CALSTRS
HOW WILL YOU SPEND YOUR FUTURE?
CALIFORNIA STATE TEACHERS' RETIREMENT SYSTEM

# CalSTRS Executive Compensation Model Policy Guidelines

CalSTRS believes companies should formulate comprehensive executive compensation policies and obtain an advisory vote of shareholders regarding the policy on a periodic basis.

The executive compensation policy should provide the overarching guidelines for how the company will structure and implement its executive compensation program. It should be written in plain English, avoid relying on boilerplate language, and be detailed enough that owners can understand the company's executive compensation philosophy, and how the program will be constructed and implemented going forward. The policy should also provide adequate flexibility for the company to implement its executive compensation program consistent with the company's evolving situation, opportunities, and challenges.

CalSTRS believes there are several important advantages to preparing a formal executive compensation policy and obtaining the shareowners' advisory vote, including:

- It articulates and reinforces a comprehensive long-term view of the executive compensation program;
- It provides a baseline for evaluating the effectiveness of executive compensation programs over time;
- It provides a comprehensive checklist of topics compensation committees should consider as part of their oversight role;
- It provides owners with appropriate input with respect to the policies under which companies will implement and operate executive compensation programs;
- It will greatly assist companies in meeting the spirit as well as the letter of SEC disclosure rules; and
- It will enhance efficiency, provide consistency, and may reduce the instances in which the company and shareowners are surprised by outcomes related to the compensation program, thereby reducing the negative reaction in the marketplace to specific events.

CalSTRS provides this Model Executive Compensation Policy Guideline to help communicate to companies shareowners' minimum expectations for the policy. The Guidelines provide the key elements of an executive compensation policy, as well as the goals and objectives companies should consider in developing the policies. CalSTRS believes the policy document should serve as one of a company's primary communication tools regarding its executive compensation programs and should encompass all forms of compensation.

CalSTRS believes executive compensation policies should contain the following components, at a minimum: Compensation Committee; total compensation, plan elements and mix; incentive and bonus compensation; equity compensation; dilution; repricing; contractual arrangements; post-employment benefits; and tax and accounting matters.

## Compensation Committee

The compensation committee is ultimately responsible for designing, implementing, monitoring and evaluating the executive compensation program. Accordingly, the policy should provide an overview of the committee's role and process in fulfilling this responsibility. The policy should specifically reference the committee's charter including how the charter is intended to support the policy and the committee's objectives.

This section should include the following specific points:

- The role and responsibilities of the compensation committee, including its authority and interaction with the full board, consultants and management in regard to designing, implementing, monitoring and evaluating the executive compensation program. This should provide specific detail on how the committee will monitor and evaluate the effectiveness of the program over time, and disclose to shareholders the results of this analysis on a periodic basis.
- The committee's policy and procedure for ensuring the company has current succession planning in place.
- How the committee makeup is established, including the process for appointments and how the committee will evaluate its effectiveness. This should include how both director self-evaluation and committee evaluation is used in the nomination and re-nomination process, whether the committee will periodically rotate its membership, and how the committee maintains the appropriate skill sets, perspective and independence. CalSTRS believes the Compensation Committee should be chaired by an independent and objective board member. The policy should specifically endorse this concept, include the definition of independence applied and provide a summary of the board's selection process for the Committee Chair, including any specified periods for rotation of this responsibility.
- How the committee will ensure that it receives all complete and relevant information needed to support its role and responsibilities. This should include the committee's policy regarding the use of outside advice and the independence of all advisors (such as compensation consultants). The committee should define how it evaluates and addresses potential conflicts between the interests of both individual consultants and their firms and the interests of the company. Any potential role that management may play in executive compensation, such as the CEO's role in recommending program design or evaluating subordinates should be explained. For example, the degree to which the committee may rely upon management recommendations in identifying specific performance metrics that may be included in the compensation should be explained.
- How the committee will provide for continuing education of its members related to compensation issues.
- How the committee will ensure the effectiveness, objectivity and independence of its contract negotiations, including who will be responsible for this role, and if the committee will use any outside resources to facilitate negotiations.
- The company's policy on communication with shareowners, particularly related to compensation issues, and how the committee ensures that it maintains input from owners. This should include the role of an advisory vote on executive compensation policies as one means of facilitating communication with owners.
- The committee's policy on meetings, including the frequency with which the committee may meet and the circumstances in which the committee may act by written consent. In cases the committee may act by consent, which CalSTRS believes should be extremely limited, the policy should specify how the committee will ensure full discussion and review of pertinent information.

## Total Compensation, Plan Elements and Mix

The policy should include the company's philosophy regarding total compensation and the relative mix of base, bonus, and long-term incentive compensation.

