SPECIAL REPORT

FORUM: Executive compensation: recent developments and best practices

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FORUM

Executive compensation: recent developments and best practices

FW moderates a discussion on executive compensation and best practices between Finn L. Dahl at Accurate Equity, Robin Ferracone at Farient Advisors, Jonathan M. Ocker at Orrick, Herrington & Sutcliffe LLP, and Alessandra K. Murata at Skadden, Arps, Slate, Meagher & Flom LLP.

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Jon Ocker is chair of Orrick's destination Compensation and Benefits group. He specialises in advising public companies, boards and high profile executives on compensation and corporate governance issues. Mr Ocker is also the founder of Orrick's Global Corporate Solutions consisting of compliance solutions in over 130 countries for global employment, global equity, global retirement and Verbatim's global subsidiary maintenance.

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Skadden counsel Alessandra Murata focuses on advising public and private companies, boards, private equity clients, asset managers and members of management on executive compensation and benefits issues arising in the context of mergers, acquisitions, initial public offerings and other extraordinary corporate events, as well as with regard to the adoption, revision and negotiation of executive employment and severance arrangements.

FW: Retaining top talent continues to be a priority for high performing companies around the world. To what extent are companies finding it tougher to do so in the current market?

Dahl: There is evidence as the world economy picks up that there is greater shortage of top people for the right jobs. A recent survey by Deloitte indicated that a global labour shortage amongst key professionals is one of the top three challenges being faced by companies. Other surveys show that replacing executives can cost as much as three to five times their annual salary, increasing the focus on retaining talent.

Ferracone: It is difficult to retain talent in the current market and this is at the top of every compensation committees' agenda. There are several reasons for why it is difficult to retain top talent. One is technology. Technology has helped to make talent very portable, because companies find it much easier to source talented people using technology. The second is that people's attitudes have changed. It used to be that employees stayed with a company for life – now, career plans often necessarily involve multiple companies and career tracks, and employees are more willing to move around. The third reason is compensation. There used to be retirement plans and other benefits that would bind people to a company for a long period of time. That is no longer the case. Defined benefit plans are all but gone and companies have the attitude that if they want somebody, they'll just buy out the unvested equity.

Ocker: Retaining top talent is particularly difficult in the Silicon Valley where the new social media companies and start-ups are perceived as 'cool' and many of the traditional technology household name employers are seen as stodgy and often are not the first choice. To combat that image, the more traditional companies are forced to offer richer sign-on packages to induce top talent to join them instead of the next cool app company. The new forms of compensation used to pry

top talent away include huge signing bonuses and large stock grants. In addition, there are all sorts of perks designed to keep employees at work and more productive, ranging from company buses, gourmet cafeterias, baby sitting and house cleaning and laundry services to massages.

Murata: Talent becomes top talent once a company is high performing and top talent is always in demand. Companies have always faced retention challenges and those challenges are exacerbated where negative media attention and public perception of executive compensation impose constraints on a company's ability to freely make compensation decisions that are in the best interests of the company. The heightened scrutiny under which executive compensation is currently being examined limits the alternatives available to a company in connection with the retention of top talent. As a result, companies are becoming more creative in structuring compensation packages to ensure that the compensation package for any particular executive provides the proper mix of short and long-term incentives and delivers appropriate economic value while not promoting risk-taking behaviour.

FW: How would you describe media and public perceptions of executive pay at present? What key issues have shaped the debate in recent years?

Ferracone: Media and public perceptions of executive pay have been written about extensively and are widely understood. The public view is that executives are overpaid and that top executives are tone deaf with respect to how their pay is perceived by others. Social issues shape this debate. We hear about the big divide between the haves and the have-nots; those who make a lot of money and those who make little. The problem is that as long as we live in a competitive talent market – which of course the capitalist market nurtures – competitive forces will drive how much executive positions are worth. That exacerbates the problem because there is not exactly an oversupply of great leaders. However, the biggest issue that rankles the public and investors on the issue of executive pay is the lack of pay for performance. They are much more forgiving if executives earn a lot of money and produce good results. Getting the alignment right is a key way for companies to address the issue.

Ocker: There has always been a division between Wall Street and Main Street, but it has never been more pronounced. The 'Occupy Wall Street' phenomenon and the recent highly publicised cases of 'pay for failure' in terms of rich severance packages have both, with some exceptions, put a lid on runaway executive compensation, particularly in financial institutions. Today, any out-size pay packages must be justified by stock price performance so that shareholders don't claim lack of alignment.

