Designing and Implementing an Effective Pay for Performance Program in a Say on Pay World

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• Compensation is a powerful tool to incentivize achievement of performance objectives
  ➢ Drives and focuses behavior
  ➢ Sends a clear message to internal and external audiences about performance expectations
  ➢ Meaningful compensation opportunities are critical to recruit and retain talent needed to successfully lead companies

• Pay for performance is everybody’s mantra, however no universal agreement regarding what this means
  ➢ How to define “good” performance?
    • Corporate versus individual
    • Operational versus stock price
    • Long-term versus short-term
To complicate matters, Say on Pay has heightened scrutiny of executive pay, and there are many participants in the dialogue:

- **Internal**
  - Management
  - Directors
- **External**
  - Government (Congress/SEC)
  - Institutional investors and the governance community (ISS, Glass, Lewis, others)
  - Retail shareholders
  - Media
- Companies and directors trying to do the right thing are often caught in the cross-fire
What defines a well-designed incentive program?

• Pay opportunities tightly aligned with responsible performance
• Balanced approach to delivering compensation
  ➢ Don’t want all your eggs in one basket
• Mitigates risk
• Reflects environment
  ➢ Internal
    • What will attract, motivate and retain executives?
    • What will drive corporate performance and the achievement of strategic objectives?
  ➢ External
    • Comparators
    • Shareholders
    • Other Stakeholders
    • Government
    • Media
Performance metrics

• Performance measures should be aligned with business strategy
• Reflect the key drivers of corporate and shareholder value
• Create clear line of sight for key employees that focuses their efforts and maps their accountability
• **Absolute vs. relative performance metrics**
  
  ➢ **Absolute metrics**
    - Highly dependent upon the ability to predict future performance
      - Strength of internal strategic planning / budgeting process
      - Stability of macro-economic conditions
      - Concerns that shareholders may not view absolute performance metrics as favorably as they do metrics that benchmark against the performance of others
  
  ➢ **Relative metrics**
    - Both helpful and problematic
      - Can serve as useful “plugs” when absolute performance is difficult to project
      - Can produce unintended results and payouts
        - Possibility of payouts for negative/poor performance that is merely “less poor” than that of some comparators
      - May penalize steady performers
        - Poor performers rewarded for “rising from the ashes”
      - Performance gates or circuit breakers can help avoid embarrassing or unintentional payouts
• Long term incentives
  ➢ Performance metrics more likely to reference performance relative to external benchmarks or comparators
  ➢ TSR is the most prevalent metric
    • Pros and cons
• Performance periods
  ➢ Performance metrics should be aligned with appropriate performance periods
  ➢ Trend towards extending performance and/or look back periods
    • Annual incentives
      • Paying portion of annual bonus in stock
      • Bonus banking
    • Longer vesting on equity
    • Additional vesting on earned performance shares/units
    • Clawbacks
  ➢ Transition to regular, annual grants complete
    • Overlapping vesting / performance periods mitigate risk and enhance retention
Balance target performance goals with target payouts

• Goals should be realistic and motivational and represent sustainable performance relative to benchmarks
  - Historical performance and volatility
  - Future prospects / market expectations
  - Continuous year-over-year improvement

• Probability of attainment
  - Threshold: 90% (lowest acceptable results)
  - Target: 67% (most likely result)
  - Maximum: 10% (best case)

• Ability to forecast future performance – how strong is the budgeting / business planning process?
  - Particularly important for long-term programs
  - May impact the decision between relative or absolute performance metrics
Peer Group Determination – Dos & Don’ts

• Selection of the “right” peer group is critical
  ➢ Key component of ISS and Glass, Lewis pay for performance methodology
• Companies are often reluctant to change comparator groups
  ➢ Disclosure of rationale
  ➢ Worried about resetting the bar
• Number of companies in comparator group
  ➢ Smaller groups
    • More targeted
    • Likely to be impacted by the same external factors in a similar way
  ➢ Larger groups
    • Less volatility
    • Minimizes impacts of M&A activity and other one-offs
- too much of a good thing can be a bad thing

• Trend towards de-leveraging some elements of compensation program as a way to further mitigate risk
  ➢ Lowering maximum performance payouts
  ➢ Eliminate uncapped payouts
  ➢ Greater attention paid to reasonableness of performance targets
    • Are they attainable? Sustainable?

