Socially Conscious Perspectives on Pay Practices

As BlackRock CEO Laurence D. Fink detailed in a 2019 letter to CEOs, the public at large is increasingly looking to companies to address economic and social issues. "These issues range from protecting the environment to retirement to gender and racial inequality, among others," wrote Fink. "Fueled in part by social media, public pressures on corporations build faster and reach further than ever before."

And, as the latest installment in NACD's Leading Minds of Compensation series demonstrated, pay practices not only reflect a company's stance on some of the most contentious social issues of the day—gender parity, to name just one—they also play a decisive role in how a company is perceived both internally and externally. *NACD Directorship* Publisher Christopher Y. Clark moderated a Q&A with subject-matter experts **Michele Aguilar Carlin**, executive vice president of the Human Resources Policy Association and its Center on Executive Compensation; **Christopher Earnest**, partner, Compensation Advisory Partners; **Aeisha Mastagni**, portfolio manager, corporate governance at the California State Teachers' Retirement System (CalSTRS); **Ben Stradley**, managing partner of Pay Governance; and **Barry Sullivan**, managing director, Semler Brossy Consulting Group. Highlights from that discussion follow.

Tell us a bit about what you do and your thoughts on how directors can go about analyzing problematic pay practices.

Mastagni: I work in what we call our corporate governance unit at CalSTRS, the $220 billion pension fund for the teachers of California. In my unit, we're responsible for a number of things. Primarily, we do all the proxy voting for the 8,000 public securities that we own. Because we have such a broad portfolio and practically own the whole market, there are a lot of issues that are very important to us in terms of environmental, social, and governance (ESG) issues. And we think that our engagement actually adds value to the portfolio. We have a pretty robust team of 15 investment professionals, and each person has their own areas of expertise. One of mine is executive compensation. I spend a lot of time looking at compensation practices.

I always say that the compensation plan is our window into the boardroom. We don't sit inside the boardroom, we don't know who's paying attention, we don't know how involved the directors are—but I can tell you the compensation plan tells us a lot of things. It tells us about succession planning. It tells us about how the board thinks about human capital. It tells us about what the board thinks the long-term strategy is. It tells us how effective the board is. I know that there are a lot of other things out there that have gotten so much more attention, but I still think compensation is an important area for investors and for people that are sitting in the boardroom.

Problematic pay practices may be harsh, but there are certain things that will get our attention. If you're targeting pay above your median peer group because everyone's supposedly average, anything above that target is going to get our attention. Using multiple metrics in the short- and long-term program makes it look like you're getting double paid. Excessive perquisites, change and control with only a single trigger, [and] a lack of disclosure also get our attention. I know everybody hates proxy advisors, and while we don't necessarily follow exactly what Glass, Lewis & Co. and ISS [Institutional Shareholder Services] do, they do highlight things for us to pay attention to.

As much as the metrics are important—and I think most companies have one or two value-driving metrics that a compensation plan can be crafted around—think about how you want to ensure an alignment of interests. If you're using equity, how do you want to deliver that equity? Using long-term restricted stock for a growth company might be the appropriate mechanism, whereas using options might be more appropriate for a faster growth company. But not all companies need to use performance awards. We don't all need long-term restricted stock. We don't all need options. Thinking about that equity vehicle is just as important as the metrics themselves.

Let's touch on the California mandate for gender parity in boardrooms. What are the consequences for [board] recruitment and director compensation?

Sullivan: California passed a fairly progressive regulation in 2018 that has big implications from a board composition and board pay perspective. There are about 620 publicly listed NYSE or Nasdaq companies in California. About 120 of them right now are short of the standard of at least one female representative on the board. And then there's a second wave in the legislation that is by 2021, you have to get even more parity in terms of gender representation on the board. For example, if you've got six board seats, by 2021, three will need to be filled by female candidates. There's a comprehensive research report on this available at BoardGovernanceResearch.com.

There's going to be a lot of updraft. And don't only think about female representation on boards because there are other diversity profiles that boards will need to be competing for—other diverse talent.

PHOTO BY JOE CHUNG

That may start to push up director pay levels over time. If you put your forward-looking lens on this, you might expect an uptick starting in California that then travels across the US in board pay levels.

Think about what's happened with board pay in the past five years or so. There's been a very strong reversion to the mean, right? Nobody wants to be an outlier on board pay. If you look at the range around median between 25th and 75th percentile board pay, 10 years ago you had companies that were still granting a fixed number of shares. And as share price took off, well, director pay climbed fairly aggressively. That practice has more or less been eliminated. There are still companies with fixed-share grants, but they are very much in the minority today. More than 90 percent of public companies are making dollar-denominated grants today. That has had a significant impact on reducing the range of director pay.

