2018 **DIRECTORS CONFERENCE**

Board Strength, Industry Sustainability

WESTERN BANKERS ASSOCIATION

Recruiting Quality Director Talent

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Audio Visual sponsored by RSM

Agenda

- Succession Planning & Recruiting
- Profiles of Desired Director Skills, Expertise
- Shareholder Considerations
- Director Compensation

Succession Planning & Recruiting

- Does your bank have a director succession plan?
  - Mandatory retirement age or term limits?
  - Subject to legal requirements
- Frequency and amount of activity around this topic
  - How frequently does your board discuss this?
  - Should you always be looking for new directors?
- Are you prepared to lose one or more of your directors?

Succession Planning & Recruiting (continued)

- How long does it take a new board member to become productive?
  - Depends on board member's experience, complexity of your bank, business model
  - Several months, one year, longer?
  - How can readiness of new directors be sped up?
    - Advisory board
    - If charter permits, bring on new directors in anticipation of other directors hitting mandatory retirement age or rolling off to train them and get them acclimated
    - Training – conferences, webinars, outside experts training
- Do you provide training and onboarding for new directors?
- Ongoing continuing education requirement for directors?

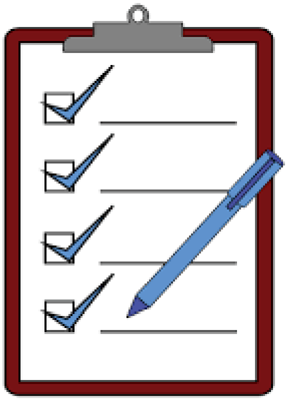
Key Questions for Board Composition

What board composition factors should you consider as you recruit new directors?

- Directors who can share advice based on your company's stage of development
- Directors who can add valuable insights on your company's industry, strategy and performance challenges
- Partly rule based (audit)
- Diversity
- Investor expectations
- Board skills

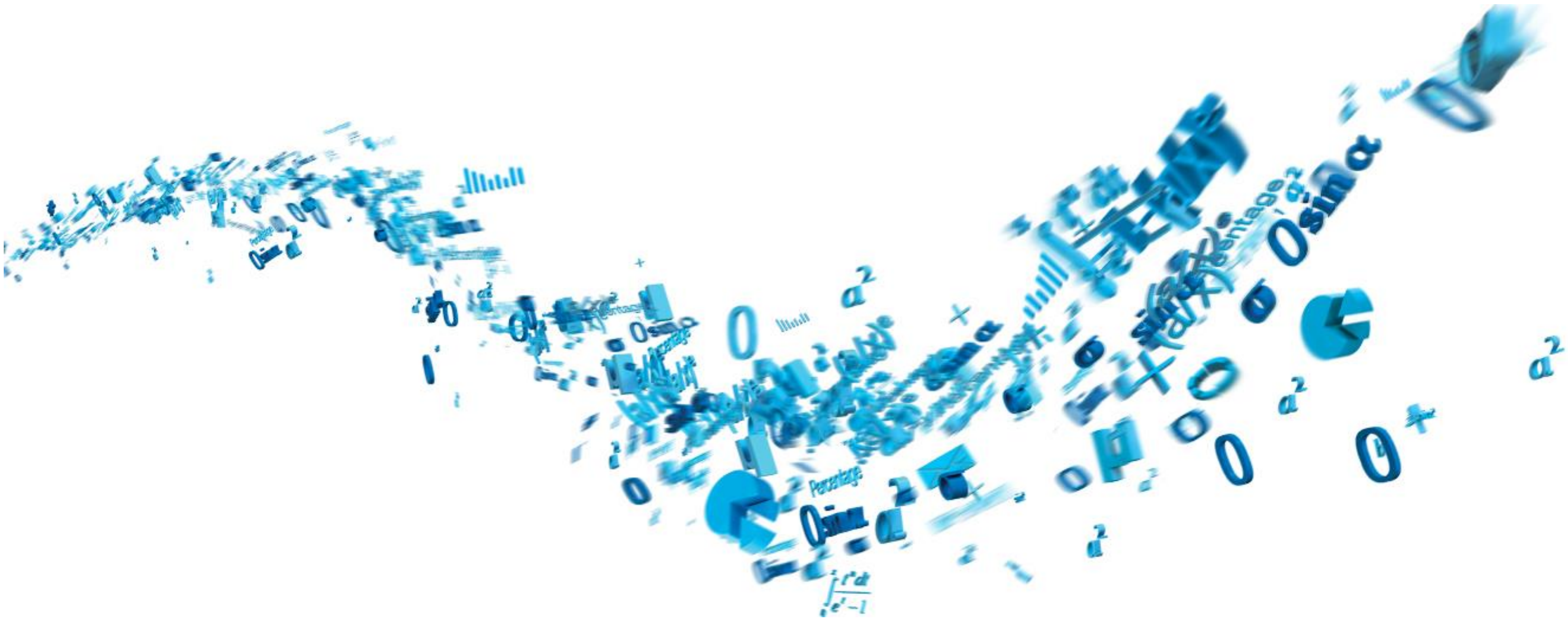
Identifying Desirable Skills and Perspectives

