

# Discussion Draft: Overview of Issues, Proposed Definitions, and a Conceptual Framework

The Conference Board Working Group on Alternative Pay Disclosure

A JOINT PROJECT WITH:



# Alternative Pay Disclosure Discussion Draft: Overview of Issues, Proposed Definitions, and a Conceptual Framework

by The Conference Board Working Group on Alternative Pay Disclosures

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FOR MORE INFORMATION ON THE WORKING GROUP OR TO PROVIDE COMMENTS, PLEASE CONTACT:

MARCEL BUCSESCU  
MANAGER, GOVERNANCE CENTER  
THE CONFERENCE BOARD  
212-339-0476  
[marcel.bucsescu@conference-board.org](mailto:marcel.bucsescu@conference-board.org)

# Overview of Issues, Proposed Definitions and a Conceptual Framework

## **Background and Executive Summary**

The Conference Board invited a group of experts in compensation and corporate governance to create a conceptual framework to encourage greater consistency in the disclosure of alternative measures of pay. The framework seeks to better enable investors to assess the linkages between (1) pay actually received and performance metrics (typically shown through a realized pay disclosure) and (2) pay and total shareholder return (typically shown through a realizable pay disclosure) and thereby facilitate more meaningful discussions with companies. The group also believes that promoting a consistent approach to the most commonly used measures of pay may be helpful to the SEC as it works to develop regulations implementing Section 953(a) of the Dodd-Frank Act, which requires disclosure of the relationship between pay actually received and financial performance.

## **Standardization vs. Flexibility in Alternative Pay Disclosures**

The working group believes that it is important to have a consistent, principles-based definition of pay with alternative pre-established variations that could be used by companies depending on their circumstances (e.g., in the case of an acquisition or merger, recruiting a new CEO, a corporate turnaround or operating under a reorganization plan). The group does not advocate a one-size-fits-all approach to telling the pay for performance story through use of an alternative pay disclosure. However, there is agreement that the disclosure of realizable pay should be consistent across companies using realizable pay, and the disclosure of realized pay should be consistent across companies using realized pay. By creating disclosures with comparable meanings across companies, investors will be better able to understand and compare the disclosures.

## **Alternative Pay Definitions**

Other than the SEC-mandated Summary Compensation Table, there is no standard method for valuing total CEO pay. There are generally three definitions of pay that are used in company disclosures: (1) the Summary Compensation Table definition of pay, (2) Realizable Pay, and (3) Realized Pay. Each of these definitions of pay serves a different purpose and provides different insights for investors.

*Summary Compensation Table.* The Summary Compensation Table definition of total pay is mandated by SEC rules and provides a measure of pay that is comparable across companies. However, this definition includes a mix of some elements that are actual pay, such as salary and annual incentives, and other elements that are accounting estimates of future potential pay, such as performance shares, restricted

stock and stock options. Further, annual fluctuations in the discount rate for pension calculations is not part of the pay decision by the compensation committee and may significantly distort the Summary Compensation Table measure of total pay. Thus, the Summary Compensation Table definition is not useful in assessing pay for performance or pay versus alignment with shareholders in the form of total shareholder return.

*Realizable Pay.* Realizable pay is used primarily to show the alignment between changes in executive compensation and changes in returns to shareholders over a period of time, typically three years. For this reason, the group believes that realizable pay may be best for showing the alignment of incentive compensation with shareholder interests over the period of time analyzed and comparing that alignment with peers.

*Realized Pay.* Realized pay is used to show the ultimate relationship between pay actually received at the end of the performance period and the specific performance metrics in the annual and long-term incentive plans that drove incentive payouts. The group discussed that realized pay may be more effective in assessing total pay actually realized by an executive compared to a particular company's performance.

