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The 2013 Compensation Committee Agenda: Go Beyond

The primary responsibility of every Compensation Committee is the oversight of programs that will attract, retain and reward the talent needed to drive the business and create long-term shareholder value. Current pay trends, peer practices and competitive data have long been standard considerations in members' decision-making, supplemented of late by concerns related to gaining Say on Pay support. These external factors all encourage Directors to "conform to the norm." But a well-tailored compensation strategy can send strong signals to employees and the marketplace about the company's goals, priorities and vision. Simply following the crowd minimizes the real impact that a differentiated compensation strategy can have on building a strong management team focused on achieving the company's business strategy.

That's why we strongly believe that Directors' most important mandate in the current economic and governance environment is to "Go Beyond" – beyond best practices, beyond data, beyond check-the-box compliance, and beyond the obvious.

We outline ideas in five key areas to help Committees think outside the box of standard practices to create and effectively communicate the right pay programs for *their* company, despite external pressures to conform to generic pay standards. They support a complex set of strategic needs that includes setting the right tone at the top, creating a strong performance culture, developing new leaders, balancing performance and retention needs, and building stakeholder confidence in the Board's ability to manage leadership talent.

1. **Buck Trends and "Best Practices" in Favor of Business-Based Plans.** Compensation should reflect the needs of the business. The Committee's goal is to build a great company; if it performs, Say on Pay will take care of itself.

2. **Link Realizable Pay to Compensation Decision-Making.** Understanding pay targets is important, but analyzing actual pay relative to actual performance gives Committees real, actionable information.

3. **Spend More Time on the Performance Side of the Equation.** There are *two* sides to the pay-for-performance equation. It's critically important to get both sides "right."

4. **Apply a New Lens to Equity Plan Design and Award Values.** The LTI vehicles selected and the size of awards made need to reflect performance *and* retention strategies.

5. **Customize Your Risk/Reward Profile to the Business.** Compensation plans should evolve to reflect the business risks and HR needs of companies at different life-cycle stages.

It's time to stop relying on political correctness as a strategy and put the spotlight back on building great leadership teams to drive long-term business success.

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1. Buck the Trends and "Best Practices" in Favor of Business-Based Plans

Say on Pay votes were intended to give shareholders a voice in executive pay practices that were sometimes perceived as running amok. It was not anyone's goal to homogenize executive compensation. Compensation Committees that model their pay program designs to the standards of proxy advisory firms may pass their tests, but lose the ability to develop great management teams who will drive differentiated business strategies. Directors' key consideration should be what makes sense for *their* organization.

While it may seem counter-intuitive, we believe the best way to balance ongoing business challenges with the prospects for Say on Pay votes, expanded regulatory requirements and greater shareholder pressures is to <u>*resist*</u> the movement toward program standardization. Instead of struggling to get advisory firms' seal of approval for pay programs, companies should make business-based decisions and then plead their case directly to shareholders.

To do so, management must propose programs that meet regulatory standards but also will drive the key priorities and strategies needed to ensure the company's success over the long-term. Outside advisors' role is to supply perspective and candid insight, along with relevant competitive information. Committees then must apply their best business judgment in making final decisions. We recommend that members reconsider some key issues around plan design and disclosure:

- ***Get comfortable using discretion.*** Deviating from program standards is viewed with suspicion, but may be the best way to address complex, unusual or unique circumstances. Committee members, senior management and Board advisors can and should rely on their combined decades of experience to exercise business judgment, particularly when a dogmatic or formulaic approach will produce a poor, counter-intuitive outcome.

- ***Take data out of the driver's seat*****.** Data should inform, but should never be the primary basis of decisions around executive pay programs, especially for named executive officers. As an example, even with median pay philosophy, Committees should exercise flexibility to vary pay levels in response to factors that are specific to the company or the individual.

- ***Trust your business judgment in picking peer groups*****.** Shareholder advisory firms evaluate companies using peer groups they create based on algorithms. Committees are expected to apply their more intimate knowledge of the business and its strategy, including issues related to size, business model, direct and indirect competitors, etc. – even if their decisions are at odds with advisory firms' conclusions.

