

Executive Compensation Reimagined

The Case for a New Approach

Why CHROs Should Challenge Conventional Wisdom When Selecting Incentive Plan Measures

SIGNS OF CHANGE ARE ON THE HORIZON

EXECUTIVE COMPENSATION PLANS HAVE BECOME MORE UNIFORM since 2011, when mandated say on pay took effect. Faced with increased leverage from proxy advisory firms, many boards are approving incentive plans that conform to proxy firm guidance instead of tailoring their plans to meet the unique needs of their firms. While this trend may ensure satisfactory say-on-pay outcomes, recent research shows that high performing companies are less likely to follow “market prevalent” pay practices, instead adopting plans specifically suited to their needs.

A move toward “sameness” in pay design isn’t new – for decades, companies and their compensation consultants have crafted executive pay programs with a studied eye on the practices of their competitors. The increased transparency required by proxy disclosure rules has made it easy to discover what everyone else is doing – and that information has evolved from being a reference point to setting “best practices.”

But there is something different about the sameness this time around, and it is related to the advent of mandatory say on pay and the corresponding rise in the influence of proxy advisory firms. Proxy advisors now play a significant role in shaping executive compensation plans, and their policies on how best to measure performance and what constitutes the appropriate form of pay have contributed to the current homogenization.

And while most large institutional investors conduct their own independent analysis of a company’s pay practices and plans, many smaller investors lack the resources to carefully evaluate the proxies of the many companies whose shares they hold; and as a result, are inclined to follow the proxy advisor recommendation

Companies understandably seek to avoid a low say-on-pay vote, and often have focused attention on identifying those actions that will help secure a “for” recommendation from the proxy advisory firms. To be fair, many of the resulting changes have been positive

– the most egregious pay practices are disappearing and the pay-performance link is stronger. But it is less clear that changing fundamental pay designs to conform to the preferences of proxy advisors is a positive development.

Of particular note is the increased use of total shareholder return (TSR) as a performance measure in long-term incentives. On average, performance-based long-term incentives now comprise over half of the total long-term compensation opportunity for executives. And TSR is by far the most commonly used measure in those performance plans. According to data published by Meridian Compensation Partners, TSR was used in 57% of performance plans in 2014, more than twice as often as the next nearest measure (EPS at 27%).

The focus of proxy advisory firms on TSR as the definitive performance metric has played a major role in its increased prevalence. While TSR is arguably the ultimate measure of management’s performance, it is very much like the score at the end of a baseball game. That is, TSR is the best measure of the final outcome, but it’s not particularly helpful in determining what it takes to actually win.

Faced with increased leverage from proxy advisory firms, many boards are approving incentive plans that conform to proxy firm guidance instead of tailoring their plans to meet the unique needs of their firms.

There is an instructive parallel between the state of executive incentive design today and the situation described by Michael Lewis in his 2003 bestseller Moneyball. Lewis describes how, in the early 1990's, the Oakland A's delivered superior results with the third lowest payroll in baseball by ignoring conventional wisdom when it came to identifying the drivers of a player's success. Instead, the A's focused on mining the vast wealth of baseball statistics to objectively identify what differentiates high performers.

Instead of adopting the de facto standard of TSR as the optimal performance metric, CHROs have an opportunity to take a page out of the Moneyball playbook and change the dialogue around pay for performance. CHROs can play a leadership role by insisting that incentive plans be linked to those measures that are the true indicators of a company's ability to create sustained shareholder value – the measures which, over time, will drive superior TSR performance. The right measures may be financial (measuring capital return or cash flow, for example) or operational (reflecting a company's ability to drive innovation, customer retention or manufacturing

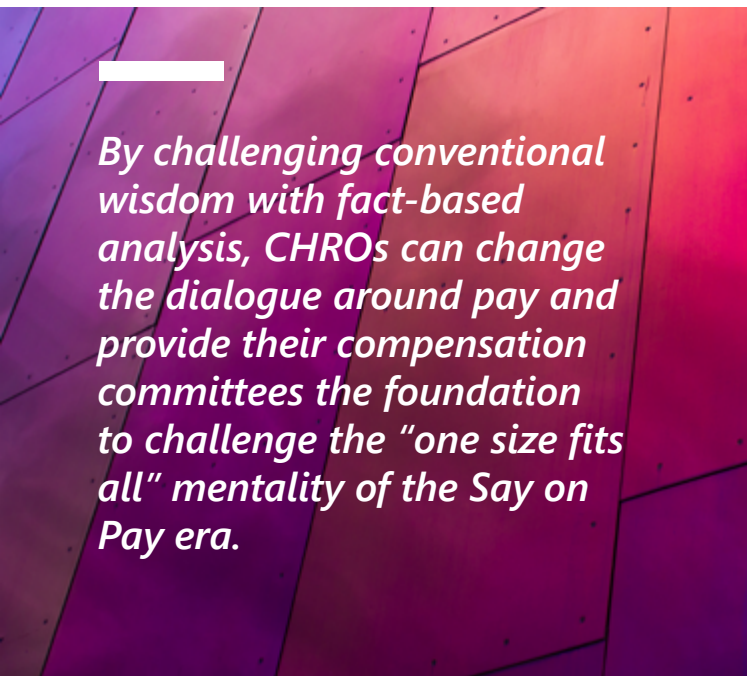
efficiency). The important point is that, rather than focusing management only on the final score, effective incentives should also communicate and measure the actions needed to win the game.

Evidence is emerging that the movement to conform to prevailing practices in incentive design may not be in the best interests of a company or its shareholders. A July 2014 Towers Watson report showed that companies with sustained high performance are more likely to tailor their pay plans to meet their own unique business needs – even if it means deviating from “market norms.” Interestingly, these higher performing companies also had a lower ratio of CEO pay to market capitalization than lower performing companies, making their CEOs less expensive relative to the value created than for the market as a whole.

Towers Watson's findings should not come as a surprise. Businesses differ dramatically – across industries and over time. It's hard to imagine that any single approach to incentive design could possibly reflect the wide variation between companies, or the different needs and circumstances faced by a single company over time.

As the architect of the organization's pay programs and strategies, CHROs have an opportunity to lead their organizations in reconsidering how pay is delivered. By challenging conventional wisdom with fact-based analysis, CHROs can change the dialogue around pay and provide their compensation committees the foundation to challenge the “one size fits all” mentality of the Say on Pay era.

Next, we'll explore in more depth how CHROs can lead the effort to identify those metrics that reflect true value-creation in their companies.



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The Case for a New Approach

**What You Pay For
Is More Important
Than How You Pay**

“ONE SIZE FITS ALL” DOES NOT APPLY

IN THE WAKE OF THE FINANCIAL CRISIS and a tepid economic recovery, the current state of executive pay has come under attack from multiple stakeholders, all of whom have (or claim to have) an interest in the outcome – institutional and activist investors, proxy advisory firms, the media, organized labor, and government officials. Rising levels of executive pay have been cited by some as a contributing factor to income inequality; and even among the defenders of the current system, many Boards of Directors feel constrained by the “one size fits all” mentality of the say on pay era, driven by the leverage of the proxy advisory firms over the voting decisions of some institutional investors.

CHROs have a unique opportunity to shape this debate and lead their organizations in a process of re-imagining executive pay. And the playbook for how to do so comes from an unlikely source: Major League Baseball.

