

ViewPoints

Executive compensation in a fast-changing environment

On September 30 and October 1, 2009, the Compensation Committee Leadership Network (CCLN) convened in New York for its ninth face-to-face meeting. Members discussed the immediate challenges of the current economic environment and the longer-term implications for compensation plans, the potential impact of the shifting legislative and regulatory landscape, and a range of approaches to CEO evaluation. Over dinner members were joined by John Castellani, president of Business Roundtable, who shared perspectives and research on public attitudes toward business and discussed developments on corporate-governance reforms being considered in Washington.

The following members participated in the meeting:¹

- John L. Anderson, Hewitt Associates
- Lewis W. Coleman, Northrop Grumman
- Michael J. Critelli, Eaton Corporation
- Thomas J. Donohue, Union Pacific Corporation
- Dina Dublon, Microsoft Corporation
- David R. Goode, Caterpillar Inc. and Delta Air Lines
- Stephen P. Kaufman, Harris Corporation and Thermo Fisher Scientific
- Geraldine B. Laybourne, Electronic Arts
- Peter M. Miterko, Hewitt Associates
- Richard C. Notebaert, Aon Corporation
- Willem P. Roelands, Applied Materials
- Daniel H. Schulman, Symantec
- Samuel C. Scott III, Motorola
- Laurie Siegel, Embarq Corporation
- William D. Smithburg, Abbott Laboratories and Smurfit-Stone Container Corp.
- Jonathan P. Ward, Sara Lee Corporation
- Kelvin R. Westbrook, Archer Daniels Midland

¹ The compensation committee chairs are identified by their board membership. John Anderson and Peter Miterko 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 Compensation Committee Leadership Network.

Executive summary

The compensation committee's responsibility to attract, retain, and motivate talent in the interests of shareholders is difficult even in stable times. The turbulent state of America's economy in 2009, which has demanded both wisdom and decisiveness from corporate leaders, made corporate performance less predictable, and often depressed share prices, has presented unique challenges to compensation committees. These challenges have been exacerbated by the many proposals for corporate-governance reform put forward by legislators, regulators, institutional shareholders, and other advocates in response to public outrage over the near collapse of the banking system.

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

- 1. Reviewing compensation in 2009.** In light of the highly uncertain economy, most CCLN members struggled at the start of the year to set financial performance targets, some even opting to set separate targets for the first and second halves of the year. As the end of the year approaches, a number of companies are easily exceeding their targets while others are falling short, raising pressing questions for compensation committees. How do you set pay when management performed heroically but operating results are well below last year's or share price has dropped significantly? How do you set pay when the company's performance has much more to do with commodity prices or other exogenous factors than it does with management? How do you award equity grants when share price is down? How will the events of the past 18 months affect pay plans in the near future?
- 2. Considering the longer-term direction of executive compensation.** As CCLN members evaluate compensation in 2009 and begin to set targets for 2010, they also recognize important new realities that may impact the longer-term design of compensation plans. These realities include market volatility, the decoupling of stock price and operating results, issues with Black-Scholes, the need to consider optics, the need to understand risk incentives in pay structures, and the shrinking tenure of CEOs. How are these factors going to affect the compensation committee's use of discretion? The weight it gives to short-term financial parameters? The long-term incentives it offers the top team? The cash-versus-equity decision?
- 3. Understanding the public mood and the shifting regulatory landscape.** In his discussion of political and regulatory pressures on corporate governance, John Castellani, president of Business Roundtable, pointed out that members of Congress frequently misunderstand and mischaracterize the ways boards operate. He also noted that the public, frustrated with all businesses in the wake of the financial crisis, defines *corporate performance* primarily in terms of expanding employment and producing a good product, not short-term financial performance and stock price. For this fundamental reason, the public view of pay for performance clashes with that of most compensation committees. Acknowledging that CEOs are not credible participants in the compensation debate and that directors have little or no public voice, CCLN members discussed ways to get more involved in the effort to foster greater understanding.

