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FOR CO-OP DIRECTORS

Executive Compensation: Emerging Trends and Best Practices

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Agenda

- ❖ Role of the Board and Compensation Committee
Compensation Executive Compensation
- ❖ Key Board Decisions Regarding Executive Compensation
 - Competitive Market Comparisons
 - Structure of the Pay Package
 - Determination of Performance Metrics/Objectives
 - Management of Risk in Incentives
- ❖ External Influences
 - Dodd-Frank Rules and Potential Spillover to FCS
 - Social Concern Over Pay Inequality and Gender Pay Equity

CEO Compensation

- ❖ What would you consider to constitute “good governance” practices regarding CEO executive compensation?
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Governance of Pay

- ❖ The board owes a *fiduciary duty* to the corporation and the shareholders. Challenges to board decisions regarding pay receive deference under the Business Judgment Rule. The Business Judgment Rule requires the board satisfy the following:
 - Duty of Care – Make informed business decisions based on all material information reasonably available.
 - Duty of Loyalty – Act in a manner reasonably believed to be in the best interest of the corporation and shareholders - no self-dealing.
 - Duty of Obedience – Act within scope of delegated authority under law and the compensation committee charter.

Role of the Board Compensation Committee

❖ Duty of Care:

- Information and governance process matter
 - What information does the board need to properly carryout its responsibility for review and approval of of compensation plans and policy?
 - What is the proper process for oversight of pay?
 - What is the proper process to ensure pay is supportive of leadership development and succession planning?

Role of the Board Compensation Committee

❖ Duty of Loyalty:

- Generally not an issue for compensation decisions unless such decisions are made with an understanding or realistic expectation of reciprocal benefit to the director.
- Board decisions regarding director compensation are reviewed under a heightened standard given the conflict of interests in such decisions.
 - There have been several lawsuits claiming “excessive” director compensation
 - Courts have used the “entire fairness standard” of review rather than the business judgment rule in assessing such claims

Role of the Board Compensation Committee

❖ Duty of Obedience:

- Requires that the responsibilities articulated in the Compensation Committee Charter are addressed by the committee.
- A standard safeguard is to match the specific responsibilities to the committee meeting calendar to ensure that all of the duties in the charter are addressed at meetings of the committee and are reflected in the minutes.
 - A best practice is to review the committee charter and the corresponding meeting calendar on an annual basis

Role of the Board Compensation Committee

- ❖ For compensation decisions, what level of executive should the full board review vs. the compensation committee vs. delegation of authority to the CEO?
- ❖ What are the potential areas of tension between the role of the compensation committee and the CEO when it comes to compensation decisions?
 - Boards need to balance the tension between good governance of pay and micro-management of the company

Role of the Board Compensation Committee

- ❖ What should be the role of the Board in:
 - Selecting external benchmarks for “market rates”
 - Selecting performance metrics for incentives
 - Mix of short-term versus long-term incentives
 - Assessing risk in incentives
 - Reviewing performance and succession for the CEO and other key executive positions
 - Discussing the optics of executive pay and communicating with stakeholders and others regarding pay and performance

Two Key Touchstones for Evaluation of Executive Compensation

❖ Effectiveness & Efficiency

- *In the context of executive pay, what does the concept of effectiveness mean?*
- *Similarly, how would you know if the executive compensation program is efficient?*

Factors to Be Considered in Developing an Executive Compensation Package

- ❖ Total pay competitiveness
- ❖ Link between pay and business strategy
- ❖ Mix of compensation
- ❖ Difficulty of incentive hurdles
- ❖ Retention of talent versus external opportunities
- ❖ Retirement benefit impact
- ❖ Expectations of the senior executives
- ❖ Risk inherent in the performance objectives and the corresponding incentive leverage/payout opportunities and how the mix of pay and metrics help mitigate excessive risk-taking
- ❖ Internal equity
- ❖ Optics with key stakeholders and regulators

Three Key Decisions Regarding Pay

1. Pay → *Versus Whom?*

2. Pay → *In What Form?*

3. Pay → *For What?*

Versus Whom

- ❖ Industry competitors
- ❖ Similar size cooperatives, associations
- ❖ Organizations with similar performance, image and reputation
- ❖ Broader market for executive talent
 - Regional
 - National
 - Specific firms from whom you have recruited talent or to whom you have lost talent

The Issue: Pay in What Form?

