The Top 5 Compensation Questions Boards Should be Asking in 2017

Compensation Series

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Pearl Meyer

NACD
NATIONAL ASSOCIATION OF CORPORATE DIRECTORS

Meet The Presenters

Mary Beth Vitale (moderator) is a director of CoBiz Financial Inc., where she chairs the board's nominating and governance committee. Previously, she was lead director for Eyeris Inc. and served as both the compensation committee chair and a member of the audit committee for Zynex Inc. She is a past president and COO of Rocky Mountain Internet and a past president and corporate officer of AT&T. She chairs NACD's Colorado Chapter and also serves as an NACD faculty member.

Terry Newth is a managing director in Pearl Meyer's Boston office, where he consults on the design, development, and assessment of executive compensation programs that support each organization's business objectives, long term business strategy, and organizational culture. His clients range from Fortune 500 organizations to pre-IPOs to private and family-owned companies in a wide range of industries.

Deb Lifshey is a managing director in Pearl Meyer's New York office, where she specializes in advising clients on compensation matters from a legal perspective including securities disclosure, taxation and corporate governance issues, negotiation contracts, and reasonableness opinion letters. She is a member of the New York and Florida Bars.

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Is Uncertainty the Only Safe Bet?

"The smart money is on the Trump administration looking to roll back the CEO pay ratio as soon as possible."
-David Wise, North American sales leader for Korn Ferry Hay Group.

"Everything has been turned on its head. Dodd-Frank will probably be repealed along with Obamacare, and EPA rules may be gone and the agency itself may be eliminated, including oil and gas rules…"
-Francis Byrd, CEO of Byrd Governance Advisory

"I think it'd be rather difficult to repeal say-on-pay." *-Charles Elson, director of the Corporate Governance Center, The University of Delaware*

"If Dodd-Frank is repealed, it doesn't mean that all of the Dodd-Frank rules go away; many of them are now codified [and] would have to be ripped out, which is a much harder thing to do."
-Josh Siegel, managing principal and CEO of StoneCastle Financial Corp.

"Republicans want to take apart the regulatory apparatus, and banks and issuers want to also. But, the work of unwinding things is very difficult. Taking apart a government is almost as difficult as putting one together."
Francis Byrd, CEO of Byrd Governance Advisory

The Business Climate Heading Into 2017

The Questions:

Are we entering a post compliance-driven era, a new era of deregulation?

What rules are coming and going?

What action should compensation committees take amidst all this uncertainty?

The Short Answer:

Stay the course, but be prepared.

Audience Poll

Which category do you think is the *most likely* to see changes?

1. *Dodd Frank provisions*
2. *Tax code*
3. *FLSA standards*
4. *Proxy advisor regulation*

Which category do you think is *most in need* of change?

1. *Dodd Frank provisions*
2. *Tax code*
3. *FLSA standards*
4. *Proxy advisor regulation*

Our View on the Coming Deregulation

- The focus on reducing the number of regulations likely will result in rolling back some unpopular rules, slowing everything in the pipeline, and taking much longer to write and approve anything new.
- A higher priority is likely to focus on reviewing and reducing banking restrictions.
- There will be a move in Congress to amend Dodd Frank, which means that there will be changes—but not wholesale revision and certainly not abolishing it altogether.
- The **pay ratio** is here to stay, but it could be simplified and the playing field may be leveled a bit (e.g., calculations for US-based employees only).
- Without Wells Fargo, the **clawbacks** rule might have gone away, however, it's now likely to be implemented with some modifications.
- **Pay-vs-performance** rules become low priority. They've already proven problematic with rTSR as the measure.

Trumped Up (or Down) Executive Compensation?

- Trump's views: populist, but highly critical of DFA
- Republican bills (Financial Choice Act)
- SEC Commissioners
  - *Until confirmed in mid-2017, it's likely rulemaking will be at a standstill*
  - ***Don't count on repeal of CEO Pay Ratio, although delay may be possible***

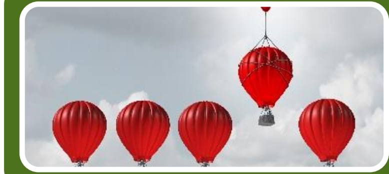
DFA Provision	Regulation Status	Priority/Likely Outcome/Timing
Say-on-Pay/Frequency	Finalized for 6 years	No change
CC Independence	Finalized for 3 years	No change
Chair/CEO Disclosure	Never regulated	No change
CEO Pay Ratio	Finalized for 2018 proxy	***High/Modified/Delayed***
Hedging/Pledging	Proposed since 2015	Low/No change/Delayed
Pay-vs-Performance	Proposed since 2015	Low/Modified/Delayed
Clawbacks	Proposed since 2015	***Medium/Modified/Delayed***
Banking Rules	Proposed in 2011 & 2016	***High/Modified/More immediate***

Trumped Up (or Down) Executive Compensation?

