

A partnership approach to executive compensation

Five steps for improving the dynamics between management and the compensation committee in today's governance environment. **BY SEYMOUR BURCHMAN AND BLAIR JONES**

THE NEW GOVERNANCE ENVIRONMENT has changed the dynamics between management and compensation committee members. Not surprisingly, it is taking a while for the issues to be sorted out. At times, the dynamics can feel threatening: It is not unusual for a previously amicable relationship to become contentious on occasion, or for the boundaries between the decision rights for management and those for the compensation committee to change without a thoughtful discussion of the implications. Friction can occur if the compensation committee suddenly becomes engaged on a topic that historically had been deferred to management or if the compensation committee assumes the primary relationship with an executive compensation consultant who had previously forged a relationship with management. Committee members, for their part, will understandably become

concerned if management appears less than forthcoming on certain sensitive matters or defensive when challenged.

Instead of feeling threatened, both parties must find more effective ways to work together under the new rules. In an ideal collaboration, management and the compensation committee would develop and implement an executive compensation program that aligns executive gains with those of shareholders; supports the business strategy; and enables the company to attract, motivate, and retain the talent needed to execute that strategy. An optimal partnership between management and committee can improve the business impact of a company's executive compensation program. Such a partnership can also reassure both parties that the program's objectives and implementation are as unassailable as possible in the eyes of the shareholders and the outside world.

To achieve these outcomes, all partners must be willing to create an environment that fosters conversation and transparency. It's a matter of agreeing on the basic direction of the decision-making process and keeping the communication



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flowing. An optimum approach to management/committee collaboration involves five steps:

Step 1: Clarify expectations and articulate decision rights

A critical first step in getting the relationship off to the right start (or to take an existing relationship to a new level of effectiveness) is to step back and have a candid conversation about expectations. This is a natural conversation to have when a new committee chair comes on board or after the committee's self-evaluation. The objective is to discuss how management and the compensation committee can best work together to achieve the committee's charter.

The conversation should focus on questions such as the following:

- What elements of their charter do the compensation committee members consider most important? Is the charter still appropriate, or does it require modification?
- How well has the committee adhered to its charter? Specifically, what has it done well? Where does it need to improve? What are the reasons for any shortfalls?
- How can management

best help the committee fulfill its charter? To what extent has management been doing this already? What is working well? What areas could be improved?

- How can the committee help management deliver to the committee's expectations?
- Do the committee members feel as if they are getting the right information in a timely manner in order to fulfill their fiduciary obligations?
- How do the committee members want to be involved in the making of critical decisions?

When expectations are clear, management and the committee will understand each other's expectations and have a basis for periodic discussions (at least once a year) of how the relationship is working. Management may choose to have individual conversations with directors first on these matters and then aggregate themes for full committee discussion. Alternatively, a third party might facilitate this process.

These discussions can lead to greater clarity around decision rights, an important outcome. Decision rights define accountability for specific actions and decisions related to compensation, benefits, and perquisites. They guarantee that the

policies and practices are in place to ensure the development of management talent, effective corporate governance, and the establishment of competitive and effective management compensation. As shown in Exhibit 1, decision rights specify the governance item (director compensation, CEO compensation, etc.), the specific actions (e.g., initiate, develop, review, approve), and accountabilities of management, the compensation committee, the full board, and the compensation consultant.

One decision right that is gaining prominence focuses on choosing the compensation consultant and "owning" the consulting relationship. Historically, the compensation consultant was hired by and reported to management in virtually all companies. This clearly is no longer the case. An increasing number of compensation committees are hiring the consultant, typically with management assisting in the screening and credentialing. In some cases, a single consultant is hired to serve both management and the committee. In other cases, the committee and management have their own consultants, particularly when a second opinion is sought or when the company's compensation program has come under close scrutiny. Discussion of decision rights helps start the conversation about critical issues such as these.

