

ViewPoints

Staying the course: executive compensation in 2009

On June 17 and 18, 2009, the Compensation Committee Leadership Network (CCLN) convened in Chicago for its eighth face-to-face meeting. Over dinner, members were joined by guest Nell Minow, editor and cofounder of The Corporate Library, who shared her views on how boards can improve executive compensation plans and engage more effectively with shareholders.

The following members participated in the meeting:¹

- John L. Anderson, Hewitt Associates
- Peter S. Egan, Hewitt Associates
- Robbi D. Fox, Hewitt Associates
- David R. Goode, Caterpillar Inc. and Delta Air Lines
- Stephen P. Kaufman, Harris Corporation and Thermo Fisher Scientific
- Robert J. Lawless, Constellation Energy Group
- Richard C. Notebaert, Aon Corporation
- Willem P. Roelandts, Applied Materials
- Stephen W. Sanger, Wells Fargo
- Laurie Siegel, Embarq Corporation
- William D. Smithburg, Abbott Laboratories and Smurfit-Stone Container Corp.
- Jonathan P. Ward, Sara Lee Corporation

The following members took part in pre-meeting discussions but were not able to attend the meeting:

- Lewis W. Coleman, Northrop Grumman
- Michael J. Critelli, Eaton Corporation
- Thomas J. Donohue, Union Pacific Corporation
- Dina Dublon, Microsoft Corporation
- Daniel H. Schulman, Symantec
- Samuel C. Scott III, Motorola
- Wesley W. von Schack, The Bank of New York Mellon

¹ *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals or corporations. Quotes in italics are drawn directly from members of the Compensation Committee Leadership Network. The compensation committee chairs are identified by their board membership. John Anderson, Peter Egan, and Robbi Fox participated in their capacity as compensation experts.

Executive summary

The tumultuous state of America's economy has made corporate governance a popular target for regulators, legislators, and proposals for change. Certainly it has dramatically complicated the work of the compensation committee. As corporate performance deteriorates and becomes less predictable, compensation plans have come under considerable pressure. In response, compensation committees are searching for ways to refine pay plans to ensure they align with performance.

In this dynamic context, CCLN members met in June and shared their experiences, perspectives, and insights in four broad areas:

- **Executive compensation plans in 2009.** Will compensation committees change the fundamental aspects of executive compensation in response to economic, regulatory, and social pressures? The short answer: no. Members report that they intend to “*stay the course,*” to adhere to the compensation fundamentals that have guided their pay practices over the past several years. Although they reject the idea of a “*broad reset,*” they recognize the need to adjust certain aspects of their existing compensation structures. Specifically, members tell us that they are refining the mix of equity vehicles used to deliver long-term incentives, defining and monitoring performance targets even more carefully, adjusting base pay in some cases, and reducing or eliminating remaining “*lightning-rod provisions,*” among them perquisites, supplemental executive retirement plans (SERPs), gross-ups, and golden parachutes.
- **Dinner discussion with Nell Minow.** Members engaged in a spirited discussion with guest Nell Minow, who shared her views on various aspects of executive compensation. Although members agree with Ms. Minow on certain “*objectionable*” pay practices, they take issue with her use of anecdotal evidence – “*exceptionally bad apples*” in executive compensation – and subsequent “*overgeneralization*” to all public company boards. For CCLN members, Ms. Minow’s “*misperceptions about executive compensation*” highlight a gap in communications between boards and stakeholders that both groups should be working to close.
- **Governance changes and enhancing shareholder engagement.** Congress and the SEC are moving forward with proposals that could impact compensation committees and corporate governance more broadly. Members believe certain provisions – proxy access, majority voting, and say-on-pay – will likely be enacted. But they believe other provisions – for example, the split between chairman and CEO and mandated risk committees – are far less likely. As they help their companies navigate the dynamic legislative and regulatory environment, members agree there is much to gain and little to lose by listening more intently to their largest shareholders. One member shared a particularly insightful example of a company’s successful communications with a shareholder group that ultimately prevented a say-on-pay proxy proposal.

- **Leadership development and succession planning.** Leadership development remains a priority for compensation committees and boards. Members talked over practices that help them better understand the strengths and weaknesses of next-tier leadership; the best approaches for identifying, assessing, and selecting a “winner;” and the need for new executive skills in an evolving business environment.

