

# ViewPoints

## Restoring Public Trust in Private Enterprise: The Compensation Committee in the Spotlight

### *Introduction*

Members of the Compensation Committee Leadership Network (CCLN) 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.

On June 20 and 21, 2006, the CCLN convened for its first meeting. Three topics previously identified by members guided the discussion: compensation committee priorities over the next 12 to 18 months, defining executive performance, and delivering pay commensurate with performance.<sup>1</sup>

The following members participated in the meeting (identified by compensation committee chair):

- J. T. Battenberg III, Sara Lee Corporation
- J. Thomas Bouchard, Manpower Inc.
- John T. Dillon, DuPont
- Diane L. Doubleday, Mercer Human Resource Consulting
- G. Steven Harris, Mercer Human Resource Consulting
- Bonnie Guiton Hill, The Home Depot
- William A. Osborn, Caterpillar Inc.
- Stephen W. Sanger, Wells Fargo
- Samuel C. Scott, Motorola

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

- Michael H. Bulkin, Bunge
- Thomas J. Donohue, Union Pacific Corporation
- Vernon R. Loucks Jr., Anheuser-Busch and Emerson
- Arthur C. Martinez, ABN AMRO and PepsiCo
- Victor A. Pelson, UPS
- Daniel H. Schulman, Symantec
- Hugh W. Sloan, Manulife Financial

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<sup>1</sup> *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.

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## Executive Summary

Wide-ranging candid conversations among CCLN members generated thoughts along three principal themes:

- 1. Tension in the executive compensation arena requires action, but what specifically should be done?** CCLN members believe the system of executive compensation in America largely works and plays a vital part in the success of global corporations that employ it. They also believe that attempts to significantly change compensation governance arrangements or hamstringing directors could jeopardize the future performance of business enterprise. Acknowledging some systemic deficiencies and too many ineffective CEO pay arrangements, CCLN members feel compelled to address specific problems while preserving the basic compensation governance system. Although a single director or company can make progress on these issues, the power of an individual director or company is inadequate in this fight. No existing body seems prepared to represent compensation committees on these issues and help shape needed reform. Could a critical mass of compensation committee chairs be assembled to take on this challenge?
- 2. The central issue in executive compensation is linking pay to performance — the devil is in the details.** Each corporation faces a unique set of circumstances related to its industry, its evolution, and its executive team. No single performance metric or compensation strategy is appropriate in all circumstances. Consequently, companies tailor their programs to their specific situation. Increasing the complexity here is the need to make payouts that are consistent with external perceptions of performance. Despite their careful consideration of payout levels, CCLN members acknowledge that it is an area where predictable outcomes are a laudable but often unattainable goal.
- 3. Executive compensation can be the foundation for effective management.** Incentive compensation is often tightly linked to specific management priorities, to encourage behavior and performance deemed to be crucial to the success of the enterprise. While the external perspective focuses on the fairness of executive pay, the internal perspective should focus on the key question “Is it working?” This disparity creates challenges for directors and can lead to confusion about the connections between pay and performance.

## *Tension in the Executive Compensation Arena Requires Action, But What Specifically Should Be Done?*

### The Situation

Executive compensation practices in the United States are in the press virtually every day. The public attention and regulatory scrutiny that were once directed at the audit committee are now focused on the compensation committee. As one member pointed out, it is not an overstatement to say that *“the [compensation] system is under attack”* from shareholder activists, politicians, regulators, and the media. CCLN members recognize the source of the criticism: the reported cases of executives who have abused their authority for personal gain; of seemingly generous payments to poorly performing and separated CEOs; of overgenerous compensation and benefits for even some strongly performing CEOs; and of disclosure practices that obscure total CEO pay from investors.

Although the members acknowledge these problems, they believe that published reports at times misrepresent both the issues and the frequency with which they occur. When an article describes total annual compensation that includes gains from an exercise of options, it may well leave readers to figure out the difference between annual pay and the exercise of stock options granted years earlier. And reported cases are often outliers — which make the best stories but don't necessarily represent the experience of most companies and their senior executives.

Still, CCLN members are acutely conscious of the need to strengthen both the governance of executive compensation and its transparency.<sup>2</sup> *“There have been cases, too many of them, where [compensation committees] have been too generous in paying people who haven't performed. That is pay for 'something' — possibly 'retention' — but it's not pay for 'performance.' This happens all the time, and it has to stop. We need to be a lot better.”*

The members are skeptical, however, about the agenda of some advocates for change. In particular, members raised questions about competition in the third-party investor advisory space and the potential for conflicts of interest where, for example, ratings and recommendations appear linked to an adviser's consulting business. Members would like to see more transparency around these groups' recommendations: *“How does the black box work and get interpreted by analysts?”*. They also seek greater focus around accountability: *“If investor advisers make the wrong governance recommendation, what is their accountability?”*.

