

ViewPoints

Executive compensation 2009–2011: Continued change to reflect new realities

On March 3 and 4, the Compensation Committee Leadership Network (CCLN) convened in New York for its 10th meeting. Members reflected on the 2010 compensation committee agenda, the current regulatory and legislative landscape, the relationship between the head of human resources (HR) and the compensation committee, and the evolving role of the independent compensation consultant. Members were joined by special master of executive compensation (also known as the “pay czar”) Kenneth Feinberg over breakfast on March 4.

The following members participated in the meeting:¹

- John L. Anderson, Meridian Compensation Partners
- Thomas J. Donohue, Union Pacific Corporation
- Dina Dublon, Microsoft Corporation
- Donald E. Felsing, Northrop Grumman
- David R. Goode, Caterpillar Inc. and Delta Air Lines
- Geraldine B. Laybourne, Electronic Arts
- Linda Fayne Levinson, NCR Corporation and Western Union
- Daniel H. Schulman, Symantec
- Laurie Siegel, CenturyLink
- Bryan E. Smith, Hewitt Associates
- Kelvin R. Westbrook, Archer Daniels Midland

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

- Stephen P. Kaufman, Harris Corporation and Thermo Fisher Scientific
- Robert J. Lawless, Constellation Energy Group
- Marshall O. Larsen, Lowe’s Companies
- Richard C. Notebaert, Aon Corporation
- Michael J. Powers, Meridian Compensation Partners
- Stephen W. Sanger, Wells Fargo
- William D. Smithburg, Abbott Laboratories and Smurfit-Stone Container Corporation
- Jonathan P. Ward, Sara Lee Corporation

¹ The compensation committee chairs are identified by their board membership. John Anderson, Michael Powers and Bryan Smith participated in their capacity as compensation experts. *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 CCLN.

Executive summary

“Never before in the history of American business has the role of the corporate director been more important or more challenging ... This past year, executive compensation has been a remarkably high-profile, politically charged topic – in short, a lightning rod for controversy.”² In this dynamic context, CCLN members shared their experiences, perspectives, and insights in five broad areas:

- 1. The 2010 compensation committee agenda.** Compensation committees may indeed, as Marty Lipton said, have become lightning rods for controversy in the context of the current wave of populist big business-bashing. But CCLN members stayed focused on their core leadership responsibilities: attracting and retaining talent, and paying for performance.

Several members reported deep concern about losing talent in the wake of consecutive years of pay levels significantly below target and below competitive benchmarks, exacerbated by equity grant values so low that they have lost their retention value. Some are considering ways to offset retention and performance challenges, including resetting their pay plans to market, awarding retention packages to their star performers, and rethinking ways to “*gain some stickiness.*”

Firms whose plans incorporate a balanced portfolio of compensation delivery elements (e.g., cash, time-based restricted stock units (RSUs), performance shares and options) and firms with plans that traditionally employ substantial discretion were far better placed than firms that rely more on formulas – and that now find themselves with unexpected outcomes and little flexibility.

In this dynamic environment, compensation committee members need a deep and nuanced grasp of the situation on the ground. They are working closely with the CEO and HR leaders to craft pay plans that serve as constructive management tools in the shareholders’ interests. Members agree that discretion, flexibility, and communication are critical in this environment given their continued assertion that “*there is no one-size-fits-all [approach] and we should not be trying to put our plans into a single formula.*” Many are poised to rethink their plans in some fundamental ways this year, with phased changes in 2011 and beyond.

- 2. Breakfast discussion with special master Kenneth Feinberg.** Members engaged in a spirited discussion with guest Ken Feinberg, who shared his views on executive compensation and lessons he has learned in his role as pay czar. Mr. Feinberg stressed that he has a limited purview of five companies. He also expressed hope that his prescriptions will be “precedential,” particularly his advocacy of modest base salary, stock as long-term incentive, and no guaranteed pay. For their part, members respect Mr. Feinberg and the work he is

² Martin Lipton, Steven A. Rosenblum, and Karessa L. Cain, “[Some Thoughts for Boards of Directors in 2010.](#)” (New York: Wachtell, Lipton, Rosen & Katz, 2009), 4.

doing, but see, at best, limited applicability of his approach to non-TARP (Troubled Asset Relief Program) companies.

