FCLTGLOBAL
FOCUSING CAPITAL
ON THE LONG TERM

REPORT

The Risk of Rewards

TAILORING EXECUTIVE PAY FOR LONG-TERM SUCCESS

Rewiring Capital Markets to Support Sustainable Growth

Business leaders have long struggled to weigh immediate financial needs against objectives many years into the future in order to succeed over the long term.

In the wake of the global financial crisis, something had to change in order to safeguard the future needs of individual savers and their communities. To call for action to reform the system, Focusing Capital on the Long Term (FCLT) was founded in 2013 as a joint initiative of CPP Investments and McKinsey & Company.

The initiative's message made it clear that those who participate in the capital markets could work to improve them. In July 2016, CPP Investments and McKinsey teamed with BlackRock, The Dow Chemical Company, and Tata Sons to found FCLTGlobal as an independent non-profit.

FCLTGlobal's mission is to rebalance capital markets to support a long-term, sustainable economy. We are a non-profit organization supported by leading companies and investors worldwide that develops research and practical tools to drive long-term value creation for companies, savers, and communities.

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Foreword

Remuneration is one of a company's most important decisions about how it pays its executives. Recently, FCLTGlobal has researched long-term behaviors related to other aspects of corporate resource allocation—including research and development, and buybacks—and their impact on long-term performance. Our research on remuneration is in that same spirit: long-term incentives for executives can help the firm perform well over time. Tailored remuneration changes can make a meaningful difference in driving long-term behaviors in CEOs.

This white paper presents practical tools that companies—and their investors—can use to frame their decisions about corporate executive remuneration.

Our practical solutions include:

1. A list of behaviors to stop and a list of alternatives,
2. A conversation guide to distinguish the remuneration provisions that fit a company's circumstances, and
3. A method for designing a long-term remuneration plan.

Executive remuneration is a critical issue for companies, for investors, and for society more broadly. Income inequality is inherently intertwined with the issues of executive remuneration—and with the working of capital markets more broadly. In our efforts to pursue our mission of rebalancing capital markets to support a long-term, sustainable economy, further research efforts may dive more deeply into the causes of and solutions for income and wealth inequality.

The insights in this report reflect and extend perspectives that FCLTGlobal and our Members have expressed throughout our organization's history. Dozens of Member organizations and their senior staff lent their time, insight, and experience to make this effort possible, and they represent the full breadth of capital markets, including companies, asset managers, asset owners, and professional services firms from Asia-Pacific, Europe, and North America. We are deeply grateful and indebted to all of them.

Sarah K Williamson

Executive Summary

Short-term incentives motivate short-term behavior. Corporate boards can drive long-term performance by making changes to remuneration that encourage long-term behavior by executives while avoiding common pitfalls. Similarly, investors can support long-term executive remuneration plans through their votes and engagement.

Financial incentives motivate behavior—indeed, financial incentives may work too well. Executive pay is focused on a short time horizon—with recent data pegging average duration of executive compensation plans for CEOs of MSCI All Country World Index (ACWI) constituents at 1.7 years.[1] This short-term focus can have far-reaching consequences, yet setting out to make remuneration longer-term is no simple task.

Both investors and corporate directors strongly believe in the importance of using performance-linked pay. At the same time, the long-term effect on executives' behavior and companies' performance remains rooted in theory rather than evidence. Behavioral studies find that performance-linked pay motivates people effectively only for routine tasks—and a CEO's job is anything but routine. This suggests performance-linked pay is not an easy solution to executive remuneration. And pay linked to the wrong metrics simply compounds the problem.

The most effective remuneration structures are tailored to a company's objectives, strategy, and management. Careful tailoring of long-term remuneration packages involves directors—and their shareholders—taking multiple steps over time. This report offers practical tools to aid in taking those critical steps, providing standardized frameworks for communicating, evaluating, and designing long-term pay plans.

Remuneration design should be tailored, but investors cannot evaluate every portfolio company's remuneration plan in isolation, and remuneration committee directors cannot ask the marketplace—regulators, proxy voting advisers, and executive candidates themselves—to treat their plan as fully bespoke. FCLTGlobal's tools aim to help define long-term executive remuneration at scale.

Our tools empower companies to replace some commonly used elements today, reflect on their long-term needs, and effectively tailor long-term remuneration to corporate strategy. By replacing remuneration provisions that drive short-term behavior—like creating large one-off moments of financial reward, accelerating vesting schedules upon departure, relying on peer groups to determine pay structure, and trying to motivate executives exclusively through their pay plans—companies have the opportunity today to take a first step towards implementing longer-term remuneration plan design.

Directors and investors can then use key questions to understand the firm's circumstances, evaluate the relationship with remuneration design, and find options for focusing remuneration on long-term value. Questions like "How long is the firm's business cycle?" "How wide is the firm's range of potential outcomes relative to expectations?" and "What is the firm's ability and willingness to pay executives over time?" help determine the parameters for plan design. Remuneration plans can then be redesigned using four key decisions focused on the degree of performance linkage, instruments of pay (e.g., cash, stock, options, etc.), targeted time horizon, and use of mandatory holding levels (as either a multiple of pay, percentage ownership in the firm, or proportion of an individual's net worth).

Designing a pay plan unconstrained by existing contract provisions occurs infrequently, usually during leadership transitions or corporate actions. Outside of those strategic moments, corporate remuneration committees can use these tools to evaluate and manage the long-term strengths and weaknesses of their existing plans. Investors can do the same, evaluating a plan prior to a remuneration-themed corporate engagement. For both companies and investors, clarity on remuneration structure is critical, and we would encourage communication in this more long-term format in the Compensation Disclosure and Analysis sections of proxy statements.

This research was conducted with full appreciation of the fact that pay structure is just one of the many issues that prevent equitable and strategic remuneration today. Beyond the structure of executive pay plans, there are considerable issues with the metrics used to determine rewards and the amount of money being paid to executives. While this research tackles pay structure as a singular issue, it is just one piece of a much larger puzzle. The job of the remuneration committee is to ensure that pay is structured strategically, calculated appropriately, and dispersed fairly, and therefore becomes a tool to achieve long-term goals.

Introduction

Financial incentives motivate behavior—dramatically. "Remember: Executives will do their best to hit whatever goals are set," remarked several scholars of executive remuneration. "So set targets that work for the company."[2] Indeed, financial incentives may work too well. Too often plan design delivers unintended, even undesirable, results. This includes inhibition of innovation,[3] short-term financial engineering and curtailed investment in quarters where equity is scheduled to vest,[4] CEOs' releasing more discretionary news items in months in which their equity vests,[5] and CEOs' maximizing their end-of-term stock values close to retirement to enhance pay.[6]

OVERVIEW OF EXECUTIVE REMUNERATION STRUCTURE

Before analyzing current remuneration trends and opportunities to improve long-term focus, it is important to understand the taxonomy of a typical executive remuneration plan. The table below presents the component parts of an executive's remuneration contract, and a glossary of terms is available on page 39.

Initiating Terms

- Sign-on Bonus and Make-whole Payments
- Employment Contract
- Resetting/Evaluation Process
- Base Salary
- Retirement Plans and Health

Short-term Incentive Plan (STIP)

- Short-term Bonus

Long-term Incentive Plan (LTIP)

- Restricted Units
- Performance Units

Control Mechanisms

- Performance Metrics
- Vesting Period
- Mandatory Holding Period
- Stock Ownership Requirements
- Peer Group
- Caps
- Clawbacks

Concluding Terms

- Change-in-Control Adjustments
- Severance
- Retirement

FCLTGLOBAL'S PRIOR RESEARCH RELATED TO EXECUTIVE REMUNERATION

Since its inception, FCLTGlobal and its Members have considered executive remuneration to be of high importance for long-term value creation, and it is a recurring theme in our research.

FCLTGlobal's 2020 report *The Dangers of Buybacks: Mitigating Common Pitfalls* examines buybacks and their attraction, followed by a deeper look at their pitfalls, and concludes with practical tools and guidelines for companies, investors, and policymakers to evaluate buybacks on their long-term merits. The report also urges companies and boards to consider a buyback's implications for executive remuneration in order to evaluate a buyback on its merits.

Driving the Conversation: Long-term Roadmaps for Long-term Success articulates how a company will create long-term value and lays out key metrics to track its performance. One of the key metrics is executive remuneration (see page 9 of the report). The report encourages business leaders to disclose a description of how executive and director remuneration ties to the company's long-term value creation and objectives.

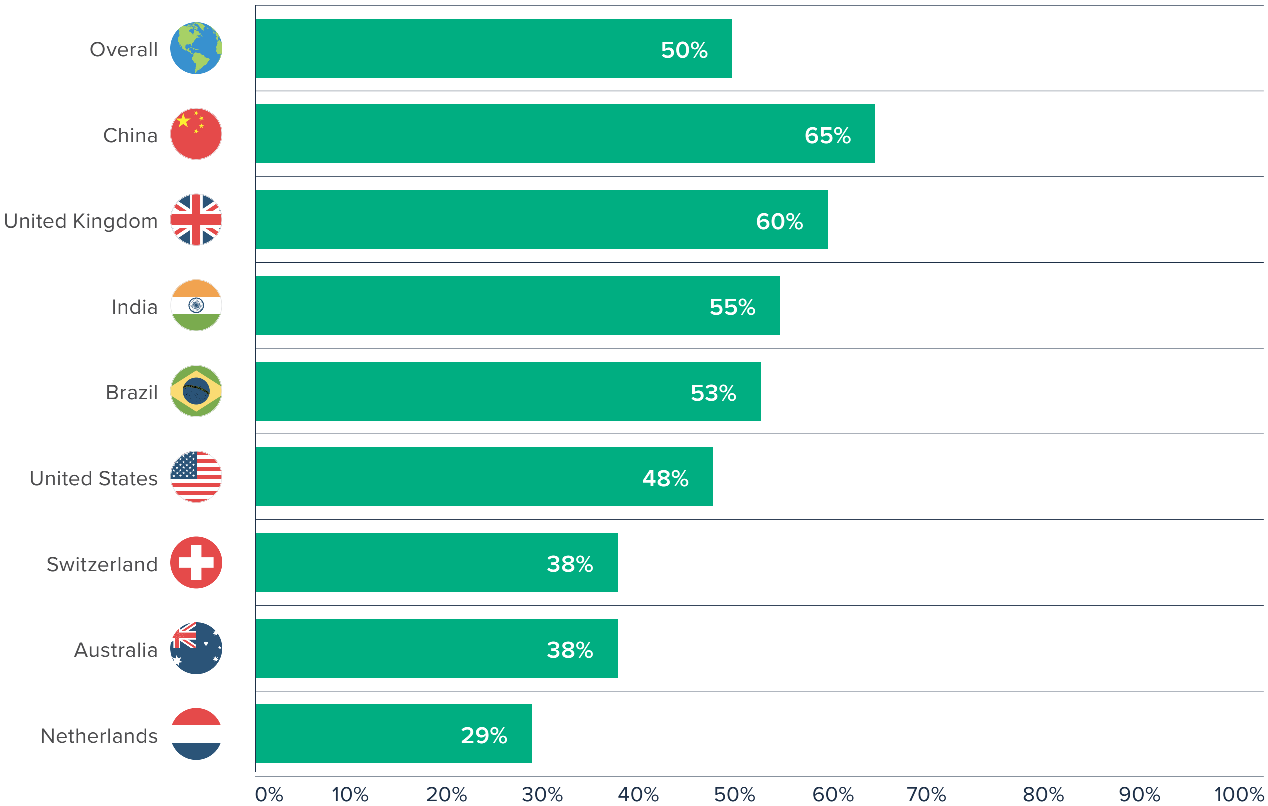
Straight Talk for the Long Term urges companies to "articulate how executive and director compensation tie to a company's long-term strategic goals." The report concludes that remuneration structure is an essential tool in migrating the investor-corporate dialogue toward a more balanced discussion about a company's short- and long-term prospects.

Short-termism: Insights from Business Leaders asks senior executives and board directors about the ways that they balance short- and long-term priorities, the time frames they use to decide on strategy and investments, and the potential benefits from taking a longer-term approach to decisions. In exhibit 7, respondents identified "Replace executive-compensation awards based on stock price with those determined through operationally oriented key performance indicators" as a top 10 action to "help cultivate a long-term orientation."

