

# CSUITE

INSIGHT

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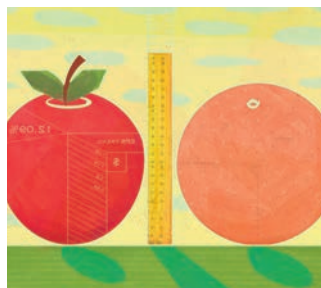


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*by Aaron C. Boyd*



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C-SuiteInsight is published by

**EQUILAR**®

1100 Marshall St.  
Redwood City, CA 94063  
Phone: (650) 241-6600  
[www.equilar.com](http://www.equilar.com)

Send address changes and circulation inquiries  
to the above address.

Publication Management

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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.


## PERFORMANCE

It's that time of year again and we are excited to welcome all of our 2014 Equilar Executive Compensation Summit attendees to San Diego. I look forward to speaking with each of you. I'd like to take this opportunity to thank our sponsors and partners who have helped make this annual event the best in the industry.

The relationship between corporate governance and performance is never more scrutinized than in the midst of proxy season. Discussion of performance permeates all levels in the governance world, from organizational performance to board and director effectiveness. In this issue of *C-SUITE Insight*, we explore these various aspects of performance with top experts in the field.

Our lineup of feature interviews includes Lydia Beebe, Chief Governance Officer and Corporate Secretary at Chevron, who shares her thoughts on her position in the chief governance role and on how the Chevron board evaluates its own performance. Providing the institutional investor perspective, Glenn Booraem, Controller at Vanguard, discusses the link between pay and performance and what Vanguard is looking for when it engages with companies. Additionally, Mary Ann Cloyd, the leader of PwC's Center for Board Governance, provides insight on how boards view performance and who is responsible for addressing underperforming directors.

To further delve into the topic of performance, in our "Ask the Experts" feature, we've compiled commentary from a number of leading professionals on the latest trends in the use of performance metrics. Even Seymour Cash is eager to talk performance—in his own unique way, of course.

We truly appreciate the time and contributions from all of the individuals who are featured in this publication. The compilation of content in this issue sets the tone for the rich dialogue that will be had at Summit this year. I hope to see many of you in San Diego. Please enjoy and feel free to contact me with your feedback. 

A handwritten signature in black ink, appearing to read "David Chun". The signature is fluid and cursive.

David Chun  
CEO and Founder, Equilar  
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FEATURE

The

MEASURE

of

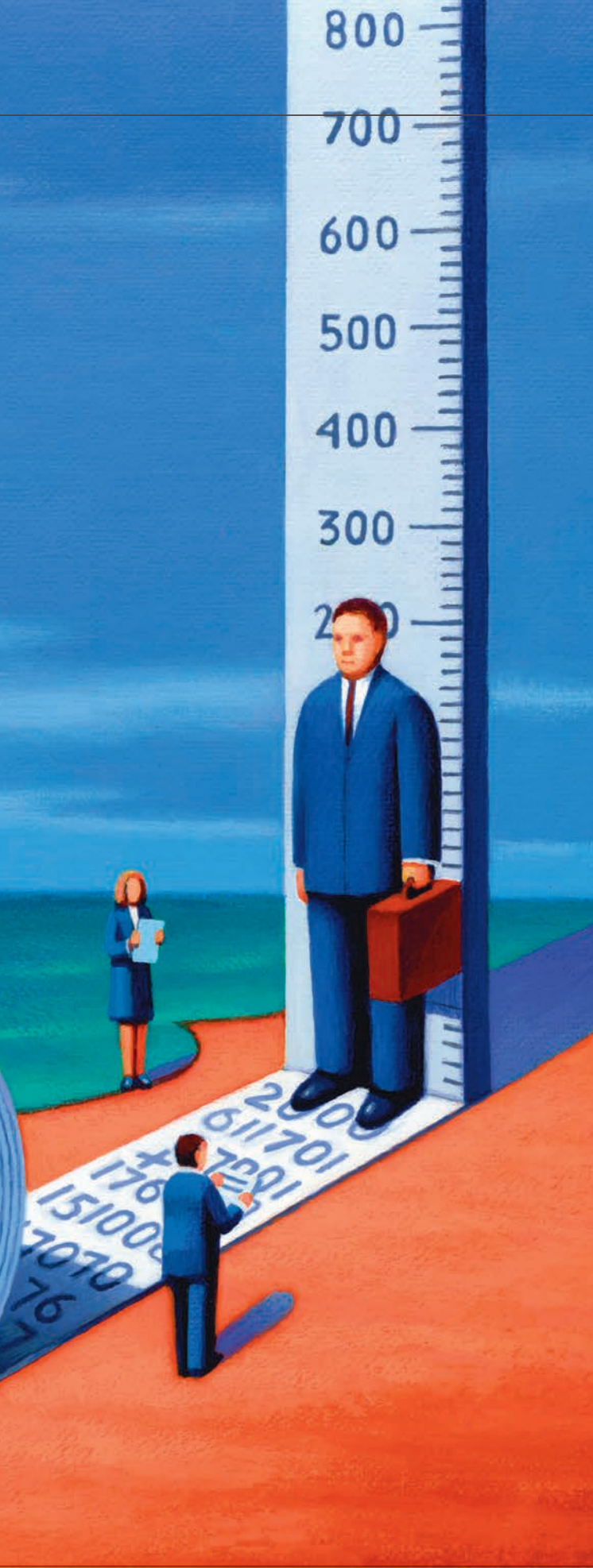
SUCCESS

Asking  
the Right  
Questions  
to Gauge  
Performance

BY AARON C. BOYD







**O**n the last page of this issue of *C-SUITE Insight*, Seymour Cash is presented with the task of measuring performance. Seymour's perspective is one that, of course, is unique to him. Without giving it away, his responsibility to determine how he and the company performed over the year is a large part of the job for CEOs and boards of directors. Yet, like it is for Seymour, figuring out the best way to measure company success and the effectiveness of an executive remains a difficult proposition. The process of gathering information and conducting a thorough analysis must come before any conclusions can be drawn. So how does one go about this process effectively? To tackle the challenge of measuring performance, we need to start with the right questions.

#### WHY DOES MEASURING PERFORMANCE MATTER?

Measuring performance is something done throughout an organization. Products must be tested, strategies evaluated, investments analyzed—all in the pursuit of identifying what is working and what needs improvement. In most areas, the objectives are clear, and determining success relies on the obvious. However, the further up the organizational ladder you go, characterizing the performance of an employee or a broad strategy becomes less black and white.

At the top of the organization, evaluating the impact of the chief executive and the board members can identify multiple shades of gray. A direct link between the actions of a CEO and the value created for shareholders may not always be apparent as important skills, such as leadership and motivation, are not quantifiable but, nonetheless, are important in creating a high-functioning organization. This dilemma is doubly difficult for directors as much of what they do is behind the scenes, and their impact is even harder to quantify.

Despite the difficulty of assessing performance, evaluating top executives and directors is of the utmost importance as they shape the organization in ways that can result in billions

## THE FURTHER UP THE ORGANIZATIONAL LADDER YOU GO, CHARACTERIZING THE PERFORMANCE OF AN EMPLOYEE OR A BROAD STRATEGY BECOMES LESS BLACK AND WHITE.

of dollars in gains or losses for shareholders. Think of the decisions made by Apple's board to bring back Steve Jobs as CEO and the impact that had on the company's stock in the ensuing decade. Think of the decisions made by Jeff Bezos to focus on expanding Amazon's product offerings beyond books instead of searching for ways to increase margins. On the other end of the spectrum, think of the decisions made by Lehman Brothers' executives to continue pursuing a highly risky and leveraged investment portfolio. Each one of the decisions mentioned did not produce immediate success and carried initial signs that suggested an outcome different than what occurred. Measuring performance in the wrong way with the wrong perspective led many people to incorrectly assign success or failure, causing some to lose out on billions of dollars. This makes using the right definition and measurement of performance essential.

### WHAT FACTORS DEFINE PERFORMANCE?

The difficulty in measuring performance can vary depending on the circumstances and what is being evaluated. The challenge of determining what works and what does not is not an issue faced only by corporations.

The NBA just crowned its champion after an 82-game season and four rounds of head-to-head competition. It is clear who won and who lost, which team had the best season and which had the worst season. Even though it is clear which team holds the championship trophy, other fan bases may have found that their teams outperformed expectations and, despite not winning it all, the season is still considered a success. In many respects, this is similar

to the position companies are in with their shareholders. Ultimately, investors want the highest return on their dollars as possible, but most will take an outperformance of expectations as a sign of true success and affirmation that the leadership team made the right moves.

Unlike an NBA team with a clear path to declaring victory, a company needs to identify objectives equal to good performance. What factors a company specifically uses to define success allows the company to figure out how to measure success.

In the long term, consensus suggests that the return to the firm's owners is what matters the most. In a 2013 study of S&P 1500 companies, Equilar found that 48% of companies use Total Shareholder Return (TSR) as a metric to determine incentive payouts in long-term plans. This figure has grown over the years as shareholders push companies to align pay with their long-term interest of maximizing their investments.

The long-term view is helpful, but long term means different things to different companies. For a technology company, the long

term may be as short as a year or maybe even months as innovations make many technologies almost obsolete once released. Conversely, an oil company may not see returns on their investments for a decade or more. The famous John Maynard Keynes quote that "in the long run we're all dead" points to the obviousness of an end result without a clear understanding of what happened to get there.

A company must succeed in the short term to get to the long term. If a board waits until it has confirmation that its CEO is not the right person to bring that about, it may be too late. That is why companies set up goals that will measure performance over a short time frame.

TSR, although popular, is not without its detractors. Considering the different outside factors that can go into a stock price, some argue that other metrics are necessary to truly determine the performance of an executive.

The same study mentioned earlier also looked at annual incentive plans and found that earnings per share and net income are included in 36% of the yearly plans with revenue being used in 27%. In fact, incentive plans among companies



in the S&P 1500 have an average of 1.8 metrics per plan. Over 15% of companies use at least three metrics in their plans, showing that most companies believe multiple viewpoints must be taken to correctly evaluate success.

What is particularly noteworthy about the study's findings is that 15% of companies use non-financial metrics to determine the annual incentive plan payout. Most companies recognize that not every positive impact a CEO makes on a company can be measured in the financial statements. Metrics such as safety and customer satisfaction may be vital to a company as it seeks to grow despite not providing a clear link to the bottom line. *The Wall Street Journal* published a story in April about the growing popularity of using a chief executive's efforts in succession planning as an appropriate focus for an executive to ensure long-term growth.

With all these choices in metrics, determining the right focus is paramount to guiding a company to success. Choosing the right measurements is an arduous task that requires discernment and a keen understanding of what really influences a company's success. Ensuring that the right people are making these choices is another important part of the process.

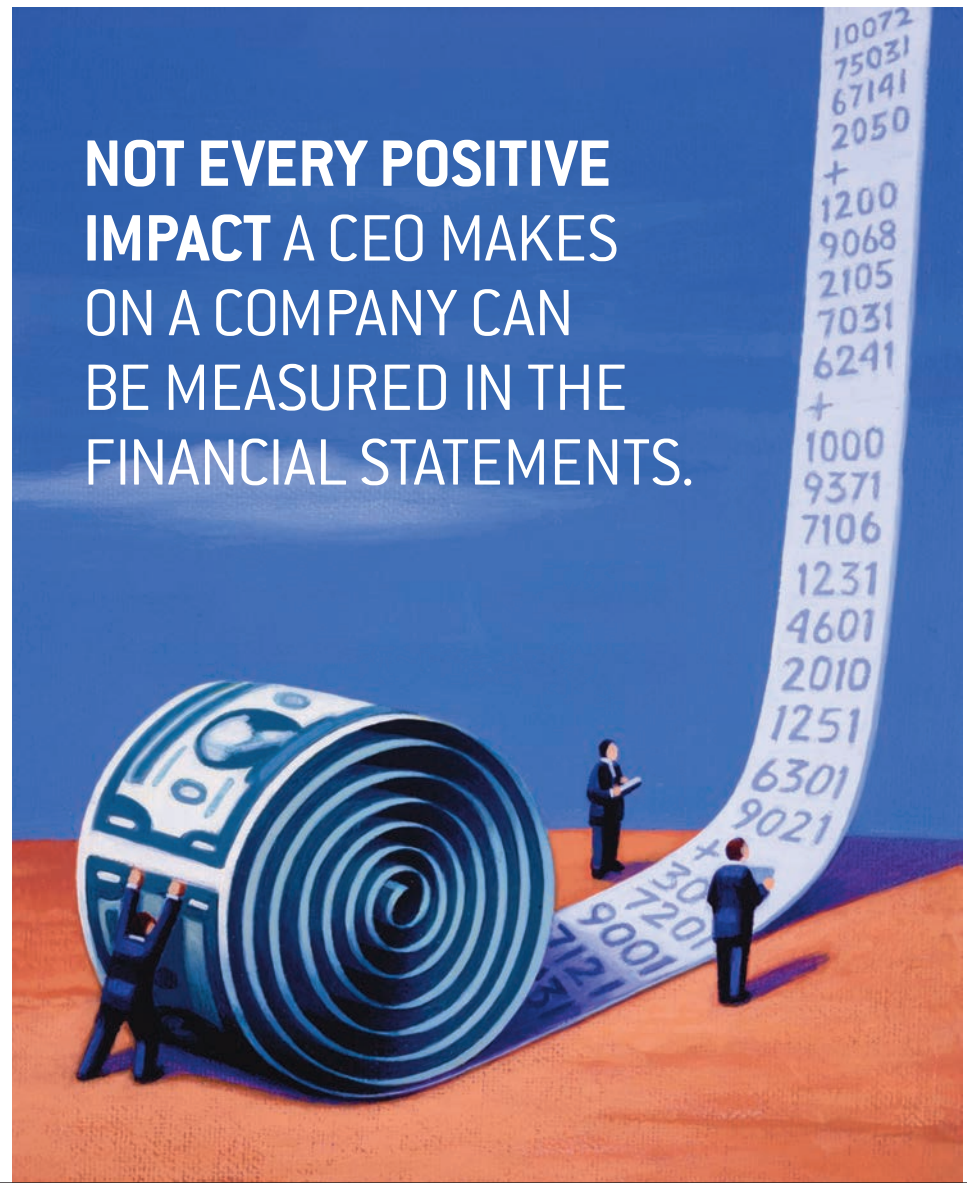
#### WHO SHOULD BE INVOLVED IN MEASURING PERFORMANCE?

