It can be reasonably argued that making decisions on executive pay is one of the most important responsibilities of the board, and in particular is the most important responsibility of the compensation committee (the ‘committee’). If nothing else, decisions on executive pay are certainly one of the most visible, and can be one of the most controversial decisions made at the board level. Each year, the annual proxy of a public company must disclose how much each of the ‘top five’ executives is paid, how the incentive compensation plans work, and why each element of pay was included. Further, after the market collapse of 2008, a new element was required with respect to the proxy—an assessment of the ‘risk’ level built into the incentive plans in order to disclose whether any incentive plans “are reasonably likely to have a material adverse effect on the company.” ‘High risk, high reward’ was no longer considered a reasonable compensation strategy (if it ever was).

Executive pay has always been a subject of interest in the popular press and, following each proxy season, the leading newspaper in virtually every major city across America publishes a story on ‘the most highly paid executives’ in the area. The data may not always be accurate but is almost always the source of serious discussion and shareholder activism.

What’s more, beginning in 2011, companies have been required to provide shareholders with an opportunity to vote, up or down, on the overall executive pay package as outlined in the proxy (a vote popularly known as ‘say on pay’). The vote is
advisory and non-binding and, in theory, could be ignored by the board. But what responsible board could ignore the will of the shareholders? And if it did, how long would the shareholders continue to elect them to the board? Shareholder activist groups are already taking an active role in shaping the votes and, in some cases, shareholders have filed suit against the company and against individual members of the board as a result of failed say on pay results. Non-binding indeed!

The problem

So...given this environment, boards and, in particular, compensation committees, must be certain that they are following a rigorous, fact-based approach to decisions on pay. As part of this process, most committees engage an independent third-party to provide them with data on market pay levels, short and long-term incentive plan design and to advise them on what may be appropriate for their company. The core of this information is typically a detailed proxy study that compares the value of the package offered to company executives relative to the value provided to executives at a select group of peer companies.

The common analysis of executive pay follows a two-dimensional approach.

- **The first dimension** is simply the value offered to peer group executives—base salary, annual and long-term cash incentives and the grant date fair value of equity grants. This dimension provides a snapshot of what was paid.

- **The second dimension** provides the committee with the ‘mix’ of pay elements—how much of the value was provided by cash, stock options, restricted shares, performance shares, restricted stock units and other incentive vehicles. This dimension can be illustrated by a pie-chart that can illustrate how much of the executive pay is ‘fixed’ (base salary, restricted shares) and how much is performance-based (annual incentive, performance shares), at-risk.

But in looking at this market ‘snapshot,’ are committees getting a full and true picture of the competitive landscape and the potential risks inherent in any compensation plan? We think not.

As a simple example, assume two executive pay packages as follows.

<table>
<thead>
<tr>
<th></th>
<th>Executive 1</th>
<th>Executive 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base</td>
<td>$1,000,000</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Target annual incentive</td>
<td>$500,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>Option grant</td>
<td>$0</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Restricted share grant</td>
<td>$1,000,000</td>
<td>$0</td>
</tr>
<tr>
<td>Grant date price</td>
<td>$10</td>
<td>$10</td>
</tr>
<tr>
<td>Total value</td>
<td>$2,500,000</td>
<td>$2,500,000</td>
</tr>
<tr>
<td>Pay mix</td>
<td>40/60</td>
<td>40/60</td>
</tr>
</tbody>
</table>

In looking at this data the casual observer may conclude that these executives are paid the same, when clearly the realized value of what they will earn as their equity grants mature may be very different based on factors such as stock market change and company financial performance.

Although the grant value of equity is the same (in dollars) based on the concept of ‘fair value,’ the number of shares used for an option grant will typically be greater than that of a restricted share grant. For this example, assume an option on three shares delivers the same fair value as one restricted share, which means:

- Executive 1 would receive 100,000 restricted shares, and
- Executive 2 would receive 300,000 stock options

As the share price changes over the term of the award, the value to the executives would differ substantially.

Assuming both grants will be fully vested after three years:

<table>
<thead>
<tr>
<th>Potential price change</th>
<th>Executive 1 100,000</th>
<th>Executive 2 300,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>95%</td>
<td>$950,000</td>
<td>$0</td>
</tr>
<tr>
<td>100%</td>
<td>$1,000,000</td>
<td>0</td>
</tr>
<tr>
<td>110%</td>
<td>$1,100,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>120%</td>
<td>$1,200,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>150%</td>
<td>$1,500,000</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>200%</td>
<td>$2,000,000</td>
<td>$3,000,000</td>
</tr>
</tbody>
</table>

1Value expressed as actual realized value, not Black-Scholes
Clearly, these alternative grant strategies do not produce the same effect, and as an issue of good corporate governance, compensation committees need to be aware of the impact plan design can have on the potential value earned. Specifically, as an enhancement to the traditional proxy analysis, good corporate governance might suggest that these committees also look at the volatility of potential outcomes—the third dimension.

**What is the third dimension?**

The third dimension is a method of evaluating not just the snapshot, but the potential outcomes of plan design given a number of different stock performance scenarios over time. Using data provided in company proxies, a careful analysis can determine the impact of plan design on each executive’s total compensation (base salary, annual and long-term incentives and retirement benefits). Data can be provided for the named executive officers both in the absolute and relative to peer companies.

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**The range of outcomes**

The below exhibit is an array of potential outcomes expressed in dollar values that highlights the potential swings in realized pay, and also compares the potential values of the compensation plan relative to competitors.

**Why is this analysis critical to the compensation committee?**

As discussed, the simple answer is that it provides the committee with an in-depth look at executive pay over time, not just the snapshot approach common to most compensation reports. In addition, having this data is consistent with the general trend in compensation disclosure requirements for more analysis and consideration of “what if” scenarios. ‘Best practice’ already expects that the committee will look at tally sheets to review executive pay in its totality. How much better to add performance scenarios and outcomes?

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2 Many companies offer defined benefit supplemental executive retirement plans (SERPs) tied to final average pay which is impacted by incentive plan outcomes. Alternatively, the values of defined contribution SERPs can be determined directly by performance factors.
It also provides the committee with a more robust illustration of compensation risk for the required disclosure in the annual proxy statement.

- Too much risk and leverage creates an incentive for risky (and ethically challenged) behavior from executives.
- Too little risk and leverage may create a competitive disadvantage and/or internal dissatisfaction with the alignment of executive rewards with the results delivered to shareholders.

One of the drivers of the economic downturn of 2008-2009 was presumed to be related to risky incentive design in the financial services industry. More importantly, following the collapse in the financial services industry, many compensation committee members confessed that they had not fully grasped the potential impact of outcomes in highly speculative compensation plans. The volatility analysis suggested would have gone far in providing committees with full disclosure and may have helped prevent disaster.

Finally, a ‘volatility of outcomes’ is not yet required as part of the proxy disclosure rules. But the trend is clearly in the direction of more disclosure regarding the relationship between pay and performance. Shareholder groups are demanding visibility and the 2010 Dodd-Frank legislation requires that companies illustrate how the company performed regarding pay versus performance. Can it be long before progressive, well-governed companies begin showing not just ‘what happened’ in the prior year, but what could happen? If nothing else, it provides a proactive defense for committees against legal action by disgruntled shareholders.

We believe that in the interests of good corporate governance, this is the wave of the future in compensation benchmarking and disclosure. Welcome to the third dimension.

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