ACC San Diego Chapter

What Every In-House Lawyer Should Know About Executive Compensation

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Panelists

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- Phil Ducoffe, Moderator, USI Insurance
- Phil Rudolph, Retired Chief Legal and Risk Officer, Jack in the Box
- Tom Hurley, Compensation Practice Leader, USI Insurance

Discussion Outline

- Objectives
- Building Blocks and Terminology
- Approach to Executive Compensation
  - Strategy
  - Design
  - Management
- Q&A

Objectives

- ✓ Learn how to effectively identify executive compensation risks before they become issues
- ✓ Provide things for you to think about, whether you work for a public or a private company
- ✓ Offer key insights on trends that directly impact, and non-financial metrics influencing, Executive Compensation

Compensation Elements

Elements	Objectives
1. Base salary	Provide fixed pay for day-to-day performance of job accountabilities
2. Annual incentive	Provide incentive for achievement of annual performance goals Deliver annual cash payouts using an objective and disciplined approach Provide award opportunities at levels that reflect: • Relative value of position to the organization • Alignment with desired target total cash compensation mix and leverage
3. Long-term incentive	Provide incentive for year over year success Longer-term focus Alignment with interests of key stakeholders Use as a retention tool for top level Plans may be designed to enable executives to defer payouts to retirement or separations from employment to defer tax on income

Compensation Analysis Terminology

Compensation Terms	Definitions
Total Cash Compensation ("TCC")	Base salary + annual incentive
Total Direct Compensation ("TDC")	TCC + annualized value of long-term incentive awards
25th Percentile ("P25")	A data point that falls at the first quarter of an array of the sample, and 75% of the sample is higher than this data point
50th Percentile ("P50" or "median")	A data point that falls in the middle of an array of the sample, and half the sample is higher than this point and half is lower
75th Percentile ("P75")	A data point that falls at the third quarter of an array of the sample, and 25% of the sample is higher than this data point
Peer Group	List of peer organizations of comparable size in the same or similar industry
Data Aging	Surveys have different reporting dates and there is a lag time from when the data is collected and report, so the data must be adjusted to account for market increases and bring the data to the future common date of the market review

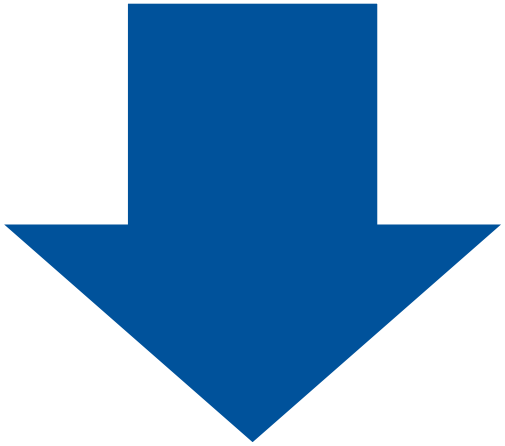
Compensation Strategy/Philosophy

The strategy is a compass to guide disciplined pay design, administration and governance

- The compensation strategy ***supports the organization's business strategy*** (i.e., incent growth and performance, utilize the financial resources of the organization, engage employees, etc.)
- The strategy provides a philosophical ***framework for the development and management*** of compensation and benefit systems, policies and programs
- It provides ***key messages to communicate*** with employees and enables the organization to recruit and retain top talent

Recent surveys indicate that the majority of top performing organizations have or are creating written compensation strategies

Compensation Planning Considerations



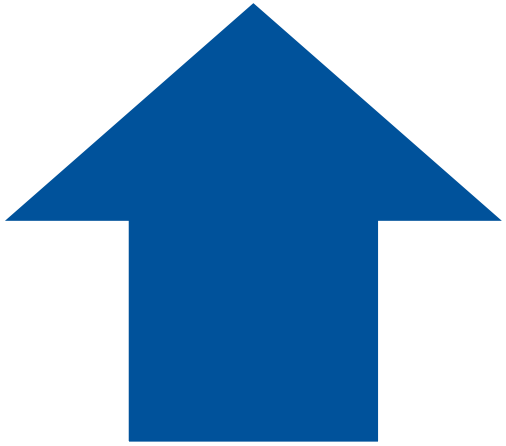
Internal

- Compensation philosophy
- Organization's strategy and vision
- Financial performance
- Equity among the various positions

Organizations must balance both the internal and external factors that influence pay decisions

