



Going Beyond Best Practices:

The Role of the Board in Effectively Motivating and Rewarding Executives



Women**Corporate**Directors
Thought Leadership Council

Pearl Meyer & Partners

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Unless otherwise designated, all persons quoted in this report are WCD Thought Leadership Commissioners. A full list of Council Members and Commissioners appears on pages 34 and 35.

Introduction

The Thought Leadership Council (TLC) of Women Corporate Directors (WCD) is pleased to present its inaugural report. Representing the expertise and insights of WCD members and our key partners, the role of the Thought Leadership Council is to move the discussion of key boardroom issues to practical, actionable advice and recommendations that Board members can adapt to most effectively guide the companies they serve.

Each year one of the Thought Leadership Council partners will take the lead on a selected topic. In 2014 Pearl Meyer & Partners, a trusted independent advisor to Boards on executive compensation, spearheaded this project and authored this report based on the input from the 23

TLC Commissioners listed on pages 34 and 35.

Going Beyond Best Practices: The Role of the Board in Effectively Motivating and Rewarding Executives presents their advice based upon the exceptional breadth and depth of their boardroom experience across industries.

Truly effective executive compensation programs are tailored to the specific business, human capital and cultural objectives of each company. Similarly, truly valuable guidance and recommendations for Boards cannot suggest a one-size-fits-all compensation template. The value of this report is its emphasis on the considerations that Compensation Committees should incorporate into their deliberations and, acknowledging

that decisions will be subject to public scrutiny, how to maintain and communicate a compensation philosophy that best creates long-term value for the business.

There are many primers on compensation theory and a myriad of reports that espouse “best practices” and prescribe specific forms of executive compensation. *Going Beyond Best Practices* addresses the persistent challenges Compensation Committees face and offers practical insights that will help shape future deliberations and decision-making.

We look forward to continuing the discussion of this critical topic with all stakeholders and observers of executive compensation.

CHAPTER ONE

The Case for Aligning Executive Compensation and Business Strategy

Executive compensation is one of the most visible and talked-about boardroom agenda items. When structured appropriately, executive compensation has the potential to support and drive the behaviors and outcomes that strengthen the corporation and enable it to thrive over the long term. When executive compensation operates independently of — rather than in support of — the business and its people, the result can lead to subpar business performance, disengaged executives and frustrated stakeholders.

Despite the strength of many executive compensation programs and strong evidence that Committees exercise their responsibilities with diligence, executive compensation has

been a lightning rod issue for many years. While Compensation Committees are responsible for ensuring that executive compensation philosophies and programs are aligned with the business strategy, many stakeholders and public voices weigh in with advice and critiques of those programs.

As a result, Compensation Committees now carry the additional burden of answering criticism from shareholders, the media and others.

When shareholders are dissatisfied, they press for change through all available channels. Executive compensation has become one of the preferred venues through which shareholders express their discontent.

Due to a series of regulatory,

legislative and exchange rule changes, executive pay has become highly transparent in recent years. Despite the increase in disclosure, however, it is not always more clearly communicated nor more accurately understood. Activist and institutional investors now emphasize executive pay issues in their voting and are pursuing the power to directly influence or determine these issues through shareholder proposals. This can lead to negative votes from a governance group even when portfolio managers are pleased with a company's strategy and performance.

Proxy advisory firms, mutual funds and other large investors have become disproportionately influential in the discussion of

executive compensation, promoting their agendas through the reports they issue and their advisory and consulting services, and via the press. Boards are often constrained in their ability to participate in this public dialog, even to correct misperceptions. Deliberations by Compensation Committees are often highly sensitive, and it is frequently not possible to publicly disclose why — or even how — a decision was reached. Additionally, with nearly 5,000 public companies listed in the United States as of this report, not all Committees will be granted time to meet with institutional investors or advisory firms for meaningful dialog about important issues.

As a consequence, public opinion has reshaped executive compensation decisions, which

have become dominated by voices unfamiliar with the specific business and talent requirements and objectives that inform the Board's deliberations in setting compensation. Executive compensation has become trapped in a vicious — rather than virtuous — cycle. As the cycle accelerates, more shareholders and their advisory firms push for reforms in their governance checklists, without the context of a company's specific business strategy, culture or performance.

These outsized, outside influences drive a new set of challenges that make it more difficult for Directors to link compensation design to their unique business strategy.

There is increasing pressure to adopt generic compensation philosophies and programs.

While adopting compensation programs that are similar to peers may initially reduce shareholder pressure, this is effective over the long run only when those programs are well aligned to the company's business, culture and talent strategy.

The focus has shifted from inside to outside factors. The Compensation Committee now spends a disproportionate amount of time dealing with outside influencers and their specific concerns, reducing available time to understand how executive compensation proposals will — or will not — support core business objectives. While public perception and disclosure are important, Committees should first consider business objectives in making those decisions and then

integrate into the process how to appropriately communicate their decisions.

Programs focus on short-term returns over long-term business results. Both short- and long-term performance measures have an important role in executive compensation. When compensation is over-weighted to short-term stock price gains, a company may gain additional proxy votes in the near term, but it may lose focus on the long-term strategy of the business, and therefore ultimate investor support.

The pressures Compensation Committees face are significant, often unpredictable, and very real. While a few historical problems might have been of a Committee's creation, such as outsized pay packages or benefits that were not tied to

the business, our challenge now is to not bow to external perceptions by trimming or reshaping packages that are well aligned to the business and human capital strategy.

Changing the executive compensation dynamic requires that Directors show commitment and courage by standing behind tough, well-reasoned decisions until results are clear. "Courage also means putting these headlines in context," says Davia Temin. Directors are accustomed to making decisions and assessing the return on investment (ROI) in other areas

of business strategy and operations without shareholder votes and proposals. Likewise, we believe Directors can maintain control of executive compensation and foster the needed alignment.

