Forecasting Key Compensation Issues

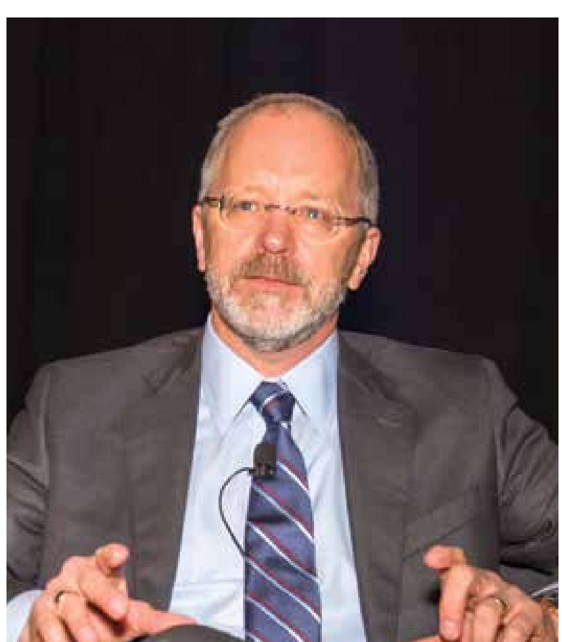
Experts examine current compensation trends to predict tomorrow's top concerns

"The key to making a good forecast," statistician Nate Silver noted in his 2012 book *The Signal and the Noise: Why So Many Predictions Fail—But Some Don't,* "is not in limiting yourself to quantitative information. Rather, it's having a good process for weighing information appropriately." For the inaugural Prognosticators of Pay event, NACD invited a panel of leading compensation experts to discuss the complexities of today's compensation landscape with an audience of directors. Comprising the panel was Lane Ringlee, managing partner of Pay Governance; Matthew Isakson, lead consultant of Meridian Compensation Partners; James Kim, managing director of Frederic W. Cook & Co.; and Gregg Passin, senior partner of Mercer and leader of its North America Executive Rewards Practice. These experts fielded questions posed by moderators Christopher Y. Clark, publisher of *NACD Directorship magazine*, and Liane Pelletier, president of NACD's Northwest Chapter and a director of Expeditors. What follows are highlights from the Q&A.

What should we know about the Securities and Exchange Commission (SEC) pay-for-performance rules?

Lane Ringlee: The key issue is that the SEC is now going to require companies to disclose how executive pay in their organization compares to performance. It's problematic in a number of ways. First, there are a multitude of definitions of pay: summary compensation table pay, realizable pay, realized pay, along with other variations that have been used in a variety of comparisons of pay and performance. But the SEC came up with its own definition. The SEC's definition is a mix of summary compensation table pay and some unique approaches to looking at equity and pension compensation calculated on an annual basis. Once we get through a transition period, we are going to have to go back and compare that annual compensation to total shareholder return (TSR), and show our peer group's TSR, over five years. A second problem is that in any year you might disclose, you may have a two-year performance share plan payout, for example, that's being disclosed relative to the

Left to right: Lane Ringlee, Matthew Isakson, James Kim, and Gregg Passin.



five year TSR measure. That is a clear mismatch of timing. Third, in addition to these mismatches, the SEC has said that the only measure of performance that's relevant is TSR over a five-year period. In other words, all of the other value drivers that we look at to motivate our executive teams to drive longer-term value aren't meaningful. So the issue is: Are we comfortable using this as the definition of pay and performance in our organization? I would say that the majority of companies would say "no." You should encourage your companies to model the disclosure to see how it fits your organization overall and then begin to think about how you define pay and performance to your shareholders. This should lead to how supplemental disclosures are defined to be included in proxy statements going forward.

What is going to be the lasting impact of say on pay?

