COMPENSATION COMMITTEE LEADERSHIP NETWORK
ViewPoints

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Enhancing compensation committee performance and shareholder communications

While compensation committees at large public companies share similar objectives, they often take different paths to achieve success. Whether in the way members prepare for and run committee meetings, evaluate their own performance, or structure their public disclosures, each compensation committee faces an endless string of choices as it addresses the issues on its agenda.

On October 3–4, 2017, Compensation Committee Leadership Network (CCLN) members discussed how they, as compensation committee chairs, approach the job and shared ways in which they have been able to improve their own performance and the performance of the committee. They also engaged in a conversation about the best ways to communicate the results of their work. This *ViewPoints* presents highlights of CCLN members' conversations on these topics.[1]

Enhancing compensation committee effectiveness

CCLN members discussed techniques they use as compensation chairs to help ensure committee effectiveness. To fulfill their objectives, members take a range of steps to engage before, during, and after committee meetings.

Pre-meeting preparation is essential to success

A committee's success depends at least as much on the work that directors and managers do in advance of meetings as on what happens in the meetings themselves. Members shared some of the things they do to prepare for meetings.

Setting the committee's agenda

Establishing an agenda that covers the necessary issues while remaining flexible enough to accommodate emerging and future areas of concern is an ongoing issue, members said. Many committees use the charter as the starting point by matching annual obligations to specific meetings over the course of the year. One member explained, *"The bulk of the agenda is set by the calendar. As we go through the year, we check off the various responsibilities."*

From there, members work with management and their compensation consultants to fine-tune their meeting agendas. One member said, *"The company comes to me with a draft of the agenda. I have ideas about new items to add to the things that must be completed."* Another member stressed, however, that the committee must drive the process: *"I disagree with the premise that management sets the agenda. This is our role and we choose the topics. We will figure out what we want to talk about and what changes we want to make to the agenda."*

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[1] *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. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

Working with management to prepare

In advance of committee meetings, compensation committee chairs engage in a dialogue with management to ensure all parties are prepared. In most cases, CCLN members said that they work with the company's chief human resources officer (CHRO) to coordinate the preparation. One member said, *"The prep call with the head of HR is one of the most important things we do. It helps me focus the issues. Depending on what we are covering, we may need more than one call."*

Members discussed ways to optimize their preparatory calls with the CHRO which also often include the company's head of executive compensation, anyone from management who is presenting to the committee at the upcoming meeting, and the committee's outside compensation consultant. One member said, *"If you get the presenters on the call, you can help prep them so that they don't embarrass themselves. I take that as a personal responsibility and I'm very tough on them, coaching them. I find that it's best for them to hear it ahead of time."* Members said it is less common for the CEO to participate in pre-meeting preparations. One said, *"The CEO and I have a prep call if we are discussing CEO succession or compensation for the CEO's direct reports. Otherwise, the CEO isn't involved in the prep process."*

Members also emphasized the importance of reviewing and revising meeting materials. Members prefer, and in many cases require, management to provide materials to the committee at least a week before a meeting. This lead time allows directors to raise any outstanding questions with management before the meeting. Some CCLN members review and help shape the contents of the materials before they are distributed to the rest of the committee. One member said, *"I've found reviewing the materials before they go out is sometimes more important than meeting with people or other forms of preparation. The quality of the materials can ensure better participation by the committee."*

Engaging other directors

It can be challenging for compensation committee chairs to include their fellow committee members in the pre-meeting preparation process. As a result, the bulk of the preparation falls to the chair. However, some members have tried to get other directors more involved. One member said, *"I will spend time with other directors before the meeting, with the objective being to ensure that, at all costs, we avoid surprises."* Some members also interact with the lead director (and in some cases all the board's committee chairs) between meetings to confirm that the committee's priorities are aligned with those of the rest of the board.

