Center On Executive Compensation

November 27, 2009

VIA E-MAIL

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW,
Washington, DC 20551

RE: **Proposed Guidance on Sound Incentive Compensation Policies, Docket No. OP–1374**

Dear Ms. Johnson:

The Center On Executive Compensation is pleased to submit comments on the Federal Reserve Board's ("Federal Reserve") proposed guidance on sound incentive compensation policies.[1] The Center supports a board-centric approach to executive compensation, based upon strong principles aligning compensation and performance, and has developed tools and recommendations on mitigating risk in incentives. However, based on the proposal, the Center is concerned that the Federal Reserve does not yet have the full expertise on the intricacies of executive compensation and urges the development of such expertise before executing its proposed reviews. Recognizing that competition for top talent in the financial services industry is considerable, it also cautions against prohibiting the use of recruitment premiums and severance arrangements, which would likely drive up compensation without having a measurable effect on risk.

The Center On Executive Compensation is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy from the perspective of the senior human resource officers of leading companies. The Center is hosted by the HR Policy Association and currently has more than 60 corporate Subscribers across all industries that are actively involved in its research and policy development activities. Because senior human resource officers play an important role in supporting the compensation committee, we believe that our Subscribers' views can be particularly helpful in better understanding how executive compensation plans are developed and executed. The Center's focus is broader than the financial services industry, and our comments reflect the reasoned judgment and experience of risk mitigation across many industries.

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[1] Federal Reserve System, Proposed Guidance on Sound Incentive Compensation Policies, Docket No. OP–1374, 74 Fed. Reg. 55,227 (Oct. 27, 2009).

The Center's Principles and Checklist for Mitigating Risk in Incentives

The Center's research and advocacy activities are based upon a set of carefully developed executive compensation principles. These principles and a more detailed document explaining how the principles should be implemented are attached to these comments. In sum, the Center supports an approach to executive compensation that is developed by an independent and informed compensation committee. In keeping with this philosophy, we believe that these principles may be useful as the Federal Reserve begins its process of review for the Large Complex Banking Organizations.

Risk Checklist. The Center has also developed a well-regarded and highly implemented Compensation Committee checklist for analyzing and mitigating the potential for excessive risk in incentive arrangements. Although the checklist is targeted to executive compensation, the underlying principles, including a balance among the types of incentives and in performance metrics, applies equally to the mitigation of risk among employees at many levels in the financial services industry. Specifically, these principles urge:

- A balance in performance metrics that measure both performance and the quality of performance;
- A balance between the share of compensation provided through short- and long-term incentives;
- Ensuring that payouts are within competitive norms for similarly-situated employees;
- Ensuring a relationship between performance and criteria and payouts under annual and long-term incentives;
- Ensuring that long-term incentives are not overly leveraged to encourage risky behavior;
- The adoption of recoupment policies (for executive officers) in the event of financial restatement; and
- Incorporating a review of risk and compensation into the Compensation Committee's process for reviewing and approving compensation.

A copy of the full checklist is attached.

As we have noted in comments to the Securities and Exchange Commission, in most industries, the Compensation Committee should be focused predominantly on compensation for senior executives. The one exception to this is where an employee or set of employees has the ability to make decisions that could have a material effect on the company, and the employees participate in an incentive system or program that could encourage the employees to take excessive risk. In those cases, the Compensation Committee and the Board need to ensure that proper business controls exist for the design, measurement and payout of the incentives. This, combined with careful incentive design, will mitigate the potential that executives or groups of employees will seek to maximize incentive compensation at the expense of the long-term health of the company.

The Federal Reserve Should Develop Greater Expertise in Compensation Matters Prior to Executing Its Supervisory Initiatives

The proposed guidance notes that the Federal Reserve will initiate two supervisory initiatives designed to review the extent to which financial institutions are complying with the Fed's compensation principles. In the case of LCBOs, the guidance notes that:

> The horizontal review of LCBOs will be led by Board staff, working with relevant Reserve Bank supervisors, and will draw on a multidisciplinary group comprised of staff with expertise in banking supervision, risk management, economics, finance, law, accounting, and other areas as appropriate. This multidisciplinary team also will have access to information and analysis developed as part of the reviews of other banking organizations, and will serve as a resource for supervisory staff across the System on incentive compensation matters.[2]

While the Center supports the use of a multidisciplinary team to execute such reviews, based on comments from regulated financial institutions and Federal Reserve officials themselves, the Center questions whether the Federal Reserve currently possesses the requisite expertise in executive compensation at the present time to conduct such reviews accurately and efficiently. Indeed, we are concerned that the process could easily devolve into a check-the-box exercise which could undermine the ability of large financial institutions to develop customized compensation arrangements carefully tailored to their businesses. The Center does not support incentive arrangements that support excessive risk taking, but neither does it support a one-size-fits-all approach to regulating.

Although the Federal Reserve has had the authority to review executive and other compensation at financial institutions for many years, it has not focused on such matters until recently. Because incentive compensation structures are complex, commencing a review of compensation practices at very sophisticated financial institutions without an understanding of how such arrangements work in practice could be detrimental to the reviews and the resulting recommendations. For this reason, the Center urges the Federal Reserve to ensure that its review teams fully understand how such compensation arrangements are designed and operate so that they can truly separate those that encourage risk from those that incentivize sound behavior and help to mitigate the potential for excessively risky behavior.

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[2] 74 Fed. Reg. at 55,229.

Recommendations Regarding Change-in-Control and Recruitment Arrangements

The Federal Reserve specifically requested comments on its recommendations that LBCOs and other financial institutions limit or eliminate change-in-control, severance and recruitment premiums made "without regard to risk or risk outcomes." The Center believes that the Federal Reserve guidance needs to carefully distinguish between the legitimate use and purpose of these arrangements and those that are poorly constructed and thus may undermine risk mitigation efforts.

The Center notes that the guidance combines the concepts of "severance" and "change-in-control" agreements into the ubiquitous term "golden parachute agreements." This merging is unhelpful because it places the focus solely on the amount of compensation rather than the purpose for the payments. Despite the generic use of the term "golden parachute" in the popular press, in compensation practice and regulation the concepts are different and thus should be separated. "Golden parachute" arrangements refer to payments made to a named executive officer in the event of a change-in-control of the organization. Such payments are provided to encourage executives to pursue transactions that are in the best interest of the shareholders and the organization, rather than focus on retaining their jobs. To keep the limits in check, payments above a certain level trigger an excise tax under Section 280G of the Internal Revenue Code.

Severance arrangements, by contrast, are agreements made with newly hired executives to provide a safety net for a certain amount of time, such as three or five years, in the event the arrangement does not work out as intended. In contrast to change-in control agreements, severance arrangements provide a safety net for the executive and also provide flexibility for the company to make a change in leadership if such a change is necessary. Severance is also a tool used in the recruitment process to convince an executive to leave a stable employment relationship and take a position elsewhere.