In the early 1990s, the Oakland A’s delivered superior results with the third lowest payroll in baseball by ignoring conventional wisdom when it came to identifying the predictors of a player’s success. Instead, the A’s employed the practice of Sabermetrics – the empirical analysis of the vast wealth of baseball statistics – to objectively identify what differentiates high performers.

Just as Sabermetrics has been described as “the search for objective metrics about baseball,” it is time for HR to insist that incentive designs benefit from a search for objective metrics about the true drivers of their company’s performance. This search should be based upon the fact that while total shareholder return is the ultimate measure of outcomes – *of how much value was created* – it fails to tell us how that value was created in the past or will be created in the future. A better understanding of the “how” will ensure that incentive plans are based on measures that clearly communicate to executives and investors what drives sustainable value creation.

By adopting a data-based, quantitative approach as a key component in the selection of performance measures, CHROs will be better prepared to improve their company’s ability to design, communicate and defend their pay programs.

Superior value creation is the result of sustained outperformance on industry-specific financial and non-financial drivers over time.

While the actual work may require the analysis of large amounts of data over varying time periods, the basic approach is simple. It is based on the idea that *superior value creation is the result of sustained outperformance on industry-specific financial and non-financial drivers over time*. Because businesses and industries differ dramatically with regard to customers, markets, suppliers, talent, company culture and numerous other factors, no single measure or a set of measures will be correlated to shareholder value for every company, in every industry, for all time periods. The question is even more complex for companies that compete across multiple industries.

So how do you discover the measures that drive value in your industry? After all, most HR organizations are in the early stages of developing expertise in financial metrics and statistical analysis. The most effective approach involves a partnership between HR and the business strategy and financial experts in the company. They have the data, the expertise, and the tools to conduct the analysis.

Using your company's strategy as a starting point, re-imagining incentive plan design is a process of discovering the financial and non-financial drivers that are most likely to result in sustained shareholder value over time. To do this, we recommend a four-step process:

- **STEP ONE:
Identify the Measures**
- **STEP TWO:
Test Correlations for
Single Measures**
- **STEP THREE:
Test Correlations for
Multiple Measures**
- **STEP FOUR:
Using the Outcomes**

Step One: Identify the Measures

The first step is to identify the measures to be tested. One logical place to start is with the measures the company is currently using, but you don't have to be limited to current measures – or even to financial measures. Any quantitative measure for which adequate data is available can be tested. What measures do your investors care about? How about your competitors? For example, if your incentive plan uses a capital return measure, but investors continue to question your company's prospects for growth, perhaps it is time to consider a revenue measure.



Once you have selected the measures to be tested, you will need to gather historic data for these measures and for TSR. It is important to gather this data over a long enough time horizon to make sure the analysis reflects the appropriate investment and product life cycle horizon for your industry.

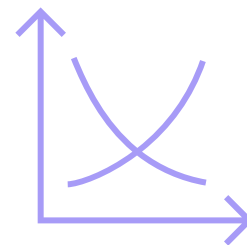
It is also important to test the selected measures for more companies than just your company. A group of companies is preferable – ideally, those in your peer group. This will provide a more robust data set, improving the validity of the analysis.

Understanding Financial Measures

There are many types of financial measures used by a wide variety of stakeholders – investors, accountants, regulators, and executives to name a few. When it comes to incentive design, the most popular measures used in short term plans are revenue, operating income and earnings per share; while relative TSR, EPS and capital return measures are most common in long term performance plans. For a detailed guide on financial measures tailored to HR, we suggest [Financial Analysis for HR Managers](#) by Steven Director.

Step Two: Test Correlations for Single Measures

Once you have gathered the data, you can use basic statistical analysis to determine the correlation between each selected measure and TSR. At this step, you should calculate the R-squared for all the selected measures independently (that is, one at a time) over multiple time periods. Then you can compare the outcomes to determine the measures most highly correlated to TSR.



At this point, it is critical to make sure the timeframes you are using for the analysis truly reflect the fundamentals of your industry or industries. Investment cycles differ dramatically between industries; and some segments are more sensitive to macroeconomic forces and global business cycles than others. It's also important to test for correlations over a relatively long historical timeframe, so that the impact of various economic conditions (recession and expansion) can be taken into account.

Understanding R-Squared

R-squared (also r^2 or R^2) is a measure of how well data fits a statistical model. It is a statistic used when the main purpose of the analysis is either to predict future outcomes, or to test a hypothesis. Also known as the coefficient of correlation, the value of r^2 ranges from 0 to 1. In general, the closer r^2 is to 1, the better the model fits the data.

Step Three: Test Correlations for Multiple Measures

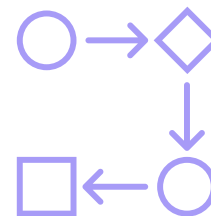
What if the single measure correlations do not show strong correlations? It could be because multiple factors, operating in combination with each other, have a bigger impact on TSR than any single measure alone. For example, a company's ability to both grow the top line and simultaneously improve operating margins could have a bigger impact on value creation than either growth or profitability alone. You can test this using multiple regression analysis – more complicated than single regression but easily completed in a spreadsheet program with a few mouse clicks.

Step Four: Using the Outcomes

Measuring the correlation of potential incentive plan measures to TSR is an important input to the incentive design process – but not an absolute answer. The analysis is backward looking – it shows how various measures have been correlated to changes in TSR in the past. As a result, it might not adequately reflect changes in your company or industry that will change how value is created in the future.

It is also important to keep in mind that correlation is not causation. While the analysis can determine which measures in the past have had the highest statistical relationship to shareholder value, it does not guarantee that focusing solely on those measures will create value.

That said, employing a data-based, quantitative approach to “discovering the facts about performance” will give CHROs, compensation committees and Boards a foundation to help tailor incentive designs that resist the “best practice” mindset and seek to achieve “best fit” instead.



In the next piece in our series, [*Pay Alone Isn't Enough: The Role of Executive Compensation in an Integrated Talent Strategy*](#), we'll put the question of executive incentive design in the larger context of the company's overall business and talent strategies.

Executive Compensation Reimagined

The Case for a New Approach

Pay Alone Isn't Enough: The Role of Executive Compensation in an Integrated Talent Strategy

IN THE FIRST TWO PARTS OF THIS SERIES, we focused our attention on making the case for a new way of thinking about incentive design – using fact-based analysis to identify the performance measures best suited to a company’s unique needs. We suggested that companies should resist the pressure to conform to the “one size fits all” mentality of the say on pay era, instead focusing on the business drivers – financial and operational – that will create sustainable value in their industries. Our approach is based on the idea that if a company demonstrates consistent performance against those measures, it will deliver sustained high returns to its shareholders over time.

We continue this series by taking a more holistic view – recognizing that a well-designed pay program is important to a company’s success, but it is not enough. It is only one component of a larger, comprehensive talent strategy.

To truly turn the company’s talent into a source of competitive advantage, CHROs need to develop people, pay, organization and culture strategies that:

- Are aligned with the company’s *business strategy*;
- Reflect the realities of the *market for executive talent*; and
- Recognize the powerful influence a company’s *culture* can have on driving business results.

