THE STRATEGIC CONTEXT OF EXECUTIVE COMPENSATION

GUIDE TO EXECUTIVE COMPENSATION | PART 1

The role of the Chief Human Resources Officer continues to evolve in response to transformational changes in the economy, the workforce and in how work gets done. Yet even as the human capital agenda reflects an increasing emphasis on talent and the workforce of the future, executive pay remains one of the most critical areas of focus for today's CHRO. Over the decade since the financial crisis, significant changes have reshaped the context in which executive pay decisions are made – elevating this topic to one of today's top corporate governance concerns. CHROs face the challenging task of understanding the detailed design decisions that shape a pay program and designing executive pay programs that meet the strategic needs of the business. But many CHROs come to the role with little experience in this complex field. We have developed this Guide to Executive Compensation as a starting point for CHROs and others who do not have specific subject matter expertise in executive compensation, but whose roles require an understanding of the external context, basic principles, and design considerations that influence pay program design. This Guide will provide a basic foundation for understanding the key elements of pay design, incorporating the perspective of the multiple stakeholders whose views have significantly influenced contemporary pay design. We have also provided links to more detailed resources for those who want to "go deep" on specific topics.

ABOUT THE CENTER ON EXECUTIVE COMPENSATION

Available only to HR Policy Association members, the Center On Executive Compensation provides deep expertise and advocacy on the top executive compensation and corporate governance public policy and practice issues facing Chief Human Resource Officers and their teams. The Center's 125 corporate Subscribers enjoy access to vast resources on executive compensation regulatory developments and implementation tools as well as detailed guides and resources on developing practices.

01

Designing an executive pay program offers the CHRO a unique opportunity to play a critical role in shaping business performance by effectively aligning the needs and interest of senior-level talent with business strategy. In the first installment of our Guide to Executive Compensation, we will examine the strategic context surrounding executive compensation. We will review the significant milestones that have shaped the current environment over the past two decades and examine the role of the key stakeholders in influencing pay practices and governance. We will also introduce an analytical framework for understanding executive pay design.

WHY IS EXECUTIVE PAY DIFFERENT?

Even a casual observer of human resources practices is likely aware that executive pay is distinctly different than the pay practices that apply to non-executive employees – and not just because the amounts are larger. The topic of executive pay is increasingly the subject of media attention and political activity, and missteps in this area can impact the reputation of a company. What makes executive pay unique?

One of the most significant factors differentiating executive pay from the pay programs designed for the rest of the workforce is that because of its strategic importance, there are multiple stakeholders who exert influence on both the process for determining executive pay and the outcomes delivered by executive pay programs. Quite simply, more people with more influence care about executive pay.

Who are these stakeholders, and why do they care? In this installment of our series, we'll examine five major stakeholder groups: investors, proxy advisory firms, government, media, and employees. These major stakeholders have vastly different motivations and interests for engaging on the issue of executive pay. Some feel executive pay should be subject to more scrutiny because of the impact that executives have on the lives and wellbeing of millions of workers. Others point to a growing societal concern regarding income and wealth inequality and view rising levels of executive pay as a contributory factor.

But stakeholders concerned with social issues are not the only ones who take an interest in executive pay. Investors – especially activists – view executive pay programs as an important indicator of alignment of interests between management and shareholders, and a "window" into the mindset and operations of the Board and Compensation Committee. Heightened scrutiny on the process by which executive pay is determined has made this topic a top governance concern with the ability to impact the reputation of the board and company – and not usually in a positive way. The heightened scrutiny on executive pay means that how – and how much – a company chooses to pay its top executives communicates important messages to all of its stakeholders – about its business strategies, financial outlook and approach to talent.

THE BOTTOM LINE: Executive pay is different than employee pay because of the context in which it exists – an environment characterized by multiple, diverse and influential stakeholders that care about both the process by which pay is determined, and the outcomes of pay programs. CHROs play a key strategic role in helping shape executive pay programs that align talent and business strategies.

KEY STAKEHOLDERS IN EXECUTIVE PAY

- **Investors**
- **Proxy Advisory Firms**
- **Government**
- **Media**
- **Employees**

02

HOW DID WE GET HERE?

Today's executive compensation landscape has been shaped by economic, regulatory and social forces that have emerged over the past two decades. Beginning in 2001, a series of high-profile corporate scandals in the US helped usher in a renewed era of regulatory scrutiny of the governance practices of public corporations. By the middle of the decade, new and more extensive disclosures had been mandated by the US Securities and Exchange Commission (SEC), increasing the transparency of both the process by which executive pay is determined and the amounts awarded.

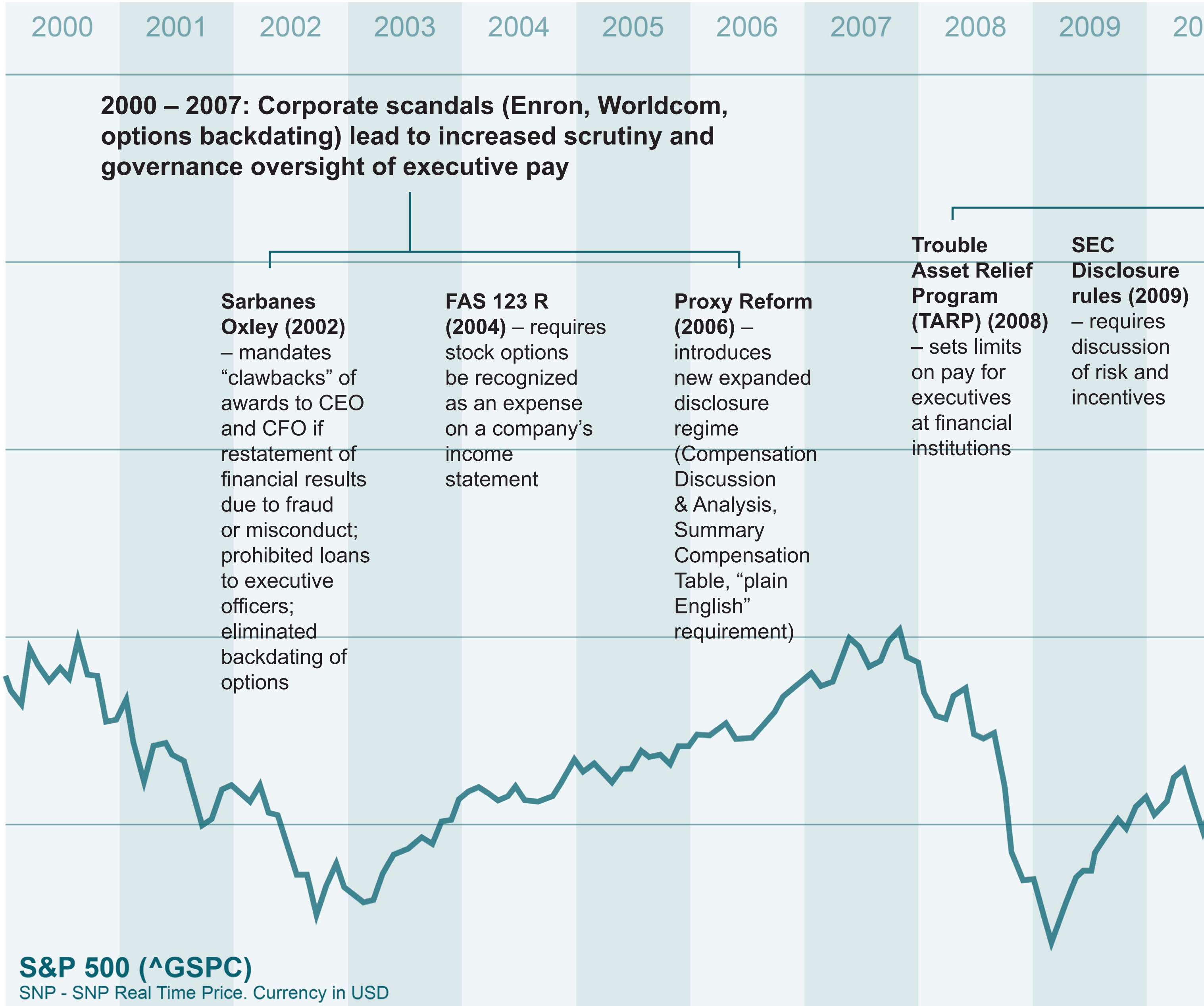
The onset of the global financial crisis and subsequent economic recession accelerated the momentum for increased regulation of executive pay. The passage of the Dodd-Frank Act in 2010 has had a significant impact on the governance and disclosure of executive pay in the US, most notably through the requirement that companies put their pay programs to an advisory vote by their investors (known as a "Say on Pay" vote).

The aftermath of the recession also gave rise to increasing concerns about income inequality and the unintended consequences of globalization. These broader issues have found their way into the executive compensation dialogue, resulting in attempts to use financial disclosure regulations as a tool to advance social causes. The Dodd-Frank provision requiring companies to disclose the ratio of CEO pay to that of the median worker is the most prominent example.

