NACD
Perspectives Paper

Pay for Performance and Supplemental Pay Definitions

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NACD Perspectives Paper: Pay for Performance and Supplemental Pay Definitions

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Introduction

This document outlines the National Association of Corporate Directors' (NACD's) point of view on executive pay-for-performance principles and pay definitions. It is informed by years of NACD research, including the *Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee* (Executive Compensation BRC), originally published in 2003 and re-issued in 2007.

NACD's Compensation Committee Chair Advisory Council—a group of Fortune 500 compensation committee chairs, leading institutional investors, and other stakeholders convened by NACD in collaboration with advisory council partners Farient Advisors and Gibson, Dunn & Crutcher—has been an important source of input, including in the development of NACD's *Pay and Performance Disclosures Survey* (Pay Survey), conducted in July 2013. Our perspective is also informed by extensive conversations with the broader corporate director community and corporate governance leaders from the private and public sectors.

Philosophy

Underlying NACD's perspective on pay definitions is the executive compensation philosophy developed by the Executive Compensation BRC, which asserts the following guiding principles[1]:

- Independence – of the board, the compensation committee, and its external advisors.
- Fairness – decisions based on strong business rationale and fairness in relation to internal and external benchmarks.
- Alignment with long-term shareholder value creation.
- Clear linkage between pay and established performance metrics.
- Transparency to investors and other key constituencies.

Pay-for-Performance Principles

The following four principles should apply to assessing and communicating the link between an executive's compensation and company performance, or "pay for performance" as it is commonly known:

1. STANDARD DEFINITIONS (WITH FLEXIBILITY). In order to enhance comparability of pay and performance disclosures, NACD believes companies should adopt standard "baseline" definitions of pay and performance, and a similarly standard methodology of presenting pay-for-performance analysis, with the understanding that any company may choose to go beyond the baseline and present additional information in order to more effectively communicate with investors and other stakeholders.

- Over 60 percent of respondents to NACD's Pay Survey, and over 65 percent of compensation committee chair respondents, support the use of standard pay and performance definitions, provided that "companies can augment the standard analysis if it helps them more effectively tell their story."
- The Executive Compensation BRC recommends that compensation committees "[u]se a range of metrics to provide a balanced assessment of performance—including both quantitative and qualitative measures." The report goes on to say that "[c]ompensation metrics should generally be based on reported financial results determined in accordance with GAAP, or other acceptable reference points, without adjustments."[2]

> Similarly, the *Report of the NACD Blue Ribbon Commission on Performance Metrics* (Performance Metrics BRC) notes that "no single metric, absolute or relative, should dominate in any measure of corporate performance. It may be helpful to use absolute goals for internal, non-financial metrics while relative goals are used primarily to measure financial performance."[3]

For example, NACD believes that while the baseline definition of "performance" should include total shareholder return (TSR), an isolated emphasis on TSR can result in excessive focus on quarterly financial numbers and encourage short-term thinking. In the interest of avoiding over-reliance on any single metric, companies may choose to include other financial and non-financial performance measures that they believe to be relevant.

- Close to 60 percent of directors who responded to NACD's Pay Survey said companies should be required to use TSR at a minimum, with the ability to include any other metrics the company deems relevant.
- In a recent NACD Compensation Committee Chair Advisory Council meeting, a compensation committee chair said: *"I'd have no problem reporting standard definitions, if it helps investors make better comparisons. But the compensation committee needs to be able to apply judgment to [executive] goal-setting and choosing performance metrics."* An investor commented: *"Shareholder value creation is much broader than TSR. It can include investments in [research and development], customer satisfaction, and many other factors."*

2. CONSISTENT TIME HORIZONS, ORIENTED TO THE LONG TERM. NACD believes that the time horizon for measuring both pay and performance should be consistent with one another. Recognizing that each company will select an appropriate time horizon for longer term pay-for-performance analysis based on relevance to its business and strategy, NACD recommends companies consider a three- or five-year baseline, as opposed to a one-year baseline, to highlight the connection between the compensation plan and the creation of long-term value for the company and its shareholders. The use of long-term time horizons in pay-for-performance analysis is distinct from companies' inclusion of one or more short-term incentive components, which are typically annually based, in the design of executive compensation plans.