This section should include the following specific points:

- The company's policy regarding overall compensation targets and how the committee will determine these levels and monitor against the plan. This should include targets related to total compensation as well as key elements of the plan.
- Specific attention should be applied to identifying and discussing relative strengths and weaknesses of the various forms of compensation in relation to the company's business objectives and situation.
- The company's rationale for the desired approach (compensation mix) including differences in the relative mix of compensation between various levels of executive management.
- How the committee will conduct total compensation analysis (such as the use of tally sheets for example), and any other tools that may be employed in plan design and evaluation to ensure the program is fair and effective (such as the concept of internal pay equity versus a highly competitive "star performer" internal pay structure for example).
- The degree to which the company may utilize peer relative analysis or benchmarking, and how the committee will ensure these factors do not dominate the justification for plan design or compensation levels. This should also include the company's procedure for selecting peer groups, the rationale for the methodology used, and its process for disclosing actual peer group members to owners (within proxy disclosures for example).

## Incentive and Bonus Compensation

The policy should contain the company's intended forms of incentive and bonus compensation, including what types of measures will be used to drive incentive compensation and the role of risk in the compensation program.

This section should include the following specific points:

- The company's philosophy for the major components of incentive compensation (e.g. annual vs. long-term, etc.), including the strengths and weaknesses of each in general and in relation to the company's strategy and situation.
- Circumstances, if any, under which the company would provide for any type of guaranteed bonus, including
  - » The frequency with which shareholders may expect this practice
  - » The rationale within the context of total compensation and its impact on the performance-based nature of the specific plan
  - » The impact of this practice on the culture of the firm
  - » Disclosure(s) the company will provide in each event.
- The types of metrics that may be used in short-term, intermediate-term, and long-term components of the program, including the rationale for the differences in the term structure of the program. This should include the company's policy on using peer relative versus company specific measures and how the program will balance between the two. The policy should consider the role of long-term total stock return, specifically given its obvious relation to the perspective of owners.
- If the company intends to use any adjusted performance measures (non-GAAP or not conforming to accepted accounting principles), the policy should contain the following, at a minimum:
  - » A detailed rationale for the use of adjusted performance measures. This should be directed at the program level, and discuss the pros and cons of this practice, and include the role of the committee in approving the proposed adjustments and monitoring the impacts of this program.
  - » A line-item reconciliation for each metric to GAAP or IFRS clearly demonstrating the magnitude of the adjustment for each measure. In cases where benchmark comparisons may be made to similarly adjusted measures, this should be

clearly disclosed, but reconciliation should still be provided to compare against a recognized accounting standard.

- The role of risk in the context of the executive compensation program, which should include both a defensive perspective (how the committee ensures potential compensation does not incentivize excessive risk), and an offensive perspective (how the program is designed to incentivize appropriate risk and aligns the interests of management with those of long-term owners).
- For all forms of incentive compensation, the policy should address how the committee will mitigate or eliminate the potential for unintended drivers or consequences. This should include a discussion of how incentive plans can be initially structured and continually monitored to mitigate unintended drivers. The policy should discuss the company's standards for recapturing unearned incentive compensation (clawback or disgorgement policies, for example). As a related topic, the policy should discuss how the company will minimize the potential for manipulation of performance related metrics and monitor performance programs for fraud (internal risk controls for example).
  - » CalSTRS suggests a three-phase approach to addressing the issue of unintended drivers or consequences related to incentive compensation.

    *(Phase 1)* The policy should intentionally address these issues in plan design and implementation, considering such factors as the relationship between short-term and long-term performance measures and the differing accounting measures (and the potential links to drive behavior) that are key in each of the performance metrics used. CalSTRS believes that eliminating duplication of drivers between short-term and long-term plans, and using diverse performance drivers with some offsetting characteristics, is one method of addressing these issues in plan design.

    *(Phase 2)* The policy should address the role of the committee and internal controls in regards to plan oversight and specifically, to monitoring the integrity and effectiveness of performance metrics. This should have a qualitative aspect (monitoring for effectiveness and link to ultimate performance) as well as a quantitative (monitoring for abuse).

    *(Phase 3)* The policy should provide significant flexibility for the company to recoup incentive compensation in circumstances where it is later determined to have been unearned. CalSTRS believes these polices should extend beyond the basic protections in law, and should include circumstances beyond intentional misconduct.
- How the company will achieve a consistent approach to incentive plan measurement. The policy should specifically address disclosure of formulae and methodologies associated with performance metrics and targets and how the company will provide adequate information for investors to assess the quality of the performance plan.
- For all forms of incentive programs, the policy should address how the company will amend incentive plans during their terms, if at all, including the need for shareowner approval of plan amendments. This should include justification for the policy position, the basic process the company would use to consider such amendments, and how the company will disclose such amendments, including justification for the individual amendment(s) at the time they are made. The policy should also address time periods within incentive plans in which amendments may be allowed (permitting amendments only in the first quarter of a one-year plan for example), and if there are caps on the overall portion of the incentive plan that may be affected or the elements of the plan that may be amended (permitting amendments only to the threshold but not the types of metrics for example).
- How the committee will scale incentive awards to be consistent with the compensation philosophy and the company's performance objectives. For example, will

the committee use sliding scales to set performance awards versus cliff hurdles, and what level of award would be set for median performance?