WHAT IS SAY ON PAY?

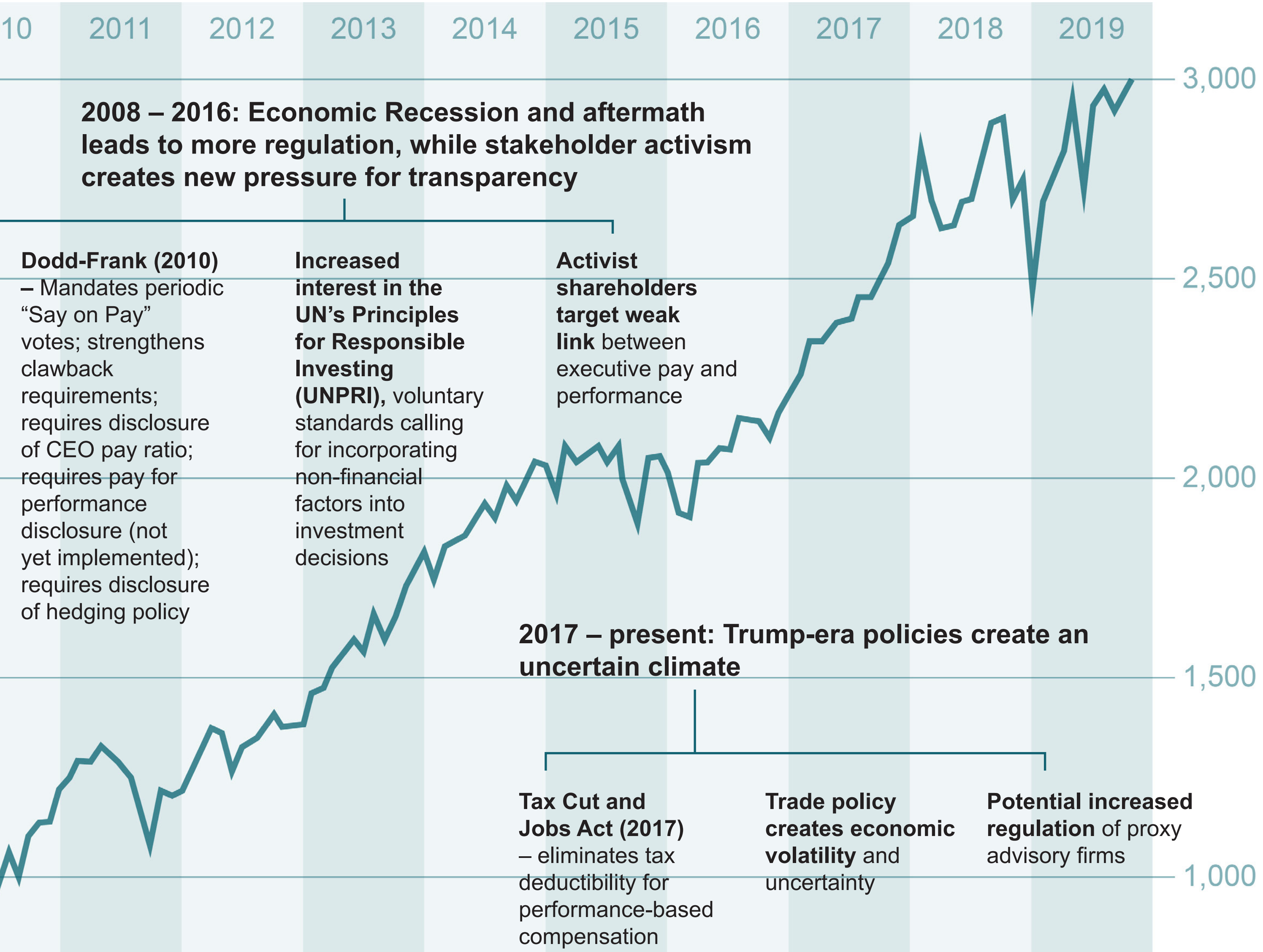
As included in the 2010 Dodd-Frank Act, Say on Pay is a mandatory, nonbinding shareholder resolution which asks investors to approve the compensation package for a company's "named executive officers" (the CEO, CFO and top three most other highly compensated executive officers). Even though the vote is advisory only, its impact has been significant. Say on Pay has increased the level of engagement between companies and their investors, often yielding positive results. However, Say on Pay has also increased the influence of proxy advisory firms – who have come under criticism by companies for the accuracy of their reporting as well as potential conflicts of interest.

MILESTONES IN EXECUTIVE COMPENSATION



With the Republican Party regaining control of the Presidency and the Congress in 2016, the pace of regulatory activity in the area of executive compensation has slowed. One exception is an effort to impose new restrictions on proxy advisory firms.

As we'll discuss below, proxy advisors are an important resource for investors but have been heavily criticized by companies for the role they have played in executive pay governance.



THE BOTTOM LINE: Over the past two decades, increased transparency and greater oversight, often in response to larger economic or social concerns, have shaped the current climate surrounding the design and governance of executive compensation plans.

03

WANT TO KNOW MORE?

Read the Center's "Guide to Institutional Investor Proxy Voting Policies on Executive Compensation"

THE STAKEHOLDERS

The presence of multiple influential stakeholders creates a unique environment impacting the design and governance of executive pay plans. These stakeholders care about both the process for determining pay and the outcomes delivered by pay programs - and they often hold very different views on key issues. Some view executive pay in a larger societal and political context, while others take a narrower performance-based perspective. The CHRO is well-positioned to help the CEO and Board understand and balance the interests of these groups, ensuring that pay programs support the achievement of the company's near and long-term objectives. Below, we'll review the key characteristics and motivations of five major stakeholder groups.

INVESTORS

One of the most influential stakeholders in the executive pay process are investors. As the owners of public companies, investors have a significant interest in how executives are paid, and they rely on their elected representatives (the Board of Directors) to protect those interests. Investors exert influence on pay issues in two ways - through engaging directly with the Board and management; and through formal governance processes – such as the periodic Say on Pay vote, submission of shareholder proposals, and the election of directors.

Institutional Investors

Institutional investors own approximately 80% of the market value of the stocks comprising the S&P 500 and Russell 3000 indices – and as a result, they exercise considerable influence on the governance activities of most public companies . Institutional investors include mutual fund companies, pension funds, endowments, and sovereign entities. Each type of investor tends to have differing points of view on executive compensation and follow different paths to try and influence change. Large ***mutual fund companies*** tend to favor a close connection between pay and long-term shareholder returns; however, they don't frequently vote against management on a Say on Pay vote or compensation proposal, seeking to influence outcomes by discussing their concerns directly with the company. ***Pension funds*** often express concerns if the amount of pay is viewed as excessive – regardless of the connection to performance – and are more likely to vote against management on pay issues. ***Endowments*** and ***sovereign entities*** will generally control a comparatively smaller portion of the voting power and may be less likely to try to influence outcomes through direct engagement with management.

The CHRO plays a key role in ensuring the company engages effectively with institutional investors by collaborating with internal investor relations and finance professionals to ensure the company's messages on executive pay are clearly communicated and understood.

LARGE INSTITUTIONAL INVESTORS

- **Mutual Fund Companies**
  - BlackRock
  - Vanguard
  - State Street Global Advisors

- **Pension Funds**
  - California Public Employees' Retirement System (CalPERS) / California State Teachers' Retirement System (CalSTRS)
  - NYCRS (NYC Public Pension Funds)
  - United Auto Workers (UAW) Retiree Medical Benefits Trust

- **Endowments**
  - Harvard Management Company
  - Stanford Management Company
  - Bill & Melinda Gates Foundation

- **Sovereign Entities**
  - Government Pension Fund Norway (managed by Norges Bank Investment Management – part of the Norwegian Central Bank)
  - China Investment Corporation
  - Abu Dhabi Investment Authority

Activist Investors

While there is no universally agreed definition of shareholder activism, the phrase is commonly used to refer to the strategies and actions employed by an investor with the intent of bringing about change in a publicly traded company. Activist investors can be categorized by looking at the goals they seek to achieve:

- **Financial –** Improving the underlying financial performance of the firm, particularly with regard to stock price.
- **Strategic or Structural –** Advocating the sale of non-core assets; separating or spinning off a business; or a major change in business strategy.
- **Corporate Governance –** Advocating the removal of a CEO and/or members of a company's board; attacking "excessive" or "misaligned" executive pay or perquisites; addressing other governance issues.
- **Social –** Advocating action on environmental issues; opposing investments in politically sensitive parts of the world; advocating for workers' rights.