- The Executive Compensation BRC advocates "pay packages that encourage long-term commitment to the organization's well-being.... Compensation committees should focus primarily on awards for achieving key metrics over an extended period of time."[4]
- When asked for preferences on pay and performance time horizons, 55.9 percent of Pay Survey respondents chose three years, 33.6 percent chose five years, and 25 percent chose "whatever time period is most relevant to the company's business" (multiple selections were permitted on this question).

3. NEED FOR DISCLOSURE BEYOND THE CEO. NACD believes companies should disclose pay-for-performance data for the CEO as an individual, and in addition, disclose a second pay-for-performance calculation which includes all other named executive officers (NEOs) as a group. For most companies, this group includes the CFO and the three most highly compensated executive officers other than the CEO and CFO.

- NACD's Pay Survey found that approximately 60 percent of directors believe pay and performance should be disclosed for "the CEO, separately, and NEOs as a group."
- In a recent advisory council teleconference discussion about pay definitions, a director said: *"This approach provides the appropriate level of detail for investors."* An investor added that the information *"is helpful to us as we look across companies. Virtually all have a CFO, a general counsel, and so on. We can make better comparisons looking at [pay-for-performance] information across the executive teams."*[5]

4. IMPORTANCE OF BOARD JUDGMENT AND COMPANY CONTEXT. NACD believes directors are responsible for exercising informed business judgment in carrying out their fiduciary objective of promoting long-term value creation for the corporation, "avoid[ing] rote 'box-ticking' in favor of a more thoughtful and studied approach."[6] This responsibility applies to all areas of corporate governance, including duties related to executive compensation.

- Institutional investors have expressed support for this principle in NACD's recent multi-stakeholder dialogues. One said: *"[We seek to] understand the variety of ways in which performance is reflected in pay structures. We have very valuable discussions with compensation committees about the context and the story behind their decisions."* Another investor said: *"We will always look at the 10K and do our own analysis and modeling, and there may be differences in the way we view 'total compensation' versus the way companies view it. But that's where ongoing engagement comes into play."*
- One-size-fits-all analysis is especially difficult to apply in complex, technical areas such as executive compensation. No single formula can adequately measure pay and performance alignment given the wide range of factors which can potentially skew pay-for-performance calculations, including peer group reporting timelines, overlapping equity award cycles, date-specific stock prices and TSR calculations, and overly narrow definitions of "performance."[7]
- The Executive Compensation BRC states: "Directors [must] exercise sound judgment in making their compensation decisions and maintain the courage of their convictions despite internal and external pressures."[8] It goes on to recommend that "each member of the committee should have the resolve and skepticism to ask probing questions…to set and adhere to necessary limits, to be an advocate for change when a current practice results in the wrong outcome, and to ask 'why'—and if necessary say 'no'—in response to questionable proposals."[9]

Supplemental Pay Definitions

CONTEXT

Title IX, Section 953(a) of Dodd-Frank requires companies to provide

> a clear description of any compensation required to be disclosed by the issuer under section 229.402 of title 17, Code of Federal Regulations (or any successor thereto), including information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions.[10]

Dodd-Frank does not provide definitions for "compensation actually paid" or "financial performance." Absent clear standards, companies are increasingly including supplemental executive compensation disclosures in their proxy statements in an effort to provide more meaningful information to their shareholders. The result has been widely divergent approaches to defining and communicating the connection between pay and performance. In the words of one investor: *"We need to make more progress on establishing common ground in areas like pay definitions, so we can all speak the same language, even if the details or the decisions are different."*

REALIZED PAY

Realized pay is intended to represent "what an executive actually made in a given year,"[11] in contrast to summary compensation table pay, which includes pay opportunity: the estimated value of future potential pay, including options, performance-based stock, or stock equivalents. Realized pay is often said to be an approximation of W-2 earnings or "take-home pay."

