Ten top questions that board compensation committees need to ask themselves in planning for 2016

This past year has seen boards of directors wrestle with roller coaster stock markets, increased shareholder activism and active rulemaking by the Securities and Exchange Commission (SEC) under the 2010 Dodd-Frank legislation. As 2015 comes to a close, here are ten top issues board compensation committees should be thinking about as they begin planning discussions for 2016:

1. Are we prepared to tackle say-on-pay votes, even during times of declining shareholder returns?

For the past five years, board compensation committees have operated under the regime of mandatory say-on-pay votes. During this time, 97 percent of companies have routinely won shareholder approval for executive pay plans, according to *The Wall Street Journal*. But these votes have all occurred during an era of economic growth that has, in turn, supported upward movement in share price and total shareholder return (TSR). This positive movement may have created a false sense of security around say-on-pay votes for some boards. Compensation committees must be prepared for a future that may bring declines in TSR and a resulting swift backlash from investors around executive pay. In planning for 2016, boards should re-examine their executive pay programs to ensure that they are carefully crafted and properly communicated to key stakeholders, striking a balance that will avoid unfairly impacting executive pay during economic downswings, while still reflecting economic realities.

2. Do executive incentive plans do a good job of incorporating strategically important long-term performance metrics?

Boards are increasingly weaving strategic operational metrics into executive incentive plans—in some cases tying strategic performance objectives to as much as 32 percent of the total direct compensation package, according to the most recent Hay Group/*Wall Street Journal* CEO Compensation Study. With the addition of these strategic performance measures, however, come considerations about how to capture results that may span multiple years and how to appropriately award executives for performance against these goals. In setting more long-term targets, boards are setting their sights beyond the annual planning cycle. Therefore, compensation strategies must also shift to account for new metrics for performance-based pay, even when those measures may not hit the bottom line of financial statements in a single year. In addition, compensation committees need to consider the challenges inherent in evaluating appropriate non-financial measures.

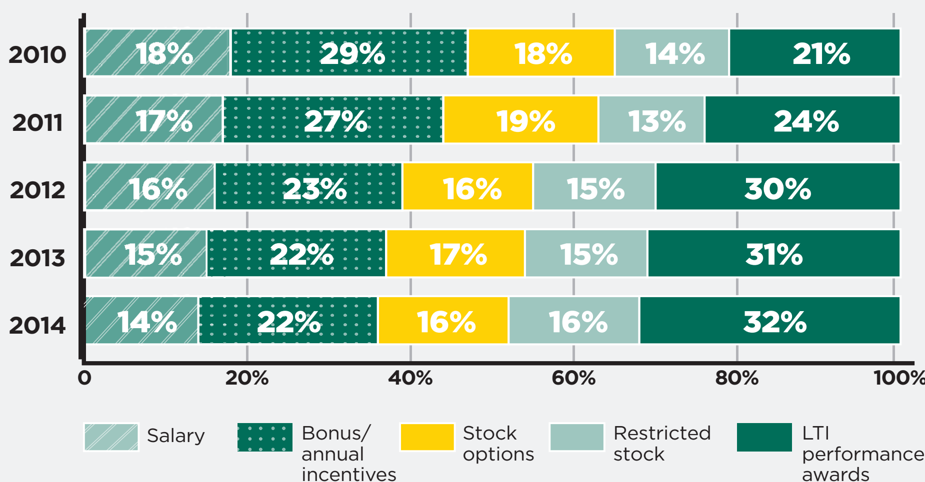
3. Are our annual performance targets rigorous enough?

Historically, many companies have not disclosed forward-looking annual performance targets. However, increasing scrutiny from major shareholder advisory firms—including Institutional Shareholder Services (ISS), which last year acquired executive compensation data firm Incentive Labs—should put compensation committees on notice to become more proactive. With a new data-backed perspective on performance targets, ISS and others will be better positioned in 2016. Looking ahead, as investors have more visibility into pay and more opportunities to critique executive compensation strategies, boards will need to become more active in disclosing their view of the business cycle, estimated market conditions and other factors impacting how and why performance targets are set. The approach should be to proactively communicate whatever information is necessary to ensure stakeholders are comfortable with how annual performance objectives are established.