4. Evaluating the CEO. Several members shared details of their CEO evaluation processes, revealing a wide range of approaches. Members were intrigued by a number of these approaches, among them the involvement of many board members and interviews with the CEO's direct reports. Value also was seen in asking the CEO for a self-assessment and a memo of understanding at the end of the process. Coming out of the discussion, members voiced a renewed commitment to an evaluation process that has the potential to boost the long-term performance of both the CEO and the corporation.

Reviewing compensation in 2009

Before the meeting, many CCLN members reported they would be reviewing business performance for calendar year 2009 in the fall and assessing results against targets set in a period of extraordinary uncertainty. *"This is the time of year [when] we do reviews to determine bonuses and decide whether we should make any changes to the compensation plan going forward."* Some were worried about the timing, that *"the tone among compensation committees is going to be one of 'Oh my gosh, how are we going to do all of this?'"*

A range of approaches to measure performance in 2009

By the end of 2008, after years of steady growth, median CEO pay at S&P 500 companies had fallen 6.8%, to \$8.4 million, due primarily to a 20.6% drop in the median annual bonus.² The negative effect on CEO and senior-executive wealth is far more pronounced when executive stock holdings – both LTI payouts and the loss of value in stock options and other amounts held in stock or related to stock price – are taken into account. Hewitt Associates recently assessed the changes made to 2009 LTI plans by reviewing Form 4 filings from S&P 500 companies. The results show that to date *"there has been a median decline in total LTI value of 20 percent, compared to a median stock price decline of 44 percent."*³ Additionally, 71% of the companies analyzed reduced LTI awards from 2008 to 2009. With multiples of salary in stock or stock equivalents, most senior executives have lost substantial amounts in the economic downturn.

Whatever the general trends, CCLN members report a range of approaches to measuring performance and setting targets in 2009: *"It strikes me that in 2009 we saw a lot more differentiation in the way companies were measuring performance than we did when winds were at our back and it was easier."*

Most members report that their compensation committees have been struggling to assess and reward performance in a period of economic tumult and poor visibility. *"There is a real challenge in figuring out how you come up with something out of the wreckage."* Members acknowledge that poor visibility had an effect on their 2009 performance measures: *"A year ago nobody in this group knew what was going to happen because there was so much uncertainty [about] the future ... We did our best to set performance targets knowing that we had limited forward visibility."*

² Julie Connelly, "Memo to comp committees: don't let investors or CEOs push you around," *Corporate Board Member*, third quarter 2009. Available at <http://www.boardmember.com/Dont-Let-Investors-or-CEOs-Push-You-Around.aspx>.

³ Hewitt Associates, "2009 trends in long-term incentive design practices and award sizes," May 2009.

Little correlation between stock price and management performance

One of the greatest challenges members are facing in their 2009 business reviews is reconciling management performance with financial returns. Many members share the frustration of the compensation committee chair who said, *“We’ve had a good year operationally, but shareholders haven’t – their stocks have halved.”*

Moreover, many members agree that often *“long-term incentives and annual incentives are designed to achieve different goals. We might want management to do something in the short term that might not drive value for some time.”* Said one: *“I think we all deal with the challenge that the decisions our management team makes today might not have a market effect until five years from now.”* And another pointed out that there are always opportunities to create short-term financial gain (*“Don’t spend the maintenance budget”*) that are inconsistent with the creation of long-term value (*“You will pay the price down the road”*).

Indeed many CCLN members report they are struggling with the dilemma of rewarding strong leadership and operational performance despite poor returns: *“You might have a dynamite year operationally, but the market won’t reward that right now ... Growing your company, meeting your targets, going above and beyond and doing everything well ... and then the company says [it] can’t pay you because the market says you didn’t do well? That doesn’t make sense.”* And one member remarked: *“I am a student of the idea that you can find out how good your managers are when they’re going into the wind rather than with the wind at their back. In a lot of ways I’m more impressed with what management did this year rather than last year, even if that performance has not shown up in the stock price yet.”*

For CCLN members, retention is one of the greatest concerns in 2010, and they continue to fight for their most valuable employees: *“Everyone was nervous about changing our pay plan because this was such a terrible year, but we’re dependent on having a very talented base of people.”* Another member pointed out: *“Everyone worries about public opinion; but if you’re in a situation where you’re afraid of losing your main horse, you have to cover your bets.”*