At a minimum, most activists will challenge executive pay, and the board's governance of pay, if they view pay as excessive or significantly misaligned with performance. However, depending on the activist's goals, their views and perspectives may be quite different. Activists who focus on social issues will often target executive pay levels (regardless of the linkage between pay and performance) as a contributing factor to rising levels of income inequality. Other activists who are more financially focused believe strongly in aligning management's interests with those of the shareholder and are very supportive of incentive designs that provide significant upside pay opportunity for superior performance. Overall, most activists will be very interested in making certain that executive pay programs are connected to the company's strategy and have a clear and direct link between pay and performance.

Stock Exchanges

Although they are not investors, stock exchanges play a role in the governance of executive pay. The two major US exchange – the New York Stock Exchange (NYSE) and Nasdaq - maintain listing standards (in addition to the SEC's disclosure regulations) that companies need to follow in order to have their shares traded on the exchanges. For example, the NYSE stipulates that all members of a company's Compensation Committee must be considered independent by meeting certain criteria.

PROXY ADVISORY FIRMS

Proxy advisory firms provide analysis and vote recommendations to institutional investors on matters submitted by public companies for shareholder approval. In the US, there are two proxy advisory firms which control approximately 80% of the market: Institutional Shareholder Services (ISS) and Glass Lewis.

These firms develop broad voting policies on a range of issues put forward for a shareholder vote, including executive compensation, corporate governance, mergers and acquisitions and environmental & social issues. Their institutional investor clients may require the proxy advisors to use customized voting policies based on the investors views and preferences. However, many institutional investors do not have the internal resources to conduct their own analyses, and instead vote according to the proxy advisor's recommendations.

Because ISS and Glass Lewis serve such a large number of US institutional investors, their vote recommendations can have a significant effect on the outcome of a given proposal. For example, if ISS recommends that shareholders should vote against a say-on-pay proposal, support for that proposal may decline by up to 20% to 25%.

When it comes to their recommendations on executive compensation matters, proxy advisory firms have been the subject of intense criticism from public companies for several reasons:

- Failure to meaningfully engage with companies to understand their pay programs
- Lack of indepth knowledge and understanding of how pay programs operate
- High rate of factual and interpretive errors
- Potential for conflict of interest, including providing consulting services relating to voting recommendations

In late 2018, the SEC began a review of the current regulatory regime governing proxy advisors. Legislation has also been introduced in the Senate that would subject proxy advisors to more stringent regulation, addressing many of the concerns expressed by public companies.

WANT TO KNOW MORE?

Check out "Shareholder Activism and Executive Pay: An Overview"

GOVERNMENT

The increase in regulatory and governance oversight of executive compensation over the past two decades is a major characteristic of the current landscape. Around the world, governments have become key stakeholders in the executive pay process. In the US, at the federal level the role of government in this process is divided between Congress and the Executive Branch.

Legislative action impacting executive pay issues is typically included within legislation dealing with broader financial system issues or revisions to the federal tax code. For example, Say on Pay, the CEO Pay Ratio and many other new requirements were included in the Dodd-Frank Act, a comprehensive overhaul of the regulations governing the US financial system. Similarly, executive pay is often impacted by tax-related legislation. As a result, jurisdiction over matters involving executive compensation generally resides with committees dealing with the financial system: the House Financial Services Committee, the Senate Banking Committee and the Senate Finance Committee.

However, the government stakeholder with the most direct day-to-day impact on executive pay is not Congress, but an agency of the Executive Branch. The Securities and Exchange Commission is the major regulator of financial markets in the US. As part of its role, the SEC determines what information companies must disclose to shareholders so that they can make informed investment decisions. Over the last 20 years, the SEC has increased the information companies must disclose about executive pay, both in terms of the process used to determine pay and the actual operation of pay plans.

The SEC has also been tasked by Congress with writing and implementing regulations that go beyond what traditionally would have been considered part of financial market operations. This has resulted from legislative mandates that were driven by political considerations; most notably, the CEO pay ratio disclosure requirement included in the Dodd-Frank Act in the wake of the 2008 financial crisis. Advocates for the pay ratio sought to highlight the large and growing disparity between CEO pay and that of the "average" worker, bringing attention to the social issue of rising levels of income inequality.

WANT TO KNOW MORE?

Read the Center's Comment Letter to the SEC

MEDIA

Two broad categories of media stakeholders are interested in executive compensation – the traditional business press and the non-business media. The traditional business press includes widely read newspapers such as the Wall Street Journal and the Financial Times (including The Economist magazine), as well as TV networks Bloomberg and CNBC. The stories covered by these organizations focus more on financial, business and governance issues and are generally viewed as more aligned with the views of large companies. The traditional business media is more likely to highlight a CEO's accomplishments rather than overtly supporting or criticizing his or her compensation package.

The non-business media includes major national and regional newspapers and broadcasters, and public media such National Public Radio (NPR) in the US and the British Broadcasting Corporation (BBC) in the United Kingdom. Journalists in non-business outlets are less likely to develop a thorough understanding of the complexities of executive pay than their business media counterparts, and more likely to approach CEO pay through a critical lens. For example, non-business media may find stories covering ratio of CEO-to-median worker pay more relevant to their readership than other pay-related issues.

Regardless of whether a media outlet is more business-oriented or more targeted to a general audience, examples of extremely high levels of executive pay, or instances of poor board oversight of pay generate headlines. High levels of pay for executives of a company announcing layoffs, or large severance packages for a departing CEO are almost certain to receive media attention across the spectrum – and create challenges for companies and their public relations teams.

EMPLOYEES

Since most pay programs are designed to attract, retain, motivate and reward executives for desired behaviors and performance, it stands to reason that senior executives are important stakeholders in the process. Although most of the regulations governing pay apply to a small group of executives, the overall climate surrounding executive pay influences the design of programs beyond just the C-Suite. As talent and culture become increasingly acknowledged as key drivers of sustainable performance, pay programs that executives understand and view as fair will become increasingly important.

While not directly impacted by the executive pay process, the broader employee population in a company can be an important stakeholder in the process. Now that the compensation of a company's median worker is published as part of the CEO pay ratio disclosure, companies may find an increasing demand for information about pay programs generally, including such potentially contentious issues such as gender pay ratios.

Employees – particularly those represented by labor unions – may also view high levels of executive pay as evidence of increasing societal inequality. They may question the fairness of rising executive pay levels at the same time as many of the financial foundations of the traditional employment relationship have been eroded – defined benefit pension plans have largely disappeared, and health care costs continue to far outpace growth in wages. Employee interest in executive pay can provide CHROs a platform to implement broad communication strategies that highlight the company's total reward strategies and engage employees in a dialogue about the company's broader employment value proposition.

THE BOTTOM LINE: Designing and managing executive compensation programs requires balancing the interests of many influential stakeholders with differing objectives, interests and motivations.

04

DEVELOPING A PAY STRATEGY: THE THREE QUESTIONS

In the next three installments in this series, we will examine the principles involved in designing an executive compensation strategy. To do this, we will frame our discussion around three fundamental questions:

1. **How much should we pay?**
2. **What should we pay for?**
3. **How should pay plans be designed?**

Part 2 of our series will examine the starting point of any pay strategy – determining "how much" your executives should be paid. We'll discuss the concept of developing a target level of pay, measured against a reference point – a "peer group." Peer group selection is a key strategic decision, encompassing both business and talent considerations, and is a subject of great interest among key stakeholders.

Once the target pay level is set, the second strategic decision is to determine what criteria will be used to determine how pay will vary from that target level. Part 3 of our series will discuss the question of "what should we pay for?" For most companies, the answer is some measure of financial performance. The selection of the right measure of performance, and the level of performance needed to determine a given level of pay, are among the most important - and potentially contentious – pay design decisions.

The final step in the process is to translate the overall intent into decisions on how pay plans will be structured. Part 4 of our series discusses the detailed questions of “how” pay programs should be designed. What percentage of total pay should be in cash versus stock? How much should pay vary with performance? What about severance and change in control arrangements? How do the choices made in program design reflect and support the company’s talent strategy?

In each part of our series, we’ll review the design considerations, shareholder and stakeholder reactions, governance requirements and financial considerations involved at each step of the process.

DESIGN CONSIDERATIONS

What are the major design decisions that need to be made in determining how much to pay, what to pay for, and how to deliver pay?

SHAREHOLDERS AND STAKEHOLDERS

How do shareholders and other key stakeholders view various design features? What decisions raise particular concerns for various groups?

GOVERNANCE AND DISCLOSURE

What are the key governance decisions that need to be kept in mind when making major design decisions? How does disclosure impact design?

FINANCIAL IMPLICATIONS

What are the financial, tax and accounting considerations involved in various design decisions?

We will conclude our series with Part 5, an in-depth look at the unique challenges associated with working with the Board’s compensation committee.

REFERENCES AND RESOURCES

Link to exchange listing standards relating to executive compensation.

UP NEXT

In Part 2 of our series, we’ll explore in detail the question of how companies determine how much to pay executives.

HOW MUCH SHOULD WE PAY?

