Executive Compensation

Variations on 'Conventional' Compensation Themes

By Mary Ann Polk and Daniel Rodda

Although very few companies have failed say on pay, the shareholder advisory vote on executive compensation has clearly impacted program design. Compensation committee members focus primarily on how shareholders will view a company's pay programs. All too often, they also feel pressure to align programs with perceived "best practices" to avoid criticism from shareholder advisory groups such as Institutional Shareholder Services and Glass, Lewis & Co.

We have observed many instances where a more customized approach to compensation was preferable and, frankly, more effective. Following are some perspectives that might not align with conventional wisdom but that are worth considering when companies seek to develop programs more appropriate for their organization.

■ **"Long-term" performance plans can be effective even when they measure performance over less than three years.** In challenging circumstances, the typical three-year time frame of most performance plans can be an improbable or even impossible period for which to set realistic goals. Companies in the midst of a significant business turnaround, at one of several points along a strategic "transformation" spectrum, and in cyclical industries all could have valid reasons to measure performance over a shorter period than is typical.

■ **Total shareholder return (TSR) is a valid long-term performance plan metric—in moderation.** The renewed emphasis on TSR means it has become the only metric in many companies' long-term incentive plans. Although relative TSR clearly measures returns to shareholders as compared to alternative investments (however defined), it provides little to no guidance on specific actions to take. TSR thus may provide less than optimal "motivation" for driving performance.

■ **Time-based restricted stock can play a meaningful role in program design.** Time-based restricted stock awards have been criticized as "pay for breathing" and deserving of only minimal weighting in an overall program. However, companies in turnaround mode or that are shifting strategic direction have found heavier weighting of restricted stock in the annual grant cycle to be invaluable in helping them attract and retain talented leaders, especially in highly cyclical industries.

■ **Retention awards for executives may be valuable tools in special circumstances.** Retention awards, particularly for executive officers, are often subject to criticism for providing "extra" compensation without direct linkage to performance. However, such grants can be both necessary and appropriate. For example, an executive who is a very strong contributor and has quickly advanced may have minimal value in unvested equity awards. It thus could be all too easy for a competitor's modest sign-on award to disrupt an established succession plan.

■ **Targeting pay above the market median may be justifiable.** To avoid concerns about "ratcheting up" executive pay, market median now is the "typical" benchmark for pay structures. However, above-market opportunities, especially with respect to incentive grants, may be needed to hire outside talent with proven track records from larger, more complex operations, or for long-tenured, high-performing executives.

■ **Discretion can be valuable when determining bonus payouts.** Proxy advisory firms criticize bonus payouts that are not based on a predetermined formula. However, markets and circumstances can change quickly, and goals set at the beginning of a year may not tell the full performance story. With the benefit of hindsight, committee adjustments—positive as well as negative—may better align payouts with performance. Likewise, built-in discretion can allow committees to take a more comprehensive view of performance when determining final payouts.

Best practices and market trends generally become majority practice because collective wisdom indicates they do fit most circumstances. Recognizing when they don't—and having the courage to vary from these norms to find alternatives that better align with a company's business strategy and circumstances—is one of the key challenges compensation committees face. Clear communication about program design decisions can go a long way toward assuring shareholders that programs are well considered, with their best interests in mind.

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