Largely in response to the requirements of say on pay, companies have focused considerable attention on ensuring that their pay programs support their business strategies. That connection is now the focus of comprehensive proxy disclosures and regular engagements with investors – and the effort has been well received. Institutional investors consistently emphasize the benefit of a company “telling its story” – clearly describing how its pay plans support its business strategy. CHROs need to make sure the same clear connection exists between their company’s business

strategy and the other talent, culture and people strategies in which the organization invests its time and resources.

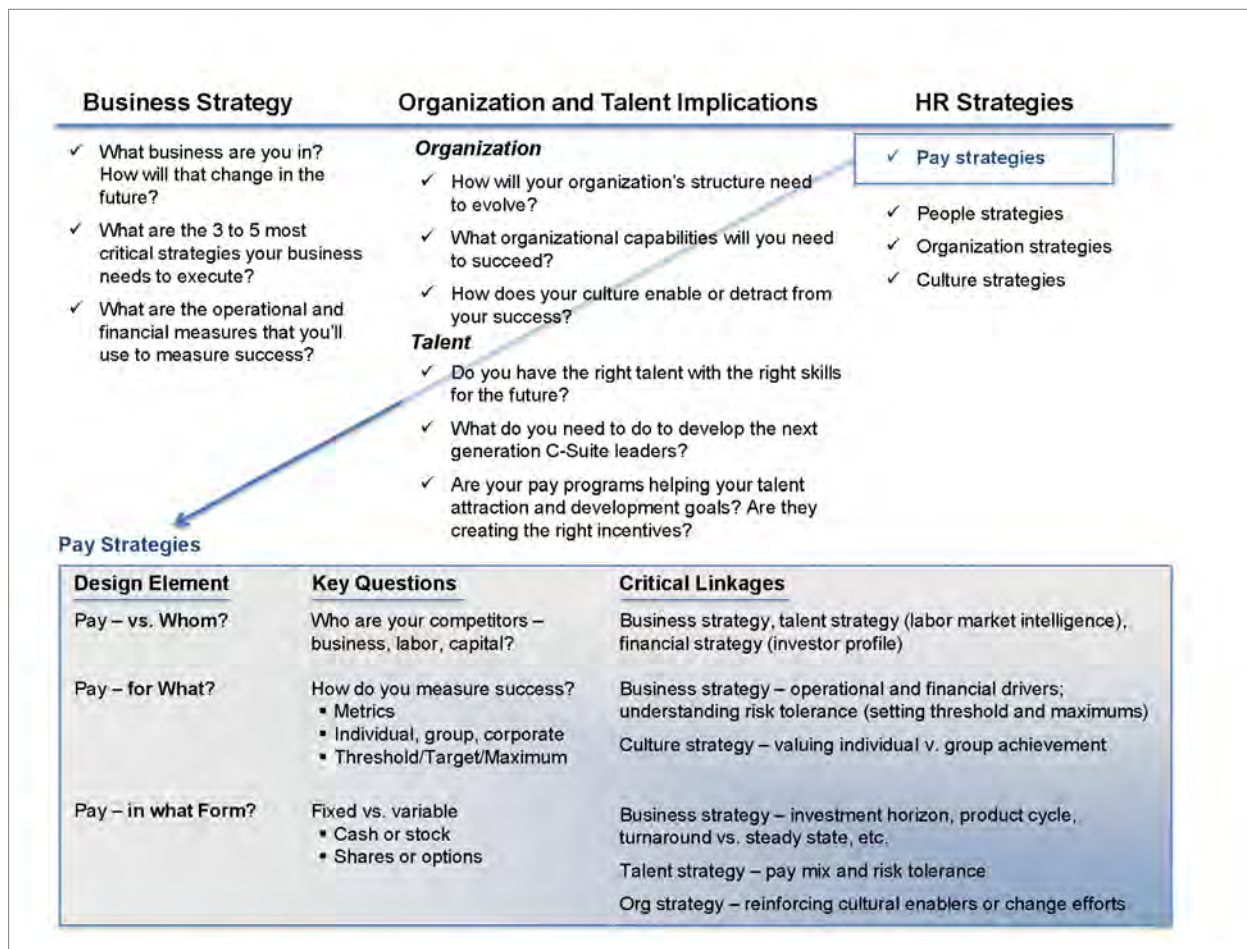
But making sure each HR initiative or strategy clearly supports your business strategy is only the first step. To truly maximize HR’s impact on business results, CHROs need to focus on the interdependence of their people, pay, organization and culture strategies, recognizing that a weakness in one area will render the others less effective.

A well-designed pay program is only one component of a larger, comprehensive talent strategy.

This interdependence can make headlines – and not always in a positive way. One example of this occurs when a company hires a CEO or other NEO from outside the company. Hiring a senior executive from the outside can result in outsized pay packages needed to attract the candidate, including “make whole” awards and other perks that draw the ire of proxy advisory firms and investors alike. A similar situation arises when a senior executive is asked to leave the company and receives a substantial financial payment. These examples often represent *failures of the talent process*, not the pay program. Yet, because the pay program is most visible, it is subject to criticism – and its effectiveness may be compromised as a result.

The executive pay-executive talent connection is only one example of how there is no single “silver bullet” that CHROs can rely on to create a talent-based competitive advantage. Instead, CHROs need to focus on a holistic approach, recognizing that their HR strategy is only as good as its weakest link.

To illustrate the point, the graphic below offers a simple example of how pay strategies must be based on business strategies, but are also closely linked to people, organization and culture strategies.



The chart above is not designed to be a comprehensive approach to setting HR strategy; rather, it's intended to illustrate at a high-level how the interdependence within HR requires a higher degree of collaboration across HR teams and professionals. This interdependence also has implications for the knowledge, talent and skills needed in the HR leaders of the future. No longer will an executive compensation professional be able to operate without an intimate understanding of the talent development approaches and strategies of his HR colleagues. In addition, talent specialists who have traditionally focused on recruiting, development and organization effectiveness will now be called on to understand the dynamics of the executive compensation landscape.

CHROs understand intuitively that driving business results depends on much more than a well-designed executive pay program. To truly turn an executive team into a source of competitive advantage, CHROs need to make sure that all of the organization's talent strategies – pay, people, organization and culture – are based in a deep understanding of business strategy and are effectively integrated and mutually reinforcing.

Executive Compensation Reimagined

The Case for a New Approach

The Advantages of A Renewed Focus On Governance

THE ESSENTIAL ROLES

PARTS ONE THROUGH THREE OF THIS SERIES addressed how CHROs and their teams can take a different approach to incentive design that links incentive metrics to long-term shareholder value and more effectively connects compensation and talent. In Part Four, we address the essential role that corporate governance plays in the process, especially the role of the compensation committee in determining the level and form of executive compensation and corresponding incentive performance metrics. Companies seeking to re-orient their incentive plans by moving beyond TSR need to ensure that the compensation committee fully understands the company's drivers of long-term value creation, how pay is linked to business and talent strategies while ensuring that appropriate governance processes are followed. This is especially the case now that large investors increasingly want to hear from directors on these issues and proxy advisory firm recommendations can have a big influence on both say on pay outcomes and on the reelection of directors.