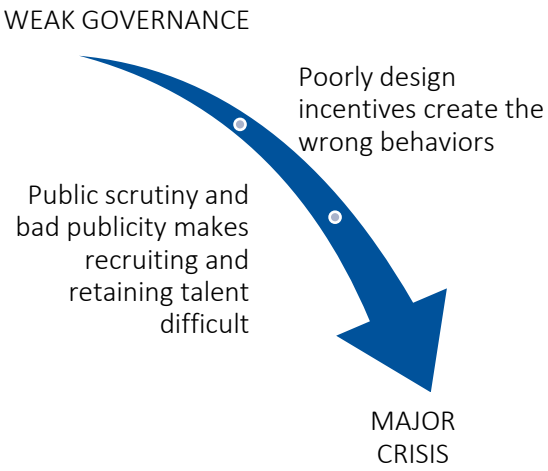
External

- Performance against peers
- Economic environment
- Legal/regulatory environment
- Availability of market pay information



Understanding Compensation Risks

- ***For both public and private companies***, a sound executive compensation program begins and ends with good governance
- Compensation and benefit agreements, including incentive plans, perquisites, or other compensatory arrangements, for executive officers should be designed and delivered to comply with regulatory requirements and not create excessive risk



The executive compensation programs should have some regular oversight from the Board, Compensation Committee, Risk Committee, or other independent governing group

Using Salary Surveys

- Understand where the data came from and determine whether it is appropriate to use
  - How large was the survey sample?
  - Who participated?
    - Location, revenues, total net assets, geographic locations, etc.
  - Are job descriptions included in the survey or just job titles?
- Look at the date of the survey and adjust or "age" the data as needed
- Avoid surveys from employee provided sources, and use only data provided by employers or obtained from SEC and IRS filings

Appendix

Sample Executive Total Rewards Philosophy

- A significant portion of total direct compensation for executive officers ***should be at-risk***, with the opportunity to accumulate meaningful and reasonable levels of wealth through ***sustained long-term performance***.
- Base salary is to be targeted at median market pay; incentive pay (i.e., annual and long term) is targeted at levels that deliver ***competitive*** total direct compensation for performance levels achieved.
- The executive management group should be rewarded as a team for ***company profitability and value growth***, and as individuals for job ***performance and achievement*** of strategic performance goals.
- Long-term incentive compensation should reflect a balance of rewards for ***growth in earnings and shareholder value.***
- Perquisites and personal benefits should not be a prominent element of total compensation and should ***reflect competitive practices*** where necessary to attract and retain top leadership talent.
- Executive officers should receive a ***reasonable level of protection*** against short-term loss of income and benefits due to termination without cause or related to a change-in-control.

Annual Incentive Plan Design

Eligibility → Incentive targets and bonus pool → Funding based on company performance → Individual performance → Bonus payouts

Individual Targets and Performance

- Individual incentives will be defined as percentages of base salaries
- Targets will be tiered to reflect the impact each position has on the performance of the company
  - Reflect the relative value of a position to the company
  - Align with the external market and desired target total cash compensation
- Employees earn funded awards through achievement of individual performance goals
- Individual goals must be under the control of the individual (i.e., have influence and can affect results)
- Target incentive opportunities will be adjusted up or down based on individual achievement of pre-established goals

Company Funding

- Establish a financial framework which creates expected levels of profits
  - Align performance measures the longer-term strategic goals
  - Create alignment of owner returns and incentive funding
- The incentive plan should be sustainable and financially sound, so the business results must fund the incentives
- Fund incentive payouts at different levels based on various levels of company performance
  - Minimum is the threshold level of company performance that must be achieved to pay incentives
  - Target is the expected level of company performance
  - Maximum is the level of company performance at which the plan will cap payouts

