

FAIR PAY

FAIR PLAY

Aligning Executive

PERFORMANCE

and

PAY

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SAME PROBLEMS, DIFFERENT CONTEXT

A Case in Point

When I walked into the boardroom, I saw four compensation committee members staring at me, eager to hear my presentation on how to retain the CEO of this publicly traded, high-flying company. The CEO had enjoyed meteoric performance, but he was threatening to quit if he didn't receive a generous helping of restricted stock¹ as part of his new employment agreement.

Weeks earlier, I had been called by the chairman of the compensation committee to provide advice to the committee regarding this matter. And while the members of the committee said they wanted my opinion concerning what they should do, my hunch was that they really wanted me to bless the CEO's requested grant.

Like most board and compensation committees, this one wanted to be supportive. It would be easier to say "yes" than "no." Further, the compensation committee thought that the CEO was doing a splendid job. The stock price had risen more than 50% since the CEO had taken charge three years prior. They figured that the company would be at considerable risk if they lost their "rock star" leader. After all, there was no successor in sight. On the other hand, the committee realized that what the CEO wanted was "over the top," and that they could be subject to undue criticism if they approved the requested package, particularly without an outside, objective opinion.

My report was not a surprise. I had telegraphed my preliminary findings well in advance of the meeting. My analysis showed that the requested grant would put the CEO's compensation well above the market, even considering the company's

high performance. As a result, I recommended a more modest grant, contingent on performance. I delivered my report to the compensation committee in the executive session, with the CEO absent from the meeting. The compensation committee heard my report and asked a few questions, and then the committee chairman excused me from the room.

A few days later, I called the chairman to see what had happened. He said, “The compensation committee was extremely pleased with your work, but decided to give the CEO what he wanted.” In fact, the board had penned a lucrative new employment agreement, complete with generous severance, change-in-control, tax gross-ups, and other bells and whistles. Of course, the news media had a heyday when the agreement was disclosed, and shortly thereafter, one member of the compensation committee even resigned from the board, although I suspect that it wasn’t only about CEO pay.

Fast forward to a year later, when the demand bubble for the company’s services burst and the financial performance collapsed. The CEO was asked to resign in return for the large severance deal that had been provided by his employment agreement. As the consultant who had given the compensation committee advice to pare back the sought-after restricted stock grant and apply performance hurdles, I felt vindicated that my advice had been sound, but not satisfied that it had been dismissed.

Is this a story out of today’s news? It sounds like it is, but it’s not. It actually took place a decade ago. But in a fundamental way it doesn’t really matter. Getting the pay-for-performance equation right is a long-running issue that remains an issue today. But why should we care? Does pay for performance really matter? Do incentives really motivate good performance?

The Role of Compensation

Among academics there is a great deal of debate regarding the motivational power of incentives. Some, such as Dan Ariely, James B. Duke Professor of Behavioral Economics, Duke University,

think incentives are not good motivators. “In experiments, we’ve seen that in some cases, people’s performance actually was lower the larger the bonus they got,” Ariely said. As a result, stock bonuses, stock grants, and other incentives are “probably better for creating loyalty than performance,” he said. Among other academics, some agree with Ariely; some disagree.

My own view from working on matters of compensation over the years is that good people, and top executives in general, are intrinsically motivated, but incentives provide a powerful messaging and focusing device. In addition, the market for executive labor is generally willing to pay more for an executive who produces great performance versus one who does not. For these reasons, incentives matter.

As for the question “Why should we care?” investors have said that *they* care. In a study conducted by the Center on Executive Compensation in 2008, twenty of the top twenty-five institutional U.S. equity investors were interviewed regarding their views on executive compensation. Investors resoundingly reported that the most important issue of concern was the alignment between executive performance and pay. Correspondingly, their second most important concern was having a compensation committee that they could trust and rely on to represent their interests. For this reason, we should care.

Nearly every board in America states that its philosophy for executive compensation is to align pay with performance (or words to this effect). This is not without reason. Not only is paying more for better performance intuitively appealing, it also has motivational value to executives and seems fair to investors. And although I have not proven causality, companies whose pay is more sensitive to performance also have better performance (as I’ll discuss later in this book). Further, corporate leaders are not living up to their pact with investors and employees if they don’t put real meaning behind the mantra “our objective is to align our executive pay with performance.”

