



HOW MUCH SHOULD WE PAY?

GUIDE TO EXECUTIVE COMPENSATION | PART 2

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.

In Part 1 of our series, we examined how executive pay is different than employee pay because of the context in which it exists – an environment characterized by multiple, diverse and influential stakeholders who care about both the process by which pay is determined and the outcomes delivered by pay programs. CHROs play a key strategic role in helping their organizations navigate this challenging environment by designing pay programs that are aligned with company strategy and appropriately reward key outcomes.

A starting point in the design of an executive pay program is determining how to answer the question, “How much should we pay?” In this installment of our series, we will discuss two factors involved in determining the right level of executive pay – establishing the appropriate target pay level (“how much?”) and selecting the right comparative benchmark (“compared to whom?”). Both of these questions will generate significant interest from important stakeholders. In addition to concern over a company’s choice of comparative benchmarks, in the years since the financial crisis some stakeholders have expressed the view that executive pay levels on an absolute basis are simply too high, regardless of comparative benchmarks or company performance.

01

DESIGN CONSIDERATIONS

ESTABLISHING THE APPROPRIATE TARGET PAY LEVEL

Most companies seek to set pay at the level that will allow them to attract and retain the talent they need to drive business outcomes. When it comes to executive pay, influential stakeholders have created significant pressure on companies to limit their targeted pay levels – what they “expect” to pay in any given year – to the median of their selected benchmark. While it is understood that actual pay levels will vary above and below the target (based on factors such as performance), most publicly traded companies establish their target pay position at the median of an external comparator group. Companies that intentionally set their target pay levels above the median must persuade key stakeholders – especially proxy advisory firms and certain investors – that such positioning is warranted.

DEVELOPING A PAY STRATEGY: THE THREE QUESTIONS

- How much should we pay?
- What should we pay for?
- How should pay plans be designed?

Deciding how much to pay executives exposes a source of potential tension in the executive compensation process – the aligned but not identical interests of management and shareholders. All things being equal, executives (like any other employee) would prefer more rather than less pay. Shareholders, as owners of the company, have an economic interest in paying the least amount possible for the quality of management they need to deliver the value they expect. The CHRO plays a difficult but essential role in helping the Board balance these competing perspectives in a way that is in the best long term interests of the company.

The business and talent context in which the company operates can also influence where a company sets its executive pay targets. For example, an organization in a turnaround or transformation situation may need to establish an above-median target pay position. While this may be counter-intuitive to some stakeholders (such as the non-business media), an organizational transformation is a high risk proposition, and the executives with the skills needed to deliver success will expect to be well compensated. In these types of cases, companies often create pay packages that may be targeted at the median for average performance but contain significant and rapidly

escalating upside payouts if performance exceeds expectations. We'll look at this pay-performance linkage in depth in Part 3 of our series.

Similarly, companies may target their overall pay at the median of their benchmark but set different targets for the components of their pay package. For example, they may target one element of pay (such as base salary) below the median of their benchmark, making up for it by targeting a different element (such as stock compensation) above the median. This approach is more than just getting the numbers to balance out; targeting different components at different levels sends a signal to the organization about what is important and valued by the company. For example, a low target base salary level combined with a high target incentive level can be seen as encouraging more risk taking, as the certainty of fixed pay is minimized in favor of the uncertainty of incentive pay. We'll examine the various components of pay in more detail in Part 4 of our series.

02

SELECTING THE RIGHT REFERENCE POINT – THE PEER GROUP

Because they compete in external markets for both customers and talent, most companies believe that pay levels should be set relative to an external benchmark. This external reference point takes the form of a group of companies known as a peer group.

Selecting the right peer group may appear to be a straightforward exercise – but in practice it can be difficult and invite the criticism of influential stakeholders. To understand this tension, it helps to identify the ways that peer groups are used.