- Prior board experience
  - For profit, non-profit
  - Professional background, training
- Prior public company experience
- Skills and expertise
  - Evaluate the skills of your current outside board members
  - What other skills/experience would be helpful to have represented on the board?
    - Financial expert
    - IT
    - Cybersecurity
    - Marketing
    - Human Resources
    - Enterprise Risk Management



Identifying Desirable Skills and Perspectives (continued)

- Retired or currently working
- Diversity and varying perspectives
  - Staying relevant with all segments of the community, customer population
  - Attracting future customers, talent, board members
- Local or in your footprint
- Community Involvement



Shareholder and Advisory Firm Considerations

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How Proxy Advisory Firms Review Board Diversity

ISS

- Proposed 2019 changes, potentially effective 2020
- Would provide for negative recommendations on directors at Russell 3000 / S&P 1500 companies with no women on the board

Glass Lewis

- Effective for 2019, with some limited exceptions, if the board of a Russell 3000 company has no female members, will generally recommend voting against the nominating committee chair (and potentially all nominating committee members)

Board Diversity

How Investors Review Board Diversity

- A number of vocal and often influential investors have publicly identified diversity as one of their top engagement and proxy voting priorities:
  - **BlackRock:** 2017-18 Investment Stewardship Engagement Priorities, Annual Letter to CEOs, and 2018 Russell 1000 Letter Campaign
    - In 2018, BlackRock amended its proxy voting guidelines to include an expectation of at least two women directors on each board—and noted that it will continue engagement efforts and may withhold votes at companies that ignore its comments
  - **State Street Global Advisors:** Stewardship 2017 (Fearless Girl Campaign) and Guidance on Enhancing Gender Diversity on Boards
    - In the 2018 proxy season, voted against directors at more than 500 companies that failed to address board diversity, while simultaneously noting gender diversity improvements at over 150 companies that it had addressed through either a withhold vote or engagement
  - **Vanguard:** Investment Stewardship Pillars and Annual Letter to Directors
  - **NYC Comptroller/Pension Funds:** Boardroom Accountability Project 2.0
  - **California Public Employees Retirement System (CalPERS):** Russell 3000 Diversity Campaign

Non-Employee Director Compensation: Case Law

Delaware Supreme Court Case

- ***Issue***: In the last few years, Delaware courts have issued several rulings in lawsuits involving complaints of "excessive" compensation to non-employee directors

- **Outcomes**:

  - Director decisions about their own compensation, if stockholders have approved **specific** awards to directors or such awards are made under a formula with **no discretion**, are subject to the lower "***business judgment rule***" standard

  - *In a 2017 financial case*: If an equity plan gives the directors **discretion** to determine their own compensation, then even if the plan is stockholder-approved, awards granted to directors are subject to the higher "***entire fairness***" review standard

  - Directors are not free to award themselves compensation that would otherwise violate their fiduciary duties merely because stockholders have approved their legal authority to do so

  - Stockholder approval of "***meaningful" limits*** on non employee director compensation is still likely to be supportive of directors upholding their duties but it is unlikely to lower the standard of review to the business judgment rule

Director Compensation Litigation: ISS & GL Policies

ISS Policy - Effective for the 2019 Proxy Season

- Effective for meetings on or after February 1, 2018, ISS will vote **against** members of the board on the committee responsible for approving or setting non-employee director compensation if there is a "pattern" (two or more years) of awarding "excessive" non-employee director compensation without disclosing a compelling rationale or other mitigating factors
- The new policy will not impact vote recommendations in 2018, since ISS is looking for two or more years of excessive pay, but moving forward, negative recommendations would be triggered after a pattern of excessive NED pay is identified in consecutive years
- Since NED pay magnitude varies by company size and industry sector, ISS has identified cases of extreme outliers **relative to peers and the broader market**, to determine what would be considered excessive non-employee director compensation
- ISS stated their rationale for the change is due to the rise of the median NED pay in the S&P1500 in recent years, as well as investors challenging director pay magnitude in court or by making boardroom compensation an issue in proxy contests. We expect additional guidance for the 2019 proxy season when ISS publishes their annual policy updates in late fall of 2018

