NACD

NACD Compensation Committee Chair Advisory Council

Effective Practices for Goal Setting and Using Nonfinancial Metrics

Introduction: The Current Environment

As elements of the Dodd–Frank Wall Street Reform and Consumer Protection Act's say-on-pay provisions are acutely focused on performance measures, and as executives navigate an increasingly complex business environment, directors might wonder what effective practices they should consider when setting goals for CEO performance and pay.

Fortune 500 compensation committee chairs convened in February 2016 to consider effective practices for goal setting and use of nonfinancial performance measures in compensation plans at a meeting of the National Association of Corporate Directors (NACD) Compensation Committee Chair Advisory Council, cohosted with Farient Advisors LLC and Katten Muchin Rosenman LLP. "We're dealing with a softening macroeconomic environment. Share prices are so volatile that year-over-year goal increases are not always realistic," said Dayna Harris, vice president at Farient Advisors. "So, total shareholder return (TSR) might decrease even if performance targets are met." As one director observed, "*CEOs are more reluctant than ever to put three-year financial goals out there, given the unpredictability of both US and global markets. It can result in some difficult conversations with the board*." [1]

The discussion generated four essential takeaways:

- Choose goals and metrics based on company strategy and value drivers.
- Factor relative performance versus peers into conversations about compensation.
- Don't underestimate the power of nonfinancial metrics to drive behavior.
- Engage with investors on an ongoing basis to clarify the link between compensation goals, metrics, and strategy.

[1] Italicized comments are from delegates or guests who participated in either the meeting on Feb. 23, 2016, or a related teleconference on March 10, 2016. Discussions were conducted under a modified version of the Chatham House Rule, whereby names of attendees are published but comments are never attributed to individuals or organizations (excepting cohosts of the event).

Choose goals and metrics based on company strategy and value drivers.

Throughout the meeting, participants emphasized the importance of using strategic priorities as the starting point for setting management's performance goals. The *Report of the NACD Blue Ribbon Commission on the Compensation Committee* notes that a poor connection between the behaviors that are rewarded in the compensation plan from corporate strategy can result in failure to execute company goals, low morale, and ultimately drive harmful levels of employee turnover.[2] "*Goal setting doesn't happen in a vacuum. It has to relate back to the business strategy*," one director observed. Another said, *"A good compensation plan should be the 'tail wagging the dog,' in a sense. You want the compensation plan elements to push the CEO toward making the company perform well."*

Several delegates agreed with one compensation committee chair who suggested, *"We need to take the conversation about strategy, goals, and associated performance targets out of the compensation committee meetings. It should be a full-board discussion first, and then the [compensation] committee can take it forward with pay-plan design*." While ultimate discretion over how senior management is compensated remains with the board, management will be involved in those discussions: 73.5% of respondents to the *2015–2016 NACD Public Company Governance Survey*[3] said that their board works with management to establish financial goals for the CEO. (See Appendix A for additional considerations by John Trentacoste, managing director, Farient Advisers, on the use of nonfinancial metrics in executive compensation plans.)

Directors—specifically, compensation committee members—can counter short-term mind-sets with a long-term focus. (See Appendix B for a list of questions on linking incentive compensation to short- and long-term performance metrics.) In addition to aligning short-term performance goals with long-term strategy, directors should ensure that those goals are tied to pay-plan elements in a way that drives value creation. "*If a metric is strategic, it will show up in the bottom line,*" one director said. At the meeting, delegates shared several examples of how their compensation committees used pay elements to drive value:

The Impact of Currency Fluctuations

Swings in currency values can complicate the evaluation of management's performance against previously-set targets: "*We see big 'wins' or 'fails' that are undeserved, simply because of currency volatility,*" said one delegate. Compensation committees can consider the following approaches:

- Establish a "collar" range of acceptable exchange rates and make after-the-fact adjustments only if the change in currency value falls outside that range. "*We use +/- 5% at one of my companies,*" a delegate remarked. "*Management eats the loss or gets the benefit and, beyond that, we will adjust.*"
- Utilize a constant currency adjustment model to eliminate fluctuations in value.

[2] NACD, *Report of the NACD Blue Ribbon Commission on the Compensation Committee* (Washington, DC: NACD, 2015), p. 15 (Hereafter referred to as the *BRC Report on the Compensation Committee).*

[3] NACD, *2015–2016 NACD Public Company Governance Survey* (Washington, DC: NACD, 2015), p. 39.

