COMPENSATION COMMITTEE LEADERSHIP NETWORK
ViewPoints

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"What is our job?": Challenges facing today's compensation committees

On July 9 and 10, the Compensation Committee Leadership Network (CCLN) convened in New York to discuss challenges facing compensation leaders in today's large companies.[1] This *ViewPoints* summarizes network members' discussion on three important topics:[2]

- **Clarifying the committee's responsibilities with pay for performance programs** *(page 1)*

  Members discussed four questions related to evaluating and executing pay-for-performance programs: How are performance metrics set and evaluated? When should the committee exercise judgment in overruling formulas? What are the compensation committee's responsibilities for line employees? How does the compensation committee chair communicate pay philosophy and outcomes?

- **Responding to popular opinion about executive compensation** *(page 4)*

  While sophisticated institutional shareholders may not be concerned about the absolute value of a high-performing company's executive pay packages, the vast majority of Americans believe that, overall, executive compensation is too high. Many members of the public hold that executive pay over certain levels (e.g., $1 million) is never appropriate, no matter how well a company is performing. Public dissatisfaction with compensation levels can create challenges for a company and board, particularly the risk of misplaced regulatory reaction. Members discussed potential responses, including improving executive pay disclosure and better explaining the compensation philosophy for the full company.

- **Evaluating the 2013 proxy season** *(page 5)*

  Meridian Compensation Partners briefed members on the 2013 proxy season, noting that it was largely similar to 2012. Members discussed two recent changes at Institutional Shareholder Services relating to the importance of their qualitative assessment of pay packages and their opinions on the quality of performance metrics. Members also discussed the high-profile annual meeting at JPMorgan Chase and its implications for the separation of the CEO and chairman roles.

Clarifying the committee's responsibilities with pay for performance programs

Members agreed that the primary job of a compensation committee is to decide how to measure and reward individual, team, and corporate performance. There is general public consensus that performance-based pay is a good thing, but there is no consensus on how best to do it.

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[1] CCLN members were also joined for off-the-record conversations by two distinguished guests. Shawn Henry, president of the security technology company CrowdStrike Services and former executive assistant director at the Federal Bureau of Investigation responsible for cyberprograms and investigations worldwide, led a dialogue on cybersecurity risks. Zach Oleksiuk, vice president of BlackRock's Americas Governance and Socially Responsible Investing Group, discussed the investor's perspective on executive compensation and board-shareholder engagement.

[2] *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 are not attributed to individuals or corporations. John Anderson and Annette Leckie have elected to have some of their comments attributed. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

Many companies are taking a close, fresh look at how they measure and pay for performance. *"Every committee is recalibrating,"* one member said. *"We are rewriting the rules,"* commented another. Against that backdrop, members focused their discussion on four questions related to pay-for-performance programs.

How are performance metrics set and evaluated?

In some cases, new CEOs are enabling boards to look hard at their pay-for-performance plans, particularly their performance metrics. For many years, compensation committees have assessed and modified metrics and targets proposed by their CEOs and other senior managers. Today, though, they are increasingly identifying metrics and targets on their own or with the help of board compensation advisors.

Many members use both approaches, drawing both on management's in-depth understanding of company operations and on the outside perspective and independence of non-executive directors and compensation consultants. Several members suggested that boards are becoming more involved and empowered in setting metrics and targets at some companies. *"When I was a CEO, we talked about metrics with the board a lot less than we do today,"* one member said.[3]

Total shareholder return in focus

Total shareholder return (TSR) was the single-most discussed metric during the July meeting. Some members saw TSR, particularly relative TSR, as an effective way to link executive pay and company performance. Stock performance is "how the shareholders get paid, and that's important," one member said at a prior meeting. "We want to take the rising tide out [of the equation]. We want to reward performance because management's driving it, not because the market is going up."[4]

Others cautioned against overreliance on TSR. Several members said that no simple metric could capture the complexity inherent in a dynamic, global business. Some were concerned that their TSR metrics suffered from the noise of stock price volatility and a focus on the near-term returns at the expense of longer-term shareholder outcomes. Because a substantial percentage of compensation is paid in stock, heavy reliance on TSR can have an unhealthy compounding effect, one member said. Another member worried that *"TSR can reward underperformers."*

However, as John Anderson noted, *"The calculation of relative TSR can be customized in response to many company concerns. For example, committees should consider an extended averaging period – I prefer 60 days – to mitigate volatility risks based on shorter periods."*

[3] For more on pay-for-performance trends, see Meridian Compensation Partners, "2013 Trends and Developments in Executive Compensation," May 2013,

[4] Compensation Committee Leadership Network, "Spring 2013: Charting a Course for Tomorrow's Compensation Committee," *ViewPoints*, April 24, 2013.

When should the committee exercise judgment in overruling formulas?