#### **Executive Summary of Conceptual Framework<sup>1</sup>**

- 1. Performance Should Be Measured Using Total Shareholder Return and Other Financial Performance Metrics Designed to Drive Business Strategy.**
- 2. Realizable Pay Provides a Relative Comparison to Judge Alignment of Pay With Stock Price for the Company and Relative to its Peers; Realized Pay Provides an Absolute Comparison of Pay to Financial Performance.**
- 3. Disclosure Should Apply Over Multiple Years (e.g., Three Years, Five Years or Longer as Appropriate) to Explain the Pay for Performance and Pay for Alignment Stories.**
- 4. Disclosure Should Be Based on Information Available in the Proxy.**
- 5. Alternative Pay Disclosures Should Apply to the CEO Only.**
- 6. The Period Over Which Pay is Analyzed Should be the Same as the Performance Period for the Long-Term Incentives to Reinforce Consistency.**
- 7. Disclosure Should Be as Simple as Practicable to Facilitate Investor Understanding.**
- 8. Disclosure Should Be Consistently Applied Year Over Year.**

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<sup>1</sup> NOTE: The full Conceptual Framework begins on page 10.

9. **Assessment of Pay Versus Total Shareholder Return (Realizable Pay) or Pay Versus Performance Metrics (Realized Pay) Should Be Based Upon Salary, Bonus and/or Annual Incentive and Long-Term Incentives But Not Include Changes in Pension Values, Which Are Not Directly Tied to the Achievement of Performance Objectives.**
10. **One-Time Special Awards for New Hires Should Be Disclosed But Not Included in Pay for Performance Comparison.**
11. **Disclosure Should Employ a Flexible Approach Based on a Standardized Format.**

## **Issues Addressed in Methodology**

While the group believes it has made significant progress in identifying a workable and helpful conceptual framework to bring greater consistency and comparability to alternative pay disclosures, certain issues remain which may generate varying opinions. We attempt to address them in the pages that follow.

<b>Issue</b>	<b>Group's Approach</b>
<p><b><u>Realizable Pay</u></b></p> <ul style="list-style-type: none"> <li>• How to value outstanding performance-based long-term cash and equity awards to provide comparability (<i>i.e.</i>, at target, based on estimated performance or excluding outstanding awards altogether).</li> <li>• How to value stock options for the purpose of realizable pay.</li> </ul>	<ul style="list-style-type: none"> <li>• The group believes that valuing outstanding awards at target is the best approach.</li> <li>• Although disclosure of outstanding awards at target may result in a higher or lower number than what is actually realized by the executive, it is the method by which realizable pay disclosures will be most comparable across companies. It is also the clearest approach for outside stakeholders to understand.</li> <li>• Valuing stock options using their intrinsic value (<i>i.e.</i>, based on stock price at year end) gives shareholders a more complete assessment of their realizable value over the one- or three-year period being assessed and avoids the potential confusion associated with valuations based on a revised Black-Scholes estimate. The Working Group believes that accounting estimates for stock options should be limited to the Summary Compensation Table.</li> </ul>
<p><b><u>Realized Pay</u></b></p> <ul style="list-style-type: none"> <li>• Inclusion of stock options in realized pay at exercise (rather than vest), considering that the decision to exercise an option post-vesting is driven by the executive and may occur as long as ten years after grant.</li> </ul>	<ul style="list-style-type: none"> <li>• Although the decision to exercise options is often a voluntary one, the fact remains that the executive realizes no compensation until the option is exercised. Since realized pay is a measure of what the executive actually receives, options should not be included until exercised, at which point the gains may be compared to the corresponding return to shareholders over the period the options were outstanding.</li> <li>• Valuing stock options at the vesting date would add a lone hypothetical number to</li> </ul>

	the realized pay disclosure, which is inconsistent with pay actually received.
<p><b><u>Both Realizable and Realized Pay</u></b></p> <ul style="list-style-type: none"> <li>• Treatment of non-performance-related compensation such as: <ul style="list-style-type: none"> <li>• Signing bonuses or make-whole awards for new executives intended to make up for awards forfeited by leaving the previous employer, and</li> <li>• Annual variations in the present value of pension accruals.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• These items, while appropriately disclosed elsewhere in the proxy, should not be included in pay for performance disclosures because they are not tied to the achievement of performance objectives and are not comparable across companies.</li> <li>• In particular, pension accrual values are affected by external factors such as the discount rate, may vary significantly from year to year and are not within the control of company or executive.</li> </ul>

Our approach to these issues is discussed on the pages that follow. We look forward to continuing the discussion on these items, with the goal of facilitating the development of standardized methodologies and achieving greater comparability of alternative pay disclosures.