Glass Lewis Policy (No Change)

Stock-Based Director Compensation Policies

- Glass Lewis policy states that equity grants to directors should not be performance-based in order to ensure directors are not incentivized in the same manner as executives, but rather serve as a check on imprudent risk-taking in executive compensation plan design
- Glass Lewis will consider recommending support for compensation plans that include option grants or other equity-based awards that help to align the interests of outside directors with those of shareholders
- Glass Lewis uses a proprietary model which analysts utilized to evaluate the costs of equity plans compared to the plans of peer companies with similar market capitalizations. Glass Lewis will use the result of this model to guide their voting recommendations on stock-based director compensation plans

Non-Employee Director Compensation Limit Considerations

- Directors have historically avoided the compensation scrutiny applied to CEOs and other NEOs; however, there has been increased scrutiny around director compensation
- In the last few years, Delaware courts have issued several rulings in lawsuits involving complaints of "excessive" compensation to non-employee directors
- Key takeaways from these cases include:
  - Decisions by directors about their own compensation will be reviewed by Delaware courts as a self-dealing transaction under the entire fairness standard, but such decisions can gain the protection of the business judgment rule if such decisions are made pursuant to a director pay limit or proposal that is approved by a fully informed, disinterested majority of shareholders
  - Shareholder approval of an equity plan does not constitute ratification of director compensation in the absence of specified limits in the plan on the amount of cash and equity compensation that may be awarded to directors
- Granting a fixed number of shares, regardless of price, may result in the director compensation policy delivering above market value if the stock price increases rapidly
- As a way to mitigate some risk, companies are establishing limits in the Board's granting authority in the equity plan
- Typical industry limits are set based on current director compensation levels, taking into account future increases (for growth, etc.), and preserving some flexibility for special awards or unique situations (new board members, M&A committees, chair responsibilities with increased time commitments)
- There is a continuum between strict specific/formula grants and somewhat more flexible "meaningful limits"
  - Evidence showing director compensation levels consistent with peers may be helpful (subject to peer size scrutiny)
  - Document the decision carefully in board minutes and disclose the process robustly (more might be better here)
  - Separate executive compensation decisions from director compensation decisions, and mitigate other factors that could suggest a lack of disinterestedness.

Director Compensation

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Director Compensation – Matched Sample Analysis (Median YOY Change)

