

ViewPoints

Executive compensation in 2011: a hopeful look forward

On February 9–10, 2011, the Compensation Committee Leadership Network (CCLN) convened in New York for its 13th meeting since the network's inception five years ago. Members discussed innovative compensation practices, talent retention and management succession planning, and other top-of-mind issues for 2011.

During the meeting, members were joined by James Kim, managing director of Frederic W. Cook & Co. and head of the firm's San Francisco office, who shared his perspectives and research on innovative compensation practices. In addition, John Gillespie, coauthor of the best-selling book *Money for Nothing: How the Failure of Corporate Boards Is Ruining American Business and Costing Us Trillions*, joined members for dinner to discuss the role and responsibilities of corporate boards in American business.

The following members participated in the meeting:¹

- John Anderson, Meridian Compensation Partners
- Don Felsinger, Northrop Grumman
- Marshall Larsen, Lowe's Companies
- Gerry Laybourne, Electronic Arts
- Linda Fayne Levinson, NCR and Western Union
- Michael Powers, Meridian Compensation Partners
- Steve Sanger, Wells Fargo
- Laurie Siegel, CenturyLink
- Kelvin Westbrook, Archer Daniels Midland

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

- Tom Donohue, Union Pacific
- Bob Lawless, Constellation Energy Group
- Dick Notebaert, Aon Corporation
- Anne Stevens, Lockheed Martin

¹ The compensation committee chairs are identified by their board membership. John Anderson and Michael Powers 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. CCLN member quotes appear in italics.

Executive summary

CCLN members shared their experiences, perspectives, and insights in four broad areas:

Innovative compensation practices

Members considered innovative approaches to executive compensation, including (1) a carried-interest and bonus bank model, introduced to members by Mr. Kim, and (2) a leveraged restricted-stock (LRS) approach, introduced by Meridian Compensation Partners. While neither model is right for all circumstances, members appreciated that a carried-interest model uniquely addresses vexing goal-setting challenges and that leveraged restricted stock provides the enhanced leverage of options *and* the retention value of restricted shares.

Talent retention and management succession planning

CCLN members unanimously agreed that talent development and management succession planning are critical compensation committee responsibilities. They differ on how much emphasis talent retention merits. Nonetheless, members identified actions compensation committees can take to ensure robust succession planning, including supporting internal management job changes, encouraging top executives to participate on outside boards, and benchmarking talent externally as well as internally.

The board's role and responsibility in shaping good governance practices

During the conversation with Mr. Gillespie, members explored and advanced ideas about good governance on corporate boards. In particular, members discussed the responsibility of each board member to create a challenging, yet respectful boardroom culture. One member observed, *“When tension invades the room, boards have to recognize that tension and embrace it because it has a place in boardroom discussions. Part of a healthy process is addressing that turbulence in the board meetings.”*

Topics of interest in 2011

Members devoted a portion of the meeting to discussing several timely topics of interest:²

1. Frequency of say on pay, or “say when on pay”
2. Clawback provisions in the Dodd-Frank Act
3. Creating boards for spin-off companies
4. Separating the chairman and CEO roles

² Certain company-specific issues members discussed in this portion of the meeting are not included in *ViewPoints* for reasons of confidentiality.

Innovative compensation practices

Members recognized that many compensation plan designs are well established and well understood across industries. In fact, prior to the meeting, one member said, *“Most compensation plans are pretty similar, even across different sectors. For instance, the equity mix [in long-term incentives] is pretty much the same, and people are really stretched for creativity ... I think a part of this is because of groups like ISS [Institutional Shareholder Services]. Everybody is afraid of going outside the mainstream and becoming a target, but that really doesn’t allow for much innovation [in compensation plans], does it?”*

Moreover, members reported wrestling with setting financial performance targets and designing compensation plans in light of the continued economic uncertainty in 2011. One member said, *“A lot of companies have struggled to set performance targets in this volatile environment.”* Another added, *“We’ve been burned in the past by setting [operational] targets too low and having executives blow past them, [resulting in] large payouts. Meanwhile shareholders are concerned because TSR [total shareholder return] [is low].”*

In our February meeting, members expressed a desire to discuss new approaches, challenge one another, and find alternatives to the status quo. One member said, *“We’re working to think of new approaches and ways to address the volatile market and align with shareholder interests.”* Members’ discussion focused on two innovative approaches to goal setting and compensation: (1) a carried-interest and bonus bank model and (2) an LRS model.

A carried-interest and bonus bank model

One CCLN member brought up this particular model because of the unique circumstances that his company was facing. The member explained, *“We had three-year cumulative goals for long-term plans, but when the bottom fell out [economically], those plans paid out zero. We kept finding ourselves giving retention grants just to keep people. We were worried because we knew that this was a period that was a great time to go hunting for talent because executives were interested in recapitalizing their balance sheets. I said, ‘I’m tired of giving these ad hoc grants and three-year target setting ... It’s not [that we set] bad goals; it’s just that this environment prevents us from knowing what’s coming next.’ So I told myself, ‘We need to do something differently and innovate in an entirely new way.’”*

At this member’s invitation, Mr. Kim joined a portion of the CCLN meeting to introduce and explain this model.³

- **Pay a percentage of economic profit.** “First, you choose a metric that is familiar to the management team and works for your particular company, preferably a metric that has already been used in the compensation plan. You use that metric (for instance, modified economic profit) and identify a specific percentage of that amount that is paid to an executive. A portion of that percentage profit is paid directly to the management team.”