## **Proposed Alternative Pay Definitions**

The working group is proposing the following definitions of realizable pay and realized pay as the standard definitions for use in comparing individual company disclosures. For the purpose of these definitions, we would exclude deferred pay that is subject to a substantial risk of forfeiture in a manner that is consistent with the definitions of realizable and realized pay.<sup>2</sup> Sample realizable and realized pay disclosures can be found on pages 13 and 14, respectively.

### **Realizable Pay**

- *Actual Salary Received* (including deferrals into nonqualified deferred compensation or into company stock)
- *Actual Annual Incentive & Bonus Paid* (including deferrals into nonqualified deferred compensation or into company stock)
- *Actual Long-term Cash Incentive Granted and Paid/Targeted Payout of Awards Granted But Not Yet Paid* during the time analyzed (including deferrals of amounts actually paid into nonqualified deferred compensation or into company stock)
- *Equity Awards*
  - Performance-Based Equity Awards
    - Actual awards granted, vested and paid out during the period analyzed, valued using stock price at end of period
    - Target value of such awards granted but not vested and thus still outstanding during the period analyzed, valued using stock price at end of period
  - Restricted Stock
    - Value of shares awarded during the period analyzed, vested or unvested, valued using stock price at end of period
  - Stock Options
    - Options awarded during the performance period, vested or unvested, analyzed using “in the money” value (calculated as the positive spread between the exercise price and stock price at end of period)

**Total Realizable Pay** (to be used in the analysis of alignment with shareholders and comparisons with peer group companies)

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<sup>2</sup> Payments subject to forfeiture due to “bad acts” under non-compete or clawback provisions will be included in realizable and realized pay definitions. Other payments subject to a substantial risk of forfeiture, such as those under a malus plan that could be lowered due to risk-adjusted results, will not be included in realizable or realized pay definitions.



### Other Compensation (with an explanation of each line item)

- Special awards not linked to company/executive performance (e.g., sign-on cash bonuses)
- Actuarial increase in present value of pension (as reported in the Summary Compensation Table)
- Other Compensation (as reported in the Summary Compensation Table)

### Total Other Compensation

### Advantages of Realizable Pay

- Shows alignment between the total value of outstanding executive compensation awards and stock price at a point in time
- The comparison of realizable pay and TSR of a particular company to the realizable pay and TSR of its peers may be a useful counterpoint to the ISS Relative Degree of Alignment test since it is a more accurate approach than using the Summary Compensation Table measure of pay in assessing whether pay is aligned with shareholder returns.
  - The ISS Relative Degree of Alignment test distorts the pay vs. TSR linkage by comparing the grant date fair value of awards, which are usually made early in the year, to TSR as of the end of the year. Realizable pay, by contrast, provides a greater consistency of the valuation of the awards and the measurement of alignment by comparing the value of outstanding compensation awarded during a period that could be realized based on the stock price at the end of the period to the company's TSR at the end of that same period.

### Limitations of Realizable Pay

- Realizable pay is a point in time measure and may significantly differ from the actual pay received and thereby understate or overstate the pay for performance relationship.