• Balance and alignment
  ➢ Between fixed and variable pay
  ➢ Between short- and long-term pay
  ➢ Among long-term performance vehicles
  ➢ Complementary performance metrics
• Say on Pay has changed the dialogue in the Board room
  ➢ Dual focus on what is right for the company and how it will be perceived by external observers
  ➢ Directors are concerned about the positions and views of significant investors and shareholder advisory firms
    • Prompted a more conservative approach to compensation decisions
    • Forced the elimination or curtailment of perks and other peripheral “irritants” where the potential backlash is viewed to outweigh the benefit delivered to the executive

• Focus on the use of the CD&A as a marketing document
  ➢ Directors far more involved in drafting and review
  ➢ Viewed as an opportunity to “sell” the program and secure a positive Say on Pay outcome
Best practices in CD&A drafting

- Use of executive summary
- Use of bullet points
- Performance summary
- Charts and graphs
- Listing of program best practices
- Identify reasons behind planned deviation from best practices
- Clear English
Shareholder Outreach Process

1. Understand the problem
2. Identify potential solutions
3. Develop the targeted list of shareholders and contacts
4. Assemble and prepare the outreach team
5. Meet with shareholders
6. Implement solutions/modifications
7. Review/revamp proxy disclosure
8. Prepare early for next year’s vote – Be proactive!
Target vs. Actual Compensation

- Importance of Say on Pay vote and continued focus on pay for performance alignment causing a shift in how pay is evaluated and discussed
- Previous discussions tended to focus predominantly on target pay
  - Benchmarking process
  - Indicative of Committee “intent”
- Current proxy disclosure reflects a mix of grant-date target and actually realized values
  - Actual salary, short- and long-term incentive plan payouts **but**
  - Grant date values of equity
    - These values do not accurately reflect how pay will vary based upon future performance
  - Equity is typically the largest portion of executive pay package, particularly for CEOs
  - ISS pay for performance assessment does not currently address this disconnect
Now what?

- Key compensation program modifications made after companies failed 2011 Say on Pay vote
  - Increasing performance-based compensation (93%)
  - Eliminating shareholder “irritants”: tax gross-ups, single triggers, automatic employment agreement renewals (73%)
  - Adopting/enhancing stock ownership guidelines (67%)
  - Incorporating TSR metric in program (60%)
  - Adopting clawback policy (60%)
  - Lowering market positioning (40%)

Result – Averaged FOR votes in 2012 increased by +54%
Equity Pitfalls to Avoid

• Pay for performance misalignment
  ➢ Majority of equity awards not performance-based
  ➢ Increasing target LTI award in year of poor corporate or stock price performance
    • Payouts of awards in years where TSR has declined
  ➢ Payment of dividends on unearned or unvested shares

• Size/concentration of awards
  ➢ Large sign-on/retention awards
  ➢ CEO and other proxy officers receive out-sized portion of grants – measured as a percentage of NEO awards to all employee awards
  ➢ Guarantee of future time-based awards in employment agreements

• Termination provisions
  ➢ Grants that have single-trigger vesting upon Change in Control
Equity Pitfalls to Avoid

- **Metrics**
  - Beware of qualitative measures or using discretion to determine payout
  - Same performance criteria utilized for both short term and long term plans
  - Using Non-GAAP metrics without clear justification
  - Use of a single, non-relative metric may draw scrutiny

- **Design parameters**
  - 1-year performance periods in a “long term” incentive plan
  - Large/uncapped upside potential
  - Low thresholds for minimum payouts
    - Watch out for goals set primarily to qualify RSUs for 162(m) deduction
  - No ownership guidelines or holding requirements
  - No clawback policy
Shareholder Expectation That Pay Deductible

• But, Code Section 162(m) limits tax deduction for compensation paid in excess of $1 million to covered employees of public company

• Covered employees are CEO and other three highest paid officers other than the CEO and the CFO

• Performance-based compensation excluded from $1 million calculation
What’s Performance-Based Compensation?

- Performance goal requirement
  - Granted or vested solely upon the attainment of one or more pre-established objective performance goals
  - Goals established by Board Committee
    - Prior to beginning of performance period – or
    - Within 90 days of the beginning of the performance period – while outcome substantially uncertain and no more than 25% of performance period has passed
  - Shareholder-approved business criteria
What’s Performance-Based Compensation?

- Payment cannot be accelerated upon involuntary termination, termination for good reason or retirement.
- Board committee cannot have discretion to increase the size of the award once the goals have been established – not even to reflect changing circumstances.
What’s Performance-Based Compensation?