GUIDE TO EXECUTIVE COMPENSATION | PART 2

The role of the Chief Human Resources Officer continues to evolve in response to transformational changes in the economy, the workforce and in how work gets done. Yet even as the human capital agenda reflects an increasing emphasis on talent and the workforce of the future, executive pay remains one of the most critical areas of focus for today's CHRO. Over the decade since the financial crisis, significant changes have reshaped the context in which executive pay decisions are made – elevating this topic to one of today's top corporate governance concerns. CHROs face the challenging task of understanding the detailed design decisions that shape a pay program and designing executive pay programs that meet the strategic needs of the business. But many CHROs come to the role with little experience in this complex field. We have developed this Guide to Executive Compensation as a starting point for CHROs and others who do not have specific subject matter expertise in executive compensation, but whose roles require an understanding of the external context, basic principles, and design considerations that influence pay program design. This Guide will provide a basic foundation for understanding the key elements of pay design, incorporating the perspective of the multiple stakeholders whose views have significantly influenced contemporary pay design. We have also provided links to more detailed resources for those who want to "go deep" on specific topics.

ABOUT THE CENTER ON EXECUTIVE COMPENSATION

Available only to HR Policy Association members, the Center On Executive Compensation provides deep expertise and advocacy on the top executive compensation and corporate governance public policy and practice issues facing Chief Human Resource Officers and their teams. The Center's 125 corporate Subscribers enjoy access to vast resources on executive compensation regulatory developments and implementation tools as well as detailed guides and resources on developing practices.

In Part 1 of our series, we examined how executive pay is different than employee pay because of the context in which it exists – an environment characterized by multiple, diverse and influential stakeholders who care about both the process by which pay is determined and the outcomes delivered by pay programs. CHROs play a key strategic role in helping their organizations navigate this challenging environment by designing pay programs that are aligned with company strategy and appropriately reward key outcomes.

A starting point in the design of an executive pay program is determining how to answer the question, “How much should we pay?” In this installment of our series, we will discuss two factors involved in determining the right level of executive pay – establishing the appropriate target pay level (“how much?”) and selecting the right comparative benchmark (“compared to whom?”). Both of these questions will generate significant interest from important stakeholders. In addition to concern over a company’s choice of comparative benchmarks, in the years since the financial crisis some stakeholders have expressed the view that executive pay levels on an absolute basis are simply too high, regardless of comparative benchmarks or company performance.

01 DESIGN CONSIDERATIONS

ESTABLISHING THE APPROPRIATE TARGET PAY LEVEL

Most companies seek to set pay at the level that will allow them to attract and retain the talent they need to drive business outcomes. When it comes to executive pay, influential stakeholders have created significant pressure on companies to limit their targeted pay levels – what they “expect” to pay in any given year – to the median of their selected benchmark. While it is understood that actual pay levels will vary above and below the target (based on factors such as performance), most publicly traded companies establish their target pay position at the median of an external comparator group. Companies that intentionally set their target pay levels above the median must persuade key stakeholders – especially proxy advisory firms and certain investors – that such positioning is warranted.

DEVELOPING A PAY STRATEGY: THE THREE QUESTIONS

- **How much should we pay?**
- **What should we pay for?**
- **How should pay plans be designed?**

Deciding how much to pay executives exposes a source of potential tension in the executive compensation process – the aligned but not identical interests of management and shareholders. All things being equal, executives (like any other employee) would prefer more rather than less pay. Shareholders, as owners of the company, have an economic interest in paying the least amount possible for the quality of management they need to deliver the value they expect. The CHRO plays a difficult but essential role in helping the Board balance these competing perspectives in a way that is in the best long term interests of the company.

The business and talent context in which the company operates can also influence where a company sets its executive pay targets. For example, an organization in a turnaround or transformation situation may need to establish an above-median target pay position. While this may be counter-intuitive to some stakeholders (such as the non-business media), an organizational transformation is a high risk proposition, and the executives with the skills needed to deliver success will expect to be well compensated. In these types of cases, companies often create pay packages that may be targeted at the median for average performance but contain significant and rapidly escalating upside payouts if performance exceeds expectations. We'll look at this pay-performance linkage in depth in Part 3 of our series.

Similarly, companies may target their overall pay at the median of their benchmark but set different targets for the components of their pay package. For example, they may target one element of pay (such as base salary) below the median of their benchmark, making up for it by targeting a different element (such as stock compensation) above the median. This approach is more than just getting the numbers to balance out; targeting different components at different levels sends a signal to the organization about what is important and valued by the company. For example, a low target base salary level combined with a high target incentive level can be seen as encouraging more risk taking, as the certainty of fixed pay is minimized in favor of the uncertainty of incentive pay. We'll examine the various components of pay in more detail in Part 4 of our series.

02

SELECTING THE RIGHT REFERENCE POINT – THE PEER GROUP

Because they compete in external markets for both customers and talent, most companies believe that pay levels should be set relative to an external benchmark. This external reference point takes the form of a group of companies known as a peer group.

Selecting the right peer group may appear to be a straightforward exercise – but in practice it can be difficult and invite the criticism of influential stakeholders. To understand this tension, it helps to identify the ways that peer groups are used.

IN THE CONTEXT OF EXECUTIVE COMPENSATION, PEER GROUPS ARE USED IN THREE PRIMARY WAYS:

- To compare the **amount of pay** being delivered – both planned and actual
- To compare pay program **design and practices,** such as whether and how companies use stock compensation, how they approach severance payments, etc.
- To compare company **performance** for the purpose of determining incentive compensation payouts

Given the potentially conflicting interests of management and shareholders when it comes to executive pay, the establishment of the compensation peer group can be contentious. Specifically, stakeholders such as proxy advisory firms have taken the position that management teams can (and often do) intentionally select peer companies that are higher paying, thus raising their own pay. As a result, proxy advisory firms have their own methodologies for selecting peer groups, which they use when evaluating a company's pay program. The resulting peer groups often differ significantly from the company's selected peer group and have been the source of dispute between companies and proxy advisors.

PURPOSE OF THE PEER GROUP

Before peer companies are selected, it's important to define how the group will be used. Peer groups that are used solely to measure performance for incentive plan purposes typically consist of industry peers – those against whom the company competes in the marketplace. These peer groups are often selected for a limited and specific purpose – for example, to measure performance against selected financial measures for a single period (such as a plan or calendar year). In selecting performance peer groups, there should be consistency

PROXY ADVISORS AND PEER GROUPS: One company's response to concerns raised by proxy advisors indicates how companies carefully select comparators that they believe accurately reflect a holistic view of their company. Alexion Pharmaceuticals provided a detailed explanation of its peer group selection criteria, and concluded:

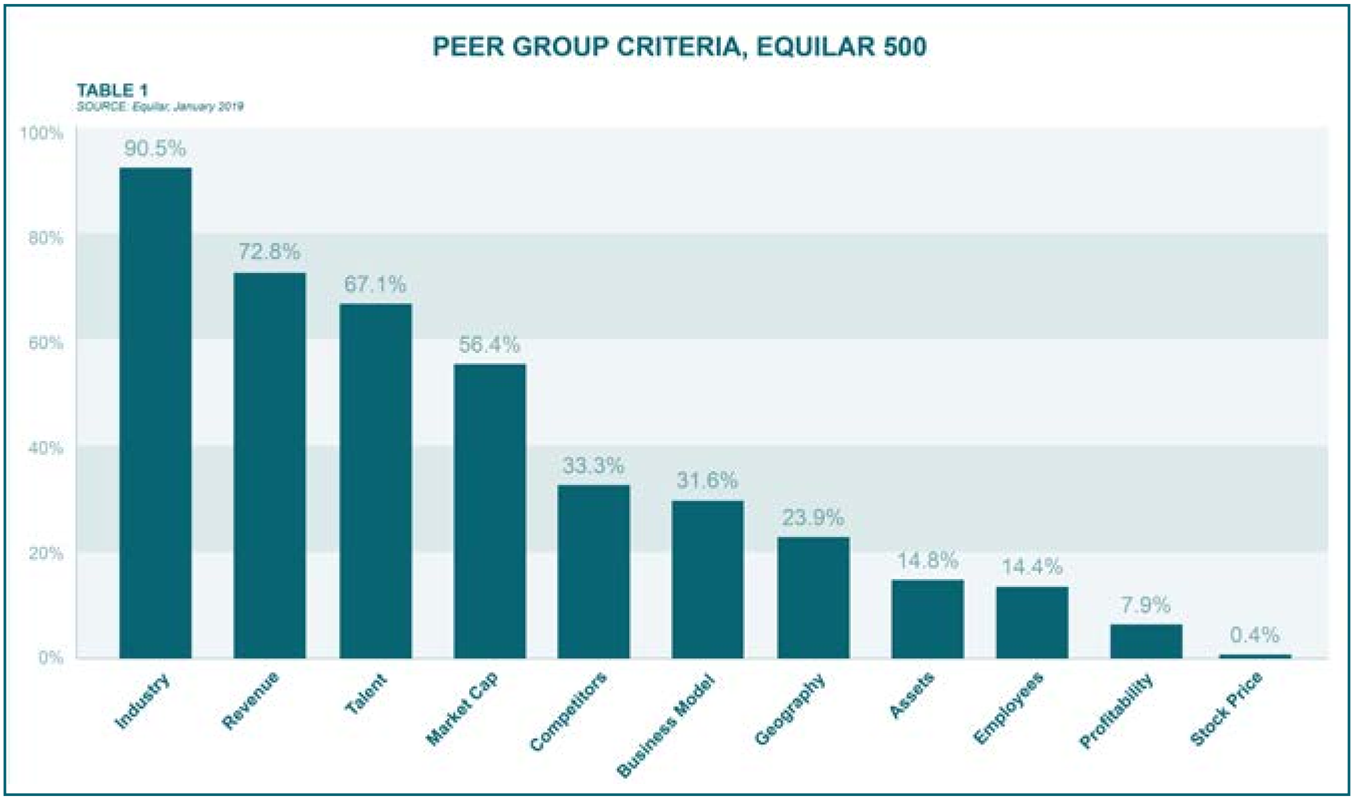
> *"After extensive consideration of generic pharmaceutical and animal health companies which are designated as peers by certain proxy advisory forms, the committee does not believe that companies in those industries represent an appropriate comparator group because the nature, size and innovation required of these businesses, market demand and influences, and employee and investor perception of these companies are all fundamentally different from Alexion."*
>
> *Source: Alexion Pharmaceuticals 2019 proxy statement*