There is a strong case for ensuring that pay programs support the business and create value, regardless of the pattern set by others or the pressures applied by outsiders. We recommend that Compensation Committees challenge outside pressures to "follow the pack" and focus on doing what's right for the business and its

INDEPENDENT THINKING OR ME-TOO?

Internal and external pressures can push Compensation Committee decisions away from individual decisions and toward a median, me-too solution. Mercer's Executive Compensation and Talent Management 2012 Survey of 280 U.S. and Canadian Organizations, for example, found that the No. 1 reason companies change their compensation programs is to align them with industry or peer group practices.

TREAT COMPENSATION AS AN INVESTMENT

While complaints about executive compensation are not always accurate, some issues provide insight into areas where Compensation Committee members can improve deliberations and processes. Many potential problems can be avoided by considering executive compensation in the same context as any other strategic investment:

- Align pay with business results. Many plans provide the right alignment of downside pay risk and upside pay opportunity tied to business success. These plans also need to be effectively communicated to achieve the objectives of motivating and retaining executives.
- Balance the short-, mid- and long-term results. Stock price and other short-term financial metrics are incorporated into plans for a variety of reasons. When performance metrics consider the various critical time horizons, they will support a healthy and sustainable business over the long term.
- Focus on metrics that deliver strong and reliable performance. Businesses with weak or inconsistent performance are less able to present a compelling case to shareholders, driving even greater focus on the same misaligned plans that started the cycle.
- Examine the business value of perquisites. While many executive perquisites have been eliminated, in the public's perception even the most business-appropriate perquisites can be third-rail issues. We believe some perquisites are appropriate and necessary to effectively conduct the company's business and provide the right return on investment. These perquisites should be adopted, and their business value should be communicated proactively.
- Resist a reactive agenda. Compensation Committees need to consider disclosure requirements and shareholder-specific interests, but these must be evaluated in the context of the business and talent strategies.

stakeholders based on their experience and knowledge. Susan Hart suggests, "When Committees include the Chief Human Resources Officer, General Counsel and CFO in their deliberations, as well as the advice of outside experts, they are able to more effectively make decisions that are in the best long-term interest of the company." Throughout the remainder of this report, we identify some of the toughest issues facing Committees and outline specific ways in which Board members can take action.

Use situational judgment. Strong, structured performance alignment is important, but Compensation Committees must also use business judgment and discretion to assess qualitative factors in the decision-making process.

Target the position; pay the person. A median pay philosophy does not mean median pay for every single individual. The benchmark data and philosophy should be references, not constraints or guarantees.

Pay for retention when warranted. While pay-for-performance is a laudable goal, a stable, cohesive management team has real value to an organization.

View value creation as a marathon, not a sprint. Compensation programs should align with the time horizons of the business.

Stop paying for failure. Severance is intended to provide appropriate protection for

executives terminated through no personal fault, yet payments often create undue negative public reaction.

This report shares ideas and insights based on practical experiences in designing effective compensation programs and strategies for managing the public and private process of setting executive compensation. Success relies on Committees that are able to:

- Exercise the courage to make difficult and potentially unpopular decisions that are right for the business.
- Commit to a multi-year approach, even when the initial results are uncertain.

- Promote clarity and transparency in communicating plans, programs and their rationale to participants and shareholders.

It is the responsibility of the Board — not the shareholders or advisory firms — to hire and compensate the CEO. We have to be willing to take unpopular stands when appropriate, whether with the CEO or with the shareholders. When the decisions are strategic, rational and focused on the right time horizon to serve the business, they trump discussion of what is currently popular or perceived as conventional wisdom.

CHAPTER TWO

Using Judgment Is Our Job

Every Board has the authority — and fiduciary duty — to use judgment in making decisions. In fact, Board members consistently use their experience and expertise to assess the needs of their business, balancing the use of data, strategic intent and current conditions to decide the best action in any situation — a process known as *situational judgment*. Within the purview of the Compensation Committee, one of the most controversial uses of situational judgment is the decision to apply discretion to the otherwise formulaic results of an incentive plan award. Compensation Committees can use discretion to either increase or decrease the actual total compensation awarded based on the plans in place. The power of discretion is provided to the Board and its Committees.

In the case of the Compensation Committee, the power of discretion is provided to enable the Committee to make the right decisions on compensation matters, especially when the compensation program design has not anticipated certain business events or will result in an unintended or inappropriate pay outcome.

As a matter of fairness, compensation programs should allow the Board to decide when to use discretion. When used in the right way and disclosed appropriately, discretion can be the linchpin that connects the compensation program to the business and management team, leading to better alignment of pay and performance. Yet Committees rarely invoke discretion for fear it will create an external optics issue with proxy

advisory firms, shareholders and others. According to Dotty Hayes, however, discretion is a tool to help get a reasonable outcome from an incentive plan. “I’m concerned that Boards are hiding behind formulas because they are deemed safe,” says Hayes. “Yet we need to be in a place where we take ownership of any decisions we make as a Board. We need to have the courage and good judgment to do what’s right.”

It’s possible some Committee members believe the use of discretion to increase or decrease compensation is unwise due to the Internal Revenue Service rule §162(m), which allows for the tax deductibility of executive compensation above \$1 million for payouts that qualify as performance based. While this applies only to incentive

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Dotty Hayes



plan payouts certified under §162(m), this rule might have helped create the perception that Committees can use only downward discretion. In actuality, discretion can be applied whenever the Committee deems it appropriate, either to increase or decrease incentive plan payouts, provided that the tax consequences are understood. For the right reasons, a Committee may decide to provide upward discretion, knowing that the payments may not be deductible under §162(m).

Internal and external factors alike can lead to the use of discretion in determining award payouts. "When a fundamental change in the business occurs, the goals set at the beginning of the year may pale in comparison to the company's mandate at year-end," says Susan Stemper.

