



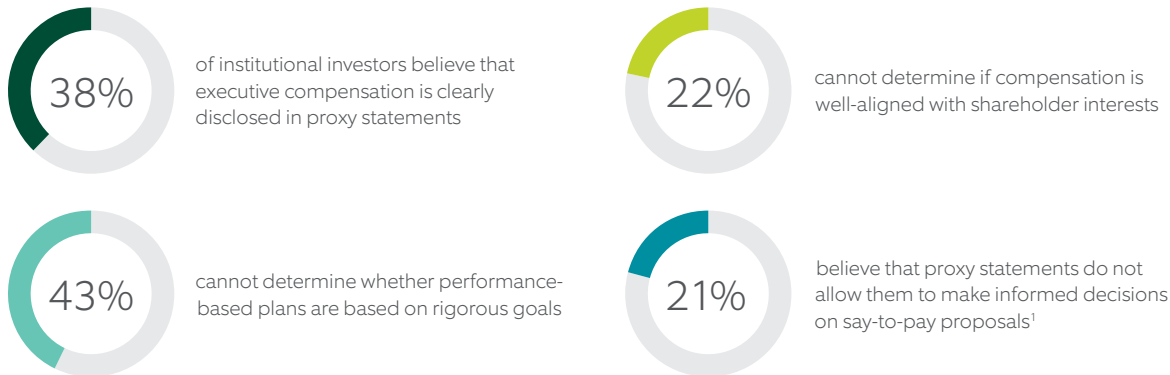
# EXECUTIVE COMPENSATION GUIDE FOR PROXY VOTING AND ENGAGEMENTS

Over the years, the way companies compensate executives has become a crucial focus within the corporate governance space. Increasingly we find issues related to compensation prompting the need for dialogue with companies. Through our dialogues we recognize that companies are interested in understanding how institutional investors, like Northern Trust Asset Management (NTAM), view executive compensation and what our expectations are in relation to various features of executive compensation.

At a high level, NTAM believes that compensation plans should be well-designed to motivate executives to achieve strong results for stakeholders while mitigating the motivation to take excessive risks. In examining compensation proposals, NTAM takes into account pay-for-performance alignment, effectiveness of governance practices, and the company's overall transparency and level of responsiveness to shareholder concerns. While not exhaustive, the following pages provide supplemental guidance on how NTAM assesses matters related to executive compensation. None of the topics discussed below are individually sufficient enough reasons to vote against a say-on-pay proposal. We view each proposal in a holistic manner, considering multiple points of view, before arriving at a final vote decision. The topics were selected based on the frequency by which companies have requested additional guidance and include descriptions of our expectations around disclosure, metric selection, target ranges, equity pay mix, and general features.

DISCLOSURE

A survey conducted by RR Donnelley, Equilar, and the Rock Center for Corporate Governance at Stanford University found that:



NTAM believes that boards and compensation committees are best positioned to make compensation decisions and should be afforded some degree of flexibility in designing and administering compensation programs. At the same time, we believe that many companies need to provide better disclosure around the structure and reasoning of their pay programs. That often includes going beyond what is required by the U.S. Securities and Exchange Commission (the SEC). Some compensation topics that should be addressed include:

- Disclosing information year-over-year in a standardized format. Often companies display pay information and metrics differently year-over-year, by either switching the visual style or changing what information is included. Our preferred approach is to keep the formats static and consistently include information that has previously been included. Where change to format is necessary, companies should clearly highlight what changes were made and why they were made.
- Reconciliation of non-GAAP to GAAP measures should be concisely detailed and easily accessible.
- Consistently including the target ranges for the incentive plans and the appropriate weight of each component relative to the overall package for both the short- and long-term incentive plans.
- Clearly showcase realized versus realizable pay, preferably over five annualized performance periods.
- Provide clear rationales for selected metrics.

NTAM assesses company compensation programs on the adequacy of the company’s disclosures around the selection of related metrics, targets and thresholds, and disclosure of peers benchmarked against for compensation purposes. Inadequate or lack of disclosure in one of these areas may contribute towards a negative say-on-pay vote.












**PAY METRICS – WHICH ONES?**

A key purpose of an executive incentive plan is to promote long-term value creation. NTAM’s preference is to see companies put a greater focus on the metrics that are most likely to promote excess return on investment, whether they are financial or non-financial. However, we leave it to boards of directors and their compensation committees to determine the appropriate mix of metrics. Companies should provide detailed disclosure around the rationale for selecting various metrics, as well as the risk assessment considered by the board when deciding on the incentive design elements.

