



## **The Council of Institutional Investors Executive Pay Policies**

### **5. Executive Compensation**

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**5.1 Introduction:** The Council believes that executive compensation is a critical and visible aspect of a company's governance. Pay decisions are one of the most direct ways for shareowners to assess the performance of the board. And they have a bottom line effect, not just in terms of dollar amounts, but also by formalizing performance goals for employees, signaling the market and affecting employee morale.

The Council endorses reasonable, appropriately structured pay-for-performance programs that reward executives for sustainable, superior performance over the "long-term," consistent with a company's investment horizon and generally considered to be five or more years for mature companies and at least three years for other companies. While the Council believes that executives should be well paid for superior performance, it also believes that executives should not be excessively paid. It is the job of the board of directors and the compensation committee to ensure that executive compensation programs are effective, reasonable and rational with respect to critical factors such as company performance, industry considerations and compensation paid to other employees inside the company.

It is also the job of the compensation committee to ensure that elements of compensation packages are appropriately structured to enhance the company's short- and long-term strategic goals and to retain and motivate executives to achieve those strategic goals. Compensation programs should not be driven by competitive surveys, which have become excessive and subject to abuse. They should recognize that it is shareowners, not executives, whose money is at risk.

Since executive compensation must be tailored to meet unique company needs and situations, compensation programs must always be structured on a company-by-company basis. However, the Council believes that certain principles apply to all companies.

- 5.2 Advisory Shareowner Votes on Executive Pay:** All companies should provide annually for advisory shareowner votes on the compensation of senior executives.
- 5.3 Gross-ups:** Senior executives should not receive gross-ups beyond those provided to all the company's employees.
- 5.4 Role of Compensation Committee:** The compensation committee is responsible for structuring executive pay, evaluating executive performance within the context of the pay structure of the entire company, subject to approval of the board of directors. To best handle this role, the Council believes that compensation committees should adopt the following principles and practices:
- 5.4a Committee Composition:** All members of the compensation committee should be independent. Committee membership should rotate periodically among the board's independent directors. Members should be or take responsibility to become knowledgeable about compensation and related issues. They should exercise due diligence and independent judgment in carrying out their committee responsibilities. They should represent diverse backgrounds and professional experiences.
- 5.4b Executive Pay Philosophy:** The compensation philosophy should be clearly disclosed to shareowners in annual proxy statements. In developing, approving and monitoring the executive pay philosophy, the compensation committee should consider the full range of pay components, including structure of programs, desired mix of cash and equity awards, goals for distribution of awards throughout the company, how executive pay relates to the pay of other employees, use of employment contracts, and policy regarding dilution.
- 5.4c Oversight:** The compensation committee should vigorously oversee all aspects of executive compensation for a group composed of the CEO and other highly paid executives, as required by law, and any other highly paid employees, including executives of subsidiaries, special purpose entities and other affiliates, as determined by the compensation committee. The committee should ensure that the structure of employee compensation throughout the company is fair, non-discriminatory and forward-looking, and that it motivates, recruits and retains a workforce capable of meeting the company's strategic objectives. To perform its oversight duties, the committee should approve, comply with and fully disclose a charter detailing its responsibilities.
- 5.4d Pay for Performance:** Compensation of the executive oversight group should be driven predominantly by performance. The compensation committee should establish performance measures for executive compensation that are agreed to ahead of time and publicly disclosed. Performance measures applicable to all performance-based awards (including annual and long-term incentive compensation) should reward superior performance—based predominantly on total stock return measures and key operational measures—at minimum reasonable cost and should reflect downside risk.
- 5.4e Annual Approval and Review:** Each year, the compensation committee should review performance of individuals in the oversight group and approve any bonus, severance, equity-based award or extraordinary payment made to them. The committee should understand all components of executive compensation and annually review total compensation potentially payable to the oversight group under all possible scenarios, including death/disability, retirement, voluntary termination, termination with and without cause and changes of control. The committee should also ensure that the structure of pay

at different levels (CEO and others in the oversight group, other executives and non-executive employees) is fair and appropriate in the context of broader company policies and goals and fully justified and explained.