• Income from stock options and SARs qualifies as performance-based if 4 requirements are satisfied:
  ➢ Option or SAR is granted under stockholder approved plan
  ➢ Plan states maximum number of shares that can be granted under an option or SAR to an individual during a specified period (usually one year)
  ➢ The exercise price is equal to FMV on the date of grant
  ➢ Option or SAR granted by Board Committee composed of two or more outside directors
Risks of “No” Votes on Say on Pay

• Reputational harm
• Difficult shareholder relations
• Potential shareholder derivative suits for:
  ➢ Breach of fiduciary duty
  ➢ Corporate waste
  ➢ Disconnect between compensation criteria articulated in proxy and actual compensation package
  ➢ Violation of rules in shareholder-approved Code Section 162(m) compensation plans
Risks of “No” Votes on Say on Pay

• Even Compensation Consultants risk suit for aiding and abetting Board breaches
Mitigation Strategies

• Revise Compensation Committee charter to make changes that reduce litigation risks
• Regularly brief Directors on developments in executive compensation
• Document in minutes compensation-setting processes, including information that was considered and relied on
• Scrutinize pay for performance policies and independence of compensation consultant
But Outside the US:

- Performance-based compensation may be taxable at grant, making it more difficult to value award and employee may ultimately forfeit award
  - Options (e.g., Belgium, Russia)
  - RSAs (e.g., Germany, Italy, Netherlands)
  - French-qualified options/RSUs (employer social tax at grant not recoverable if targets not attained)
But Outside the US:

• If local entity involved in assessing whether performance target attained, may result in tax withholding / social tax issues (e.g., Japan, Belgium)

• There may be labor/entitlement implications – If vesting based solely on performance (particularly if individual performance), entitlement risks are greater
  - Considered “earned” – at least pro-rata
  - Often tied more directly to bonus/local benefits
But Outside the US:

- Securities law thresholds – Need to take into account maximum target payment for awards, which may trigger filing (e.g., Australia, Japan (options), Philippines)
Overview of Jabil – St. Petersburg, Florida

- Founded in Michigan, 1966
- Global Manufacturing Services Provider
- 23 Million Manufacturing Square Feet
- 60 Sites on Four Continents
- Tenured Management Team
- 121,000 Employees
- Compensation Department created in 2008
Equity Program

• Immediate need to reduce complexity of the equity program in 2009
• Underwater options/SARs and cancelled performance shares presented retention/motivation challenges
• The need to differentiate equity awards based upon scope of job and impact on organization
  ➢ “A VP is not a VP is not a VP….”
• Burn rate at P75 of peer group; frequent requests for more shares
Equity Program – complexity only an attorney could love….

- Two time-based vehicles
- Four performance-based vehicles
- Cash-settled SARs
- Spread across 25 countries
- Ex-pats treated differently than employees in their home country

“I’m an attorney, and I’m here to ‘help’ you…”

http://michaldziekan.blogspot.com/
## 2009 Equity Program

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TSR-based awards – “The Sad Saga of 2010”

- Three 1-year performance periods
- JBL TSR compared to S&P500
- Point-to-point measurement dates
- JBL beating the S&P 500 with 15 days left in FY2010
- Sudden dip and rebound in JBL over 30 days
- First tranche of 50% does not vest in FY2010
- Demonstrates weakness of relative TSR awards – what’s the correct benchmark?
- Focuses on “effects” and not “causes” that management can influence
Slaying the enemy of…. **COMPLEXITY**

- RSUs globally, with accumulated dividend equivalents
- One time-based award
- One performance-based award
- Ex-pats treated the same
- RSUs allowed the addition of continued vesting of *time-based* awards upon retirement in the USA
  - Accelerated Medicare tax when retirement-eligible in USA (for time-based)
  - Retirement eligibility in Europe can’t be age-based
  - Allows retirement of officers without worry of losing equity awards – *facilitates talent management*

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**CODE**
- TBRSU: TIME-BASED RSUs (ADEs)
- PBRSU - EPS: PERFORMANCE-BASED RSUs (Cumulative EPS Goal – ADEs)
Changes to JBL Performance-based RSUs

- Vesting changed to **cumulative** corporate core earnings per share (EPS) dollars compound annual growth rate (CAGR)
- Five-year initial performance period (base year EPS of $1.48)
  - Maximum potential payout is capped at 150% of shares granted
- Accelerated vesting would occur at **year three** according to the criteria below:
  - If performance is **greater than or equal to** target ($5.29), then shares vest up to 150% of amount granted, and no more shares may vest from FY2011 award – i.e., performance cycle is closed
  - If performance is **below** target, then any shares earned vest and up to 100% of target shares could be earned in either year four or five based upon 4-year and 5-year cumulative EPS CAGR dollars
    - EPS CAGR targets stay fixed throughout life of award
- Rationale for this design includes:
  - Ameliorates the performance issue whereby one poor year eliminates entire 3-year cycle
  - Recognizes the potential volatility of Jabil’s business cycle