## Realized Pay

- *Actual Salary Received* (including deferrals into nonqualified deferred compensation or into company stock)
- *Actual Annual Incentive & Bonus Paid* (including deferrals into nonqualified deferred compensation or into company stock)
- *Actual Long-term Cash Incentive Paid* (including deferrals into nonqualified deferred compensation or into company stock)
- *Equity Awards*
  - Performance-Based Equity Awards
    - Valued at payout if paid out during period analyzed
  - Restricted Stock
    - Valued at vesting date if vested during period analyzed
  - Stock Options
    - Valued at gain upon exercise, regardless of when granted, if exercised during period analyzed
    - It would be most helpful if the disclosure describes the period over which the options were outstanding and the corresponding return to shareholders over this period

## Total Realized Compensation

## Other Compensation (with an explanation of each line item)

- Special awards not linked to company/executive performance (e.g., sign-on cash bonuses)
- Other Compensation (as reported in the Summary Compensation Table)

## Total Other Compensation

### Advantages of Realized Pay

- Allows a comparison of how the actual pay received compares to the intended level of pay.
- Enables the compensation committee to monitor the robustness of the pay for performance relationship (e.g., through a look-back analysis) by comparing the degree to which performance objectives were achieved to the pay actually received by the executive.
- Realized pay would appear to be consistent with a literal reading of the language of Section 953(a) of the Dodd-Frank Act which requires disclosure of “compensation actually paid.”

### Limitations of Realized Pay

- The major limitation of realized pay is that the executive has control over when to exercise a stock option once vesting requirements have been satisfied, requiring a more detailed description of the linkage of gains from option exercises and the change in shareholder return over the period the option was outstanding. However, until a stock option is exercised, an executive does not realize pay from this type of award.
- Some executives may wait to exercise a stock option until after they retire and in some cases restricted stock may not vest until after retirement, and such gains would not be reported in the realized pay disclosure.

## **Conceptual Framework for Disclosure of Alternative Forms of Pay**

### **1. Performance Should Be Measured Using Total Shareholder Return and Other Financial Performance Metrics Designed to Drive Business Strategy.**

Compensation committees should incorporate performance objectives into their annual and long-term incentive plans that best reinforce company business and talent strategies. Investors primarily use total shareholder return (TSR) to judge company performance. For this reason, total return to shareholders should be a primary focus of the disclosure of the alignment of pay and the interests of shareholders under both realizable and realized pay disclosures. However, it is not recommended that TSR be the sole metric. Companies should demonstrate that the operating metrics used in their incentive plan are consistent with long-term increases in shareholder value and with the company's business strategy. In addition to or in lieu of TSR, realized pay disclosures should compare pay to the performance metrics established by the compensation committee. These often include measures of financial performance that executives can more readily impact, that are supportive of the company's business strategy and that are reflective of the pay for performance linkage intended under the compensation awards granted by the committee. Inclusion of financial measures of performance, in addition to or in lieu of TSR, is also consistent with the language of Section 953(a) of the Dodd-Frank Act which requires a disclosure of "... the relationship between executive compensation actually paid and the financial performance of the issuer."

**2. Realizable Pay Provides a Relative Comparison to Judge Alignment of Pay With Stock Price for the Company and Relative to its Peers; Realized Pay Provides an Absolute Comparison of Pay to Financial Performance.** Realized pay disclosures should focus on the company only and compare the magnitude of realized pay to the performance results achieved by the company under the metrics specified by the annual and long-term incentive plans. Comparison of a company's realizable pay to that of peer group companies using identical definitions of realizable pay may provide additional insight to investors regarding the company's alignment of pay and performance as compared to peers. Due to the lag in the timing of disclosures of pay, relative comparisons may be best accomplished by comparing pay and TSR for years prior to the current year. This will be possible on a greater scale as disclosures become more consistent and will reinforce to shareholders that the compensation committee is conducting comparative analysis using an alternative pay approach.

**3. Disclosure Should Apply Over Multiple Years (e.g., Three Years, Five Years or Longer if Appropriate) to Explain the Pay for Performance and Pay for Alignment Stories.** The longer the time period involved, the greater the insights that are available to investors as to whether pay and performance are aligned with investor interests. A longer time period may also reduce the distinctions between realizable and realized pay. In general, at a minimum, a three-year period should be used in the pay for performance analysis, but the time frame should be consistent with the company's investment and business cycles, so for some industries the time frame may be shorter and for others the time frame may be longer. The comparison should consist of realizable pay calculated over the selected performance period compared to TSR over that period, or total realized pay for three one-year periods compared to company performance for those periods.

