Guidelines for Mitigating Reputational Risk in C-Suite Pay

June 1, 2016

Key Takeaways

- Peer group comparison and industry benchmarking has resulted in significant increases in C-Suite compensation across industries in the US. Given the growing income inequality in the country[1], SSGA sees increased reputational risk arising from the high quantum of pay to C-Suite executives; in 2018, this risk will be further heightened when companies begin disclosing CEO to median employee pay as mandated by the Securities and Exchange Commission (SEC).
- SSGA has typically focused its attention on enhancing the pay-for-performance element of C-Suite compensation. However, with overall CEO pay remaining largely stable or increasing despite performance challenges[2], the variability in pay and its link to performance is not apparent to investors.
- Many directors cite competitive pressures, industry practice and talent retention as reasons for the ever-increasing compensation levels. Acknowledging the competitive challenges that limit a board's ability to address the growing reputational risk from high quantum of pay, SSGA believes passive index investors need to take action to mitigate long-term reputational risk stemming from these practices.
- Consequently, SSGA has developed a screen that identifies companies where C-Suite compensation is well above the average CEO pay at Dow 30 companies. We believe that elevating investor concerns regarding overly excessive C-Suite compensation is needed to empower directors to take appropriate action to mitigate reputational risk in C-Suite pay.
- Finally, we have provided guidance for directors on ways to identify and mitigate reputational risk in pay.

Background

During the 2016 proxy season, when analyzing pay at US companies, SSGA's governance analysts noted a lack of variability in the year-to-year compensation packages of C-Suite executives. When evaluated in the context of poor performance and shareholder returns of the past year, the stable nature of compensation payouts was surprising given that investors have been working since 2011 to strengthen the pay-for-performance aspect in compensation.

Some of the methods used by companies to circumvent the pay-for-performance alignment include:

- Increased base salary and/or long-term stock grants that made up the decrease in short-term bonus payouts
- Above-target payouts under annual bonus plans for exceeding short-term performance goals that were recalibrated downwards in the middle of the performance cycle
- Relying on the discretionary element in compensation to pay out annual short-term bonus at-or-above target levels despite the failure to meet financial and business targets
- Additional one-time or multi-year grants that increased overall compensation in a given year

Our observations were confirmed by the Institutional Investor Services' May 11, 2016 publication — A Look at Compensation Trends. The report, which was published at the mid-point of the US proxy season, noted that when adjusted for pensions, the median increase in CEO pay in S&P 500 companies was 3.7% in 2015, compared with 4.6% in 2014 and 8.8% in 2013. While the growth in median pay is slowing, the overall trend of increasing CEO pay despite poor stock performance is of concern to investors.

The debate on income inequality in the current political environment has brought heightened focus on the quantum of CEO pay at US companies. This year alone, we have seen worker unions strike against companies citing high CEO pay[3], and politicians naming and shaming companies for their low employee wages and high executive compensation practices[4]. Such negative publicity has the potential of damaging a company's brand with customers and impacting the long-term returns for shareholders.

Why Investor Action is Needed to Help Mitigate Reputational Risk in Pay

SSGA has been engaging on compensation-related matters with directors for a few years. On occasions when we have raised concerns with quantum of C-Suite compensation, directors have communicated the competitive challenges that limit their ability to address our concerns. As a long-term passive index

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investor, the rising reputation risk from pay is a serious concern. In the absence of action by directors, investors need to hold companies to a set of common expectations that requires boards to assess and mitigate reputational risk in C-Suite pay. Failure to act on this issue could potentially result in C-Suite pay regulation similar to that introduced in the European Union[5], which has had unintended consequence for long-term investors.

As a result, this year we developed a screen to identify companies that may be building up reputational risk due to the current quantum of C-Suite compensation. We are adding this screen to our growing suite of proprietary ESG screens developed to help identify companies for engagement and proxy voting.

SSGA's Excessive Pay Screen

Our screen leverages reported compensation granted in the 'Summary Compensation Tables' in proxy statements at Dow 30 companies. Factors that were considered in designing the benchmarking screen were:

- Size of company by market capitalization and revenue, complexity of business and geographic footprint
- Mix of companies from different sectors to accommodate for competitive aspects of sector-specific differences in pay levels
- Reputation and ability of management to create and deliver value to investors over the long-term
- Additional buffers to the average benchmark compensation to accommodate and pay for superior and sustained performance

Based on 2015 CEO pay data for all proxies filed by April 30, 2016, 38 companies in the Russell 3000 were identified through our screen. The total compensation, excluding pension, at these outlier companies reached a maximum of $119M, with the average reported total compensation being $40M. SSGA recognizes that a majority of these companies are large-cap and that the screen may be ineffective in addressing quantum concerns in mid-and-small cap companies. However, given that the primary purpose of the screen is to empower boards to mitigate reputational risk in pay, we believe it is appropriate at this time to focus on quantum issues in large-cap companies that tend to be targeted in the media. We also hope that directors of small-and-mid-cap companies respond to this guidance and proactively take action to rationalize pay levels in their companies.

Guidance for Compensation Committee Members on Mitigating Reputational Risk in Pay

- Scenario test C-Suite compensation packages to threshold, target and stretch goals established by the board to understand the variability of the total compensation payout to performance, as well the variability within each pay component.
- Introduce reasonable maximum payout limits as percentage of base pay on short-term and long-term compensation plans.
- Disclose the maximum payout limits under each pay component to shareholders; this will enhance transparency and will help set investor expectations with regards to quantum of pay built into the current compensation plan.
- Explain anomalies in pay that may increase reputational risk for the company in a given year and demonstrate how the board has mitigated this risk through pay design.

We hope that board members of our portfolio companies find this guidance useful. Any questions or comments regarding this guidance may be directed to Rakhi Kumar, Managing Director, Head of Corporate Governance at Rakhi_Kumar@SSGA.com

1 CEO pay continues to raise as typical workers are paid less, Economic Policy Institute, June 12, 2014 http://www.epi.org/publication/ceo-pay-continues-to-rise/.

2 US Proxy Season 2016 Midterm Analysis – A look at Compensation Trends, Institutional Shareholder Services, May 11, 2016.

3 Striking Verizon union is demanding big changes to executive pay, NJ.com, May 5, 2016 http://www.nj.com/business/index.ssf/2016/05/verizons_striking_union_is_demanding_big_changes_to_executive_pay.html.

4 When CEO pay exploded, NPR, February 5, 2016 http://www.npr.org/sections/money/2016/02/05/465747726/-682-when-ceo-pay-exploded.

5 Europe moves to a Swiss-style executive pay curbs, Reuters, March 6, 2013 http://www.reuters.com/article/us-eu-pay-idUSBRE9250WM20130306.

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