The political world thrives on making judgments quickly and emphatically.

What is truly impressive about politics is decision-makers' ability to decide that something is both an accomplishment and a failure at the same time. Pick any issue, and you can find people who will claim it to be an unbridled success and others who view it as an unmitigated disaster with all views in between. This contradiction is one faced by many corporations. Public corporations can have a diverse set of shareholders

that have differing opinions on the right direction for the company. Like with the government, there is no shortage of analysts, reporters, bloggers, and people in the general public who are happy to weigh in with their opinions. In the end, a company may not please everyone, but executing on the stated objectives—such as meeting earnings targets—will typically keep the majority viewing things in a positive light. So who decides the right objectives?

The role of setting metrics has typically been left to the CEO and top executives with approval from the compensation committee. As individuals who are involved in the day-to-day business, the managers of the company are



**NOT EVERY POSITIVE  
IMPACT A CEO MAKES  
ON A COMPANY CAN  
BE MEASURED IN THE  
FINANCIAL STATEMENTS.**

in the best position to determine which of the many possible metrics provide the strongest correlation to long-term success. The practice of executives and directors deciding on metrics is not new. What has changed over the past few years is the involvement of shareholders in the compensation-setting process.

Say on Pay has had many effects on companies with perhaps the most notable being increased engagement with shareholders. More than ever, companies are discussing their compensation structures with shareholders and listening to feedback. There are clear examples of companies making changes to their compensation plans in response to feedback from shareholders. For example, Boston Properties included an entire section in the most recent proxy discussing specific feedback received from investors and how the company responded. In this issue of *C-SUITE Insight*, Equilar's Innovation in CD&A Design Report showed the growing number of companies that described their engagement with investors from 2009 to 2013. This year continues to see examples of more proxies where a company lists its response to shareholder feedback. In fact, in an analysis of companies

that failed their 2012 Say on Pay votes, the most popular action taken by companies in response to investors voting down the proposal was a change in the type of metrics or the weighting of the metrics for the incentive plan. Clearly, investors' opinions on metrics are being heard and taken seriously.

Executives will always have the most knowledge of what is going on in the firm and will have access to more information than investors. That said, shareholders have access to more and more information about companies, resulting in more informed opinions on the right measurements. There may be some concern about having too many people involved in the goal-setting process, but it seems clear that the responsibility of evaluating performance is being done with a wider amount of feedback than ever before. It will be interesting to see how the involvement of outside parties continues to change over the next few years.

#### WHAT ROLE DOES DISCRETION PLAY?

One issue that comes up with incentive plans is the desire for discretion by the compensation committee to adjust a

payout based on circumstances not captured in the pre-determined formula. Issues like an unexpected rise in inputs or a macroeconomic climate pulling back consumer spending can cause the performance of a company to lag despite strong performances from the executives. It can also be the case that a surging market can cause a company to see strong returns without needing a strong effort from its leaders. In both cases, compensation committees would like to have discretion to adjust the payout for what they view as appropriate.

Investors have taken issue with discretion, specifically positive discretion, where the board increases the amount a CEO receives above and beyond what the formula dictated. The criticism around positive discretion centers on the perception that a board will make excuses for the CEO while also not providing the kind of accountability that the plan was meant for in the first place. Positive discretion is an area of incentive plans that has all but disappeared for the public company CEO.

The elimination of positive discretion leaves the onus on generating an appropriate payout on the design of the plan. Using the right metrics and weighing them properly becomes all the more important. Thus, the setting of goals and deciding on the right indicators becomes paramount to correctly aligning pay and performance.

Based on the process for goal setting that has been discussed, measuring performance is one of the most difficult and most important duties of a board and the executives. Endless debate about what provides the best indication for present and future company success will be had, but ultimately, it is up to the top leaders of a company to determine the strategy and measure themselves against it. The marketplace will bear out who chose wisely and who chose poorly, but in the interim, finding success means asking the right questions. **C**

SHAREHOLDERS HAVE ACCESS TO MORE AND MORE INFORMATION ABOUT COMPANIES, RESULTING IN **MORE INFORMED OPINIONS** ON THE RIGHT MEASUREMENTS.



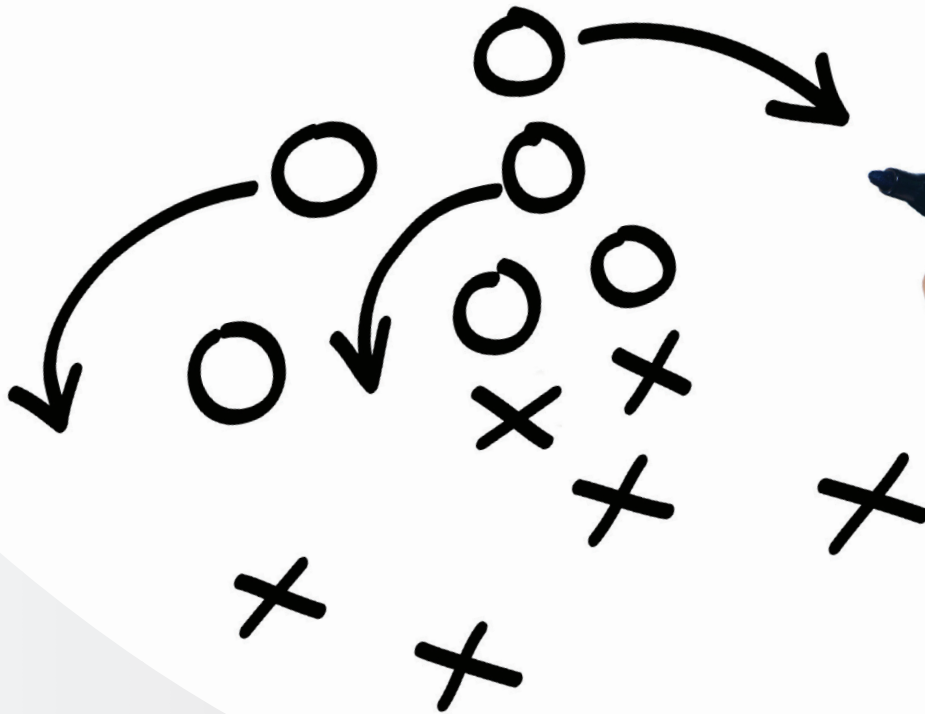
# Why be a sitting duck for a proxy fight?

Make a game plan for shareholder activism with:

- **A vulnerability assessment.** Identify issues that could attract activist interest and tactics that may be used against you.
- **Preparedness training.** Be ready to take quick action should an activist situation arise.
- **Stakeholder engagement.** Create a plan to rally support among current shareholders and influential proxy advisory firms.

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FEATURE

# Is it Time to Your Board? PART 2

Analyze,  
Audit  
Appraise,  
or maybe  
Assess.

**BOARDROOM  
REALITIES**



In the last issue, I promised to take a more in-depth look into board evaluations as a viable tool to address the growing trend of refreshing one's board. Previously, we looked at term limits and mandatory retirement age requirements for directors. It is universally recognized that neither tool provides the right solution for evaluating specific directors' performance or a perfect method for refreshing one's board. This was particularly clear in the results of the 2014 "What Directors Think" Board Survey that the NYSE Governance Services/Corporate Board Member conducts jointly with Spencer Stuart. When directors were asked, "Which of the following do you believe are effective tools to encourage board refreshing?," approximately 25% identified term limits, 49% chose mandatory age limits, and a whopping 85% selected board evaluations as the tool of choice. To me, those results are very telling with regard to how sitting directors feel about the potential value of board evaluations/assessments.

Now, before a contingent of naysayers targets me as someone who is making board refreshment a bigger issue than it really is, let me share this other factoid that suggests that board refreshment is a topic that is gaining ground. In our board survey, we asked directors, "How important is it for good governance to periodically refresh the board with new blood?" More than two-thirds (67%) of directors told us that it was important or critically important, with another 26% saying it was somewhat important. That means only 7% of current board members thought that board refreshing was not important. Perhaps even greater evidence of this trend is ISS' recent declaration that board tenure of more than nine years will be considered "excessive" under its newly released QuickScore 2.0. So in summarizing, board members think board refreshment is important and so do proxy advisory firms and activist shareholders. I'd say it's a trend!

So now, having established that refreshment is important and that evaluations are a prime tool to encourage good turnover, how do we improve the vast majority of boards that already do take part in some form of evaluation? Let's start by admitting that there are board evaluations, and then there are effective board evaluations that actually assess board and director performance. What's the difference? Effective evaluations or assessments of board members have these common traits:

1. Evaluations are periodically (at least once every three years, preferably every other) conducted by a third-party advisor. Having a member of the board

or even the general counsel facilitate the evaluation can cause a conflict and skew the results, especially if the internal facilitator is part of the problem. Because annual board evaluations are required by the NYSE and strongly encouraged by NASDAQ, they may seem to crop up very quickly. It's okay to have an internal evaluation plan in the off years to meet the letter of the law, but don't mistake the value of an internal evaluation for the same as an independent outside evaluation.

2. The evaluation process should include a peer-to-peer component of some kind. Nothing changes behavior like a peer-to-peer review, and nobody knows better the directors who aren't contributing than their fellow directors. That's evidenced in the PwC Annual Corporate Directors Survey, which reports that 33% of board members feel there are directors on their boards who should be replaced.
3. The final trait for distinguishing effective evaluations is the presence of board leadership. Simply put, just the knowledge that there is a leader on the board who will actually do something constructive with the evaluation information will increase the effectiveness of the process. All boards are unique, so it doesn't matter whom you choose—outside chairman, lead director, the chair of the nominating/governance committee—you need a strong leader. No board leadership means no meaningful value in the evaluation process. In the end, it isn't about being collegial, it's about doing the job that shareholders elected you to do.

I am not going to address the various evaluation mechanics like interviews versus surveys or outside attorney versus governance expert facilitator because I've seen all different means of orchestrating evaluations work for different boards, and the points I outlined above are more important. Finally, the most important element to successfully refresh your board is being committed to a plan. Make sure your corporate governance guidelines outline your process and periodically review your board's skill, age, and contribution mix. In the end, the board should be run like the business it oversees. So have a plan and the necessary strategies to get the job done right. **C**



*TK Kerstetter is the chairman of NYSE Governance Services – Corporate Board Member and is a second generation pioneer of governance thought leadership and board education.*

# Taking in the Full View

The “Four P’s” of Pay for Performance and Why They Matter to Investors.

Increasingly, our clients are asking for our advice about their proxies, in particular the Compensation Discussion and Analysis (CD&A), to help them effectively communicate their compensation stories and pay for performance alignments, thereby improving the odds that the owners of a majority of their shares will support Say on Pay votes.

## HARD DATA ON INVESTOR INFORMATIONAL NEEDS

RR Donnelley is the preeminent global communication services provider. Each year we assist over 1,900 U.S. companies with the design, production, filing, hosting, and distribution of their proxy statements, other regulatory filings, and investor communications. To identify recommendations that hit the mark with the institutional investors who own and vote the majority of our clients' shares, RR Donnelley surveys a broad range of institutional

investors about proxy statements to determine the following:

1. Do they read them?
2. How do they read them?
3. What topics are investors most interested in?
4. How well are companies doing in meeting investors' informational needs?
5. What design and navigational features make the proxy a more useful and digestible resource for investors?

Our research reveals that the top subjects of interest to these investors include:

1. Disclosure of performance metrics
2. Pay for performance alignment
3. Peer group benchmarking

Performance metrics for earning short- and long-term incentives include a variety of stock performance, financial and operating/strategic measures. In evaluating relative performance, investors are simultaneously scrutinizing both the appropriateness and rigor of the performance metrics as well as the appropriateness of the peer group(s) used to benchmark CEO/NEO pay and measure their performance.



Given these concerns, we've identified the "Four P's" of pay for performance: pay, performance, performance metrics, and peers.

In crafting their pay for performance stories, companies generally focus on two primary audiences:

- **INVESTORS:** Interested in understanding the board's pay philosophy and its actual decisions, investors have a demonstrated appetite for clarity and transparency in disclosure of performance metrics, target and actual performance levels, and resultant pay outcomes. Not wishing to substitute their judgment for that of the board, most investors acknowledge the importance of board discretion in making pay decisions. That said, many view discretion skeptically if they believe it is used primarily to justify enhanced pay with the board never exercising negative discretion when it is warranted.
- **PROXY ADVISORS:** Both ISS and Glass Lewis apply a combination of quantitative and qualitative tests in making Say on Pay vote recommendations. While their models differ and their vote recommendations are not in lock step, for both, disclosure of performance metrics is among the key qualitative criteria they examine.

So whether your primary audience is investors, proxy advisors, or both, clarity of disclosure regarding performance metrics is important.

### **DON'T LET THE (VOTE) TAIL WAG THE (COMPENSATION) DOG**

It is problematic for companies to design their compensation plans primarily with investor voting support and proxy advisor recommendations in mind. Companies employing discretionary plans, which do not strictly follow (or disclose) specific performance measures and target performance levels, may be acting in the best interests of their companies and investors. However, since they are not fully appeasing investors' appetites for specific disclosures of the pay process and metrics, they face a greater hurdle in demonstrating how the pay outcomes are appropriately aligned with company and shareholder performance.

### **KEEP IT SIMPLE AND CONSISTENT**


Executive compensation programs have, over time, become complex, multilayered and highly technical. In addition, on several occasions over the past decade, the SEC has required expanded disclosure of compensation

programs. As a result, many proxy statements have become lengthier—and often mind-numbing—documents. But more disclosure to satisfy regulatory requirements isn't necessarily clearer disclosure which helps investors better understand these programs.

The Compensation Discussion and Analysis requirement (emphasis on "analysis") was meant to add some of the important "why" to the existing "what" of compensation programs. Over the past six years, many companies have started doing a better job of clearly communicating the essence of their programs and why they deserve shareholder support. When this does not occur, frequently a lack of understanding of key aspects of pay programs drives negative Say on Pay voting results, not just poor performance relative to pay levels. Thus, clarity in disclosure is critical.

### **EXPLAIN HOW PAY SUPPORTS STRATEGY**

Even prior to the CD&A requirement, many investors were telling companies, "We know that executive compensation is a complicated yet important topic. We're not compensation experts, and we don't want to micro-manage the company or second-guess the board, yet we need to exercise oversight somehow. Our big question is, how does pay support strategy and efforts to deliver sustainable shareholder performance?" Some companies are articulating how pay supports strategy very clearly. When investors understand the big picture, they're less likely to get side-tracked by minutia.