It's also very important to think about ISS and Glass Lewis and the investor perspective on this. Glass Lewis has said it will vote against nominees to governance committees that do not have female representation on the board. That is starting now in 2019. ISS has followed suit. They're allowing 2019 as a grace period, but you can expect against recommendations in 2020 if there is a lack of female representation on the board. At BlackRock, Larry Fink came out with his letter last year and said he wants to see at least two female representatives on each board. Most large-cap companies are already down the path in terms of managing diversity on the board and being very intentional about board composition. The real impetus now is on the mid- to micro-cap companies, particularly here in California, to step up to this new legislation and really become more intentional about board composition and board diversity.

Speaking to ESG issues, gender pay equity is an issue. How are boards doing on this front?

Earnest: ESG's impact on executive pay is evolving fairly quickly. It has moved beyond the question of whether companies have a duty to shareholders and society to emphasize ESG issues. Shareholders don't merely want executives speaking to their importance. There is now pressure to put your money where your mouth is by incorporating ESG-related measures into executive incentive plans. A sliver of ESG is the issue of gender pay equity. [Compensation Advisory Partners] did a study where we looked at 150 large

The panelists (from left): Christopher Earnest, Aeisha Mastagni, Ben Stradley, Michele Aguilar Carlin, and Barry Sullivan.

companies and found that less than 50 percent of those companies had a female in the named executive officer group. When you did find females in that group, they were earning about 87 percent of their male counterparts at median in terms of total pay. I think the conversations around pay equity awareness are happening in the boardroom among compensation committees, and these issues are being addressed. This is particularly true when you can narrow it down to males and females in the same role with similar levels of experience. It will take some time to address these issues, but I think we're getting there.

The bigger issue, in our view, is the pipeline of females in management and executive roles. There is an under-representation of women in leadership roles. Companies should be asking what are we doing to develop that pipeline of women throughout the company? And as they do rise and get promoted from within, the company needs to look at overall pay levels relative to men and make sure that the same proportion of females and males are eligible for and have an opportunity to receive incentive-based compensation.

How should human resources officers and boards think about the potential impact of stock repurchases?

Carlin: It's no surprise to any of you that buybacks are increasing. And the criticisms largely come from the [political] left, who argue that the massive surge in buybacks deprives the economy of needed investment. It enriches executives and contributes to our inequality problem.

Part of what we're doing at the [HR Policy] Association is to really look at the data and ask, are these criticisms valid? Largely, our conclusion is no, there are really few facts to support them, except there is some slight evidence of executive behavior in terms of selling stock when a buyback is announced. US Securities and Exchange Commissioner [Robert J.] Jackson did some research which showed that executives tend to sell more frequently once a buyback is announced. That is somewhat problematic, and as a result of his research, he's advocating that the SEC adopt reforms that focus on potentially eliminating the safe harbor for companies if their executives sell during a buyback period and increasing disclosure requirements. Basically, what Democratic senators say is we want legislation that forces employers to create a safety net for employees or invest in their workers before they would be able to execute a buyback. And there are many parts of the Republican Party that aren't fans of large corporate buybacks.

So what should you be looking at, and what should your CHROs [chief human resources officers] that work in your company be doing? First and foremost, make sure there's clarity in the boardroom about how the buyback will impact compensation, if at all. Your CHRO should be driving that conversation to make sure the board understands that if you're amid a buyback, or thinking about a buyback, how that would impact compensation.

The biggest question I would push CHROs on is why our company doesn't have more internal opportunities to deploy this capital. Why don't we have new projects, new products, or new acquisition opportunities? Is there something around innovation in our company that is not there? Is there something about risk tolerance? So, while all the compensation-related matters are pretty much check-the-box, the harder, underlying questions are: Are we innovative enough? Are we taking enough risk to have opportunities to deploy this capital in a way other than returning it to shareholders?

What challenges do you see compensation committees facing in the years head?

Stradley: Several clients that I've worked with recently have used a "North Star" concept to consider what's important and the objectives of their compensation plans. I think that's a really interesting way to think about the vision of what we want to become, knowing that this next three- to five-year plan is just a step along the way. Having that clear vision of where you're heading serves as a great guide, knowing there are going to be bumps in the road. Those bumps in the road represent issues around attraction, retention, motivation, and helping participants feel like they're in the game.

One issue we've dealt with recently is volatility and uncertainty in the market. When we look at what's driving that, I don't think we can say that it's necessarily the economy. Frankly, the economy has been performing pretty well. Rather, it's trade wars, government shutdowns, and similar uncertainties that are causing volatility in the market. A client said, "We don't want those factors to be driving the way that we deliver compensation to our employees."

This creates challenges with how we calibrate our awards. I have definitely seen clients consider how they're going to approach long-term incentive grants this year, with most using some sort of averaging period.

We also have some additional tools we don't want to forget. I'm going to use the dangerous "D" word: discretion. Discretion has become more widespread following last year's changes in the tax law and the elimination of 162(m). [The section of the tax code that placed a $1 million limit on the amount of compensation corporations could deduct.] That took away guardrails that had been in place. And with the guardrails gone, we have the opportunity to experiment. Section 162(m) constrained what we could do before, but now we can get a little more experimental. We're going to have to be thoughtful, however. If we can't explain our rationale to our investors, they'll let us know and bring us back in line.