

Post-Modern Pay

*Developing Unique Compensation Strategies in the
Era of Universal Solutions*

By Todd McGovern and Tom Williams

The Evolving Landscape

While developing an executive compensation strategy has historically been an internal organizational matter, the modern rise of external influencers has begun to change this. Due in part to the considerable attention executive compensation receives; many decisions on its form are increasingly based on multiple, outside points-of-view. Specifically, the influential trio of empowered proxy advisors, increasingly attentive shareholders, and new regulations have all exerted significant pressures on pay. These entrenched forces are now a critical component of every plan design process. They essentially define the “modern” era in executive compensation, often making executive compensation a balancing act between the outside forces wishing to affect executive compensation and the internal goals of retaining and motivating talent.

While such external mandates and perspectives often aim to affect compensation trends on a national level, many notably lack a nuanced understanding of a given company’s day-to-day compensation needs. Those viewing compensation from the outside tend to do so only peripherally (largely through proxies) and have limited information on the specific outcome, business case, or context of a particular decision. By nature, many modern pressures seek more uniformity among pay practices, driving many organizations’ plans toward similar-looking design. In this evolving landscape, creating a compensation program aligned with a company’s talent strategy requires a reassessment of these pressures.

The “New Normal” in Compensation Plan Design

In an ideal world, every executive compensation program would reflect the unique needs and culture of the organization, while simultaneously achieving regulatory compliance and shareholder satisfaction. In practice, however, many companies increasingly seek to mollify all outside perspectives on pay, including those of proxy advisors, vocal shareholders, and those often shared by the media. In doing so, the companies tend to apply formulaic solutions to multifaceted pay issues, regardless of specific talent strategies. This externally motivated push towards “sameness” creates a natural tension with a company’s individualized talent strategy. It reduces an organization’s ability to provide strategic incentives to its employees.

In other words, the modern environment for developing a compensation program favors structuralism over creativity. This can often result in the perception that many are moving towards standardization in design, when in fact they have been restrained to act otherwise. The following chart provides some illustrative examples of this new orthodoxy in executive compensation and how modern influences exerted themselves. The research draws from Aon Hewitt’s extensive proxy disclosures research of the Fortune 200 bellwethers, as those companies’ influential practices tend to trickle down. Over the course of just four proxy seasons, we have witnessed some striking increases in the disclosure of certain governance policies and more uniformity in plan designs, often in response to the design pressures of the modern era.

Research Methodology Notes

Aon Hewitt monitored Fortune 200 proxy filings for the last four years (2008–2011) and gathered information on plan design and corporate governance disclosures in the CD&A and compensation tables.

For further research on the vehicle mix for the same CEO over a consistent period, Aon Hewitt identified 57 of the 2011 Fortune 200 CEOs that remained in that position over the last five years, excluding founders.