CCLN members are concerned about some of the more ambitious changes to corporate governance that have been proposed by shareholders and groups representing shareholder interests. They believe that a number of these proposals represent a fundamental and revolutionary shift in the role and authority of boards of directors in their oversight of publicly traded companies. Similarly, members worry that if lawmakers enter the executive compensation arena, the results could be unpredictable and unworkable. For example, members cite the unintended consequences of previous congressional interventions, notably the golden-parachute tax and the million-dollar deduction limit. While most members agree that regulators and law makers would be unlikely to set specific executive pay restrictions, one member cautioned that *“You could see all kinds of very strange things if [lawmakers] get involved.”* Consequently, members want to be part of the solution, helping to inform the public debate and to improve the governance of executive compensation practices in publicly traded companies.

While media reports and some shareholders and advisory groups have focused on fixing the magnitude of executive compensation, CCLN members view the debate in the broader context of corporate governance. Members have strong reservations about the need for dramatic changes in governance and believe the *“stakes are high”* on two counts:

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<sup>2</sup> Members were generally supportive of the Securities and Exchange Commission's sweeping proposed changes to the disclosure rules to improve the transparency of executive compensation. They do not anticipate that the new compensation discussion and analysis requirements will trigger substantial changes in compensation plans. However, at least one member expects that *“there may be some surprises. There are some compensation elements that haven't been disclosed. When it's all broken down and put on display, I suspect that we will see some interesting numbers.”*

1. They believe that American-style executive compensation has played an important role in the success of American business. Members want to improve on the existing system, not remove its edge. They believe that the compensation system in the United States deserves at least part of the credit for producing some of the most competitive and vibrant companies in the most robust economy in the world. Members find that critics, *“often with a lack of understanding or experience on boards,”* are aggressively advancing an agenda to overhaul the governance and structure of executive compensation with insufficient appreciation for the many elements of the system that work well.
2. The increased number of critical media reports on executive compensation impugns the reputation of American business. Thus discredited, business will inevitably lose its voice in public policy debates. This collateral damage may be even more costly than the primary damage. One member feels that public opinion of big business may have fallen *“below the status it held in the days of the robber barons.”* So badly is business losing in the court of public opinion that *“not even the Republicans can stand up for business today.”*

### Potential Solutions

Virtually all compensation committee chairs and committee members take their responsibilities seriously. They work diligently to tailor executive pay to company circumstances; they are experienced and independent; they adhere to the highest standards of ethical behavior; and they feel they are generally effective. As one member put it, *“There is a lot of wisdom and insight”* in the compensation committees of large corporations.

To date, CCLN members’ efforts have focused primarily on the compensation programs that they oversee in their capacity as compensation committee members. Most board members generally have not participated in the public debate, challenged reported assumptions or conclusions, or proposed their own solutions to acknowledged deficiencies. Recognizing the need for improving compensation governance and the importance of restoring public trust in the system, members share a strong sense that the compensation committee as a governance institution has to exercise leadership publicly. *“[We] have to set a clear course and make that known to the investors,”* one member said. Said another: *“We have to take control of our own destiny . . . stand up and fight. [We can’t] expect someone else to do it for us. If a set of major companies does something creative and effective, you will see changes follow.”*

There is a sense that existing business organizations — for example, the Business Roundtable<sup>3</sup> and the Business Council — are positioned for policy action but do not represent the voice of the compensation committee. One member asked: *“What if 50 or 100 Fortune 500 companies could come together and agree on some compensation principles, like the portion of compensation that should be tied to stock performance?”*

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<sup>3</sup> The Business Roundtable issued a press release subsequent to the CCLN meeting that announced the results of a ten-year study of CEO pay and corporate performance, and specifically criticized misleading press reports on CEO compensation. See “Business Roundtable Releases New Research That Sets the Record Straight on Executive Compensation,” July 5, 2006, <http://www.businessroundtable.org/newsroom/Document.aspx?q=5906BF807822B0F1AD2408522FB51711FCF50C8>

That type of coalition does not seem beyond the realm of possibility. It might even include existing business groups and other organizations with a stake in the outcome (e.g., academia or shareholder groups). The idea, however, was left as just that — an idea.