SCENARIO MODELING

Many Compensation Committees extensively model a range of outcomes that could result from their incentive plan design, and they use this modeling to fine-tune their plans. Ideally, relevant modeling in the design stage can eliminate or limit the need for judgment and ex post discretion. *Scenario modeling* is a formal exercise used to consider in advance how qualitative and quantitative variables in a plan will affect the outcome. Tools to use in conducting incentive plan scenario modeling include these:

- Models that present the lowest and highest potential levels of incentive plan payouts based on the plan design
- Analyses that model highly probable scenarios under the company's business and strategic plans
- Reviews of what a particular new incentive plan design would have paid in each of the past 5–10 years if the plan had been in place during that time

"When executives identify the need for a change and take decisive action, it's reasonable for a Committee to discuss whether to pay incentives above those indicated by the formal plan, even if it means disqualifying those payments under §162(m)." In anticipation of these decisions, the Committee

should ensure that §162(m) disclosure alerts shareholders to the fact that the Committee will use its judgment in determining pay so as to best serve shareholders, even if this results in certain payments not being deductible for the company.

At the same time, Committees should exercise caution to en-

sure that discretion is used to reinforce and motivate future performance. While external factors such as economic and social issues may influence the setting of targets and earnings opportunities, they are a less natural pathway to determining whether to apply discretion to either increase or decrease payments.

We have seen companies move toward an entirely formula-based incentive plan design to help eliminate the need for and use of judgment. However, no perfect metric can be devised that completely eliminates the need for discretion. Even the best-designed incentive plans cannot take into account every situation that might occur. Situations ranging from acquisitions/divestitures to turnarounds, mergers, changes in tax and accounting rules, and

WHEN DISCRETION IS APPROPRIATE

Situations that may warrant the Committee's use of discretion might arise through the influence of one or more high-level factors such as changes in a company's economic, regulatory or operational environment.

For example, discretion to increase or reduce payments might be appropriate in these and other situations:

- When significant and appropriate changes in business strategy occur, but the impact on company financials has not yet occurred
- When factors outside of the company's control affect its financial well-being, but management has taken significant and appropriate action to optimize business performance in the best interests of the shareholders
- When there have been business achievements or efforts that were not anticipated during the year
- When outside economic conditions are significantly different than anticipated when the goals were set
- When a company acquires a new business, invests in a new product, or encounters business challenges during the year that were not taken into account at the time that the performance metrics were established
- When there are retention concerns

other external challenges can affect the business at a moment's notice, altering the milestones of any incentive plan year in a way that does not align

with the results of the company or the efforts of the executive team. So the use of discretion is an extremely important tool for Boards, and each Committee

may want to proactively establish a list of potential situations in which discretion may be used on a case-by-case basis.

While the use of discretion by Boards is important, we should also be cautious of its overuse. Too much discretion suggests the need to redesign incentive programs or the overuse of

exceptions and exclusions of business results that may not be necessary. A sign of a well-designed incentive program is that discretion is rarely needed. Therefore, a high level of proof should be established when using discretion.

Finally, the use of discretion demands clear and compelling

disclosure so that the external universe understands that the Directors are holding the management team accountable and are not letting its shareholders down. We need to have the courage to do all of this transparently, according to Laurie Siegel.

COMMITTEE CHECKLIST

- ✓ Thoroughly review all facts and circumstances before deciding to use discretion. Understanding what the incentive plan payout would have been had the company included and excluded the unique circumstance affecting the plan can help establish a potential payout range to assist in sizing actual awards. Examine how such results were achieved for the year relative to what was actually achieved.
- ✓ Consider the impact of using discretion “inside” vs. “outside” the plan. Discretion applied inside the plan (i.e., increasing or decreasing the formulaic results) may affect participant perceptions of future goal setting. Conversely, applying discretion outside the plan (e.g., making a separate bonus award or decreasing the normal equity grants) risks appearing arbitrary.
- ✓ Plan ahead when designing incentives to anticipate all possible outcomes. Scenario planning – reviewing the consequences of various business outcomes on the compensation plan in advance – is a very important tool.
- ✓ Bring the full Board into the discussion early in the process. Board buy-in is critical when using discretion.
- ✓ Bring the management team into the discussion, when appropriate and as needed, to solicit input and feedback.
- ✓ Flesh out the “why” behind any compensation decisions. Stakeholders will expect a logical rationale that supports the use of judgment as being in the best interests of the company and its business and talent strategies.
- ✓ Consider how the impact of using discretion in the current year could affect the design or outcome of the incentive plan in future years.
- ✓ Develop a good communication plan to address the use of discretion internally with the management team.
- ✓ Closely manage the communication of this decision with the CEO and the management team. The CEO is essential to the effective implementation of the communication plan.

Target the Position, Pay the Person

Some formal compensation philosophies provide guidance for positioning compensation levels relative to competitive market practices. For example, companies might target the combination of base salaries, bonuses and long-term incentives generally at the market median (for a set of peer group companies), with the opportunity to earn more or less depending upon actual

performance. The intent is to establish an ideal positioning of overall compensation costs relative to the market. This positioning should be a guideline, however, rather than a rule. Each executive's compensation should be positioned relative to the market based on their individual skills, experience and performance. Pay is part of a company's overall talent strategy, and compensation design should

differentiate among standard, above-standard and below-standard performing individuals.

Companies without a compensation philosophy tend to rely principally on market data to make compensation decisions. Their challenge, however, can be an overabundance of information. Volumes of compensation data are readily available, including proxy peer group and compensation survey data, financial performance data, dilution data, incentive design practices, tally sheets, and pay-for-performance data. Yet not all data are created equal. Compensation data differ for a multitude of reasons, ranging from different data-collection methodologies to small sample sizes to differing market positions from company to company. In addition, proxy advisory firms, institutional

THEORY VS. PRACTICE

According to compensation theory, establishing a compensation philosophy would result in paying individuals exactly according to a predetermined guideline. In practice, when we add individual performance, human emotion and judgment into the mix, actual pay decisions can and should deviate from the compensation philosophy. Executives shouldn't be paid exactly the same because they do not all perform the same. We believe Compensation Committee members have a responsibility to help the CEO use situational judgment, driving toward differentiated pay for all executives. In exercising this responsibility, Boards often enlist the help of their independent consultants to better understand the nuances of the market and their Chief Human Resources Officer to give context to an individual's role, performance and experience, and the complexity of the company environment.

shareholders, compensation consultants and regulators differ in their approaches to compensation data analysis. Further complicating a data-only approach is the fact that not all jobs across organizations are identical. In a time when companies are doing more with less talent, jobs within companies have become more complex and differentiated, and therefore more challenging to compare to the market. For example, some CFOs have responsibilities for finance, facilities and information technology,

while other CFOs may be solely responsible for finance.

