

Opening Keynote: Four Trends in Executive Compensation

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Beware the unintended consequences of these well-intentioned approaches to compensation.



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The last several years have been ones of transformative change and high pressure for executive and stock-based compensation. Legislators, regulators, shareholder activist groups, and the media continually weigh in on executive pay decisions.

And given the tentative financial outlook, one can expect ever-greater heat in the executive pay arena even as the economy cools down.

These converging forces—combined with the desire of boards to do right by shareholders—have prompted a majority of companies to scrutinize and revamp their executive compensation programs. The solution for many has been

commitment to link pay and performance is clearly the right direction, but these two popular choices present challenges, which may not have been fully considered by the boards that approved the plans.

In their quest to do the right thing, companies too often blindly follow the crowd without fully examining the many consequences associated with the choice. We have selected four of today's executive pay trends related to the higher use of long-term performance plans and explored the challenges associated with each. We offer the discussion to help companies decide whether their fixes are achieving their desired objectives, or whether they may still be in need of a longer term cure.

Promoting performance restricted stock/ performance shares

Enron and Worldcom gave stock options a bad name, causing companies to abandon stock options in favor of service-vested restricted stock. Yet, many boards quickly realized that, as was the case 20

selective use of service-vested restricted stock and replacing it, especially for more senior executive levels, with performance-vested restricted stock or performance shares.

Done right, performance restricted stock can powerfully focus organizational efforts, and it can provide equivalent or better leverage than stock options. However, in our view, too many companies quickly embraced performance restricted stock as “the answer” without adequately considering the challenges associated with selecting the right performance measures and setting appropriate goals. The latter has been exacerbated in today's uncertain economic environment. As a result, many plan participants may not understand how the performance plan works, or find it demotivating because they lack line of sight to the goals.

Performance measures must reflect the drivers of value in the business and be consistent with the business imperatives. Thus, they become a critical management tool for communicating and implementing strategy. Companies that tie the earn-out of restricted stock to the performance of autonomous business units must make sure the measures reflect the business units' particular circumstances, which might vary significantly from one business to another.

Goal setting may present a bigger challenge. Companies using multi-year performance periods often

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to increase the use of long-term performance plans, particularly performance restricted stock and performance shares. The

years ago, service-vested restricted stock represents largely guaranteed pay that lacks much in the way of performance. The solution: more

choose one of several courses: they base the goals on a) performance relative to peers or a broader market index, b) their three-year business plan, or c) fixed targets that reflect longer-term sustained aspirations for the business. Others have succumbed to this challenge and instead have moved to annual goals. More about this below.

We suggest that companies considering performance restricted stock ask themselves the following questions:

- What is the most appropriate basis for setting goals: business plans, fixed goals, or relative to peers (assuming there are an adequate number)?
- If based on business plans, should executives be held to goals in spite of changes in the economy or sector that makes the goals more challenging to achieve?
- If awards are adjusted, on what basis will adjustments be made and how will symmetry be ensured, such that achievement

shareholders lose (though value of shares does decline)?

- If based on fixed goals, can they accept potentially prolonged periods of up or down markets, where the plan may not pay out?

Adopting shorter performance periods in long-term performance plans

As noted above, companies adopting performance restricted stock and performance shares face goal-setting challenges. In fact, many companies find it tough to project goals beyond one year. Consequently, a one-year performance period, typically followed by two to three years of vesting once an award is earned, has come into vogue. While an annual time frame facilitates goal-setting, it ushers in a new set of issues.

First, tying both annual incentives and a portion of long-term incentives to annual results over-emphasizes annual performance. With greater pressure on a given year's achievement comes greater risk that actions may be taken to optimize this

A shortened performance period works best for targeted periods of time where "the future is now," and showing a track record of one-year results is a strategic imperative. However, it should not be a sustained strategy.

Companies setting shorter goals need to ask:

- Are there good, solid reasons for emphasizing one-year performance (e.g., in a turnaround situation, initial annual commitments may give investors confidence that the company can hit its longer term goals)?
- If not, would measuring performance relative to a peer group capture the effectiveness of longer-term strategies?
- Might other long-term incentive vehicles such as options be more effective?