**TSR vs. Fundamental Performance Metrics**

Total shareholder return or TSR continues to be the most prevalent metric contained in long-term incentive plans in most industries. Despite its popularity, emerging research indicates that it may not be the best way to align management’s interests with those of shareholders. An analysis on long-term incentive plans conducted by Goldman Sachs to identify the metrics associated with higher alpha found that, with the exception of the materials industry, TSR is not typically linked to the highest three-year average returns (Table 1).<sup>2</sup>

**TABLE 1. MOST FREQUENT LONG-TERM EXECUTIVE INCENTIVE METRICS VS. METRICS LINKED WITH HIGHEST 3-YEAR AVERAGE TSR**

SECTOR	MOST FREQUENT METRIC	METRIC LINKED WITH THE HIGHEST THREE-YEAR AVG. TSR
 <b>Consumer Discretionary</b>	Total shareholder return	Return on capital
 <b>Consumer Staples</b>	Total shareholder return	Operating income
 <b>Energy</b>	Total shareholder return	Return on capital
 <b>Financials</b>	Return on capital	Revenues
 <b>Health Care</b>	Total shareholder return	Revenues
 <b>Industrials</b>	Return on capital	Return on capital
 <b>Information Technology</b>	Total shareholder return	Return on capital
 <b>Materials</b>	Total shareholder return	Total shareholder return
 <b>Real Estate</b>	Total shareholder return	Funds from operations
 <b>Telecommunications Services</b>	Total shareholder return	N/A
 <b>Utilities</b>	Total shareholder return	EPS

Source: Goldman Sachs Sustain – ESG Series. Data compiled prior to the September 28 changes to the GICS sectors and sub industries.

A study conducted by James Reda and David Schmidt, compensation consultants at Arthur J. Gallagher & Company, found that companies using TSR as a performance metric for at least one year out of the five years in the study underperformed compared to companies using other benchmarks.<sup>3</sup> Separate research conducted by Cornell University found that, in general, TSR is not a significantly impactful measure for structuring pay packages.<sup>4</sup>

NTAM does not withhold support for executive compensation based on TSR as a performance metric in either long- or short-term incentive plans, but we would prefer to see more traditional fundamental metrics. In our view, fundamental metrics are more directly linked to management actions compared to TSR, which is often susceptible to macro conditions.

### Non-Financial Metrics

The inclusion of non-financial metrics in compensation plans appears to be gaining popularity. Similar to financial measures, it is up to the company to identify which ones are most applicable to their unique circumstances and incorporate them within their compensation framework. As an example, research by professors Vincent O’Connell and Don O’Sullivan of Gulf University and University of Amsterdam, respectively, found that customer satisfaction was a strong leading indicator of future financial performance in the telecommunications space.<sup>5</sup> NTAM believes that balanced use of non-financial metrics (i.e., between 10-20% of all the metrics) results in a more well-rounded compensation structure.

### To GAAP or to Non-GAAP

Another area of concern is the increased use of non-GAAP measures in proxy statements. Data has shown that the percentage of proxies including non-GAAP language has, on average, increased since 2009.<sup>6</sup>

Use of non-GAAP measures provides a potential path for pay inflation that could run counter to shareholder interests. According to a recent study by Robert Pozen and S.P. Kothari, “most compensation committees in firms with substantial differences between GAAP and non-GAAP numbers used the non-GAAP ones to set pay” and, at those companies, “adjusted earnings or adjusted operating cash flow determined at least 40% of either annual cash bonuses or long-term stock awards, or both.”<sup>7</sup>

The use of non-GAAP measures is an emerging area of focus for NTAM engagement purposes. We understand that the use of adjusted metrics may be warranted in unique situations; but in such situations, we expect comprehensive disclosure explaining the modifications. Excessive and unreasonable adjustments may contribute towards a negative say-on-pay vote.



*Most compensation committees in firms with substantial differences between GAAP and non-GAAP numbers used the non-GAAP ones to set pay.*

**FROM A STUDY BY:  
ROBERT POZEN AND S.P. KOTAHRI**

### HOW MANY?

NTAM assesses compensation plans on the number of metrics employed in both the short- and long-term plans. While not a sufficient condition for a vote against on its own, having an excessive number of metrics in the plan may contribute towards a negative say-on-pay vote. Companies typically vary in how many metrics they utilize to assess performance when determining pay, but most rely on two to three per incentive plan (annual or long-term).<sup>8</sup> NTAM believes too many metrics could create complexities in how executives are paid and assessed. We don't have a preferred exact number, but we would encourage companies to continue the common practice of fewer than five metrics rather than more.