In addition, it is important to guard against sending mixed messages. While many institutional investors maintain separate groups for investing versus voting, increasingly they are cross-checking and reviewing all the company's disclosures for consistency. If you've told investors in your investor-relations messaging, "this is what will drive the success of our company and efforts to grow shareholder value, and this is how you should track our progress," then something at least approximating these "IR value-drivers" should appear among the CEO performance metrics. If they don't, investors understandably may question why this is the case—leading to further skepticism not only about the executive compensation process and pay outcomes, but also about the board's ability to provide effective oversight. 



*Ronald Schneider is the Director of Corporate Governance Services at RR Donnelley. Over the past three decades, Ron has advised public companies of all sizes, industries, and stages of growth facing investor activism, as well as challenging and sensitive proxy solicitations involving corporate governance, compensation, and control issues.*

## ASK THE EXPERTS

As a result of increased shareholder engagements, have you seen boards change the definition of performance metrics?



M. Shân Atkins

The Pep Boys – Manny, Moe & Jack  
Compensation Committee Chair



I have definitely seen a heightened focus over the past few years on making sure incentive metrics are appropriate to the industry and a particular company's situation rather than a simplistic focus on EPS, as was more common in the past. However, I'm not sure I'd attribute that only to heightened shareholder engagement. I believe it's just a continuation of what good boards have been trying to do for a long time: motivate management to do the things that can drive long-term shareholder value through intelligently designed incentive programs that reward achievement of business results and/or inputs. This makes a real difference.

I have served on public boards in both the United States and Canada for the past decade, and I would say that in Canada, there has been more systematic conversation between shareholders and major issuers on these issues through an organization called the Canadian

Coalition for Good Governance (CCGG). CCGG comprises all the major institutional investors in the country, and they have been meeting with every major Canadian public company over the past five years. A major focus of those conversations has been executive compensation—how a company's incentive compensation programs are designed and why that makes sense for that business.

In the U.S., these conversations have been more bilateral and intermittent, especially in the mid-cap space. Overall, I'd say that although there has been some expressed shareholder interest in the U.S. in discussing this subject, the greater impetus for change has come from boards themselves trying to do the right thing.





**Eric Marquardt**  
Pay Governance LLC  
Partner



Say on Pay and the appointment of an independent board chairman were primary focuses of an increasing level of shareholder engagement activity in 2013. Much of this activity has come from proactive communication by companies, beyond the annual meeting, to explain the rationale behind their executive compensation plans. Poor Say on Pay support in the prior year(s) has also led to more reactive engagement of shareholders.

The advisory Say on Pay vote mandated by Dodd-Frank has been a primary cause of the increased focus on performance in U.S. public company executive pay programs. The percentage of companies with LTI performance plans has risen from roughly 30% prior to Say on Pay to almost 70% today. Shareholder returns are now the primary measure in about half of these LTI performance plans. This is a positive and necessary trend given the corresponding decline in the prevalence of stock options, from almost 90% in 2000, to less than 50% today. Options also required positive shareholder returns to have any value.

Most companies, however, continue to design pay programs that are also in the best interests of the company, strongly aligned to the business strategy, and supportive of talent needs. Shareholder returns are the ultimate arbiter of a company's success, but in the majority of executive performance plans, shareholder return is just one of a portfolio of metrics including profitability, cash flow, and capital returns—all key metrics in the overall business strategy. Eliminating these other measures in favor of a single shareholder return measure, either absolute or relative, can produce an ineffective homogenization of incentive pay plans and will very likely have negative consequences on executive motivation and encourage excessive risk taking.

Eric Marquardt advises a wide variety of leading public and private companies on executive and director compensation matters and, in recent years, he has advised many Fortune-ranked companies and their boards.

Before joining Pay Governance, Marquardt spent 11 years as a principal with Towers Watson. Prior to that time, Marquardt served as the Director of Executive Compensation for Merck & Co and managed the Silicon Valley (Santa Clara, CA) office of another leading consulting firm.

Marquardt earned a Bachelor of Arts degree in Business Administration from the University of Michigan and a Master of Arts degree in Industrial Relations from Michigan State University. He has authored chapters in two recently published books on executive pay. Additionally, Marquardt teaches courses in leadership and human resource strategy at Washington University in St. Louis.

M. Shân Atkins is a professional corporate director and co-founder of Chetrum Capital LLC, a Chicago-area private investment firm where she presently serves as Managing Director. From 1996 to 2001, she was a senior executive at Sears, Roebuck, & Co., where she led a \$2.5 billion hardlines division to record results. Previously, Atkins was a partner and leader in the global consumer and retail practice of Bain & Company, the international management consultancy. Atkins began her career in public accounting with Price Waterhouse in Toronto. She holds CPA (Illinois) and Chartered Accountant (Ontario) designations, and is an alumna of Harvard Business School and Queen's University at Kingston, Ontario.

Atkins presently serves on four corporate boards: SpartanNash Company (NASDAQ:SPTN), Tim Hortons (NYSE:THI), The Pep Boys – Manny, Moe & Jack (NYSE: PBY), and True Value Hardware (private, member-owned co-op). Atkins currently chairs the compensation committee at The Pep Boys – Manny, Moe & Jack and the audit committee of True Value Hardware. She is a prior board member of Shoppers Drug Mart Corporation and Chapters, Inc., two leading Canadian retailers, as well as Newgistics, a PE-backed company in the U.S. logistics industry. Atkins also presently serves as an independent appointee of the Blue Cross & Blue Shield Association to the board committee overseeing plan financial health and brand standards.





Jonathan Foster

Current Capital LLC  
Founder & Managing Director



In recent years, increased pressure from institutional investors, activists, and the Say on Pay vote have encouraged an enhanced focus by boards on tying a significant percentage of executive compensation to various metrics. For example, more than 50% of the companies that failed their Say on Pay votes in 2012 changed their performance metrics. Benchmarks can include income statement items such as EBITDA, efficiency items such as return-on-capital, and stock-price-driven items such as a company's stock price performance.

One significant change in metrics has been the addition of relative performance metrics. For example, an analysis of the 2013 compensation programs of some 300 public companies done by a major compensation consultant showed that Total Shareholder Return (TSR—predominately indexed to peer groups) was used in 58% of the performance-based, long-term incentive plans. In 2012, 61% of the CEOs in the Standard & Poor's 1500 and about 40% of the companies in the Fortune 100 had TSR-based incentive compensation. Over the past three years, the use of TSR has been growing at about 15% per year. This has been driven by an increasing view that management should have a significant incentive to outperform a reasonable set of industry peers, recognizing that strong performance is that which exceeds median peer group performance. This mitigates the effects of a strong environment where all companies benefit.

Jonathan Foster is the Founder and Managing Director of Current Capital LLC, a private equity investing and management services firm. Foster is an experienced corporate board member, including serving as a director at Masonite International Corp., Lear Corp., Chemtura Corp., and Berry Plastics Group. He is the Chair of the Audit Committee at Masonite International, previously served as Chair of the Compensation Committee for Chemtura, and serves on various committees among his other boards. Foster is also a Trustee of the New York Power Authority.

From 2007 until 2008, Foster served as a Managing Director and Co-Head of Diversified Industrials and Services at Wachovia Securities. From 2005 until 2007, he served as Executive Vice President—Finance and Business Development of Revolution LLC. From 2002 until 2004, Foster was a Managing Director of The Cypress Group, a private equity investment firm and from 2001 until 2002, he served as a Senior Managing Director and Head of Industrial Products and Services Mergers & Acquisitions at Bear Stearns & Co. From 1999 until 2000, he served as the Executive Vice President, Chief Operating Officer, and Chief Financial Officer of Toysrus.com, Inc. Previously, he was with Lazard, primarily in mergers and acquisitions, for over 10 years, including as a Managing Director.

Foster has a bachelor's degree in Accounting from Emory University, a master's degree in Accounting & Finance from the London School of Economics, and has attended the Executive Education Program at Harvard Business School.

Kenneth Bertsch

CamberView  
Partners LLC  
Partner



As is commonplace to note, Say on Pay has prompted substantially increased engagement between shareholders and their portfolio companies. As part of this, institutional shareholders have stepped up their understanding of compensation. And corporate directors, as well as compensation, governance finance, and IR executives at corporations, have developed a stronger understanding of investor perspectives on pay.

The institutional investor capacity relates, in part, to expanding governance staffs, perhaps most noticeable at large asset managers. But another cause is that companies have become better and more insistent in reaching out. In addition, sophistication at some institutions is promoted by increased integration of investment and governance staff.

As a generalization, institutions do not want to micromanage compensation design and choice of metrics, but they do want comfort that companies are thoughtful in putting metrics in place that relate to the particular company's strategies. Where investors do comment on metrics used, opinions differ, and appropriate performance measures vary depending on industry and other company-specific factors.

I would have some concern on emphasis on Total Shareholder Return (TSR) as a least-common-denominator performance measure, easily understood as a bottom line for all investors, and in some sense, "objective" and transparent. TSR is removed from financial and other measures more directly linked



to company goals. Long-term linking of pay to TSR makes sense as a test and reality check for those outside the company and boardroom, but that does not mean that board compensation committees and their advisors should make it their primary instrumental measurement in incentive pay design.

Kenneth Bertsch joined CamberView in January 2014 with more than three decades of leadership roles in corporate governance. Previously, Bertsch led corporate governance teams at Morgan Stanley Investment Management, Moody's Investors Service Corporate Governance Ratings, and served as Director of Corporate Governance at TIAA-CREF. He most recently served as CEO and President of the Society of Corporate Secretaries and Governance Professionals. Early in his career, he served for 14 years in various capacities at the Investor Responsibility Research Center (a predecessor company of ISS), including as Director of IRRC's Corporate Governance Service and Director of its Social Issues Service.

Bertsch currently serves as a director on the board of the Investor Responsibility Research Center Institute, and has been named one of the 100 most influential leaders in corporate governance by the National Association of Corporate Directors.



Since 2011, most shareholders have been afforded the opportunity to vote on their company's Say on Pay proxy proposal under Dodd-Frank (some companies have opted for a biennial or triennial vote). Results indicate shareholders are overwhelming in favor of the compensation arrangements provided to the CEO and other named executive officers (NEOs).

But these positive results did not occur in a vacuum. Companies that received significant opposition to Say on Pay (defined as 25% to 30% opposition or more) took the opportunity to engage shareholders to understand what's working and ask, "What can we do better?"

Shareholder feedback included the following:

- Consider using more than one performance measure in the annual and/or long-term incentive plan as no single performance measure captures all aspects of performance.
- Use multiyear goals (three years or more) to determine long-term incentive award vesting (as opposed to annual performance metrics).
- Reduce the use of service-based, long-term incentives and adopt performance-vested, long-term awards.
- Eliminate non-performance-based compensation arrangements, such as perquisites, gross-ups, and supplemental pension arrangements.
- Set challenging performance goals (and pay well for achieving them).

In the majority of cases, shareholders did not demand the company adopt a specific type of incentive plan or performance metric. For the most part, institutional investors trust the compensation committee and management to identify the right metrics and to set the bar high enough to be motivating.

Boards have responded positively and improved the design of the incentive plans. There has been a significant increase in the use of performance shares. Also, incentive plans include more shareholder-friendly performance metrics, including relative Total Shareholder Return, return on invested capital, and growth over the prior year's results (including EPS, free cash flow, and revenue).

Another important development is the increased disclosure of the relationship of pay and performance. Several companies now "connect the dots" to show just how pay relates to performance.

So far, this virtuous cycle seems to be working. Shareholders provide principle-based feedback on compensation concerns, and boards of directors adjust compensation practices in a way that best fits the company's needs and culture. In turn, shareholders overwhelmingly support the company's Say on Pay proxy proposal.

Michael S. Kesner is a principal at Deloitte Consulting, LLP. He leads Deloitte's National Compensation Practice and has more than 30 years' experience advising boards of directors on executive compensation, including incentive plan design, pay performance, and corporate governance issues.

## Pearl Meyer & Partners

Mark Rosen

Pearl Meyer & Partners  
Managing Director



There's been a rise in the use of relative shareholder return (TSR) as a metric for aligning executive pay and performance driven by standards used by shareholder advisory firms. While useful, it is more of an outcome-based measure. By defaulting to relative TSR as an incentive measure, many companies miss the opportunity to employ incentive metrics that capture executives' success in driving business strategies and leadership initiatives—key aspects of performance that are critical to the creation of long-term shareholder value.

We have encouraged companies to customize incentive designs to their specific business needs by retaining internal performance metrics (or introducing them if they were not used before), such as operating earnings, EBIDTA or return measures (ROIC/ROE), and using TSR as an additional performance measure or modifier. In such cases, actual incentive payouts under the plan might ultimately be adjusted upward or downward, respectively, based on whether relative TSR is above median, suggesting the targets were set too high, or below median, suggesting the targets were not sufficiently rigorous. Such an approach provides a broader and more sensitive perspective on aligning executive pay with performance.

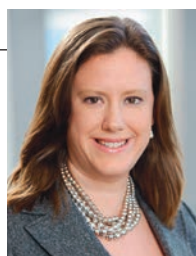
Mark Rosen is a Managing Director and head of the Charlotte office at compensation consultancy Pearl Meyer & Partners. He has consulted on executive and board compensation issues for more than 20 years for a broad range of public companies, as well as tax-exempt organizations and academic institutions. Rosen has extensive experience with benchmarking, retirement plan design, governance issues, and tax and accounting considerations. He can be reached at [mark.rosen@pearlmeier.com](mailto:mark.rosen@pearlmeier.com).



Skadden, Arps, Slate, Meagher & Flom LLP

Erica Schohn

Skadden, Arps, Slate,  
Meagher & Flom LLP, Partner



The definition of "performance metrics" is one of the components of compensation most frequently commented on by shareholders since the adoption of Say on Pay. Common complaints include that the performance metrics are not robust enough, are not sufficiently long-term, or are not significantly varied.

My clients seriously consider the comments received directly from their shareholders and strive to effectively balance the requests of shareholders with what their boards believe, based on experience and intimate knowledge of the company, the best interests are of their companies and those they represent. There are certain shareholder comments that are more easily, and more frequently, addressed. For instance, when companies receive the comment that the goals are not varied enough, my experience is that the boards will act quickly to introduce additional metrics in the following year. In addition, in response to shareholder comments and the comments of proxy advisory firms, most companies now consider Total Shareholder Return (TSR), whether relative or absolute, at least to some extent when measuring long-term performance. However, one difficulty that is not always considered is that the comments of individual shareholders often directly conflict with each other, so even the most responsive companies cannot be responsive to all shareholder comments.

