

a new approach to executive *compensation*

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Executive compensation continues to grow in both dollars and media attention, and at times the arguments and news stories seem circular and repetitive. The Securities and Exchange Commission (SEC) recently increased the amount of pay disclosure required, which has highlighted the complexity of today's executive compensation programs. For example, Citigroup's most recent proxy statement uses 16 different tables to describe its compensation program. Executive compensation programs have gotten so complex that the media, shareholders, the compensation committee and the executives themselves often fail to understand how these programs work. This has led to some programs that are excessive and not linked to the performance of the company. High-performing executives are in limited supply and deserve to be well compensated, but companies need a competitive,

performance-focused program that is fair and easy to understand.

This article outlines a simple and straightforward approach to executive pay that provides a better linkage between performance and pay. The new model is less complex, easier to communicate, directly related to performance and contains no "hidden" pay.

The Case for Simplicity

It can be said that executives and their advisers like complex executive compensation programs, and most maintain that each element is intended to solve a specific compensation issue. Consequently, the programs are difficult to analyze. Companies mirror each other's compensation plans in order "to stay competitive," but as new programs become standard "practice," pay programs can get even more complicated. The authors maintain that salary

QUICK LOOK

- ➔ It is long-term incentives such as stock options and restricted stock that cause the most confusion and unnecessary complexity.
- ➔ It makes more sense to base grant levels on current performance rather than to just mirror peer group grant levels.
- ➔ Compensation not related to performance, such as supplemental retirement and excessive perquisites, should be reallocated to performance-based stock awards.



and annual incentives are really not the problem; rather it is long-term incentives, such as stock options and restricted stock, as well as supplemental retirement and deferred compensation that cause the most confusion and unnecessary complexity. For example, Figure 1 shows a long-term incentive program that uses the same grant date, grant price and vesting schedule for each program. The level of complexity grows exponentially when grants are made on different dates, with different grant prices and with different vesting schedules, which is how most programs are administered. The value of these grants is based on the future performance of the company's stock price. First, the initial grant is made, in order to provide a competitive level of long-term incentives. Then the performance of the stock determines the eventual payout.

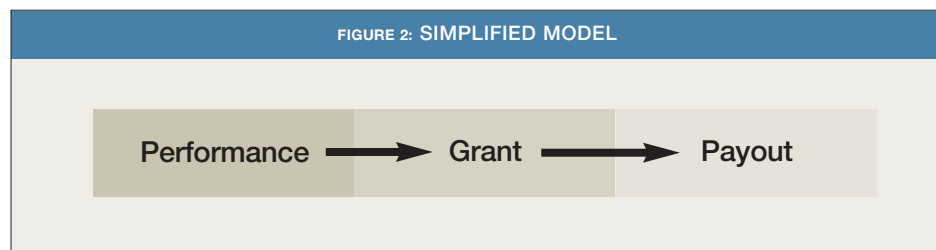
Keeping track of the value is difficult for the company and the executive, which may reduce the motivational impact of these plans. General economic and stock-market conditions, as well as individual company performance, determine the ultimate value of the award. McKinsey & Co.'s 2002 study says that factors outside of the executive's control, such as the overall economy and stock market, provide much of the value of a specific company's stock. The article further suggests that companies should consider alternatives to stock options. Given these uncontrollable performance factors, it makes sense to base grant levels on current performance instead of future performance.

Simple Executive-Compensation Model

In order to simplify, the company should consider moving the performance to the front end, where the grant is based on that year's performance. (See Figure 2.) This is similar to the model used by many investment banking firms. At the

FIGURE 1: STANDARD EXECUTIVE COMPENSATION MODEL

	2007	2008	2009	Value 2010	Value 2011	Value 2012
Share price	\$30.00	\$32.10	\$34.35	\$36.75	\$39.32	\$42.08
Option Grant	200,000			\$1,350,258		
Option Grant		200,000			\$1,444,776	
Option Grant			200,000			\$1,545,910
Restricted Stock	50,000			\$1,837,565		
Restricted Stock		50,000			\$1,966,194	
Restricted Stock			50,000			\$2,103,828
Performance Shares	50,000			\$1,837,565		
Performance Shares		50,000			\$1,966,194	
Performance Shares			50,000			\$2,103,828
TOTAL				\$5,025,388	\$5,377,164	\$5,753,566



