What if Equity Markets Stop Making Sense for Pay?

Compensation questions to ask during volatile times.

BY TODD SIRRAS

The U.S. equity markets may become in the short-term, a poor marker for long-term value creation.

What does that mean for equity-based pay?

This is a multi-faceted topic, and at its heart a matter of managing change.

Macro forces

Uncertainty is a hot topic. It feels more scary and volatile today, but that's partially because we know how it worked out before. Whatever change occurs may bring about a period of major upheaval as responses adapt accordingly. "Normalization" of monetary policy will also roil the waters, with an unforeseen impact on economic activity and growth.

The global and U.S. economies are likely to experience some dislocation, but are also likely to continue to function. The ability to adapt and innovate will create winners and losers in a landscape that may be markedly different. An old colleague of mine used to say, "Don't bet on the end of the world. It's only going to happen once."

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Stakeholder responses about executive pay

Institutional shareholders and activists will retain and increase their voice around equity usage and executive pay. Dodd-Frank may go away, Say on Pay may get stale, disclosure may change. But Pandora has left the building — shareholders will demand accountability and the trend toward specialized policies and shareholder engagement will continue. Proxy advisors will continue to develop policy and act as an aggregate marker of shareholder perspectives, but with stable or declining prominence on this topic.

Compensation committee preparedness

Effective compensation management is about managing change and expectations. We've touched on the potential for macro-level economic dislocation, the need for innovation and adaptability, and the increased accountability being demanded by shareholders. How does that filter to pay?

Very high volatility in share prices creates all kinds of unintended consequences. The potential is greater for extreme outcomes, and the timing of awards can be a material driver in the ultimate value of awards. Compensation committees must consider how to dampen the unintended consequences and ensure that pay levels are commensurate with performance.

There are several questions that should be investigated by the committee in determining the best approach for using equity when share prices get volatile.

• Are the return expectations much different than originally thought because of external factors?

If yes, consider reducing leverage in the pay program, by reducing the payout scale for performance shares, or reducing the amount of stock options. Consider implementing cash-based long-term awards if extreme uncertainty exists.

• To what degree will financial performance be aligned by market movement?

If you expect alignment to weaken, then focus on financial performance in determining award size and performance share measures. Reinforce the message that the market price may not reflect the long-run value, and encourage long-term ownership mentality through clear communication of performance expectations and program structure.

• What's the "new normal?" Is the high volatility temporary?

If temporary, bolster time-based awards by increasing holding requirements or extending vesting. Adopt averaging policies to smooth out the grant price, or potentially make awards at multiple times during the year.

The compensation design outcomes should be backed up by clear analysis and communication to participants showing their incentives and potential value, and through communication to external stakeholders through Compensation Discussion & Analysis and direct engagement. ■

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