# Are You Rewarding Short-Termism?

## by Eric Hosken and Dan Laddin

**While we acknowledge that executive compensation is a factor in corporate "short termism," what if the amount of pay is not the problem we think it is? Could it be that the subtleties of compensation design today push executives to take a "get rich and get out" approach—including some pay reforms that we hoped would encourage a long-term focus.**

A common complaint about corporate behavior is that there is an excessive focus on the near term at the expense of the long term (for example, see the July/August 2014 issue of *The Corporate Board,* "Curbing Short-Termism in Corporate America," by Robert Pozen). While executive compensation may not be the *reason* for an excessive focus on the short-term, it may be a contributing factor to short-termism.

Depending on the circumstances, a focus on the short-term may be a bigger or smaller issue. Fundamentally, the time frame for executing the business strategy, realizing financial results and seeing those improved financial results translate into improved shareholder value should determine how the company structures its pay program. For businesses that measure their success over decades, a focus on quarterly or annual results is likely misplaced.

**The potential reason for a short-term focus is hidden in the makeup of the almost two thirds of CEO pay that is labelled as "long-term" incentives.**

□ ***Current state of CEO compensation.*** The typical Fortune 100 company's CEO compensation can be characterized by the chart on the following page. At first glance, you could jump to the conclusion that any concern about short-termism in CEO pay is unfounded. Close to two-thirds of a CEO's total compensation is delivered in the form of long-term incentives. However, what some people characterize as a long-term incentive, others might view as a relatively short-term element, compared to the strategic time frame of different businesses.

Some critics of executive pay focus on cash bonuses as a problem. However, for large companies cash bonuses paid for annual performance are only 20 percent of the CEO's total package. We think that it is reasonable that 20 percent of the CEO's total pay depends on how effective the CEO is in achieving the company's near-term financial objectives.

While there may be some industries where the annual bonus element is too high, we do not think that this is the main issue when it comes to an excessive short-term focus. The real problem comes with the makeup of the almost two-thirds of CEO pay is labelled as long-term incentives.

Long-term incentives are delivered to executives in three common forms:

- □ Restricted stock (or restricted stock units).
- □ Stock options.
- □ Performance shares (or performance cash).

Historically, stock options were the most prevalent form of long-term incentive compensation. Once companies had to recognize the expense of options in their financial statements, they began to rely less on options as an incentive, with most of the shift in the direction of performance shares. The move away from stock options has been encouraged to some degree by shareholder advisory firms (Institutional Shareholder Services, etc.) and other executive pay critics. They take the view that options are not inherently performance-based, and are concerned that they encourage executives to take on excessive risk.

Despite the criticisms of stock options, options have several design features that are appealing from a shareholder perspective. First, options only reward

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executives to the extent that the stock price increases above the exercise price (typically the price on the date of grant). Second, options typically have a long-term time frame (the most prevalent option term is 10 years). When CEOs are granted stock options, they often do not exercise them until relatively late in the term. This implicitly bases their rewards on the long-term performance of the company.

**With the move away from stock options to performance shares and restricted stock, there is a risk that executives will focus on short-term financial performance.**

CEOs with long-term incentives delivered as 100 percent stock options accumulate these over their tenures. As long as the CEOs do not exercise the options too early in their term, their wealth becomes highly sensitive to the stock price over the long term.

With the move away from stock options to performance shares and restricted stock, there is a risk that executives will focus on short-term financial performance and stock price movements. Performance shares typically use a three-year performance period, and executives are seldom required to hold shares for long following that. Similarly, restricted stock typically vests over three or four years, and may not require holding the shares after vesting.

If we consider historical practices, in many companies CEOs and other senior executives hold options for quite some time. If we look at the typical expected life of an option, six to seven years tends to be the norm for senior executives. This is much longer than the typical three year performance period found in long-term performance plans. While a stock option often vested after three or four years, executives saw value in holding on to the option longer before exercising it, spurring a longer-term focus.