3. **Regulatory and legislative developments in corporate governance.** The Securities and Exchange Commission (SEC) and Congress are moving forward with proposals that could impact compensation committees and corporate governance more broadly. While members report that they continue to be wary of pending legislation, they acknowledge that there are some “*positive outcomes*” that result from their recent compensation-related risk assessments. CCLN members continue to believe a legislative mandate on pay is inevitable and almost all are undertaking a “*wait and see*” approach until then.
4. **The relationship between the head of human resources and the compensation committee.** CCLN members report three things they value most in the head of HR: technical expertise, process management, and an ability to balance independent insight and advocacy of management’s position. Meeting participants agreed that executive sessions play a critical role in eliciting candor and creating opportunity for deeper understanding and context. Members also play a valuable developmental role for the HR head by providing direct feedback and articulating the committee’s expectations.
5. **The evolving role of the compensation consultant.** CCLN members agree that the independent compensation consulting industry is likely to be “*in transition for the next three years or so.*” Although members ultimately agree that “*it’s about the individual,*” companies continue to weigh the respective benefits and limitations of using a boutique versus a multi-service firm. Members agree that a quality compensation consultant is independent, opinionated, does not disrupt committee meetings with irrelevant discussion, and understands the company they work for and its industry.

The 2010 compensation committee agenda

At last fall’s CCLN meeting, many members reported wrestling with setting financial performance targets in light of the uncertain 2009 economy. Some opted to set individual targets for the first and second halves of the year with many lamenting that “*it feels like the past few years has been one fire drill after another.*” At the March meeting, CCLN members reported a range of circumstances: a number of companies reported that they easily exceeded their targets while others reported falling short, raising questions for compensation committees.

How will compensation plans pay out in 2010?

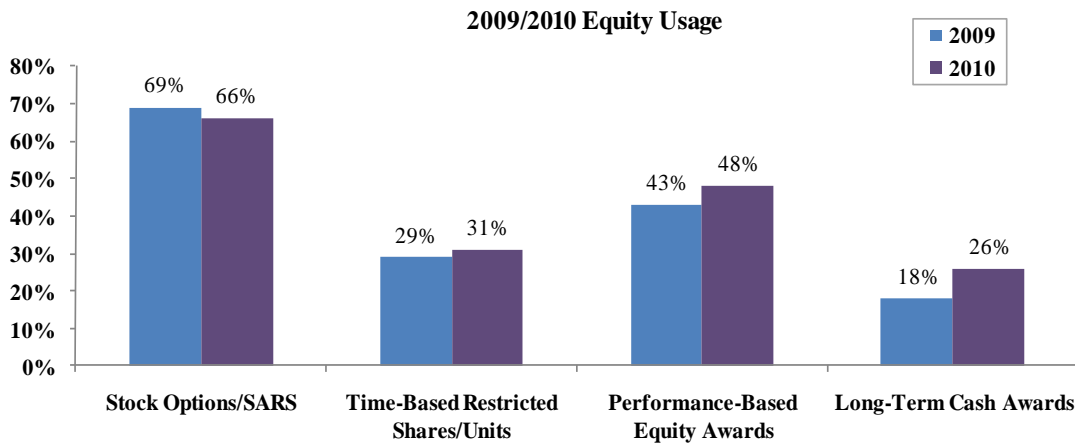
Members agree that 2009 was a challenging year and anticipate 2010 will be as well. As such, members continue to revise and fine tune their pay plans in an effort to create more stability. Some of the adaptations CCLN members are making and considering include:

- **Using a portfolio of compensation vehicles to counterbalance market volatility.** “*At our company, our long-term incentive [LTI] consists of three components: RSUs, options, and cash that pays out on a two-year basis. As the stock has gone down, the options are barely worth anything, RSUs are worth even less, but cash has done well ... I*

have no concerns about [holding on to people] because of the way we've put that plan in place, there's always something to keep them there. You always have something that works for each cycle that you can focus your management team on."

