

ViewPoints

The Board's Role in Enhancing Stakeholders' Understanding of Executive Compensation

Introduction

On September 25, October 10, and October 12, 2006, the Compensation Committee Leadership Network (CCLN) met in a series of three small-group teleconferences to address the board's role in enhancing stakeholders' understanding of executive compensation policies and practices. The structure was the same for all three teleconferences. Approximately five members took part in each session. Multiple teleconferences were scheduled to accommodate members' schedules, maximize their participation, and ensure that a full range of perspectives was expressed.¹

The following members (identified by the Compensation Committee they chair) participated:²

- J. T. Battenberg III, Sara Lee Corporation
- J. Thomas Bouchard, Manpower Inc.
- Michael H. Bulkin, Bunge
- Jerry D. Choate, Amgen
- A. Steven Crown, Hilton Hotels Corporation
- John T. Dillon, DuPont
- Thomas J. Donohue, Union Pacific Corporation
- Diane L. Doubleday, Mercer Human Resource Consulting
- G. Steven Harris, Mercer Human Resource Consulting
- Bonnie Guiton Hill, The Home Depot
- Vernon R. Loucks Jr., Anheuser-Busch and Emerson
- Victor A. Pelson, UPS
- Stephen W. Sanger, Wells Fargo
- Daniel H. Schulman, Symantec
- Hugh W. Sloan, Manulife Financial

CCLN members believe their primary responsibility is to devise and implement effective executive compensation policies and practices in the companies they serve through independent leadership of the compensation committee. They also believe that these policies and practices can influence corporate

¹ *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule: Names of members and their company affiliations are a matter of public record, but comments made during meetings are not attributed to individuals or corporations. Comments made by members are shown in italics throughout the document.

The views expressed in this document represent those of the Compensation Committee Leadership Network. They do not reflect the views nor constitute the advice of network members, their companies, Mercer Human Resource Consulting, or Tapestry Networks. Please consult your counselors for specific advice.

² Arthur C. Martinez (ABN AMRO and PepsiCo), William A. Osborn (Caterpillar Inc.), and Samuel C. Scott (Motorola) took part in pre-meeting discussions but were not able to attend the teleconferences.

performance for the benefit of all stakeholders. Members seriously question whether compensation committee chairs in particular, or any board member, can or should play a substantial role in communicating with shareholders, shareholders' representatives, employees, the investment community, or the general public for the purpose of explaining executive compensation policies and practices — except under extenuating circumstances. Nor are members sanguine that other groups will step forward to take on this job.

Background

Public trust in private enterprise sunk to a modern low in the wake of the Enron, Tyco, WorldCom and other scandals. Congress enacted Sarbanes-Oxley legislation in July 2002 to address weaknesses in corporate governance. In October 2003, Peter Peterson, speaking to the Senate Banking Committee on behalf of the Commission on Public Trust and Private Enterprise, focused his remarks “on the Commission’s recommendations about executive compensation, which we consider the most fundamental and toxic cause of the serious breakdown of public trust in American business.”

In the three years since Peterson addressed the Senate committee, much has been done to restore trust in financial reporting and corporate governance through the conscientious, costly, and difficult implementation of Sarbanes-Oxley legislation. But the furor over executive compensation continues. There has been a crescendo of criticism aimed at everything from backdated options to the size of CEO pay award to generous supplemental executive retirement plans (SERPs) and non-business related perquisites. That criticism has come from any number of individuals, including academics, members of governance groups, institutional shareholders, newspaper columnists and editors, and shareholders at annual meetings.

The SEC’s new disclosure rules for executive compensation go into effect in early 2007. CCLN members fully expect that the upcoming proxy season will “*attract new levels of media scrutiny.*” In particular, the new disclosure requirements will “*arm critics*” with additional information about executive compensation. They also agree that “*the single compensation number*” is easily misunderstood and that disclosures around SERPs and non-business perquisites could “*draw attention*” and further “*aggravate*” observers.

Although easily sensationalized, executive compensation is in fact an arcane and complicated topic. Even business press professionals can show an alarming naïveté on the subject. Critics and advocates of change in corporate governance often lack any experience in the field. At times, they distort or misrepresent the facts — sometimes deliberately, other times for lack of understanding.

Against this background, members acknowledge that strong compensation practices, with clear links between pay and performance, may not be enough to counter the criticism that characterizes much of the current debate on executive compensation. “*Any of us could find ourselves in that position,*” said one member describing companies and committees that find themselves demonized in the media.

CCLN members clearly “*feel the pressure to respond*” to “*attacks on the compensation system.*” But no one seems to speak for compensation committees individually or collectively. Rarely does a compensation committee chair publicly defend the company’s pay policies and practices against public criticism. More often, a statement to the effect that the compensation committee is satisfied with its decisions is issued without elaboration.

