Give Your Shareholders a Bonus: Leverage Pay Transparency to Build Confidence

Compensation questions to ask during volatile times.

BY BLAIR JONES

With the constant clamor by shareholders for better governance, compensation committees have become ever more transparent about handling executive pay but there's a missed opportunity.

The transparency can also give shareholders confidence in the overall governance of the company by the board.

Good pay program design and execution, simply put, is a surrogate for good governance. Give shareholders confidence in one, and they will have reason to believe they should have confidence in the rest.

Why give them any doubt that directors are keeping on top of the governance game?

Here are four best practices for boards to capitalize on the clarity:

• **Competent Communication.** Hold regular, scheduled meetings with key shareholders. The compensation committee chair or lead director should go with the corporate secretary (or general counsel or HR chief). Don't wait for complaints at the annual meeting. Give shareholders, including their governance experts, a chance to offer face-to-face, unfiltered feedback. This allows you to show your command of a range of governance issues.

Following in-person meetings, show you value feedback by making changes in the pay program, or looping back to explain why you didn't. When you meet with shareholders, you do run a risk that they won't like what they hear. One investor we encountered had less confidence in a company after meeting with directors, because the directors didn't have command of all the issues related to pay. So do your homework and let shareholders see your meticulousness.

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• **Balancing the Up and Downsides.** Show that performance and pay align with good times and bad, over the long term. Shareholders obviously detest a plan that pays no matter the performance, so goals should be set not just to trigger generous bonus payouts in up years but to curb them in down years.

It goes without saying that you can't overly dock executives for a run of bad industry luck, lest they lose their commitment to hanging tough and gain a yearning for greener pastures. But be sure your pay program "auto-corrects" on the downside, shrinking peak payouts during valleys of performance. For example, during a bad year, a payout of, say, 70% to 80% of target sends the right message to executives and shareholders. Everybody shares the pain.

In the meantime, explain clearly your rationale when you use discretion to adjust pay on either the up or downside in a way that deviates from the pay plan. Be wary of making exceptions just because executives worked hard. As an example, in one company, a CEO was paid handsomely—and appropriately—for many successful years. But the directors shook investor confidence when he took home almost the same pay during a down year.

We worked with a top-performing company which lost a major client, hurting prospects for future performance. The board docked the CEO 10% of his bonus even though the loss had not yet shown up in the financials, which showed shareholders clearly that the board was paying attention for the longer term.

• **Windfall Protection.** Make sure that shareholders are protected from executives earning undeserved windfalls. If you give a retention award designed to pay off only with achievement of higher performance, don't use discretion to allow executives departing early to receive the award anyway. If you use discretion to raise awards that would otherwise be down owing to unfavorable foreign-currency swings, be sure you do the reverse when the currency swings produce windfalls.

• **Metrics That Matter.** Make sure the compensation program pays not just against standard metrics, namely revenues, profits, and returns. Show that executive paydays depend on executing strategy well. If the strategy is to bump up cash flow to pay down debt or create a war chest for acquisitions, include a cash flow measure. If the strategy is to migrate the brand to demonstrate strong environmental, social and governance performance, be sure to include metrics that at least indirectly measure those factors. To do otherwise suggests the board hasn't spent the time to align pay and strategy—or worse, doesn't understand the strategy.

Putting the focus solely on pay to show shareholders the company is well-governed is admittedly simplistic. But it gives you a chance to show that directors care about issues that investors care about. Conversations about pay naturally lead to broader issues that show the board keeps shareholders in mind when it comes to all critical governance topics—independence, diversity, performance, succession planning, proxy access, special meetings and the notion of shareholder democracy in general.

The message sent to shareholders by an engaged compensation committee is that the board is playing an active role, that it is part of the strategic discussion, that directors are indeed fiduciaries and governors. Shareholders get to see for themselves the board's active hand. Don't let a lack of transparency in pay lead shareholders to think otherwise. Use your outreach to demonstrate holistic, disciplined governance shareholders can trust. ■

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