Executive compensation plans in 2009

Members were eager to discuss how their committees rewarded executives in 2008 and 2009 and what issues remain on their agenda for 2009. *“I think we were working with decisions on how to do things this year that were without rules and without ... precedent. Now, if this is our reality, how do we do things differently?”* Overall, members report that they continue to struggle with ways to *“design, develop, and implement compensation in this extremely unstable and unpredictable environment.”*

“Staying the course”

One executive compensation expert recently pointed out: “Few issues stir up more controversy, resentment, and debate among investors, executives, board members, politicians, and everyday citizens than executive compensation, especially in a period of economic downturn.”² Indeed, as one member remarked, *“Compensation is right up at the top of the hot-button list of all the corporate critics. Behind them all is an agenda that has picked up an enormous amount of momentum since last fall to change the entire compensation approach. We’re under the gun and criticized for whatever we do.”*

Yet despite pressure to overhaul the fundamentals of executive compensation, most members report that they *“are not persuaded that the system is flawed”* and that they intend to *“stay the course,”* continuing to implement policies that they believe are correct and that have successfully guided pay practices over the past several years. Remarkd one member: *“My view is you design the compensation plan that is right for your company and try to have the discipline to stay the course. That’s what we have been trying to do. We say, ‘We believe in this plan, and over time everything will balance out as it should.’”*

Considering select adjustments

Of course a commitment to *“the core philosophy ... doesn’t mean you don’t adjust to a uniquely difficult situation,”* noted one member. Added another: *“You can’t be afraid to change performance standards to make them appropriate for today and tomorrow.”* At the meeting, members discussed several areas where they are considering change.

² Frederic W. Cook & Co., “Executive compensation 2008: the year in review & the road ahead,” *Alert Letter*, April 28, 2009. Available at http://www.fwcook.com/alert_letters/04-28-09-Exec-Comp-2008-The-Year-in-Review-&-The-Road-Ahead.pdf.

Mix of equity vehicles

Members agree that “the monumental drop in the equity markets and rapidly slowing economy [have] turned LTI programs on their head. Underwater stock options, failed performance plans, and restricted stock with diminished retentive value are forcing companies to reevaluate the very plans that traditionally have provided the incentives needed to attract, retain, and motivate key talent.”³ Recent data suggest that “the median value of unvested CEO LTIs declined from more than three times their annual pay to little more than one times their pay – a decline of approximately 67%.”⁴ Still, members report that designing effective long-term incentive plans (LTIPs) continues to be a challenge: *“To me, the things left undone are the LTIPs and how to address those ... There are a lot of questions about what are the right performance measures to think about and trying to balance and develop those over the right time frame.”*

An increasing number of members tell us they are taking a closer look at canceling “*underwater options and reissuing new options.*” None are considering repricing. On the table are exchange programs that would offer at least certain executives new stock options for their underwater ones. Broadly speaking, under “*fair value option exchanges*” the company determines the value of the underwater option and uses that value as a basis for determining the exchange level for new options.

Members shared several ways they are adjusting equity vehicles in response to the exceptional economic circumstances:

- **Option exchange.** *“We excluded the board and the top five ... and gave employees with underwater options the choice of whether or not they wanted to participate in the exchange. I think what we’ve done is right. Exchanging options allows you to get some gain out of something that would have been much tougher to get a gain out of.”*
- **Greater emphasis on performance-based restricted stock.** *“We’re moving from a mix of options and time-based restricted stock to performance-based restricted stock.”* One member was quick to point out: *“The amount of options you get might be based on performance metrics, but we should distinguish between equity as currency and equity as performance metrics.”*
- **Back to options.** *“We had switched to performance-based shares but, with the stock going down, feel like now is the time to use options. We proposed this, and it was very well received by the population. The company had already been taking significant cutback actions – we wanted to give something back, and options were very well received because people saw the immediate value. It’s really improved morale.”*

³ Ibid.

⁴ Allen Jackson and Ben Stradley, “2009 proxy statements highlight the new realities in executive compensation,” *ECRonline* (Towers Perrin), April 23, 2009. Available at http://www.towersperrin.com/tp/getwebcachedoc?webc=USA/2009/200904/April_7__New_Realities_in_EC.pdf.