Forms of Pay

- ❖ Cash-based awards
 - Annual Incentive
 - Long-term cash incentive
 - Performance Units
- ❖ Equity-like Awards
 - Phantom stock
 - Book value shares
- ❖ Current or Deferred Payout
- ❖ Perquisites and Executive Benefits
 - Supplemental Pension
 - Executive Medical and Disability Coverage
 - Severance/Golden Parachutes

Board Decision Points

- ❖ Why provide one or more of these forms of pay?
- ❖ How does each element of pay fit with the Board's pay philosophy? Fit with culture?
- ❖ How does each form of pay drive performance or retention of key talent?
- ❖ What is the proper mix of fixed vs. variable pay?
- ❖ Annual vs. Long-term?
- ❖ How to mitigate excessive risk-taking?
- ❖ How will it look to stakeholders?
- ❖ Tax/accounting/expense implications?

Annual Bonus: Design Considerations

- ❖ How much at targeted payout?
 - Bonus usually set as a percent of salary
- ❖ How much to pay for different levels of performance:
 - At threshold, target and max
 - (e.g., 25%, 100%, 200% of targeted award)
 - Slope of payout curve – linear, steep, flat, asymmetrical
 - What do different slopes signal to the participants?
 - Capped vs. Uncapped payout opportunity
- ❖ Payout currently or require deferral
 - Retention of talent
 - Risk management/recoupment

Long-Term Incentives

- ❖ Why grant long-term awards
 - Increased emphasis over recent years in linking a greater portion of pay to long-term results
 - Sustained performance and/or risk mitigation
- ❖ Percent of total pay based on long-term incentives?
 - Long-term incentives represent 60% to 70% of large company CEO total pay
- ❖ Type of award to grant?
 - Cash-based awards (performance units)
 - Equity-like awards (phantom or book value shares)
- ❖ Length of performance cycle?
 - Most common is 3-years
 - Over lapping awards or end-to-end award cycle
- ❖ Additional deferral/vesting after awards are earned?

How prevalent are long-term incentives in your organizations?

Pay for What?

- ❖ Executive's position within the company
 - Scope of responsibility
 - "Tournament theory"
- ❖ Overall financial results
 - Financial measures that create value
 - Safety and soundness measures for risk mitigation
- ❖ Increasingly firms are rewarding accomplishment of non-financial goals
 - Sustainability, employee engagement, diversity, talent development, other "intangibles"
 - Assessment of individual performance – what percent of bonus on non-financial goal?
- ❖ Attraction (*golden hello*)
- ❖ Retention (*golden handcuff*)
- ❖ Termination (*golden goodbye*)

Pay for What?

- ❖ Most incentive plans base payouts on the achievement of pre-determined financial objectives
 - Profit, revenue and cash flow are the most prevalent metrics for incentive awards
 - Individual performance objectives
 - Increasingly return measures are being used (ROIC, ROE, ROA)
- ❖ Key decision for the compensation committee is whether to adjust or not adjust for non-operating issues. Some of the more common adjustments to GAAP financial results are:
 - Foreign exchange, litigation expenses, legal settlements, tax law change, divestments and acquisitions
 - Should incentive eligible results be adjusted for the impact of tariffs?

Executive Severance

- ❖ Why provide severance?
- ❖ Have a set policy/practice or ad hoc?
- ❖ What types of termination would warrant severance? Which would not?
- ❖ How to determine amount of severance?
 - Tenure, and/or circumstance surrounding termination
- ❖ Form of severance payments
 - Salary continuation or multiple of salary and bonus
 - Vesting long-term awards
 - Continuation of perks and benefits
- ❖ Conditions on the severed executive
 - Non-compete
 - Non-solicitation
 - Waiver of legal claims
 - Non-disparagement
- ❖ Trend is toward less generous severance

Special Severance – “Golden Parachutes”

- ❖ Companies generally provide special severance in the event of a merger and involuntary termination or voluntary separation for “good reason” following a change in control.
- ❖ Good reason includes:
 - Termination
 - Demotion
 - Relocation of office > 50 miles
 - Cut in pay or benefits
 - Change in title or status
- ❖ Typical benefits provided
 - 3 times salary plus bonus (trend toward 2 times)
 - Accelerated vesting of long-term incentives (trend toward pro-rated vesting)
 - Continuation of benefits
 - Extra pension service and age credits
 - Outplacement services