³ See Attachment 1.

- **Place a portion of the payout amount in a “bonus bank.”** “One-third of the executive’s pay is paid out immediately. The remaining two-thirds are placed into a bonus bank. The bonus bank then pays out a certain percentage of the total bank balance each year (see illustrative table).”

An illustration of the carried-interest and bonus bank model⁴

Target performance

(\$ in millions)	2011	2012	2013
A. Begin Bank	\$0.0	\$100	\$167
B. CEO Carried Interest \$	\$150	\$150	\$150
C. Available for Payout (A + B)	\$150	\$250	\$317
D. Payout Ratio	33.3%	33.3%	33.3%
E. Payout Amount (C X D)	\$50	\$83	\$106
F. Banked Forward (B - C)	\$100	\$167	\$211

For public companies, Mr. Kim suggested that this plan could be used as a component of the overall compensation plan. One member clarified: *“This plan would be used as a long-term incentive plan in combination with an annual bonus plan.”*

This model may work best in particular sectors or industries. For example, *“The [economic value] metric wouldn’t work for a company where the price of commodities just goes up and management is rewarded for being in the right place at the right time [rather than for something they did].”*

Members engaged in lively discussion of the potential benefits and drawbacks of the proposed plan. One member stated, *“It’s important to be aware of and anticipate the unintended consequences of any new thinking like this.”* Members pointed out the following benefits of the proposed plan:

- **It stabilizes payouts in volatile environments.** *“By measuring performance over multiple years and banking some portion of performance into the bonus bank each year, compensation committees can smooth out anomalies and allow for the ups and downs.”*
- **It protects sensitive performance target information.** *“You don’t have to disclose targets in this plan, and that is a definite up side ... You don’t want to have a plan where you have to disclose [that] our strategy is to go into X markets and acquire Y share of the markets.”*

⁴ See Attachment 1.

- **It imbues senior executives with a unique sense of ownership.** *“I’ve seen a private company use this plan. They use economic profit, and the executives get a percentage of it. These people make a lot of money, but they’re flying coach.”*
- **It correlates with long-term value creation.** *“What I like about this plan is that executives get paid according to how much value they create for the shareholders.”*
- **It does not require long-term goal setting.** *“Three-year goal setting is a problem for everybody. This could address some of those concerns.”*

However, members also noted a number of potential difficulties:

- **This model is uncapped.** *“I worry about the fact that this is uncapped. People are going to take issue with that – but you could always exercise discretion and even delay payments in some years.”*
- **The approach relies heavily on a single metric.** *“One really scary thing about this is relying on a single metric. You have to put a lot of faith into that single metric as really reflective of your company and encouraging the right kind of behavior from your executives.”*
- **Economic profit alone is an inadequate metric.** *“This feels a little too safe for me in that it doesn’t encourage [investing] in growth. You can grow the economic profit at the expense of the company by minimizing capital returns or not investing in the future.”* Another member agreed, *“You can generate economic profit in one year without immediately seeing that reflected in the stock price.”* Further, a member said, *“It could endanger some of the company’s charitable donations. If executives start thinking, ‘Every dollar we spend is my money,’ then they might ask the question, ‘Should we really be giving to our charitable foundation?’”*

An LRS approach

Michael Powers and John Anderson of Meridian Compensation Partners discussed another innovative approach to compensation: adding a performance element to restricted stock and restricted stock units (RSUs).⁵

In this model, companies grant a number of restricted shares with any vesting period, then “specify that increases or decreases in stock price over the vesting period will have a direct impact on either the number of shares actually earned or the value of the vesting date, or both ... LRS has the enhanced leverage characteristic of a stock option and the inherent value and retention characteristics of restricted stock.”⁶ Mr. Anderson added, *“With stock options, there is no downside risk, only upside reward. This model is more leveraged than restricted stock; you can lose or gain value more quickly.”*

⁵ For more information on this model as well as specific case examples, please see Attachment 2.

⁶ Jane T. Romweber and Donald G. Kalfen, *Enhancing the Performance Aspects of Time-based Awards with Leveraged Restricted Stock* (Lake Forest, IL: Meridian Compensation Partners, 2011), 1–2.

This model is attractive to some members who observed that pure restricted stock and restricted stock units are often a lightning rod for public criticism: *“The pushback on restricted stock is often that they’re not performance based.”* Another member said, *“ISS and institutional investors prefer seeing a performance element to restricted stock grants.”* One member commented, *“This would solve the problem of critics’ saying restricted stock has no performance element.”*

Other members observed that some companies have already begun experimenting with performance elements in restricted stock grants: *“We already set performance targets on our RSU grants. We set performance targets that trigger the restricted stock grant. The trigger is typically pretty low with RSUs, but it does add a performance element to the grant.”*

One member cautioned, *“Sometimes when we use restricted stock, our intention is not to attach performance to it. For instance, for retention purposes, pure restricted stock grants are essential. I’m not sure about attaching performance goals to restricted stock [in all situations].”*

Talent retention and management succession planning

CCLN members agreed that *“retention and succession [planning] is a critical piece of our job.”* However, CCLN members are divided over how much emphasis to give retention. One member underscored its importance: *“Retention [does] serve a purpose when there is uncertainty in your organization and you want to send a signal to people that everything is okay: you give someone restricted stock and talk about their value to the company.”*