Compensation targets

Members report that setting targets is another area where they see an opportunity for adjustments given the unique challenges of the current environment: *“How you actually set and receive your target is very different this year. In the past, we would have said that if we hit budget, we might get 50 to 60% of target. This is definitely going to be a low payout year because of uncertainty. Just to get from here to there and achieve what would be an acceptable budget is going to be very hard to do.”*

One member described the importance of agreeing on what constitutes “good results” when setting compensation targets in a turbulent economy: *“I think boards are going to need to look more closely at how the compensation targets are reached. If they have been reached by downsizing employees, cutting benefits, cutting commitments to community, skimping on R&D, and skimping on customer service, that’s something we should take into account.”*

Base pay and bonuses at financial institutions

According to our members, *“Everyone’s still questioning what to do about salary for next year.”* This is particularly true for those companies that have received Troubled Assets Relief Program (TARP) assistance: *“Those companies that have always had a principle of pay-for-performance and used stock price to align managers with shareholders, the government has now said we can’t do those things, so they’ve only left you with salary and bonus. How can you pay in a competitive way and maintain a structure where top people have pay relevant to everyone else? You could do it strictly with salary, but TARP companies are so closely watched you have to figure out how to thread the needle and not become a poster boy for excessive pay while still paying people in a really restrictive environment.”*

One member pointed to the significant “*semantics problem*” financial institutions face in defining base pay versus bonus and suggested this could be an area in need of adjustment: *“What financial institutions have historically called base compensation and what they called bonus [were] a fiction. Bonus would never go to zero under any circumstances, so there is an element in the bonus that was essentially base pay. They just never bothered to fix the semantics of the compensation structure even though bonuses behaved in a way that was essentially base pay. All they are doing now is adjusting for what has always been the mode of operation. You can say what they are doing is wrong or right, but they needed to do something to get away from ... nomenclature that did not accurately describe the pay practice.”*

Eliminate lightning rod provisions

Members continue to eliminate provisions that attract unwanted attention and do little to motivate performance:

- **Perquisites.** With pay plans under the microscope more than ever before, members agree that perquisites are an “*irritant*” that they have been working diligently to eliminate. When one member raised the question of revising current CEO contracts to diminish perks, another member offered: *“I would certainly have a conversation with the CEO and say,*

‘Look, you see it, you’re the one that gets the headlines and gets letters from proxy activists. Times have changed. Let’s talk about what you’re willing to give up and how we can work to modernize the contract.’”

- **SERPs.** Members all report that they are seeing a “rapid decline” in the use of SERPs today: *“It’s become more of a generational issue. Folks that are in it now will be grandfathered and frozen, and then the next generation of leaders will not have SERPs.”* Of course *“some new CEOs might say, ‘All CEOs have SERPS, where’s mine?’”* But, as one member explained, they should recognize that *“you’re sending the wrong message if you do that today.”*
- **Gross-ups.** *“If you’re hiring a CEO today, would anyone even put in gross-ups?”* Members agree that gross-ups are fast becoming a thing of the past. In fact on June 17, the Obama administration recommended banning tax gross-ups in TARP recipients: *“All companies receiving taxpayer assistance will be prohibited from paying executives’ state and federal taxes related to perks and golden parachutes. The unexpected ban on the controversial and widespread practice, known as tax gross-ups, was applauded even by pay watch groups who criticized the administration’s broader approach to compensation.”*⁵
- **Golden parachutes.** On June 10, Treasury Secretary Timothy Geithner included a reexamination of golden parachutes as one of the five key principles of aligning compensation with risk: *“Golden parachutes were originally designed to align executives’ interests with those of shareholders when a company is the potential target of an acquisition ... We should reexamine how well these golden parachutes and supplemental retirement packages are aligned with shareholders’ interests, whether they truly incentivize performance, and whether they reward top executives even if their shareholders lose value.”*⁶ For their part, members agree that the use of golden parachutes is decreasing, and many are moving away from contracts entirely: *“[The] best solution is to not have a contract. Frequently it’s worth another three years on someone’s pension to get them to leave.”* Another member pointed out: *“Investors will understand grandfathering an old guy, but any new contracts for new guys [are] bad.”*

Exercising discretion

Members agree that one of the most important roles of the compensation committee is to exercise discretion in applying compensation formulas. *“One of the things I’m hearing from almost every committee is ‘Can we have more discretion? We want more discretion in the final analysis to look at things more qualitatively.’”* Members also agree that discretion is particularly important in an uncertain and volatile economy: *“We changed our graph and made it easier at the bottom but*

⁵ Tomoeh Murakami Tse, “Executives unruffled by proposed compensation rules,” *WashingtonPost.com*, June 11, 2009, <http://www.washingtonpost.com/wp-dyn/content/article/2009/06/11/AR2009061103860.html>. The government document, *Financial regulatory reform: a new foundation* (U.S. Treasury, June 17, 2009), is available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf.