- Tax Code
  - *Simplification and reduction at top end (39.6% to 33%) >>> fewer deferrals in long run?*
  - *409A to 409B >>> extreme restructuring of existing agreements*
  - *Elimination of carried interest loophole >>> reduction in profits interest*
  - *Elimination of ATM >>> ISOs back in vogue?*
  - *Reduction in corporate tax rate (35% to 15%) >>> reduction in performance-based compensation?*
- New FLSA standards (24k to 47k for exemption)
- Proxy Advisor Regulation
  - *Transparency of evaluation methodologies*
  - *Conflicts in sale of related consulting services*

The Top 5 Compensation Questions Boards Should be Asking in 2017

1. At certain times, management may need to take short-term actions that are in the best long-term interests of shareholders but may negatively impact short-term results and compensation. How do we manage this?



2. Do we have compensation programs that create a competitive advantage; how are our compensation programs different than market and do those differences help with attraction, retention, and motivation?

3. Should our compensation committee expand its role to encompass broader talent management responsibilities?

4. The pay inequality issue isn't going away. Is our management team fully prepared to address internal and external questions?

5. How do we get ahead of the scrutiny of proxy advisory firms and avoid being sent to the penalty box?

Question 1

At certain times, management may need to take short-term actions that are in the best long-term interests of shareholders but may negatively impact short-term results and compensation. How do we manage this?

- The emphasis on short-term results in public companies may encourage management to take actions that are not in the best long-term interests of the company and its shareholders.
- Boards need to develop and help promote a long-term perspective.
- Does the compensation committee have a formal framework or process for adjustments or are you applying discretion post-facto?

Audience Poll

How often has your compensation committee exercised discretion with the annual bonus plan?

1. *Almost Always*
2. *Periodically*
3. *Rarely*
4. *Never*

How often has your compensation committee exercised discretion for long-term incentive plan payouts?

1. *Annually*
2. *Periodically*
3. *Rarely*
4. *Never*

Question 1: Next Steps

- Agree to “rules of the road” for allowing adjustments; considering:
    - *Materiality*
    - *Consistency*
    - *Accountability*
    - *Disclosure*
- Ensure metrics themselves are strategically balanced with dynamic tension between driving and outcome-based measures.
- Create on-going dialogue with management; have regular discussions about progress toward the long-term plan.
- Having a rolling results evaluation can bridge short-term issues in service to long-term results.
- Consider implementing 162m “umbrella plan” to preserve tax deductibility.

Question 2

Do we have compensation programs that create a competitive advantage; how are our compensation programs different than market and do those differences help with attraction, retention, and motivation?

- External influencers may unintentionally lead to conformity trap for public companies.
  - *Narrowing of market pay ranges as companies coalesce around median*
  - *Little differentiation in incentive design*
  - *Same program offerings*
- Compensation strategy should entail understanding what your company can do differently (internally and externally) to create competitive advantage.
  - *What unique company attributes should translate to compensation design?*
  - *What unique employee attributes should translate to compensation design?*
  - *What changes should we make to our program to alter course?*

Audience Poll

To what extent do your programs create a competitive advantage in attracting, retaining, and motivating individuals?

1. *Entirely*
2. *Almost entirely*
3. *Somewhat*
4. *To some extent*
5. *To no extent*

Question 2: Next Steps

- Step back and evaluate compensation programs in the context of the business and employees (not market practice and proxy advisor views).
  - *What are the key business and organizational strategies?*
  - *How are those desired actions embedded in compensation philosophy and design?*
  - *What programs are working? Not working?*
- Arrive at recommended changes and designs…
- …Now overlay market and other factors to inform and understand differences.
  - *What differences exist?*
  - *Do those differences support the strategy?*
  - *Will those differences create a competitive advantage? Disadvantage?*
  - *Will those differences cause issues with investors or proxy advisors?*
- Adjust as needed; don't allow programs to become stale.

Question 3

Should our compensation committee expand its role to encompass broader talent management responsibilities?

- The charter of the compensation committee has traditionally been focused on approving compensation and benefits for senior executives.
- Many committees are expanding their purview to address other critical talent issues, including
  - *Succession planning and leadership development;*
  - *Performance management and employee engagement;*
  - *Corporate culture; and*
  - *Environmental, social, and governance (or "ESG") issues.*

Audience Poll

Has your compensation committee expanded the formal committee name/charter to include non-pay related issues?

