



THE STRATEGIC CONTEXT OF EXECUTIVE COMPENSATION

GUIDE TO EXECUTIVE COMPENSATION | PART 1

The role of the Chief Human Resources Officer continues to evolve in response to transformational changes in the economy, the workforce and in how work gets done. Yet even as the human capital agenda reflects an increasing emphasis on talent and the workforce of the future, executive pay remains one of the most critical areas of focus for today's CHRO. Over the decade since the financial crisis, significant changes have reshaped the context in which executive pay decisions are made – elevating this topic to one of today's top corporate governance concerns. CHROs face the challenging task of understanding the detailed design decisions that shape a pay program and designing executive pay programs that meet the strategic needs of the business. But many CHROs come to

the role with little experience in this complex field. We have developed this Guide to Executive Compensation as a starting point for CHROs and others who do not have specific subject matter expertise in executive compensation, but whose roles require an understanding of the external context, basic principles, and design considerations that influence pay program design. This Guide will provide a basic foundation for understanding the key elements of pay design, incorporating the perspective of the multiple stakeholders whose views have significantly influenced contemporary pay design. We have also provided links to more detailed resources for those who want to “go deep” on specific topics.

ABOUT THE CENTER ON EXECUTIVE COMPENSATION

Available only to HR Policy Association members, the Center On Executive Compensation provides deep expertise and advocacy on the top executive compensation and corporate governance public policy and practice issues facing Chief Human Resource Officers and their teams. The Center's 125 corporate Subscribers enjoy access to vast resources on executive compensation regulatory developments and implementation tools as well as detailed guides and resources on developing practices.



Designing an executive pay program offers the CHRO a unique opportunity to play a critical role in shaping business performance by effectively aligning the needs and interest of senior-level talent with business strategy. In the first installment of our Guide to Executive Compensation, we will examine the strategic context surrounding executive compensation. We will review the significant milestones that have shaped the current environment over the past two decades and examine the role of the key stakeholders in influencing pay practices and governance. We will also introduce an analytical framework for understanding executive pay design.

WHY IS EXECUTIVE PAY DIFFERENT?

Even a casual observer of human resources practices is likely aware that executive pay is distinctly different than the pay practices that apply to non-executive employees – and not just because the amounts are larger. The topic of executive pay is increasingly the subject of media attention and political activity, and missteps in this area can impact the reputation of a company. What makes executive pay unique?

One of the most significant factors differentiating executive pay from the pay programs designed for the rest of the workforce is that because of its strategic importance, there are multiple stakeholders who exert influence on both the process for determining executive pay and the outcomes delivered by executive pay programs. Quite simply, more people with more influence care about executive pay.

Who are these stakeholders, and why do they care? In this installment of our series, we'll examine five major stakeholder groups: investors, proxy advisory firms, government, media, and employees. These major

stakeholders have vastly different motivations and interests for engaging on the issue of executive pay. Some feel executive pay should be subject to more scrutiny because of the impact that executives have on the lives and wellbeing of millions of workers. Others point to a growing societal concern regarding income and wealth inequality and view rising levels of executive pay as a contributory factor.

But stakeholders concerned with social issues are not the only ones who take an interest in executive pay. Investors – especially activists – view executive pay programs as an important indicator of alignment of interests between management and shareholders, and a “window” into the mindset and operations of the Board and Compensation Committee. Heightened scrutiny on the process by which executive pay is determined has made this topic a top governance concern with the ability to impact the reputation of the board and company – and not usually in a positive way. The heightened scrutiny on executive pay means that how – and how much – a company chooses to pay its top executives communicates important messages to all of its stakeholders – about its business strategies, financial outlook and approach to talent.

THE BOTTOM LINE: Executive pay is different than employee pay because of the context in which it exists – an environment characterized by multiple, diverse and influential stakeholders that care about both the process by which pay is determined, and the outcomes of pay programs. CHROs play a key strategic role in helping shape executive pay programs that align talent and business strategies.

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KEY STAKEHOLDERS IN EXECUTIVE PAY

- Investors
- Proxy Advisory Firms
- Government
- Media
- Employees

HOW DID WE GET HERE?

Today's executive compensation landscape has been shaped by economic, regulatory and social forces that have emerged over the past two decades. Beginning in 2001, a series of high-profile corporate scandals in the US helped usher in a renewed era of regulatory scrutiny of the governance practices of public corporations. By the middle of the decade, new and more extensive disclosures had been mandated by the US Securities and Exchange Commission (SEC), increasing the transparency of both the process by which executive pay is determined and the amounts awarded.