The guidance uses the term "golden handshake" agreement to refer to recruitment premiums made to hire a senior executive or other senior employee. The premise of a recruitment premium is to "buy out" the compensation that would have likely vested in some amount if the executive or individual chose to remain with the company. As with severance, a recruitment premium is paid to keep the individual whole when making an employment change.

The Center acknowledges that, in certain cases, payment of change-in-control payments, severance payments or recruitment premiums (so-called "golden handshake" agreements) could potentially negative affect risk mitigation efforts. However, there are approaches available to retain risk mitigation features of such arrangements while incorporating the flexibility that such arrangements provide for recruiting, retaining or removing talent. These include retaining an original vesting schedule for equity in severance arrangements, minimizing the use of tax gross-up provisions in a change-in-control, and providing a deferred element of a recruitment premium, similar to the terms that would have applied under the arrangement at the individual's former employer.

The Center does not believe that the Federal Reserve should discourage the use of change-in-control arrangements, severance agreements or recruitment premiums because of the unintended consequences that could result. Eliminating the use of such arrangements could simply increase the amount of non-performance-related pay or increase the overall pay package to make up for such amounts. Specifically:

- Not providing for change-in-control arrangements may discourage management from seeking out appropriate business combinations or encourage them to seek greater non-performance pay up front in advance of any such combination.
- Not allowing appropriate severance arrangements for new hires may result in higher levels of non-performance-based pay to make up for the lack of severance and the risk that the arrangement may not work out.
- Limitations on sign-on or attraction bonuses may put upward pressure on non-performance-based pay and distort the ongoing pay package and/or impose additional expenses on shareholders as other arrangements are constructed to account for the amounts that employees would have forfeited to switch employer.

Attracting high caliber talent and inducing these individuals to leave their current employer is best accommodated with tailored compensation arrangements that in the reasoned judgment of the compensation committee balances the need to attract talent with the desire to not disrupt the ongoing balance of salary, annual incentives and long-term incentive opportunities. The compensation committee is in the best position to make these decisions and regulations that tie their hands as to the form of mix of pay limits their ability to tailor compensation to best serve the interests of shareholders.

The discussion regarding these arrangements reinforces one of the Center's central principles: that compensation must be tailored to the company and the individuals in question. It also reinforces the point that the Federal Reserve needs to develop the expertise so that its reviews incorporate the company-specific purposes for certain compensation arrangements while seeking to protect the safety and soundness of the overall financial services regime.

Thank you for the opportunity to comment on these proposals. The Center stands ready to discuss these concepts further. Please do not hesitate to contact me at 202-789-8692 if you have any questions about our comments.

Sincerely,

Timothy J. Bartl

Timothy J. Bartl
Senior Vice President & General Counsel

Center On Executive Compensation

Compensation Committee Checklist for Assessing Incentives and Risk

As Board Compensation Committees consider and finalize executive compensation arrangements for 2009, they will seek to confirm that the company's incentive programs are appropriately structured for the company and discourage executives from taking "excessive risk." Many Committees will also voluntarily disclose how their compensation programs address the subject of risk. The Center On Executive Compensation, a research and advocacy organization that provides a principles-based perspective on executive compensation matters, has created the following checklist to help guide Compensation Committees on these issues. The questions that form the basis of the checklist are provided below and in greater detail on the subsequent pages.

1. **Do the performance criteria and corresponding objectives represent a balance of performance and the quality and sustainability of such performance?**
2. **Is the mix of compensation overly weighted toward annual incentive awards or is there a balance of annual and long-term incentive opportunities?**
3. **When compared to a carefully chosen peer group, is the relationship between performance and incentive plan payouts within the range of competitive practices?**
4. **Is there a relationship between performance criteria and payouts under the annual incentive award consistent with targeted performance under the long-term incentive awards?**
5. **Are the long-term incentive performance measures or equity devices overly leveraged and thereby potentially encourage excessively risky behavior?**
6. **Is there a requirement that a meaningful portion of the shares received from incentive award payouts be retained by the participants?**
7. **Has the Board of Directors adopted a recoupment policy which provides for the clawback of incentive payouts that are based on performance results that are subsequently revised or restated and would have produced lower payouts from incentive plans?**
8. **Does the Compensation Committee discuss the concept of risk when establishing incentive performance criteria and approving incentive payouts? Are such discussions recorded in the minutes of the Committee meeting? Does the Compensation Discussion and Analysis articulate how the company's incentive plans mitigate risk?**

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Role of the Compensation Committee in Assessing Excessive Risk

The Center On Executive Compensation believes that the Compensation Committee is in the best position to assess the appropriate relationship between the risk inherent in compensation arrangements and how that level of risk corresponds to the overall business strategy and competitive environment of the company. The Compensation Committee is responsible for establishing company-specific performance goals and potential incentive payouts that will motivate and reward performance supporting the long-term success of the company. The following checklist is offered to aid Compensation Committees in assessing the extent to which the design and administration of executive compensation encourages or reinforces excessive risk-taking by management.

1. Do the performance criteria and corresponding objectives represent a balance of performance and the quality of such performance?

- The committee should evaluate whether performance criteria under annual and long-term incentive plans include measures of performance (such as financial or managerial goals) and measures of the quality of that performance (such as return measures or measures of sustainability of performance).
  - For example, incentive plans may focus on performance such as revenue, market share or other growth measures, and profitability, return on invested capital, or other measures of efficiency and return.
- This dual approach mitigates the potential that executives will aim to achieve increases in measures such as sales or growth while not focusing on the ultimate value creation or sustainability of such performance.

2. Is the mix of compensation overly weighted toward annual incentive awards or is there a balance of annual and long-term incentive opportunities?

- Does the annual incentive make up more than 50 percent of the total compensation opportunity?
  - To avoid placing too much focus on achieving short-term results, the annual incentive should not comprise a disproportionate share of the total annual executive compensation opportunity (base salary, annual incentive, estimated value of long-term incentive).
    - Too much emphasis on short-term results may jeopardize long-term performance

2. Is the mix of compensation overly weighted toward annual incentive awards or is there a balance of annual and long-term incentive opportunities? (Continued)

- Recognizing that each company will be slightly different, the median division among the elements of compensation for Fortune 500 companies are
  - Salary ≈ 15-20 percent
  - Annual Incentive ≈ 15-20 percent
  - Long-Term Incentive ≈ 60-70 percent
- Annual incentive in excess of 50 percent of annual compensation opportunity should trigger additional Compensation Committee scrutiny and potentially re-allocation of the annual pay opportunity to other components of the pay package.

