LONGNECKER
& ASSOCIATES
ALL IN®

LONGNECKER'S TOP 10 COMPENSATION FAVORITES

COMPENSATION DESIGNED TO MAINTAIN A COMPETITIVE ADVANTAGE

TABLE OF CONTENTS

HOW DO WE DEFINE EXECUTIVE PAY?

By Brent Longnecker, Chris Crawford, and Kevin Kuschel

How much do you pay your CEO and other top officers? That depends on how you define "pay." Is it the amount reported on SEC filings, those numbers that stoke media outrage over "giveaway" CEO compensation? Is it what the executives could potentially earn if performance targets are met? Or is it the amount they take home at the end of the year? How well does your compensation committee explain why these numbers are all so different?

Do you remember this great discussion?

Lou Costello: Well then, Who's on first?
Bud Abbott: Yes
Costello: I mean the fellow's name.
Abbott: Who.
Costello: The guy on first.
Abbott: Who.
Costello: The first baseman.
Abbott: Who.
Costello: The guy playing…
Abbott: Who is on first!
Costello: I'm asking you who's on first!...

Before they are done, we find out their leftfielder's name is "Why," "Because" is the centerfielder, and "Sure" is the pitcher.

Confused? Absolutely! Yet if you think this vintage Abbott and Costello routine is tough, just look at executive pay in regard to publicly traded companies. Trying to understand the concept of "targeted pay" versus "reportable pay" versus "realized or actual pay" can be even more confusing than hanging out with Bud and Lou.

For compensation committees, this confusion has a significant impact on how they make the decisions shareholders have charged them to make. Being able to separate the wheat from the chaff can make the difference in being able to attract, retain, and motivate the top talent needed for a company to be successful.

Moreover, compensation committees are feeling pressure from proxy advisors and shareholders to ensure a proper correlation exists between company performance and pay. The rub comes from compensation committees when pay does not follow company performance. They may then face a "No" vote from shareholders upon re-election.

There are basically three alternative compensation definitions used by boards today. Typically, none of them are even close mathematically.

There are basically three alternative "compensation" definitions used in today's boardrooms by compensation committees with respect to executive pay:

- Targeted pay
- Reportable pay
- Realized, or actual pay

Typically, none of these are even close mathematically. This is one reason compensation committees, their advisors, and even executives themselves have such a hard time trying to compare "apples to apples" when handling the critical issues around pay. The ability to compare to peers, and even the design of short and long-term incentive plans, hinges on the committee's ability to observe and understand the differences involved.

continued on next page

HOW DO WE DEFINE EXECUTIVE PAY? (continued)

- **Targeted pay** is typically what is reported in survey sources and CD&A's, and thus is used by compensation consultants, outside advisors, and compensation committees. Targeted pay is not only used in determining market competitive levels, but also aids in designing the appropriate total compensation package (base, short-term, and long-term pay opportunities) needed to attract, retain, and motivate the type of executive talent for long-term success.

Companies usually design short-term and long-term incentive plans around minimum, targeted, and maximum pay levels based upon the achievement of certain levels of performance (whether that be individual or company).

However, targeted pay has typically been used on a "go-forward" (assuming performance) versus a "look-back" (actual performance basis). This sometimes creates a disconnect as to whether or not the pay of the executive aligned with the company performance in prior periods. This is a key issue for companies today as they work through the issues around Dodd-Frank and say-on-pay.

So, although useful, targeted pay has its limitations. Targeted pay does not take into account the actual pay realized by the executive, or even what is reported in the proxy statement. It is simply a good tool for comparison purposes only. This is a real problem with traditional pay analyses. They are typically done annually looking at a single year, in a vacuum of sorts, and do not look at pay-versus-performance over a longer period (both backward and forward), which would be more practical.

"Reportable" pay is a hodge-podge of both actual pay as well as accounting-based long-term incentive opportunities that carry a myriad of financial assumptions.

- **Reportable pay** is what is reported in the Summary Compensation Table (SCT) as required by the Securities & Exchange Commission. This table details pay of the company's named executive officers for each of the prior three years. It includes each executives':
  - Actual base salary
  - Actual short-term incentive/bonus payments or accruals
  - Actual long-term incentive payments or accruals
  - Change in actuarial present value of benefit or pension plans
  - Other compensation paid including perquisites
  - Grant date, fair market values of equity awards, and long-term incentive plans as determined by Generally Accepted Accounting Principles (GAAP)

Reportable pay is thus a hodge-podge of both actual pay as well as accounting-based long-term incentive opportunities that carry a myriad of financial assumptions. These assumptions are only good if the stock price appreciates (a key assumption), or performance targets are met — Which may or may not happen. The assumptions usually overstate the value of the executive pay package to a significant degree.

This is often the area where the media gets confused. They report figures as "earned" by the executive, when in reality, they are simply accounting numbers that are used and may or may not be even close to what the executive will eventually receive and be taxed on.

To make matters worse, for equity awards, common stock valuation models like Black-Scholes, Binomial, and Monte Carlo can all be very misleading; especially to those who just read the numbers and assume that the executive is receiving what is published. This simply is not the case in many instances. Assumptions based on appreciation, stock price volatility, dividends to be paid, discount rate, and expected terms of the award can all vary — even within the same company.

Although this is required for GAAP, it does not take into account any stock price movement after grant. As a result, we typically see tremendous discrepancies between what is reported versus what is actually realized as pay by the executive.

continued on next page

- **Realized or actual pay.** So before you start wondering who the "who" is on first and what "what" is doing on second, we should examine actual or realized pay.

Actual pay is what the executive actually gets, is taxed on, and what he or she takes home. As you can imagine, what the executive gets is all that really matters. In addition, for any and all who are looking for true alignment between pay and performance, this is it, especially for review by compensation committees.

An executive's total (or actual) take home pay should be highest during periods of strong performance, both short and long-term. Conversely, pay should be lowest when performance has been mediocre.

However, if an executive's pay is in fact higher during poor performance periods, the alignment desired is not there. This misalignment may show that payouts in cash or stock were not tied to anything performance-related at all. This has been a controversy for the past few years, especially in light of the SEC, Dodd-Frank, and now proxy advisors calling for a more pay-for-performance reward system for executives, most importantly the CEO.

Thus, compensation committees are becoming ever more vigilant on the incentive programs companies put in place, and how performance is tied to payouts. Typically, actual or realized pay includes the following:

- Earned/taxable pay, including base salary and other cash incentives.
- Earned/taxable payouts under performance share, restricted stock, or other long-term incentives. Either the right was exercised, the restrictions lapsed, or the performance period expired.

It is important to know that realized or actual pay with long-term incentives can span over a multi-year period. We only consider what is taxable in this category. Therefore, anything vested but not exercised (or anything unvested) does not fall into this category, since there is still risk associated with final value.

Long-term incentive pay granted now may not actually be received for years to come, and may significantly differ from that shown in the Summary Compensation Table.

There are many good examples of how reported pay in the Summary Compensation Table can vary greatly from what is actually realized by the executive in the same year. More and more companies are challenging proxy advisors that use only SCT figures in determining pay-for-performance judgments.

Base salary and annual bonus amounts are actual dollars received, no one disputes that. It is the equity grants to executives, the long-term incentives, which have the most impact on what is reported versus what is actually received in the same year by executives.

The companies whose pay is charted above (Safeway and ExxonMobil) argue that a substantial portion of their executives' pay represents an incentive for future performance. Long-term incentive pay granted now may not actually be received for years to come, and may be significantly different from the amounts reported to the SCT.

Even though they are required to disclose grant date fair values for long-term incentives, many companies are now supplementing the proxy statement to include tables that show the actual values received by executives. This includes any exercised stock options, vested restricted stock, or performance awards where restrictions may have elapsed and an award vested.

These examples show very different results when you look at what is reported in the SCT and what is actually received by the executive over the same period. If you were to add the concept of "targeted pay," it would only get worse. Just imagine compensation committees having to juggle all three while in a conversation with shareholders. Abbott and Costello may be easier to understand.

It is high time we found a solution to this insanity. Having to juggle targeted, reportable, and actual pay is simply inefficient and time-consuming. Further, having to explain the differences to institutions, the media, and the public is just overwhelming.

continued on next page

The media is biased to bigger numbers, so they can make a case for no alignment with performance. The consultants and other advisors want to look at targets to ensure they are getting the right comparisons. The executives look at their W-2s, and would prefer actual numbers be used to indicate what they really received.