⁶ US Department of the Treasury, “Statement by Treasury Secretary Tim Geithner on Compensation” (press release, June 10, 2009), <http://www.ustreas.gov/press/releases/tg163.htm>.

harder at the top end. [We looked again] at our discretionary capability ... We were really uncomfortable with being able to project three years from now and want to have discretion on both sides in case it gets totally out of whack."

And members agree that compensation committees should not hesitate to exercise discretion in either direction as they see fit: *"At the end of the day, we're in an environment that makes it really hard to set goals. We as a board use discretion in all these other areas, why don't we do it here? We shouldn't be afraid to do what we're supposed to do."*

Dinner discussion with Nell Minow

Members welcomed Nell Minow for dinner and discussion at the June meeting. They recognize her intelligence and compelling communication style and the critical role she is playing in shaping the public discourse on executive compensation. But they strongly reject her assertion that *"directors are making a lot of bad decisions"* in setting executive compensation. Members argue that her criticism relies heavily on anecdotal evidence of outliers and *"overgeneralizes"* in condemning executive compensation practices across corporate America. Said one: *"I am so tired of 10,000 public institutions being painted as 'bad' because of the poor examples of a few companies. They do not represent the majority of public companies at all, nor do they represent the companies I serve."*

Ms. Minow responded, "[My criticism] is based on anecdotes that take up a very significant and material proportion of the sample. You can't dismiss every bad example as naïve or an anecdote. If our system permits excesses that even this group considers indefensible, there is something wrong with the system."

Nell Minow's objections

Although fundamental differences of opinion separate Ms. Minow and the members of the CCLN, common ground was revealed in a discussion of the particular pay practices to which Ms. Minow objects:

- **Paying full bonuses when a limited number of metrics have been achieved.** "At Bear Stearns you saw that bonuses were being awarded on the basis of nine metrics. Okay, that's fine. However the plan also went on to say that the board has discretion to decide whether achieving even one of those metrics results in executives getting full bonus. That is like throwing a dart at the wall and then drawing the bull's eye around it." Members generally agreed that this example, as presented, appeared to reflect poor compensation oversight.
- **Incentives tied to quantity not quality of transactions.** "As Countrywide demonstrated, pay plans are oftentimes designed to reward quantity of transactions rather than quality of transactions. You can tell executives all you want about Strategy A, but if you pay them for Strategy B, they're going to pursue Strategy B." Again members agreed that this example demonstrated a compensation approach they would not take at their companies.

- **Gross-ups.** In testimony before the House Committee on Financial Services on June 11, Ms. Minow stated: “There is no justification, under any circumstances, for having the shareholders pay an executive’s taxes.”⁷ During our discussion, she reiterated her point: “The atrocities that have happened with gross-ups are astounding.” She then went on to describe a company that paid a \$4 tax gross-up for an executive, asking rhetorically, “Did he need the \$4? Why did he take it?” Although members generally agree that gross-ups should be reduced or eliminated, they felt her example focused “*on form over substance.*” Said one: “*If a CEO is spending his time worrying about a \$4 tax gross-up, he should be fired.*”
- **Incentive payments attributed to fraud or error.** “There was recently a company that accelerated the reporting of certain sales figures and awarded bonuses based on that. It wasn’t uncovered by investors until a year ago.” Members wholeheartedly agree that bonuses should only be paid against accurate measures.
- **Perquisites.** “My current worst-case pay plan involves abuse of perquisites at Chesapeake Energy, where the company bought back the CEO’s vintage map collection for over \$12 million and then claimed it was important to the ‘company culture.’” CCLN members have eliminated many, if not all, perquisites at their companies and would not approve this kind of purchase.
- **Peer-group manipulations.** In her testimony on June 11, Ms. Minow stated: “We need to watch for manipulation of the peer group to support higher pay. When pay would be higher by assigning a peer group based on sector rather than market cap, the board will adjust the peer group accordingly. When it goes the other way, so will the board.”⁸ CCLN members agree that peer-group manipulation is wrong. But they feel strongly that the quality of peer-group comparison has improved over the last 5 to 10 years and that this criticism is “*out of date.*”
- **Increasing base pay for bank executives.** “The idea of Morgan Stanley doubling the base pay to make up for restrictions on performance pay [is not right].” Members found this criticism naïve. “*Base pay is practically the only tool we have to compensate these people. The other vehicles that we have are not allowed under TARP ... We have to pay them, and base is all we have to do it. Total pay is still down dramatically.*”

What does Ms. Minow think boards should be doing differently?