- Does the annual incentive plan have unlimited payout potential?
  - The annual incentive plan should limit total payouts and the range of payouts should be set at a reasonable level, as determined by the Compensation Committee, to avoid encouraging decisions that maximize short-term earnings opportunities (swinging for the fences) at the expense of long-term viability.
- Do the annual incentive plan criteria and administration mitigate excessive risk?
  - It may be advisable to provide the Compensation Committee discretion in the incentive plan to adjust above-target payouts downward in the face of excessively risky behavior and discuss why this discretion was exercised in the proxy statement.

3. When compared to a carefully chosen peer group, is the relationship between performance and incentive plan payouts within the range of competitive practices?

- The range of performance, and corresponding payouts, should be within a realistic range of results as compared to the performance of the company's peer group.

4. Is there a relationship between performance criteria and payouts under the annual incentive award consistent with targeted performance under the long-term incentive awards?

- While the annual and long-term incentive plans play different roles in the compensation plan, it is important that annual and long-term incentive plan objectives, metrics and targets are aligned to ensure that both types of awards encourage consistent behaviors and sustainable performance results.

5. Do the long-term incentive performance measures or equity devices potentially encourage excessively risky behavior?

- Do the long-term incentive performance measures require excessively risky behavior to realize target or above target payouts? (e.g., do the targets require performance at so high a level that executives would take improper risks to achieve them?)
- Do the performance criteria and vesting periods of long-term incentive awards overlap and thereby reduce the incentive to maximize performance in any one period?
  - With overlapping awards, an attempt to increase short-term performance may jeopardize company performance in future years and thus payouts under other outstanding awards.
- Does the mix of long-term incentive awards meet the Committee's pay for performance objectives?
  - The Compensation Committee should determine the specific mix of long-term incentive awards that serve the best interests of the shareholders and the company, and may include:
    - performance-vested performance shares or units (which reward the attainment of key financial objectives)
    - time-vested or performance-vested restricted stock or restricted stock units (which may aid in the retention of key talent)
    - stock options or stock appreciation rights (which provide value only if share price appreciates thereby producing direct gains to shareholders).

6. Is there a requirement that a meaningful portion of the shares received from incentive award payouts be retained by the participants?

- Require meaningful stock ownership requirements to link executives' interests to shareholders' interests
- In the Compensation Committee's discretion, require executives to hold a percentage of net equity received as a continuing link between shareholder and management interests.
- The level of share ownership should build over the executive's career
  - As the executive approaches a targeted retirement date the compensation committee may determine it advisable to approve a phased-diversification plan.
  - If the Compensation Committee determines appropriate, ownership may be also be required for some period after retirement
    - consistent with Internal Revenue Code Section 409A, which requires "key executives" to delay payout of deferred compensation for six months' after departure.
  - Holding requirements should not be so great as to potentially encourage overly conservative management decisions that would harm shareholder value.

7. Has the Board of Directors adopted a recoupment policy which provides for the clawback of incentive payouts that are based on performance results that are subsequently revised or restated and would have produced lower payouts from incentive plans?

- Adopt a strong clawback provision to provide for recoupment in the event of a material restatement.
- The Compensation Committee, in its discretion, should determine when the need for a clawback is triggered, to whom the clawback should apply and the mechanism for recouping incentive payments.

8. Does the Committee discuss the concept of risk when establishing incentive performance criteria and approving incentive payouts? Are such discussions recorded in the minutes of a Committee meeting? Does the Compensation Discussion and Analysis articulate how the company's incentive plans mitigate risk?

- In addition to competitiveness and the linkage of pay and business strategy, the relationship between business risk and incentive compensation should be a key consideration in setting performance criteria, the corresponding mix of awards and the range of incentive plan opportunities.
- The Compensation Committee should meet with the company's principal financial officer and/or corporate risk officer prior to approving financial incentive criteria and meet with him/her periodically to facilitate a complete understanding of how the company's financial performance interacts with its strategy and compensation programs.
- Company proxy disclosures should briefly explain how incentive designs mitigate risk to help demonstrate how risk is considered and addressed by the Committee in approving incentive plans.

Principled Pay Practices
The Center On Executive Compensation

Mission Statement

The Center On Executive Compensation is dedicated to developing and promoting principled pay practices and advocating compensation policies that serve the best interests of shareholders and other corporate stakeholders. The Center believes that the management of the executive compensation function by corporations should be conducted in accordance with a set of clearly defined principles. The Center encourages companies to incorporate these principles in the development, administration and communication of their executive compensation arrangements. The Center further believes that executive compensation principles should be periodically updated to reflect the most contemporary thinking on the subject. The following is an explanation of the Center's principles, as well as a document providing more detail of how they are applied in practice.

Principled Pay Practices

- ***Aligned*** With the Best Interests of the Company's Shareholders and Other Stakeholders
- ***Fully Compliant*** With Applicable Laws and Regulations
- ***Independently Informed and Approved***
- ***Appropriately Customized*** to the Company's Culture, Values, Industry and Strategy
- ***Transparent and Accessible***
- ***Fair and Reasonable*** to the Company's Shareholders and Executives as a Whole

***Aligned*: Executive Compensation Arrangements Should Be Aligned With the Best Interests of a Company's Shareholders and Other Stakeholders**

- Link to Results. Incentives should be contingent on achieving stringent, well-defined results-based measures linked to a company's business, with a significant share of the total compensation at risk, or not guaranteed, and compensation proportionate to results.
- Ensure Appropriate Incentive Balance. Incentives should be structured to mitigate the possibility that executives would be encouraged to make decisions that could significant reduce the long-term value of the firm by including, for example, caps on total earnings potential, an appropriate mix among short- and long-term compensation elements and an appropriate balance among equity used in long-term incentives.
- Require Appropriate Ownership Stake. Executives should have a significant ownership stake in their company, driven by an appropriate amount of pay delivered through equity-based compensation, a substantial portion of which is linked to results, and implemented through meaningful ownership and/or retention guidelines applied to option exercises, stock vesting and/or payouts of stock compensation.
- Enable Necessary Talent. Executive compensation arrangements should enable companies to attract, retain and develop the executive talent necessary to serve the shareholders' and other corporate stakeholders' best interests, while ensuring a proper balance between pay that is focused on results and that which is focused on retention.
- Support the Business Strategy. Compensation should be structured to support the company's ability to execute its business strategy.

***Fully Compliant*: Executive Compensation Arrangements Should Be Structured and Executed in Full Compliance With Applicable Laws And Regulations and a Culture of Compliance Should Be Adopted to Guide a Company's Pay Policies and Practices.**

***Independently Informed and Approved*. Executive Compensation Arrangements Should Be Approved by the Board of Directors' Independent and Active Compensation Committee That Is Guided by High Corporate Governance Standards Implemented Through a Well-Defined Charter and Informed by Independent Advisors.**

The Board's compensation committee will:

- Employ Sound Corporate Governance Practices. Leading corporate governance practices help ensure that all elements of compensation are carefully reviewed and appropriately structured.
- Use Independent Compensation Advisors. Outside advisors retained by the compensation committee should not provide other services that create an actual or perceived conflict of interest with the executive pay advice provided.

