

# ViewPoints

## Designing Effective and Equitable Executive Compensation Policies and Plans

### Perspectives and Guiding Principles for Compensation Committees

#### *Introduction*

Thirteen members of the Compensation Committee Leadership Network (CCLN) met on November 29 and 30 to share their thoughts on how to design executive pay policies and practices that shape and drive corporate performance while securing public trust in private enterprise.<sup>1</sup>

The following members<sup>2</sup> participated in the meeting:

- J. Thomas Bouchard, Manpower Inc.
- Michael H. Bulkin, Bunge and Ferro
- 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
- Samuel C. Scott, Motorola
- Hugh W. Sloan Jr., Manulife Financial

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

- Jerry D. Choate, Amgen
- A. Steven Crown, Hilton Hotels Corporation
- Arthur C. Martinez, ABN AMRO and PepsiCo
- William A. Osborn, Caterpillar Inc.

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<sup>1</sup> Members of the Compensation Committee Leadership Network include the compensation committee chairs of some of the largest and most respected companies in North America. Collectively they represent more than 40 publicly traded companies, more than \$700 billion in annual revenues, and more than \$1 trillion in market capitalization.

<sup>2</sup> The 11 compensation committee chairs are identified by their board membership.

## *Executive Summary*

Conversations among CCLN members revealed a common perspective and generated a valuable set of insights on key executive compensation issues. Out of the discussions a broad consensus emerged on a set of guiding principles that has the potential to materially improve the efficacy of executive pay practices.

### **The CCLN Perspective**

CCLN members believe that the system of executive compensation in the United States both attracts and retains leadership talent, and that high-performing CEOs deserve to be rewarded for creating economic value and strengthening the global competitiveness of the companies they lead. However, members also believe that CEO pay is simply too high in too many cases. The network urges compensation committee chairs to exercise greater care in determining executive pay and to be ready to defend their decisions, recognizing that they are the most credible spokespeople on an issue that is vital to securing public trust in corporations.

### **CCLN Key Insights and Observations**

This section provides a brief summary of members' observations on recent SEC disclosure requirements, particularly the Compensation Discussion and Analysis (CD&A). It also includes their candid insights on the principles and procedures they follow when crafting compensation packages and offers practical guidelines that other compensation committees can use in their own decision making.

### **The CCLN's Seven Guiding Principles**

CCLN members support the following seven guiding principles:

1. Minimize those elements of executive compensation that differentiate the CEO and senior executives from the rest of the employee population and do little to attract, retain, or reward executive talent.
2. Link the largest portion of executive pay to results by choosing a mix of metrics and pay elements designed to achieve specific objectives.
3. In cases where executives fail to perform at acceptable standards, make sure that failure carries commensurate consequences to pay.
4. Scrutinize and avoid practices that can result in excessive compensation.
5. Carefully examine the structure of peer groups used for benchmarking executive pay, and balance the influence of peer-group norms on pay decisions.
6. Exercise measured discretion, recognizing that in setting executive compensation, no set of hard-and-fast rules can substitute for the diligent deliberations of independent directors.
7. Be prepared and available to defend core compensation principles and the decisions that emanate from them.

### *The CCLN Perspective*

The American system of executive compensation has proved to be successful in attracting and retaining outstanding leadership talent, rewarding leaders for performance, providing incentives for continued performance, and aligning management's interests with shareholders' interests. Our system of executive compensation plays a vital part in the overall success of U.S. companies and the competitiveness of the U.S. economy. Members believe that an effective CEO can make an enormous difference to the success of a company — for the benefit of shareholders, employees, customers, and society.

However, CCLN members recognize that compensation systems occasionally fail. Members are highly critical of management fraud, deceitful and possibly illegal *“backdating of option grants,”* and large *“pay-for-failure”* awards. They have no sympathy for *“complacency on the part of the compensation committee.”* And they recognize the impact a few particularly noteworthy cases of overcompensation have had on corporate boards. As one member said, *“the visibility of some of these [cases] has cast suspicion on almost every board.”*

These failures have energized those who want to use executive compensation policies as a political wedge issue. For CCLN members, the use of executive compensation as a means to promote an agenda, legislative action, or corporate reform threatens the future of American business. Said one: *“Unless we change, American business ten years from now will be quite different from what it is today.”*

Importantly, members largely agree that CEO pay is simply *“too high”* in too many instances. *“I don't know what the exact number is, but I know it when I see it,”* a member commented, invoking Justice Stewart's famous standard. The excessive-pay issue cannot be dismissed as relevant to only a few isolated cases.