Executive Compensation Design in the Modern Era

Compensation Design Feature	Modern Pressures	Reaction Among Fortune 200 ('07-'10)																								
CEO Stock Ownership Guidelines	Proxy advisors view guidelines favorably that are over the 5x salary typically seen in the market.	During FY2007, 92% of the Fortune 200 disclosed ownership guidelines. Of those that disclosed guidelines as a multiple of salary, 29% were over 5x salary. Going forward to FY2010, about the same percent disclosed ownership guidelines, but at that point 43% of the guidelines were over 5x salary.																								
Clawback/Recoupment Policies	While recoupment policies have been law since Sarbanes-Oxley, the pending rules from the SEC under Dodd-Frank and the influence of proxy advisory firms have rapidly increased implementation of clawback programs.	While the FY2007–2009 period saw the clawback policy disclosures increase from 50% to 76%, the prevalence leveled out during FY2010.																								
Anti-Hedging Policies	Anti-hedging policies are also mandated by Dodd-Frank, but the SEC has yet to finalize its rules. Proxy advisory firms also favor these policies.	The prevalence of anti-hedging policies has skyrocketed over the last four years, from 28% to 62%, but disclosures do not necessarily mean these policies are new. Many Fortune 200 companies already had anti-hedging policies in place for years, but the influence of proxy advisory firms' policies has spurred significant growth in disclosure, even though some practitioners would argue they are not material to the CD&A.																								
CEO's LTI Mix	Various pressures on long-term incentive mix (most notably the pay-for-performance policy from an influential proxy advisory firm) have had an undeniable effect on the use of stock options.	<p>The chart below illustrates the most common equity mixes and clearly shows a trend away from using only stock options and towards more vehicles in plan design.</p> <table border="1"> <thead> <tr> <th>LTI Combinations Among F200 Top 5 in 2010</th> <th>FY '07</th> <th>FY '10</th> <th>Percent Change</th> </tr> </thead> <tbody> <tr> <td>All Three Equity Vehicles</td> <td>17%</td> <td>27%</td> <td>59% Increase</td> </tr> <tr> <td>Options & Performance Equity</td> <td>25%</td> <td>27%</td> <td>8% Increase</td> </tr> <tr> <td>Options & Restricted Stock/Units</td> <td>20%</td> <td>18%</td> <td>10% Decrease</td> </tr> <tr> <td>Performance Equity Only</td> <td>14%</td> <td>14%</td> <td>No Change</td> </tr> <tr> <td>Options Only</td> <td>18%</td> <td>7%</td> <td>61% Decrease</td> </tr> </tbody> </table>	LTI Combinations Among F200 Top 5 in 2010	FY '07	FY '10	Percent Change	All Three Equity Vehicles	17%	27%	59% Increase	Options & Performance Equity	25%	27%	8% Increase	Options & Restricted Stock/Units	20%	18%	10% Decrease	Performance Equity Only	14%	14%	No Change	Options Only	18%	7%	61% Decrease
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Number of Equity Vehicles for CEO	The shift toward performance-based vehicles to satisfy shareholder and proxy advisory guidelines has in turn increased the usage of multiple vehicles used to align and reward CEOs.	During FY2007, 36% of Fortune 200 companies used only one equity vehicle for CEO compensation, while 18% used three. Going forward to 2010, 25% used only one equity vehicle, while 27% used three.																								

The modern pressures that drive similarities also make implementing alternatives challenging. For example, a company that wishes to offer more differentiated incentives than those in its industry may find itself constrained to do so by external demands on pay. Those companies that attempt to break out of the increasingly formulaic design cycle with customized solutions (which may run against external perspectives) risk sharing their fate with the proverbial “tallest nail”—and may get the hammer. As a direct consequence, a conflict is often created between what executives prefer in their own compensation package and what their company is able to offer them¹. For many executives, compensation has become too reactive to external inputs, and less internally proactive to their needs.

Aon Hewitt Perspective: Breaking Free of the Modern Compensation Mold

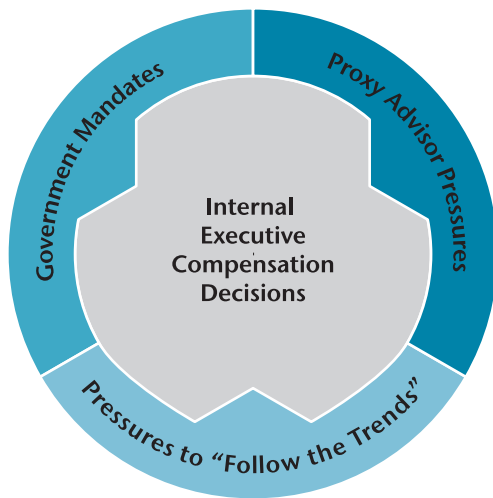
For companies who aspire to offer something different, the question becomes: “How can we develop novel compensation solutions when powerful external forces provide ample disincentives to do so?” The answer may be to view compensation design in a post-modern context.

