COMPENSATION COMMITTEE LEADERSHIP NETWORK
ViewPoints

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Motivating senior executives with compensation

On July 14–15, the Compensation Committee Leadership Network (CCLN) met in New York to discuss how compensation committees can most effectively motivate executives. In one session, members discussed how boards pick metrics and set targets and payout curves. In another, members were joined by a panel of institutional investors to discuss how owners think about compensation and how they communicate those views to companies and boards. Members also participated in a dinner conversation with Professor Michael Dorff of Southwestern Law School about whether plans that link executive pay with company performance achieve their stated objectives.

Building incentive plans

During the meeting, members discussed how four board activities – overseeing the budget, selecting metrics, setting targets, and establishing the payout curve – help them set executive compensation.

The corporate budget

The internal goal-setting process for many executives begins with the company's budget or annual plan. Likewise, 92% of compensation committees surveyed recently by Meridian use budgets or plans as at least one of the factors in setting annual compensation goals.[1] Members said that it is therefore important for a compensation committee to understand the company's budgeting process. One said, *"One of the best things we could do is more rigorous budget activity since that is the backbone of the plan targets."*

There is no standard approach to the board's review and approval of the company's budget. At some companies, the audit or finance committee has the initial responsibility for budget review. At others, budget approval lies with the whole board. While compensation committees are not usually responsible for the initial budget review, some members said that their committees are finding ways to take a closer look at draft budgets if budgeted numbers are considered when establishing compensation goals. One noted, *"It causes us to think about the interconnection of committee members. It is important to have a member of the committee overseeing the budget also serve on the compensation committee. That linkage has caused us to have a more robust debate."*

Metrics

Before evaluating the numbers, the compensation committee must select the right metrics to motivate management. The link between metrics and strategy is critical. One member explained, *"All the metrics flow from the strategic plan. Whether it is revenue or earnings, it is easy to figure out what drives business growth."* Ideally there is little change in metrics year to year. A member said, *"Keeping the same metrics provides stability and clarity. If they change often, it gets confusing to the management team."*

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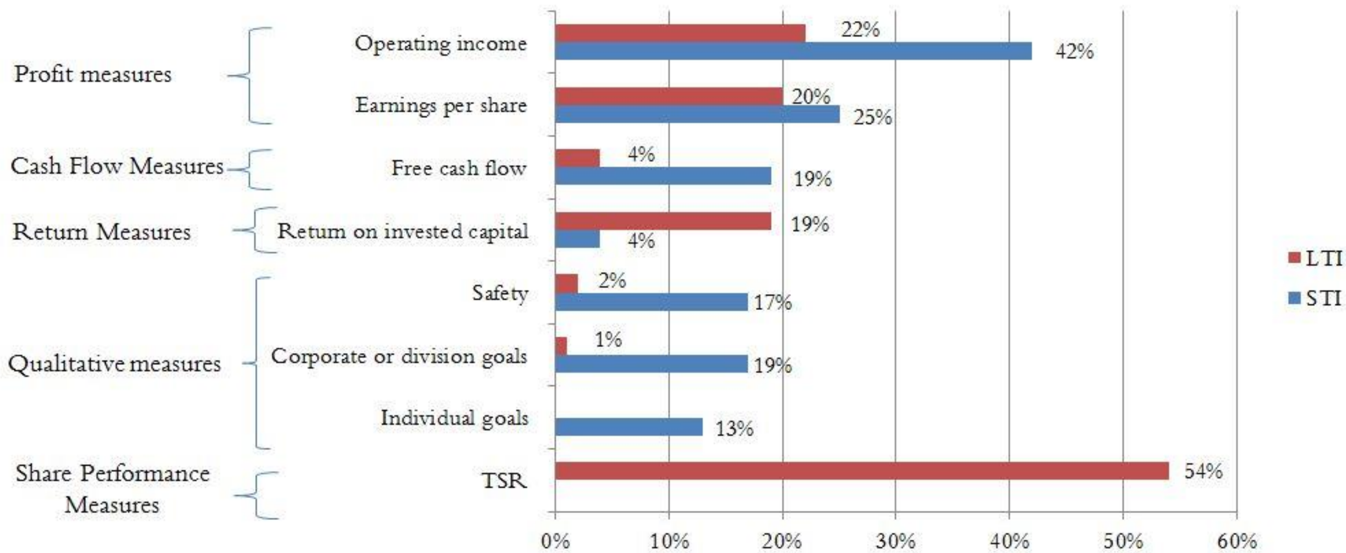
[1] Meridian Compensation Partners, 2015 Trends and Developments in Executive Compensation (Lake Forest, IL: Meridian Compensation Partners, 2015), 14.