- 5.4f Committee Accountability:** In addition to attending all annual and special shareowner meetings, committee members should be available to respond directly to questions about executive compensation; the chair of the committee should take the lead. In addition, the committee should regularly report on its activities to the independent directors of the board, who should review and ratify committee decisions. Committee members should take an active role in preparing the compensation committee report contained in the annual proxy materials, and be responsible for the contents of that report.
- 5.4g Outside Advice:** The compensation committee should retain and fire outside experts, including consultants, legal advisers and any other advisers when it deems appropriate, including when negotiating contracts with executives. Individual compensation advisers and their firms should be independent of the client company, its executives and directors and should report solely to the compensation committee. The compensation committee should develop and disclose a formal policy on compensation adviser independence. In addition, the committee should annually disclose an assessment of its advisers' independence, along with a description of the nature and dollar amounts of services commissioned from the advisers and their firms by the client company's management. Companies should not agree to indemnify or limit the liability of compensation advisers or the advisers' firms.
- 5.4h Clawbacks:** The compensation committee should develop and disclose a policy for recapturing unearned bonus and incentive payments that were awarded to senior executives due to fraudulent activity, incorrectly stated financial results, or some other cause. At a minimum, the policy should apply to Named Executive Officers, and boards should require repayment in the event of malfeasance involving the executive.
- 5.4i Disclosure Practices:** The compensation committee is responsible for ensuring that all aspects of executive compensation are clearly, comprehensively and promptly disclosed, in plain English, in the annual proxy statement regardless of whether such disclosure is required by current rules and regulations. The compensation committee should disclose all information necessary for shareowners to understand how and how much executives are paid and how such pay fits within the overall pay structure of the company. It should provide annual proxy statement disclosure of the committee's compensation decisions with respect to salary, short-term incentive compensation, long-term incentive compensation and all other aspects of executive compensation, including the relative weights assigned to each component of total compensation. Other recommended disclosures relevant to specific elements of executive compensation are detailed below.
- 5.4j Benchmarking:** Benchmarking at median or higher levels is a primary contributor to escalating executive compensation. Although benchmarking can be a constructive tool for formulating executive compensation packages, it should not be relied on exclusively. If benchmarking is used, compensation committees should commit to annual disclosure of the companies in peer groups used for benchmarking and/or other comparisons. If the peer group used for compensation purposes is different from that used to compare overall performance, such as the five-year stock return graph required in the annual proxy materials, the compensation committee should describe the differences between the groups and the rationale for choosing between them. In addition to disclosing names of companies used for benchmarking and comparisons, the compensation committee should disclose targets for each compensation element relative to the peer/benchmarking group and year-to-year changes in companies composing peer/benchmark groups.

## 5.5 Salary

**5.5a Salary Level:** Since salary is one of the few components of executive compensation that is not “at risk,” it should be set at a level that yields the highest value for the company at least cost. In general, salary should be set to reflect responsibilities, tenure and past performance, and to be tax efficient—meaning no more than \$1 million.

**5.5b Above-median Salary:** The compensation committee should publicly disclose its rationale for paying salaries above the median of the peer group.

**5.6 Annual Incentive Compensation:** Cash incentive compensation plans should be structured to appropriately align executive interests with company goals and objectives and to reasonably reward superior performance that meets or exceeds well-defined and clearly disclosed performance targets that reinforce long-term strategic goals set and approved by the board and written down in advance of the performance cycle.

**5.6a Formula Plans:** The compensation committee should approve formulaic bonus plans containing specific qualitative and quantitative performance-based operational measures designed to reward executives for superior performance related to operational/strategic/other goals set by the board. Such awards should be capped at a reasonable maximum level. These caps should not be calculated as percentages of accounting or other financial measures (such as revenue, operating income or net profit), since these figures may change dramatically due to mergers, acquisitions and other non-performance-related strategic or accounting decisions.

**5.6b Targets:** When setting performance goals for “target” bonuses, the compensation committee should set performance levels below which no bonuses would be paid and above which bonuses would be capped.

**5.6c Changing Targets:** Except in unusual and extraordinary situations, the compensation committee should not “lower the bar” by changing performance targets in the middle of bonus cycles. If performance targets must be lowered, amended or changed in the middle of a performance cycle, reasons for the change and details of the initial targets and adjusted targets should be disclosed.

