

Executive Compensation in Volatile Markets – Board of Director Perspective

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In our most recent discussions with The Directors College, the HRCC Specialist Program, CICA, groups such as the Canadian Coalition for Good Governance and institutional investors like OTPPB, the key question we are always asked is “what is the best way to manage variable compensation and equity grants in the current volatile market?” We then get asked “is our answer geared to enabling a Board of Directors to meet its obligations in an effective and reasonable manner, or to advancing the interests of executives?” We believe that what follows in this article will answer these questions.

The recent economic crisis has raised a lot of issues regarding executive compensation. Some of the traditional compensation consulting firms have, not surprisingly, pointed to the need to increase the number of equity grants to maintain executive motivation during these trying times. The belief is that many public company executives are feeling like “victims.”

While the absurdity of this last statement is completely self-evident, it exemplifies the current problem with executive compensation and traditional pay consultants. The “chumming up” of pay consultants to top executives has created a situation where executives continue to be

rewarded for substandard performance.

“Are traditional compensation consulting firms interested in supporting the executives, or supporting the Board?”

Pay consultants who are taking direction from executives have every reason to ensure that the CEO receive his/her bonus and long-term incentive grants (options, units or share grants), no matter what his/her performance. Of course, the responsibility for the design of executive compensation plans lies not with the executive, but with the Board. Any advice the Board receives should be real information (not survey based), accurate, appropriately comparative (based on appropriate peer financial and compensation comparisons), and free from any conflict of interest. This means enlisting the services of consulting firms who work only with Boards, and answer only to the Board on issues of executive compensation.

Gil Bennett, a long-time proponent of reasonable, performance-based compensation for executives, says, “Ensuring the integrity and defensibility of board’s compensation decisions demands completely independent advice and an understanding by directors of the role and accountability of the board. The independence of compensation

consultants employed by the board is absolutely critical”.

Recent events have provided an opportunity to correct the issues that have plagued executive compensation systems for years.

Shareholder and public outrage over excessive executive compensation has reached an all time high. The time to enact or support sound variable compensation plans is now. If your company has a working short-term incentive plan (STIP), and by that we mean a plan that includes real, measurable, documented, and appropriate financial, operational and personal performance targets, then there should be no need to re-adjust the STIP design. As your Board and executives work through the 2009 strategy and budget process, your STIP plan should work exactly as it is intended to. The only time performance hurdles should be changed is by the Board, and only when the environment changes or business situation changes radically beyond the scope of control of the executives.

If company performance has been poor against internal and external targets (relative to appropriate peers - see our next article on Peer Groups) then executives should not be additionally rewarded. Paying executives for lackluster performance destroys the

integrity of the executive compensation system and approach. Short-term incentive plans, should be designed to reward above target performance and be designed to pay for themselves through self-funding (paid for out of that outstanding performance).

“Paying for lackluster performance sends a message to executives that performance doesn’t matter.”

If cash-based compensation is likely to be an issue in the incoming year, the STIP might be cancelled in lieu of an equity-based incentive plan. The Board is responsible for the pay delivery system, so the Board must ensure that performance-compensation is handled to avoid future liability issues

The pundits, including many so-called “independent” pay consultants, would claim otherwise; nevertheless, Boards should consider that a properly functioning STIP is designed to reward executives for superior performance, not mediocre performance. Gil Bennett observes “by consistently paying out bonuses, regardless of performance, Boards are sending the message to their key executives that performance doesn’t matter”. The power a Board has to make discretionary cash payments exists to ensure that executives are not excessively penalized for issues beyond their control. But remember, this does not give Boards carte blanche to pay out bonuses indiscriminately. Boards should exercise caution and have good reason to override existing executive compensation policies and practices which would otherwise dictate a zero bonus payout.

A well-executed compensation plan should also be clearly communicated and understood by executives beforehand. Executives should be well aware of the consequences of poor performance so that if and when it does happen, individuals are not caught off-guard. If a Board is concerned about losing executives for failing to pay out bonuses (for legitimate reasons), then they should be questioning whether or not these individuals are right for the company in the first place.

In 2007, Ford paid \$7 million in bonus to their CEO in a year where Ford lost \$2.7 billion and its share price dropped by 12%.

Similarly, GM paid its CEO \$1.8 million under its Annual Incentive Program, in a year where GM lost \$39 billion and its share price dropped by 18%. These payments seem even more outlandish given the current backdrop of economic crisis that has left GM and Ford on the brink of extinction.

Of most consequence is the issue of **long-term incentive grants**. It’s true that for many companies, the majority of options grants would currently be underwater. However, the opportunity to realize a gain on those option grants has only disappeared for those grants whose terms will be expiring over the short term (i.e. over the next 24 to 36 months, before they have time to regain any lost ground in share price).

Over the long-term, companies with solid foundations will most certainly rebound. If we assume that this recovery takes longer than expected, then the next round of option grants will be at an artificially low level (because

of the low value attributed to the underlying share). Therefore this will result in higher gains in the future when the grant vests and can be exercised.

The concept of increasing the size of the grant based on the Black-Scholes Option Pricing Model might be equally flawed. Gil Bennett asks, “How does a Board justify a dramatic pay and wealth increase to executives if the company has not outperformed competitors?” Boards should consider offering equity grants in the form of Restricted Share Units (RSUs), or Performance Share Units (PSUs), to complement current stock option plans. In the USA the use of stock grants is of equal importance. Share units and share grants continue to offer incentives since they still have some value even when share price plummets.

In short, there’s nothing wrong with a Board reviewing its current compensation plans; reviewing your current plans, in fact, periodic review should be encouraged. However, rushing to change a plan based on some perceived threat of CEO loss for failure to payout a bonus or a long-term incentive (again, for legitimate reasons) may be unfounded.

In reality, if a Board has confidence in a compensation plan, and the CEO and executive continue to perform well, the incentive design should perform in the manner it was designed and intended to perform – unless of course, the plan design was flawed in the first place.

Gil (Gil) Bennett is on the Faculty at the Director's College and is currently Chairman of the Board of Discovery Air and FortisOntario Inc. He is also a director of Samuel, Son & Co., Ltd. Gil was former Chairman of the Board of Canadian Tire Corporation Limited and Board Member at Encal Energy Ltd., Bracknell Corporation, IPL Energy, The Consumers Gas Company, Eldorado Nuclear Limited, de Haviland Inc., Algoma Steel Inc., NAV Canada, Air Nova Inc., FortisInc., Ontario Casino Corporation and Cablecasting Limited.

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We would encourage readers to explore other opinions on these issues. References to recent publications by some of the leading pay firms in North America are included on our website at

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