Some possible solutions to this quandary include:

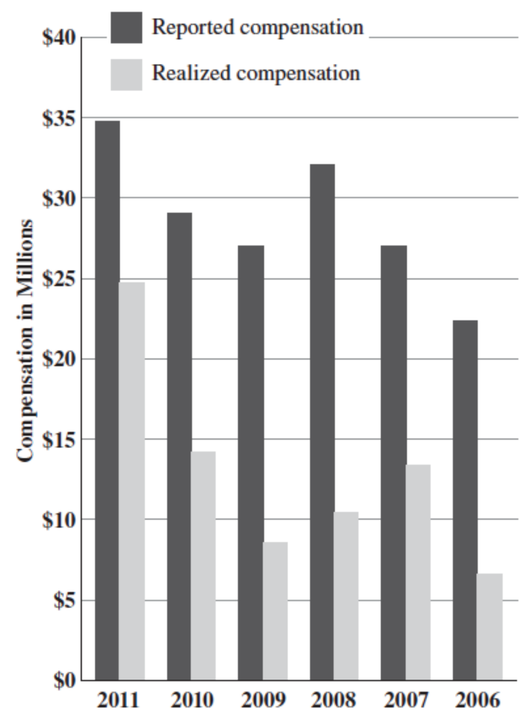
- Every report by an outside advisor should address all three scenarios and outline the pros and cons of each.
- At least once every three years, the compensation committee should look back at the last three to five years to compare what each CEO and top report received as targeted, reportable, and actual pay to see if it is in alignment with the committee's expectations. We have done this at our firm, and call it Wealth Accumulation versus Performance Analysis. From our experience, it seems to help committees with their long-term decision making.
- The committee should consider working with outside counsel on how to explain this in the CD&A's, so institutions and regulators will be better educated. Again, the use of tables could prove helpful.
- Petition the SEC for a better, more consistent approach, especially as it relates to paythat is reportable due to GAAP.

Today's compensation committee is yesterday's audit committee.

Being on a compensation committee has never been harder. Say-on-pay, pay for performance, Dodd-Frank, ISS, and new rules on independence make this one of the most challenging fiduciary tasks boards have. As Jay Lorsch, governance professor at Harvard, points out: "Today's compensation committee is yesterday's audit committee."

WHEN NUMBERS LIE

Exxon Mobil CEO Reported Compensation vs. Realized



Source: ExxonMobil Corporation proxy statement, filed April 12, 2012

To make matters worse, the way targeted, reportable, and actual pay are discussed make it virtually impossible to talk "apples to apples." Hopefully, one day we will finally be able to figure out "who's on first" and What's on second." Perhaps CEO pay will still be on third, but we must first understand and be able to discuss the differences in how compensation is reported, how it is set, and ultimately what executives really receive.

There needs to be consistency, and the SEC is the one governing body that can make this happen. Until then, compensation committee meetings may continue to sound like an old Abbott and Costello routine.

EXECUTIVE COMPENSATION: THE #1 REASON YOU MAY LOSE YOUR BOARD SEAT

By Brent Longnecker and Kevin Kuschel

In the last two years, Longnecker & Associates has actively helped our clients work with their shareholders on rising activism and advisory firms' power to sway votes, both of which reduce board seats' guarantee. So far this year, 300 companies have been subjected to activist campaigns, and projections say this number will only increase.

According to a 2015 Brunswick study, 53% of campaigns were tied to executive compensation. Regardless of claims' authenticity, activists use compensation as the hook to gain support. A recent Harvard Law School article entitled "Shareholder Activism and Executive Compensation" stated "low levels of support for a company's say-on-pay vote can serve as an early warning sign for both companies and activists that shareholders may have mixed feelings about management's performance or a board's oversight." This statement demonstrates how vital effective communication is. Communicating effectively, though, often proves to be more difficult than it seems. Recently, there's been a paradigm shift in the investing markets. In the past five years, more than $1 trillion shifted away from traditional institutional investors into the hands of index funds and retail investors — i.e. the groups with the greatest propensity to wage an activist campaign. Traditional communication strategies fail to address these groups, causing major gaps in understanding say-on-pay and ultimately increasing failed say-on-pay votes, activist campaigns and lost board seats.

It's important to have a strategy that not only addresses these groups specifically, but one that also maintains a plan for communicating with traditional investors since succeeding with your investors is key to mitigating the risk of activism on your board. Most companies don't communicate with investors or get stuck in the traditional outreach and disclosure rut.

In today's environment, companies should proactively assess their compensation programs through the lens of shareholders and proxy advisors to know where they can diverge from standards. Additionally, they should have an annual outreach strategy. Although involving shareholders has become the new standard, many companies choose not to address shareholders directly. These companies either: 1) have very standard, best-practice compensation programs, 2) have never experienced activism or shareholder dissent, and therefore do not see the need, 3) are a controlled company with little need to influence a vote, or 4) are not concerned with the thoughts of their shareholder base. The majority of well-governed companies take a more aggressive, shareholder-friendly approach to proactively communicating governance and compensation items that could garner attention. This process usually takes the same form across multiple companies: 1) identify potential issues shareholders or advisory firms may address, 2) develop a plan to communicate why these programs are appropriate, 3) call the top 25% of shareholders to deliver the message, and 4) ask for their support. This four-step process results in increased support, but as with anything, evolution is necessary.

Today's shareholder engagement process should look vastly different. Focusing on top quartile investors and calling to deliver a message are no longer enough. Now, companies need to take a forward-thinking, aggressive approach to shareholder engagement. The ideal outreach process should include the following steps:

1. **Identify the issues.** This step is always first because the best way to avoid activists is to understand where they have a potential foothold. You should understand ISS, their voting policies on compensation and governance, and how proxy voters align with ISS, or if you don't, you should hire a firm that does.

2. **Develop a concise message.** Proxy voters are busy. They won't read a treatise on why your severance package included a gross-up, so it's necessary to educate them with a message that's less than a page.

3. **Style the message appropriately.** Many people do not realize this, but most proxy voters are 28 – 35-year-old women. You should tailor your message to this demographic to see success.

4. **Meet with top shareholders.** Not all investors want to meet or see the need for it, but you should offer it. If a meeting is set up, management shouldn't attend if compensation will be discussed. Nothing irritates people more than hearing someone talk about their own pay. Rather, send a board member and/or a consultant familiar with the plans to talk with them.

continued on next page

5. **Call all shareholders.** Most companies don't do this, but they should. Many votes can be picked up from smaller shareholders. When asked directly, smaller investors are more inclined to listen and agree to vote with you.
6. **Ask for support.** Never be too proud to ask for their vote.

Often, establishing best-practice pay programs is the best way to secure the vote and mitigate activism. According to the Harvard Law School article mentioned above, companies should take measures to ensure that: 1) adjustment provisions of stock plans permit adjustments to awards in the event of both extraordinary dividends and divestitures, 2) all plans are clear as to whether an employee ceasing to be part of the affiliated group of companies in a divestiture will be treated as a terminated employee for purposes of the relevant plans, 3) performance goals still work after extraordinary dividends, the divestiture of a major business, and particularly if there are per share performance metrics, a share buyback, and 4) performance plans are designed in a manner to minimize the effect of such events and related adjustments on the deductibility of compensation under Section 162(m) of the Internal Revenue Code.

What we have learned in talking with institutions and activists, is that it is not enough to sit idly by, waiting for the votes to come in and hoping they are favorable. Board seats are in the crosshairs of activists looking for a foothold, and given the chance, will engage in a proxy battle aimed at gaining a seat or seats. A failed say-on-pay vote or low support for management proposals is a red flag. Engage your shareholders, and develop a strong strategy for communicating in a way that brings the votes. Your board seat may depend on it.

COMPENSATION LANDMINES & KEY ISSUES

By Brent Longnecker, Kevin Kuschel and Daniel Wilson

"I would not give a fig for the simplicity this side of complexity, but I would give my life for the simplicity on the other side of complexity."

Oliver Wendell Holmes, Jr.

Executive compensation has continued to develop as a result of new say-on-pay ("SOP") disclosures and proxy advisory firms continuing to influence institutional shareholders. Listing standards related to independence requirements for compensation committee members and the selection of their advisors are now in place, all public companies are now influenced by SOP regardless of size, pay for performance continues to be a hot button, clawback policies are ambiguous but polarizing, and internal pay equity and the ratio of median company employee to the CEO now has legs to it. Steven Hall & Partners brings more color to this in their 2016 report, "Trends In Proxy Access Votes." It shows as of August, 39 companies (1.5%) of Russell 3000 Failed say-on-pay. Bottom line, it's tougher today than ever before if you have any responsibilities around pay.

As we all know, Institutional Shareholder Services ("ISS") and Glass Lewis ("GL") have a significant impact on how institutions vote on compensation-related practices and the boards that govern those companies. Now, more than ever, is the time for companies, executives, committees and board members alike to reach out to their major shareholders whom ISS and GL influence the most. Thus far in 2016,"ISS voted against 224/1,929 companies (12%)." So, of the 224 companies that were voted against 39 failed to receive majority shareholder approval, according to Semler Brossy. In fact, L&A is seeing more and more companies stepping up discussions with these key institutional shareholders to communicate to them what is important to the company and shareholders, identifying key components in compensation programs that align executives with shareholders, and ensuring that company performance plays a vital role in determining the measures used in those programs. What is most interesting is that a company can have an analyst at an institution rate them a "strong buy", but have a compliance person at the same institution vote against the company because they just robotically follow ISS and/or GL. This is a tremendous disconnect that, in time, needs to be corrected.