Private Company Long-term Incentives Alternatives

Performance-based Cash Bonus	Non-qualified Deferred Compensation (NQDC) Plan	Executive benefits (162M plan)
• Award bonuses based on achievement of longer-term financial goals (i.e., 3 or 5 year) or using some other methodology • May establish vesting period (3,5, 7 years) to require additional continued employment after the end of the performance period • Vesting may vary by individual and may be set up on "cliff" or "graduated" schedules • Typically set up as unfunded liabilities and payments from the plan are made from operating cash flow • The expense is not recognized for taxes by the company until paid • Plan can be designed so it does not need to comply with 409A, which restricts how and when the participant balances can be paid	• Deferral and vesting plan design similar to the cash payment option • Phantom stock and phantom stock appreciation rights (SAR) plans are designed as NQDC plans • Participants do not receive payments from plan until separation from service or some other time in the future as specified in the plan • Payments are typically spread over 5, 7, 10 years after separation of service to supplement retirement income • Must comply with 409A, which puts rules in place regarding the timing and form of payouts to participants • Typically set up as unfunded liabilities and payments from the plan are made from operating cash flow • The expense is not recognized for taxes by the company until paid	• Company provides the key executive with a bonus that is taxable as income to the recipient and used to purchase whole life or universal life insurance policy that builds cash value that grow tax deferred • Bonus is generally a deductible business expense for the company • Access to the cash surrender value is restricted by the company until a specific date (i.e., like a "vesting schedule") • Any cash value accumulation will grow tax deferred and may be accessed by the employee income tax-free through withdrawals and policy loans • If the key executive dies, in most cases, the heirs will receive the death benefit proceeds from the life insurance policy income tax free • Executive bonus plans offer the company very little control of the policy, and the accumulated bonuses are never recovered by the company even if the key employee leaves the company prior to vesting

Illustration: XYZ Bank Annual Compliance Review

	Incentive plans should have key features or components that will help mitigate risk	Compliance Review
1.	Incentive plans should be formal, performance-based plans that are well documented with pre-defined objective goals	✓
2.	Earning opportunities under executive officer incentive plans should be reasonable and capped, which is viewed favorably in today's economic environment	✓
3.	Balance risk taking incentives by designing incentive plans that have both earnings-based goals and strategic goals such as asset quality, capital raising, and core deposit growth	✓
4.	Ensure appropriate weighting of performance goals - there should be more weight on company-wide goals for the senior officers and reduced focus on bank-wide goals as responsibility levels decrease at the Bank	✓
5.	Pay cash incentives on an annual basis as opposed to a shorter frequency (i.e., monthly or quarterly) to allow the Bank to assess the risk over a sufficient period of time and give the Bank time to reduce payouts as needed	✓
6.	Incorporate a "clawback" provision in the incentive plans that requires all officers to pay back any bonus payouts if performance results are misstated	✓
7.	Bank goals and strategic plans, as well as industry or peer group performance, should discussed by the Board and considered when setting goals	✓
8.	At year end, the Board or Compensation Committee should be allowed to modify bonus payouts for senior executives due to extraordinary circumstances, inappropriate risks taken, or compliance deficiencies	✓
9.	Long-term incentives should be an element of compensation for executives to mitigate regulators' concern that executives focus exclusively on short-term goals	✓
10.	Stock ownership guidelines and/or long-term incentive plans should be in place for executives to better align their interests with stakeholders	✓

Achieving Pay Equity

Pay equity has become a top issue for employers. With the spotlight on politicians seeking election, pay equity continues to gain more attention. Federal laws, such as the Lilly Ledbetter Fair Pay Act of 2007, define pay discrimination. State and local laws have been introduced to specify how organizations should address pay equity. As your organization formulates a plan to review pay equity, consider these action steps.

1 Build Understanding

Make sure you understand how **the law defines equal pay, including** the reasons unequal pay may exist (seniority, experience, performance, location).

2 Review Compliance

Equal pay laws may differ by state, city, or county laws. This can make compliance more complex if **your organization operates in more** than one jurisdiction.

3 Define Jobs

Job descriptions must accurately **reflect the work being performed.** By being transparent and sharing **job descriptions it allows individuals** to understand the requirements for each job.

4 Develop Performance Tools

A pay differential may be justified if the employer demonstrates there are differences in performance. Be sure to implement tools that clearly measure performance in a **disciplined and objective manner.**

5 Conduct Pay Audit

Determine how your organization is paying employees and understand any differences for similarly situated **workers. Use survey data to assess the competitiveness of pay to the** market.