### SETTING RIGOROUS TARGETS AND THRESHOLDS

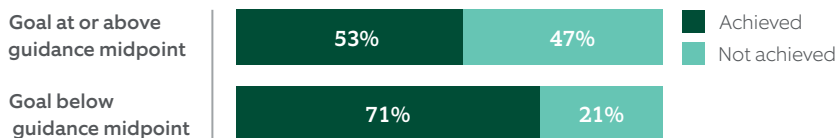
A lack of rigor in the performance targets was one of the most commonly cited reasons Institutional Shareholder Services (ISS) recommended votes against say-on-pay proposals in 2017. Pay Governance LLC did an analysis in 2012 to see how often companies set target goals at or above incentive guidance or analyst consensus. The results show that 59% of reviewed companies set their incentive targets at or above the midpoint of guidance. From this subset of companies, only 53% met or exceeded their achievement targets. Conversely, of the remaining 41% of companies that set their targets below guidance midpoint, 71% of the companies met or exceeded their achievement targets.<sup>9</sup>

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One-third of CEOs start the fiscal year expecting to beat their performance targets.

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### ACHIEVEMENT RATE OF TARGETS RELATIVE TO DIFFICULTY OF GOALS



In 2016, “250 S&P 500 companies paid CEOs cash incentives above the levels they promised for meeting certain performance goals.” Furthermore, one-third of CEOs start the fiscal year expecting to beat their performance targets.<sup>10</sup> Beyond the aforementioned research, we recognize that this is an area that needs to be evaluated further. However, given the data we have today, one could deduce that some companies are achieving targets by setting relatively easy targets for their executive teams. There are risks in setting targets too high – e.g., a lack of effort by executives because of a perceived impossibility of accomplishing the goals or executives making harmful and aggressive maneuvers to achieve the target. However, targets that are set too low, and are consistently surpassed, are unfair to the shareholders of the company.

NTAM prefers to see a primarily static set of metrics, with targets that are reasonably adjusted to adapt to the changing economics of the business, taking into consideration performance expectations, industry trends and other factors specific to the company which should be clearly disclosed in the proxy statement. Lowering the absolute targets year-over-year or frequently surpassing the targets will call into question the difficulty of those goals unless adequate explanation is provided in the proxy statement.

Target range is another important area of consideration. Typically the target range spans a few percentages points, depending on the type of metric, and allows for a bit of flexibility around actual performance outcome and associated monetary payout. There are benefits to this approach, such as mitigating the risk that employees will make last-minute, potentially damaging, maneuvers to stretch performance in order to meet a target ahead of deadline. The target range itself should not be excessive.

### **EQUITY PAY MIX**

Increasingly we see executives' long-term incentive plans divided between a mix of performance share units and time-based restricted shares or stock options. NTAM believes it is good practice for companies to grant a portion of long-term equity compensation in the form of performance-based units with a multi-year performance period (i.e., compensation that vests after specific targets are achieved).

When an executive is granted options, value accrues from stock appreciation above the strike price while a strike price below the market price at expiration would render the option worthless. In certain circumstances, this payoff structure could motivate a shorter-term focus or excessive risk-taking behavior. Conversely, performance-based share units allow for management to account for a broader range of metrics and outcomes that, when designed well, should discourage excessive risk-taking and support long-term strategies and objectives.

NTAM believes that, when deciding on the weightings of options versus performance-based share units (PSU), the certainty of the payout and risk tolerance of the company should be considered. Because PSUs can be based on factors not subject to macro-economic conditions, such as strategic business objectives, there is the possibility of a more assured payout compared to options, which could result in zero payout if the stock price were to move in an unfavorable direction. NTAM prefers that disclosure be provided as to why a specific structure was ultimately chosen so that shareholders are able to comprehend fully the rationale and provide feedback when appropriate.

NTAM assesses compensation plans on the percentage of equity compensation that is performance conditioned. Having less than 20% of equity compensation performance conditioned may contribute towards a negative say-on-pay vote. Similarly, the length of the performance period for performance-based equity may contribute towards a negative say-on-pay vote if the performance period is less than one year.

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NTAM prefers that disclosure be provided as to why a specific structure was ultimately chosen so that shareholders are able to comprehend fully the rationale and provide feedback when appropriate.

## **GENERAL FEATURES**

NTAM believes that the following constitute best practices and should be adopted either formally by policy or in practice:

- Executives, directors and employees should be prohibited from hedging or pledging equity-based awards granted as long-term incentive compensation or other stock holdings in the company.
- Any provisions providing for compensation following a change-in-control event should stipulate 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.\*
- Senior executives should not receive excise tax gross-ups.

