NACD Compensation Committee Advisory Council

Aligning Executive Compensation Plan Design With Strategy

Introduction

Compensation committee mandates have continued to grow, but one of the most important components remains steadfast: focus on aligning executive compensation with the overall company strategy. As boards look to strengthen this link, many are focusing on pay design and adding nonfinancial metrics to executive compensation plans. According to data from the *2018–2019 NACD Public Company Governance Survey*, 86 percent of survey respondents use nonfinancial metrics in their CEO's compensation plan. Of these companies, 40 percent use employee engagement as their metric.[1]

The Compensation Committee Chair Advisory Council, cohosted by NACD and Farient Advisors—an executive compensation, performance, and corporate governance advisory firm—met on April 10, 2019, to discuss aligning executive compensation plan design with strategy. After a discussion on current trends, the following insights emerged from the dialogue:

- Compensation committees are using a variety of tools to better align pay plans with strategic objectives.
- Top-of-mind considerations include retaining key talent and supporting a healthy organizational culture.
- Pay plan reviews should include consideration of ways to enhance the clarity of communications to both internal constituents and external stakeholders.

Current Trends in Executive Compensation

The *2018–2019 NACD Public Company Governance Survey* showed that 32 percent of respondents discussed the link between executive compensation and company strategy in investor meetings, compared to only 27 percent of survey respondents in the 2017–2018 survey.[2] This increased prevalence shows that investors are finding it harder to link the two concepts as pay plans become more and more homogenous. Meeting participants observed that over the past several years, there has been a convergence of executive pay plan design, where compensation metrics and

[1] NACD, *2018–2019 NACD Public Company Governance Survey* (Arlington, VA: NACD, 2018), p. 27.

[2] NACD, *2017–2018 NACD Public Company Governance Survey* (Arlington, VA: NACD, 2017), p. 39.

DISCUSSION TOPICS WITH INSTITUTIONAL INVESTORS

Issues discussed in meeting with institutional investors

45.2%
Board oversight of long-term strategy

32.2%
Executive compensation philosophy and link to company strategy

27.6%
CEO performance metrics and goals

23.6%
Board composition: director skill sets, diversity, etc.

15.6%
Executive compensation payouts, including CEO-to-median-employee pay ratio

Source: *2018–2019 NACD Public Company Governance Survey* structures look increasingly similar, especially within industries. "There's essentially a checklist of what to do and not to do to avoid proxy advisor scrutiny, and that's leading to a move away from metrics that directly support a strategic plan," said Robin Ferracone, founder and CEO of Farient Advisors LLC. A participant remarked: *"Compensation committees may want to stay under the radar, but that might detract from the plan's power to reward the right outcomes and behaviors.*"[3] Compensation committees should take a hard look at their compensation plans to ensure the metrics they are using are for the right reasons, and were not just selected because they are the industry standard.

One example of the trend toward homogeneity in pay plan design is the prevalence of total shareholder return (TSR) as a metric, with 56 percent of S&P 500 companies using TSR in their long-term plans, according to data from MyLogIQ. However, Dayna Harris, partner at Farient Advisors, noted that some investors are beginning to step back from a heavy TSR focus: "Investors want to see alignment with total shareholder return, but it is not the be-all and end-all metric; they want you to focus on other things that will help drive business—return on capital or long-term sustained earnings growth." This sentiment was echoed by a director in the room who stated, "*On one of my boards, we gave up TSR because management can't influence the stock price directly. It's really an outcome metric."* Another participant commented, *"Last year's financial performance and equity market performance went in opposite directions, especially toward the end of the calendar year, which could really impact your executive's compensation if it's tied only to TSR."* Given the repeal of the 162(m) exemption,[4] the provision that allowed performance-based compensation over $1 million to be tax deductible for top executives, participants expect pay plans to shift away from purely financial metrics to more strategically aligned compensation plans.

Compensation committees are using a variety of tools to better align pay plans with strategic objectives.

As many investors view executive compensation as a "window into the boardroom," they have a well-established expectation that there should be clear alignment between companies' long-term strategy, directors'

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[3] This document reflects NACD's use of a modified version of the Chatham House Rule in which the names and institutional affiliations of participants are published, but their comments (rendered in italics) are made anonymously. See page 8 for a list of participants.