- “*We have [goals associated with] five core metrics that roll up to [compose] 20% of the CEO’s annual incentive. It’s difficult for executives to game these [metrics], [which] makes a strong cultural statement.*”
- “*At one company, 30% of the CEO’s bonus is tied to one major customer-related metric. If the company is not number one or number two versus our competitors for a majority of the year, there is a zero payout.*”

Directors noted that using strategy as a baseline for goal setting can help mitigate against actual or perceived pressure to conform the executive pay-plan design to proxy advisors’ recommendations or other “fads” in compensation. To take one example, TSR has become a commonly used element of compensation, with 50% of directors reporting that, when linking senior executive pay to long-term corporate financial performance, they use TSR to define corporate performance.[4] TSR, however, is based on share price, which depends on a wide range of both internal and external factors. “[TSR] is not a direct reflection of how well or poorly management is running the firm,” Harris cautioned in an *Agenda* article.[5] Compensation committees should therefore consider how best to use it—for instance, as a modifier. Several delegates at a previous council meeting reported that their boards use TSR or other relative measures as a “collar” on incentive payouts: “We base our incentive plans on absolute financial and operational metrics. If they meet the targets, but TSR is below median, they can’t get the maximum payou*t*”.[6] Delegates at the spring 2016 meeting highlighted the importance of using TSR as a way to communicate the alignment between pay and performance. “W*e report it, but we don’t base compensation [plan design] on it*,” one director remarked. But because TSR depends on many factors outside executives’ direct control, it is less useful as a performance metric in and of itself.

Factor relative performance versus peers into conversations about compensation.

Delegates encouraged compensation committees to consider comparative analyses. “*Set stretch objectives within the context of the industry,*” a director

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[4] NACD, *2015–2016 NACD Public Company Governance Survey* (Washington, DC: NACD, 2015), p. 20.

[5] Dayna Harris, “*Negative TSR Prompts Hard Look at Exec Pay*,” *Agenda*, 2016 (content available exclusively to *Agenda* subscribers).

[6] NACD, *NACD Compensation Committee Advisory Council: Setting Incentive Goals and Targets* (Washington, DC: NACD, 2015), p. 7.

said. Considering industry context can be particularly helpful during periods of economic downturn. "*You'll have down periods, but you want to [create incentives for management to] weather [them] well compared to your competitors,*" a director advised. Another delegate commented, "*Looking at performance as compared to peers can help to capture the 'degree of difficulty' factor in tough markets.*"

Conversation revealed that council delegates incorporate relative performance into compensation decisions as follows:

- To define one or more peers: "*Part of our performance review includes an evaluation of the company's results against a major competitor.*"
- As an input or modifier: "*We have a goal of new-customer growth, and the threshold for payout is the overall category growth rate. Target payout is set at the average of our top five competitors. To get the 'exceeds' payout, management has to be above that.*"
- As a part of the compensation committee's discretion: "*We look at relative performance in a qualitative way. We can use it to adjust [incentive awards] as necessary.*"

Attendees highlighted several areas of caution related to relative performance considerations. First, some companies, especially those with complex structures and multiple business units, may find it difficult to identify appropriate peers. Second, the process of doing so can leave companies vulnerable to scrutiny. Right or wrong, the selection of narrowly-defined compensation peer groups, e.g., those paying only in the 50th or 70th percentile, has been highlighted as a "gaming" practice that contributes to the inappropriate escalation of executive pay.[7] Additionally, proxy advisory firms have determined their own ways of identifying peer groups and often recommend that investors vote against pay plans that do not match their analyses.[8] Finally, delegates agreed that boards should also consider that, though they can look to peers to help determine appropriate performance metrics, it is best to avoid making the incentive system overly complex.

In Practice

DEFINING THE RELEVANT MARKETPLACE

It is important to define the relevant "compensation marketplace" at the outset of the process of creating a peer group. Finding a suitable group of peers for highly specialized companies or large conglomerates may be difficult. As a result, [some] companies have started to use multiple peer groups—for example, one peer group for comparing company pay practices and another for comparing company performance. Compensation committees can work with an independent consultant to derive an unbiased comparative group for use as a reference point.

The committee should oversee peer group selection and have a clear understanding of the survey/selection methodology used by their independent consultant. When judging peer companies, committees should use multiple criteria beyond revenue, which could include

- number of employees;
- market capitalization;
- financial structure;
- geographic and/or business footprint; or
- competition for customers, suppliers, and talent.

