Pearl Meyer

TRENDS & ISSUES

2016 Compensation Committee Agenda: Think Strategically, Act Decisively

Pearl Meyer once again shares the annual top five recommendations for compensation committees. In prior years we have suggested that boards “go beyond” check-the-box compliance and “raise the bar” to avoid one-size-fits-all compensation program design.

Our belief that compensation can play a key role as a catalyst of value creation has helped elevate the conversation in the boardroom and in the marketplace. By encouraging organizations to align compensation with their business and leadership strategy, we’ve provided a road map to help companies achieve their strategic goals and be successful over the long-term.

We begin this year by sharing insight and guidance for boards on the top five compensation priorities for 2016. We continue to encourage the appropriate balance between the immediate need to respond to regulatory pressures, the looming proxy season, and the longer-term initiatives that can create a strategic link between compensation programs and business outcomes.

1. **Put TSR in its proper context and if not TSR, then what?**
   Use it as an alignment tool and indicator of long-term value creation, but not as an incentive. Instead, design incentives to directly reflect business objectives and long-term strategy.
2. **Link compensation strategy to leadership strategy.**
   Avoid designing pay programs without considering the corporate culture.
3. **Use equity to combat short-termism.**
   Extended holding requirements may offer positive results.
4. **Don’t let time run out: model new disclosure requirements now.**
   Pay-vs-performance modeling in line with the proposed SEC rules is crucial.
5. **Think (really *think*) about director compensation.**
   Adopt an activist mindset.

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Put TSR in its proper context and if not TSR, then what?

It doesn't matter if you are running a multi-billion dollar investment fund or if you're managing your own equity investments. Over a long period of time—at least 10 years—virtually everyone agrees that total shareholder return (TSR) is the best measure of long-term value creation. But can or should we come to the same conclusion about the effectiveness of total shareholder return as an incentive plan metric?

Empirical research from Pearl Meyer and Cornell University shows there is no evidence that using TSR in an incentive plan leads to increased firm performance. In fact, it is fairly easy to show that some of the most highly performing companies over the past several decades have gone through sustained periods when TSR either led or lagged financial and operational performance. This result plays havoc with traditional three-year TSR performance plans and can give misleading indications of the pay-for-performance relationship.

Given the focus on TSR both from institutional shareholders and proxy advisory firms, many compensation committees feel compelled to prominently include TSR as a metric in the long-term incentive plan. A more effective approach may be to lessen the role of TSR in the long-term incentive plan, which will allow compensation committees to introduce another financial metric that is closely related to historic TSR performance. This approach accomplishes several goals. It will:

- Better align pay with performance;
- Help the compensation committee think about the difference between long-term value creation versus near-term performance and what role a TSR metric should have, if any, in the near-term;
- Continue to align management's and shareholders' interests; and
- Satisfy certain stakeholders who staunchly believe TSR must be used in the long-term incentive plan.

As a general statement, long-term incentive plans are the most complex pay element to design and analyze. We believe compensation committees would be well served by reviewing their long-term incentive plans, identifying the metrics that have strong alignment with their company's historic TSR performance, and discussing if TSR should be used beyond the measurement of long-term value creation.

Executive compensation programs are expected to achieve the impossible. They need to help attract, retain, and motivate executives while at the same time, be designed in a way that supports pay-for-performance, achieves management and shareholder alignment, and gives management clear line-of-sight. Obviously incentive plans that are heavily weighted with a TSR metric will come up short when measured against these numerous and lofty expectations.

Perhaps one of the biggest challenges facing compensation committees is not recognizing the challenges of using TSR in achieving the above-stated goals, but rather identifying a process that will lead to more effective incentive programs.

- Understand the objectives of your compensation plan and the potential trade-offs between them (e.g., attract, retain, motivate, communicate performance objectives, pay for performance, align with shareholders, etc.).
- Outline the company's business objectives and strategy and the drivers of long-term value creation. Then select short- and long-term incentive performance measures that directly tie to the achievement of milestones toward these goals.
- Ensure measures are fair, easy to understand, calibrated appropriately, and actionable (i.e., have substantial "line of sight").
- Identify and focus on the centerpiece financial metrics that will signal success within your company, your industry, and the global economic environment.
- Incorporate both "lag" metrics—that reward achievement—and "lead" metrics—that spur desired new actions and behaviors.

It is very possible the TSR metric may not find a home in the new incentive program. If circumstances or pressures exist where TSR must be incorporated into the compensation plan, consider using it as a performance modifier to a financial metric in order to minimize its impact.

Link compensation strategy to leadership strategy.

The concept of leadership development should be simple: compensate people for delivering results tied to company strategy and values. Unfortunately, as with determining corporate performance drivers, the constant pressure to conform compensation programs to an ever-narrowing definition of what is considered "acceptable practice" results in companies designing programs for external consumption rather than for their people or business strategy.