Executive Remuneration Plans: We Are Not Consistently Paying for What We Want

Since financial incentives drive behavior so significantly, it is critical that companies—with the support of their long-term shareholders—design executive remuneration plans that motivate long-term behavior. However, the data about whether this is happening are mixed. A PwC global survey that included more than 1,000 executives across 43 countries found that only half agreed that their companies' long-term incentive plans (LTIPs) were "effective incentive."[7]

Respondents Agreeing Their Firm's LTIP Is an Effective Incentive



Source and analysis: PwC, *Making executive pay work: The psychology of incentives*, 2012.

As another example, the pay duration (i.e., the average vesting period of pay) of US executives from 2006 to 2009 was about 1.2 years, while US CEO pay had a slightly longer duration of about 1.7 years.[8] Rather than suggesting a long-term focus, such short-duration remuneration correlates with clear short-term behavior: "firms that offer shorter duration pay contracts to their CEOs have higher abnormal accruals in the current period. This negative association is stronger for earnings enhancing positive accruals."[9]

Data about the performance of companies only adds to this uncertainty about the behavior of individual corporate executives. Overarching conclusions regarding the effects of pay and firm performance are difficult to isolate. MSCI[10] demonstrated a low correlation between 10-year total shareholder return (TSR) and 10-year cumulative realized pay,[11] and PwC found a high correlation after controlling for additional variables.[12] This uncertainty is inherent, further complicating the task of remuneration committees. As several leading academics conclude, it is "impossible to interpret any observed correlation between executive pay and firm outcomes as a causal relationship."[13] This impossibility may be because "pay affects performance, because firm performance affects pay, or because an unobserved firm or CEO characteristic affects both."[14]

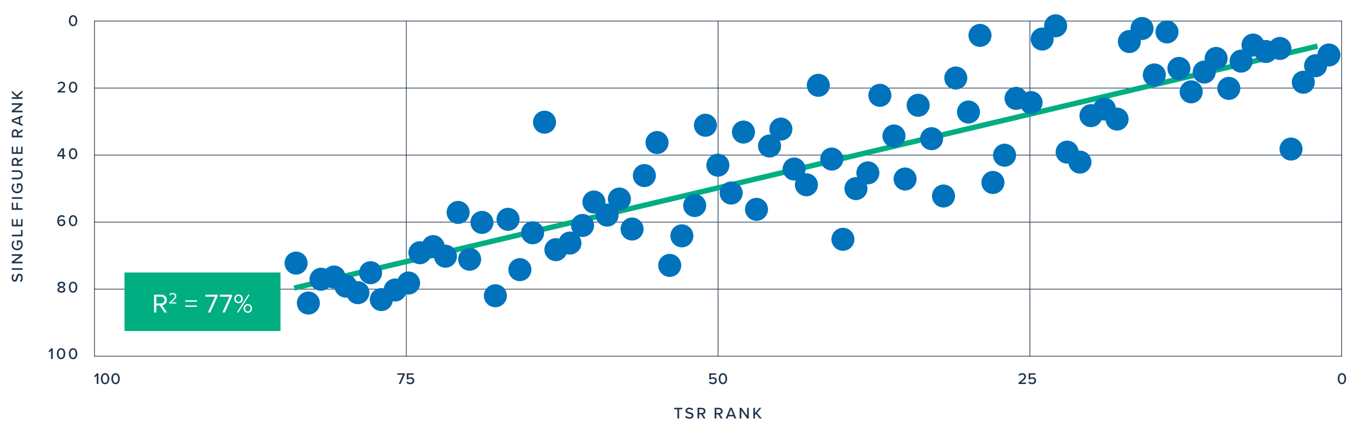
TSR vs 10-year Cumulative Total Realized CEO Pay

10-year TSR as of Dec. 31, 2015 vs. 10-year cumulative total realized CEO pay as reported in 2007-2016 proxy statements, reflecting a one-year lag in reporting. Source: MSCI ESG Research.

Our own in-depth discussions and working group sessions with companies and long-term investors provided abundant anecdotal evidence of the uncertainty surrounding executive remuneration plan design as well as the dissatisfaction that follows from it.

Target CEO Pay, Adjusted for Size and Wealth Effect of Previously Granted Equity, for the FTSE-100 Compared with 3-year TSR Rank

Wealth and Size-adjusted Single Figure vs 3-year TSR



Source and analysis: PwC Database, Datastream.

COMMON BLIND SPOTS IN EXECUTIVE REMUNERATION DESIGN

Remuneration is a key lever for incentivizing executives. However, many important, and potentially more powerful, tools to drive alignment are often overlooked or deemphasized.

Intrinsic Motivation

Remuneration is intended to find motivational synergies, not to be the sole motivator of long-term value creation.[15] It therefore is critical to accentuate aspects of the firm, such as culture and purpose, that give executives greater intrinsic motivation. Executives' roles inherently share many of the characteristics considered essential for what academics called "job enrichment" at the outset of motivational research, including the number of skills required by the job, the degree to which the job produces something meaningful, the importance of the work, the level of autonomy, and the degree to which the individual obtains ongoing feedback.[16] Despite the intrinsically motivating nature of executives' job descriptions, there often is more emphasis on how to structure remuneration to extrinsically motivate rather than amplify these natural reservoirs of intrinsic motivation. It is critical that remuneration committees consider how to best align external and intrinsic elements because nonsynergistic external motivations have been shown to crowd out intrinsic motivation.[17]

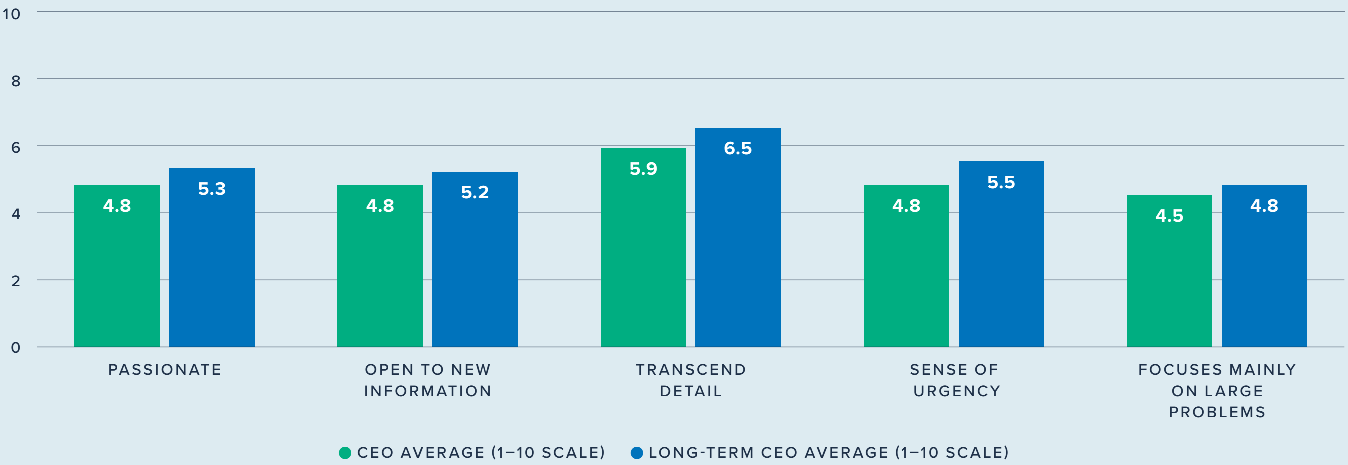
Fairness is a particularly remarkable motivator in this context because of its unintended consequences. Executives frequently measure their prestige and self-worth in economic terms relative to other executives. Eventually, the marginal dollar of remuneration no longer has value in terms of purchasing power; instead, it signals executives' prestige within their communities. Indeed, PwC's global survey showed that executives prioritize getting paid more than their peers over getting paid more in absolute terms.[18]

Hiring and Retaining the Right Executive

The second important blind spot for boards and investors is the overemphasis of the executive hiring process relative to ongoing motivation. Companies seek the right executive to execute the long-term strategy, which will evolve as the company matures. If remuneration is the main tool to attract and retain talent, the wrong person is likely in the seat. To achieve a desired outcome, it is important not only that the right incentives are implemented but that they are incentivizing the right person. The most thoughtful executive remuneration plan will not drive its desired outcome if it is incentivizing an executive who cannot do the job.

Research by Russell Reynolds using psychometric testing reinforces not only that each executive is unique but that their personal traits will influence their behavior and aptitude.[19]

Long-term CEOs Demonstrated Stronger Psychometric Traits in Several Areas Compared to Typical CEOs

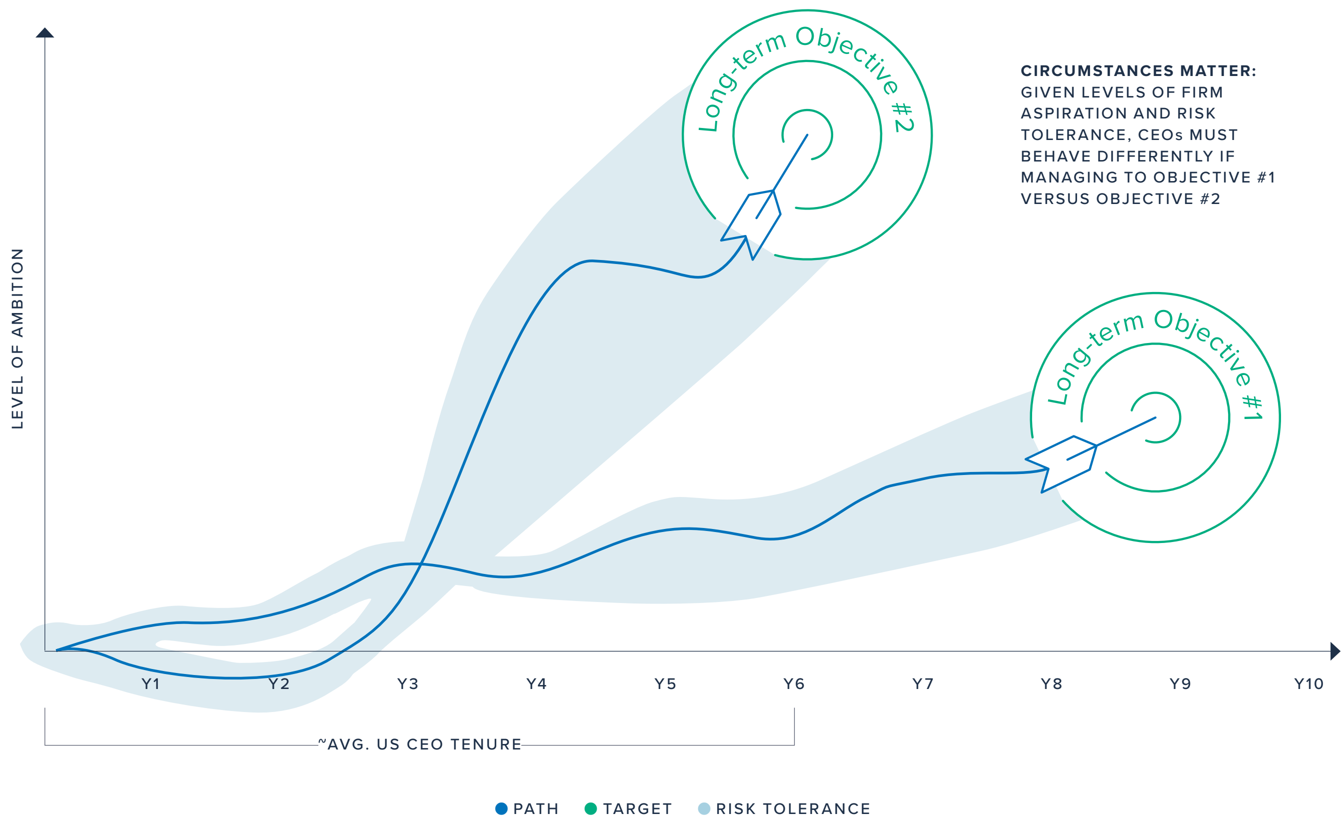


Source: Russell Reynolds and Associates, *Creating Sustained Value: Finding and Supporting Long-term CEOs*, October 2016.