[4] For more details, please see *New IRS tax reform guidance on Section 162(m) changes*.

decision making on pay-plan design, and eventual pay outcomes. Vanguard's 2019 engagement update states that "companies should provide clear disclosure about their compensation practices and how those link to performance and to the company's espoused strategy. We believe that this transparency gives shareholders confidence that the board is looking out for their best interests."[5]

Harris commented, "We're seeing this trend play out in compensation as boards are getting more comfortable with approaches to build strategic measures into pay plans." Council delegates discussed how their compensation committees are using the following tools:

- **Building strategic metrics into long-term incentive plans.** As examples, Novartis uses innovation metrics in its long-term plan and Tesla has used product development and production metrics in the past. As one participant noted, *"These are more frequently used in annual incentive plans, but some things can't be done in one year."*
- **Special, one-time awards.** *"Special awards, which tend to be more prevalent below NEOs at my organization, haven't gotten any pushback. The board is very articulate in terms of rationale, clearly delineating the purpose and use of the award,"* said a director.
- **Incentives to take stock in lieu of cash.** One director discussed a new design feature that their board has put in place to encourage executives to think about the long term: *"For our bonus plan, the board knew we wanted our top people to be owners. To encourage this, we decided to give team members who would take stock in lieu of cash a 20 percent premium—but they had to hold it for two years. This really encouraged them to focus on the long term for retention and performance."*
- **Short-term incentives as yearly milestones for long-term goals.** *"Strategic change takes time. Putting smaller milestones, nonfinancial metrics, into the short-term program helps to not only ensure engagement but also isn't as punitive if executives need to pivot and change course,"* noted one participant.
- **Options.** Options have been out of vogue due to the fact that proxy advisors do not view them as performance based, coupled with the removal of tax incentives, but several meeting participants raised the question as to whether they should make a

[5] Vanguard, 2019 Semiannual Engagement Update (2019), p. 8.

comeback. One director noted, *"Options can be a really great way to motivate senior management to focus on the long term and get out of short-term thinking, especially during a transformation. They have to improve the stock from the day of grant to get any value."* Another director commented that *"options can be a great way to get new talent in the door."*

Top-of-mind considerations include retaining key talent and supporting a healthy organizational culture.

Meeting participants discussed the particular challenges associated with aligning compensation and strategy when the organization is going through a transformation—a major strategic shift, business model change, turnaround, major acquisition or restructuring, and so on. One meeting participant suggested, *"Once the CEO and management team have clearly articulated the new strategy, the board can use short- and long-term incentives to create accountability for the leadership team to realize those commitments."* Another director noted, *"One board I chair is concerned about supporting a healthy culture and keeping key people, so we added succession planning metrics into the senior management pay plans. We went one level deeper than the CEO and NEOs because demographic changes will be causing a spike in retirements."*

Boards and compensation committees should review the company's recognition and reward systems (including incentive compensation as well as promotion decisions and other nonfinancial rewards) to ensure that they reinforce the desired culture and avoid unintended outcomes that could undermine culture.[6]

While the levers discussed in the previous section are all positive mechanisms to encourage the right culture, participants also noted that in some situations, compensation committees may choose to use levers to discourage negative aspects of culture. For example, clawback clauses have long been a potential deterrent to unfavorable behavior. Ferracone said, "We are starting to see companies consider including in their clawback language that covers not just financial fraud, but also specifies links to reputational risk an executive may cause a company. Boards are starting to view this mechanism as a way to send a cultural message."

Discretion can also be used as either a reward or as a punishment for bad behavior. Many compensation committees view discretion as a

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[6] NACD, *Report of the NACD Blue Ribbon Commission on Culture as a Corporate Asset* (Washington, DC: NACD, 2017), p. 24.

"bad word," and when discretion is used improperly, it can be. However, compensation committee discretion, whether positive or negative, is an important tool to use when needed to align executive compensation with overall performance. Using discretion can help to militate against unintended behaviors. "Companies are using bounded discretion in their design—where you have a cap on the percentage changed in the final amount. This gives the committee some flexibility in case the metrics chosen don't accurately reflect the financial or strategic performance of the company," stated Ferracone. One director commented, *"Proxy advisors don't like discretion, but when you are trying to change a culture and putting more emphasis on nonfinancial metrics, discretion becomes paramount."*

Pay plan reviews should include consideration of ways to enhance the clarity of communications to both internal constituents and external stakeholders.