- Continued review of equity mix.** "The most notable trend in instrument-mix change was the decline in the number of companies using only stock options. While in 2009, 24% of respondents granted only stock options, companies indicate that in 2010 only 15% plan on granting options alone, as many companies seek to balance the upside leverage of options with the retention of full-value awards."³ The report continued: "23% of respondents indicated that they plan on modifying their equity instrument mix in 2010, as compared to 44% last spring [2009], indicating that the pace of change in long-term incentive plan design may be beginning to slow as companies are now fine-tuning their plans and the market has somewhat recovered."⁴

Other members report that in assessing equity vehicles, they are mindful of the lingering uncertainty of the future: *"Even though stocks are not nearly as bad as they were a year ago, they're still not great. We didn't end up giving any more options because otherwise we were potentially going to cause a windfall."* One compensation expert observed: "The pace of adoption for [a mix in LTI] practices will accelerate with a sustained market recovery ... Many executives will be willing to sacrifice at least some liquidity and diversification opportunity for the growth potential of continued equity grants."⁵



Source: DolmatConnell & Partners, "Executive Compensation Trends in the Current Economic Climate." February 1, 2010, 3.

³ [Ibid.](#)

⁴ [Ibid.](#)

⁵ Stephen Miller, "For 2010, Matching Executive Pay to Performance – For Real." *Society for Human Resource Management*, December 7, 2007.

- **Going to zero bonuses when necessary.** *“We forced management to take zero bonus because of the rapid depression in stock. We’ve done that before and we’ll consider doing it again if it is appropriate.”*
- **Greater focus on operational metrics.** Members agree that in some cases financial metrics are less directly connected to a current year’s performance than operational metrics and therefore are a less reliable indicator for how an executive should ultimately be paid. As one compensation committee chair shared, *“We have designed our plan so that financial results play at most 25% of the final determination. Instead, we place a greater emphasis on operational metrics.”*
- **Defrosting base salaries.** The economic downturn prompted companies in 2009 to grant the lowest base salary increases in 33 years.⁶ In a recent Hewitt report, base salary increases dropped below 3% for the first time since Hewitt started tracking the data in 1976.⁷ Moreover, in a similar report conducted in the fourth quarter of 2009, 73% of survey respondents reported that they plan to increase base salaries for 2010.⁸ A third report, issued recently by Equilar, looked at 40 examples of salary reductions during the second half of 2008: “Of those, a quarter have been reinstated.”⁹
- **Increasing use of clawbacks.** Less than 3% of Fortune 100 companies had clawback provisions in place in 2005. Five years later, just over 33% do.¹⁰ Moreover, that percentage is expected to climb to 42% in 2010.¹¹ One member shared, *“We decided to step back and revisit clawbacks more broadly as a committee and talk about compensation that would be subjected to clawbacks. We looked at the plan and who should be subjected to clawbacks. For starters I would focus my attention on officers who really are the decision makers and have a great deal more responsibility for material acts. Not sure quite where that line is but we’ve been talking about it.”*
- **Considering more cash.** *“Have we as a compensation committee been making up for the difficulty in setting meaningful targets by using stock? Suddenly we find ourselves in an environment where stock doesn’t reflect the effectiveness of efforts – do we need to take things we’ve been doing off the table and say, ‘Hey, we have a new environment, maybe we should go back to emphasizing cash.’”* One member responded by reporting, *“We put more cash into our plan. The reason we did that is that we found we have executives [who] are young enough that they need cash but are ‘patriotic’ enough to think they never want to sell a share. Cash allows us to keep them there.”*

⁶ Hewitt Associates, [“Hewitt Study Finds that While Salary Increases Were Lowest in 33 Years, Variable Pay Awards Reached an All Time High in 2009,”](#) August 11, 2009.

⁷ [Ibid.](#)

⁸ DolmatConnell & Partners, [“Executive Compensation Trends in the Current Economic Climate,”](#) *Directors Letter*, February 10, 2010.

⁹ Amy Miller, [“Let Me Tell Your Fortune: Executive Pay Projections for 2010,”](#) *Corporate Counsel*, January 22, 2010.