Most incentive plans have both short- and long-term components, with different sets of metrics. Members agreed that incentive plans should not be overloaded with metrics. Most felt that for a short-term plan to be effective, it should include three or fewer metrics, while long-term plans should include no more than two. Meridian's Marc Ullman and Andrew McElheran explain why: "It is hard to believe that a plan participant's behavior will change in any meaningful way if their annual bonus depends on their performance on eight to ten or more measures, none of which is worth more than several percentage points of the total."[2] At the dinner conversation, Professor Dorff offered another reason: an incentive plan with a large number of metrics ends up functioning like a straight salary because a CEO is unable to focus on any single metric.

According to a recent Meridian study, only 36% of companies use a single metric to establish short-term incentives (STI); 42% use two metrics, and 18% use three. For long-term incentive (LTI) plans, total shareholder return (TSR) is the most common metric used to evaluate performance. However, 60% of the companies that consider TSR also consider at least one additional metric in their long-term plans.[3]

The metrics that committees use generally fall into five categories:[4]



Members said that even when their committees use the same metrics year after year, they generally adjust the weights assigned to each metric more frequently. In some cases, committees use the weight to send a signal to management about the board's priorities for a particular year. One explained, *"Depending on where we are in the cycle, we may assign more weight to revenue growth or to margin."* Another added, *"We often shift the weights to make sure we are keeping up with our competitors in certain areas that are important in our industry."*

[2] Marc Ullman and Andrew McElheran, "Setting Appropriate Performance Metrics and Goals," *Insights* (blog), November 14, 2014.
[3] Meridian Compensation Partners, *2015 Trends and Developments in Executive Compensation*, 12, 19.
[4] Ibid., 13, 19. This chart is based upon and consolidates data from two similar charts in Meridian's report.

Some compensation committees consider qualitative metrics in addition to quantitative ones. One member described the process of creating a metric to evaluate the pipeline of products that have not yet made it to market: *"Some directors insist that this is all qualitative and you can't make a number out of it, but then we constructed a process to quantify it. Directors still wonder if it is a little bit of witchcraft, but we all realize it is an incredibly important part of the compensation program."* Another member noted, *"There are certain things like safety that are incredibly important to our company, so we compensate management on them."* In some cases, those measures are not part of the incentive plan but are used by the compensation committee to adjust the results at year end. For example, in some firms, a fatality or major safety failure can sharply reduce payouts for a given year, or even set them to zero.

Targets

Once a committee selects the metrics it will use to evaluate management, it must set numerical targets for each of those metrics. Members described three options for the finer points of target setting:

- **Budgeted numbers.** At many companies, senior executives' compensation targets are the company's budgeted numbers. Some members said it was important to keep the numbers the same so that management has a consistent sense of the board's expectations. They explained that it can be confusing if the board approves one set of numbers for budgeting purposes then the compensation committee introduces a different set of numbers for pay decisions.
- **Adjustments to budgeted numbers.** Many committees use company budgets as a starting point – but not an end point – when setting targets. Some members said that they set better goals when they consider several factors, including the budget, and then triangulate. Some of the other factors include historical performance, historical peer performance, external guidance, analyst expectations, and the sharing ratio (i.e., the percentage of the value created that is paid to management).[5] Sometimes, management may even ask that the targets differ from the budget. One member said, *"Our CEO wanted us to add stretch, so we set the target at 105% of budget."*
- **Alternatives to budgeted numbers.** Some compensation committees' target-setting process is completely separate from the company's budget-setting process. Members who favor this process said it removes the potential for managers to *"sandbag"* when they prepare the budget and supporting materials. They also said that the budgeting process has become so complex at their companies that it is easier to create a separate process for determining compensation plan targets.

