Issue 15 2014

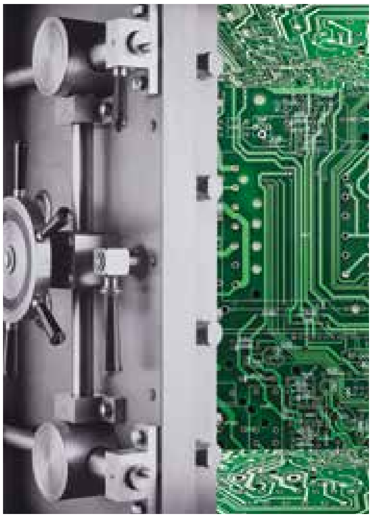
CSUITE INSIGHT

RISK

CONTENTS

ISSUE 15 2014

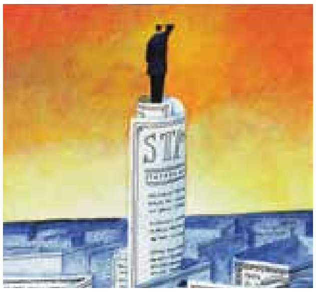
Features

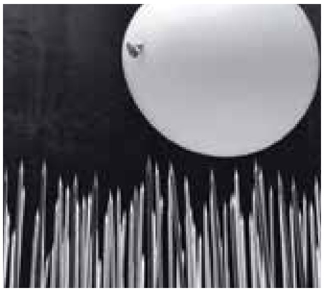


COVER STORY

CONTENTS

ISSUE 15 2014





Latest Research

Departments

Feature Interviews

CSUITE INSIGHT

C-Suite Insight is published by

EQUILAR®
1100 Marshall St.
Redwood City, CA 94063
Phone: (650) 241-6600
www.equilar.com

Send address changes and circulation inquiries to the above address.

Publication Management
GLC
glcdelivers.com

PRINTED IN THE USA EQU-003

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.

Risk

Risk is one of the most important topics executives and board members wrestle with as they seek growth and success. It comes in many shapes and forms—from security threats posed by advancing technologies to sudden market shocks in commodities. Successfully managing these risks requires being proactive and well-informed. Our latest issue of *C-SUITE Insight* explores some of the greatest risks facing companies today. We provide our readers with the knowledge and experience of a diverse set of board members, executives, lawyers, consultants, and risk experts.

Chip Lawrence, Management Development and Compensation Committee Chair, and Sarah Teslik, Senior Vice President of Communications, Public Affairs, and Governance, provide an account of Apache's recent Say on Pay experience as they used a difficult vote to make changes to compensation and governance issues through engagement with shareholders. Also, David Holley, Managing Director at Kroll, shares his views on risk and the best strategies to protect valuable assets. David Eaton, Director of Research at Glass Lewis, identifies how his company's research helps investors minimize risk while maximizing value.

You will find thought leadership pieces from our regular contributors at Corporate Board Member, RR Donnelley, and The Miles Group. We also asked a number of governance professionals to discuss their thoughts on the risks faced by board members in our "Ask the Experts" feature. Of course, we can't forget to check in on Seymour Cash to find out what he's doing about upcoming SEC regulations.

We are grateful to all our contributors for providing their thought leadership and insight. We appreciate your taking the time to read our latest issue. Have a wonderful rest of the year. Please enjoy and feel free to contact me with your feedback. C

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

FEATURE

Game of GUI

The Critical Role of the Board in Overseeing Risk

by Belen E. Gomez

During the global financial crisis, the threat of collapse of some of the largest financial institutions and downturn in stock markets produced crippling effects across many different industries and markets. Together, they exposed the gaps (or, in some cases, the complete failure) in risk management and oversight processes. In the years following, organizations have had to reassess their approach to risk exposure and management to rebuild wisely and alleviate shareholders' concerns.

Regulators intervened in an attempt to prevent this catastrophic failure from recurring. The Dodd-Frank Wall Street Reform and Consumer Protection Act implemented a host of new regulations. Specifically, there was an acute focus on a board of directors' role in risk oversight, and this aspect remains even today. Now more than ever, investors expect boards to clearly disclose how they are executing their oversight responsibilities to mitigate the risks associated with strategic business decisions.

Companies should invest in building robust risk management programs as **the cost of not doing so could potentially be much greater**.

SHAREHOLDER EXPECTATIONS

Elected by shareholders to represent them, a board of directors is responsible for overseeing executive leadership's actions in the best interests of the company and its investors. This oversight function comprises a critical factor in establishing the risk appetite for the company and ensuring that strategic decisions are aligned with the company's risk profile.

To effectively perform their fiduciary duties, it is imperative that directors understand the risks facing the companies they serve. With increased scrutiny from regulators and shareholders, risk oversight processes have evolved. Boards have changed their approaches to strategic decision making. They are establishing more effective methods by which to identify and analyze the areas of greatest concern. Strategy is driven not only from a financial perspective but also by careful assessment of the impact of potential risks.

The recent Hot Topics report "The 2014 Boardroom Agenda," published by Deloitte's Center for Corporate Governance, defined risk assessment as a part of setting strategies: "Risk-intelligent organizations consider potential threats and strategically select the risks needed to pursue value before making any decision. The board should assist management in incorporating risk intelligence into the company's strategy. Similarly, boards should understand and accept

DANCE

an appropriate risk appetite, continually assess the maturity of the risk governance process, and seek to ensure that the organization discloses the risk story to its stakeholders."

The difficulty of this role lies in determining the risk-and-reward balance. The boards that effectively manage risk realize that all potential risks cannot be managed simultaneously. They understand that there are risks that will require more focus and effort, and they also recognize those risk areas where they have the greatest opportunity for reward. Depending on risk appetite, some boards may be too risk averse, thereby avoiding strategies where the uncertainty of success is too great.

The challenge for directors is to remain up to date on all material risks, even though they meet as a board four or five times per year. Additionally, today's boards understand that shareholders expect to be kept abreast of the measures taken to avoid undue risk and be assured that steps are being taken to mitigate the greatest risks that threaten the success of the company.

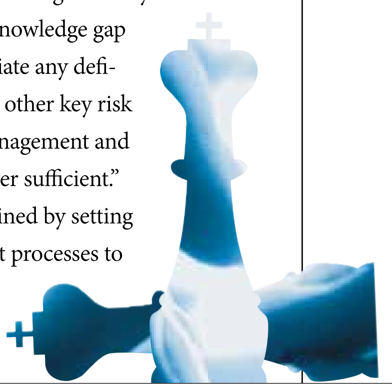
RISK INTELLIGENCE IS KEY

In large part, a board's ability to oversee risk management is influenced by the information provided by the executive team. Recently, the focus on enterprise risk management processes has increased as companies seek to ensure that thorough risk analyses are available for their senior leaders and boards. It is widely understood that the quality of risk intelligence that board members receive is paramount for boards to effectively execute risk oversight responsibilities.

Effectively analyzing and prioritizing risks—and then condensing these findings into valuable information—are critical to the success of the board's oversight role. While the board is now integral to setting the risk tolerance of an organization and making broad strategic decisions accordingly, it is the executive team that must ensure operational decisions are aligned with the company's risk appetite. It is imperative that the board and senior leadership team establish rigorous processes to deliver information on potential risks to the top of the organization. Companies should invest in building robust risk management programs as the cost of not doing so could potentially be much greater.

In the report "Risk Oversight: Evolving Expectations for Boards," authors Parveen Gupta and Tim Leech suggest how boards can take the lead in closing gaps that prevent them from receiving critical information: "Boards should ensure a formal assessment process is in place to identify risk governance skill and knowledge gaps for all key players in the company, including the board, and a clear-cut plan to close any gaps. Boards can lead by example by requesting an entity-level risk management and governance skill and knowledge gap assessment and a training plan to remediate any deficiencies. This will send a strong signal to other key risk governance players, including senior management and work units, that the status quo is no longer sufficient."

Successful execution is largely determined by setting a strong foundation for risk management processes to deliver high-quality, comprehensive risk



information to the board. Wise companies will take a more proactive approach to thoroughly identify and understand risk. By doing so, they better position themselves for more informed strategic decisions and the ability to capitalize on future opportunities. Enlightened boards realize that implementing risk policies and controls creates a competitive advantage for their companies—allowing swifter strategic movement within the marketplace and a thorough analysis of each decision's impact on a company's risk profile.

TOP RISKS FACING TODAY'S ORGANIZATIONS

The board serves as another checkpoint for executive teams who are often "too close" to spot all the areas that may be cause for concern. However, over the past decade, the cultural phenomena of globalization, technological advancements, and regulatory and societal changes (among others) have increased exposure to the number and types of risks. These factors make it even more difficult for boards to effectively identify, assess, and mitigate risk.

In a recent survey of board members from companies large and small, the risk consulting firm Protiviti, collaborating with North Carolina State University, categorized risk into three general areas.

3 Risk Categories:

Macroeconomic At a high level, macroeconomic risks were defined as those relating to global markets, currencies, and access to capital.

Operational Operational risks include cyber threats, supply chain issues, and succession planning.

Strategic Strategic risks are related to regulatory changes, competitors in the marketplace, and disruptive technology.

Interestingly, researchers found that **boards rank regulatory risk as the greatest risk to companies today**. According to the report, "Regulatory changes and heightened regulatory scrutiny may affect the manner in which an organization's products and services will be produced or delivered. This suggests companies continue to have significant concerns that regulatory challenges may affect their strategic direction."

Faced with the sluggish pace of regulatory action and the uncertainty of rule implementation, it is difficult for companies to be proactive in managing regulatory risk.

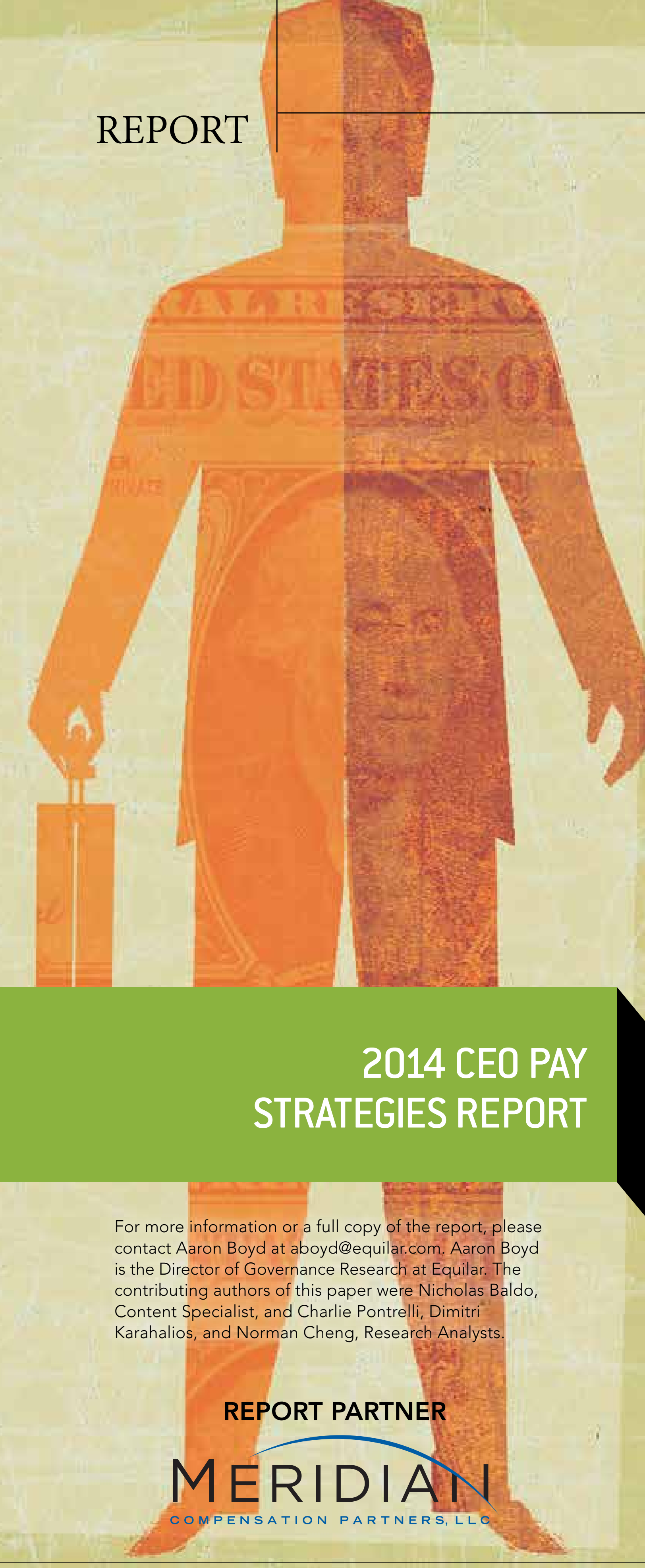
The next two highest-ranked risks fell into the macroeconomic category. Economic conditions were ranked as the second-highest risk that boards deal with. This indicates a general lack of confidence in the stability of the global marketplace and how a downturn in the markets can swiftly prevent successful execution on growth opportunities. Likewise, the third-highest ranked risk, uncertain political leadership, has a similar negative effect on organizations.

Surprisingly, cyber threats did not crack the list of the Top 5 greatest risks. Ranked sixth of the Top 10, the perception regarding cyber-related risks remained relatively consistent with last year's results. However, when the researchers focused on responses from larger companies, they found that cyber-related threats did move into the list of Top 5 threats. As the survey highlights, this indicates that larger companies perceive themselves as higher priority targets for cyber attacks and are taking great measures to prevent security breaches. Given the fast pace of technological advances, the level of sophistication and complexity of potential threats is constantly evolving; therefore, this threat requires more sophisticated systems to avoid risk.

LOOKING FORWARD

Governance processes around risk oversight and risk intelligence will continue to dominate hot-topic discussions in the industry as senior leadership teams and their boards navigate in turbulent times. Adopting or refreshing frameworks for addressing potential risks should be a key initiative for boards of directors to ensure that senior management has implemented the best processes to identify and mitigate their greatest risks. By linking thorough risk assessment to strategic decision making, boards have the power to steer their companies toward successful long-term growth. C

REPORT



2014 CEO PAY STRATEGIES REPORT

For more information or a full copy of the report, please contact Aaron Boyd at aboyd@equilar.com. Aaron Boyd is the Director of Governance Research at Equilar. The contributing authors of this paper were Nicholas Baldo, Content Specialist, and Charlie Pontrelli, Dimitri Karahalios, and Norman Cheng, Research Analysts.

REPORT PARTNER

MERIDIAN COMPENSATION PARTNERS, LLC

To the interested observer, CEO compensation plans can serve both as reflections of broader economic circumstances and as beacons that illuminate shareholders' expectations of their chief executives. In 2013, growth in CEO compensation demonstrated the extent to which CEOs benefitted from a strong economy, and the structure of pay plans made apparent the degree to which CEO compensation is expected to correspond to company performance. The following report examines how America's most influential companies motivate and reward their top executives.

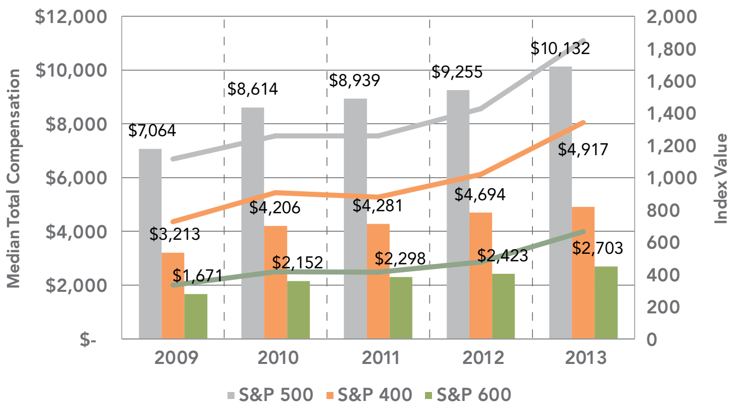
METHODOLOGY

The CEOs in this analysis include all who served in such position at the end of their company's applicable fiscal year and for the entire year preceding that. Previous versions of this report have excluded CEOs not in place for at least two full years and included only those years in the analysis. The new methodology has the benefit of more accurately reflecting the current makeup of America's CEO population and allowing comparison across any number of years. The period chosen for most graphs and statistics is five years, encapsulating the developments taking place since the financial crisis reshaped the American economy and once again brought increased national attention to compensation-related issues.