Certainly, there is no one-size-fits-all approach. Shareholders should recognize that companies are more likely to change their metrics in response to individual shareholder feedback when the feedback is tailored to the company rather than simply representative of the shareholder's across-the-board approach.

Erica Schohn's practice focuses on compensation and benefits arrangements in U.S. and cross-border corporate transactions (including mergers and acquisitions, public offerings, and bankruptcy reorganizations), the negotiation of executive employment and severance arrangements, and the drafting and implementation of equity and other compensation programs.

Schohn frequently advises clients on the U.S. Securities and Exchange Commission (SEC) rules governing executive compensation disclosure and corporate governance matters relating to compensation practices. As part of this practice, Schohn is a member of panels and committees comprised of leading government and private- and public-company governance professionals, and she speaks regularly with representatives from the SEC, stock exchanges, institutional investor groups, and proxy advisory firms on the latest issues in corporate governance.

Schohn also regularly advises clients regarding tax planning with respect to compliance with Internal Revenue Code Section 409A and the tax rules relating to deferred compensation, the excise tax on excess parachute payments, and limits on the deductibility of executive compensation.

Schohn received her J.D. from Duke University School of Law (magna cum laude) and her B.A. from Pennsylvania State University (high honors).





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## INTERVIEW WITH **LYDIA BEEBE**



**L**ydia I. Beebe is Corporate Secretary and Chief Governance Officer of Chevron Corporation, a position she has held since 1995. She provides advice and counsel to the board of directors and senior management on corporate governance matters and manages the company's corporate governance function. Beebe also serves as Secretary to the board, the Executive Committee, and the board Nominating and Governance Committee.

Throughout her career, Beebe has been active on many public and non-profit governing boards. In 2003, President George W. Bush appointed her to the board of directors of the Presidio Trust, where she served until 2008. Governor Pete Wilson appointed Beebe to the California Fair Employment and Housing Commission in 1991, where she was Chairperson from 1995 through the end of her term in 1999. In recognition of the accomplishments made during her tenure leading the commission, she was honored as a Civil Rights Hero by the state of California.

Beebe has been named Corporate Secretary of the Year by *Corporate Secretary* magazine and a distinguished alumna by both Golden Gate University and the University of Kansas School of Law. In May 2010, she received the Founder's Award for exceptional business leadership from the Women's Initiative for Self Employment. In 1996, she received the Breakthrough Award from the Professional Business Women of California. In 2012, the San Francisco Business Times inducted her into its "Forever Influential Honor Roll" of the most influential businesswomen in the Bay Area.

Beebe serves on the governing boards of the National Judicial College, Kansas University Endowment Association, Kansas University Law Alumni, the National Association of Corporate Directors of Northern California, and the San Francisco Symphony. She is an advisory board member of both the Arthur and Toni Rembe Rock Center for Corporate Governance and the John L. Weinberg Center for Corporate Governance. She also serves on the board of directors of the Chevron Employees Political Action Committee.

Previously Beebe served on the governing boards of the Council of Institutional Investors, the Professional Business Women of California, the Society of Corporate Secretaries and Governance Professionals, Golden Gate University, and the San Francisco Municipal Fiscal Advisory Committee.

She earned a bachelor's degree in journalism in 1974 and a J.D. law degree in 1977, both from the University of Kansas. She earned an MBA in taxation from Golden Gate University in 1980.



**C-Suite Insight:** Let's start by discussing your role at Chevron, in particular, your role as Chief Governance Officer. The role is not as prevalent as other chief titles among companies. What has this role meant for Chevron, and how do you see your role evolving?

**Beebe:** I was elected Corporate Secretary in 1995 but was not elected to be the Chief Governance Officer until, I believe it was 2003. I think that was an evolution at Chevron of recognizing that the title of Corporate Secretary didn't convey appropriately the breadth of the role and responsibility and the importance that Chevron placed on having strong governance. After Enron and WorldCom and the passage of Sarbanes-Oxley, there was a lot more focus on governance, and I think it was in recognition of the importance of that role and the responsibilities that go beyond being the secretary to the board of directors.

**CSI:** In your experience working with the Chevron board as well as your own non-profit board experience, what are some best practices that boards can adopt to better assess their own performance? Do you see more effective individual director performance becoming a greater issue, and how might boards approach this subject?

**Beebe:** I do think the requirement to have an annual board self-evaluation has turned out to

be a good one. It causes all boards to be somewhat reflective on how far they've come and how they've performed in the past year. Chevron has primarily used a written evaluation that tries to focus on the key responsibilities of the board, including strategic planning, development of CEO succession candidates, supervision of the CEO, and development of the senior officers. We try to pick out those big areas and have the directors provide individual evaluations and comments, and then we augment that by having one-off conversations, interviews really, by the lead director with each director. That's been very helpful as I think many people have found some of the most difficult subjects to tackle, or the critical comments are shared more readily in a private conversation than in black and white on a piece of paper. I know many companies have found having an external facilitator help with the board evaluation has been very beneficial. Generally, the facilitator does an individual interview with each director separately and pulls out themes.

I think this is important for boards as they evolve. It's important for boards to continue to develop some mechanism to provide 360-degree feedback—in other words, peer-to-peer feedback to directors. In a company like Chevron, where most of our directors have been on a number of boards, while there are different styles, at least they've all somehow successfully figured out how to work with a variety of different boards. I think

it's more and more important for people to be thoughtful in regard to peer feedback because we still have challenges in corporate America of refreshing boards at the right time.

Many, if not most, companies have a mandatory retirement age and a few now are moving toward term limits, which is an equally good idea. And some companies have both, although a small number. I think the use of peer feedback can help to keep people focused on when the value they add starts to slip. Another key takeaway from board evaluations is consensus on the hot-button issues. I think one of the most valuable questions that a director evaluation can ask is something like, "What are the three most important strategic issues for the board to focus on in the coming year?" If you can share people's views on that and if there's consensus, it not only clarifies people's thought processes, but it also gives the board a little bit more of a roadmap about how it should be spending its time.

**CSI:** This is along the same lines of board performance, and that is measuring good governance. Can it be measured, and is it solely linked to increased shareholder value?

**Beebe:** Well, I always try to tell our board and my chairman that you knew we had good corporate governance because we never read about ourselves in the newspaper on that topic. One of my bosses once told

me, "Being the Corporate Secretary is like playing goalie. You have a lot of chances to get scored on and very few chances to score." In some ways, good governance is hard to measure on the positive side but easy to measure on the negative side. I think that can be despite a company's performance, not always, but sometimes the performance takes a while to follow. When you think

me, one of the most important measures of how good your governance is has to do with good strategies, whether you have good strategies and you're following them, and your processes are robust as far as board selection, CEO selection, and development of key people. Those are the early indicators, and stockholder value is what would be called a trailing indicator or trailing metric.

had many shareholder proposals in the social or environmental area that have produced ongoing dialogue with activists. They're all subjects that are in the newspaper, in the social environment area, so they're not subjects that we weren't already having internal dialogue about. I think the dialogue with stockholders has helped us, in many cases, understand better the concerns and issues people have. It has caused us to examine the disclosures in the areas that are of interest to stockholders to try to make the disclosures and information we share on our website more robust and more informative.

## "ONE OF THE MOST IMPORTANT MEASURES OF HOW GOOD YOUR GOVERNANCE IS HAS TO DO WITH WHETHER YOU HAVE GOOD STRATEGIES AND YOU'RE FOLLOWING THEM."

about a company like Enron, when it was at its peak, it was thought to have very good governance. It had all-star directors, and it had done all the dotting the Is and crossing the Ts, but it was superficial. We didn't find out until after the fact that the verification wasn't really happening.

I think that you can, to some extent, measure governance as part of shareholder value, but that's not the only measure. Certainly there are industries that are cyclical, that have very strong governance but are in the down part of their cycles, and the shareholder value has gone down. And the business results aren't as good. You have to be a little bit more subjective, I think. To

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**CSI:** Has Chevron made any notable governance changes as a result of shareholder action or to be aligned with governance best practices?

**Beebe:** I think we constantly try to take input from our stockholders and make adjustments to be responsive. When the whole thing came up about special meetings, we had no provision to have a special meeting, and we certainly have one now. We didn't have a majority vote provision for directors until it became something people were talking about, and it seemed like that was something that was consistent with the way our directors felt about serving on a board. We've

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**CSI:** How has shareholder engagement changed at Chevron? What has your experience been like interfacing with shareholders over the past decade?

**Beebe:** We have, in the last two years, increased the amount of internal resources we devote to shareholder engagement. Up until three years ago or so, on the governance side, most of the response on the ES&G (environmental, social, and governance) issues was done in the corporate governance group by myself and the people I work with, and we still are certainly doing the lion's share of it. But we have many more people involved internally now, and we make a greater effort to have them in more direct involvement in conversations with stockholders. I'm talking about the people that work in the health environment and safety



group in Chevron or our experts on executive compensation or some of our policy experts and corporate responsibility folks from our government affairs and public affairs staff. Those people are all part of a larger team—a task force or working team, and ordinarily there are at least six or eight people on phone calls with stockholders.

We have gone back to New York to meet with a number of key stockholders who are interested in in-person meetings. I think that's another response, another way that we've changed our way of engaging with shareholders to try to be more responsive to their desires to have more direct interactions. Business unit people, of course, are involved in those too, to offer more perspective on how we operate.

I do think there are many more large stockholders that we interface with on a broader array of subjects now than a few years ago, and these stockholders have more staff. So they have people that are focused on these different ES&G areas. Some of our larger investors historically abstained on a number of the shareholder proposals, just weren't interested in voting on those, or had more of a routine of supporting management unless there was some call-out reason not to. Now I think some of them are trying to develop more resources to focus on these issues. If we both develop more resources, it lends to a better, more meaningful conversation.

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**CSI: How has your own work on external non-profit boards influenced your work with the Chevron board?**

**Beebe:** Well, I do think you always learn from different approaches, different processes people use, and you get ideas of how you can make things run more smoothly or be more efficient. You get a lot of good input from comparing your processes with that of other organizations or companies and by talking to colleagues. I try to keep a line of communication open between myself and my counterpart at the companies where my directors also serve so that I stay up to speed on what other companies are doing. You get a little bit of a window into how they've approached some of the new regulations or analyses.

One of the things that always strikes me is the whole notion of "How do you use your time?" I think you get more of an appreciation from that experience of understanding the frustration as a director and being lectured to and having all the meeting time taken up by a series of talking heads rather than having time for meaningful conversation and input. That's certainly one of the things that we try to focus on diligently in our preparations for each board meeting. We try to make sure that the subjects we're going to discuss, if they're presented in a formal discussion initially, are targeted at the right level, at a strategic level, and the issues or questions are presented in a holistic way, again, at the strategic level rather than

some granular operating discussion of the nuts and bolts.

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**CSI: We're in the midst of proxy season. Give us your thoughts on some of the other governance issues we might see arise this year.**

**Beebe:** Compensation has been the number one issue for a number of years, and I expect it will be this proxy season. We, of course, always have a litany of shareholder proposals. We have seven on our proxy this year, most of which are repeats from prior years. We haven't talked about disclosure of political contributions and lobbying expenses. That proposal has been submitted at a large number of companies, so that's one that will receive some attention. I think over time in the big picture in the governance world, we're going to be focusing increasingly on private equity, hedge funds, and their impact on more traditional investment, investors, and companies in which they invest. Even though it may not be a takeover attempt or some major headline activity, activist investors are having more and more impact on more and more companies, on just who their investors are, what the tolerance is for long-term versus short-term returns, attitudes toward corporate organization, and the issues of spinoffs or splits. I think that's creeping up to a larger and larger sized company, and more and more people will be involved in thinking about those issues. **C**

## INTERVIEW WITH **GLENN BOORAEM**



**G**lenn H. Booraem is Controller of the Vanguard funds and a Vanguard Principal. Vanguard holds more than \$2 trillion in U.S. and international mutual funds. Booraem is responsible for Vanguard's global fund accounting operations, which includes execution and/or oversight of fund accounting and security valuation, fund compliance monitoring, and corporate governance operations for Vanguard's investment products worldwide. He is a member of the Vanguard Pricing Review Committee, Proxy Oversight Group, and Disclosure Oversight Group. Booraem has also served on the New York Stock Exchange's Proxy Working Group and Commission on Corporate Governance.

Booraem joined Vanguard in 1989 as a fund accountant in Fund Financial Services (FFS). He has since held various roles of increasing responsibility in FFS and was elected a principal of Vanguard in 1999, the funds' assistant controller in 2001, and the funds' controller in 2010.

Booraem earned a B.B.A. from Temple University in 1989.



**“WE’RE AT A HISTORIC HIGH FROM AN ENGAGEMENT STANDPOINT, AND WE BELIEVE THAT’S A REALLY GOOD THING.”**



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**C-Suite Insight: Tell us about your background, your role at Vanguard, and the responsibilities that you hold.**

**Booraem:** At Vanguard—where I’ve spent my entire 25-year career—I have responsibility for fund accounting and administration functions, as well as oversight of fund compliance and our corporate governance program. While there’s some variety among these responsibilities, the unifying dimension is that they’re all fund-centric. Most relevant to this discussion, I’ve been responsible for our corporate governance program for the past 14 years or so.

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**CSI: The theme for this issue is “Performance.” We want to focus a bit on performance metrics and get your perspective on what Vanguard looks for when assessing pay plans and how this all ties into the Say on Pay decision.**

**Booraem:** For us, Say on Pay boils down to an assessment of the consistency between pay and performance. Though that’s easy to say, figuring out what “pay” and “performance” actually mean is easier said than done. On the performance side of the equation, we typically start with Total Shareholder Return (TSR) relative to a group of peer companies. TSR has the benefit of being objectively determinable and readily observable, and we believe that ultimately shareholder value should be reflected in the price of the company’s stock, and consequently, TSR.

That said, we know that TSR is not the be-all, end-all metric. A company’s momentary stock price may not fully reflect the company’s operating performance—for better or worse—and companies within a peer group may not be impacted by information such as current earnings reports at the same time, clouding comparison of their TSR on a specific date.

