Wanted: “Pay For Performance” CEOs

by Myrna Hellerman

New disclosure rules compel companies to demonstrate how executive pay plans directly reward top performance. A board that hopes to prove this linkage needs a CEO who not only is “paid for performance,” but who works to drive the concept throughout the company.

With the next proxy season, investors, as well as their advisors and advocates, will have expanded pay-for-performance insights to critique the quality of boards’ overall executive pay stewardship. To face off against a new set of investor challenges, boards must enhance their own insight into the facts behind the executive pay recommendations they approve. Boards can and should assure investors that top executive compensation reflects pay-for-performance—without usurping the CEO’s pay setting responsibilities.

Almost every publicly traded company seeks to demonstrate pay-for-performance. The definition and execution of that commitment varies widely. As a result, despite long explanations of pay-for-performance processes, skepticism continues on the alignment of executives’ pay with corporate performance.

Boards need to deeply engage with the CEO to ensure that executive payouts are the outcome of a disciplined and rigorous pay-for-performance process.

Implementation of the SEC pay-for-performance disclosure rules as mandated under Section 953(a) of Dodd-Frank may further distort investors’ perspective. The rules require explicit disclosure of the relationship between the actual pay of executives and the financial performance of the company. This disclosure may drive a misguided conclusion that pay-for-performance must be a rigid, formulaic linkage between individual pay and specified measures of company financial performance. Investors and their advocates may unfairly judge boards of companies that fail the “linkage test” as failures in their executive pay stewardship responsibilities.

Investors will hold board members accountable for the relationship of pay to performance not only for the CEO, but also the other top executives. The traditional “CEO recommends/board approves” process for top executives is being challenged. Thus, boards need to more deeply engage with the CEO to ensure that executive payouts are the outcome of a disciplined and rigorous pay-for-performance process. For some boards this will be easy because the CEO already is a champion and practitioner of *real* executive pay-for-performance—a “P4P” CEO.

P4P CEOs base top executive pay on a rigorous process that demands evidence of each executive’s contribution to the company’s financial achievements. Furthermore, P4P CEOs ensure that similar pay-for-performance rigor is applied throughout the organization. Through their pay decisions and recommendations, P4P CEO’s demonstrate to the board (and to investors) that company executives “win” financially only when the investors win.

P4P CEOs have adopted several maxims to guide their pay decision making. Four maxims are most relevant to boards in an era of tougher investor pay-for-performance scrutiny:

- ☐ What’s good for the goose is good for the gander.
- ☐ The buck stops here.
- ☐ Show me performance, I’ll show you rewards.
- ☐ Talk the talk and walk the walk, but not alone.

Tough, performance-based, individual differentiation directs limited pay dollars to employees with proven top performance.

☐ *What’s good for the goose is good for the gander.* P4P CEOs prove through their actions that perfor-

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mance expectations (and consequences) are being applied seamlessly at all levels in the company. For instance, participants in Sibson's latest *Real Pay for Performance Study* were asked, "Does your CEO use the same approach with the leadership team members as is applied further down in the organization?" The answer was a resounding "yes" at companies lead by P4P CEOs—about 20 percent of participants.

For some CEOs this "good for the goose; good for the gander" approach is a natural component of their management style. For others, it often is born out of adversity.

As an example, at XYZ Corp. differentiated pay-for-performance was practiced everywhere in the company—except for the top executive group. Year after year, every executive on the leadership team expected to receive automatic incentive awards and equity grants based on a company performance formula.

Several years ago, like many companies XYZ was forced to take draconian actions to weather the economic downturn. As a consequence, the CEO became more intimately involved in the allocation of the limited compensation budget for the non leadership population. He saw first-hand how tough, performance-based, individual differentiation directed the limited dollars to employees with proven top performance.

XYZ's CEO recognized that his pay recommendations to the compensation committee had never shown similar rigor. He faced two personal impediments to successful performance differentiation for the leadership team. First, he was reluctant to confront the emotionally charged egos of his team, plus he disliked all the "paper work" associated with a performance management process.

To resolve the dilemma, this CEO applied the maxim "what's good for the goose is good for the gander." He adapted the tools and processes to the reality of the executive suite. This included a simplified, yet well-documented expectation-setting exercise at the beginning of the performance cycle, frequent planned (not *ad hoc*) face-to-face performance conversations, and a fact-based evaluation approach.

The key output of such a rigorous process is the CEO's fact-based pay recommendations to the board. At XYZ, the CEO's significantly differentiated payouts caused great angst for the board in the first year. XYZ's directors had always relied on a mechanical formula driven by company performance metrics to set top executives' incentive payouts and equity grants. The CEO rarely deviated from the formula calculation. The board had seen this approach as a safe harbor from "outsider" pay-for-performance criticism. Now, the board received CEO pay recommendations that required them to exercise significant negative discretion, as well as allowing non-deductible bonus awards.

XYZ's CEO was undaunted. The compelling nature of fact-based differentiated pay convinced the directors to become more engaged in top executive pay setting. Today, the XYZ board reports to investors: "From the top down, we confidently can demonstrate that payouts are closely aligned with investor returns [and] overall corporate performance, and are further differentiated by individual contribution." New pay disclosure rules are not a concern for XYZ Corp.

