Strong Advice for Compensation Committees On Targets, Methods, and Clean Sheets

Comp consultants—and a director—reveal new ideas to overcome pay challenges.

The complexity of executive pay programs leaves many in a fog of doubt about what's equitable and fair. This popular forum provides an unrivaled opportunity for directors to ask leading compensation consultants for their advice on some of the most vexing questions and issues facing compensation committee chairs and members. Panelists field questions from the moderator before the floor is opened to directors. Panelists at the most recent forum—Leading Minds of Compensation–West, in June in Half Moon Bay, Calif.—were **Tracy Bean**, partner, Mercer; **Matthew Isakson,** partner, Meridian Compensation Partners; **Jeffrey Joyce,** partner, Pay Governance; **Daniel Laddin**, partner, Compensation Advisory Partners; **Singleton B. McAllister**, of counsel to Husch Blackwell and a director of Alliant Energy Corp. and United Rentals; and **Barry Sullivan,** managing director, Semler Brossy.

How can directors best manage reputational risk for themselves and the compensation committee?

Barry Sullivan: Let me break it down in two ways. One, you've got to know where you're different than conventional practice. We talk a lot about the homogenization of executive pay, which is an unfortunate outflow of the current say-on-pay era. I think that's a dystopian view of the future. Companies still need to tailor their programs and largely, have the flexibility to do that. And we'll see much more of that in the years to come.

That dovetails into the second point, which is all about communication—communicating both internally to employees so that you get the maximum power of the compensation program internally with employees, and externally to investors. That's the soup *du jour*, right? The compensation discussion and analysis (CD&A) remains the principal communication tool around pay, and most CD&As today are in pretty good shape.

Compensation committees have approached CD&As with an eye for continuous improvement in the last three, four, and five years. As you think about the influence of Institutional Shareholder Services and the other proxy advisors, you've seen a tamping down of problematic pay practices. For example, we've seen a reduction in severance multiples and an increase in the prevalence of hedging policies and ownership requirements.

That's all good hygiene around compensation.

You have advised a number of compensation committees. What can make the compensation committee more productive?

Singleton B. McAllister: Things have changed dramatically. We have to look at talent management. And CEO succession planning is the responsibility of the full board, but you need direct input from compensation committee members as well.

With regard to talent management, you have to figure out where the company is and where you want it to go in the next three, five, or ten years, making sure that you are properly rewarding those hypotheticals. We get together often, and as a board we have our head of human resources give us a list of senior management members, where they are right now, and if someone got hit by the milk truck tomorrow, who would be ready now to fill that position. If we don't have someone in that position, we need to be able to identify an individual or think about looking outside the company. If we're doing our job right, we should have people who have the right capabilities. And if that person is not quite ready, then we should look at opportunities to rotate that individual to another position to gain additional exposure and experience, making sure that we have individual coaching or outside training for that person in our efforts to fill our capacity.

In your role as an advisor, how can you help the compensation committee have a productive discussion?

Matthew Isakson: Our primary goal is to make sure that directors have an effective compensation committee meeting. The committee meeting process has evolved a lot in this say-on-pay era, along with other corporate governance processes. Our firm sees hundreds of compensation committees each quarter. We know the good, and unfortunately, we've also seen the bad. We are well-positioned to know what best practices are. I use that term loosely, but most committee process best practices can be applied to any company, of any size, and in any industry.

First, have a compensation committee calendar that goes out as much as a year in advance. You know at each meeting what topics are going to be discussed. You have on the bottom periodic topics—you do not want anything falling through the cracks, and you certainly don't want to have a surprise. Next, schedule agenda reviews. Give the compensation committee chair an

Barry Sullivan, Singleton B. McAllister, Matthew Isakson, Jeffrey Joyce, Tracy Bean, and Daniel Laddin.

opportunity to walk through the agenda, ask questions, and see if there is anything he or she really wants to see on that agenda or any follow-ups that need to be prepared in time for the meeting. Also, review materials in advance. Sometimes you see that done together with the independent advisor and management. Sometimes the compensation committee chair reviews [materials] alone with the independent advisor. Do a page flip or a very high-level review with the committee chair, making sure there are no additional questions and that the most important issues are teed up for a good discussion.

Then, hold debrief meetings. After a committee meeting there's a tendency for everyone to run off. As consultants, we want to review and assign those responsibilities for follow-up, making sure that the committee is prepared for that next meeting.

Importantly, have an executive session at each meeting. One-on-one time with the CEO, your independent advisor, and, more importantly, among yourselves, to get any issues out on the table, is key. Interestingly, we have seen some committee chairs hold an executive session at the beginning of the meeting as well [as at the end], especially when there are one or two major issues that need to be put on the table and come to a resolution in that meeting.

How do you know if the compensation is right?

Jeffrey Joyce: Committees should be asking themselves this question on an annual basis. Are our compensation programs accomplishing what we had intended? Pressure to receive a favorable say-on-pay vote has resulted in a homogenization of compensation programs for many companies. Today, there exists for many companies a standardized, cookie-cutter approach to pay—total pay is targeted at median; formulaic incentive programs that discourage committee discretion; long-term incentives delivered in approximately the same mix across companies; significant use of total shareholder return in performance-based long-term incentives (LTI). Five years ago, earnings growth was the most prevalent metric used in LTI. Today, it's total shareholder return (TSR). There's discouragement of anything outside the norm for fear of criticism or failure of a say-on-pay vote.