4. What trends in the mix of pay are expected to affect executive compensation in 2016?

In recent years we have seen the pay mix of top executives increasingly focus on long-term incentives, especially performance-based awards. With investors concerned that pay be linked to measurable performance, this trend surely will continue in 2016. The key role of performance-based awards is most strikingly illustrated when we look at the components of CEO pay. For example, the following table (based on our 2015 study of CEO compensation at large US companies for *The Wall Street Journal*) provides a five-year look at the composition of total direct compensation (TDC, which is base salary plus short-term incentives plus long-term incentives (LTIs)) for CEOs. Notably, performance awards now make up the largest portion, by a wide margin, not just of the long-term incentive mix but also of TDC. While the percentage of TDC composed of LTIs typically is lower among non-CEO members of the top executive team, compensation committees should consider the growing importance of pay mix—and the role of performance awards within that mix—in discussions of (and the rationale for) their decisions on the executive pay disclosed in annual proxy statements. Committees need to determine what mix of pay—at various executive levels—is most suitable for the organization's business objectives and circumstances.

The evolving TDC pay mix, 2010 to 2014.



5. What steps will we take to reflect the impact of currency fluctuations and commodity price swings on our performance results?

Global companies have seen their performance results significantly impacted by fluctuating currency rates, including a spike in the value of the dollar, over the past year—a trend that is poised to continue in 2016. Similarly, commodities markets have been, and will likely continue to be, in a state of turmoil. Both these trends can have a heavy impact on performance results and stock price. Compensation committees need a plan for how they will communicate the impact of these changes to the market at the end of the year. Further, boards will need to decide how to support management and provide relief from investors who take a short-term view of performance, while simultaneously continuing to hold leadership accountable for long-term performance goals, in spite of tumultuous markets.

6. How can an M&A transaction affect an organization’s compensation arrangements and its personnel?

With *The Wall Street Journal* reporting 2015 as “the biggest year ever for mergers and acquisitions,” compensation committees need to be prepared for how a continued boom in M&A activity could impact their compensation programs and workforce needs. Regardless of whether an organization’s overall circumstances or strategy make it more likely to be a buyer or seller, the current M&A environment reinforces the need for a compensation committee to understand the transaction-related components of existing compensation arrangements and their impact on people should the company undertake an acquisition, sale or divestiture.

At the most basic level, compensation committees need to focus on what may be needed to motivate and retain critical talent whether in contemplation of a sale or following an acquisition. Both buyers and sellers require an understanding of what payments and/or vesting may be triggered at an organization being acquired and what changes should be considered to accomplish or avoid a certain result. If accelerated vesting and/or payouts may occur in connection with a change in control, a buyer may be concerned about key executives leaving following an acquisition; this in term raises a potential need for appropriate retention arrangements. On the seller’s side, severance programs should be examined to make sure that key talent is appropriately protected.

M&A transactions also call for compensation committees to provide guidance on certain non-pay issues affecting critical personnel. For example, at an acquirer the committee needs to plan for the smooth integration of the seller’s key executive talent, including clarity around the duties and responsibilities of the position and the reporting relationships. The committee also may determine that coaching should be made available to promising executives who are promoted or assigned to new roles.

7. How does the organization evaluate the CEO?

As our recent Hay Group/*Agenda* 2015 CEO Performance Evaluation Study revealed, CEO evaluations are too often treated as an annual report card on the chief executive's performance, rather than an opportunity for continuous discussions designed to improve performance. More than half of the organizations we polled in our research conduct CEO performance evaluations only once each year, or even less, while we have found that many of the most successful chief executives carry on regular, ongoing conversations with the board about their performance. Compensation committees should consider performance discussions more regularly and treating these interactions as opportunities for team mentoring and growth, rather than strict evaluations. This can help build the relationship between the board and CEO, while also ensuring closer alignment on key performance goals for the larger organization.