- Conduct Periodic, Independent Competitive Compensation Reviews. A thorough periodic assessment of the company's executive compensation programs and practices helps to reinforce sound governance and appropriate compensation design.
- Evaluate Committee Regularly. Committee member evaluation helps ensure the committee acts consistent with its charter thus reinforcing accountability.

***Appropriately Customized*: Executive Compensation Arrangements Should Be Appropriately Customized to and Aligned With the Company's Culture and Values, Business Strategy, Industry, and Competitive and Financial Conditions.**

- Utilize Well-Defined, Relevant and Rigorous Results-Based Metrics. Incentive plans should be customized to the company to support the realization of its business strategy while limiting overly aggressive or overly conservative decisionmaking.
- Ensure Pay Peer Group Is Appropriate for the Company. The pay peer group typically includes similarly situated companies in terms of industry, size, location(s) and performance and should correlate closely with the performance peer group.
- Confirm Compensation Levels Are Proportionately Appropriate Relative to Competitors. By comparing the company's compensation program to that of its peers, the compensation committee can determine the competitiveness of each element of executive compensation and the total program.

***Transparent and Accessible*: The Compensation Committee Should Ensure That the Company's Executive Compensation Program Is Disclosed in a Clear and Understandable Manner and Ensure That the Company Is Accessible to Explain the Program to Shareholders and Other Stakeholders.**

- Provide Clear, Concise, Customized Disclosure. Executive compensation arrangements should be disclosed and explained in a clear, concise and customized manner that facilitates a full understanding of the rationale for and levels of all aspects of reportable executive compensation.
- Be Accessible. Designated company executives and/or directors should be accessible to discuss and respond to inquiries about the company's executive compensation policies and practices with its shareholders and other corporate stakeholders.

***Fair and Reasonable*: Executive Compensation Arrangements Should Be Fair to the Company's Shareholders and Executives When Viewed as a Whole, and Reasonable Given the Context in Which the Arrangements Are Structured and Compensation Is Earned.**

Putting Executive Compensation Principles Into Practice

The Center On Executive Compensation believes that executive compensation programs, especially incentive programs, should be evaluated an approved by an independent and engaged Compensation Committee. The Compensation Committee is in the best position to assess and establish the appropriate relationship among the elements of compensation, set performance goals and approve potential incentive payouts that will drive performance consistent with business strategy while not exposing the company to excessive risk.

Correspondingly, the Center believes that the management of the executive compensation function by corporations should be conducted in accordance with a set of clearly defined principles. The Center encourages companies to incorporate these principles in the development, administration and communication of their executive compensation arrangements. The Center further believes that executive compensation principles should be periodically updated to reflect the most contemporary thinking on the subject. The following expands on the Center's principles, explaining how they work in practice. It demonstrates that the development and administration of executive compensation arrangements is not a simple, one-size-fits-all approach, but rather a highly customized one designed to promote the best interests of the shareholders and other corporate stakeholders.

1. ***Aligned*: Executive Compensation Arrangements Should Be Aligned With the Best Interests of a Company's Shareholders and Other Stakeholders**

Executive Compensation arrangements should enable the company to execute its overall business strategy in the best interests of the shareholders and other stakeholders. Failure to align pay arrangements to the business conditions in which the company is operating can lead to a decline in financial performance, employee morale and damage to the company's image and reputation. Alignment is best achieved by linking pay to results, requiring executives to have an appropriate ownership stake in the company, facilitating the leadership talent necessary to execute the strategy and ensuring that overall, pay arrangements support the strategy.

Link to Results. Compensation committees should insist that executive compensation arrangements pay executives for achieving positive results. These results should be measured by the sustained long-term value that management creates for shareholders. Value creation is based in part on the company's financial and operating performance relative to a carefully chosen peer group, the executive's achievement of his or her specific short-term objectives, and the performance of the company's share price. Results-based compensation that provides a balanced focus on short-term and long-term results helps ensure that executive pay will be directionally consistent with company financial performance and shareholder value.

Several elements help ensure that a company's executive compensation arrangements will be structured to pay for results:

- <u>Company Understands and Identifies Results-Based Incentive Measures That Drive Shareholder Value</u>. To pay for results, companies and their Compensation Committees must have a solid grasp of which measures will create value for the company and its shareholders. Typically, these measures are directly related to the company's business strategy and thus should be customized for each company. Value may be driven by profits, revenue, market share, new product development, or cash flow, just to name a few, or a combination of measures. The particular measures used may change over time as the company's business strategy and global economic environment changes.
- <u>Stringent Results-Based Measures Drive Executive Pay</u>. Once identified, results-based measures must be incorporated into executive compensation arrangements, thus driving the pay realized by executives at the end of the performance period. Measures applicable to annual incentives should be specific to short-term operating strategy. Thus, they are often different from those linked to long-term incentives, which are targeted to developing and executing business strategy over a three-to-five-year period. Under both types of incentives, the measures must be stringent enough to ensure close alignment with outcomes. Using a carefully selected mix of incentive compensation vehicles tied to these measures helps to ensure that the compensation realized by executives will not be greater than is warranted by company results and to guard against encouraging the pursuit of short-term gains at the risk of jeopardizing longer-term value creation.
- <u>Incentive Programs Carry Risk of No Payout</u>. Results-based pay means that executives have the risk of receiving no payout from short- and long-term incentives if the threshold level of performance is not achieved. This reinforces the higher

standard to which executives are held. Certain companies and their Compensation Committees have been criticized for paying in spite of poor results, helping fuel cynicism around executive compensation. To reinforce results-based pay, Compensation Committees should ensure that executives have an actual risk of receiving no payment from short- and long-term incentives.

- Significant Portion of Executive Pay Tied to Results. Senior executives have the broadest management authority in the company. Therefore, a substantial part of their compensation–typically 50 percent or more–should be tied to company results in order to provide an incentive for executives to achieve company objectives. Most large companies currently follow this model because it reinforces the pay for results philosophy.
- Actual Results and Realized Executive Pay Directionally Correct. Pay for results means that if results go up, executive compensation should go up, and if results fall, so should executive compensation. Although directionally inconsistent results may occur due to unforeseen events even under carefully structured plans, Compensation Committees should carefully evaluate whether compensation arrangements are truly designed to be directionally correct.
- Compensation Is Proportionate to Results. Compensation arrangements should not only be structured to be directionally correct, but the amount of compensation must not be substantially larger than the results achieved. As with directionally correct pay, proportionate pay requires Compensation Committees to carefully evaluate and limit compensation arrangements that will pay significantly more or less than company results and circumstances warrant.