TOTAL COMPENSATION

The last year witnessed a continued rise in CEO compensation consistent with recent years, a trend that held across S&P 500, S&P MidCap 400, and S&P SmallCap 600 companies, as shown in Chart 1. The growth in CEO compensation was commensurate with exceedingly strong stock market performance throughout 2013.

Chart 1 **S&P 1500 Median Total Compensation by Index (in thousands)**



2010 saw a jump in CEO compensation, but the two years after saw much slower growth (and even a decrease at the upper quartile in the S&P 500). In 2013, pay increased significantly within the S&P 500 with the median of $10.1 million growing 9.5% over the 2012 median of $9.3 million—compared to 3.5% growth in 2012. While the 75th percentile of pay decreased 1.0% from 2010 to 2012, it grew notably 11.7% from 2012 to 2013.

- Median S&P 1500 CEO pay increased 8.5% in 2013, the highest rate of growth since 2010.
- In the S&P 500, median CEO pay increased 9.5% in 2013.

KEY FINDINGS

- **Median compensation in 2013:**
  - S&P 500: $10.1 Million (+9.5% YOY)
  - S&P 1500: $5.0 Million (+8.5% YOY)
- **Performance awards increasingly dominate equity compensation.** 75.7% of S&P 500 and 63.8% of S&P 1500 CEOs received performance-based equity grants in 2013, up from 71.0% and 57.1% in 2012 respectively. 13.0% of S&P 500 CEOs received only performance-based equity in 2013.
- **Realizable pay exceeds Grant-Date Fair Value pay.** Driven primarily by larger equity valuations, realizable pay, calculated using the methodologies of ISS, Glass Lewis, and the Conference Board Working Group, generally exceeds Grant-Date Fair Value pay.
- **Equity mixes that do not include performance-based stock are declining.** All equity mixes that included options and/or time-based stock without performance-based stock declined in 2013. The most common equity combination in the S&P 500 was options and performance stock, at 25.5% prevalence.

MERIDIAN COMMENTARY

- As companies gradually emerged from global recession over the last five years, CEO compensation continued to increase its sensitivity to pay-for-performance, with the vast majority of total compensation delivered via annual- and long-term incentives. As a result, CEO compensation increased commensurately with improving external economic conditions, growth in the stock market, stronger internal operating performance, and overall increasing company size through consolidation and organic growth.
- CEO compensation in any year reflects two critical aspects—performance over the past few years and expected performance in the next few years. CEO total compensation must be viewed in its entirety over a longer-term time horizon as sources of year-over-year movement in pay can often be hard to isolate and explain. Equity-based compensation, which constitutes a majority of CEO total compensation, is intended to reflect performance over 3 years or more and is subject to the vagaries of the market. Nevertheless, we see that, directionally, CEO pay has been generally moving up with the market.

Chart 2 **S&P 1500 Total Compensation (in thousands)**

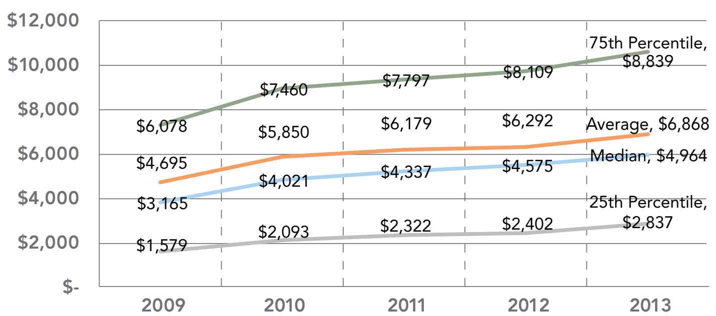
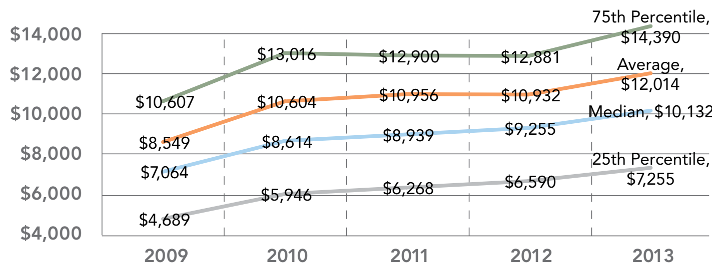


Chart 3 **S&P 500 Total Compensation (in thousands)**



MERIDIAN COMMENTARY

- With the majority of compensation delivered via equity, there is greater potential for outliers on the high-side, as illustrated by average pay being consistently higher than median pay levels (see Charts 2 and 3). This upwardly skewed phenomenon is a primary reason that shareholders are often critical of disclosed compensation philosophies that target the 75th percentile.
- Shareholders tend to be more open to targeting a range (like 50th to 75th percentile), suggesting some comfort when companies retain flexibility in targeting the competitive market and enabling an ability to reflect all aspects of individual pay drivers, including experience, competence, and scarcity of talent that can require target compensation to be above median. Pure 75th percentile pay positioning outside of a few circumstances (like being the largest in the peer group) is limited.

REALIZABLE PAY

The increasing desire for pay for performance transparency brings with it a need to define pay and performance. There is general acceptance that a company's performance can be represented by a measure such as total shareholder return (TSR) or a combination of financial metrics, including revenue and earnings per share (EPS). CEO pay, however, does not invoke the same consensus.

A number of different calculations are used to determine total CEO compensation. Grant-Date Fair Value has historically been a popular choice because it relies on figures from the SEC-mandated tables found in annual proxies and provides a level of compensation targeted by the company. However, a calculation that is quickly growing in popularity is Realizable Pay, which provides the strongest alignment between the performance of the company and the resulting pay for a given period. The relative novelty of Realizable Pay has led to a variety of calculation methods.

The proliferation of Realizable Pay definitions has resulted in inconsistency when they are used in pay for performance comparisons. As more companies begin to use them, three different calculations will likely prove most influential. The calculations used by ISS, Glass Lewis, and The Conference Board Working Group are currently the most influential, and one of those methods will likely gain wide-spread adoption.

Chart 4 compares S&P 1500 CEO pay using the four methodologies. Due to strong economic performance in 2013, many equity awards have values exceeding those disclosed on a Grant-Date Fair Value basis earlier in the year. Thus, Realizable Pay tended to exceed Grant-Date Fair Value pay during 2013, as shown below.

ISS's Realizable Pay figures are the highest, in part because pension and deferred compensation are included. ISS also uses the Black-Scholes method to value options rather than intrinsic value. This last point is crucial because it incorporates an additional time-based element into option valuation absent from other calculations.

- Using ISS and Glass Lewis definitions of Realizable Pay, CEO compensation exceeded Grant-Date Fair Value pay at the median. At the 75th percentile, all three definitions exceeded Grant-Date Fair Value pay.

Chart 4 **S&P 1500 2013 Realizable Pay Values by Definition (in thousands)**

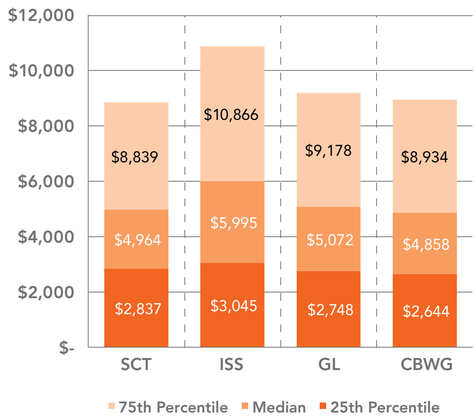
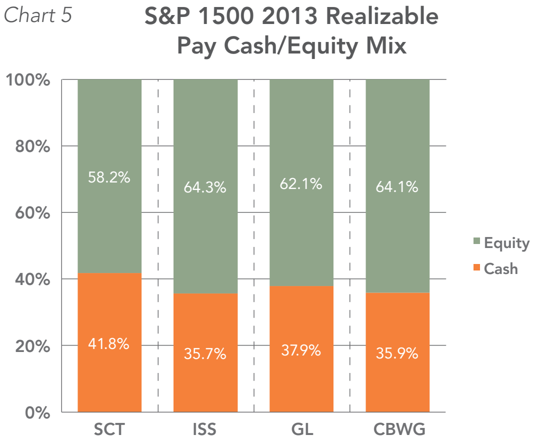


Chart 5 shows the percentage of S&P 1500 CEO compensation attributable to cash or equity on average, broken down by pay definition. Using the valuation methods commonly employed in Realizable Pay calculations for the year 2013 generally had the effect of boosting equity values.

- Equity made up a larger share of Realizable Pay totals than Grant-Date Fair Value totals across all definitions.
- Most of the discrepancy between Realizable Pay values and Grant-Date Fair Value (SCT) values is attributable to the greater amounts of equity in Realizable Pay calculations.

Though there is no single accepted definition of Realizable Pay yet, more and more investors are using it to evaluate pay packages as more companies choose to disclose Realizable Pay values in addition to the summary compensation table. With an understanding of the methodologies and time periods used in the calculation of alternative pay methods, investors and analysts can gain a deeper understanding of a company's pay packages beyond the standard SCT values.

Chart 5



MERIDIAN COMMENTARY

- The emergence of multiple, yet fairly similar Realizable Pay methodologies illustrates the challenge in fully reconciling the timing of pay relative to performance, the timing of pay disclosures, and the timing of compensation decisions. While each approach has its merits and limitations, this issue is indicative of how companies and shareholders must triangulate in on compensation to truly understand the quantum of pay in relation to performance over a multi-year time horizon.
- Companies can model and test different realizable pay methodologies to help identify potential issues and be prepared for potential questions. These methodologies can also be customized to better reflect the company's compensation program.
- Companies are split on including realizable pay in their CD&As as they can sometimes create more questions than answers. For many companies, these analyses are simply done for internal purposes to better monitor pay and performance.

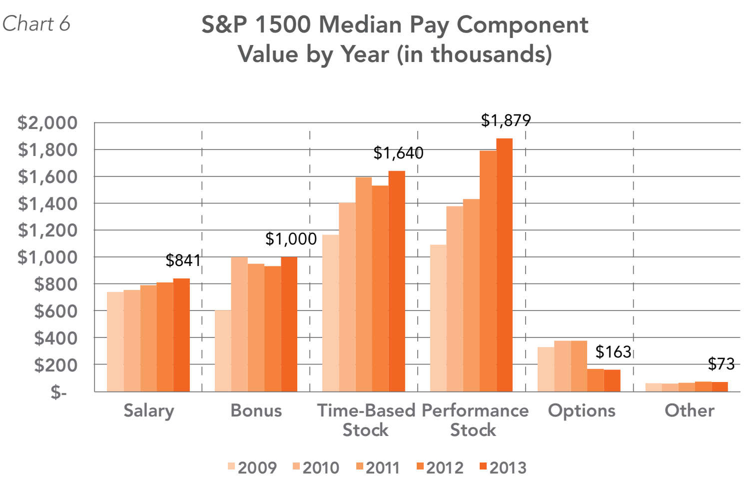
> "**COMPANIES ARE SPLIT** ON INCLUDING REALIZABLE PAY IN THEIR CD&As AS THEY CAN SOMETIMES CREATE MORE QUESTIONS THAN ANSWERS."

PAY COMPONENTS

Charts 6 and 7 vividly illustrate the degree to which CEO compensation trends over the last five years have been driven by stock awards. Median values of all other compensation elements are either flat over the time interval or down slightly, while median stock awards have grown sharply, thanks in large part to growth in performance-based stock compensation. Charts 6 and 7 show the median value for each pay type with 2013 values labeled.

- From 2009 to 2013, the median value of performance-based stock compensation in the S&P 1500 increased 49.8% from $1,089,832 to $1,879,465, while the median salary value increased a much lower 13.3%.
- Options were the only component that diminished, with the median value falling to around half of its 2009 figure of $331,556.

Chart 6

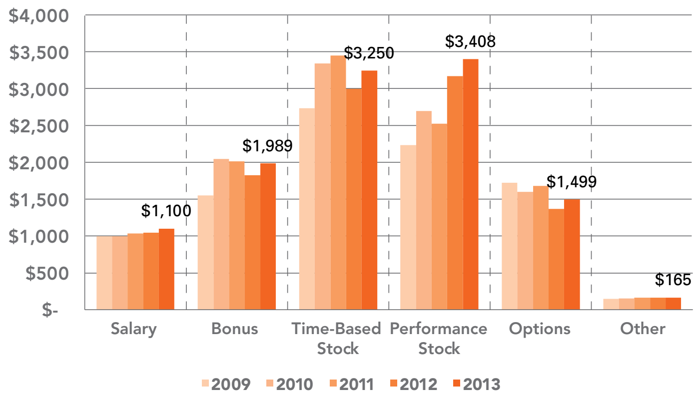


In the S&P 500, the same trends play out at higher values, and stock plays a larger role in compensation packages. While the ratio of median stock values to median salary values was about 2.3:1 in the S&P 1500 in 2013, the gap was much greater among the larger companies in the S&P 500, with median stock at nearly four times the median salary.

- In the S&P 500, median performance-based stock compensation increased 52.0% since 2009 and 7.3% since 2012.
- Options have not decreased as steadily as in the S&P 1500, and from 2012 to 2013, the median values granted instead rose, growing 9.5%.

Chart 7

S&P 500 Median Pay Component Value by Year (in thousands)



MERIDIAN COMMENTARY

- First, it is important to note that each category in Charts 6 and 7 is calculated independently, so it is not appropriate to add all the components to arrive at median total direct compensation level as not all companies grant all forms of equity.
- With ISS categorizing stock options as nonperformance-based and the continuing negative press stemming from the dot-com era, the WorldCom/Enron era, and the financial crisis, companies have reduced their emphasis on stock options in favor of performance-based, full-value equity awards, such as Performance Stock.
- With the prompt from ISS, companies were generally quick to see the benefits of performance stock plans as they are the one pay vehicle that can most easily be designed to meet all 3 primary objectives of LTIs: 1) Retain: performance plans are more likely to retain value than stock options; 2) Reward for sustained operating performance: performance plans are often tied to operating metrics over 3 years; 3) Aligned with shareholders: performance plans are typically settled in shares and often have share price as an underlying metric.

PERFORMANCE EQUITY AND EQUITY MIX

The type of equity that large American companies use to incentivize their executives has changed profoundly over the period studied. The years since 2009 have seen performance-based equity take center stage with the share of S&P 1500 CEOs receiving it rising from 39.7% to 63.8%. Performance-based equity is even more popular within the S&P 500, received by 75.7% of CEOs. Options, meanwhile, have declined from a prevalence of 58.0% among S&P 1500 companies in 2009 to 49.8% in 2013, though the last year appears to buck the trend of decline with prevalence levelling out. Larger companies are more likely to grant each type of equity and generally rely on a greater diversity of equity vehicles.

- Performance awards are now a more popular vehicle for S&P 1500 CEO awards than either time-based options or time-based stock.
- While S&P 500 companies have been the quickest to adopt performance awards, the rate of growth is similar at overall S&P 1500 companies.

> "EACH LONG-TERM INCENTIVE VEHICLE **PLAYS AN IMPORTANT ROLE** IN THE OVERALL OBJECTIVE OF COMPENSATION."

