COMPENSATION: QUIET BEFORE THE STORM?

Why now is the right time for an executive compensation audit.

Compensation committees fared well in the 2019 proxy season, with the vast majority of Russell 3000 companies receiving support on their compensation programs from proxy advisors and shareholders. Yet, compensation programs continue to be a hot=button issue for stakeholders, with scrutiny of incentive pay metrics, goal rigor and policy transparency only intensifying. *CBM* recently spoke with Charles Grace, lead consultant with Meridian Compensation Partners, about where compensation committees should be focusing in the current environment.

What should compensation committees be focusing on during what has been a relatively quiet period with regard to compensation plan criticism?

While this is a good situation for companies to be in, it rarely lasts. And when a company's performance eventually softens, that's when criticism from proxy advisors and shareholders is more likely to surface. So when things are quiet, that's precisely the time when committees want to challenge management and themselves to ensure they have a sound pay program in place that incents the right behavior, supports the business strategy and has good governance practices in place to minimize risk.

From my perspective, an executive compensation audit is a good place to start. And the purpose of the audit is the key—it is not about finding out what the market is doing and making changes consistent with market practice. Instead, it's about understanding the differences between your program and market practices, embracing those differences and articulating how your program supports the business strategy.

If it's done right, the audit process can breed confidence among the committee with respect to the design of the program and the committee's pay decisions. It can also help with proxy disclosure and other shareholder engagement efforts. In addition, it often forces management to report to the committee on a wide variety of program features at a level that the committee is probably not accustomed to reviewing. So it can be a real learning experience, particularly for newer committee members.

If it turns out that there are market practices that resonate with the committee, then program changes can certainly be considered. But potential changes are really secondary to raising awareness of market practices and perspectives, proxy advisor policies and investor preferences. That way, if and when performance starts to soften, the committee will be well-positioned to be responsive to any criticisms in a thoughtful manner and on a timely basis.

What are some of the more common issues that an audit may surface?

When it comes to incentive design, questioning the performance metrics being used to drive behaviors is a big one. An audit may also surface governance issues, such as having clawback policies in place so the company can take appropriate action when circumstances dictate. If a company has an aging workforce, then including retirement protection in the incentive program can go a long way to easing tension around retirement and facilitating a smoother transition to the next generation of leaders.

Frankly, some of the issues that may surface in connection with an audit may have nothing to do with the incentive plans. For example, they could be social issues that are garnering a lot of attention in governance circles—the gender pay gap and gender diversity in senior management roles are two issues that come to mind. On those types of issues, the committee may want management to report on whether there is a real or perceived concern at the company and, if so, what is being done about it.

What are you seeing with respect to clawback discussions at the board level? Is it warranted?

Until recently, I don't think clawbacks were getting enough attention at the board level. For years following the passage of Dodd-Frank, too many board and management discussions seemed to begin and end with "we are waiting for final rules before doing anything." More recently, things have changed. Boards are more focused than ever on what protections they need in place as part of their overall clawback policy. Protecting against reputational harm and protecting the employees—these are the issues boards seem to be talking about the most.

It is important to mention that there's often a focus around market practice and a concern about not wanting to be on the leading edge of an issue that's not otherwise popular with management. I understand the concern and think that it's a valid consideration for the committee. But I don't think it should be a primary driver of a company's clawback policy design.

After all, when a company is faced with serious misconduct, market practice is not going to be that important compared to the company's ability to take action and make a statement, both internally and externally, that this kind of behavior will not be tolerated.

In addition to the triggering events of a clawback policy, there are other important issues as well, such as whether the application of a clawback policy should be mandatory or discretionary depending on the triggering event, or how the clawback policy interacts with other corporate policies, such as retirement policies or severance policies, just to name a few.

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I think committees would be well-served to catalog all the clawback and forfeiture policies that they have in place—not just the standalone policies, but also those provisions embedded in omnibus plans, incentive plans, severance arrangements and employment agreements—to determine whether there are any holes to be filled or conflicts between internal policies that might make implementing a clawback more difficult.

Given all the issues that can surface, how should the compensation committee prioritize them?

Since a committee has only so much time and so many resources, it is forced to focus on the issues that are most critical to their specific company. But no matter how many issues the committee decides to tackle and whether or not any program changes result from the audit process, an executive compensation audit can be a really valuable exercise for the committee.

In addition to raising awareness as to market practices and perspectives and breeding confidence in the committee, an audit often generates critical discussion at the committee level about important topics related to compensation philosophy and governance philosophy. Ultimately, I think an audit can help make the committee, and by extension the board, more effective over time.

Charles Grace, lead consultant with Meridian Compensation Partners, advises boards and senior management on a range of executive compensation and related governance matters.

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