Principles of Executive Compensation

Chapter 2

Overarching and Operating Principles of Executive Compensation

As the leading global HR consulting firm, Willis Towers Watson has taken a lead role in establishing guiding principles for executive compensation (EC). The contents of this book are the result of an almost decade-long effort to research, create, validate, and apply a robust, meaningful, and effective set of compensation principles in corporate settings. This paper presents and explains the principles in detail.

As a starting point, let's discuss the rationale for using principles in the first place.

Why Principles

Principles have been described as "self evident, self validating natural laws [that] . . . apply at all times in all places."[1] Many lines of research and thinking suggest that people will naturally orient to a principle, both as individuals and collectively. On a more practical level, most people understand intuitively the concept of using principles to guide thoughts and action. Based on these features of principles, multiple professions, including the longstanding domains of medicine, law, accounting, and actuarial science have developed guiding principles and standards for practical application, and continue to use these principles effectively today. Principles of healthcare include those related to the Hippocratic oath and the bioethics principle of nonmaleficence ("First, do no harm"). The American Bar Association states core law principles including an impartial jury and access to justice for all people. In accounting, a field related more closely to EC, the Financial Accounting Standards Board has promoted the use of several core principles—including relevance, reliability, and usefulness—in decision-making. The American Academy of Actuaries approaches the US retirement-income system with principles reflected in the acronym "AGES": alignment, governance, efficiency, and sustainability.[2] Executive compensation is a relatively new field of study, with less support from a cohesive body of theory, research, and practice than the fields above enjoy.

Multiple bodies worldwide have developed corporate governance principles that inform the decisions and actions of boards of directors across sectors.[3] While some of these efforts have included principles for executive compensation specifically, the output was not sufficiently detailed or actionable for those "in the trenches" of executive pay—practitioners, board members, and consultants—to use in helping to make short- and long-term decisions regarding executive pay.[4] In short, while opinions and

---

[1] Stephen Covey, *The 7 Habits of Highly Effective People (25th anniversary edition)*, Simon and Schuster, 2013, p. 19.
[2] American Academy of Actuaries, "Retirement for the AGES," http://www.actuary.org/Retirement-for-the-AGES (accessed May 5, 2015).
[3] Governance principles have been developed mainly by three types of groups: US-based independent oversight groups (such as the National Association of Corporate Directors, which published its *Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies* in 2008, and the Aspen Institute), independent oversight groups outside of the US (such as the International Corporate Governance Network, which published *The ICGN Statement on Corporate Governance Principles* in 2005, and the Organisation for Cooperation and Economic Development), and groups comprising corporate executives (such as the Business Roundtable, a CEO group, that publishes its *Principles of Corporate Governance* at irregular intervals).
[4] Note that one of the more thorough efforts in this regard was the 2009 report of the Conference Board Task Force on Executive Compensation, which offered five detailed guiding principles and called on compensation committees to "restore trust in the executive compensation setting process" and "demonstrate credible oversight."

prescriptions for sound executive pay practices abound, clear, comprehensive and unbiased guidance to help organizations set pay appropriately is rare, especially in the context of an overarching set of EC principles supported by more practical guidelines.

Most boards—and their executive compensation committees—rely significantly on *precedent* for guidance on EC. Directors also place high value on exercising "good judgment" in this domain, in line with standards set by the Business Judgment Rule for director actions. As such, to defend executive compensation decisions, boards often rely on data regarding what other companies have done, under the broader umbrella of using precedent as a component of good judgment.

Against this backdrop, which both legitimated the use of principles in domains outside of executive compensation and revealed that a comprehensive set of EC principles did not yet exist, we developed our overarching and operating principles of compensation.

How We Developed the Principles

Over the last decade, Willis Towers Watson—specifically our Executive Compensation practice—and The Delves Group (now part of Willis Towers Watson) pursued parallel paths to developing executive compensation principles. The goal was to research and analyze the full range of views on pay for senior executives, to seek emergent consensus on what's working and what's not. Thus as a first step we conducted comprehensive research on executive compensation program effectiveness using our proprietary surveys and databases, along with leveraging publicly available data.

With this scan of the current landscape and our research as starting points, we conducted a series of in-depth workshops to distill the insights and experience of more than 100 of our senior executive compensation consultants. In parallel, The Delves Group (now part of Willis Towers Watson) had formed the Independent Directors' Executive Compensation (IDEC) Project, which collected the views of hundreds of board members across various organizations and industries to develop core principles for the governance of executive compensation. The collective result of these efforts is Willis Towers Watson's *Principles and Elements of Effective Executive Compensation Design***.** These represent a detailed framework of recommendations and considerations for pay program design that can help executive compensation practitioners, corporate management, and boards make better decisions about what—and how—to pay their top executives.