Finally, pay for performance has become a biting social issue. The populist view is that executive compensation is the root of

all evil. In fact, some blame the largest financial collapse since the Great Depression on egregious executive pay. While I have not met anyone sophisticated in business and finance who agrees with this view, the fact of the matter is that it has built up a head of steam and is implicitly shaping public policy. According to a study conducted by Farient Advisors, the executive compensation and performance advisory firm I founded, the vast majority of board directors and executives feel as though greater government intervention will not only *not* solve the pay-for-performance issue, but could make matters worse.

Except for requiring clearer disclosure, there are almost always unintended and negative consequences to government intervention in matters of executive pay, the most famous of which was the decision made to cap the deductibility of non-performance-based pay at \$1 million for certain executives in public companies. As a result of this governmental decision made in 1993, early in the first Clinton Administration, CEOs began receiving less in the way of cash, but more in the way of stock options² and restricted stock. Ultimately, rather than pushing down CEO compensation, the result of this action was to raise CEO pay levels.

But if we come back to our question, “Should we care about linking pay to performance?” the answer is a resounding “yes.” Short of inviting the government to do our work for us, it is incumbent upon boards, their advisors, and management to crack this code. Charles M. Elson, director at the John L. Weinberg Center for Corporate Governance at the University of Delaware, sums it up nicely: “Government will only make it worse. If you didn’t like what they did in 1993, then you’re really not going to like what they’re doing now.” It is something that we all need to get right.

Old and Persistent Problems

For nearly thirty years I have worked on solving vexing issues around performance and pay. I certainly am not the first or only one to tackle these issues. Many have gone before me and

acknowledged the difficulty. As far back as the 1980s, Robert A. G. Monks, founder of Institutional Shareholder Services, Inc. and cofounder of The Corporate Library, was practically inventing the shareholder rights movement when he took on Sears, Roebuck for the way it generously compensated its top team, made poor investments, and developed an ill-fated strategy. From Monks's point of view, the compensation system is far too arcane. In fact, he calls it "complex, difficult, remote, and virtually inaccessible to anyone without a lot of experience."

At about the same time, Graef "Bud" S. Crystal left the world of compensation consulting to become the bête noire of American CEOs by widely publishing articles with extended tables showing how CEOs compared to each other with regard to pay and performance. Crystal's analysis led to a great deal of finger pointing. What he did was to tally CEO salaries, bonuses, stock options, restricted stock, and other types of compensation. He then compared what CEOs received relative to the performance of their companies and created tables comparing who got what, when, and what for. Crystal's 1992 book *In Search of Excess: The Overcompensation of American Executives* became a best-seller and for many people a reason for outrage, since so much of the information Crystal uncovered was hidden in proxy statements that were difficult to decipher. Crystal is still at it and publishes a weekly newsletter not surprisingly called *The Crystal Report*, but let's pick up where Crystal's book left off.

What Exactly Are the Problems?

What exactly are the problems? Is it that executive compensation is simply too high? Or are there executive pay outliers that attract undue attention and create a media feeding frenzy? Is the problem that there are too many instances when executive pay is high but performance is low (including cases in which executives take lucrative stock option gains off the table right before the bottom falls out of company performance)? The short

answer is “all of the above,” although my view is that the most significant issues are outliers, which I am defining as companies paying at the 95th percentile or higher, and high pay coupled with low performance.

Median executive compensation is not really the issue. On the surface, performance-adjusted CEO pay (to be defined later in this book) increased threefold since 1995. This seems like a lot. But if we take into account (1) inflation (as measured by the Consumer Price Index) and (2) the increase in median company size (larger size begets higher CEO pay) over this same time period, then real size- and performance-adjusted CEO pay has increased approximately 1.6 times the 1995 level. This implies a compound annual increase in real performance-adjusted CEO pay of 3.6%. Because Gross Domestic Product rose by 2.6%, productivity gains account for all but \$400,000 of the total compensation increase. As a result, I conclude that the absolute level of executive compensation is *not* the issue on which to focus. The real issues are about outliers and performance and pay alignment. Investors agree with me. About 75% of the investors surveyed by the Center On Executive Compensation in 2008 said that they had no real concerns about the levels of executive compensation in the United States.

