

Compensation Committee Challenges in Fall 2011

An NACD Peer to Peer Program

FRIDAY, OCTOBER 28, 2011– REGISTRATION AT 7:30 AM, PROGRAM FROM 8:00 TO 10:30 AM

Location: Waltham Woods, Waltham, MA

Event Overview

This peer to peer program on executive compensation brought up the key timely issues in proxy statements and Say on Pay, featuring a comprehensive case study. The panelists shared their views on what the boards should do to prepare for 2012 and beyond.

Questions of interest

Professor Fred Foulkes opened the round table discussion by inviting each of the directors to do a brief self-introduction and to identify topics of interest to them as it relates to executive compensation. The issues topics that the directors were interested in included performance objectives and incentive plans; how to comply with regulations for small companies, new public companies, mature companies, and global companies; BSV issues; economic impact of incentive plans; how to balance and manage shareholder impact and optics; how to deal with unintended consequences and risks in compensation as a result of the new financial reform.

Panelists and Keynote Remarks

Windle B. Priem

Executive compensation is always a controversial issue, Win said. When he asked how many of the directors in attendance considered that CEO pay is too high, all hands were raised up. Win continued that looking at the executive compensation data from the 1000 large companies, the CEO's pay today increases 1.5-2 times greater than the company growth compared to the 1980s. Why? There are various reasons. For instance, companies are growing bigger and thus more complex; more leverage due to the stock options adds fuel to the fire; companies are targeting at 75% percentile of the CEO payments from peer group based on consulting reports; greedy CEO are dominating the board, compensation committee are not tough enough, and so on. Win concluded by suggesting that the directors step back and look at a big picture instead of focusing on the matrix of the peer group.

Melissa Means

In Melissa's point of view, alignment meant two things - pay for performance and the alignment of the compensation strategy to the business strategy. For Pay and Performance - in the first year of Say on

Pay, there was more focus than ever on pay for performance. 40 companies had shareholders vote against pay, and 10 of them now have shareholder derivative lawsuits. So it is important to tell the shareholders your pay and performance story to help ensure a positive vote on Say on Pay. Although the Dodd – Frank Act has been pushed off and the rule of pay-for-performance probably won't be implemented until 2013, boards need to get ready now in understanding your company's pay and performance story. Melissa further cautioned that ISS only looked at the TSR to define pay for performance which results in a very limited story.

For compensation alignment with the business strategy – companies need to balance doing what's right for the company in the compensation program, as it aligns with the company's business strategy, with shareholder optics and good governance practices.

Reggie Sommer

Reggie's presentation focused on the communication between directors and shareholders as well as between directors and advisory firms. Due to all of the focus lately on executive compensation there is more responsibility for communication on the board, which means more work for the board. And communication is more outbound, more comprehensive, broader, and has more information. Specifically, the Compensation Discussion and Analysis has to be easier to read. She went on to talk about how to get feedback from advisors since it will be helpful, instructive and, more importantly, proactive. She emphasized that it was crucial to get to know and meet those people who were actually going to vote on the proxy – who most likely are not the same ones with whom executives meet in shareholder outreach meetings. There should be more effort put into getting feedback from investors, Reggie said, for example, companies have started to clearly provide investors with specific email address on their websites, as well as the online investor survey and shareholder feedback forms. She gave an example of a board that did shareholder outreach communication but did not get any feedback, and the proxy was voted down even though it was supported by ISS. She ended her speech with "even with a good story, you don't know how investors are going to vote".

Professor Fred Foulkes

Fred considered the compensation committee more and more like an audit committee since the compensation committee had to meet more outside requirements and have their own outside consultants. Compensation committee director independence is now improving since there is more transparency and in the system. The compensation committee of a board on which he served previously only met once a year for an hour and the chairman and CEO would tell them what they should be paid. Because of the policy which requires more disclosure, the new role of compensation committees require more time and more work. Prof Foulkes suggested that hiring a consulting firm can help greatly, but now many firms have hired two consulting firms, one for management, and one for the board. It costs too much money to decide CEO pay. He also posed the following - is there any way that the new pay for performance potential regulations can work? No evidence yet. Every company is in different place, so it is important to understand your company's story on this issue. The key point for boards is to determine your own measures of performance, your pay guidelines and your own story to communicate.

Case Study Highlights

In the case study session, Melissa first introduced the background of the case and answered some questions that the directors had regarding the case study material. The case was about how to deal with real issues on CEO pay, particularly, the degree of pay and performance alignment. After a 30 minute small group discussion, all directors and the panelists reconvened to discuss the case study. The major issues that were brought up were: re-negotiating change of control, considering the response from management in the face of a crisis, when to use a short term “pay bail out”, using stock options to retain people, using more than just TSR for the pay and performance story was preferred, no changes to the pay plan but re-examine the metric for the future, and so on.

Further Discussion

Should bonuses be paid more frequently (i.e., quarterly) instead of just annually? While it is possible, 98% of the companies do annual bonus. Shorter bonus period could drive a milestone, but this does not seem to be the case in practice. Quarterly bonuses can help during a crisis to help management get performance back on track.

Generally it is not ideal to change your metric because the compensation committee has to disclose the change to your metrics in proxy.

How often do you see a discretionary bonus? Rarely. It is not a bad thing to do discretionary bonus, but it is controversial. When asked if people have seen compensation committee using discretion to impact bonus, about half of the directors raised their hands. There is an increasing use of discretion, but typically negative discretion.

When it's a bad economy that results in missing of the original plan, it is hard to tell a great team that they cannot be paid because it is not their fault. But if stock price has dropped 60%, shareholders suffer, so executives shouldn't expect to be paid. There are always ups and downs in performance, so it is hard to set the pay when the grant is a 3 year grant but performance varies so much in each of the years.

In reality, most metrics are often finalized in November and ratified 2-3 months into the year that has already started. The board needs to first understand the performance of previous year before the new plan can be established.

Win commented on the case and said time based measures were limited and now old fashioned. EMC blends 40% time based and 60% performance based. Single biggest issue is being driven to one metric - TSR. Don't control the peer group and the definition. Peer groups should be industry not chosen by company as relevant peers. EMC has met with ISS for many years and has inside governance people who are proactive and speak out on panels.

The final comment of the meeting is that there should be rules to regulate to the advisory firms.