Thus, data should serve as only one factor to consider when making pay decisions. According to Charlie Tharp, blindly following market data is not consistent with the Compensation Committee's applying judgment in tailoring compensation to the needs of the organization. "The key to the data's effectiveness as a tool is its relevance," adds Nancy Reardon. "Data should also be congruent, that is, used and applied in the same manner across all executives, unless

WHAT MAKES A PEER COMPANY?

Even establishing the appropriate benchmarks through the use of a comparison group of companies is challenging. Historically, companies and proxy advisory firms developed peer groups based on revenue and market capitalization. Yet there are many other factors that can play a role in developing an appropriate peer group for compensation comparison purposes. Getting buy-in for the use of the "right" set of peers to help establish market pay practices and a compensation philosophy is a much more complex challenge and requires a fair amount of attention, review, decision-making and disclosure.

there is a clear justification to do otherwise."

Individual circumstances also legitimately affect pay structure. "Don't be a slave to market data," says Melissa Means. "Compensation surveys and other market information are useful, but it is equally important to consider the performance and potential of the individuals. Are they key contributors with high growth potential? How are they paid relative to other executives in the firm? What unique skills and experience do they have? How strongly did they contribute to overall company performance?"

The following examples highlight situations in which Committees might need to deviate from their compensation philosophy to do what is appropriate for the individuals and the business:

"Data should be... used and applied in the same manner across all executives, unless there is a clear justification to do otherwise."

Nancy Reardon



- An executive has a role and responsibilities that are more or less than what is typically found within other companies for such a position, and thus she may be paid differently as compared to the market.
- A business unit president of a small division may be paid more than the market median because the division is where all of the growth for the company is expected in the next few years.
- An executive is newly hired or promoted into a role he has not previously occupied, and he may be paid differently as compared to the market until he has worked in the job for a period of time. (See “The Dilemma When Hiring a New Executive,” right.)
- An executive might receive a package that accelerates at a greater or lesser pace than comparable positions based on the time horizon of expected results (i.e., product development).
- A company’s job titles and the scope of its job duties do not align with peer companies or the broader market.

THE DILEMMA WHEN HIRING A NEW EXECUTIVE

When companies promote or recruit an executive into a new role, every Committee faces the same challenging compensation issue of how much to pay the individual for stepping up into a role he has not previously held. Unfortunately, there is no clear right or wrong answer to this dilemma — yet it serves as a perfect example of the need to use situational judgment.

One side of the coin: Some Directors feel that executives stepping up into a new role should neither be paid at the same level as the prior executive nor near the market median for a role they have never held. Rather, they should prove themselves in the new role before reaching their predecessor’s level of compensation — often over a period of two or three years. This is the most common approach.

The other side of the coin: Other Directors suggest the above approach can cause unintended problems. Pamela Lenehan asks, “What message are we sending to the executive, the company and our shareholders by not paying the person a fair and reasonable rate to do the new job? The unintended message is the person is not ready for the job. If the Board thinks the individual is capable of taking on this new role, and asking him or her to step up and do the full job, we should pay the person full price.”

Situational judgment in this case should also take into account factors such as the position’s level of risk, especially if the previous incumbent was dismissed or the new incumbent faces especially tough challenges such as changing a culture or business strategy.

- The importance or criticality of a position relative to a company's strategy could result in pay that is different from the philosophy or market.
- A company may need to fill a risky role (one with an especially high barrier to success) within the organization, and it might need a different pay practice to successfully recruit the best talent for this position.

As Directors, we are trying to do the right thing, but conventional wisdom might be driving us toward more of the same — the same pay decisions and outcomes. This is appropriate when setting compensation guidelines for a role, but Committees serve the long-term business strategy well when they include individual factors in their final decisions. In *Directors and Boards*,

Charles M. Elson and Craig K. Ferrere of the University of Delaware observed, "By inquiring into the intrinsic worth of an individual's contributions, rather than blindly referencing the pay of others, we can arrive at more equitable and less controversial compensation. This will bode well for the health of the corporation and, more importantly, its shareholders."ⁱ

COMMITTEE CHECKLIST

- ✓ Regard market data as one of many pieces of information Committees can use to establish compensation. Just as important as external market pay data are how well the individuals perform, their skills and experience, their pay relative to the rest of the team, their growth potential, and the company's overall performance.
- ✓ Be cautious of shortcomings that can exist with available compensation data and the complexity and uniqueness of the executive roles within the company relative to others.
- ✓ Craft a compensation philosophy and review it on an annual basis to ensure its continued alignment with the business and talent strategy.
- ✓ Have the courage to hold the CEO and the Committee accountable for making individualized pay decisions.
- ✓ Develop a pay strategy for new incumbents. If they are brought in at a below-market pay level, determine how they will be brought up to market pay, and over what time period.

Retention Is Worth Paying For

Committees are under enormous pressure to justify executive compensation levels in pay-for-performance terms. And we agree that an appropriately leveraged incentive structure tied to key performance metrics is a critical part of an overall executive compensation strategy. But a holistic approach to talent management, and the associated compensation structure, also acknowledges the importance of a solid, stable management team. Companies are always at risk of losing key talent, and recent data suggest that CEO turnover is near an all-time high.ⁱⁱ Increasingly, we find our Boards spending time with senior management on succession planning issues — to understand where potential retention risks exist and the organization's readiness

to fill vacant positions. While executives seldom list money as the key motivation behind leaving (or staying), compensation structure can have a secondary influence on their decision to leave, as well as the timing of their departure. In the right circumstances, retention is a legitimate strategic objective for a compensation program.

