

Performance and Pay Alignment: A Top Priority for Compensation Committees

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One of the legacies of the recent financial crisis is a sharpened focus on ensuring genuine alignment between executive compensation and performance. There is an ongoing debate as to the role that executive compensation played in intensifying the financial crisis by rewarding short-term performance that had little to do with long-term value creation. The key constituencies to this debate (the government, ^[1]shareholders, boards and management) are now particularly concerned with ensuring that executive compensation programs significantly strengthen the degree to which performance and pay are aligned going forward. Whether this takes the form of a “say on pay vote,” increased shareholder

activism or companies proactively redesigning their executive compensation plans, the demands on compensation committees will continue to increase. As a result, new compensation committee members will need to hit the ground running, and the entire committee will need to establish a common foundation for future decisions that will enhance performance and pay alignment.

A good compensation committee education process will to some extent include new as well as current members. New members can learn not only about the substance of the compensation system, but also the context for past compensation committee decisions. Current members will have an opportunity to take an inventory of the company’s executive compensation plans and decisions. Further, they will be forced to articulate answers to probing questions. Within this context, we suggest that the education process include the five components shown below, which we refer to as the ABCs of educating new compensation committee members

Explain the roles of the board, the committee, management and the compensation consultant.

Some aspects of this education could take place as part of the committee’s normal ongoing annual planning processes, while other aspects are better handled up front as a new committee member comes on board. Regardless of the timing of these components, we have outlined the specifics of each component, based on our experience with clients:

Articulate the company’s business strategy and performance and their link to executive pay.

Our view is that executive compensation should be a derivative of corporate strategy and should help drive value for shareholders. How a company creates economic value should have a direct impact on its executive compensation plans and policies including the pay mix, the selection of performance metrics and goal setting. The linkage between the company’s business strategy, performance and its executive compensation programs should be something that any compensation committee member, current or new, can readily explain to fellow board members, shareholders and executives.

Bring in current information on the external executive compensation environment.

The only thing constant in the world of executive compensation is change. For example, in December 2009 the SEC issued new disclosure rules, and RiskMetrics issued new proxy voting guidelines, both of which address the relationship between executive compensation and excessive risk taking behavior. It is critical that new compensation committee members be brought up to speed fast on what they need to know about the world around them. Farient suggests that compensation committees receive an

environmental update as part of their annual compensation planning cycle, or more frequently if warranted by the pace of change. New committee members should be afforded this environmental update as early on in their service period as possible.

Catalog the company's executive compensation strategy and programs.

Compensation committee members can't be expected to remember every aspect of the company's executive compensation programs. Therefore, we recommend that the salient aspects of the compensation strategy, programs and policies be summarized on a single sheet of paper. Farient has developed a tool for this purpose called the Executive Top Sheet. Our clients have found it to be a highly effective resource for current committee members, let alone new members, to refresh their knowledge of the company's plans.

In addition we develop glossaries for our clients as a reference tool to ensure that there is a consistently high level of technical knowledge across all committee members. The need for a glossary has intensified due to the increase in the number of laws, regulations and accounting rules that are applicable to executive compensation and the proliferation of unique acronyms and language every company develops to describe its executive compensation objectives, philosophies, programs and policies. These glossaries typically cover:

- Definitions embedded in plan descriptions
- Tax provisions (162(m), 409A, 280G)
- Accounting provisions
- Disclosure requirements
- Long-term incentive valuation parameters

Discuss the degree to which the company's performance and pay are aligned. "Aligned pay" occurs when total compensation, after performance has been factored in, is sensitive to company performance over time and reasonable relative to the market for executive talent given the performance delivered. Achieving alignment requires that compensation committees not only design performance-sensitive compensation plans, but also manage and administer them consistently over time. A pay system that is "designed to align" can still be misaligned if the committee makes exceptions to the plans or frequently changes the plans themselves. In the extreme, the company runs the risk of creating "runaway pay," which could make it a target for shareholders, the public and possibly the government. New committee members always will inherit plans that were implemented and decisions that were taken prior to their joining the committee. New members deserve to know "what they're getting into."

To provide insight to new and current committee members alike, Farient has developed a simple visual called the Alignment Report. This report shows the degree to which performance, as indicated by three-year rolling Total Shareholder Return (TSR), drives reasonable Performance-Adjusted Compensation (PAC), and the extent to which the current pay system likely will achieve alignment going forward. Further, the Alignment Report can facilitate a robust discussion between current and new committee members as to potential changes in plan design or decision-making processes that can strengthen alignment going forward.

Explain the roles of the board, the committee, management and the compensation consultant. To ensure that committee members can adequately plan and prepare for meetings, we routinely help establish an annual planning calendar, as well as a roles matrix that clearly outlines the roles of the board, the committee, management and the compensation consultant. Together, the calendar and roles matrix guide committee processes and ensure that committee members have timely information such that they can make the highest quality decisions. If a planning calendar and roles matrix has already been established, they should be reviewed with new committee members and refreshed with their input—as appropriate.

In the current environment, there can be no higher priority for compensation committees than strengthening performance and pay alignment. The appointment of a new committee member provides

an ideal opportunity to ensure that all committee members are equally prepared and equipped to carry out their responsibilities in the most effective way possible.

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