The importance of discretion

Given the unprecedented challenges of 2009 – the difficulty in setting performance targets, the volatility in the stock market, and the continued spotlight on executive compensation – how are members making compensation decisions? In a word: *discretion*. *“Having now been in the recession for over a year, we’re bringing much more rigor to the [compensation] process but holding on to this tool [of discretion]. We’ve taken the rust off it and are now using it in a more informed way. We’ve always had discretion, but now we’re [using it] more fully.”*

Specifically members report exercising a great deal of negative discretion in 2009, primarily a function of the fact that *“the targets we set at the beginning of the year had a great deal of conservatism baked in because we thought the world was coming to an end.”* In companies where management ended up exceeding those conservative targets, compensation committees found themselves asking why. Where performance was largely a product of external market

factors – for example, fluctuations in commodities prices – compensation committees adjusted payouts downward to more accurately reflect the contribution of management: *“We had to ask ourselves, ‘What things happened this year that were out of management’s control?’ This is one of the first years we really exercised discretion in a meaningful way, and we took the plans down.”*

A number of members described how they exercised negative discretion in 2009: *“This year we actually used greater discretion and knocked them down about 10%.”* Members agree that communicating effectively with management is key: *“We started the discussion [about possibly applying negative discretion] long before we had to make a decision. At the end of the year we charged management with coming back to us and building a bridge between target and actual. We told them, ‘Let’s look at the thing that drove performance and talk about whether it was something you did or something the market did.’”*

Some members report exercising discretion in other ways:

- **Making midyear adjustments.** *“At my company we split the year consciously and explicitly given that the market is absolutely irrational at this time. We only set targets for the first half of the year and then came back in July ... We did a midyear evaluation and determined in many cases [that] ‘this goal isn’t working out, we ought to make it this.’”*
- **Testing discretionary decisions against historical scenarios.** *“We went back and looked at the past five years to see how discretion would have affected pay. We said to ourselves, ‘Instead of sitting here and not knowing how this will evolve, let’s go back and do a sanity check.’ We tweaked the plan as a result because some of it didn’t play out the way we wanted.”*

Equity grants

Members agree that there has been *“no one-size-fits-all”* approach to equity grants in 2009. At the meeting they talked about several ways they delivered grants in response to the exceptional economic circumstances:

- **Share basis.** *“When we made stock grants, we pretty much hit bottom on the grant date. As a result we decided to issue the same number of shares even though that effectively doubled the shares. We went with the share-based stock grant because due to the extreme reduction in the value of shares, we would make it up.”*
- **Value basis.** *“Our stock component is based on value, not on shares. We had a debate about it but concluded that we were going to shift away from share-based and go with target values.”*
- **Sticking with the plan.** *“We basically kept the burn rate the same, and for the most part it played out how we had hoped.”*

Target payouts in 2009

CCLN members agreed last June that *“how you actually set and receive your target is very different this year.”* At the fall meeting, members confirmed this assessment: *“Over the past*

several years we had determined what a deep worldwide recession would look like [and set targets accordingly]. Then earlier this year, we blew right by anything we ever imagined would happen. Just hit the bottom and kept on going.”

Several members reported the percentage of target they ultimately paid out both historically and in 2009:

- *“The financial metrics represent roughly 25% of compensation. So 75% is in a whole bunch of other metrics. On that basis, the bonus award to executives came out to roughly 75% of target.”*
- *“The target we shoot for is 100%, but it could go above or below. The last five years I would say it probably was around 80% to 90%. It has ranged from 40% to 170%, with the average below 100%.”*
- *“In the past several years we had targets pay out at 180% and at 200%. They maxed out every year. It was designed to be a feel-good system ... [but] eventually you lose track of what ‘good’ is. Now we’ve broken back to two digits, but we’ve never gone all the way to zero.”*
- *“We’ve been all over the place. We’ve paid out between 120% and 150%, and then this year we’ll probably be at 45% to 50%. We’ve had some years the CEO missed completely and got zero. It really depends on the company and the year.”*

Communicating 2009 compensation decisions

As members reflect on how their executive compensation plans paid out in 2009, there is a general consensus that better communication is needed going forward: *“We haven’t done a good job educating our shareholders around the differences between short-term and long-term goals, and it’s always only today’s award that gets the headline in the newspapers. We have to do a better job pointing out that alignment.”*