with the peers used by the company's finance and strategy teams in evaluating business performance and setting company strategy.

A performance peer group is often different than the peer group used to compare pay levels, pay practices and program design elements. Peer groups used for these purposes often include a range of companies that go beyond a narrow industry focus – including commercial competitors, labor market competitors, and sometimes even companies with little direct relationship to the company's business but who may share similar operational or financial characteristics (such as profitability, global footprint, or business model). Companies that use a broadly defined peer group seek to reflect a multidimensional view of their unique history, operations and talent, which they believe provides a more accurate reflection of their competitive landscape – and a more appropriate benchmark for comparison.

IN DETERMINING THE APPROPRIATE COMPENSATION PEER GROUP, COMPANIES SHOULD CAREFULLY CONSIDER THE FOLLOWING:

- **What is the purpose of the peer group – comparing compensation levels, practices or company performance?**
- **What is the appropriate size of the companies in the peer group, and how should size be measured?**
- **How many companies should constitute the peer group?**



SIZE OF PEER GROUP COMPANIES

While industry is the most common factor for selecting peers, size (as measured by revenue) is also extremely important (see Table 1). Determining the appropriate size of the companies in the peer group is important because of the relationship between compensation level and company size. Stated simply, companies with higher revenue typically pay their executives more. Because of this positive correlation between size and pay levels, critics of executive pay are wary of management populating peer groups with companies larger than their own in an attempt to boost their pay levels.

A study by Equilar, a data analytics firm specializing in executive compensation and governance issues, indicated that in fact most firms select peers that are comparable in size. The study found that in 2017 87% of firms in the Equilar 500 fell between the 25th and 75th percentile of their peer group on revenue.

NUMBER OF COMPANIES IN THE PEER GROUP

The size of peer groups varies considerably, but the majority of companies (70%) disclose a peer group of between 11 and 20. The challenge in constructing a viable peer group is to make sure it is large enough to provide meaningful data for comparison purposes, yet not so large as to include companies that are vastly different on measures of size or other business characteristics.

ARE EXTERNAL PEER GROUPS APPROPRIATE?

While the vast majority of companies establish pay levels relative to an external benchmark, Professor Charles Elson of the University of Delaware argues that such a system is based upon "flawed assumptions, particularly the easy transferability of executive talent." He argues that by "basing pay on primarily external comparisons, a separate regime which was untethered from the actual wage structures of the rest of the organization was established." He advocates for a process that sets internal pay equity as its objective.

WANT TO KNOW MORE?

Read "Executive Superstars, Peer Groups and Overcompensation: Cause, Effect and Solution"

03

SHAREHOLDERS AND STAKEHOLDERS

STAKEHOLDER EXPECTATIONS FOR TARGET PAY

As noted above, most companies establish their expected, or "target" pay level at the median of their comparator group. This reflects the influence of investors and proxy advisory firms over the past two decades. A company that seeks to target pay at a level above the median of their peers – for example, to attract talent needed to drive a turnaround or a transformation - should expect to receive significant scrutiny and will need a well-considered and effectively communicated rationale.

A median target pay position is almost always part of an overall pay philosophy that allows pay to vary above and below target based on company performance. We'll examine this pay for performance linkage in Part 3 of our series.

In the aftermath of the financial crisis, some stakeholders – media, labor unions, and investors such as union pension funds – have increasingly questioned the overall levels of executive pay, regardless of whether those levels are justified by market benchmarks or performance. These stakeholders point to rising levels of inequality as a serious social issue and call out executive pay as a contributing factor. They seek to focus attention on the issue by comparing the pay levels of executives to those of "average" workers in an attempt to redress what they believe is an unequitable distribution of company profits. The passage of the CEO pay ratio disclosure requirement as part of the Dodd-Frank financial reforms was the most visible result of the efforts of these stakeholders.

STAKEHOLDER VIEWS ON PEER GROUPS

The stakeholder group with the most interest and influence on the selection of a company's peer group are the proxy advisory firms. Because the peer group is the foundation of the proxy advisor's evaluation of a company's pay program, differences between their methodology and the company's approach can have significant consequences. In fact, peer group selection has been one of the greatest sources of tension between companies and proxy advisors.

Why are companies and proxy advisors at odds over peer groups? Both philosophical and operational causes help explain this disconnect. Proxy advisors – and some of their investor clients - believe that management has an inherent incentive to create peer groups that will maximize their own compensation; and as a result, they view the company-selected peers with skepticism. More practically, while companies go to great lengths to create custom peer groups that reflect their uniqueness, the proxy advisory firms' operational models require the efficient and rapid processing of thousands of votes – a process that requires standardization, not customization.

WANT TO KNOW MORE?

Proxy advisory firms continue to adjust their peer group selection methodologies. In January 2020 proxy advisory firm Glass Lewis introduced a new methodology designed to result in a higher level of independence in its peer group and pay for performance analyses. The new methodology relies less on the "peer of peers" approach (which considers the connectivity between groups of corporate peers) and instead incorporates investor views and factors such as revenue, market capitalization and assets.

"By incorporating the investor view, we can avoid the "echo-chamber" effect and market-wide ratcheting on executive compensation levels that is encouraged by peer-of-peers methodologies that rely exclusively on how companies reference one another in their disclosures," the company stated in its release announcing the new methodology.

Read "Understand Glass Lewis' Approach to Peer Groups" here.

04

GOVERNANCE AND DISCLOSURE

TELLING YOUR STORY

The establishment of a target pay position and selection of a peer group are foundational decisions underlying a company's executive pay programs. As such, clear and transparent disclosure is essential.

EFFECTIVE DISCLOSURES:

- **State clearly the company's target pay position and the reason for it. This is especially important if overall pay is targeted at other than the median; or if different components of pay are targeted at different levels.**
- **Disclose the peer group and discuss how it was selected. It is also wise to determine in advance with the Compensation Committee how changes in the peer group will be handled. Avoiding peer group changes other than those resulting from mergers, acquisitions and other corporate transactions will help avoid creating unnecessary investor skepticism and accusations of "gaming" the system.**

THE IMPACT OF THE CEO PAY RATIO ON TARGET PAY LEVELS

Some proponents of the CEO Pay Ratio disclosure requirement hoped that the expected negative publicity would act to reduce overall levels of executive pay. Based on data since the first disclosures in 2018, levels have not declined. While large CEO pay packages and high pay ratios have gained media attention, actual pay levels continue to increase.

05

FINANCIAL IMPLICATIONS

When determining a target pay level for executives, financial factors such as affordability are not generally a consideration since the amounts paid to executives are typically not material to a company's overall financial results. More important than the total dollars spent on executive pay is whether the amounts are appropriate in the context of the company's profitability, size, operations and strategic plan.

For example, a target pay position above the median of a peer group is always a challenge to defend but will be extremely hard to justify if the company is underperforming its own or investor expectations. If a company is transforming and requires new skills and experiences it doesn't currently have, an above target pay position may be necessary to attract skills at a premium price in the labor market. That position should be communicated as a logical part of the company's business transformation story to all of its stakeholders.

Most importantly, the overall context in which the company is operating is key. Have pay or benefit levels been reduced for rank and file employees? Is the company's reputation under attack due to questionable behaviors by executives or unseemly business practices? Evaluating these circumstances and their impact on establishing a target pay position requires the sound judgment of the Compensation Committee and the Board.

REFERENCES AND RESOURCES

Peer Group Choice and Chief Executive Officer Compensation

UP NEXT

In part 3 of our series we'll explore the factors that determine the actual level of pay awarded to executives.

