a successful executive?

Thompson: There are some differences between the two. That is certain.

When looking for a director, boards like someone with domain experience. They are looking for someone who understands the challenges and complexities of the company's ecosystem. These characteristics can help to avoid groupthink or colluding with the management team about what the strategy is. Successful directors effectively challenge and push management and their other director peers. They ask questions, and they hold themselves and each other accountable. More and more, boards are involved in shaping the strategy rather than just accepting it.

More and more board members may be representative of the customer base. For instance, if you do business in Asia and you do not have anyone familiar with the Asian market, or if there are other key demographics identified as critical to the company's long-term success, it is often incredibly helpful to have that representation and insight at the board level.

> When looking for a director, boards like someone with domain experience. They are looking for someone who understands the challenges and complexities of the company's ecosystem.

> "One of the challenges that stems from this environment, and the tech sector in general, is that companies have to be willing to accept a higher amount of risk when considering candidates for internal succession planning.

Finding specific skills like that sounds like a time-consuming part of the process. Could you perhaps touch on other unique challenges to finding a good director?

Thompson: Some of the unique challenges that boards face are the limits set by proxy advisory services such as ISS or Glass Lewis. Current line executives, including CEOs, are only allowed two outside public boards per these organizations. Additionally, as boards continue to focus on improving diversity, this poses another challenge as, unfortunately, the population is still thin. Until you generate more women and ethnic candidates in the executive ranks, boards need to be willing to think more broadly about the profiles they seek and/or consider stepping down a level from the most commonly sought CEO or CFO profiles. Today, CEOs and CFOs remain the top sought-after profiles, but very good boards will think creatively about their needs and will consider how to get that valuable expertise through a broader approach to their recruiting practices.

And, of course, conflicts always pose a challenge—whether those are stated and common competitive or supplier conflicts or whether they stem from a candidate's personal or ethical bias, these remain a top challenge. And even if the conflict is not a documented or clearly established and defined legal conflict, if there is the possibility of a perceived conflict, this could also prevent a board from recruiting a highly qualified director.

As you are based primarily in the heart of Silicon Valley, can you touch upon some of the main differences between what companies are looking for in a candidate in this highly competitive and fast-paced arena versus elsewhere?

Thompson: In Silicon Valley, companies are most focused on finding qualified directors who are not conflicted. Even more common in the Valley, directors have to be concerned about not just SOX conflicts but also perceived conflicts. Even though there may not be a legal conflict, if it could potentially upset a customer—on either the board's or the candidate's end—the board and/or the candidate most likely will not continue the recruiting dialogue.

Silicon Valley is a unique environment. The companies that are grown and nurtured here have a very unique and special ecosystem that is specific to this region. Because tech companies tend to grow so quickly, they do have unique issues. Unless you are a larger technology company, it is unlikely companies will have a structure that supports individual P&L's because it is an expensive way to organize. This is in vast contrast to larger multinational companies like GE, Danaher, Honeywell, Emerson, etc.

What are some of the unique challenges technology companies in particular face in effective succession planning? This can be for either directors or CEOs, if there is a difference.

Thompson: One of the challenges that stems from this environment, and the tech sector in general, is that companies have to be willing to accept a higher amount of risk when considering candidates for internal succession planning. Because these companies are growing rapidly, leadership is often a first-time GM or CEO. Boards need to be able to assess what those risks are, compensate for those and mitigate them. This could be done by who you bring on your board—a non-executive chairman or an executive chairman. You can moderate this risk by having qualified executives on the board who are available to coach and mentor a new CEO.

For directors, Silicon Valley boards are clearly looking for a director to bring something—experience, stature, global connections. They're also interested in director candidates from non-tech companies if they have certain qualifications, such as experience with a similar customer base or market. I did a search for a major tech company interested in consumer experience, and so we looked for directors with specific consumer market expertise rather than a technology-centric domain expert.

> "Silicon Valley boards are clearly looking for a director to bring something—experience, stature, global connections.

