COMPENSATION COMMITTEE LEADERSHIP NETWORK
ViewPoints

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Setting goals in an uncertain environment

Boards and their compensation committees face a range of difficult decisions that are further complicated by the uncertainty of the current economic and political environment. The prospect of sweeping policy changes – comprehensive tax reform, a Dodd-Frank overhaul, and new approaches on tax and trade – create unique challenges for companies and their boards.

On March 23–24, 2017, members of the Compensation Committee Leadership Network (CCLN) discussed how boards could best set goals that encourage both short- and long-term success. Members also discussed the principles of inclusive capitalism and anticipated changes to the regulatory agenda in Washington, particularly at the Securities and Exchange Commission (SEC). This *Viewpoints* presents highlights of CCLN members' conversations on these topics.[1]

The challenge of goal setting

CCLN members discussed how challenges around setting annual budgets – and, therefore, compensation and performance goals – can be exacerbated in a volatile environment. One member said, *"Given the uncertainty we currently face, it's near impossible to know how the numbers will end up."* For more on anticipated political and regulatory changes, see page 5. Members and guests outlined various approaches and responses to current challenges.

Committees are reassessing long-term plans

Members were especially interested in ways to address the specific challenge of creating a long-term incentive plan (LTIP) that motivates management and is properly aligned with company performance. John Anderson of Meridian Compensation Partners told members, *"There's a notion that the design and structure of the LTIP should have stability, durability, and consistency, but there comes a point where that can go too long."*

Some members discussed projects to reassess their LTIPs and make them more fit for purpose. One member described an effort to incentivize long-term thinking: *"We were focused on short-term bonuses and incentives even in long-term projects. We made basic changes to our compensation plan and revised our long-term equity plan to get management to consider a broader time horizon."* Another member described a committee that shifted its entire long-term pay philosophy: *"We decided to take out stock options and put in performance-based metrics. It's been well received."*

Members said one of their biggest challenges is creating an LTIP that motivates management despite a significant wait time to receive compensation for reaching the goals. One member said, *"Three years is a long time and we question if our LTIP is motivating the management team. We need to ensure we are giving the management team what they need to succeed."*

[1] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

Members also emphasized the importance of having an LTIP that management understands. This concern is particularly acute given the sizeable amount of equity that is used to fund LTIPs. One member advised others to make sure that any LTIP changes are well understood: *"We institutionalized radical changes to our compensation plans a few years ago and looked very closely at [the LTIP]. Throughout the process, we went overboard in exercising transparency as we put the metrics in place to ensure that the CEO understood all the changes."*

Adjusting and refocusing annual goals can be a helpful approach

Balancing investors' expectations with the need to set goals that will reward and retain strong performers on an annual basis is a difficult task. Some members said that in the current environment, they have less confidence in their companies' budgets and goals than in years past. Meridian's Marc Ullman said, *"A good rule of thumb is that the more uncertainty, the greater the performance range. For companies in a cyclical space, whatever ranges felt comfortable in the past may need to be increased by as much as 50%."*

Some members plan to examine results over the course of the year and adjust goals if the numbers are trending in a far different direction from what they originally forecasted. One member discussed a situation where the committee lacked confidence in the company's ability to project performance across the board: *"We realized that goal setting was going to be a real problem. Going into this year, we've decided to go quarter by quarter."* Other committees are asking management to produce multiple budgets. *"Our company is very sensitive to changes in the economy. I tell our people to do their best estimate and if they can't, then to provide a budget every six months,"* said one member.

Members also discussed linking annual bonuses to non-financial goals in order to incentivize management to focus on core business issues. These goals are often unique to a particular company or industry; for example, a consumer-facing company may prioritize customer satisfaction while an industrial company may focus on workplace safety. *"We implemented a customer experience metric that is measured, audited, and tracked. It is a big deal for my company,"* said one member. Other members find these goals difficult to set and measure, since they are not tied to financial performance or easily quantifiable. Members said this challenge is especially present in the first year a company implements a new goal, when there is a lack of historical baseline data. One member said, *"When we set new non-financial targets, it's like we are sticking our finger up in the wind. We know it's not exact, but we want to encourage management in these areas."*

Currency fluctuations complicate compensation decisions

The multiyear strength of the US dollar is also causing CCLN members to question how they approach currency fluctuations in their incentive compensation plans. According to *MarketWatch*, "[President Donald] Trump's election sparked a rally in the dollar, taking the primary index to its highest level since 2002 earlier this year on bets that his plans for tax cuts and fiscal stimulus would stoke inflation."[2] Although the increase has stalled, Mike O'Rourke, chief market strategist at JonesTrading, expects the dollar to continue to strengthen during the Trump administration: "If [Trump] executes the policies he's proposed, the dollar should remain stronger. Ultimately I don't believe the dollar is anywhere near a ceiling. As we're

[2] Hiroyuki Kachi and Ryan Vlastelica, "Dollar Rises as Expectations Grow for March Rate Hike," *MarketWatch*, March 1, 2017.

just starting our tightening cycle, I suspect we're going to continue being the favored currency for some time."[3]