#### **4. Disclosure Should Be Based on Information Available in the Proxy.**

Investors should be able to recreate the company's calculations in the alternative pay disclosure through the use of information disclosed in the proxy. Creating a standard that involves proxy-available information will limit confusion, enhance credibility of the disclosure and facilitate flexibility within a standard format. To this end, however, companies should report their TSR in the proxy (and the SEC may want to consider requiring such disclosure as part of its rulemaking under Section 953(a) of Dodd-Frank). When equity awards vest shortly after the period covered by the disclosure, the company should have the flexibility to include such awards to more fully describe the intended pay for performance linkage. In addition, companies should specify the vesting date and stock price used in their calculations of equity awards in the stock options exercised and restricted stock vested table.

**5. Alternative Pay Disclosures Should Apply to the CEO Only.** Investors are primarily concerned about the CEO. Therefore, it is recommended that the pay for performance disclosure mandated by the SEC under Dodd-Frank, and the standard approach for voluntarily adopted alternative disclosures, should apply to the CEO only and not the other named executive officers. If companies feel strongly about going beyond the CEO, they may add this additional disclosure, but any pay for performance analysis required by the SEC should apply only to the CEO.

#### **6. The Period Over Which Pay Is Analyzed Should be the Same as the Performance Period for the Long-Term Incentives to Reinforce Consistency.**

Aligning the pay period with the performance period reinforces consistency and makes the disclosure more meaningful. For example, pay realized from a long-term cash award with a performance period of five years should be compared to company performance over five years, rather than three years. Any special award (*i.e.*, one that would not be part of the normal compensation arrangement) should be clearly disclosed and explained, but only supplemental awards related to performance or alignment over a term of years should be included in a realizable or realized pay disclosure. Examples of such awards include sign-on bonuses, which are generally intended to facilitate the hiring of a new executive. Pensions and other compensation typically not directly related to performance, as discussed in number 10 below, should not be included in the pay for performance calculus.

**7. Disclosure Should Be as Simple as Practicable to Facilitate Investor Understanding.** Alternative disclosures that are easily understood will be more useful to investors and do a better job of communicating the intended information. Simple explanations or easy to understand tables or graphs that explain the key assumptions used are preferable. Complex definitions or tables require readers to expend too much effort in deciphering the information (or ignore it altogether), and may lead to confusion or detract from the understanding of the pay for performance linkage.

**8. Disclosure Should Be Applied Consistently Year Over Year.** To the greatest extent possible, investors should be able to compare the alternative disclosures over the three years (or other measurement period) disclosed in order to determine trends in pay for performance. Companies should strive to establish a consistent approach to the pay for performance disclosure that allows comparability within a company year over year. It is understood that there will be circumstances

under which the disclosures may evolve due to changes in pay structures or additional explanation will be required due to changes in senior executives, but consistency from year to year should be the norm.