Components of Realized Pay: NACD Perspective

- Base salary.
- Cash bonus/incentive awards.
- Gains from stock option exercise during the specified time period (regardless of original grant date).
- Value of restricted shares or share units if vested during the specified time period.
- Value of performance shares or share units if vested during the specified time period.

- While definitions of realized pay vary, the above definition is becoming the most-commonly cited in reports on the increasing use of such disclosures by companies in their proxy statements.[12]
- Commentators have observed that this definition of realized pay "would appear to be consistent with a literal reading of the language of Section 953(a) of the Dodd-Frank Act which requires disclosure of 'compensation actually paid.'"[13] Thus, realized pay would prove useful in calculations such as the proposed CEO-to-median-employee pay ratio. Section 953(b) of Dodd-Frank, however, requires the use of summary compensation table data in the pay ratio calculations.
- An important aspect of realized pay "is that in the case of stock options it picks up investment decisions by the executive, i.e. decisions on when to exercise stock options,"[14] regardless of the date the options were originally granted. NACD believes this makes realized pay unsuitable for use in pay-for-performance analysis because pay and performance time frames could differ significantly.

REALIZABLE PAY

Like realized pay, realizable pay disclosure is not required by the Securities and Exchange Commission, but companies are increasingly including it in proxy statements as a way of communicating the alignment between pay and performance. Realizable pay includes components that reflect stock price performance over a period of time (typically a multi-year horizon, e.g., three years), and excludes the effect of individual investment decisions such as the exercise of stock options granted in years prior to the company performance period being analyzed.

At a recent NACD Compensation Committee Chair Advisory Council meeting, one institutional investor described realizable pay as a *"progress report"* that *"allows us to see how the reward structure and philosophy is actually playing out. We don't ignore the summary compensation table, but we like the notion of realizable pay for this purpose."*

Components of Realizable Pay: NACD Perspective

- Base salary.
- Cash bonus/incentive awards paid.
- Long-term cash bonus/incentive granted but not yet paid.
- Change in pension value and non-qualified deferred compensation.
- Value of executive benefits and perquisites.
- Stock options: Black-Scholes value of options awarded during the specified time period (whether vested or unvested), using stock price at the end of the time period.
- Restricted stock: Value of shares awarded during the specified time period (whether vested or unvested), using stock price at the end of the time period.
- Performance-based equity awards: Value of shares earned during the specified time period, using stock price at the end of the time period.

There is general agreement that base salary, cash bonuses and incentives, and long-term incentives granted but not yet paid should be included in definitions of realizable pay. Several key questions remain, involving non-compensatory benefits and the treatment of long-term equity incentives.

NON-COMPENSATORY BENEFITS

Although non-compensatory benefits such as deferred compensation, changes in pension value, and perquisites are already disclosed elsewhere in the proxy statement, NACD believes that they should be also included in realizable pay calculations.

- 76 percent of directors who responded to NACD's Pay Survey said pay-for-performance analyses should include non-cash compensation, including "pension accruals/deferred compensation contributions, executive benefits, and perquisites."

- Compensation committee chairs and institutional investors were aligned on the importance of including non-compensatory benefits in realizable pay in recent advisory council dialogues. One director said: *"I'm interested in seeing how senior executives are treated versus others in the company.… If it's in the bank, it should be counted."* Another director pointed out that *"[p]ensions are part of our retention strategy, so they should be considered [in pay-for-performance analysis]."* An investor noted that changes in pension values are *"a real-world factor that would be meaningful for executives to take into account when considering their compensation and income, so we should as well."* This view is borne out in NACD's *2013–2014 Public Company Governance Survey* results, which report that the average change in CEO pension value of large- to mega-cap companies, as reported in summary compensation tables, ranged from $1.4 million to $2.9 million.[15]

LONG-TERM EQUITY INCENTIVES

NACD believes Black-Scholes option valuation should be used to determine the value of stock options in realizable pay calculations. Put simply, executives accept options as currency, even when they are out-of-the-money.