After the committee makes the compensation design decisions, the communication around those choices is vital to trust and success for both internal and external stakeholders. One participant discussed how their organization recently changed their compensation structure because "*it was so complex that even the executives didn't understand it. If [executives] can't understand how they are being paid, then we can't drive the right behaviors."*

One director commented, *"In M&A situations, especially with acquisitions of entrepreneurial businesses, boards can face the challenges of a two-tiered pay design and reward structure. We need to strike a careful balance with both the design and communication of the pay mix and pay vehicles."* Another delegate noted, *"The CEO can play a leading role on communication to employees. He or she has the vision for the company's transformation, so get them out there championing that vision and explaining how the milestones and metrics all fit together."*

After internal constituents understand the new plan, it is important to ensure that investors and other external stakeholders understand the new plan and—even more important—the board's rationale for any changes that were made. One director remarked, "*Management should be covering the critical metrics on quarterly calls with analysts. The CD&A should go beyond that to include how issues like culture and leadership development are incorporated into incentives and rewards. We need to provide an integrated and comprehensive view for investors."* Another council member commented, *"There is a changing nature of response in the CD&A—we can't just* *say what we did, but also [must say] why we made particular decisions or even why we didn't make alternative decisions."* As proxy filings increasingly become a tool for engagement with stakeholders, many compensation committees are including more information on their compensation philosophy and considerations of plan design. (See the Appendix for company examples). One director summed it up this way: *"Any questions that investors or proxy advisors ask us [about how the compensation plan, strategy, and culture are linked together] are ones the compensation committee and board should have already asked ourselves."*

Questions directors should consider when speaking to management about compensation:

1. What are the short-term milestone goals we need to hit in order to achieve our three-to-five-year goals as an organization?
2. What processes and procedures does management have in place to ensure focus on the long term while still being agile enough to make course corrections if needed?
3. What are our top shareholders' views and concerns on executive pay and corporate governance issues? What approaches have been the most effective when speaking with investors about the pay program?
4. How is management aligning the broader company pay structure with named executive officer pay metrics and focus?

Questions directors should consider when speaking with compensation consultants:

1. What types of metrics have our peer organizations used when they are in a similar business state to our company (e.g., transformational, steady state, etc.)?
2. How does our executive compensation program and its mix of pay elements compare to that of our strategy peers and our industry peers?
3. How have other companies successfully used discretion, and what did their public disclosures look like?

For Further Reading:

- "Dare To Be Different – The Case Of Amazon.com"
- "Raising The Bar of Your Incentive Plan with Automatic Goal Setting"
- *NACD Joint Advisory Council Brief: Nonfinancial Metrics, Strategy, and Culture*
- *NACD Directorship* Magazine: "Dare to Be Different: Strategic Compensation Plan Design"
- NACD Compensation Committee Resource Center

Appendix:

Prudential Financial 2019 Proxy Statement – “Philosophy and Objectives of Our Executive Compensation Program” (p. 43)

Coca-Cola Co. 2019 Proxy Statement – “Compensation Discussion and Analysis” (p. 49)

Ford 2019 Proxy Statement – “Compensation of Named Executives” (p. 47)

Microsoft 2018 Proxy Statement – “Section 2–Compensation program design” (p. 36), “Named Executive Officer Compensation” (p. 38)

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* This list includes delegates, partners, stakeholders, and guests who participated in all or part of the meeting on April 10, 2019, and/or in a related teleconference on April 18, 2019.

About the Compensation Committee Chair Advisory Council

In support of a sustainable, profitable, and thriving corporate America, NACD created the Compensation Committee Chair Advisory Council. Since 2011, this council has brought experienced compensation committee chairs from Fortune 500 companies together with key shareholder representatives, regulators, and other stakeholders to discuss ways to strengthen corporate governance in general and the work of the compensation committee in particular. Farient Advisors LLC collaborates with NACD in convening and leading this council.

Delegates of the council have the opportunity to engage in frank, informal discussions regarding their expectations for compensation practices, processes, and communications and to share observations and insights on the changing business and regulatory environment. The council's purpose is threefold:

1. Improve communications and build trust between corporate America and its key stakeholders.
2. Give directors engaged in the compensation arena a voice and a forum in which to exchange perspectives with regulators, standard setters, investors, and other important constituents on committee-related matters.
3. Identify ways to take board leadership and compensation committee practices to the next level.

NACD believes that the open dialogue facilitated by this advisory council is vital to advancing the shared, overarching goal of all boards, investors, and regulators: to build a strong, vibrant capital market and business environment that will continue to earn the trust and confidence of all stakeholders.

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