- The company's policy on providing incentive pay related to transactions or other corporate events. This should include a definition of what constitutes long-term and short-term incentive-related activities, and what is a routine part of the job. For example, would the policy permit debt reduction targets to be included in an incentive program, or would this be considered a routine part of an executive's duties?
- The company's policy on any non-financial metrics that may be used in an incentive program. This should include the rationale for utilizing non-financial metrics, their target weight in the overall plan (or how the committee will make those determinations during plan construction), and how the committee will ensure accuracy in measurement of non-financial metrics. For example, this may include the committee's commitment to use quantifiable measurement methodologies to the greatest degree possible, or using a proxy to capture the desired goal if possible. To illustrate, if a company wishes to incentivize customer satisfaction, it may commit to use quantifiable and consistent survey methodologies to capture the desired goal, and it may use easily identifiable metrics, such as retention and complaints, to help proxy customer satisfaction. The degree to which any non-financial metrics may be measured by subjective evaluation should be clearly explained. The policy should include how any non-financial metrics are considered related to ultimate performance issues and how any unintended incentives related to the non-financial metrics will be mitigated.

## Equity Compensation

The policy should discuss the company's philosophy regarding equity compensation, including the company's objectives in utilizing these tools, the relative strengths and weaknesses of each type of equity in relation to the company's business objectives and situation, and the role of ownership and retention guidelines.

This section should include the following specific points:

- For each form of equity and equity-like compensation, the policy should address the company's overall objectives in using these tools. Following on this point, the policy should address the efficiency with which these tools can accomplish these objectives, and provide careful consideration of alternative approaches. For example, the policy should examine the relative advantages of equity ownership obtained through outright purchases versus options, restricted shares, and equity-like grants under the compensation program. This section should specifically address the committee's philosophy of performance as it relates to equity tools.
- In cases where a company may use various forms of equity, the policy should address the relative values of each in the context of the compensation program, including how the company would determine a ratio of "value" between various equity tools. For example, if a company intends to shift emphasis in the equity component of its compensation program from options to restricted stock, would it use a ratio (1 to 4 for example) in determining the grants and, if so, how would the ratio be determined?
- The committee's philosophy regarding award structure, including the size, timing, valuation, and terms of grants. This should include whether the company would use any forms of "mega-grants" and, if so, how they fit into the long-term objectives of the program. In regards to valuation, the policy should discuss the company's approach establishing the intended value of awards, including the expectation for performance vesting, the performance levels that should be achieved to obtain specific levels of "value" in awards, and the approach to establishing grant size (specified value target or specified share amount, for example).

The policy should also include the company's methodology for grant date pricing. If the company intends to time equity grants in any way to take advantage of pending news or other information, the policy should fully explain the rationale for this approach and provide the company's process for disclosure of actions related to grant timing.

- The role of dividends, dividend equivalent rights, or other cash flow and corporate actions in relation to the equity component of the program.
- The means by which participants will be permitted to monetize equity and equity related grants, and the potential impact on the goals of the compensation program.
- The company's approach to ownership and retention guidelines, including the objectives, ownership levels targeted over specific time frames, periods in which retention would apply (including post retirement), and how it will be monitored and enforced. As a long-term investor, CalSTRS is particularly interested in the role of equity ownership in the overall context of the compensation plan. The policy should address the expected value of the alignment from equity ownership, most specifically in relation to long-term investors, and how the role of equity may evolve over time. For example, are there levels at which the value of equity in the compensation plan reaches a saturation point and the incremental alignment and motivation is mitigated?

## Dilution

The policy should contain the company's philosophy regarding the dilution of existing owners. This section should include:

- A comprehensive plan covering dilution associated with all equity compensation programs, addressing the intended life of individual programs/plans including optimal yearly and long-term run rates. The dilution plan should provide the rationale for projected run rates, and how the company will evaluate the effectiveness of the plan over time. This should include a detailed analysis of intended dilution from a return-on-investment perspective, supporting an optimal run rate and equity plan based on its contribution to long-term performance and other objectives as may be appropriate. Simple peer group analysis to support a targeted run rate is not adequate.
- The plan should contain a detailed description of how the company will treat equity grants that expire or are not earned through vesting requirements, including if these awards would be returned to the pool of "eligible" equity under the plan.
- If the company's plan(s) permits repricing of any kind (assuming with shareowner approval), the company's policy regarding dilution should take repricing into account.
- If the company plans to repurchase equity through share buyback programs to reduce dilution from equity compensation plans, the policy should clearly articulate how the repurchase decision is made in relation to other capital allocation decisions.