How Investors View Pay

According to Patrick S. McGurn, vice president and special counsel to RiskMetrics Group, Inc.

“There are some investors and obviously other interested parties for whom the numbers are very important, and I think there are some people who simply would like to see pay go down. However, I can’t remember having too many conversations with our clients with that as the ultimate goal. The conversation is generally not about *how much* you pay them but *how* you pay them. How much you pay

them does come into play, particularly when boards do an absolutely terrible job of calibrating those pay programs and get these huge outsized payouts that I think, even from a board perspective, were never intended when they designed the programs. They simply didn't take adequate care in either setting maximums or multiples or whatever it is they're going to use to stop those payouts from going into uncharted waters."

Outliers

Let's consider outliers. They shock the senses. They're the stuff that headlines are made of, and for good reason. As shown in Exhibit 1.1 (page 20), there are always a few outliers—companies that generate performance-adjusted compensation that looks "off the charts," regardless of how high performance might be. For CEOs, these outliers can range anywhere from 15 to over 250 times *median* performance-adjusted pay in any given three-year rolling period.

Moreover, outliers are powerful contributors to public perception. As you can see from the chart, the outlier issue is not new. It's been going on at least as far back as the database will take us. Outliers often are the result of runaway pay programs that weren't intended to pay out that way in the first place.

For example, take Cisco Systems, Inc. in the mid-1990s. The company was on a roll, generating an annualized average total annual shareholder return of 96% in the last half of the decade. I'm sure that the compensation committee thought it was doing the right thing when it bestowed upon John Chambers, chairman and CEO, five to six million stock options per year during this period, along with a modest annual salary of \$300,000 and an average bonus of \$400,000 per year. However, this equity-laden package resulted in *three-year average* Performance-Adjusted Compensation of approximately \$300,000,000—that's

right, \$300 million.³ Other employees' compensation rose too because of stock options. As one Silicon Valley observer said, "What I saw was entitlement. It was worse with options than with an annual bonus because people started living on their options. They could do this because options vested monthly. These people would say to the CEO, 'You have to give options now. The price is only going to go up.' They were living it up."

Today, Cisco has moderated its CEO pay package to be more in line with the market. Total cash compensation (both salary and bonus) is targeted to be below the 50th percentile of peer companies, including a continued modest salary level of \$375,000, combined with a target bonus of \$2.5 million, such that a greater percentage of Chambers's total cash compensation is directly tied to Cisco's operating performance. Long-term incentives are targeted at the 75th percentile of Cisco's peers, and equity grant sizes are considerably more modest than those of ten years ago. In addition, the company has shifted away from relying solely on stock options as a long-term incentive vehicle, to a combination of stock options, performance-based restricted stock units, and time-based restricted stock.

Why Pay Level Is in the Spotlight

According to Jay W. Lorsch, Louis E. Kirstein Professor of Human Relations, Harvard School of Business, and chairman, Harvard Business School Global Corporate Governance Initiative

"The people who are complaining in many respects are the people who have a political or some kind of moral reason for being upset, and I'm even talking about the shareholders. Why did the people at the AFL-CIO get so upset?"

They're not getting upset because the investment is in some way damaging their return. They're getting upset because the union guys don't like it. Or the media get upset because it sells newspapers."

According to Stephen W. Sanger, retired chairman and CEO, General Mills, Inc., and director of Wells Fargo & Company, Target Corporation, and Pfizer, Inc.

"I would say with the general public and the politicians that you could make a case that executive pay level is the main issue—'Nobody needs to be paid that much' kind of mentality. I don't think the big shareholders look at it that way. The big shareholders want to talk about other things."

Fair Pay and Alignment

Now, let's consider the issue of high pay despite low performance. This question is one of *misalignment*, that is, the extent to which pay is high when performance is low, or vice versa. In mining our database, we found plenty of examples in which executive pay was too high for the level of performance delivered. In fact, approximately one-third of the "cases" (to be defined later in the book) in our database fell outside of what we consider to be an acceptable range for the relationship between performance and pay.