Specifically, there is a difference in the Valley in terms of the velocity of change and the general state of mind. The notion that you can fail, get another chance, and not have it be career-ending is really unique to this area. There is an ecosystem where small companies can look larger, and there are investors willing to invest and take risks. This level of excitement and energy is really attractive to people who are not in the Valley, and by serving on these boards, they can learn and apply those lessons back at their own companies.

Do you have any final advice you think companies should know when considering looking for a new director or executive?

Thompson: When boards look for new director candidates, I advise them to think beyond hard skills and to consider the softer leadership skills and attributes as well. I encourage them to ask, "Can you work with this person in good times and bad?" Also, boards need to fully vet candidates for fit and style. You do not want what I call a "shadow CEO." You do not want someone who is really trying to run the company from the boardroom. An effective board member is humble but appropriately assertive and confident.

In terms of executives, I believe self-awareness, situational awareness and mental agility are very important.

And for both directors and executives, I believe truly successful candidates have excellent pattern recognition, which can help mitigate risk. CS

An interview with Raymond J. Milchovich

Raymond J. Milchovich currently serves on the Board of Directors of the Dow Chemical Company. He also serves on the board of NTS, the world's largest independent provider of environmental simulation testing, and is the Lead Director of the Nucor Corporation board. Raymond was Chairman, President, and CEO of Foster Wheeler AG from 2001 to 2007, and continued working for the company as Chairman and CEO until 2010. From 2010 to 2011, he served as a non-executive Chairman and consultant for Foster Wheeler.

In his time at Foster Wheeler, Raymond led the company through an out-of-court restructuring of the balance sheet by convincing the company's creditors to support a series of equity for debt exchanges while maintaining a modest level of value for the existing equity. In 2005, which was the first year after completion of the restructuring, Foster Wheeler achieved $62 million of adjusted net income. In 2006 through 2008, the company achieved three consecutive years of record earnings, which peaked in 2008 at $533 million of adjusted net income.

Ray, you recently joined the Board of Directors at Dow Chemical. Interestingly, you were put forth as a nominee by the activist investor, Third Point. What was the process like for you when joining the board?

Raymond Milchovich: Once an agreement was reached between Dow and Third Point, to Dow's credit, they ran a very professional governance process. They put forth a slate of new directors and brought them onto the board as they would have in any other circumstance.

> A newly elected director has the responsibility to come down the learning curve as rapidly as possible and to do so, you can't be shy.

How should a newly elected director approach getting up-to-speed in the role?

Milchovich: I think a newly elected director has the responsibility to come down the learning curve as rapidly as possible and to do so, you can't be shy. I have found it very beneficial to do extensive reading and then to meet with members of management to get acquainted and to gain an understanding of the business, how it operates, and strategically what management is trying to accomplish. It is a must to meet with other members of the board to benefit from their experience and to gain their perspective.

As part of this knowledge-gathering process, when is it appropriate for a new board member to begin engaging with shareholders?

Milchovich: One of my guiding principles is that the board must be a highly functional independent governing body and that management must run the company. Management should be able to credibly engage and satisfy most, if not all, shareholder needs. However, in today's governance world, there can be a role for directors with shareholders, but I believe that must be carefully coordinated with management.

What would you do if a shareholder reached out to you as a member of the board?

Milchovich: The first thing I would do is listen and ask questions to learn as much as possible about the shareholder needs. Second, I would discuss my perception of the shareholder need with management. Finally, I would collaborate with management and expect to develop a plan of action to address the shareholder need.

As we discussed earlier, you were nominated to the board of Dow Chemical by Third Point. It's not the traditional route to joining a board. Does that change the responsibility of a director in terms of shareholder engagement?

Milchovich: On January 1, 2015, my relationship with Third Point changed because my tenure as a Dow director began and as such I am legally obligated to behave consistent with a very specific set of disclosure requirements. Dow, Third Point, and I thoroughly understand this.

> "Management should be able to credibly engage and satisfy most, if not all, shareholder needs.

The theme of this issue is performance. You have been involved in a number of companies that rely on natural resources that may be vulnerable to external price volatility, causing large fluctuations in revenue and profitability. As a director and an executive, how do you assess a company's performance with that sort of uncertainty?