Step 2: Understand the implications of business issues and talent needs for rewards design

The next step in forging understanding and collaboration is for management and the compensation committee to articulate how the company's business issues and talent needs should influence rewards design. Exhibit 2 illustrates how one company summarized the executive rewards implications of its key business imperatives.

Articulating business and talent needs lays the groundwork for structuring a rewards strategy that responds to the company's business situation and provides necessary guidance as programs change. A rewards strategy must go beyond "motherhood and apple pie" to summarize a company's enduring beliefs about compensation and help ensure that rewards align with and support the vision, mission, business strategy, and financial priorities of the company. The rewards strategy provides a yardstick for retrospective evaluation and a framework to guide the future direction of program design and administration. It becomes the means for establishing agreement and commitment among management and the compensation committee about pay and performance principles. It allows management and the compensation committee to make de-

When committee members import pay practices from another board on which they serve, they run the risk of a bad fit.

EXHIBIT 1 Decision rights matrix

Governance Item	Description	Decision Roles			Frequency
		Management	Compensation Committee	Corporate Board	
Director Compensation	The compensation, benefits, and perquisites provided to directors (policy)	Initiate, Develop	Review, Recommend	Review, Approve	Annually
CEO Qualifications	The skills and experience required of CEO	Initiate, Develop	Review, Approve	Review, Approve	Annually (review) As Needed (recommend, approve qualifications)
CEO Compensation and Performance Evaluation	The compensation, benefits, and perquisites provided to the CEO; performance standards and evaluation process	Provide Input and Tools	Initiate, Develop, Recommend	Review, Approve	Annually
CEO Succession Planning	Succession process under various scenarios	Develop	Initiate, Review, Recommend	Review, Approve	Annually (review process) As Needed (develop process)
Officer Compensation	The compensation, benefits, and perquisites provided to officers	Initiate, Develop	Review, Recommend (Approve)	Review, Approve	Annually
Stock Options	The issuance of stock options to employees subject to Rules 16b-3 and 162(m)	Initiate, Develop	Review, Approve	Review	Annually
Officer Appointment and Promotion	Decisions regarding the appointment, promotion, and continuing service of management	Initiate, Develop	Review, Recommend	Review, Approve	As Needed
Officer Removal	The removal by the CEO or officers for cause and/or performance	Initiate, Develop, Approve	Review	Review	As Needed
Compensation Philosophy and Principles	The guidelines that shape the corporation's compensation strategy and approach	Initiate, Develop	Contribute, Approve	Review	Annually (review) As Needed (approve)
Corporate Social Responsibility	Policies and practices regarding corporate social responsibility issues (e.g., Equal Opportunity Employment)	Initiate, Develop	Review, Monitor, Approve (policy)	Review	Annually (review policy) Periodically (monitor compliance)
Board Communication	Presentations to the board that explain the business impact of the compensation committee's actions	Initiate, Develop	Contribute, Approve	Review	As Needed

decisions within a mutually agreed-upon framework, rather than face each pay decision as if for the first time.

Rewards strategies typically define the following principles:

- **Pay Prominence** — the visibility and impact of pay relative to other programs that influence behavior. Prominence is influenced by pay variability, executives' influence over performance results, and the explicitness of communication about the pay/performance relationship.

- **Emphasis** — the primary goal of pay (e.g., attraction, motivation, or retention). Typically each component of the compensation program has its own focus.

- **Comparative Framework** — the companies used for pay and performance comparisons. This involves establishing a peer group of industries/organizations to compare pay practices and performance.

- **Pay Positioning/Mix** — targeting pay levels relative to companies in the comparative framework for different levels of performance (e.g., 50th percentile versus the 40th or 60th percentile). Pay mix addresses the proportion of fixed and variable compensation components, e.g., what percentage of pay will be delivered in salary versus incentives, what percentage will be based on annual versus long-term results, etc.

- **External/Internal Balance** — the relative influence placed on external market competitiveness in determining pay levels versus internal factors, such as the strategic importance of jobs to the company.