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Members agree that *“the stakes are high”* for society, investors, and American corporations and their directors in the area of executive compensation. They share a belief that business drives our economy and has enjoyed a powerful voice in public policy debates. And they agree that it is essential for business to regain the high ground. As one member said, *“If we don’t get it right, someone else will set the rules for us.”*

### *The Central Issue in Executive Compensation Is Linking Pay to Performance — The Devil Is in the Details*

#### **Is Stock Price the Only Thing That Matters?**

One member posed a critical question for compensation committees: *“With respect to executive pay, is stock price the only thing that matters?”* Said differently, should *pay for performance* mean “pay only if the stock price goes up”? In support of this idea, another member asked, *“But shouldn’t the share price of a ‘successful’ company rise over some time period? Even if you looked over 10 years?”*

Stock price has long played a major role in executive compensation in the United States. In fact, stock options dominated executive compensation programs until the dot-com bubble showed that an increase in stock price may be unrelated to a company’s underlying financial performance. Believing that the market’s “rising tide raised all boats,” shareholders demanded a tighter link between compensation and performance and they complain bitterly about companies that make payouts when share prices are depressed. Indeed, criticism of high executive pay is seldom directed at companies whose shareholders also have profited handsomely.

CCLN members know the importance of achieving share price growth over the long term. They are also painfully aware that stock price does not always move with the underlying performance of the business or the CEO. That raises a question: When, if ever, is it appropriate to pay a CEO very well when a company’s stock price is moving sideways or downward?

#### **Performance Challenges Vary Widely**

Members described their companies and how they define performance. The stories they told demonstrate that circumstances vary dramatically, requiring markedly different, individually tailored executive compensation arrangements. *“Defining performance is a company-specific board challenge,”* noted one member. *“There is no template for defining performance. In fact, greater customization is needed.”* A common theme was the challenge of defining performance — and appropriate pay for performance — during times of corporate or business transition.

Consider the following examples cited by members:

- One company had been through a period of rapid growth and commensurate stock appreciation. Following a merger, the board needed to shift its compensation philosophy to one designed for a time of consolidation and slower growth.

- Another company is shifting from a decentralized and diversified collection of businesses to a centralized and sector-focused enterprise. The board believes this major restructuring will serve shareholders' interests in the long term, but that it will likely drive share prices down in the short term. Still, the board must reward and provide incentives to the company's executives if it's going to retain management leadership through the transition.
- A market leader recruited a CEO to design a growth strategy and spearhead a major rebuilding. The program has led to substantial growth and other notable improvements. The directors are fully satisfied with the CEO's performance and have rewarded him accordingly. Yet the company's stock price has fallen while that of its closest competitor has risen.
- A leader in its industry, one company has improved operating performance in virtually every metric and its stock sells at one of the highest multiples in its industry. Nevertheless, the current stock price is approximately two-thirds of what it was in 2000.
- The market leader in a global, asset-intensive, cyclical business, one company's share price fell gradually along with its peers over many years. "Shareholders" invested by playing the cycle: *"Short-term investors held shares for a week; long-term investors held their shares for a year."*

### Non-Financial Measures

Against this background of vastly different circumstances, members described the need for different approaches to defining performance. While financial metrics of performance are always important, members also describe the merits of including non-financial metrics such as customer satisfaction, brand awareness, demonstration of leadership attributes, and people development.

- At one company, product quality and market share drive 30 percent of short-term incentive pay, with operating income and revenue growth driving the remaining 70 percent.
- At another company, product quality also plays into the short-term incentive pay calculus, but specific divisional targets and metrics dominate pay at the second and third management levels.
- A third company incorporates customer survey results into the incentive pay of those who are in a position to influence customer satisfaction. One member commented that *"the customer really needs to be at the center of executive pay design."*

### Financial Metrics

By contrast, other members described the systems at three different companies where compensation is driven completely by financial goals. These companies pay cash for base and annual incentive pay, with stock option awards for long-term incentive pay. Those advocating this approach applaud its simplicity and ease of communication with employees. However, not all members agree. Said one: *"It's too easy to use only financial measures. If you do, especially if it is a shareholder measure, your business will end up in a lot of trouble."*

Adding to the complexity, even the financial metrics used by members come in a wide variety of "flavors," including earnings per share (EPS), total shareholder return (TSR), operating income, sales revenue, return on capital employed (ROCE), economic profit, revenue growth, return on net assets (RONA), and return on equity (ROE). Members expressed their concern over the ability to get it

right: *“We still worry about ‘Do we have the right measures?’ How do we link pay to the strategic plan?”*

One member noted that *“we have a hard time predicting goals.”* The comment was made in regard to single-year financial goals; clearly, multi-year goals are even more speculative. Another said: *“We went 12 years where the long-term plan zeroed out due to a failure to meet the RONA threshold.”* A third asked: *“If we set our operating margin goal at 20 percent and management blows through it, producing 30 percent, did they do a great job, or did we do a poor job understanding what was possible?”*

Members were not uncomfortable with the uncertainty inherent in choosing financial targets; they simply wanted to point out the realities they face.