Chart 8

S&P 1500 Equity Vehicles Grant Prevalence

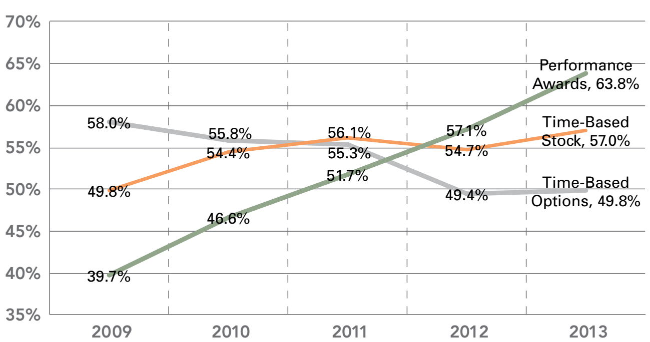
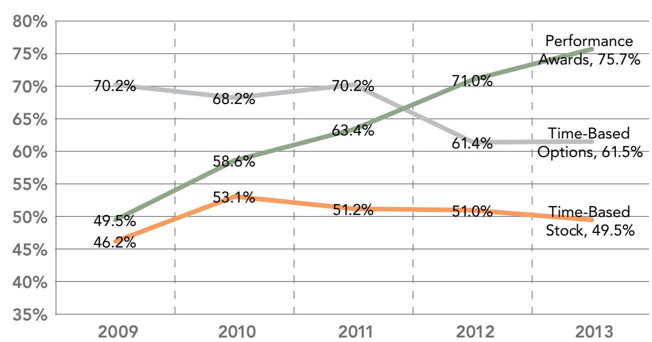


Chart 9

S&P 500 Equity Vehicles Grant Prevalence



MERIDIAN COMMENTARY

- Each long-term incentive vehicle plays an important role in the overall objective of compensation: Stock options provide shareholder alignment, time-based equity supports retention of talent, and performance-based equity encourages sustained operating performance. While they each continue to hold importance, what we see now is a change in priorities. Five years ago, as companies were struggling with the impact of the recession, focus centered on executive retention and improving shareholder value versus performance plans, where setting long-term operating goals was a greater challenge. However, today with more stable economic conditions, companies are focused on long-term operating performance, and therefore, performance-based equity awards are on the rise.
- As mentioned earlier, the popularity of performance-based equity can be attributed to its hybrid features that combine the leverage and performance orientation of stock options with the lesser risk aspects of time-based awards. Additionally, in this Say on Pay environment, companies are being influenced by shareholder advisory firms' endorsement of performance-based equity over other equity vehicles.

"IN THIS SAY ON PAY ENVIRONMENT, COMPANIES ARE BEING INFLUENCED BY SHAREHOLDER ADVISORY FIRMS' **ENDORSEMENT OF PERFORMANCE-BASED EQUITY** OVER OTHER EQUITY VEHICLES."

Charts 10 and 11 show the mix of equity vehicles (time-based options, time-based stock, and performance-based equity) awarded to CEOs from 2009 to 2013. A mix of time-based stock and performance-based equity was most common in both years and across both indices. The percentage of companies granting no equity to their CEOs fell from 2012 to 2013 in both indices. In addition, equity mixes increasingly favor performance awards and disfavor mixes featuring only one award type.

- Equity mixes that included performance-based awards had the highest prevalence in 2013. All such mixes were up sharply in prevalence over the five-year period except for the combination of options and performance shares.
- All equity grant mixes that decreased in prevalence over the last year, including single-vehicle equity mixes, were mixes which either included options or did not include performance stock. The greatest decline was in grants of restricted stock only, which fell 24.3% from 11.5% prevalence in 2012 to 8.7% in 2013.
- In the S&P 1500, the most common equity vehicle mix was a combination of restricted stock and performance stock, and the most common mix in the S&P 500 was a combination of options and performance stock. C

Chart 10 **S&P 1500 Equity Grant Mix**

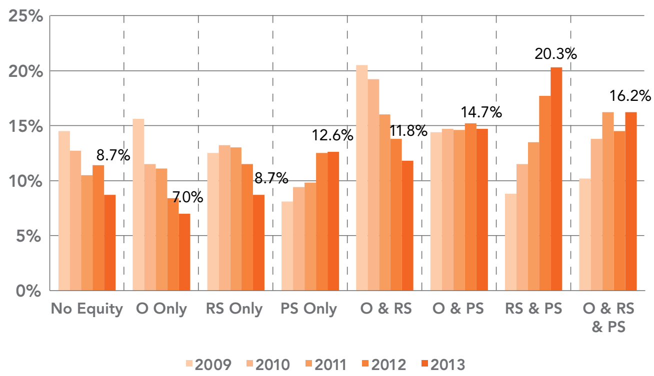
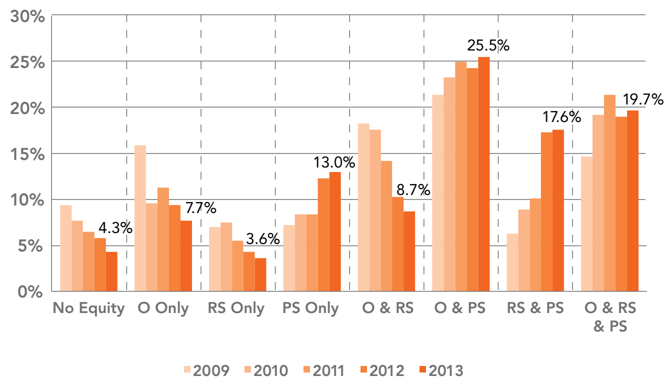


Chart 11 **S&P 500 Equity Grant Mix**



FEATURE

Super-sized disclosure

Are companies' risk oversight disclosures in proxies satisfying investors?

The SEC adopted new rules in 2009, effective for most companies in 2010, requiring that they provide enhanced disclosure in their proxy statements and other SEC filings about a number of issues believed to be of interest to investors and other stakeholders. Chief among these is the topic of risk, including the board's role in risk oversight. Risk is broadly-defined, including but not limited to financial, regulatory, strategic, operational, compensation, reputational, environmental/sustainability, and increasingly, cyber-security risks.

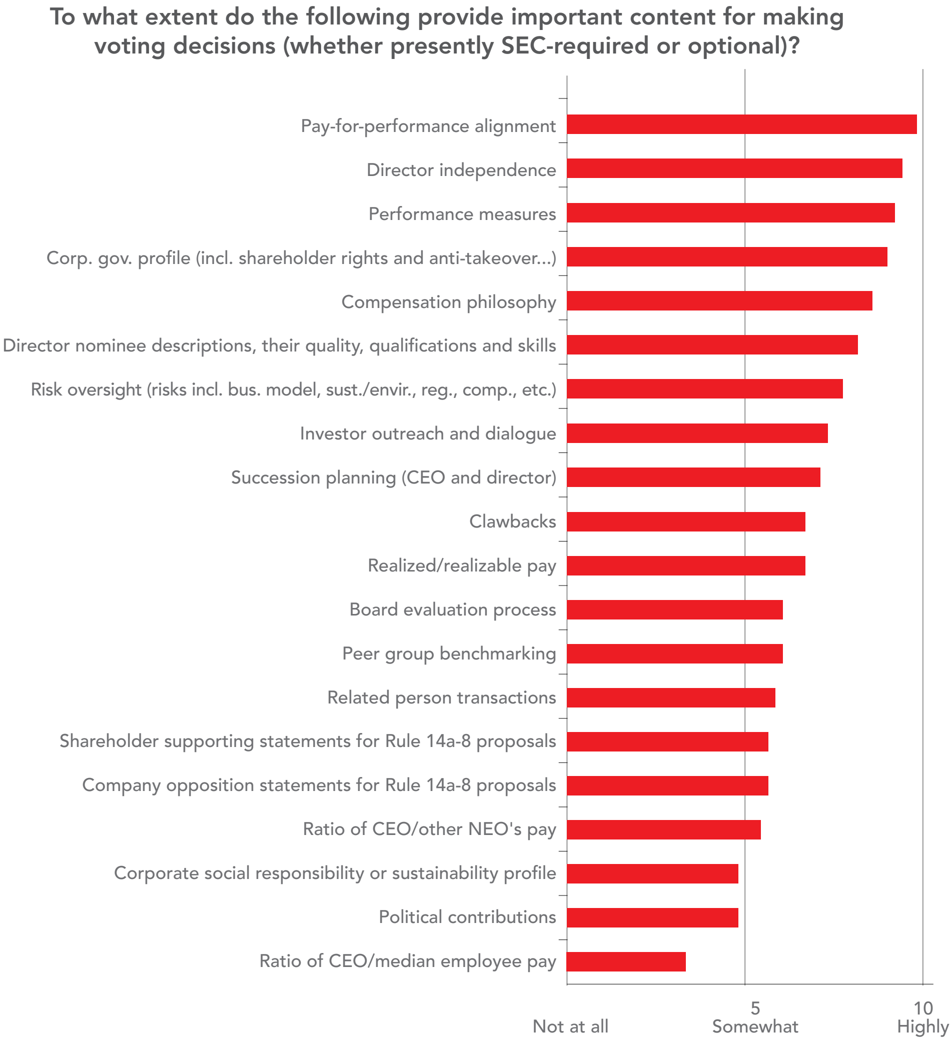
Over the past year, in response to increasing requests from clients for guidance on which aspects of their proxy disclosure and design deserve more focus, RR Donnelley conducted original research to help answer these questions. To do so, RR Donnelley, which serves as financial printer for proxy statements and other documents for over 1,900 U.S. companies, surveyed a broad range of institutional investors about proxies. Questions asked included:

1. What topics are investors most interested in?

2. How well do they feel companies are doing in addressing those topics?

As you can see from the graphics on pages 16 and 17, Risk Oversight was ranked 7th out of 20 topics that we asked investors to rank in importance yet only 13th in terms of how well investors feel companies are addressing this issue in their proxies.

THE GAP BETWEEN INVESTOR EXPECTATIONS AND COMPANY DISCLOSURES



WHAT MIGHT EXPLAIN THIS "DISCLOSURE EXPECTATIONS GAP"?

Our survey was directed to institutional proxy voters and governance heads (who typically are industry generalists), not portfolio managers and equity analysts (who often are industry specialists). Given their regular contact with companies and knowledge of their strategies, competitive environment, management teams and boards, portfolio managers may have greater insight and appreciation into the quality and effectiveness of company and board risk oversight programs than do their colleagues on the voting side of the aisle, whose knowledge of company risk oversight practices may be limited to the discussion of this topic in the proxy.

What is clear is that with five years of such disclosure experience under their belts, some companies are providing greater detail in the proxy about how their boards perceive and oversee risk than are others. As is often the case with new disclosure requirements, initially, most companies stay on safe ground, comply with the letter of the new disclosure requirement, and don't stray much beyond that. Over time, certain companies—often in response to investor requests for additional information—start providing more insight and specifics. This then sets a higher disclosure bar, which over time other companies seek to clear.

In the case of risk oversight, a review of recent proxy disclosures reveals that most companies provide a fairly general statement about risk oversight and the respective roles of the board and management. That said, a growing number of companies are listing specific risks they have identified as relevant to the company, and even identifying which board committee(s) oversees each identified risk. **More detailed disclosure is likely to increase investor confidence that the company's key risks are understood and appropriately managed or overseen.**

Some companies are presenting information in more visually inviting formats. As increasingly is the case with disclosure of compensation information, we are starting to see some companies supplement their narrative disclosure with easily-understood graphics of specific risks and the parties with principal responsibility for their monitoring and oversight. **More visual presentation of this information will**

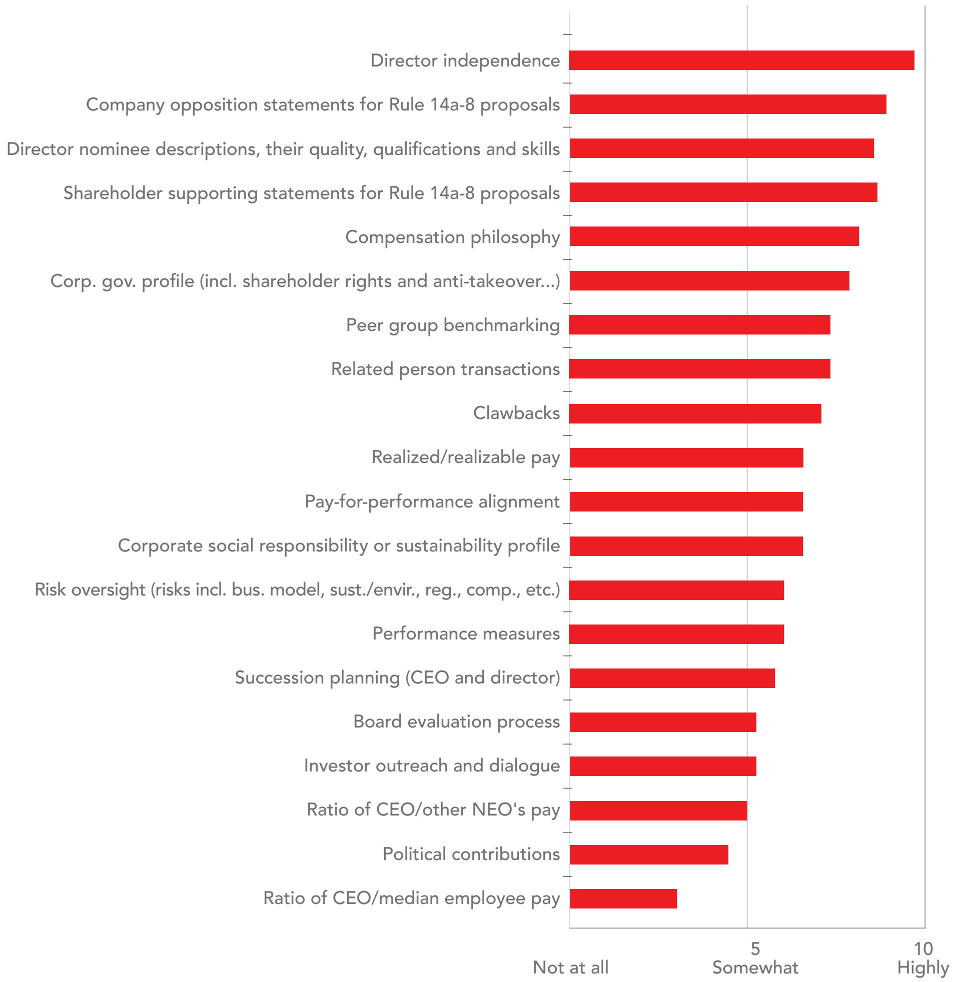
increase the likelihood that investors actually read and digest this information.

Finally, recognizing that investors need to find key information quickly or they may overlook it, more companies are improving the ease of location and navigation to this information. **One way is by listing "board risk oversight" directly in the table of contents, hyper-linked directly to the relevant content, as opposed to requiring readers to locate it within the broader "board leadership structure" or "corporate governance" sections that are identifiable in the table of contents.**

WHAT SHOULD COMPANIES DO?

Clearly, these more specific and visual disclosures help to set investors' expectations. Since your investors often own your peers and other companies, as well, it's advisable to go beyond re-confirming that your disclosures are accurate from year to year and that you're meeting all regulatory disclosure requirements. Increasingly, you should consider how your level of clarity, visual appeal, and ease of location stack up against other companies against which you're competing for investor capital. By the time of our next survey, perhaps the expectations versus disclosure gap between you and your peers will have closed! C

On average, how clearly and effectively are these topics disclosed?



"MORE DETAILED DISCLOSURE IS LIKELY TO **INCREASE INVESTOR CONFIDENCE** THAT THE COMPANY'S KEY RISKS ARE UNDERSTOOD AND APPROPRIATELY MANAGED OR OVERSEEN."

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.