Nor do members support the idea that the pay of CEOs should be considered in the same terms as that of star athletes, performers or even hedge fund managers. *“When you're in the position of managing the trillions of dollars Americans have invested in these companies and providing jobs for tens of millions of employees, it is critical that you are seen as part of mainstream American society.”*

CCLN members are prepared to redouble their efforts to ensure that the programs they oversee are informed by best practice. They believe that executive compensation plays a vital role in the overall success of U.S. companies and the competitiveness of the U.S. economy. And they accept their part in this system with diligence and humility. They understand that it is *“not good enough to be right.”* Members are prepared to stand up and defend their policies and practices, and, in some cases, to engage in the broader debate.

### *CCLN Key Insights and Observations*

At the meeting, members offered candid insights into the principles and methods they apply when designing compensation packages. Here their observations are grouped by topic, to allow easy comparison.

#### **Disclosure**

CCLN members embrace the transparency in executive compensation embodied in the SEC's new disclosure requirements. In most cases, members had already seen a mock-up of the new disclosure

tables and even some CD&A Analysis drafts. Although they are concerned about the public's ability to understand the CD&A, they acknowledge its value as a means of communication. *"The upside of the CD&A is that instead of providing the minimum legalese, companies must put their selling shoes on."*

An area of the new disclosure rules that concerns many CCLN members is the requirement to disclose incentive plan performance measures unless doing so would cause the company competitive harm.

- *"Our executive committee has a specific set of objectives set by the CEO in conjunction with the compensation committee. At the end of the year, we then review [the CEO's] performance and [the CEO's] objectives. We can't put that in the CD&A."*
- *"To take the other side, if [the goals and objectives] are strategic targets that must be accomplished by the whole organization, do we think for a minute that data isn't widely available to investors?"*
- *"The CD&As I've seen drafts of, and the measures that are being disclosed, aren't any different from the numbers we disclose to investors. But there's not a lot of detail on anything but earnings and the return and sales growth and other basic measures that our companies use to drive competition."*

Disclosure requirements do not seem to have triggered significant changes in the plans themselves. Many have tightened up their stock option granting practices to eliminate any opportunity to manipulate grant date or price. Using the closing price on the date of grant as the strike price appears to be a popular approach because it avoids additional SEC disclosure requirements. Also some perquisites have been eliminated.

CCLN members are divided on whether the disclosure rules in themselves will drive future change in the level of executive compensation or in any particular practice:

- *"The transparency of the CD&As will lead people to think differently about compensation, [but there will only be] small modifications and changes to compensation practices."*
- *"One reason companies say they won't make changes [in response to the new disclosure requirements] is because these issues aren't new. A lot of companies have been making changes to options [and the like] for some time."*

Some anticipate that future change is likely in perquisites and post-termination benefits.

Although the members may disagree on the impact disclosure will have on corporate compensation practices, they are unanimous in their belief that disclosure will do little to enhance the public's understanding of this complex area or to assuage concerns about excessive executive compensation.

The CD&A requires companies to discuss how decisions are made. Most of the CCLN members said that the general counsel often attends compensation committee meetings now but does not necessarily serve as the secretary for the committee.

### **The Role of Committee Discretion**

The CD&A requires companies to address the use of discretion in setting compensation awards, prompting many committees to discuss how discretion should or should not be used. CCLN members agree that the board must retain a measure of discretion over pay awards. Fixed, formulaic

compensation processes cannot address changes in the broader market environment, individual retention or motivation issues, or the value recipients attach to their compensation.

- *“We had a situation where we rewarded our CEO for not hitting one of his objectives. We rewarded him for the discipline not to make the wrong acquisitions.”*
- *“Short-term [compensation] is formulaic and discretionary. The discretion ranges from 30 percent-plus to 120 percent-minus. . . . Long-term [compensation] is formulaic. There’s negative discretion.”*
- *“Twenty percent of our annual incentive plan is discretionary. It’s based on where you want to put the emphasis that year. It’s not a zero-sum game.”*

### Financial versus Non-Financial Metrics

Members agree on the importance of financial metrics in judging a CEO’s performance. Most also use some form of non-financial metrics in their compensation system, based on targets determined by the compensation committee or the CEO — building senior leadership, attracting high-quality people at all levels, and improving relationships with external parties, for example. In the course of discussions, an interesting question emerged: Should committees re-examine financial metrics when it seems those metrics will yield an unanticipated payout?