### **Defining a Peer Group**

Virtually all members reported that they define a peer group of companies for the purpose of understanding the range of executive pay in comparable firms. The question is not whether peer group comparisons should be made; it is *“Who is in the peer group?”* For industries in consolidation, there may be only a small set of peers remaining. Very large corporations with multiple lines of business also can have difficulty identifying entities with a similar enough portfolio of businesses to constitute a peer. Another potential problem is comparing operating performance metrics across a peer group for the purpose of calibrating executive pay.

### **The Use of Discretion**

The topic of board discretion over pay awards revealed a range of practices and a variety of concerns:

- One company felt its highly quantitative goals yielded identical pay for division executives. It introduced discretion to allow top management to reward exceptional performance.
- At another firm, *“short-term incentive compensation is discretionary at a 1:3 spread. It gets your attention.”*
- Leadership evaluations at a third company led to discretionary short-term incentive awards of *“between 70 percent and 130 percent of target.”*

Members perceive an *“unfortunate”* move away from discretionary compensation toward fixed arrangements. Asked one member: *“You can explain it, but is it right?”*

### **Equity Awards**

CCLN members advocate a variety of long-term incentives, including restricted stock, performance shares, and ordinary stock options. Members like stock options, but they did express several concerns:

- *“Options are a powerful tool, despite abuses. Restricted stock is a sham. It is a surrogate for cash, not a performance vehicle.”*
- *“Options are still the best way to tie management and shareholder fortunes together.”*
- *“Options have a unique place. The requirements regarding expensing options will cause people to calibrate the value of options to the employee receiving them against the cost to the organization.”*

Members generally agree that Black-Scholes option pricing leads to perverse option grant policies. When the stock price is depressed, it leads to more options (at a given value) rather than fewer. “[Our] share price was so low that we were fearful of giving away too many options,” one member said.

### **Size of the CEO Pay Award**

No consensus emerged among CCLN members on one critical issue facing compensation committees: Has the size of the CEO pay package become excessive? But a variety of thoughtful questions were raised:

- What is the value of a marquee CEO who performs well against the targets carefully set and monitored by a fully engaged compensation committee? Is \$25 million or \$35 million per year too much?
- “Why shouldn’t a CEO be paid like a star athlete?” asked one member, who then added this qualification: “But they would need to be promptly fired or traded for non-performance.” A second member agreed, saying, “We have been too generous to people who do not perform.”

When asked how to think about whether there was a need to limit pay, members said the key issue was whether the total award was fair and equitable relative to peer-company CEOs. Members understand the Lake Wobegon effect – where everyone is above average – but they believe there is a market for CEOs, as for star athletes, and a fair market price. “We need to manage the expectations of the public and of management – including some who have a ‘get rich quick’ mindset,” said one member.

One member candidly concluded, “We don’t yet know what is the right amount.”

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Given the extraordinarily wide range of pay philosophies and practices currently in effect, and the uncertainty over precisely how to design compensation packages and set specific targets, it is not surprising that there are, as yet, no normative approaches more specific than the general principles outlined by the Business Roundtable<sup>4</sup> or the Commission on Public Trust and Private Enterprise.

Members unanimously concur, however, on the “need to put together a package of pay elements to reward different aspects of performance.”

### **Executive Compensation Can Be the Foundation for Effective Management**

Members agree that when the full package of performance metrics — financial and non-financial — shapes the executive compensation program, the program itself serves as the foundation for effective management. Indeed, members point out that “how the plan is used to manage” is as important as how the plan rewards performance.

“We spend so much time thinking about how these plans will be received externally, and we don’t spend enough time on how they will be applied internally.” The real question the members believe they should be asking is “Are they working?”