Beyond starting with relative TSR, we don’t want to adopt a cookie-cutter approach to specifying particular metrics. From a philosophical standpoint, we’d like metrics to be as objective as possible and to reflect the efforts and impact of the executives whose compensation they influence. To the extent that companies can skew the value of their metrics by some sort of financial engineering or other creative accounting, it lessens their value as objective measures of performance.

Where possible, we also prefer the use of relative metrics, which are performance measures evaluated in the context of the company’s peer group. They normalize out forces to which all companies within a particular sector are subject. Nonetheless, we understand that relative metrics aren’t always practical due to the characteristics of the peer group or the company’s stage of development. In those cases where a company uses absolute metrics, we’d like to understand through disclosure the process that the compensation committee uses to set the target levels of accomplishment against these metrics, preferably with some competitive context, how they evaluated actual results, and what factors

they considered in exercising discretion with respect to awards.

At the end of the day, for us, it’s all about getting the compensation committee’s perspective on what metrics it has chosen, why they’re relevant to the business, and why achievement of the targets selected is competitively compelling. This is an area where companies shouldn’t underestimate the importance of great disclosure and other shareholder communications that answer these questions.

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**CSI: What are those company-specific factors that you look for in determining the best metrics used company to company?**

**Booraem:** It comes down to the reality that compensation design is so individualized at the company level, and rightfully so, that it’s very difficult to take a purely objective approach to the Say on Pay vote. We’ll do a lot of objective, quantitative screening up front to identify those companies where we need to understand more about pay and its linkage to performance, but once we’ve identified companies based

**“NOT EVERYTHING THAT APPEARS TO BE A DISCONNECT INITIALLY IS PROBLEMATIC.”**

on that relatively quantitative screen, it's ultimately a case-by-case analysis to understand what the underlying mechanics are.

You can't just start with the far right column of the summary compensation table and say that's the end of the pay story. It's really case by case once we've done that initial quantitative screen.

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**CSI:** Are there performance metrics that you look at for the short term versus long term? Are there more effective metrics used for both of those analyses? Are there metrics that can be misleading, not intentionally, but some metrics that could be misinterpreted?

**Booraem:** We certainly want metrics to be objective and not easily manipulated, which is not to say that plans should be entirely formulaic. That said, in those situations where the compensation committee exercises discretion, it's critical that we understand the factors that went into their decision-making process. It's also critical that the metrics used are relevant to the long-term growth of the enterprise and appropriately calibrated to the incentive period. It generally makes sense to us for there to be distinct metrics for the annual incentive and the long-term incentive plans, with a multi-year measurement period for the long-term incentive. We're looking to understand the compensation committee's perspective about how the metrics selected—whether for the short-term or long-term plan—have an enduring connection to shareholder value.

Ultimately, our objective as investors is increasing shareholder value, which we believe ultimately translates into a higher stock price. While TSR is an imperfect metric in the short and intermediate

terms, ultimately that's where performance will show up.

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**CSI:** There is a section in Vanguard's proxy voting guidelines focused on the support for pay programs that effectively show the linkage between pay and performance over time. How do companies demonstrate an effective linkage between pay and performance?

**Booraem:** The top two considerations in our executive compensation principles are "pay for performance" and "pay within reason." Those perspectives really operate together in that we expect to see some consistency in compensation among companies that are situated similarly from a size, complexity, and industry perspective, as well as from a performance standpoint. "Pay within reason" sets the expectation that, within a peer group, adjusted for size, complexity, and sector, there is likely to be some norm as to the level of compensation that reflects the market's assignment of value to executive roles. Given that presumption, we expect those companies that perform best within this framework to have the most significant compensation outcomes and those companies that lag to have lagging compensation outcomes.

The linkage is expressed through this correlation between relative performance and relative compensation. It's the disconnect between pay outcomes and performance outcomes that is the basis for our deeper analysis, because not everything that appears to be a disconnect initially is problematic upon further review. All of the up-front quantitative work gets us down to the subset of the universe on which we need to do a deeper qualitative dive to evaluate the actual linkage.

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**CSI:** What are some of the trends you are seeing in shareholder proposals?

**Booraem:** Proposals seeking governance reforms—board declassification, majority voting for directors, and the like—continue to attract strong support, though as many of these provisions become the norm for most large companies, shareholder proponents will have a diminishing number of typical targets. I suppose that creates potential for these proposals to migrate to companies in the mid- and small-cap range where some of these provisions have yet to be as widely adopted.

We've seen this trend both through the shareholder proposal route and also through our own engagement. While we haven't gone down the road of submitting shareholder proposals, we have engaged in direct outreach to companies where we have a significant stake and where there are changes we'd like to see implemented. In late 2013, we sent letters to about 350 U.S. companies where we held significant positions and where there were inconsistencies between their governance practices and our views. We were very specific, and we've gotten great responses thus far. We're still getting responses back as companies address our requests in the cadence of board and shareholder meeting schedules, but an increasing number of firms are adopting the changes we requested, or, where necessary, putting them on the ballot for shareholder approval—all without necessitating a shareholder proposal. We're very encouraged by this level of collaboration and responsiveness.

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**CSI:** You are a member of the Shareholder-Director Exchange. Can you talk a bit about the mission of the Exchange and the protocol the group



## has developed? How have you seen shareholder engagement evolve?

**Booraem:** Over the last 10 years, and I would say accelerating even more over the last five, there has really been an uptick in corporate interest in engaging with shareholders. We're probably talking directly to more companies in a year now than we did in my first five years in this role combined. I think there are a number of forces at play here. We're doing more proactive outreach. We've communicated our governance and compensation principles broadly to our investee companies a number of times over the last 10 years. In the last couple of iterations, as mentioned above, we've asked specific companies to make specific changes where their practices are inconsistent with our principles. As we've evolved into an increasingly active ownership role, we're seeing increasingly beneficial results.

While the introduction of Say on Pay in the U.S. seems to have driven more companies to engage with investors, we're hearing from them that they've gotten value out of the discussion beyond winning support for their pay programs. While Say on Pay may have been the impetus, we've been able to leverage the opportunity to communicate with them on a broader, more principles-based level.

I would say the other significant change over the past few years is the increasing involvement of directors in the discussion with investors. In the early days, the primary situation in which we'd have discussions with directors was a proxy fight, and individual directors were fighting to retain their seats. Now it's much more the norm, particularly where a company has had issues, for our discussions to include the lead independent director or chairman, or the chair of the relevant

committee—for example, the chair of the compensation committee where we have pay concerns.

Getting back to the SDX component of your question, we believe the value of things like the SDX Protocol and The Conference Board's Guidelines for Investor Engagement is that they provide a framework for companies and investors to think about as they're evaluating engagement. The reality is that engagement is nothing new for a significant number of companies, but by the same token, it's an alien concept for others. We see leveraging what's worked well for many companies and investors and socializing that across the broader market as a great opportunity to elevate the dialogue for the benefit of all investors.

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## CSI: What are some other governance issues that are going to be most important or most interesting this proxy season and throughout the year?

**Booraem:** We're at a historic high from an engagement standpoint, and we believe that's a really good thing. We view engagement as a dialogue. It's certainly not our intent to dictate to companies how to do things. We don't invest in companies to micromanage them. We do have a point of view on certain high-level governance matters in order to create the right level of protection for investors, so we'll continue to engage on those. The great news is that we see companies being increasingly receptive to those discussions. Importantly, though, engagement is an important listening opportunity for us to understand more deeply how specific boards think about risk and succession and compensation and governance and capital allocation and all the other things

that boards are responsible for. We see this as a continuing trend and one that we view as positive.

Another area is the increasing attention being paid to activism. We stay attuned to activist involvement in companies that we own, and to the extent that that involvement reaches a point where there's consideration of alternate business strategies or alternate board arrangements, we get involved and will listen intently to both sides and make decisions that we think are in our shareholders' best long-term interests.

Finally, as the basic structural protections we support—such as board declassification and majority voting—become more the norm, the next level of engagement for us is really around board composition and effectiveness.

So once we can elect directors every year by majority vote, the next question is how do we ensure that we've got the right directors overseeing the company? While there's not a single measure that we're looking at to analyze board effectiveness, there are a number of board characteristics that we want to understand and evaluate. What's the right mix between general business/leadership experience and functional skills or industry expertise? What's the appropriate balance between board tenure and fresh perspectives? How does the diversity of the board along multiple dimensions affect its performance? How does the board evaluate director performance—both individually and in aggregate—to ensure that they're positioned optimally to oversee the company in years to come? While there is no single “right” answer to any of these questions, understanding the board's approach to them provides meaningful insight for investors to evaluate those who oversee their interests.

## INTERVIEW WITH **MARY ANN CLOYD**



**M**ary Ann Cloyd leads PwC's Center for Board Governance, a practice of experienced partners and governance specialists that provides perspectives and insights on corporate governance issues and leading processes to audit committees and boards of directors of the firm's clients.

Cloyd and her team make up one of the largest governance practices globally, and bring unsurpassed experience in guiding directors faced with the challenges of achieving strategic growth and managing risk in a fast-changing regulatory environment. Cloyd oversees the production of the Center's Annual Corporate Directors Survey, and spearheads its numerous publications and education programs related to board governance.

Cloyd has more than 35 years of public accounting experience serving multinational corporate clients in a variety of industries. Prior to assuming her role and eventual leadership in the Center, Cloyd was the Tax Market Leader for the firm's Southern California, Phoenix and Las Vegas tax practices, and as a senior partner, continues to work closely with clients.

On the firm's U.S. Board of Partners and Principals, Cloyd chaired the Risk Management, Ethics & Compliance Committee and the Partner Admissions Committee. She was also on the Management Executive Compensation Committee and People Committee. She also serves on the Global Board of Partners and Principals, currently sitting on the Risk and Operations Committee and previously on the Clients Committee.

Active in professional and community organizations, Cloyd is President of the PwC Charitable Foundation, Inc. and is on the UCLA Iris Cantor Women's Center Advisory Board, as well as the board of directors for the Geffen Playhouse. She has also previously served on several other boards including the American Red Cross of Greater Los Angeles, where she was active Chairman of Volunteers.

Cloyd graduated Summa Cum Laude from Baylor University with a Bachelor of Business Administration. She is a Certified Public Accountant in the states of California and Texas, and is a member of the American Institute of Certified Public Accountants.



**C-Suite Insight: Discuss your role at PwC's Center for Board Governance and the mission of the Center.**

**Cloyd:** I'm the leader of PwC's Center for Board Governance. We're a group within PwC whose mission is to be a resource to help directors effectively meet the challenges of their critical roles. We do this by sharing leading practices on governance, publishing thought leadership, and convening and participating in governance forums. We also meet with boards of directors, audit committees, and executives to share leading practices and insights into developments and trends.

**CSI: In regard to boards, how do you see the topics of director education and director performance evolving? How has performance typically been assessed, and what measures can be taken by boards to implement more effective evaluations?**

**Cloyd:** When I think about excellence in director performance, three key things immediately come to mind: effective board leadership, robust board assessment processes, and continuing board education. All three play important roles in the overall performance of the board.

Board leadership is always top of mind for me when thinking about high-performing boards. A strong board leader—chair, lead

director, or committee chair—will keep board matters moving, facilitate robust board discussion, and when necessary, address issues with underperforming directors. But leadership isn't limited to the directors in those formal roles. There's also the individual leadership that can and should be exhibited by every member of the board.

A robust board evaluation process can be a critical component in handling any difficult issues the board is facing and can ultimately result in enhanced board effectiveness. Our 2013 Annual Corporate Directors Survey asked about board evaluations. As a result of issues identified in their last board or committee self-evaluation process, more than one-third of directors told us their board sought additional expertise to join the board, and just under one-third said they changed the composition of board committees.

As the boardroom agenda evolves, continuing director education can play an important role in helping directors stay updated about new issues facing their companies. Our survey also asked directors their views about board education, and 59% said annual training should be required. And more than four in five directors said they are currently using educational programs to stay abreast of emerging trends in corporate governance in order to effectively discharge their oversight responsibilities.

## “CONTINUING DIRECTOR EDUCATION CAN PLAY AN IMPORTANT ROLE IN HELPING DIRECTORS STAY UPDATED ABOUT NEW ISSUES FACING THEIR COMPANIES.”

**CSI: Along those same lines, has increased shareholder engagement caused boards to look at how they are assessing executive performance, especially in regard to pay and the performance metrics used?**

**Cloyd:** Many companies have amended their approaches to compensation as a result of their Say on Pay voting results. In 2013, 70% of directors said their company took some form of action in response to the vote. One such action was an increase in the company's communication with shareholders, which 20% of directors said happened. Other changes were enhancing proxy statement compensation disclosures and making compensation more performance based. In addition, a number of institutional investors have commented that the restructuring of the CD&A

has made it easier to read and more concise.

I think this is a good time to mention that direct board communication—with shareholders and other stakeholders—continues to be a subject of debate in the boardroom. In recent years, various stakeholders have pushed for direct communications with the board. Our research shows that more than 60% of directors say their board has communicated with institutional investors, and nearly 30% say there was an increase in these communications in 2013 from the previous year. Based on what we've been hearing, we expect our 2014 research to show this trend continuing.

But we've observed a difference in opinion among directors on the issue, as in 2013, one-third of directors said their board doesn't and shouldn't speak with institutional investors. That said, executive compensation is one of the topics that a majority of directors think is

appropriate to talk directly to shareholders about—two-thirds say it's at least "somewhat appropriate" to do so.

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**CSI:** In this issue we have a feature article, written by TK Kerstetter, on the topic of board evaluations as a way to refresh boards. From your perspective, what are some effective evaluation methods boards are utilizing to assess performance, and how do you see more effective evaluations impacting board composition and board turnover?

**Cloyd:** Leading boards generally don't view board evaluations as a compliance requirement but instead use them as an opportunity to improve individual and overall performance. Evaluations can help assess whether all directors are performing well and have the needed skills. But the key is effective board leadership dealing with any issues identified.

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**CSI:** In anticipation of PwC's 2014 Annual Corporate Directors Survey, what are you expecting to see in this year's results?

**Cloyd:** I think three key trends are likely to continue this year. First is an increased focus on cybersecurity. We expect to see a continued increase in the time and focus on IT oversight, particularly around cybersecurity. Cyber risks are business

risks and should be treated as such. Most discussions about cyber-attacks are now centered around when one will happen and protecting the company's critical assets—what you might call the company's "crown jewels." There should also be discussions about crisis management.

