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How Compensation Committees Can Do a Better Job

By David N. Swinford and Robert E. Hallagan

The light is shining on compensation issues. Here's how to raise the bar on your committee's performance.

It is counterintuitive that the compensation committee's overarching mission is neither the oversight of pay and benefit programs, nor compliance with the demands of governance and regulatory standards. Now more than ever, its mission is fulfilling the board's pivotal responsibility: to develop a talent-rich organization by ensuring programs are in place to attract and retain a team of senior managers with the necessary ability, integrity, and drive to advance strategic priorities as part of a carefully planned succession process. In recent years, investor pressure on boards to quickly replace corporate leaders who are underperforming or face ethics questions has highlighted the need for boards to identify and foster future leadership in advance of a management crisis.

Maintaining a leadership perspective beyond the current CEO's tenure is critical to directors' ability to protect and maximize long-term value for shareholders and readily qualifies as a board-level function. As a matter of practicality, that responsibility has long been delegated to the compensation committee to make certain it receives focused attention, just as governance committees have taken on emerging

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Suite 700
Washington, D.C. 20036
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governance responsibilities to which the full board cannot devote the needed time and effort. Recognizing the dual nature of the compensation committee's role is a means to ensure that long-range talent development issues will help drive and be integrated into—and ultimately enhance—the committee's decisions on compensation issues.

This will prove important as committees deal with an array of new challenges related to executive pay, including intense media scrutiny and a judicial trend to allow shareholders to challenge decisions made by the board. In the face of heightened regulatory attention—most recently the implementation of expanded SEC disclosure rules—board members now must justify, and will be held responsible for, the details of executive compensation programs, from the cost of hiring and change-in-control arrangements to the nuances of how stock option programs are administered.

Maintaining a focus on talent development amidst the growing demands of compensation oversight requires that compensation committees examine and re-assess every aspect of how they discharge their duties, with an eye toward bringing processes and programs in line with new standards of good governance, recent regulatory mandates, and changing shareholder expectations. We offer some suggestions for launching the process.

Rethinking the Committee's Purpose

A focus on future leadership begins with a rigorous debate by the committee, with input from the full board, to establish the organization's key long-term goals and the essential management skills that will be needed to achieve them. Committee members then need to determine whether recruitment and compensation programs are structured to effectively identify, attract, retain, and motivate the kind of talent needed—including coaching, regular feedback, and regular opportunities for expanding executive skills. Additionally, the committee should make a priority of promoting from within and providing opportunities and incentives for valued executives to build ownership in the company. Without in-house talent in the wings, boards must lure new and untested management from outside the organization with premium pay and special deals.

At the same time, the committee also must exercise its prerogative to regularly and candidly evaluate the performance of current leadership. While there is room for even the most talented employee to grow professionally, reviews of top management tend to be limited to a by-the-numbers analysis of specific financial goals. Directors understandably are less comfortable making subjective judgments about issues related to management style—such as leadership, customer, and industry relations, or the extent to which an executive effectively manages the organization—which nevertheless can significantly impact both employee morale and the stature of the organization.

In the current governance environment, such frank discussions also serve to reinforce the appropriate balance of power between the board and management. Moreover, periodically making the CEO subject to a formal and rigorous performance evaluation by the committee signals to employees and shareholders alike that everyone in the organization is held to account, and it may inspire the CEO to institute an effective process for his or her own direct reports.

Compare the Company's Performance Against Its Peers

Competitive pay data is a key factor in considering the level and structure of programs, but it is only half the pay-for-performance equation. What committees too often fail to get a good handle on are the results achieved by peer companies: essentially, what other companies got for the executive rewards they paid out. Pegging pay to the competitive 75th percentile is defensible only if the payout is tied to 75th percentile marketplace performance. Committees should annually take a retrospective look at whether competitors exceeded or fell short of their goals and the extent to which results were due to strategic decisions, operating excellence, or general market conditions.

Even if comparative performance analysis isn't factored into the final payouts, it provides the committee with a solid understanding of how good the company's performance really was. Managements sometimes discourage such comparisons to the marketplace on the grounds that peer companies have different structural or financial characteristics which impact their performance. But that should suggest to the committee that their pay programs may not offer a meaningful yardstick for comparison, either.

The degree of upside/downside leverage built into the plan is another frequently overlooked factor in the design

Director Summary: Maintaining a focus on talent development amidst the growing demands of compensation oversight requires that compensation committees examine every aspect of how they discharge their duties. The authors advise on how to begin this process, while keeping an eye toward bringing programs in line with new standards of good governance, recent regulatory mandates, and changing shareholder expectations.

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of performance-based plans. Ideally, the level of executive payouts should be in proportion to both the effort expended and quality of results achieved, with incremental bonuses calibrated to varying levels of achievement. Essentially, an executive should not be excessively enriched for exceeding a performance target, nor overly penalized for a near-miss.

Diversify the Performance Demands on Executives—and Don't Make Excuses for Shortfalls

Executive pay programs are generally focused on goals related to financial performance that are straightforward and easily measured, but which fail to provide a complete picture of current corporate performance or establish conditions favorable to future growth. Executives also should be evaluated and directly compensated for their success in managing underlying indicators of the strength of the firm's growth engine and its investment in the future. Such factors as investment in research and development or training; customer satisfaction levels; and management development are critical but easily overlooked building blocks of long-term corporate performance. They should be measured and rewarded accordingly. For example, along with establishing executive performance hurdles related to earnings per share or annual sales, a consumer product company might want to require that a specific percentage of revenues be driven by products that are less than two years old, or that the company achieve a particular level of growth in its customer base.

