



Executive Pay Oversight in an Economic Crisis

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Widespread turmoil in the world's financial markets has intensified the need for compensation committees to move beyond competence to excellence in their oversight of executive pay programs. Many critics blame the design of performance incentives for encouraging senior executives to take undue risks in pursuit of windfall payouts, ultimately causing the current crisis. Proposed "reforms" range from changes in tax and accounting rules to legislation restricting how much, and in some cases how, executives may be compensated.

We believe these efforts are misguided. More than most industries, Wall Street pay programs for the most senior executives generally have not rewarded nonperformance: when targets are missed, the value of executives' equity incentives historically has fallen. The root of the current crisis is not that executives and boards were driven by pay considerations to ignore the huge downside risks of increasingly exotic new financial investments, but that in most cases, they never recognized the potential for disaster.

Regardless, the reality is that executive pay is going to remain a focus of scrutiny, suspicion, and skepticism. Many companies will issue their proxies within these first 100 days of the new Administration. That means 2009 pay disclosures are certain to be the most heavily viewed and reviewed ever, particularly the explanations provided in the Compensation Discussion and Analysis (CD&A) sections. For compensation committee members to do right

Director Summary: The authors surveyed compensation committee members and suggest that there are governance lessons available to directors—particularly compensation committee members—to fully address executive compensation by making the most of disclosure reporting requirements, pay-for-performance measures, and clawback provisions without the need for further regulations.

by shareholders and executives in the tough economic times ahead, there are clear governance lessons that should be kept in mind.

We'd like to suggest some approaches, coupled with the perspective provided by a November 2008 survey in which we asked more than 100 NACD members who are currently serving on compensation committees about compensation governance, best practices, and their top concerns.

Make the Most of Disclosure

The SEC largely got it right when it pushed through expanded disclosure on the grounds that it offers the most effective means of improving boards' decision-making processes and empowering shareholders with the information needed to assess those results. In contrast, the "Thou Shalt Not" approaches to controlling pay that are the basis of multiple past and proposed tax and legislative changes have proven to be blunt instruments that neither reduce pay levels nor improve the links between pay and performance.

Two years of more detailed reporting of executive compensation programs already have prompted more knowledgeable and thoughtful questions by outside constituents about the workings of pay. In turn, the mandate to clearly and persuasively explain how and why programs are structured has prompted boards to take a fresh and more incisive look at programs and practices. Going forward, committees should take full advantage of the insights provided in disclosures by their peers to refine and improve their own decision making and oversight.

The positive impact of disclosure on the quality of compensation oversight was affirmed by survey participants. Fully 83% indicated that the transparency of their organizations' compensation programs and decision making in recent years had improved beyond purely regulatory requirements. Another 15% indicated that they needed to go even further.

Additionally, given continued growth in investor activism, boards should complement the disclosure process by giving more consideration



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to how and what they communicate with shareholders. Shareholder frustration due to a sense that companies are insensitive to their concerns about pay, especially pay for performance, is the reason for the “say-on-pay” movement. Companies need to go to greater efforts here to reduce the need for shareholder actions on pay. Only about one-third of survey respondents said their committees have a specific process in place to address questions and concerns from major shareholders, with another 14% saying they need to put such a process in place. The remaining respondents indicated either that they don’t have a formal process or do not consider it necessary.

Show Backbone

There is rarely a good reason for boards to give corporate leaders a pass for nonperformance, and a bad economy is an especially inappropriate time to go out of the way to cushion the downside for executives. More than ever, directors should align pay with performance results, even when they fall short because of factors outside the control of management. Committees also must be particularly diligent about analyzing the potential outcomes of every component of multi-part pay programs and under a wide range of performance scenarios. In fact, more than one-fifth of respondents said their boards have been caught unawares by an unexpectedly high incentive payout, which points to a continuing need for more utilization of payout projection tools such as tally sheets.

Directors are also responsible for monitoring and adapting programs as needed so they continue to function as intended. In the current economy, that may mean giving greater consideration to exercising discretion. The problem is that the deep and very rapid decline in share prices may create a significant disconnect in the goal-setting process that took place when the economy was humming along. If so, it may be appropriate for boards to pay a bonus that deviates from formula—that is, to provide more or less value than executives would have “earned” based on the plan’s stated objectives. Paying below

formula can be useful in realigning rewards with both market performance and the loss being experienced by investors. Paying above formula may also be appropriate in certain circumstances, but the exercise of positive discretion should be built into the plan formula, rather than having the committee surprise shareholders by making an exception after the fact.

Clawback Unearned Compensation

Well-structured clawback provisions are an assurance to investors that executives ultimately will return performance-based payouts that are subsequently discovered to be based on incorrect financial information. Such money-back guarantees should apply not just to the CEO, but also to division presidents and other top managers who are directly responsible for corporate results. While Sarbanes-Oxley requires this now for the CEO and CFO, most companies are too restrictive with respect to the circumstances under which they would pursue clawbacks and the executives to whom they would apply the rules. You don’t benefit from bank errors, and you shouldn’t benefit from incentive-plan administrator errors.