In sum, pay for results is the cornerstone of sound executive compensation arrangements and is therefore the cornerstone of the Center's principle on alignment. By truly linking pay and results, companies will be able to demonstrate that executive compensation is more closely aligned with company and shareholder interests.

Ensure Appropriate Incentive Balance. The financial industry crisis and the resulting federal bailout legislation have put the focus on the impact that imbalanced incentives can have on encouraging executive behavior that may significantly reduce the value of the firm (the "excessive risk" issue). Although compensation in the financial services industry had some unique characteristics compared to other industries because of the greater weight placed on annual incentives, the bailout is a good illustration of why balanced incentives are important in a successful executive compensation program.

- Ensure Appropriate Mix of Compensation. Executive compensation programs typically incorporate five elements of compensation: salary, annual incentives, long-term incentives, benefits and perquisites. In its judgment, the Compensation Committee should ensure that the compensation program is properly balanced among the first three elements. A compensation program that is over-weighted in salary will tend to encourage executives to maintain the status quo, rather than seek to innovate, potentially limiting shareholder value. A program that puts too much emphasis on annual incentives, which often focus on financial measures, may encourage executives to seek short-term gains while risking the firm's long-term stability. Typically, long-term incentives, earned over a three-to five-year time frame make up 50 percent or more of the executive compensation plan and reward sustained performance. As the Compensation Committee conducts its annual reviews, balance among elements of the program helps limit the potential for the incentive program to encourage excessive risk.

- Cap Payouts From Incentive Programs. Incentive programs should encourage the executive team to take risks that are aimed at enhancing the firm's competitive advantage and expanding sustainable shareholder value, and should include a range of payouts corresponding to varying levels of performance, as set by the compensation committee. Incentive programs typically have tiers of awards based on the executive's performance:

    - a threshold amount, below which no incentive compensation is received,
    - a target amount, which provides an award for achieving the main objectives, and
    - a stretch amount for exceptional performance.

    If the stretch goal, particularly in annual incentives, provides for increasing amounts of compensation without bounds, and if the incremental increase in the incentive payment is substantial relative to performance, executives may be encouraged to maximize short-term earnings opportunities at the expense of long-term company success (i.e., "swing for the fences"). By putting an upper bound on total compensation under annual incentive programs, the Compensation Committee, in applying its judgment, ensures that compensation is appropriately aligned with strategy, and reduces the potential of encouraging excessive risk-taking.

- Adopt Proper Performance Criteria and Weighting. Depending on how performance criteria are structured and the company's competitive circumstances, performance criteria used in incentive plans can encourage executives to take greater risks than may be warranted by the circumstances. For example, annual incentives that are weighted too heavily toward revenue or growth measures alone may encourage executives to achieve these results without sufficient attention to profit or return measures. In general, annual incentive performance criteria should include a balance of performance (e.g., revenue or net income) and quality of performance (e.g., return on equity or net assets). Long-term incentive performance criteria should balance returns to shareholders and achieving sustainable financial performance.
- Balance the Benefits Between Shareholders and Executives. Pay that is aligned to results ensures that a disproportionate share of profits is not being given to executives at the expense of shareholders.
- Adopt a Strong Clawback Provision and/or Other Mitigating Measures. The essence of pay for performance is that executives earn performance-based awards when the company performs well. However, where it is later determined that initial results were incorrect, the Compensation Committee should recoup amounts paid to executive officers that were based on inaccurate or misstated measures of performance. The clawback policy should be adopted by the Board of Directors and incorporated in all executive agreements and incentive plans. However, the Board should have limited discretion over implementing the provisions to ensure enforcement does not have unintended consequences. Board discretion may also include the ability to adjust downward annual incentive payout amounts that are above the target level if the Board or Compensation Committee determines that executives took excessive risk in achieving the results. This would allow the Board to adjust incentive payouts based on *how* performance results were achieved.

Require Appropriate Ownership Stake. It is logical to assume that executives act more consistent with shareholder interests when they themselves are long-term company shareholders. Thus, Boards should require senior executives to obtain and hold a significant amount of company stock as stock-based compensation is received or vests, but not so much that it encourages them to manage the company overly conservatively.

- Executive Stock Ownership Creates Alignment of Interests With Company Shareholders. Stock ownership requirements put executives in the shoes of long-term shareholders, ensuring that when the company stock performs well, the shareholders and executives both gain in a similar manner. This alignment acts as an ongoing incentive for executives to manage the company prudently but provides downside consequences to executives in proportion to the impact on shareholders in the event of performance shortfalls.

- Appropriate Portion of Compensation Should Be Delivered Through Stock-Based Vehicle(s) and/or Linked to Company Stock Performance. A significant portion of executive compensation should be provided in stock, stock options, or performance-oriented vehicles linked to stock performance. Different types of equity have different purposes and thus should be carefully structured and explained to shareholders. Stock options provide a direct link between executive incentives and returns to shareholders. Restricted stock serves to retain skilled executives and thereby ensure the capability to realize performance objectives. Performance-vested restricted stock or performance equity arrangements (such as performance shares) are designed to reward executives for company financial and/or operating results, while providing a link to company stock performance and often providing a retention element.

- Stock Ownership and/or Retention Guidelines Apply to Option Exercises, Stock Vesting and/or Payouts of Stock Compensation. Companies should require executives to be long-term shareholders by adopting stock ownership guidelines and/or retention requirements. Stock ownership guidelines, expressed as a multiple of salary or an outright number of shares, require executives to become and remain long-term shareholders. For example, CEOs typically are required to hold five times their salaries in stock. Used separately or together with retention guidelines (see below), these approaches can effectively align the interests of executives and shareholders.

- Require Executives to Hold a Substantial Percentage of Equity Received for a Long Period of Time. Another and increasingly complementary approach to encouraging senior executives to think and act like shareholders through share ownership is the use of share ownership guidelines and retention requirements. Retention requirements require executives to retain a significant percentage of the stock received through the exercising of stock options or the vesting of restricted stock either for a certain period of time, until ownership guidelines are met, or both. An emerging best practice is to require executives to hold a substantial net percentage of equity received for a long period of time to ensure that stock ownership builds over a career. If the Board determines it is in the shareholders' best interest, the retention requirement could be extended until retirement or even for a period of time after retirement. However, in those situations, at a minimum, the executive should have an opportunity to obtain Board approval to sell shares or to implement a phased-diversification plan aimed at a targeted retirement date. Stock retention policies should be designed to minimize unintended consequences such as overly conservative or aggressive executive decision making.