Members shared several ways they are communicating their compensation decisions in 2009:

- **Issuing press releases.** *“We considered making [a positive adjustment] to the CEO’s compensation but didn’t do it in the end. What went through our minds very frankly was that the CEO needs to be able to look the workforce in the eye and say that he has taken a [significant] hit in compensation. We issued an immediate press release that said that’s what we had done because we knew we were about to make significant layoffs.”*
- **Including an executive summary with the CD&A.** *“We added an executive summary to the front of our CD&A that outlined what has worked in our plan and what hasn’t worked over the past several years.”*
- **Meeting with top shareholders to review the pay proposal.** *“Before we issued stock grants, the chief of investor relations and I went to see our 10 largest shareholders and went over an outline of the proposal to see if they were okay with that.”*

More-conservative pay plans in the immediate future

Members report that as a result of the events of the past 18 months, *“boards and management share an expectation of a lot more volatility and risk in the future.”* Consequently most members agree that any changes that are ultimately made to pay plans in the immediate future will be designed in a way to create more stability and predictability.

- *“I think we’re going to face another funny year as we think about both short- and long-term incentives, and my sense is that many companies are going to be conservative in how they think about next year’s grants.”*
- *“In 2010 I think we’re going to see probably a more conservative approach, similar to what we saw this year. In 2009 a lot of companies ‘broke the rules’ compared to what they’d done in the past, and my sense is that it’s still not a happy place to rest so there will be a more intentional model going forward. I think we’ll be midway between 2010 and 2011 before we start seeing some shifts.”*
- *“2010 might be even more conservative than 2009. Even though stock prices are somewhat back up, I don’t think they’re any more predictable than they were before.”*

In the end, CCLN members share a common objective as they review performance in 2009 and look ahead to 2010: *“We should focus on getting a handle on what we’re responsible for. I don’t want to be worried every moment about how underwater we are. We need to have some solid ground, and ultimately you just need to do the right thing.”*

Considering the longer-term direction of executive compensation

As one member pointed out before the meeting, *“We often focus on short-term, tactical responses – which are important. But should we also counter-balance with longer-term considerations? How is the game we are all playing changing, and what are its new rules?”* At the fall meeting, members continued to wonder what the new executive-compensation landscape will look like: *“I’m not sure what the new paradigm is going to be. Where does it say in the Bible that our mix is the right one? How deeply should we be rethinking the whole game?”*

What are the new rules of the game? First, members acknowledge that volatility in the markets makes target-setting problematic, particularly as stock prices are decoupled from operating performance. Second, they recognize that Black-Scholes pricing tends to distort option values, which suggests that pricing formulas may need adjustment. Third, they understand that some of the best executive performance happens during economic hard times and that acknowledging that performance can be crucial to retaining executives. Finally, they are fully aware that compensation committees must explicitly consider risk in the design of pay plans.

Moreover, given that *“the average CEO tenure in the U.S. is 4.2 years, less than half the 10.5-year average in 1990,”* members acknowledge that often the compensation a CEO receives during

his or her tenure is more dependent on timing (a “lucky cycle”) than anything else.⁴ As one member commented at the fall meeting, “*If it’s raining when you retire, you’re just out of luck.*”

An opportunity for change

Our members agree that the economic crisis could serve as a catalyst for reconsidering the design of compensation plans. Said one member: “*This is a great environment to go back through and scrub [the compensation plan] down and bring more rigor to the process.*” Added another: “*This economic crisis has brought about a lot of good. We’ve gone back and said, ‘Does all of this stuff make sense?’ As a result we’ve gotten rid of a lot of things. We charged management with telling us how this environment has allowed them to do more things that benefit the shareholders.*”

Members tell us that bringing in a new CEO also can provide an opportunity to re-examine the compensation plan: “*I think if you have a new CEO you should re-assess executive compensation because it’s one of the few times you can. CEO transitions are good times to at least rethink it or at least talk about it because how everyone else in the company gets paid rolls downhill from there.*”