- **Choose performance measures, and stick with them.** “I am very open to boards picking their own metrics, but by God they better stick with [them].” Ms. Minow went on to add: “I personally love cash flow as a measure. I think it’s the least susceptible to

⁷ Nell Minow, “Hearing on Compensation Structure and Systemic Risk” (testimony before the US House of Representatives Committee on Financial Services, June 11, 2009). Available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/minow.pdf.

⁸ Ibid.

manipulation.” Members agree on the need to set measures and stick with them, and several use cash flow or similar performance measures.

- **Improve compensation disclosure.** “My view of the CD&A is that it doesn’t do what it is supposed to. In order to comply, it seems like one person wrote the first CD&A and then everyone else just photocopied it. I would like them to be a bit more individual and would totally support improvements around that. I would be happy to work together to make changes to the requirement and to be constructively involved in improving the CD&A.” Members share Ms. Minow’s view that SEC requirements have made the CD&A a document that is *“still long and still pretty damn complicated.”*⁹
- **Engage with shareholder groups.** Ms. Minow strongly urged members to encourage their general counsels and corporate secretaries to work with groups like The Corporate Library to improve communications between corporations and their shareholders. Depending on their company’s circumstance, members are open to doing so.
- **Bank bonuses.** In her June 11 testimony, Ms. Minow said she would like to see “banking of bonuses, preferable to clawbacks, a kind of escrow to ensure that any adjustments to the financial reports will result in adjustments to the bonus. This is essential not just in case of fraud but also in cases of mistake.”¹⁰ Members fully support paying bonuses against accurate financial information, but they do not necessarily agree that “bonus banking” is the most effective way to do that. The tricky questions: What percentage do we bank, and for how long? And how can we make sure pay plans remain competitive?
- **Restrict stock grants for directors.** “I like restricted stock grants for directors, with some cash – enough to pay taxes. I feel strongly directors should not be able to sell their stock because they should care about looking into the future. We need to have some holding period even after directors retire from the board – say three years.” One member said in response: *“I’m a professional director. Are you saying I should work for free for all my years of service? I would have no net remuneration.”*

Ms. Minow’s “key point ... was that pay should not be based on ‘comparables,’ which are too often a distraction, but, like any other asset allocation, on return on investment.”

Several members found Ms. Minow’s suggestions *“naïve”* and *“potentially harmful,”* given the realities of attracting, retaining, and incentivizing executives in today’s economic environment. Some members disagreed: *“I don’t find her naïve at all. It’s clear she doesn’t live in our world, but she’s not naïve in her style, messaging, and ability to create a captivating argument.”* But another member was not dissuaded: *“I think she’s dangerous because her job is to agitate and make things black and white, and she’s had success doing that. That is what her criticism is all about.”*

⁹ Compensation Committee Leadership Network, “Executive compensation in 2008: never a dull moment?” *PreView*, May 22–23, 2008, 2.

¹⁰ Minow, “Hearing on compensation structure and systemic risk.”

In the end, despite concerns about overgeneralizations and a perceived lack of understanding of how large complex institutions are run, members felt the discussion with Ms. Minow highlighted the need for boards to improve their communications with stakeholders. *“We need to give serious thought to how we take people like Nell and give them a better depth of understanding into what boards really do and how the process really works.”*

Governance changes and enhancing shareholder engagement

Executive compensation remains a lightning-rod issue for public policymakers and those who influence them. Congress and the SEC are moving forward with proposals that will impact compensation committees and corporate governance more broadly:

- **Shareholder Bill of Rights Act of 2009.** On May 19, Senators Charles Schumer (D-NY) and Maria Cantwell (D-WA) introduced legislation that would give shareholders significantly more influence over executive compensation and the composition of corporate boards.¹¹ S. 1024 addresses virtually all shareholder reform issues that have been raised in recent years, including proxy access, advisory votes on compensation, independent board chairs, adoption of a separate risk committee, golden parachutes, and director elections.¹² The bill asserts that its intention is “to provide shareholders with enhanced authority over the nomination, election, and compensation of public company executives” and includes in its findings statements that management and boards at many companies failed to act in the best interest of shareholders.¹³ In the words of one analyst: “This legislation would go significantly farther in changing corporate governance practices and expanding shareholder rights than even the Sarbanes-Oxley Act.”¹⁴
- **Shareholder Empowerment Act of 2009.** On June 12, Congressman Gary Peters (D-MI) introduced legislation that includes all the provisions of the Schumer-Cantwell bill and would amend the Securities Exchange Act of 1934 to prohibit management from retaining compensation consultants used by the compensation committee, ban “uninstructed broker votes that allow fund managers to vote on investors’ behalf,” and strengthen clawback provisions used to recoup management payouts tied to “fraudulent or faulty earnings statements.”¹⁵
- **TARP spillover.** The Troubled Assets Relief Program – which was signed into law by President Bush on October 3, 2008, as part of the Emergency Economic Stabilization Act –

¹¹ Andrew Ross Sorkin, ed., “Schumer seeks shareholder vote on executive pay,” DealBook (blog, *NYTimes.com*), May 19, 2009, <http://dealbook.blogs.nytimes.com/2009/05/19/schumer-seeks-shareholder-vote-on-executive-pay/?sp=1&sq=Schumer%20Seeks%20Shareholder%20Vote%20on%20Executive%20Pay&st=cse>.

¹² The text of the proposed bill is available at <http://thomas.loc.gov/cgi-bin/query/z?c111:S.1074>.

¹³ Frederic W. Cook & Co. “Shareholder Bill of Rights Act of 2009 introduced in Senate,” *Alert Letter*, May 22, 2009. Available at http://www.fwcook.com/alert_letters/05-22-09-Shareholder-Bill-of-Rights-Act.pdf.

¹⁴ Ted Allen, “Schumer introduces governance legislation,” Risk & Governance Blog (RiskMetrics Group), May 20, 2009, http://blog.riskmetrics.com/2009/05/schumer_introduces_governance.html.

¹⁵ Congressman Gary Peters, “Congressman Peters introduces bill to empower shareholders” (press release, June 12, 2009), <http://www.peters.house.gov/?sectionid=22§iontree=21,22&itemid=148>.

includes several substantive provisions related to executive compensation.¹⁶ Specifically, compensation committees in those companies participating in TARP “are required to certify in their CD&As that they have taken measures to ensure that executive incentive compensation policies have not encouraged and do not encourage ‘unnecessary and excessive risks that threaten the value of the financial institution by the executive officers.’”¹⁷

Said one member: *“I worry about TARP and all the bailout mandates that are coming from the government. What’s the bleed over to the rest of general industry? How’s that going to affect us? How do we prepare?”* Another member remarked before the meeting: *“The kind of things that TARP is doing will ripple through industry ... It’s got everybody in Washington talking about compensation because now they’ve got the purse strings with those who’ve taken TARP money.”*

Accepting the inevitable

Members are resigned to certain changes they foresee in board governance:

- **Proxy access.** On May 20, the SEC voted 3 to 2 in favor of publishing a proxy-access rule for comment, marking the first time in eight years that there has been a Democratic majority vote after two failed attempts to resolve the issue during the Bush administration. For their part, CCLN members anticipate that *“proxy access will be getting through. [It] might not occur exactly as it is described in the Schumer bill, but it will be something in that direction.”*
- **Majority voting.** *“Majority voting is a done deal [in terms of likelihood of adoption]. I’m not in favor of cumulative voting – that is a hill I would die on – but majority voting is not a hill I would die on. How can you be against majority voting in America?”*
- **Say-on-pay.** Members have long since accepted that the adoption of nonbinding shareholder votes on executive compensation is inevitable, and many predict that the Schumer-Cantwell bill will give say-on-pay the final push. In the meantime, they are waiting to see what the final legislation entails: *“I think it’s wise to wait and see the regulation before we start making any decisions ... We still need to see what say-on-pay is a ‘say’ on. Say-on-metrics? Say-on-philosophy? It’s not worthwhile to guess and try and anticipate the outcome.”* Although CCLN members accept the inevitability of say-on-pay and acknowledge that there has been a fundamental shift in the tone of the conversation, most maintain that they are still vehemently opposed to say-on-pay in theory: *“I’m still as emotionally against say-on-pay as I was 18 months ago, but it’s just the reality of the world now.”*

¹⁶ “Emergency Economic Stabilization Act of 2008,” Section 111(b)(2)(A).