Source: *BRC Report on the Compensation Committee*, p. 16.

[7] *BRC Report on the Compensation Committee*, p. 16.
[8] *BRC Report on the Compensation Committee*, p. 16.

Don't underestimate the power of nonfinancial metrics to drive behavior.

Nonfinancial metrics can be used in powerful ways during times of organizational transformation—even if those metrics are not attached to a large dollar value—particularly if those nonfinancial metrics point toward cultural or strategic priorities, as in the customer-service metric example cited earlier. Delegates' discussion echoed themes from a prior council meeting, in which a director said, "At my current board, safety is critical. It is the first thing we talk about. Other industries may have different metrics that fall into the mission-critical category."[9]

In NACD's most recent governance surveys, respondents reported that their compensation plans utilize the nonfinancial metrics in the graphic to the right.

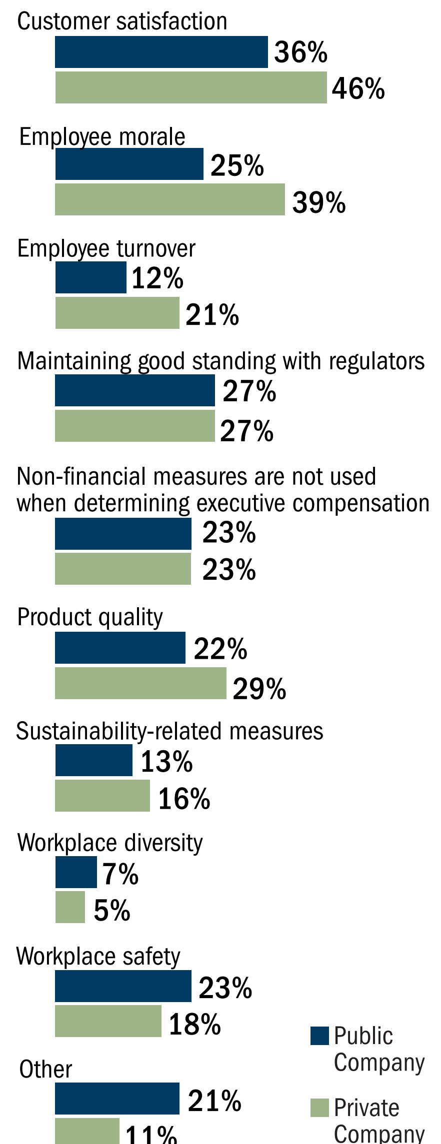
Directors at the most recent meeting pointed out that the same caution about complexity in the case of relative performance measures applies to the use of nonfinancial metrics. "*If you want to use nonfinancial metrics, ask yourself if it's really influencing behavior,*" one director said. "*The more metrics you have, the more complicated it is to communicate the plan [to stakeholders] and [that] could be seen as window dressing.*" That said, delegates agreed that non-financial metrics are well worth considering as tools to "*move the organization and drive alignment on important issues.*"

Engage with investors on an ongoing basis to clarify the link between compensation goals, metrics, and strategy.

F. William McNabb III, CEO of The Vanguard Group, recently said, "We want to continue to increase the levels of engagement we have with boards. We believe that directors—and investors—are moving in the right direction on that front."[10] Continuous improvement on communication with shareholders regarding compensation philosophy, pay-plan design and pay outcomes has been a frequent topic of discussion at this advisory council. At this meeting, one director observed, *"Sometimes companies have to go back in order to go forward. We may need to go to shareholders and say,*

[9] NACD, *NACD Compensation Committee Advisory Council: Setting Incentive Goals and Targets* (Washington, D.C. 2015) p. 7.

[10] F. William McNabb III, "Getting to Know You: The Case for Significant Shareholder Engagement," *Harvard Law School Forum on Corporate Governance and Financial Regulation,* June 24, 2015.



Source: NACD, *2015–2016 NACD Public Company Governance Survey*, (Washington, DC: NACD, 2015) p. 20.

Source: NACD, unpublished data from the *2015–2016 Private Company Governance Survey* series.

because of investments associated with a new strategy or new initiatives, we may have different or lower results in the short term. Can we describe that in a way that makes sense to investors?" Another attendee said, "*Tell the story behind the numbers*"—and tell it early in the year and often when communicating with shareholders. That way, when it comes time to disclose compensation data, investors already have a clear understanding of how compensation and strategy are linked. Claudia H. Allen, partner at Katten Muchin Rosenman, said, "Investors are keenly interested in the metrics that drive value. So, when engaging with investors and writing proxy disclosure, companies should clearly explain those metrics and how they are reflected in their compensation plans." (See p. 7 for more information on investors' perspectives on executive compensation.)