Some members said that whatever target-setting process is adopted, the committee should reserve discretion. One member explained, *"We set our targets at the beginning of the year, and by the end of the year things have changed, so it seems silly to focus on the targets we originally set."* Others said that committees must find the right balance between a formula and discretion. One member described the trade-offs: *"We can use discretion, but the price we pay for it is a more intense deconstruction of the data by the committee, along with more emphasis on explaining our decisions to investors."* Too much discretion can also make a plan confusing or ineffective. *"Management needs to have some clarity about its goals during the year,"* a

[5] Ibid., 14.

member said. *"We had a detailed system to determine what management contributed, backing out industry or economic growth. It was almost impossible to understand the plan,"* reported another.

An alternative that one member suggested is to reassess goals during the course of the year: *"On one board, we stopped having annual goals because [given unique circumstances facing the industry] we couldn't see the end of the year. We set six-month goals instead, and it worked well. Management felt some more control and investors understood it."* Other members recommended reserving the right to make after-the-fact adjustments to the targets for unexpected changes in factors such as foreign exchange rates, commodities prices, interest rates, weather, or other industry-specific events. One member said, *"I often wonder why the energy industry should reward someone for a hot summer or a cold winter."*

Payout curves

While targets are important, Meridian's recent study shows that only 18% of companies performed at between 95% and 105% of their targets in 2014.[6] Because a company is unlikely to hit its targets on the nose, one member concluded that *"the curve in many ways is more important than the target."*

Many committees create a threshold level of performance for executives to be eligible for participation in the incentive plan and a maximum level of performance that sets a cap on payouts. Relatively few companies use unlimited payout curves – there is almost always a top end. Members explained that this is due both to regulatory pressure and to the difficulty of explaining what may appear, after the fact, as overly large payouts. Members recommended that committees be thoughtful about the consequences of performance at each point on the curve between threshold and maximum rather than follow a linear formula. Meridian partner John Anderson emphasized, *"It doesn't always make sense to just put a threshold at 80% and a maximum at 120% of the target and create a line between them to determine payouts. You should spend more time determining how hard each outcome is to achieve. Symmetry is not necessary. Increasingly, companies are constructing payout curves that are nonsymmetrical."*

Engaging with investors about executive compensation

Members confirmed that in recent years investors have demonstrated increased awareness of and interest in executive compensation. This is consistent with disclosures by large investors and their representatives about the importance of pay plans. The Council of Institutional Investors states, "Executive compensation is the most critical and visible aspect of a company's corporate governance."[7] In a letter to the independent board leaders of its portfolio holdings, Vanguard's CEO F. William McNabb III identifies "sensible compensation tied to performance" as one of six ways to distinguish good governance programs.[8] In addition, The *Wall Street Journal* recently noted that, "Once left to governance hounds, unions and academics, executive pay is getting a closer look from activist investors."[9]

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[6] Ibid.,12.

[7] "Executive Compensation," Council of Institutional Investors, accessed June 23, 2015.

[8] F. William McNabb III, Letter to the Independent Leaders of the Boards of Directors of the Vanguard Funds' Largest Portfolio Holdings, February 27, 2015, 1.

[9] Liz Hoffman, "Activist Funds Put Executive Pay Formulas Under Microscope," *Wall Street Journal*, June 11, 2015.

Questioning pay for performance

In a dinner conversation with members, Michael Dorff, author of *Indispensable and Other Myths: Why the CEO Pay Experiment Failed and How to Fix It,*[10] argued that paying CEOs for company performance has not worked. He pointed out that the introduction of performance pay has not demonstrably improved corporate performance. Earnings per share growth did not improve after companies began using performance pay, and econometric studies have failed to find a link between greater use of performance pay and improved corporate performance. To explain why performance pay has failed to generate better corporate outcomes, he cited research that paying for performance only motivates effort for relatively simple, mechanical jobs. For complex, multidimensional, highly analytical tasks such as running a public company, performance pay is likely to have a neutral or negative impact. He also presented studies that found CEOs have little power over the bottom-line metrics that are often included in incentive plans.