WHAT SHOULD WE PAY FOR?

GUIDE TO EXECUTIVE COMPENSATION | PART 3

The role of the Chief Human Resources Officer continues to evolve in response to transformational changes in the economy, the workforce and in how work gets done. Yet even as the human capital agenda reflects an increasing emphasis on talent and the workforce of the future, executive pay remains one of the most critical areas of focus for today's CHRO. Over the decade since the financial crisis, significant changes have reshaped the context in which executive pay decisions are made – elevating this topic to one of today's top corporate governance concerns. CHROs face the challenging task of understanding the detailed design decisions that shape a pay program and designing executive pay programs that meet the strategic needs of the business. But many CHROs come to the role with little experience in this complex field. We have developed this Guide to Executive Compensation as a starting point for CHROs and others who do not have specific subject matter expertise in executive compensation, but whose roles require an understanding of the external context, basic principles, and design considerations that influence pay program design. This Guide will provide a basic foundation for understanding the key elements of pay design, incorporating the perspective of the multiple stakeholders whose views have significantly influenced contemporary pay design. We have also provided links to more detailed resources for those who want to "go deep" on specific topics.

ABOUT THE CENTER ON EXECUTIVE COMPENSATION

Available only to HR Policy Association members, the Center On Executive Compensation provides deep expertise and advocacy on the top executive compensation and corporate governance public policy and practice issues facing Chief Human Resource Officers and their teams. The Center's 139 corporate Subscribers enjoy access to vast resources on executive compensation regulatory developments and implementation tools as well as detailed guides and resources on developing practices.

In the first two parts of our series, we examined the context in which executive pay decisions are made and the stakeholders who influence those decisions. We also reviewed the two factors companies consider in determining the right level of executive pay – establishing the appropriate target pay level (“how much?”) and selecting the right comparative benchmark (“compared to whom?”).

One of the most important strategic decisions that companies must make in designing executive pay programs is deciding what determines the amount executives actually earn in any given year, and how that varies from the target level. Most companies adopt a pay-for-performance philosophy that establishes performance as the most important factor in determining how much executives actually earn. In this installment of our series, we examine the critical decisions underlying how companies establish the link between executive pay and performance, including how performance is defined, how goals are established, and how performance levels and pay levels are linked. The answers to these questions convey meaningful information about a company’s goals, strategies and values – information that is important to its key stakeholders.

DEVELOPING A PAY STRATEGY: THE THREE QUESTIONS

- **How much should we pay?**
- **What should we pay for?**
- **How should pay plans be designed?**

01

DESIGN CONSIDERATIONS

SELECTING PERFORMANCE METRICS

The selection of incentive plan performance metrics sends a strong signal about what actions and outcomes the Board of Directors considers most important. Because the majority of a typical executive compensation package is delivered in the form of incentive compensation, this signaling is especially important to the executives of the company – those whose actions most directly impact business performance. Shareholders also have an interest in the metrics used to measure performance, seeking to ensure that their interests are aligned with those of the management team running the business. Balancing the needs and interests of executives and shareholders requires selecting metrics that are linked to the company’s strategy, reflect management’s performance, and measure value creation for shareholders.

As the architect of the organization’s pay programs and strategies, the CHRO plays a key strategic role in this process by ensuring that incentive plans reward performance on those metrics that are true indicators of a company’s ability to create value and are challenging yet viewed as reasonable and realistic by executives. A strong partnership with the CFO is essential in achieving these objectives.

Metric prevalence

While increasing attention in recent years has been focused on non-financial factors - especially in the environment, social and governance (ESG) areas - most executive incentive plans use financial metrics to assess performance. The prevalence of specific incentive metrics varies, depending on whether the plan rewards short-term or long-term performance.

Companies use a wide variety of metrics in their short-term incentive plans, and typically use more than one measure. The most commonly used are earnings measures, such as Operating Income, EBITDA[1], Net Income, and Earnings per Share. In performance-based long term incentives, Total Shareholder Return (TSR) is predominant, used in over 60% of such plans[2]. Return measures, such as Return on Capital and Return on Assets, tend to be more frequently used in long-term plans, reflecting a company's interest in ensuring an efficient use of capital and delivering sustained value to investors over time.

The focus of proxy advisory firms on TSR has been a significant factor in driving its adoption in long term incentive plans. In its 2014 Executive Compensation Reimagined series, the Center addressed the limitations of TSR as a performance metric, noting that:

> *"While TSR is arguably the ultimate measure of management's performance, it is very much like the score at the end of a baseball game. That is, TSR is the best measure of the final outcome, but it's not particularly helpful in determining what it takes to actually win."*

In the next section, we'll discuss how companies can select performance metrics that both drive shareholder value creation and effectively focus management attention on actions within their control.

Identifying the right metrics

Identifying the right incentive plan metrics starts with a simple assumption: to create superior shareholder value, a company must consistently outperform its peers on industry-specific financial and non-financial measures over time. No single measure will be right for every company for all time periods, so it is important to analyze actual data to uncover the right metrics for a specific company and its industry.

UNDERSTANDING FINANCIAL MEASURES

For a detailed look at financial measures and their use by HR professionals, we suggest Financial Analysis for HR Managers by Steven Director.

[1] Earnings Before Interest, Taxes, Depreciation and Amortization.

[2] Meridian 2019 Executive Compensation Trends and Developments Survey

“Identifying the right incentive plan metrics starts with a simple assumption: to create superior shareholder value, a company must consistently outperform its peers on industry-specific financial and non-financial measures over time.”

Fortunately, the analysis does not have to encompass the entire universe of potential metrics; instead, a reasonable starting point can be to evaluate the metrics the executive team already uses to manage the business. Those metrics should then be assessed in light of what is important to the company’s investors. For example, if a company is focused on operating margins but its investors continually question its ability to grow, it may be advisable to include a revenue metric in the data analysis.

Once a group of metrics has been selected, they should be analyzed using historical data. Each of the identified metrics (alone and in various combinations) should be tested for correlation against a measure of shareholder value creation – typically TSR – over various time periods. It is important that the analysis be conducted on a broad data set (for example, a company’s industry competitor group) not just on historical data for a single company. This will help ensure a more robust analysis, minimizing the impact of anomalies and non-recurring events that may impact any single organization.

By engaging in a collaborative effort with their finance and business strategy teams, CHROs can ensure the right expertise is brought to the table. Expertise in financial metrics, business analysis and industry dynamics are critical in interpreting the results of the statistical analysis. By definition, correlation analysis is backward looking – it shows how changes in the metrics being testing related to changes in TSR in the past. This backward looking analysis should be informed by the judgment of finance and strategy professionals as to how macroeconomic and industry conditions in the future may differ from prior years to help put the correlation results in the appropriate context.

While correlation is not the same as causation, using statistical analysis as an element of incentive plan metric selection adds an element of rigor to an often subjective process, helping companies and boards tailor incentive designs to meet the needs of their companies and industries.

SETTING PERFORMANCE GOALS

Once the right metrics are identified, the target level of achievement for each metric can be determined. Establishing performance targets is one of the most challenging aspects of incentive plan design. To understand the dynamic influencing this process, it is important to first understand the role performance goals play in an organization. Companies use goals for three purposes – to facilitate planning their operations, to monitor progress toward objectives, and to reward performance. When performance against goals is used to determine management’s compensation, the potential for a conflict is created.

Management has an incentive to select performance metrics that are within its control and goals that are attainable, in order to maximize the likelihood of favorable compensation outcomes. Shareholders, however, favor the best possible performance at the lowest possible cost – and as such prefer aggressive performance goals and a strong and direct link between pay and performance. The CHRO plays a critical role in helping the Board achieve the right balance between these important stakeholders with potentially conflicting interests.

The first step in establishing incentive plan performance goals is to determine the reference point – what is the benchmark against which performance will be measured? Is it an internal reference point – for example, the company's operating budget or performance against prior year results? Internal goals have the advantage of being easier for an organization to understand and embrace; but shareholders may be skeptical that management is manipulating the goal for its own purposes.

Alternatively, goals may be established relative to an external competitor group. When set on a relative basis – such as relative Total Shareholder Return – external goals can be more effective in situations where goal setting is difficult due to economic disruption or uncertainty. External goals that use standard accounting measures are also more objectively determinable than internal goals. However, effective external goals require a robust and relevant peer group (discussed in Part 2 of this series) and as such may be difficult to construct for companies with diverse businesses and competitors.

DETERMINING THE PERFORMANCE PERIOD

Deciding on the right time horizon over which performance will be measured also requires the balancing of potentially diverse interests, even within a stakeholder group. For example, not all shareholders have the same investment time horizons – institutional shareholders typically view performance over a much longer timeframe that activist shareholders. Similarly, individuals differ in their career objectives, personal preferences for risk and the transferability of their skills to other companies, all of which influence an executive's views on the appropriate length of a performance period.