Boards should not think of the compensation discussion and analysis disclosure or meetings held during proxy season as the only methods of communicating to investors.[11] Rather, consider how meetings held outside of proxy season could lead to more effective engagement with investors regarding executive pay. The compensation committee and full board should be familiar with the pay-plan elements that are likely to receive negative criticism from proxy advisory firms and investors and discuss those elements with the investor community before pay disclosures are released.[12] Jack Zwingli, head of research at Farient Advisors, noted, "Investors and proxy advisors are looking at the relationship between goals, performance levels, and payouts. When executives receive higher compensation for lower performance, or goals drop year-on-year but payouts do not, those are red flags that boards will need to be prepared to explain."

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[11] *BRC Report on the Compensation Committee*, p. 20.
[12] *BRC Report on the Compensation Committee*, p. 21.

INVESTOR PERSPECTIVES ON EXECUTIVE COMPENSATION[13]

For most companies, 2016 will be the sixth year of annual say-on-pay votes, but several investors pointed out that "while compensation may seem like an 'old hat' topic, it still comes up in nearly every one of our engagements with portfolio companies." Relevant questions for compensation committees include:

- Have any of our company's major investors recently updated their executive-compensation voting guidelines?
- Are our communications (written as well as face-to-face) structured in a way that gives a clear picture of the connections among company strategy, pay philosophy, pay-plan design, performance, and compensation outcomes?
- Do we know how our board's governance practices compare with those of our peers? Have we communicated the rationale behind the board's decisions in areas where our major investors are likely to have questions?
- Do we have opportunities to receive feedback on governance and board leadership issues directly from shareholders, or is input on these matters provided to the board solely by way of management (e.g., via the CEO, general counsel, investor-relations team) and/or external advisors?

[13] NACD, *Investor Perspectives: Critical Issues for Board Focus in 2016*, (Washington, DC: NACD, 2015) pp. 3–5.

For Further Reading

NACD, *Report of the NACD Blue Ribbon Commission on the Compensation Committee* (Washington, DC: NACD, 2015).

Dayna Harris, "Aligning Goals When the Future Is Not So Rosy," *NACD Directorship* magazine (Washington, DC: NACD, 2015).

NACD, *Report of the NACD Blue Ribbon Commission on the Board and Long-Term Value Creation,* especially Appendix D – Long-Term-Oriented Performance Metrics (Washington, DC: NACD, 2015).

NACD, *Preparing the CD&A: Priority Considerations for Boards* (Washington, DC: NACD, 2015).

Katten, *Update on Final and Proposed SEC Compensation Rules and Director Compensation* (Chicago, IL: Katten, 2016).

NACD, *Executive Compensation Strategies in Periods of Disruption* (Washington, DC: NACD, 2015).

APPENDIX A

The role and prevalence of nonfinancial metrics in executive compensation[14]

John Trentacoste, managing director, Farient Advisors, tackles nonfinancial metrics in the compensation mix. Trentacoste outlines four reasons why nonfinancial metrics encourage value creation for shareholders and stakeholders and paint a fuller image of executive performance.

When we look at the reasons why nonfinancial metrics are used in determining executive compensation, it really comes down to the following four primary reasons:

- Nonfinancial metrics and the achievement of nonfinancial metrics helps round out a more holistic picture of corporate performance.
- Achieving nonfinancial metrics in tandem with financial metrics can help drive long-term value creation of the organization.
- They can provide focus for executives on either executing against an articulated strategy or pivoting the corporate strategy.
- Nonfinancial metrics can help organizations focus on stakeholder return in addition to shareholder return.

The question is how are nonfinancial metrics being used currently? Although we often see them in the short-term plan, there are some difficulties with calibration. They are either a weighted measure, which means that a percentage of the incentive is based on the achievement of nonfinancial metrics, or they are modifiers, which means that after the financial performance is determined, there is either a plus up or a plus down based on achievement of predetermined goals. Because companies are often working within a §162(m) construct for tax deductibility, we are not seeing nonfinancial metrics as a large part of the incentive plan. Instead, they comprise about 25% of the incentive, and if they are a modifier, the incentive could be weighted up or down about 25%.