6 Train Managers

Help recruiters, hiring managers, and other decision-makers **understand the organization's** pay philosophy and structure. Managers must also understand what other restrictions exist around pay decisions, such as allowable **interview questions.**

Develop Communication Strategy

Promote your compensation philosophy – including messages about equity – **to current and potential employees. Spend time and resources planning and developing strong communications about pay, rewards and culture.**

Compensation Trends for Remote Workforce

- Geographic wage differential (or cost of labor) refers to the differences in wages between employees with similar skills within differing localities
- Some states and cities have higher wages than others for jobs due to local demand for talent and cost of living
- In practice, most organizations adjust pay for differences in wages only in markets where the differentials are significant
- Organizations may have between 3-5 salary structures to account for differentials

Sample Wage Differentials:
Base/National Average: Salary $100,000

Destination City	Destination Salary	% of Base/ National Average
San Diego, CA	$110,600	110.6%
Seattle, WA	$115,400	115.4%
Cleveland, OH	$98,700	98.7%

Develop policies by answering the following questions:

- ✓ Where are employees located?
- ✓ What are the geographic wage differences in those markets?
- ✓ Should we adjust pay to account for differences?
- ✓ What geographic area do we use – employee home address or closest employer location?
- ✓ What happens if an employee voluntarily chooses to move and work remotely?
- ✓ Do you decrease pay when an employee relocates to a lower paid area?
- ✓ What is the effective date of the change (immediately or at annual merit increase cycle)?

Conducting an External Market Review

01. View job descriptions and organizational chart

02. Match jobs to available surveys and peer data

03. Collect data for base salary and total cash compensation

04. Determine market reference points (P25, P50, P75)

05. Compare incumbent pay to market pay levels

06. Identify "outliers" and develop strategies for future pay adjustments

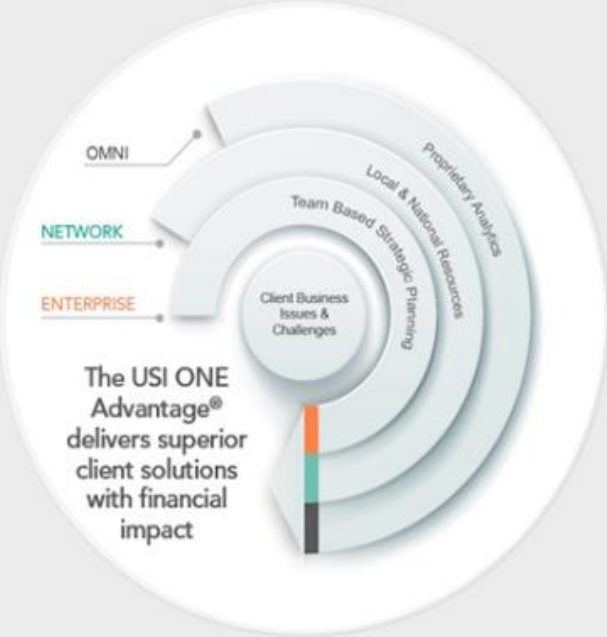
Sample Market Benchmark Data ($000's)		Base Salary			Total Cash Compensation		
		P25	P50	P75	P25	P50	P75
Scope: $500M -$1B annual revenues, all industries, San Diego	General Counsel	$320.7	$405.1	$513.4	$438.1	$586.8	$794.8
	General Counsel (Public)	$419.2	$429.4	$441.2	$1,091.5	$1,134.0	$1,191.9
	Assistant General Counsel	$228.9	$260.7	$298.0	$268.8	$322.0	$390.8
	Senior Managing Attorney	$198.1	$225.3	$253.6	$223.2	$264.4	$314.0
Scope: $50M -$200M annual revenues, all industries, San Diego	General Counsel	$233.8	$280.2	$338.5	$291.5	$374.6	$489.1
	Assistant General Counsel	$209.3	$238.4	$272.4	$245.7	$294.4	$357.3
	Senior Managing Attorney	$186.1	$211.6	$238.2	$209.6	$248.3	$294.9

USI at a Glance

Largest privately-held broker of U.S. business

"America's Best Large Employers"

Forbes Magazine, 2018



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USI Compensation Consulting Practice

What We Do:
We help organizations align pay and rewards with business objectives and core values. We design compensation programs to help clients attract, motivate, and retain key talent.

Who We Help:
We work with small, middle market, and large public, private, and not-for-profit organizations. We are regularly engaged by Board Compensation Committees and management.

Executive Compensation

- Benchmark executive compensation
- Design performance-based annual incentive plans
- Design long term incentive plans, such as equity-based and nonqualified deferred compensation plans
- Evaluate executive benefits and perquisites

Employee Compensation

- Benchmark employee compensation
- Build or evaluate salary structures and pay administration policies and procedures
- Design company-wide annual incentive plans
- Integrate performance management systems into pay programs

Sales Incentive Plans

- Design effective sales incentive and recognition plans to deliver competitive pay and reward top performers
- Analyze pay versus sales performance to identify areas of concern in plan design
- Assist sales leaders in evaluating sales roles and designing effective sales teams