In Professor Dorff's view, boards would get better corporate performance by giving CEOs a straight salary. This would also reduce overall CEO pay levels, because, in his view, shareholders and directors are more willing to accept large pay packages when they are tied to increases in the company's stock price or earnings per share. Professor Dorff pointed out that large fixed salaries have negative tax implications and are contrary to the conventional wisdom of institutional investors, proxy advisors, analysts - and most CEOs. He therefore proposed a "second-best" alternative to fixed pay: an incentive plan that ties bonuses to a large number of metrics that are largely within the CEO's control and difficult for the CEO to manipulate. He said that having a large number of metrics should diminish the distractive effects of conventional performance-pay forms that tie enormous pay to a single metric and bring CEO pay back within the board's control, not the stock market's.

In a lively conversation, members and Professor Dorff debated the root causes of high CEO salaries. Members suggested that factors such as the rise of large, global companies that generate outsized profits; changes to the marginal tax rates; and the limited pool of people capable of running major companies played a significant role. Professor Dorff blames incentive pay plans that rely so heavily on equity awards, particularly stock options, combined with the historic bull market during the 1980s and 1990s.

Professor Dorff also argued that boards often fail to negotiate pay with CEOs because they can become too attached to their top choice, increasing the perceived distance between the top candidate and the runners-up: *"There is a tendency to think that the person you pick will perform far greater than anyone else. The research demonstrates that while superstar CEOs do exist, it is hard to predict who will become a superstar."* He said boards would improve their CEO search outcomes by narrowing the pool to two or three finalists, then holding salary negotiations with each. Even if the board ended up hiring the most expensive choice, negotiating before choosing would provide more leverage. Members challenged this assertion. One said, *"I have been part of five CEO searches and it was never a close call."* Another asked, *"Do I really want my company to be the petri dish that tests the performance of our third choice?"*

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[10] Michael Dorff, *Indispensable and Other Myths: Why the CEO Pay Experiment Failed and How to Fix It* (Berkeley, CA: University of California Press, 2014).

Members met with Donna Anderson, Vice President and Global Corporate Governance Analyst at T. Rowe Price; Glenn Booraem, Principal and Fund Treasurer at Vanguard Group; and Drew Hambly, Executive Director – Corporate Governance at Morgan Stanley Investment Management, to discuss their views on compensation and governance choices, shareholder-director communication, and proxy voting.

Compensation and governance choices

Boards and their compensation committees make many decisions when establishing their overall compensation philosophy and designing their compensation plans. Members discussed the investors' preferences and the choices that could lead investors to question a board's choices.

- **Compensation plans should align pay and performance.** The investors were clear that they defer to compensation committees' plan design choices, so long as the results reflect clear connections between pay and performance. Mr. Booraem said, *"We have no desire to dictate how people are paid. We provide deference to the committee to the extent we understand what they are doing. But we have views on how certain practices can lead to a disconnect between pay and performance."* Ms. Anderson added, *"We don't get caught up in the details unless we see a problem. Shareholders should not be in the business of designing compensation plans. We should just judge the results."*
- **Metrics should be consistent with corporate strategy.** The investors expressed that incentive plans should provide management and other stakeholders with guidance about the board's priorities. *"It is important for us to understand that management has a small number of clear goals and that at least a piece of their compensation is tied to achieving those goals,"* said Mr. Hambly. Ms. Anderson added that investors often view the choice of a particular metric as a signal about the company's broader strategy: *"Some metrics show us the board is on the right track but other send a signal that the board is driving the wrong behavior. For example, our portfolio managers get concerned if they think a retailer should be closing stores but management is paid for growing square footage."*
- **Investors seek long-term value creation.** In his letter to directors, Vanguard's CEO says, "Executive pay should be tied to the creation of long-term shareholder value."[11] Mr. Hambly said that Morgan Stanley Investment Management is *"looking at the change in total pay that an executive receives over a five-year period and how that change compares to the change in the company's performance over that same period."*
- **Boards can pay with cash or equity.** Members were interested in when investors think it is more appropriate to use cash (as opposed to equity) as currency. One asked, *"Do our plans include too much equity? Why should we be giving the company away to management?"* The investors said that they do not have a blanket preference; boards are free to choose the vehicle they believe is right for the company. But the investors cautioned members to closely manage dilution in their equity share plans, especially when they use stock options, because the number of options awarded could tie up a substantial equity stake. Ms. Anderson also added that there are no true financial reporting benefits to