The onset of the global financial crisis and subsequent economic recession accelerated the momentum for increased regulation of executive

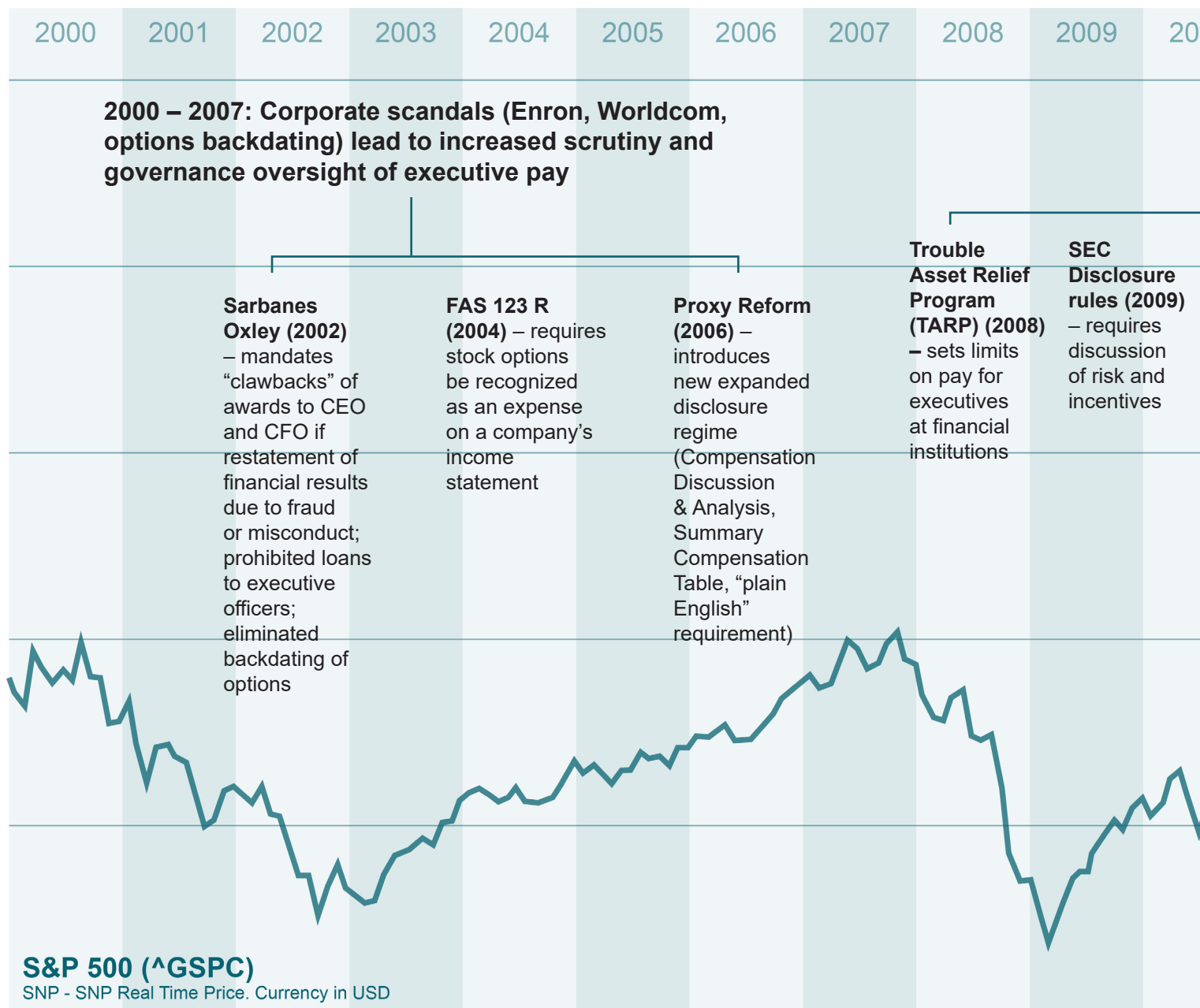
pay. The passage of the Dodd-Frank Act in 2010 has had a significant impact on the governance and disclosure of executive pay in the US, most notably through the requirement that companies put their pay programs to an advisory vote by their investors (known as a "Say on Pay" vote).

The aftermath of the recession also gave rise to increasing concerns about income inequality and the unintended consequences of globalization. These broader issues have found their way into the executive compensation dialogue, resulting in attempts to use financial disclosure regulations as a tool to advance social causes. The Dodd-Frank provision requiring companies to disclose the ratio of CEO pay to that of the median worker is the most prominent example.