However, it is ultimately executives and employees who execute the strategy. Multiple surveys show that compensation is consistently ranked as an important engagement and motivation factor, but tends to place near the bottom of the top five factors at best. Conversely, compensation is typically cited as one of the main factors contributing to executive departure and employee turnover. The general characterization of compensation as a "hygiene factor" (in the same category as job security or company policies), clearly indicates a missed opportunity for most companies to look at compensation as an engagement tool.

Unlike other hygiene factors, a compensation program designed within the context of an organization's unique cultural and leadership attributes could serve as a valued engagement tool for many. When employee preferences on risk tolerance, wealth creation, culture, and career aspirations serve as the foundation of the compensation design, the company's quest for results that create value and the employee's needs become fully aligned.

For example, in today's environment it is very important for companies to have an overall compensation philosophy that is aligned to the performance objectives the company lays out. If the organization wants to adopt aggressive performance targets, above market payouts for achievement may be warranted. However, if aggressiveness is not a core cultural trait of your management team, the program structure is likely a “bust” from the outset.

Bringing the human element into executive compensation may be uncharted territory for many companies, but the actions steps below will place them on the right path.

- Conduct a culture and leadership diagnostic. Assess executive views on corporate values and beliefs, opportunity for career progression, risk tolerance, autonomy, accountability, and innovation.
- Map your current compensation program. Conduct a gap analysis between the results of the culture and leadership diagnostic and your current compensation program. (Note: results/implications may be different for different executive populations within the same organization.)
- Prioritize the gaps. Review the gap analysis holistically and determine the key areas that need to be addressed.
- Identify the right compensation program elements and structure. Create a program design (e.g., pay components, pay levels, pay mix, and performance metrics and goals) that is both uniquely tailored to your organization and resonates with recipients on an individual level.
- Implement and monitor the plan. Develop a communications strategy around the roll-out of the new compensation program design, agree at the outset on the measures used to determine effectiveness, and be willing to adapt to evolving employee preferences and business realities.

Use equity to combat short-termism.

In some ways, equity compensation is simply another form of pay delivery intended to create a market-competitive offering to executives. However, equity is distinct from cash in that it provides a direct link between executive and shareholder interests, not just during a performance/vesting period, but for the entire time it remains held by the executive. The performance feature of equity is also distinct in that it is a forward-looking assessment of firm performance. That is, the value of a share of stock today reflects shareholder expectations of future financial and operational performance.

This forward-looking character of equity compensation should prompt compensation committees to consider a reframing of vesting, holding, and the appropriate treatment of equity upon the departure of executives, especially at retirement. As companies begin to more frequently and more effectively link compensation and long-term strategy, and since many decisions of an executive influence firm performance over multiple years, why not strengthen the alignment of equity compensation to those decisions?

Over the past several years we have seen an increase in holding and ownership requirements. More recently we have even seen a “liberalizing” of equity treatment upon retirement, allowing for extended vesting of the full value of lately-granted awards. Such treatment remains a minority practice, but is increasing in prevalence.

Extended vesting upon retirement not only aligns late-career management decisions with compensation, it also provides another tool for talent management. Such treatment can be conditioned upon orderly, planned-in-advance retirement and non-compete arrangements. Moreover, such treatment may be considered more “fair and balanced,” especially if at the start of an executive’s equity-eligible career, he or she received a grant that did not vest for several years (i.e., no true-up or “stub year” grants). This treatment creates a symmetry.

There are technical concerns and accounting costs associated with a change in equity treatment of this nature. Nevertheless, it is worthwhile to consider how such changes can better align equity compensation with your leadership strategy and long-term outlook.

Don’t let time run out: model new disclosure requirements now.

Last year brought a wave of disclosure rules that while not imminent, will creep up on us very quickly. Now is the time to start planning—not only to ensure your proxy statements are sound when it is time to file, but that your organization is prepared to clearly communicate the reasoning for your approach to meeting these rules and the underlying rationale for your compensation programs. Here we cover the three looming changes and what you can do now to get ahead of and mitigate unforeseen issues.

The CEO Pay Ratio is the one 2015 SEC proposal that has been finalized. We now know that beginning in 2018, the ratio between CEO pay and the median employee pay—as well as the methodology for calculation—will be included in the Compensation Discussion & Analysis (CD&A). The primary risk with this rule is not the perception of the general public, media, or shareholders, it is to employee engagement and internal discord.

Our top recommendation to the board on the Pay Ratio is to ensure HR teams are developing a solid communication strategy and implementing a plan to educate the employee population on the company’s pay philosophy and programs, and how they translate to the individual.

The next proposal—Clawbacks Policy—is awaiting finalization and in its current form, appears fairly straightforward. However, there are potential contractual and indemnity implications and the board should ensure there is a thorough legal review taking place well in advance so that any issues can be addressed. Many companies already have some form of clawback policy in place as a result of Sarbanes-Oxley, but need to dig deep to ensure all changes that will be needed to comply with the SEC rules can be met and clearly communicated.

Finally, we come to the proposal that we anticipate will be by far the most complex: pay-vs-performance. This proposal is likely to add considerable new calculations and text to an already detailed and lengthy CD&A. In our view, these additions will further confuse and complicate understanding of a company's pay philosophy and programs, rather than provide clarity to shareholders. Our recommendation is two-fold and we suggest companies begin work on this proposal as soon as possible.