**5.6d Transparency:** The compensation committee should commit to provide full descriptions of the qualitative and quantitative performance measures and benchmarks used to determine annual incentive compensation, including the weightings of each measure. At the beginning of a period, the compensation committee should calculate and disclose the maximum compensation payable if all performance-related targets are met. At the end of the performance cycle, the compensation committee should disclose actual targets and details on the determination of final payouts.

**5.6e Shareowner Approval:** Shareowners should approve the establishment of, any material amendments to, annual incentive compensation plans covering the oversight group.

**5.7 Long-term Incentive Compensation:** Well-designed compensation programs can lead to superior performance. Long-term incentive compensation, generally in the form of equity-based awards, can be structured to achieve a variety of long-term objectives, including retaining executives, aligning executives’ financial interests with the interests of shareowners, and rewarding the achievement of long-term specified strategic goals of the company and/or the superior performance of company stock.

But long-term incentive compensation comes at a cost, and poorly structured awards permit excessive or abusive pay that is detrimental to the company and to shareowners. To maximize effectiveness and efficiency, compensation committees should carefully evaluate the costs and benefits of long-term incentive compensation, ensure that long-term compensation is appropriately structured and consider whether performance and incentive objectives would be enhanced if awards were distributed throughout the company, not simply to top executives.

Companies may rely on a myriad of long-term incentive vehicles—including, but not limited to, performance-based restricted stock/units, phantom shares, stock units and stock options—to achieve a variety of long-term objectives. While the technical underpinnings of long-term incentive awards may differ, the Council believes that the following principles and practices apply to all long-term incentive compensation awards. And, as detailed below, certain policies are relevant to specific types of long-term incentive awards.

- 5.7a Size of Awards:** Compensation committees should set appropriate limits on the size of long-term incentive awards granted to executives. So-called “mega-awards” or outsized awards should be avoided except in extraordinary circumstances, because they may result in rewards that are disproportionate to performance.
- 5.7b Vesting Requirements:** Meaningful performance periods and/or cliff vesting requirements—consistent with a company’s investment horizon, but no less than three years—should attach to all long-term incentive awards, followed by pro rata vesting over at least two subsequent years for senior executives.
- 5.7c Grant Timing:** Except in extraordinary circumstances, such as a permanent change in performance cycles, long-term incentive awards should be granted at the same time each year. Companies should not coordinate stock award grants with the release of material non-public information. The grants should occur whether recently publicized information is positive or negative, and stock options should never be backdated.
- 5.7d Hedging:** Compensation committees should prohibit executives and directors from hedging (by buying puts and selling calls or employing other risk-minimizing techniques) equity-based awards granted as long-term incentive compensation or other stock holdings in the company. And, they should strongly discourage other employees from hedging their holdings in company stock.
- 5.7e Philosophy/Strategy:** Compensation committees should have a well-articulated philosophy and strategy for long-term incentive compensation, which should be fully and clearly disclosed in the annual proxy statement.
- 5.7f Award Specifics:** Compensation committees should disclose the size, distribution, vesting requirements, other performance criteria and grant timing of each type of long-term incentive award granted to the executive oversight group and how each component contributes to long-term performance objectives of a company.
- 5.7g Ownership Targets:** Compensation committees should disclose whether and how long-term incentive compensation may be used to satisfy meaningful stock ownership requirements. Disclosure should include whether compensation committees impose post-exercise holding periods or other requirements to ensure that long-term incentive compensation is appropriately used to meet ownership targets.
- 5.7h Shareowner Approval:** Shareowners should approve all long-term incentive plans, including equity-based plans, any material amendments to existing plans or any amendments of outstanding awards to shorten vesting requirements, reduce performance

targets or otherwise change outstanding long-term incentive awards to benefit executives. Plans should have expiration dates and not be structured as “evergreen,” rolling plans.

**5.8 Dilution:** Dilution measures how much the additional issuance of stock may reduce existing shareowners’ stake in a company. Dilution is particularly relevant for long-term incentive compensation plans since these programs essentially issue stock at below-market prices to the recipients. The potential dilution represented by long-term incentive compensation plans is a direct cost to shareowners.

