Board Governance Series

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Key Compensation Committee Guidelines in a New Environment

Blair Jones, senior vice president and practice leader, Leadership Performance & Rewards, Sibson Consulting, discusses how boards can find the right compensation philosophy for their company.

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A number of forces have emerged over the last two years that are gaining momentum and dramatically impacting the executive pay landscape. The first is the regulatory environment, starting with the changes introduced by the Sarbanes-Oxley Act, which actually just touched the surface of executive pay. These reforms abolished some of the worst excesses of executive pay, such as executive loans, and began tightening the noose around executives at companies where financial numbers were poorly reported and required restating, but they were just a first step.

More dramatic changes have happened over the last year, resulting in the expectation of an imminent expense for stock options and in stock exchange requirements that call for all equity compensation plans, both broad-based and executive, to be approved by shareholders.

The second force has been seen at the shareholder level on two fronts. First, shareholders have become increasingly concerned about the dilution in their equity. Second, they're becoming more active and vocal in developing guidelines for executive compensation. Many institutional investors are asking to discuss their executive pay expectations with the board and management, and if they don't achieve the types of changes they would like, then they are putting forward their proposals in the proxy.

Add to the first two forces employees who are disappointed about their option gains, which, until recently, have been limited because the market has been volatile, and the outcry from the public, which has a very low tolerance for executive pay when performance isn't there, and you've got a perfect storm around executive compensation and a demand for change in the way it is designed. The bottom line is executive pay decisions over the next few years will be watched with a high degree of scrutiny, and executive compensation will become one of the litmus tests for good corporate governance.

In this environment, compensation committees must step back and reevaluate the appropriateness of their executive compensation programs. A good starting point is a diagnostic test of a company's existing programs. This checkup begins with an assessment of participant perceptions and consideration of how well the program supports the business strategy and talent needs. Of course, it is also important to look at how the program aligns competitively. A final analysis should pertain to how the program is doing from a performance standpoint. The committee should check historical data to see how payouts have aligned with actual performances.

If a committee completes this checkup and gets a clean bill of health–that is, the committee finds that the program supports the business strategy and talent needs, and there is good variation in pay with performance –there may not be a need for any changes. If, however, the system starts to break down such that when the committee is looking at different scenarios in the pay performance analysis and they find that, for instance, the program pays out really well on the upside but doesn't decrease enough on the downside, then perhaps some of the elements of their program may need to be tweaked to improve the alignment. Or, if talking to participants reveals that three out of four programs are well understood and really seem to change behavior but the fourth just seems like an after-the-fact reward, that's a symptom that something isn't working properly.

In addition to conducting a diagnostic checkup, it is also important

to develop a shared philosophy of how the program should be structured and what it should be designed to achieve in the organization. Most companies have a philosophy of some sort, but the environment has changed, and these philosophies should be revisited in today's new context.

The most important thing for companies to keep in mind is that that philosophy should be unique to the company. The problem throughout the 1990s was that companies tried a one-size-fits-all solution. The only question people had was, "How many options are you going to give me?" Companies should be encouraged to look at their own participant perceptions, talent needs, business needs, and how well the program has performed and, after all that, come up with a unique solution for their situation. That's a tremendous opportunity. It's also a tremendous challenge, because it's a lot easier to follow the trend. We don't expect companies to have the same business strategies, so why would we expect them to have the same compensation strategies? For example, in considering what has happened with stock options and thinking about some of the design objectives a company might have around long-term incentives, one goal would be to align executive wealth creation with shareholder wealth creation. Stock options do that pretty well. Another objective might be executive retention. Stock options do an average job of meeting that objective if the stock price is rising. If the stock price isn't rising, it's not as strong a retention vehicle. The third objective might be to reinforce some of the key business imperatives. Stock options don't do that very well, and that's where a second vehicle might come into play. In retrospect, while it was hard for companies to avoid the stock options trend, they were probably naive to expect one vehicle to be all things to all people. Companies now have a chance to reconsider their objectives and find the mix of compensation vehicles that is most appropriate for their unique circumstances.

In coming up with the right philosophy, a company should avoid creating one that is "motherhood and apple pie." There are a number of questions that need to be considered. In the past, for instance, a typical compensation philosophy might have simply stated the compensation program was structured to ensure that the company could attract and retain top talent. It probably also included a statement about where pay was positioned. Now companies should also look into issues such as how prominent they want pay to be in driving executive actions and decisions. Should it be a major agent of change within the organization, or should it be a secondary support to all the other messages sent through the organization? Some organizations have tremendously strong cultures, so in those cases, compensation may play a supporting rather than a lead role. Of course, this varies by company and by industry.

The second thing compensation committees must ask is, "What mix of pay do we want?" What mix of base salary to annual incentives to long-term incentives is best? But also, what mix in terms of equity versus nonequity is desirable? To whom should pay and performance be compared; how should pay be positioned under a variety of scenarios relative to that group; what expectations should there be relative to stock ownership expectations, and how will compensation decisions be made? In each case, again, companies are urged not to think of the motherhood and apple pie solution, but to put together a series of statements supported by a clear rationale so that when the committee and management come together to consider future executive pay decisions, they can all agree on the meaning of this principle and its implications. Principles constructed in this manner can typically guide compensation decisions for at least three to four years, at which point, they should be revisited to ensure their continued relevance.

With all the attention being given to executive pay through shareholder activism, the media, and the public, boards must respond to all the inquiries they are receiving. Boards must look at their companies' situations and tailor solutions that meet their particular needs in the most effective way. In doing so, we believe companies can restore the integrity of their executive pay programs and, in coming up with a solution that's unique for them, perhaps even use that to their competitive advantage.

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