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

Equilar unveils its new, powerful executive networking platform

EQUILAR Engage

- Networking & connection features built especially for executives & directors
- Mobile-friendly for your phone or tablet
- Pre- and post-event platform access
- Up to date event info, agenda and session materials to keep you informed

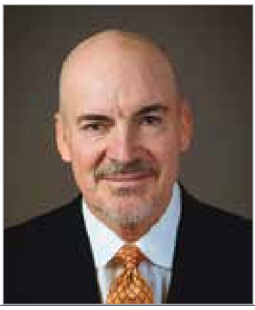
Managing Cyber Risk

Cyber and data security issues compel a re-examination of the usefulness of risk committees

Some 12 years ago, I facilitated a thought leadership discussion among a prestigious group of academics as part of Corporate Board Member magazine's Academic Council. The Council represented some of the top universities in the U.S. and included professors or deans who had pioneered thought leadership around board corporate governance. One of the more interesting topics we spent time on was whether corporate boards should have more than just the standard three committees (i.e., Audit, Compensation, and Nominating/Governance). This was around the time that some boards began forming risk, environmental, or strategy committees to deal with specific problems or challenges that were inherent to certain industries. The most interesting discussion centered on the concept of the risk committee. Who owned the oversight responsibility? Was it the full board, audit committee, or was a risk committee even necessary? As you might imagine with a collection of academics from different parts of the country, the Council discussions rarely ended with unanimous consensus, but I do remember that most participants did not recommend creating a committee for all the different challenges a corporation might face. At the time, a majority of the Council felt that since the audit committee had the responsibility for financial risk oversight, it probably wasn't a stretch to also oversee all risks, but even then, the entire board should somehow be involved in enterprise risk management.

After many years of debating what might be a best practice at many corporations (remember, Corporate Board Member has always opposed the governance theory that one size fits all), I have revisited the concept of establishing board risk committees. Not just for financial institutions as dictated by regulation, but for all public companies. Now, before I go any further, I need to disclose that I am the author of several articles and blogs where I have stated that managing risk is not a new concept. It has been around since the beginning of business itself, and I think it's ultimately the full board's responsibility. But the reason I am waffling today is due to the game-changing reality of cyber or data security risk. Personally, I don't know how to suggest a board get its arms around this risk to ensure its crown jewels are safe from attack.

So this new paradigm has changed my view on whether a public company board should have a risk committee. See if my analysis makes any sense.



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.

First, over the years, I've witnessed how well many board committees operate when the audit or compensation chairman is already knowledgeable about the committee topic and possesses good leadership skills. A good chairman often translates to an effective board committee, and to have someone on the board who is focused in that single, critical area is important. Having a qualified risk committee chair would mean having someone who would own the responsibility of overseeing the risk committee charter, and a focused, single person assures that enterprise risk has prudent oversight.

Second, with the recent exposure to cyber and data security attacks in every phase of our economy, risk exposure as we define it today is very different than the basic risk/reward philosophy that was popular in previous decades. While an integral part of strategic planning means understanding that increased levels of calculated risk-taking can produce better returns, with the cyber and data security risk threats that exist today (and what we don't know about the future), this area requires a different level of risk analysis than most sitting directors are equipped to deal with. This risk extends beyond the standard business acumen or logic gained by years of operating experience and time in the trenches. Therefore, it's time to recognize this challenge and re-evaluate our board composition and committee structure to keep with the times.

Having said all this, here is a committee structural change you may want to consider after you revisit the viability of forming a board risk committee: Assign or recruit a board member who is familiar with risk philosophy and understands IT and data risk. In addition, consider forming a risk committee including the sitting chairpersons of audit, compensation, and nominating/governance committees to ensure there is an exchange and communication of risk oversight through all disciplines of the company. The risk committee would then report out to the full board in the same fashion as any other committee. In doing so, your board will be one step closer to being prepared to oversee the vast array of new risks that are changing the corporate environment every day. Is your board prepared? C

For more insight from TK Kerstetter, visit ***csuiteinsight.com/author/tkkerstetter****.*

FEATURE

Setting Up for Success

Avoid the five talent management mistakes that put companies at risk

One of the CEOs we work with once asked, "If we do talent management so well and I lead a 40,000-person organization, why am I always one short when it comes to finding the right person for an open role?" Unfortunately, this is not an uncommon perspective, and we see many companies putting themselves at risk in the area of talent.

Leaders often brag about their robust talent management processes, complete with organizational charts and development plans. However, this can instill a false sense of security that things are working because there is a process. But all too often, when a role opens up, companies find themselves one short. All the systems and processes they have in place are necessary, but not sufficient.

What are the ways that companies are putting themselves at risk when it comes to talent?

RISK #1: NOT DEFINING A ROLE FOR WHAT'S AHEAD

Mistakes in talent management can happen before the talent is even brought into the organization. When a company is hiring for an open position, it typically pays little attention to developing the position description found in the job posting. But how the role is framed and what kind of situation the new executive is placed into is often just as important as the hiring decision itself.

We've seen companies replace executives in a knee-jerk manner—slotting in a new hire with the same job description the departing executive had, without any thought of what is needed now and down the road. Even within a time frame of a couple of years, though, the corporate strategy might have undergone a significant shift, or there may be a new set of players in the C-suite—new context that demands that this new executive fill in gaps that may not have existed before.

People generally fill roles for 2-3 years, and so the role must be defined according to the work that needs to get done in those 2-3 years (versus using a vanilla position profile). The hiring executive should be very specific on what the "gold star" for that position looks like at the end of year one and the end of year two. This provides real specifics to execute against—and you can assess and hire against those.

RISK #2: FAILING TO SUPPORT AN INTERNAL TRANSITION

Most advice on executive transition is focused on external transitions to new roles, but internal transitions can be equally as difficult as external ones, if not more so.

In an internal transition, an executive is often not afforded the support and "diagnostic period" that someone from the outside is given. He or she is expected to have a game plan and start making decisions from day one—and if the person doesn't, the decision-makers start to question whether this was the correct choice for the role. As an additional complication, if the executives are being promoted from their peer groups, that means they have to establish themselves as the leaders, managing people who may feel "passed over."

RISK #3: DUMPING VS. DELEGATING

It's very tempting, when we need something done yesterday, to call on someone reliable and say, "I need X by Tuesday—go figure it out." Because the person we are tapping is high-performing and smart, they typically go figure it out by themselves.

What was just done, however, is not delegating, but "dumping." Ironically, we usually only take the time to delegate to the low performers, precisely because they don't "get it," and then we end up "dumping" on the higher performers. What is lost by the failure to delegate is the opportunity to help people grow and learn from our experience. "Figuring it out" is one way to learn, but it does not convey our own learnings and therefore does not accelerate the learning of the person working for us.

RISK #4: COACHING THE WRONG PEOPLE

In working with hundreds of the most senior executives around the globe, we have found that the large majority of these high-performing executives invest their limited managerial time trying to "fix what is broken" instead of investing in their highest-performing people.

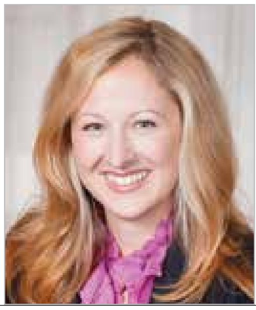
Underperformers over-consume resources needed to compensate for their lack of experience or abilities. But managers often magnify the negative consequences of underperformers by failing to diagnose the problem and spending too much time waiting for the situation to sort itself out.

As time goes by, the underperforming executive gets a disproportionate amount of the manager's attention—and the development of the high performers on the team gets neglected. Months later, the manager is left with a group of people who have performed well, but not nearly up to their potential (and also the underperformer who likely has not made any meaningful progress).

RISK #5: WAITING FOR THE "READY NOW" SUCCESSOR

The myth of the "ready now" successor is prevalent across all leadership levels of an organization. We see this in CEO successions, where there is often a long journey of getting boards to accept an internal promotion, as directors are often nervous about giving an "untested" executive the full reins.

This feeling tends to echo at levels beneath the CEO. In any form of selection and succession, no internal candidate is truly going to be "ready now." Holding candidates to a rather backward-looking standard of easily slotting into their predecessor's shoes ignores the dynamic requirements of the role at hand. It also too narrowly views succession as a single-person event rather than what it should be—a multi-person event where team members all fit together and complement each other's specific backgrounds and capabilities. C



Stephen Miles is the founder and Chief Executive Officer of The Miles Group, an executive consulting firm specializing in talent strategies. Taylor Griffin is a partner and Chief Operating Officer of The Miles Group.

Read C-SUITE Insight*'s March 2014 interview with Stephen Miles and Taylor Griffin at* ***csuiteinsight.com/category/interviews****.*

ASK THE EXPERTS

What are some of the greater risk factors that boards need to spend more time addressing?

Skadden
Skadden, Arps, Slate, Meagher & Flom LLP

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

Recently we have seen the development of new types of executive compensation litigation, which represent a new type of risk of which many board members are not yet aware. One type is proxy litigation, which is initiated primarily by a single plaintiff's law firm. These cases are typically filed shortly after a company files its proxy and allege breaches of fiduciary duties in connection with compensation-related proposals, most commonly a proposal to adopt or increase the amount of shares under an equity compensation plan. The demands for additional disclosures are not based on allegations of deficient disclosure under SEC rules but rather on a purported breach of state-law fiduciary duties. Another new type of proxy litigation relates to Section 162(m) of the Code—these are shareholder claims and are brought even where the Internal Revenue Service has not asserted any noncompliance. These claims usually allege some mix of corporate waste, unjust enrichment, and breach of fiduciary duties by directors by reason of a company's failure to comply with Section 162(m) (often by reason of a technical "foot fault" such as grants in excess of individual plan limits or failure to reapprove plans every five years). The discovery by plaintiffs' firms of these types of claims requires even greater focus by board members on disclosure and compliance of executive compensation matters.

Regina Olshan is the global head of Skadden's Executive Compensation and Benefits Group. Her practice focuses on advising companies, executives, and boards on navigating the regulatory complexities of executive compensation and benefits. This includes tax laws (including laws governing deferred compensation, golden parachute arrangements, and deduction limitation rules), securities laws (including reporting and disclosure requirements and registration issues), and compensation-related litigation matters.

Olshan regularly advises public companies, boards, private equity clients, and members of management on executive compensation and benefits issues arising in the context of mergers, acquisitions, spin-offs, initial public offerings, restructurings, and other extraordinary corporate events, including private equity and leveraged buyout transactions. She also regularly advises large public companies and individual senior executives on the adoption, revision, and negotiation of executive employment and severance agreements, as well as litigation and controversies involving executive compensation.

Allie Rutherford
Ernst & Young LLP's Center for Board Matters
Director of Corporate Governance

Today's corporate boards face expanding agendas that include shifting global economic conditions, rapid technological change, and market and industry challenges and complexity. Moreover, boards are now addressing reputational risk. An inextricable element of business success and brand identity, this responsibility includes oversight of legal and regulatory compliance risks as well as emerging risks like cybersecurity, big data, and issues within supply chains. This role is being undertaken as boards are under increased scrutiny from regulators, shareholders, customers, and other stakeholders.

While there are many issues boards must pay attention to, the greatest danger to not effectively overseeing these growing risk factors is not having the right mix of skill sets, expertise, backgrounds, and diversity of perspectives represented on the board.

Investors in particular are paying closer attention to board composition. They want to know that the right people—those with qualifications aligned with the company's strategic goals and risk oversight needs—are in the boardroom and part of strategic conversations. They are looking more carefully at skill sets, qualifications, track records, tenure, and diversity, along with director succession planning and board refreshment practices.

Boards that are not challenging their composition and effectively conducting board assessment and development strategies may risk becoming under-performing boards and lack the dynamism required to compete in today's global markets.

Allie Rutherford is the Director of Corporate Governance in Ernst & Young LLP's Center for Board Matters. The Center seeks to foster alignment among boards of directors, management, and investors on corporate governance matters, raising awareness, encouraging understanding, and serving as a conduit of information. Rutherford leads a team of professionals who provide thought leadership and company-level analysis, offering a balanced perspective on corporate governance trends, leading practices, and the impact of governance decisions on shareholder actions and proxy voting. Rutherford has spent more than 15 years researching and advising on corporate governance matters. She regularly speaks on and writes about governance trends and implications, focusing on proxy season results, shareholder initiatives and engagement, boards of directors' structure and composition, and proxy statement disclosures.

Expert responses are the personal opinions of each expert and may not reflect the opinions of their firms.

Yonat Assayag
ClearBridge Compensation Group
Partner

The success (or demise) of a business ultimately comes down to the decisions of a group of people. Shareholders benefit when management makes decisions that support the company's long-term health; on the flip side, a great deal of damage can be done through a few misguided decisions. To manage this risk, it is critical that boards spend time developing an effective compensation program that encourages desired behaviors.

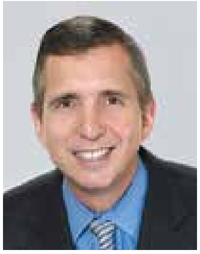
The right performance metrics and the right goals are key to an effective program. Metrics and goals send a message to the management team about the decisions they should—and should not—be making. In identifying metrics, boards need to determine the most critical performance drivers for the business. TSR is unquestionably important, but it can be far removed from management's direct influence. Financial-based measures, such as growth and returns, or strategic measures, such as customer satisfaction and safety, may better reflect management's actions and results. Using multiple metrics can also provide checks and balances to further manage risk.

Once measures are defined, next up is goal setting. Performance goals align management with the desired degree of risk in the business. If goals are set too conservatively, management may not take the appropriate risks to spur the company's growth. If goals are set too aggressively, management may be unintentionally incentivized to make decisions that put the company and shareholders at risk.

In short, boards should dedicate time to ensuring incentive plan metrics and goals encourage decision-making that reflects appropriate degrees of risk and supports the long-term sustainability of the company.

Yonat Assayag is a partner at ClearBridge Compensation Group. Assayag has over 15 years of experience in compensation strategy and design, working with both publicly traded and privately held companies in a variety of industries. She is a regular speaker on executive compensation issues and is frequently quoted in major publications. She holds an MBA from New York University's Stern School of Business and a Bachelor of Science in Business Administration from Syracuse University.

Doug Friske
Towers Watson
Global Executive Compensation Line of Business Leader



An inability to find, engage, develop, and retain top talent is one of the greatest risks companies and boards face. In today's growth-challenged business environment, having people who innovate, operate, and motivate, better than the rest of the pack, at even the slightest margins, can make all the difference in the world.

A key component of success in this area is having reward programs that are laser focused on the organization's key priorities and provide direction to employees on what actions, behaviors, and results are most important. Developing truly tailored programs can be challenging in today's world, where access and influence of external perspectives and practices is unprecedented, though not always helpful.

Boards should work with management to develop reward programs that are tailored to the organization's needs. Just as companies develop differentiating business strategies, they ought to consider differentiated rewards programs. The exercise of sound business judgment, even if it leads to practices that may be outside conventional norms, is critical. Using a tailored set of clearly defined guiding principles can help organizations structure rewards that will resonate with top talent and help drive enhanced performance.

Doug Friske is recognized as one of the leading global experts in executive compensation consulting today. In addition to his consulting work with clients, Friske has served in many leadership roles during his career, including Global Leader for Towers Watson's Executive Compensation LOB, and continues to serve on the Talent and Rewards Segment Operations Council and Executive Compensation LOB global leadership teams. He holds a B.S. degree in finance from the University of Illinois at Urbana-Champaign and an M.M. degree in finance and marketing from the J.L. Kellogg Graduate School of Management at Northwestern University.

CtW Investment Group

Michael Pryce-Jones
CtW Investment Group
Senior Governance Policy Analyst

Breaching the artificial micro-/macroeconomic divide, forward-looking boards must grapple with how enterprise-level decisions on capital allocation are impacting the health and sustainability of the broader economy, and the consequences this macro picture has for the political, fiscal, and financial environment facing the individual firm. Two key risks or dilemmas present themselves: the worrying decline in U.S. investment and evidence of growing economic inequality. As the British economist Andrew Smithers has persuasively argued, perverse management incentives not only risk forgoing long-term value-creating activities at individual firms, but at the national level help explain falling investment levels, corresponding productivity declines, as well as many of our fiscal challenges. In thinking through firm-level decisions, boards must resist treating the economy as an exogenous risk, or a challenge best left to political lobbying. The issue of inequality demands similarly expansive thinking on the part of boards when addressing wages and human capital management, lest they fall into the trap of being penny wise, but pound poor.