Selecting the number and type of metrics, how they will be weighed and measured, and what the target payouts will be for different levels of performance is important, complicated, and time-consuming. No matter how much time is invested in these programs, they are imperfect, and members generally agreed that compensation committees and boards need scope to exercise discretion when an outcome is inappropriate. As one member bluntly said, *"The day you stop exercising judgment, quit."* Members felt that discretion was especially important for longer-term plans, since targets were often established years before a piece of business was brought to completion.

Determining when and how to exercise discretion is a challenge for compensation committees. Members told us that they were most likely to use discretion to increase payouts, especially when executives would have otherwise been *"punished"* for events outside their control, such as natural disasters. Other members commented that events outside of management's control could only be forgiven, for compensation purposes, if due and prior care had been taken to anticipate and respond to the event. They also cited examples of downward discretion; for example, Chevron's board recently trimmed both annual and long-term awards for executives because of a string of accidents.[5]

What are the compensation committee's responsibilities for line employees?

Compensation committees may discuss a company's overall compensation philosophy; their engagement with the compensation of more junior employees is often limited, but it may be growing. *"We should evaluate how much involvement we have in understanding how it all fits together below the [named executive officers], making sure that the whole thing makes sense,"* one member said. Members commented on the challenge of establishing performance metrics for divisions and business units that face disparate market environments. *"China won't be in profit for several years, and that's OK,"* one member said. *"But how do we reward that division head?"*

How does the compensation committee chair communicate pay philosophy and outcomes?

Executive compensation is perhaps the most salient aspect of corporate governance for the media and general public. It is also the single most frequent topic on which most directors and general counsel expect to spend time this year.[6] Compensation committee chairs may be asked to communicate pay philosophy and outcomes to different groups, and nearly all are responsible for explaining compensation to directors who do not sit on the compensation committee. Although no member felt that committees should speak directly to the press, many said they field compensation questions at the annual general meeting, and some also have direct meetings with large shareholders outside of the meeting. Courage and conviction are essential in these communications, members said: *"We have to believe in what we are doing."*

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[5] Daniel Gilbert and Joann Lublin, "Chevron Cuts Compensation for CEO John Watson, Others Over Safety," *Wall Street Journal,* March 29, 2013.

[6] Kimberly S. Crowe, "Law in the Boardroom," Corporate Board Member, Second Quarter 2013, Volume 16, No. 2 (noting that 60% of directors and 46% of general counsel expect to spend time on executive compensation in 2013, higher than any other topic for either group).

Responding to popular opinion about executive compensation

"Committees are more deeply involved in all aspects of pay for performance because the public thinks that we are paying outrageous salaries," one member said. In addition to refining their pay-for-performance systems, members struggle to respond to public dissatisfaction around executive compensation.

What the public believes

Some audiences, such as the community of large institutional investors, have no concern with large pay outcomes that stem from exceptional company performance; as one member said, *"I've never heard one of our major shareholders complain about the absolute value of pay."*

But others think that executive compensation beyond some absolute amount can never be justified, even when a company has created substantial shareholder value. Broad public opinion – what one member termed *"the voice"* – seems most concerned about inequalities either within a company or in society at large. A 2012 Rasmussen survey found that 69% of Americans believe that the level of pay and bonuses for executives at major US companies is too high.[7]

Popular opinion matters

Compensation committee members may see public criticism of executive compensation and say, "So what?" But the belief that executive compensation is too high can create friction with customers, employees, and the communities in which a company operates. *"The concern that pay was too high is part of the reason we have say on pay,"* one member said, *"and if we do not effectively respond to the criticism, we can expect more regulatory reaction."* Members mentioned recent developments in Europe, where reactions to perceived excesses in pay have led to regulations that have reduced the performance gearing of executive pay in some sectors; they want to avoid such outcomes in the United States.

In addition, talented young employees may not want to work for a company that is seen as contributing to systemic inequality. *"Concerns about excessive executive pay have consequences for talent acquisition,"* one member said.

Potential compensation committee responses

Public concern with the dollar figures reported for CEO pay packages seems to stem, in part, from the way pay is reported in summary compensation tables. In addition to meeting regulatory requirements, some companies also publish realized and realizable pay figures. One member said, *"[My company] is considering changing the timing of our equity awards to avoid the perception that an award based on one year's performance was unjustified because accounting rules make it appear to be tied to a different year."* Another member suggested that the CCLN *"examine the issue and propose an alternative way to present information in the [compensation discussion and analysis]."*

But some people will not be satisfied that a CEO's actual compensation was $11 million instead of a reported $35 million; both may be considered inappropriately large. Because these criticisms are often based on

[7] "17% Favor Government Regulation of All Executive Pay," *Rasmussen Reports*, April 23, 2012.

fairness or equality concerns, members suggested that better communicating their companies' overall pay philosophies, from bottom to top, may help mitigate popular complaints about company practice.

Members discussed the relative roles of the compensation committee, the board as a whole, and top management in communicating pay philosophy and in responding to volatile public opinion. *"Who proclaims to the public that the compensation philosophy and the compensation plan are fair?"* asked one member. Members agreed that, in light of a far more dynamic and diverse media universe than what existed even a few years ago, compensation leaders need to sharpen their skills both in listening to *"the voice"* and in responding to it.

