Winds Of Change In Executive Compensation As Propelled By Corporate Governance

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Overview

"Say on Pay" is a significant new factor affecting executive pay in North America and the UK. Regulators and shareholder-activists have demanded a shareholder vote on the company's executive compensation program. The trend has started gaining momentum more than three years ago in the U.K. and is now law in the US and Canada. Currently, the requirement is a simple one—each shareholder gets to vote on whether or not they approve of the company's executive compensation program. A typical resolution would read as follows:

RESOLVED, that the stockholders approve the compensation of the companies named executive officers as described in the Proxy Statement under "Executive Compensation" including the Compensation Discussion and Analysis and the tabular and narrative disclosure contained in this Proxy Statement.

As you can see, this is a very blunt instrument that simply asks the shareholders to vote on the entire package. They don't get to say whether it is too high or too low; they don't get to say whether they like the incentives but not the salaries; or they don't even get to say whether they approve of everything but the CEO's pay level.

While the impact of say on pay on corporate decision making is still working its way through, we would like to take stock of the issues and challenges that emerged so far, and postulate what implications say on pay may have in Asia as the executive compensation and corporate governance practices evolve.

Say on pay is premised on the basis that the rationale of any management proposals need to be made transparent to the shareholders in order to win their votes, albeit non-binding votes. First of all, let us review the challenges in making executive compensation decisions.

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The Dynamics Of Executive Compensation Decisions

There are a number of key challenges as described below, which if communicated well with the shareholders, would go a long way in gaining their approval.

Performance Information

While it is very much a well-accepted principle that incentives need to be correlated with the financial returns to the business, we have learned in the Global Financial Crisis that the returns need to be adjusted for the risk taken to achieve them as well as the time horizon of the risk. On the other hand, no single measure can adequately capture the true performance of a business. Multiple measures from multiple perspectives must be examined and balanced against one another in the incentive design. Incentives should be delivered only if there is certainty that revenue/profits will be realized—in the current financial reporting period as well as ultimately. In the event that compensation was delivered for performance that never materializes, there should be a mechanism to recover it. The recovery mechanism is via a clawback rule.

Furthermore, people are smarter than any pay-for-performance formulas, and pay decisions need to take into account some of the non-financial behavioral or strategic considerations. Along the same line, the conditions requiring clawbacks have expanded in some situations from the original narrow definition of financial restatement and ethical lapses and mismanagement of employees (who take material risk for the business) to future losses and write offs.

Market Data & Trends

It is important to be clear to shareholders that the market benchmarking is done appropriately. For example, the company must demonstrate that it has chosen the correct peer group (e.g., chosen on the basis of industry, size, business mix, or operating model). They should also demonstrate that the peer group selected is consistent with the investment community's view. The company must also illustrate that any proposed incentive payout takes into account performance in relations to the peer group. In other words, it is no longer a simple static comparison of pay position against the peer group. Investors are expected to challenge the bases of the compensation decisions. A well thought-out benchmarking approach would provide a sound basis for the compensation decisions.

Need For Retention

It is another truism that individuals can add great value to a business, and not adequately rewarding them constitutes an institutional risk. Talent retention need is, however, too often used as a general excuse for high compensation. As a Chairman once mused, "In good times, management asks for performance-based payments. In bad times, management says we must keep compensation competitive to prevent talent taking flight."

Retention incentives need to be thought through, just like any incentive plan. Who is at risk and what is the risk? How do the retentive mechanics work? How is the incentive delivered, over what time frame? Are there mitigating features?

The Role Of A Skeptic

While the corporate governance principle of disclosure and transparency has intended to ensure good practices, the principle on its own clearly has not been effective in preventing malpractices in executive compensation. This is seen time and again in the corporate scandals in the U.S. in the early 2000s and the Global Financial Crisis of 2008. When self governance by the board and management failed, shareholder oversight is seen as a savior. If that does not work, regulatory control is the last resort.

Executive compensation is filled with many interested parties and multi-faceted considerations. Directors have traditionally been nominated by the management and approved by the shareholders. Internal advisors such as CHROs or CFOs report to their CEOs, whose compensation proposals they have to prepare in a delicate fashion. External advisors, although increasingly being hired by the compensation committees, need to tread carefully between the board and the management. Market competition for executive talent, pay for performance, and unique circumstances of the company and executives all warrant due considerations in the compensation design.

The "say-on-pay" trends, and the potential of a "no" vote have surfaced the need to carefully consider these issues in an objective and rational manner. It has been the vehicle where executive compensation proposals have been challenged and has instigated a healthy debate in the board room.

While we are not advocating "say on pay" for Asia because it is an overly blunt tool that was created in an emotional environment, we do however advise companies to begin to review all their programs with an eye on the view of the shareholder. Due to Asia's generally concentrated shareholdings, there is already a powerful shareholder voice. However, as shareholdings become increasingly broadly held, these issues will become more prominent in Asia.

The proposed revised Singapore Code of Corporate Governance includes the following section in Principle 9 Disclosure on Remuneration:

> *9.6 For greater transparency, companies should disclose more information on the link between remuneration paid to the directors, the CEO and key management personnel, and performance. The annual remuneration report should set out a description of performance conditions to which entitlement to short-term and long-term incentive schemes are subject, an explanation on why such performance conditions were chosen, and a summary of the methods to assess whether such performance conditions are met.*

With or without say on pay, compensation committees and boards must demonstrate to investors that they are actively pursuing ways to link executive pay to performance. Investors will be looking for stronger links of short-term and long-term incentive plans and performance that has an impact on share price, and the reduction of unnecessary risk taking.

Call For Action By The Compensation Committee

Compensation committees need to understand that the playing field has fundamentally changed after the Global Financial Crisis, and this is not just a Western phenomenon. Companies should be prepared to discuss all significant compensation decisions and justify anything that could potentially be challenged as poor pay practice. They are expected to discuss actions taken to address any performance shortfall and steps taken to mitigate risks associated with existing compensation programs.

Compensation committees should consider taking the following preparatory steps towards disclosure:

- Understand your shareholder base and if you think shareholders may be critical of certain areas of your program, consider explaining the rationale for these program features and why they continue to make business sense for your company.
- Ensure that compensation committee members and committee advisors are not only independent in thinking but follow a due process to safeguard their independence.
- Assemble a team (internal and external) early, and coordinate efforts among Finance, HR, compensation consultant, management reviewers, and compensation committee reviewers that can challenge many of the assumptions that underlie the current program.
- Ensure that pay levels meet business and talent objectives while considering internal pay relationships (e.g., between the CEO and next-level), and external benchmarks such as those of a peer group.
- Demonstrate how the compensation plans align with financial performance and stock price, and support other business objectives that create shareholder value. This can be done by assessing incentive-pay measures and goals as well as incentive-pay mix (i.e., short-term and long-term incentives, and cash versus equity). Determine whether a quantitative analysis of historical pay-versus-performance makes sense.
- Use shareholder-friendly mechanisms such as stock ownership guidelines, stock holding requirements, and clawback provisions, where applicable.

Most importantly, you must be able to answer affirmatively to the following questions:

- Are your compensation plans performance-based and aligned with shareholders/long-term value creation?
- Are your compensation plans related to the business strategy and tailored based on size, industry, performance and competitive position?
- Does the plan articulate a coherent compensation philosophy appropriate to the company and clearly understood by directors?

Via disclosure, critical information is communicated to the shareholders. Your message should be clear, concise and understood by the shareholders. None of these can be achieved without a rational and well-thought-out compensation design. A good design is a prerequisite to quality disclosure. Both complement each other, but neither can substitute for the other. ■

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