In my work with boards, I have developed a simple definition of fair pay, which I am also calling *alignment*. Fair pay, or *aligned* pay, is when total compensation, after performance has been factored in, is

- *Sensitive* to company performance over time
- *Reasonable* relative to the relevant market for executive talent and for the performance delivered

In my explanation of fair pay, or alignment, I've deliberately kept it simple. I've excluded caveats, footnotes, measurement information, and definitions. But while my definition may be succinct, I believe it is powerful because it makes an important philosophical point: executives ought to earn compensation on the basis of the performance they generate over time relative to others in the marketplace.

I believe my definition of fair, aligned pay is simple enough that an outside observer would be able to discern when a CEO's pay is fair and when it is not. As such, it is the kind of definition that can be written on the back of an envelope or committed to memory, and by being kept in mind, can keep boards and executives from getting unwanted calls from the press.

For most of us, the concept of alignment is intuitively appealing. As shown schematically in Exhibit 1.2 (page 21), executive compensation is aligned with performance when company performance and executive pay both are high or low over a sustained period of time. Conversely, executive compensation is not aligned with company performance when executive pay is high and performance is low or executive pay is low when performance is high over time.

Searching for Alignment

Why do companies pay high when performance is low? There are a number of reasons, but the one that tends to crop up the most is when compensation committees want to retain and sustain executives through difficult economic times, in other words, when poor performance is a result of a tough environment and not because of poor leadership. It is in times like these when beefed-up pay packages are particularly painful to investors, as well as to employees who are not doing as well. It is in times like these when the social agenda of wealth redistribution builds a new head of steam. It is also in times like these when boards are jittery and in the mood for buying some "insurance" to retain their top talent.

Jill S. Kanin-Lovers, former senior vice president of human resources at Avon Products, Inc. and director of Bearing Point, Heidrick & Struggles, First Advantage Corporation, and Dot Foods, shared her perspectives with me about what tends to happen in the marketplace in general. “When performance is poor, everybody involved with certain companies—their boards, executives, employees, and shareholders—are in an uproar. Some of the executives in these companies get paid numbers that are lightning rods. I don’t believe they were based on any kind of analysis.”

In most of these instances, compensation committees and management think that they are doing right by shareholders. After all, retaining good executives when the going gets tough is ultimately good for shareholders, isn’t it? But this not only is shaky logic, it also undermines the pay-for-performance objective that is clearly stated in most proxy reports. Further, one wonders why in the first place certain elements of the pay package weren’t designed to tide executives over for a rainy day. And one also wonders whether executives are coming to work for more than just the money. Finally, what is the psychology driving this fear of losing a good leader? Are the executives instigating this fear? Or are the compensation committees just an overly cautious bunch?

The evidence is that the retention issue is generally overblown, particularly for the CEO. “I think the retention issue is grossly overstated in most companies,” says Robert A. Eckert, chairman and CEO of Mattel, Inc. and chairman of the compensation committee of McDonald’s Corporation, “because people aren’t really leaving. If somebody says, ‘Well, we have to do this for retention,’ I say, let’s look at the retention track record. How many of your top fifty people have left in the last three years? If nobody has left in the last three years, why do you think they’re all going to leave now? So I think the retention argument is a weak one and is frequently abused.”

Now, don’t get me wrong, most compensation committees aren’t deliberately paying high when performance is low.

When this happens, the transgressions are usually much more subtle, and may not show up right away. They come in the form of such things as a handsome dollop of low-priced stock options in lieu of no bonus payout. These low-priced options will hardly even show up in the target pay numbers when assessing competitive pay. But most assuredly, these options will show up in performance-adjusted pay once the company's fortunes turn around, and likely will show up as excessive pay at that time.