- **Performance Measurement** — the measures, standards, and time frames for evaluating performance.

Some companies also define expectations for executive stock ownership, the process and criteria for CEO evaluation, and the desired nature and scope of communication.

To provide further useful context, management can help the committee understand the historical evolution of the company's rewards strategy, program design, and pay levels. An historical pay audit, conducted by pay component and overall, can show the compensation committee how pay has changed over time, what factors influenced design changes in the past, and how the design must evolve further to meet current demands arising from changes in the business or the need to attract, motivate, and retain key executives.

Exhibit 3 illustrates the executive compensation history that management at a public utility prepared for its compensation committee. The exhibit covers three elements of the compensation philosophy: pay prominence, pay comparators, and pay positioning for salary and incentives. Management used the exhibit to explain the changes in pay comparators and positioning, which reflected deregulation in the late 1990s and the increasing pressure to attract and retain key executive talent whose roles were becoming more like general industry exec-

EXHIBIT 2 How business needs influenced one company's rewards strategy

What are the key business imperatives?

- Rationalize the brand portfolio through ongoing assessment of the strategic significance of each brand
- Promote brand innovation while continuing to support re-branding initiatives
- Address the strains on infrastructure that have resulted from rapid growth in recent years
- Sustain current growth levels through period of economic growth

What are the implication for compensation?

Annual Incentives

- Reinforce key strategies and intermediate-term operating and financial results (e.g., reduction of operating costs and increase in same-store-sales) needed to promote progress toward longer-term results
- Incorporate shared accountability for results in order to promote collaboration among members on the issue of brand portfolio management
- Utilize discretionary pools to reward for innovation
- Reward innovative and breakthrough performance through increased leverage and upside
- Set individual or team goals for those accountable for building and maintaining infrastructure by examining key operational/service metrics that would be improved through a more effective infrastructure (e.g., service data could be collected through franchisee satisfaction survey)

Long-Term Incentives

- Reward innovative and breakthrough performance through increased leverage and upside
- Consider the use of a special multiplier if some specified level of improvement is exceeded

Special Entrepreneurial Plans

- Create an entrepreneurial-based incentive plan that would provide individuals and teams a 'stake' in new concepts/platforms

utive roles. As the industry changed the pace of its movement into unregulated businesses, the comparators reverted back to a blended utility and general industry group.

Step 3: Seek committee input on compensation designs

Rather than present a compensation design as a *fait accompli* ready for the compensation committee’s stamp of approval, management teams are including committee input throughout the plan development process. This input starts with involving committee members in initial interviews as well as providing for multiple touch points during the design process. For example, a retail company in the midst of changing its incentive design and mix involved its committee at the following four different checkpoints:

1. Initial input (through individual interviews) about what changes needed to occur.
2. Review of executive and committee interview findings and the results of a competitive assessment, with a focus on understanding the implications for the rewards strategy.
3. Preliminary review of alternative design changes.
4. Approval to proceed with the final version of the new design.

Management benefited from having the com-

mittee as a partner in the design process rather than just an approval body. The process raised issues early and ensured buy-in, enabling the committee members to understand and trust the objectives and mechanisms of the designs.

Step 4: Analyze and communicate compensation program outcomes to ensure the program delivers as designed

Communication is critical in helping compensation committees understand the implications of compensation decisions and proactively guiding them to an appropriate conclusion. Management can play a central role by ensuring full transparency about the facts and figures that support compensation decision making.