The Role of the Compensation Committee

The role of the compensation committee is to draw upon the informed judgment of the committee members to help the company adopt incentive plans and corresponding performance metrics that best fit the business strategy, support the talent strategy and thereby serve the interests of shareholders. Viewed another way the compensation committee's role is an extension of the board's role in mitigating unnecessary risk, while encouraging a prudent level of risk to grow the business. To effectively carry out its role, the compensation committee looks to a variety of data points, both within the company and externally, often working with the committee's independent consultant,

to ensure that incentive arrangements are properly aligned with sustained value creation and achieve the desired competitive position. Because directors effectively rent their reputations to the company, they have an important interest in making sure that the decisions are in the best interests of the company and shareholders.

Say on Pay and Proxy Advisory Firm Influence

With the advent of say-on-pay, the influence proxy advisory firms have over shareholder votes has likewise increased. Correspondingly, there has been a logical increase in the attention paid by compensation committees to the proxy voting guidelines of proxy advisory firms and institutional investors whom they seek to influence.

Research indicates that proxy advisory firms, particularly Institutional Shareholder Services (ISS), can influence the voting outcomes on compensation-related proposals by as much as 20% to 30%. Further, proxy advisory firm recommendations on director voting can also have a significant impact, and ISS and Glass Lewis have both sought to link recommendations on say on pay votes and the reelection of directors where they have found, under their guidelines, an ongoing pay for performance disconnect exists. In view of the increased attention to executive compensation and the governance of pay, it is not surprising that there has been a trend toward adopting performance share plans and utilizing total shareholder return (TSR) as a metric in those plans. These elements are favored by the ISS methodology for assessing pay for performance and are the basis of determining say on pay voting recommendations.

Unfortunately, in recent years, proxy advisory firms, primarily through say on pay, have had a disproportionate influence on committee actions. A 2014 survey of Center On Executive Compensation Subscribers indicates that 74% of companies changed a compensation policy and or practice in the past three years primarily to meet a proxy advisory firm standard and 66% reported that a positive recommendation from proxy advisors is a significant consideration in compensation decisions.

Opportunity to Drive a More Tailored Approach

While the post-financial meltdown environment created a very challenging context within which to make compensation decisions, we are seeing significant improvements in the overall economy and generally strong shareholder support for company compensation programs. Companies have experienced four years of say-on-pay voting with overwhelming support for company pay programs with the vast majority of large companies receiving over 90% support, shareholder resolutions on executive pay receiving very limited support from shareholders, and there is an increased effort by large institutional investors to conduct their own nuanced and in-depth analysis of executive compensation programs, thereby reducing the impact of proxy advisors on the voting decisions of the largest investors. Combined, these changes create an opportune time for compensation committees to redouble their efforts to take a more tailored approach to incentive awards. By doing so, their actions will help to reduce the influence of proxy advisory firms, and further solidify relationships with institutional investors.

While competitive practice and the policies of proxy advisors are still important considerations in the design of executive pay programs, it is increasingly important that compensation committees move beyond the recent over-emphasis on these narrow lenses through which to view compensation. Compensation committees should be asking a broader and more probing set of questions in an effort to ensure that incentives are aligned with the best interests of their companies and shareholders. This reframing of committee focus should include four key areas, which significantly influence the effectiveness and efficiency of executive pay: pay and business strategy; pay and talent strategy; pay and shareholders; and pay and governance.

Pay and Business Strategy

- Are our executive compensation programs and practices aligned with our business strategy?
- Have the performance results as measured by the company's incentive metrics, for both long-term and annual awards, correlated well with the key drivers of achieving the business strategy?
- Do investors understand our business strategy and how our incentive programs support achievement of the strategy?
- Where does our mix of pay and level of pay fall in the range of competitive practices? Does this positioning correspond to our relative performance versus key competitors?
- Are the costs of our executive pay programs reasonable?
- Are our programs efficient from a tax perspective?

Pay and Talent Strategy

- Have we had regrettable losses of talent that were due, at least in part, to our pay programs or Have we lost key external candidates for executive roles due to the inability to structure an attractive pay package?
- Do our executives understand and value our pay programs?
- Do our decisions on pay align with our assessments of talent in terms of sustained performance and potential for advancement?
- Are there disconnects between our executive pay program and the company's espoused pay philosophy?
- Are there disconnects between executive pay and the desired company culture?

Pay and Governance

- Have our disclosures and reporting of pay been fully compliant?
- Are our governance practices consistent with what is generally accepted as good governance practices and processes?
- Have we conducted evaluations of the compensation committee and sought to improve any issues raised by the evaluations?

Pay and Shareholders

- Have the performance results as measured by the company's incentive metrics, for both long-term and annual awards, correlated well with changes in total shareholder return?
- During our outreach/engagement with investors what feedback have we received on our pay programs?
- How have we fared on our say-on-pay votes relative to peers and relative to other companies in similar performance situations?
- Has the company received shareholder proposals on executive pay that garnered a meaningful level of shareholder support?
- How have the proxy advisory firms assessed our approach to executive compensation? Do our largest shareholders have similar concerns?
- Have our compensation programs been the focus of negative media stories generated by shareholder concerns?

Compensation committees that move beyond mere reliance on competitive practices and the influence of proxy advisors will be better positioned to add increased value to the companies they serve. Exploring in depth key questions of effectiveness and efficiency of the executive pay programs, as outlined above, should lead to a more robust dialogue on pay and performance, greater insights regarding the effectiveness and efficiency of pay decisions and serve to better inform the independent judgment and reasoned point of view that is the foundation of the compensation committee's role in the modern corporation.

Executive Compensation Reimagined


The Case for a New Approach

Establishing Performance Targets

THE FOCUS HAS SHIFTED

AFTER FIVE SAY ON PAY VOTES RESULTING IN overwhelmingly positive support for management, it would be understandable to conclude that the debate over executive compensation has been settled. The most questionable pay practices have largely disappeared, shareholder engagement with management is at an all time high, and pay packages are more closely linked with performance than ever before. However, as we have discussed in the first two parts of this series, the focus on executive pay has now shifted to questioning whether companies are basing the assessment of pay for performance on the metrics most aligned with their business strategy. While total shareholder return (TSR) has become the predominant metric for long-term performance plans, investors are questioning whether it is the right metric for focusing management's attention on long-term value creation.

But, as we've seen in several recent cases, selecting the right performance measures is only part of the solution. Once those measures are set, creating the most appropriate link between the level of performance achieved and the amount of pay earned is both science and art, requiring a balance of data, analysis and informed business judgment. In Part V of this series, we examine the challenges companies face in establishing performance targets, discuss several approaches to some fundamental incentive plan design challenges, and advocate for the Board's exercise of informed business judgment in ensuring targets are appropriate.



Selecting the right performance measures is only part of the solution.

The Role of Performance Targets

In order to understand why the target setting process is so challenging, it's important to first consider the role performance targets play in an organization. Why do companies set performance goals? What purpose do those goals serve?

Performance targets serve three primary purposes in an organization: a planning function, a control function and a rewards function.

Planning Function

Performance targets are the foundation of a company's planning process; they translate the company's business strategies into concrete, tangible outcomes. In order to achieve those outcomes, operational, financial and human resource plans must be established – defining what products will be produced and when, and the financial and human capital that will be required. These plans mobilize the organization to procure the resources needed to meet the targets. They also enable management to prioritize activities and allocate limited resources.

Monitoring and Control Function

Once plans are in place, management delegates the authority and responsibility for their execution. Targets are the means by which management monitors and controls the performance of those to whom authority has been delegated. The monitoring function allows course corrections to be made so that targets can be achieved, while the control function protects the interests of the shareholder by ensuring resources are directed in the most efficient way possible toward the achievement of the targets.