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<sup>4</sup> “Executive Compensation: Principles and Commentary,” November 2003,  
<http://www.businessroundtable.org/pdf/ExecutiveCompensationPrinciples.pdf>

One member suggested that *“anyone covered by the plan needs to understand how these plans work. Someone needs to sit down with each individual and show them how it affects them in order to translate the plan into the desired behavior.”* Another member suggested that *“for every incentive plan individual, there should be a quarterly review of where they stand.”*

But one member offered an opposing view. He cautioned against confusing the design of a compensation plan — for which simplicity can be a virtue — with the complicated job of leadership. Managing and motivating people throughout the organization cannot be guided solely by executive compensation arrangements.

For those who do see the benefits of leveraging the motivational power of well-designed pay plans in their management approach, non-financial metrics become an even more important dimension. *“It is easy to use a financial measure or a measure of shareholder value, but that is a reflection of many other things that are going on. If we want to focus on things that are really important — like safety in our stores or customer service — then we have to put those in the plan.”*

Members noted that while *“90 percent of the attention that the compensation committee receives is on CEO pay,”* the vast majority of the committee’s time is actually spent on leadership development and succession planning. As one member said, *“Succession planning is one of the most important responsibilities we have. It takes a lot of work. It is very time consuming. It is a hard job.”* Added another member: *“Organizations with strong succession planning and management development are top performers over time.”*

Finally, members believe that CEO evaluation, though closely related to CEO pay, is not at all the same. When the criteria used to evaluate a CEO are integrated into the incentive compensation plan, the conversation on performance evaluation *“gets . . . attention.”*

### Conclusion

The compensation committee is clearly in the spotlight. As one member concluded, *“All of us are trying to do the right thing. None of us have all the answers. . . . We need to get to the point where we can help people see that those dealing with [executive compensation] have knowledge and wisdom, and that good compensation practices contribute to shareholder value creation. It is up to us.”*<sup>5</sup>

Members left the meeting pondering many of the same important issues they brought to the meeting. They also left with a commitment to meet again in the fall and keep working on the problem, using the most pressing questions as a guide:

1. How much is too much? Do we have a problem with the size of CEO pay awards?
2. If we do have a problem, how should we address it?
3. How can we link pay more closely with performance when we are dealing with so many performance and personnel variables and unknowns?

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<sup>5</sup> In addition, CCLN members considered the role of compensation advisers in developing performance and compensation plans. Members were uniformly generous in their descriptions of their working relationships with compensation consultants. The group discussed how consultants could be most effective in their work with boards. That discussion is summarized in the Appendix, The Role of Compensation Advisers.

4. Setting aside external perceptions, are our pay plans working?
5. What can we do, individually and collectively, to revise and defend compensation governance and practices? How exactly do we take matters into our own hands and make progress?

CCLN members are committed to addressing these and other issues, and to improving the performance of their committees. As one member said, *“Executive compensation is a subject that is bothering everyone. We won’t get it right in one meeting, but we can get it better and deepen our understanding of what is going on.”*

## Appendix: The Role of Compensation Advisers

CCLN members suggested a number of ways that compensation consultants could be most effective:

- *“I think the role [of compensation advisers] is going to change. The consultants will play a greater role in pushing the compensation committee. They will need to be more strategic, lay out more radical ideas, and not just tweak the existing system.”*
- *“We look to our advisers to provide facts, data, and ideas — with the emphasis on ideas — but they are not the decision makers. We are.”*
- *“Like the audit firms that increased the capability of their partners and their staff support, the compensation advisers have to upgrade.”*
- *“We hire the individual, not the firm. It doesn’t matter who they work for. We want someone with knowledge and wisdom and moxie.”*

Members also addressed the issue of how they view the potential conflict of interest when a full-service consultancy works with both management (for example, on HR systems or outsourced operations) and the compensation committee (on executive compensation). Not surprisingly, there were a range of views:

- *“Our HR consultants do a lot of work for [the company], and we keep that separate from the board advisory work. My compensation advisers work for me exclusively.”*
- *“Our compensation advisers can do some other work [for management]. We don’t require complete separation, but we don’t want them to do a lot. We watch it.”*
- *“There is no policy that [compensation advisers] can’t do other work. We recognize that it is different people and different divisions doing the work. We review the consultant spending on an annual basis to be sure there isn’t a situation that might present a conflict.”*
- *“There is a perceived conflict of interest [if the same firm works for management and advises the board on compensation]. I don’t think it’s a big issue, but if you end up in the paper, [the media] will pick on everything. Companies need to take a look and be sensitive to the perception. That should be enough.”*

On balance, compensation consultants appear to face a tremendous opportunity as committees manage through this inflection point. Compensation consultants can “*upgrade*” by bringing ideas and independent perspectives to the table; while managing perceived conflicts with sensitivity.