Planning Above and Beyond Pay Ratio Disclosure

Edited by Katie Grills

The bedrock of executive compensation theory is shifting as proposed elements of the Dodd-Frank Wall Street Reform and Consumer Protection Act are completed. So too have the essential principles and philosophies that compensation committees have relied on—and those principles will be shaken further when the executive-pay-to-median-worker ratio must be reported in 2018. Executive compensation consultants discussed how to address these challenges at Leading Minds of Compensation/East, one of the National Association of Corporate Directors' (NACD) hallmark events, in New York City in March. A panel of six experts shared what they believe directors have to do to employ executive compensation as a tool for long-term value creation, to incentivize the retention of top executive talent, and to ensure executive management is focused on building value for all of the stakeholders across their ecosystem. The panel included **David Swinford**, president and CEO, Pearl Meyer; **John Trentacoste**, managing director, Farient Advisors; **Daniel Laddin**, founding partner, Compensation Advisory Partners; **Barry Sullivan**, managing partner, Semler Brossy Consulting Group; **David Fitt**, partner, Pay Governance; and **Steven Hall**, founding partner and managing director, Steven Hall and Partners. Christopher Clark, publisher of *NACD Directorship* magazine, moderated the discussion.

What bumps in the road do boards hit when aligning executive compensation with long-term value strategy?

Swinford: If you listen to external discussions, long term is never longer than three years—that is a short-term definition of long term. Because of say on pay, every public company board is dealing with investor perspectives of performance, the quality of the CEO, and appropriate rewards for performance. This is driven by relative total shareholder return (TSR), which has a lot to do with analyst perceptions of what will happen in one, three, and five years.

Aligning compensation with strategy requires the use of performance measures that management can heavily influence over the requisite time frame, and which reflect the priorities of the business plan. Selecting these measures is a lot harder than simply aligning pay with performance through a mechanism like relative TSR against a peer group. Defaulting to TSR means that you are relying on management to have a good strategic plan to make value creation happen. The problem is that TSR has relatively little to do with management's performance in the short term—it is at a minimum 80 percent market conditions and industry conditions as perceived by the buyers of stock. If there's only a 20 percent management influence in the short term and we're measuring short term, then there's a disconnect between what's happening in the marketplace with stock value and how to assess the success of management's performance.

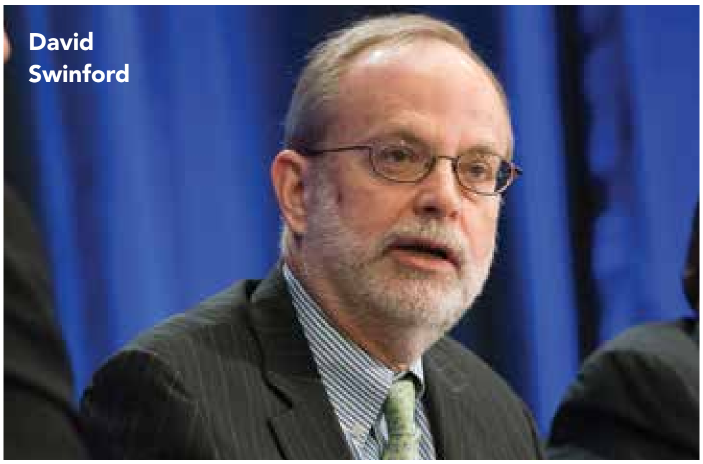
We worked with Cornell University to study this and found no correlation between the use of TSR and better performance, let alone earnings on returns, over periods of one, three, and five years. It comes at 10 years. Before the study we were suspicious—too many of us were relating stories of disconnects. The study confirmed our suspicions.

How are boards really incorporating non-financial metrics into their compensation plans?

Trentacoste: There are four primary reasons why non-financial metrics are used. The first is that their achievement paints a holistic picture of corporate performance. The second is that achievement of both non-financial and financial metrics can help drive long-term value creation. The third reason is providing focus for executives on either executing against an articulated strategy or pivoting the corporate strategy. The fourth is that non-financial metrics help executives focus on stakeholder return as well as stockholder return.

We're seeing three non-financial metric constructs. The first is where the entire executive committee coalesces around corporate measures like customer satisfaction and safety. The second is individual achievement—you're providing opportunities for executives to own a highly relevant, localized, tailored piece of their incentive. The third is a performance-year construct, which is most often seen in financial services organizations. At the end of the year, take a look at what was achieved financially in tandem with how non-financial metrics are achieved to determine a final pay package.