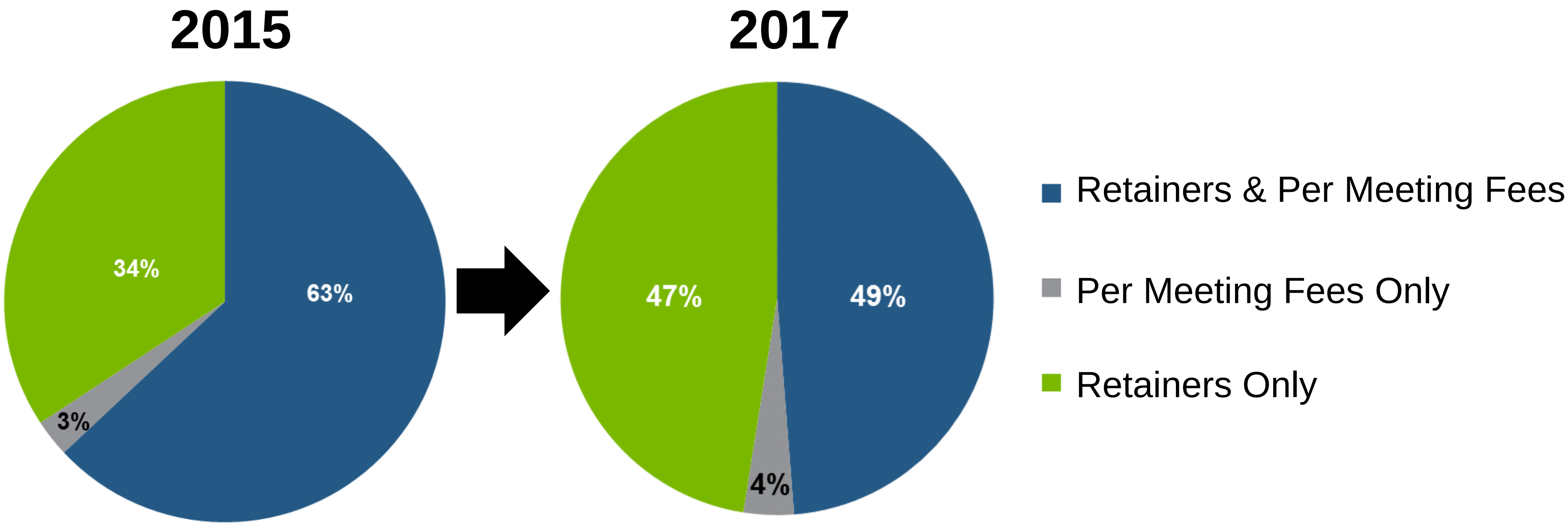
		Average Director Compensation - Matched Sample Analysis					
		Cash		Equity		Total	
Asset Size	n	2017	% Change '16 to '17	2017	% Change '16 to '17	2017	% Change '16 to '17
>$25B	5	94,996	1%	117,098	8%	208,194	4%
$10B-$25B	10	76,959	3%	66,400	0%	156,731	3%
$5B-$10B	12	55,293	-2%	51,218	0%	111,872	3%
$3B-$5B	8	57,898	5%	35,694	20%	91,385	13%
$1B-$3B	18	39,567	1%	25,574	11%	53,566	3%
<$1B	19	27,391	0%	11,900	48%	34,577	2%

* Equity values are summarized based only on those banks granting equity in 2017.

- Director compensation continues to increase and be dynamic
- Increases were often more significant in equity compensation

Director Compensation

- The market is moving away from meeting fees toward the use of fixed retainers only.



Retainers	- Compensates directors for service rendered - Clear and easy to administer - Does not encourage meeting excessively
Per Meeting Fees	- Compensates directors for time spent - Compensate directors for time-intensive projects

Director Compensation Litigation: Practical Implications

Recommended Approach

- To ensure that director compensation lawsuits cannot survive a motion to dismiss, companies should:
  - Have the compensation committees conduct an annual review of the cash and equity compensation paid to the non-employee directors
  - Consider including a “meaningful” limit on director compensation in the equity plans that is approved by the shareholders
  - Consider expanding the director compensation disclosure in the annual proxy statement to provide a brief discussion of the basis for director compensation decisions

Director Compensation Litigation: Entire Fairness

- In general, because directors "stand on both sides" of a decision to fix their own compensation, the decision will not be entitled to the presumption of the business judgment rule but will be tested under the entire fairness standard, which requires a showing of "fair price" and "fair dealing"
- Stockholder "ratification" of director compensation decisions may restore the presumption of the business judgment rule
  - Ratification may be prospective, as in the case where stockholders approve an incentive plan providing for grants to directors in specified amounts or within a narrow specified range
  - Ratification may be retroactive, as in the case where the board's decision is submitted to stockholders for adoption
- Stockholder ratification requires a vote of a majority of the disinterested stockholders, acting on a fully informed basis
  - *If ratified by a fully informed vote of disinterested stockholders, decisions made in accordance with the terms of the plan should be entitled to the presumption of the business judgment rule*

Director Compensation Litigation: Costs/Risks

- Costs and disruption to the company in defending claims related to director compensation
  - If the entire fairness standard of review applies to the board's decision to grant the applicable director compensation, the complaint will likely survive a motion to dismiss
- Payment of plaintiff's attorneys' fees and/or the company's agreement to take certain actions (including the implementation and maintenance of corporate governance changes) in connection with a settlement of the claims
- If the case continues to a trial on the merits, the possibility that the directors lose the case and court imposes certain remedies (including but not limited to disgorgement of director compensation or monetary damages)

In Summary…

- Select directors with the aligned interests, values and commitments of the bank
  - Finding people with time, passion, interest in the bank and the community are critical
- What skills, expertise and experience should be added to the board?
  - Having these additional skills and expertise can lead to greater efficiency, a more effective board and strong corporate governance.
- Pay a competitive and appropriate level of compensation
  - Pay will never be commensurate with the time and value provided by directors
- What directors will make your board stronger and more effective today and in the future?

Q & A

Thank you!

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