¹⁷ “SEC Division Director White draws CD&A lessons from TARP and 2008 filings,” *Corporate and Financial Weekly Digest* (Katten Muchin Rosenman), October 31, 2008, 1. Available at http://www.kattenlaw.com/files/Publication/a31c6c11-43f1-4e9b-9dec-0228dc56f187/Presentation/PublicationAttachment/5e688b3a-73b6-48b0-9dae-04f8455b4cb6/Corporate_and_Financial_Weekly_Digest-10_31_08.pdf.

Legislation foreseen as less likely

Members report that they are not gearing up to address legislation they believe is less likely to be adopted in the near future:

- **Split of chairman and CEO role.** *“All of my boards have discussed it, but no one is treating it as a major crisis issue.”* Added another member: *“I don’t see it being legislated ... To me, it’s a bit of a tempest in a teapot. If you have the right mechanisms in place, in terms of leadership of the independent directors, I don’t think it should matter either way.”*
- **Mandated separate risk committee.** *“I think risk committees are a good idea for certain companies but don’t make sense for others. End of story. I don’t think this will be mandated across the board [beyond nonfinancial institutions].”*

Although the general consensus is that these bills are not going to be adopted, at least one member wondered if boards should be careful about making assumptions: *“Certainly the conventional wisdom [is that these provisions will not make it through]; but any time it gets too conventional, I worry we’re missing something. Will we get some of these provisions passed as well? We could. If the other provisions are accepted, then a few others could slip through too.”*

Recognizing the need for greater shareholder engagement

Members report an evolving view of shareholder engagement. *“We need to go out and promote ourselves better as boards. I have done a complete 180 on that. We’ve gone from a model that was very reluctant to have directors talking to shareholders, to a model that is much more shareholder centric ... [I believe that] under certain circumstances, the directors may engage with investors directly.”*

One CCLN member shared an example of successful communications with a shareholder group that ultimately prevented a say-on-pay proxy proposal:

We received a say-on-pay proposal last proxy season, and we met with [an activist shareholder group] afterward; we mutually agreed to study the issue and come back with a recommendation. I made sure our board knew we were seriously going to study the issue and not approach it with a preconceived outcome. The compensation committee read several articles both ‘for’ and ‘against’ say-on-pay and hosted three conference calls. We ultimately came back with a recommendation ... Our engagement led to enhanced credibility, and the activists, compensation committee, and board were satisfied with the resulting outcome.

For many members, this example confirms that boards need to do more to improve communications with shareholders. One compensation committee chair remarked: *“I think there’s too much of an effort to stonewall on our part. Rather than stonewall, why don’t we go out and engage with them more often? The only thing you get from stonewalling is passion and emotion and complaints over \$4 tax [gross-ups].”*

Leadership development and succession planning

CCLN members report that leadership development and succession planning remain a central focus and responsibility of the compensation committee regardless of the current economic crisis: *“I don’t subscribe to pulling out and waiting and deferring until this crisis is over.”* Added another member: *“Life goes on no matter how deep the crisis is, and this is one of the most important aspects of our corporate governance responsibilities.”* And a third member pointed out: *“This is right up there as one of the top priorities of the board, if not the top priority. A recession does not change that.”*

Understanding the strengths and weaknesses of the “next tier”

“How do others manage the process of understanding the strengths and weaknesses of – not so much the CEO – but the next level down?” Members agree that they have an even greater interest in understanding their *“bench strength”* given current economic conditions: *“The CEO succession plan is critical; but with all of this turmoil, there is a desire to look a little deeper than we would normally.”*

Most boards look to senior management to keep them apprised of up-and-coming talent within the company. But some members are concerned about the process: *“Management tends to show the board and committee grade inflation, so you see a lot of strong candidates who are doing really well, and then three years later they’re suddenly gone. Where was the in between, where you woke up one day and saw the warts? The interactions with the candidates tend to be very stated. How do we get through that and find a way to get beneath that veneer?”*

Members acknowledge that the board has a responsibility to *“trust but verify”* that management is developing the strongest possible management team for the future. *“A CEO shouldn’t mind keeping the board updated, but the directors can’t just parachute in one day a year and tell them where to look.”*

Members discussed several ways boards and compensation committees can get to know the candidate pool better:

- **Dinner meetings.** *“We always invite candidates to come to board dinners. It’s a nice informal way to get to know these people.”*
- **One-on-one breakfast meetings.** *“We have a director breakfast with only 1 or 2 of the top 25 people. When you’re one-on-one, you really get to know these people. Anyone can do a cocktail-hour talk for an hour in a big group; but when you’re alone with the individual, you hear a lot more.”*
- **Executive retreats.** One member suggested that executive retreats are another opportunity for boards to gain more exposure to the next tier of executives.