Inherent in deciding performance around non-financial metrics is some discretion, and proxy advisors and investors will give some leeway to goals that are objective, clearly stated, and disclosed well—we call this "bounded discretion." Be aware, however, that investors and proxy advisors are noticing disconnects between financial performance and the non-financial performance. Finally, where are these metrics going? We think they will increase in prevalence and will be focused around what we call stakeholder return—around environmental, social, and corporate governance metrics.



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What are the reasons for and against the adjustment of grants based on market swings?

Laddin: We all know that 2015 was in general a volatile year in the market. Stocks were flat, many were down—some dramatically. How do companies stay true to their compensation philosophy in an environment like this? Let's focus on the more extreme cases—energy, steel, and those industries where we saw 50 percent decreases in stock prices. As a company in those situations you have to think about your long-term compensation philosophy. Most companies target executive pay at median, with equity being a key component of pay. Logic would say, "The stock is down, and we're going to stick to our philosophy and deliver the same percentage of salary as we have done in the past in long-term incentive plans." Well, you may have to do a sanity check.

I think boards really need to think about how to balance multiple dynamics. How do we stay true to our compensation philosophy, responsible to shareholders by not giving away too much equity, and come up with a long-term strategy of how to deal with this? If the stock price goes up, will we stay true to what we decide to do when the stock is down?

Some companies have addressed this by having an informal burn-rate cap. For example, they may not grant more than 2 percent of shares in any given year, and will adjust how those shares are delivered to management. I think what's really important is to consider whether compensation is being handled fairly. What's the potential perceived value to participants? Keep in mind that if we are dealing with a situation where the stock price is down, executives are likely holding a lot of equity that might be worth dramatically less than we had intended. So it's not just about shareholder issues. It's also retention, managing burn rate, being true to the compensation philosophy, and thinking about how equity currency is used in the most effective way.

Is there a better model than the make-or-beat-budget model?

Sullivan: Executive pay today is center stage, so the rigor of the goal-setting process is incredibly important. It's one thing to test the relationship of executive pay with company performance using a rearview mirror. But boards and management teams are faced with looking forward, setting goals for the period that is just beginning. That's not nearly as easy as the retrospective analysis performed by the major proxy advisors or the new pay-for-performance disclosure requirements made by the Securities and Exchange Commission.

How do we get to that next level with goal setting? The answer is fairly intuitive. It's simply adding a step to goal setting. When setting the goals at the beginning of the period, we're using the best available information at the time. The new thought, then, is to test that best available information at the end of the period based on what actually happened during the year. Did those assumptions we used to set the budget bear fruit? How well did we predict? Did we beat our budget? And ultimately, was the budget overly hard or overly soft? It's a fairly simple idea: if we beat a hard budget, we should be willing to pay more than if the budget was a little soft.

This doesn't reduce the need to be rigorous in setting the goals up front. Rearview-mirror assessments work best when the goals are still carefully planned. But rearview-mirror assessments give the option to consider truly exogenous factors that held up or held down the company's performance relative to its beginning-of-year budget.

What is your advice to companies that are preparing a strategy for communicating the compensation plan to shareholders?

Fitt: Get started early. This applies whether you or your shareholders have concerns about your compensation programs or if you've enjoyed a very high say-on-pay vote for the past several years. In general, institutional investors are looking for your calls and outreach, but not in February or March. When their busy season starts

to slow down—call it July for a calendar-year cycle—that's when they have the time to answer the phone. It's also important to identify with whom you want to speak. While your relationship with institutional investors may be strong, the big houses tend to have a separate corporate governance staff that makes most say-on-pay voting decisions. They're your target.

Next, you need to define your agenda, which will be influenced by your circumstances. Have you historically had say-on-pay voting issues? Do you expect there may be a future concern or issue? Are you implementing changes that might not be center of the fairway? If yes, then I would suggest that starting earlier is better, in case you need to make adjustments based on the feedback you collect. If it's largely business as usual, or if the communications are more informational and educational, then engaging a bit later in the cycle will work, but it's not just as you're beginning your next proxy season.

You need to make sure you have a team versed in your programs and in each investor's say-on-pay voting policy to address the agenda. If you have concerns or issues around philosophy and rationale, it may be appropriate to have the compensation committee chair or the lead independent director available. If, on the other hand, you anticipate addressing detailed questions about the program's mechanics, you need to make sure someone can discuss the details fluently. That may mean the director of executive compensation is one of your team members. And lastly, make sure you spend adequate time in the Compensation Discussion & Analysis summarizing the key messages, both positive and critical, that you heard from the process.

Can you do a deeper dive into shareholder communications and how to secure a positive vote?