Some committees make a constant currency adjustment to their results, so management is not helped or harmed by currency swings. One member said this is a major issue for global companies that earn money in foreign denominations but have to convert to US dollars for reporting purposes: *"The strength of the dollar last year was a major factor for our company. We have decided to make our plans currency neutral."*

Other members choose not to adjust for currency in an attempt to keep executive and shareholder outcomes aligned. *"We don't try to adjust for it. We don't make any adjustments in annual outcomes to protect executives in incentive programs,"* said one member. Another member added, *"I think adjustment is too easy an out."*

Meridian's Mr. Anderson discussed the compromise that some committees make: *"Some companies are not neutralizing for foreign currency swings if they are within a 5-8% fluctuation but using a "collar" approach, whereby if the currency changes alter the results beyond a certain percentage (up or down), then they factor in some neutralization."*

Understanding the case for "inclusive capitalism"

In a discussion with members about how their boards push management to focus on the company's long-term priorities, Frank Blasio of the Coalition for Inclusive Capitalism described his organization's efforts broaden the group that benefits when business does well. Proponents of inclusive capitalism advocate that investing in people and society is key to long-term financial success. Many leaders believe that organizations that are focused on inclusive concepts are more likely to produce better financial returns over the long term and benefit from improved employee productivity and retention, sustainable production, reduced risk, increased resiliency, and a cheaper cost of capital.[4] One CCLN member said, *"The long-term ways the company invests may cost more initially but will have more impact on their bottom line over time."*

Mr. Blasio and members identified three reasons why companies may consider additional factors when assessing their strategic priorities:

- A focus on short-term results at the expense of long-term priorities can be risky
- Environmental, social, and governance (ESG) metrics can drive financial performance
- Investing in the workforce is good for business

A focus on short-term results at the expense of long-term priorities can be risky

The Coalition for Inclusive Capitalism encourages companies to extend "the decision-making purview to ensure investments are made for the long-term benefit of all stakeholders. More often than not, short-term financial benefit is prioritized over long-term value creation, and misaligned incentives create a value-

[3] Ibid.
[4] Coalition for Inclusive Capitalism, "About Us," accessed March 1, 2017.

destroying environment. Over time this will erode an organization's ability to generate sustained profit and will negatively affect its stakeholders."[5] A recent McKinsey study that Mr. Blasio cited found that firms that are more focused on long-term results outperform their short-term–focused counterparts in a number of key metrics, including revenue and earnings growth.[6]

Mr. Blasio added that companies should look at this as a risk management issue: *"If you tie long-term goals, including non-financial goals, to your business effectively, then you get better returns, not necessarily by increasing alpha but by decreasing beta."* One member was generally open to this concept but emphasized a caveat: *"We've done this in several initiatives, but you need to be sincere to be credible."* Some investors are reticent to embrace goals that are not clearly tied to financial performance. To overcome this, Mr. Blasio encouraged communication. *"Have conversations with investors and emphasize that it is all about financial performance in the end. Outreach is a necessity,"* he said.

ESG metrics can drive financial performance

CCLN members and Mr. Blasio also discussed companies' enhanced efforts to track, monitor, improve, and disclose their ESG practices.

Members discussed the challenge of identifying the right metrics to use for tracking ESG performance. Mr. Blasio advised members to *"focus on two types of metrics: ones that create value and ones that preserve value."* One CCLN member said, *"It can't just be about ethics that are nice to have – it has to be connected to your business plan."* Another member added, *"It's more than just culture. It should be about things that are completely quantifiable and understandable."*

Some members struggled to identify value-creating metrics, noting that while these metrics track principles tied to a company's long-term priorities, the metrics themselves might not be suitable long-term goals because they are subject to constant change. One member said, *"The relationship between our business and social issues is very strong. The message is absolutely embedded into what the company is doing and delivered on an ongoing basis. The question is, how do you measure it? We don't have it as tangible metrics that you can put on the table."* Another member added, *"My challenge is how to transfer our identified goals into specific measures to evaluate and then communicate it to investors."*

Investing in the workforce is good for business

Members recognized that in order for a company to achieve long-term success, it must have a well-trained, motivated, and satisfied workforce. Mr. Blasio cautioned against relying solely on standard employee surveys to understand the workforce: *"Employee satisfaction surveys are valuable only if you ask the right questions. Focus on identifying the employee's needs and matching them with the company. You need to know what you are looking for before you ask."*

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[5] "Promote Long Termism," Coalition for Inclusive Capitalism, accessed March 5, 2017.

[6] Dominic Barton et al, *Measuring the Economic Impact of Short-Termism* (McKinsey Global Institute, February 2017).