A reward for sustainable performance

At the fall meeting several members ultimately agreed that one of the primary responsibilities of the compensation committee going forward should be to incentivize and reward sustainable performance: “*I think we should focus on the notion of paying for sustainable performance rather than just pay for performance. It can be an awkward thing to think your way through, but I do think it’s something that will help the ‘smell test.’ Where we get caught is with these big payouts when performance is poor. Going forward, instead of just measuring performance, you need to figure out how to measure performance that is sustainable and modify your plan in response.*” This compensation committee chair concluded: “*I think the best measurement for sustainability turns out to be the equity markets longer term. I think you essentially have to pay attention to business cycles.*”

Considering areas for review

As members contemplate what executive compensation will look like in the future, they recognize that even the best designed plans can have a measure of unpredictability and trigger unintended consequences. At the meeting they talked about ways to align long-term performance and rewards:

- **Considering the practicality of holding deferred stock.** “*We’ve been thinking a great deal about ... whether or not the top guy should be selling stock. If you hold it for 40 years and then go out the door, they think you took the company with it. Maybe we should be rethinking when they should take it off the table.*” Another member said, “*The press picks up on the number that’s vesting the year somebody leaves or the total deferred compensation,*

⁴ Vivek Wadhwa, “Why be an ethical company? They’re stronger and last longer,” *BusinessWeek*, August 17, 2009. Available at http://www.businessweek.com/technology/content/aug2009/tc20090816_435499.htm.

which is different from thinking about cumulative wealth ... [One former CEO] discouraged people from deferring compensation because he didn't want the headlines that come when you get 10 years of deferred compensation on the day you leave."

- **Changing the equity mix.** One member said, *"We aren't giving raises anymore and are instead issuing performance shares."* But another reported: *"We were on performance shares, but we're moving away from that and are now moving more toward options and long-term incentives as a greater percentage of the mix."*
- **Assessing the performance-cycle time frame.** *"There are always going to be things that change year over year, but there's not a sense of continuity, which gets to how you measure consistent cycles."* Noted one member: *"Almost everybody uses 3 years, but you might ask yourself if we should rethink that. Should we make it ... 5 years? 10 years?"* Another member shared: *"We're looking at a 7- to 10-year cycle now. It's a very long time, but it's meant to measure both the performance and vesting period."* And a third member said: *"Most companies I know, if you don't lay the foundation now, 5 years from now you'll be dead in the water. Everyone's making decisions now that will be determined down the road. We all have different things we look at [in] our companies though, and there's certainly no one-size-fits-all approach to this."*
- **Defining bonus versus salary.** *"We have moved into an environment in which bonuses never seem to go to zero. Even though they technically range from zero to whatever, it's very rare that we [are willing] to bring it down to zero. The whole notion of bonus was that it was supposed to be variable compensation ... If there's no floor, then you may as well call it what it is – which is salary."*
- **Utilizing caps and cliffs to dampen volatility.** *"We have to get some of these excesses under control. When you're designing a new contract, be careful what you put in there and perhaps add caps."* Another member said: *"We have cliffs around certain metrics, and if they don't make them, they don't make them. Below that we established a chunk of bonus that is highly discretionary. We've made the cliffs slightly wider because of the current environment, but we'll stick to them if they miss in the future."*
- **Considering absolute versus relative performance.** *"I see people moving away from absolute numbers and more toward a relative index – whether that's defined by the peer group or defined as an ... 'industrial group.' S&P has a number of subindices that no one can accuse you of having cooked up."*

Members also debated the merits of Netflix's corporate culture as defined in a slide presentation that has been widely shared via the Internet.⁵ One member remarked: *"It's an internal document that was a deep, passionate exposé on what their culture stood for and how they were designing compensation for that culture ... To have a slide show like that, that ties the compensation plan to*

⁵ The slide show is available at M. C. Siegler, "Other companies should have to read this internal Netflix presentation," TechCrunch (blog), August 5, 2009, <http://www.techcrunch.com/2009/08/05/other-companies-should-have-to-read-this-internal-netflix-presentation/>.

the company's values, was pretty darn interesting." Echoed another: *"I never thought that radically about the issues, and I think it's interesting. Could be a good way to shake up the thinking."* And another pointed out: *"I wonder how many of us have gone to the trouble of setting up a slide presentation on how the plans we're all approving tie into our cultural values."*

Finally, one member observed, *"This is a changing environment. Things are not going to be the same five years from now."* CCLN members agree that the evolving landscape of executive compensation demands ongoing discussion and that it is a subject we will return to in the future.