- In recent NACD dialogues, institutional investors and compensation committee chairs shared a preference for Black-Scholes valuation. As one director said: *"There's a value in consistency: so many companies use this approach."* An investor pointed out:

  > *Investors understand options, including the strengths and weaknesses of Black-Scholes. If a company tries to say that options are valued at zero with eight years to go [before vesting], the credibility of their overall analysis is hurt in our eyes. It can call other parts of the [compensation discussion and analysis] into question.*[16]

NACD believes that calculations of realizable pay should include the earned value of performance-based equity awards during the relevant performance period, in order to increase accuracy of the analysis.

Conclusion

At a recent NACD Compensation Committee Chair Advisory Council meeting, delegates observed that "say on pay has enhanced and strengthened engagement between the board and investors. After several years of increased investment in terms of time and resources, boards have continued to raise the bar on linking and communicating pay with performance, and shareholders are responding with supporting votes."[17]

NACD believes clear and informed communication between directors and investors on governance matters is a critical element of corporate governance transparency. Establishing shared definitions for realized and realizable pay which can be widely adopted by public companies is one important way to enhance such communication. ▲

Endnotes

[1] *See* National Association of Corporate Directors (NACD), *Executive Compensation and the Role of the Compensation Committee* (Washington DC: NACD, 2007) (a report of the NACD Blue Ribbon Commission) [hereinafter Executive Compensation BRC].
[2] *Id*. at 26-27.
[3] National Association of Corporate Directors (NACD), *Performance Metrics: Understanding the Board's Role* (Washington DC: NACD, 2010) (a report of the NACD Blue Ribbon Commission), 6.
[4] Executive Compensation BRC, *supra* note 1, at 14.
[5] Compensation Committee Chair Advisory Council, NACD, "Compensation Committee Chair Advisory Council Teleconference Summary," Sept. 4, 2013, 2 [hereinafter Advisory Council Sept. 4 Teleconference Summary].
[6] National Association of Corporate Directors (NACD), *Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies* (Washington DC: NACD, 2009), 9.
[7] *See* Cathy Rochford, "Using Realizable Pay to Tell Your Pay-for-Performance Story," (Pearl Myer & Partners, 2012).
[8] Executive Compensation BRC, *supra* note 1, at 33.
[9] *Id*. at 18.
[10] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 953(a)(i) (2010).
[11] Emily Chasan, "Many Ways to Say Executive Take-Home Pay," *Wall Street Journal*, Oct. 3, 2012.
[12] Emily Chasan, "Executive Pay Gets New Spin," *Wall Street Journal*, Sept. 25, 2012. *See also* Robin Ferracone and Jack Zwingli, Pay Definitions: What Works Best in Pay for Performance Analysis (New York: Farient Advisors, Nov. 2012), 6 (a Farient executive compensation white paper) [hereinafter Ferracone and Zwingli].
[13] The Conference Board, *Supplemental Pay Disclosure: Overview of Issues, Proposed Definitions, and a Conceptual Framework* (New York: Conference Board Working Group on Supplemental Pay Disclosure, 2013) (this white paper was prepared by the Conference Board Working Group on Supplemental Pay Disclosure, a joint project with the Center on Executive Compensation and the Society of Corporate Secretaries and Governance Professionals), 9.
[14] Ferracone and Zwingli, *supra* note 12, at 6.
[15] National Association of Corporate Directors (NACD), *2013–2014 NACD Public Company Governance Survey* (Washington DC: NACD, 2013), 48-49.
[16] Advisory Council Sept. 4 Teleconference Summary, *supra* note 5, at 2.
[17] *Id*. at 3.