[11] F. William McNabb III, Letter to the Independent Leaders of the Boards of Directors of the Vanguard Funds' Largest Portfolio Holdings, 1.

using equity instead of cash because most investors will treat equity compensation as an expense even if it is not reported that way by the company.

- **Adjustments are acceptable – when they come with a good explanation.** Members sought guidance from the investors on after-the-fact adjustments. One asked, *"What are your views on adjusting for something like an unexpected change in foreign-exchange rates?"* The investors said they consider adjustments on a case-by-case basis and usually find them acceptable. However, Mr. Hambly observed, *"It can become a problem when you say something is a one-time adjustment, then you try to make it three or four years in a row."*
- **Buybacks should not influence incentive plan payouts.** As boards authorize management teams to buy back shares of company stock, the investors said that compensation committees should ensure their incentive plans are buyback neutral. Mr. Hambly explained, *"If you use earnings per share as a metric, we believe that you should adjust out the buyback when you calculate the results. Buybacks should not be used to help someone hit a target."*
- **Investors care about good governance.** All three investors said their firms consider governance when evaluating whether to invest in a company. Ms. Anderson said, *"There are certain boards or directors that have made us money in the past. We look for companies that follow a similar pattern to those boards. Likewise, if we perceive a major breach by the board then we would start tracking the company more closely and consider selling the investment."* Mr. Booraem added, *"As essentially permanent holders, we view governance protections like seatbelts in a car we can't get out of. We pay attention to the firms that we own and advocate when we see opportunities for improvement."*

Shareholder-director communication

Compensation committees communicate with investors both in writing and through direct engagement. The investors shared their perspectives on ways to make these communications valuable. They said strong written disclosures are a necessary starting point for a successful board-shareholder relationship. *"There is untapped value in written communications,"* Mr. Booraem said. *"Not everybody who owns the stock understands the company as well as the board. A good CD&A [compensation discussion and analysis] can be very helpful."* However, the investors said that it is important to keep disclosures brief and easy to read. One member noted a potential conflict between useful and brief disclosures: *"Longer CD&As are about explanation. If we overemphasize transparency, we aren't able to take things out."*

Some investors believe that it is valuable for shareholders and directors to engage directly with one another. This is particularly true for index funds that do not have the option of selling their shares. Mr. Booraem said, *"Direct engagement with directors helps to inform our perspective on the company and our broader thinking about governance. The vast majority of our engagements with directors leave us feeling better about the company and its board."* Ms. Anderson, however, advised directors to be careful about when and how they engage: *"Sometimes I wonder why directors request engagement with us. It is often enough for us to just engage with management and not take up a director's limited time. When we do engage with directors, we find that it doesn't always go well."*

One member asked the investors, *"Who is the person that should show up for these engagements? Is it the non-executive chair? Or a specific committee chair?"* The investors said that in nearly every case they defer to the board's choice of an appropriate director. They added that boards should select directors for engagement and make sure they are prepared, whether or not a meeting is imminent. *"Every board should have someone camera ready. If you don't know who that person is, you should be developing someone,"* Mr. Hambly said. Ms. Anderson added, *"While we don't always request direct engagement, there are some cases where we are a very large investor and we make outbound requests to talk to a director. In those cases, we get concerned if the board refuses to allow any director to speak with us."*

The investors stressed that directors must arrive at a meeting with investors well prepared and with a clear agenda, ready to use limited time to full effect. In particular, they suggested that engagement during the proxy season be focused on a particular issue at the company. Members were also interested in whether there was a benefit to engaging with investors even when there was no outstanding problem or issue. One asked, *"If the CEO says we are doing well and have a great relationship with investors, should the board still engage?"* Mr. Booraem said that as a holder that lacks the option to sell its position, Vanguard would still be interested in engagement in that situation: *"We find value in building relationships over time, but that does not mean we need to see everybody today. The best time to build relationships is outside that second quarter [of the calendar year]."* Ms. Anderson and Mr. Hambly, however, suggested that their firms are less eager to spend time with directors when there are no major issues to discuss.