Also, as mentioned earlier, we expect more directors to consider communicating directly with shareholders. Finally, fraud prevention is top of mind. This subject is not going away. There will likely be continued discussions and focus on "tone at the top," FCPA, whistleblowers, and risks embedded in compensation plans.

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**CSI:** What are some of the major committee issues you are seeing boards deal with?

**Cloyd:** We hear audit committees asking how they can continue to raise their performance bar. At the Center for Board Governance, we're trying to contribute to the conversation with our new Audit Committee Excellence Series. The topics we're covering in the series are drawn from our conversations with audit committees about their concerns. These include a company's forward-looking guidance practices and the potential risks associated with analysts' consensus estimates, financial reporting oversight, the importance of press releases covering preliminary results, and the evolving role of internal audit.

**"DIVERSITY ISN'T JUST ABOUT RACE AND GENDER, BUT ALSO EXPERIENCE, BACKGROUND, PERSONALITY, AND OTHER ATTRIBUTES."**



Many nominating and governance committees are focused on addressing board renewal and diversity. Diversity isn't just about race and gender, but also experience, background, personality, and other attributes. It's really about making sure the board has directors with the right skills, now and for the future. Term limits, mandatory retirement policies, and board tenure are frequently part of the discussion. There's also been a continued interest and focus on how to acquire and retain top talent.

Compensation committees are continuing their focus on aligning pay with performance and communicating the rationale behind the company's pay program to investors. They're also focusing on the new Dodd-Frank CEO pay ratio rule and anticipating a rule on clawbacks.

**CSI:** There has been much talk about the CEO pay ratio rule. What are you hearing from board members about this topic? What's your perspective on the impact?

**Cloyd:** Many board members have expressed concern about comparability. In the proposed rules, the SEC gives companies flexibility as to the methodology they can use to determine the median employee compensation. So that will likely result in a variety of methods for coming up with the ratio, which in turn could mean there won't necessarily be comparable methods

among companies. Some directors worry this will skew investor and public perception and, consequently, question the usefulness of this number to investors. Some are also concerned that it's not necessarily a useful figure in trying to understand the company's executive compensation program.

**CSI:** What are some of the other governance issues that are going to be top of mind this year?

**Cloyd:** Cybersecurity continues to be top of mind. I recently moderated a webcast about the increasing demands of cybersecurity with The Honorable Tom Ridge and

getting more sophisticated, and so are their techniques. And companies need to understand which "adversaries" are interested in their businesses. Governor Ridge noted that cybersecurity matters are a clear and present, and permanent, danger. And companies and their boards should view cyberattacks as a business issue, not an IT problem.

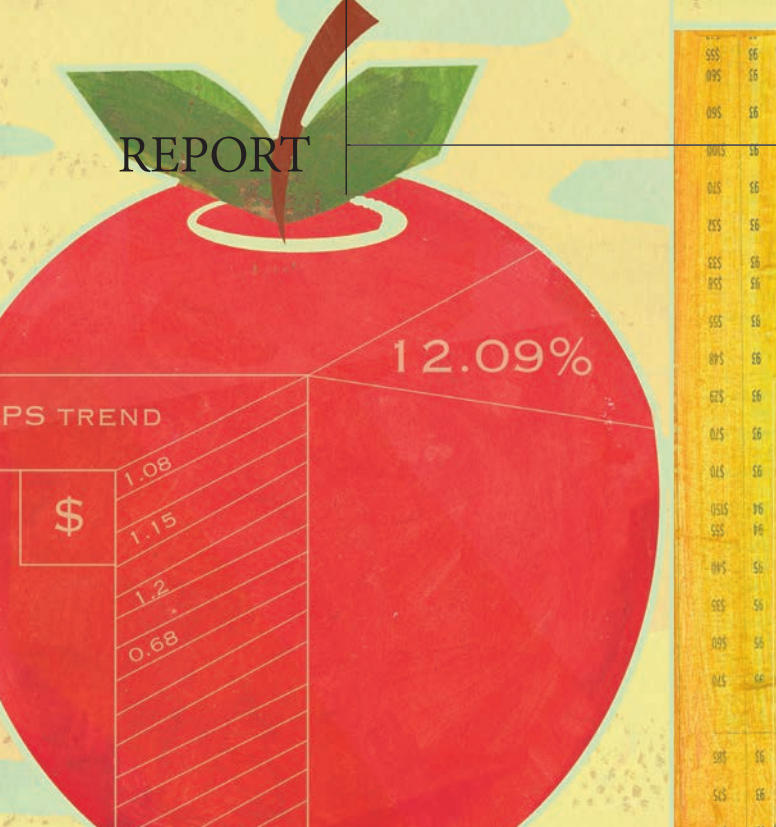
Finally, shareholder proposals continue to be on many boards' radars. Some of the top issues in the early 2014 proxy season are not particularly new: political spending, board declassification, majority voting, and the separation of the chair and CEO roles. Many of these issues have gained

## "COMPANIES AND THEIR BOARDS SHOULD VIEW CYBER AS A BUSINESS ISSUE, NOT AN IT PROBLEM."

Charles Beard, a Principal with PwC's Forensic Services practice. We discussed the current cybersecurity landscape, the Department of Homeland's Cybersecurity Framework, the evolution of cybersecurity oversight at the board level, and the role management plays. There were some key takeaways. For one, the number of cyber incidents continues to climb, and the threats come from all over—both outside and inside the company. The actors are

traction over the past few years, prompting adoption of changes by many large companies. So the thinking now is that shareholders may turn their focus to mid-sized and smaller companies with the same types of proposals. There's also been a substantial increase in the number of activists who are approaching companies and demanding operational changes. Our data shows an increase of over 60% in the number of proxy fights year-over-year. **C**

# REPORT



## 2014 S&P 1500 PEER GROUP REPORT

For more information or a full copy of the report, please contact Aaron Boyd at [aboyd@equilar.com](mailto:aboyd@equilar.com). Aaron Boyd is the Director of Governance Research at Equilar. The contributing authors of this paper are Shelby Dempsey, Anthony DyPac, and Robert Lee, Research Analysts.

### REPORT PARTNERS:

FREDERIC W. COOK & CO., INC.



In recent years, companies have come under increased scrutiny to justify their executives' compensation packages. Faced with various pressures from proxy advisory firms and shareholders, companies must take great care to create peer groups appropriate for their benchmarking needs.

The two leading proxy advisory firms take different approaches when establishing peer groups for comparison purposes. Institutional Shareholder Services (ISS) creates a peer group ranging from 14 to 24 companies, primarily chosen by GICS industry classification, and by financial constraints, such as revenue and market capitalization. Glass Lewis uses Equilar Market Peers, which uses a relational approach in creating peer groups, looking at whom a company benchmarks to and its peers, as well as who benchmarks back to the company, and assigning weight to the strength of those relationships.

Companies employ a variety of methods and criteria when creating their peer groups. Many look beyond industry and revenue to consider additional factors such as competition for talent, geographic location, or company and industry complexity. Since compensation among peer firms is one way companies justify compensation, clear disclosure of the approach taken to select peer groups is important to include in an annual proxy statement. It helps clarify benchmarking decisions for both shareholders and proxy advisory firms.

In this study of peer group creation, Equilar examined the peer groups of S&P 1500 companies. This analysis determines how companies formulate their peer groups. It then compares the percentile rankings of companies against their disclosed peers and Equilar Market Peers. This detailed review offers information on peer group size, selection criteria, and revenue.

### REPORT SCOPE AND METHODOLOGY

Due to the lack of peer group disclosure by certain companies, the sample group consisted of 1,329 companies within the S&P 1500 that disclosed at least one peer between July 1, 2012 and June 30, 2013. All companies that disclosed a general industry group or index in lieu of listing individual peer companies were excluded from this study.

## DISCLOSURE PREVALENCE

Benchmarking to a peer group is an increasingly common practice in executive compensation. However, not all companies in the S&P 1500 benchmark to a peer group or disclose the peers they use for benchmarking. In the S&P 1500, 89.0% of companies disclosed a peer group in their most recent proxies. As the size of a company increases, it is more likely that the company will disclose a peer group. In the S&P 500, 95.4% of companies disclosed a peer group, compared to 87.7% of companies in the S&P MidCap 400 and 84.4% of companies in the S&P SmallCap 600.

Some companies are more popular benchmarks. Ten companies in the S&P 1500 were referenced as peers by between 43 and 62 other companies. Their industry classifications and revenue ranges may have made these companies

appeal to a wide array of companies. All but two of these 10 companies were classified as Industrial or Consumer Goods. Additionally, they all belonged to the S&P 500 and had revenues of at least \$14 billion.

3M continued to be the most benchmarked company in the S&P 1500 with 62 references. The top 10 most benchmarked companies in the S&P 1500 are shown in the Table 1.

Table 1

S&P 1500	
COMPANY NAME	NUMBER OF REFERENCES
3M	62
Johnson & Johnson	57
Eaton	53
PepsiCo	50
Honeywell International	50
Procter & Gamble	46
General Mills	45
Emerson Electric	44
United Technologies	44
Colgate Palmolive	43
Illinois Tool Works	43
Kellogg	43

number of peers disclosed in the S&P 1500 in the past fiscal year was 16. When making peer group selections, ISS generally uses a peer group size containing a minimum of 14 and a maximum of 24 companies. Equilar Market Peers establishes a peer group of 15 companies.

Although 35.9% of companies disclosed a peer group of between 16 and 20 companies, companies may disclose significantly more or less depending on their benchmarking needs. Chart 1 shows the prevalence of peer group sizes for companies in the S&P 1500.

## KEY FINDINGS

- Some companies are more popular than others. 3M continues to be the most commonly referenced peer, named by 62 companies. Johnson & Johnson follows with 57 references and Eaton comes in third with 53 references.
- Most peer groups consist of 11 to 20 companies. Of peer groups in the S&P 1500, 68.7% included 11 to 20 companies. The number of peers increased with the size of the company. The median number of peers for the S&P SmallCap 600 was 15, while the S&P MidCap 400 was 16, and 17 for the S&P 500.
- The most commonly utilized peer criterion is industry. Industry was used as a peer group determination criterion by more than 1,200 companies. Industry was followed in popularity by revenue and market capitalization.
- Most companies used peers in the same industry. Of S&P 1500 companies, 56.1% used peer groups with 80% to 100% of companies in their same industries.

## PEER GROUP SIZE

In 2013, companies in the S&P 1500 selected between two and 278 companies when creating a peer group. The median

Chart 1

S&P 1500 Peer Group Size

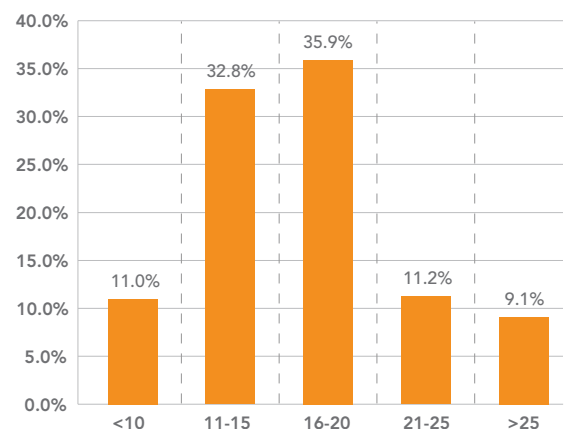
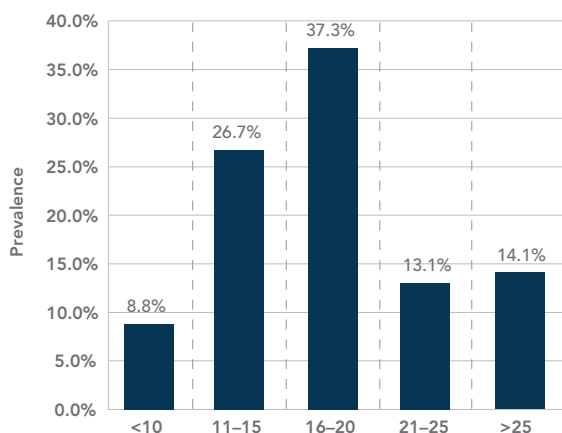




Chart 2 S&amp;P 500 Peer Group Size



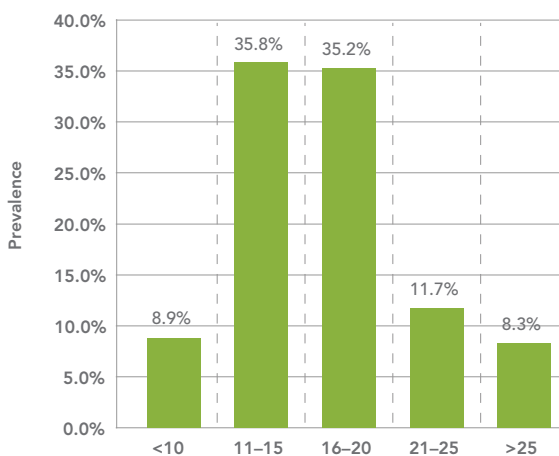
Breaking the S&P 1500 down by index, it is evident that larger companies tend to disclose more peers. In 2013, the median number of peers for the S&P 500 was 17 compared to a median of 16 for the S&P MidCap 400 and 15 for the S&P SmallCap 600. The three charts show the prevalence of peer group sizes for companies by index.

### MULTIPLE PEER GROUPS

A company may choose to create multiple peer groups. One of the most common reasons cited is that the company belongs to a smaller, niche industry. Its first peer group may contain a small number of companies within the same industry, while a second peer group may be composed of companies within a broader industry index or within a certain revenue range. Other companies may choose to establish separate peer groups for different executives, or for different geographies.

Whatever the reason, the number of companies that disclose multiple peer groups is low. In the S&P 1500, 90.8% of companies had only one peer group, 8.1% had two peer groups, and 1.0% had three. One company disclosed five peer groups (Stamps.com). Stamps.com chooses to benchmark to a different set of companies for each of its named executive officers.

Chart 3 S&amp;P MidCap 400 Peer Group Size



### FREDERIC W. COOK & CO. ANALYSIS

We find that most companies now use a single peer group to simplify administration and streamline disclosure. However, some companies use multiple peer groups to address unique issues caused by few industry peers existing within their size ranges. We also find that there is often confusion over various peer groups. Proxy advisory firms have different selection criteria to identify peer groups that they use to evaluate companies and those peer groups may vary from peer groups developed by companies to evaluate compensation opportunity levels, incentive practices, relative dilution levels, etc. If companies do use multiple peer groups, it is important to disclose the rationale, selection process, and actual use of each peer group in the decision-making process.