It's important to point out that upward discretion isn't the only game in town during tough times. Compensation committees use downward discretion as well. Kanin-Lovers witnessed acts of restraint following the 2008 financial debacle. "Several of the companies that I was on the board of in 2008 didn't feel the impact of the economic downturn until later in the year. They were sort of humming along, and then the economic downturn hit. So when we looked at their annual numbers, they didn't look as terrible as we thought they would. But then, we had to consider how to pay these people, because coming into 2009, we knew these companies could potentially crash further. So we had this situation where we were supposed to pay bonuses in early 2009 for 2008 performance, but we had to use downward discretion because the downward momentum in 2009 was so awful that it would look like we were drunk and disorderly if we paid large bonuses at that point in time."

As you can see from these examples, the list of the types of "system overrides" that are used is long.

Analytic Tools Needed

In making these types of decisions, most compensation committees and management lack the proper analytic tools needed to understand the subtle shifts in alignment that are taking place. For that reason, when I started Farient Advisors, I built it around three important elements: people who have a deep understanding of executive talent strategies, corporate

performance, and executive pay; a set of proprietary analytical tools designed to assess pay *and* performance, as well as other things such as risk; and our ability to provide objective, fact-based advice. The analytics that we developed and will be described in this book are quantitative in nature. They are based on an evaluation of executive pay and performance in the S&P 1500 companies over rolling three-year periods since 1995. From nearly 50,000 data points, or “cases,” we have been able to determine the relationships between executive pay and company size, industry sector, and performance. Most of the data in this book are shown for the CEO, although we also analyzed data for the top five named executive officers (NEOs). I feel comfortable using the CEO data to make my case because it is an easy way to illustrate the issues:

- CEO pay is generally the highest among the executives, so it carries the most exposure for companies while also giving us the most demanding test for alignment.
- The data show that companies generally pay other executives in a way that is consistent with the CEO. In other words, if the CEO is paid relatively high, then there’s a good chance that other NEOs will be paid relatively high as well. So showing the CEO data is indicative of how other members of the executive team are paid.

Fariant’s Alignment Model was constructed for the entire S&P 1500, covering all industry sectors. We also can model industry groups (which make up a sector), subgroups, select peers, and even individual companies. It represents the first time that compensation committees, executives, shareholders, and the media have access to a tool that can objectively assess whether their company is paying fairly over time. In addition, the alignment model represents the first time executives and compensation committees are able to determine whether certain programs, or actions that they intend to take, will create

more or less alignment, making it both forward and backward looking. As a result, all constituencies evaluating executive pay will be able to determine, on an objective, analytically grounded basis, whether pay actions and design are within an appropriate range for the performance delivered (or to be delivered).

Fair Play and Alignment

If I'm making all of this sound formulaic and shrink-wrapped, this isn't the intent. The intent is to provide more meaningful benchmarks and guidance than what has been offered to date. To be sure, resolving thorny issues will still consume time and require judgment. But my hope is that stronger guidance from our Alignment Model, coupled with insights from years of experience, my own as well as that of the people we interviewed, will help strengthen and streamline the decision-making process surrounding pay. This process is where *fair play* comes in.

To make use of the Alignment Model, companies don't just need fair pay, they also need *fair play*. What do I mean by fair play? In its most basic terms, I mean having an overall pay philosophy, analytic methodologies, and decision-making processes in place to test and ensure alignment. In other words, boards and management need to ask and be able to answer the following questions:

- How much compensation is enough for our executives for the performance delivered? How much is too much?
- How have our pay system and actions affected the relationship between executive performance and pay in the past? How will our pay systems and actions affect this relationship in the future?
- What program designs or actions might cause poor alignment between performance and pay?
- How can we design an Alignment Model that is right for our company (fair pay)?

- What decision-making processes best support this model (fair play)?
- How should performance outcomes be measured and translated into pay decisions?

Suffice it to say, without *fair play*, you are unlikely to have *fair pay*. Companies need comprehensive fair play methods that consistently result in fair pay outcomes, for the good of investors and executives alike.

About This Book

The book is designed to offer practical insights, combined with analytic rigor. Please note that Chapters Three and Four cover performance and pay alignment across U.S. industry, and Chapter Five begins our journey into compensation alignment on a company-by-company basis. Once you break through the definitions and analytics in Chapters Three and Four, you will be rewarded with case studies and useful applications of our Alignment Model throughout the remainder of the book.