That being said, the most significant impact ISS and GL have on companies relates to the pay for performance disconnect. ISS and GL evaluate pay for performance alignment on both quantitative and qualitative measures. Quantitative measures seek to gauge the alignment of a company's executive pay practices to company performance and evaluating the CEO's compensation against the company's total shareholder return. Qualitative measures seek to determine how a company defines its peer group for benchmarking purposes, the ratio of performance-based equity to time-based equity awards, or the appropriateness of performance goals and how easily they can be achieved. Whatever the case, companies have continued to evolve their compensation programs to meet these stringent requirements by these shareholder activists.

As a result, many companies are continuing to implement performance-based equity programs so that compensation is directly tied to company performance. The continued elimination of tax gross-ups, implementation of anti-hedging policies for executives, and increasing executive's stock ownership requirements are just some of the ways that companies are conforming to ISS and GL. Even though companies are implementing these devices to appease the crowds, compensation committees and board members must keep in mind that they must do what is in the best interests of shareholders, even if that means gaining a negative vote from ISS and GL. These committees and boards know their company better than proxy advisors and know what it takes to attract, motivate, and retain the talent needed at their company, especially with a dwindling executive work force in all industries.

Every year that passes brings enhanced SOP legislation and new disclosures for companies to be cognizant of, which ultimately means that companies will continue to have to enhance disclosure of pay practices, performance measures, independence guidelines, etc. in their respective Compensation Discussion & Analysis ("CD&A") sections of their proxy statements to shareholders.

continued on next page

As such, what better opportunity to let shareholders know what you as executive leaders, committee members, and board members are doing as fiduciary stewards of the company. While CD&A sections of the proxy statement are getting longer and longer as years pass, companies should use this opportunity to disclose best practices, give shareholders a sense of accomplishment for the year, and to define pay practices that set them apart from other companies. *L&A suggests more use of charts and graphs, in lieu of less language, which helps to better illustrate compensation decisions, programs, and links between pay and performance*. An executive summary describing company performance and compensation relative to that performance is a key component to the CD&A that companies need to utilize more frequently. A trend that is coming to the forefront which needs to be disclosed, especially in light of ISS and GL pushing so hard for executive pay packages to be reeled back in, is the concept of targeted vs. reported vs. realized compensation. How many times the compensation that is reported in the summary compensation table of the CD&A is actually realized by the executive, less than the general public, ISS, or GL actually are aware of, they only see what is reported and don't think about the latter.

Summary

Ultimately, compensation committees and Boards of Directors are responsible for the compensation packages that each of them receive and have a fiduciary role to shareholders to hold up their end of the bargain for it to be reasonable, market competitive, attracting, motivating, and retentive to all parties involved. As such, the buck stops there. All this legislation, new disclosures, nitpicking of company policies, and taking apart of executive compensation packages are not only getting outrageous but overwhelming for some companies. Companies are increasingly, with each new piece of legislation passed, being tempted with the opportunity to go private, discourage existing private companies from conducting an IPO, or even contemplate leaving the country in search of better corporate tax rates (but that's another discussion). All of this could eventually leave America wondering, what just happened?

BONUS PAYOUT DEBATE: FORMULA VS. DISCRETION!

By Brent Longnecker, Chris Crawford and Ian Keas

Nearly every employee, shareholder, board member and newspaper reader seems to have his or her own opinion regarding formulas and discretion in determining executive incentive payouts. Over the past several years, the amount of attention and heat on this topic has escalated as the Securities and Exchange Commission (SEC), proxy advisors like Institutional Shareholder Services (ISS) and Glass Lewis, shareholder activists, and activist law firms continually push for more transparency, more linkage to pay and performance, and more formulas in company incentive programs. Conversely, shareholders have elected compensation committees and boards to determine fair and reasonable compensation in light of many factors, including but not limited to market competitive costs, complexity and size of the organization, tenure of the executive, and yes performance. These board members, better than anyone, know the industry and company, as well as what it takes to attract, retain, motivate and reward key executives appropriately. As a result, there is an escalating power struggle between company boards and institutional advisors over the fairness and reasonableness of incentive compensation payouts.

Many companies are being encouraged to establish purely formulaic incentive plans at the beginning of the year. Proponents of formulaic bonuses indicate they can accomplish the following:

- Reduce the amount of gaming perceived to occur by boards and management
- Provide transparency on the company's goals and objectives
- Reinforce decision making that should be in shareholders' best interests
- Create connections between employees, executives, board members and shareholders where interests are aligned
- Directly link actual pay with actual performance of the company

These tenets of formulaic incentives are reasonable. However, the last one is the crux of the matter. Said another way by a respected compensation committee chair, *"I know better at the end of the year how our company did than an excel spreadsheet would predict at the beginning of the year."* Predictive modeling has always been tricky business, but when you consider the volatility of the 21st century economy, it's downright near impossible.

The coming 2016 proxy statements filed by oil and gas companies will be "exhibit A" for this ongoing debate. Oil and gas prices didn't look great in the third and fourth quarter of 2014, plummeting from $112/barrel earlier in the year to $60/barrel at the end of the year. However, very few saw the perfect storm of economic events that drove prices below $30/barrel and have seriously plagued the industry in 2015 and so far this year. The result? Many exploration and production companies with 2015 formulaic bonuses pushed by ISS, institutions and activist investors have produced above target payouts while stock prices dropped in half or more. Compensation committees across the U.S. have wrestled with what we should do. Is it best to let the formula payout retain credibility in the plan or make a discretionary call to recognize an imperfect formula at the beginning of the year? Every compensation committee seems to have weighed their own set of facts and circumstances to derive their own conclusions. While there doesn't seem to be a perfect answer for this difficult dilemma, those companies that stuck to the formula may likely face more serious criticism and "votes against say-on-pay" by the very institutions that encouraged the formulaic incentive in the first place.

It's early in the proxy season, and this debate will certainly escalate in the coming months and years. However, we at L&A conclude with several guiding principles to good incentive plan design practices as it relates to formula versus discretion:

- The ability for a compensation committee and management to use both positive and negative discretion is an important element to factor into annual incentive payouts.

continued on next page

- The discretionary portion, or weighting as a part of the whole payout, should be established in the beginning. For example, if a CEO has a targeted payout of 100% of base salary, 20%-50% of the final payout may be tied to discretionary decision making. This allows the compensation committee and management to adjust for unforeseen events and resulting performance.
- The company may have key objectives it routinely assesses in discretionary decision making. In that case, these overarching objectives should be communicated to employees and shareholders.
- If the compensation committee or management utilizes discretion — whether positive or negative — that produces an incentive payout result different than the formula, the committee should crisply articulate the why behind the decision making for the benefit of employees and shareholders.
- The final incentive payout and total compensation provided to the executive team should pass the smell test. If company performance was great, incentive payouts should be great. If company performance was not great, incentive payouts should not be great.

DOES A HIGHER GOVERNANCE SCORE IMPROVE SHAREHOLDER VALUE?

By Brent Longnecker, Chris Crawford and Ian Keas

The influence and scope of public company governance advisory firms like Institutional Shareholder Services (ISS) and Glass Lewis & Co (Glass Lewis) continues to widen. These firms continually shift policies and guidelines which in return keeps company management and board members on their toes, and generates significant debates. Many Directors take the position that if ISS or Glass Lewis recommend it, they should do it. This position is often generated and encouraged by board members who would like a "good score" or "for vote" by the governance advisory firms. Let's not forget many of these board members are the top of their class.

As a result of this increasing debate in the boardroom, we at L&A have decided to pose a question and provide an analytical answer to help guide the debate: Does a higher governance score improve shareholder value?

ISS' Governance QuickScore Background

L&A notes that a growing number of companies are turning to ISS' proprietary Governance QuickScore rating platform for a better understanding of potential concerns related to governance. It is designed to indicate the level of recourse a shareholder has in resolving an issue with the respective company. Per ISS' website, "as governance factors play a heightened role in investment decision-making, ISS Governance QuickScore provides investors with comprehensive data and quality scores to identify governance risk and support their analysis. Scores provide an indication of management quality, deliver a snapshot view of risk, and are supported by factor-level data that is critical to the research process." ISS notes that "QuickScore allows investors to understand the issues potentially affecting company performance and enhance their analyses of portfolio companies…" We will dig into the company performance angle a little later to see if there are noteworthy correlations.