Members said that some scenarios require the whole committee to weigh in before a meeting. For example, if the committee is considering new metrics for the long-term incentive plan or some other compensation overhaul, it can be difficult to start the conversation in the committee meeting itself. One member explained, *"If there is a debate to be had, 90% of it should occur between meetings. It is better to give members a chance to address things they think need addressing before the meeting so that we don't spend the whole meeting in a debate."*

Another member described the benefits of an off-cycle committee meeting to address complicated issues: *"This way, we are not constrained for time. We can put strategic items on the agenda and we have enough time to discuss the issues, get the needed data, and decide if we want to incorporate these things into our* *compensation plan or not."* Another member responded positively to this concept: *"I like this idea because I find we do not spend enough time thinking together. We make decisions but do not talk out the issues enough."*

Efficient and effective meetings require thoughtful choices

With limited time and a host of topics to cover, CCLN members stressed the need to be meticulous about the purpose and execution of compensation committees meetings. Members discussed several key considerations related to the structure and conduct of committee meetings:

- **Meeting timing and frequency.** Members said that their committees almost always hold their in-person meetings right before board meetings. Any additional meetings are usually held by telephone, either on a set schedule or as necessary. Some members said that, absent an unexpected event, the committee might meet just four times a year. Others said they regularly hold telephonic meetings between board meetings and consequently meet up to 10 times a year. In addition, as described above, some members hold in-person committee meetings that are not scheduled around a board meeting, usually once a year.
- **Meeting duration.** The average length of a compensation committee meeting varies by board. Most members said their in-person meetings last around two hours, though some typically spend closer to three hours. Some members were concerned about whether they allocate enough time. One said, *"I have felt rushed in every committee meeting we've ever had."* However, other members said that longer meetings are not always the answer. One said, *"I've found that some committees meet for four hours but don't get anything more done."*
- **Attendees.** Members also reported variation in who attends their compensation committee meetings. On some boards, all of the independent directors attend the meetings, while on other boards, the attendance of directors who are not assigned to the compensation committee varies. One member said all the independent directors *"have an open invitation to attend all of our committees if there are issues coming up that we'd like to be a part of."* Some members lamented that the resulting number of participants is not conducive to getting things done. One said, *"Between management and everyone on the board, I end up having meetings with 20 people in there. I had to tell directors who are not on the committee that they are welcome to come, but they cannot have a speaking role."* In other cases, boards do not face this issue because they hold some or all committee meetings at the same time.
- **Management presentation quality.** Members said that the relative success of a committee meeting depends on the quality of management's presentations. To enhance these presentations, committee chairs often try to persuade management not to reiterate the contents of the written materials. One member emphasized the importance of directness and brevity: *"I tell them, don't come in and pitch me. I'll let them do three or four points, and when they start getting to the fifth or sixth point, I'll say 'alright, that's enough,' and they'll usually learn their lesson and not do that again."* Another described a challenge, especially for managers who are not in front of the board regularly: *"They want to show you how smart they are rather than tell you what you need to know."*

- **Use of executive sessions.** One way to focus the committee's conversation is to go into a private session, either just as a committee or with a particular individual or group. Members said that they commonly end their meetings with a closed session of just the independent directors. One member noted, *"In addition, we've instituted an executive session at the beginning of the meeting. This is a tactical process to ensure the meeting meets everyone's needs and all important topics are being addressed."* Another member endorsed this concept: *"I think it is important, just to get the face time with my committee. It gives the independent directors a chance to talk."*
- **Role of outside advisors.** In addition to directors and management, outside compensation consultants regularly attend members' committee meetings and advise the committee on a range of issues. Members discussed whether it was also beneficial for the committee to have its own attorney in attendance. One member said, *"We generally have our board counsel at all meetings. It is good to have the lawyer's perspective when certain issues come up."* Other members said that they do not typically have separate counsel at the meetings, unless there is a specific issue on the agenda that warrants it.

Members also described the general challenge of keeping the committee meeting on track. One member described an approach that has helped streamline discussions: *"One thing we've done is separate the agenda between items for approval and items for discussion. That way, by the time we get to the point where we are taking an action, the discussion is done and we can easily move on to other issues."*

Performance assessments and succession planning are key to long-term success

There is much more to leading a committee than preparing for and chairing meetings. Members addressed two important questions related to the committee's long-term performance.

How do we assess our own performance?