No member of the leadership team should be able to blame someone else for their own underachievement of agreed-upon goals.

☐ *The buck stops here.* P4P CEOs also embrace this second maxim. It means that a leader accepts personal accountability for decision-making outcomes. The CEO accepts responsibility and accountability for overall corporate outcomes, and no member of the leadership team can blame someone else for their own underachievement of agreed-upon goals.

An oft-repeated story at one large retail company tells of the CEO's announcement to his leadership team at the end of his first full year at the financially troubled company:

"I'm not even a three [on a five-point scale]. We did a lot of good things, overcame a lot of challenges, but the bottom line is that the company's performance didn't fulfill shareholder expectations. I know some of you exceeded the overall expectations I set for you, and I've recommended awards and grants for you to the board. The rest of us shouldn't expect any incentive awards or equity grants."

In the ensuing years, this CEO continued to set individual performance standards for his leadership team, which, if achieved would allow him to fulfill the financial expectations of the board. While there were a few more years without any payouts for both the CEO and some team members (and several team members exited), the company's overall performance improved significantly. For the leadership team, there is no ambiguity about the need to achieve performance targets (and no tolerance for excuses about underachievement).

Occasionally, the executives get nostalgic for the times when everyone got "a little something" despite actual performance achievement. However, they respect how the CEO's "the-buck-stops-here" mindset has resulted in better corporate performance and executive payouts that are clearly based on that performance.

True P4P CEOs do not allow individual executives to ride on the shirttails of overall corporate success.

☐ *Show me performance, I'll show you rewards.* P4P CEOs demand proof that the performance of executive leaders is worth paying for, and translates into shareholder value creation. Thus, "show me performance, I'll show you rewards."

At performance-evaluation time, CEOs inevitably hear from some executives, "It's true I didn't hit all of the specific performance targets you set, but I still should get a decent payout. Just look at all the other things I did, and look at how well the company did in general." P4P CEOs do not allow individual executives to ride on the shirttails of overall corporate success.

Incentive plans designed to comply with Internal Revenue Service rules under Section 162(m) are a common "shirt-tailing" vehicle. Some CEOs and boards believe they are limited by the formula established at the beginning of the year. However, P4P CEOs use the "negative discretion" feature of Section 162(m) to allow them to truly differentiate incentive payouts based on individual contribution. These "plan-within-a-plan" arrangements can take many forms.

Many boards embrace the plan-within-a-plan approach. It allows them to differentiate payouts to top executives based on individual performance through a tax-favored vehicle. Rewards are paid only to the extent that the company's performance also has met the shareholders' demand to "show me performance."

☐ *Talk the talk and walk the walk…but not alone.* While P4P CEOs recognize that they personally need to be role models, they also know that sustainable success requires broader buy-in. They build a "community" committed to pay-for-performance which

A Plan Within A Plan

Performance Pay Within The Tax Rules

A midsize financial services company adapted its Section 162(m) annual incentive plan to strengthen the CEO's ability to deliver performance rewards to the top leadership team. Each year, the maximum award payable to each executive is set by a Section 162(m)-compliant formula, based on corporate performance achievement (for example, an individual's award will not exceed X percent of net income).

The actual individual award, which is calculated at the end of the performance cycle, evaluates executive performance through two "filters":

Filter 1: Based on their performance against individual *quantitative* goals, each executive preliminarily qualifies for either 50 or 75 percent of his or her individual maximum award.

Filter 2: Each executive's performance is then reviewed against individual objectives the CEO has set for him or her.

Each executive who qualifies for 50 percent of the maximum award under Filter 1 can be awarded an amount less than 50 percent of the maximum award, but no more.

On the other hand, each executive who qualifies for 75 percent of the maximum award under Filter 1 can be awarded less than 75 percent, or the CEO can recognize exceptional performance with an award of as much of 100 percent of the executive's maximum award. By using the "negative discretion" feature of Section 162(m), the CEO is able to differentiate individual value contribution and promote real P4P.

includes investors, the board, and the leadership team. This then cascades down through the organization. Sibson's studies have identified several practices that guide these CEOs as they "talk the talk and walk the walk…but not alone." These CEOs:

□ Communicate and prove the pay-for-performance message to the board and investors at every opportunity.

□ Repeatedly tell the total employee population (and most especially the leadership team) about investor performance expectations and how those expectations translate into real pay for performance.

□ Ensure that the necessary performance evaluation tools and pay plan designs are in place (and appropriately applied) to support the individual differentiation required for real pay-for-performance.

□ With each member of the company's leadership team, establish that performance expectations are unambiguously aligned to their pay opportunities. Regular individual performance discussions with the leadership team builds understanding and support for real pay for performance.

□ Focus on the quality of the execution as opposed to just "check list" execution.

The key is for the board to mold a CEO with a diciplined pay-for-performance mindset and execution plan.

Regulatory mandates and broader pay disclosure requirements have shaped investor scrutiny of the board's role in aligning executive pay with company performance. Boards must be able to assure investors that top executive compensation reflects pay-for-performance, without usurping the CEO's pay determination responsibilities.

The key is to mold a CEO with a disciplined pay-for-performance mindset and execution plan. This P4P CEO has the courage (and board support) to apply pay-for-performance precepts, without exception, across the company, and with added rigor specifically to the company's top executives. ■

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