Evaluating the 2013 proxy season

Meridian Compensation Partners briefed members on the current proxy season. This year's say-on-pay results are largely consistent with prior years, with 44 of the Russell 3000 companies (four from the S&P 500) failing to receive majority support as of June 27.[8] More than 75% percent received at least 90% support, while 6% received between 50% and 70% support from shareholders.[9] So far, 30 of 45 companies that failed to receive majority support in 2012 received greater than 70% support in 2013, with the majority receiving at least 90%.[10]

"There are two notable changes at Institutional Shareholder Services," Annette Leckie said. *"In prior years, if ISS's quantitative review of your pay package was successful, you would get an approval vote; if the quantitative review indicated a problem, a qualitative review could result in a 'yes' recommendation. This year, it seems that some negative qualitative results have resulted in 'no' recommendations even when the quantitative test was successful."* Ms. Leckie said that another disturbing trend is that *"ISS is now opining on the difficulty of the performance goals in the compensation plan. We are frankly concerned they are not equipped to make such a determination."*

Beyond say on pay, the 2013 proxy season has mainly concentrated on four areas of governance: separation of chairman and CEO, repeal of classified boards, majority voting, and removing supermajority requirements for amending the charter or bylaws.

Members discussed the year's most visible company meeting: JPMorgan Chase, where shareholders decisively rejected a proposal to strip the title of board chairman from CEO Jamie Dimon.[11] Some shareholders and governance advocates see the non-executive chairman as a more effective independent board leader than a lead independent director. Nonetheless, CCLN members thought that overall shareholder support for future proposals to separate the chairman and CEO roles at well-performing companies would not receive broad support.

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[8] Meridian Compensation Partners, "2013 Proxy Vote Outcomes to Date," *Meridian Client Update*, June 27, 2013.

[9] Ibid.

[10] Ibid.

[11] Dan Fitzpatrick, Joann Lublin, and Julie Steinberg, "Vote Strengthens Dimon's Grip," *Wall Street Journal,* May 21, 2013.

Despite shareholder attention, a majority of US companies still have a unified CEO/chairman.[12] Only 18 companies in the S&P 500 have a formal policy mandating an independent board chairman,[13] but others have nonetheless separated the CEO and chairman roles. The number of companies with separate CEOs and chairs rose from 25% in 2002 to 43% in 2012.[14] A percentage of independent chairs are only in short-term transitional roles; one member said, *"I just had someone do research on this, and only 27% of the Fortune 1000 have long-term independent chairmen in place."*

Throughout the meeting, we heard members express greater confidence in their ability to persuade institutional investors, proxy advisors, and voting shareholders to support compensation plans. With courage, conviction, and, as one member put it, *"readiness to show your work,"* a board has a good likelihood of gaining shareholder support for a thoughtful compensation plan. Gaining support from the broader public remains a challenge.

Conclusion

Each compensation committee chair faces different challenges, and these challenges shape the role and responsibilities of each committee. Some chairs take the lead in creating pay-for-performance plans, while others serve as well-informed evaluators of plans drafted by management. Some chairs take an active role in engaging directly with their largest shareholders, while others work with management to make sure that the board is aware of investor opinion. Some chairs devote committee time to understanding how the company's pay philosophy affects junior professionals, while others focus primarily on the most highly compensated employees.

One size does not fit all. Nonetheless, the question "what is our job?" – as compensation committee leaders, board members, and influencers of public opinion – is one that we expect CCLN members will revisit in future meetings.

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[12] Spencer Stuart, *2012 Spencer Stuart Board Index* (Spencer Stuart, November 2012), 12.
[13] Ibid., 23.
[14] Ibid., 6.

Appendix: Contributing members[15]

The following members participated in the discussion:

- John L. Anderson, Meridian Compensation Partners
- Thomas A. Dattilo, Harris Corporation
- David R. Goode, Caterpillar and Delta Air Lines
- Karen N. Horn, Eli Lilly and Company
- Marshall O. Larsen, Lowe's Companies
- Annette Leckie, Meridian Compensation Partners
- Marjorie M. Magner, Accenture
- Steven S. Reinemund, Marriott International
- Laurie Siegel, CenturyLink
- Marc Ullman, Meridian Compensation Partners
- Kelvin R. Westbrook, Archer Daniels Midland Company

The following members took part in pre-meeting or post-meeting discussions:

- Lloyd H. Dean, Wells Fargo
- Thomas J. Donohue, Union Pacific Railroad Corporation
- Anne Stevens, Lockheed Martin Corporation
- Samuel C. Scott, III, Bank of New York Mellon Corporation

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[15] The compensation committee leaders are identified by their compensation committee membership. John L. Anderson, Annette Leckie, and Marc Ullman participated in their capacity as compensation experts.