Shareholders and others tend to be skeptical of pay elements labeled “retention” vehicles, especially during periods of economic sluggishness. However, as Committee members, we intuitively know that unwanted turnover in the senior ranks has a cost to the organization, and that intuition is supported by several well-documented consequences of a valuable executive’s departure:

- Unexpected turnover has quantifiable hard dollar costs for executive search fees and inducement packages for new hires. Additionally, the more senior an external replacement hire, the more likely there will be “trickle-down” turnover in reporting positions. Numerous studies estimate total turnover cost for executives to be multiples of base salary.
- The “soft” costs of unwanted turnover can be even more significant. At best, executive turnover creates organizational distraction. More typically, it also results in the loss of crucial knowledge, cultural influence, acquired judgment, and even employee loyalty and morale. Further, it can slow or even derail progress toward

the strategic objectives of the corporation.

- Lastly, despite the best efforts of Directors, senior executives and placement firms during the recruiting and selection process, outsiders are often unsuccessful — which can lead to shareholder value deterioration and another round of new hiring.

Having justified retention as a legitimate business objective, Compensation Committees need to determine when to include retention incentives in an executive's pay structure. This requires thinking more strategically about how we incorporate retention into the reward structure and the overall talent management strategy.

It helps to consider separately two domains of business activ-

BALANCING PRIORITIES

Prior to the requirement to expense option grants, the typical public company chief executive received the majority of long-term incentives in the form of stock options at fair market value. That option grant value often represented the lion's share of a CEO's total target pay opportunity. Pearl Meyer & Partners found that in 2000, the typical Fortune 200 CEO had a total target pay package of approximately \$8.5 million, and the median option grant value was roughly \$4 million — nearly half the total. Furthermore, while nearly all of the CEOs received options, only 40 percent received time-vested restricted stock, and even fewer (30 percent) had performance shares.

Today, the picture looks much different. Looking at typical target CEO pay for the Fortune 200 in 2012 (the most recent data available), options now represent only 22 percent of the total pay package, with restricted stock at 17 percent and performance shares at 29 percent. More importantly, while the prevalence of options has decreased to approximately 65 percent of plans, the prevalence of restricted stock and performance plans has increased to 55 and 77 percent, respectively.

Once the accounting "playing field" was leveled, companies looked at their long-term plans more strategically, weighing the balance between retention and performance, as well as the importance of stock price results vs. the achievement of financial, operational or strategic objectives.

ity for which retention awards are designed. First, there are *structural retention* elements — the elements of a standard compensation structure that are

earned or vested over multiple years (e.g., time-vested options or restricted stock, deferred compensation or retirement benefits). Many committees

“When Committees determine that action is warranted, an explicit retention award can be very effective. But we should also remember that employees value things other than money.”

Gabrielle Greene



already seem to have a good handle on these retention elements in their regular compensation structure. We've also seen an evolution in long-term incentive design since the advent of stock option expensing from what was a singular, often over-weighted, reliance on options to what is now a more tailored, layered approach to long-term incentives — one that prioritizes goals and objectives and matches vehicles to those goals.

Committees face a greater struggle dealing with *episodic retention* issues, in which the structural retention elements of the compensation program fall short of their objectives due to unusual circumstances. These situations are often emotionally charged, and there can be an atypical level of disagreement about the need to take action.

MOTIVATION AND MONEY

A 2009 study by McKinsey & Company found that praise from direct managers, attention from firm leaders, and the opportunity to lead projects all provided more employee motivation than compensation.ⁱⁱⁱ For example, high-potential incumbents might respond to high-profile or international assignments, expanded responsibilities and/or increased Board-level exposure. Later-career executives, by contrast, might respond more positively to interesting focused assignments, sabbatical and/or research opportunities.

In some cases the heightened retention concern applies to a group of executives or employees — for example, companies or divisions facing periods of management uncertainty (such as CEO transitions) and/or organizational uncertainty (such as M&A activity). In other cases, the retention concern is focused on an individual — for example, an experienced, high-performing leader or a key successor. By their nature, these episodic situations don't fit neatly into a one-size-fits-all solution.

For example, retention pay might be needed when hiring a top executive who is being asked to shake up the culture or manage a massive change. Retention pay with vesting might also be appropriate for a new executive joining a founder team already in possession of significant equity. This newcomer may have widely disparate economic interests, but she may be critical to the team. A bonus structured over several years of vesting could bridge the financial gap between otherwise coequal executives.

EQUAL PAY FOR UNEQUAL RESULTS: AN EXAMPLE

A public company wanted to determine if its compensation program was “broken.” There had been high and unexpected executive turnover in the past year, and compensation was mentioned as an issue in every exit interview. Through a review of the compensation programs and executive interviews, it became apparent that there was an issue with the compensation program — the way it was being determined and communicated. The company had six executives managing the global manufacturing, distribution and sale of different products. All six were paid the same base salary, had the same target bonus award opportunity, and received the same long-term incentive grant. All received the same cash bonus payout for the prior year’s performance despite the fact that their performance, and that of their groups, differed widely. Executives of the two highest-performing groups stated that they believed the same pay to all executives was a message to them to leave and that neither they nor their group’s performance were valued.

The outcome of this inquiry highlighted a disconnect between how the compensation program rewarded the executives and the expectations of the executive team. The CEO informally designed a structure to create parity among the direct reports, encouraging cooperation by rewarding the whole team for overall results. Meanwhile the executives expected recognition and reward for their group results. Both objectives were equally valid and important to the overall success of the organization, but they had never been appropriately prioritized or communicated. The following year, the Board and the CEO agreed to develop a compensation program that rewarded executives based on a combination of company and group performance, and they communicated these intentions to the team.