Many CCLN members said that their companies prioritize training, even if there is less certainty that employees will remain with the company for the duration of their careers. *"We use training as a recruitment tool. We can't guarantee lifetime employment, but our employees will be highly marketable when we part ways, and we have a track record to prove it. I think training is costless,"* said one member. Another member added, *"We continue to train laid-off employees so that when the market comes back they can step in."*

Companies' investments in the workforce are not limited to training and pay; they also include promoting causes that their employees care about. Members discussed how employees, especially millennials, seek companies that have a sense of social purpose and responsibility. One member said, *"It's about how you treat employees and give back to the community. Our corporate social responsibility report is becoming more important than the annual report to the people we are recruiting."* Another member added, *"Employees want to know that they are doing something meaningful."* Mr. Blasio highlighted this trend but cautioned companies to maintain a strategic focus. *"It's about matching employee needs with company needs. You don't need to make your work aligned with everyone in the country. I suggest using it as a hiring practice to make sure interests are aligned,"* he said.

Anticipating political and regulatory change

President Trump has promised huge changes to benefit business and the economy but has offered few details, aside from promising to "cut regulation by 75%, maybe more."[7] Brian Breheny, partner at Skadden, Arps, Slate, Meagher, and Flom, joined members for a political and regulatory update. Mr. Breheny discussed anticipated changes to the political and regulatory agenda in Washington, with a focus on the SEC.

The SEC's priorities will change

President Trump has an opportunity to significantly reshape the agenda of the SEC. He has already nominated Wall Street lawyer Jay Clayton as SEC chair and will have the opportunity to nominate two other commissioners, including one more Republican, for the five-person panel.[8] In the meantime, acting SEC chair Michael Piwowar has already signaled a push toward deregulation by asking the SEC staff to reconsider the forthcoming pay ratio rule.[9]

Mr. Clayton is moving closer to confirmation. On April 4, the Senate Banking Committee approved his nomination by a 15-8 vote, and he now advances to a full Senate vote.[10] Mr. Breheny predicted, *"If confirmed as SEC chair, Clayton will likely prioritize capital markets and capital formation, given his professional background and his testimony at his confirmation hearing."* Mr. Breheny added, *"While he has not yet unveiled a specific plan of attack for Dodd-Frank, Mr. Clayton has indicated he is willing to look at the rules to determine their effectiveness."* During his testimony to the Senate Banking Committee, Mr.

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[7] Stuart R. Levine, "Huge Regulation Cuts in 2017: Directors Beware," *Forbes Insights*, January 25, 2017.

[8] Francine McKenna, "Trump's SEC May Take Aim at Corporate Disclosure," *MarketWatch*, January 3, 2017; Jessica Dye, "Trump's SEC Pick Jay Clayton Clears Senate Panel," *Financial Times,* April 4, 2017.

[9] Sarah N. Lynch, "Acting SEC Chair Takes Aim at Dodd-Frank CEO Pay Ratio Rule," *Reuters,* February 6, 2017.

[10] Dye, "Trump's SEC Pick Jay Clayton Clears Senate Panel."

Clayton said he had no "specific plans" to dismantle Dodd-Frank but that the law "should be looked at, in particular rules that have been in place as to whether they are achieving their objectives effectively."[11]

Congress may curtail regulatory demands on US companies

Members were nevertheless interested in how quickly, if at all, the new SEC chair could roll back portions of Dodd-Frank. Mr. Breheny emphasized that as a general matter, rolling back Dodd-Frank would take longer than most expect. *"The fastest way would be if Congress enacted a new statute, effectively nullifying the regulations under Dodd-Frank. Any new statute would require approval of both the House and the Senate,"* he said.

Mr. Breheny told members that the statutory vehicle for change is likely the Financial Choice Act, currently being drafted by House Republicans. While details of the new bill have not been disclosed, *Bloomberg BNA* reported that "the bill proposes to repeal and amend in part executive compensation and corporate governance provisions of [Dodd-Frank]."[12] According to Mr. Breheny, *"The Financial Choice Act and the elimination of Dodd-Frank obligations was once a pipe dream of Congressional Republicans with little chance of becoming law. But now that a bill like this might become law, House Republicans are in the process of determining what changes it should make, including which parts of Dodd-Frank to roll back."* Mr. Breheny encouraged members to *"keep an eye out for the proposed bill; it is expected to move after the administration addresses tax reform."*

About this document

[11] Benjamin Bain, "Trump SEC Pick Says He Has No 'Specific' Plans to Gut Dodd-Frank," *Bloomberg*, March 23, 2017.
[12] Sharon H. Lee, "Financial Choice Act 2.0, What's New?" *Pension and Benefits Blog, Bloomberg BNA,* February 17, 2017.

Contributing members

The following CCLN members participated in the meeting:

- John Anderson, Meridian Compensation Partners
- Erroll Davis, Union Pacific
- Roxanne Decyk, Orbital ATK
- Marianne Harris, SunLife
- Kathy Hill, Moody's
- Mel Lagomasino, The Coca-Cola Company
- Karen Maidment, TD Bank Group
- Maria Otero, Herbalife
- Virginia Ruesterholz, The Hartford and Frontier
- Samme Thompson, American Tower
- Marc Ullman, Meridian Compensation Partners
- Linda Wolf, Wal-Mart

The following members took part in pre- or post-meeting discussions:

- Bill Kerr, IPG
- Ramani Ayer, XL Group
- Steven Reinemund, Marriott International
- Laurie Siegel, CenturyLink