The Principles

Our effort resulted in the development of two related types of principles: *overarching* or comprehensive, big-picture principles that inform larger-scale decision-making on compensation, and *operating* or more ground-level principles that support the overarching principles with actionable guidance in more specific domains.

Overarching Principles

The four overarching principles form the foundation of an effective EC program: Purpose, Alignment, Accountability, and Engagement. We found that while many board members dig into the details of compensation, most desire a synthesized conceptual framework that captures the core elements of EC; that's what we've aimed to provide. As such, the overarching principles yield a powerful shorthand that allows boards and directors to weigh fundamental tradeoffs and orient to a higher level of conceptual decision-making.

Here is a brief summary of each overarching principle:

- **Purpose:** Purpose captures why an organization exists, what its mission is with its various constituents, and its strategy and objectives. Purpose is the highest level of abstraction in corporate governance, incorporating the core governing questions that guide an enterprise. With regard to the other overarching principles below, Purpose answers the questions: *Aligned* with what? *Engaged* toward what? *Accountable* for what?

- **Alignment:** Alignment captures the essence of agency theory—or the inherent potential conflict of interest between the owners of a corporation and those hired to manage it—by ensuring that management is aligned with and acting in the best interests of shareholders, and possibly in those of other stakeholders. This principle prompts the question: Aligned with what? Thus, it can serve as a unifying theme, tying together the purpose, mission, strategy, and objectives of the organization with the interests of shareholders, and using compensation as part of the system that creates and enforces this alignment of interests. Alignment also captures the unification of the entire company across levels and geographies to achieve a common purpose, mission, vision, strategy, and objectives.

- **Accountability:** Accountability captures the relationship among pay, organization performance, and individual actions. It also captures the relationships among employees, management, the board, and shareholders. Management is accountable to the board, which, in turn, is accountable to shareholders and possibly other stakeholders. Employees are accountable to management. Management uses accountability as a primary tool for running the organization, including setting objectives, directing behavior, assessing performance, and determining rewards and consequences. Compensation is an element of accountability at all levels. Another part of accountability is clear and complete reporting and disclosure of EC principles, programs, actions and results to shareholders, employees, and other constituents.

- **Engagement:** Engagement captures human motivation and the psychological implications of disciplines like behavioral economics and self-determination theory. Engagement encompasses the core elements and objectives of compensation at all levels in an organization: motivating people, directing their behavior, attracting them to the organization, ensuring their retention, and creating differentiation based on performance, responsibility, competence, and experience.

Operating Principles

The operating principles support the overarching principles by providing specific, practical guidance in six interrelated areas of EC, as follows.

1. **Governing Objective and Executive Compensation Philosophy:** In fashioning EC programs, boards and management must comply with all relevant laws, regulations and standards of business ethics, while taking into account how the organization's activities might affect various stakeholders. While the financial return to shareholders is a key measure of the value organizations create, benefits for other stakeholders (e.g., debt holders, customers, employees, the broader community) should also be taken into account. Ultimately, EC programs should incent and reward the behaviors and processes that reinforce the activities organizations undertake to create sustainable long-term value for multiple stakeholders. In assessing the extent to which EC programs support long-term value creation, it's important to recognize that there might be points in the business performance cycle at which intermediate compensation decisions produce pay outcomes that do not align perfectly with reported short-term performance.

2. **Pay Level Reference Group Selection and Benchmarking:** Benchmarking—the comparison of an organization's current compensation levels to market norms—is a core element of EC management. The effectiveness of benchmarking is largely dependent on the appropriateness of the organization's market reference group or groups. Accordingly, organizations need to take care not only in selecting appropriate reference groups but also in ensuring that the market data sources they use are robust. At times, the quality and appropriateness of market data are not fully assessed by the compensation committee and management, and there is an undue focus on the assumed precision of the data (as well as on disclosed data). The adage that benchmarking is more art than science continues to apply even in this age of detailed compensation disclosure.

3. **Performance-based Pay:** Performance-based pay design is one of the most fundamental and, arguably, the most important aspect of EC. It encompasses a wide range of considerations—from establishing incentive objectives and the mix of incentives (e.g., annual, long term) to selecting incentive vehicles and, ultimately, to determining incentive payouts. Given the range of considerations, their complexity and the potential trade-offs among various decisions, effective performance-based pay design belies simple conclusions (e.g., "options are not performance-based," "the same incentive measures should not be found in multiple incentive plans"). The assessment of incentive program effectiveness requires in-depth analysis. The operating principles in this area address the full range of performance-based pay design issues and offer perspectives that reflect their complexity and importance.