¹⁰ Amy Miller, [“Let Me Tell Your Fortune: Executive Pay Projections for 2010.”](#)

¹¹ DolmatConnell & Partners, [“Executive Compensation Trends in the Current Economic Climate.”](#)

Addressing retention concerns

Members report that retention concerns are starting to re-emerge and their committees are discussing ways to address the challenge. Select approaches under consideration include:

- **Resetting pay plans to market.** *“Last year [2009] management decided – and the board approved – making almost draconian cuts in compensation. Now, senior executives are making 30%–40% of compensation and we’re looking at next year and considering how to create more competitive compensation. Had to ask ourselves, ‘Do we really want to continue compensating our senior team over the long term at half the market level?’ We concluded we did not so we’re resetting the pay plan to the market in an effort to get back to more competitive equity grants.”*
- **Rethinking ways to gain some stickiness.** *“How do you deal with compensation when performance has not been as great as the prior year because of the economy but you don’t have sufficient value to keep executives? That is an issue we’ve been dealing with as our original equity grants have shrunk to be worth maybe 15% of what we originally awarded ... Last year we thought we’d have more visibility by moving to two, six-month plans and that still wasn’t easy. We really believe we have to do something to get some stickiness here because it is a good management team. I’ve been struggling with it, though.”*
- **Awarding retention packages to star performers.** *“We have gone through and taken some of our individual business unit leader heads and given them some interesting retention packages because we have been worried about retention. [Specifically], we went through and adjusted for the president heads because they are the ones that are out there pounding the pavement and we felt by [making those adjustments] we were sending an important message.”*

Discretion, flexibility, and good communication are critical in this environment

CCLN members report that discretion is playing as great a role as ever given the unprecedented challenges of the past 18 months and the continued difficulty in setting performance targets, the volatility in the stock market, and the continued spotlight on executive compensation: *“Looking at this year, there will be more use of discretion and adjusting for the judgment factor. We’re saying more often that we’re just not comfortable with a certain number. It’s a much more direct approach.”*

Likewise, members emphasized the importance of maintaining flexibility: *“You can’t have a box that everybody just puts their plans in. If the compensation committee gives away their flexibility, then you might as well just have a clerk do it.”*

Moreover, members agreed that effective communication should be a key focus in 2010: *“There needs to be communication in a multi-level way with employees, with [institutional shareholders], and with management. We have been making some progress in adjusting our pay plans, but the communication that has to take place around some of these things is huge.”*

Longer-term considerations around compensation for 2011 and beyond

As boards have been developing agendas for 2010, most CCLN members would agree with the compensation committee chair who said: *“I do not see 2010 at this point being a year in which we will undertake radical changes in the way we are approaching compensation.”* This is particularly true given the volatility of the past 18 months: *“At the height of the recession, setting compensation was like trying to catch a falling knife.”*

While members agree that they will not be implementing any significant changes this year, many also report that their compensation committees will be reflecting on their plans in a fundamental way in 2010 with an eye toward making adjustments applicable in 2011 and beyond. Many companies are saying that they’re going to make some significant changes to their plan in the future. Indeed, as one member shared: *“Our experience with applying our compensation plan in this rapidly declining market has been such that we’ve discussed throwing it all out and starting fresh and thinking of a new basis ... Challenging ourselves to question and rethink the company’s entire compensation philosophy.”*

Others are considering more specific, long-term considerations: *“We are in the midst of early stage discussion about undertaking a longer-term assessment of whether strategic goals are being achieved or not. We feel we could do a better job of linking them to pay and we will be revisiting that in the future.”*

Ultimately, members agree there is a need and an appetite to address some of the things that have been learned over the past tumultuous years. “The economic shock of [the past several years] appears to have caused many directors to reconsider what their boards had been doing and to question whether they could or should be acting differently.”¹² As one member remarked: *“A lot of us are thinking about some pretty dramatic paradigm shifts in pay and that you lay the groundwork in one year and change a few things the next. This is definitely a multi-year change and laying that three- to four-year plan and understanding how to bring management along with you is going to be one of the greatest challenges in the near future.”*