Understanding the public mood and the shifting regulatory landscape

John Castellani joined us at the meeting for dinner and discussion. Mr. Castellani initiated the conversation by making three broad observations:

- 1. There is a misconception in Congress about how boards operate.** "Congress has little idea how you operate; they assume how they operate is the way you operate. They think that the board is a body that represents individual constituencies, as in 'by a vote of 8 to 3 the board approved investment in Brazil, but by a vote of 5 to 6 additional capital expenditures were rejected.' Few understand how a corporation actually operates. So they defer to a model familiar to them."
- 2. There is a misconception in Congress about the dynamic between directors and the CEO.** "Congress still views corporate directors as merely the toadies of the CEOs. I've heard that from members of both parties – including some who served on boards a long time ago."
- 3. There is a disconnect in the way the general public defines good performance and the way investors and management define good performance.** "Pay for performance is not seen as a positive thing – it's viewed as 'paid for efforts.' The people want 'pay for results.' The conundrum we all face is when you sit down with the American people and ask them the attributes that they apply to good CEO performance, they say, in order, 'The company is hiring and creating jobs; creates good products; has good ethics; is responsible to its workforce; is responsible to its community; has good financial performance; and the company stock is performing well.' Those are the views that are driving the regulatory view of 'performance.' Investors and management, of course, would put the last two – financial results and stock price – at the top of their list. That mismatch is really what we're seeing right now."

One member was particularly struck by the third point: *"I think [the mainstream-consumer expectations that John Castellani highlighted] are great things for every company to do. Whenever I have conversations with consumers, they expect good companies to do those things as well. These are exactly what great brands should be concentrating on. I don't think we should see it as a tension but rather a reminder and an opportunity!"*

Overall, CCLN members found Mr. Castellani's observations *"insightful"* and *"eye-opening"* and agree that directors need to take steps to better understand the public mood and address the

disconnect “*between Main Street and Wall Street.*” As one member pointed out: “*We as directors always focus on Wall Street, and I think we need to shift our thinking more toward the middle because, like it or not, Congress is driven by Main Street’s agenda.*”

The need for a “board voice”

Almost all members share the view that “*we have not done a good job explaining how compensation committees and boards do their work.*” The issue, as Mr. Castellani observed, is how to “deal with a situation that’s explainable to everyone and understandable to nobody.” One member wondered: “*In the short term, where do we stand and fight? And in the long term, how do we improve the public’s perception of boards?*” And another member asked: “*How do we get across the message that the world has changed, [that] we’re not the toadies of the CEO and not the bad guys?*”

The discussion then moved to the value of establishing “*a coordinating nucleus*” of directors that would represent the directors and help address some of the widespread misconceptions that Mr. Castellani outlined: “*There clearly does need to be a voice. This uproar is begging for someone to make sense of it.*”

Although members agree that some action needs to be taken, many argue that “*setting up another organization ... is not any sort of solution.*” Several members suggest using existing affiliations to promote the voice of directors: “*Boards have changed a great deal – one of the most visible aspects being that there are more minorities and women on boards now – and we need to use these opportunities to [deliver our] message.*”

Members discussed several other ways to make themselves heard:

- **Op-eds.** “*Getting trained to write op-eds would be a very good thing for directors. If we actually write about what happens in boards and how they work on a more individual basis, I think it would help.*”
- **Blogs.** “*I think blogging is a fantastic approach. [We] need to be broad in our communication methods.*”
- **Employees.** “*One constituency we tend to overlook is our own employees. Part of the reason for that is that the board has always respected the wall between management and employees, but most employees don’t understand how boards work. [Among the members of the CCLN], that’s a couple million voters right there.*”

And many members shared the thinking of the compensation committee chair who said: “*With this call for action individually to address the public-myth perception, I’m reminded that change can start with one [person]. I’m really thinking about the next conversation I will be having with members of Congress from my district and making sure this is on my agenda. I didn’t appreciate the need to do that until I came to this meeting.*”