In response to an episodic situation, market data can sometimes help to quantify the outer boundaries of a potential retention plan, but it seldom provides a clear-cut answer. Greater clarity can be achieved through a diagnostic exercise that builds Committee consensus around the issue and solution. The discussion should include the following points to identify the most salient issues:

- Define the risk and its causes.
 - Does the company face a one-off situation or a fundamental change to its business? If the former, an episodic retention award might be appropriate. If the latter, the company may need to reexamine the underlying compensation structure.

- Is the risk time-bound (e.g., the company will not have a successor for two years)?
- Define the ideal end result.
 - Is the retention goal tied to a specific date or event?
 - Does a successful outcome require specific performance results as well as retention?
 - Upon completion of the retention objectives, does the executive stay or leave?
- Consider the precedents and unintended consequences.
 - What signal will a retention award (or the loss of an executive) send to other senior managers?
 - How would a special retention award impact other elements of compensation? (For example, does it change the executive's change-in-control severance?)
 - How will voluntary or involuntary termination be treated?
 - Does the ultimate earn-out of the retention award create a new retention concern? (In other words, does it give the executive a reason to leave?)
- Consider the communication needs.
 - How and when should the awards be communicated, and to whom? Assume that the awards will not remain confidential over time, and communicate the rewards rationale proactively.
 - While the Board may have legitimate reasons not to dwell on retention awards, the Board shouldn't be overly-defensive either.

As Paula Cholmondeley advises, “We shouldn’t be afraid to disclose special arrangements for a ‘rock star’ executive, such as a technical visionary or a founder CEO. These are the people that drive value for the organization, and retaining them is critical.”

The Committee decision-making process can also be important. As Richard Antoine notes, “These episodic retention awards should be reviewed by the Committee separately from the regular annual compensation decisions. It is important that no one confuse the response to a legitimate retention concern with the results of the annual incentive determination process.”

COMMITTEE CHECKLIST

- ✓ Explicit retention awards are most effective when targeted toward specific individuals or in reaction to specific events. Companies that continually need to take extraordinary action may need to reassess the structural retention elements of their existing compensation programs.
- ✓ Differentiate the plans and opportunities for high-potential employees in relation to other employees.
- ✓ Conduct scenario analyses to understand the impact of retention awards on the overall leverage in the pay structure. While retention awards provide downside protection (i.e., they create a “floor” to expected compensation levels), they can also dampen upside leverage.
- ✓ Likewise, consider the impact at the time of the potential payout to avoid the unintended consequence of creating a secondary retention issue.
- ✓ Avoid using retention awards as “consolation prizes” for incentive plan under-performance. This damages the credibility of the incentive plan and the importance of the goal-setting process.
- ✓ Consider the retentive value of noncompensatory actions, especially for high-potential employees. Coveted assignments, expanded responsibilities, and Board-level exposure can sometimes have more power than money.

Value Creation Is a Marathon, Not a Sprint

One of the benefits of a long-tenured, stable management team is its ability to operate under a longer strategic time horizon. Management teams with a long-term perspective will likely make different choices regarding growth and investments than those teams focused on the short term, and they will more likely forego short-term gains for the benefit of the long-term upside. Likewise, long-term investors are more willing to take the long view toward value creation and shareholder returns, and they are less likely to be upset by quarter-to-quarter volatility.

Short-termism in corporate management and strategy — a focus on short-term financial gains at the expense of long-term strategic initiatives — is the result of multiple incentives and pressures. Management

claims that short-term investors clamor for quarterly returns, while investors claim the short tenure of executives leads to a focus on maximizing immediate results. The Board's role is to help the company navigate these pressures to achieve a balance between acceptable short-term results and sustainable long-term value. Providing advice and consent regarding corporate business strategy and results are the purview of the full Board, while the Compensation Committee has the primary responsibility for

ensuring that there is alignment between the company's business objectives (and anticipated business cycles) and the structure of the compensation programs. "Selecting the right performance measures, and then aligning the levels of performance to the appropriate levels of pay, continues to be one of the Compensation Committee's toughest and most important jobs," notes Jill Kanin-Lovers.

A typical executive pay package consists of base salary, an an-

SHORT-TERMISM

The effect of executive compensation on short-termism is discussed by Gregg D. Polsky and Andrew C. W. Lund in the March 2013 *Issues in Governance Studies*, published by the Brookings Institution. Their paper "Can Executive Compensation Reform Cure Short-Termism?" acknowledges that poor compensation design can exacerbate short-termism, but their general finding is that short-termism is the result of the current governance and investment environment, and it is unlikely to be eliminated by changes to incentive design.

nual incentive or bonus, and a long-term incentive structure that may have one or more elements (time-vested options, time-vested restricted stock and/or a long-term performance plan). Increasingly, Committees are tailoring the measures used in both short- and long-term incentives to link directly to key business metrics. Historically, most incentives had either a very short-term focus (i.e., annual bonus) or a very long-term focus (i.e., 10-year stock options). The recent proliferation of multi-year incentive plans, however, offers an opportunity for Compensation Committees to take a strategic look at the company's specific value creation cycles and to better tailor incentive plan time horizons.

While we see increasing differentiation among companies

with regard to metric selection and goal setting, most companies still appear to take a "default" approach to incentive plan time horizon: bonus plans tied to a 1-year fiscal period, long-term performance plans with a 3-year performance period, restricted stock and options with 3- to 5-year vesting and a 10-year option term. In the same way that Committees continue to tailor metrics and goal setting to reflect company strategy, they should also think strategically about alternative time horizons:

- Nearly all short-term incentive plans are tied to fiscal year performance, which is expedient for measurement and communication, but Committees should ask whether that matches the

company's business cycle. For example, there are some retail companies that use a 6-month incentive structure to align with their buying and selling seasons.