Governance QuickScore uses a numeric, decile-based score that indicates a company's governance risk relative to their index or region, with a 1 indicating the lowest governance risk and a 10 indicating the highest. Companies are assigned an overall QuickScore and are also analyzed on four governance pillars: Board Structure, Audit & Risk Oversight, Shareholder Rights, and Compensation. While the overall platform is proprietary and changes on an annual basis, we note that nearly 200 factors are analyzed, including Director accountability, board diversity and board refreshment. Each of the 200 factors is assigned a weight which varies based on ISS' understanding of governance practices and ISS voting policy. **The table below highlights some of the topics covered in the ~200 factors.**

GOVERNANCE PILLARS

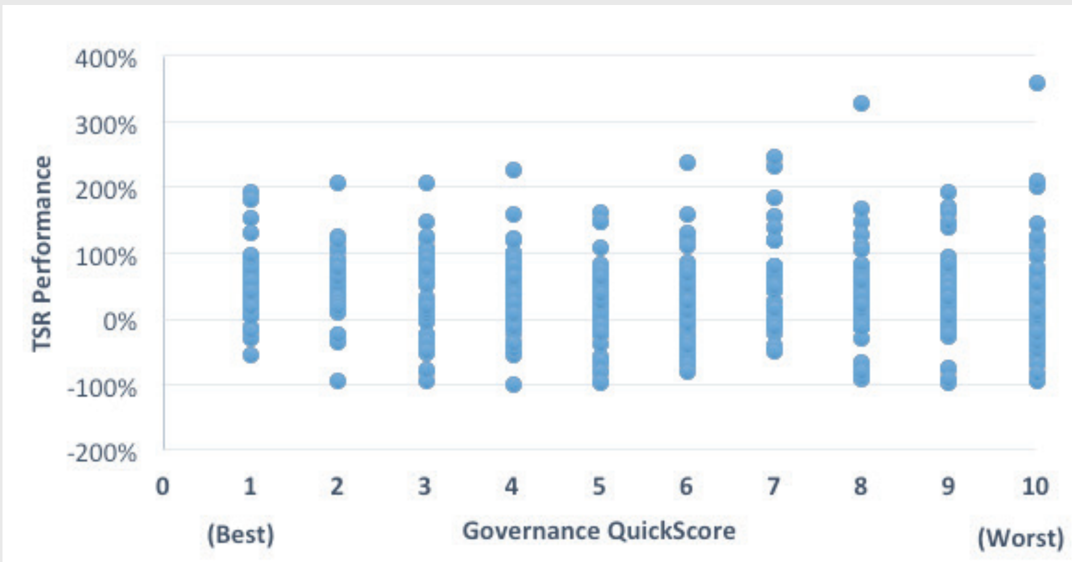
BOARD STRUCTURE	COMPENSATION	SHAREHOLDER RIGHTS	AUDIT
Board Compensation	**Pay for Performance**	**One Share One Vote**	**External Auditor**
Composition of Committees	**Non-Performance Based Pay**	**Takeover Defenses**	**Audit and Accounting Controversies**
Board Practices	**Use of Equity**	**Voting Issues**	**Other Audit Issues**
Board Policies	**Equity Risk Mitigation**	**Voting Formalities**	
Related Party Transactions	**Non-Executive Pay**	**Other Shareholder Rights Issues**	
	Communications and Disclosure		
	Termination		
	Controversies		

continued on next page

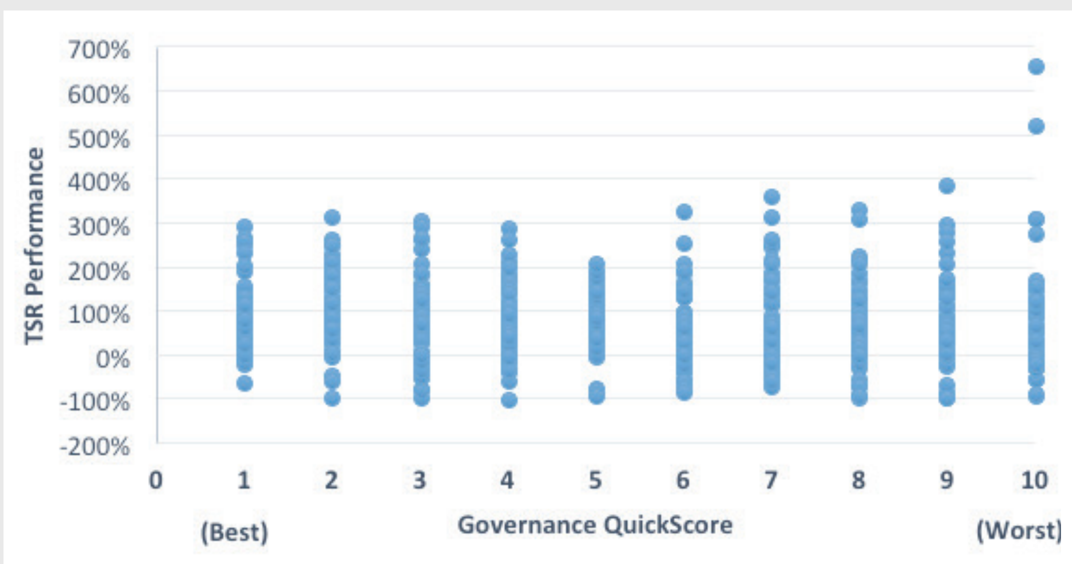
Does a Higher Governance Score Improve Shareholder Value?

To answer our question, we wanted to see how a company's QuickScore, and scores from the four pillars, correlated to company performance. Communicated as a relative score of shareholders' capacity for recourse, we opted to see how these governance scores corresponded with total shareholder return over a three and five year period. **We utilized data from companies included in the S&P 500, highlighted below.**

3 YEAR TSR PERFORMANCE



5 YEAR TSR PERFORMANCE



continued on next page

Key Takeaways

We note the following key takeaways based on Governance QuickScore data:

1. There is no correlation between a company's Governance QuickScore and TSR performance, the metric often identified as a key performance measure in executive long-term incentive compensation plans.
2. Improving a company's Governance QuickScore may ease institutional voting on items like say-on-pay, but there is no evidence it will improve shareholder value.

So what does this mean for Directors? We believe that while firms like ISS and Glass Lewis are effective platforms for identifying and laying out certain key issues impacting today's governance world, boards should take these platforms into consideration when making governance decisions. While certain factors, and their corresponding "best practices" might make sense for implementation, boards should analyze their governance programs in aggregate and make informed determinations on what is in the best interest of the company and its shareholders, not necessarily in the best interests of advisory groups or special interest groups.

In summary, L&A concludes that good governance is key for every company. Where the debate begins is how we define "good governance". The governance agendas and platforms proposed by institutions and advisory firms should be thoroughly reviewed by board members, but with question marks at the end of the sentence rather than periods or exclamation points.

Longnecker & Associates is here to help if you are uncertain about the impact of your current governance practices, or would like more information on the key governance factors proxy advisors are zeroing in on. Feel free to contact any of the members of the L&A team who will be more than willing to assist.

WHAT IS REASONABLE COMPENSATION AND HOW IS IT MEASURED?

By Brent Longnecker, Chris Crawford and Tyler Brown

What seems like an easy question to answer is quite the opposite. Reasonable compensation in today's market is a relative term. Determining reasonable pay is one of the biggest and most taxing challenges that Directors face in today's business environment. Based on readings from the IRS and the SEC, it is the company's responsibility to justify that pay is reasonable and to what extent. Justifying pay packages has become increasingly difficult with each passing year due to increased legislation and numerous shareholder advocacy groups. However, we at L&A are able to determine key points to help Directors navigate these treacherous waters and arm themselves with reasonable and defensible compensation practices.

When evaluating executive compensation, the IRS considers the complexity of the company, the amount of time required, general cost of living and compensation levels relative to the company's size amongst other various financial metrics. However, the IRS, as well as shareholder advocacy groups place a heavier weight on both absolute and relative performance measures in determining whether or not a compensation package is reasonable. The following are common methodologies used to determine the reasonableness of compensation by comparing compensation to performance:

Independent Investor Test

This test considers the return on investment of the executive valued by the increase in the corporation's stock during the performance period compared to a comparator group consisting of similarly sized companies with matching operational footprints as the company in question. This test provides logical reasoning that can illustrate an investor should be happy with the return on investment of the executive and would not be opposed to the compensation being provided in the event the rate of return is above that of the comparator group.

Under-compensation for Prior Years Service

One factor that is often overlooked in these performance measures is under-compensation for prior year's service. Often times when a company is in a start-up or growth cycle, companies may pay below market wages in order to maintain capital to invest in the continued growth of the company or until a point when the company can become more profitable with sustainable cash flow. As a result, an executive may be under-compensation in the early stages of the company and therefore, the compensation paid in the current year could be intended to adjust or "make-up" for the years in which the executive was under-compensated compared to their counterparts. Section 162(m) of the internal revenue code has enabled companies with the ability to fight through potential lawsuits based on the idea of under-compensation.