8. Are we prepared for the next generation of leaders?

Regardless of where the organization currently stands within the overall CEO Life Cycle[SM], boards, through their nominating or compensation committees, need to be thinking about CEO succession planning as part of the overall talent management process. Making succession planning and talent development an ongoing process and a set part of the committee's and the board's calendars can help alleviate anxiety around the process and make it simply another part of "business as usual" within the organization. The process of succession planning should include ensuring that directors are aligned around the current and future strategy of the company as the basis for building consensus on the desired leadership profiles for future CEOs, as well as ensuring that a robust internal talent development pipeline and a tailored knowledge transfer and development program are in place for mid- to near-term CEO candidates.

While the board must hold the CEO and CHRO accountable for this process, they also need to be aware of the company's high potential talent and the steps that are being taken to develop them for future leadership roles. Additionally, the committee and the board must ensure that the CEO succession requirements include the ability of the CEO to create and foster a healthy relationship with the top executive team and that the top team is likewise creating the conditions for leadership development at all levels. After all, a dysfunctional top team can put at risk the development of a strong leadership pipeline and easily erode enterprise value in the process. Without proper focus on these items, the CEO succession planning process is not likely to be successful.

9. What messages are sent by our pay-for-performance disclosures?

This year the SEC proposed rules under Dodd-Frank requiring the disclosure of CEO pay with respect to performance. While awaiting final rulemaking, board compensation committees need to be proactively planning how best to address the proposed requirements—especially the focus on TSR (including peer group TSR). Directors should discuss whether the minimum proposed disclosures match

the organization's priorities, or whether supplemental disclosures may be needed to more accurately explain how CEO and named executive officer pay correlates to TSR, or even to other strategic measures of performance. Additionally, because the proposed SEC rules would require highlighting annual pay alongside annual TSR (and peer group TSR), the resulting comparisons often won't appropriately reflect organizations' strategic realities, especially for those entities with longer-term incentive strategies based on multi-year performance targets and including performance awards that vest over time. Further explanation of compensation strategies will likely be needed to help stakeholders more clearly understand how pay is linked to relevant performance goals.

10. How are we preparing for the upcoming finalization of the SEC's proposed clawback rules?

Similar to the above provision regarding pay-for-performance disclosures, the SEC's proposed rules broadening and mandating the reach of compensation clawbacks present a critical governance issue that compensation committees should begin proactively addressing. The expanded rules apply not only to CEOs and CFOs, but to any executive officers (including a three-year lookback for former executive officers), and they apply regardless of the reasons behind financial restatements. Any existing clawback policy should be compared against the proposals to determine what changes—which are often significant—may be needed for compliance.

Another important step is the determination of who would be an executive officer subject to a recoupment of incentive pay. Existing incentive programs should be examined to determine how their features might affect the amounts subject to clawback. And, of course, changes in incentive plan design might be considered, including increased focus on amounts or types of awards not subject to clawback. While the regulatory minimum requirements will need to be satisfied, boards should think about how wide a net to cast when crafting company policy—for example, should the policy extend beyond executive officers? Perhaps to cover senior-level managers? How clawback provisions are drafted can have a significant impact on external and internal stakeholders' views of the firm, and compensation committees need to hold discussions in 2016 that will prepare them to tackle this issue head-first once final rules are adopted.

Having faced tumultuous market conditions, increased scrutiny from activist investors and significant SEC regulatory activity in 2015, each board needs to examine the particular circumstances and considerations at its company and then formulate a strategic plan to tackle the coming challenges; this will be the best safeguard for boards as they face uncertain waters ahead. From say-on-pay to CEO performance evaluations, as boards begin 2016 planning, proactively discussing these ten key issues will be of critical importance—especially in managing stakeholders' views of the company, building a robust internal talent pipeline and setting the stage for long-term growth into 2016 and beyond.

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