- At the other end of the spectrum, Committees should ask if a 10-year option life serves its purpose of creating a longer-term focus than could be achieved by a typical 3-year performance share plan. For some companies, a 10-year option can provide an important balance to a "mid-term" long-term incentive (LTI) plan that might not capture the full value creation cycle of decision-making. For others, 10-year options could be unnecessarily long. As Pamela Lenehan points out, "In today's world, if a company is doing

"As Directors, we have insights into our companies' long-term business strategies that others may not appreciate. We have to be prepared to defend compensation decisions that support the required long-term behaviors and results, even if they aren't viewed favorably by the external world in the short term."

Cynthia McCague



well, management teams often put in place a 10b5-1 plan to exercise and sell shares prior to the 10-year term.

If the company is not doing well, these long-lived options are underwater and create overhang, which prevents Committees from issuing new options that might actually incent management.”

- Long-term incentives may be more effective when tied to achievement milestones rather than specific periods of time. Committees should ask if the standard 3-year performance LTI period really reflects the business cycle for the individual company.
- Many companies look for measures to fit their expected incentive plan performance period (i.e., what measures

make sense for a bonus plan vs. what measures make sense for a 3-year LTI plan).

Compensation Committees

should instead focus first on what measures drive value for the company, and then determine the appropriate

THINKING ABOUT VALUE

In addition to time horizon considerations, many Boards are reconsidering the entire *value proposition*. There is little doubt that shareholder value continues to be an important measuring stick for public companies. But increasingly we see evidence that other factors are important to shareholders as well. Many of the proposals put forth by shareholders are focused not on improving stock price performance but on social and environmental issues or governance concerns. In other words, constituents seem to be focusing on how companies achieve their results, in addition to the results themselves. As Lynn Stout notes, “A single-minded focus on shareholder return can, in fact, be harmful to the long-term prospects of the company. It encourages maximizing short-term earnings, which, in turn, can stifle investment and innovation.”

That said, shareholder value cannot be ignored. For many companies, public capital is necessary to fund the underlying business strategy. Continued access to that capital demands that companies provide attractive, or at least reasonable, returns to their investors. The goal of the Board is to find the right balance. “The goal of shareholder return doesn’t have to be at cross-purposes with long-term value creation,” says Jan Koors. From a compensation perspective, many Committees have revamped their long-term plans to reflect a balance between rewarding shareholder return and rewarding the achievement of goals unrelated to the stock price. Additionally, Dodd-Frank requires that companies conduct annual assessments to ensure that executives are not overly-incented to take undue risks. “A machine that runs at maximum capacity will fail sooner than one running at a more moderate pace. Companies are the same,” adds Koors.

time period over which to judge performance.

In addition to thinking about the structure and time horizon of each pay element, the Committee should examine and confirm that the overall program's focus aligns with the business. Traditional

compensation design theory suggests that the more senior the executive, the longer term (and the higher risk) their pay mix should be. However, Committees should test that theory relative to the needs of their particular situation. While a company in a start-up mode may want to

weight executive compensation toward long-term equity to focus executives on an ultimate sale or initial public offering (IPO), a company in a turnaround mode may want to emphasize the achievement of shorter-term goals that are necessary to corporate survival.

COMMITTEE CHECKLIST

- ✓ Tie incentive measurement periods to the company's business cycle. The current 3-year "default" period may not make sense for all businesses. Using a combination of measurement periods and vesting schedules can often address concerns regarding the inability to calibrate metrics in future years.
- ✓ "Back-test" the results of goal setting over a long period (e.g., 10 or more years) to understand how the business cycles affect performance and how rigorous the company's budgeting process is.
- ✓ Consider whether some or all option terms should be shorter (or longer) than the standard 10-year period.
- ✓ Model how changes in the company's strategic objectives would affect executive compensation under current and alternative incentive structures.
- ✓ Understand the short-term and long-term value drivers, including the influence of external factors such as commodity prices, interest rates and anticipated regulatory intervention.
- ✓ Be prepared to explain, and if necessary defend, a compensation design that drives strategic business behaviors and long-term results, even if it might inspire criticism or debate outside the company.

Stop Paying for Failure

Severance protection in executive contracts is an area where standards of “reasonableness” have shifted over time, and they will continue to evolve. Objectively, severance provisions are greatly reduced and are far more shareholder friendly than ever. For example, whereas tax gross-ups for change-in-control severance awards used to be standard practice, they are rarely included in new contracts today, and they have been eliminated from many long-standing plans and agreements — due in large part to the criticism from institutional investors and their advisors.

And yet, severance awards routinely make front-page news, providing fodder to critics who claim these packages are still far too rich. (It is interesting to note that the required proxy disclosure

of potential termination payouts seldom garners much attention from either shareholders or the media.) The criticisms are further fueled by the continuing socio-economic woes of relatively high unemployment, as well as the accelerating concentration of wealth at the top of the economic pyramid. In some respects, the critics may be right. However, it is naïve to believe that severance contracts will disappear completely. So, Committees find themselves in the challenging spot of trying to balance the expectations of the executives and the shareholders.

Realistically, making revolutionary changes to contract norms is an uphill battle. Both sides in the contract negotiation rely on market practices to argue for and against certain provisions. As a result, the final

agreement provisions often end up somewhere near current market norms. That said, “the best time to change severance policies is when hiring a new CEO,” notes Mark Poerio. In fact, some companies have successfully eliminated the use of individual contracts in favor of standalone company policies regarding severance and/or change-in-control. While this approach doesn’t eliminate termination payments, or the resulting risk of negative press, it does provide the company with two notable advantages:

- It puts all executives on the same policy, eliminating the need for individual negotiations.
- It affords the company greater flexibility in changing severance provisions prospectively

to reflect changing market norms. This can get a bit tricky, however. Whereas changes to an individual contract would need to be renegotiated and agreed to by both parties, companies technically have leeway to change company programs and policies unilaterally. Many Committees contemplating a take-away in one plan will look for ways to offset the change, in order to balance the perceived loss.