## Repricing

Repricing represents a potential fundamental shift in the relationship between long-term performance and compensation. In its basic form, repricing materially undermines this relationship by altering the impact of poor performance on plan participants, thus altering the risk reward profile of the plan, and the alignment with long-term owners. CalSTRS recognizes that issues surrounding compensation plans are complex, and will consider proposals to reprice or otherwise alter the performance characteristics of a plan on a case-by-case basis. However, it is incumbent upon companies to provide clear policies on this topic up front, and to consider the serious concerns of owners in regards to this topic.

CalSTRS' strong preference is that plans prohibit repricing in any form, and that this fact be clearly communicated to participants in an effort to manage expectations. In cases where companies wish to consider repricing, we believe this should be done only with explicit shareholder approval (as required in many cases) and the proposal should include exemplary rationale and clear explanation of the mechanics, the impact on the performance-based nature of the plan (including pros and cons), and the reforms that will accompany the proposal. We believe reforms are a critical component of any proposal to reprice because by their very nature, repricings represent a failure of the committee to design an appropriate long-term incentive plan and communicate expectations (including the ramifications of poor performance) to participants.

## Contractual Arrangements

The policy should contain the parameters by which the company will utilize employment agreements, severance arrangements or other contractual arrangements, if at all.

This section should include:

- A definitive statement of the company's philosophy on employment agreements, severance arrangements and change in control contracts and any other contractual employment or benefit-related arrangements.
- A justification for the use of these arrangements specific to the company's circumstances and consistent with the overall purpose of the compensation program. Special care should be taken to explain the rationale for these arrangements within the overall context of a performance-based plan, including how the arrangements impact its alignment and incentive characteristics.
- In cases where the company will utilize such arrangements, the policy should discuss the overall parameters of how they will be used, including specific details regarding the positions within the company that may receive these benefits, the maximum periods covered by the arrangements, provisions by which the arrangements will be reviewed, renewed or eliminated, and a clear description of the company's philosophy related to key terms of the arrangements (such as triggers and how the company intends to define terms like termination for cause), and disclosure of where investors can view the entire text of the applicable agreements or contracts.

## Perquisites

The policy should include the parameters by which the company will provide perquisites, including a definition of what constitutes a perquisite.

This section should include:

- The committee's rationale for including perquisites in the company's compensation program, including the expected weight of perquisites in relation to total compensation, and how the perquisites relate to the program's overall objectives. This should also include how the use of perquisites may be monitored for potential abuse. CalSTRS believes certain perquisites, such as gross-ups for example, have a detrimental impact on alignment when considered in the context of the overall plan. Care should be taken to consider the benefit to long-term shareholders in relation to the potential cost and the impact on alignment when providing a rationale for perquisites.
- A general list of appropriate types of perquisites that may be included in future compensation plans.
- The company's policy and procedure for valuing perquisites, including the rationale for the method and why it is considered accurate.

## Post-Employment Benefits

The policy should include the parameters by which the company will utilize post-employment benefits or "other" forms of compensation, including all forms of health care coverage, and any deferred compensation program or retirement benefit.

This section should include:

- Guidelines by which the company will use "other" forms of compensation and post-employment benefits, including the expected weight of these forms of compensation relative to total compensation.

- The committee's rationale for these forms of compensation including the justification and link to the company's overall performance and business objectives. Care should be taken to consider the benefit to long-term shareholders in relation to the potential cost and the impact on alignment when providing a rationale for post employment benefits. In this context, certain benefits, such as post-death benefits (golden coffins) for example, would significantly weaken alignment with shareholders and should be avoided.
- Any limitations placed on retirement or other benefits, including dollar amounts and time period for executives.
- Eligibility of family or other beneficiaries to receive benefits.
- The company's policy on benefit calculations and how the executive plans are consistent with all other plans. Any differences, such as the basis for calculating eligible income and additional multipliers available to executives, should be fully explained.

## Tax and Accounting Matters

The policy should include the company's philosophy regarding the impact of tax and accounting matters on the compensation program. The company's policies and procedures for addressing the tax deductibility of all forms of compensation should be included in this section, as well as a definitive position regarding tax gross-ups or any other form of tax payment on behalf of employees. In any case where a company's policy permits gross-ups or other forms of tax payments on behalf of an employee, the policy should include the committee's justification for this benefit and how it relates to the company's overall compensation philosophy.

## Summary

CalSTRS has provided this detailed model policy guideline in an effort to better communicate institutional investors' viewpoint on executive compensation. It is our hope this effort will lead to more effective disclosures from public companies, which we believe will help shareholders understand compensation programs more fully and support an appropriate role for owners in advisory votes on executive compensation plans.