Dilution from long-term incentive compensation plans may be evaluated using a variety of techniques including, but not limited to, the reduction in earnings per share and voting power resulting from the increase in outstanding shares.

**5.8a Philosophy/Strategy:** Compensation committees should develop and disclose the philosophy regarding dilution including definition(s) of dilution, peer group comparisons and specific targets for annual awards and total potential dilution represented by equity compensation programs for the current year and expected for the subsequent four years.

**5.8b Stock Repurchase Programs:** Stock buyback decisions are a capital allocation decision and should not be driven solely for the purpose of minimizing dilution from equity-based compensation plans. The compensation committee should provide information about stock repurchase programs and the extent to which such programs are used to minimize the dilution of equity-based compensation plans.

**5.8c Tabular Disclosure:** The annual proxy statement should include a table detailing the overhang represented by unexercised options and shares available for award and a discussion of the impact of the awards on earnings per share.

**5.9 Stock Option Awards:** Stock options give holders the right, but not the obligation, to buy stock in the future. Options may be structured in a variety of ways. The Council considers some structures and policies preferable because they more effectively ensure that executives are compensated for superior performance. Other structures and policies are inappropriate and should be prohibited.

**5.9a Performance Options:** Stock option prices should be indexed to peer groups, performance-vesting and/or premium-priced to reward superior performance based on the attainment of challenging quantitative goals.

**5.9b Dividend Equivalents:** To ensure that executives are neutral between dividends and stock price appreciation, dividend equivalents should be granted with stock options, but distributed only upon exercise of the option.

**5.9c Stock Option Expensing:** Since stock options have a cost, companies should include these costs as an expense on their reported income statements and disclose valuation assumptions.

**5.9d Discount Options:** No discount options should be awarded.

**5.9e Reload Options:** Reload options should be prohibited.

**5.9f Option Repricing:** "Underwater" options should not be repriced or replaced (either with new options or other equity awards), unless approved by shareowners. Repricing programs, for shareowner approval, should exclude directors and executives, restart

vesting periods and mandate value-for-value exchanges in which options are exchanged for a number of equivalently valued options/shares.

- 5.10 Stock Awards/Units:** Stock awards/units and similar equity-based vehicles generally grant holders stock based on the attainment of performance goals and/or tenure requirements. These types of awards are more expensive to the company than options, since holders generally are not required to pay to receive the underlying stock, and therefore should be limited in size.
- 5.10a Structure:** Stock awards should be linked to the attainment of specified performance goals and in some cases to additional time-vesting requirements. Stock awards should not be payable based solely on the attainment of tenure requirements.
- 5.10b Transparency:** The compensation committee should provide full descriptions of the qualitative/quantitative performance measures and benchmarks used and the weightings of each component. Whenever possible, disclosure should include details of performance targets.
- 5.11 Perquisites:** Company perquisites blur the line between personal and business expenses. The Council believes that executives, not companies, should be responsible for paying personal expenses—particularly those that average employees routinely shoulder, such as family and personal travel, financial planning, club memberships and other dues. The compensation committee should ensure that any perquisites are warranted and have a legitimate business purpose, and it should consider capping all perquisites at a de minimis level. Total perquisites should be described, disclosed and valued.
- 5.12 Employment Contracts, Severance and Change-of-control Payments:** Various arrangements may be negotiated to outline terms and conditions for employment and to provide special payments following certain events, such as a termination of employment with/without cause and/or a change in control. The Council believes that these arrangements should be used on a limited basis.
- 5.12a Employment Contracts:** Companies should only provide employment contracts to executives in limited circumstances, such as to provide modest, short-term employment security to a newly hired or recently promoted executive. Such contracts should have a specified termination date (not to exceed three years); contracts should not be “rolling” on an open-ended basis.
- 5.12b Severance Payments:** Executives should not be entitled to severance payments in the event of termination for poor performance, resignation under pressure, or failure to renew an employment contract. Company payments awarded upon death or disability should be limited to compensation already earned or vested.
- 5.12c Change-in-control Payments:** Any provisions providing for compensation following a change-in-control event should be “double-triggered,” stipulating that compensation is payable only: (1) after a control change actually takes place; and (2) if a covered executive's job is terminated because of the control change.
- 5.12d Transparency:** The compensation committee should fully and clearly describe the terms and conditions of employment contracts and any other agreements/arrangements covering the executive oversight group and reasons why the compensation committee believes the agreements are in the best interests of shareowners.
- 5.12e Tabular Disclosure:** The compensation committee should provide tabular disclosure of the dollar value payable, including gross-ups and all related taxes payable by the company, to each member of the executive oversight group under each scenario covered