Matthew Isakson: Say on pay has had a profound impact on U.S. pay practices. It is easy to categorize these changes as either good or not so good. The good changes: efforts to improve governance practices are at an all-time high, compensation committees are much more engaged, and, overall, there is a greater awareness of executive compensation. Many fairly questionable pay practices have been almost washed out of the system, including premium pay philosophies, rich perquisites, excise tax gross-ups—and the list goes on. The not-so-good things: say on pay has solidified the standing of the proxy advisors, Institutional Shareholder Services (ISS) and Glass, Lewis & Co. I think that after say on pay, those organizations almost have a de facto seat on your board. Another not-so-good change is this beating of the war drum against any use of discretion. In our opinion, that is why boards exist: to exercise that discretion and use business judgment to make tough calls. Regarding the future of pay practices, it is tough to prognosticate. Absent any crisis, I think we are in a relatively quiet time of executive compensation. We are going to have to take time to digest the issues that are being presented by the SEC, including the pay ratio. Some companies are going to want to reevaluate stock options. We could see some pay practices come from across the pond, for example say before pay or binding say-on-pay votes. If reactions to execu-

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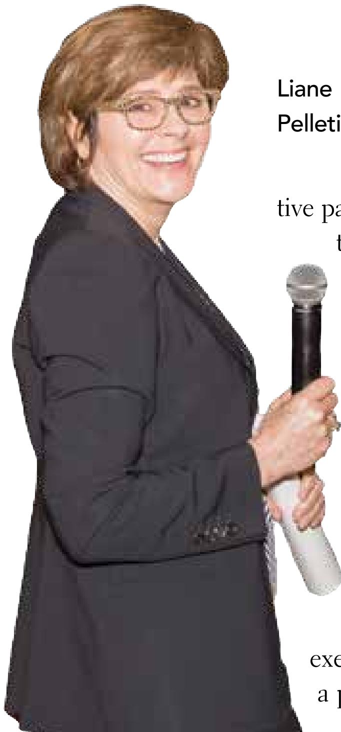


Liane Pelletier

tive pay carry over to the U.S., I do not think we should underestimate the risk of some of those practices impacting our companies.

How might an activist investor view compensation?

James Kim: Our experience with activists is that generally there are two types. The first type is the longer-term investment fund manager who typically takes a passive view on executive compensation. They are a presence you should be mindful of, but they are not going to dictate their own view of executive compensation. The second type is more transaction oriented. They tend to be more vocal about executive compensation, and as a general rule they tend to fixate on TSR to see if their interests are aligned with the management team. They also take the viewpoint that big payouts are OK if they are aligned with their interests. It's a very personal issue when you attack executive compensation, so there are times when those attacks are a red herring and are being used for a different agenda—such as to get the company sold—and executive compensation is a way to get everyone's attention. As board members, we need to be mindful of what the activist's agenda is. At the same time, we need to continue thinking about the long-term shareholders and keep in mind that the activists may not be involved in the company in the long run. It's very difficult to manage both sides.

Audience Participation

During the second half of the program, attendees had the opportunity to challenge the panel with their own compensation-related questions. What follows are select questions and responses.

Some directors and C-suite executives don't stay with a company for more than five years. When you are recruiting, how does this short termism impact compensation structures as they relate to attracting talent?

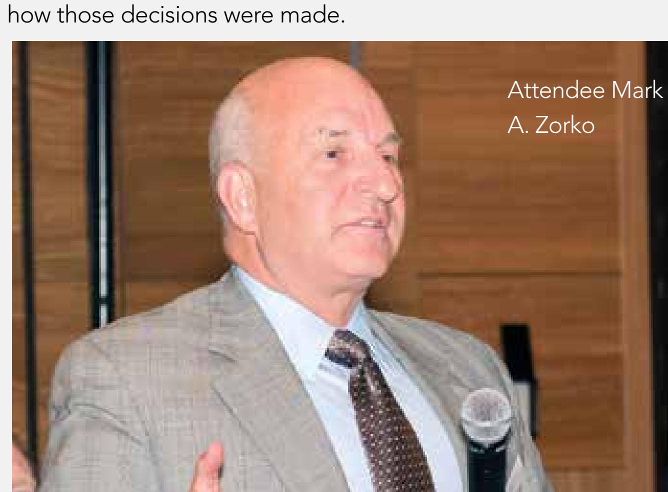
Ringlee: This gets to the issue of succession and developing a team. You'll never be 100 percent certain that you're going to lock people in. It comes down to making sure you have a fair compensation system. But a lot of it is really outside of compensation and it may have more to do with coaching, leadership development, and other things within that reward framework than the pay program itself.

Kim: For companies with teams in place for years, they've got a program that is very clear and very transparent. Each member is able to map out a model of the value of staying with a company over their career. The more stable and transparent the program is, the better the chance that compensation won't be the reason why new executives leave the company.