Avenues for Communicating Executive Compensation Policies and Practices

A Fundamental Tension?

Members acknowledge the board's implicit responsibility to communicate with those who have a vested interest in the effects of executive compensation on corporate performance, including institutional and individual investors, corporate management, lawmakers and regulators, the larger business community, financial analysts, proxy advisory firms, and the public as a whole. *"Open communication with these people is constructive,"* said one member. Added another: *"Any communication with shareholders about CEO pay is more credible if it comes from the board."*

But members express little interest in communicating directly with these constituencies about executive compensation practices. As one member stated: *"I don't think we'll undertake an active campaign to go out and educate people."* In fact, members generally support a *"low profile"* approach, communicating no more than necessary about executive compensation. They cite several reasons:

- The complexity of the subject matter makes effective communication difficult. *"It took me three or four years to understand all the aspects of compensation on a compensation committee of a public company, and I am still no expert. Educating the broad public and every shareholder constituency is unlikely to happen."*
- Certain aspects of compensation cannot be disclosed for competitive reasons. *"It is a fine line. . . . The performance-based [elements of compensation] can only be discussed in generic terms. We don't want to reveal strategic information. . . . There are some things that we just can't put out there."*
- Public statements can create obligations that could have unintended consequences later. *"The more you communicate around how you measure plans, the more you are committed to that."*
- When a company's stock is performing well, shareholders generally are not concerned about CEO compensation. *"There are CEOs who have made a hell of a lot of money for themselves and for their shareholders. You never see these shareholders demanding an explanation of the pay package. . . . They are very accepting when the company and the stock are performing."*
- The actions of an individual company are unlikely to change public opinion or influence critics, especially those who have other agendas or who have *"already made up their minds."* *"The people who most want to get their hands on this information are not curious. They are adversarial."*

Although members are reluctant to speak out on compensation practices, they are worried that public outrage over executive compensation will *"spill over into the political process,"* producing *"legislation that would create regulatory issues, not just for compensation but for American business as a whole."* Members' views on the likelihood of such legislation vary, but all share the concern that a political response to executive compensation could have unintended negative consequences on corporate performance and competitiveness.

Members acknowledge a *"tension"* between, on the one hand, their desire for greater transparency and stakeholder understanding of executive compensation, and on the other hand, the compelling logic to remain relatively silent on the issue. They also acknowledge that there is no easy, *"one-size-fits-all"*

resolution to this tension. But they did identify and discuss four primary avenues for communicating with stakeholders: in proxy statements, at annual meetings, at private meetings, and through investor relations or public relations departments.

Proxy Statements

Fundamentally, members *“rely on the proxy statement as the primary vehicle for communicating”* compensation policies and practices to the company’s stakeholders. Generally, members share a concern that *“the quality of executive pay disclosure in corporate proxy statements has stagnated in recent years”*³ and the belief that new disclosure requirements will provide a more comprehensive picture of executive pay.

All CCLN members are actively engaged in complying with the new disclosure requirements on compensation. And all acknowledge that compliance could be combined with efforts to improve shareholders’ understanding of executive compensation practices. For some, that’s a compelling prospect: *“After getting initially pissed off about having to do this, we realized that here is an opportunity to begin down the road to greater transparency. This is the beginning of the opportunity to communicate compensation more holistically.”* But others, though committed to full compliance with the SEC requirements, do not plan to disclose more than the bare minimum of information. They don’t want to create future obligations during what they see as a transitional process: *“Once you put something into a graph or table on how companies link pay to performance, it is very hard to change. Certain expectations will be there next time.”* These members intend to start modestly and possibly expand both disclosure and explanation in 2008.

Although CCLN members see the proxy statement as the primary vehicle for communicating executive compensation policies and practices, they also recognize its limitations as a communications medium: *“We will all comply fully, but that doesn’t mean that people will read it and understand it.”*

Annual Meetings

CCLN members agree that the annual meeting is not a good forum for communicating with shareholders about executive compensation and that there is little to be gained from putting the topic on the agenda. *“Don’t create an issue if one isn’t being raised,”* cautioned one member. Another added that *“presenting investors with the compensation program . . . is like talking to customers about how you’re going to raise prices.”*

What about responding to direct questions from shareholders at annual meetings? Members generally agree that the board chair should respond to a direct question — especially if its purpose is informational rather than adversarial — or should ask the compensation committee chair to respond on behalf of the board.