- *“To me, all metrics are financial. You may call certain metrics non-financial, but it’s still part of running a complex company that is driven by financials. The non-financials are there to make the financials happen. Ultimately, all your metrics should have a financial result.”*
- *“We do a grid with financial metrics. On the soft side, we have the CEO come to us and ask him what’s going to keep him awake and what he’s worried about. At the end of the year, he self-evaluates, and the board checks his annual evaluation. It’s great to know what’s in the CEO’s head.”*
- *“I lie awake worrying about our metrics. We’ve had terrific performance, but you have to wonder if our goals are ‘too soft.’ But we keep poking at that, and I ask the audit committee to look it over. But when you’re knocking down EPS and operating goals, something in the back of your head says, ‘Am I doing this right?’ An important part of the process is where do you set the goals and how do you do it?”*

### Talent Market

Members believe deeply that there is a market for CEO talent, although it may not always be efficient or fluid. CEOs and CEO candidates are regularly courted by executive recruiters, and mobility in the C-suite is a reality. Retaining a well-regarded CEO and building “bench strength” are responsibilities that the compensation committee takes seriously. However, members also agree that even a CEO with unique talent is likely to be forgotten if his or her successor performs well.

- *“The average person doesn’t understand what a CEO does. They don’t look at him as the overseer of 100,000 employees. If you believe in what CEOs do, you must compensate them properly.”*
- *“What happens when someone walks in and is ready to pay your CEO twice what you are paying him or her? Compensation committees exist to deal with these situations.”*

- *“These executives regularly receive lucrative job offers in other public companies and are increasingly sought after by private-equity investors. How are you going to keep your chairman if some private-equity firm offers him \$100 million?”*
- *“Some say CEO pay escalates because talent is scarce. Maybe not. There seems to be a pool of resources in this company that’s very deep when it comes to management talent.”*

### **Pay for Performance**

Members point out that some, but by no means all, of the highest-paid CEOs are being compensated at levels beyond those needed to attract, retain, or reward them. In addition, some moderately paid CEOs are overcompensated relative to the performance of the companies they lead.

- *“The real thing is we have to stick with the rules we make and penalize the CEO for a year that wasn’t a good year. We have to hold ourselves accountable.”*
- *“We eliminated dividends [on performance-restricted shares]. We said, ‘You’re rewarded a performance plan at the end of the three years equivalent to the dollar value converted to shares.’ [Previously,] if you got 1,000 shares, you received dividends on those 1,000 shares.”*
- *“What do you do if you have a company with a fairly long cycle? One management team is in there on the upside, and you pay them a lot. And then another management team appears on the downside of the cycle, and they earn dramatically less [even though] they have been performing at close to the same level.”*

### **The Relationship between the CEO and the Compensation Committee Chair**

One member asked CCLN members to elaborate on what they believe is the ideal relationship between the CEO and the compensation committee chair. The insights that emerged underscore the importance of communication and goal sharing.

- *“The important thing from the CEO’s perspective is making sure the comp chair understands what issues you’re facing. If the comp committee doesn’t recognize your issues, it’s a very bad situation and can be very frustrating.”*
- *“Comp chairs must understand that they’re not designing the company’s compensation. Comp chairs must look at . . . the objectives of this company’s compensation plan and . . . the appropriate metrics. Also, comp chairs often design plans in their own image. You have to make judgments relative to goals and the nature of the industry.”*
- *“[As a CEO] I spend a lot of time talking to the comp chair so he understands what I’m trying to do. It’s very important that I’m also on a compensation committee. I understand his perspective and can explain what we’re doing better.”*

### **Equity Compensation Portfolio**

For some time CCLN members have been using a portfolio approach to equity-based compensation that includes stock options, time-restricted stock units, performance-restricted stock units, and performance share units. Although many businesses customize compensation portfolios to suit the

specific needs of the corporation and its executives, CCLN members believe these instruments are most effective when they take into account *“an assessment of the value the recipients attach to the grant.”*

- *“We do only stock options. From a Black-Scholes standpoint, the relationship of equity to cash is probably half [to] two-thirds of the total package. The real value though, because of performance, is well in excess of a Black-Scholes expense calculation. As long as that continues to be the case, options are a great compensation instrument.”*
- *“We have a short-term bonus that’s based on very specific financial objectives that are valued by the entire board. The second element of pay is a three- or four-year restricted-share performance-based program. And then we have stock options that are driven by long-term performance over ten years and influenced by market forces and the performance of the company. One element is cash; another is market driven and driven by the position of the company.”*

### **The Role of Compensation Consultants**

CCLN members discussed the potential for conflict when the board’s compensation consultant is engaged in other consulting work for management. Most CCLN companies have reached at least an informal conclusion on whether and under what circumstances a consultant can work for both the compensation committee and management. Not surprisingly, there is no single answer for all CCLN companies.