Hall: One of the scary things I'm hearing when talking to a potential CEO client about his or her shareholder outreach is, "We passed with 92 percent last year. We didn't change anything. I don't even want to discuss it." Then you mention to them that for the past three or four years, 20 percent of the companies with failed say-on-pay votes had a 90 percent pass the year before. You've got to make sure you're telling your story and reaching out to people. Key to effective shareholder outreach is making sure that you're talking to shareholders early and following up later. As soon as your vote takes place, see who voted against you and ask them why. We're hearing more and more that the person to go out and talk to people has got to be the compensation committee chair or the lead director. That's posing a whole new problem, because the required skills and time commitment are new to the role and are generally not considered when selecting a compensation committee chair. We're finding that you need a camera-ready person. You need someone who can talk, who can put the concepts together, who has a deep understanding of the program and the reasons for decisions made, and importantly, who has the time to travel to multiple shareholder meetings. Not every company has a compensation committee chair who has these capabilities, so that's something we're all going to be looking at a bit differently moving forward.

What is the relatively new relationship that the compensation committee may have with succession planning?

Trentacoste: As our clients' compensation committees have asked human resources departments to update them on CEO and named executive officer succession, many were surprised by how underprepared their organizations were. Why aren't their talent and compensation strategies linked? We think there's a disconnect in timing. Talent planning is prospective, while compensation is largely retrospective. Despite that disconnect, we think there is an opportunity to link talent and compensation strategies with something we call "pay for potential." Build pay for potential into your existing talent planning framework. Consider differentiating pay opportu-

nity through a nine-box grid that assesses performance and potential within the organization. Differentiating equity awards based on this grid will award future stars with a higher opportunity vis-à-vis the market, while lower performers will have awards decreased. The second is philosophical in that they know every year the company is going to set aside some portion of equity for spotted retention for high-potential individuals. So what should directors do now? Ask yourselves if you're ready for executive succession. If the answer is yes, then you're likely ahead of the game. If the answer is no, that's okay. Assess the value of unvested equity to "hold" crucial talents, determine which positions are at greatest risk for succession, and identify candidates who are ready now, in six months, and in a year. Finally, develop a formal philosophy around talent planning.

What is a metric you would like to see used in the long term?

Sullivan: I like the term "stakeholder value." It recognizes society at large, including shareholders, and big-ticket social and environmental issues facing businesses and their customers. The thought going forward is that businesses need to bring to bear the engine of capitalism to address social and environmental pressures. Importantly, this thinking need not be solely altruistic. Businesses can be profit-motivated, driving economic value hand in hand with social value.

A 2015 study by *The Economist* magazine asked business leaders if they believed corporations have a role in addressing social and environmental needs on par with governments. Eight out of 10 said yes. Marry that with a recent McKinsey & Co. study that found the major misstep in following through on sustainability initiatives is a lack of pay tied to those initiatives. These two studies underscore business leaders' feeling of responsibility and the role for compensation supporting that responsibility. So what's next? Consider thinking more broadly about performance, extend the time frame for performance, and understand that compensation can play a key role. It's often where the rubber meets the road—where larger strategic issues take tangible form, helping to focus attention and shape behaviors.

How should boards prepare for pay-ratio disclosure in 2018?

Hall: Compensation committees should at least ask the question of HR, "Are you ready for this?" Have you begun the process of collecting the data, and are you sure that it will be readily available? You'd be surprised at the number of companies that can't tell us very quickly how much senior executives in other countries are making.

How do we address the ratio? We know that the disclosures are going to be placed in an ugly light. I've got an extreme example of a company with a CEO and 180,000 employees, 150,000 of which are working in China making $3,000 a year. I don't know how to fix that ratio. It's not going to be pretty, so we've got to be prepared to tell the story as to why it is what it is. In some cases we are getting ourselves a bit too concerned with optics. There are only two ways to change the ratio: either reduce CEO pay or increase pay for all employees. Since neither is an acceptable answer, I think we need to focus on communication. The other story we've got to tell is that stakeholders should be more focused on the ratio of the CEO's pay to the second, third, fourth, and fifth highest-paid employees in the company. Do we have an imperial CEO situation and executives who don't look like they're strong enough to make things happen on a going-forward basis? We should work closely with the public relations sections of our company thinking about how to tell the story in a way that clearly and honestly addresses the reality of the ratio.

Swinford: Focus on that median employee. Everyone knows what the CEO makes if they care to read the proxy. What people in the company don't know is what their fellows make, and many will be shocked they make less than your median employee. It's a bigger employee relations issue than an executive compensation issue.