The Regulatory Landscape: Status of The Implementation of the Dodd-Frank Act

Composition of the SEC in 2018



Robert Jackson (D)
Term ends 2019



Kara Stein (D)
Term Ended 2017*



Chairman
Jay Clayton
Term Ends 2021



Elad Roisman (R)
Term Ends 2023



Hester Peirce (R)
Term ends 2020

**Commissioners may serve up to 18 months beyond the expiration of their terms*

Dodd-Frank Disclosure Requirements

Issue	Requirement	Regulatory Status
Pay Ratio	<ul style="list-style-type: none"> Ratio of median global employee to CEO 	<ul style="list-style-type: none"> First Disclosures in 2018 Proxies
Pay for Performance	<ul style="list-style-type: none"> Link between comp “actually paid” & financial performance 	<ul style="list-style-type: none"> Rule proposed 4/29/15; 3-2 vote
Clawbacks	<ul style="list-style-type: none"> No-fault policy on current, former executive officers 3-year lookback 	<ul style="list-style-type: none"> Stock exchange listing standard SEC rules proposed 7/1/15; 3-2 vote
Hedging Disclosure	<ul style="list-style-type: none"> Disclosure of Hedging Policies 	<ul style="list-style-type: none"> Rule proposed 2/9/15; 5-0 vote
Incentive-Based Compensation	<ul style="list-style-type: none"> Prohibit excessive compensation Prevent risks leading to “material financial loss” 	<ul style="list-style-type: none"> Rule proposed 3/30/11 Revised rules proposed 4/21/16

Looking Forward: What Can We Expect?

- ❖ Continued pressure on non-performance elements of executive pay
 - perquisites, supplemental pensions & severance arrangements
- ❖ Increased communication with major stakeholders regarding pay, performance and value creation
- ❖ Increased scrutiny of the rigor of performance metrics and objectives
- ❖ Increased focus on CEO succession and talent development

Continued Focus on Risk Mitigation – Clawbacks

- ❖ Wells Fargo and Equifax have increased legislative and regulatory focus on clawbacks as a key response to excessive risk and corporate missteps
 - Would you want your CEO to face Elizabeth Warren over a failure of risk management?
 - <https://www.c-span.org/video/?415547-1/ceo-john-stumpf-testifies-unauthorized-wells-fargo-accounts> beginning at 1:26.40
- ❖ What governance lessons can we learn from the Wells Fargo fiasco?

Looking Forward: What Can We Expect?

- ❖ Increased focus on environmental, social and governance (ESG) metrics of performance
 - Are ESG issues a topic of your committee discussions?
 - Should ESG factors be part of incentive objectives?
- ❖ Increased adoption of clawbacks and clarity as to how the policies would be implemented (e.g., reputational harm)
- ❖ Increased focus on board “refreshment” and gender representation on board (e.g., California requirement re board diversity)

Looking Forward: What Can We Expect?

❖ Greater attention to pay inequality

- Beginning in 2018 public companies were required to disclose the ratio of CEO pay to that of the median employee
 - Median employee based on an analysis of the pay of full-time, part-time, seasonal and all employees both domestic and located outside of the US
 - Part-time and seasonal workers could not be annualized to full-time equivalents