Others were less concerned about retention issues: *“I’m not really seeing people leave [their jobs]. [Retention] is just not that much of an issue for us.”* One member suggested that companies should move beyond focusing purely on retention: *“Some people are motivated by the intangibles. They just want to know how their piece connects to the larger organization. We need to move beyond throwing money at people.”*

In fact, many members emphasized that succession planning, rather than retention, is the ultimate goal: *“Retention is not the goal. Having the right skills is the goal ... It’s okay for people to leave; that’s natural. If you had three people in a horse race, and one was chosen for the job, those two people will probably find great opportunities elsewhere.”* Another member said, *“Our focus is people development. We are serious about succession planning and have put specific processes in place to develop our pipeline.”*

Members acknowledge that although the board plays a key oversight role in retention and succession planning, ultimately *“It’s the management team that does the heavy lifting, every day, to get the work done. The board plays a role in assuring that there’s good clear thinking from management on retention and succession, but management takes the lead.”*

Nonetheless, CCLN members mentioned actions compensation committees can take to contribute to talent retention and management succession planning:

- **Support the management team in developing senior talent through internal job changes.** *“If there is a high-performing executive leading a particular business unit, and we see value in expanding [that executive’s] portfolio of experience by moving him into another*

area, the board recognizes that [the top management team may] undergo some pain [during the transition and adjustment period]. But it's the board's job to help management find the courage to make some of these difficult decisions and help management understand the value of taking risks."

- **Encourage management to provide high-potential individuals with development opportunities.** *"Giving people unlikely development experiences is important. At one company, the CEO gave one of his direct reports an amazing external-facing opportunity. It was a terrific decision as far as retention because the guy felt appreciated ... Another CEO sent his five high performers to a CEO development program, and although those executives were still at least five years away from being CEO, it gets them thinking about the job and develops loyalty."*
- **Discuss retention issues with senior management.** *"People quit bosses, not jobs. I always say to my people, 'If a member of your team leaves, I'm coming to you and asking why, because it's your job to understand why they want to leave their jobs.'"*
- **Create specific, tailored development plans for internal CEO successor candidates.** *"The potential CEO successors meet in small group dinners with the board without the CEO, which gives the board an opportunity to question them on anything. I've also used a corporate psychologist to make assessments of the candidates. Each candidate was also given an assignment where they were asked how they would organize the company if they were chosen as the next CEO. The board also gave the candidates their list of the characteristics of a good CEO, and we asked them to discuss how they think they measure up in those categories."*
- **Encourage outside board service for select members of senior management.** *"All of my boards try to get their senior people onto public boards. It does wonders for their perspective. It's really a critical development move, especially for someone being groomed for CEO. This person now has the opportunity to see firsthand how another CEO works with his board."*
- **Recognize board meeting participation as a development opportunity.** One member complained, *"We have 10 people in the board meetings, but I find it hard to have a candid conversation."* Another member stated, *"We have developed a system where three to four people from senior management attend the board meetings, and management is satisfied with that."* Another member added, *"Typically, we segment the meeting – we bring in senior executives for specific portions of the meeting, and then they leave and understand that we'll be having conversations just as a board."* Overall, members agreed: *"It's important for the senior executives and the board to have visibility to each other. They don't sit at the table, but it's educational for them. They're there to learn and observe, and they're part of the social experience and dinner afterwards."*
- **Benchmark talent externally.** *"We have a contract with an outside recruiter who knows our company very well. We give them a few job types where we have gaps, and they are obligated to introduce us to one to three people per month. We then screen those people and*

set up informal dinners with the top candidates between the candidate and the CEO. Oftentimes, we don't have a specific job in mind, but it gets our antenna up about who may be interested downstream and what the talent market is like. We modify the job profiles we give to the recruiters over time as our needs change ... This process is a source for talent in unanticipated openings, and it also allows you to benchmark your own talent and broaden your perspective about what [available talent] is out there." Another member praised this approach, saying that it allows companies to "avoid the spot market."

Overall, members agreed that companies should plan ahead, anticipating possible retention issues and developing internal talent. One member reflected, "We realized in one position that we didn't have time to develop the talent deeper into the organization, and we needed to go outside ... We want to avoid that in the future." Another member advised compensation committees to avoid "patching a hole in your management team and backfilling spots immediately when someone unexpectedly leaves. You need to work on developing deep bench strength over the long term."

The board's role and responsibility in shaping good governance practices

In their conversation with Mr. Gillespie over dinner, members acknowledged some egregious examples of corporate governance failures. However, members don't believe these problems are either systemic or reflective of today's environment.

Furthermore, they reject the characterization that CEOs "exercise powerful control over their boards."⁷ One member said, "There are always outliers. But ... this isn't a broader trend ... I don't believe your profile of a successful CEO is an accurate portrayal of today's leader. That sort of CEO megalomania [which you reference] is not tolerated."

