The Executive Compensation
PODCAST

Driving Shareholder Value Through Innovative Compensation Strategies
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Designing an executive compensation plan is a complicated process, with many stakeholders and influencers. Every company is unique; every plan should be, too, but there are a variety of trends and standard practices that have become habitual, almost default. As compensation professionals, it's critical that we step back and reevaluate our approaches and identify opportunities for improvement.

In general, there are three major challenges facing executive compensation professionals today. These challenges are not recent; rather, they have emerged because of trends and standard practices that took root years ago.

How Did We Get Here?

The events surrounding the Enron scandal and the later passage of the Sarbanes-Oxley Act in 2002 were already reshaping how companies designed executive compensation plans. The major turning point occurred in 2006 when the Financial Accounting Standards Board modified FAS 123 to require companies to show stock options as an expense on the income statement. Once stock options were not "free" to distribute, companies began to explore other vehicles, e.g., salary, bonus, and other equity instruments.

Dodd-Frank (2010) cultivated a heightened focus on Say-on-Pay. Proxy advisors like ISS and Glass-Lewis began to put more pressure on companies to develop programs in alignment with their rules and procedures. As proxy advisor influence grew, executive compensation programs became more and more homogenous to meet these expectations. The underlying goal, in many cases, was to achieve a positive Say-on-Pay vote outcome by focusing on relative shareholder return and three-year performance plans.

The pandemic in 2020 and 2021 affected many aspects of executive compensation, but perhaps most important is the extremely negative stigma that is now associated with a failed Say-on-Pay vote. Companies go to great lengths to avoid an "against" recommendation from proxy advisors. Breaking the mold and designing alternative compensation plans is considered highly risky and opens companies up to scrutiny.

These evolving perspectives have all contributed to the three major challenges facing executive compensation professionals today: excessive uniformity, outsized attention to short-term incentives and corresponding goal-setting, and insufficient attention paid to long-term value creation.

1. **Excessive Uniformity in Compensation Plans:** There is little variation between many programs, from how performance measures are weighted to 50th percentile market philosophies. While this seems ideal for aligning with proxy advisor expectations and achieving the desired Say-on-Pay vote, repeating patterns can squash innovation.
2. **Hyper-Focus on Short-Term Incentives:** Short-term incentives take on a high level of perceived value, even though they only comprise 30–35% of an executive's total compensation. Boards tend to spend a disproportionate amount of time establishing short-term goals and metrics compared to focusing on long-term goals.
3. **Insufficient Attention to Long-Term Value Creation:** Long-term incentives make up as much as 80% of total compensation but, every year, compensation committees end up focused on the 1- to 3-year financial goals that management has determined are appropriate and achievable. The term "long-term incentive" is something of a misnomer in many organizations—plans often look like many annual plans lumped together to form a 3-year view.

Changing the Paradigm: A Value-Driven Approach to Compensation

Compensation is a tool. Its purpose is to drive specific behaviors from management to achieve specific objectives. There is no one-size-fits-all approach, and there are circumstances in which companies need a tailored, innovative compensation program to address a particular business challenge. Regardless of the challenge, investors large and small are interested in one thing: value creation, i.e. stock price appreciation and dividends.

This creates a certain tension between management and the board. Management teams would argue that achieving 1-3 year financial goals should create value. Executives have the line of sight into the business necessary to set goals and targets. They are responsible for achieving them and will reap the rewards if they do. By contrast, the board of directors has final approval over the compensation plan, but members may have little insight into the day-to-day operations of the company. Because they are beholden to shareholders, they must focus on whether long-term value is created. How can we strike a balance and shift the conversation from "Did we meet budget?" to "Did we create shareholder value?"

What Does It Look Like?

This approach is not appropriate for every circumstance, but it is another useful way to think about tailoring and customization based on the unique needs of the business:

- **Part A: Cash Compensation:** Executives typically earn a salary and performance-based bonus every year. One option is to combine these amounts into a new base salary and do away with short-term incentives. Without an annual bonus plan, executives can focus less on short-term financial goals and reorient leadership toward a long-term value trajectory. It takes a CEO or CFO out of the mindset of “How do I deploy capital in this 12-month period to maximize returns?” to “What can I invest in today that might pay dividends five to 10 years from now?”
- **Part B: Long-Term Incentive Grants:** This approach also eliminates annual long-term incentive grants of performance shares and RSUs. Instead, executives will receive five or more years’ worth of equity grants right now consisting of stock options and restricted shares. This grant is designed to be a very compelling equity stake in the company and separates goal setting from pay altogether. Management can let go of bonus-driven priorities and behaviors and focus on the long term.

This compensation program changes who is responsible for driving behaviors and holding people accountable. Right now, the compensation committee is responsible for approving goals, making adjustments, and determining payouts. What if the CEO had this responsibility? They have the greatest insight into all the possibilities and eliminating the short-term bonus program means they can set goals based on criteria most correlated with long-term value creation—goals that the whole organization will be rewarded for.

It can also be a much more streamlined process. This value-driven approach is designed for senior leaders. They will still have to create a short-term incentive plan for other managers, but they can be more objective since they don’t have a stake in individual outcomes. They set goals within the context of what the business as a whole needs to achieve in the coming year. Goal setting becomes a management process that does not require the involvement of the compensation committee.

Conclusion

Even if companies adopt this approach, Say-on-Pay is still just as important. We know that ISS and Glass-Lewis do not care for up-front grants outside of a normal plan. Granting five years of equity up front with no amount of performance in the grant year almost guarantees a negative Say-on-Pay outcome. There will be pushback in the first year from proxy advisors and shareholders, and companies must be prepared to explain why they are using this approach and what they hope to achieve.

None of this is to say that the common paradigm of salary, bonus, annual grants, and long-term grants does not work, because it can, and it does. But innovation and creativity are key to value

creation, behooving companies to explore non-traditional compensation plan designs based on their unique circumstances.

This kind of plan is not for everyone. It requires a compensation committee that believes philosophically that this is the right thing to do. Board members need a shared mentality, not only of oversight and governance but also of creating long-lasting value. It’s not enough to come in for a three-to-five-year stint just to manage the business and get through a checklist of charter items. It also requires an executive team willing to buy in. With the right alignment, it could work for the company, its leaders, and ultimately its shareholders.