Rewards Function

When performance targets are used for the purpose of determining management's compensation, the potential for a conflict is created. Managers, while entrusted to act in the best interests of shareholders, understandably want to be well compensated for their performance as well as for their skills, judgment and experience. However, because the compensation paid to executives diminishes the profits of the business, rational shareholders seek to ensure that rewards are proportional to the returns created for shareholders.

The competing interests of management and shareholders may impact the target setting process in several ways:

- Management has an incentive to persuade the Board to adopt performance metrics that are within management's control and targets that are attainable in order to create compensation outcomes that are more predictable and certain. This includes a preference for "line of sight" measures that insulate rewards from the impact of factors that are out of management's control.
- Shareholders seek the best possible performance at the lowest possible cost and as a result favor aggressive or "stretch" targets. And because they are not insulated from the impact of exogenous factors, they have an incentive to look critically at long lists of "exceptions" that exclude the impact of events outside management's control. Additionally, shareholders may focus on indirect measures of performance, such as total shareholder return, rather than metrics that more directly reflect the performance of management.

In light of these differing needs and perspectives, companies should take steps to ensure that the interests of both management and shareholders are considered when addressing the basic design questions of setting incentive plan targets:

- **Against what reference point will performance be measured?**
- **What is the appropriate time period for measurement?**
- **What is the right relationship between the level of performance achieved and the amount of pay received?**

1. Paying for Performance – Selecting the Reference Point

In setting performance targets, the first task is to determine the standard against which performance will be measured. Will the reference point be internal or external? Will it be an absolute goal, or will it reflect relative performance against a benchmark?

As the chart below indicates, the various approaches to establishing the reference point for performance all have specific advantages. Internal goals can be easier to communicate and, if established through a collaborative process, can promote engagement and buy-in at multiple levels. They are also well-suited to establishing goals specific to discrete business units. External goals – especially those set relative to a peer group – provide an objective and easily determinable standard not subject to internal negotiation. Stock price performance goals can provide an effective means of incorporating shareholder expectations into the performance process. However, external goals may not be easily established for business units, may be problematic in the absence of a representative peer group, and are indirect measures of management performance, especially over the short term.

The importance of these factors – simplicity and buy-in, objectivity and comparability – in driving a company’s business and talent strategies are important considerations when determining the appropriate reference point for executive incentives. Companies may choose to balance these factors by using internal reference points in their annual incentives – thus creating greater line of sight in the short term – and linking long term incentives to external performance against a stock price goal or a peer group. The point is that the Board’s compensation committee should apply its judgment in working with management

to determine the design that best meets the needs of the company. In its unique role bridging the perspectives of shareholders and management, the Board is in the best position to determine the best mix of incentive metrics and the appropriate level of targeted performance.



2. Setting the Appropriate Performance Horizon

Determining the right time horizon for performance goals similarly requires a balance between the interests of shareholders, the reality of the market for executive talent, and the ability to set meaningful multi-year goals within the context of the company’s business strategy. This is made more complex by the fact that neither investors nor executives have a uniform set of preferences as to the relevant time horizons for long-term incentives. Large, traditional institutional investors typically view performance over very long periods of time. But others – notably some of the more aggressive activist investors – have investment horizons that span only a few years. Similarly, executives differ dramatically in their career objectives, personal preferences for risk, individual marketability, and the importance of pay in the overall employment value proposition.

In light of these differing perspectives, what is the appropriate time period over which performance should be measured for the purposes of executive incentive plan design? In our view, there is no single time frame that is right for every company. The appropriate time frames will depend on the nature of the industry, the specific

strategic challenges facing the company, and the unique talent strategies employed by the organization.

Equally important as the appropriate time horizon is the relationship between the metrics used in annual incentives to those used in long-term incentives. Over the relevant time horizon for the company and industry, changes in annual incentive measures should be correlated to changes in the measures used in long term plans. This holds true whether a company uses stock price (through traditional stock options or time-vested restricted stock, or by using Total Shareholder Return, or TSR) or other measures in its long-term incentives, such as earnings or capital return measures.

3. Establishing the Relationship Between Performance and Pay – The Payout Curve

Once the reference point and time horizons have been determined, the final step in the process is to establish the specific relationship between the level of performance delivered and the amount of pay received. Setting the “payout curve” depends on answering three fundamental questions: What level of performance is required to earn the “target” or “expected” level of incentive? What is the minimum level of performance below which no incentive will be earned? Is there a maximum level of performance above which payouts will be capped? If so, what is it?



Setting the Target

As noted above, the reference point against which performance is measured involves choosing whether performance will be calibrated against an internal or external measure, and whether the comparison will be to a relative or absolute benchmark. Once those choices are made, the actual target level of performance can be established. For example, when a company chooses a relative, external measure such as TSR against its peer group, the target level of performance required to generate target pay is commonly set at the median of the peer group.

Companies that choose to use internal reference points often use their annual operating budget or their published earnings guidance as the target-setting mechanism. In those cases, the judgment of the Board is key to ensuring the operating plan established by management incorporates a sufficient amount of challenge, in light of management’s understandable preference for certainty in the form of readily attainable targets.

Increasingly, proxy advisory firms and other observers are pressuring companies to make sure that a given year’s performance targets represent an improvement over the prior year’s results. However, a rigid requirement that targets should only increase may not always be appropriate, especially in cyclical industries, in cases of a significant divestiture or other corporate reorganization, or when macroeconomic conditions are deteriorating rapidly – as was the case at the onset of the 2008 recession. In the event a company is considering a year over year reduction in an incentive target, a clear and proactively communicated business rationale for the lower target is essential to ensuring acceptance by investors.

	Relative	Absolute
Internal	Performance compared to prior year's results <ul style="list-style-type: none"> • Simple • Easily communicated • Fosters continuous improvement 	Performance against budget <ul style="list-style-type: none"> • Promotes buy-in • Continuous monitoring • Can be applied to discrete business units
External	Performance against peer group <ul style="list-style-type: none"> • External validation • Incorporates unanticipated factors • Not subject to negotiation • Simple 	Performance against stock price target <ul style="list-style-type: none"> • External validation • Reflects shareholder expectations • Continuously available information • Simple