WHAT IS SAY ON PAY?

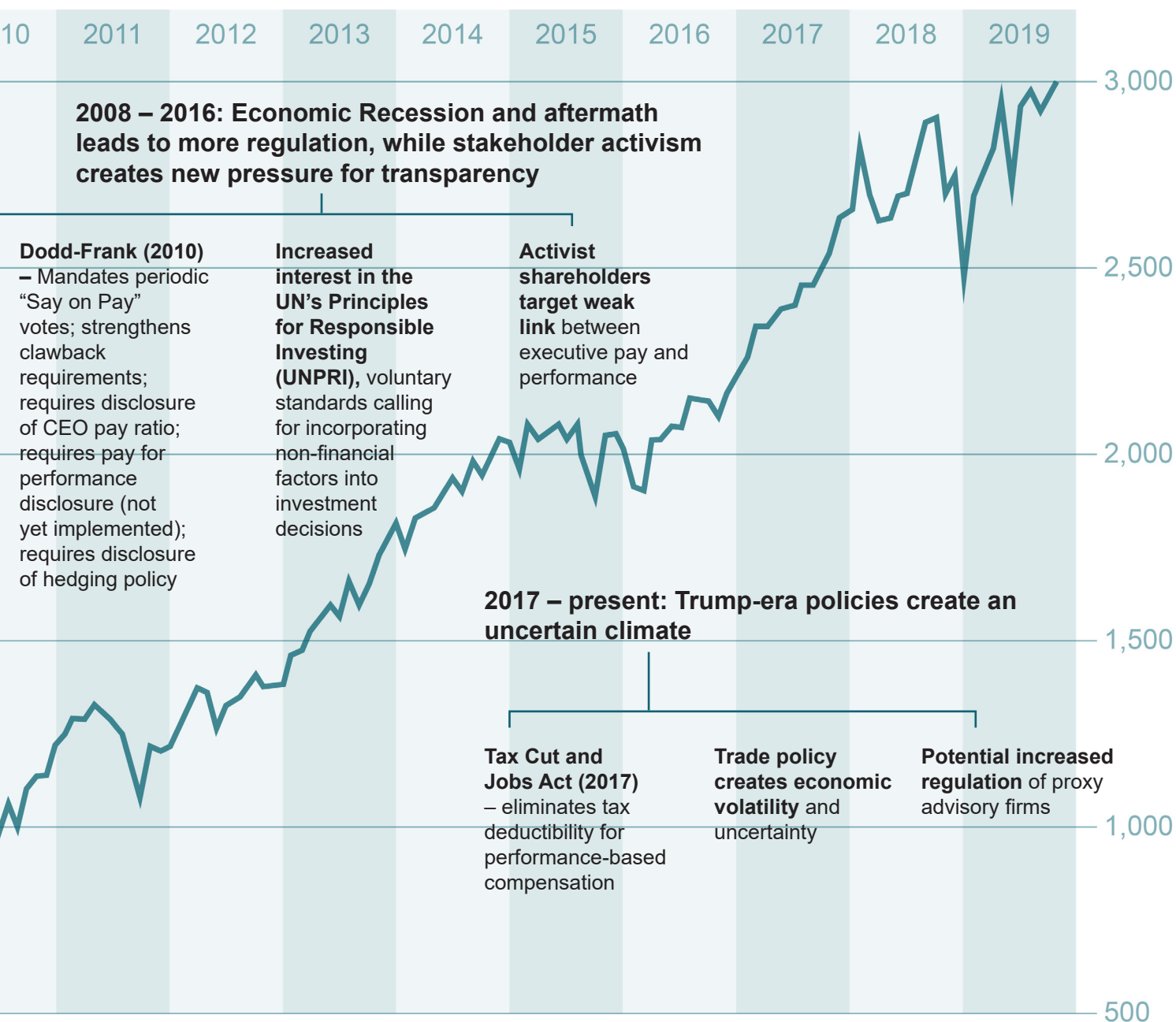
As included in the 2010 Dodd-Frank Act, Say on Pay is a mandatory, nonbinding shareholder resolution which asks investors to approve the compensation package for a company's "named executive officers" (the CEO, CFO and top three most other highly compensated executive officers). Even though the vote is advisory only, its impact has been significant. Say on Pay has increased the level of engagement between companies and their investors, often yielding positive results. However, Say on Pay has also increased the influence of proxy advisory firms – who have come under criticism by companies for the accuracy of their reporting as well as potential conflicts of interest.