We Can Pay for What We Want More Consistently

Remuneration committees can focus remuneration design on the long term by tailoring it for the firm's risk-return goals, its strategic roadmap, and the behavioral tendencies of the executive in question.

Level of Firm Ambition vs. Avg. US CEO Tenure



Analysis by FCLTGlobal.

Every company has a unique purpose, objectives aligned with that purpose, and business strategy to achieve those objectives. Companies also have different time horizons and levels of ambition. High ambitions entail greater risks, bumpier pathways, and more long-term uncertainty. In practice, pay design that influences corporate executives to behave in long-term ways must differ, for instance, between a recently listed, small-cap firm betting on the next-generation innovation and a mature, mega-cap firm looking for the next operational efficiency. Remuneration committee directors have a balance to strike between encouraging long-term growth and providing stability along the way. Tailoring remuneration design can signal this balance to executives and influence the risks that they accept or avoid. Investors can support this balance through the remuneration engagement.

Firms use long-term strategies to navigate their intended paths, and effective long-term strategies frame remuneration design. FCLTGlobal's 2019 report *Driving the Conversation: Long-term Roadmaps for Long-term Success* demonstrates that remuneration is the culminating step for boards and investors setting a long-term strategy, tailored according to each of the earlier steps, not the first step.[20] Indeed, the Aspen Institute enshrined this as one of five principles for executive pay, emphasizing that "pay is unambiguously tied to the company's purpose and the drivers of its long-term success."[21]

BROADER EXECUTIVE REMUNERATION CONCERNS

Though there are many other high-profile concerns related to executive pay, *Risk of Rewards* narrowly focuses on the structural-design issues related to this topic. We chose to focus on structural design as it is a facet of pay most related to our mission: rebalancing capital markets to support a long-term, sustainable economy. This focus on pay design in no way diminishes the importance of broader concerns related to executive remuneration.

A selection of questions that deserve attention but that are out-of-scope for this publication include:

- **Pay amount ("quantum"):** Is the rising remuneration awarded to executives, particularly in the United States, an unintended consequence of investors' and remuneration committee directors' efforts to align pay with performance, say-on-pay votes, or other factors?
- **Income inequality:** What responsibilities might remuneration committees and investors have to address income inequality and the countless other inequities associated with it through the types of rewards that they offer to executives?
- **Defining and measuring executive performance:** To what extent might remuneration committees and investors have introduced counterproductive incentives for executive behavior by their selection of performance metrics? What is the appropriate time horizon for performance metrics for a long-term company?
- **Emphasis on short-term total shareholder return:** Is it consistent to focus on the long term in the context of executive remuneration and use 3-year total shareholder return (TSR)—absolute or relative—as a metric? Is it consistent for a stakeholder-minded company to use TSR or relative TSR as a performance metric at all?

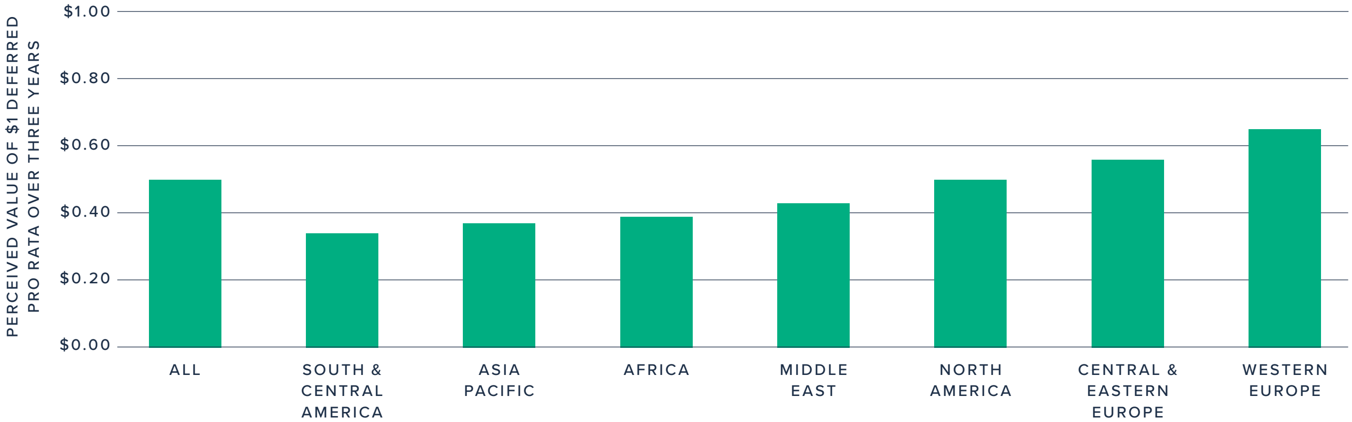
These and other questions raise important topics that merit careful consideration. Please share your views and references for our attention at research@fcltglobal.org.

What Makes a Good Long-term Roadmap?

1. REASON FOR BEING A clear statement of purpose, mission, and vision	**2. CORE DRIVERS OF GROWTH** How the company's business model creates long-term value	**3. MARKET VIEW** Management's perspective on the market	**4. COMPETITIVE ADVANTAGES** The company's unique strengths and assets	**5. LONG-TERM OBJECTIVES** Strategic goals with three- to five-year targets ultimately tied to core drivers of growth
6. STRATEGIC PLAN A detailed execution roadmap that defines short-, medium-, and long-term actions in support of achieving long-term objectives	**7. CAPITAL ALLOCATION PRIORITIES** An explanation of how investments will create long-term value (including sources and uses of cash)	**8. KEY PERFORMANCE INDICATORS** Medium- and long-term metrics and targets that track progress of the strategic plan	**9. RISKS** An overview of risks and their mitigation plans	**10. COMPENSATION** A description of how executive and director compensation ties to long-term value creation and objectives

Source: Focusing Capital on the Long Term, *Straight Talk for the Long Term*, 2015.

Perceived Value of $1



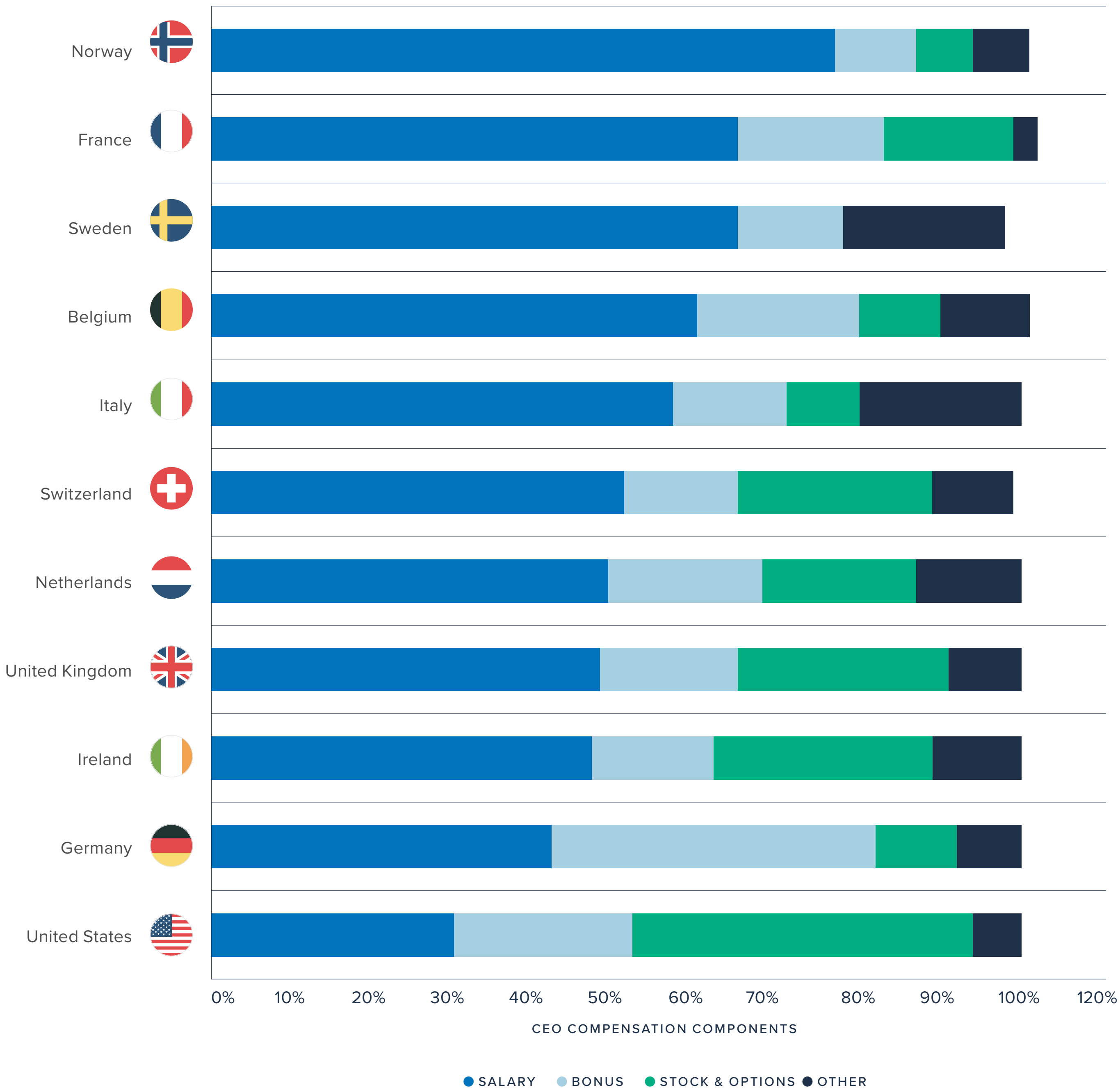
Source and analysis: PwC, *Making executive pay work: The psychology of incentives*, 2012.

Executives are individuals with individual risk appetites, time values of money, and intrinsic motivations. These behavioral tendencies—including those specifically of corporate executives—have proven ripe for new behavioral economic research. "Different demographic groups have a different attitude to risk, and cultural factors also have their part to play in different geographies," PwC found in a survey of global executives. "This suggests that a centralized incentive strategy simply won't work. Organizations should start developing a deep understanding of the attitudes and preferences of their own executive population."[22]

It is difficult for companies to tailor remuneration design based on the firm's risk-return goals, its strategic roadmap, and the behavioral tendencies of the executive. Markets are trending away from differentiated remuneration plans toward more one-size-fits-all approaches.[23] Evidence suggests that proxy advisors are a driver of this convergence. One study calculates a 25 percent decrease in support of say-on-pay proposals if Institutional Shareholder Services (ISS) provides a negative instead of a positive recommendation.[24] Investors, in turn, reward convergence because of the difficulty associated with evaluating thousands of remuneration plans, and companies respond accordingly.[25] Companies also may add momentum to this convergence in their reliance on consulting firms to design their executive remuneration packages.

Still, remuneration committees and investors can tailor their remuneration design approaches despite these difficulties, and they do, particularly across geographies.[26] Boards can take advantage of these examples and tailor remuneration structures to their companies' strategies, not just geographic norms.

CEO Compensation Components by Country



Source and analysis: Edmans, Alex et al "Executive Compensation: A survey of theory and evidence," National Bureau of Economic Research, July 2017.

How to Pay for What We Want More Consistently

Companies can tailor long-term remuneration by replacing some elements today, then by reflecting on their long-term needs, and finally by using four decisions to redesign pay packages:

- **Today:** Replace remuneration provisions that are counterproductive in the long term.
- **Near Term:** Complete a conversation guide to understand the firm's circumstances, evaluate the relationship with remuneration design, and find options for focusing more on the long term.
- **Over Time:** Redesign the remuneration plan using four key decisions: (1) the performance linking of pay, (2) the instruments of pay, (3) the time horizon in which pay is delivered, and (4) the holding levels that executives are required to maintain in company securities.

This three-part tool kit to aid in tailoring long-term remuneration can be applied to a wide spectrum of companies. The intent of these tools is not to recommend the creation of thousands of bespoke remuneration plans. Rather, these tools may assist companies and investors by providing them standardized tools to classify, evaluate, and act on their circumstances.