The discussion with Mr. Gillespie sparked several observations from members about shaping boardroom and corporate culture:

- **They trust and respect each other and management.** "I agree to a degree that CEO has control over how much information the board receives. But when you're on a board, you have to believe and trust the CEO. If you don't, you need to get a new CEO." Another member said, "Respect among board members and the management team is essential ... Respect is different than coziness."
- **They challenge the CEO, when necessary.** "I like many of the CEOs I've worked with, but that doesn't mean I won't challenge them." One member noted, "Boards want candor from their CEOs. One difference between a good board and a great board is they challenge their CEO on his thinking and push him to defend his positions."
- **They embrace the tension in board meetings.** "On boards, there's a tendency to want to be liked. Both boards and senior management have the ability to influence each other and

⁷ John Gillespie and David Zweig, *Money for Nothing: How the Failure of Corporate Boards Is Ruining American Business and Costing Us Trillions* (New York: Simon and Shuster, 2010), 97.

have robust discussions. You have to create a cohesive board culture where people are comfortable enough disagreeing with each other and maybe even being disliked.” Notably, members remarked on how useful executive sessions can be for airing these tensions: *“After executive sessions, I saw the tenor on boards change. These sessions really shape the culture of the board and allow for positive, effective conflict between board members.”*

- **They know when to stand their ground.** *“We’re all on boards for our judgment; if you’re feeling uncomfortable, you should stand up and say it.”* Another member responded, *“At one of my companies, the [Securities and Exchange Commission (SEC)] challenged us and threatened us with an investigation. The board looked at the facts and knew the SEC had no case. You also have to have the courage to stand up and say, ‘You have no case, and I’m sticking with my management team on this.’”*
- **They trust their instincts.** *“My emotional literacy and intuition are strong. That’s a part of being a good board member – sensing when someone is hiding something from you or not being honest.”*

Topics of interest in 2011

Members devoted a portion of the meeting to discussing four key topics of interest to compensation committees:

- Frequency of say on pay, or “say when on pay”
- Clawback provisions in the Dodd-Frank Act
- Creating boards for spin-off companies
- Separating the chairman and CEO roles

Frequency of say on pay, or “say when on pay”

The Dodd-Frank Act requires companies to hold an advisory vote on compensation, known as say on pay, at their annual shareholder meetings beginning on or after January 21, 2011.⁸ Companies must also ask their shareholders to indicate whether they would prefer annual, biennial, or triennial say-on-pay votes, or they can abstain from voting. This vote is commonly referred to as “say when on pay.” Both votes are nonbinding and advisory.⁹

One member noted, *“At our company, we recommended three years, and the shareholders voted for one year. My sense is that no matter what the companies recommend, the shareholders will vote for one year.”* Members observed that ISS’s recommendation,¹⁰ paired with early indications of shareholders’ preferences for annual voting, portend say-on-pay votes every year at most companies. One member said, *“It looks like annual say on pay is the inevitable outcome.”*

⁸ Ted Allen, [“Two Different Approaches to Say When on Pay.”](#) December 6, 2010.

⁹ Corporations are not required to follow the wishes of shareholders.

¹⁰ Meridian Compensation Partners, [“ISS Releases FAQ Guidance Regarding Updated Compensation Policies for the 2011 Proxy Season.”](#) *Meridian Client Update* 2, no. 1 (January 19, 2011).

Looking ahead, members expressed concerns about next year and the practicalities of responding to possible negative say-on-pay votes. One member said, *“Proxies come out in April, but you’ve made your compensation decisions for the next year prior to when proxies come out [in January or February typically]. So let’s say you get a no vote on your compensation, you won’t be able to change anything for the next year, and you’ll look unresponsive. So how do we change that?”* Another member responded, *“You’ll just have to explain in the proxy that you’re changing things, but it won’t take effect until the following year.”*

Clawback provisions in the Dodd-Frank Act

The Dodd-Frank Act includes a clawback provision that significantly expands upon the scope and scale of the clawback provision in the Sarbanes-Oxley Act of 2002. For instance, the Dodd-Frank Act differs from Sarbanes-Oxley (SOX) in that while “the CEO and CFO are subject to clawbacks under Section 304 [of SOX], Section 954 [of Dodd-Frank] applies to any current or former executive ... and Section 304 applies to a 12 month period prior to restatement while Section 954 applies to a period of three years.”¹¹ Moreover, with Dodd-Frank, “there does not need to be executive wrongdoing involved to trigger the recoupment of pay.”¹² Dodd-Frank mandates that the clawback is triggered following an accounting restatement due to material noncompliance with any financial reporting requirements under securities laws. Congress has left many of the specific details and rulemaking around the clawback provision to the SEC, which “has indicated that it plans to propose rules during April–July 2011 (with no timeframe for adoption indicated, but presumably at least in time for the 2012 proxy season).”¹³

While virtually all CCLN member companies have clawbacks in place, members are troubled by the “vagueness and breadth”¹⁴ of the Dodd-Frank Act’s clawback policy. Many of the CCLN members’ concerns were addressed in a letter the Center on Executive Compensation sent to the SEC, excerpts of which follow in the discussion below:

- **The importance of board discretion.** The Dodd-Frank Act does not appear to permit any board discretion on how to enforce a clawback required by the new law. One member said, *“It’s important for boards to have discretion in how much to claw back and who to claw it back from ... I think it’s appropriate for the board to have responsibility to disclose the decision they made [about the clawback] and speak to the treatment of the clawback.”*
- **Cost to shareholders of recouping the compensation.** Members expressed concern about the possibility that the cost of recoupment could exceed the amount to be clawed back, *“It would be good not to have to spend shareholder money in court to claw back certain awards. There are many scenarios in which this would be dysfunctional.”*

¹¹ Randall J. Fons and Tiffany A. Rowe, [“The SEC Speaks: Aggressive Enforcement to Intensify in 2011.”](#) *Client Alert*, February 9, 2011, 3.