Murata: Current media and public perception of executive pay can generally be described as unfavourable. While this perception is not new, the level of scrutiny and media attention devoted to executive compensation is arguably greater now than it has been historically. Lately, executive pay has become part of the mainstream consciousness and a key fixture of nearly every congressional session. In recent years, particularly with say on pay and say on parachute votes, the public and media focus has been on shareholder approval percentages as a measure for shareholder satisfaction with compensation practices. The chief executive officer (CEO) pay ratio rules will likely keep CEO compensation at the forefront of media attention.

Dahl: The financial crisis certainly led to an increase in media and public interest in executive pay. Initially focusing on levels of compensation within the financial services sector, this has broadened to increased scrutiny across all industries. The European CRDIII/IV – and local equivalents – as well as Dodd-Frank in the US have all had a great impact on executive pay levels, but most of all the composition of executive pay. There is an increased focus on 'paying for performance' instead of 'paying for pulse'.

FW: To what extent has shareholder influence grown since the onset of the global financial crisis? In what ways are shareholders exercising new rights and powers that affect executive compensation packages?

Ocker: The growth of shareholder influence is profound as we experience the 'rising tide of shareholder empowerment'. Around the world, shareholders exert their influence through annual say on pay proxy voting and 'withhold' votes on board members. Companies are responding with heavy emphasis on pay for real performance and by doing away with lavish perks, severance pay for failure, excess severance, no severance for retirement, gross ups and huge stock grants not tied to performance.

Murata: The Dodd-Frank Wall Street Reform Act provided shareholders with influence through the introduction of both say on pay and say on parachute shareholder advisory votes. The advisory votes give shareholders the ability, albeit indirectly, to influence companies' compensation structure and philosophy. In addition to the vote itself, say on pay has incentivised companies to adopt compensation policies and programs that provide a clear linkage between executive compensation and company performance and to convincingly convey these programs in their disclosures to shareholders. Although the advisory votes are non-binding, the votes are intended to influence the decision-making process and policies implemented by compensation committees and company boards. Additionally, say on pay voting has tremendously increased the influence of shareholder advisory groups, like Institutional Shareholder Services.

Dahl: Shareholder influence and activity have certainly increased, illustrated by say on pay regulations in the EU and US. Shareholders more often turn to proxy advisory firms to get a steer prior to voting. The fact that close to 100 percent – 98 percent in the US in 2013 – of the compensation policies are approved indicates increased compliance and transparency by corporations. Furthermore, several companies are seeking acceptance from key shareholders prior to the AGM to ensure they are aligned and receive a favourable outcome of their proposal.

Ferracone: Shareholder influence has grown dramatically – and boards are paying attention. Not only do shareholders have a licence to exercise their influence through a non-binding say on pay on executive compensation, they also band together on various initiatives. The Council of Institutional Investors, for example, is a not-for-profit organisation that supports and represents investor interests. It represents pension funds, institutional investors and mutual funds, among others, and we see investor influence growing through those types of organisations. There has been some concern and discussion over whether the non-binding say on pay vote, passed into law in the US in July 2010, would have much of an influence. We see binding say on pay in other markets, for example the UK, but I would say that a little influence does go a long way. It is a common occurrence in the boardroom today to hear compensation committee members talk about what investors think. There is a lot of engagement with investors; companies will call investors to explain their compensation programs and request their feedback on whether those programs are acceptable. That said, investors use say on pay votes judiciously in the US – we don't see many companies failing their say on pay vote.

FW: What regulatory developments covering executive pay have emerged in recent years? How have these developments altered executive compensation practices?

Murata: The Dodd-Frank Act introduced say on pay and say on parachute advisory votes, enhanced compensation disclosures, enhanced compensation committee independence standards and clawbacks. While it is unclear whether say on pay changed compensation practices for all companies or whether compensation changes are attributable to the increased influence of shareholder advisory groups like Institutional Shareholder Services, certain companies with particularly poor say on pay voting results have adopted shareholder outreach and many companies have taken steps to modify various aspects of their compensation programs – for example, eliminating gross-ups, adopting clawback policies, reducing or eliminating time-based vesting equity awards in favour of performance based vesting. What remains to be seen is whether the pay ratio rules, which will undoubtedly be expensive from the perspective of both time and human capital, will have an impact that exceeds – or even equals – the anticipated compliance cost.