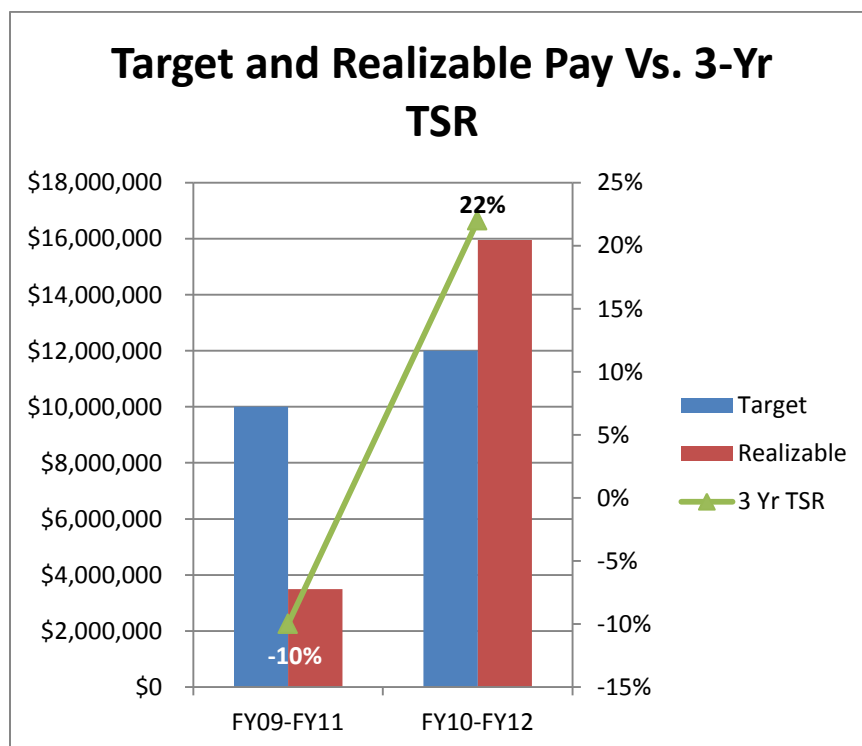
**9. Assessment of Pay Versus Total Shareholder Return (Realizable Pay) or Pay Versus Performance Metrics (Realized Pay) Should Be Based Upon Salary, Bonus and/or Annual Incentive and Long-Term Incentives But Not Include Changes in Pension Values, Which Are Not Directly Tied to the Achievement of Performance Objectives.** For the specific purpose of comparing pay for performance and pay for alignment, the analysis should use salary, bonus, annual incentive and long-term incentives. The alternative pay disclosure should not include special awards (see number 10 below) or calculations of the annual change in the present value of annual accruals of pension benefits since such awards are not directly tied to the achievement of performance objectives. Including the change in pension value is particularly problematic because many companies have frozen their defined benefit plans, including those for executives, and a decrease in the discount rate may require companies to report a large number, even though the ultimate value of the benefit the executive will receive is capped.

**10. One-Time Special Awards for New Hires Should Be Disclosed But Not Included in Pay for Performance Comparison.** Special awards in the form of one-time signing bonuses or inducement awards upon joining the organization are not directly tied to the achievement of performance objectives. Although they should be fully disclosed in the proxy, they should not form part of the pay for performance analysis. By contrast, the alternative pay disclosure should include special awards such as inducement grants that include cash or equity awards tied to financial performance or stock price appreciation that vest over a period of years. Other supplemental awards not tied to performance objectives should be included in a disclosure that is adjacent to but separate from the pay for performance analysis. These elements should not be included as part of the standardized definitions of realizable or realized pay.

**11. Disclosure Should Employ a Flexible Approach Based on a Standardized Format.** The company's disclosure should seek to follow a standardized format, recognizing that individual company circumstances will require flexibility, and some companies will require more flexibility than others. While additional disclosures may be necessary to explain unique circumstances or assumptions, it is expected that all companies will disclose the typical elements of their pay programs in as standardized a format as possible. For example, this includes using standardized definitions wherever possible and disclosing the elements of pay in the same order.

## Sample Realizable Pay Disclosure

Compensation Component	Period Earned	Amount Earned
Base Salary	FY10-12	\$3,000,000
Annual Incentive (evenly split between achievement of sales, profit and ROIC metrics)	FY10-12	\$4,500,000
Value of FY10 Performance Share Award (based on percentile ranking of TSR relative to peers, valued as of 12/31/12 stock price)	FY12	\$2,500,000
Target Value of FY11 and FY12 Performance Share Awards (as of 12/31/12 stock price)	Outstanding (may be earned in FY13 and FY14 respectively)	\$4,000,000
"In the Money" Value of FY10-12 Stock Options (as of 12/31/12 stock price)	Outstanding (each option grant has a ten year term)	\$1,500,000
<b>Total Realizable Compensation</b>		<b>\$15,500,000</b>
Cash Perquisites (All Other Compensation)	FY10-12	\$450,000
<b>Total Other Compensation</b>		<b>\$450,000</b>