Milchovich: I haven't seen a business yet that doesn't have some form of cyclicality that it must be managed. When I hear people talk about the new normal, sometimes I chuckle because I've never seen a business situation that didn't present us with some level of surprise. We must plan, however, any good business plan includes scenario planning. We have to do that so that we don't overextend ourselves and get into trouble because we acted on the wrong scenario.

> When I hear people talk about the new normal, sometimes I chuckle because I've never seen a business situation that didn't present us with some level of surprise.

What does scenario planning look like?

Milchovich: For example, the oil business has been a boom/bust business for as long as I can remember, and I think it's probably likely that it's going to continue that way. At Foster Wheeler, we served that industry. We looked at our business plans, and we always did scenario planning with the most-likely case, the upside case, and a downside case. Thinking about those cases impacted the choices we made.

How do you view performance in light of uncertain external factors?

Milchovich: I think the best you can do is pick a set of metrics that compare against the most representative peer group. That's what we've always tried to do. It's what we try to do in the businesses that I'm involved with today. It's an imperfect science, but in my view, it needs to be done.

How does that play into compensating executives for their performance?

Milchovich: When we are setting compensation structure for management, we must always keep in mind how shareholders are likely to be doing at various points in the business cycle. If management is doing well in terms of compensation and shareholders aren't in terms of returns regardless of the reasons, my experience would suggest that we are asking for trouble.

Shifting focus from executives to directors, there's been a lot of talk about how to evaluate a board and the performance of the individual directors. What can boards do to ensure each director is contributing? What would you say is the best way to gauge whether a director is performing well?

Milchovich: When I think back over all my board experience, the relative quality of all board members has always been known and understood. If the situation is such that the performance of one or more directors needs to be addressed, then that needs to be dealt with candidly and respectfully with the annual evaluations, direct counseling from the lead director, or some other process that the full board thinks is appropriate. Boards must have the willingness to deal with performance.

What would you say are some of the characteristics of an "additive" director?

Milchovich: Directors today must have a strong work ethic, very sound judgment, and courage. To expand on the characteristic of courage, directors must be willing to ask the difficult questions, the courage to say no when it may not be easy to do so, and courage to challenge management when it may be awkward to do so. Our duty is to become an excellent governing body and doing so is not always comfortable or easy.

> " If management is doing well in terms of compensation and shareholders aren't in terms of returns regardless of the reasons, my experience would suggest that we are asking for trouble.

There is continued pressure by certain shareholders about splitting the roles of CEO and chairman. As former CEO/chairman of Foster Wheeler, and considering your current role as lead director of Nucor, which also has a CEO/chair, what are your opinions on splitting these roles?

Milchovich: Today this issue is getting a tremendous amount of attention in terms of governance and I don't happen to agree with the focus. In my opinion, the focus needs to be on behavior much more than structure. In other words, I have seen both structures work very well and not work so well because of the behavior of the Chairman, the CEO, the Lead Director, and/or the other board members.

As the lead director at Nucor, you experience that relationship differently than as chairman. How have you seen that dynamic work?

Milchovich: In the situation at Nucor today, we have a combined CEO/chair role. We have an outstanding chairman and CEO in John Ferriola. John behaves exactly the way shareholders would want to see him behave, and I believe that I'm behaving as lead director exactly the way a lead director should behave. What it comes down to is behavior more than structure. I think you can have separate roles, but if you have a different chairman than the CEO and the behavior of the chairman and CEO is not what it needs to be, you'll still not have the kind of governance that you want.

C·S +

*Read more interviews with experts in the executive compensation field at **csuiteinsight.com/category/interviews**.*

Any final words of wisdom for us?

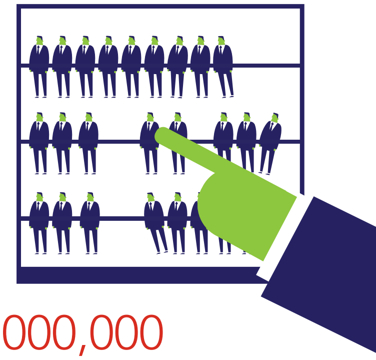
Milchovich: I believe that we are experiencing tremendous change in the public company governance environment today mainly if not exclusively due to the dramatic increase in shareholder activism. While I think this has created a high degree of anxiety in many board rooms and while I'm sure some situations can be questioned in terms of the long-term value that is being created, I think the aggregate impact is positive in terms of "raising the bar" regarding performance standards. In my view, the only way to establish and maintain autonomy is to perform and that is where our focus should be. CS

> Our duty is to become an excellent governing body and doing so is not always comfortable or easy.