Breakfast discussion with special master Ken Feinberg

Members welcomed special master of executive compensation Kenneth Feinberg for breakfast and discussion. Mr. Feinberg began his conversation with members by pointing out that he has a statutory responsibility for only five companies – down from seven – that have yet to repay their debt to the government under TARP. Specifically, his job is to set compensation for the top 25 executives and create a compensation structure for employees ranked 26 through 100. As such, Mr. Feinberg points out that his work is both substantive – having significant authority over pay-at-large companies – and a “side show” in that it is limited to relatively few individuals who face very unusual circumstances.

¹² Martin Lipton, Steven A. Rosenblum, and Karessa L. Cain, [“Some Thoughts for Boards of Directors in 2010,”](#) (New York: Wachtell, Lipton, Rosen & Katz, 2009), 2.

Select views of special master Feinberg

When it comes to executive pay plans, Mr. Feinberg was quick to point out that “one size certainly does not fit all.” He told members that, in general, the compensation structure he favors is a low, modest base salary coupled with stock as long-term incentive that vest over a multi-year period. He repeatedly emphasized his belief that there should be “no guaranteed pay.”

During the discussion, Mr. Feinberg also shared his views on three areas of particular interest:

- **Attracting talent.** Mr. Feinberg points out that he works in a political fishbowl and must work within those constraints. For example, when it came to recruiting a new CEO for Bank of America, he deemed the common practice of negotiating a payment for in-the-money-but-not-yet-vested values in the candidate’s current pay package as politically unacceptable.
- **Retention.** Among the distressed organizations that Mr. Feinberg oversees – where oftentimes leadership had played a significant role in the company’s current predicament – he admits that “We reject the issue of retention. There are a lot of great people out there. I’m told if we do not offer them retention pay, they’ll take a job in China. I do not believe that.” This is another area where populist sentiment and politics play a major part in shaping pay arrangements.
- **Setting targets.** Mr. Feinberg reviews the targets that are developed and set by management and the board of the companies he oversees. But he does not independently set those targets himself. His view is that others are better qualified under his oversight and that his primary responsibility is to set pay relative to those targets.

Although he is the first to point out his limited jurisdiction, Mr. Feinberg also acknowledges – and welcomes – the “halo effect” that could potentially result from his actions: “I’m hoping that the prescriptions that I’ve articulated will have some precedential value. I think most of what I’ve called for the [CCLN members] around this table have been talking about for years.”

CCLN member reactions

Members of the CCLN found the conversation with Mr. Feinberg enlightening and appreciated his willingness to share the lessons he has learned in his capacity as “pay czar” thus far. Most members agreed with the compensation committee chair who said, “*He’s coming up with compensation structures that are probably fine for the companies he is dealing with.*” Another added, “*I don’t know what kind of impact his decisions will have, but we’ll see how it plays out 3–4 years from now.*”

However, members were not willing to accept the idea that the Feinberg “pay prescriptions,” were broadly transferable to healthy large-cap companies. They pointed out several key differences:

- **Attracting talent.** Compensation committees are guided by shareholder interests and cultural fit when considering special arrangements to bring in top talent. The compensation

committee makes judgments about the potential value of its decisions, with appropriate consideration of any public relations and reputational impact.

- **Retention.** CCLN members invest time and energy understanding retention issues and engineering pay plans with “stickiness.” In these times, special retention arrangements may be exactly what are needed to ensure key talent remains in some companies.
- **Setting targets.** Since our first meeting in 2005, CCLN members have consistently cited the importance – and difficulty – of establishing the correct metrics and performance targets around which pay is based. To be sure, this work demands collaboration between the committee and the CEO. But it remains a key part of the committee’s role.
- **Sources of advice.** Mr. Feinberg asserted that he could find no “independent compensation advisers” to assist him in his work. All advisers either worked for one of his five companies, or worked for a competitor of one of those companies. He, therefore, turned to academics for advice, citing Professor Lucian Bebchuk as an example. CCLN members are almost always able to find compensation advisers that they determine to be independent.