Relative Degree of Alignment

Over the past several years shareholder advocate groups, such as ISS and GlassLewis, have developed proprietary quantitative and qualitative tests to determining what these organizations may deem to be excessive compensation based upon their measure of performance. One of these tests is ISS' Relative Degree of Alignment test. ISS analyzes pay-for-performance over a three-year period by measuring the percentile rank of CEO compensation as compared to the ISS peer group's relative Total Shareholder Return ("TSR") percentile rank. It is worth noting that the ISS defined peer group is often very different than the company's defined compensation peer group. Based on this analysis a company can be given a score and rating on the level of concern regarding their pay practices. For example, if the difference between CEO pay percentile rank and TSR percentile rank is: less than -30 = Medium Concern; less than -50 = High Concern. These values are subject to change from a year over year basis based on changing ISS methodology and approach.

Multiple of Median

Multiple of Median is a relative measure that compares the prior year's CEO pay to the median pay of the ISS selected peer group. The Multiple of Median is calculated by dividing a company's one-year CEO pay by the median pay of the identified ISS peer comparator group. ISS currently has determined that if the CEO's pay is more than 2.33x the ISS peer group's median compensation would result in a Medium Concern, and if the CEO pay is greater than 3.33x the median compensation, the test would result in a High Concern.

continued on next page

L&A understands and communicates with the IRS, shareholder activist organizations and board members regularly concerning reasonable compensation and effective ways to dispel the potential for compensation being viewed as excessive or unreasonable. L&A stands in a unique position with the ability to assist Directors in continuing down the path of removing doubt of unreasonable compensation within their organizations through strategically partnering with the company to identify solutions. With the 2014 proxy season coming to a close, beginning the process in determining executive compensation levels and reasonableness for the upcoming year can pay benefits for next year's proxy disclosures and say-on-pay voting, putting your organization ahead of potential scrutiny and market security.

HEAR YE, HEAR YE: IS ISS STARTING TO LISTEN? YES AND NO...

By Brent Longnecker, Kevin Kuschel and Ian Keas

As markets progress in 2015, management teams and Boards of Directors are busy guiding their respective companies through a variety of new challenges stemming from numerous sources: dramatic drops in commodity prices, surprising shifts in government monetary policies, ever-changing geopolitical events and shareholder apprehension. These challenges in the marketplace are the unfortunate norm of today's energy industry.

Last month, ISS released its most recent policy updates, including revisions to its peer group selection process for the energy industry. After reviewing, L&A was left wondering: is ISS finally starting to listen or is it just a clever maneuver where in reality, the ISS "game ball" is still well over-inflated? Are they beginning to realize that not all industries are created alike? Finally, should all industries be paying attention to what is happening in the energy sector and will that affect us?

The Changes

To ensure company leadership understands how the methodology changes are going to impact vote recommendations and governance scores in the 2015 proxy season, let's review the updates.

I. ISS generally constructs its peer groups based on the following: a company's industry (based on GICS code), revenue size, and market capitalization. For the 2015 proxy season, ISS' updated methodology dictates that peers are selected within a 0.4x – 2.5x range of the subject company's market capitalization for energy companies within the following GICS codes: 10102010 (Integrated Oil & Gas), 10102020 (Oil & Gas E&P), 10102030 (Oil & Gas Refining & Marketing), 10102040 (Oil & Gas Storage & Transportation), and 10102050 (Coal & Consumable Fuels).

II. Further, ISS' policy update includes a measure for the Integrated and E&P GICS codes in particular, whereas ISS will only select peer companies from within the subject company's GICS group and/or the GICS groups of its selected peers.

The Impact

So what does this mean for the energy market as it moves into the 2015 proxy season? The first update of market cap as the only measure of size differs from its approach to all other non-financial companies. Not only has ISS elected to ignore revenue, the metric with the greatest correlation to pay and company performance as taught by WorldatWork and included in its curriculum, but it has decided that the primary and only measure of company size is market cap, which can be relatively volatile based on external factors completely out of a company's control (OPEC announcements, national unemployment news, consumer holiday shopping sentiment, the Swiss Central Bank's decision to eliminate recent monetary policy, China's economic growth – just to name a few). Add in the impact of being an E&P company with a highly leveraged balance sheet that is vulnerable to those external (out-of-your-control) factors, and this method seems even more counter-intuitive.

While L&A has additional concerns with this approach, it is important to note the immediate impact this change will have on companies. Unless your company conducts the annual review of its peer group after the end of the calendar year, there is a good chance your peer group will have already been developed for fiscal 2015, likely based on revenue, and will be comprised of a much different list of companies than what ISS will select. Add in the fact that the end of the year saw many investors realize significant losses due to commodity price volatility, and it looks as though ISS is setting itself up for an influential proxy season. L&A believes that due to the lack of correlation between market cap and revenue size, asset size, reserve characteristics, etc., this new policy will result in peer groups that will be inconsistent in terms of size, aside from market cap. Further, L&A believes this update will result in peer groups that are not shareholder friendly, as revenue has the single greatest correlation to executive compensation and company size.

continued on next page

While the switch from revenue to market cap goes against compensation principles, the second policy update is something that has been long overdue. As such, there may be some "selective hearing" going on. Companies will not be forced to consider other players outside of their respective energy sub-sectors, as those companies utilize different compensation practices to effectively attract, motivate, and retain top talent. Compensation best practices differ based on the industry and sector a company competes in. Hence that is why an oil-focused onshore E&P company, a midstream company with a Master Limited Partnership corporate structure, a mid-market oilfield services company, a natural gas producer, and a coal producer, despite being similarly sized in terms of market capitalization and operating in the general energy industry, should not be included in the same peer group. However, if the self-selected peer group contains any companies not in the specific sector, this may trigger ISS to consider companies outside the sector.

The majority of key executive/employee turnover occurs between companies competing in the same sector and industry. While L&A hopes to see this policy update put into effect for all industries, L&A notes that this change will help alleviate some of ISS' related headaches for companies that have dealt with unreasonable peer companies being included in their ISS peer groups in the past. Look for this policy update to encourage greater alignment of company and ISS peer groups this proxy season. If only ISS would extend this policy revision to its broader U.S. policy updates!

Key Takeaways

While L&A views these updates as offsetting — one in the wrong direction and the other in the right — L&A notes that it appears ISS is possibly starting to listen to the industry and its list of governance complaints.

Finally, we still think someone should check that ISS "game ball" for over inflation. L&A is attacking this by working with our clients by running BOTH revenue and market cap peers. In addition, we are performing regression analysis on both so that we can prepare proxies and CD&A's appropriately and share what compensation committees are dealing with. Presently, these changes only apply to the energy industry, but if we know ISS, all industries should begin preparation for future ISS changes similar to that of the energy industry.

If you have any questions about this article, ISS policies in general, or interest in discussing how L&A can assist you in navigating today's corporate governance environment, please feel free to contact us.

EVOLVING HR'S ROLE IN THE BOARDROOM

By Brent Longnecker and Ian Keas

It wasn't long ago where a quick Google search or a published survey would produce less than glamorous themes surrounding HR. Phrases like "strategic HR is self-contradictory," "HR is a necessary evil," - or worse - "a dark bureaucratic force that blindly enforces nonsensical rules, resists creativity, and impedes constructive change." Fast-forwarding to today's corporate environment, we here at Longnecker & Associates have noticed a significant and positive shift in the paradigm. Overriding HR themes are undergoing a change: "HR in the boardroom – advanced boardroom excellence," "Pioneering move to give HR a voice in the boardroom," and "Want the right talent? Get HR into the boardroom" continue to pop up. HR practice leaders are experiencing growth in their roles and influence in the boardroom. So how has HR, theoretically the key driver of business performance (see: key talent acquisition or compensation programs), turned in its scarlet letter for a seat at the strategic discussion table?

To understand this shift, one must first understand the HR function of recent past. Generally speaking, HR was stuck in a reactive state. Partly due to the influence of outside consultants, the actions of the HR department encompassed reviews of programs initiated through various catalysts: employee complaints, employee turnover, etc. Such events would result in HR developing talent recruitment initiatives or compensation and benefits program designs, often times going outside the organization to consultants for guidance and assistance. Once developed, HR would then be responsible for the communication and administration of its programs until the next issue presented itself. Such a process was often cumbersome and time consuming, leaving the HR function lagging other corporate functions in the company life cycle.

This lag was the other major hindrance impacting the HR function's ability to accomplish its strategic potential. A key component of success for HR is the ability to "cross pollinate" with the other corporate functions. Strategically partnering with Accounting, Finance, Legal, and Operations would assist HR in aligning its strategies and initiatives with those functions. Better alignment enables the various corporate functions to identify and share critical ideas and intellectual capital, while streamlining processes to eliminate inefficiencies throughout the company. Such goals cannot be accomplished if the HR function is in a perpetual state of "catch up".

Once a company has an understanding of the flaws within the HR of old, it can better identify the individuals, functions, and processes that characterize a *proactive* HR component of the business. Strategic HR leaders with the business acumen necessary to contribute to business strategy are leading this shift in HR from administrators to strategic advisors. By understanding the language of the business, relaying HR strategy in financial terms and expressing its value in relation to its impact on the bottom line, HR quickly becomes a compelling component in strategy discussions.