Members point out the importance of recognizing that development is a continuous process and the benefit of having long-term directors who can more effectively track succession candidates: *“It’s important to think about building these relationships over the long term. If you’ve been on*

the board for a long time, you're in a better position to judge because you know the people. [You] need to make sure there is a clear process in place so you're constantly creating that continuity."

Identifying, assessing, and selecting senior executives

Members discussed at length the processes their boards use to identify and select individuals for key executive positions. They acknowledged the challenges in identifying candidates. Specifically, one member asked: *"When do you look outside?"* Another pointed out that looking at external candidates *"is a delicate thing."* Added another: *"There's a period of time where boards have a sense that they need to look outside, but they are afraid to do so because it sends a signal to the internal candidates and the rest of the company."*

Once a candidate pool has been identified, members report they often struggle with the best approach to *"pick a winner."* One compensation committee chair questioned: *"How do you play it in the final stages? Let's say you're down to the final two or three [candidates], what do you do then?"*

Members shared two approaches their boards and compensation committees have found effective in making a decision:

- **Committee makes a recommendation.** *"We form a committee and then narrow it down to one person and [ask] everyone else on the board to meet [that person]. You can't have ten people doing it, and you can't have two people doing it, so a committee seems to work best. We make a recommendation, and anyone who wants to meet the finalist can do that."*
- **Committee narrows it down and brings finalists before the full board.** *"We selected the final candidates in committee and then had the two finalists come and spend an hour and a half with the board. We are all around the table asking them questions. Going into this process, I was concerned that it would be two guys to hold him and seven guys to hit him, but it was actually really illuminating. We wound up making a choice that has worked out very well."* Another member pointed out: *"Bringing candidates before the full board can be awkward and strained, but that's illustrative in itself. I have seen candidates who were great in front of the committee but then flamed out in front of the board."*

Identifying skill needs for a new environment

CCLN members question whether the economic crisis signals a shift in the type of executives companies will be looking to recruit in the future: *"We need to start thinking about things six months from now. Should we be asking ourselves what we need going forward? The answer for the short term might be status quo, but I do see a significant number of boards rethinking what kind of skills we need."* As one member remarked before the meeting: *"It's not always about keeping people who we don't want to go. It might be that we have the wrong team. I think it's a multidimensional issue that both compensation committees and governance in general have to deal with. We've been through a stressful period. Have we adapted well? [Have we] adjusted to*

the new reality? Based on that, do we have the right team and skill sets going forward? There's a new reality and a new economic environment for the next 24 to 36 months. Have we adapted well, and do we have the right team to deal with this?"

Members agree that *"challenging times lead some leaders to perform differently."* Company results can be a useful indicator for gauging the quality of talent: *"If you have a series of successful products that lead the industry, you draw the conclusion that you have a top quartile of individuals."* For those companies not performing well, members say external consultants can provide additional insight: *"We knew we were not in the first and second quartile, so we hired an outside consulting firm to bring us through everything from a process standpoint and give us some better benchmarks. Coming out of that dialogue, you also get the consultants' body language about the competence of your people."*

Conclusion

At the start of the year, compensation committee chairs reported that they continued to find themselves in *"uncharted territory,"* overseeing compensation in an extraordinary period of change, bracing for outspoken criticism of executive pay packages, and anticipating sweeping legislative and regulatory reform. As they look ahead at the second half 2009, members continue to feel frustrated with the poor visibility and unpredictability of the economy but remain confident in their abilities to attract, retain, and incentivize key executives during these turbulent times: *"It is a year where we're trying to continue to do the things we did in the past. For now, let's just let things play out as intended and let LTIPs shift as capital markets shift down. This is not the year to throw everything away. I think it is a time to go steady and accept that pay plans were set up for the long term."*

About this document

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