Regulatory and legislative developments in corporate governance

“The current economic and regulatory landscape poses unprecedented challenges for public companies and their boards of directors. They are facing scrutiny from shareholders, Congress, regulators and the public, and new proposals to address the causes of the financial crisis have been emerging on almost a daily basis for over a year now.”¹³

SEC’s updated proxy disclosure rules¹⁴

On December 16, 2009, the (SEC) adopted final rules that require public companies to provide enhanced disclosure of proxy statements, as well as all forms filed with the SEC that address risk, compensation, and corporate governance.

The new rules, which apply to proxies filed on or after February 28, 2010, address the following:

- **Compensation risk.** Proposed rules requiring companies to disclose how compensation practices affect company risk were adopted. However, the final rules raised the materiality threshold for disclosure to cover only compensation policies and practices that create risks “reasonably likely to have a material adverse effect” on the company. (The threshold was raised from risks that “may have a material effect on the company.”)

continued on overleaf

¹³ Gibson, Dunn & Crutcher, “[Considerations for Public Company Directors in the 2010 Proxy Season](#),” February 1, 2010.

¹⁴ The text here is a summary of Latham & Watkins, “[Update on Final SEC Enhanced Proxy Disclosure Rules](#),” (Latham & Watkins, 2010). The final SEC rules can be found [here](#).

- **Board diversity.** A company must disclose how its nominating committee considers diversity in the process of identifying director nominees.
- **Director qualifications.** Enhanced disclosure is required with respect to directors and director nominees. A company must disclose the credentials and qualifications of all directors and nominees as well as the board’s reasons for selection.
- **Compensation consultants.** Requires certain disclosures – e.g., aggregate fees paid – when a company employs a compensation consultant that helps set or recommend executive compensation.

At the March meeting, CCLN members discussed how, in addition to the SEC’s proxy disclosure rules, regulators and lawmakers have proposed reforms that, if passed, would dramatically alter the landscape of executive compensation and corporate governance. Members discussed two specific developments among those initiatives in Washington: compensation risk disclosure and say on pay.

Compensation risk disclosure: “a worthwhile process”

Members discussed the processes that they have undertaken at their companies to assess the possibility of undue risk being incentivized through compensation. Most members reported that they looked to their outside consultants to provide a template to identify and assess appropriate compensation-related risk before undertaking a comprehensive review.

In virtually every case, compensation committees found the risk assessment led to some positive outcomes. As one member shared, *“A lot of things would come up in that process that would not surface unless you were looking at it with your best glasses on. For example, we found things in our clawback policy that were limiting ... This process was not only cleansing, but also educational. The things we found weren’t earth shattering, but we came away better informed of what our comp committees are supposed to do. We will do that again.”*

Members intend to fully report that they undertook the risk review: *“We are going to disclose what we did because it was a very comprehensive process.”* While they plan to report their process, most members do not intend to disclose the specific details of the way changes were made to the plans.

Some compensation committee chairs report that they revised their committee charter as a result: *“I think companies should adjust their charters to reflect this review process. Now that we’ve gone through this the first year, you really just need to add one line. You want to acknowledge the whole notion that you now have a better sense of [risk] inventory as a result of this process.”*

Say on pay: “wait and see”

While CCLN members have largely accepted that non-binding shareholder votes on executive compensation are inevitable, several members weighed in on the potential implications – positive and negative – of early adoption.

For example, Microsoft Corporation recently decided to proactively implement say on pay. Rather than vote on an annual basis, Microsoft shareholders will vote on the compensation plan every three years: *“It’s impossible for anybody to vote annually on a pay plan. You need to have some sense of whether it’s actually paying by looking at it over a period of a few years and making sure it’s actually linking pay to performance.”*

Although members respect and appreciate Microsoft’s approach, they recognize that theirs is a unique example. Consequently, many members report that they continue to debate the value of voluntary adoption for their own companies: *“Do we proactively adopt say on pay a year early? Do we get any points for doing that or is it a no-good-deed-goes-unpunished kind of thing?”* One member pointed out, *“What little advantage you may gain in proactively adopting say on pay is probably offset by approaching it the wrong way and asking for the wrong kind of approval or doing something you don’t want to do that you’ll just have to fix later.”*