Replacements to Make Today

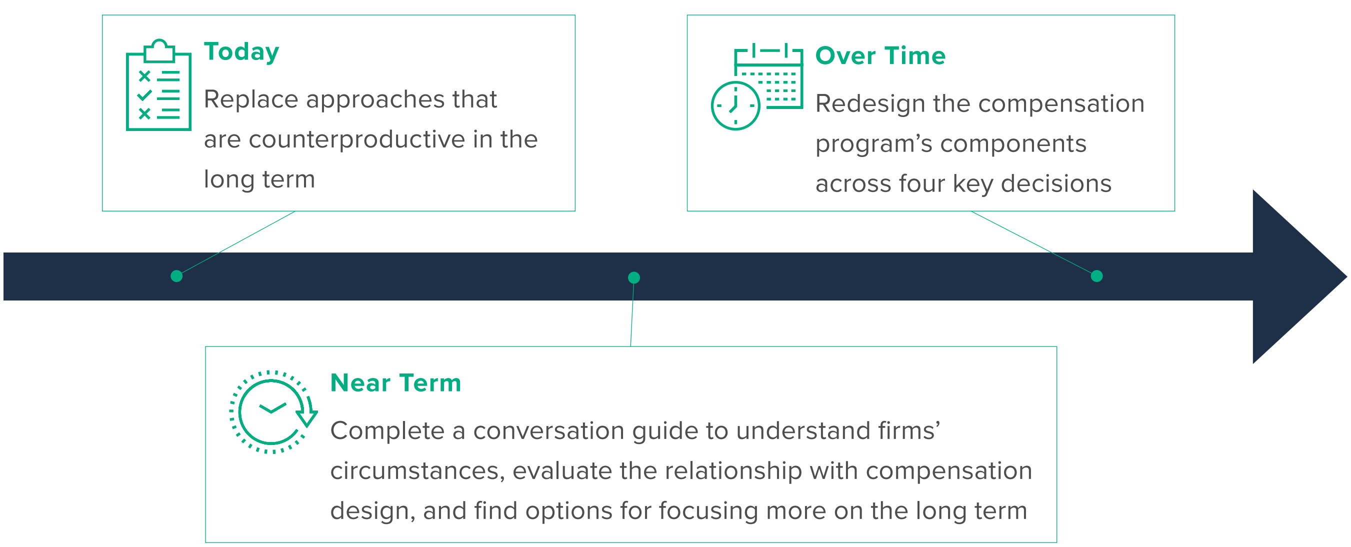
Today: Board directors and investors can replace elements of pay that are common today but are counterproductive in the long term.

Certain remuneration provisions are warnings whenever companies and investors encounter them. While their prevalence varies, evidence argues for discontinuing them immediately and in all instances. Replacement provisions, ones that are amenable to long-term tailoring, are available for each.

Making these changes will accentuate three long-term behaviors related to remuneration: doing no harm through the remuneration design, choosing your own long-term path with remuneration design, and checking blind spots related to foreseeable unintended consequences of remuneration design.

DO NO HARM

Incentive remuneration can influence an executive's long-term behavior constructively, but it can have much wider unintended consequences, ranging from simple inefficiency and distraction to crowding out executives' long-term intrinsic motivation or even encouraging counterproductive behavior. Doing no harm to an executive's long-term focus is the most elementary goal of long term remuneration design,



yet several practices remain in use that pose this risk. Harmful provisions include the following:

DO NO HARM	
Stop	**Instead**
Creating large one-off moments of financial reward	Set vesting and mandatory hold periods to smooth payouts via rolling distributions
Accelerating vesting schedules upon an executive's departure	Maintain preestablished vesting schedules
Assuming companies and individuals have the same time value of money and risk appetite	Measure and adjust for how executives' time values of money and risk appetites diverge from that of the company

- **Creating large, one-off moments of financial reward.** These moments, such as a large vesting date or end of a holding period, introduce short-term pressure. Companies and investors effectively are paying the executive to ensure that their performance metrics—whether stock price or otherwise—are optimized at that moment, even at the expense of performance over time. Even if the large moment of one-off reward is well in the future, it is entirely possible for remuneration design to create short-term pressure a long time from now. Rolling distributions of vested remuneration and rolling holding periods reflect long-term companies' and investors' priority on performance over time and avoid these large paydays.
- **Accelerating vesting schedules upon an executive's departure.** Vesting periods are commonly accelerated at an executive's time of departure, creating perverse incentives to focus on maximizing the value of the firm at the end of the tenure. Evidence shows that CEOs focus on maximizing their end-of-term stock values close to retirement.[27] Other research demonstrates CEOs cut investment and report higher short-term earnings after acceleration of option vesting.[28] Instead of accelerating vesting, maintaining preestablished vesting schedules will help CEOs focus on succession planning and the future state of the firm after their departure.
- **Assuming companies and individuals have the same time value of money and risk appetite.** Individuals within the executive suite have different risk appetites and time preferences. However, these differences are even more stark when comparing how executives discount the future versus how the company does. There are many ways to frame questions to an executive that surface their discount rate, and the first key step is recognizing that executives will have unique rates instead of assuming a rate equal to the general corporate rate.

CHOOSE YOUR OWN PATH

Long-term executive remuneration is specific to strategy. Equally, executive behaviors are very unlikely to align with strategy if their incentives reward something else. Still, there are instances in which remuneration committees design and investors approve plans to pay for something other than what they want:

CHOOSE YOUR OWN PATH	
Stop	**Instead**
Relying on peer groups to determine the remuneration structure, as opposed to pay levels	Design pay structures that are derived from the firm's unique strategy and circumstances
Trying to be all things to all market participants (e.g., tacking on miscellaneous provisions or accepting conflicting provisions because they are broadly demanded)	Establish remuneration structures that best suit the company, its purpose, and its strategy

- **Relying on peer groups to determine the remuneration structure, as opposed to simply gauging pay levels.** Market data from peer groups can serve as useful input on an ex post basis, specifically when evaluating the competitiveness of pay amounts. Yet a long-term firm cannot just borrow the structure of pay from peers. Indeed, pay-plan structure is long-term to the extent that it corresponds to the firm's own circumstances, not those of its peers.

- **Trying to be all things to all market participants (e.g., tacking on miscellaneous provisions or accepting conflicting provisions because they are broadly demanded).** "The Board bears ultimate accountability for making decisions about executive pay and for aligning pay with the long-term health of the enterprise," according to the Aspen Institute's principles for executive compensation.[29] Investors, proxy advisers, and remuneration consultants—among many others—scrutinize companies' remuneration plans, but fully integrating all parties' views compromises focus of any kind and risks internal inconsistency. Long-term companies establish remuneration structures that best suit the company, its purpose, and its strategy.

CHECK BLIND SPOTS

Unintended consequences are rife in executive remuneration, and many are foreseeable. Remuneration design is not a panacea for short-term behaviors by executives or companies. It is important to recognize common mistakes, such as the following:

CHECK BLIND SPOTS	
Stop	**Instead**
Trying to motivate executives exclusively through their remuneration	Integrate monetary incentives and executives' individual intrinsic motivations into a comprehensive package
Overemphasizing the objective of remuneration to be "attract" and "retain"	Focus pay on enhancing alignment; alignment driven by extrinsic and intrinsic motivation will help attract and retain talent
Avoiding risk by hiring or continuing to retain an executive to satisfy the market	Accept the risk of hiring the right executive for the long-term strategy

- **Trying to motivate executives exclusively through their remuneration.** Overemphasis on remuneration can be destructive by crowding out individuals' intrinsic motivations, including creating a legacy, being part of something bigger than oneself, and teamwork. The job description of the CEO embodies many of the characteristics that make work intrinsically rewarding,[30] and good long-term remuneration design will complement these motives. Specifically, long-term companies integrate financial incentives and executives' individual intrinsic motivations into a comprehensive package.

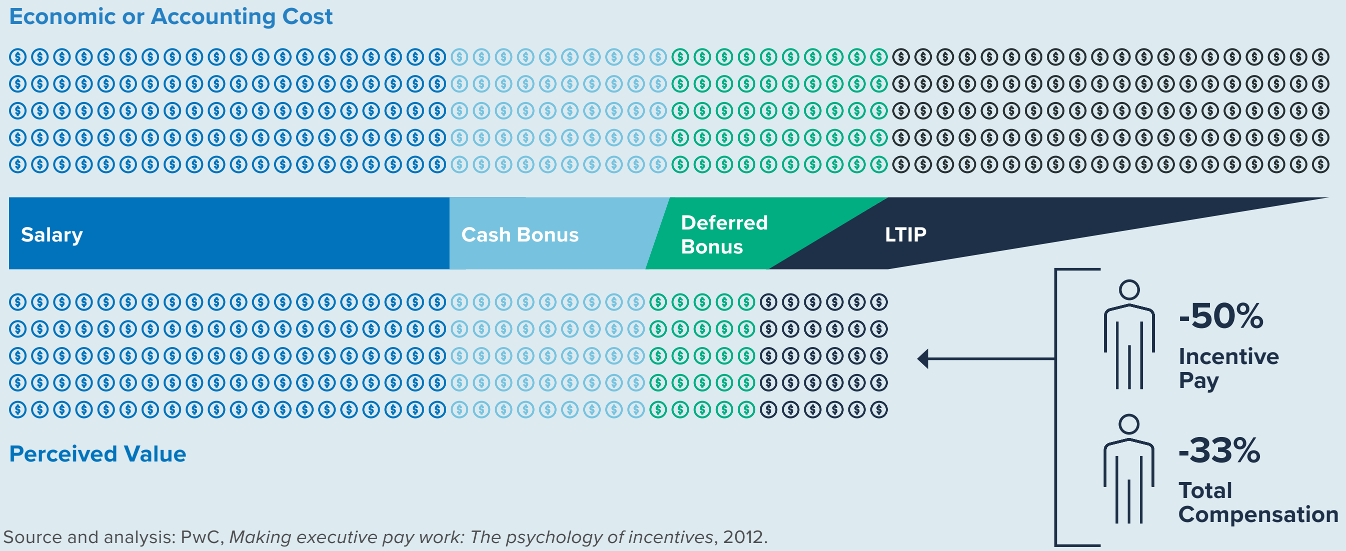
- **Overemphasizing the objective of attracting and retaining relative to alignment.** The three most cited objectives for executive remuneration are to attract top talent, align them with long-term value creation, and retain them. Remuneration packages are often negotiated during the attract or retain phase, but these priorities are not as important over time as alignment. If financial remuneration is the main driver for an executive to join or to remain at the firm, the firm is likely hiring or retaining the wrong executive. Long-term companies focus on using pay to shape alignment.

- **Avoiding risk by hiring or continuing to retain an executive to satisfy the market.** Long-term companies find the right executives for their circumstances and are conscious of the fact that those circumstances will evolve over time. The long-term alignment of executive behavior and corporate performance begins with having the right person in the job—not with remuneration design. Indeed, the most thoughtful executive remuneration plan will not drive its desired outcome if it is rewarding the wrong executive for the job.

EXECUTIVES GET PAID FOR THE RISK THAT THEY TAKE

Employees discount pay based on two factors: riskiness and how long they must wait to receive it. Corporate executives are no exception. PwC was able to determine in a global survey of more than 1,000 executives that the average discount rate for deferred remuneration is 30 percent per annum. For example, the perceived value of a LTIP deferred for three years is only 50 percent of its nominal value of pay.[31] Discounting, as well as the gap between actual and perceived value, grows when variability of pay (i.e., the instrument or performance linking of pay) is added to the equation.[32]

Incentive Pay Can Easily Be Discounted by Half, Relative to Fixed Pay in Executives' Minds



Source and analysis: PwC, *Making executive pay work: The psychology of incentives*, 2012.

This increased discounting results in higher levels of pay for executives. Although technically an expense, rather than a capital allocation, pay is a form of investment—one that can have either a positive or a negative return. The investment in pay earns a positive return to the extent that it influences executives to behave in ways that create long-term, sustainable value. Conversely, the investment earns a negative return when that influence is weak, imprecise, or misdirected.