- ***Go beyond minimum disclosures*****.** The annual proxy isn't merely an exercise in compliance – it's the Board's premier opportunity to make a bold and persuasive case to shareholders for its decisions. SEC disclosure rules in no way preclude Committees from providing supplemental data and more extensive information to help explain programs, especially to counter negative comments or recommendations from proxy advisors.

- ***Find out what your shareholders care about*****.** Every company should conduct an annual communication program around executive compensation with its largest shareholders. Resist the temptation to dwell on the shortcomings of proxy advisory firms, and focus on listening and responding directly to the concerns expressed by shareholders. Investing the time and money to explain programs, particularly positions that may not be fully aligned with perceived “best practices” or advisory standards, can prove critical to gaining Say on Pay support regardless of an advisory firm’s voting recommendation.

2. Link Realizable Pay to Compensation Decision-Making

While not new, realizable pay is one of the latest buzz-words in executive compensation, mainly in response to the increased focus on performance-based pay created by Say on Pay voting. In contrast to the pay total required in the proxy’s Summary Compensation Table, realizable pay relies on the value of equity awards based on actual company performance, rather than simply the grant date accounting value – which makes it a far more relevant number for analyzing the pay-to-performance linkage.

However, rather than being relegated to the appendix of a once-a-year report to the Committee, a realizable pay analysis should be referenced at key points throughout the annual compensation planning cycle to help assess and promote pay-for-performance alignment:

- ***As part of goal-setting for incentive plans.*** Looking at historical pay-for-performance on the basis of realizable pay offers guideposts for setting future performance goals and executive payouts relative to peers. If there is misalignment, the problem may be that pay is not competitive (e.g., targets are too high/low, the pay mix lacks sufficient leverage, or thresholds and maximums are not competitive). Alternatively, the plan’s performance metrics and goals may not be appropriate (e.g., financial/operational performance metrics do not correlate with shareholder value creation, or goals are too hard/easy).

- ***As part of shareholder communications.*** An increasing number of companies are including alternative charts, graphs and commentary around realizable pay in their CD&As and in targeted discussions with large shareholders and proxy advisory firms. Along with helping to explain the Board’s thinking, the use of more complex pay-for-performance analytics helps demonstrate the Board’s commitment to “getting it right”.

- ***As part of the proxy season post-mortem.*** Devote all or part of a summer Committee meeting to a review of peer group results, including target and realizable pay for peers and a full pay-for-performance review, to identify competitive gaps in the current structure. Too often, this peer review is delayed to the 3rd or 4th quarter planning meeting, when there is little opportunity to make design changes for the coming year.

- ***As part of any new incentive plan assessment.*** The Committee can enhance its usual pro-forma analysis of the proposed payout curve of new incentive programs by looking at pay-for-performance on the basis of realizable pay potentials. The results can highlight the interplay among multiple incentive plans tied to different performance metrics, while a competitive pay leverage model can reveal how a new plan would change potential threshold/target/maximum payouts relative to peers.

3. Spend More Time on the Performance Side of the Equation

Compensation Committees devote great time and effort to determining how much executives should be paid, from assembling peer groups and conducting comprehensive benchmarking studies to determining the mix of cash/ equity, short-term/ long-term and fixed/ variable pay. In contrast, many companies give too little consideration to picking the right incentive measures and periods for their specific company, setting challenging but reasonable performance goals, and then calibrating awards for every level of performance. It may take more upfront time to creatively apply analytical tools in making such decisions, but the payoff in better plan design is generally well worth the effort.

We believe the following considerations can help give Committees a fresh perspective on the complex issues around performance:

- ***Don't be a slave to prevalence in selecting performance metrics*.** Committees tend to default to the practices of their industry peers. Yet the choice of incentive metrics sends a strong signal to a company's employees and shareholders about what the organization views as most critical to its future success and sustained shareholder value creation.