The Role of Compensation

According to Edward D. Breen, chairman and CEO, Tyco International, Ltd.

“The number one thing to me is to just have the right people on the team and put the right people on the field every day to play the game. That stuff transcends pay. If people are motivated, want to do a good job, are challenged in their job, are promotable, and are excited about what they’re doing, then these things are actually more

(Continued)

important than pay. So you have to get that part right or you pay the price. If you don't get the people right, the company's not going to work right."

According to Robert E. Denham, co-chair of The Conference Board Task Force on Executive Compensation; a partner at the law firm of Munger, Tolles & Olson; and a director of Chevron, Westco Financial, The New York Times Company, and Fomento Economico Mexicano, S.A.

"Companies with really good corporate cultures use other motivators, and compensation needs to be aligned with those other motivators. But the enjoyment of the people you're working with and the level of trust for the people who are fighting the battles with you every day make a lot of difference. If you're having good results, if you've got a team that you're enjoying working with, and if that team's winning, it's really hard to recruit somebody away from that winning team."

According to Vernon R. Loucks Jr., chairman, The Aethena Group LLC, retired chairman and CEO, Baxter International, and director of Emerson Electric Co. and Segway LLC

"Well, let's put it this way, nobody goes to work because they get a pay offer, and if they do they're crazy, and there are people who will lob a big number at one of our people, and they'll look at it, and some pop for it, but most don't. It really sort of reinforces the point that pay isn't everything. It's more about being part of a process and part of a company that's really successful at what they do. It's about the process—the process is what produces success, rather than success being an accident.

"But, having said that, pay better be right or you've got a real problem, because if pay goes awry, then people start talking about it, and then people start feeling like the company that they're working for is underpaying and is trying to get away on the cheap. You never make it that way.

Pay isn't everything, but it's got to be right, it's got to be fair. People want to feel like they're being treated fairly."

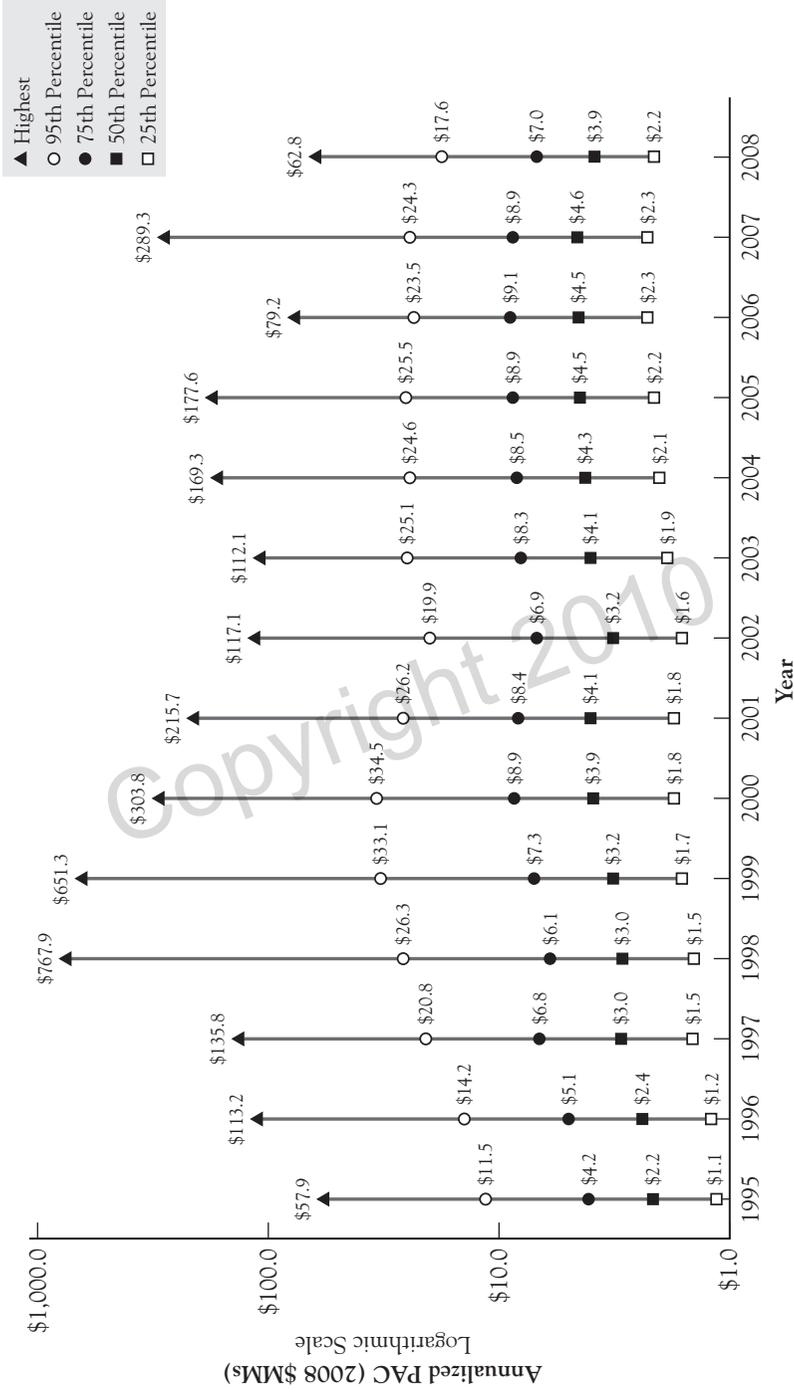
According to Ronald M. DeFeo, chairman and CEO, Terex Corporation, and director of Kennametal Inc.