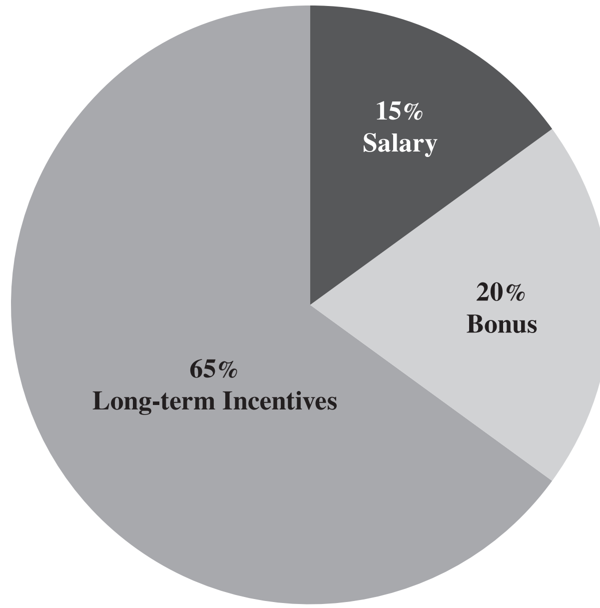
Performance shares have been welcomed by shareholder advisory firms as superior to stock options. The main appeal is that they allow a compensation committee to directly link the number of shares earned to specific goals that the company sets over a multi-year period. Compensation committees have taken mixed approaches to performance share design with performance measures tied to mid-term financial results. We support the use of performance plans, and believe they can be an effective tool for helping to align pay and performance if well designed.

When companies tie performance shares to financial measures like earnings per share or return on invested capital, they tend to gravitate to performance periods no longer than three years. The main reason for this approach is that most companies feel that making meaningful financial plans beyond three years is too difficult due to the number of factors that must be predicted (market factors, industry factors, changes in business strategy, etc.). If the goals cannot be set with confidence, the incentive value of the plan diminishes.

In addition, executives have a preference for a three-year vesting period, consistent with the typical vesting period for stock options and restricted shares. While companies could theoretically assess financial performance measures in comparison to peers,

## CEO Total Compensation

**Long-Term Incentives, But Short-Term Rewards**



in practice relatively few companies do this. There are major technical difficulties (diversified business models among peers, data availability, performance measure adjustments, etc.) that make an "apples to apples" comparison challenging.

When companies tie performance shares to relative total shareholder return (TSR), they also tend to use a three-year performance period. Unlike performance shares linked to financial measures, there is no inherent difficulty in setting performance goals for relative TSR plans.

The performance goals on a relative TSR plan are linked to the performance of the company relative to a peer group, or a broad market index, such as the S&P 500. The biggest unknown as the performance period extends beyond three years is the potential for comparison companies to be acquired and no longer valid for comparison. However, with a large enough peer group, this risk can be mitigated.

**Delivering shares over a two or three years rewards managers on the perceived quality of business strategy. Earning rewards over the longer term depends on how well they execute this strategy.**

☐ ***Why and where change is needed.*** Many corporate management teams make business decisions today that will have an impact on shareholders for a long time into the future. These include acquisitions, product development, research and development, and oil and gas exploration. While the current stock price of these companies incorporates investors' views about the potential of these decisions, the future stock price will depend on the actual outcome.

In a sense, delivering shares over a two or three year period allows management teams to reap rewards based on the perceived quality of business strategy. Earning rewards over the longer term (seven to ten years) weighs more heavily on how well they executed this strategy.

There may be some transactional businesses where long-term timeframes are not really relevant, and the effectiveness of management's business strategy can be assessed over a three-year period. However, there are really very few businesses where the management team does not have to balance execution today with strategies for the future. The problem is that with the current state of executive pay, almost all of an executive's reward is realized within three years of the date of grant, particularly when stock options are not part of the design.

Compensation committees should recognize that a few safeguards that help to ensure management focus on the long-term have already been built into executive pay designs. Most companies require senior executives to hold shares of company stock equal to a multiple of their salary; six times salary is prevalent for a large-cap CEO. While six times salary may seem like a large amount, it is less than two times the typical annual long-term incentive grant opportunity for the CEO of a large company.

In addition to stock ownership requirements, many companies mandate that executives retain shares from exercises or vesting for a period of time. However, in most cases, the shares are only required to be held for an additional one or two years, though some companies do require that a portion of shares be held until retirement.

One of the main reasons for equity-based long-term incentives is to align the executive management team with the interests of shareholders. By delivering pay in the form of stock or options, we help to ensure that the management team cares about what happens to the stock price because stock price movements will directly affect their personal wealth.