Committees also need to resist the widespread tendency to unquestioningly provide full rewards when plan goals are met under exceptionally favorable market conditions, and to regularly forgive underperformance. This effectively neutralizes performance risk and biases the plan in favor of executives. In fact, performance goals should be rigorous but reasonably achievable, tied to the greatest extent possible to results over which executives have direct influence, but recognizing that all performance is influenced to some extent by factors outside their control. Recognizing that there is no absolute standard, the committee has the right to apply its judgment in making payouts on the upside as well as the downside.

Generally, "exceptional circumstances"—whether bad weather or a downturn in the industry—are not a sufficient rationale to pay out despite failure to perform. To at least some extent, executives share the risk of unfavorable external circumstances with shareholders. Nor should the committee feel compelled to provide a windfall payout for extraordinary financial performance that had little to do with management, such as record sales volume at a lumber company in the aftermath of a major hurricane.

Make Executives Long-Term Owners

Share ownership by executives is good governance and good business. We all want to protect what's important to us. Requiring a level of equity ownership and/or requiring that executives hold a portion of equity payouts promotes a long-term performance perspective and can reveal the extent of an executive's commitment to the organization. Stock ownership also serves to promote retention: an executive who receives a disappointing bonus one year, but who holds a significant equity nest egg, is less likely to walk because he or she still has a long-term investment in the company. Worried about push-back? An executive who insists on bigger, quicker cash payment on the grounds that he can't predict if he'll be with the company in 10 years may not be the ideal employee in whom the company should make a long-term investment.

Understand the Company's Commitments

Several highly prestigious corporate boards have been caught off guard in recent years by the size of executive payouts that had accrued through arrangements approved over a multi-year period. Evaluated annually, individual components of complex compensation and benefits programs are more likely to sound reasonable. Avoiding overcompensation requires a big-picture view: a holistic, integrated approach that considers the cumulative value and impact of each element of the compensation package, including a worst-case scenario of total payouts under all possible future circumstances.

In recent years, tally sheets have become the essential tool for tracking the total values accumulated in multi-part pay programs, particularly for deferred compensation, pensions, and equity holdings. Increasingly, compensation committees have been using an expanded "pay-for-performance tally sheet" which forecasts the range of payouts

that programs would provide to executives under various performance scenarios. The additional data clarifies the relationship between total compensation, company performance, and shareholder value, especially with regard to the degree of leverage built into the program. Ultimately, it provides the compensation committee with a degree of assurance of exactly what results the program is designed to reward and that it is working as intended. Armed with a more in-depth understanding, the committee will be in a better position to tackle one of the SEC's key new disclosure mandates: the compensation discussion and analysis (CD&A) portion of the proxy. Previously, the compensation committee's proxy disclosure was limited to a general description of the structure and level of executive pay programs. The new CD&A is more about the "why" of those programs. The lengthy narrative must clearly explain the considerations and rationale behind the compensation programs approved by the committee, including how and why particular performance measures were picked and how leverage is built into the program. While time-consuming to prepare, the CD&A offers committees an ideal opportunity to clarify their own thinking about how management should be paid and to explain to investors how those programs will drive shareholder value over the long term.

Deal with Controversy

Committees today face a growing risk that they will be required to defend their decisions to a full board, seeking assurance that all members concur with those judgments. After all, every director is subject to external scrutiny of the company's executive pay programs. The compensation committee can best help avert any second guessing when decisions reach the full board by making membership representative of the entire board—including those directors who have criticized past pay decisions and whose concerns are likely to be shared by at least some outside interests. In place of the well-rehearsed and conciliatory atmosphere that has traditionally prevailed, committee members must foster an environment of complete candor and open dialogue. Members should be free to question past decisions and be creative about the future, and management must remain receptive to new ideas and constructive criticism. The compensation committee chair should maintain an open line of communication with the full board, communicating regularly with the non-executive board chair or lead director, and reviewing with the full board what transpired after every committee meeting.

Similarly, compensation consultants must bring more to the party than just data. Along with providing information on viable alternatives, trusted senior advisors should take a stand, using the power of persuasion while being mindful not to force their views on members. The advisor also can provide a fresh and critical perspective on how the committee conducts itself, including longtime practices and processes that may fall short of heightened standards of good governance. Areas of assessment should include: the structure of the committee charter; the choice of peer groups and how this data is used; how agenda content is decided; the level of detail in committee minutes; and the process and timeframe in which proposals are presented, discussed, and voted upon. By being open to a complete audit of the quality and appropriateness of how the committee operates, and by making needed changes, members can ensure that their oversight is guided by best practices.

Avoiding overcompensation requires a big-picture view: a holistic, integrated approach that considers the cumulative value and impact of each element of the compensation package.

Conclusion

There will be no shortage of critics who will continue to second-guess many board pay decisions without ever having actively managed such programs themselves. However, directors increasingly possess the resolve and the tools needed to effectively manage and defend their compensation programs and decisions, addressing critical governance issues and cultivating quality executive teams who will drive real long-term value creation for investors. ■

David N. Swinford is the senior managing director of Pearl Meyer & Partners. He advises clients on linking compensation with business strategy, compensation policy, incentive plan design, and compensation-related corporate governance issues. **Robert E. "Bob" Hallagan** became chairman of NACD in January 2006 and is currently vice chairman of Heidrick & Struggles, having served as its CEO from 1991 to 1997. Bob was the cofounder, and is now chairman, of NACD's Center for Board Leadership, where he oversees its mission of developing best practices for effective board leadership.