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<th>5-Yr EPS CAGR¹</th>
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¹ Target EPS CAGR at 9% versus previous awards at 11%, which reflects 20-year S&P500 returns.
² Potential maximum payout reduced to 150% versus previous years at 200%
Example of Performance-Based RSUs:

Number of shares granted: 1,000  
Base year EPS: $1.48

Scenario 1:
EPS in year 1 = $1.69, EPS in year 2 = $1.92, EPS in year 3 = $2.19  
Total 3 year EPS = $5.81, or 14% Cumulative CAGR over $1.48 starting point

Result: Payout at 150% of target, 1,500 shares vest
No opportunity for earning additional shares in this cycle for years 4 or 5

******************************************************************* *************

Scenario 2:
After 3 year period, cumulative EPS CAGR dollars are above threshold, but below target

Assumed 3 yr result: Payout at calculated % based on actual performance, 250 shares vest

Opportunity to earn 750 shares if 4-year cumulative EPS CAGR dollars are >= target 3 year cumulative EPS CAGR % extrapolated out for 4 years. Assumed Year 4 result: 4-year cumulative EPS CAGR dollars are above threshold, but below target, 250 shares vest

Opportunity to earn 500 more shares (max.) if 5-year cumulative EPS CAGR dollars are >= target 3 year cumulative EPS CAGR % extrapolated out for 5 years.
Now we tackle the issue of share usage…

- We have reviewed all officer jobs and have multiple levels of EVPs, SVPs & VPs – to differentiate equity awards by one’s impact on the organization
- Senior management jobs were leveled this year so that shares are allocated more prudently
  - Jabil is not “Lake Wobegon” – jobs are not equal in scope/impact
- Officer awards, *in aggregate value*, targeted to the market position of the CEO
  - This still allows for above-market placement for high performers/potential
- Most officers have two-thirds of their equity awards tied to performance-based vesting
- Back-pocket strategy – *contingent-based awards* – in case of market correction
  - Apply to time-based awards for officer population only (easier communication)
  - No problem with Section 162(m)
  - Shareholders would vote on contingent-base awards and additional shares to Stock Plan
Other things…

- Share ownership guidelines in place for executive officers
  - Ownership reviewed with Compensation Committee each January (after October equity awards)
- Performance-based awards achievement history is shown in CD&A
- Focus on large institutional shareholders – e.g., Fidelity has its own voting guidelines
- Each year we show the Compensation Committee JBL’s standing in the eyes of ISS
  - Burn rate (1 and 3-year)
  - Risk concerns, if any
- 93% approval of Jabil’s executive compensation program in its first “say-on-pay” vote
- Stock Incentive Award Policy Statement
Stock Incentive Award Policy Statement

- The Compensation Committee annually will pre-set, before the beginning of each fiscal year of the Company, the dates on which Awards may be granted to officers, directors and employees (including new hires and promoted employees).
- The Compensation Committee will disclose the pre-set Award grant dates (or events, such as quarterly in-person meetings of the Board) in each of the Company’s annual proxy statements.
- Awards will generally be made only after the Company has publicly released its quarterly or annual financial results and the Company is believed to be in an open “Trading Window.”
- Only the Compensation Committee, or the Board, or a committee of the Board consisting exclusively of independent directors, may make the final determination of all grantees, amounts and vesting periods of all awards. There will be no delegation of authority to make such final determination to officers or a committee not consisting of exclusively independent directors.
Stock Incentive Award Policy Statement (cont’d)

- Management will prepare and submit to the Compensation Committee (with copies to Legal, Tax and Finance) a summary of its Award and other compensation-related requests at least 5 days prior to the Compensation Committee meeting for Annual Awards (2 days for non-Annual Awards). Each summary will have already been reviewed by Legal, Tax and Finance, and will include, with respect to each proposed Award:
  - the name of the employee,
  - the type and amount of the requested Award or other compensation, and
  - relevant information concerning the proposed Award’s compliance with the provisions of the governing plan (if applicable) and the anticipated accounting and tax treatment of the proposed Award.
- The Company will require legal counsel to attend all meetings at which awards and other final compensation decisions are made.
- The Audit Committee will have a meeting with internal and external auditors on accounting for stock-based compensation at least once a year.