Michael Pryce-Jones is the Senior Governance Policy Analyst at the CtW Investment Group where he is responsible for leading the group's engagements with major publicly traded companies. Before joining CtW Investment Group, he was the senior ESG analyst at Proxy Governance, a proxy advisory firm. His doctoral research looked at the role of pension funds in corporate governance.

Based in D.C., CtW Investment Group works with pension funds sponsored by unions affiliated with Change to Win, a federation of unions representing nearly 5.5 million members, to enhance long-term shareholder returns through active ownership. Members of CtW affiliates participate in Taft-Hartley plans with over $200 billion in assets.

JONES DAY | One Firm Worldwide℠

Charmaine Slack
Jones Day
Partner

Although effective oversight of executive compensation is one of many risk factors boards must consider in discharging their duties relating to compensation, executive compensation-related shareholder litigation nears the top of the list of executive compensation-related risks boards need to address. As companies are in the midst of completing or have just completed their fourth season of enhanced executive compensation proxy disclosure, including disclosure required for Say on Pay votes, plaintiffs lawyers will continue to look for innovative ways to push the envelope with executive compensation-related litigation beyond the types of claims we have seen alleged to date (e.g., Section 162(m) and allegedly false and misleading disclosure regarding stock plan proposals and performance pay, to name a few). With an uptick in such claims, boards and compensation committees may be able to minimize executive compensation disclosure risks by considering disclosure decisions during each step of the governance process—design, adoption, and implementation—and ultimately, disclosure of the company's executive compensation arrangements.

The requirement under the enhanced executive compensation proxy disclosure rules to provide shareholders with a better understanding of the relationship between risk and a company's compensation policies and arrangements and whether any risks from those policies could have a material adverse effect on the company is now the new norm. Taking advantage of opportunities to minimize executive compensation disclosure risks with planning at all stages of the executive compensation governance process should go a long way to better prepare boards to proactively manage the risks of executive compensation-related shareholder litigation.

Charmaine L. Slack is a partner in the Employee Benefits and Executive Compensation practice of the global law firm Jones Day, resident in the New York office. Slack's practice is focused on advising senior management, compensation committees, and boards of directors of public and private entities on executive compensation, M&A, and other transactions and related tax and corporate governance matters. She received her LL.M. in Taxation from New York University, her J.D. from Harvard Law School, and B.B.A. from Pace University (summa cum laude).

Expert responses are the personal opinions of each expert and may not reflect the opinions of their firms.

Interview with CHIP LAWRENCE and SARAH TESLIK

Chip Lawrence has served on the board of Apache Corporation, an independent oil and gas company, since May 1996 and is currently Chairman of the Management Development and Compensation Committee. Lawrence was chief executive officer and a director of The Phoenix Resource Companies, Inc. from 1990 until May 1996, when Phoenix merged with Apache.

Prior to entering the oil and gas business, Lawrence served as the Assistant Chief of the Environmental Enforcement Section of the United States Department of Justice in Washington, D.C.

Sarah B. Teslik was appointed senior vice president—Policy and Governance of Apache Corporation in October 2006. She was promoted to senior vice president—Communications, Public Affairs and Governance in May 2014.

Prior to joining the company, she was chief executive officer of the Certified Financial Planner Board of Standards, Inc. from November 2004 to October 2006, and executive director of the Council of Institutional Investors from July 1988 to October 2004.

Teslik holds a bachelor's degree from Whitman College, a master's degree from Oxford University, and a Juris Doctor from Georgetown University.

Apache
EXPLORING WHAT'S POSSIBLE

"MOST SHAREHOLDERS WERE APPRECIATIVE OF A BOARD THAT WOULD TAKE THE TIME TO SEND AN EMISSARY INTO THEIR OFFICES TO **LISTEN TO THEIR OPINIONS.**"

—Sarah Teslik

C-Suite Insight: Thank you, Sarah and Chip, for agreeing to this interview about Apache's recent Say on Pay experience. Where does this story begin?

Teslik: Apache, like most companies, elected to have Say on Pay votes on an annual basis, and we have now had Say on Pay votes for four years. We received 95% approval at our 2011 and 2012 annual meetings, just under 50% at the 2013 annual meeting, and then at the 2014 annual meeting we were back over 95%. The failure in the third year made for quite an experience.

Lawrence: Let's start at the beginning. The structure of our executive pay was about the same for the first three years. We were cruising along keeping our CEO's reported compensation right in the middle of the fairway for our peers as we saw them and carefully tailored to reflect performance and other key metrics. While our stock was underperforming our peers, we were relying on our pay structure, which was heavily weighted to stock compensation, to align CEO realized compensation with the experience of our shareholders.

The first sign of trouble was a red flag from ISS. Even this wasn't a total wake-up call, because we had a green flag from Glass Lewis. We started calling major shareholders during the proxy season to seek their input. They told us that, while they liked many aspects of our compensation plan, there were two elements they strongly disliked. First, our CEO's reported total compensation was up from the year before, while our stock price was down. Second, we had exercised our discretion to increase the annual cash bonuses of a small group of people, including our CEO, because they had brought home an important transaction. We heard loud and clear from our shareholders that with an underperforming stock, they do not like to see discretion used to increase pay, even when tied to a specific success.

Teslik: We could see from a round of phone calls and an early tally of the votes that our Say on Pay vote was going to be split down the middle, which was not an outcome about which we could be proud. And we knew our shareholders had limited time to re-visit issues during the peak of proxy season, although many of them were good enough to indicate they would. So we had the sad duty of informing the compensation committee and the board of the likely result.

CSI: What was the board's reaction?

Teslik: The board took immediate action even before the vote was final.

Lawrence: Neither the board nor Steve Farris, the chairman and CEO, took the split vote lightly. Steve and the other board members immediately agreed that they needed to take whatever actions were necessary to produce a state-of-the art compensation system.

The day before the 2013 vote was final we cut our CEO compensation by almost 20%, cut our annual director equity-based pay by 25%, reduced our CEO target bonus by 25% and took a number of other measures.

> **"WE HEARD LOUD AND CLEAR** FROM OUR SHAREHOLDERS THAT WITH AN UNDERPERFORMING STOCK, THEY DO NOT LIKE TO SEE DISCRETION USED TO INCREASE PAY, EVEN WHEN TIED TO A SPECIFIC SUCCESS."
>
> —Chip Lawrence

CSI: Why did the board think it was necessary to act so quickly and what risk did they see in waiting?

Lawrence: Prompt action was necessitated by the calendar. By the time we received the negative Say on Pay vote, almost half of the calendar year had passed. Fortunately for us we typically issue the bulk of our long-term compensation at the annual meeting and not at the beginning of the year, so we still had the opportunity to substantively affect compensation for the current year. Had we hesitated even for a day though, and issued the long-term compensation as previously planned, it would have been very difficult to meaningfully impact the total compensation numbers to be reported in the next proxy and voted on at the next annual meeting.

> **"PROMPT ACTION** WAS NECESSITATED BY THE CALENDAR."
>
> —Chip Lawrence

CSI: What happened next?

Lawrence: The board and the CEO together agreed that we wanted to have a difficult experience produce a positive result for both pay package quality and shareholder support.

Teslik: In our telephone calls in the weeks prior to the annual meeting, our shareholders made it clear that proxy season is not a good time for them to have meaningful conversations about executive compensation. They also made it clear that the topic of executive compensation is one they generally prefer not to have with the executives themselves.

Lawrence: We had a discussion about board engagement with shareholders. We quickly came to agreement that while in general management speaks for the company, when the topic is executive compensation and the conversations are with shareholders in the wake of a failed Say on Pay vote, board engagement with major shareholders is appropriate.

We had several things working for us, and a couple working against us. Against us we had an underperforming stock and a number of unpopular governance and compensation provisions. Working for us we had a desire to get it right and, very importantly, good relationships with our shareholders, including the proxy voters. As part of the regular course of engagement every year, Sarah visits with virtually all of the people who vote the proxies for our major shareholders, so it was merely a matter of setting up meetings with known people and showing up and listening.

Teslik: We were also fortunate that we had a compensation committee chair who was willing to devote time and effort to shareholder engagement. This was a very time-consuming process. It was also good because Chip was very familiar with our compensation structure and with executive compensation and governance issues in general.

Over the ensuing months we met with as many major shareholders as possible to seek their input. It turned out we met with most of our large shareholders representing over 60 percent of our shares. We had meetings right up to the 2014 annual meeting, though most were held in 2013.

CSI: How did these meetings go?

Teslik: Almost all of the meetings were held in the offices of our shareholders. We grouped the meetings to cover one geographic area at a time. Chip and I attended most of the meetings, though our Lead Director and another member of our compensation committee also met with shareholders.

Lawrence: We went to each meeting without any materials: no handouts, no PowerPoints, no preset agenda. A number of shareholders thanked us for not bringing decks. Each meeting started the same way. We told shareholders we were there to receive their input and hear their concerns. We listened and listened, and then solicited more input.

From our shareholders we heard a lot about governance, compensation, and stock performance. We heard the good and the bad. With some shareholders, we had to solicit the concerns as they weren't sure if we were having the meetings for show or for real. We weren't selling, we were listening.

CSI: Did your shareholders share a similar approach to Say on Pay?

Lawrence: Definitely not. It is very clear that our shareholders are not a monolithic group. Some focused exclusively on the proxy table total compensation numbers while others meticulously studied the mechanisms of the compensation structure. Some could vote with their feet, others were index funds with no choice but to try to influence through their Say on Pay votes. Most big institutional shareholders had their own very skilled staff and only used advisory firms for screening or not at all. Some followed the advisory firms without question, and a few just voted on stock performance. Value players thought differently than growth players, even when they were from the same firm.

CSI: How did the board interaction with shareholders differ from management interaction?

Teslik: I found it interesting to compare meetings with a director to meetings with management. Some shareholders were a little more reluctant to share concerns with a director than with a member of management. And some shareholders started out assuming that a director's level of knowledge about pay and performance details would be limited. I also felt that most shareholders were appreciative of a board that would take the time to send an emissary into their offices to listen to their opinions.

CSI: Did these meetings substantively affect compensation and governance decisions?

Lawrence: Absolutely. I reported back to the compensation committee and the board on the substance of the conversations and whether or not there was shareholder consensus. We took several very important actions with greater confidence that we'd obtained important input from key stakeholders. We were fortunate to have an extremely talented human resources leader; she and her great staff were able to efficiently distill our general directions into concrete proposals.

CSI: Did you change your proxy statement at all?

Teslik: One of the things we heard from our shareholders was they wanted a clear and crisp proxy, so we tried to make the CD&A more user friendly. We put in an upfront summary. We tried to use plain English. We used graphics and tables to make it easier to read quickly.

Lawrence: I think it is very important for compensation committees to understand that the CD&A is their opportunity to present their case and demonstrate the board's good judgment.

We were gratified that our efforts led to receiving the support of more than 95% of our shareholders this year despite our stock continuing to lag. We are even more gratified that our stock is picking up the pace and this year, so far, running ahead of median in our peer group.

CSI: So, could you summarize the lessons learned from this experience?

Lawrence:

1. If your stock becomes an underperformer, your shareholders will give you less leeway if anything in your compensation package is sub-optimal.
2. Be very wary of exercising discretion to increase CEO compensation, no matter how justified.

> "OUR SHAREHOLDERS WANTED A **CLEAR AND CRISP PROXY.**"
>
> —Sarah Teslik

3. If you fail Say on Pay, act quickly and decisively. Listen to your shareholders and respond to their concerns.
4. All shareholders are not the same. You will not find consensus. But if you listen hard you will find common themes and concerns.
5. Use shareholder engagement as a platform to listen to shareholders and build relationships that can matter over time.
6. Most large institutional shareholders have their own staffs to make judgments on pay and governance, but these staffs commonly use the proxy advisors as a screening tool. So no matter how you feel about proxy advisors, don't ignore them. C

INTERVIEW WITH **DAVID HOLLEY**

David Holley is a Senior Managing Director and the head of Kroll's Boston office. With nearly 25 years of investigative experience, Holley has directed a wide variety of complex assignments and provided litigation support for clients throughout the New England region.

His practice areas include environmental matters, contests for corporate control (proxy fights and hostile takeovers), major fraud investigations, internal investigations, due diligence matters, patent infringement and theft of trade secret engagements, crisis management, security and vulnerability assessments, and other sensitive investigations. Holley also consults with clients on best practices for compliance with the Foreign Corrupt Practices Act, BSA/AML money laundering rules and other regulatory regimes.

Prior to joining Kroll in 2000, Holley was a senior investigator with the Boston office of an international investigative firm. There he managed a wide variety of investigative assignments and served as deputy director of the company's environmental practice group. Previously, David worked in a litigation support capacity with the Environmental Enforcement Section of the U.S. Department of Justice. In that role, David identified and built the liability case against potentially responsible parties at several of the country's most polluted Superfund sites.

Kroll®

"WE ARE SEEING A LOT OF **UNINTENDED INTELLECTUAL PROPERTY TRANSFERS** RESULTING FROM OVERSEAS JOINT VENTURES."

C-Suite Insight: David, could you tell us your background and what your role is at Kroll?

Holley: I am a senior managing director and head of Kroll's Boston office. In this capacity, I assist corporate clients and their law firm advisors with developing factual information to allow them to make the most informed business and legal decisions. This fact-finding arises in the context of internal investigations, pre-transaction due diligence, corporate control contests, and disputes, such as litigation. In addition, I consult with clients on best practices for mitigating the risks posed by international business activities, such as violations of anti-bribery laws, vendor and procurement fraud, and other regulatory breaches. I am also currently the regulator-ordered compliance consultant for an international financial institution under an agreement with a state banking regulator.

CSI: The theme of this issue of *C-SUITE Insight* is Risk. Your area of expertise centers on investigations in a number of areas, including take-over defense, fraud, and allegations of regulatory breaches. What sort of risks do those areas pose for companies?

Holley: Setting aside take-over contests for a moment, fraud and potential regulatory violations open corporate entities up to a myriad of potential issues to manage, including the "big three": regulatory scrutiny, loss of shareholder value, and public relations challenges. For example, on a number of occasions, I have been involved in investigations into procurement fraud in clients' overseas operations that led to the discovery of suspected improper payments to government officials. There are countless examples in the recent media of unsuccessful efforts by organizations to identify, contain, and manage similar events. Not handled properly in their early stages, these matters have led to remarkable response costs, including lawyers' fees and time spent away from managing the business, as well as meaningful penalties and fines, and negative reports in the press and elsewhere. Lastly, many of these regulatory investigations have led to settlement agreements and consent orders requiring ongoing monitoring at further cost and disruption.

Contests for corporate control present similar risks to those I just mentioned. In addition, these contests frequently turn nasty and have the propensity to air a company's or executive's "dirty laundry." As we have discovered, these contests are a huge distraction for any organization and require the full attention of board members and executives. On an individual basis, there are studies that indicate that board members displaced from a board subsequent to a proxy or other corporate control contest have fewer opportunities on corporate boards in the future.

CSI: Cybersecurity has been a big topic as some notable companies have had their databases exploited. However, cybersecurity isn't the only threat facing companies. What are the biggest threats for companies? What are areas of risk that most people may not consider?

Holley: Cybersecurity continues to be a big focus of corporate organizations and is starting to get the attention it deserves in the boardroom. The most frequently discussed loss resulting from a cyber breach continues to be personally identifiable information and individual financial data, such as credit cards. However, the conversation around safeguarding sensitive intellectual property, generally, has not been as robust recently. We continue to see a number of intellectual property losses caused by lower-tech methods, such as social engineering and stolen laptops and briefcases. Likewise, we are seeing a lot of unintended intellectual property transfers resulting from overseas joint ventures, usually resulting from improperly vetted or unsupervised partners.