Pay-vs-Performance	Challenges to Consider	What to Do Now
Proposed 4/29/15 You must disclose specific information about CEO and average NEO pay relative to TSR **and** peer group TSR over a five-year period *(initially requires three years of data; requirement will migrate to five years).*	▪ Requires you to define performance solely in terms of TSR—regardless of performance measurement and pay practices ▪ Entails complex calculations that differ from the SCT, with complicated modeling scenarios ▪ Involves decision-making around which peer group to use and why	▪ Develop tabular disclosure as required and model in advance ▪ Prepare additional narrative to support rationale for outcomes ▪ *But* create compensation programs fully independent of the rule ▪ Keep programs focused on industry, business life cycle, and long-term value creation strategy

First, satisfying the requirements will take some skillful writing to ensure stakeholders understand how your company has developed its executive compensation design and what it is intended to achieve. It will be important to ensure that they aren't distracted or confused by the additional information required, which may not be at all relevant to the strategic and implemented pay program. Begin drafting and refining narratives that outline what the "real plan" is, how it was determined, and what it should achieve. Also outline the additional story that offers the required calculations and why that information is or is not relevant to the real world of your company.

Second, in order to achieve air-tight communications on this proposal, accurate modeling will be required. Begin with a full understanding of the traditional benchmarking process and the term "compensation" as defined by the SEC and proxy advisors, including realized and realizable pay. Understanding the differences in these figures will help you better understand your true pay-for-performance alignment and help your shareholders better interpret the disclosures. It is also worth considering how much supplemental disclosure is helpful. If the required disclosures are inadequate to tell your pay-for-performance story, consider a more tailored picture of realizable pay and its alignment with performance.

Finally, it's critically important that a company keeps its "eye on the prize" in terms of executive compensation design. Understand the rationale for structuring your program according to the organization's unique business and leadership strategy, regardless of annual TSR and peer TSR outcomes and be able to articulate the board's goals for creating long-term value based on compensation drivers.

Think (*really think*) about director compensation.

Most boards spend far more time thinking about how to pay their executives than how to pay themselves. This makes sense. Executive compensation design is far more complex, and CEO pay levels are subject to much more public scrutiny and criticism. But the landscape has been shifting recently. Boards are facing increasing external pressures to defend their role in governing their organizations and delivering value to stakeholders. In turn, there is new focus on board composition, director independence, and related governance issues, such as compensation.

The approach is no longer as straightforward as in the past. Part of the playbook for many activist shareholders is to influence company strategy by obtaining board seats. In recent years, we've seen some activists propose special compensation arrangements in order to attract their selected candidates to run on a dissident slate. While not common, these "golden leashes" have generated a fair amount of debate and concern, and NASDAQ is currently contemplating adoption of disclosure requirements. Anecdotally, we have encountered other outside-the-norm ideas, including private equity and venture capital investors who believe director compensation should include incentives (aka a director bonus plan) to ensure that directors are as committed as management to the achievement of company goals.

Recent Delaware case law (Calma v. Templeton [Del.Ch. Apr.30, 2015]) also focused on director compensation, suggesting that companies' reliance on the single grant limit in their equity plans (which are typically set at a level designed to cover the potential size requirements of CEO grants) may not be sufficient protection in the event of a shareholder lawsuit over director compensation. The Delaware Court reaffirmed this position in its Facebook decision.

So, is director compensation on the brink of change?

First, a look at the current landscape. Unlike executive compensation, the structure of public company director compensation is fairly consistent across industry and size. Our analysis of 1,400 public companies in Pearl Meyer's 2015/16 Director Compensation Study, published in conjunction with NACD, found that 97% of companies pay a cash retainer, 93% provide an annual equity grant, and 94% give committee chairs additional compensation. The level of compensation varies by size and industry, but even there the normative range is fairly narrow—the median compensation for the smallest size group in our analysis (companies with revenues between $50 and $500 million) was approximately $115,000, while the median for the largest companies (revenues greater than $10 billion) was just over $265,000—a difference of roughly $150,000 for oversight responsibility of a company more than 20x larger.

This suggests radical change may not be warranted, but we believe that companies should review their current director compensation structure and levels with a critical, strategically-focused eye.

Given the new level of scrutiny boards are facing about their self-governance, we caution companies against going too far out of bounds (e.g., adopting a director bonus plan), but a strategic review of director compensation could uncover "disconnects" between the roles, responsibilities, and expectations of directors and the size and/or structure of the director compensation program, and provide an opportunity for boards to get in front of any potential issues before investors, activists, or the media come calling.

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As the new focus on directors illustrates, there is increasing complexity in *all* aspects of corporate governance, particularly compensation. We anticipate the role of the board, the compensation committee, and executive pay practices will face increasing pressure and public demand for clear and effective results. Organizations that are serious about achieving their long-term strategy will look at all opportunities available for advancement and we suggest that compensation, and particularly the suggestions outlined here, can offer a strong tool for building corporate value.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Francisco.

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