Specific observations on where legislation is heading

In recent months lawmakers and regulators have proposed a slew of reforms that, if passed, would dramatically alter the landscape of executive compensation specifically and corporate governance more broadly. Among the major initiatives are the Corporate and Financial Institution Compensation Fairness Act of 2009 (Representative Barney Frank, D-MA); the Shareholder Bill of Rights Act of 2009 (Senators Charles Schumer, D-NY, and Maria Cantwell, D-WA); the Shareholder Empowerment Act of 2009 (Representative Gary Peters, D-MI); the US Treasury's Investor Protection Act of 2009; and the SEC's proposed disclosure rules.

At the meeting members acknowledged that they 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. Although SEC chair Mary Schapiro said in a statement on October 2 that the agency will not vote on proxy access until early in 2010, proxy access remains one of the most significant and controversial proposals on the SEC's agenda.⁶ For their part, CCLN members continue to be concerned about the potential impact of the proposed changes. Said one: *"We're used to building on consensus; but with proxy access, we as directors will have to build on majority. I think we need to consider what consensus versus majority means for board members in the future."*
- **Majority voting.** *"The thing that really makes me pause is majority voting. It is a serious issue that we will be spending a lot of time trying to figure out [in the near future]. It gives a lot of power to the wrong people."* Others argue that majority voting is *"virtually a done deal"* but do not find it particularly problematic unless it is combined with other reforms.
- **Say-on-pay.** Members have long since accepted that nonbinding shareholder votes on executive compensation are inevitable. But 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."* Despite the general consensus that passage of say on pay is inevitable, preliminary results of a survey by compensation consultants Pearl Meyer & Partners show that "nearly 70 percent of respondents haven't taken any steps to prepare for 'Say-on-Pay,' and only a quarter say their companies are either 'prepared' or 'very prepared' for such votes."⁷

For now members report that they are not gearing up to address legislation they believe is less likely to be adopted in the near future – splitting the chairman and CEO role, for example, or

⁶ Quoted in "US SEC won't finalize proxy access until early 2010," Reuters.com, October 2, 2009, <http://www.reuters.com/article/americasRegulatoryNews/idUSN0213181320091002>.

⁷ Melissa Klein Aguilar, "Comp bill passed, poll reveals cos. unprepared for SOP," The Filing Cabinet (blog, *ComplianceWeek.com*), July 31, 2009.

mandatory separate risk committees. But they all agree that they will continue to weigh their approaches to different proposals carefully and watch the governance reform agenda vigilantly.

Evaluating the CEO

Almost all CCLN members report confidence in their CEO evaluation process. As one member pointed out before the meeting: *“In the old days, boards used to sit around for five minutes in January and say, ‘How’s old Dave doing?’ Then we’d ask ourselves, ‘What’s the competition doing?’ That was pretty much it. Now you have to be a bit clearer in how you assess these things.”*

Current approaches to CEO evaluation

The most common approach companies take to CEO evaluation is a two-step process that mirrors the standard performance management cycle: “Step 1: Define the CEO’s objectives. Before the start of the fiscal year, the CEO works with the compensation committee of the board to establish key short- and long-term business objectives, which are consistent with the company’s strategic plan ... Step 2: Evaluate the CEO’s performance. At the end of the fiscal year, the CEO’s performance is formally measured against the previously established objectives.”⁸

One member shared an example of a similar straightforward approach: *“We have a hard result that we set objectives for with growth, and then we have soft issues like succession planning. At the end of the year we discuss [CEO] performance as a compensation committee, discuss it at the full board, and then we bring the CEO in and discuss what’s been accomplished and what hasn’t. Then [the CEO] leaves, and we take a final look and come back on the compensation side and say how it plays out.”*

Members agree that the benefits of a good CEO evaluation are obvious: *“When the process works well, if the CEO has any significant flaws they show up like an open wound.”* Another member pointed out: *“The benefits are absolutely clear when the process is done well and the [CEO’s long-term] development is palpable.”* Before the meeting, one member told us that CEO performance reviews serve as a good leading indicator: *“To use a sailing metaphor, rather than having someone in the back of the boat saying, ‘You just missed a rock!’ I want someone at the front of the boat saying, ‘There’s a rock up ahead!’”*

⁸ Patrick Shannon, Colleen O’Neill, Nanci R. Hibsichman, and J. Carlos Rivero, “CEO performance evaluation – getting it right,” *Perspective* (Mercer), April 21, 2005. Available at <http://www.mercer.com/referencecontent.htm?siteLanguage=100&idContent=1180620>.