Passin: Don't let your compensation program be the barrier to getting the right talent. On the other hand, you shouldn't radically revise a compensation program for someone. You shouldn't compromise the values of the organization and the alignment with shareholders. And when you bring these people into the organization, you hope that they stay even though you recognize they might not be there for the long term.

How do you make the compensation committee's work the full board's work so that the board can have the right dynamic to make key decisions around compensation?

Ringlee: It starts with the committee charter, which defines the responsibilities of the committee versus the responsibilities of the full board. The board also has responsibilities for a variety of other areas. So the committee can do the heavy lifting—the analytics, the research, interacting with advisors—and then bring recommendations and decisions to the full board and educate them on how those decisions were made.



Attendee Mark A. Zorko

MERYL ALCABES

Director pay seems to be gaining scrutiny. Why is this and how should boards manage this issue?

Gregg Passin: Director compensation has inched up over time, and some practices have evolved, such as replacing committee fees with retainers in recognition that the value directors deliver is based on more than just meeting attendance. But what is at issue now—and what directors need to be aware of—is litigation related to director pay. When directors are sued in regard to executive pay, they are able to rely on the business judgment rule to say that they made the best judgment for the organization. But there have been recent cases involving director compensation in the Delaware courts where the case wasn't dismissed outright. The issue that we're seeing is the concern that directors are self-serving by setting their own compensation. Because of that, the Delaware courts have said in a few cases that directors are not able to use the business judgment rule. We're seeing the need to have some sort of shareholder approval of director compensation, and director compensation plans may need absolute caps, both for equity and cash compensation. Some companies are now looking to amend their director compensation plans to make sure that caps are there so to fend off shareholder suits. Other companies are looking to retroactively go back and get past grants approved by shareholders. I don't think every organization is under this threat, but there are some things I would advise directors to think about: Is your plan approved by shareholders? Do you benchmark compensation and have you sought the advice of an advisor or consultant to help with any potential shareholder issues? Lawyers who represent shareholders as a group have director compensation under the microscope. So far, the proxy advisors have been more concerned with governance issues rather than directors' own compensation.

Isakson: There is a balance that needs to be struck. The full board should not get too involved so as not to ruffle the feathers of the compensation committee chair or call into question the judgment of the overall committee, because the committee has the perspective from outside experts and is well-versed in the issues.

For private company boards, what makes a good compensation plan when you're in an environment where you don't get shareholder feedback?

Isakson: You can take multiple perspectives. A sharing ratio, for example, where you look at how much goes back to family or private shareholders, may work. With our clients we also look at public company data. Just because you are private does not mean you can't look at growth data or return on invested capital. There are ways you can pull in market perspectives. Look at similar industry peers or look at internal metrics to test the plans you have in place.

Kim: Management of private companies and value creation is not far off from what you would see in a public setting. Performance management is largely the same. The only difference may be the forms of compensation.

Passin: If you're private and your information is not disclosed, typically we would say that you need to have a line of sight to know what the expectations are. You need to report that so people know how they're doing. Some private companies don't want to do that because their financials are not public. How you create that line of sight and communicate that to the participants is the biggest challenge I have found.

Ringlee: We tend to see more subjectivity in these incentive programs which we've seen evaporate in public company programs. Secondly, in addition to private companies adopting a public framework in terms of setting goals and structuring programs, you see an evolution with regard to adopting public company governance structures.

What characteristics do directors need today to be ready to serve on a compensation committee?

Ringlee: I would look for diversity of experiences to the extent that you can. Having a compensation committee composed of directors with audit committee expertise is helpful. And then there are industry issues. You should have someone with deep industry background who understands the talent market within which the compensation committee is designing programs to be competitive.

Isakson: You need business experience, analytical experience, and some legal experience as well. You need someone who will ask the right questions at the table and who is going to be an active member of the committee.

Kim: You need independence of thought, strong leadership, and the ability to tackle difficult issues. It's so easy to say "yes" and satisfy the individuals who run the company. Directors need to be principled, market-oriented, and objective with strong leadership skills who aren't afraid to have confrontations when necessary.

Passin: Diversity of experience. People have different experiences that allow them to ask questions and think about things in different ways.