I continue to counsel clients to view the safeguarding of company data, particularly sensitive or important intellectual property holistically, in which cybersecurity is only a piece of that effort. Organizations must continue to focus on simpler, less high-tech protection avenues, such as robust policies and procedures for access, maintaining the confidentiality of documents, visitors, vendors, and partners. Other strategies include training employees on the nature of the company's sensitive data, making colleagues aware of social engineering methodologies, and having a holistic plan in place in the event of a potential or suspected loss of proprietary data, one that includes crisis communications in how to deal with such loss internally and externally. Not being prepared when the limelight is on can have even further repercussions beyond an initial loss.

CSI: One of your practice areas is contests for corporate control that covers proxy fights and hostile takeovers. The activity in companies being taken over seems to have grown in the last few years. What companies are at the biggest risk for being taken over and what can they do to fend off unwanted advances? Have the strategies used by outside parties in these contests changed over the years? What trends have you seen in this area?

Holley: First and foremost, corporate control contests should not be viewed by any board of directors as something that "only happens to other companies." Reflecting upon a number of contests I have been involved in over the years, it seems that no industry, geography, or level of success places a company fully off-limits.

In almost all instances, information and the ability to use it effectively are as important as many legal remedies, particularly if used as part of a coordinated strategy with an organization's legal and public relations teams. Knowing how to obtain and use facts in real time is often the difference between winning and losing a contest for corporate control.

The most interesting recent development in the area of corporate contests is illustrated by the current contest between two pharmaceutical firms, Allergan Inc. and Valeant Pharmaceuticals International Inc. What makes the contest novel is the fact that Valeant's partner in the pursuit is activist hedge fund Pershing Square Capital. Pershing, as is customary, acquired a significant position in Allergan with an understanding that Valeant was pursuing the company, effectively teaming Pershing Square and Valeant. With the Securities and Exchange Commission now reviewing the arrangement between Pershing Square and Valeant to determine whether insider trading rules were violated, the outcome of that investigation may determine whether we see more hedge funds and acquirers teaming in these takeover efforts.

CSI: You previously worked at the Department of Justice in the Environmental Enforcement Section. What was that like?

Holley: Working for the Department of Justice's Environmental Enforcement Section was my first opportunity to undertake investigations of any nature, and the job solidified my interest in the field. I was initially staffed on a matter that actually commenced while I was in high school, and many of the colleagues working on the matter had been involved since the case was filed. It was an incredible team of attorneys, litigation support professionals, and others all singularly focused on recouping current response and future clean-up costs to remedy historic environmental contamination.

CSI: What did you learn from working in the public sector? How has that helped you in your current role?

Holley: Aside from becoming well-versed in Superfund and other environmental regulations, the most transferable learning from that job to my current position applies to my role as a supervisor and identifying motivators in colleagues. At the Department of Justice, we were all aligned with a single purpose and seemingly all motivated by the desire to make a positive impact on our environment.

As I build teams at Kroll to address client needs, I think about that experience and work hard to align motivations amongst team members. I have found that aligning motivations and finding like-minded people for certain assignments gives the client the best experience and value regardless of the nature of the assignment.

CSI: How can companies work with public authorities to better protect and prevent against outside risks? What are some available resources of which companies should take advantage?

Holley: Foremost, it is worth mentioning that public authorities, such as regulators and law enforcement, both at the state and federal level have been more responsive than in the past to cases we have referred to them. Law enforcement, particularly the Federal Bureau of Investigation and the U.S. Attorney's Office in Massachusetts, has demonstrated a willingness to take on a larger role recently in protecting Massachusetts corporations against fraud, particularly as it relates to threats from foreign nations.

For example, Kroll recently worked with federal law enforcement authorities on a theft of trade secrets case that appeared to be an attempt by a China-based firm to acquire a confidential chemical compound that would have effectively allowed the Chinese firm to beat Kroll's client to obtaining approval for the drug in China. Kroll worked side-by-side with federal law enforcement, and a lot of the work undertaken by Kroll prior to law enforcement's involvement was instrumental in quickly identifying the involved parties and resolving the matter. There are countless recent examples of this type of cooperation amongst investigations firms and law enforcement.

"NOT BEING PREPARED WHEN THE LIMELIGHT IS ON CAN HAVE EVEN FURTHER REPERCUSSIONS BEYOND AN INITIAL LOSS."

CSI: Kroll has completed studies showing that the major threat of fraud comes from insiders at a company. What should companies consider to reduce this threat?

Holley: We consider inside threats to not only be employees, but also third parties, including vendors, joint venture partners, and others that our clients may willingly grant access to. What becomes concerning is the frequent lack of diligence corporations do on prospective third-party relationships, instead trusting a referral or other source. We see the aftermath in a number of ways, including fraud investigations, asset search investigations, and litigation support.

CSI: Are there areas of fraud that companies may not be as vigilant in preventing as you think they should?

Holley: We also find many organizations fail to properly train and otherwise make their employees aware of risks of fraud and other threats. For example, the latest scam—the CEO scam—in which an employee in an organization's finance department receives a frantic call in the middle of the night purportedly from the company's CEO to wire money to a far-off destination allegedly for closing an acquisition or some other company reason, continues to hit companies hard. As it turns out, the CEO is not the CEO of the company at all, but a fraudster taking advantage of unwitting, yet eager employees who should, but do not, know better. Staying on top of and making employees aware of such scams would undoubtedly reduce the success rate of the fraudsters.

Further, one of the single biggest problems within organizations is the "failure to escalate" issue. While my experience indicates it arises in a number of contexts, I see it when we are brought in to investigate a data breach. We frequently discover that there have been numerous prior attempts to hack the system, maybe at an offshore location, maybe at a smaller facility, but these attacks were not reported up the management chain in a timely fashion. With different cyber security plans, oversight, and procedures in place before the final breach occurred, there could have been time to analyze and address the weaknesses in the enterprise instead of reacting to a major breach and potential crisis. C

INTERVIEW WITH **DAVID EATON**

David Eaton is Vice President of Research at Glass Lewis. He currently manages Glass Lewis' research department and has held multiple positions at Glass Lewis, including U.S. Research Analyst and Director of Glass Lewis' Common Law research team (covering Canada, United Kingdom, Ireland, Australia, and South Africa). More recently, Eaton was AVP of Compensation and ESG Research, responsible for the company's compensation analysis globally, with oversight of the firm's Say on Pay policies. In this role, he also oversaw environmental, social, and governance (ESG) research and proposal analysis. Prior to joining Glass Lewis in 2004, Eaton worked as a research analyst for GovernanceMetrics International. In 2008, he joined Mercer Consulting and managed their Global Executive Remuneration Research and Insights team for two years before returning to Glass Lewis in 2010. Eaton holds a bachelor's degree in Economics from Haverford College and a master's degree in business administration (MBA) from the Yale University School of Management.

GLASS LEWIS & Co

"THE CONCEPT OF RISK HAS ALWAYS BEEN A KEY PART OF COMPANY FILINGS—PARTICULARLY THE 10-K—BUT IT HAS PRIMARILY FOCUSED ON FINANCIAL AND ACCOUNTING RISKS."

C-Suite Insight: David, could you tell us about your background and what your role is at Glass Lewis?

Eaton: During the first weeks of the MBA program at Yale School of Management, I attended a lecture by Ira Millstein and Paul MacAvoy about corporate governance and the role of shareholders. It was fascinating and new (to me)—I studied economics in undergrad, but we really didn't cover this. During my second year at Yale, Enron blew up, and many of the governance concepts that Millstein and MacAvoy spoke about came to the forefront; about a year later, I got an analyst job at GovernanceMetrics International (now GMI Ratings). While at GMI, I heard about a proxy advisory firm, Glass Lewis, which recently launched. I met up with one of the founders for a beer and learned more about the firm; fast-forward six months, and I interviewed for a position at Glass Lewis, got the offer, and moved to San Francisco. I worked at Glass Lewis for four years, covering U.S. markets and then heading our "common law" team, which focused on U.K. and Australia. Covering these markets afforded me the opportunity to work on remuneration report analysis, which was a great learning experience. I parlayed that experience into moving to Mercer Consulting and heading up their executive remuneration research, which was a great experience—particularly in that it was approaching the issue of compensation from a different perspective.

The financial crisis hit, Dodd-Frank was in the works, and I was still in contact with friends and former co-workers at Glass Lewis, which needed to develop an approach to and voting policies for Say on Pay research. I decided to re-join Glass Lewis to undertake this. After two years in that role, I was promoted to Vice President of Proxy Research. While I continue to work on executive compensation issues, my responsibilities are much broader. In particular, I now oversee our research efforts across all markets and across our offices, managing a team of over 60 analysts and ensuring we provide timely, high-quality analysis on nearly 20,000 annual and special meetings each year. I also spend a great deal of time engaging with public issuers to discuss our policies and approach.

CSI: Risk has most commonly been approached in terms of financial or accounting risk. However, risk oversight can and should encompass much more, including risks associated with compensation, strategic initiatives, and cybersecurity. In your role, how have you seen the concern over risk develop and shape company filings?

Eaton: The concept of risk has always been a key part of company filings—particularly the 10-K—but it has primarily focused on financial and accounting risks. Of course, it makes some sense this would be the focus, in the wake of accounting scandals such Enron, Worldcom, and AIG. Now, however, I think investors are expanding their scrutiny of risk to include corporate governance-related areas: compensation, sustainability, and the protection of shareholder rights. Risks associated with compensation programs are numerous, ranging from quantum issues (executive pay as a percentage of cash flows or revenues is too high, or the executive team is receiving too much equity) to the provision of shareholder safeguards (double-trigger provisions in change in control arrangements, executive ownership guidelines, anti-hedging and pledging policies). A closer examination of these issues is crucial to understanding if management and shareholder interests are sufficiently aligned.

Over the last several years, there has been a growing concern among investors regarding environmental and social risks. As was the case with the Deepwater Horizon explosion and resultant oil spill, the accident at Fukushima Daiichi and the explosion of a Massey Energy mine, inattention to environmental and social risks can have significant adverse impacts on shareholder value. Investors are increasingly concerned with such issues and they have expressed these concerns through both engagement with companies on these issues and through the submission of shareholder proposals. While the number of these proposals has increased slightly, attention to and shareholder support for these proposals has risen dramatically over the past decade.

CSI: What has increased investor concern meant for companies?

Eaton: Given this newfound attention to environmental and social risks, companies are beginning to place more meaningful disclosure regarding these risks in both their proxies and their 10-K filings. For example, in the last several years, the SEC has provided guidance to companies on how they should be disclosing the risks associated with climate change, leading a number of companies to provide a robust accounting of potential risks associated with a changing climate. Additionally, with heightened attention paid to corporate political spending, companies are increasingly providing an explanation of related policies in their proxy filings. While much of the increased disclosure in official filings has been voluntary, there have also been a number of required disclosures concerning environmental and social issues. For example, companies are now required to provide investors with information concerning mine safety, the use and sourcing of conflict minerals, and the board's consideration of diversity when nominating new directors.

The totality of these voluntary and mandated disclosures—including compensation, environmental, and social issues—has offered investors a better sense of how companies are managing these issues and thus mitigating potential risks.

CSI: In the wake of both the financial crisis and the Dodd-Frank Act, proxy disclosures have increased in length and added transparency on a number of issues. What do you see is the impact of this for both companies and shareholders?

Eaton: For public issuers, increased transparency and disclosure requirements (whether driven by regulation or voluntary and more market- or peer-driven) has meant more work. Most issuers will tell you it is more costly to put together their annual public filings. For shareholders, this increased transparency is primarily a good development: More disclosure and transparency provides greater insight into how a company is stacking up versus its peers, its market, and investor expectations. Of course, more disclosure also means more information to sort through, so the effort is certainly increasing for both companies and shareholders alike.

Overall, improved transparency has probably reduced governance-related risks for companies. Optimistically, shareholders now have a better idea than ever of the governance of a company they are investing in.

For a company who is lagging peers in certain areas, such as protecting shareholder rights, it perhaps invites shareholders to be more active, either through engagement efforts, the submission of shareholder proposals, or even by pursuing a contested meeting.

CSI: Another important issue for investors is ensuring that board oversight is functioning properly. What are some potential flags for this? What are the impacts of poor or weak governance practices on investors and the company?

Eaton: Glass Lewis strongly believes that our research and vote recommendations inform investors as to which governance structures will drive performance, create shareholder value and minimize risk. To this end, we believe it all really begins with the "tone at the top"—that a talented board is vital toward the fulfillment of these goals.

> "I THINK INVESTORS ARE **EXPANDING THEIR SCRUTINY OF RISK** TO INCLUDE CORPORATE GOVERNANCE-RELATED AREAS."

Therefore, we spend a great deal of time analyzing board composition and performance. Potential flags regarding board oversight include a lack of sufficient board independence, material-related party transactions between directors and the company, and overboarded directors. All of these issues can call into question whether the board is properly representing and protecting the interests of shareholders, and whether individual directors are able to dedicate sufficient time and energy to that endeavor. Ultimately, given the public information available to shareholders, we want to assure that this board consists of sufficiently independent directors with the time and relevant experience to protect shareholder interests and make objective decisions. When these flags—as well as others, such as attendance records and a director's service track record on other bards—are raised, we believe there is greater risk for shareholders.

Outsized compensation, particularly in relation to peers and to performance, can also be quite indicative of a board whose oversight and/or objectivity should be questioned. Because the CD&A is so dense, oftentimes compensation practices can give shareholders the greatest insight into the operations and the thought-process of the board.

CSI: You have done research on companies across the globe. What are trends you have seen outside of the U.S. that you think may be imported here and vice versa?

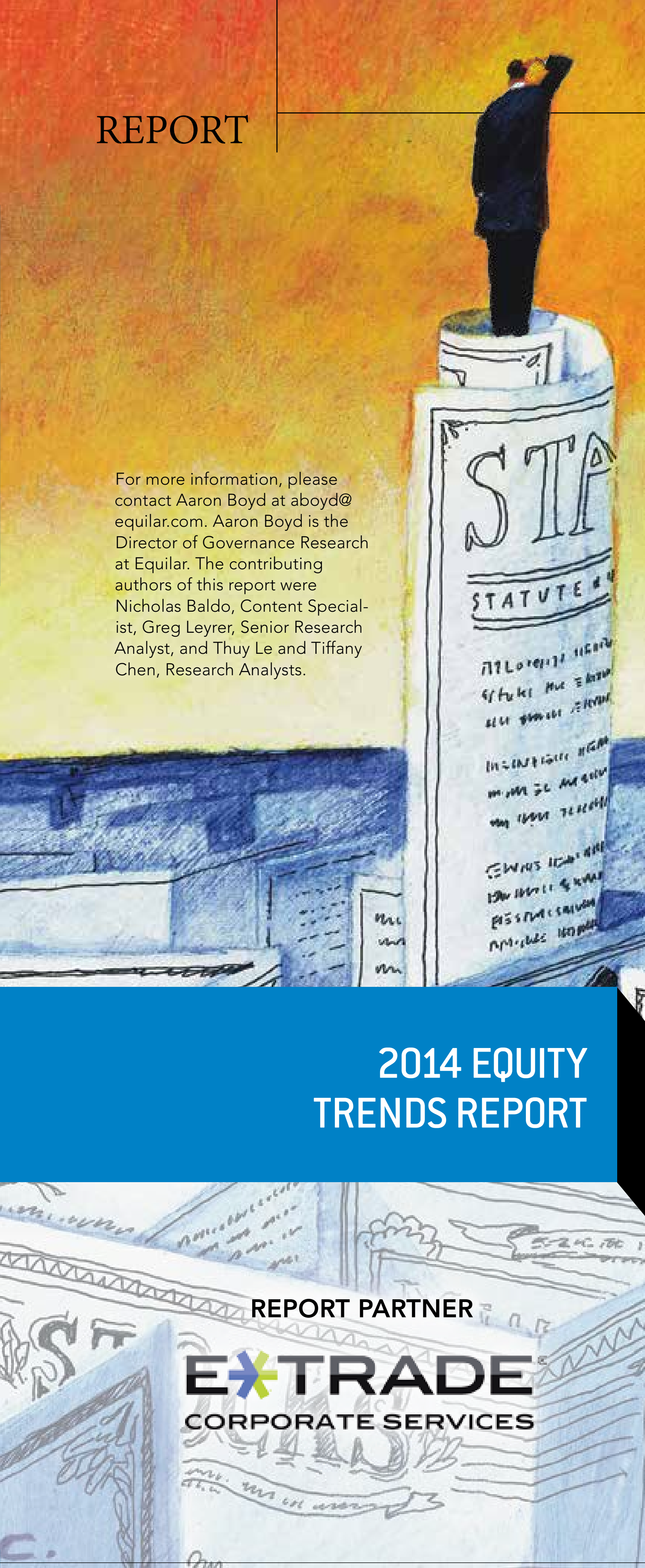
Eaton: Overall, risk is approached, I think, quite similarly in the U.S. and Europe, though perhaps slightly different in Asia, where more leeway appears to be given to companies that the financial statements are done properly and the board is performing satisfactorily. However, I could be wrong here, and this appearance could be more of a reflection of limited disclosure and therefore limited insight on these matters.