Chart 4 S&amp;P SmallCap 600 Peer Group Size

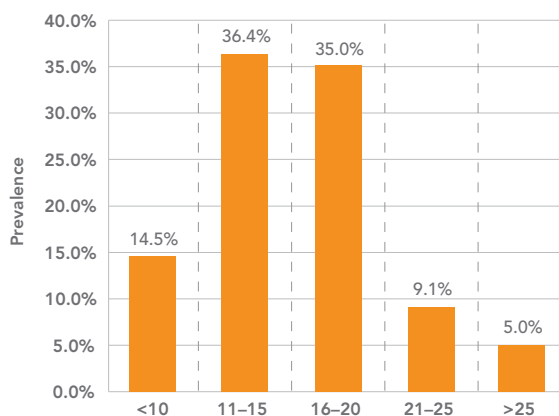
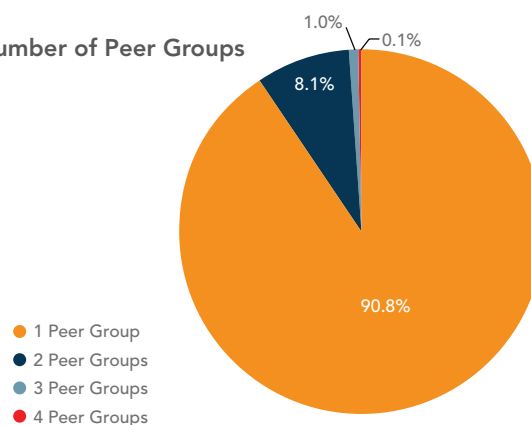


Chart 5

### S&P 1500 Number of Peer Groups





## SELECTION CRITERIA

When selecting peers, companies want to be able to justify to shareholders why they have included certain companies. The explanations vary, but companies often cite that they reference their peers' industry classifications, financial metrics (such as market capitalization or revenue), or competition for talent. It is important for a company to justify to shareholders that chosen companies are appropriate for benchmarking purposes and have not been selected just to make company performance look better or to increase executive compensation. The median number of selection criteria used by companies was four, while the maximum number of criteria was nine. Table 2 shows the top 10 criteria cited by companies in the S&P 1500. Industry tops the other criteria by a substantial margin, with 1,202 companies in the S&P 1500 naming it as a benchmarking criterion.

Table 2

S&P 1500	
CRITERION	NUMBER OF COMPANIES
Industry	1,202
Revenue	920
Market Capitalization	693
Competition for Talent	582
Business Model	431
Direct Competitor	286
Geographic Location	249
Assets	223
Number of Employees	157
Profitability	121

## FREDERIC W. COOK & CO. ANALYSIS

Peer companies should generally operate in similar industries and to the extent possible have similar cost structures and business models. The stronger the match on these characteristics, the more robust and meaningful the resulting compensation and performance data will be. Compensation opportunity levels are strongly correlated with company size and it is important to avoid peer companies that are substantially larger or smaller. As illustrated here, the most common size determinants for compensation purposes are revenue and market capitalization. With respect to criteria such as talent competitors, it is important that the peer companies are in talent competition for executives, not only employees. For example, even though two companies might compete for engineers, a CFO at a \$7 billion revenue company is not likely to take a position at a \$200 million revenue company, and therefore a \$7 billion company is unlikely suitable as a peer for a \$200 million company.

## JOHN L. WEINBERG CENTER COMMENTARY

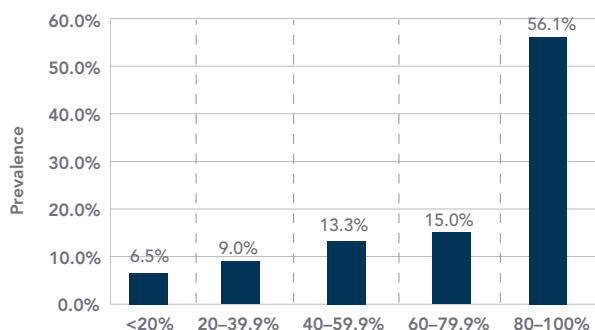
Our recent research (Executive Superstars, Peer Groups and Overcompensation, 38 J. CORP. L. 487, 2013) has called the retention-based justification for peer benchmarking into question. We provide evidence which shows that during the period from 1993-2009, amongst the largest 1500 or so companies, only 27 sitting CEOs left their current positions to run other firms. It is an exceedingly rare—and performance-wise typically disappointing—occurrence for a CEO to be hired away by another company. There are two possible explanations for this. It may indicate the success of companies in retaining chief executives with effective benchmarking. Conversely, as we believe, it may suggest that because running a company requires a vast array of firm-specific skills, chief executives are simply not as marketable as the practice of benchmarking suggests—and that the retention justification is therefore merely a platitude. Indeed, typical CEOs, at typical companies, have had very long tenures during which intensive knowledge was developed. And, when they or other top executives do move to other companies, it is most often in extraordinary situations, so as to execute a turnaround or a sale of the business for instance. The correct interpretation, however, is debatable.

## INDUSTRY CONSIDERATIONS

Since more than 1,200 companies in the S&P 1500 reference industry when setting executive compensation, it is not surprising that there is a large amount of overlap of companies within the same SIC code. On average, 73.8% of peer companies are in the same industry. The median is even higher, with 85.7% of companies belonging to the same industry. Just over 56.0% of companies had peer groups in which 80% to 100% of their peers belonged to their same industry. Only 6.5% of companies had peer groups with less than 20% industry overlap. These companies may have decided to place more of an emphasis on a certain financial metric or stage of development, rather than on the industry classification.

To illustrate this comparison, the first digit of the company's Standard Industrial Code (SIC) was compared to its peers' SIC codes. Chart 6 shows the percentage of companies that included peers of similar industry.

Chart 6 S&amp;P 1500 Industry Peer Percentage



## FREDERIC W. COOK & CO. ANALYSIS

We find that some companies benefit from examining not only financial and industry metrics, but also current executives' previous employment to determine their peer companies. For example, a telecommunications company may find that the predominant background for their executives is information technology or software, indicating that strict adherence to its industry classification may not be the best approach to peer group company identification. Taken in isolation, any one peer company may be singled out or criticized as not a great comparator. The critical determination is whether, in totality, the peer group is reasonable and defensible for comparison purposes.

## REVENUE PERCENTILE RANKING

The second most prevalent criterion S&P 1500 companies used to select their peers in 2013 was revenue, disclosed by 920 companies. In order to investigate how relevant revenue was in determining a company's peers, Equilar compared each company's revenue in the S&P 1500 to the revenue of its selected peers. The percentile ranking used for this analysis refers to the position the company ranks in revenue when compared to its peer group.

Companies within the S&P 1500 generally had lower revenues compared to other companies in their peer groups. Within the S&P 1500, 63.7% of companies ranked at or below the 50th percentile of peer revenue, with a median of 43.8% and an average of 43.7%. 65.4% of peers fell within 0.5 to two times the range of the benchmarking company's revenue, a common rule of thumb for determining relevant peers.



## JOHN L. WEINBERG CENTER COMMENTARY

The most consistent empirical finding concerning executive pay is that larger firms pay more. It is therefore problematic for companies to construct peer groups that are comprised of larger companies. Because pay is almost always targeted to the peer group median or higher, such an approach will have a tendency to raise pay levels in an inappropriate fashion. The best practice is for companies to aim to be at the median in revenue and market-capitalization when constructing peer groups. A number of studies have examined the tendency for biased peer group company selection in terms of their relative size or pay levels. For instance, Professors Michael Faulkender and Jun Yang show empirically that companies, particularly those with weak governance, engage in "strategic peer selection activities" by actively selecting highly-paid peers as opposed to lower-paid peers.

## MARKET PEERS COMPARISONS

Equilar Market Peers consist of the 15 companies that have the strongest connections to each target company resulting from an algorithm that considers self-constructed peers, incoming peers, peers of peers, and peers of incoming peers. Equilar Market Peers provides a way to evaluate a company against a peer group that consists of not only the peers disclosed by each company, but also a group of peers that represents the complex relationships in the marketplace.

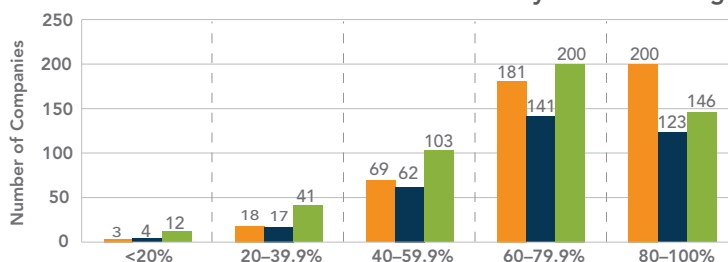
The average overlap of Market Peers and peers disclosed by the S&P 1500 is 68.0%, while the median overlap of peers is 73.3%. Additionally, 75.1% of these companies had at least a 60% overlap, while only 16.8% had less than a 50% overlap. Table 3 shows the average and median overlap for each of the S&P 500, S&P Mid-Cap 400, and S&P SmallCap 600.

Table 3

PERCENT OF MARKET PEERS OVERLAP				
	S&P 500	S&P MIDCAP 400	S&P SMALLCAP 600	S&P 1500
Average	71.5%	68.5%	64.5%	68.0%
Median	73.3%	73.3%	66.7%	73.3%

Chart 7 illustrates the distribution of percentile rankings among the S&P 1500. The vertical axis represents the number of companies that fell within each percentile range of overlap. **C**

Chart 7 S&amp;P 1500 Industry Peer Percentage





## INNOVATIONS IN CD&A DESIGN: A PROXY DISCLOSURE ANALYSIS

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REPORT PARTNER:

**RR DONNELLEY**

CD&A length increased over the past five years. As companies continued to improve compensation disclosures to communicate more effectively with shareholders, CD&A word count increased 17.6% from an average of 7,773 words in 2009 to 9,142 words in 2013.

In recent years, the Securities and Exchange Commission has implemented various changes to the compensation disclosure requirements for public companies in their annual proxies. This has been especially true for the Compensation Discussion & Analysis (CD&A) section, which details a company's executive compensation and corporate governance practices. Using data from the past five years, Equilar looked into the CD&As of S&P 100 companies to identify these trends and point out significant changes in both the design and content of CD&As.

CD&As have become lengthier each year, and mentions of important concepts such as Realizable Pay, Realized Pay, and pay for performance, have steadily increased in frequency. Some of this likely stems from changes in the regulatory environment. There has also been a shift toward enhancing the readability of CD&As, with more companies writing proxy summaries and utilizing colors in their disclosures to make the content easily digestible for readers. This shift is also reflected in the increased prevalence of supplemental pay tables and graphs to better summarize the compensation plans disclosed in CD&As.

Almost half of S&P 100 companies now mention engagement with shareholders in their CD&As, reflecting an increase in shareholder interaction and the effect that advisory votes on executive compensation have had on companies. Another significant trend is the emergence of proxy advisory firm mentions and discussions of risk mitigation. In a fast-changing regulatory landscape, companies are looking to make their disclosures as comprehensive and accessible as possible to promote understanding among various stakeholders.

Considering these changes in the design and content of CD&As, this report provides an in-depth look at the evolution of trends and strategies used by S&P 100 companies to improve their CD&A disclosures for readers. As executive compensation continues to be a heavily scrutinized issue, trends in disclosure reveal important insights into the changing priorities for top companies today.

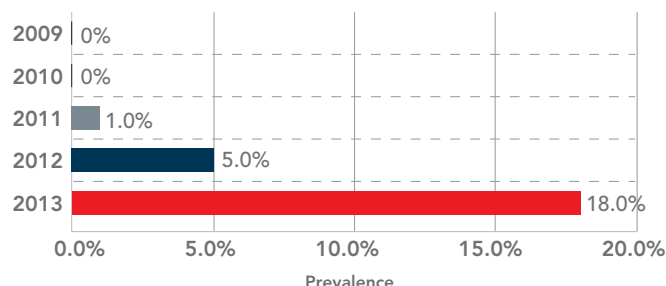
### COMPENSATION PROGRAM CHECKLISTS

To assure shareholders that their compensation practices are beneficial, many companies have opted to go into more depth with their CD&As. In an effort to cover all angles, this additional disclosure entails not only the details of the compensation practices they follow, but also the practices they do not follow.

One way that companies approach this is through the inclusion of simple “What We Do” vs. “What We Don’t Do” tables. Five years ago, none of the companies within the S&P 100 had these tables featured in their proxies, whereas today 18.0% incorporate a similar table or program checklist. On average, the “Dos” and “Don’ts” sections tend to be around six or seven items in length and address topics such as pay for performance, severance-related compensation, risk mitigation, stock ownership guidelines, anti-hedging/pledging policies, and other key corporate governance areas.

Companies including these tables are looking to appease not just shareholders, but proxy advisory firms as well. In evaluating these lists, approximately two-thirds of the items stated in an average “Don’ts” section were found to directly overlap with the items found on ISS’s official poor pay practices list.

Chart 1 Compensation Program Checklists



## RR DONNELLEY COMMENTARY

Any company that has ever received a negative proxy advisor recommendation—or investor vote—because the reviewer simply “missed” a key fact disclosed midway in the proxy can appreciate the value of such checklists. One objective of including such lists in a highly visible fashion is to make it as unlikely as possible the information will be overlooked.

Also, since virtually every company maintains some practices that someone may criticize, companies want to put these practices in context. Part of this involves reminding investors not just of pre-existing best practices, but also of “shareholder-friendly” changes they have made over the past year or two, whether based on investor feedback, board and management decisions, advisor input, or evolving best practices. In effect, they are saying “you may not agree with every one of our current practices, but give us credit for the direction and distance we have come—and the journey continues.”

## SUPPLEMENTAL PAY CALCULATIONS

Since 2009, CD&As have increasingly discussed supplemental methods of

## KEY FINDINGS

- Supplemental methods of calculating compensation grew more common in 2012. While Realizable Pay was only disclosed by a single company in 2009, 2010, and 2011, it was disclosed by four companies in 2012 and eight companies in 2013. Over the same period, references to Realized Pay increased from eight companies in 2009 to 35 companies in 2013.
- Pay for performance references increased in the wake of Say on Pay. Emerging as a principal phrase in compensation disclosures, pay for performance was cited in the most recent proxies of 81 companies, as compared to 59 in 2009.
- Shareholder engagement disclosure increased as more companies reached out to investors. In 2009, six companies disclosed outreach efforts to shareholders, and this increased to 49 instances disclosed in 2013.
- Proxy advisory firms were mentioned more frequently. In 2009, 2010, and 2011, three companies referenced either specific proxy advisory firms or proxy advisory firms in general. These references increased to 11 and 17 companies in 2012 and 2013, respectively.