Dahl: The EU has taken a significant role. CRDIII and IV have led to a greater link between performance and reward. Paying for performance has become commonplace, and malus and clawback features are increasingly used. CRDIV sets a cap for variable pay for certain employees within the financial industry. The flipside is that such a cap forces companies to raise fixed salary levels in order to compete for talent – and to maintain the same levels of total compensation. In a bear-market this could have a substantial negative impact as the fixed cost may be significantly increased.

Ferracone: In the US, the most dramatic legislation that we saw was the Dodd-Frank Act. The non-binding say on pay vote was a feature of that Act. Since then, non-binding say on pay has been adopted and its influence has been significant. Also, SEC rules on consultant and board member independence have been enacted. These have had less of an effect because boards have been paying attention to independence for a long time. We are now waiting for the SEC to establish rules on three items. One is a pay for performance disclosure item, which has not yet been implemented. The second concerns 'pay ratio', which is the ratio of CEO pay to median worker pay. Preliminary rules were put out for comment last year on this item and we are now waiting for the SEC to respond to those comments with final rules. The third issue is clawbacks, where a company takes back compensation that has been 'falsely earned' – that is, earned in a situation in which there was a financial restatement.

Ocker: Perhaps the greatest influence on executive pay in recent years is Institutional Shareholder Services. Like it or not, ISS and its quantitative CEO pay for performance say on pay test, its qualitative review based on a list of 'poor pay practices' and its rules on stock plan proposals – for example, the shareholder value transfer test – have done more than anything else to alter the landscape of executive compensation. ISS has given shareholders powerful tools to influence pay and those tools have become popular leitmotivs for Main Street. There is not a company that doesn't consider ISS when it designs and implements its pay program.

FW: In terms of the SEC's new CEO pay ratio disclosure rules, what are the potential implications and what should companies consider when communicating the pay ratio to shareholders, employees and other stakeholders?

Dahl: The disclosure rules are flexible with few guidelines on calculation methodology – for example, statistic sample vs. all employees – and allow the company to report according to what is appropriate for the size and structure of its business. I believe we will see significant variations in methodology, which is likely to be scrutinised by the media. Due to the administrative expenses and challenges of complying, I believe many companies will take a simplified approach to these calculations. Finally, pay ratio is probably not important for shareholder's investment decisions and will serve more as information to the general public than shareholders.

Ferracone: The key issue is how companies should communicate this ratio. Right now companies are trying to calculate the pay ratio, even if the rules are not clear. The SEC still needs to respond to issues raised during the comment period and final rules are pending. Companies will then have some time to put together details of their pay ratio, and will not have to report and interpret it fully until the proxies come out in 2016, at the current best guess. Most companies feel as though pay ratio disclosure is not helpful, that it is politically motivated, and that it doesn't lend itself to being compared between companies. Nevertheless, it is the law and it will be incumbent upon companies to put this ratio in the right light. In other words, they will have to report the ratio and then explain it. My advice to issuers is to let shareholders know how to interpret your ratio – use the data to tell the company's story, just like you would with any other statistic.

Ocker: The SEC's pay ratio disclosure rules as proposed will require the disclosure of CEO pay relative to a company's median employee, and it seems that determining the median employee will be the tricky part. These rules may also drive companies to change their rank and file pay practices for a more favourable disclosure – for instance, giving employees more reportable cash and less unreportable welfare benefits. Whatever the result, a company should consider getting ahead of these rules by preparing a mock pay ratio, how its disclosure might affect employee morale or be a public relations issue and potential litigation and what can be done to avoid it. For now, we need to wait for the SEC to publish final rules and see how they have been revised based on the numerous comments received.

Murata: One potential implication of the pay ratio rules is that companies may be incentivised to structure their compensation in a manner that results in more favourable ratios while still delivering the same economic value to the CEO. Although advocates of pay ratio ▸▸

disclosure hope the disclosure will narrow the gap between CEO compensation and the typical employee, whether this will actually be the case remains to be seen. When communicating the pay ratio to shareholders, companies should ensure their disclosure is clear and easily understood.

FW: How have the legal obligations and potential liabilities of the compensation committee changed in recent years? How can committee members ensure they discharge their responsibilities appropriately?

Ferracone: The governing document that companies tend to use when they are thinking about their responsibilities is the charter. Most compensation committees will review their charter every year and make sure it is strong and broad enough to cover all necessary bases. Today's charter will cover the independence of the committee, the fact that they need to think about pay and performance, the pay strategy, pay levels and pay programs, measures of performance, and goal-setting. Some charters will outline executive succession planning, although often that is left up to the whole board. The best compensation committees will then take their planning calendar and map it against the charter to make sure everything has been covered by the time they get to the end of the year. Another consideration is the rule of due care, meaning boards and companies have to prove that there has been due care in their consideration of the issue and that they have dealt with it responsibly.