MILESTONES IN EXECUTIVE COMPENSATION



With the Republican Party regaining control of the Presidency and the Congress in 2016, the pace of regulatory activity in the area of executive compensation has slowed. One exception is an effort to impose new restrictions on proxy advisory firms.

As we’ll discuss below, proxy advisors are an important resource for investors but have been heavily criticized by companies for the role they have played in executive pay governance.



THE BOTTOM LINE: Over the past two decades, increased transparency and greater oversight, often in response to larger economic or social concerns, have shaped the current climate surrounding the design and governance of executive compensation plans.



WANT TO KNOW MORE?

Read the Center's "[Guide to Institutional Investor Proxy Voting Policies on Executive Compensation](#)"

THE STAKEHOLDERS

The presence of multiple influential stakeholders creates a unique environment impacting the design and governance of executive pay plans. These stakeholders care about both the process for determining pay and the outcomes delivered by pay programs - and they often hold very different views on key issues. Some view executive pay in a larger societal and political context, while others take a narrower performance-based perspective. The CHRO is well-positioned to help the CEO and Board understand and balance the interests of these groups, ensuring that pay programs support the achievement of the company's near and long-term objectives. Below, we'll review the key characteristics and motivations of five major stakeholder groups.

INVESTORS

One of the most influential stakeholders in the executive pay process are investors. As the owners of public companies, investors have a significant interest in how executives are paid, and they rely on their elected representatives (the Board of Directors) to protect those interests. Investors exert influence on pay issues in two ways - through engaging directly with the Board and management; and through formal governance processes – such as the periodic Say on Pay vote, submission of shareholder proposals, and the election of directors.

Institutional Investors

Institutional investors own approximately 80% of the market value of the stocks comprising the S&P 500 and Russell 3000 indices – and as a result, they exercise considerable influence on the governance activities of most public companies. Institutional investors include mutual fund companies, pension funds, endowments, and sovereign entities. Each type of investor tends to have differing points of view on executive compensation and follow different paths to try and influence change. Large **mutual fund companies** tend to favor a close connection between pay and long-term shareholder returns; however, they don't frequently vote against management on a Say on Pay vote or compensation proposal, seeking to influence outcomes by discussing their concerns directly with the company. **Pension funds** often express concerns if the amount of pay is viewed as excessive – regardless of the connection to performance – and are more likely to vote against management on pay issues. **Endowments** and **sovereign entities** will generally control a comparatively smaller portion of the voting power and may be less likely to try to influence outcomes through direct engagement with management.

The CHRO plays a key role in ensuring the company engages effectively with institutional investors by collaborating with internal investor relations and finance professionals to ensure the company's messages on executive pay are clearly communicated and understood.

LARGE INSTITUTIONAL INVESTORS

- **Mutual Fund Companies**
 - BlackRock
 - Vanguard
 - State Street Global Advisors
- **Pension Funds**
 - California Public Employees' Retirement System (CalPERS) / California State Teachers' Retirement System (CalSTRS)
 - NYCERS (NYC Public Pension Funds)
 - United Auto Workers (UAW) Retiree Medical Benefits Trust
- **Endowments**
 - Harvard Management Company
 - Stanford Management Company
 - Bill & Melinda Gates Foundation
- **Sovereign Entities**
 - Government Pension Fund Norway (managed by Norges Bank Investment Management – part of the Norwegian Central Bank)
 - China Investment Corporation
 - Abu Dhabi Investment Authority

Activist Investors

While there is no universally agreed definition of shareholder activism, the phrase is commonly used to refer to the strategies and actions employed by an investor with the intent of bringing about change in a publicly traded company. Activist investors can be categorized by looking at the goals they seek to achieve:

- **Financial** – Improving the underlying financial performance of the firm, particularly with regard to stock price.
- **Strategic or Structural** – Advocating the sale of non-core assets; separating or spinning off a business; or a major change in business strategy.
- **Corporate Governance** – Advocating the removal of a CEO and/or members of a company's board; attacking "excessive" or "misaligned" executive pay or perquisites; addressing other governance issues.
- **Social** – Advocating action on environmental issues; opposing investments in politically sensitive parts of the world; advocating for workers' rights.