The role of compensation committees, which hitherto was primarily strategic, now must also consider compliance. New regulations, proxy advisor voting standards, and activist investors have shifted committee attention toward compliance in recent years. A lot of companies felt the pressure to adopt these standardized compensation programs to win a favorable vote from ISS and to win the say-on-pay vote.

In an era where proxy advisors such as ISS, the [Securities and Exchange Commission] SEC, and activists have shaped our compensation programs to solely focus on total shareholder return, what does this say about how well compensation programs are achieving the objectives identified by CEOs? There appears to be a disconnect. So companies should be asking themselves, are our programs doing what we want them to do? Look at pay positioning, fixed versus variable pay, short- versus long-term objectives, key performance metrics, and how long-term incentives are being delivered. Is it options? Is it performance shares? Is it restricted stock? Then ask, are we in an area where we need any special compensation programs put in place?

Once you've done that, then you have to consider how does all this play with our institutional investors, the proxy advisors, and any other important stakeholders. It cannot be done in a vacuum—you have to review what the potential changes are and how they would stand with your largest shareholders and your largest investors. Decide what is most important—doing what's right for the business or appeasing the shareholders. If you need to, change the program to support your objectives. Then make a targeted communication

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effort with your key institutional investors and through your public disclosures.

No one knows what's going to happen with Dodd-Frank. How would you guide and advise the compensation committee?

Tracy Bean: Let's talk briefly about Dodd-Frank. There is a bill in Congress that would repeal many of its provisions and amend others, but its prospects are dim. At this time, we can't count on any changes. There are a number of executive pay provisions that Dodd-Frank covers. One of the earliest and most important is say on pay. That's been with us since 2011, and honestly, I don't think that's going to go away. If anything, we may see it voted on less frequently, but it's been very popular with shareholders who believe it gives them more of a voice on executive pay.

The rest of the pay provisions haven't taken effect yet, although many companies have complied to some degree in light of investor and proxy advisor pressure and emerging best practices. For hedging policies, most of my clients have adopted an anti-hedging policy, and we think that's best practice. Next, there's the clawback rule, a provision where you are required to claw back incentive compensation resulting from an accounting restatement. Most of our clients have adopted a clawback [policy], and you get brownie points from ISS for doing so. The issue is how far does it go? Many feel that Dodd-Frank takes those clawback rules pretty far in terms of who it covers and under what conditions—for example, Dodd-Frank doesn't require fault on the part of the executive. A best practice is to agree to adopt a clawback policy and then consider what makes sense to have in that policy. It may need to be amended later, but it is considered good governance to have one.

Another Dodd-Frank provision relates to the pay versus performance disclosure. We suggest that you mock up that disclosure and review it with your committee. The proposal may change, or it may be repealed, but we think that discussing pay and performance alignment with your shareholders is good practice.

Now, let's talk about the very unpopular CEO pay ratio rule, which is final and scheduled to go into effect in 2018. This is the rule where companies will have to disclose the ratio of the CEO's pay to that of the median worker. It has been criticized both for its complexity and the fact that it's going to produce ratios that nobody really understands how to use. Mercer did a spot survey recently of about 90 companies asking them how prepared they were to face the CEO pay ratio. Seventy percent said they were at least somewhat or moderately prepared for this disclosure. There has been some activity to delay or repeal this rule, but it's looking less likely as time passes, and, as you can see, a lot of companies have at least taken that initial stab at the calculation, and you probably should do that as well. The interesting thing our survey showed was that the ratios companies are calculating are all over the place. This is going to lead to a need for all of us to take great care in our disclosures of the ratio. The calculation is producing very high ratios particularly in some industries and not in others. We pulled data last year out of our database, and for technology companies, the ratio was about 80 to 1. So you can see, depending on who you are and what kind of workforce you have, your ratio may be very high or not so bad. Finally, if you ask the average person on the street what they think these ratios look like, they'll say something like 10 to 1 or 20 to 1, so some education will be needed with this.

What would you advise about setting targets in times of uncertainty? I know you have a unique philosophy.

Daniel Laddin: We're working with our clients to look at the year, set a calendar, define what's important, and then set a theme. Some of those themes might be around a strategic issue the company is dealing with and how it impacts compensation, it might be a process issue, it might be an employment issue. We've had compensation committees say, "Every decision we're going to make is going to be through a lens of diversity and succession. If we're thinking about pay decisions, pay design changes, and even ownership guidelines, we're going to look at each of these through that lens."

Let me give you an example. We had ownership guidelines for one client that cascaded fairly deep into the organization. As they looked at their population and the combination of diversity, be it gender or age, they said, look, we are requiring our executives to hold a pretty significant amount of equity, and these could be relatively junior executives or at the vice president level. These are people whose kids were going to college, they might be buying their first house, they have life decisions. They said, let's look at this again. We would never have gotten to that decision unless we were looking at all decisions through that lens that year.

Another example: a company chair said, "I want to make sure the process we're going through is the right process." We all agreed and bought into it and said we're not going to use a single report from the prior year, management, or the compensation consultant. Every report has to start with a clean sheet of paper and with a different approach. That was the theme for that year.

I would encourage you to think about what your theme should be for this year or the coming year and how you can apply that to every meeting you go through. You need buy-in from the committee, management, and ultimately the compensation consultant. It has really helped a few of our clients to rethink their compensation programs and how they make decisions.