So what can a company implement to provide its HR department the framework transition from a reactive to proactive modus operandi? We propose a two-fold approach. The first aspect is to develop a line of communication that freely incorporates both the Board of Directors and the executive team, inclusive of the head of the HR function, in the discussions and developments surrounding company strategy and direction. As previously mentioned, the competition for top talent that can drive the achievement of long-term company goals is extremely tight. In today's corporate environment, a top HR executive employing a proactive approach will need the ability to communicate with the rest of the executive team and the Board as they work to understand and mitigate the complex issues around attraction, retention, and motivation of key executives, management development, and succession planning.

Secondly, in order for the company's head of HR to effectively develop and contribute to high-level discussions around company strategy and mission, they need to have the time necessary to contribute. An effective HR leader understands the business in order to make decisions that positively impact the company and are aligned with the company's corporate goals and objectives. To accomplish this, the HR function should devote its top employee to strategy development initiatives, while assigning department's second in command to take the lead on other operational responsibilities. Accomplishing these two tasks will free up HR leaders to add value to high-level discussions.

continued on next page

EVOLVING HR'S ROLE IN THE BOARDROOM (continued)

As HR roles continue to progress in their transition to a more strategic asset to the boardroom, companies need to be aware of what they can do to further solidify this process. Realizing the value qualified HR leaders bring to strategy discussions and identifying lines of communication between HR, other members of the management team, and the Board are paramount. Whether you attribute it to the heightened scrutiny on executive compensation, concerns over leadership development and succession planning, limited supply of key talent in the labor market, or the effect of increased corporate governance regulation, there is no denying that the HR role continues to evolve in the boardroom. While the switch from revenue to market cap goes against compensation principles, the second policy update is something that has been long overdue. As such, there may be some "selective hearing" going on. Companies will not be forced to consider other players outside of their respective energy sub-sectors, as those companies utilize different compensation practices to effectively attract, motivate, and retain top talent. Compensation best practices differ based on the industry and sector a company competes in. Hence that is why an oil-focused onshore E&P company, a midstream company with a Master Limited Partnership corporate structure, a mid-market oilfield services company, a natural gas producer, and a coal producer, despite being similarly sized in terms of market capitalization and operating in the general energy industry, should not be included in the same peer group. However, if the self-selected peer group contains any companies not in the specific sector, this may trigger ISS to consider companies outside the sector.

The majority of key executive/employee turnover occurs between companies competing in the same sector and industry. While L&A hopes to see this policy update put into effect for all industries, L&A notes that this change will help alleviate some of ISS' related headaches for companies that have dealt with unreasonable peer companies being included in their ISS peer groups in the past. Look for this policy update to encourage greater alignment of company and ISS peer groups this proxy season. If only ISS would extend this policy revision to its broader U.S. policy updates!

ISS ANNOUNCES PAY FOR PERFORMANCE AND PEER SUBMISSION UPDATES

By Brent Longnecker,Tyler Brown and Ian Keas

Institutional Shareholder Services (ISS) announced a number of important updates relating to its 2017 pay-for-performance evaluation for U.S. and Canadian companies. The headlines are:

- ISS will evaluate companies' performance relative to peers on six financial metrics, and present the results in a standardized table in all companies' proxy research reports. On a three-year basis, relative ROIC, ROA, ROE, revenue growth, EBITDA growth, and growth in cash flow from operations will be evaluated, along with TSR, with the weight on each metric varying by industry.
- ISS will use the relative financial metric results in its qualitative pay-for-performance analysis. For the 2017 proxy season, no changes are being made to the quantitative pay-for-performance tests, although ISS is leaving the door open for changes in 2018 and beyond.
- The ISS peer groups for Canadian companies will, for the first time, incorporate information from a company's self-determined peer group. ISS has used this information for U.S. companies in recent years, generally yielding closer overlap between a company's peer group and the ISS peer group.
- ISS' peer submission window for U.S. and Canadian companies will run from November 28 to December 9. For most of your issuer clients, this is their opportunity to have ISS consider changes to the company's self-selected compensation peer group in the ISS peer group construction process. Only companies that have made changes to their peer group for 2016 pay decisions need to participate.
- The existing Relative Degree of Alignment test will only apply to companies with two full fiscal years of TSR and pay data. This move reflects the spirit of this test, which is to measure the longterm alignment of a company's CEO pay and TSR performance relative to peers.

More details on these announcements will likely be forthcoming from ISS through its annual compensation FAQs and other publications.

WHAT YOU NEED TO KNOW ABOUT ISS' NEW RELATIVE FINANCIAL PERFORMANCE EVALUATION

Evaluating financial performance is not new for ISS; this update adds standardized relative analysis and presentation.

For many years, ISS has presented financial performance data in proxy research reports, and that data has been available to ISS analysts to use in their qualitative assessment of a company's pay-for-performance alignment. The evolutions that ISS are making this year include computing relative 3-year measures for each of the metrics, compared to the ISS selected peer group, comparing performance on these metrics with relative compensation levels, and presenting the results, including an overall weighted financial performance metric, in a new standardized table.

The weighted financial performance metric will measure relative financial performance against relative granted pay, and will generate a numeric result indicating the alignment between three-year financial metric performance and three-year granted pay.

Strong investors and issuer support led ISS to incorporate relative financial performance metric evaluation using six key financial indicators.

Investors and issuers responding to this summer's ISS policy survey voiced strong support for expanding the focus on performance beyond total shareholder returns. In response, in its proxy advisory reports for annual meetings on or after Feb. 1, 2017, of companies subject to ISS's quantitative pay-for-performance screens, ISS will display a company's three-year performance not only on TSR but also on six financial metrics relative to its ISS peer group, using data from S&P Compustat: return on equity; return on assets; return on invested capital; revenue growth; growth in earnings before interest, taxes, depreciation, and amortization; and growth in cash flow from operations.

continued on next page

Existing quantitative pay-for-performance tests will not be affected for 2017; relative financial performance used in qualitative evaluation only.

This new assessment will not be a component of ISS's quantitative pay-for-performance screening for 2017, and the calculation and scoring of the three existing tests in the quantitative screening — Relative Degree of Alignment, Multiple of Median, and Pay-TSR Alignment, are not impacted by this change. However, ISS may use the relative financial performance information in its qualitative assessment of a company's pay-for-performance alignment.

ISS Corporate Solutions' online modeling capabilities for the relative financial performance evaluation will be available by mid-December.

Online projections of the relative financial performance evaluation will be provided at no additional charge to companies with ExecComp subscriptions with ISS Corporate Solutions (ICS).

What does the relative financial performance evaluation mean for my compensation disclosure?

If CD&A's have not traditionally emphasized the company's financial performance, now may be the time to suggest considering it — not merely because of today's announcement from ISS, but because shareholders increasingly seek to understand at a high level how a company's compensation decisions relate to the company's recent financial and market performance, even before they dive into details of the company's incentive program design.

For subscribers to ICS ExecComp Suite or ExecComp Platinum, ICS includes a confidential reviews of drafts of the CD&A and executive compensation tables at no additional charge, to ensure that the company's compensation narrative is as clear and useful for shareholders as possible. Contact us if you have questions about this service.

WHAT YOU NEED TO KNOW ABOUT TODAY'S PEER GROUP ANNOUNCEMENTS

The peer group submission window is opening soon, using the ICS Governance Analytics platform.

Because ISS must construct its peer groups before most companies' 2017 proxy filings are available, U.S. and Canadian companies subject to ISS' quantitative pay-for-performance screens that will hold shareholder meetings between Feb. 1, 2017, and Sept. 15, 2017, are welcome to submit the peer groups used in setting compensation for the most recently completed fiscal year prior to their upcoming shareholder meeting. (For companies with calendar fiscal years, this means the 2016 peer group — not the 2017 peer group.)

The window for submitting these peer groups to ISS is November 28th through December 9th. This year, peer submissions will flow through ICS' Governance Analytics platform. Only representatives of the company may log into the Governance Analytics platform and complete the peer submission process; if any of your clients need an account, please have them reach out to us at contactus@isscorporatesolutions.com. We will make sure you and they receive additional information on the submission process as the opening of the window nears.

Canadian companies' peer groups will influence ISS peer group selection, and Canadian firms are eligible to participate in the peer submission window.

ISS conducts a pay-for-performance evaluation, including quantitative pay-for-performance screens that rely on comparisons to an ISS-constructed peer group, for companies in the S&P/TSX Composite index and all companies that put a voluntary say-on-pay proposal on the ballot. For AGM's at these companies on or after Feb. 1, 2017, ISS will incorporate a Canadian company's self-determined peer group into its process for constructing the company's ISS peer group.