When appropriately tailored to the company, stock ownership guidelines and retention requirements are effective tools that help align executives' and shareholders' interests and incentivize executives to manage the company in a manner consistent with the creation of shareholder value.

Enable Necessary Talent. Executive compensation arrangements must be structured to attract, retain and develop the desired executive talent. The arrangements should make it possible to recruit talented new executives and reward high performers, especially the senior leadership team, for delivering superior company results. Achieving this principle requires a careful mix of pay programs designed to assist the development and retention of successor candidates for key leadership positions.

- Executive Compensation Sufficient to Attract and Retain Executive Team. Attraction and retention of high-level talent involves a mix of recruiting top-tier executives (often senior executives) from outside the company and development of internal executive talent. In some cases, attraction of top talent may mean fashioning a pay package designed to recruit a CEO or other executives from outside the company. Initially, such a pay package may be overly weighted to components necessary to attract the executive to the company, but over a relatively short period of time, the emphasis should move increasingly toward results achieved and retention.
- Pay for Results and Pay for Retention Are Properly Balanced. For an existing executive team, pay arrangements must achieve balance between pay-for-results and retention incentives.

Arrangements weighted too heavily toward retention are less likely to drive the results sought by shareholders. On the other hand, arrangements that are solely results-based can cause talented executives to seek employment elsewhere if company or industry performance is down for a period of time because of factors beyond the executive's control. Including retention-based compensation, such as restricted stock that vests over a long period of time, as a portion of a pay arrangement is effective at encouraging talented executives to remain at the company and stay focused on achieving results.

- <u>Executive Compensation Program Supports Internal Development and Retention of Current and Future Leaders</u>. A company's executive compensation program should promote development of junior executives with future senior leadership potential, as well as provide incentives for retaining the company's senior leaders. The integration of talent management—the practice of identifying and developing talented executives—with compensation plans designed to reward top performers can increase financial results and shareholder value. It helps create a pool of potential leaders who have substantial knowledge of the company, its operations, and its culture. Sound development practices usually reduce the need to hire senior leaders from outside the organization. This saves the company substantial time, money and effort in recruiting and produces candidates who are more quickly able to impact results because they already know the company and the industry.
- <u>Appropriate Severance Arrangements</u>. At times there may be a need to separate executives from the company due to the need to eliminate or restructure job responsibilities, address performance issues or facilitate an orderly change in leadership. Boards should structure severance arrangements such that the interests of the company are protected and the departing executive is treated fairly and proportionately to his or her time of service, contributions to the company, compensation history and the circumstances surrounding the separation. Severance is also an important element of the compensation arrangements provided to newly hired executives to recruit them to come to the company and should be fair and reasonable in view of the total compensation package provided to the new executive.

Executive compensation arrangements should aspire to retain proven senior leaders, attract outside leaders when necessary, and support the development of new leadership talent. The application of talent management which generates a bench of successor candidates within the company can be a useful approach in moderating increases in executive pay which are often exacerbated by the need to recruit external candidates for key executive positions.

Support the Business Strategy. Aligned executive compensation programs and arrangements are those that reinforce the company's business strategy. As Compensation Committees and Boards of Directors undertake their reviews of executive compensation, elements of pay that do not support the business strategy should be eliminated or brought into conformance with that strategy. The pay elements that deserve the greatest attention include perquisites, executive retirement plan formulas, and severance and change-in-control arrangements.

In sum, executive compensation that is designed to pay-for-results and link executives' pay with returns to shareholders will reinforce the company's execution of its business strategy in the shareholders' best interests.

2. *Fully Compliant*: Executive Compensation Arrangements Should Be Structured and Executed in Full Compliance With Applicable Laws And Regulations and a Culture of Compliance Should Be Adopted to Guide a Company's Pay Policies and Practices.

A fundamental difference between companies with the best compensation practices and those that are more at risk of generating adverse media, shareholder and regulatory attention is the adoption of a compliance orientation throughout the organization. Regulators scrutinize executive compensation when a company's practices move beyond poor optics towards inadequate compliance efforts or outright noncompliance with the law. Sound compensation practices are most effective when the company adopts a culture of compliance that is reinforced by best disclosure practices and internal enforcement.

- Adopt a Culture of Compliance. There are noticeable distinctions between companies that adopt a culture of compliance and those assuming that because of their superior operational or financial performance compliance will occur. Companies adopting a compliance orientation regularly and objectively review how their governance practices stack up against legal requirements and best practices. They question the assumptions on which their programs are based and regularly make adjustments to ensure that compliance is achieved in fact. By contrast, companies making an assumption of compliance rely on internal and external perceptions, but may fail to take a closer look at how their compensation practices—and the effects of those practices—measure up to legal requirements and recognized best compliance practices. Such companies may try to manipulate performance programs or financial results to achieve a certain pay level.

- Present Financial and Operating Results Clearly and Accurately and Adjust Pay If Financial Results Are Restated Due Misconduct or Fraud. A corollary of a compliance-based approach is that company financial and operating results are presented clearly and accurately. In addition to meeting the requirements of myriad securities laws and accounting rules, this approach helps ensure that compensation programs are truly paying for results. To reinforce this approach further, companies should adopt formal "clawback" policies, which provide for recoupment of incentive compensation when financial results are restated due to inaccurate or fraudulent accounting or financial reporting or where the performance metrics upon which the incentives were based turn out to be below the level originally determined.

In sum, a compliance orientation goes beyond merely following the rules. It means adopting a culture of compliance so that executive compensation plans, filings, and disclosures comply fully with the laws and regulations.

3. *Independently Informed and Approved:* Executive Compensation Arrangements Should Be Approved by the Board of Directors' Independent and Active Compensation Committee That Is Guided by High Corporate Governance Standards Implemented Through a Well-Defined Charter and Informed by Independent Advisors.

The Compensation Committee of the Board of Directors is responsible for approval and oversight of the company's executive compensation programs. Thus, Compensation Committees must follow the highest governance standards to ensure that compensation arrangements are developed and administered in the best interests of the company and its shareholders. This is a significant priority for institutional investors, who will take action to protect their ownership interests in a company if they perceive that it is following poor governance or compensation practices.

Employ Sound Corporate Governance Practices. Sound governance practices include standards that support the development of sound compensation practices. These governance practices include the following attributes.