Employing discretion when determining awards

In the midst of economic uncertainty, many Compensation Committees are applying discretion when interpreting incentive plan results and determining individual incentive awards. Their intent is to ensure flexibility to "do the right thing" at a time when results may be difficult to measure exclusively by formula. Discretion can be particularly helpful at times of strategic repositioning, when milestone goals may take precedence over near-term financials. However, discretion can also be a slippery slope. Discretion fell into disrepute in the late 1980s and early 1990s because it became synonymous with "forgiveness." That's why Section 162(m) of the Internal Revenue Code (i.e., the requirement that compensation over

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in the face of severe obstacles or challenges is rewarded while underachievement is also taken into account?

- How will unplanned events, like major acquisitions, be accounted for?
- If based on relative performance are boards willing to pay for good relative performance even if

year's results at the expense of next year's. This risk can be mitigated in part when the earned stock vests over a period of time, requiring sustained results in order for stock price to grow. A second challenge is that shortened performance cycles inhibit a company's ability to address payback periods on investments. It can divert management from clarifying long-term objectives and investing appropriately for the future.

\$1 million be “performance based” in order to remain tax deductible) only allows for negative discretion.

While there is a place for discretion, it must be consistent with a company’s leadership style and pay-for-performance philosophy (e.g., overuse of discretion could undermine a CEO’s “no excuses” pay-for-performance philosophy). Companies are best served by developing a structure for how discretion will be employed, for example:

- The extent of adjustments should be agreed to by the Committee in advance, or, if after the fact, as soon as is practical.
- Adjustments should be symmetrical—in some cases negative and in others positive.
- Adjustments should generally only be made for non-recurring items that were unplanned and material in amount.
- Adjustments for unplanned items should be made only if they could not have been reasonably anticipated (i.e., planning failures are not items for adjustment).

Providing retention grants

In recent years, retention grants have increased in prevalence. In certain circumstances, they can be very effective. For example, it will always be important for a company to recognize its very top performers and lock them in to the extent possible. Retention awards can also provide security and help stabilize an organization in the midst of turnaround or a major strategic transition. Targeted retention awards are one area where service-vested restricted stock can be used with high impact.

Retention awards are most effective when they remain isolated to a select group or are provided for a targeted purpose for a targeted period of time. This allows them to be more meaningful in size and more recognizable as something special. Unfortunately, retention awards are often considered for different reasons—for example, the tough economy, anticipation

When a company gets to a point where a large percentage of the population are receiving retention awards on a regular basis, it has to question whether there’s a fundamental issue with the core compensation program.

These four practices are just some of the solutions companies are turning to in an effort to resolve their

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of a challenging year, and in some cases, multiple years of unrealized gains in existing compensation programs. Providing grants for these reasons calls into question the basic premise of incentives—i.e., that they are about performance, not pay delivery.

Compensation Committees should not feel pressured to provide retention awards broadly just because incentive awards are not paying out. Instead, they should take the opportunity to explore the underlying reasons for and circumstances surrounding non-payment:

- Has the company underperformed peers?
- Is the current management team responsible for these results?
- Were performance goals set based on realistic assumptions?
- Have there been factors beyond management’s control that have affected results, but management has actually taken actions that have minimized potential damage?

executive compensation dilemmas and adopt seemingly competitive fixes. Perhaps the greatest risk in all these fixes is the eagerness of many companies and their boards to adopt a trend without carefully examining its implications, and further, assessing whether it is right for the company, the executives and the shareholders.

Companies must withstand the pressure to change for the sake of change, and instead take the time to evaluate their strategy, consider the compensation implications, make sure each change is consistent with the strategy, and confirm that all aspects of the compensation plan are explainable.

Blair Jones and Seymour Burchman are managing principals of Semler Brossy Consulting Group LLC, an independent executive compensation consulting firm that advises management and boards of major U.S. companies on all aspects of executive pay (www.semlebrossy.com). Both Burchman and Jones work with compensation committees and management teams, counseling them on compensation designs that best meet their business’ needs, ensure alignment with shareholders, and yield appropriate pay/performance relationships.