THOUGHT LEADERSHIP PROVIDED BY FW COOK

COMPENSATION

REALITY CHECK

Despite Say on Pay, very few companies suffer compensation plan comeuppances from their shareholders. Yet, pay plans continue to evolve. Here's why.

IT'S BEEN seven years since the Dodd-Frank Wall Street Reform and Consumer Protection Act ushered in a new era for executive compensation. Angst over the prospect of detailed disclosure of pay practices (e.g., CEO pay ratio, pay for performance, etc.) has faded now that most items have been adopted or stalled. Trepidation about shareholder yay-or-nay votes has ebbed (for the most part). Today, we are firmly in the new normal—one in which companies have largely embraced compensation best practices pushed by proxy advisory firms (ISS and Glass Lewis) and institutional investors.

In fact, over the last several years, including 2018 year to date, approximately 98 percent of companies subject to "Say on Pay" received a passing shareholder vote, says Lanaye Dworak, an executive compensation consultant at FW Cook, who credits a "wave of conformity" to proxy advisor and institutional best practices for this overwhelmingly positive approval rate. "Our client experience shows that most companies have transformed their proxy disclosure and have taken proactive steps in compensation design and pay level determination to mitigate the risk of a negative proxy advisory vote recommendation and a negative shareholder vote."

Generally speaking, companies failing the Say on Pay vote tend to be outliers that, one, have not adopted performance-based equity; two, make special retention grants following underperformance or controversial incentive program adjustments; and/or, three, have outsized pay levels and low levels of performance.

Time to break out the champagne, throw a parade and call it a day for compensation redesign? Not quite. Sure, there is much to celebrate, including the near extinction of entitlements and problematic pay practices, such as "tax gross-ups." Applause is also warranted for the widespread adoption of a stronger focus on performance-based pay, not to mention the longer measuring periods for those awards that encourage companies to reorient away from short-term goalposts. Plus, attempts to level playing fields and align management incentives with shareholder interests by introducing relative performance measures warrant a nod of approval.

ADOBE STOCK

> **"The pendulum has swung pretty far toward TSR, but as companies get more experience with it, they're starting to realize some of the drawbacks."**

With all this progress behind us, what work is left to be done? Put bluntly, it's time for a reality check on whether the pay practices outlined by proxy advisory firms—and those that companies have employed in recent years—are living up to their promise. "Now that the dust has settled, companies are developing a compensation program that effectively supports business strategy, while focused on managing proxy advisory firm and shareholder expectations," says Dworak. "Sometimes there's a strong rationale for doing things differently."

While widely understood, proxy advisor perspective on best practices in executive compensation is not universally agreed upon, even among shareholders, adds Eric Winikoff, a managing director at FW Cook. "Proxy advisors still have significant influence, but some of the larger institutional investors have built out their own governance departments and are now voting their shares more independently than at the outset of Say on Pay," he explains. "Increasingly, there are different views out there, which pave the way for differentiation from typical market practice, so long as it can be rationalized by sound business judgment and communicated as such in the CD&A."

Theories of Relativity

Take relative TSR. Use of the metric, which proxy advisors employ as their primary metric to gauge whether pay opportunities align with share performance relative to a peer group of companies, has increased dramatically since Say on Pay. According to research by FW Cook, 60 percent of top 250 companies used it to evaluate pay in 2017, versus just 38 percent in 2011. Despite its prevalence, however, TSR has its share of flaws.

"The move to relative TSR was partly a defensive one, because it was hard for proxy advisors to challenge a metric that's used in their own analysis," says Winikoff, who also notes that the measure is simpler than some in that it doesn't require multi-year goal setting or "after-the-fact" adjustments. "The pendulum has swung pretty far toward relative TSR, but as the initial grants of relative TSR-based awards vest, companies are realizing some of the metric's drawbacks."

Chief among these is that relative TSR is backward-looking, where equity award earnouts are tied to retrospective stock price performance against a peer group rather than the achievement of the underlying financial goals that correlate to sustainable shareholder value creation. On the plus side, as an outcome-based metric, it frees management and compensation committees from the tricky task of setting operational goals in an environment of uncertainty. "But it doesn't drive management focus on key strategic and financial goals, such as improving return on investment, economic profit or top-line growth," says Winikoff. "Relative TSR rewards the final outcome rather than rewarding the key measures of success that drove it."

The relative aspect of the measure can also be problematic. Some companies have difficulty identifying an appropriate peer group or index; others may find themselves with high earnouts for negative returns or rewarding for stock volatility. A company might, for example, have an instance where its absolute TSR is down, but relative TSR is allowing performance awards to pay out above target or even at maximum.

Although relative TSR is here to stay because of the positives noted above, companies that use the metric may seek ways to mitigate these drawbacks and enhance compensation program design around relative TSR. In some cases, relative TSR acts as a modifier to another performance metric (versus being used as a standalone metric), such as earnings growth. "You might be entitled to a certain number of shares based on earnings growth over a multi-year period, which would then be modified—by, say, a 25 percent bump or a 25 percent haircut—based on your relative TSR," says Winikoff. Other companies opt to employ a portfolio of performance metrics rather than a single metric. In fact, according to FW Cook's 2017 Top 250 Report, the majority of Top 250 companies (74%) use TSR in combination with another metric. Fifty-one percent of companies use two or three metrics, and 8 percent use four or more.

ISS's 2018 policy update to formally evaluate three-year performance on various financial metrics (in addition to relative TSR) may further support a trend of diversification of performance metrics.

Targeting Transparency

At a time of increasing focus on compensation design, all companies should be striving for clarity in articulating their pay policies. But shareholder outreach and proxy disclosure are even more critical for those choosing to deviate from the standard practices, notes Dworak, who advises proactively enhancing proxy disclosure to be more transparent and easier to navigate, as well as including supplemental analyses that enhance external understanding of compensation program design (e.g., additional pay and performance disclosure).

In cases where there has been significant shareholder engagement or when a company is planning changes to a pay program, companies may want to consider conducting shareholder outreach to solicit feedback. "When such efforts have taken place, it is best practice for companies to clearly disclose common themes and concerns in the proxy statement and address any changes to compensation design stemming from such efforts," she says. "It is also important to clearly disclose the business rationale for the program design and how it effectively supports company strategy and human resource objectives."

Companies should brace themselves for the next wave of demands around pay policy, warns Winikoff. "Now that generally accepted poor pay practices are out of the picture and that most stakeholders accept the pay-for-performance lens through which compensation programs will be analyzed, the next phase is likely the detail around how companies are defining performance," he says. "Making sure that the goal setting is sufficiently rigorous and definition around permitted adjustments to financial performance is likely the next phase."

Proxy advisors have started to comment on the rigor of performance goals in annual and long-term incentive plans as part of their qualitative review process, and shareholders have raised questions during outreach efforts, particularly in cases when company performance has been poor and/or goals are set below prior year actual performance. Given that goal setting is already an inherently difficult process for seasoned management teams and board members, it will be important for companies to clearly disclose the business rationale around the goal-setting process, financial adjustments, etc. so that proxy advisors and shareholders are well informed. **CBM**

NUMBER OF PERFORMANCE MEASURES COMPANIES USE

59% of Top 250 companies use two or more performance measures.