We are seeing three overall constructs when you look at nonfinancial metrics use:

- **First, at the corporate level**. Measures have been identified for the entire executive team to coalesce around. For example, if you take

[14] John Trentacoste (adapted from a discussion at NACD's "Leading Minds of Compensation" program, New York City, Apr. 6, 2016).

a survey of publicly traded companies, the measures might include customer satisfaction and safety. Airlines, for example, are using on time arrivals and departures as a nonfinancial metric.

- **Second, the individual level**. This often mirrors the corporate metrics; however, thinking about it on a more individualized basis provides opportunities for executives to own a piece of their incentive that is highly relevant to them. It creates more differentiation. If, for example, you have a chief human resources officer and have a metric or scorecard ascribed to that person, you can include things like implementing a human resource information system or diversity initiatives. The individual metrics are highly localized to that talent for maximum impact.
- **Third is a performance-year construct**. This is really used more frequently by the financial-services industry. At the end of the year, the books close and the compensation committee reviews what was achieved financially. They also review how the results were achieved focusing on risk mitigation and the ways in which the executives drove those results.

And finally, where are nonfinancial metrics going in terms of proxy disclosures, investors, and stakeholders? Inevitably they will increase in prevalence. My colleagues at Farient and I agree that these metrics will be focused around what we are calling stakeholder return—around environmental, social, and governance (ESG)—metrics. So, areas like sustainability, diversity, clean sourcing, supply-chain management, safety, and all things of that nature. We are hearing from our clients that in shareholder engagement, investors are concerned about how these corporate governance and diversity plans are factoring into compensation and how the companies are actually making good on what they are writing in their proxies. There is a lot of capital behind ESG. There is a lot of capital behind sustainability and we think that those will continue to flow into the executive incentive plans.

APPENDIX B

Special considerations of the compensation committee[15]

There are many factors to consider when relating incentive compensation to short- and long-term performance metrics. Compensation committees, chiefly responsible for this activity, should review some of the following questions:

- Do the chosen performance metrics support the basic strategy? Do they measure the key value drivers?
- Does the required performance fall within the scope of industry performance and economic projections?
- Are the performance metrics incentivizing teamwork or individual merit?
- Have we reviewed performance metrics as disclosed in our competition's proxy statements?
- What are the weights of varying business units? Have we placed too much emphasis on one particular unit?
- Have we placed too much emphasis on a particular individual performance factor? Have we ensured no one metric dominates?
- Are the metrics able to be communicated externally with respect to legal issues and confidential information?
- Are the short-term bonus metrics supportive of and consistent with long-term metrics?
- What are the pros and cons of using relative performance measures?
- Should there be a payout if performance is negative but beats peers' performance?
- Is there sufficient confidence in the integrity of the numbers and the measurement process of the metrics, whether financial or nonfinancial, to be sure that fraud or erroneous reporting would not subject the payments to clawback provisions required under the Dodd–Frank Act?
- Can the performance metrics be skewed inappropriately by nonrecurring or nonoperating performance?

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[15] NACD, excerpted from, *Report of the NACD Blue Ribbon Commission on Performance Metrics,* (Washington, DC: NACD, 2010), pp. 14–15.

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About the Compensation Committee Chair Advisory Council

In support of a sustainable, profitable, and thriving corporate America, the National Association of Corporate Directors (NACD) created the Compensation Committee Chair Advisory Council. Since 2011 this council has brought experienced compensation committee chairs from Fortune 500 companies together with key shareholder representatives, regulators, and other stakeholders to discuss ways to strengthen corporate governance in general and the work of the compensation committee in particular. Farient Advisors LLC and Katten Muchin Rosenman LLP collaborate with NACD in convening and leading this council.

Delegates of the council have the opportunity to engage in frank, informal discussions regarding their expectations for compensation practices, processes, and communications and to share observations and insights on the changing business and regulatory environment. The council's purpose is threefold:

- Improve communications and build trust between corporate America and its key stakeholders.
- Give directors engaged in the compensation arena a voice and a forum in which to exchange perspectives with regulators, standard-setters, investors, and other important constituents on committee-related matters.
- Identify ways to take board leadership and compensation committee practices to the next level.

NACD believes that the open dialogue facilitated by this advisory council is vital to advancing the shared, overarching goal of all boards, investors, and regulators: to build a strong, vibrant capital market and business environment that will continue to earn the trust and confidence of all stakeholders.

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