by the contracts/agreements/arrangements, including change-in-control, death/disability, termination with/without cause and resignation.

**5.12f Timely Disclosure:** New executive employment contracts or amendments to existing contracts should be immediately disclosed in 8-K filings and promptly disclosed in subsequent 10-Qs.

**5.12g Shareowner Ratification:** Shareowners should ratify all employment contracts, side letters or other agreements providing for severance, change-in-control or other special payments to executives exceeding 2.99 times average annual salary plus annual bonus for the previous three years.

**5.13 Retirement Arrangements:** Deferred compensation plans, supplemental executive retirement plans, retirement packages and other retirement arrangements for highly paid executives can result in hidden and excessive benefits. The Council believes that special retirement arrangements, including ones structured to permit employees whose compensation exceeds IRS limits to fully participate in similar plans covering other employees, should be consistent with programs offered to the general workforce, and they should be reasonable.

**5.13a Supplemental Executive Retirement Plans (SERPs):** Supplemental plans should be an extension of the retirement program covering other employees. They should not include special provisions, such as above-market interest rates and excess service credits, not offered under plans covering other employees. Payments such as stock and stock options, annual/long-term bonuses and other compensation not awarded to other employees and/or not considered in the determination of retirement benefits payable to other employees should not be considered in calculating benefits payable under SERPs.

**5.13b Deferred Compensation Plans:** Investment alternatives offered under deferred compensation plans for executives should mirror those offered to employees in broad-based deferral plans. Above-market returns should not be applied to executive deferrals, and executives should not receive “sweeteners” for deferring cash payments into company stock.

**5.13c Post-retirement Exercise Periods:** Executives should be limited to three-year post-retirement exercise periods for stock option grants.

**5.13d Retirement Benefits:** Executives should not be entitled to special perquisites—such as apartments, automobiles, use of corporate aircraft, security, financial planning—and other benefits upon retirement. Executives are highly compensated employees who should be more than able to cover the costs of their retirements.

**5.13e Transparency:** The terms of any deferred compensation, retirement, SERP or other similar plans covering the executive oversight group should be fully disclosed, in plain English, along with a description of any additional perquisites or benefits payable to executives after retirement.

**5.13f Tabular Disclosure:** A single table should be provided detailing the expected dollar value payable to each member of the executive oversight group under any deferred compensation, retirement, SERP or similar plan, along with a dollar value of any additional perquisites or benefits payable after retirement.

## 5.14 Stock Ownership

- 5.14a Ownership Requirements:** Executives and directors should own, after a reasonable period of time, a meaningful position in the company's common stock. Executives should be required to own stock—excluding unexercised options and unvested stock awards—equal to a multiple of salary, scaled based on position, such as two times salary for lower-level executives and up to six times salary for the CEO.
- 5.14b Stock Sales:** Executives should be required to sell stock through pre-announced 10b5-1 program sales or by providing a minimum 30-day advance notice of any stock sales. 10b5-1 program adoptions, amendments, terminations and transactions should be disclosed immediately, and boards of companies using 10b5-1 plans should: (1) adopt policies covering plan practices; (2) periodically monitor plan transactions; and (3) ensure that company policies discuss plan use in the context of guidelines or requirements on equity hedging, holding and ownership.
- 5.14c Post-retirement Holdings:** Executives should be required to continue to satisfy the minimum stock holding requirements for at least six months after leaving the company.
- 5.14d Transparency:** Companies should disclose stock ownership requirements and whether any members of the executive oversight group are not in compliance.

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