- ***Balance "outcome" metrics with "driver" metrics.*** Outcome-based metrics like revenue and earnings growth and return on capital reflect a company's success at selling its current products and services. But they should be complemented by metrics that drive *future* value creation, e.g., development of new products, strategic initiatives, customer service, quality and sustainability.

- ***Create "dynamic tension" between short-term and long-term metrics*.** Many companies rely on the same incentive metric for their short- and long-term incentive programs, reasoning that if achieving annual earnings growth is important, then sustaining that growth over multiple years should be an even bigger priority. But employing different metrics is a good way to motivate and reward short-term actions that drive long-term value creation – for example, focusing on revenue growth as a goal in the short-term plan and return on invested capital in the long-term plan. The complementary measures communicate to participants that momentum (i.e. annual revenue growth) is important, but not at the cost of long-term business efficiency (i.e. improving return on capital).

- ***Recognize that TSR is not an "incentive" metric*.** Many companies rely on relative TSR as an LTI metric, since it avoids the need to set long-term goals and is viewed favorably by shareholder advisory firms and many institutional investors. It also can promote alignment with shareholder interests and can be an effective check/balance against internally set goals. Remember, however, *incentive* plans are intended to motivate and reward management actions and decision-making. In that respect, TSR is less effective as a stand-alone metric, since share prices naturally reflect factors that are outside the control and influence of management.

- ***Go beyond budget in determining performance goals*.** Similarly, too often, the default setting for target payouts is the company's budget. Companies should not ignore other considerations, including: analysts' expectations for the company and the industry, the degree of risk, the difficulty in the performance goals, and the historical context. Rather than creating an unrealistic budget to justify a target incentive payout, Committees should judge the budget independently, then decide what level of incentive award is merited by the performance. This same level of analysis should hold true in establishing the end-points (i.e., threshold and maximum) – while symmetry is common (e.g., a -20% below budget threshold and a +20% above budget maximum) it is not always the best approach.

4. Apply a New Lens to Equity Design and Award Values

Equity awards typically represent the lion's share of an executive's performance opportunity in the short-term and over time. In addition, as retirement benefits have declined, equity is increasingly relied upon as a way to help retain valued executives. While outsiders often are critical of time-vested grants and retention awards, Boards know that a bench of talented leadership is essential for internal succession and business continuity. That makes it more important than ever to recognize the strategic role of equity plans.

Most companies grant annual equity awards using a target multiple of salary or dollar value that is approximately equal to market median pay data. Recent stock market volatility and the laser focus on pay-for-performance alignment have highlighted two big problems with this approach:

- Starting with a target dollar value has a counterintuitive result since executives receive fewer options/shares in the wake of strong stock performance and more options/shares as the stock price declines.

- If companies always target median, then grant values do not vary with performance – making the ultimate achievement of actual pay-for-performance alignment that much more difficult.

Consider applying a new lens to equity grants to improve alignment:

- ***Proactively manage the existing target value approach*.** For example, hold the target value steady for more than one year and/or de-couple the target from annual base salary increases.

- ***Incorporate performance retrospectively.*** Adjusting the size of annual equity awards based on past performance can avert the possibility that target pay will be stuck at median even if performance is consistently higher or lower.

- ***Migrate to a stable, target number of options/shares*.** When the number is fixed, the grant value will vary with stock price performance. However, it is still necessary to monitor deviations from competitive market value and periodically (not frequently) adjust the target number over time.

- ***Consider using a front-loaded, multi-year equity grant*.** A larger initial opportunity can be very motivational and also send a bullish signal to the market. However, this approach is definitely not on the standard "best practices check list" and will require a detailed and persuasive disclosure to investors of the Committee's rationale.

- ***Don't ignore retention value***. Proponents of purely performance-contingent equity awards rightly maintain that management should be rewarded for doing their jobs, not just keeping their jobs. However, given that equity grants are the sole executive retention vehicle at many companies, avoiding the cost of unintended turnover and supporting an effective succession planning strategy are legitimate and important equity design objectives. The retention power of time-vested equity holdings should be weighed against the mantra of pay-for-performance.