When ISS began doing this for U.S. companies in 2013, the level of agreement between companies' own peer groups and their ISS-constructed peer groups increased substantially; this year, about 60% of U.S. companies saw at least half of their own peers in their ISS constructed peer group. Higher overlap should make some companies more comfortable with the ISS peer group construction process, although it has not had a material impact on the proportion of U.S. say-on-pay proposals that ISS supports.

continued on next page

WHAT YOU NEED TO KNOW ABOUT TODAY'S QUANTITATIVE PAY-FOR-PERFORMANCE SCREENING ANNOUNCEMENTS

The existing Relative Degree of Alignment test, and the new relative financial performance evaluation, will only apply for companies with two full fiscal years of trading data.

U.S. and Canadian companies subject to the ISS quantitative pay-for-performance screens have, up to now, been eligible to receive a score on the Relative Degree of Alignment test after one full fiscal year of trading as a public company. However, this test is designed to provide a lens into the long-term alignment of a company's CEO pay and TSR performance relative to its ISS peer group. Accordingly, effective for shareholder meetings on or after Feb. 1, 2017, ISS will require two full years of trading data and two years of CEO pay data before applying this test as part of its quantitative screening.

Similarly, the relative financial performance evaluation announced today will apply to companies with at least two full years of trading data and financial results as a public company.

Source: ISS Press Release 11-8-2016

A NEW DAY, A NEW DEFINITION

By Brent Longnecker and Chris Crawford

In the past decade, America's white-hot stock market provided tempting payouts and contributed to many high-profile headline-making excesses in executive compensation. The environment was such that, in spite of good intentions and accountability checkpoints, more board members, compensation committees, consultants and executives made decisions that have been called into question.

As history attests, mistakes are more easily overlooked when economic good times are on a roll. However, the stock market bust in 2000 served as a refiner's fire, revealing several distinct impurities in the compensation system. This spotlight on governance and executive compensation practices launched a corporate governance revolution that continues to unfurl.

One of the most important and conclusive revelations being reinforced is that Boards of Directors need to be held accountable for their actions — or inactions. Providing evidence of this are several important and recent legislative enactments, guidelines and rulings imposed by Congress, the New York Stock Exchange (NYSE), NASDAQ, Internal Revenue Service (IRS) and Delawere courts.

Research published in mid-2004 addresses the ineffectiveness of compensation committees. In the academic study "Board Compensation and Corporate Fraud," by the Association for Investment Management and Research (AIMR), researchers and authors Hatice Uzun, Samuel H. Szewczyk and Raj Varma draw this ironic conclusion:

"A troubled finding of our study is that, in general, the presence of compensation committee increased the likelihood of corporate fraud in the sample. The implication is that compensation committees have been ineffective in evaluating and properly rewarding the performance of top executives. They may also have designed compensation packages with dysfunctional incentives, as claimed by many critics. Whatever the reason for our findings, compensation committees deserve more attention from regulators, rule-making bodies (such as the NYSE and NASDAQ) and shareholders."

HOLDING BOARDS OF DIRECTORS ACCOUNTABLE

Congress

Signed in 2002, the Sarbanes-Oxley Act formalized personal liability on the Directors and corporate officers of publicly traded companies by forcing them to sign attestation forms as to the accuracy of the process and results of financial reporting. Violations may result in a personal fine up to five years in prison and/or $10 million in fines, which likely would not be covered by Directors and officers insurance.

NYSE and NASDAQ

These agencies redefined rules, such as what constitutes an outside Director, how an independent board should be comprised and how executive compensation should be determined.

IRS

The agency launched an unprecedented audit of 24 public companies on eight specific executive compensation and benefits components and has since extended its focus to include privately held companies. Also, nonqualified deferred compensation compliance has been targeted as the No.1 item for the IRS to review.

Delaware Courts

Most recently, the Delaware Court of Chancery made a decision that completely countered historical rulings that had not held Directors personally liable for breaching their fiduciary duty in making executive compensation decisions. The court ruled in The Walt Disney Co. Derivative Litigation, 825 A.2d 275 that "where a Director consciously ignores his or her duties to the corporation, thereby causing economic injury to its shareholders, the Director actions are either 'not in good faith' or 'involve intentional misconduct.'"

While it's difficult for the academics to explain the irony of the conclusions drawn from their empirical research, advisers sitting in the boardroom can shed some light; many compensation committee members admit to a lack of training in this increasingly complex yet critical function.

continued on next page

The compensation field and its related imputs, processes and results are becoming a battleground of liability. Suddenly, the potential exposure for board members is enormous. Never before has there been such a need for a "guide" to maneuver these new and more treacherous waters to help reduce the fear and liabilty for existing or prospective board directors. The idea guide truly is an independent and competent adviser.

The Changing Role of Independence

As the need increases for an independent opinion on reasonable and competitive practices, the definition of independence comes into question — and rightly so. This question goes to the core of selecting compensation consultants who can ultimately elevate the overall process within corporate America and the reputation and results surrounding executive pay.

Defining Independence

Historically, independent opinion in the compensation consulting industry has been loosely defined. The one-stop shop in which large HR consultancies and accounting/audit firms provided many of the independent reviews has been commonplace. It only seemed reasonable that, if a firm was adept at independently reviewing a company's financial statements, it should have no problem reviewing the reasonability of compensation provided to executives. However, there is a sizable hiccup in this natural extension of services because an acccounting audit can conflict.

The new definition of indepence is as much about having technical expertise as it is about rendering opinions and recommendations without a conflict of interest. In many consulting firms, the conflicts are numerous because of the number of other services the firm offers. For example, the more "revenue streams" a company can offer a consulting firm, the more likely it will be difficult to give an candid advice that might hamper other business opportunities. For this reason, executive compensation consultants with large firms often paid as "loss leaders" because they may represent an opportunity to introduce the other services. Any business opportunity that even tempts a consultant to water down advice could dilute independence.

Independence Checklist

Independence is being put to the test. The guidelines surrounding governance and executive compensation in today's environment apply equally to defining a truly independent consultant. The following fence posts provide an evaluation checklist whereby an ethical, independent consultant can be chosen to provide valuable answers and solutions to the often-complex world of executive compensation benefits. Specifically, as it relates to independence in this new day, a compensation committee should look for the following.

Get Opinions Without Conflicts of Interest

Many consultants provide other services outside of executive compensation and benefits that they either are waiting to introduce or are providing to compensation clients. While executive compensation consultants may stand their ground in the interest of ethics, there still is a temptation for good consultants to compromise their recommendations to protect larger service lines on behalf of the firm, For example, it is common for a large HR consultancy to have one partner providing a client's payroll services (e.g. $500,000 outsourcing revenue per year) and another partner representing the same client's executive compensation services (e.g. $50,000 consulting revenue per yer). If a sticky executive compensation issue comes up, there could be a strong temptation to cater to the executive rather than risk the loss of payroll business. While this conflict may not play out in the majority of such situations, it is important to recognize that by tempting good people to do the wrong thing, independence could be compromised.

Obtain Independence Attestations

If a company's Directors and key officers have to sign attestation forms, it should only follow that an independent consultant should sign an attestation form as to the independence of the process, findings and recommendations. (See "Sample Attestation Form.")

continued on next page

SAMPLE ATTESTATION FORM

This form must be completed at the end of every client engagement to attest that all individuals assigned to the project meet the requirements for consulting independence.

I ____________________ (Individual's Name), ____________________ (Job Title), of ____________________ (Firm Name), hereby attest that the work performed by my group for ____________________ (Client Name) was independent in nature from other work performed by my firm. I attest that the work product, process, procedures, conclusions and recommendations are the sole opinion and operational approach of my firm and at no time during the engagement was the group coerced by the client, board of directors, executives or others associated with the client maintaining consulting independence.

Signed: ____________________

Date: ____________________

Reviewed by Client on:

Date: ____________________

Signed: ____________________

Ensure an Independent Process

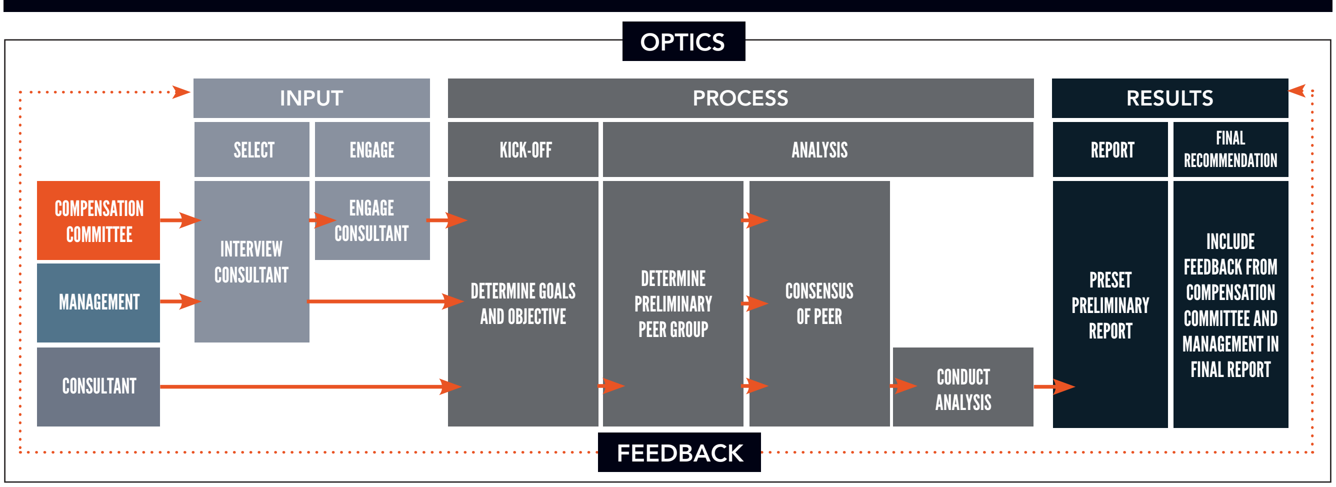
Governing bodies (e.g. IRS, Federal Bureau of Investigation) recently emphasized that process is as important as results. Figure 1, an adaptation from Frederick Taylor's management model, may provide compensation committees with the one type of process guideline. Companies should check reference as part of the process guideline. Companies should check references as part of the process in selecting an adviser. Consultants should be asked if they have returned fees due to poor process, and whether they are under a lawsuit for having a conflict of interest.