The investors said that board-shareholder engagement need not replace the ongoing relationship that investors have with management. Ms. Anderson said, *"Company-level engagement on compensation is really important. In most cases, we learn everything we need from our conversations with the corporate secretary or the head of human resources."* Mr. Hambly told members that directors should be aware of what investors are saying to management: *"When we engage with a corporate secretary or investor relations team, we tell them one thing the company is doing well, one thing the company is not doing well, and one thing for the company to work on. The issue may be small, but it is important for the board to hear it from the people on the front lines."*

Proxy voting analysis

Members also inquired about the process that each investment firm follows when making say-on-pay and other proxy voting decisions. The investors said that their processes include a holistic view of the board's decision. Mr. Booraem said that evidence of a disconnect between pay and performance is likely to trigger a closer look: *"Nothing, by itself, gets us to a no vote. [A disconnect] is a starting point for a deeper dive that may also include engagement with the company and the compensation committee."*

While institutional investors publish proxy voting policies, the guests stressed that their voting decisions do not follow a formula and are not always aligned with the preferences stated in their policies. Mr. Hambly explained, *"The policy is a high-level view of what we think is the right thing to do. But we look at things on a case-by-case basis and determine whether pay is warranted over the long term."* Ms. Anderson said that T. Rowe Price's proxy voting policy is part of a multipart screening process: *"This screening tells us where* *to spend our time. Eighty percent of companies screen out entirely; we take a closer look at the remaining 20%."*

Ms. Anderson and Mr. Hambly also clarified that while their teams analyze proxies, the individual fund managers at their firms make the ultimate voting decision. Ms. Anderson said, *"We provide guidance and advice in concert with the analyst who covers the stock, but if two portfolio managers see an issue differently, they vote differently."* Mr. Booraem explained that at Vanguard, too, there could be instances where different funds reach different conclusions. For example, in the case of a merger, each fund may reach a different conclusion depending on its position in each of the companies that are merging.

The investors also reminded members that proxy advisers' views and policies never determine voting; they are rarely even an input to a voting decision. Mr. Booraem said, *"Their recommendations have no bearing on our votes. There are times where our votes are consistent with their recommendations, and people may assume we followed them. Those are cases where we happen to share a common view on a particular topic."* Mr. Hamby added, *"The proxy advisers provide a tremendous amount of operational support behind the scenes to help us cast votes globally. But it is clear that investors and proxy advisers don't always agree. For example, ISS recommends against about 12% of companies on say on pay. We only agree with that 'against' recommendation about 40% of the time."*

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Compensation committees face many choices when deciding how to pay, and thereby motivate, management. While some directors lament that increased attention to compensation has caused many committees to adopt highly similar incentive plans, public firms still find opportunities to create distinctive compensation schemes. As investors and other stakeholders confirm, compensation committees have discretion to adopt plans that are right for their companies, and to make after-the-fact adjustments, as long as they are able to provide a compelling justification for their decisions to those stakeholders.

About this document

Appendix: Contributing members

The following members participated in the meeting:

- John Anderson, Meridian Compensation Partners
- Erroll Davis, Union Pacific
- Roxanne Decyk, Orbital ATK
- Karen Horn, Eli Lilly
- Bill Kerr, Interpublic Group
- Marshall Larsen, Becton Dickinson
- Fig Newton, Torchmark
- Michael Powers, Meridian Compensation Partners
- Samme Thompson, American Tower
- Marc Ullman, Meridian Compensation Partners
- Linda Wolf, Wal-Mart

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

- Lloyd Dean, Wells Fargo
- Mel Lagomasino, The Cola-Cola Company and Avon Products
- Mary McDowell, Autodesk
- Steve Reinemund, Marriott
- Sam Scott, Bank of New York Mellon
- Laurie Siegel, CenturyLink
- John Wulff, Moody's