## Sample Realized Pay Disclosure

Compensation Component	Period Earned	Amount Earned	Performance Results
<b>Plan Triggered Payout</b>			
Base Salary	FY12	\$1,000,000	We generally target the market median when establishing base salaries. The CEO did not receive a merit increase for FY12.
Annual Incentive	FY12	\$1,305,000	While sales performance was strong (10% growth vs. target of 8.5%) the company did not achieve its targeted level of profit growth (\$1.4MM vs. target of \$1.6MM) and fell short of the targeted rate of ROIC (14.2% vs. 15.0%). Performance on other nonfinancial objectives was as planned. Sales growth is weighted 40%, profit 40% and ROIC 20%. The performance on other objectives can increase or decrease incentive awards by +/- 25%. The weighted performance produced a payout of 87% of the targeted award, as compared to a payout of 100% in 2011. The targeted annual incentive award for Mr. Jones is 150% of salary, \$1,500,000.
2010-2012 Performance Share Payout	FY10-12	\$2,500,000	The total 2010-12 Performance Share Plan award was \$2,500,000, representing 125% of the targeted award of \$2,000,000. The payout can range from 0% to 200% of targeted award based upon the company's ranking on total return to shareholders (TSR) vs. peer group companies over the 3-year performance period of the award. The 3-year TSR for the company over the period 2010-12 was 7.3% vs. a median TSR of 4.7% among the peer group companies. This level of performance ranked 3rd among the 12 peer group companies producing a payout of 125% of target.
<b>Total Plan</b>		<b>\$4,805,000</b>	
<b>Executive Triggered Exercise</b>			
Stock Option Exercises	FY03-12	\$2,012,500	The gains upon exercise of stock options in 2012 were \$2,012,500, based upon stock price appreciation over the 9 year period the options were outstanding from 2003 to 2012 - this reflects an annualized gain of \$223,611. During this time company shareholders realized an annual compounded rate of return of 11.5% vs. the S&P 500 annual return of 6.7%. During that time, the stock price appreciated from \$8.50 when the options were awarded in 2003 to \$20 at date of exercise on August 11, 2012.
<b>Total Executive</b>		<b>\$2,012,500</b>	
<b>Subtotal Realized Compensation</b>		<b>\$6,817,500</b>	
Restricted Stock Vested	FY09-12	\$2,000,000	A special award of restricted stock was made to the CEO in FY09 in relation to the acquisition of a new business. The Company does not intend to repeat this award, which cliff-vested in 2012 after four years.
<b>Total Realized Compensation</b>		<b>\$8,817,500</b>	
All Other Compensation	FY12	\$150,000	This amount represents the value of cash perquisites and costs related to personal use of Company's aircraft for the CEO.
<b>Total Other Compensation</b>		<b>\$150,000</b>	



## **Working Group Members**

**James D. C. Barrall**

Partner, Latham & Watkins LLP

**Timothy J. Bartl**

President, Center On Executive Compensation

**Kenneth A. Bertsch**

Chief Executive Officer, The Society of Corporate Secretaries & Governance Professionals

**Marcel Bucsescu**

Manager, Governance Center, The Conference Board

**Donna C. Dabney**

Executive Director, Governance Center, The Conference Board

**Lisa L. Hunter**

Program Director, The Conference Board

**Ira T. Kay**

Managing Partner, Pay Governance LLC

**Arthur H. Kohn**

Partner, Cleary Gottlieb Steen & Hamilton LLP

**Robert B. Lamm**

Senior Fellow, The Conference Board

**Charles M. Nathan**

Partner & Senior Advisor, RLM Finsbury

**Darla C. Stuckey**

Senior Vice President, Policy & Advocacy, The Society of Corporate Secretaries & Governance Professionals

**Charles G. Tharp**

Chief Executive Officer, Center On Executive Compensation