Lastly, companies should ***examine executive wealth creation opportunities*** at different future stock prices and performance levels. Most companies construct "tally sheets" for executives, but they seldom include scenario modeling of potential future equity values as a diagnostic tool for understanding the evolving pay-for-performance relationship or for choosing among new equity design alternatives.

5. Customize Your Risk/Reward Profile to Your Business

Balancing risk and reward is at the heart of executive pay design. Overly leveraged incentive plans can drive overly aggressive management decisions, while putting too little pay at risk or providing the wrong upside/downside leverage can promote a "pay for pulse" culture.

Following the financial markets meltdown, companies in all sectors reviewed the riskiness of their compensation plans. Many chose to reduce risk in reaction to the pressures of shareholder advisors and other outsiders. But effective and responsible risk-taking, matched to a company's strategy, stage of development and the maturity of its markets, is an integral part of any successful business. That said, early stage firms are very different from mature organizations – their business risks are not the same, and their compensation plans shouldn't be either.

Rather than relying on prevalence-based pay designs, companies need to be willing to consider atypical pay programs that will attract and motivate the talent needed to execute the business strategy. Once the HR priorities are identified, the compensation strategy can be designed to support those priorities. Companies typically have numerous **design levers** at their disposal for fine-tuning the emphases of their executive compensation program. Three examples:

Stage of Business	Business Strategy	Human Capital Priorities	Compensation Design Levers
High Growth	• New product development • Reinvest limited cash flow	• Innovative executive team • Recruitment	• Modest cash compensation targets • Rewards for key milestones • Upside from stock options
Mature Industry	• Gain market share • Maintain margin • Contain costs/improve efficiency	• Stable executive team • Internal succession • HR ROI	• Rewards for annual profit goals • Retention from full-value awards
Global Expansion	• M&A • Seek dominant market share	• Nimble executive team • M&A savvy	• Separate assessment of organic vs. acquired businesses • Rewards based on discretionary evaluation of M&A activities

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- ***Ensure that the compensation risk is mitigated by good compensation program governance.*** Risk mitigating program design characteristics such as stock ownership guidelines, compensation clawbacks, hedging/pledging prohibitions and post-termination/change-in-control vesting restrictions can help enforce the alignment of your carefully designed program with the interests of your shareholders.

- ***Review and update your plan to reflect changes in circumstance.*** Businesses move through stages over time, based on both internal evolution and changes in the competitive landscape. Boards need to periodically re-assess the company's human capital priorities, and ensure that compensation programs have been adjusted to keep pace.

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As we acclimate to a "new normal" following a prolonged period of stock market losses, economic uncertainty and new regulations, it is tempting to take a well-earned break and let the dust settle. However, our best advice in the current environment is to keep pushing forward and doing better – in short, ***to go beyond best practices***. The very best companies will spend the months ahead re-examining whether their management pay programs merely comply with expected or competitive norms, or are specifically built around the critical needs and priorities of *their* business. We all know that compensation is a powerful tool that speaks volumes to stakeholders about a company's culture, goals and priorities. A program structured to simply follow the pack may be safe, but won't provide the competitive advantage that creates a great company.

About Pearl Meyer & Partners

For more than 20 years, Pearl Meyer & Partners (www.pearlmeyer.com) has served as a trusted independent advisor to Boards and their senior management in the areas of compensation governance, strategy and program design. The firm provides comprehensive solutions to complex compensation challenges for multinational companies ranging from the Fortune 500 to not-for-profits as well as emerging high-growth companies. These organizations rely on Pearl Meyer & Partners to develop global programs that align rewards with long-term business goals to create value for all stakeholders: shareholders, executives, and employees. Pearl Meyer & Partners maintains U.S. offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, Los Angeles, San Francisco and San Jose, as well as an office in London.

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