- Independent and Active Board Compensation Committee. A company's Compensation Committee must be comprised of Board members independent of the company in appearance as well as under applicable requirements. Independence guards against the actual and perceived influence of senior executives or other interested parties in the pay setting process. It should be noted that independence does not suggest there be an adversarial relationship between the Board and management on issues of pay. Rather, independence means that the Compensation Committee should be actively involved in all key decisions, and should have sufficient time for thorough evaluation, discussions, decisions, and implementation. Committee members should receive orientation training upon joining the Committee, thus enabling them to contribute from the start, and companies should consider regular updates on trends and changing practices. The chair of the Committee should be knowledgeable about executive compensation through prior professional experience, service on other Compensation Committees, or tailored training. Knowledge of the discipline and the process empowers the committee members to ask pertinent questions on the basis for pay, evaluate the alignment of the programs with the company's strategy, and ensure that executive pay is appropriately linked to results.
- Company Has a Well-Defined Charter and Follows Good Governance Process Throughout the Year. The Compensation Committee should adopt a charter identifying its authority and responsibilities during the year and diligently follow it to ensure pay programs are implemented and administered in a consistent and appropriate manner. Committee meetings should have clear agendas and briefing materials should be provided in advance thus enabling members to be prepared to discuss the issues at hand. Approval of pay packages should include a full explanation of their impact on the company and the affected executives. The Compensation Committee should always retain responsibility for establishing CEO pay and/or recommending it to the full Board of Directors. The Compensation Committee should periodically engage in director education

initiatives that provide an update on current and emerging trends in executive compensation.

- Contracts Do Not Overly Bind Future Actions of the Compensation Committee. Executive contracts have both positive and negative elements, and have been regularly used when recruiting a senior executive from outside the company. They have alternatively been criticized as a vehicle for providing "pay for failure" and praised for clearly defining all terms and elements of compensation. If contracts are used, they should have a defined term (generally two to three years), and should carefully define circumstances and payments in the event of termination.

Use Independent Compensation Advisors. The Compensation Committee should have the opportunity to retain independent advisors, such as compensation consultants, attorneys, and other professionals without company interference. Independent advisors are those whose firms do not provide other services to the company that may cause an actual or perceived conflict of interest with the executive compensation advice provided to the Committee. The Compensation Committee should have the chance to meet with these advisors outside the presence of management at each meeting. This approach reinforces the principle that executive compensation is the responsibility of the Board, not management, while recognizing that management also plays an important role in the process.

Conduct Periodic, Independent Competitive Compensation Reviews. Because approaches to executive compensation can change rapidly, Compensation Committees should make a periodic review of the company's executive compensation practices a regular part of the compensation development process. This helps identify potential weak points in compensation practices or programs and ensures that where appropriate, the company has adopted the latest best practices. The review should be conducted by an independent advisor not affiliated with the company. It is a top-to-bottom assessment of the committee's charter and annual processes and the company's pay programs to determine if they reflect best practices and are competitive with similarly situated companies. All pay elements should be reviewed independently and collectively, including long-term incentives, retirement plans, deferred compensation and perquisites. The review should confirm the appropriateness of the peer group, the overall compensation philosophy, the relationship between risk and incentive awards, and whether disclosure practices are consistent with the philosophy as well as regulatory requirements. Executive contracts should be evaluated to ensure consistency with market practice, and be clearly and understandably disclosed.

Evaluate Committee Regularly. The Board should require the Compensation Committee to conduct periodic self-evaluations and consider soliciting input from other Board members. This helps ensure the committee is acting consistent with the latest developments in good governance and is carrying out its responsibilities in a manner consistent with the committee's charter.

In sum, by following good governance, the Compensation Committee reinforces its role as the entity responsible for setting executive compensation. Adopting a best practice approach will go a long way to ensuring that compensation will be formulated in the best interests of the company and the shareholders.

4. *Appropriately Customized*: Executive Compensation Arrangements Should Be Appropriately Customized to and Aligned With the Company's Culture and Values, Business Strategy, Industry, and Competitive and Financial Conditions.

Pay for results is best achieved through pay arrangements customized to the nature of the company and its competitive position. Thus, the Compensation Committee should ensure that the plans include measures and amounts that are consistent with the results the company seeks to achieve and other developments inside the company.

Utilize Well-Defined, Relevant and Rigorous Results-Based Metrics. Customized executive compensation arrangements are those that are specific to the company, its industry and competitive positions. A core component of such arrangements is rigorous results-based metrics, informed by the competitive market, that are sufficiently stringent to ensure close alignment with actual outcomes.

- Company Has an Accurate Understanding of the Competitive Market. A company must have a true understanding of the competitive market for the type of executive it is looking to hire or retain. While some of this understanding can come from compensation surveys, the "market for talent" is much more complex than a series of numbers in a survey. Compensation levels vary based upon each executive's skills and abilities, the norms and practices of both the company and the industry, and the current and potential performance of the executive. When setting compensation levels, companies must take these factors into consideration based on a realistic assessment of the company's needs and the expectations of the market.

- Incentive Programs Consistent With Company Culture and Values. Perhaps most importantly, executive compensation should fit the company's culture and values. Some companies have fewer managerial layers and take an egalitarian approach to compensation; executive compensation packages should reflect that culture. Similarly, companies that place a high premium on customer service or quality of goods produced should find ways of integrating those values into their executive compensation systems. Where companies have codes of ethics or values statements, the Compensation Committee should incorporate the essence of those statements into its review of executive compensation plan design as well.
- Consistent With the Company's Industry, Strategy and Financial Condition. Executive compensation plans should be structured to reflect the conditions and culture of the industry in which the company operates. This approach promotes shareholder alignment and company-specific performance. A company in financial distress will pay differently than a company with sustained growth and success. Companies with long product life cycles will take a longer-term approach to compensation as compared to industries which move and change very quickly. Executive compensation programs and payouts should also be philosophically and directionally consistent with the company's strategies related to the broader employee population. Compensation committees should factor into their compensation review process the notion that perception is reality when dealing with employees, and seek to maintain a shared risk/shared reward approach wherever possible. Thus, the committees should be aware of significant actions affecting the general employee population such as pay cuts, layoffs or offshoring. Where significant changes to benefits plans are involved, the company should consider making similar changes in the analogous programs for senior executives.

Ensure Pay Peer Group Is Appropriate for the Company. In most cases, a competitive compensation plan requires that the Compensation Committee establish pay levels by benchmarking pay against an appropriate group of companies. This peer group typically includes similarly situated companies in terms of industry, size, geography and/or performance. Companies that are either among the largest in their industry or operating in multiple industries will, by definition, have more complicated peer groups. The pay peer group should closely correlate with the company's performance peer group.

Confirm Compensation Levels Are Proportionately Appropriate Relative to Competitors. Once the company has a full sense of the competitive market, identified rigorous metrics and has an appropriate peer group, it will want to compare its executive compensation program to that of its peers. This enables the Compensation Committee to determine the competitiveness of each element and whether the entirety of the executive compensation program is appropriate. Alternatively, if this analysis is conducted during the creation of the program, it allows the company to properly position the program to achieve its overall competitive objectives. These comparisons are generally done at the target performance level, but also at various estimated performance levels above and below target, enabling the Compensation Committee and company to better understand how the performance elements of the program will compare relative to the peer group benchmark.