Behavioral tendencies, like having a discount rate in excess of the firm's or an aversion to losses greater than the valuing of gains, are entirely foreseeable but often not foreseen, and unintended consequences include the upward spiraling of an executive's compensation and diminishing—potentially even negative—marginal returns for the firm. Remuneration committee directors and investors can focus more on the long term by recognizing that pay resembles a capital allocation decision and that the incremental dollar of remuneration needs to be more than offset by an incremental increase in the firm's long-term, sustainable value.

Self-Evaluation Conversation to Have in the Near Term

Near term: Board directors and investors use a conversation guide for longer-term remuneration design before making changes. This planning process helps to anticipate foreseeable unintended consequences.

At least six questions can help illuminate firms' circumstances, evaluate the relationship with remuneration design, and find options for focusing more on the long term. Companies and investors will learn that some design combinations are very promising for their circumstances and that other design combinations are prohibitive. No company will enjoy total, absolute optionality in the design of long-term remuneration because their unique circumstances will determine which provisions can be long-term for them.

The focus during this near-term phase is internal, a reflection on circumstances and the implications they have on an optimal pay structure, rather than on external factors and the evaluation of common market practices. The first three of these questions explore expectations about the firm's performance pathway, and the latter three surface expectations about the firm's relationships with its leaders.

We have applied our conversation guide to two hypothetical companies to roughly illustrate how an organization might approach evaluating the implications of its answers. One is a young, sharing-economy, technology firm (TECH), and another is a mature beverage manufacturer (BEV). The critical distinctions here between these firms are growth trajectories, uncertainty and risk, current profitability, length of business cycle, and the stability of corporate strategy.

Conversation about the firm's pathway expectations:

- How long is the firm's business cycle?
- What is the firm's growth expectation during the next business cycle?
- How wide is the firm's range of potential outcomes relative to expectations?

These questions broach the subject of uncertainty and opportunity as well as the timeline over which they may materialize. The way in which remuneration committee directors and investors answer these questions affects the extent to which they can link pay to performance, the pay instruments that they can use to do so, and the time horizon of pay that they can offer.

Firms that can invest in opportunities before them, manage the uncertainty that results along the way, and keep it up over long time horizons have great performance potential, like our hypothetical firm TECH. They also have a wide array of choices about the time horizon of pay and the instruments including stock, options, and cash. Yet the effect of uncertainty is real: firms in this circumstance have fewer ways to link pay to achievement of specific performance targets because their forecasts are less precise.

PATHWAY EXPECTATIONS

Conversation Guide Question	Example	Implication
How long is the firm's business cycle?	TECH ↑ BEV ↓	Firms can use longer time horizons of pay more easily when they have longer business cycles.
What is the firm's growth expectation during the next business cycle?	TECH ↑ BEV ↔	Higher-growth firms will have more of an opportunity to pay in instruments like stock or options. Lower-growth firms will have the inverse.
How wide is the firm's range of potential outcomes relative to expectations?	TECH ↑ BEV ↔	Paying for performance depends on stable, reliable, and valid metrics. Such metrics are more feasible when the firm's pathway is more certain.

LEADERSHIP EXPECTATIONS		
Conversation Guide Question	**Example**	**Implication**
To what extent is the firm led by founders relative to professional managers?	TECH ↑ BEV ↓	Concerns about the alignment of interests between investors and managers are greater when executives have no personal, "lives-and-legacies" connection to the firm, and firms very often seek alignment by linking pay to performance, using stock or options as instruments of pay, preferring longer time horizons of pay, and requiring larger levels of holding in the firm's stock.
What is the firm's ability to pay executives now?	TECH ↓ BEV ↑	Firms may choose to pay in variable instruments like stocks and options for strategic reasons, or they may do so because they are at a point in their lifecycle at which they have no other choice.
What is the firm's willingness to pay executives over time?	TECH ↑ BEV ↔	Firms are more able to pay variably, in terms of both linking pay to performance and remunerating in stocks or options, to the extent that they are willing to vary the amount that they pay, including increasing pay to compensate executives for whatever level of risk that they take. Firms also are more able to require larger holding levels to the extent that they are willing to grant those holdings to the executive.

On the other end of the spectrum are firms with a great deal of certainty: their opportunities are clear, and the task of management largely is to make incremental investments to preserve and strengthen their positions. These more stable firms, like our hypothetical firm BEV, can link pay to specific performance targets and can use a variety of instruments to deliver this pay. Executives will tend to accept longer time horizons for this pay only to the extent that firms are willing to reimburse them for the risk-adjusted time value of that money.

Conversation about the firm's leadership expectations:

- To what extent is the firm led by founders relative to professional managers?
- What is the firm's ability to pay its executives now?
- What is the firm's willingness to pay its executives over time?

Who leads the firm and the firm's balance sheet position both affect how the firm can pay its leaders. The way in which remuneration committee directors and investors answer these questions affects the holding levels that they set for executives, the instruments that they can use to pay, and the linking of performance to pay.

Firms with lower liquidity may be limited from using cash as an instrument for pay and may have to choose an alternative instrument—likely stocks or options. Founding executives, whose foremost investments in the firm are their lives and legacies, accept this tradeoff of cash for equity instruments and longer required holding periods.

Meanwhile, well-capitalized firms have wider abilities to pay executives either in cash or in various securities. Yet they likely will have to negotiate these provisions carefully if they are led by professional managers who lack this "lives and legacies" investment in the firm. Typically, professionally-led firms prefer to tightly link pay to performance targets and to deliver that pay in equity or other securities under the theory that these provisions enhance alignment. Some firms with a long-term focus also prefer executives to maintain high levels of ownership in the firm over long periods of time for the same reason.

Increasing the variability of an executive's pay to align with firm performance and increasing an executive's ownership requirements are both mechanisms that increase the risk that executives bear. Since executives get compensated for the risk that they take (see callout box), these provisions result in higher levels of pay. Firms that are unwilling to accept this tradeoff will have to compromise on the extent to which pay is linked to performance, delivered in an instrument other than cash, and/or held at risk over time.

Design Decisions to Make Over the Long Term

Over time: Board directors can use four decisions over time to tailor executive remuneration to a company's long-term roadmap and its executives' unique circumstances.

Corporate executive remuneration plans have an array of provisions. Our scope includes only those that meaningfully influence executives' long-term behavior and the corresponding long-term performance of the firm. Two macro elements encompass those provisions: the variability of pay and ownership of pay within the plan.

Variability of pay describes whether the actual value of the executive's pay is contingent in some way. Variability corresponds with the riskiness associated with an executive's remuneration. Pay variability can stem from two sources: performance linking (i.e., paying for the achievement of specific targets) and instrument (i.e., paying in an instrument such as equity that fluctuates depending on market valuations). Variability is the cornerstone of alignment theory, which hinges on a belief that agents (such as corporate executives) will misbehave unless they experience the same outcome as the principals (such as corporate boards and shareholders). Executives, boards, and shareholders share *outcome* risks in this model, not just *input* and *output* risks.[33]

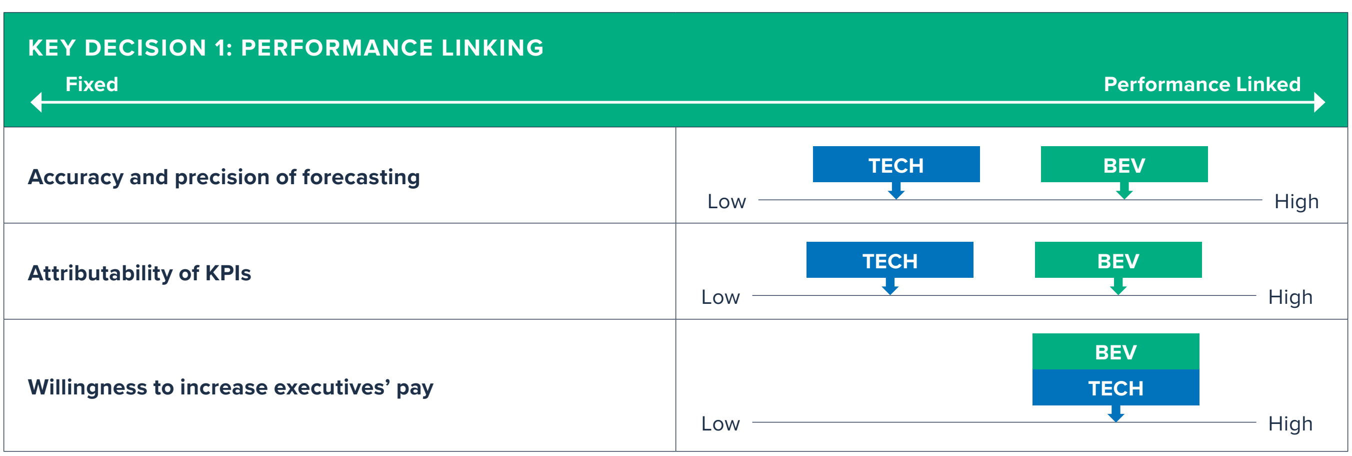
Ownership of pay also is rooted in alignment theory but intends to minimize misalignment by turning corporate executives ("agents") into shareholders ("principals") so that they too think like owners. Boards and investors attempt to encourage this mindset by using the time horizon (i.e., the length of time that executives maintain a risk exposure to the firm) and the holding level (i.e., the amount of risk exposure to the firm).[34]

VARIABILITY OF PAY: A USER GUIDE

Linking pay to fulfillment of performance metrics is a common mechanism for varying pay. Pay increases if the key metrics linked to an executive's pay structure indicate high performance, whether that pay is in the form of cash, stock, options, or any other instrument. Effectively no executive remuneration plan is linked entirely to performance, though, and the task of remuneration committee directors is to decide how much to link pay to performance, rather than having some abstract goal of paying only for performance.

The long-term impact of linking pay to performance depends on the accuracy and precision of the company's forecasts, the extent to which key performance indicator (KPI) outcomes are attributable to executive behavior, and the willingness of the firm to reward its executives.[35] Performance-linked remuneration can influence long-term behavior by executives and long-term performance of the firm when the following conditions are met:

- Forecasts are accurate and precise.
  - » Accurate and precise forecasts offer a valid and reliable benchmark for assessing executives' skill. Vague or mistaken forecasts, by contrast, are much likelier to reward or punish executives for volatility and luck.
  - » Consistent KPIs provide the foundation for accurate and precise forecasts. Changing KPIs dilutes the goals and incentivizes whipsawed behavior.
- Achievement of KPIs is attributable to executive behavior.
  - » A presupposition of paying for performance is that the person being paid can meaningfully influence the performance being rewarded.
  - » Rewarding performance outside of the executive's control encourages manipulation.
- Willingness to increase executives' pay is high. Variable pay on average will be higher than fixed pay because the risk of missing performance targets increases discounting by executives.

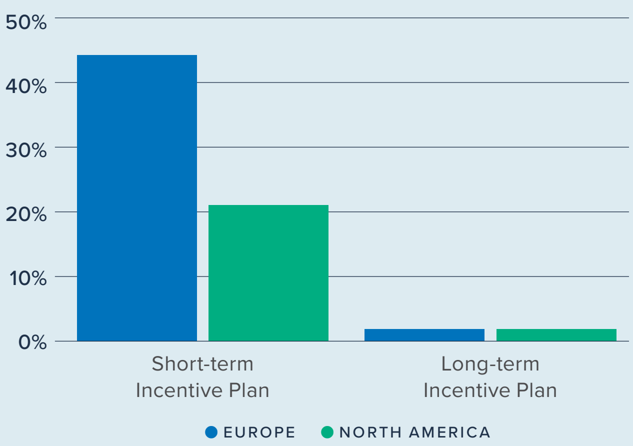


Financial and Nontraditional Performance Metrics

Performance-linked pay raises several important questions associated with establishing appropriate metrics and setting the right targets. This process is important and complicated, deserving its own report. However, one important aspect is how to include both financial and nontraditional measures.