Avoid Dueling Consultants

Many companies are considering or already engage two consultants: one for the board and one for the executives. This begs the question, "Are two consultants better than one?" Consultants, in an effort to increase sales, may recommend hiring two consultants. But the ramifications could lead to each firm trying to represent its own interests, resulting in a series of negotiations and "opposing sides," as well as consulting fees that would be more than twices the normal rate. *One independent, one ethical compensation consultant will serve the best interests of the company, not the individual. But if management believes two consultants are necessary, it may prove wise — especially for shareholders — to detail the expectations of deliverables, process, reporting relationships, etc.*

continued on next page

FIGURE 1: PROCESS GUIDELINES



Provide a Direct Link to the Compensation Committee

While it is important that an independent consultant interview both management and the compensation committee to determine goals, objectives, company background, culture, etc., ultimately the consultant should be engaged by the comittee and report its findings accordingly. In fact, management and compensation committees for some of the leading companies across the United States are joining forces to conduct the search for the right consultant. This reinforces the point that independent adivse on executive compensation is important to both groups, and it's a good way to avoid division.

Transfer Knowledge

A truly independent consultant will not facilitate an addition to future consulting services. Independent consultants are more concerned with delivering reasonable compensation solutions while educating both board members and management along the way. Providing insight into the processes and framework is another safeguard for establishing appropriateness in a pay system designed to attract, retain and motivate key performers.

Conduct an Executive Session

While most preliminary findings and recommendations are made directly to the compensation committee in management's presence, often it is necessary for the committee to ask the consultant candid questions in an executive session. This also may allow the committee to be further educated.

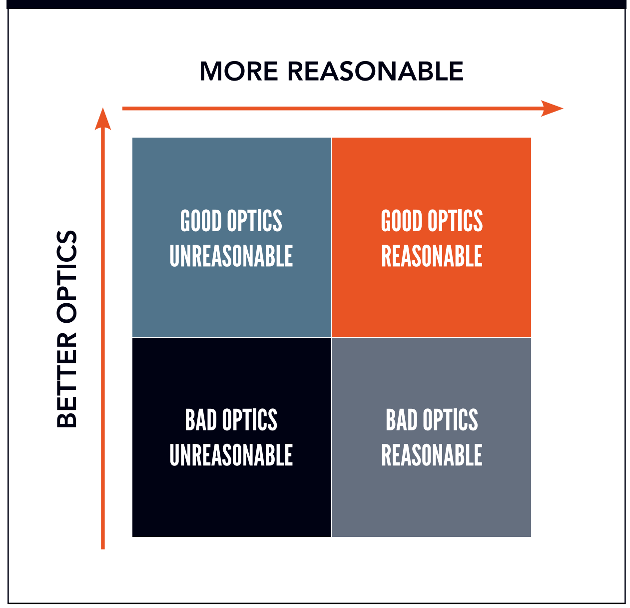
Provide Reports in Advance

Gone are the days when a consultant provided a report the day of a board meeting, then required a stamp of approval from the board. This approach is far from independent and runs counter to the educational approach necessary for raising critical questions.

Provide Expertise

Being technically adept is not only critical in the boardroom, but also in the courtroom. A true executive compensation expert knows the very nuances that force black or white into a gray area. Figure 2 is one way for compensation committees and their independent advisers to push out the gray in deciphering tough issues.

FIGURE 2: THE REASONABLE AND OPTICS QUADRANT TEST



A New Independence Day

When it comes to CEOs, as G. Richard Wagoner Jr., chairman and CEO of General Motors, recently said, "Everything is under a magnifying glass." Legislators and other key regulatory entities are nipping at the heels of executive pay, the national media has positioned corporate ethics in the crosshairs and even the academimc community is rendering an opinion. All of this has ushered in the need for a new type of "independence day" for executives and boards. Independent consulting facilitates competitive and reasonable compensation practices but more importantly, provides peace of mind by reducing the tremendous risk and liability that board members, executives and companies are facing as a whole. Truly independent opinions result from independent processes, the removal of bias, direct communication links and technical prowess in this increasingly specialized field. With personal liability issues intensifying more than ever, executives, shareholders, board members and compensation committee members need sound, independent advice worthy of their trust.

WHY CHOOSE LONGNECKER & ASSOCIATES?

EXPERIENCE

With 30 years and 20 years of experience respectively, principals Brent Longnecker and Chris Crawford serve the company in the following capacities: Board of Directors, executives, consultants, executive coaches, expert witnesses, teachers, authors and keynote speakers.

STRATEGIC THOUGHT LEADERS

Not all compensation consultancies are created equal. Through years of business experience at all levels, the L&A team has built a reputation as strategic thought leaders focused on providing customized recommendations that take into account clients' cultures, leadership and unique circumstances.

QUALITY

With our multi-layered, "Big 8" quality control process including partner-level reviews, our team at L&A ensures a level of accuracy unparalleled in the executive compensation consulting field.

INDEPENDENCE

We conduct an independent process by guaranteeing that all projects will be approved and directed by the necessary members of management. Our process displays sound governance and mitigates any perception of impropriety.

SUBJECT MATTER EXPERTS

L&A representatives have authored more than 14 books and more than 500 articles in the compensation and human resources fields.

INNOVATION

L&A has registered more than 14 trademarks on innovating compensation, benefit and corporate governance strategies, such as: Reasonable and Optics Quadrant Test™, LTI Decision Tree™, Valuation Data Analysis™, L&A Compensation Scorecard™, L&A Independence Process™ and more.

RELATIONSHIPS

L&A is a team-oriented, relationship-focused consultancy that removes the transactional nature of the typical client/consultant relationship. Rather than solely relying on market data to determine our tailored conclusions and recommendations, we focus on clients' needs by conducting personal interviews to understand corporate culture as well as individual goals and objectives.

EDUCATORS

Brent Longnecker, Chairman & CEO, and Chris Crawford, President, serve as faculty members for WorldatWork®, the world's leading professional association dedicated to knowledge leadership in total rewards, compensation, benefits and work-life balance. They are also responsible for building the compensation curriculum used to teach human resources and other professionals.

SIZE

L&A is one of the largest executive compensation consultancies in the U.S. in terms of consultants and number of clients.

BOARD MEMBERS

Brent Longnecker has served on the boards of a publicly traded REIT and energy company, and he currently sits on board for the Tri-Cities Chapter of the National Association of Corporate Directors, thereby positioning the L&A team to provide clients with a unique fiduciary perspective few other consultancies can offer. Chris Crawford serves on various private company boards.

LITIGATION EXPERIENCE

We understand the growing litigation land mines in executive compensation. We provide expert witness analysis and testimony to many of the most high-profile compensation lawsuits in the U.S. and have testified in more than 100 cases.

AWARDS/CERTIFICATIONS

The L&A team holds several key certificates of competence, including:

- Brent Longnecker named one of Top 25 Consultants in U.S. by *Consulting Magazine*
- Certified Executive Compensation Professional (CECP)
- Certified Compensation Professional (CCP)
- Certified Compensation Analyst (CCA)
- Compensation Committee Certification (CCC)
- Certified Benefits Professional (CBP)
- Global Remuneration Professional (GRP)

WALK THE TALK

In 2011, 2012, 2013, 2014, 2015, 2016 and 2017, Longnecker & Associates was selected by Texas Monthly as one of the "Best Small Companies to Work For in Texas." In 2011 and 2013, Longnecker & Associates took the #1 spot in that category.

LONGNECKER & ASSOCIATES
ALL IN.

Houston: 11011 Jones Road, Suite 200 | Houston, Texas 77070 | 281.378.1350 | **longnecker.com**
Dallas: 13155 Noel Road, Suite 900 | Dallas, Texas 75240
Denver: 1873 South Bellaire Street | Denver, Colorado 80222