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CEOs Sign Voluntary Governance Principles, but Emphasize Flexibility in Executive Pay

Newly released "Commonsense Principles of Corporate Governance" highlight the importance of individualized and well-articulated compensation plans.

A set of high-level "Commonsense Principles of Corporate Governance" were released July 21, 2016, and signed by a select group of business leaders representing a handful of America's largest businesses, including General Electric, General Motors, Verizon and Berkshire Hathaway and mutual fund giants like BlackRock, State Street Global Advisors, Vanguard and T. Rowe Price. Notably, there were no technology or life sciences companies among the signatories.

The Principles are organized into eight areas: I. Board of Directors – Composition and Internal Governance; II. Board of Directors' Responsibilities; III. Shareholder Rights; IV. Public Reporting; V. Board Leadership; VI. Management Succession Planning; VII. Compensation of Management; and VIII. Asset Managers' Role in Corporate Governance.

In Part VII, the principles address "Compensation of Management" in seven succinct bullets, highlighting the importance of tailoring compensation programs to the individual company's business and other competitive needs, flexibility to adjust pay programs over time, and the importance of maintaining a mix of short- and long-term incentives.

On the topic of performance measures and the goal-setting process, the principles highlight the need to "ordinarily" disclose details necessary to enable shareholder evaluation on the rigor of the company's goals and goal-setting process. However, the signatories agree that companies should also retain discretion to consider qualitative factors when determining compensation.

With regards to the use of equity, the principles suggest that companies should consider paying a "substantial" portion of compensation for senior management in the form of equity or similar vehicles (defined as 50% or more for some companies), with particular attention paid to the dilutive effect of any such awards and with the flexibility to set appropriate vesting periods for each business.

Notably, one of the few entirely prescriptive principles in the document is the explicit statement that companies should maintain clawback policies for both cash and equity compensation.

While the principles clearly encourage dialogue between companies and shareholders on compensation- and governance-related topics, they also explicitly state that companies should not feel constrained by competitive practice or the views of proxy advisors when designing pay programs. Ultimately, pay programs should link compensation to performance with a long-term horizon. Shareholders should give companies latitude in connection with individual compensation decisions in instances where the overall program is well-designed and clearly articulated. Nonetheless, we note that the influence of proscriptive standards set by proxy advisory firms is still highly influential with some institutional investors.

Although not explicitly a compensation-related issue, the principles also explicitly highlight that all compensation, including equity compensation, is clearly a cost of doing business, and as such, should be reflected in any non-GAAP measurement of earnings.

Next Steps

The primary thrust of the principles is that companies should be free to make compensation and corporate governance decisions that are tailored to their businesses, but that clear and full articulation of the rationale for those compensation decisions is critical— especially when pay programs depart from the norms set out by a company's own past practices, those of its peers, or those of prominent shareholders or proxy advisors.

Additionally, companies should examine their policy on non-GAAP income measurements to determine whether or not the exclusion of compensation, and especially equity-related expenses, continues to make sense. While this has long been the practice of technology and life sciences companies, these principles, coupled with decisions by several large and prominent companies in this space, may suggest the beginning of a sea change on this topic.

To speak with a member of our compensation consulting group about how this release might impact your company, please reach out to your primary consulting contact or write to consulting@radford.com.

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