¹² Deborah Lifshay, [“Summary of Clawback Policies Under Dodd-Frank Reform Act.”](#) *Boardmember.com*, 1.

¹³ Jeffrey S. Klein and Nicholas J. Pappas, [“New Clawback Requirements For Listed Public Companies.”](#) *New York Law Journal*, October 4, 2010.

¹⁴ Timothy J. Bartl, [“Re: Comments on Executive Compensation and Governance Provisions in Title IX, Subtitle E of the Dodd-Frank Wall Street Reform and Consumer Protection Act.”](#) September 1, 2010, 1.

- **Scope of compensation recoupment.** One member said, *“The clawback should only occur if the compensation is related to the financial metric that was restated.”* Another member added, *“If you have a restatement on income and you have a compensation payout that links to TSR, how do you figure out the impact of the income restatement on TSR and resulting payouts?”*
- **Applicability across business units.** Members questioned a scenario in which one business unit’s circumstances trigger a restatement that then prompts a compensation recoupment across the company, negatively affecting unrelated, high-performing business units. One member asked, *“Is pay for performance really aligned in that situation?”*

Creating boards for spin-off companies

Members discussed the challenges associated with establishing a board for a newly created, large public company that has been spun off from another large public company. When creating this board, directors must fulfill a host of specific fiduciary and independence requirements.¹⁵

Members discussed how to assemble the optimal team of directors. One member emphasized the importance of building a positive culture amongst the individual board members: *“I’ve been on two boards that were spin-offs. I strongly advise thinking about the culture in the boardroom before you establish your board. When you start from scratch ... you have to be sure you’re aware of making the culture in the boardroom work. It’s about having really smart people, but it’s also about making the culture work and having a well-functioning team of people.”*

Determining the optimal structure for the newly established board is critical. One member is recruiting a non-executive chairman for the spin-off board: *“This is someone we really want to lend credibility and expertise to the board.”* Stephen Morris, who built the board for Arbitron when it was spun off from Ceridian, stated, *“I’m a big believer in having a non-executive chairman for spin-off boards. Setting up a board – the committee charters, the mentoring – everything needed to create a structure for the board is a tremendous amount of work. A spin-off CEO is learning and leading a brand new company. Having a non-executive chairman in the initial stages is a logical division of labor.”¹⁶*

In the case of a spin-off, the original company’s compensation committee may play a role in setting compensation for the spin-off’s board of directors. One member said, *“We are spinning out a company that is 25% revenue of the original company ... Setting the directors’ pay is difficult. We are providing some founders’ equity for directors, but we don’t want to pay in the upper quartile because, after all, this business is an underperformer, and that’s why we’re spinning it out – but we want to recruit successful, established board members to join.”*

¹⁵ A memo from the law firm Wachtell, Lipton, Rosen & Katz states, “It is more difficult than ever to recruit and retain directors who meet the requirements – including the increased legal and regulatory requirements imposed [on boards] within the past ten years – for experience, expertise, diversity, independence, leadership, collegiality and character. Competition for the best candidates is intense.” Jeremy L. Goldstein, [“Director Pay.” Harvard Law School Forum on Corporate Governance and Financial Regulation](#), February 26, 2011.

¹⁶ Charles H. King and Madeleine Condit, [“Spin-off Boards: Creating Dream Teams.” Corporate Board](#), November–December 2001, 12.

Separating the chairman and CEO roles

While some observers see a push towards greater separation of the chairman and CEO roles,¹⁷ members agreed that the appropriate leadership structure depends on specific company circumstances. One member said, *“This debate is highly circumstantial. At one company, it could be a terrific idea to have a non-executive chairman. At another company, the [joint] CEO and chairman role could work best.”* Another member said, *“At one of my companies, the CEO holds the chairmanship title, and it works well.”*

Meridian Compensation Partners observed, *“The high level of investor support for separation of the roles of Chairman and CEO is not consistent with the observed practice of large public companies. It remains a minority but growing practice to separate the role of Chairman and CEO. The high level of investor support signals that the practice of separating the roles of chair and CEO will likely become more prevalent as investors continue to put pressure on issuers to abide by this emerging ‘best practice.’”*¹⁸

Furthermore, members observed that in some cases, a non-independent chairman and CEO structure can work well: *“In one instance, we set up a CEO with a chairman (who was the former CEO of the company), and they both came to us after a length of time and said, ‘We’d like to continue this structure for longer because this is working for us.’ And we agreed.”* In general, however, members agreed that this structure works best for a limited period of time, such as *“six months to a year”* after the new CEO has begun.

Members suggested that boards communicate openly with the CEO to help determine the right leadership structure for the company: *“When we had a young CEO, we had three people on the board who we knew would make spectacular chairmen. We actually went to the CEO and said, ‘Which of these three directors would you embrace as chairman?’ It’s unorthodox, but it was important to get the CEO’s perspective.”* Another member said, *“We [the board] talk to the CEO about whether he’s ready to be chairman and when he thinks he’s ready to assume the title.”*

Members anticipate that splitting the chairman and CEO roles will continue to be a key governance question for companies throughout 2011.¹⁹ One member said: *“I think this is an issue we may encounter in the future. It’s no longer a fait accompli that the new CEO gets the chairmanship title. It’s something we think very carefully about and will probably revisit in the future.”*

¹⁷ According to Spencer Stuart, as of 2010, “40% of boards [are] now splitting the CEO and chair roles, up from 23% a decade ago. And 19% of chairs are truly independent, versus just 9% in 2005.” Spencer Stuart, [2010 Spencer Stuart Board Index](#) (Spencer Stuart, 2010), 4.