Tally sheets, prepared by management or an outside consultant, can help explain the total financial impact of rewards decisions and identify potential issues with pay programs. Tally sheets can provide the complete picture of compensation, for both the CEO and the executive group as a whole. A tally sheet might include base salaries and annual incentives for the last three years, plus long-term incentives and gain opportunities for the same three years. It also could illustrate likely realized gains under various performance scenarios. Added to that would be retirement income at different points in time and potential payouts if executives

EXHIBIT 3 Compensation history for a public utility

Compensation philosophy element	Plan year										
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Pay prominence	Moderate to high pay (i.e., pay is a secondary driver of executive actions and decisions behind the company’s vision and shared values)										
Comparators and pay positioning (salary)	Average of the general industry median and the utility industry 75th percentile for all top executives		General industry median for all executives		General industry median for top 2 executives; utility industry 75th percentile for others		General industry median for all top executives		General industry median for top 2 executives; utility industry 75th percentile for others		General industry median for top 2 executives; utility industry 75th percentile for others
Comparators and pay positioning (incentives)	General industry median for all top executives										

were terminated or retired. Tally sheets can prompt meaningful conversations about stewardship and fiduciary responsibility — discussions that can head off embarrassing “surprises.”

The committee and management should also identify and agree on the metrics that will show whether the compensation program is meeting its objectives. Metrics should focus on whether the compensation program is: 1) motivating and rewarding the right results, 2) succeeding in the attraction and retention of key executive talent, 3) achieving the right relationship between pay and performance, and 4) adhering to key elements of the rewards strategy. The metrics can be based on:

- **Specific Outcomes** (e.g., executive turnover rates, success in hiring sought-after recruits).

- **Targeted Analyses.** For example, some companies use a three-part test to evaluate pay/performance relationships. These tests focus on answering the following questions:

- How well correlated have pay and performance been over time relative to correlations in peer companies?

- Is there appropriate value sharing between executives and shareholders?

- How well are pay and performance aligned relative to the company’s peer group?

- **Interviews/Surveys of Plan Participants.** For exam-

ple, one company conducts periodic surveys of plan participants to gauge the effectiveness of their plan designs and their implementation. The survey addresses issues such as how well participants understand the program, whether the right measures are being used, how effective the goal setting process is, and how well bonus decisions are communicated at year end.

These metrics provide a “report card” for the program and open the door for constructive dialogue about the compensation program’s effectiveness. The metrics also allow management and the committee to proactively address any issues instead of being on the defensive.

Step 5: Remain open to new ideas and provide committee with the right resources

An atmosphere of transparency breeds more discussion. Many committee members serve on multiple boards and are exposed to a wealth of ideas. More information and opinions about executive compensation practices are available than ever be-

fore. Management must remain open to ideas introduced by the committee or evident in the marketplace and help committee members objectively evaluate appropriateness of these ideas for the company’s situation.

Many compensation committees set aside time during one of their regular meetings for a proactive discussion of current trends and their implications for the company. This often occurs in the summer, after proxy season. Other companies prepare white papers for their boards on issues and questions related to the applicability of certain practices for the company. Such discussions can provide important context and avoid situations in which committee members feel compelled to follow prevailing trends or other companies’ practices.

When committee members import plans and practices either from their employer or another board on which they serve, they run the risk of introducing plans that will not fit the given company’s business and talent needs or its culture. Before superimposing another company’s “best practices,” committees and management must ensure the practices are appropriate to the company’s situation, and evaluate the potential for any unintended consequences. For example, one company examined prevailing practice with respect to the replacement of options with some form of restricted stock. However, the company — a start-up company looking to attract young, entrepreneurial talent motivated by large upside opportunity — found that conventional, or even performance-based, options met its unique business needs much more effectively.

Given the amount of information available and the visibility of executive compensation decisions, committees sometimes need to reach out to other resources to ask questions, validate points, or satisfy curiosity. Management should not be threatened by the committee’s desire to seek other opinions. In fact, management should adopt a proactive stance and invite committee members to consult the company’s HR, finance, and legal resources as well as outside advisers. These individuals should be prepared to expect committee interaction and advised on how to handle a call.

In today’s governance environment, it is challenging to address the issues surrounding executive pay. But if the five steps outlined above are followed, we believe the result can be more effective executive pay programs that successfully balance the interests of all key stakeholders — the company, the shareholders, the board, and the executives. ■

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