Setting CEO Compensation
by Annette Leckie and Daniel Rodda

With this year’s proxy season all but wrapped up, Compensation Committees have received their “grade” on how well they set CEO pay this past year. For most companies, the grade is quite favorable. Over 73% received more than 90% shareholder support for their Say on Pay vote, and another 11% received over 80% support. But as a number of companies can attest, support can change dramatically from one year to the next, even when no changes are made to compensation programs. Therefore, Compensation Committees need to stay vigilant and keep focused on executive pay and shareholder returns throughout the year.

Committees must evaluate several factors when making decisions on CEO compensation. This article outlines six key considerations. While most decisions on salary increases, actual bonus payouts, new equity awards, and target compensation for the year are made shortly following year end, Compensation Committees should be taking action through the year to ensure a defensible position for all significant decisions.

Key Considerations
1) Company Performance
Top of the list is the company’s financial and stock price performance over the last year. Performance should be measured against the business plan and pre-established goals set for incentive purposes. A fulsome review of performance, however, doesn’t stop there. How well has the company responded to unanticipated events? In hindsight, how rigorous were the goals for incentives? How has the economic/political/governance environment impacted the company’s ability to achieve those goals? How has the company performed against other important strategic initiatives? How has the company performed relative to industry peers or broader indices? These questions should be considered throughout the year to set the stage for informed compensation decisions, protected by the business judgment rule.

Obviously boards try to set goals that will result in the creation of shareholder value. However, you only know if goals were appropriate in hindsight. During the year, Compensation Committees should conduct an analysis comparing realizable pay with actual performance results. In any one year, grant date long-term incentive values may not align with the most recent year’s performance. But over time, the pay realizable by the CEO should line up with the value created for shareholders. If it does not, the Committee should analyze its goal setting, metric selection, and incentive leverage to determine the source of early disconnects. This analysis should take place well before compensation decisions, or even business plans, are finalized so that remedial steps can be taken, if needed.

2) Individual Performance
Company performance alone doesn’t always tell the full story of the CEO’s performance. Who personally drove those results? Was it the CEO? Was it the executive group (or individuals within that group)? Was it the team as a whole? The CEO should have documented performance objectives, including succession and development plans, separate and apart from expected financial results. Progress against these goals should be reviewed with the CEO during the year to make sure they are still meaningful and that there are no surprises at year end. If the board has performance concerns, a surprise action on CEO compensation at year end can be disruptive and counterproductive.

3) Alignment with Pay Decisions for Other Executives
For some executive teams, incentive compensation rises and falls together. Other companies, however, allow for significant differentiation. The Compensation Committee should be monitoring performance of the executive

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1 Realizable pay for a specific time period (generally 3 to 5 years) includes salaries paid, actual bonuses paid, and the current value of long-term incentives granted during the period.
team, in addition to the CEO, throughout the year to anticipate the need for differentiation, and potential consequences. Are incentive plans tracking to pay the CEO (and/or corporate staff) significantly more than one or more of the divisions? Does that outcome make sense based on the individual performance assessments? If not, expectations may need to be managed and/or corrective action taken before the Board finds itself in an awkward situation at the end of the year.

4) Market Data and Expected Trends
While market data clearly should not be the sole driver of executive pay decisions, it is an important input. Ideally, the data process (including peer group selection, survey sources, valuation models, and data elements) is vetted by the Compensation Committee before analysis is started. The Committee should also have time to analyze the data in advance of final pay decisions. This allows for questions and supplemental analyses to be addressed before final pay decisions are made.

In addition to the data, Compensation Committees should understand trends in governance practices, supplemental benefits, severance protections, and perquisites. These other elements have an indirect impact on pay level as well as on how it’s structured. The time to initiate change is not in the midst of year-end pay decisions. Alternatively, structure changes should be considered during the year and changes approved before the start of the next year to allow time for communication and implementation.

5) External Messaging
Compensation decisions (both on incentive payouts and on increases to salary or target total pay) signal the Board’s view of performance. What message will your Board’s decisions send? Will those messages align with external views of performance? If there are disconnects, how can they best be explained? The primary venue for communicating the rationale for pay decisions is through the proxy statement. Certain circumstances, however, may require more active involvement by Compensation Committee members. It’s difficult for a CEO to defend his or her own pay, particularly when it’s deemed controversial or challenged at the annual meeting. It’s also difficult for Investor Relations, HR, or Legal to defend their boss’s pay in meetings with investors. Sometimes, investors need direct access to the decision makers to understand the rationale. While almost unheard of just two years ago, more board members these days are meeting with investors to explain their decisions and gather feedback. Based on anticipated reactions, the Compensation Committee should work with management to determine if additional institutional shareholder outreach is appropriate.

6) Internal Messaging
In addition to external reactions, company employees and other executives will evaluate the highly-visible CEO pay in light of their own pay and benefit levels. Compensation Committees should be cognizant of how their decisions may be viewed internally by monitoring broad-based pay and benefit actions taken through the year. Have employees seen pay frozen and benefits cut while the CEO’s pay increased? Is everyone sharing in the “pain” or “wealth creation”? While there may be times when diverging actions are needed and warranted, Compensation Committees should be fully aware of, and plan for, potential internal reactions.

Summary
While Compensation Committees (and the full board) are in the best position to determine CEO compensation, they do not operate in a vacuum. These days there are multiple external parties who may try to second guess their decisions. By taking into account these 6 key considerations, Committees and boards will be equipped to make defensible decisions and to anticipate (and address) potential negative reactions.

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Annette Leckie is a Partner in Meridian’s Boston office. Daniel Rodda is a Senior Consultant in Meridian’s Atlanta office. Additional information about Meridian can be found at www.meridiancp.com.