¹⁸ Meridian Compensation Partners, [“ISS Announces the Results of Its 2010–2011 Policy Survey.”](#) *Meridian Client Update* 1, no. 17 (December 9, 2010), 1.

¹⁹ Members realized during the course of the discussion that time did not allow for an exhaustive examination of the complexities involved in separating the chairman and CEO roles. Please see appendix for greater detail on the topic.

Conclusion

Members are mindful of how the latest round of corporate governance reforms, such as the Dodd-Frank Act's mandatory say-on-pay provisions and clawback requirements, will impact the compensation committee's ability to implement competitive, effective pay plans. One member said, *"We have to be two steps ahead, thinking about how these [reforms] might impact our companies and our ability to do our jobs."*

Despite their concerns, members are eager to continue shaping and refining the *"art of compensation."* They are not content merely to fulfill the legal requirements surrounding compensation structures and disclosures. On the whole, CCLN members are optimistic about the new challenges and enthusiastic about exploring innovative approaches to compensation programs: *"We're tinkering towards utopia. This is an art and will remain an art because there are so many variables that come into play. It's difficult to craft a formula that captures all those things and can be communicated so that shareholders understand it. The thinking is to frame these concepts and challenges to provide some clarity to shareholders. We provide the frame, but it is truly an art. There's no perfect formula for any one company, but we continue striving."*

About this 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, or Tapestry Networks. Please consult your counselors for specific advice.

This material is prepared by Tapestry Networks. It may be reproduced and redistributed in its entirety including all trademarks and legends.

Appendix: Additional information on the debate over splitting the chairman and CEO roles

The debate over the benefits and drawbacks of splitting the chairman and CEO roles is being carried out in many forums. A *Wall Street Journal* article summarized some of the pros and cons of splitting the roles: “Supporters of splitting the roles say the setup lets the CEO run the business while the chairman leads the board, recruits new members, and manages CEO succession ... Critics say separating the chairmanship can trigger power struggles and confuse staffers, especially when outside chairmen get involved in daily operations. Most CEOs prefer to chair their boards because ‘they think having one boss at the helm is better than having two.’”²⁰

Some groups, such as the Millstein Center for Corporate Governance and Performance at Yale University’s School of Management, strongly recommend that companies split the chairman and CEO roles. The center released a report stating, “Having an independent chairman is a means to ensure that the CEO is accountable for managing the company in close alignment with the interests of shareowners, while recognizing that managing the board is a separate and time intensive responsibility. The independent chair curbs conflicts of interest, promotes oversight of risk, manages the relationship between the board and CEO, serves as a conduit for regular communication with shareowners, and is a logical next step in the development of an independent board.”²¹ A 2009 study by the Corporate Library found that “companies with the roles combined tend to have less shareholder-friendly governance structures in general.”²² In addition, pressure from institutional shareholders to separate the roles is ongoing. The American Federation of State, County and Municipal Employees, which is the largest public employee and healthcare workers’ union in the United States, and the California Public Employees Retirement System (CalPERS), which is the largest US public pension fund, typically vote in favor of shareholder proposals mandating the separation of the chairman and CEO roles.²³

However, directors who are skeptical about the benefit of separating the roles suggest that there is little evidence that splitting the roles actually improves the performance of a company. In a July 2008 meeting of lead directors, members of Tapestry Networks’ Lead Director Network were “skeptical of the benefits of the European model of splitting the CEO and chairman roles: ‘I would like to see ... one piece of data that shows that the separation ... actually benefits the company.’”²⁴ In a prior CCLN meeting, network members observed that “CalPERS presses companies to conform to CalPERS’ approved governance practices, under the threat that they will otherwise pursue shareholder proposals to address their concerns. In its zeal for governance reform, some members believe that CalPERS pays more attention to its governance agenda than

²⁰ Joann S. Lublin, “[Chairman-CEO Split Gains Allies.](#)” *Wall Street Journal*, March 30, 2009.

²¹ Millstein Center for Corporate Governance and Performance, [Chairing the Board: The Case for Independent Leadership in Corporate North America](#) (New Haven, CT: Millstein Center for Corporate Governance and Performance, 2009), 1.

²² Annalisa Barrett, “[GM Combines Roles of CEO and Chair.](#)” *Corporate Library Blog*, January 26, 2010.

²³ Dawn Kopecki and Dakin Campbell, “[Calpers Votes to Split JPMorgan Chairman, CEO Posts.](#)” *Bloomberg Businessweek*, May 17, 2010.

²⁴ Lead Director Network, “[The Role and Value of the Lead Director.](#)” *ViewPoints*, July 30, 2008, 9.

to the primary drivers of those companies' weak performance, such as depressed sector performance, failure in R&D, bloated costs, etc. In this view, the leadership of these underperforming companies focuses on correcting operating and strategic problems, while CalPERS focuses on winning governance concessions.”²⁵ Members are likely to explore the various dimensions of this discussion at a future meeting.

²⁵ Compensation Committee Leadership Network, [“A Unique Moment in Time.”](#) *ViewPoints*, April 12-13, 2007, 7.