At the meeting members were intrigued by one compensation committee chair's somewhat unique approach to assessing the chief executive's performance:

A comprehensive approach to CEO evaluation: one company's process

"The [approach] we take is probably the most elaborate and participatory process I have ever witnessed."

- **All independent board members interview the CEO's direct reports and skip-level reports.** *"These are one-hour conversations, and each director speaks with roughly two to three people."*
- **The CEO writes his or her own performance review against annual goals.** *"The board and the CEO have all set and agreed to the goals for that year. We try to focus less on the past year [and more on] cumulative development."*
- **The head of HR solicits feedback within the company and produces a summary.**
- **The board discusses overall CEO performance in executive session.** *"We go through a process amongst ourselves and review what we discovered in our independent conversations."*
- **The lead director provides a summary, and the full board holds an executive session with the CEO to review the results of the assessment.** *"This is typically a one-hour discussion where we're providing a more nuanced review and discussing how we will tweak next year's goals as a result."*
- **The CEO and the compensation committee chair have a one-on-one discussion.** *"I subsequently have an independent session with the CEO to review compensation."*

Those who take a more comprehensive approach to CEO evaluation observe an added benefit: *"As a result of our one-on-one conversations with other executives in the company, we have much better insight into the succession planning process. Directors get much better exposure and insight into the problems and managerial strength below the top level."*

Variations on standard practices

A number of novel practices emerged from our discussion of CEO evaluation that piqued the interest of members:

- **Conduct exit interviews.** *"When key executives leave, we've now started to have multiple board members do the exit interviews. It's a good way to help solidify where the problems are."*
- **Review performance with the CEO as a full board.** *"We used to sit down one-on-one with the CEO, but I think it's better for the CEO and better for the board [to sit down together] because it's a good way to express their particular perspective on the process, on the goals, and on performance. It is a richer conversation than a one-on-one summary."*

- **Have the CEO write a memo to the board after the evaluation.** One former executive shared: *“After my evaluation [the board] would ask me to think about it for a week and then write a memo ... and synthesize what I heard and what could become actionable. Twice I wrote up the memo and got a call saying I had ‘over-heard’ or ‘under-heard’ what I thought [the board was] saying.”*
- **Conduct evaluations midyear.** *“I think the most effective evaluation of people happens when you’re not talking about compensation. Better to do it six months at the other end of the year – six months away from when you issue bonuses – because you can really get people to sit down and talk in a way that’s totally different. It really separates the coaching from the evaluating pay.”*
- **Give real-time feedback in executive sessions throughout the year.** *“Every board meeting we have an executive session, and after the meeting we always give real-time feedback to the CEO. We want the CEO to build a relationship with board members.”*

Ultimately most members share the optimism of the member who remarked, *“It sounds like we’ve definitely made progress [in CEO evaluations]. I’m pleased to hear we’ve moved away from the five-minute conversation. It’s clear we still have a ways to go, but I’m encouraged to hear how things are moving.”*

Conclusion

By and large, CCLN members left the meeting very satisfied with their ability to adapt their compensation decisions this year, in a period of extraordinary uncertainty and external pressures. They considered a wide range of potentially useful changes to plan structure and philosophy that reflect the realities of the economy, the stock market, public and shareholder sentiment, and the needs of the corporation. They reconfirmed that *“it’s not all about pay”* and took away a renewed commitment to rigorous CEO evaluation and feedback.

Above all, the discussions once again reminded us that board members have the responsibility, in partnership with management, to build great institutions for the long haul. Sustainable performance is the goal. This requires a steady hand on the tiller and the wisdom to do the right thing in the face of whatever short-term pressures that come along.

About this document

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