IN THE CONTEXT OF EXECUTIVE COMPENSATION, PEER GROUPS ARE USED IN THREE PRIMARY WAYS:

- To compare the **amount of pay** being delivered – both planned and actual
- To compare pay program **design and practices**, such as whether and how companies use stock compensation, how they approach severance payments, etc.
- To compare company **performance** for the purpose of determining incentive compensation payouts

Given the potentially conflicting interests of management and shareholders when it comes to executive pay, the establishment of the compensation peer group can be contentious. Specifically, stakeholders such as proxy advisory firms have taken the position that management teams can (and often do) intentionally select peer companies that are higher paying, thus raising their own pay. As a result, proxy advisory firms have their own methodologies for selecting peer groups, which they use when evaluating a company's pay program. The resulting peer groups often differ significantly from the company's selected peer group and have been the source of dispute between companies and proxy advisors.

PURPOSE OF THE PEER GROUP

Before peer companies are selected, it's important to define how the group will be used. Peer groups that are used solely to measure performance for incentive plan purposes typically consist of industry peers – those against whom the company competes in the marketplace. These peer groups are often selected for a limited and specific purpose – for example, to measure performance against selected financial measures for a single period (such as a plan or calendar year). In selecting performance peer groups, there should be consistency

PROXY ADVISORS AND PEER GROUPS: One company’s response to concerns raised by proxy advisors indicates how companies carefully select comparators that they believe accurately reflect a holistic view of their company. Alexion Pharmaceuticals provided a detailed explanation of its peer group selection criteria, and concluded:

“After extensive consideration of generic pharmaceutical and animal health companies which are designated as peers by certain proxy advisory forms, the committee does not believe that companies in those industries represent an appropriate comparator group because the nature, size and innovation required of these businesses, market demand and influences, and employee and investor perception of these companies are all fundamentally different from Alexion.”

Source: Alexion Pharmaceuticals 2019 proxy statement

with the peers used by the company’s finance and strategy teams in evaluating business performance and setting company strategy.

A performance peer group is often different than the peer group used to compare pay levels, pay practices and program design elements. Peer groups used for these purposes often include a range of companies that go beyond a narrow industry focus – including commercial competitors, labor market competitors, and sometimes even companies with little direct relationship to the company’s business but who may share similar operational or financial characteristics (such as profitability, global footprint, or business model). Companies that use a broadly defined peer group seek to reflect a multidimensional view of their unique history, operations and talent, which they believe provides a more accurate reflection of their competitive landscape – and a more appropriate benchmark for comparison.

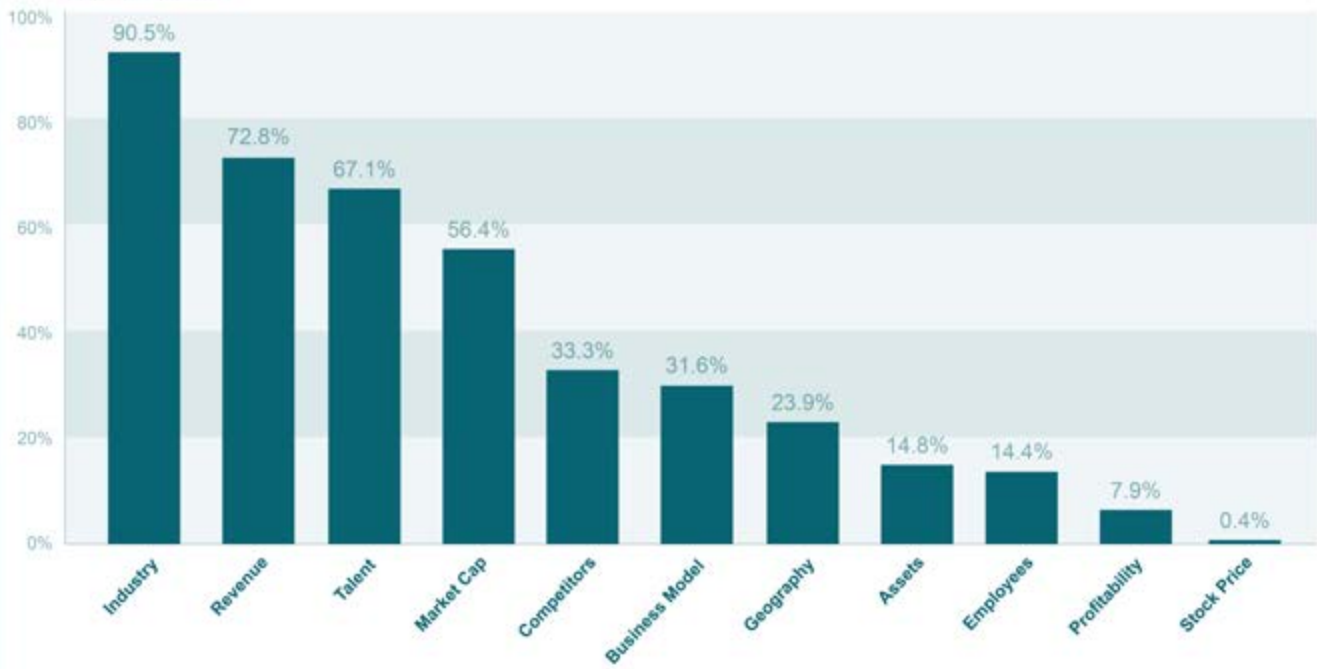
IN DETERMINING THE APPROPRIATE COMPENSATION PEER GROUP, COMPANIES SHOULD CAREFULLY CONSIDER THE FOLLOWING:

- **What is the purpose of the peer group – comparing compensation levels, practices or company performance?**
- **What is the appropriate size of the companies in the peer group, and how should size be measured?**
- **How many companies should constitute the peer group?**

PEER GROUP CRITERIA, EQUILAR 500

TABLE 1

SOURCE: Equilar, January 2019



SIZE OF PEER GROUP COMPANIES

While industry is the most common factor for selecting peers, size (as measured by revenue) is also extremely important (see Table 1). Determining the appropriate size of the companies in the peer group is important because of the relationship between compensation level and company size. Stated simply, companies with higher revenue typically pay their executives more. Because of this positive correlation between size and pay levels, critics of executive pay are wary of management populating peer groups with companies larger than their own in an attempt to boost their pay levels.

A study by Equilar, a data analytics firm specializing in executive compensation and governance issues, indicated that in fact most firms select peers that are comparable in size. The study found that in 2017 87% of firms in the Equilar 500 fell between the 25th and 75th percentile of their peer group on revenue.

NUMBER OF COMPANIES IN THE PEER GROUP

The size of peer groups varies considerably, but the majority of companies (70%) disclose a peer group of between 11 and 20. The challenge in constructing a viable peer group is to make sure it is large enough to provide meaningful data for comparison purposes, yet not so large as to include companies that are vastly different on measures of size or other business characteristics.

ARE EXTERNAL PEER GROUPS APPROPRIATE?

While the vast majority of companies establish pay levels relative to an external benchmark, Professor Charles Elson of the University of Delaware argues that such a system is based upon “flawed assumptions, particularly the easy transferability of executive talent.” He argues that by “basing pay on primarily external comparisons, a separate regime which was untethered from the actual wage structures of the rest of the organization was established.” He advocates for a process that sets internal pay equity as its objective.



WANT TO KNOW MORE?

Read “[Executive Superstars, Peer Groups and Overcompensation: Cause, Effect and Solution](#)”

03

SHAREHOLDERS AND STAKEHOLDERS

STAKEHOLDER EXPECTATIONS FOR TARGET PAY

As noted above, most companies establish their expected, or “target” pay level at the median of their comparator group. This reflects the influence of investors and proxy advisory firms over the past two decades. A company that seeks to target pay at a level above the median of their peers – for example, to attract talent needed to drive a turnaround or a transformation - should expect to receive significant scrutiny and will need a well-considered and effectively communicated rationale.

A median target pay position is almost always part of an overall pay philosophy that allows pay to vary above and below target based on company performance. We'll examine this pay for performance linkage in Part 3 of our series.

In the aftermath of the financial crisis, some stakeholders – media, labor unions, and investors such as union pension funds – have increasingly questioned the overall levels of executive pay, regardless of whether those levels are justified by market benchmarks or performance. These stakeholders point to rising levels of inequality as a serious social issue and call out executive pay as a contributing factor. They seek to focus attention on the issue by comparing the pay levels of executives to those of “average” workers in an attempt to redress what they believe is an inequitable distribution of company profits. The passage of the CEO pay ratio disclosure requirement as part of the Dodd-Frank financial reforms was the most visible result of the efforts of these stakeholders.