Pay Ratio Disclosure Example

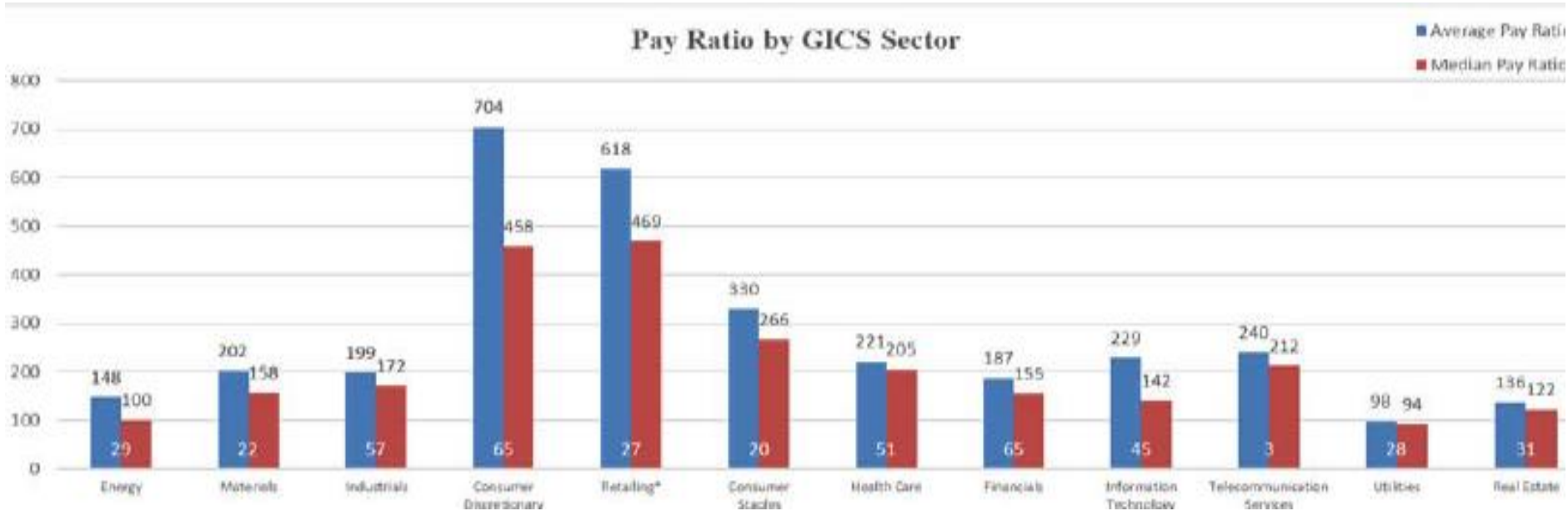
BNY Mellon

- *The 2017 annual total compensation of the median employee of BNY Mellon (other than our CEO) was \$55,970;*
- *The annual total compensation of our CEO, Mr. Scharf, was \$19,837,535; and*
- *For 2017, the ratio of the annual total compensation of Mr. Scharf to the median annual total compensation of all our employees was 354 to 1.*

McDonald's Corporation

- *The 2017 total compensation for our median employee (a part-time restaurant crew employee located in Poland) was \$7,017.*
- *our CEO's 2017 total compensation was \$21,761,052,*
- *resulting in a ratio of 3,101:1.*

Pay Ratio By Industry



S&P 500 Pay Ratio Data as of 8/14/18

Looking Forward: What Can We Expect?

- ❖ Increased attention to gender pay equity and pay parity
- ❖ Example:
 - UK Amendments to Equality Act 2010 require disclosure of mean and median pay gap between men and women
 - Reported in four pay quartiles
 - Disclosure applies to all employers with 250 or more “relevant employees” in the UK
 - “Relevant employees” are those who ordinarily work in Great Britain and whose contracts are governed by U.K. legislation.
 - Initial disclosures show median pay gap of 10%, but larger issue is under-representation of women in highly paid positions across industries
 - France is adopting a similar requirement
- ❖ Critics would like to have the UK approach adopted in the US

Gender Pay Equity - US

- ❖ State bans on disclosure of salary history proliferating
- ❖ Arjuna Capital has launched multi-year shareholder campaigns targeting financial services, tech and retail demanding gender pay disclosures
 - Many voluntary disclosures including Bank of America, BNY Mellon, American Express, MasterCard, Wells Fargo

Gender Pay Equity Example

Bank of America Gender Pay Equity Disclosure

... as part of our regular work to support our gender and race neutral pay-for-performance philosophy, we have retained outside experts that use rigorous process and analysis ... compensation received by women is equal to on average 99% of that received by men. Results also showed that compensation received by minority teammates is equal to on average 99% of non-minority teammates.

Pay Inequality and Gender Pay Equity

- ❖ Is pay inequality an issue your board focuses on?
- ❖ Has gender pay equity been a topic of focus for the board?

Continued Focus on Now Organizations Deal with Sexual Harassment

- ❖ Several senior executives terminated for sexual harassment
- ❖ Controversy over severance payments to executives terminated for violation of code of conduct

The New York Times

Why Les Moonves Might Still Get \$120 Million From CBS

Employee Discontent Threatens Google's Reputation

Walkouts demonstrate a crisis in faith at a company that prides itself on its culture

Employee activism at Google has risen of late in response to a New York Times article last week, which detailed how the company protected three senior executives over the past decade after they were accused of sexual misconduct, including one who received a \$90 million exit package in 2014. Google declined to comment on details in the Times story.

Continued Focus on How Organizations Deal with Sexual Harassment

- ❖ What is the board's role in monitoring sexual harassment within the organization?
- ❖ Has sexual harassment been a topic of discussion for your compensation committee? The full board?

QUESTIONS?