There are a number of benefits and challenges associated with bonus banks

Benefits

- Emulates economics of ownership in the entity
- Does not require goal-setting or negotiation of goals each year; participants are then directly aligned with shareholders and motivated to put in place proper goals for rest of the company
- For NEOs, does not result in reported compensation until payouts are earned
- Does not consume shares
- Banking concept is:
 - Consistent with best practices and used currently by financial institutions,
 - Allows for mitigation against excessive risk through adjustment feature, and
 - Provides incentive to minimize losses in down years
- Provides for uncapped compensation opportunities linked to a performance metric which is viewed as directly correlated to long-term shareholder value creation; payouts are always funded by performance (unlike share price)

Challenges

- Is not currently utilized by most publicly-traded companies
- Lack of cap can be viewed as encouraging excessively risk behavior, though banking feature would likely be sufficient mitigation
- Payouts do not necessarily correlate with increase in share returns in all periods
- Negative EP years can wipe out bank balances
- Separate plan for participants can create significant internal inequities or be viewed as excessive relative to external benchmarks
- Must be structured to comply for 409A and cash sublimits under long-term incentive plans may not be sufficient for 162(m) purposes

Illustrative Examples

Target Performance

(\$ in millions)	2011	2012	2013
A. Begin Bank	\$0.0	\$100	\$167
B. CEO Carried Interest \$	\$150	\$150	\$150
C. Available for Payout (A+B)	\$150	\$250	\$317
D. Payout Ratio	33.3%	33.3%	33.3%
E. Payout Amount (C x D)	\$50	\$83	\$106
F. Banked Forward (B - C)	\$100	\$167	\$211

Volatile Performance

(\$ in millions)	2011	2012	2013
A. Begin Bank	\$0.0	\$67	(\$33)
B. CEO Carried Interest \$	\$100	(\$100)	\$100
C. Available for Payout (A+B)	\$100	(\$33)	\$67
D. Payout Ratio	33.3%	33.3%	33.3%
E. Payout Amount (C x D)	\$33	\$0	\$22
F. Banked Forward (B - C)	\$67	(\$33)	\$44

High Performance

(\$ in millions)	2011	2012	2013
A. Begin Bank	\$0.0	\$200	\$333
B. CEO Carried Interest \$	\$300	\$300	\$300
C. Available for Payout (A+B)	\$300	\$500	\$633
D. Payout Ratio	33.3%	33.3%	33.3%
E. Payout Amount (C x D)	\$100	\$167	\$211
F. Banked Forward (B - C)	\$200	\$333	\$422

Enhancing the Performance Aspects of Time-Based Awards with Leveraged Restricted Stock

Jane T. Romweber and Donald G. Kalfen, Meridian Compensation Partners, LLC

Introduction

Regular time-vested restricted stock, while it has the benefits of being simple, retention-oriented and linked to shareholder value, has been criticized as mere “pay to stay.” It can be redesigned to be more performance-oriented yet still relatively simple, without the need for goal-setting or a peer group. We have termed the redesigned awards “Leveraged Restricted Stock” or “LRS” for short. (The term refers to either restricted stock or restricted stock units.)

LRS is stock-based and performance-leveraged, reflects shareholder value creation and results in actual stock ownership. It can be designed to meet the diverse reward, motivation and retention needs of most publicly traded companies.

LRS would be most appropriate where one or more of the following are present:

- There is difficulty in setting long-term performance goals or in developing appropriate peer group for relative performance comparisons.
- There is a desire to significantly enhance both performance and retention elements in the long-term incentive program.
- Grants will be made in a relatively healthy stock market, i.e., not during a bubble nor at an historical market low point.
- Severe market or stock fluctuations have interfered with stock options’ ability to be a true incentive.
- The company is concerned about high share usage attributable to stock option grants.

LRS Concept

The concept of LRS is as follows:

- Grant a target number of restricted shares with any vesting period.
- Specify that increases or decreases in stock price will have an impact on either the number of shares actually earned (Version A below) or the value on the vesting date (Version B below). Version A is simpler to understand and describe to participants, and is used in the examples on the next page. Version B may present additional design opportunities, however.

Version A: Increase or Decrease the Original # of Shares by the Same % as Stock Price Change	Version B: Multiply the Stock Price Change by a Factor (Sample Factor: 2)
<p>Example:</p> <ul style="list-style-type: none"> ▪ If price has increased by 30% at time of vesting, the participant will receive 30% more shares than originally granted ▪ If price has decreased by 20% at time of vesting, the participant will receive 20% fewer shares than originally granted 	<p>Example:</p> <ul style="list-style-type: none"> ▪ If price has increased by 30% at time of vesting, the participant will receive the amount of shares that would deliver a 60% increase in value ▪ If price has decreased by 20% at time of vesting, the participant will receive the amount of shares that would deliver a 40% decrease in value

LRS has the enhanced leverage characteristic of a stock option and the inherent value characteristic of restricted stock. Either or both of those can be enhanced through additional design features. For example, designs can:

- Include a floor on the number of shares to be earned, e.g., guarantee 50% of the original shares, primarily for retention purposes.
- Increase the multiple applicable to price changes, either symmetrically (e.g., 2X the percent that the stock price increases or decreases) or asymmetrically (e.g., 2X the percent *decrease*, but only 1X the percent *increase*).
- Subtract a fixed number of percentage points from actual results. For example, reduce change in stock price by 10 percentage points, turning a 10% stock price decrease into a 20% reduction in shares, and a 20% stock price increase into only a 10% increase in shares. This reduces the reward in the event of a flat share price.
- Cap the eventual number of shares that can be earned, e.g., 150% of the original number of LRS granted. This can help control how quickly the available share pool is used up, and avoid windfalls.