The move from individual contracts to company policies is really more form than substance. Severance payments that are viewed as “undeserved” will be criticized regardless of their source. That said, Committees understand the need to provide severance protection to executives, especially in the

event of a change-in-control. Within that basic premise, Boards could consider design changes that address two of the largest perceived problems:

- Short-tenured executives who receive significant signing bonuses, do not deliver on their potential, and then get full severance payments.
- Long-term executives terminated for delivering poor results who still get generous severance payouts.

In the first situation, the Committee faces the constraints of the hiring environment. In fact, depending on how immediate the hiring need is, the executive might have the upper hand in contract negotiations. That said, the Committee can consider design features that mitigate the possibility of overpaying if

the new executive does not work out:

- Sign-on/severance offset. If severance occurs within a relatively short period of time (i.e., 12 to 18 months), then any potential severance payments are offset by all or a portion of any sign-on awards provided at hire.
- Fixed dollar severance value. Severance that is tied to pay multiples and accelerated vesting can result in payouts that are larger than intended. Fixing the severance amount as a dollar value — an amount that includes the value of any accelerated equity — can limit the exposure of a potentially outsized severance payment.

The second situation, in which a senior executive is removed based on poor performance,

“The best time to change severance policies is when hiring a new CEO.”

Mark Poerio



represents a different set of challenges. Dismissals for Cause, which eliminate the need to provide severance, are generally very narrowly-defined and typically do not include the failure to achieve financial, operational or strategic objectives. Yet by the time a Board reaches the tough decision to make a leadership change, the company may have already suffered financially, and it has lost shareholder value. In many cases, the company has also sustained workforce layoffs in an effort to stem financial losses, which can exacerbate negative public reaction to executive severance

packages. While the negotiation of a truly performance-based severance agreement would be very difficult, there may be some features that would limit the perception of “unwarranted” severance payments in the wake of poor company performance:

- Sunsets. The rationale for severance is to provide financial protection if the executive is terminated through no fault of her own. This is most needed when an executive is new to the firm and hired from the outside. Under a sunset, general severance protection would either phase out or cliff

after the initial two- to three-year contract period.

- Cash severance phaseouts. As the cumulative value of equity awards grows, the size of cash severance protection would decrease until eliminated.
- Extended vesting or exercise provisions. Rather than accelerated vesting, vesting and exercisable periods of equity would be extended beyond termination so that the former executive’s payout is tied to company performance for a period of time following departure.

COMMITTEE CHECKLIST

- ✓ Take advantage of a CEO transition as an opportunity to review severance for all executives. The CEO provisions often set the tone for provisions for other executives.
- ✓ Consider adopting a company-wide executive severance policy in lieu of individual agreements.
- ✓ Structure the timing of payments to support adherence to the existing noncompetition and nonsolicitation policies.
- ✓ Use tally sheets as a way of tracking accumulated wealth created over each executive's tenure, and consider the interplay between current equity-based wealth accumulation and severance value.
- ✓ Consider setting severance values in absolute dollar terms, rather than in multiples of pay, such as 3X for CEO.
- ✓ Eliminate any red flags in contract terms (e.g., single triggers, evergreens, or tax gross-ups).

Conclusion

Executive compensation has been and will continue to be a topic of discussion and debate within and beyond the boardroom. Compensation Committees can view this conversation as an unreasonable burden or as an opportunity to continue to improve the design, implementation and communication of executive compensation programs. We believe it is an opportunity to improve and encourage Directors to embrace it. Decision-making is always improved when the debate considers a diversity of opinion, and ultimately it is our responsibility as Directors to consider a broad array of information and then exercise our judgment in setting the best course of action for the companies we represent.

Committees that continue to improve executive compensation design will do so by integrating their compensation philosophy and relevant data with Directors' knowledge of the business and its requirements. This integration aligns executive compensation in support of the business strategy.

These same Committees will proactively describe and communicate their decisions; they will make explicit their reasoning and why the compensation design is appropriate to both the business and the individual.

In this report, we have focused on five areas of current debate, recommending that all Compensation Committees merge situational judgment with data-based compensation program design; apply market data appropriately; integrate compensation and

talent management strategies; balance short-, mid- and long-term performance objectives; and re-evaluate severance protection in the context of pay-for-performance principles.

Our Compensation Committee work must both manage and transcend these current high-profile topics. Therefore, we have woven several foundational principles throughout this report. These principles should be employed by Committees to ensure that executive compensation is strategically aligned with the businesses in both the short term and the long term:

- Use a business-based compensation philosophy and principles to set the foundation for all deliberations, designs and decisions.

- Allow the specific business situation and individual circumstances to take precedence over data, trends and peer practices.
 - Be open to deliberation about the interplay of established formulas and current business circumstances, using informed judgment to decide whether to adhere to or vary from formulas or the current program design.
 - Anticipate and prepare for the communication of decisions and the process by which they were reached, understanding the appropriate constraints of confidentiality.
- Compensation Committee members serve in a governing role that will continue to be in the public spotlight. While there is no single right answer for all companies at any moment, diligent Committees have the ability to positively shape the immediate and future success, growth and prosperity of the companies they serve.

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Notes

- ⁱ Charles M. Elson and Craig K. Ferrere, “What Is a CEO Worth? Don’t Look to Peers.” *Directors and Boards*, Third Quarter, 2011.
- ⁱⁱ A 2012 Booz & Company study found that CEO turnover at the 2,500 largest public companies in the world was up from 14.2 percent in 2011 to 15.0 percent in 2012. The number of CEO turnovers in 2012 (375) is the second largest in the 13-year history of the study, second only to that in 2005. Source: Booz & Company, *Time for New CEOs: The 2012 Chief Executive Study*.
- ⁱⁱⁱ A 2009 study by McKinsey & Company found that praise from direct managers, attention from firm leaders, and the opportunity to lead projects all provided more employee motivation than compensation. Source: http://www.mckinsey.com/insights/organization/motivating_people_getting_beyond_money.

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