"I think there are two types of people when it comes to compensation. Some, where compensation is their primary driver, more is always better than less, and the more they make, the more important they feel and the more value they feel they add. Those are highly ego-driven people where the metric of pay is a direct contributor to their own view of self-importance. Then there is, I think, a much different style of individual where pay is not their primary motivator, it's the emotional attachment they get from generating a successful environment, whatever that successful environment is, whether it's a successful business, a successful charitable organization, or a successful town. And people can live very happily without making a ton of money, but having felt like they made a difference. And I think it's important for people to feel like they made a difference in their lives."

According to Richard E. Boyatzis, professor, organizational behavior, Weatherhead School of Management at Case Western Reserve University

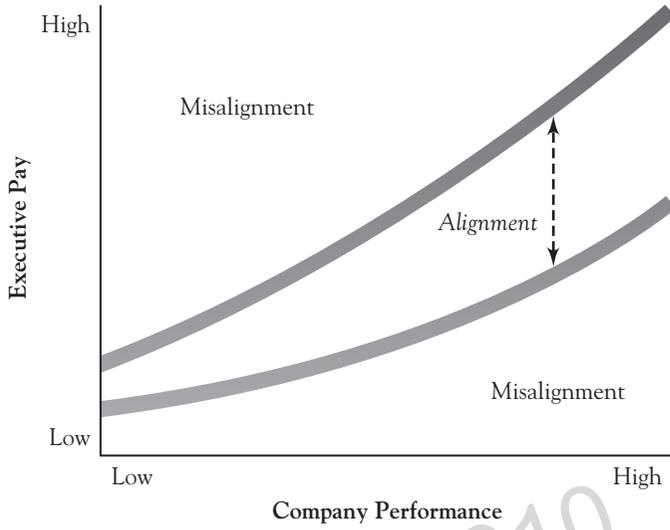
"The whole thing about transactional versus transformational leadership is that the more you make it a transaction, the more a person then puts it on exchange. And this is one place where the economists have helped to destroy the relationship between individuals and their organizations. If you make me feel like you're going to pay me every time I do something good, then at some point, I'm going to start thinking, well, why should I do something good if I don't get paid? And if I do something even better, shouldn't I get paid more? At that point, I've stopped thinking about our purpose—our clients, the ingenuity of the products and services—and I've started thinking about the transaction."

Exhibit 1.1. CEO Performance-Adjusted Compensation (PAC)



Note: Average PAC over three-year periods ending in each year shown.

Exhibit 1.2. Alignment Concept



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