1. *Our name and committee charter both reflect expanded responsibilities*
2. *Our committee charter includes expanded responsibilities, but we haven't changed the committee name*
3. *No change to charter or name (while we may discuss non-pay issues, formal responsibility is not included in our charter)*

Question 3: Next Steps

Areas for potential dialogue:

- Succession planning and leadership development
  - *Do we have ready now/ready soon successors for key positions? What is the company doing to provide targeted development opportunities for "high potentials"? How can board members help to mentor them?*
  - *Committees should review statistics on leadership/pipeline diversity and understand actions being taken to address gaps.*
- Employee engagement and company culture
  - *In the wake of Wells Fargo, any review of compensation "risk" should consider a program's impact on culture and tone, in addition to financial impact.*
  - *How can committees track "culture at the core" in addition to "tone at the top"? Review engagement surveys, site visits, town hall participation, etc.*
- HR communications
  - *With media focus on gender pay issues, committees need to understand the company's positioning and strategy for communications to the public, investors, and employees.*

Question 4

The pay inequality issue isn't going away. Is our management team fully prepared to address internal and external questions?

- Regardless of what happens with regulation, the media will continue to push the controversy.
    - *CEO pay levels will make for easy headlines.*
    - *Investors may not care much, but the working public will.*
    - *Proxy statements will have a new, greater level of visibility.*
- If the CEO Pay Ratio does go into effect, new access to published pay data will cause internal challenges.
    - *Just over half of U.S. employees believe they are being paid fairly compared with people who hold similar jobs either at their own or other companies*.*
    - *Most companies are far more concerned about employees comparing their own pay to that of the median employee than to the CEO's pay**.*
    - *HR and managers will have a critical communications role; they will need to know how to defend pay practices, policies, and processes.*

**2016 Willis Towers Watson Global Workforce Study; **2016 Pearl Meyer OnPoint Survey: Looking Ahead to Executive Pay Practices in 2017*

Audience Poll

In addition to reviewing and approving the CEO Pay Ratio disclosure for the proxy statement, should the compensation committee review and approve the communication strategy and materials being prepared by management that may be used to respond to questions from employees, investors, and/or the press?

1. *Yes*
2. *No*
3. *Unsure*

Question 4: Next Steps

Draft the narrative:

- Establish the level of detail to be provided.
  - *Will it be the bare minimum to comply or is there a need to provide more context?*
  - *What are the pros and cons of either approach?*
- Decide where the narrative will be positioned within the proxy statement.
  - *Does it belong in the CD&A or somewhere else?*

Prepare for the questions:

- Develop collateral materials for your internal teams.
  - *Who is best suited to address questions from employees, investors, and the press?*
  - *What do we need to provide to make sure they are prepared?*
- Consider how the external environment impacts your message strategy.
  - *Will employees be "smarter" on pay issues than in the past?*

Question 5

How do we get ahead of the scrutiny of proxy advisory firms and avoid being sent to the penalty box?

- Despite all political and economic uncertainty, the proxy advisory firms are here to stay.
- Their policies are based on their estimation of “best practices” based on external input and in the best of times, are generally benign.
- However, several disconnects (e.g., CEO pay-for-performance or peer group selection differences) can trigger their attention.
- As companies move toward better alignment between their long-term business strategy and compensation design, there is real potential for the advisory firms’ formulaic assessments to overlook important nuances in the pay program.
- Your program may include carefully calibrated elements that you won’t want to toss out based simply on negative feedback – especially if these elements deal with unique issues designed in a challenging environment.

Audience Poll

Has your compensation committee developed a formal response plan for any proxy advisory firms' negative reports or votes?

1. *Yes, we have a set plan of action*
2. *Not formally, but we routinely discuss how we would handle potential issues*
3. *No, we are not concerned with the advisory firms' assessments*
4. *No, we haven't considered what our response might be*

Question 5: Next Steps

- Set aside time on the 2017 agenda to establish a proxy advisory firm strategy.
  - *Understand which firm has the most influence with your shareholders and focus on those policies, but be informed about the others as well.*
  - *Review research reports going back several years – is there progression in the advisory firms' criticisms?*
  - *Ask the management team to summarize feedback from major investors – is it consistent with the advisory firms?*
  - *Don't feel compelled to make changes that don't support your business strategy; understand the consequences of not aligning with proxy advisory firm policies.*
- Begin the regular practice of effectively communicating your compensation philosophy and strategy in the CD&A; ensure the format of your CD&A best promotes your point-of-view.
- Knowing your approach in advance to possible negative reports or votes helps prevent overreaction and shifting your compensation committee's focus from supporting business strategy to simple compliance.

Key Takeaways

1. Develop a long-term perspective for your company that can weather short-term peaks and valleys.
2. The current climate of uncertainty offers a good opportunity to step back and holistically evaluate the state of your compensation programs, independent of outside influences.
3. Improve executive engagement and alignment by integrating your compensation and leadership programs.
4. Understand the company’s public position and messaging on pay inequality issues.
5. Recognize the benefits of a proactive shareholder engagement strategy and the role of effective communication in advancing long-term value creation.

Questions

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