Private Meetings with Key Stakeholders

Some CCLN members believe that private meetings with stakeholders’ representatives constitute *“an opportunity for better dialogue between business and advocacy groups.”* For example, one member

³ Mark Borges and Diane Doubleday, “A Call for Transparency,” *DM Extra!* (NACD), January 19, 2006.

has had successful meetings with representatives of CalPERS and the AFL-CIO to address each group's concerns about executive compensation.⁴

Other members caution that private meetings should be undertaken only under special circumstances and with careful consideration: *"There are so many different situations. Should a CEO meet with Fidelity or other shareholders? It's very hard to come up with a clean set of rules and guidelines."*

In some cases, concerns about Regulation FD — the SEC's rule governing fair disclosure — have led directors to reject private meetings.⁵ Members point out that there are *"certain things you cannot legally discuss."* But in its February 2004 report, the CII-NACD Task Force on Improving Board-Shareowner Communications concluded that Regulation FD does not "prohibit companies from engaging in private, one-on-one meetings with shareholders." The report states that "most communications that address corporate governance issues do not fall under the purview of Regulation FD."⁶

Said one member about the benefits and pitfalls of private meetings: *"When you go out there, you have to be prepared. You have to know what you're going to say and what you can't talk about. You also have to understand you're probably not going to change anybody's mind."*

Investor Relations and Public Relations

Members generally rely on the company's investor relations function to address all questions regarding executive compensation from the investor community, and on the public relations function to handle media inquiries. *"That's where all inquiries are supposed to go,"* said one. In other words, management, not the board, takes primary responsibility for communicating with stakeholders.

Compensation committee members are open to working with investor relations and public relations, although they seldom do. Instead, the human resources department usually briefs investor relations and public relations. *"You try to help them when they get those questions [about compensation], but they're usually pretty effective at saying 'We don't know the answer, but we'll get back to you.'"*

Of course, during a crisis, board members do whatever they need to do. Compensation committee chairs are highly motivated to avoid the kind of spotlight that recently was focused on the New York Stock Exchange, Pfizer, and The Home Depot.

⁴ These meetings were reported on favorably in the *Wall Street Journal* and described as "productive" by the union participants, who had previously been outspoken critics of the company's executive compensation practices. See Kaja Whithouse, "Move Over, CEO; Here Come the Directors," *Wall Street Journal*, October 9, 2006.

⁵ Council of Institutional Investors (CII)–National Association of Corporate Directors (NACD) Task Force on Improving Board-Shareowner Communications, *Framework and Tools for Improving Board-Shareowner Communications*, February 26, 2004, <http://www.nacdonline.org/images/White-CIITaskForce-2004-2-26-04.pdf>, 9.

⁶ Ibid.

If Not the Board or Management, Who?

Business Roundtable recently published a defense of CEO pay, a study carried out by Fredric W. Cook using Mercer HR data.⁷ The study concludes that CEOs' pay increases over the past decade or more were fully justified by increases in the market capitalization of the corporations they led. Although previous research arrived at similar conclusions,⁸ the Business Roundtable's report was denounced by some members of the media who pointed out that the organization is hardly a neutral party in this debate.⁹ It remains to be seen whether or not Business Roundtable, which is primarily a lobbying – not a public relations – organization, will continue to speak out on this topic on behalf of the business community.

Similarly, the U.S. Chamber of Commerce weighed in with some success to modify the proposed SEC disclosure rules. Should adverse regulation or legislation appear to be a serious threat, the Chamber certainly would be available to lobby on behalf of Corporate America. However, until that time, the Chamber is not likely to seek out opportunities to engage important stakeholders on this topic.

CCLN members do not expect the NACD, The Conference Board, or similar bodies to take aggressive action to educate the public about executive compensation.

Conclusion

Executive compensation has become a lightning rod for criticism of public corporations. The intensity of that criticism has increased over the past several years, exacerbated by the current options-backdating scandals. Members anticipate that the coming proxy season and regulations requiring increased disclosure will produce even greater public scrutiny and, in some cases, excoriation of executive compensation policies and practices.

CCLN members agree that despite SEC-mandated disclosure, executive compensation will remain poorly understood by even the closest observers and often grossly misunderstood by shareholders and their representatives and by the general public. They also are concerned about the possibility of new regulations or legislation that could have a negative impact on their organizations.

To date there have been very few attempts by compensation committee chairs or other directors to explain or speak in support of compensation practices. The Business Roundtable's modest effort to defend pay levels has been hampered by the organization's position as a representative body of CEOs.

Most CCLN members see no advantage to changing the way they communicate compensation policies and practices beyond what is required by the new proxy disclosure regulations. At least for now they intend to keep a low profile.

⁷ Frederic W. Cook – Mercer Human Resource Consulting Research on CEO Compensation for Business Roundtable, June 29, 2006.

⁸ For example, Princeton economist Xavier Gabaix observed: “The six-fold increase of CEO pay between 1980 and 2003 can be fully attributed to the six-fold increase in market capitalization of large US corporations during that period.”

⁹ See, for example, Gretchen Morgenson, “Is ‘Total Pay’ That Tough to Grasp?” *New York Times*, July 9, 2006.