Despite external pressures, the next generation of executive compensation plans should be crafted to shun formulaic design and instead focus on subjectivity. By reappraising the modern perspectives on executive compensation (which tend to limit alternatives), we should instead view each external design input as a piece of a puzzle—one where each has an important, but not necessarily prominent, place in the overall design structure. Compensation decision-makers should be mindful of all the influential demands on pay, but decisions should be as minimally influenced by externalities as possible. Of course, the actual levels of compensation should be considered with moderation and according to governance standards.

Certainly, developing a method to balance both external and internal considerations has become the most challenging part of compensation design in the post-modern era. To achieve balance, companies need proper governance processes to monitor the regulatory environment, as well as an established systematic approach to monitoring their top institutional investors’ views. Compensation committees should open direct communications with investors early in the design process in order to understand whether their companies’ investors consider proxy advisory firms’ guidelines or use their own internal proxy voting guidelines. Such intelligence is vital for clarifying expectations in terms of governance and ultimately should dictate the manner in which compensation programs are disclosed. Once the compensation priorities of investors have been established, committees should review and address any potential “exposure items” found in the plans under applicable guidelines.

¹ Please see previous research, “Executive Compensation Arbitrage: Exploiting Preferences for Competitive Advantage.”

Modern Environment



- Internal decisions are limited by reactivity to external pressures—leaving little room for creative compensation design
- Objective and less responsive to unique company needs; leads to cookie-cutter design

Post-Modern Environment

Internal Executive Compensation Decisions



- Internal decisions are inclusive of how external pressures fit into overall design decisions, and are balanced with what is right for the company
- Subjective and responsive to unique company needs; leads to personalized pay strategies

In addition to assuring that the proper governance processes are in place, designing the post-modern compensation plan necessitates thinking about plan design creatively and putting an internal premium on innovation. Previous Aon Hewitt research has found many executives do not find significant retentive value in their plans. With improving economic conditions, the increased mobility of executives presents an opportunity for each organization to reassess if its pay is properly aligned with organizational and talent strategy. An organization that wishes to offer differentiated incentives can do so more effectively with an understanding of the types of programs and vehicles that optimally appeal to its unique executive population. Within the framework developed by shareholders and advisors, there is often ample room to provide tailored solutions to executives.

Since the ultimate post-modern executive compensation plan is custom to a company's unique situation, our conclusion is not so much a singular solution but rather a call for action. Compensation committees that subjectively evaluate their compensation plans (while making the design process less mechanical overall) will become increasingly relevant in the talent market. For many, this will require viewing executive compensation through a more strategic lens and seeking alternatives to conventional design features that were formerly considered implicit.

Evaluating Executive Compensation Strategy: A Checklist to Customization

At the end of the day, executive compensation is really about how much success a company should share with its executives. Plans need to be customized to reflect this. The following is a checklist of questions compensation committees should consider when evaluating their executive compensation strategy in a post-modern context.

- How often does the compensation committee consider the percentage of earnings used for executive compensation? What is the appropriate amount for the company?
- Has the company developed a systematic approach to monitoring and balancing shareholder views on executive compensation? Has it proactively approached its shareholders with details on compensation strategy?
- How can a company's proxy disclosures appeal directly to its shareholders?
- What level of understanding does the compensation committee have of the compensation preferences of its executive talent?
- Are "Say on Pay" results contextualized by considering the individuality of a company's institutional make-up? For some companies, results in the low- to mid- 80 percents should be considered a reasonable goal when balanced with the preferences of executives and expectations of shareholders.
- Are adjustments to a compensation plan due to the regulatory environment or to business strategy? If due to the former, then what are the alternatives, if any?
- Are there similar design preferences (synergies) between executive participants, shareholders, and proxy advisors that can be realized?
- Is there an understanding of what trends a company compensation strategy should follow? Or what trends a company should counter to differentiate itself from its peers?
- Can context be used to communicate unpopular compensation decisions to executives in order to reduce friction?

About Aon Hewitt

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