Equilar 200 CEO Pay Rankings

Equilar and *The New York Times* recently collaborated to bring readers the Equilar 200 Highest Paid CEO Pay Rankings, which looks at the highest paid chief executives at public U.S. companies with a minimum value of $1 billion in market capitalization. CEO pay calculations included salary, cash bonus, all other compensation, and stock and option awards. With information on 200 CEOs, the rankings offer plenty of data to analyze. Here are a few interesting data points we pulled along the way.

Adding Value

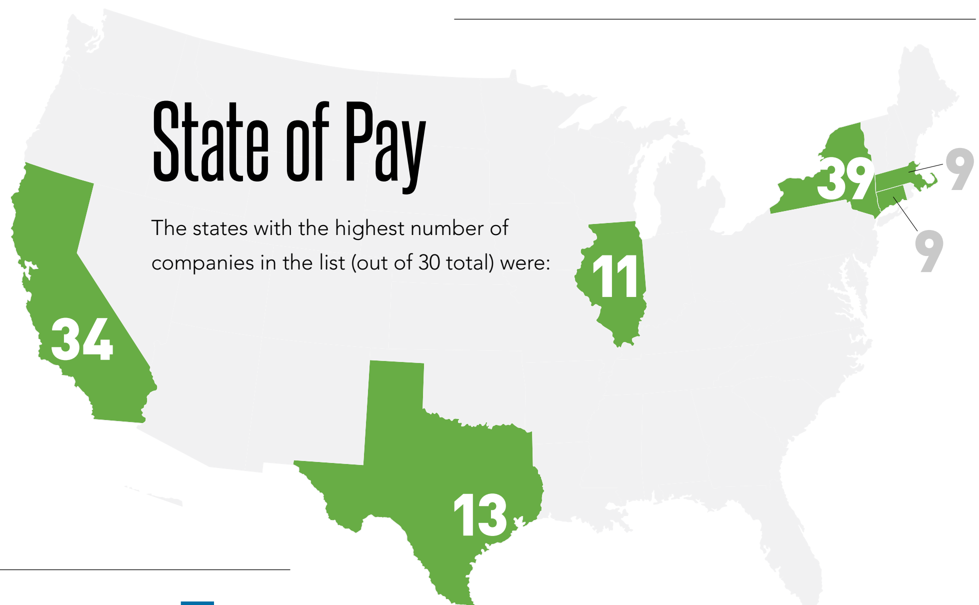


The cumulative value for the 201 companies, measured by market capitalization as of their most recent fiscal year end, was

$10,525,900,000,000

State of Pay

The states with the highest number of companies in the list (out of 30 total) were:

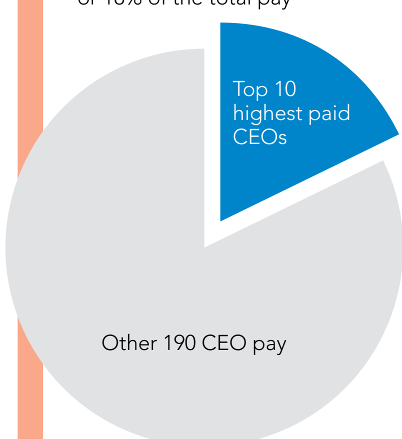


View from the Top

The 10 highest paid individuals accounted for

$834,737,414

or 18% of the total pay



C·S +

To see the full Equilar 200 Highest Paid CEO Pay Rankings, visit ***Equilar.com/nytimes200***.

Cumulative Compensation

Total pay for all 200 CEOs was

$4,520,341,803

average: $22,601,709

median: $17,581,258

$EYMOUR CASH

"Seymour's Board Skills"

C-SUITE MAGAZINE Performance Issue Vol 2, Issue 1 2015