I think the concept of independence in the board room is being exported primarily from western countries, such as the U.S. and the U.K., to Asian markets. You can see this in Japan, where traditionally boards are made up primarily of insiders, but slowly independent, outside directors are getting a seat or two. In fact, some of the larger Japanese companies, such as Canon, Toyota, and Nippon Steel, are leading the charge and appointing two or more outside directors (although not all can be considered truly independent, at least by Glass Lewis standards). Perhaps this is the influence of their western investors?

In the other direction, we have already seen the U.S. market import the advisory Say on Pay proposal from other markets. It will be interesting to see if down the road the U.S. market imports the binding compensation policy vote from the U.K., which was introduced in 2014. In a lot of ways, the binding policy vote, used in conjunction with an advisory vote on implementation over the past year, makes sense, as it separates out the concepts of the policy and structure from implementation.

Another concept that the U.S. has gradually imported from its U.K. and European counterparts is the importance and benefit of investor-issuer engagement. Certainly the advent of mandatory Say on Pay proposals spurred this, but now engagement is a pretty standard market best practice.

> **"POTENTIAL FLAGS REGARDING BOARD OVERSIGHT** INCLUDE A LACK OF SUFFICIENT BOARD INDEPENDENCE, MATERIAL-RELATED PARTY TRANSACTIONS BETWEEN DIRECTORS AND THE COMPANY, AND OVERBOARDED DIRECTORS."



For more information, please contact Aaron Boyd at aboyd@equilar.com. Aaron Boyd is the Director of Governance Research at Equilar. The contributing authors of this report were Nicholas Baldo, Content Specialist, Greg Leyrer, Senior Research Analyst, and Thuy Le and Tiffany Chen, Research Analysts.

2014 EQUITY TRENDS REPORT

Any discussion of executive compensation must begin with a discussion of equity compensation. The vehicles and features that companies use in their equity plans are vital components of their overall governance goals that deserve shareholders' utmost concern. The last year witnessed the continuation of a long-term shift from options to performance-based, full-value shares, mirroring the increased emphasis placed on performance equity by institutional investors and proxy advisors. The trend is broad and undeniable, cutting across industry lines and manifesting itself both among companies that had previously granted few options and among companies that had theretofore granted many. As fewer companies utilize options, overhang stemming from them has fallen as well.

EXECUTIVE SUMMARY

Over the last five years, a large set of America's largest companies has stopped granting options. In 2009, 77.2% of companies granted options, a share that has since decreased to 63.9%. Meanwhile, the percentage of companies granting only full-value shares has risen from 20.0% to 34.7%.

Since 2009, the share of companies granting performance-based equity has risen from 45.5% to 68.9%, a change in line with what would be expected if performance shares were the type of equity used as a substitute for options. In 2012, the percentage stood at 64.0%. This trend was prominent across all major sectors of the economy.

Average overhang fell consistently over the five-year interval studied, from a median value of 6.3% in 2009 to 4.9% in 2012 and 4.3% in 2013. The trend appears to be driven by the fall in outstanding options and the attendant decline in option overhang.

The reasons for the decline of options as an equity compensation vehicle are subject to intense debate, but there appears to be an evolving consensus in the executive compensation community that performance shares, with specific metrics that can be directly chosen by plan designers, provide a more finely-tuned means to incentivize performance. Documenting the nature and rise of performance shares is an important theme of this report.

METHODOLOGY

This analysis included S&P 1500 companies with five years of publicly disclosed equity grant practices available at the time of writing (n=1,345), as well as a subsample of companies that filed annual proxy statements before early April and that therefore had information on specific awards granted in 2013, including performance equity (n=859). The smaller sample is used for award-specific figures, and the larger to determine equity grant mix and the quantities of options and stock granted or outstanding. Throughout the report, options and SARs, as well as restricted stock and restricted stock units, are summed in graphs and calculations unless otherwise stated. The analysis sheds light on how the country's most important companies motivate and reward their leadership.

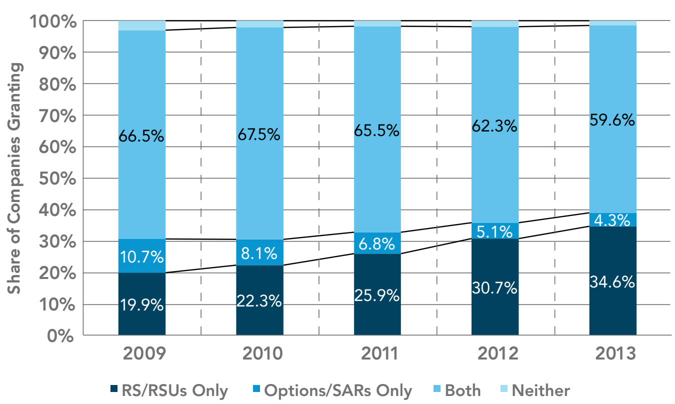
EQUITY GRANT PRACTICES

The chart below shows the percentage breakdown of sample companies granting each combination of stock and options over the five-year study period. The shift from options to restricted stock (including restricted stock units) is quite salient. In 2013:

- 34.6% of companies granted exclusively restricted shares compared to 19.9% in 2009.
- 4.3% of companies granted exclusively options compared to 10.7% in 2009.
- 59.6% of companies granted both compared to 66.5% in 2009.
- 1.5% of companies granted neither compared to 3.0% in 2009.

Chart 1

Equity Mix



KEY FINDINGS

- **The share of companies granting performance equity awards rose to 68.9% in 2013** from 64.0% in 2012 and 45.5% in 2009. The most common type of performance equity award was the multi-year stock unit, constituting 47.6% of performance equity awards.
- **Only 63.9% of companies granted options in 2013**, down from 67.4% in 2012 and 77.2% in 2009.
- **Of time-vesting equity awards granted by companies in 2013, 74.6% vested in multiple installments** rather than in one final installment. Graded stock and option awards both had average vesting periods of 3.6 years.
- **Median overhang among companies fell to 4.33% in 2013** from 5.77% in 2012, driven by a sustained decrease in the number of outstanding options.

E*TRADE CORPORATE SERVICES COMMENTARY

The performance of a company's underlying stock, as well as the characteristics of its employee base, may influence the type of award a company chooses to grant. For example, a mature company that pays regular dividends may have stable stock prices because earnings are being distributed to investors. In such a case, restricted stock grants may serve as a more effective incentive than stock options because restricted stock has intrinsic value even if the underlying security does not appreciate. It is also common for restricted stock grants to incorporate dividends or dividend equivalents, aligning the interests of employees with those of non-employee shareholders.

RESTRICTED STOCK

A key aspect of the shift enumerated above is the increasing use of restricted stock and restricted stock units. In 2013, the median number of RS/RSUs granted grew to 440,000, a 28.3% increase since 2009, while the median number of RS/RSUs outstanding increased by 43.7% since 2009 to stand at 1,026,671.

Chart 2

Granted (in thousands)

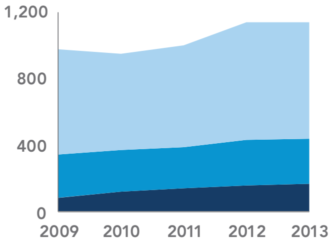
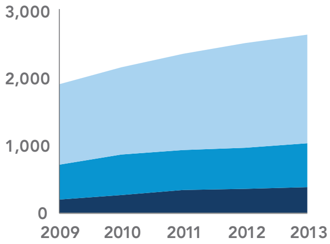


Chart 3

Outstanding (in thousands)



▪25th Percentile ▪50th Percentile ▪75th Percentile

E*TRADE CORPORATE SERVICES COMMENTARY

We believe that the rise in the use of Restricted Stock as an equity incentive is due to a combination of factors. Two likely contributors are expense requirements and the cost to the company compared to perceived value on the part of employees.

Changes to expense requirements

For years, employers were able to compensate employees using at-the-money stock options without recognizing any compensation expense, while restricted stock grants were required to be expensed based on the intrinsic value (typically equal to the stock price on the date of grant). This preferential expensing treatment created significant incentives for employers to grant stock options.

With the implementation of ASC 718 in 2005, companies were required to begin recognizing expenses for at-the-money options, which eliminated the expensing advantages of options and put restricted stock on an even playing field. This change in the accounting standards has likely contributed to the trend away from options and toward a more balanced mixture of equity compensation vehicles.

Cost relative to perceived value

The implementation of ASC 718 impacts options granting in another way. When an option expires out-of-the-money, the employee reaps no value from that company-paid benefit, and the company is not able to reverse the accounting expense associated with those options. It may be challenging for a company to justify booking expense for a benefit that may not provide value and, in fact, may be perceived negatively by employees whose vested stock options are significantly underwater. This, too, may cause companies to consider granting restricted stock rather than options.

OPTIONS

While the use of restricted shares continues to rise, the number of options granted and outstanding has fallen consistently over the study period, although the decline appears to be tapering somewhat. In 2013:

- The median number of options and SARs granted stood at 181,000, a 65.0% decrease from 2009.
- The median number of options and SARs outstanding stood at 2,092,500, a 45.4% decrease over the five-year period.

Chart 4 **Granted (in thousands)**

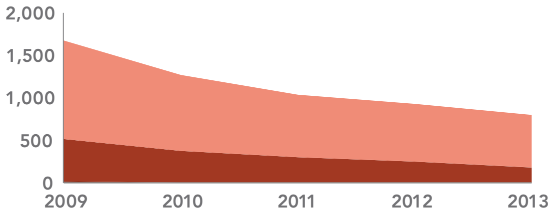
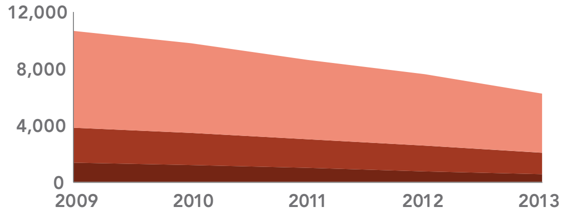


Chart 5 **Outstanding (in thousands)**



▪25th Percentile ▪50th Percentile ▪75th Percentile

E*TRADE CORPORATE SERVICES COMMENTARY

During the most recent economic downturn, many employees saw the value of their stock options decline or disappear as stock values dropped. As a result, employees began to view stock options as a less valuable form of equity compensation.

Surely everyone has heard an anecdote about junior employees who became millionaires because of stock options granted by rapid-growth firms. The allure of this potential windfall continues to attract some employees to companies that offer sizable stock option grants in lieu of competitive salaries. But just as lottery sales skyrocket as the jackpot increases, the demand for options is highest in an up market. In a down or fickle market, employee demand tends to shift away from options toward other types of compensation. In recent years, market downturns and uncertainty may have been partly responsible for the decrease in options grants.

RESTRICTED STOCK AND OPTIONS IN COMPARISON

Charts 6 and 7 illustrate the overall distribution of stock and options granted and outstanding showing percentiles on the horizontal axis, from the 10th through the 90th. Companies are ranked according to the amount of options or stock granted or outstanding.

- While options both granted and outstanding have fallen across the board, the decline is particularly evident at higher percentiles as companies diversify their equity vehicles and mitigate the outliers.

Chart 6 **RS/RSUs and Options/SARs Granted by Percentile (in thousands)**

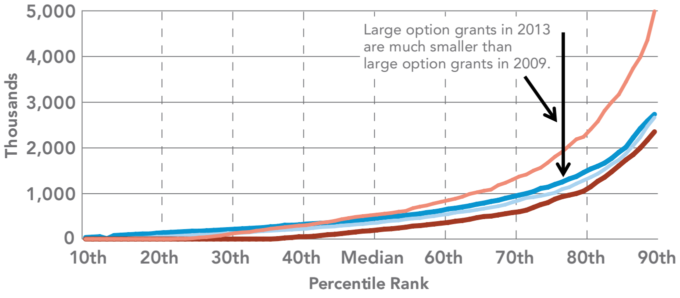
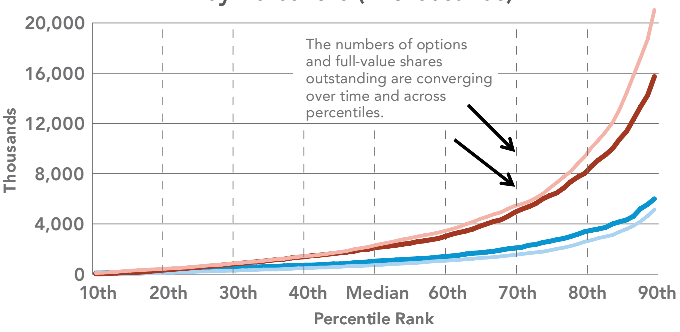


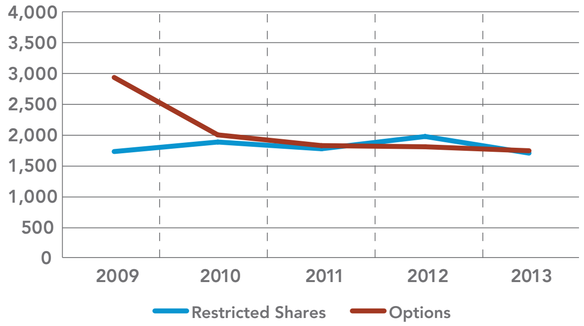
Chart 7 **RS/RSUs and Options/SARs Outstanding by Percentile (in thousands)**



The average numbers of options and full-value shares awarded by companies that granted nonzero amounts of the respective equity vehicle have remained relatively stable over the last few years. This indicates that changes in the equity compensation landscape have been driven primarily by companies either adopting or abandoning different vehicles. Conditional on nonzero grants of a given equity vehicle, in 2013:

- The average number of RS/RSUs units granted was 1,696,932.
- The average number of options and SARs granted was 1,737,897.

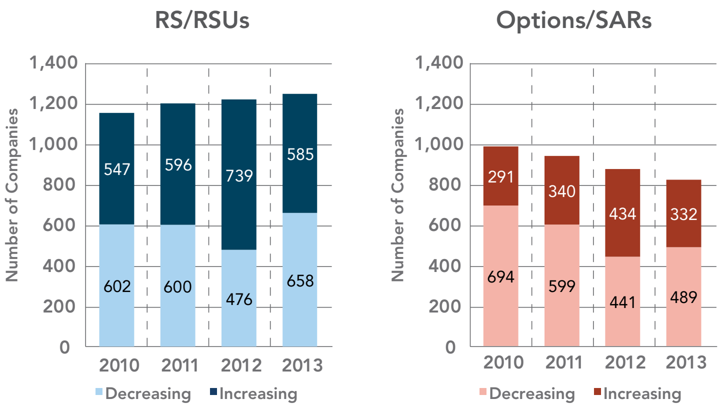
Chart 8 **Average RS/RSUs and Options/SARs Granted Conditional on Nonzero Grants (in thousands)**



Charts 9 and 10 show the number of companies that made year over year changes to their nonzero stock or option grants of certain percentage values. They sum to the total number of sample companies in each year changing their grant values.