Chart 2 Realizable Pay References

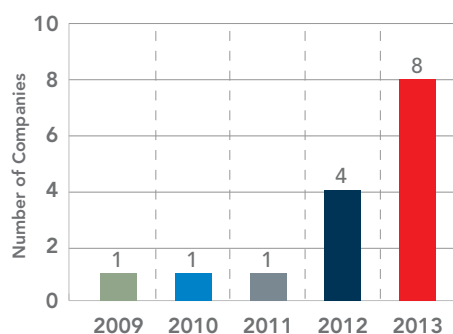
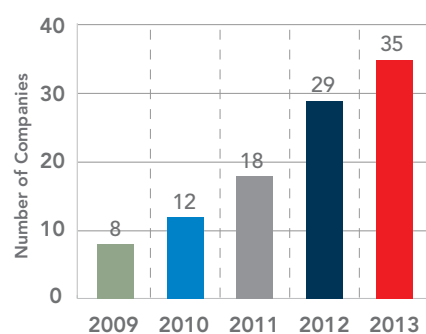


Chart 3 Realized Pay References



calculating executive compensation. Summary Compensation Table figures are being supplemented by these pay calculations, namely Realizable and Realized Pay, to paint a fuller picture of how executives are paid. Although there are different methods of calculating Realizable and Realized Pay, for the purposes of this report, all definitions were counted.

In 2009, only one company mentioned Realizable Pay in its CD&A, but that number grew to eight mentions in 2013. Mentions of Realized Pay grew from eight to 35 from 2009 to 2013. Accenture was the only company to mention Realizable Pay in all five years.

## SPECIFIC METRICS AND CRITERIA

In each of the past five years, a majority of the 100 sample companies disclosed specific performance metrics. In 2009, 62 of the 100 companies mentioned specific metrics in their plans. That number grew to 77 in 2012 but fell slightly to 74 in 2013.

There has also been an increase in the past five years in the number of companies mentioning the criteria and range for their peer group selection. All companies stating the specific parameters of their peer group criteria were tallied in this analysis. With increasing scrutiny of performance in relation to peer groups, companies appear to be increasing the amount of detail in the disclosure of peer group criteria for the readers of their proxies.

Chart 4 Specific Metric Goals

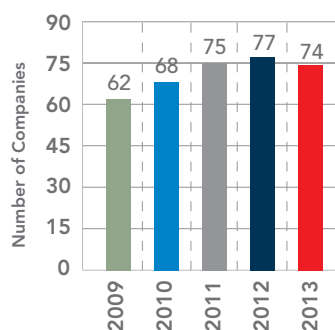
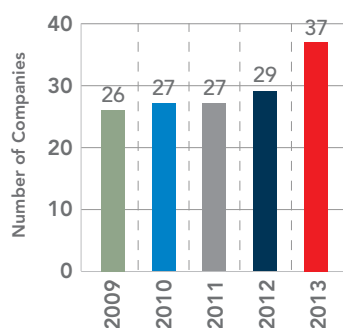


Chart 5 Peer Group Criteria Disclosures



## PAY FOR PERFORMANCE

Pay for performance has emerged as one of the key phrases in compensation over the last several years. It is no surprise that many companies do what they can to assure shareholders that they make this link between pay and performance as strong as possible. The number of companies with direct pay for performance mentioned in their annual proxies has increased consistently over the last five years, making up 81.0% of the S&P 100 in the most recent filing year.

The emphasis on pay for performance is important to note as its influence on the filing goes far beyond this simple metric of keyword mentions. The inclusion of supplemental pay tables and graphs addressing Realizable and Realized Pay

## RR DONNELLEY COMMENTARY

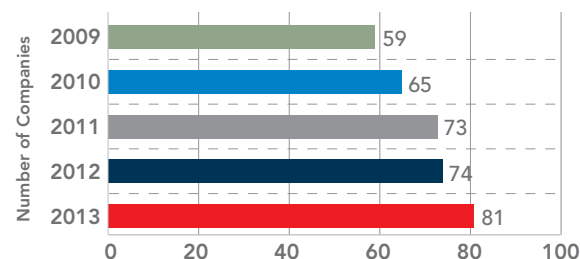
Our investor research revealed that the top three topics of interest by institutional investors are director independence, disclosure of performance goals, and pay for performance alignment, with investors giving companies relatively good grades on director disclosure but expressing less satisfaction with the clarity of compensation disclosures.

Companies with formulaic pay plans generally provide the most clarity about CEO and other NEO performance measures (for short- and/or long-term incentives), weightings, target levels of achievement, actual achievement, and resultant payouts. For these companies, investors focus on the clarity, appropriateness, and rigor of the performance measures and targets.

This is not to criticize more discretionary plans, which to investors appear more opaque or even "black box." But it does place added pressure on those companies to demonstrate pay for performance alignment. To the extent pay is compared to peers, including discussion of relative TSR, the focus is on the appropriateness of the peers and why they were selected. Here, we are seeing companies explain in greater detail their peer selection criteria, why they may have changed certain peers from one year to another, and even where their company ranks relative to peers on any of the key peer selection criteria shown in tabular or graphical format.

Lack of clarity around performance goals or peer selection often leads to investor skepticism and negative votes.

Chart 6 Pay for Performance References





expanded discussions on performance criteria in regard to annual bonuses and equity awards, and many other changes to the proxy can also be attributed to the increased focus on pay for performance. With all the attention the topic now receives, its impact will likely continue to increase in the years to come.

## RR DONNELLEY COMMENTARY

Virtually all companies list pay for performance as a key element of their compensation philosophy and its administration. Investors look past these assertions, seeking hard data particularly on CEO pay for performance alignment. A diverse array of graphical depictions is being utilized. But first, several questions arise: 1) What is pay? Is it SEC Summary Compensation pay, or some alternative form of Realized or Realizable Pay? 2) What is performance? Is it TSR (absolute or relative), and/or performance against relevant financial or operating metrics? 3) What is the appropriate performance period? Is it one year, three, five, or longer? 4) How does pay compare to peers? Again, the focus is on the appropriateness of the peer group.

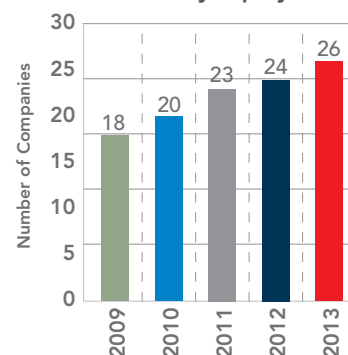
One cautionary note: While companies may consider traditional time-vested stock options to be performance based, investors and proxy advisors do not, unless the options vest based on specific performance criteria. In part for this reason, investors have reported to us that they look skeptically upon, or even ignore, the common fixed-versus-performance-based graph unless they have clarity and confidence in the underlying performance criteria.

On a fundamental level, the question we've most often heard from investors, even prior to CD&As, is, "How does pay support strategy?" If investors understand that alignment, they are more likely to support the overall program. Watch out for sending mixed messages. If in your investor relations messaging you've told investors, "This is what will drive the success of our company and efforts to grow shareholder value, and how you should track our progress," yet your proxy discloses nothing approximating those "value-drivers" among the CEO's performance goals, investors understandably may wonder, "You said X is important, but you're paying for Y. Please explain." Furthermore, rather than ask the question, many investors will simply vote against and move on to their next portfolio companies whose meetings are the same day as yours.

## INTERNAL PAY EQUITY

Internal pay equity is another factor many companies consider when designing pay packages. Although a CEO's pay is often heavily influenced by external factors, many will agree that the final amount should still remain reasonable compared to what other individuals at the corporation receive. Within the last year, 26.0% of S&P 100 companies mentioned looking at internal pay equity while determining pay, a 44.0% increase from five years ago. Interestingly, internal pay equity among S&P 100 companies did improve over that period, with the median pay multiple of CEO compensation compared to average NEO pay falling from 3.4 to 2.6. These proxy mentions of internal pay equity, however, rarely go into any detail as to what the company actually targets or aims for when looking at pay equity. With the exception of E. I. du Pont de Nemours and Company, which disclosed target pay multiples for its CEO compared to its other NEOs, no other S&P 100 company provided numbers in internal pay equity discussions.

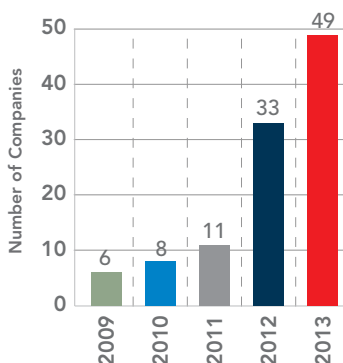
Chart 7 References to Internal Pay Equity



## SHAREHOLDER ENGAGEMENT

In response to the advisory vote on executive compensation legislation introduced by the Dodd-Frank Act in 2009, compensation committees have reached out to shareholders to address many potential shareholder concerns. Mentions of their engagement with shareholders have increased each year since.

Chart 8 Shareholder Engagement References

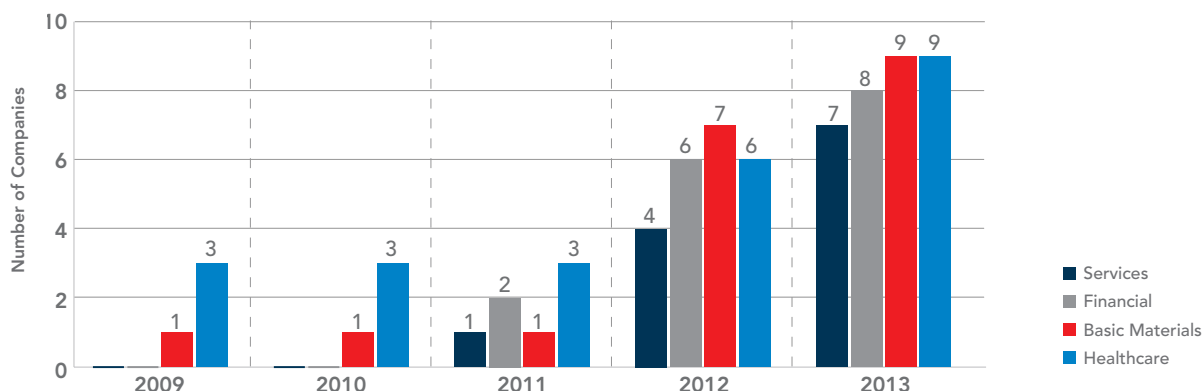


Recent public conversations with shareholders at Oracle and Simon Property Group illustrate that not passing a Say on Pay vote can lead to immediate shareholder engagement. Simon Property Group received 25.7% in favor of its executive compensation policy in 2012. After not passing, the company introduced a shareholder outreach program.

The response from Simon Property Group helped them pass the

Chart 9

## Shareholder Engagement References by Sector



following year by more than doubling the approval percentage from the year before, receiving 55.1% in favor of its executive compensation policy in 2013.

Disclosure of shareholder engagement has increased in frequency over the past five years among S&P 100 companies. This trend will likely continue as the practice of engaging shareholders emerges as common practice within corporate governance. Engaging shareholders could help companies pass their advisory votes on executive compensation if shareholders agree that the discussions were effective in aligning companies' executive compensation policies with shareholders' best interests.

## PROXY ADVISORS

Proxy advisory firms have become familiar names in the world of corporate governance. Companies frequently issue statements regarding the recommendations of proxy advisory firms. The creation of the advisory vote on executive compensation has magnified the presence of proxy advisors in the discussion of executive compensation policies. It has only been within the past two years that these proxy advisory firms and their recommendations are now more frequently mentioned in proxies.

Although proxy advisory firm mentions are not as prominent as shareholder engagement, the rise of their mentions in proxies is closely related to the reasons that shareholder engagement mentions are

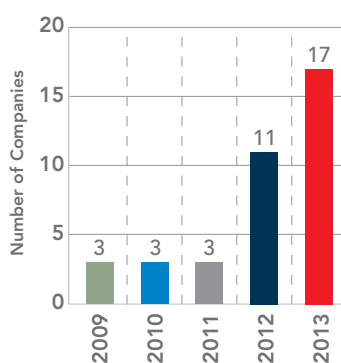
increasing. Proxy advisory firms advise shareholders on how to vote on shareholder proposals, and as a result, companies are reaching out to the proxy advisory firms to ensure that their proposals are satisfactory. More companies will likely mention proxy advisory firms in their proxies if they feel it is necessary to counter negative recommendations from the advisory firms.

## RR DONNELLEY COMMENTARY

Many have expressed concern that proxy advisors have outsized influence over Say on Pay and other votes. In reality, most investors that subscribe to one or more proxy advisors use them primarily as data aggregators and as screening tools, often giving a "free pass" to companies receiving positive recommendations, and further scrutinizing companies receiving negative recommendations. To companies, it may appear that investor voting in line with proxy advisor recommendations indicates a causal relationship. Most investors would assert that the votes are parallel—with the proxy advisors simply reflecting the investors' direct views.

This debate will rage on, but what is clear to us is that one mark of a great proxy is that it conveys a sufficiently clear and compelling story such that a meaningful number of investors, who typically might follow a negative proxy advisor recommendation, will instead support the company.

Chart 10 Mentions of Proxy Advisory Firms



# \$EYMOUR CASH

## "SEYMOUR MEASURES UP"



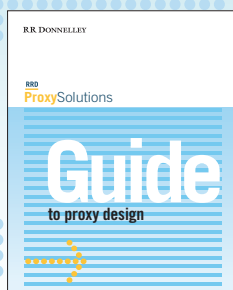


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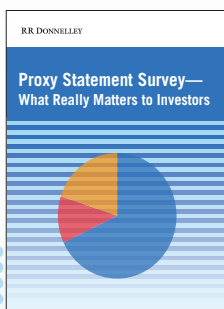
## TOOLS



## Our Proxy Guide

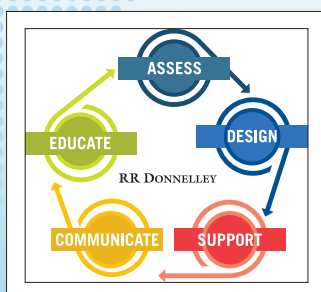
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