Long-term companies and investors have shown interest, for instance, in the power of linking of nontraditional metrics to executive pay levels. Research demonstrates that such incentive structures lead to better performance on measures that track corporate social responsibility,[36] longer-term orientation within the firm, increased firm value, more social and environmental initiatives, reduced emissions, and more environmentally friendly patents.[37]

ESG Metrics in Incentive Plans – Europe and North America Compared



Source and analysis: Mercer, *ESG Metrics in Incentive Plans: Europe and North America Compared*, 2019.

Today, the incorporation of environmental, social, and governance (ESG) metrics into remuneration plans is more common in Europe than in North America and more common within the short-term bonus structure than within the long-term incentive structure.[38] This relative emphasis on including ESG metrics in bonus calculations more than LTIPs deserves dedicated research particularly because ESG commitments tend to be inherently longer horizons. Still, despite the low utilization of ESG metrics in programs that use performance-linked pay, inclusion of ESG metrics is shown to drive better outcomes.[39]

Another aspect is the mix of metrics. Firms encourage executives to make thoughtful tradeoffs across stakeholders and timeframes when they include nonfinancial metrics rather than optimizing only for financial targets.

Using these nontraditional metrics—whether ESG or otherwise—can be difficult, however, in part because markets have observation bias. Research by Alex Edmans, Mirko Heinle, and Chong Huang[40] demonstrates that as long as stock markets incorporate information included in financial statements, such as earnings, better than information not in financial statements, disclosing more of this “hard” information will skew the managers’ decisions at the expense of nontraditional or “soft” measures. This finding is instructive for forming long-term roadmaps as well. Long-term hard targets could lead to excessive management of those targets; therefore, companies sharing KPIs may want to consider including a balanced mix of hard and soft metrics as targets. This mix can help ensure management’s focus is on improving the performance of both financial and nontraditional measures.[41] And as non-traditional metrics become more widely accepted, incorporating them with targets will likely become the norm.

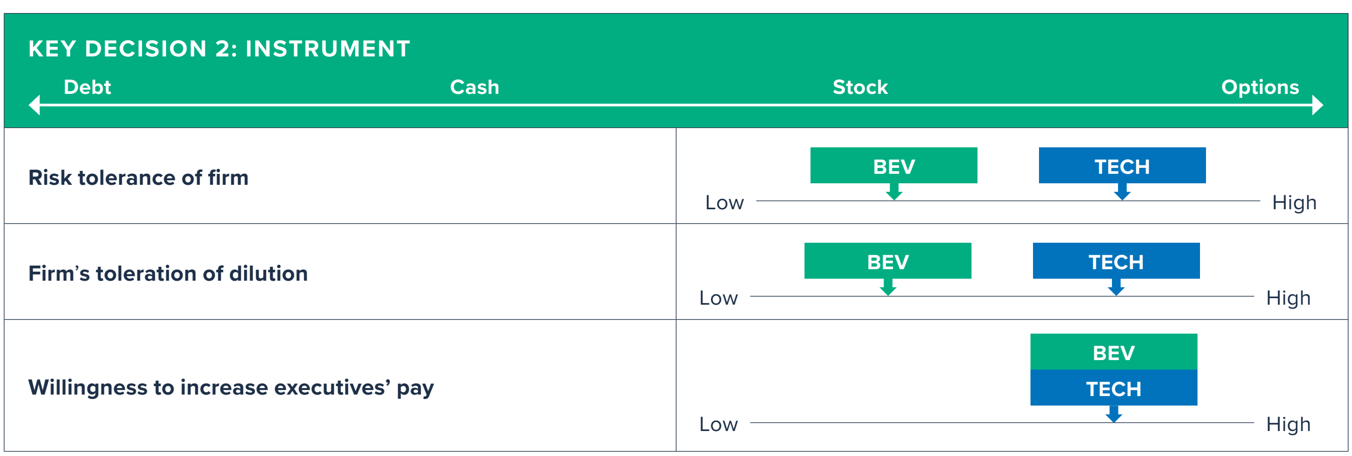
Companies' mix of fixed versus performance-linked pay today varies greatly by geography, but over time, companies around the world have trended toward greater emphasis on performance-linked pay.[42] Yet even in these most ideal conditions for linking pay and performance, the long-term effect on executives' behavior and companies' performance remains rooted in theory rather than evidence. Performance-linked rewards remain a valued tool for companies to articulate and signal commitment to long-term strategies,[43] and both investors and corporate directors strongly believe in the importance of using performance-linked pay as one form of reward. However, behavioral studies find that contingent (i.e., performance-linked) pay motivates people effectively only for rote tasks,[44] that variable pay can crowd out people's intrinsic motivation to do a job well,[45] and that performance-linked pay is more expensive.[46,47] Given this evidence, performance-linked pay is not a one-size-fits-all solution to executive remuneration.

The instrument is also an important component of executive pay. Cash is one instrument; debt as defined by pension benefit and other deferred cash is another; and securities are a third instrument, including various combinations of stock and options. These instruments signal distinct long-term risk-taking strategies.

(The spectrum from debt to options in this graphic depicts the desired level of risk taking for the firm's executive, not the riskiness of the instrument. For instance, a remuneration plan with high payments of debt is intended to incentivize executives to take the least risk, while an option-heavy plan would be intended to incentivize the most risk.)

The instruments of pay that most influence long-term behavior by executives and corporate long-term performance depend on the following qualities of the firm:

- Risk tolerance for *each executive role* (i.e., desired risk taking can vary greatly among executive roles). The goal in choosing instruments of pay is to align the risk and behavioral effects of the pay instrument with the forecast path of the firm and risk profile of the corporate strategy.
    - » **Options:** Asymmetric payoff with high upside that encourages greater risk seeking. Numerous studies have demonstrated a correlation between options and greater risk taking on the part of executives, but it is not clear whether options-based pay causes executives to take more risk or is part of an overall corporate strategy to take risk.[48]
    - » **Stock:** Symmetric payoff according to market fluctuations. Empirical studies demonstrate that equity incentives are associated with lower risk taking than are options.[49]



- » **Cash:** Uncorrelated, stable value that is fixed and not held at risk. Given this, we expect that it will not affect risk appetite, though this is not proven through empirical research.
- » **Debt:** Inside debt are liabilities held on the firm's balance sheet that act as deferred cash payments bearing the firm's asymmetric credit risk. The most common form of inside debt is an executive pension. Debt promotes high financial reporting quality, less risky investments, and reduced probability of default.[50, 51, 52]

- **Dilution tolerance.** Paying in stocks or options creates dilution, which firms can accept or offset. (See *The Dangers of Buybacks: Mitigating Common Pitfalls*).
- **Willingness to increase executives' pay.** Higher-risk instruments are discounted more by the executives who bear the risk. Using riskier instruments will increase executive remuneration.

OWNERSHIP OF PAY: A USER GUIDE

Pay structures with longer time horizons correlate with less earnings manipulation, higher growth, higher proportions of long-term assets on the balance sheet, greater research and development intensity, and better stock price performance.[53] Some investors, such as Norges Bank Investment Management, believe that extending time horizons far out into the future and extended past an executive's retirement will generate more long-term value.[54]

Boards have numerous ways to vary the time that executives receive pay. They can arrange the timing as a performance period, vesting period, mandatory holding period, or clawback period.

- "Performance period" is the time during which the pay is being earned. Companies control the metrics of executives' behavior within the performance period, including how long they will evaluate performance before awarding the pay.

Varying the Time Horizon Executives Receive Pay

TODAY

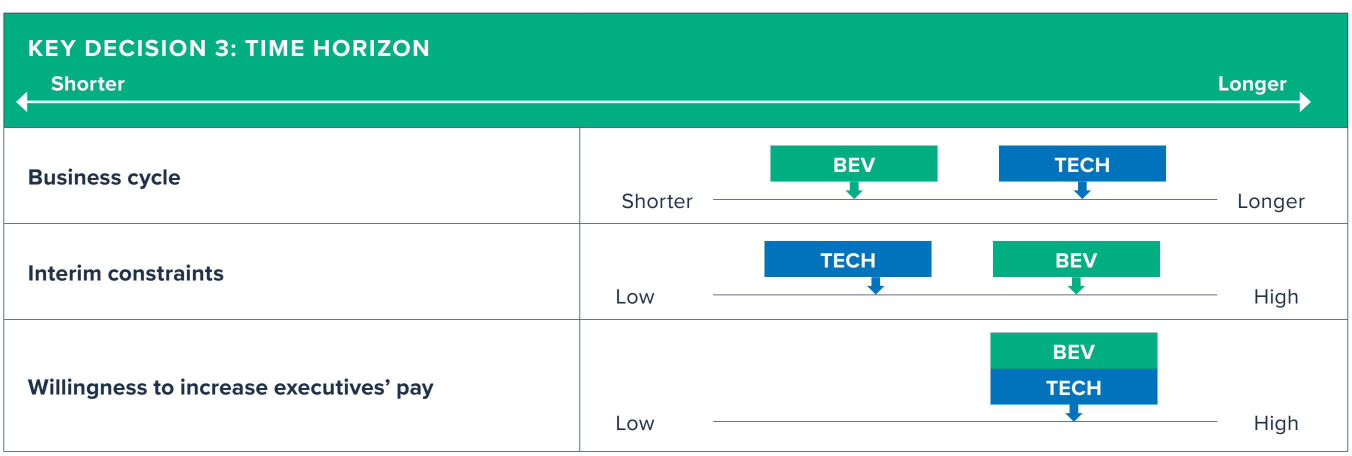
PERFORMANCE PERIOD	VESTING PERIOD	MANDATORY HOLDING PERIOD	CLAWBACK
Definition Period during which performance is measured to determine if performance-linked goals are achieved.	**Definition** Period during which any of the reward is at risk. As the rewards vest, they are transferred to the executive, usually on an incremental basis.	**Definition** Assigned period that the executive's pay must be held in the instrument in which it was granted.	**Definition** Forced surrender of previous rewards.
Use Incentivize specific behaviors	**Use** Hedge the risk of a poor hire and incentivize retention	**Use** Ensure the risks taken to achieve prior performance are sustainable	**Use** Recoup unjustified pay for performance, often found to be difficult to enforce
Length Approximately 1 to 3 years	**Length** Incrementally often over 3 years	**Length** Can vary and extend past retirement	**Length** Beyond retirement

- “Vesting period” is the time frame during which companies transfer to executives the pay that they have earned.
- “Mandatory holding period” applies to the time frame after awards vest to executives. Companies may expect executives to keep this award invested for the holding period that they mandate, and they can do so by requiring executives to buy securities of the firm with vested cash or by simply mandating that executives keep vested equity.
- “Clawback period” is the last in this sequence. Even after earned awards vest and holding periods expire, companies can assert clawback periods in which executives may have to reimburse them.

The distinction among these periods of pay is the extent to which the executive can bank the remuneration. Boards can combine these ways to vary the timing of executives’ pay, and each way of building the time horizon of pay rewards different behaviors. For example, companies that use variable pay have the choice to apply their metrics within the performance period as well as to determine the extent to which pay vests. Whether a company links pay to performance metrics, it may expect executives to signal their continued commitment and to share in strategic risk taking by keeping awards invested for the holding period that it mandates, likely extrapolated from the company’s business cycle or strategic horizon. Likewise, clawing back pay is a critical choice for the board, for instance in the case of restating accounting performance or a bad-faith gaming of performance metrics. Companies can encourage different behaviors—intentionally or unintentionally—with all of these choices.

The long-term impact of extending the time horizon of pay depends on the firm’s business cycle, interim constraints, and the willingness of the firm to increase its executives’ pay. Longer time horizons of pay can influence long-term behavior by executives and long-term performance of the firm when the following are true:

- The firm has a longer business cycle. Remuneration committee directors can set the executive pay horizon to match the company’s business and investment cycle.
- The firm sets wider constraints on interim performance. Conversely, an inability to tolerate interim volatility across financial and nonfinancial metrics can require greater focus on the short term.
- Willingness to increase executives’ pay is high. Delayed pay will be higher because it increases discounting by executives.



Patience Required to Measure Long-term Results of Norges' Model of Executive Remuneration[55]

Some long-term investors are ready for companies to depart from the pay-for-performance status quo, but controversy still surrounds the most often cited potential replacement.