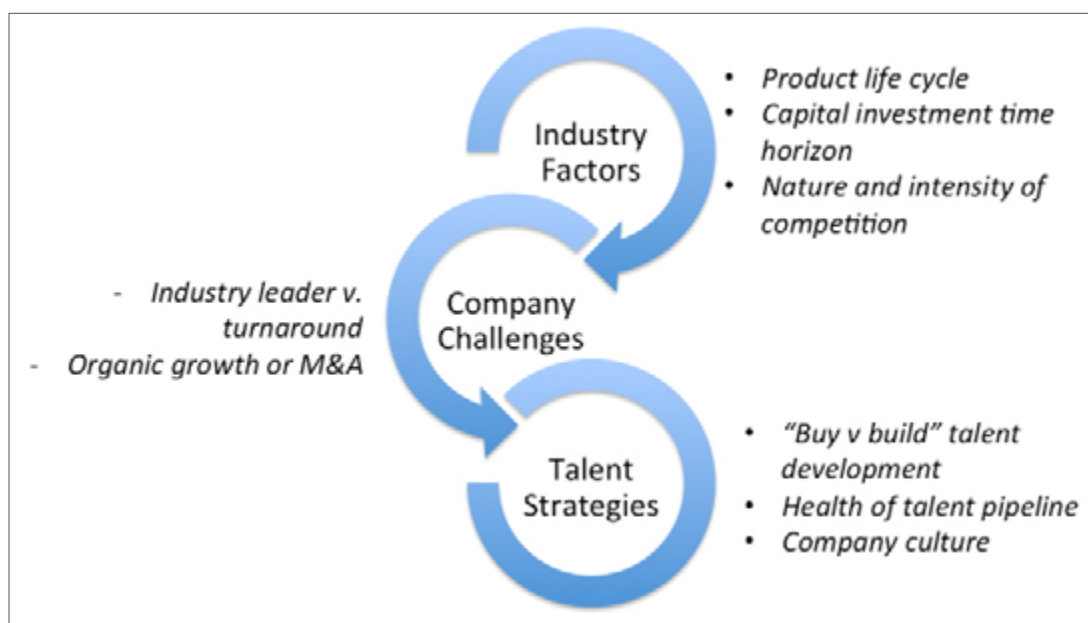
Establishing the Minimum

A fundamental principle of performance-based compensation design is that as performance falls short of the target, pay correspondingly declines; and at some point, performance levels deteriorate to such a low level compared to expectations that no pay is earned. Establishing the threshold level of performance and the resulting amount of pay that will be earned sets the starting point of the performance-pay relationship.

An analysis of historical data can be helpful in understanding the degree to which performance against the selected metric varies from year to year, as well as

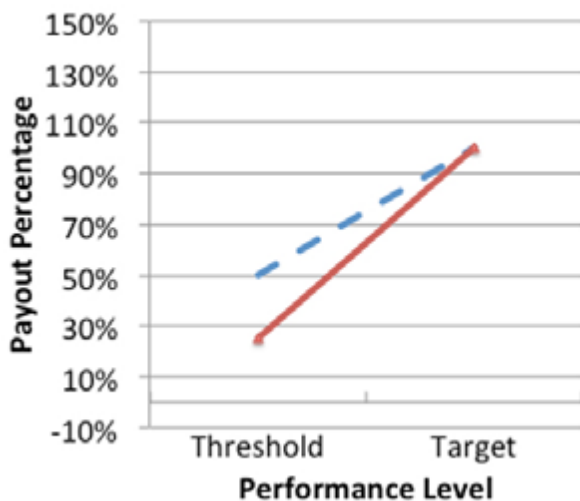
how the company's actual performance relates to its planned or budgeted level. If results have been highly variable from year to year, Boards should consider setting a threshold level of performance that reflects the fact that there is a significant probability that in any given year, performance may fall substantially short of target. In contrast, a metric that is highly predictable and shows little volatility from year to year argues for a narrower corridor between threshold and target.

Setting the threshold level of performance is only part of the equation; determining how much pay should be earned at threshold is more subjective. Many companies and Boards look at prevailing practices to set the



appropriate payout level; but increasingly, investors and others are putting downward pressure on threshold payments. This desire to put "teeth" into the pay-for-performance relationship by creating significant downside may be appropriate; however, Boards should carefully evaluate the risk-reward tradeoff that results from this approach.

As the chart below shows, setting the “cut in” payout percentage (the percentage of the target award that is payable at the threshold level of performance) at a very low level without also lowering the threshold level of performance can create a steep payout curve. This creates a situation where each incremental unit of performance carries with it a big potential payoff in the form of increased incentives.



Determining the Maximum

Once the target and threshold levels and payouts have been determined, compensation committees must decide “how much is too much.” In a perfect world, there would seem to be no reason to truncate the performance-pay relationship; if high performance is a good thing, isn’t higher performance even better? But just as management’s downside risk is limited (at a zero payout), the upside opportunity is typically capped at a certain level. This limiting of upside potential also serves to limit management’s ability to realize windfall gains, and is cited as a “mitigation feature” to prevent excessive risk taking.

Just as the slope of the curve from threshold to target signals the Board’s risk-reward preference, so does

the slope of the curve from target to maximum. That relationship may not always be uniform from threshold to maximum. Boards who wish to encourage greater risk taking once the target performance level has been attained often implement an asymmetrical payout curve, with a steeper slope from target to maximum. In these cases, the curve must be evaluated and judgment applied to ensure that the slope is not so steep that it encourages excessively risky behavior and that the sharing of the returns attributed to incremental performance between management and the company is appropriate.

Once the points along the performance continuum are set, and the corresponding payout percentages established, the compensation committee should review the total cost of the incentive plan in relation to the operating profit performance that generated it. This “sharing percentage” evaluation gives the committee a sense for how much of the company’s profits are being transferred to its managers versus returned to shareholders or reinvested in the business and how this sharing varies along the payout curve. Determining the appropriate sharing percentage may be different in a turnaround situation, early in a company’s life cycle or if the company is operating in growing or mature markets. The concept of sharing of returns between management and shareholders is receiving increasing attention from investors as well.

The Role of the Board – Exercising Judgement

Ultimately, targets and the resulting payouts should be set using fact-based analysis, informed by the business judgment of the Compensation Committee and the Board. That judgment involves recognizing and balancing the potential conflicting interests of two key stakeholder groups – shareholders and management.

Boards play a critical role by exercising sound judgment in determining which performance metrics are appropriate for each element of executive compensation; in establishing incentive plan performance targets and payout curves; and in deciding when, whether and how to make adjustments to actual performance results in determining incentive plan payouts.

Prior to the 2008 financial crisis, the relationship between compensation design and risk taking was a topic raised infrequently – if at all – among compensation committees. But in light of the perception that outsized executive pay packages contributed to inappropriate risk taking on Wall Street, companies are now required to disclose the potential that the company incentive plans will expose the company to excessive risk. Color-coded stop light charts are now a regular part of the compensation committee agenda, and the risk assessment has become routine. Further, with the economic recovery progressing more slowly than many would like, companies are being challenged to develop strategies to deliver future growth. They may structure incentives to accumulate growth by encouraging risk; this tendency must be carefully balanced against encouraging excessive risk-taking.

Establishing Performance Metrics

As discussed in Part II of this series, “What You Pay for is More Important than How You Pay,” selecting performance metrics begins with a simple idea: **superior value creation results from sustained outperformance on industry-specific financial and non-financial drivers over time**. But while the idea is simple, selecting performance metrics that both satisfy shareholder interest for true value creation and are

seen by management as relevant and within its control can be challenging. Boards must exercise judgment in deciding whether the incentive plan performance metrics proposed by management are the best ones, or merely the ones with which management feels most comfortable. This judgment should be informed by a data-based, quantitative assessment of the relationship of the preferred metrics to value creation over time.

However, an analysis of historical relationships between metrics is by definition backward looking. Boards play a critical role in assessing to what degree the value drivers of the past will remain relevant in the future. Conversations with investors, industry analysts and even customers can shed valuable light on this question.

Setting Performance Targets

Once the metrics are established, Boards face the difficult task of evaluating whether the targets proposed by management are appropriate. Boards must assess the degree of difficulty inherent in the target and must do so without the benefit of the detailed information and insight on current market conditions possessed by management. This asymmetrical access to information emphasizes the importance of building a high degree of trust between management and the board, an in-depth analysis of past experience and knowledge of the risk preferences and capabilities of management, as well as industry and economic factors that will influence the degree of difficulty inherent in the performance targets.