In the end, almost all members agreed with the compensation chair who remarked, *“You really want to wait and see what finally shakes out with this so you can have as much information as possible before you have to implement it.”*

The relationship between the head of HR and the compensation committee

“As corporate governance has evolved, the agendas have changed. The board has greater expectations of its involvement in every aspect of the business. It’s requesting more information and wanting to get deeper into [HR and other] issues.”¹⁵ Members were eager to dive into the discussion and agreed that this is *“a critical topic,”* pointing out that *“it is important to get this right”* given the important role HR plays in making the compensation committee’s work effective.

At the March meeting, members identified three predominant requisites for the head of HR:

1. **Know the landscape.** *“You don’t need to be a technical expert in everything, but the head of HR should have a full understanding of the compensation issues and current developments in order to ensure that [the compensation committee] gets the right issues on the table and brings the right data points.”*
2. **Implement effective process management.** *“It is the head of HR’s job to design and contribute to the process that helps the compensation committee make good decisions. The head of HR can help management with time management, setting the agenda and managing priorities to ensure that the committee has all of the information that it requires.”*
3. **Establish the line between insight and advocacy.** *“It’s not [the head of HR’s] job to advocate for [their] boss, the CEO’s, pay. It is [their] job to share insight. If the CEO is saying to the board that everything is great and [the head of HR] thinks that there’s a retention risk, it’s [their] job to make sure the compensation committee sees the full picture. Those conversations are always tricky and establishing that line is really the greatest challenge.”*

¹⁵ Robert Grossman, “HR and the Board,” *HR Magazine*, 52, No. 1 (January 2007).

Members particularly emphasized this last point, and agreed that executive sessions can play a key role in eliciting the necessary candor: *“We have an executive session only with the CEO in the room and then an exec session with only the head of HR in the room and then we have a session with only the consultant and then we have a session where it’s just [the compensation committee]. You get four bites of the apple.”* Another member reported, *“Executive sessions provide an opportunity in which we are welcoming and promising confidentiality and creating the trust between the committee and HR. It makes for a richer discussion and conversation if you hear their insights when the CEO is not present. The ability to hear those things without a filter is very important.”*

Several compensation committee chairs report taking proactive development responsibility and giving direct feedback to their head of HR: *“I spend a lot of time talking to our head of HR about things from a governance standpoint. We’re going back to ground zero and talking about our company’s compensation philosophy.”* Another compensation committee chair shared, *“Part of my job is to evaluate my HR head so I give direct feedback saying, ‘This is what I need from you. I know these other voices are in the room and I know you have this role because you’re part of the management team, but here’s a set of expectations and here’s a critique of your performance.’ Having that kind of open, trusting relationship is important.”*

The evolving role of the compensation consultant

Many companies are in the midst of assessing the compensation committee’s relationship with their independent pay consultants in the wake of SEC proxy disclosure rules mandating greater transparency around the work of compensation advisers.¹⁶ “Activist investors contend multi-service consultants have an incentive to recommend that directors award rich pay packages to top executives, who control more lucrative contracts for other HR consulting gigs.”¹⁷

Executive compensation consulting firms are responding. As Hewitt Associates noted in its press release announcing the spin-off of Meridian Compensation Partners, “Pressure from regulators and institutional shareholders is forcing some of our clients to adopt exclusivity guidelines that essentially require boards of directors to work with executive compensation consulting firms that provide no other services to that company ... We formed Meridian Compensation Partners to help these valued clients meet these new governance standards, while maintaining their trusted relationship with their current adviser.”¹⁸

Other radical changes have been taking place: “On January 1, [2010], HR consulting giant Towers Perrin combined with rival Watson Wyatt Worldwide to form Towers Watson in New York. The firms held about 27% of board compensation gigs at Fortune 1000 concerns in the year, ending February 28, 2009.”¹⁹ Additionally, the recent turn of events “probably will boost

¹⁶ Under the new SEC ruling, as of February 28, 2010, shareholder proxies must reveal whether boards pay consultants to do other work for the business and what fees they receive if management services exceed \$120,000 a year.