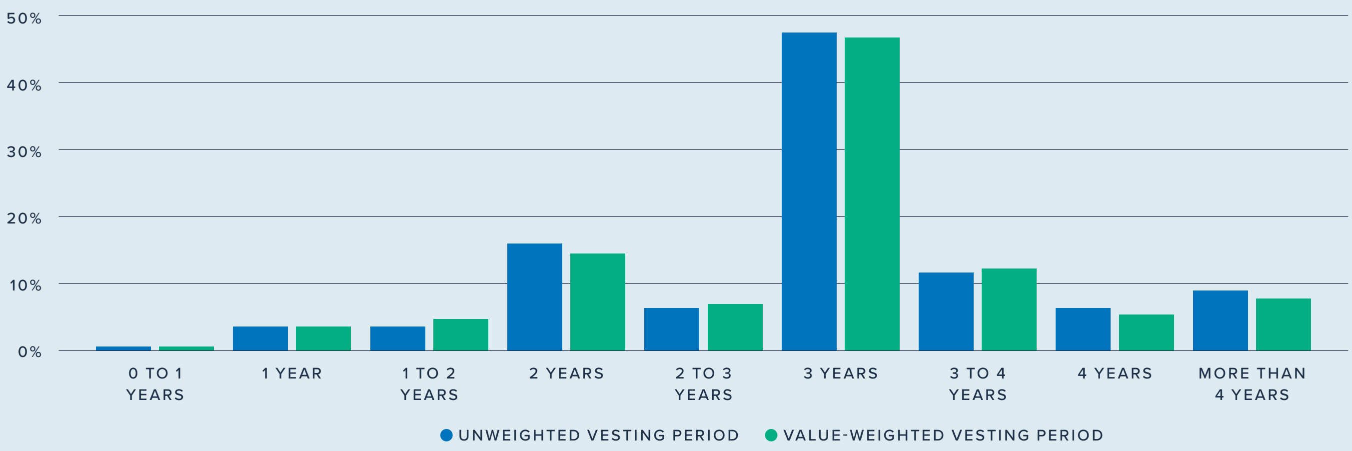
Norges Bank Investment Management, the sovereign wealth fund that stewards Norway's oil and gas resources, pioneered an alternative method[56] that focuses on cultivating an ownership mindset and using time-centered share grants (i.e., long duration). In its 2017 position paper,[57] Norges emphasized, "A substantial proportion of total annual remuneration should be provided as shares that are locked in for at least five and preferably ten years, regardless of resignation or retirement... Allotted shares should not have performance conditions and the complex criteria that may or may not align with the company's aims."

Many investors around the world agreed. Indeed, this shift strongly implies long-term thinking, and investors are watching it closely to determine whether companies that use this approach outperform over the long term.

However, too few companies have used this plan for too little time to answer this long-term question empirically.

SEO Amsterdam Economics and Reward Value, a Netherlands-based nonprofit organization focused on executive remuneration, illustrated these limits for us.

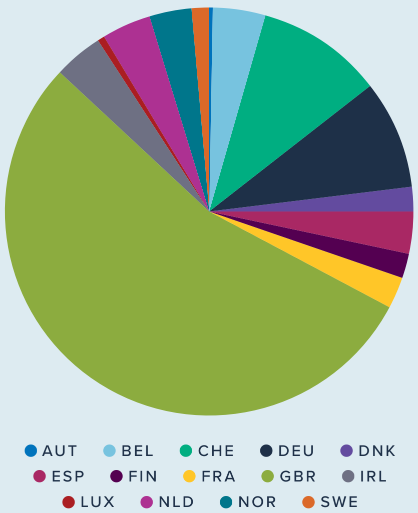
Most Time-based Grants Have a 3-year Vesting Period



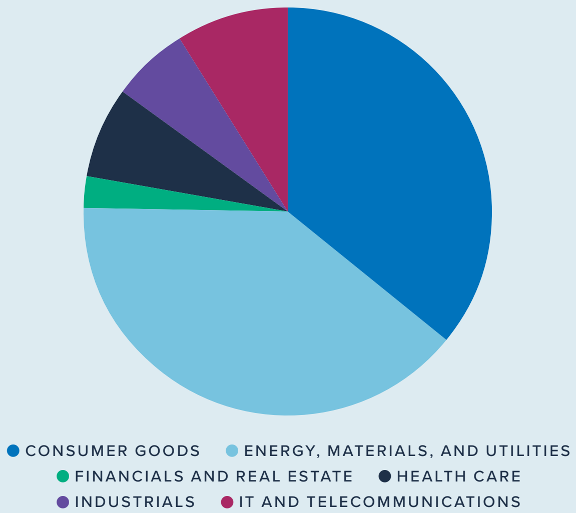
Source and analysis by SEO Amsterdam Economics (2020). n=633 executive-year combinations.

Vesting time-based stock grants after five or more years is still very uncommon. Specifically, less than 10 percent of time-based grants in SEO's (European-only) data set[58] are longer than four years. While these data indicate that European companies are not yet meaningfully adopting this standard, they are still well ahead of US-based companies in this regard.

Time-vesting Grants per Company



Time-vesting Grants per Sector



Source and analysis: SEO Amsterdam Economics, 2020.

In addition, about 50 percent of the sample comprises UK firms, and most firms are in either the consumer goods or the energy, materials, and utilities sectors.

It is still too soon to tell what lasting effect the Norges approach to executive pay will have on long-term corporate performance. More companies will need to experiment with this approach in order to draw long-term conclusions. In the interim, Norges' transparent consideration of the pros and cons before arriving at an investment belief is unparalleled.

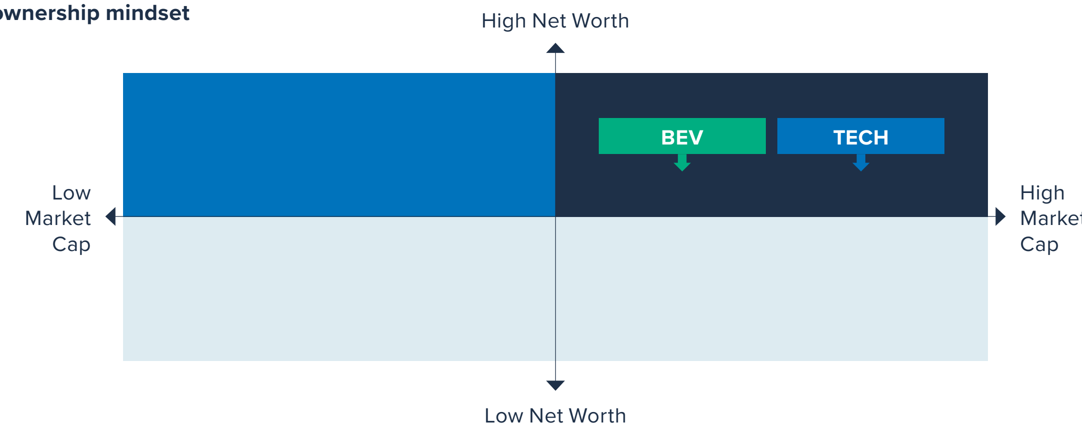
The lack of data does not prove or disprove the long-term validity of Norges' proposed approach by any means. Rather, it just means that this approach reflects an investment belief right now, something with which long-term investors are very familiar and comfortable.[59]

It also shows what it will take to reach an empirical conclusion: patience. Researchers cannot estimate long-term patterns without a long-term data set. Accordingly, it will be some years before we can return to this question. In the meantime, if you have data relevant to this study, please contact FCLTGlobal's research staff by emailing research@fcltglobal.org.

KEY DECISION 4: HOLDING LEVEL

Lower — Higher

Ability to engender ownership mindset



Remuneration structure also can try to prompt a mindset of ownership in executives by mandating *amounts* of stock that they must hold. Empirical studies have demonstrated that executive ownership of the firm drives long-term value creation.[60,61,62] Higher CEO shareholding relative to firm value is associated with excess stock returns,[63] and higher inside shareholding measured by dollar value is similarly associated with increased firm value.[64]

At the same time, a variety of questions surround these studies and raise uncertainty about how practical they are in the real world. For instance, they demonstrate the value of voluntary ownership, not ownership that is compelled, and that distinction may encourage different behaviors than those intended. These studies also may evaluate levels of shareholdings (in terms of size) that rarely are practical for publicly traded firms.[65,66,67]

According to research by Ulf von Lilienfeld-Toal and Stefan Ruenzi, the effect of mandatory holding levels appears to be tied inherently to the net worth of the individual executive in question.[68] Thoughtful remuneration committees make the decision in that context of the individual's net worth.[69]

Several circumstances may affect the way that these dynamics play out in individual remuneration agreements. Wealthier executives may be more prone to accepting these holding-level mandates—but having them maintain holdings in *meaningful proportion* to their wealth can create some risk to the firm. The level of stockholding required to maintain a ratio of stockholding to wealth rises with the net worth of the executive, and increased ownership beyond certain levels—relative to firm value—correlates with *decreasing* firm value, presumptively because of entrenchment.[70,71,72] This provision also can inflate the executives' pay—either by compensating very wealthy executives for the added risk in their personal portfolio associated with concentrating their investments in one firm—or by simply giving less wealthy executives the equity required to meet the holding-level mandate.

Use Cases for Tools

FCLTGlobal designed these tools to help companies and investors move money in longer-term directions in at least three ways.

- **High-level Evaluation:** Long-term companies—and their investors—constantly monitor the effect of remuneration packages, and these tools can highlight areas of relative strength and weakness. Questions can include whether the firm uses short-term-focused remuneration provisions, which areas of remuneration design are most promising given the firm's circumstances, and the extent to which the firm's current remuneration package incorporates these promising opportunities.
- **Standardized Communication:** Long-term investors engage with companies regularly on matters of executive remuneration, often around proxy disclosures. The Compensation Discussion and Analysis portions of proxy statements are dense and can be differently formatted, yet many include a list of "What We Do/What We Don't." Investors and companies both would benefit from a more uniform and precise form of communication. Investors could encourage companies to discuss and analyze their remuneration packages in the format of these tools (see page 33) and could inform regulators of their preference for receiving remuneration disclosures in this style.
- **Catalyst and Guide for Redesign:** Firms will have strategic moments in which they can overhaul remuneration plans, including when they first list publicly, during a merger or acquisition, and at the time of executive turnover. They can use these tools then to avoid immediate pitfalls, identify the types of design that are most promising for them from a long-term perspective, and then construct that design accordingly.

Risk of Rewards provides a guide and justification for companies and investors to use these tools in remuneration evaluation, design, and communications. The tools themselves are the catalysts for action. Each is available at the end of this report as a tear sheet so that companies and investors can remove them and put them to work.

Conclusion

Corporate boards can encourage long-term behavior by executives and long-term performance by companies by making changes to executive remuneration, and investors can support this approach through their engagement. The tools in this report empower companies to tailor long-term remuneration by replacing some elements now, then by reflecting on their long-term needs, and finally by using four decisions to redesign pay packages:

- **Today:** Replace remuneration provisions that are counterproductive in the long-term.
- **Near term:** Complete a conversation guide to understand the firm's circumstances, evaluate the relationship with remuneration design, and find options for focusing more on the long-term.
- **Over time:** Redesign the remuneration plan using four key decisions: the performance linking of pay, the instruments of pay, the time horizon in which pay is delivered, and the holding levels that executives are required to maintain in company securities.

Remuneration powerfully influences executives' long-term behavior and companies' long-term performance. While there remains no substitute for long-term corporate boards and long-term investor-corporate dialogue, we expect that using these tools will help executive remuneration both reward long-term behaviors and drive long-term performance.