The company's business strategy also influences the selection of the appropriate performance period. At times, the ability to accurately set multi-year goals is limited, as when a company is undergoing a period of transformation. Macroeconomic factors also play a role, as in the recession of 2008 and the swift and massive deceleration of economic activity in the wake of the COVID-19 pandemic.

While there are exceptions, most companies define the performance period as follows:

- For short-term incentive plans: performance over a single year
- For long-term performance plans: performance over a multi-year timeframe, typically three years.

WANT TO KNOW MORE?

Check out the Center publication Setting Incentive Targets in a Time of Economic Volatility and Increased Uncertainty for more insights on alternative incentive plan design approaches in the event of an economic downturn.

ESTABLISHING THE PAYOUT CURVE

The performance goal serves as the "anchor" of what is known as the "payout curve". The payout curve is the mathematical representation of how pay is related to performance. It answers the question, "how much pay is delivered at a given level of performance?"

Typically, the performance goal is "anchored" at a target payout – so that if the performance goal is achieved, the plan will pay out at 100% of its targeted level. For performance goals that are set relative to an external benchmark, it is common to deliver target pay if performance on the metric is at the median of the peer group. For plans that use a company's internally established performance goal (such as operating profit), target pay is often anchored to the company's annual budget or operating plan.

The key decision in designing the pay for performance relationship is to determine how much the actual amount paid will vary up or down with performance that exceeds or falls short of the goal. That relationship is determined by answering two important questions:

- What performance level is too low to justify any payout at all?
- What performance level is the "upper limit" beyond which we no longer want to create a pay-performance incentive?

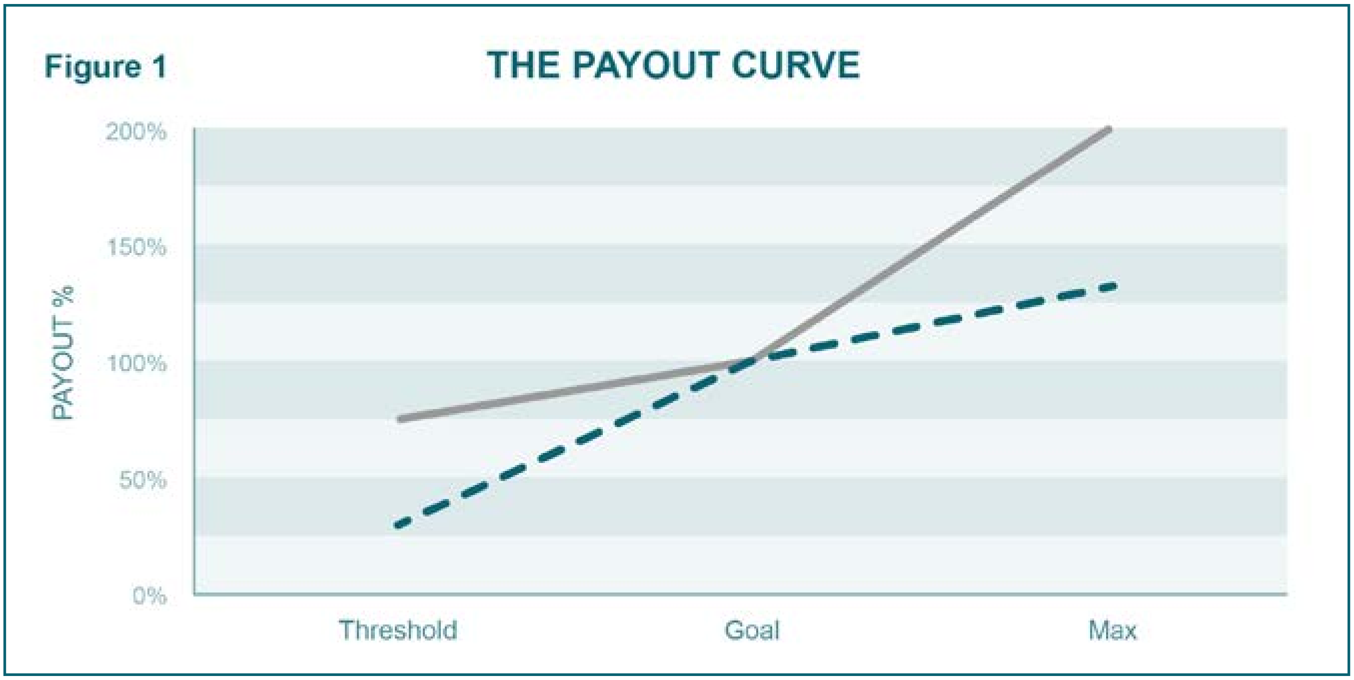
Establishing the minimum

A pay for performance approach is based on the idea that as performance falls short of the expected level, pay will also decline; and at some point, performance may deteriorate to such a low level that no pay should be earned. This minimum level of performance is known as the threshold and sets the starting point for the pay-performance relationship.

Setting the appropriate threshold level of performance is made easier by analyzing historical data for the performance metric that is being used. If the metric shows a high degree of variability from year to year, it is advisable to have a greater distance between the threshold level of performance and the goal. This anticipates the fact that in any given year, performance may fall well short of target – and still provides executives an incentive to drive performance even in difficult years.

Once the threshold level of performance is set, the next question to be answered is "how much pay will be earned at the threshold level?" The lower the level of pay earned at threshold, the "steeper" the curve is between threshold and target, as is illustrated in Figure 1.

A lower percentage payout at threshold means that every incremental improvement in performance results is bigger jump in potential earnings, creating a stronger pay-performance link. Conversely, if the percentage payout at threshold is only slightly lower than at target (say, 75% payout at threshold, 100% at target), changes in pay are less sensitive to changes in performance. The decisions made regarding the performance and payout thresholds send a clear signal to management about the Board's expectations and its risk-return tradeoff.



Determining the maximum

The last step in creating the payout curve is to decide “how much is too much?” In a perfect world, it may seem puzzling to set a limit on how much performance will yield additional incremental pay; after all, if high performance is good, isn’t higher performance even better? In practice, incentive plans have maximum payouts in order to limit management’s ability to realize windfall gains, and to inhibit excessive risk taking. Just as management’s downside risk is limited to a zero payout, its upside risk is also capped, most commonly at 200% of target[3].

The payout percentage at maximum establishes the pay-performance relationship between target and maximum – the slope of the payout curve. It is not uncommon for the slope of the payout curve to be different from threshold to target than from target to maximum. By varying the slope of the curve, the Board can tailor the message it sends to management about the incremental value of performance below and above expectations – and the level of risk-taking they are comfortable encouraging at each point along the curve.

In Figure 1, the dashed line reflects a flatter curve above target and a lower maximum, indicating that incremental performance improvements above target are less valuable than those below target. In this way, the Board can signal its expectation that target should be achieved but discourage aggressive risk-taking above that level. In contrast, the solid line in Figure 1 shows a flat curve between threshold and target (driven by a higher threshold payout), with an aggressive sloping curve above target, sending the clear signal of the importance of stretch performance.

[3] FW Cook, 2019 Annual Incentive Plan Report

THE USE OF DISCRETION IN INCENTIVE PLAN DESIGN

The majority of executive incentive plans use a formulaic approach, where the amount earned is based on the measurement of actual results compared to a quantifiable and measurable target. The use of discretion to modify an award that results from a plan's formulaic calculation is typically viewed negatively by key stakeholders such as investors and proxy advisors.

However, Compensation Committees do exercise discretion that impacts incentive pay in other less visible ways. They make adjustments to standard GAAP financial measures, often to improve the alignment of pay and performance by removing items that are unanticipated and are not reflective of a company's underlying operations. They also exercise discretion in establishing the size of an executive's incentive opportunity. The use of discretion to alter the operation of an established incentive plan formula is less frequent – but may be appropriate under certain circumstances, as the COVID-19 pandemic illustrates.

Compensation Committees who choose to use judgment to alter the amount paid under an incentive plan will be best served by clearly stating their rationale, and by limiting the frequency with which they exercise discretion – especially in ways the increase awards over what otherwise would have been earned.

02

SHAREHOLDERS AND STAKEHOLDERS

STAKEHOLDER EXPECTATIONS FOR SELECTING PERFORMANCE METRICS

Traditionally, the selection of performance metrics has been viewed as the responsibility of management, under the oversight of the Board of Directors. In recent years, however, certain investors have focused increasing attention on the performance metrics used in executive incentive plans. Two areas of particular interest are the growing prevalence of non-financial metrics (specifically, ESG measures) and the proliferation of "non-GAAP" metrics (metrics whose calculations do not follow the standardized definitions established by Generally Accepted Accounting Principles, or GAAP.)

The Rise of ESG in Incentive Plans

Responding to a growing interest on the part of institutional investors, there has been an increase in the use of ESG metrics in incentive plans. Over 25% of large companies who use a metric-driven annual incentive plan disclosed using at least one ESG goal, with human capital goals being the most common[4]. However, these metrics typically are used in annual incentive arrangements, impacting a relatively small portion of the incentive opportunity and have been viewed as being mostly symbolic[5]. However, as ESG issues increase in importance and metrics become more standardized, more companies may begin to incorporate them into their incentive plans.