- *“Part of the role of a comp consultant is more nuanced. It really has to do with how well a board is getting along with a company. It’s important to use consultants to create the right balance between board and management oversight.”*
- *“If [management] wants to use the same firm [the compensation committee] uses, that is fine. We have oversight.”*
- *“Committee chairs want trust and depth in the relationship more than anything else.”*
- *“The optics of any conflicts with consultants should be pure and clean.”*
- *“Our compensation consultant doesn’t do work for the rest of the company.”*
- *“Our consultant provides an executive summary of what he sees in the materials he’s presented and the conversations he’s had with management. The better the information he’s given, the better our working relationship.”*
- *“We wanted to avoid any ‘dueling-consultant’ views. We have a consultant who works for the committee. The consultant can work for management, but it takes prior approval from the committee.”*

### **The CCLN’s Seven Guiding Principles**

In the course of nearly ten hours of animated discussion, a set of principles to guide the work of compensation committees began to emerge. These principles, by and large, are not intended to replace

guidelines published by other organizations.<sup>3</sup> These seven principles are intended to inform the choices committees make on a particularly sensitive set of design alternatives. Further, these principles are consistent with the members' strongly held belief that each plan needs to be tailored to the unique circumstances of each corporation.

CCLN members support the following seven guiding principles:

- 1. Minimize those elements of executive compensation that differentiate the CEO and senior executives from the rest of the employee population and do little to attract, retain, or reward executive talent. These elements include, for example:**
  - Perquisites, such as financial planning, cars, housing, spousal travel, personal use of aircraft at company expense, etc.
  - Tax gross-ups of perquisites and benefits (such as gross-ups of taxable perquisites).
  - Post-employment benefits that are different in nature from those available to employees generally.
- 2. Link the largest share of executive pay to results by choosing a mix of metrics and pay elements designed to achieve specific objectives, recognizing that:**
  - Equity-based instruments are effective in aligning the interests of management with shareholders' interests.
  - Stock price is not everything when it comes to performance.
  - Operating-performance metrics reward excellent results even when stock price does not correlate with that performance.
  - Non-financial measures of performance have an important role to play in motivating executives and in setting priorities.
- 3. In cases where executives fail to perform at acceptable standards, make sure that failure carries commensurate consequences to pay.**
  - When hiring a CEO from outside, structure severance agreements to reduce large multi-year guarantees that can amount to pay for failure.
  - Trim back "conventional" severance provisions so that poor performance on the part of an executive carries a substantial financial cost to the individual.
- 4. Scrutinize and avoid practices that can result in excessive compensation. For example:**
  - Change-of-control agreements that can yield windfalls rather than simply ensure that management remains aligned with shareholders' interests during and after merger negotiations.
  - SERPs that can balloon in value when incentive payments are included in compensation covered by the plan.

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<sup>3</sup> For example, the National Association of Corporate Directors, The Conference Board, and Business Roundtable have each published useful guidelines and principles for compensation committees.

- Internal pay equity gaps between the CEO and the next tier of management that have widened over recent years and now are at an uncomfortably high multiple in some cases.
- 5. Carefully examine the structure of peer groups used for benchmarking executive pay, and balance the influence of peer-group norms on pay decisions:**
- Use multiple peer groups to assess company and individual performance as well the competitiveness of the compensation package.
  - Remove from peer groups companies with executive compensation practices that are outliers.
  - Calibrate peer groups by performance, size, and complexity.
  - Make compensation decisions based on a variety of data, and use benchmarking figures as a final check on internal calculations.
- 6. Exercise measured discretion, recognizing that in setting executive compensation, no set of hard-and-fast rules can substitute for the diligent deliberations of independent directors.**
- While these seven principles should guide the design of executive pay arrangements, each company needs to tailor compensation arrangements to its own unique set of circumstances.
  - Members of compensation committees are chosen for their independence and experience precisely because their independence and experience are valued in the decisions the committee makes.
- 7. Be prepared and available to defend core compensation principles and the decisions that emanate from them. For example:**
- When compensation is on the agenda at the annual general meeting, the compensation committee chair should be prepared to lead the discussion.
  - When shareholder or investor groups come to the corporation with legitimate requests for information and insight on executive compensation, the compensation committee chair should be part of the discussion.

### Conclusion

CCLN members see the need and the opportunity to change executive compensation practices without damaging the overall effectiveness of the programs. The CCLN Guiding Principles summarize members' insights regarding these needed changes in executive compensation practices. Members acknowledge that inaction can lead to legislative and regulatory policies that could limit the flexibility and creativity of American business.