Similarly, communicating the Board’s views on risk when setting the incentive plan payout curve requires a sophisticated understanding of business conditions, the macroeconomic environment, and the characteristics and skill of the management team. Balancing these insights is key to ensure that a desire to encourage stretch performance doesn’t translate into incentives that foster inappropriate risk.

Determining Adjustments and Exceptions

One of the most important areas where Boards exercise judgment is in determining whether, when and how to make adjustments and exceptions to the actual results that are used to calculate incentive payouts. Most often, Boards are asked to balance the desire of management to be held accountable only for performance that is within its control against the interests of shareholders who are not protected from the impact of external forces or unplanned events. Set in the context of increasing transparency in disclosure, and greater scrutiny by investors and proxy advisors, the result has been an increase in the “fine print” of incentive plans – detailed definitions of the incentive plan financial metrics and how they differ from what may be reported in financial statements, as well as a roster of events or actions that are to be included in or excluded from actual results in determining performance for incentive plan purposes.

This desire to anticipate and document in advance all of the potential events or situations that may impact the actual incentive plan payment stems in large part from management’s understandable desire to know in advance the terms and conditions that will determine its pay. For its part, the Board also benefits from having the rules established in advance, as the terms can be agreed in a more objective setting – before decisions on actual payouts must be made.

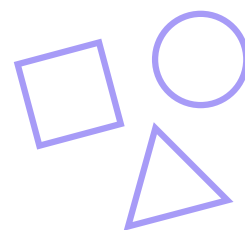
Unfortunately, this desire to define the rules of the game up front can turn incentive design into a formula-driven exercise, characterized by long lists of exceptions and exclusions designed to address a myriad of unanticipated events that may negatively impact the company’s performance. These exceptions and exclusions create unnecessary complexity and can erode investor confidence in the pay for performance connection.

Establishing in advance an overall philosophy, asking how much – or little – insulation against unplanned

events is appropriate through a constructive dialogue between the Board and management may help to enhance trust and a feeling of fair treatment in the determination of pay. Such discussions may cover events such as the impact of the recent global collapse of oil prices or the unexpected fluctuations in foreign exchange rates. However, it’s important to point out that not all unplanned events are the result of external factors; and shareholders do have an interest in ensuring that management does not avoid or defer taking a particular action (for example, investing in a new and promising product innovation) that would create long-term value because of its potential negative short-term incentive impact. Having a clear dialogue and understanding about the Board’s views on these issues will help mitigate the potential for unintended consequences of incentive plan design.

In determining its position on exceptions, both management and the Board should consider that the desire to codify every potential scenario in advance creates complexity – which, to the extent it makes the incentive plan difficult to understand, will limit its effectiveness. Simplicity in plan design can have significant advantages.

As Boards face increasing pressure to follow the prescriptive regime of proxy advisors and other governance activists, their ability to exercise informed business judgment in matters of executive pay becomes even more important. Because determining the key elements of incentive plan design – metric selection, target setting and the length of the performance cycle – is both art and science, Boards must increasingly apply their business judgment to appropriately balance the potentially competing interests of shareholders and management.



Executive Compensation Reimagined

The Case for a New Approach

Diversity and Inclusion Metrics in Incentive Design

SIGNS OF CHANGE ARE ON THE HORIZON

AMIDST THE TURMOIL created by recession, political and social unrest, and a global pandemic, executive compensation practices in the U.S. have remained relatively stable over the past decade. Pay for performance is still the predominant approach to compensation design in public companies, equity remains the primary vehicle for creating alignment with shareholders and pay levels for executives continue to rise.

But signs of change are on the horizon. Responding to the events of the last few years, companies are assessing their role in creating a fairer society, looking beyond the shareholder to consider how their actions affect the interests of other stakeholders. As calls for a more just society highlight the gender racial and ethnic disparities in all aspects of daily life, companies are evaluating how they can play a positive role in leading change.

Most large public companies are responding to the call for action by committing to do better – setting goals for improvement and taking actions to achieve those goals. These actions are often part of a larger commitment to address environmental, social and governance issues important to a broad group of the organization's stakeholders. As a result, the specific plans, strategies and approaches used differ across companies and industries. For some, these issues are critically important to the future of their business; for others, addressing a these concerns is driven by a commitment to company values.

Creating a more diverse and inclusive workforce involves a range of actions, including recruiting more diverse workers, ensuring equal access to opportunities, investing financial resources in underserved communities, understanding the life experiences of employees and working to create more inclusive corporate cultures. Some companies are going a step further, creating accountability for achieving results by linking performance on these initiatives to pay. In a recent analysis of disclosures by Standard and Poor's 500 companies, the Center found that 20% link diversity and inclusion (D&I) activities to executive pay.

Achieving more equitable workforce representation is a difficult task, involving complex and longstanding social challenges. Companies need a long-term approach that recognizes and rewards both ultimate outcomes and the milestones achieved along the way.

In this installment of our Executive Compensation Reimagined series, we'll explore how companies who have decided to incorporate D&I metrics into executive pay can apply established principles used in selecting financial metrics to address this important design challenge. We'll discuss the key steps in this process, including:

- **Clearly defining the overall objective of the D&I efforts and the actions needed to achieve success**
- **Using analysis to select metrics linked to the identified actions**
- **Ensuring the appropriate weight is assigned to D&I metrics**
- **Establishing the appropriate performance horizon, and allocating metrics between annual and long-term plans**
- **Setting realistic targets**

Defining the Goal – Workforce Representation

Choosing the right incentive plan metrics starts with understanding how the company defines success over the long term. When evaluating financial performance, total shareholder return (TSR) has become the most common example of a metric designed to measure how well a company is meeting its primary goal of creating value for shareholders.

What metric best represents the outcomes companies are seeking through their D&I efforts? Although not always explicitly stated, the primary purpose of D&I efforts in most organizations is to achieve a more equitable representation of women and people of color at all levels of the company. Companies may want to improve representation for altruistic reasons, or they may believe that doing so is “good for business.” Whatever the motivation, companies implement workforce diversity initiatives to improve the numbers.

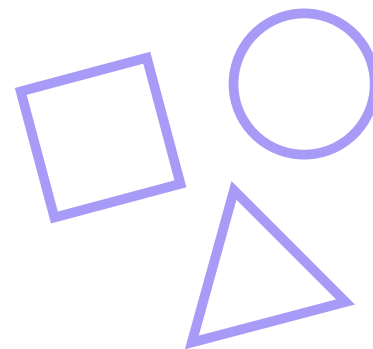
The Value-Driver Approach

Linking near term incentive rewards to actions that, based on empirical data analysis, can be shown to have a positive correlation with the achievement of a desired long-term goal.

Choosing Effective Metrics – Adapting the “Value-Driver” Approach

To effectively link the achievement of a goal to pay, companies look for incentive plan metrics that are quantifiable, determinable, and substantially within the control of management. As noted above, TSR is widely used in executive incentive plans even though management doesn’t control it directly. To compensate for TSR’s shortfall as an incentive metric, plan designers employ techniques such as lengthening performance periods to smooth out the impact of unplanned events and rewarding managers for performance on other metrics that help improve TSR over time - the “value-driver” approach.