At a minimum, most activists will challenge executive pay, and the board's governance of pay, if they view pay as excessive or significantly misaligned with performance. However, depending on the activist's goals, their views and perspectives may be quite different. Activists who focus on social issues will often target executive pay levels (regardless of the linkage between pay and performance) as a contributing factor to rising levels of income inequality. Other activists who are more financially focused believe strongly in aligning management's interests with those of the shareholder and are very supportive of incentive designs that provide significant upside pay opportunity for superior performance. Overall, most activists will be very interested in making certain that executive pay programs are connected to the company's strategy and have a clear and direct link between pay and performance.

Stock Exchanges

Although they are not investors, stock exchanges play a role in the governance of executive pay. The two major US exchange – the New York Stock Exchange (NYSE) and Nasdaq - maintain listing standards (in addition to the SEC’s disclosure regulations) that companies need to follow in order to have their shares traded on the exchanges. For example, the NYSE stipulates that all members of a company’s Compensation Committee must be considered independent by meeting certain criteria.

PROXY ADVISORY FIRMS

Proxy advisory firms provide analysis and vote recommendations to institutional investors on matters submitted by public companies for shareholder approval. In the US, there are two proxy advisory firms which control approximately 80% of the market: Institutional Shareholder Services (ISS) and Glass Lewis.

These firms develop broad voting policies on a range of issues put forward for a shareholder vote, including executive compensation, corporate governance, mergers and acquisitions and environmental & social issues. Their institutional investor clients may require the proxy advisors to use customized voting policies based on the investors views and preferences. However, many institutional investors do not have the internal resources to conduct their own analyses, and instead vote according to the proxy advisor’s recommendations.

Because ISS and Glass Lewis serve such a large number of US institutional investors, their vote recommendations can have a significant effect on the outcome of a given proposal. For example, if ISS recommends that shareholders should vote against a say-on-pay proposal, support for that proposal may decline by up to 20% to 25%.

When it comes to their recommendations on executive compensation matters, proxy advisory firms have been the subject of intense criticism from public companies for several reasons:

- Failure to meaningfully engage with companies to understand their pay programs
- Lack of indepth knowledge and understanding of how pay programs operate
- High rate of factual and interpretive errors
- Potential for conflict of interest, including providing consulting services relating to voting recommendations

In late 2018, the SEC began a review of the current regulatory regime governing proxy advisors. Legislation has also been introduced in the Senate that would subject proxy advisors to more stringent regulation, addressing many of the concerns expressed by public companies.



WANT TO KNOW MORE?

Check out [“Shareholder Activism and Executive Pay: An Overview”](#)

GOVERNMENT

The increase in regulatory and governance oversight of executive compensation over the past two decades is a major characteristic of the current landscape. Around the world, governments have become key stakeholders in the executive pay process. In the US, at the federal level the role of government in this process is divided between Congress and the Executive Branch.

Legislative action impacting executive pay issues is typically included within legislation dealing with broader financial system issues or revisions to the federal tax code. For example, Say on Pay, the CEO Pay Ratio and many other

new requirements were included in the Dodd-Frank Act, a comprehensive overhaul of the regulations governing the US financial system. Similarly, executive pay is often impacted by tax-related legislation. As a result, jurisdiction over matters involving executive compensation generally resides with committees dealing with the financial system: the House Financial Services Committee, the Senate Banking Committee and the Senate Finance Committee.

However, the government stakeholder with the most direct day-to-day impact on executive pay is not Congress, but an agency of the Executive Branch. The Securities and Exchange Commission is the major regulator of financial markets in the US. As part of its role, the SEC determines what information companies must disclose to shareholders so that they can make informed investment decisions. Over the last 20 years, the SEC has increased the information companies must disclose about executive pay, both in terms of the process used to determine pay and the actual operation of pay plans.

The SEC has also been tasked by Congress with writing and implementing regulations that go beyond what traditionally would have been considered part of financial market operations. This has resulted from legislative mandates that were driven by political considerations; most notably, the CEO pay ratio disclosure requirement included in the Dodd-Frank Act in the wake of the 2008 financial crisis. Advocates for the pay ratio sought to highlight the large and growing disparity between CEO pay and that of the “average” worker, bringing attention to the social issue of rising levels of income inequality.



WANT TO KNOW MORE?

[Read the Center’s Comment Letter to the SEC](#)

MEDIA

Two broad categories of media stakeholders are interested in executive compensation – the traditional business press and the non-business media. The traditional business press includes widely read newspapers such as the Wall Street Journal and the Financial Times (including The Economist magazine), as well as TV networks Bloomberg and CNBC. The stories covered by these organizations focus more on financial, business and governance issues and are generally viewed as more aligned with the views of large companies. The traditional business media is more likely to highlight a CEO’s accomplishments rather than overtly supporting or criticizing his or her compensation package.