STAKEHOLDER VIEWS ON PEER GROUPS

The stakeholder group with the most interest and influence on the selection of a company's peer group are the proxy advisory firms. Because the peer group is the foundation of the proxy advisor's evaluation of a company's pay program, differences between their methodology and the company's approach can have significant consequences. In fact, peer group selection has been one of the greatest sources of tension between companies and proxy advisors.

Why are companies and proxy advisors at odds over peer groups? Both philosophical and operational causes help explain this disconnect. Proxy advisors – and some of their investor clients - believe that management has an inherent incentive to create peer groups that

will maximize their own compensation; and as a result, they view the company-selected peers with skepticism. More practically, while companies go to great lengths to create custom peer groups that reflect their uniqueness, the proxy advisory firms' operational models require the efficient and rapid processing of thousands of votes – a process that requires standardization, not customization.



WANT TO KNOW MORE?

Proxy advisory firms continue to adjust their peer group selection methodologies. In January 2020 proxy advisory firm Glass Lewis introduced a new methodology designed to result in a higher level of independence in its peer group and pay for performance analyses. The new methodology relies less on the “peer of peers” approach (which considers the connectivity between groups of corporate peers) and instead incorporates investor views and factors such as revenue, market capitalization and assets.

“By incorporating the investor view, we can avoid the “echo-chamber” effect and market-wide ratcheting on executive compensation levels that is encouraged by peer-of-peers methodologies that rely exclusively on how companies reference one another in their disclosures,” the company stated in its release announcing the new methodology.

[Read “Understand Glass Lewis' Approach to Peer Groups” here.](#)

04

GOVERNANCE AND DISCLOSURE

TELLING YOUR STORY

The establishment of a target pay position and selection of a peer group are foundational decisions underlying a company's executive pay programs. As such, clear and transparent disclosure is essential.

EFFECTIVE DISCLOSURES:

- **State clearly the company's target pay position and the reason for it. This is especially important if overall pay is targeted at other than the median; or if different components of pay are targeted at different levels.**
- **Disclose the peer group and discuss how it was selected. It is also wise to determine in advance with the Compensation Committee how changes in the peer group will be handled. Avoiding peer group changes other than those resulting from mergers, acquisitions and other corporate transactions will help avoid creating unnecessary investor skepticism and accusations of "gaming" the system.**

THE IMPACT OF THE CEO PAY RATIO ON TARGET PAY LEVELS

Some proponents of the CEO Pay Ratio disclosure requirement hoped that the expected negative publicity would act to reduce overall levels of executive pay. Based on data since the first disclosures in 2018, levels have not declined. While large CEO pay packages and high pay ratios have gained media attention, actual pay levels continue to increase.

05

FINANCIAL IMPLICATIONS

When determining a target pay level for executives, financial factors such as affordability are not generally a consideration since the amounts paid to executives are typically not material to a company's overall financial results. More important than the total dollars spent on executive pay is whether the amounts are appropriate in the context of the company's profitability, size, operations and strategic plan.

For example, a target pay position above the median of a peer group is always a challenge to defend but will be extremely hard to justify if the company is underperforming its own or investor expectations. If a company is transforming and requires new skills and experiences it doesn't currently have, an above target pay position

may be necessary to attract skills at a premium price in the labor market. That position should be communicated as a logical part of the company's business transformation story to all of its stakeholders.

Most importantly, the overall context in which the company is operating is key. Have pay or benefit levels been reduced for rank and file employees? Is the company's reputation under attack due to questionable behaviors by executives or unseemly business practices? Evaluating these circumstances and their impact on establishing a target pay position requires the sound judgment of the Compensation Committee and the Board.

REFERENCES AND RESOURCES

[Peer Group Choice and Chief Executive Officer Compensation](#)

UP NEXT

In part 3 of our series we'll explore the factors that determine the actual level of pay awarded to executives.