Companies can choose D&I metrics using a similar approach. Adapting the techniques discussed in [Part II of this Series](#), statistical analysis can uncover the actions most likely associated with improvements in workforce representation over time. If companies want greater numbers of underrepresented individuals in senior management, they can start by deciding what actions they need to take to achieve that goal, and then quantify the impact of those actions over time.



These actions may include investments in accelerated development programs for underrepresented groups; enhanced and targeted recruiting efforts; actions taken to improve the engagement of targeted groups; and policies such as the “Rooney rule” that seek to ensure more diverse representation on candidate slates. Incentive plans can reward managers for taking actions that are likely to be most effective at driving sustainable increases in representation over time. This technique is used routinely with financial measures: annual incentive plans typically include profitability metrics (such as operating income) that companies believe will drive improved returns to the shareholder over time.

While most companies have had active D&I efforts for decades, not all have taken a structured approach to establishing goals, measuring outcomes, and evaluating the long-term success of those initiatives. As a result, they may not have enough quantitative historical data to complete a robust statistical analysis linking these programs to representation outcomes. In that case, in the near term they will need to rely on their best qualitative judgment about which actions are most likely to drive improvements in representation – and start measuring the outcomes delivered by these programs in the future.

When considering both financial and non-financial performance, no single metric or approach is appropriate for every company or every situation. Just as different financial metrics are more closely related to value creation in different industries, the actions needed to achieve a company’s diversity goals will depend on its specific circumstances, culture, history, location, and other factors. The “value-driver” approach can help companies identify a more robust range of metrics that balance the need for outcomes with the legitimate line-of-sight concerns of management.

Incorporating D&I Metrics in Executive Incentive Plans

After determining the long-term goal and identifying the D&I actions most likely to drive achievement of the goal, three more design challenges remain:

- How much impact should D&I performance have on the total incentive award?
- Over what time frame should we measure and reward progress?
- How do we set appropriate targets that balance the desire for progress with the need to ensure gains are sustainable?

Weighting of D&I Metrics

Once companies decide to include D&I metrics in an executive compensation program, they need to determine how much of an executive’s award should be at risk. Interested stakeholders are likely to interpret the weighting assigned to D&I metrics as a signal of how important the issue is to the company. But while companies may believe in the importance of improving representation, some are reluctant to link D&I performance to large amounts of pay. Why?



A common concern is the measurement challenge just discussed. Companies have had diversity initiatives for decades but haven’t made much progress in understanding what works. Years of initiatives bearing

little fruit breeds both frustration and a lack of confidence on how to make meaningful and sustained progress on improving representation. As a result, most are reluctant to incorporate metrics into incentive plans without a greater understanding of how to get results.

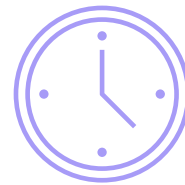
Others may be concerned about the optics of weakening an incentive plan's link to financial performance by the including D&I metrics. Because progress against near term diversity drivers may not translate into positive financial results, some fear weakening the pay-performance linkage they've worked hard to create and to communicate to their investors.

Plan designers will need to innovate in ways that show a serious commitment to D&I while recognizing the need to preserve a strong link to corporate financial performance. One potential solution: fund the total incentive pool for NEOs using the company's current financial measures while allocating individual awards based on D&I performance.

Establishing the Performance Period

Improving workforce representation takes time. To make progress, companies will need to hire more people from underrepresented groups and keep those they already have. But the pace of progress will depend on the state of the business. Is the company growing, resulting in many of new job openings? What is the age profile of the existing workforce – how many employees do you expect to retire in the next few years? Is the company going through a business transformation that can offer the opportunity to engineer a 'skill reset' of its workforce and create more hiring and promotional opportunities? Companies must 'do the math' to determine what's realistic in setting the performance period for workforce representation goals. Arbitrary goals that are disconnected from the reality of the business plan will fail.

While improving representation takes time, the drivers of progress are easier to move in the near term. For example, actions that foster the development and engagement of the current workforce and prepare current and future workers for success can be measured over shorter periods of time. Companies should consider implementing robust measurement systems to determine the success of these near-term actions in driving improved representation.



Annual or Long-Term Plan?

Determining the relevant time horizon over which to measure progress helps the company decide which D&I metrics they will include in annual incentives, and which are more appropriate in a long-term plan. For example, if the company's goal is improving representation of minorities at all levels, progress could take years. In that case, it may be more appropriate to include a representation goal in the long-term program. The more impact external factors have on the company's ability to achieve the goal, the longer it will take – and the greater the need to allow time for management to adapt and respond.

The specific actions taken to meet the long-term representation goal may be a better fit in the annual incentive plan. Companies should consider adopting quantitative metrics linked to specific actions they believe will improve recruiting, engagement, advancement, and retention of underrepresented groups. Just as yearly improvements in operating cash flow over time are linked to improved TSR, actions to increase the pipeline of qualified talent and keep it engaged and thriving in the organization can help drive long-term improvements in representation.

Setting Targets

Faced with minimal progress despite decades of effort, companies are struggling with how to set appropriate targets for their representation goals. Unlike financial metrics, they don't have data on what competitors are doing, so external benchmarking of progress isn't possible. Companies can access external data on labor force availability, but setting targets based on a labor pool where diverse talent is already underrepresented will do little to accelerate progress.



Because of this, most representation targets are best set relative to an internal benchmark – either an absolute standard or a measure of relative improvement over time. Based on what companies have learned about setting targets for metrics whose outcome is volatile or uncertain, a relative improvement target may be most appropriate when seeking long-term improvements in workforce representation. The target could also reward retention of existing talent separately from the hiring of new employees, so that managers have an incentive to work on creating an inclusive culture as well as filling new openings with more diverse candidates. Arbitrary, absolute targets – for example, 50% of managers will be women within three years – may make good external optics but may not be realistic or achievable.

The Path Forward

Executive compensation plans can play a supporting role in a company's efforts to achieve more equitable workforce representation. To make the link between D&I performance and executive pay most effective,

AMID INCREASING CALLS FOR TRANSPARENCY on D&I issues, companies have responded by disclosing more information than ever before on their efforts in this area. When these metrics are included in executive pay plans, companies will need to ensure their proxy disclosures adequately tell the story of the role of pay in supporting their D&I efforts. For examples on the current state of D&I disclosures, including goals linked to pay, refer to our sister publication, "Diversity and Inclusion Disclosures."

companies can benefit from applying the same level of rigor and analysis to selecting these metrics as they do when choosing how to measure financial performance. This will help ensure they select metrics that are quantifiable, determinable, and substantially within the control of management. Because improving workforce representation is a complex problem rooted in longstanding social issues, companies need a long-term approach that incorporates both representation and process goals. Rewarding outcomes and the actions needed to achieve them both have a role in a thoughtfully designed executive pay program, which should be tailored to meet the unique needs of each company.



Compensation committees can exercise oversight to the metric selection process and, when appropriate, apply informed judgment when approving payouts under the plan. The committee can provide input on assessing the progress being made, whether any gains are sustainable, and how incentives can be used to support the overall D&I strategy. Importantly, the Committee also plays a critical role in considering whether a particular incentive plan payout is advisable considering the overall context of the company's D&I efforts.