Beyond design, pay-for-performance assessment (i.e., how actual total pay compares with actual performance on an absolute and relative basis) is an issue that continues to gain increased attention, as it's becoming a key focal point for shareholders in organization disclosures. We view this as a positive development because it has helped to crystallize relationships between relative pay and relative performance, while also expanding the definitions of pay considered by organizations and shareholders (e.g., "realizable pay"). This growing attention to alternative definitions of pay not only yields insights for shareholders and stakeholders about EC program structure and effectiveness but also can provide important insights that promote better pay program design. We believe we're still relatively early in the evolution of pay-for-performance measurement and encourage organizations to explore and embrace the emerging analytics to help enhance program designs for all senior executives and pay disclosures in applicable jurisdictions.

We believe that certain components of performance-based pay design warrant particular attention. Specifically, we believe that organizations with above-median pay philosophies have a responsibility to consider pay-for-performance analyses to ensure that pay outcomes are appropriate across all levels of performance, especially poor performance. The lack of such analyses can perpetuate scenarios in which pay levels outpace actual performance. Additionally, organizations should be more thoughtful about their determination of incentive objectives (e.g., line of sight, shareholder alignment, retention), which should support the selection of more effective vehicles and performance measures. Finally, organizations should also seek to improve the rigor in certain design areas that often receive too little attention—namely target and range setting, testing of incentive payouts relative to performance, and the effective use of discretion.

4. **Governance:** For public companies in the U.S. and certain other markets, listing exchanges require that compensation for selected senior executives be set or approved by a compensation committee made up of independent (outside or nonexecutive) directors. Our guiding principles for EC governance focus primarily on the role and operations of such committees and their advisors. Our consulting experience suggests that many private organizations and nonprofit organizations

are also adopting more formal governance structures, albeit without the legal and regulatory requirements that public companies face. These organizations may benefit from application of our governance-related operating principles.

5. **Other Terms and Conditions:** In addition to the programs that provide regular compensation opportunities to executives, organizations also offer additional programs and policies necessary to recruit new executives, ensure continued retention, and effectively manage various kinds of risk. An ever-changing regulatory landscape coupled with increasing shareholder scrutiny require that organizations and compensation committees proactively review their risk mitigation programs, perquisites, and employment terms and conditions to ensure that these elements align with shareholder interests and the organization's evolving business objectives.

As a general rule, whenever practical, we believe that organizations should endeavor to shift from individualized contractual arrangements to consistent policies covering broader employee segments and should differentiate their rewards programs through direct compensation, rather than via these other terms and conditions.

6. **Special Circumstances:** Compensation committees are often faced with a number of special circumstances that require particular attention and planning, including hiring new executive officers, executive terminations, and corporate transactions such as mergers and acquisitions. In planning for these events, organizations should keep in mind the same key objectives that underlie the design of the EC program generally: to incent and reward the behaviors and processes that reinforce the activities the organization undertakes to create sustainable long-term value for multiple stakeholders.

Applying the Principles

We wish to offer some upfront, general advice on applying the EC principles. The principles may be used not only to design EC systems, but also to assess and refine existing systems, along with serving as the basis for the education and training of board members, senior management, and HR and other compensation staff. We encourage organizations to apply these principles thoughtfully and flexibly, rather than mechanically. As our consultants debated and came to consensus on these principles, there were many times when practitioners could cite valid exceptions to the general rules — for example, practices that in many organizations appear problematic, while making perfect sense for a few. It's important to remember that no two organizations are alike and there will always be unique — and highly successful outliers in the mix. In short, these principles are designed to be helpful, not prescriptive. As such, we view them as *guidelines that will work for most organizations — most of the time*.

In line with this note about flexibility, we also sought to have the principles provide some clear direction and preferences, and to avoid banal statements of ideals. We thus adopted an effective hierarchy in which principles include either a "must," "should," or "could." In effect, principles that include "must" are ones with which we feel strongly that almost all organizations should align; it would be a true exception for an organization not to align and still to have an incentive system design that is appropriate. As we move to "should" and "could," we expect the frequency of nonalignment to increase, while maintaining appropriately designed EC systems. In short, our experience counsels us to be open to alternative points of view in a world of virtually limitless business and executive circumstances.

Finally, we view these principles as reflecting a point in time. Organizations and their leaders change and evolve, and multiple dimensions (e.g., legal, tax, social) of the external environment are in constant flux. Our intention is to revisit these principles periodically, in the context of the future corporate environment, to ensure that they remain relevant and reflect ongoing research and experience.

About Willis Towers Watson

Willis Towers Watson (NASDAQ: WLTW) is a leading global advisory, broking and solutions company that helps clients around the world turn risk into a path for growth. With roots dating to 1828, Willis Towers Watson has 40,000 employees serving more than 140 countries. We design and deliver solutions that manage risk, optimize benefits, cultivate talent, and expand the power of capital to protect and strengthen institutions and individuals. Our unique perspective allows us to see the critical intersections between talent, assets and ideas — the dynamic formula that drives business performance. Together, we unlock potential. Learn more at willistowerswatson.com.

WillisTowersWatson