Ocker: The obligations and potential liabilities have increased dramatically as the public focuses on executive pay. With the spotlight of shareholder scrutiny, directors are well advised to receive education about their roles and responsibilities. Companies should provide 'director camps or colleges' that educate directors on subjects ranging from the basics of the company's business and financial statements to regulatory knowledge of technical tax code and accounting issues. Directors can rely on experts in discharging their responsibilities but they cannot do so blindly and must be engaged and informed. Another best practice is to make sure there is an annual calendar of compensation committee meetings and have the meeting materials reviewed with the compensation committee chair and circulated at least a week in advance of the meeting. It is also important to have a really good compensation consultant and an expert lawyer who can choreograph smooth meetings that pave the way for a proxy that tells a clear and compelling compensation story.

Murata: One significant change in the legal obligations of the compensation committee in recent years relates specifically to the increase in executive compensation-related lawsuits. Although the say on pay vote introduced as part of the Dodd-Frank Act is a non-binding advisory vote, say on pay gave rise to a wave of disclosure-related litigation which has, recently, resulted in the filing of lawsuits alleging breaches of fiduciary duties by both management and directors in connection with say on pay proposals and proposals to increase the number of shares reserved under a company's equity incentive plans. In addition to say on pay litigation, lawsuits have been filed alleging failure to meet the requirements of Section 162(m) of the Internal Revenue Code. Another change is the increased activity of compensation committees. Presently, compensation committees are playing an even more active role in scrutinising compensation programs and comparing proposed programs against the programs maintained by the company's peer group and actively engaging consultants to perform analyses of the company's proposed compensation programs. Committee members can ensure they discharge their responsibilities appropriately by making certain they are fully informed regarding any actions being taken by the committee and by actively participating in the ongoing compensation decision-making process.

Dahl: Compensation committees, as with audit committees, have reacted to legislation and regulation with increased interest and with a conservative approach. Directors who serve on remuneration committees in the UK will be personally liable for overpayments that fall outside a company's pay policy. I have seen the committees sometimes engage a proxy and compensation adviser, in addition to one engaged by the company. The increased level of regulations has increased the workload and responsibility of the compensation committees, and professional advisers are more frequently used.

FW: Do you believe it is possible to truly quantify executive performance? In your opinion, do the current models of executive pay motivate executives toward greater performance?

Ocker: I do believe it is possible to quantify executive performance but I am not sure the current models do a great job. Companies should keep it simple and, absent intervening unseen circumstances or retention issues, year over year pay should increase or decrease in proportion to how the company has performed operationally and for shareholders. Generally speaking, if performance is up, pay should go up and *vice versa*. Where that isn't the case, companies should communicate with shareholders about the business case for executive compensation that is not in sync with operational or shareholder results.

Murata: It is very difficult to truly quantify executive performance – just as there is no universal measure of 'success'. While it is theoretically possible to quantify executive performance across all companies by imposing a single artificial performance measurement on every company – for example, total shareholder return, EBITDA or share price – this 'one size fits all' approach ignores that companies are at varying stages in their life cycles and would not take into account many other factors that contribute to enterprise growth and longevity as well as talent retention. Additionally, executive performance is not always clearly measureable because sometimes short- and long-term company achievement is attributable to intangible subjective measures or, on the contrary, to market or industry trends independent of management actions.

Dahl: To the extent that executive performance is determined relative to a peer group, there are quantifiable measures. The company should have a robust measurement strategy which is transparent and can be justified, particularly where non-financial conditions are used. I believe that relative performance measures will remove 'macro-noise' and ensure that executives are focusing on how they can improve relative to peers. Company-specific performance criteria will also have motivational effects, but may be subject to distorted or unintended outcomes due to macro conditions.

Ferracone: Quantification is not only important but essential. At the executive level, that quantification is framed in terms of how well the company is performing. There are two issues here. The first issue is the output, looking at how the company performed financially and strategically for shareholders. This should be measured with total shareholder return, based on stock price appreciation over time, which can be quantified on an absolute or relative basis. The second issue is the input – not where the company went but how it got there. Was its strategy right and correct? Have executives lined up the organisation for future success? Are they managing for the future? Have they made good investments? Have they led the company in a healthy way?