Replacement List for Short-term Remuneration Provisions

	STOP...	INSTEAD...
Do No Harm	Creating large one-off moments of financial reward	Set vesting and mandatory hold periods to smooth payouts via rolling distributions
	Accelerating vesting schedules upon an executive's departure	Maintain preestablished vesting schedules
	Assuming companies and individuals have the same time value of money and risk appetite	Measure and adjust for how executives' time value of money and risk appetites diverge from those of the company
Choose Your Own Path	Relying on peer groups to determine the remuneration structure, as opposed to pay levels	Design pay structures that are derived from the firm's unique strategy and circumstances
	Trying to be all things to all market participants (e.g., tacking on miscellaneous or broadly demanded provisions)	Establish remuneration structures that best suit the company, its purpose, and its strategy
Check Blind Spots	Trying to motivate executives exclusively through their remuneration	Integrate monetary incentives and executives' individual intrinsic motivations into a comprehensive package
	Avoiding risk by hiring or continuing to retain an executive to satisfy the market	Accept the risk of hiring the right executive to execute the long-term strategy
	Overemphasizing the objective of remuneration as "attract and retain"	Focus pay on enhancing alignment; alignment driven by extrinsic and intrinsic motivation will help attract and retain talent

Remuneration Conversation Guide for Companies and Their Investors

Board directors and investors need to clarify goals for using longer-term remuneration design and anticipate unintended consequences before taking action. To facilitate these discussions, FCLTGlobal has created this Remuneration Conversation Guide for corporate boards to use, including in engagements with their investors. We have provided illustrative answers to these questions, but they are not intended to be exhaustive or comprehensive.

PATHWAY EXPECTATIONS

How long is the firm's business cycle?

Implication for executive remuneration: Firms can use longer time horizons of pay more easily when they have longer business cycles.

- Less than 2 years
- 2–4 years
- 5–7 years
- Longer than 7 years

What is the firm's growth expectation during the next business cycle?

Implication for executive remuneration: Higher-growth firms will have more of an opportunity to pay in instruments like stock or options. Lower-growth firms will have the inverse.

- Exponential
- Linear
- Little to none

How wide is the firm's range of potential outcomes relative to expectations?

Implication for executive remuneration: Paying for performance depends on stable, reliable, and valid metrics. Such metrics are more feasible when the firm's pathway is more certain.

- Our prospects are quite uncertain.
- We manage the firm within a range of certainty that we can largely control.
- Our prospects are quite certain.

LEADERSHIP EXPECTATIONS

To what extent is the firm led by founders relative to professional managers?

Implication for executive remuneration: Concerns about the alignment of interests between investors and managers is greater when executives have no personal, "lives and legacies" connection to the firm, and firms very often seek alignment by linking pay to performance, using stock or options as instruments of pay, preferring longer time horizons of pay, and requiring larger levels of holding in the firm's stock.

- Our founder is our CEO.
- A member of our founder's family is our CEO.
- A small number of investors hold a significant portion of our shares, and our CEO is their representative in executive management of the firm.
- Our shares are widely held, and our CEO has only business connections with the board.

What is the firm's ability to pay executives now?

Implication for executive remuneration: Firms may choose to pay in variable instruments like stocks and options for strategic reasons, or they may do so because they are at points in their lifecycles at which they have no other choice.

- We have sufficient cash that we can freely choose the portion of variable remuneration that we offer in cash versus shares or options.
- Our cash position can allow us to pay a limited portion of variable remuneration in cash.
- Our cash position can allow us to pay cash for base salary, but we have to pay any variable remuneration in shares or options.
- We do not have sufficient cash to pay cash for any portion of remuneration, so the variable-incentive plan paid in stocks or options is the entirety of our remuneration.

What is the firm's willingness to pay executives over time?

Implication for executive remuneration: Firms are more able to pay variably, in terms of both linking pay to performance and remunerating in stocks or options, to the extent that they are willing to vary the amount that they pay, including increasing pay to compensate executives for whatever level of risk that they take. Firms also are more able to require larger holding levels to the extent that they are willing to grant those holdings to executives.

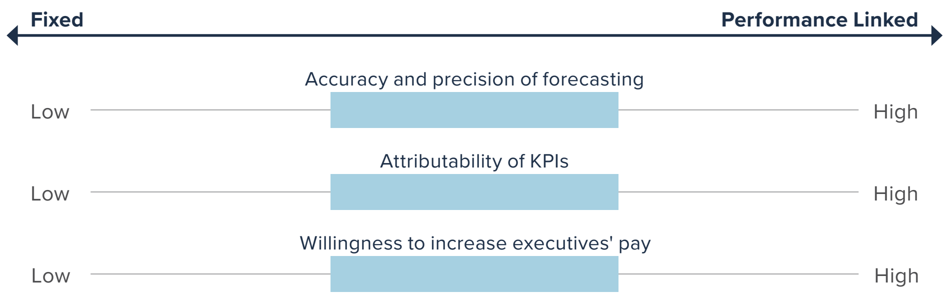
- We are willing to leave executives' potential pay entirely uncapped.
- We have a relative cap on executive remuneration (e.g., CEO to C-suite, CEO to median worker, CEO to revenue).
- We have a real cap ($, €, £, ¥) on executive remuneration.

Key Decisions for Designing Long-term Executive Remuneration

VARIABILITY OF PAY

1. Performance Linking of Pay

- **Accuracy and precision of forecasting:** Accurate and precise forecasts offer a valid and reliable benchmark for assessing executives' skill and are less likely to reward executives for volatility and luck.
- **Attributability of KPIs:** A presupposition of paying for performance is that the person being paid can meaningfully influence the performance being rewarded.
- **Willingness to increase executives' pay:** Variable pay on average will be higher than fixed pay because the risk of missing performance targets increases discounting by executives.



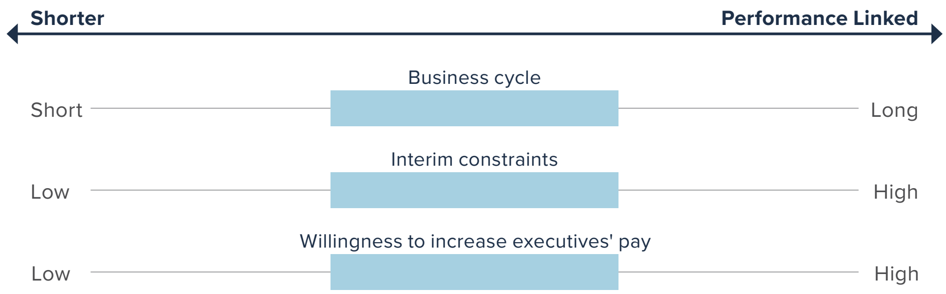
2. Instrument of Pay

- **Risk tolerance of firm:** The goal in choosing instruments of pay is to align the risk and behavioral effects of the pay instrument with the forecast path of the firm and risk profile of the corporate strategy.
- **Firm's tolerance of dilution:** Paying in stocks or options creates dilution, which firms can accept or offset.
- **Willingness to increase executives' pay:** Higher-risk instruments are discounted more by the executives who bear the risk. Using riskier instruments will increase executive remuneration.

OWNERSHIP OF PAY

3. Time Horizon of Pay

- **Business cycle:** Remuneration directors can set the executive pay horizon to match the company's business and investment cycle.
- **Interim constraints on interim performance:** An inability to tolerate interim volatility across financial and nonfinancial metrics can require greater focus on the short-term.
- **Willingness to increase executives' pay:** Delayed pay will be higher because it increases discounting by executives.



4. Holding of Pay

- **Ability to engender ownership mindset:** The level at which the firm requires an executive to co-invest is a measure of the extent to which that executive is a principal, not just an agent, but requiring higher holding levels can inflate pay.

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FCLTGlobal Authors

ARIEL BABCOCK

MATT BRADY

MATT LEATHERMAN, Lead Author

VICTORIA TELLEZ

Project Contributors

EDWARD ALLEN
MSCI

LINDSEY APPLE
MFS Investment Management

FREDERIC BARGE
Reward Value

KATIE BEITH
New Zealand Super Fund

ROMAIN CADARIO
Erasmus University—Rotterdam School of Management

ALEXANDRE CHARTRAND
Public Sector Pension Investment Board

SHAWN COOPER
Russell Reynolds Associates

JACQUES CROTEAU
Caisse de Dépôt et Placement du Québec

MATT DIGUISEPPE
State Street Global Advisers

ALEX EDMANS
London Business School

BEN FALK
EY

MARGOT FRANSEN
Unilever

TOM GOSLING
London Business School

MARIANNE HARPER GOW
Ballie Gifford

DARRYL GUTHRIE
BP plc

JEAN-LUC GRAVEL
Caisse de Dépôt et Placement du Québec

GABRIEL HASSON
BlackRock

MARC HODAK
Farient Advisors

KELLIE HUENNEKENS
Nasdaq, Inc.

BLAIR JONES
Semler Brossy Consulting Group

RIC MARSHALL
MSCI Inc.

NINA MAŽAR
Boston University, Questrom School of Business

CAITLIN McSHERRY
Neuberger Berman

CHRISTINA MEDLAND
Meridian Compensation Partners

BRIDGET MURPHY
Washington State Investment Board

RÉJEAN NGUYEN
Caisse de Dépôt et Placement du Québec

SABASTIAN NILES
Wachtell, Lipton, Rosen & Katz

LYNN PAINE
Harvard Business School

ASHOK PILLAI
BP plc

VICTORIA POTTER
McKinsey & Co.

JOEL POSTERS
Future Fund

ROBERT POZEN
Massachusetts Institute of Technology

JENN RYNNE
Wellington Management

JUDY SAMUELSON
Aspen Institute

BRUCE SHAW
Georgetown Law School, Denny Center for Democratic Capitalism

CRAIG STEVENSON
Kempen Capital Management

PAUL SCHNEIDER
Ontario Teachers' Pension Plan

MARGARET THERRIEN
MFS Investment Management

MARC TREVIÑO
Sullivan & Cromwell

DANIEL VEAZEY
Schroders plc

ESZTER VITORINO
Kempen Capital Management

THEO WAGEMANS
Royal DSM

ANDREA WAHLQUIST
Wachtell, Lipton, Rosen & Katz

AMY WILSON
Federated Hermes

ROBERT WILSON
MFS Investment Management

JOOST WITTEMAN
SEO Economics—Amsterdam

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Glossary for Contract Terms Taxonomy

INITIATING TERMS

Sign-on bonus and make-whole payments
Sign-on bonuses are benefits, typically in the form of cash or equity, that are received for joining a firm. Make-whole payments have the specific intention of matching benefits that were sacrificed when leaving a prior employer (e.g., unvested equity).

Employment contract
Terms including length of contract, payment criteria, and legal terms.

Resetting/evaluation process
Period and procedure for setting and appraising remuneration plans.

Base salary
Fixed-cash remuneration that vests and is payable immediately for remaining employed.

Retirement and health plans
Retirement contributions, in the form of defined benefit or defined contribution, and insurance premiums provided as part of the contract.

SHORT-TERM INCENTIVE PLAN

Short-term bonus
Variable-cash remuneration set as a percentage of annual salary. Often includes a minimum, maximum, and target dollar amount. Payment commonly vests immediately and is set by short-term targets.

LONG-TERM INCENTIVE PLAN

Restricted units
Outright grants of shares, options, or cash.

Performance units
Performance shares, cash, or options that are earned by obtaining specific accounting, financial, or ESG targets. Performance measures commonly cover three- to five-year periods.

CONTROL MECHANISMS

Performance metrics
Measures that are used to monitor the achievement of short-term bonus and performance units. Accounting, financial, and ESG metrics are commonly used. Measures can be in absolute terms or relative to peers.

Vesting period
Period during which full value of the reward is held at risk. As the reward vests, it is transferred to the executive. Rewards can be cliff vested, when all the rewards vest at one time, or pro rata vested, when the rewards vest proportionately over time according to a set schedule.

Mandatory holding period
Assigned period that the executive's pay must be held in the instrument in which it was granted.

Stock ownership requirements
Amount of stock that is required to be owned by executives. Often such limits are set as a multiple of base salary.

Peer group
Group of companies used as a benchmark for pay. Peers are selected by the remuneration committee or external advisor.

Caps
Pay is commonly geared by levels of performance, including a maximum level of pay.

Clawbacks
Terms to recover pay due to financial restatement, ethical misconduct, or violation of a noncompete clause.

CONCLUDING TERMS

Change-in-control adjustments
Terms for adjusting pay due to an executive's changes in employment status, payment, and other contract terms due to an acquisition or merger.

Severance
Terms and conditions for when a company terminates an executive's contract.

Retirement
Terms and conditions for the planned retirement of an executive.

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31 Saint James Avenue, Suite 880A, Boston, MA 02116 USA | +1 617 203 6599 | www.fcltglobal.org