end of the year, performance is evaluated and the total compensation is determined. It is not uncommon for companies to estimate the current economic value of the position and the incumbent and to establish a range of pay opportunity. Likewise, annual or biennial performance expectations that are based on financial performance, milestones and personal contributions can be easily measured and used to determine the value earned. Part of these earnings can be paid in cash and part in stock. The company decides to use stock options, restricted stock or performance shares to pay the noncash portion of the incentive. The ultimate value of the payout may be higher or lower because it is tied to future stock price, which would vest over time. Sales restrictions may also be part of the overall program. Since grants will be

based on performance that has already happened, criticism of programs that have a huge upside in a bull market for average performance and a huge downside in a bear market for good performance is no longer justified.

From a compensation perspective, the amount paid would be approximately the same. Figure 3 on page 47 shows CEO compensation for a large public company under both models. Under the new model, the \$9-million bonus would be earned based on performance, and would be split between cash and stock.

Eliminate the Hidden Paycheck

Given the income paid and earned among most executives, it is also time to rethink supplemental retirement programs, deferred compensation and excessive change-in-control payments. These amounts tend to be significant and

FIGURE 3: COMPARING MODELS

	Old	New
Salary	\$1,500,000	\$1,500,000
Bonus	\$2,000,000	\$9,000,000
Options	\$3,000,000	TBD
Restricted Stock	\$3,000,000	TBD
Performance Shares/Units	\$1,000,000	TBD
TOTAL	\$10,500,000	\$10,500,000

often are completely unrelated to performance. If the executives wish to defer their own compensation, then the rate of return should mirror the company's own internal rate of return on funds invested in the business. Change-in-control payments too should be rethought so that options and restricted stock do not automatically vest, and salary and benefits continue for a period of one to two years in the event of employment termination. If the executives are as good as their compensation packages represent, then they will have no problem finding other employment. The company should not continue to provide incentives to seek to trigger change-in-control windfalls.

Implementation Considerations

In order to implement this type of program, it would be necessary to have the compensation committee and management team agree on a change in philosophy and strategy. A material change would not be expected in pay opportunity levels but rather a change in the way performance and pay are linked and how pay is distributed. From there, the range of opportunity by job and by performance expectations would need to be established. Since this is currently done indirectly by most organizations, the challenge here is to establish the performance expectations around the pay opportunity. By its nature, the performance expectations would likely need to be linked with operating results,


FIGURE 4: EXECUTIVE WITH A \$500,000 BASE SALARY

Proxy Total Compensation	Market Total Reward	Percentile	Performance Expectation (Operating Cash Flow)	Pay Delivery
\$1,800,000	\$900,000	25th	\$130,000,000	50% Cash
	\$1,500,000	50th	\$150,000,000	25% Options
	\$2,300,000	75th	\$162,000,000	25% Restricted Stock
Distribution				
Performance Result	\$162,000,000			
Total Reward	\$2,300,000			
Cash Payment	\$1,150,000	50% Cash		
Net Cash Payment	\$650,000	Cash payment less \$500,000 base salary		
Stock Option Grant Value	\$575,000	25% Options		
Restricted Stock Grant Value	\$575,000	25% Restricted Stock		

growth and significant milestones, as well as individual performance or even a performance scorecard. The performance expectations would need to be established with a baseline, threshold and target, and with high-performance levels and varied pay opportunity to reflect the performance. From here each organization could establish its own methodology to determine the distribution of cash, options and restricted stock. Cash payments would be net of any base salary paid during the year or performance period. Existing deferred compensation and other supplemental plans could be maintained without future contributions or, in time, terminated and the proceeds distributed. (See Figure 4.)

Conclusion

The current long-term incentive pay model is far too complex, and a simple plan with clear linkage to performance is needed. Companies should first determine total compensation on performance then pay part of this compensation in stock. This puts the focus directly on pay and performance in a discreet performance period without removing the link between shareholders and executives. Companies should begin to move away

from the current pay model that provides upfront grants of stock in order to provide executives with a competitive compensation opportunity and redirect or eliminate pay not related to performance. 

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