NTAM assesses compensation plans on their general features. Presence of excessive pledging/hedging activity, single-trigger of severance under change-in-control agreement(s), or excise tax-gross ups may contribute towards a negative say-on-pay vote.

## **FINAL THOUGHTS**

NTAM believes boards and compensation committee members are in the best position to make compensation decisions and should be allowed a degree of flexibility in designing and administering the pay program. Recommendations identified in this paper are intended to provide a better understanding of NTAM's views and facilitate a more robust engagement process with management.

We may engage with companies to understand better their approaches to executive compensation and where there are areas of significant concern we would expect to engage with independent members of the compensation committee. As a major index investor representing permanent capital, our discussions will always consider a long-term time horizon. Much progress has already been made in the area of executive compensation and we expect more progress over time.

\* i.e. a double-trigger

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# COMPENSATION SCORECARD METHODOLOGY

The 2019 executive compensation methodology for companies in the Russell 3000 consists of both a quantitative and a qualitative assessment (also referred to as the “quantitative scorecard” and “qualitative scorecard”). Used in combination, these assessments will determine the scope of Northern Trust Asset Management’s (NTAM) proxy engagement and proxy voting activities as they relate to executive compensation in 2019.

## QUANTITATIVE SCORE CARD

The quantitative scorecard is intended to screen companies for engagement, focusing in on companies whose pay appears out of line with their fundamental performance based on relative overall average spread between fundamental performance indicators, total shareholder return (TSR) and CEO total compensation. It consists of the following parts:

1. Three sets of percentile rankings across five 1-year performance periods:

**A**

A percentile ranking the CEO’s total granted pay relative to industry or peers identified in the proxy statement<sup>1</sup>.

**B**

Percentile rankings of nine unique fundamental performance indicators relative to the same peer group in box a.

**C**

A percentile ranking of the company’s TSR relative to the same peer group in box a.

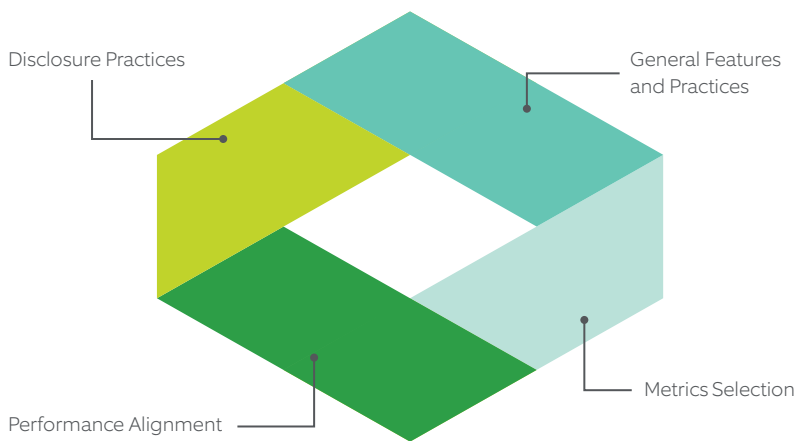
2. A “fundamental spread” between the CEO’s pay percentile and each fundamental performance indicator’s percentile for each performance year is calculated and averaged in each year resulting in a set of five annual fundamental spreads.
3. A “TSR spread” is calculated between the CEO’s pay percentile and the 1-year TSR performance for each performance year, for a set of five TSR spreads.
4. An average spread of the fundamental spreads and TSR spreads, at equal weights, is calculated to arrive at an “overall average spread”.
5. Each company is ranked by its overall average spread within its GICS industry group (2-digit GICS group).

1: S&P 500 companies are ranked amongst peers identified in the proxy statement; Russell 3000 companies (ex. S&P 500) are ranked against their industries ( 4-digit GICS group)

Companies that fall within the bottom 10th percentile of their respective sectors<sup>2</sup> will be the focus of NTAM's compensation engagements for 2019, and will also be subject to the qualitative assessment described below. NTAM will continue to engage with companies in the Russell 3000 that have received less than 70% support on a management say-on-pay proposal (MSOP) in the prior year and where Northern Trust holds 1.5% or more of the total votable shares even if they do not fall within the bottom rankings of their GICS sectors under the quantitative assessment.

### QUALITATIVE SCORE CARD

The qualitative scorecard assesses the features and disclosures of the company's compensation plan. It consists of four segments:



Within each segment, there are a series of factors, each of which carry a range of point values. Companies that fail the qualitative scorecard will be flagged for a potential negative vote on the company's advisory vote to ratify named executive officers' compensation at the next annual general meeting of shareholders.

2: NTAM may establish alternate thresholds for sectors with fewer than 50 constituent companies

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