¹⁷ Joann Lublin, “More Boards Opting for Independent Pay Advisers,” *Wall Street Journal*, January 11, 2010.

¹⁸ Hewitt Associates, “[Hewitt Associates Announces Partial Spin-Off of Its Executive Compensation Consulting Business in North America](#),” press release, February 1, 2010.

¹⁹ Joann Lublin, “[More Boards Opting for Independent Pay Advisers](#),” *Wall Street Journal*, January 11, 2010.

the fortunes of roughly 30 small and midsize independent consulting firms that shun management work when directors retain them. Many are relatively new and led by veteran refugees from larger firms. The latest is a New York boutique launched January 4, 2010, by Ira Kay.”²⁰

Compensation consultants respond to an industry in transition

At the March meeting, members agreed that independent compensation consulting firms are part of *“an industry that is going to be in transition for at least three or so years.”* Regardless, members agreed that *“ultimately, it’s a lot about the individual.”* Moreover, as one member pointed out: *“If we have a good consultant who has given us great counsel, I am loath to give them up just because of regulation.”*

Still, some shared their preference for moving to a boutique firm to avoid the appearance of a conflict of interest: *“We were previously working with [a multi-service firm] but they were doing work for us elsewhere. Even though our guy was not necessarily compromised, it was not worth the fight to convince the world at large that they were objective so we chose instead to work with a smaller boutique.”*

However, others expressed skepticism that this issue was worth the effort of changing firms: *“Isn’t [the independence issue] just a disclosure where you say you looked at it, you’re independent, and then move on? Are there really shareholders out there that are so uncomfortable with it that the company is going to lose money over it? I, personally, don’t think so.”* As another member pointed out, *“There are obviously certain boutiques that could do quite well but if you stampede toward the smaller firms just because they’re independent you could wind up with someone who’s just not effective.”*

A “good” versus “great” independent compensation consultant

CCLN members took some time at the March meeting to highlight the qualities they find most valuable in their compensation consultant. In addition to looking for informed insight and subject matter expertise, they also value:

- **Independence.** As compensation committee chairs, members point out that *“there is a great dependence on the chair to tell the compensation consultant exactly what’s required in terms of objectivity. I want them to be an objective and independent sounding board.”*
- **Independent perspective.** *“It’s important that [compensation consultants] have independent opinions and don’t try to figure out what I want to hear or what management wants to hear.”*
- **No surprises.** *“Don’t bring grenades,”* one member said. Another echoed this sentiment, pointing out that, *“Management will come to the compensation committee meeting prepared to address certain things and then there have been a couple of times where the*

²⁰ [Ibid.](#)

consultant comes in and raises issues that weren't previously discussed and your whole conversation gets thrown off."

- **Focused on the company.** *"I tell my consultant, 'Don't just bring your favorite idea of the year – understand my company. Understand the nature of our business and how we're trying to create shareholder value.'"*

When faced with an underperforming compensation consultant, members shared that *"putting the account under review is incredibly beneficial. I had someone I felt was not quite as engaged as I wanted and putting the whole thing up for review was very helpful."* Added another member, *"Nothing puts [a consultant] more on their toes than being told that they are under review. Ideally, there should be a constant feedback process."*

Conclusion

CCLN members left the March meeting in agreement that the job of the compensation committee chair has not become any easier in the past year and predicted that it will not be getting easier any time soon. Still, as they reflect on the lessons of the past 18 months, members have been quick to find a silver lining: *"I think going forward, if nothing else, the recession gave compensation committees a little more 'oomph' in the discussion. I think things going forward will be a little different than we've seen in the past as a result of the events of the past year, but I think that might be a good thing."*

Another member remarked, *"I think the upcoming meetings [of the CCLN] will be important. I think 2010 will be a year of change for design and assessing. I think 2011 may look different and it's important how we can share with each other what we're doing about these changes."* In the meantime, a final member astutely pointed out, *"It's going to be an interesting year."*

About this document

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