Reward Sustained Long-Term Performance and Plans

There is general agreement that it is in the interests of shareholders and the organization alike for executive compensation programs to be focused on long-term performance gains. Compensation committee members in the survey indicated that they recognize this as a priority. Asked about nine major compensation issues, 69% of respondents cited “performance measure selection and goal setting” as one of their three top priorities, followed by 56% who selected “program design and strategy.”

There are multiple approaches to designing plans so that long-term performance is paramount: longer-term vesting on equity compensation; performance plan cycles longer than the typical three years that companies use today; significant ownership requirements, with strong incentives to achieve them quickly. By taking a long view on performance and rewards, directors reduce the pressure on executives to manipulate short-term plans or to take on excessive risk in pursuit of the attainment of short-term objectives. Companies should also consider imposing significant equity retention requirements following retirement or termination for executives and directors alike, to avoid scenarios in which corporate leaders sell their shares on the way out the door to avoid the huge losses being sustained by investors.

A related essential element of long-term planning is preparing for future leadership well in advance of the need for change. There are plentiful examples of organizations that failed to cultivate management bench strength and



overpaid to bring in outside talent when they experienced unexpected change at the top. Yet in the survey, compensation committee members rated succession planning as the second lowest among the nine key issues given—only slightly ahead of compliance, which was last. Another aspect of such planning is for committee members to interact with members of management other than the CEO, so they can identify, track, and get to know emerging leaders. But progress has been slow in this area: Nearly 28% of survey respondents said they had “not enough” or insufficient interaction with any top executives other than the CEO.

Limit Benefits for Poor Performance

There are legitimate reasons why a new executive may not work out, or why the board may decide it is in the company’s best interest to replace a career manager. However, large settlements paid to failed executives are the single greatest contributor to the current public outcry on executive pay. There is a growing, reasonable expectation that severance benefits should be appropriate to the circumstances of the termination as well as the particular executive’s length of service and performance. That may not be the case if boards do not fully understand the ramifications of highly complex arrangements that are dependent on multiple factors. Generally, directors had been more attuned to this issue in recent years: Just 8% of survey respondents said their committees had been caught by surprise by the size of severance payments. However, members are not necessarily always happy about the packages mandated by contractual obligations. Severance benefits have their place, but a reduced or eliminated severance benefit for poor performance is often appropriate.

Maintain Perspective

Particularly in a down economy, compensation committees need to cultivate a broad and keen awareness of pay practices and issues inside and outside their own industry. This is another area in which recognition is lacking: Fewer than 20% of survey respondents said that discussing marketplace trends and practices was among their committees’ key priorities. Regular participation in director education programs is not only to be desired, but ideally it should be made mandatory. This is generally not the case: Nearly 60% of respondents said their committee imposed no requirement, while only 30% of respondents said their members were encouraged to attend director education programs more than once annually,

Recognize the Dangers of Setting Bad Goals

While compensation designs did not cause the current crisis, they remain a concern of investors and should be

a critical consideration in compensation planning. As companies focus on developing more sophisticated and holistic enterprise risk management systems, compensation committees should apply that understanding in setting the parameters of incentive plans, in terms of the nature of the goals, the degree of leverage on payouts, and any circumstances under which it might be appropriate to adjust payouts. Programs should be run through a risk tolerance filter to clarify the consequences of incentive designs—essentially, a sort of “disaster tally sheet”—that would identify problematic performance outcomes that could damage the company.

Boards also put their organizations in jeopardy if they fail to scrutinize the quality of earnings, especially in a difficult economy. Directors need to be sure that there is an appropriate mix of short- and long-term incentives so that executives will get the right results by making the right decisions, and not steer the company off course when performance hurdles prove elusive. In recent years, too many companies have discovered—upon closer examination after the fact—that results were the product of financial manipulation or strategies such as maintenance deferral or radical cost-cutting that put their companies’ long-term prospects at risk.

Conclusion

Compensation committees are heading into an extraordinarily difficult environment—a severe economic downturn coupled with an incoming presidential administration that has expressed support for greater involvement by government and/or shareholders in how corporate leaders are paid. As they make their 2009 planning and granting decisions and prepare related disclosures, compensation committees will need to demonstrate that they are addressing the risks posed by poorly designed pay programs that can put the organization’s long-term health at risk. At the same time, directors should not lose sight of the fact that good executives try to do the right thing, irrespective of the impact on plan payouts. However, it is the committee’s responsibility to make sure the incentive plans reward such behaviors. They must exercise increased discretion, judgment, and flexibility to ensure that the design of incentives and the type and level of payouts are reasoned and proportionate, and ultimately in the best interests of both shareholders and the organization. ■

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