- The number of companies growing the size of their stock grants jumped in 2012 before returning to previous levels.
- Companies shrinking option grants outnumbered companies growing them in every year, although the margin was closer in 2012.

Charts 9 & 10 **Number of Companies Increasing or Decreasing Grants Year Over Year**

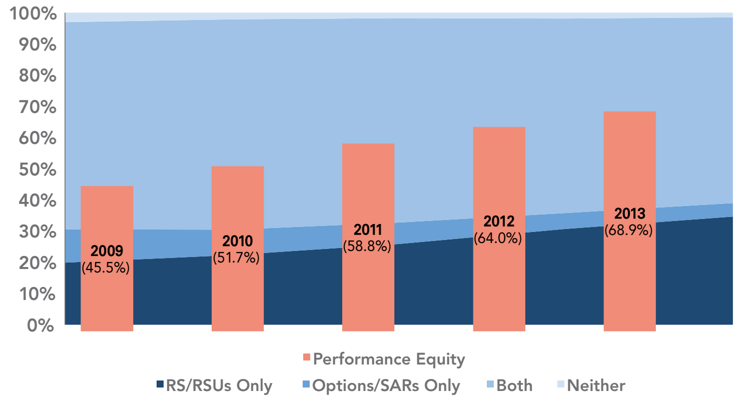


PERFORMANCE EQUITY

As companies work to meet shareholders' expectations regarding overall pay and performance alignment, performance share awards—which have payout values dependent on predefined metrics—have become the vehicle of choice for incentivizing performance at many companies. Laying performance equity over overall equity mix in the last five years depicts the parallel growth of performance equity and RS/RSUs grants.

- In 2013, 68.9% of companies granted performance equity.
- Year over year growth in the percentage of companies granting performance equity has remained very steady over the last several years.

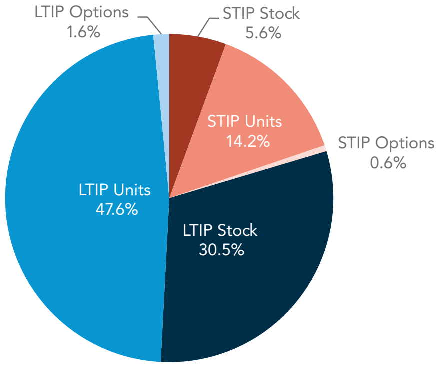
Chart 11 **Prevalence of Companies Granting Performance Equity Chart**



E*TRADE CORPORATE SERVICES COMMENTARY

A number of factors are likely responsible for the steady increase in the use of performance equity. First, corporate governance of compensation has increased significantly over the past 10 years as a result of legislation, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act, driving more companies to link executive compensation to performance. Second, under Section 162(m), performance equity is not subject to the limit placed on corporate tax deductions for compensation to executive officers, which can make these awards attractive to some companies as part of their compensation mix. Last, accounting guidelines and plan administration providers have evolved. With the implementation of ASC 718 in 2005, the accounting guidance for performance equity was simplified. And as these awards have grown in popularity with companies and shareholders alike, third-party administrators have responded with more robust solutions to accommodate performance awards programs, enabling companies to create plans that are tied to more diverse performance metrics and to grant performance awards more deeply into the employee base.

Chart 12 **Performance Equity by Vehicle and Plan Type**



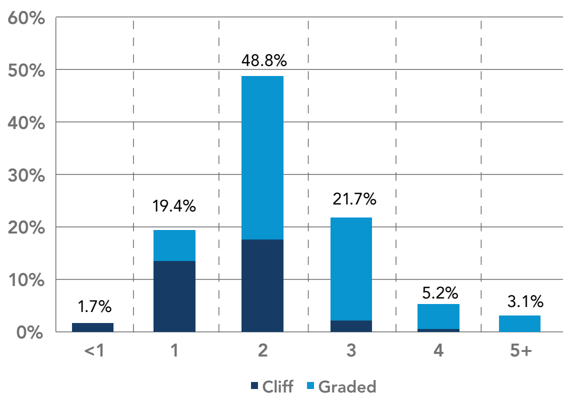
Growth in the use of performance equity has been steady across all economic sectors, as shown in Chart 11.

The rise in performance equity has brought a variety of equity structures. In 2013, long-term performance awards comprised 79.7% of total performance awards.

Over the last five years, the share of performance-based equity awards with time-based restrictions following performance periods has ranged from 23.5% to 27.3%. Such periods are added if companies wish to add additional retention incentives to performance-based equity awards. The graph below provides a breakdown of the vesting periods included in performance awards with additional time-based restrictions.

- Two years of additional vesting was the most common post-performance period vesting restriction, representing almost half of the time periods.

Chart 13 **Time Vesting After Performance Periods**



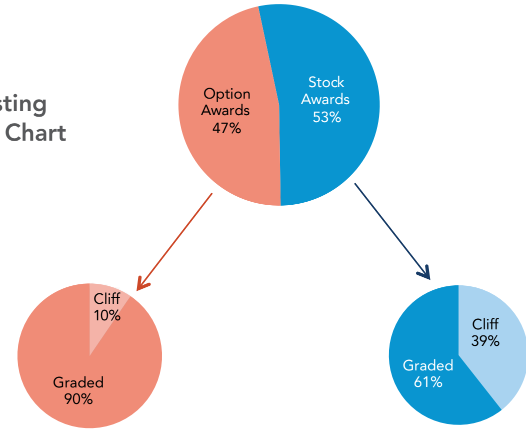
TIME-BASED EQUITY VESTING

Equity grants without specific performance conditions attached still serve as valuable retention incentives for executives. The time frame and manner in which the equity vests is important to the effectiveness of equity plans. The following chart divides 2013 time-based equity grants into options and stock, with both vehicles further separated according to whether they vest all at once (cliff vesting) or over multiple installments (graded vesting).

- Graded vesting was more popular than cliff vesting for both options and stock.

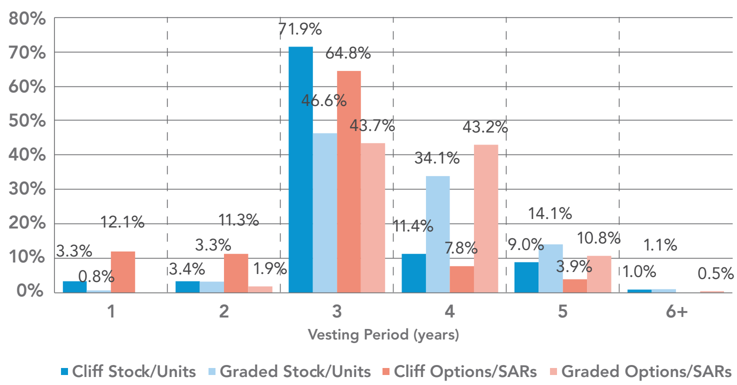
Chart 14

Equity Vesting Schedules Chart



The Equity Vesting Periods chart shows the same data as the Equity Vesting Schedules breakdown, but splits it according to vesting period length (of at least one year). Three-year vesting periods remained the most common, especially for cliff-vesting awards.

Chart 15 **Equity Vesting Periods**



E*TRADE CORPORATE SERVICES COMMENTARY

Looking at Chart 15 from the perspective of options valuation, we see that options are even more tightly grouped around a three-year vesting period than the raw data suggest. A four-year graded vesting option with annual vesting has a weighted average vesting period of 2.5 years. Thus, vesting, on a weighted-average basis, takes place between two and three years for 80% of all options granted.

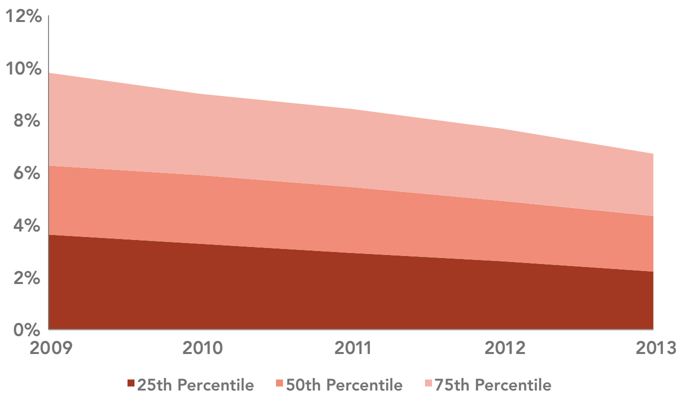
While long-term vesting schedules may align employee interest with long-term investor interest, employees' perceived value of a grant can be diminished with long waits for vesting. Graded vesting may increase perceived value because it brings periodic vesting of shares throughout the long-term service period.

DILUTION

Dilution directly impacts shareholder wealth, and therefore receives a great deal of scrutiny from the investor community. Total overhang is a measure of potential dilution defined as the ratio of equity grant shares outstanding to total common shares outstanding.

- Median overhang among sample companies fell to 4.3% in 2013 from 4.9% in 2012 and 6.3% in 2009.

Chart 16 **Total Overhang**



The decline in total overhang shown above parallels the decline in option overhang shown in Chart 18. Overhang from stock is up slightly as grants of full-value shares continue to rise. In 2013:

- Median overhang from options was 2.8%.
- Median overhang from stock was 1.1%.

Chart 17 **Stock Overhang**

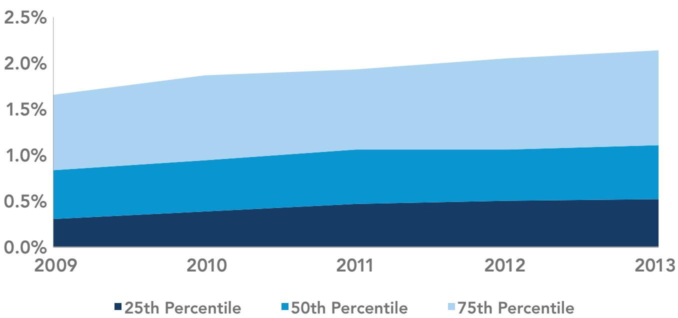


Chart 18 **Options Overhang**

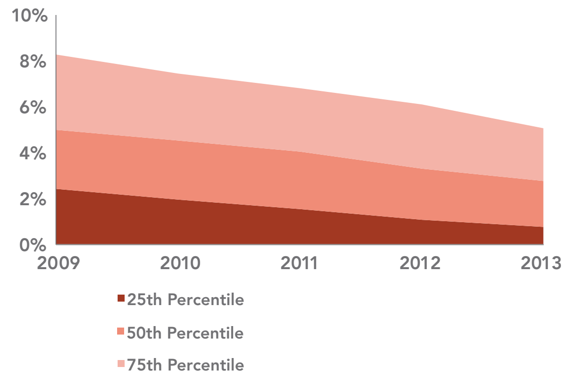
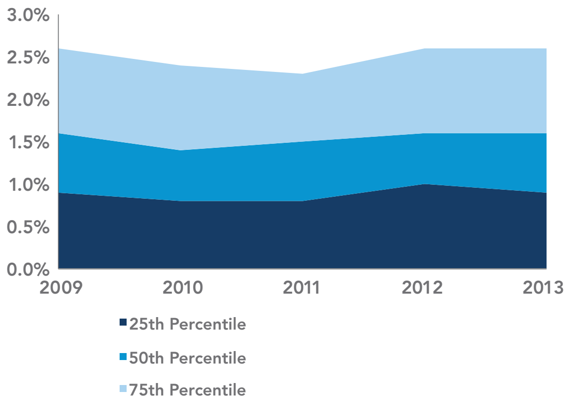


Chart 19 **Run Rate**

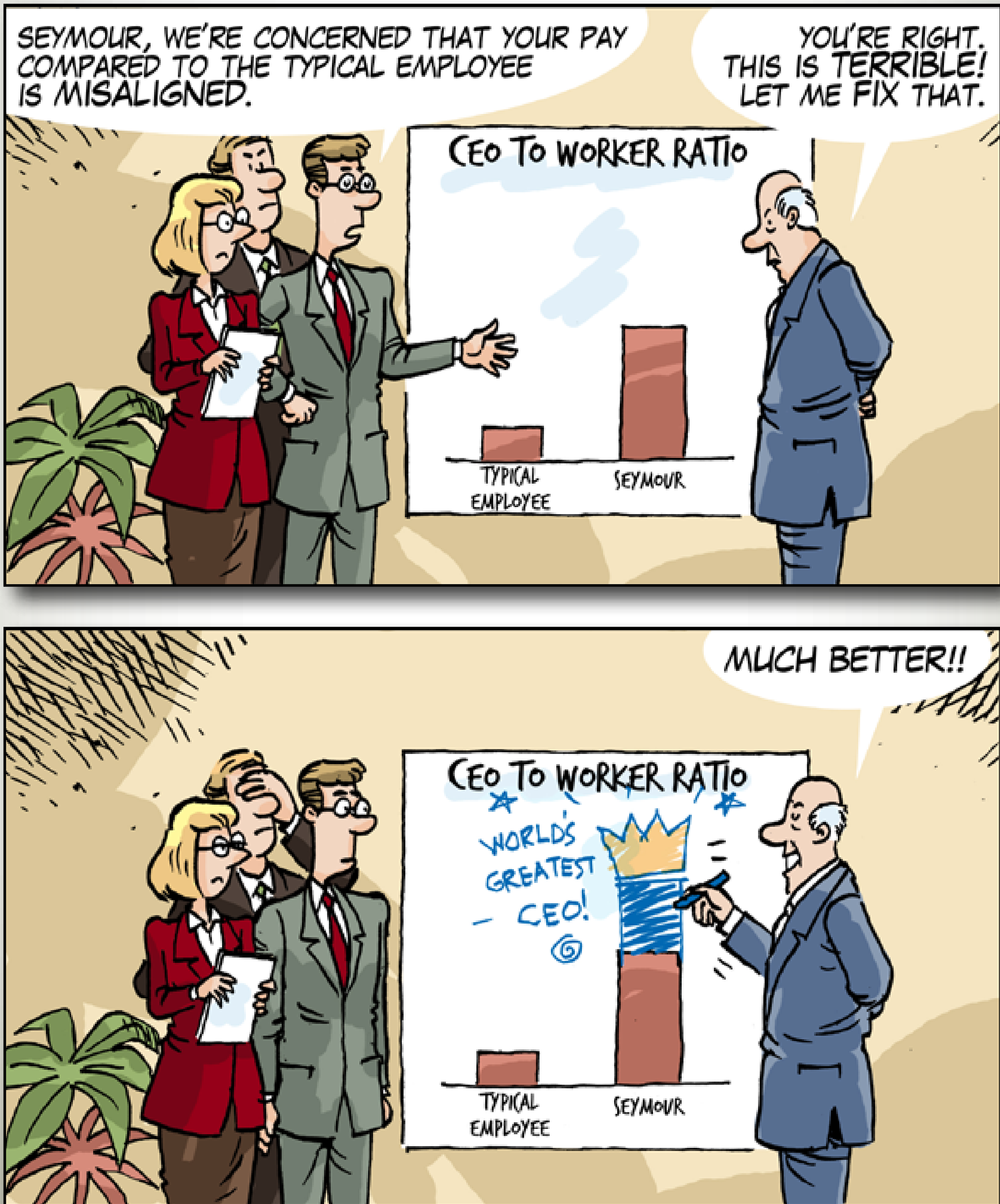


Run rate is defined as the sum of options assumed and new equity shares granted divided by the total number of common shares outstanding. It is an important calculation in the measurement and evaluation of equity plan dilution.

- Over the last five years, run rate has remained stable despite equity mix changes.

$EYMOUR CASH

"SEYMOUR ALIGNS THE MEDIAN"



2015 EQUILAR
EXECUTIVE COMPENSATION
SUMMIT



C-Suite Insight • **Risk** *Issue 15 2014*