The non-business media includes major national and regional newspapers and broadcasters, and public media such National Public Radio (NPR) in the US and the British Broadcasting Corporation (BBC) in the United Kingdom. Journalists in non-business outlets are less likely to develop a thorough understanding of the complexities of executive pay than their business media counterparts, and more likely to approach CEO pay through a critical lens. For example, non-business media may find stories covering ratio of CEO-to-median worker pay more relevant to their readership than other pay-related issues.

Regardless of whether a media outlet is more business-oriented or more targeted to a general audience, examples of extremely high levels of executive pay, or instances of poor board oversight of pay generate headlines. High levels of pay for executives of a company announcing layoffs, or large severance packages for a departing CEO are almost certain to receive media attention across the spectrum – and create challenges for companies and their public relations teams.

EMPLOYEES

Since most pay programs are designed to attract, retain, motivate and reward executives for desired behaviors and performance, it stands to reason that senior executives are important stakeholders in the process. Although most of the regulations governing pay apply to a small group of executives, the overall climate surrounding executive pay influences the design of programs beyond just the C-Suite. As talent and culture become increasingly acknowledged as key drivers of sustainable performance, pay programs that executives understand and view as fair will become increasingly important.

While not directly impacted by the executive pay process, the broader employee population in a company can be an important stakeholder in the process. Now that the compensation of a company's median worker is published as part of the CEO pay ratio disclosure, companies may find an increasing demand for information about pay programs generally, including such potentially contentious issues such as gender pay ratios.

Employees – particularly those represented by labor unions – may also view high levels of executive pay as evidence of increasing societal inequality. They may question the fairness of rising executive pay levels at the same time as many of the financial foundations of the traditional employment relationship have been eroded – defined benefit pension plans have largely disappeared, and health care costs continue to far outpace growth in wages. Employee interest in executive pay can provide CHROs a platform to implement broad communication strategies that highlight the company's total reward strategies and engage employees in a dialogue about the company's broader employment value proposition.

THE BOTTOM LINE: Designing and managing executive compensation programs requires balancing the interests of many influential stakeholders with differing objectives, interests and motivations.

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DEVELOPING A PAY STRATEGY: THE THREE QUESTIONS

In the next three installments in this series, we will examine the principles involved in designing an executive compensation strategy. To do this, we will frame our discussion around three fundamental questions:

1. How much should we pay?
2. What should we pay for?
3. How should pay plans be designed?

Part 2 of our series will examine the starting point of any pay strategy – determining “how much” your executives should be paid. We’ll discuss the concept of developing a target level of pay, measured against a reference point – a “peer group.” Peer group selection is a key strategic decision, encompassing both business and talent considerations, and is a subject of great interest among key stakeholders.

Once the target pay level is set, the second strategic decision is to determine what criteria will be used to determine how pay will vary from that target level. Part 3 of our series will discuss the question of “what should we pay for?” For

most companies, the answer is some measure of financial performance. The selection of the right measure of performance, and the level of performance needed to determine a given level of pay, are among the most important - and potentially contentious – pay design decisions.

The final step in the process is to translate the overall intent into decisions on how pay plans will be structured. Part 4 of our series discusses the detailed questions of “how” pay programs should be designed. What percentage of total

pay should be in cash versus stock? How much should pay vary with performance? What about severance and change in control arrangements? How do the choices made in program design reflect and support the company’s talent strategy?

In each part of our series, we’ll review the design considerations, shareholder and stakeholder reactions, governance requirements and financial considerations involved at each step of the process.

DESIGN CONSIDERATIONS

What are the major design decisions that need to be made in determining how much to pay, what to pay for, and how to deliver pay?

SHAREHOLDERS AND STAKEHOLDERS

How do shareholders and other key stakeholders view various design features? What decisions raise particular concerns for various groups?

GOVERNANCE AND DISCLOSURE

What are the key governance decisions that need to be kept in mind when making major design decisions? How does disclosure impact design?

FINANCIAL IMPLICATIONS

What are the financial, tax and accounting considerations involved in various design decisions?

We will conclude our series with Part 5, an in-depth look at the unique challenges associated with working with the Board’s compensation committee.

REFERENCES AND RESOURCES

Link to exchange listing standards relating to executive compensation.

UP NEXT

In Part 2 of our series, we’ll explore in detail the question of how companies determine how much to pay executives.