Aligning Pay to Value Creation and Performance

12 compensation opportunities that boards and committees should consider

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COMPENSATION IS A VERY EMOTIONAL subject for executives. And it is a personal subject, sometimes inspiring competition, greed, or even wrongdoing. The legacy of the recent financial crisis will not be as much the quantum of compensation, but rather ensuring that boards and shareholders are more involved in determining compensation, and that pay is tied more closely to performance and risk-taking. Regulators have stepped in to ensure that shareholders have a vote, and that compensation committees and consultants are independent. In regulation to come, pay will likely be more linked to performance and compared officially to that of the average worker. The intent of compensation reform should not be a compliance exercise dominated by consultants and lawyers, but rather a re-thinking and realigning of compensation even more closely by the compensation committee to value creation for shareholders, and listening to their concerns. This is the heart of the issue.

From my review of recent evidence and my work with investors, boards and compensation committees, here is a list of 12 opportunities I see for linking executive pay more appropriately to performance and shareholder value:

1. Have Performance-Based Vesting

According to a 2009 study by Frederick W. Cook, only 5% of top U.S. top 250 firms have performance-based vesting of long-term equity. This means vesting is largely based on time – “pay for pulse” as it is pejoratively known. Performance vesting is “still relatively rare” in the U.S., according to Stanford researchers. If this is truly the case, this is a serious lapse in board oversight and in alignment with shareholder value. Non-executive directors should also receive performance-based restricted stock.

2. Be Aware of Structural CEO Pay Increases, Irrespective of Performance

University of Delaware researchers claim there is a 17% structural annual increase in CEO compensation simply by virtue of using peer groups that are based on company size rather than value creation, coupled with the common policy of remunerating CEOs at the 50th, 75th or 90th percentile. This structural increase occurs irrespective of performance. So long as the current system of awarding pay continues, this ratcheting-up will continue.

3. Simplify Compensation and Link it to Key Value Drivers

Increased disclosure of compensation has resulted in compensation consultants devising multiple vehicles, methodologies and time periods that are complex for investors to understand. This is the law of unintended consequences at work, but it also reflects commercial interests by advisory firms (including legal) in generating unnecessary complexity and a continued annuity for their services. There is a case to be made for the simplification of key value drivers associated with shareholder value and a very high upside for executives, but only if key metrics are met. Private-equity firms align pay and performance very well, without the need for an army of consultants. They tend to have directors who focus more on strategy, understand the business, and are more engaged, disciplined and results-oriented. There is also evidence such companies significantly outperform publicly traded peers.

4. Retain "Independent" Advisors and Define Independence Upward

An independent advisor to a compensation committee should be one who has not done, nor is doing, nor seeks to do in the future, any non-committee related work for management. This definition should apply to anyone in the firm. If a compensation consultant or lawyer's partner does work for management, then he or she does too, given the nature of working relationships and firm culture. With regard to compensation consultants, there is no robust evidence linking compensation consultant conflicts of interest and ultimate CEO pay. Nevertheless, when the rubber hits the road, the consultant must be free to recommend pay plans that may be adverse to management. Shareholders should also be aware of how compensation consultants or lawyers are retained. They should not be pre-selected by management.

5. Tie Ethics and Risk to Pay

There are examples of equity vesting when ethical transgressions have occurred (e.g., breaching of a code of conduct). This should not be the case. Malus clauses should be used rather than clawbacks. Clawbacks occur when cash is awarded and equity vests; they must be contractually paid back after the fact based on certain conditions. Malus occurs when the committee can actually prevent the vesting of all or part of the deferred remuneration before the fact. The compensation committee or an independent advisor who has no relationship to management should draft the tailored clause and the conditions. A malus clause properly drafted will be adverse to the interests of management. For example, leading practices triggering malus clauses include breach of the code, significant changes in capital or qualitative risk, a violation of internal rules or an external regulation, or bad financial performance (based on specific indicators). The executive, on the other hand, may want a high threshold for the clause, such as a material restatement of financial statements, or prefer that no non-financial considerations be used to invoke the clause.

6. Separate Incentive Pay from Pay-for-Performance

The periods covering pay and performance should be aligned and simplified. Right now there is overlap among intended, earned and realized compensation. This causes confusion in assessing executives' compensation by journalists and investors. Companies should do this on their own. If they refuse or are incapable, regulators should step in and require non-overlap in summary compensation figures of expected compensation (e.g., forward-looking incentives) and earned and realized compensation (e.g., backward-looking pay-for-performance).

7. Ensure Bonuses are Truly Discretionary

Research studies suggest bonuses at many companies are not based on stretch goals, but are really just forms of disguised salaries. Bonuses should be discretionary and awarded by the committee over time as performance effects are realized, and risk tails assessed.

8. Look at Pay Ratios as Sources of Potential Mis-Alignment

Despite shareholders' high approval rate at companies that have adopted say-on-pay, controversies over executive compensation are based primarily on two factors: examples of pay for non-performance, and internal pay inequity (versus other officers and the average worker). Boards should specifically take a look at both issues. A high ratio of CEO to C-suite compensation (say beyond 2:1 or 2.5:1) may for example be a red flag for undue influence, succession planning problems, and flight risk of senior executives.

9. Don't Assume Large Equity Grants to Management are a Good Thing

Researchers have found no causal relationship between stock ownership by executives and firm performance. This should be kept in mind when considering target ownership plans – plans that set a minimum target for share ownership by executives (e.g., holding shares equivalent to three times one's annual salary). The research suggests that large equity positions held by top management appear to decrease firm value, and may also encourage management entrenchment, asset misuse, and accounting and grant manipulation (e.g., manipulation of the timing of the release of information and the grant). The evidence is mixed, but shareholders should be conscious that large equity positions are not necessarily associated with firm value, and may promote undesired behavior.

10. Engage in "Risk-Adjusted Compensation"

Compensation committees need to make greater progress on adjusting compensation for risk, including incorporating risk into performance metrics, and allowing equity to vest only after risk has been assessed. There is much progress to be made here, and Basel regulations are emphasizing this.

11. **Engage in CEO Succession Planning, as External Hires are Costly and have less Success**
    Greater progress needs to be made by boards on CEO succession planning, which affects compensation and firm performance. Stanford researchers have found that boards spend only two hours a year discussing CEO succession, and that 39% of boards have not identified an internal successor candidate. Outside successors cost more, and there is considerable evidence that they tend to perform worse than internal successors.

12. **Don't be Afraid to Make Your Case When Proxy Advisory Recommendations do not Work for You**
    Proxy advisory firms should not be as influential as they are now. Research suggests weak governance systems are associated with excessive compensation. However, research into the recommendations of proxy advisory firms also suggests that they neither assess governance quality nor predict shareholder performance. Boards and compensation committees should not necessarily amend their practices to suit proxy advisory firms if the reliability of their criticisms cannot be established.

Conclusion

The 2013 compensation landscape will include all of the above touchpoints. Getting executive compensation right will require committees with both expertise and courage, particularly where they are dealing with systemic problems or questionable linkages to performance and value creation for shareholders.

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