FW: Could you outline some of the popular performance measures for short-term and long-term incentive plans? Are more companies looking to adopt best practices in this area?

Murata: Some popular performance measures for short-term and long-term incentive plans include earnings, including earnings before or after taxes; levels of or changes in income; earnings per share; operating profit; revenue; revenue growth or rate of revenue growth; operating expenses; and personal and strategic business criteria possibly including geographic, product expansion or product performance or placement. One performance metric that is rapidly growing in popularity is total shareholder return or relative total shareholder return, which measures a company's total shareholder return against the other companies in its peer group.

Dahl: Total shareholder return and earnings per share, or a combination of these, are the most popular performance metrics, as they align perfectly with the overall goals of the shareholders. Total sales growth, EBIT and EBITDA are also widely used depending on the size and nature of the company. Individual performance conditions are becoming more popular for short term incentives, but the challenge in long-term incentives is how to measure performance over time – two to three years – and to eliminate sub-optimisation within the company when using individual performance metrics.

Ferracone: We have done significant work on which performance metrics best link to shareholder value by industry. Earnings-based measures link to value most significantly and are frequently used by companies. That said, each industry is different and for some companies the financial measures fail to correlate particularly well to value. Using a direct total shareholder return measure tends to be the best way to link to value in certain industries. Most utilities, for example, use total shareholder returns as the sole if not primary measure in their long-term incentive plans because financial measures tend not to correlate particularly well to shareholder value in the utility industry.

Ocker: For short term plans, we see revenue and operating income a fair amount and to a lesser extent earnings per share and sometimes cash flow. The trick is to make sure any non-GAAP definitions make sense and don't unfairly exaggerate results and also make sure the carve outs or exclusions from GAAP definitions are objective and not discretionary to avoid Internal Revenue Code Section 162(m) tax deduction issues. For long term plans, generally the performance goals should be different than the goals for the annual bonus plan. We see total shareholder return a lot for long term plans and primarily relative total shareholder return and not absolute, usually over a three year performance period. Total shareholder return is rarely used alone for long term plans because stock price performance does not necessarily reflect good company performance. As a result, we usually see other performance conditions relating to company operations that accompany total share return and are either used in addition to total shareholder return as component parts, or as the primary parts with a total shareholder return modifier. Under these circumstances, the question is whether the long term operational goals are one year or multi-year and if multi-year goals are used, we recommend setting them annually and using the multi-year average to avoid setting unattainable aggregate multi-year goals.

FW: What general advice can you offer to companies on designing effective compensation strategies? How important are risk and sustainability considerations in such arrangements?

Dahl: The obvious advice is to seek professional assistance from the outset. Advisers will have access to best practices and peer group reviews and are able to suggest appropriate performance measures. We believe in employee ownership and encourage for a proportion of the compensation arrangements to be made up of equity in the company – thereby enhancing motivation and retention as well as reducing risk and ensuring that individual interests are aligned with those of the shareholders.

Ferracone: Focusing attention to how to align pay with performance is one of the most critical aspects of designing a compensation program. This means ensuring that pay is targeted and set at competitive levels, and allowing performance to drive pay to higher levels once targets have been reached. A key tenet of aligning pay and performance is linking measures to value and setting goals that support value creation. Having a longer term perspective on pay programs, such as whether there is a requirement to actually hold on to stock before liquidating, encourages sustained performance. When companies are administering pay programs, they need to make sure they do so in a balanced way. This might mean using discretion, within bounds, to increase or decrease the award. It also means ensuring that considerations are not biased and programs are followed faithfully. Being consistent in the design and administration of a pay program is very important.

Ocker: I think that the core of any good pay philosophy has to be performance and the percentage of non-performance based compensation should be very small, perhaps just base salary. In addition, in keeping with the prevailing Main Street mentality, executives should not receive benefits or perks not available to employees. For example, other than deferred compensation plans that provide benefits in excess of the IRS limits – currently $260,000 – companies should avoid SERPS and special retirement arrangements. If the company has a business use for certain executives to fly on a private plane, best practice dictates that they reimburse the company for any personal use with no gross up.

Murata: The most effective compensation strategies are those designed taking into account the specific needs of the particular company and include both short- and long-term goals, and subjective and objective performance metrics. Both risk and sustainability are important considerations because companies do not want to inadvertently promote individual risk-taking as a means of achieving short-term economic gain for the individual. Sustainability highlights the importance of having long-term objectives and rewarding continued performance over a longer period of time to promote sustained corporate growth and vitality. ■