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The Case of New and Conflicting Executive Compensation "Best Practice" Guidelines

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Too Many Chefs Stirring the Pot?

The prevailing theme in executive compensation in recent history has been an emphasis on tying pay to long-term company performance and, thus, to shareholder value. But in recent years, more and more influencers are expressing views on "company purpose" which guides governance principles and executive pay programs. Also, the use of performance-based compensation as a necessary and "best practice" is being questioned by some. We highlight a few of the themes below, all emanating from different entities. The real challenge for companies is how they should reconcile the different perspectives when setting executive pay programs that support the company's goals, objectives, and strategic plan, factoring in that we are on the brink of an election year and, perhaps, in a late-cycle financial environment.

Business Roundtable—Statement on the Purpose of a Corporation

In August of 2019, 181 CEOs from the Business Roundtable (BRT) amended a long-standing statement of corporate purpose with a new definition of the "purpose of a corporation." The new statement revises the long-held belief that a business enterprise's primary (if not only) purpose is to generate economic returns to its owners (i.e., shareholder value). The August 2019 statement expresses the view that a company should serve all "stakeholders," including customers, employees, suppliers, and communities, in addition to generating long-term value for shareholders.

BlackRock's Larry Fink's 2019 Letter to CEOs—Purpose and Profit

BlackRock CEO Larry Fink was one of the 181 CEOs signing his name to the BRT statement. However, eight months prior, Mr. Fink foreshadowed the BRT statement in his annual letter to the companies in which BlackRock invests. The letter argues that because government is failing to provide lasting solutions to pressing social and economic issues, society is increasingly looking to companies to solve them. He indicates that a company's purpose "is not the sole pursuit of profits but is the animating force for achieving them" and that profits are essential if a company is to serve all of its stakeholders over time—which he indicates *are not only shareholders but also employees, customers, and communities.* In his letter, Mr. Fink implores companies to take a more active role in addressing critical issues from retirement to infrastructure to job preparation.

Council of Institutional Investors

Concepts introduced by Larry Fink and the BRT were not met with universal enthusiasm by business leaders. The Council of Institutional Investors (CII) expressed major concerns with the notion that corporations have obligations to a variety of stakeholders, arguing that "accountability to everyone means accountability to no one." CII disapproved of BRT referring to shareholders as "providers of capital" and not "owners" and pointed out that the BRT statement put shareholders last on the list of stakeholders. As a result, CII advises company boards and managers to maintain their focus on long-term shareholder value, arguing that government, not companies, should shoulder the responsibility of addressing societal objectives. These ideas are reflected in the CII's Corporate Governance Policies (revised in September 2019) which indicate that "corporate governance structures and practices should protect and enhance a company's accountability to its shareholders" and that "executive compensation should be designed to attract, retain, and incentivize executive talent for the purpose of building long-term shareholder value and promoting long-term strategic thinking." CII considers "long-term" to be at least five years.

CII's policy updates also included significant policy revisions, reflecting concerns about excessive complexity in US executive pay plans and the effectiveness of pay-for-performance plans. Some of the major executive compensation policy revisions included recommending:

- The adoption of simpler and more understandable programs, for example, comprised of base salary and a single incentive plan (the policy revisions suggest that time-vesting restricted shares that begin to vest after five years and fully vest over 10 years or more may provide an appropriate balance of risk and reward as well as alignment between shareholders and executives);
- Increased scrutiny and oversight of performance-vesting plans, which CII indicates are a great source of complexity and confusion because they are less transparent, harder to understand, more difficult to value, and vulnerable to manipulation; and
- Careful selection of peer groups and peer data, warning companies that overreliance on benchmarking to peer practices can escalate executive compensation.

CalPERS

Some major institutional shareholders, such as the California Public Employees Retirement System (CalPERS), have taken a leading role in integrating consideration of environmental and social factors into their governance agendas. CalPERS has given an economic framework to environmental, social, and governance ("ESG") factors in helping to analyze and select its own investments. And its Governance and Sustainability Principles (which incorporate its principles on executive director and employee compensation) stress that compensation programs should align the interests of companies' executives and employees with shareholders by rewarding executives and employees for focusing on and generating sustainable long-term performance.

The CalPERS principles note that compensation programs should be designed to support relevant sustainability performance objectives. In contrast to CII, CalPERS guidelines advocate for performance-based plans and suggest that a significant portion of compensation programs should be performance-based. In order to evaluate the effectiveness of these programs, CalPERS has developed its own executive compensation quantitative analysis framework which utilizes a custom five-year quantitative analysis that generally compares CEO realizable pay to total stock performance relative to a company's peers.

Conclusion

Business leaders and institutional investors are expressing very different takes on fundamental issues critical for setting corporate strategy and resulting executive pay programs, such as defining corporate purpose and who should be considered the relevant stakeholders. In fact, not all agree that performance-based pay is a "best practice" for compensating executives. Given some of these views reflect significant shifts in pay philosophies, with volatile markets and an election year on the horizon, compensation committees and boards are well advised to identify and stick to their overall business strategies, keeping in mind that long-term performance and sustainability as a company are increasingly important factors for business leaders and institutional shareholders.

About the Authors

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