The issue with executive compensation today is that the timeframe for earning rewards is implicitly weighting the interests of shorter-term shareholders more heavily than those of long-term shareholders. With this in mind, we have identified some modifications to current compensation practices that will help to better align executive interests with those of the company's long-term shareholders. These recommendations are intended as "food for thought" and not prescriptive for every company. As mentioned earlier, all incentives need to be structured based on company-specific goals and objectives. While a longer time-frame may be appropriate for the CEO and other senior executives who drive the strategy, it may not be as effective for those deeper in the organization who are more focused on operations and execution.

## Performance measured over a short time period can reward executives for volatility, not shareholder benefit.

Two suggestions can go a long way toward putting the "long-term" back into long-term incentive pay:

□ *Lengthen the performance period for performance shares based on relative TSR to five to seven years.* There is very little reason for TSR performance shares to be based on a performance period as short as three years. The three-year time frame is a by-product of plans that used other metrics focusing on three years at most due to the challenges of setting goals beyond that point.

One criticism leveled against plans that pay out based on relative TSR is that they are akin to a lottery. When these plans measure performance over a relatively short performance period, volatility of the company's stock can work to the benefit of the participants even when shareholders have not benefited over the long-term.

The reverse can also be true. A management team that delivers steady returns may lag companies with high price volatility over short periods of time, even when long-term performance is superior.

Lengthening the performance period for relative TSR plans helps extend management's focus beyond a three-year horizon, and better aligns them with the interests of the company's long-term shareholders. By making this adjustment to the design, you help to ensure that executives are rewarded for long-term outperformance of alternative investments, rather than short-term anomalies in stock price movements.

To avoid punishing executives participating in these designs, we recommend that companies continue to allow management to vest in these shares over the current three-year time frame. The ultimate number of shares paid to them would be subject to performance for the longer time period. Our intent is not to "take away" value from executives—the goal is to focus and reward management on long-term performance.

## Executives should view their long-term incentives as a form of retirement savings dependent on the future value of the company.

□ *Introduce mandatory deferral of shares for grants of restricted shares and/or performance shares.* Another way to refocus senior executives on the long-term is to limit their ability to sell long-term incentive shares over the short term. For example, today if an executive vests in 10,000 shares of stock three years following the date of grant at a price of \$50, that executive can immediately sell the shares and recognize \$500,000 of value on a pre-tax basis.

To tie the executive to the long-term value for the company, the company is better served if a portion of the shares/share units were mandatorily deferred for an additional period of time (five years, ten years, to retirement). With mandatory deferral, the compensation committee can ensure that executives care about the stock price beyond the vesting date, and that they accumulate meaningful amounts of company stock over their careers.

If, for example, 5,000 share units are deferred, and grow in value to \$75 at the date of settlement, the executive recognizes another \$125,000, on top of the \$500,000 in value at the original vesting date. However, if the stock price falls to \$25 at the date of settlement, the executive loses \$125,000.

A common practice is to accelerate the payment of deferred compensation upon the termination or retirement of the executive. In our opinion, paying out all deferred compensation at termination (plus six months delay for 409A) may allow a departing CEO to "cash in" when there is no evidence they have set the company up for future performance. First, many decisions that the executive makes in the years prior to leaving will continue to affect the stock price following termination. Also, accelerating the payment to the date of departure may provide an undesirable incentive for the executive to retire just to sell shares.

We would prefer that executives begin to look at a substantial portion of their long-term incentive pay as a form of retirement savings that is dependent on the future value of the company. This creates a strong financial incentive for executives to care deeply about the long-term prospects of the companies that they manage today.

It should be noted that mandatory deferral of shares will be counterproductive if the executive is allowed to "hedge" his interests in the company's shares. Many companies have implemented policies to forbid executives from hedging their interests in company stock. Anti-hedging policies are critical to aligning executive management with the interests of company shareholders. Lacking such a policy, many of the benefits of equity-based pay for executives disappear.

As companies moved away from stock options, the shortening of the time period for paying long-term incentives was an unintended consequence. It is time for compensation committees to take a fresh look at their pay programs and consider whether three years is "long enough" to effectively reward management for successful execution of the business strategy. ■