In sum, executive compensation design has been widely criticized as following a cookie-cutter methodology. The solution to the one-size-fits-all approach is the creation of an executive compensation plan that reflects the company's performance goals and that is aligned with the company's business strategy, culture, and values.

5. *Transparent and Accountable*: The Compensation Committee Should Ensure That the Company's Executive Compensation Program Is Disclosed in a Clear and Understandable Manner and Ensure That the Company Is Accessible to Explain the Program to Shareholders and Other Stakeholders.

Clear, complete and understandable disclosure of executive compensation is essential to enable investors to evaluate whether pay is directly linked to company results and thus designed to maximize overall shareholder value. Good disclosure is based on the Compensation Committee's full understanding of the amount to be paid in all scenarios, and it explains both the "what" and the "why" of the pay program. It is the bedrock principle on which director accountability to shareholders is based.

Provide Clear, Concise, Customized Disclosure. Successful disclosure is customized the company and is designed to communicate the information required to obtain a true understanding of the company's executive compensation arrangements in as concise a matter as possible.

- Committee Understands Executive Compensation at Various Performance Levels and in Special Situations. The starting point for good disclosure is ensuring that the Compensation Committee has a clear picture of the programs it has approved and the levels of risk associated with the various incentives under alternative performance scenarios (i.e., a tally sheet approach to pay-for-performance relationships). It is imperative that the Compensation Committee understand the compensation that senior executive pay arrangements will produce in various performance and separation scenarios and ensure that those payments are consistent with the company's pay philosophy and the committee's intent. The use of tally sheets can greatly aid in this evaluation. Where necessary, the committee should adjust pay arrangements to prevent substantial payouts where a senior executive has failed to produce expected results. This deserves special mention in light of ongoing examples where executives have received substantial pay and either the company's results were poor or the large payments were due to separation or change-in-control agreements.

- Full Disclosure of the Amounts and Rationale for All Payments or Grants. Each company's Compensation Discussion and Analysis (CD&A) should explain the company's compensation philosophy and how each element of executive compensation fits that philosophy. The CD&A requires companies to explain why they pay senior executives the way they do. It also gives them a unique opportunity to explain how company results drive incentives.

Be Accessible. Clear disclosure also means that the company takes steps to make the executives and/or directors who are knowledgeable about the company's executive compensation program available to shareholders, stakeholders and the media. The company can choose one or more of many mechanisms, such as through written responses to submitted questions, electronic forums, meetings, media interviews or even in the CD&A. The important point is that those with direct knowledge provide responses to serious inquiries about the company's program. Periodically the Compensation Committee should solicit the input from the company's largest shareholders to determine the extent to which compensation programs are understood and to provide additional explanation of the compensation philosophy and practices.

Clear disclosure that is carefully tailored to communicate the essential elements of the company's philosophy, the plan elements, and the results is both required and good business. By providing pertinent information to and maintaining communication with the largest shareholders and other stakeholders, disclosure is a fundamental part of the system of checks and balances over executive compensation and corporate governance.

6. *Fair and Reasonable*: Executive Compensation Arrangements Should Be Fair to the Company's Shareholders and Executives When Viewed as a Whole, and Reasonable Given the Context in Which the Arrangements Are Structured and Compensation Is Earned.

In the final analysis, executive compensation arrangements as a whole should be objectively fair and reasonable first to the company, and second to internal and external stakeholders. This should be a final "litmus test" that involves reviewing executive compensation arrangements from multiple angles after they are structured each year. It ensures not only that the arrangements will have the intended effect in terms of recruitment and retention, but that they avoid flashpoints and are defensible to stakeholders and the public. By asking "does this make sense," this principle seeks to avoid the myopia that can result in a technically well-designed program whose hidden rough spots could also embarrass the company or its executives.

- <u>Amount and Form of Executive Compensation Makes Sense Holistically</u>. When looked at in its entirety, a "fair and reasonable" compensation arrangement should be appropriately structured to provide total pay in line with its—
  - results,
  - company's peers,
  - competitive position, and
  - strategic objectives.

  Compensation committee members should periodically step back, look at the executive compensation program in total, and consider everything else occurring at the company. In this final review, the committee members should use their judgment to determine whether the executive compensation program and resulting payments holistically make sense. This step will ensure that the company's executive compensation will pass most people's sense of fairness and reasonableness.

- <u>Sound Corporate Governance Practices Ensure Careful Review of All Elements of Pay</u>. As a corollary to the point that total compensation must make sense holistically, Compensation Committees should take a step back and ensure that the company has put in place sound governance practices that ensure a careful review of all elements of pay. The committees should likewise determine if estimated future payments are reasonable, and confirm that they fit the company's compensation philosophy. Not only does this act as a check on existing programs, but helps ensure that future arrangements will be reviewed with an appropriate rigor.

- Arrangement Has Appropriate Sensitivity to Key Stakeholders. Executive compensation arrangements should demonstrate appropriate sensitivity to the most important outside and inside interests, such as employees, shareholders, the general public, unions, retirees, regulators, and executives. "Appropriate sensitivity" means the Compensation Committee has considered the perspective of these interests in developing the pay arrangement and has sought to minimize flashpoints while accomplishing the company's compensation objectives. For example, lavish perquisites or large severance payments often generate significant negative reactions among the general public. While it is not possible to satisfy all stakeholders with every compensation program, Compensation Committees and companies should seek to address the most serious concerns that could lead to criticism. It is essential to have clear communication of the underlying rationale for each element of the program. This gives all interested parties a better understanding of what was done and why.
- Special Situations May Require Custom Solutions. The Center believes that these executive compensation principles lead companies to develop sound executive compensation programs that help drive strong performance. There are, however, a number of special business situations that may necessitate custom solutions for at least a period of time. These situations include going into or emerging from bankruptcy, managing a turnaround, or running a business in an industry that is in financial distress. In these special situations, the company might philosophically adhere to the principles, but practical concerns may dictate a tailored solution that fits the unique circumstance of the situation, a solution which may, for a period of time, fit some but not all of the principles. This is one of the many reasons why the committee should use its "fair and reasonable" holistic lens to determine what is best for the company and its shareholders.

In sum, the previous five principles provide the basis for a sound executive compensation program. The final principle suggests that a final holistic look is appropriate to evaluate whether the programs and amounts are fair and reasonable overall. This approach reinforces that in addition to meeting the company's philosophy and achieving its business objectives, pay should make sense to the stakeholders involved. While this involves a complex balancing act and ultimately requires a judgment call, incorporating such a review into a company's decision processes helps to identify and eliminate red flags early and reinforces a proactive pay-for-results approach.