Example

The example below illustrates Version A with no caps, floors or enhanced multipliers. If stock price stays flat, it has the same result as time-based restricted stock. It amplifies stock price increases or decreases, however.

Scenario: Version A: Number of shares to be earned is reduced or increased by same percentage as stock price change	Stock Price Change				
	Significant Decrease	Some Decrease	Flat	Some Increase	Significant Increase
Initial Grant size (# of shares)	10,000	10,000	10,000	10,000	10,000
Price at grant	\$100	\$100	\$100	\$100	\$100
Stock price change	-40%	-20%	0%	20%	40%
Price at vesting	\$60	\$80	\$100	\$120	\$140
Total LRS shares actually earned	6,000	8,000	10,000	12,000	14,000
LRS vested value	\$360,000	\$640,000	\$1,000,000	\$1,440,000	\$1,960,000
For Reference: Value if Initial Grant had fully vested	\$600,000	\$800,000	\$1,000,000	\$1,200,000	\$1,400,000
LRS Value as % of above value	60%	80%	100%	120%	140%

LRS Compared to Other Vehicles

The following tables show how LRS compares to time-based restricted stock and stock options.

LRS vs. Time-Based Restricted Stock

Similar to Time-Based Restricted Stock	Different from Time-Based Restricted Stock
<ul style="list-style-type: none"> ▪ If the basic design is used, if stock price stays flat participants will still receive all or most of the original grant value ▪ Operates as a retention device, though with a lower level of confidence of payout than time-based restricted stock ▪ Links pay to how shareholders are doing ▪ If paid in stock, results in actual stock ownership ▪ Offers similar choices to restricted stock regarding how to treat dividends ▪ Taxation similar to restricted stock 	<ul style="list-style-type: none"> ▪ Designs without a floor cannot guarantee they will have value at time of vesting ▪ More performance-based and more leveraged than restricted stock; can lose (or gain) value more quickly ▪ Provides a more compelling performance story given preferences of institutional investors and their advisors, like ISS ▪

LRS vs. Stock Options

Similar to Stock Options	Different from Stock Options
<ul style="list-style-type: none">▪ Enhance the impact of stock price increases▪ Eventually can go under water unless a floor is set▪ Taxed as ordinary income	<ul style="list-style-type: none">▪ Deliver value even if stock price declines some or stays flat▪ Go under water more slowly▪ Not as highly leveraged on the upside▪ Not subject to employee choice as to when gains are taken▪ Taxation date is not tied to individual choice of when to exercise, but rather depending on the plan design either at vesting (for restricted stock) or at payout (for restricted stock units). (See below for additional details.)▪ Shorter performance period than 10 years▪ Simpler to understand and administer

Dividend Treatment

The illustrations do not consider dividends. For companies with a significant dividend, the choices regarding how to proceed are similar to those available for restricted stock or performance share plans. Common choices are listed below.

- Pay no dividend to LRS recipients during the performance period, given ISS pressure on this issue (but companies could grant more initial awards to counteract the value loss, if desired).
- Add dividends declared during the performance-vesting period to the number of shares finally earned (this is currently the median treatment for performance shares). Dividends either can be reinvested quarterly and increase the target number of shares, or be tacked on to the final award and paid in either stock or cash.
- Pay dividends as declared on the target number of shares (this is the most common current treatment for time-based restricted stock).

Share Usage

Depending on the design, fewer LRS may be needed from the shareholder-approved share pool to provide values similar to a combination of restricted shares and stock options. However, a company with a flexible share authorization (a term used when a plan document specifies that full share grants use up the share pool more quickly than stock option grants; also called a “fungible share pool”) would likely not experience that result.

Accounting Treatment

If LRS will be paid solely in stock, the accounting expense will be fixed at grant and amortized over the service period. Expense will be calculated using stock price on the date of grant and an estimated number of shares (i.e., as a percent of target) that will be earned based on probability of achievement calculated through Monte Carlo modeling. No increase or reduction will be made in the expense if more or fewer shares are actually earned.

If LRS can be paid in cash, grants will have mark-to-fair value accounting, and the entire amount paid will be expensed.

Tax Treatment

To the Company

If any part of the grant is guaranteed (i.e., if the design includes a floor), the grant will not qualify as performance-based under Section 162(m). To retain tax deductions, companies will want to grant or vest the awards under a performance override formula that does meet the Section 162(m) requirements.

To the Individual

The taxation date, and thus the date on which the amount of taxable income is determined as follows:

- For restricted stock, on the first date on which there is no longer a substantial risk of forfeiture. This is often, often but not always, the vesting date.
- For restricted stock units, on the date the stock or cash payout is received.

Summary

While not commonly used today, we believe that LRS can be an improvement on time-based restricted stock, still providing retention (which will be influenced by the specific design) while being more performance-based.

Disclaimer

Meridian Compensation Partners, LLC does not practice law or accounting. The conclusions regarding tax, accounting and proxy disclosure herein should be confirmed by counsel before relying on them.

For Additional Information

Contact Jane T. Romweber, a Partner at Meridian Compensation Partners, LLC for additional information regarding LRS, at jromweber@meridiancp.com. Contact Donald G. Kalfen, a Partner at Meridian Compensation Partners, LLC at dkalfen@meridiancp.com.