The Use of Non-GAAP Metrics

Another area of investor interest is the increasing use of non-GAAP metrics in incentive plans. According to a recent study, in 1996 only 59% of the Standard and Poor's 500 used non-GAAP measures in their financial reporting; by 2018, that number had increased to 97%[6]. The use of non-GAAP metrics to supplement traditional GAAP reporting is a response to investor demands for additional information upon which to evaluate performance, as well as management's desire for metrics that are more closely linked to underlying operating performance.

Incorporating non-GAAP metrics into incentive plans reflects the desire to create an effective incentive plan – one that actually creates an inducement to drive differentially better results in a manner that is perceived as fair by executives. GAAP metrics can be significantly impacted by events beyond management's control; and in some cases, can actually discourage managers from making decisions that are in the best interest of the business. For example, managers may avoid a significant but disruptive restructuring of the company because the near-term impact of that decision on reported financials may result in a lower incentive payout. Non-GAAP metrics also provide flexibility that allows the plan to operate effectively in periods of uncertainty, such the rapid economic recession caused by the COVID-19 pandemic.

Adjusting GAAP metrics to take account of these factors is a reasonable action taken to recognize the need to balance the interests of shareholders and executives. However, recent research found that the use of non-GAAP metrics was associated with significantly higher than expected levels of CEO pay, without any corresponding evidence that those metrics were better predictors of company performance[7]. As a result, companies should take care in determining what kind of non-GAAP metrics they will use in their incentive plans and strive for transparent disclosures about not only the mechanics of the adjustments, but their rationale as well.

WANT TO KNOW MORE?

Check out the Center publication "The Use of Adjustments to GAAP Metrics in Executive Incentives" for a detailed discussion on the advantages and disadvantages of the use of non-GAAP metrics in incentive plans.

STAKEHOLDER VIEWS ON PERFORMANCE GOALS

Stakeholders – especially shareholders and proxy advisory firms – also take a serious interest in the performance goals used in executive incentive plans. Proxy advisory firms and some investors expect companies to set more challenging performance goals, insisting that a given year's performance goal is always higher than the prior year's actual results. Companies are responding to the pressure, with over three quarters of companies setting their threshold performance goal at or above the prior year's actual performance[8]. The insistence that performance goals must always be set above prior year performance may provide challenges to companies who are in cyclical industries, who have divested significant operations, or during periods where macroeconomic conditions are deteriorating.

[4] F.W. Cook 2019 Annual Incentive Plan Report

[5] "How should environmental, social and governance (ESG) performance be reflected in executive compensation?" Meridian Insights Blog Post, January 22, 2020

[6] Non-GAAP measures and the ongoing dialogue: What you should know" PwC, October 2019

[7] "High Non-GAAP Earnings Predict Abnormally High CEO Pay," Nicholas Guest, S.P. Kothari and Robert Pozen, September 2017.

[8] F. W. Cook, 2019 Annual Incentive Report

03

GOVERNANCE AND DISCLOSURE

TELLING YOUR STORY

Investors want a clear, concise description of the relationship between performance and a company's pay program – and most often do not feel that proxy statements effectively meet their needs. Most feel that the link between pay and performance is not clear; and in response many companies have broadened their disclosure beyond what is required in the proxy statement. In 2018, 56% of the Equilar 100 companies provided a supplemental disclosure in addition to what was required.

If the pay for performance relationship is one of the most important concerns for investors, why is disclosure falling short? One reason is that the standard required proxy statement disclosure does a poor job of showing how actual pay varies with performance. The cornerstone of the standard proxy disclosure, the Summary Compensation Table (SCT), reports pay actually earned as well as accounting estimates of the "potential" or "expected" value of other types of pay; and even includes calculations that have no relationship to an executive's pay or company performance (see Figure 2).

As Figure 2 shows, only the amounts disclosed for base salary and annual bonuses reflect the amount actually paid to executives in a given year. Because of the limitations of the SCT, companies have adopted alternative ways of showing the pay for performance connection. Two of the most common are Realized Pay and Realizable Pay. Realized Pay gives a clearer picture of the total amount actually received by an executive, while Realizable Pay shows a "point-in-time" picture of the value of pay that allows more effective assessment of the alignment of pay to a company's performance.

Each of these alternative approaches allow companies to show more clearly the connection between pay actually received and performance; however, because there is no commonly accepted standard for these approaches, comparisons between companies (or of a single company's results over time) are difficult and adoption has not been consistent or universal.

Figure 2 **SUMMARY COMPENSATION TABLE ELEMENTS**

PAY COMPONENT	SUMMARY COMPENSATION TABLE REPORTING
Base salary, annual bonus	Amount actually paid, including any elected deferrals
Restricted stock, Stock options	Value at the date of the grant; for options, value typically established using an option pricing model
Long term performance plans	Value that can be earned if performance target is achieved
Other compensation	Non-performance-based compensation, including any increase in actuarial value of pension, above-market credits to deferred compensation amounts

WANT TO KNOW MORE?

Realized and Realizable Pay are alternative approaches to pay disclosure that allow investors a more realistic assessment of the relationship between executive pay and performance. There are no standard definitions of these approaches, making comparisons challenging and inhibiting widespread adoption. For more information, check out these Center resources:

Supplemental Pay Disclosure: Overview of Issues, Proposed Definitions, and a Conceptual Framework

Comparison of Different Approaches to Calculating Total Executive Compensation

Five Alternative Approaches to Disclosing Executive Compensation

THE DODD-FRANK PAY FOR PERFORMANCE RULE

The 2010 Dodd Frank Act contained provisions requiring the disclosure of the relationship between executive pay and performance. In April 2015, the SEC published proposed rules implementing the Act's mandate. The proposed rule, which has not been finalized, defines compensation "actually paid" as a mixture of actual compensation received by the executive, along with point-in-time estimates of equity compensation and accounting estimates of the value of stock options. The proposal also relies solely on total shareholder return as the measure of company performance.

In the economic analysis of the proposed rule, the Commission admitted that the disclosure had the potential to be misleading, and suggested companies use additional narrative disclosure to clarify any misleading information. Many observers, including the Center, do not believe this provides a sound and rationale basis for a securities disclosure and has urged the SEC to revisit the proposed rule and replace it with a principles-based approach.

04

FINANCIAL IMPLICATIONS

As paying for performance has become the foundation of executive pay programs, the importance of understanding the drivers of company performance has increased. CHROs and rewards professionals now work in partnership with finance and strategy teams to determine the right performance metrics for their executive incentive plans, and the target levels of performance that must be met to earn competitive rewards.

Given the inherent potential for conflict between management and the Compensation Committee in selecting metrics and setting goals, the use of a data-based approach to informing incentive plan design is important. An analysis of the correlation of incentive plan metrics to shareholder value creation over time gives management and the Board an objective foundation to guide incentive design.

Investors and other stakeholders are also interested in understanding how much of a company's profit is paid out in the form of compensation. This is typically called a "sharing percentage" – for example, the total value of incentive compensation divided by an earnings measure, such as operating profit or earnings per share. Because these percentages differ widely based on industry and company-specific factors (such as labor strategies, incentive plan eligibility, etc.) there are no well-developed standards or benchmarks for an appropriate sharing percentage. Boards and Compensation Committees rely on their judgment and on historical trends for their company to gauge whether the portion of profit shared with management is appropriate.

Similarly, shareholders are also interested in how many shares are reserved for use in compensation plans. This is typically done by looking at the percentage of shares reserved for compensation plans as a percentage of total shares outstanding, a calculation called "overhang". Overhang levels vary considerably by industry and reflect the unique talent, rewards and capital allocation strategies of each company. Shareholders watch overhang levels to make sure that their ownership interest is not unduly diluted by diverting too much equity to management.

TERMS TO KNOW: OVERHANG AND BURN RATE

Overhang: a measure of how much stock is being given to management and employees in the form of equity compensation. Sometimes referred to as dilution. Typically calculated as follows:

$$\frac{\textit{Number of shares available for use in compensation plans}}{\textit{Total shares outstanding}}$$

The numerator includes shares available to grant, outstanding stock options that haven't been exercised, as well as outstanding restricted stock and performance shares that have not vested.

Burn Rate: a measure of how fast shares are used by compensation plans. Sometimes referred to as run rate. Typically calculated as follows:

$$\frac{\textit{Number of shares actually granted in a year}}{\textit{Weighted average total shares outstanding}}$$

REFERENCES AND RESOURCES

Executive Compensation Reimagined

Council of Institutional Investors SEC Petition regarding non-GAAP metrics

Proposed Pay for Performance Rule Fact Sheet

UP NEXT

In part 4 of our series we'll explore the detailed elements that comprise an executive pay program.