The board and committee evaluation process offers committees a way to identify opportunities to improve. One member said, *"We have had a consultant spend time with us as a committee to see how we operate, and also attend several board meetings. All of that is folded into a set of comprehensive feedback."* A number of members favor individual director evaluations as part of the process. One said, *"We received feedback on how other board members think we are performing. Am I coming prepared? Am I engaged? It gave us great insight on that, although maybe some board members didn't like it as much."*

While a number of members described positive experiences using external advisors to perform the evaluations, some members expressed a preference for a board member, usually the lead director or the chair of the nominating and governance committee, to lead the process. One member said, *"We found that people were much more open about their experience with other board members when they are talking to a peer as compared to when we use consultants."*

How should the board handle committee chair succession?

Another area of focus for some CCLN members is compensation committee chair succession. Members were particularly interested in the timeline their boards use to identify and appoint a new chair. In general, members favored a multiyear transition. One said, *"Having at least a year under your belt as a committee member, and preferably more than that, goes a long way. It lets you see how the committee works."*

Members debated whether the outgoing chair should stay on the committee after the official transition. One said, *"I will know a year in advance who my successor will be, then I will remain on the committee for another two years."* Others, however, recommended that once the successor is in place, the outgoing chair should leave the committee entirely to demonstrate that the new chair has complete authority.

Communicating effectively with shareholders

In 2006, the Securities and Exchange Commission (SEC) began requiring companies to include a compensation discussion and analysis (CD&A) section in their proxy statements. Its purpose was to complement executive compensation numbers and tables with "principles-based narrative disclosures … made in plain English."[2] Despite the SEC's intentions, in its early years, creating the CD&A was seen as merely a compliance exercise. Things began to change dramatically in the wake of advisory say-on-pay votes. At many companies, the CD&A is intended to contextualize, explain, and persuade while still meeting regulatory requirements. The CD&As of S&P 100 companies are now more colorful, graphical, and longer – 9,400 words last year compared with 8,900 words in 2012.[3]

According to meeting guest Iain Poole, founder and managing director at Argyle Company, CD&As are also becoming more effective. *"More and more companies are closing the usage gap with their public disclosures, speaking to what investors care about while satisfying regulatory requirements,"* Mr. Poole said. He added that the most effective disclosures explain how the company's purpose, strategy, and performance are linked while also neutralizing concerns about environmental, social, and governance issues. Disclosure examples on a range of important topics were in the materials that Mr. Poole prepared for the CCLN meeting. A copy of that presentation can be found in the appendix.

Before and during the meeting, members explored substantive disclosure questions and discussed how to organize the disclosure drafting process most effectively.

Demonstrating pay-for-performance alignment and committee oversight

Members identified two overarching purposes for the compensation-related disclosures in the proxy: show how pay and performance are (or will be) aligned and exhibit the quality of the committee's oversight.

How do we address the link between pay and performance?

"Across all the companies I have worked with, across industry, the fundamental purpose of the CD&A is the same: demonstrate alignment between pay and performance," one member said. According to Equilar, 95%

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[2] US Securities and Exchange Commission, "SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters," news release, Washington, DC, July 26, 2006.

[3] Equilar, *Innovations in Proxy Design* (Redwood City, CA: Equilar Inc., February 2017), 13.

of S&P 100 companies discuss linking pay and performance in the CD&A, and a quarter of those go the additional step of providing a graph that demonstrates that link.[4]

The task is easiest when the company's performance is strong, members said. In more difficult circumstances, companies often get credit from investors if executives suffer some consequence when the company underperforms or an individual fails to meet his or her targets. One member said, *"We used negative discretion to make the bonuses zero. Putting that up front in disclosures and reaching out to shareholders was very important."* Another said, *"Our executives hit over 99% of the metrics in the plan. Shareholders were surprised that we held firm to the targets and did not pay bonuses that year. It was a tremendous response from our shareholders."*

Pay sometimes looks misaligned with performance because of the way in which the summary compensation table numbers are calculated. As a result, several members are considering adding alternative pay calculations – such as realized, realizable, or earned pay – in their next CD&A to further demonstrate that pay and performance are aligned. Alternative pay calculation disclosures are still somewhat uncommon: only 14% of S&P 500 companies disclosed "realized pay" in 2016.[5] *"This is an important topic. The [table] can be misleading. We have not made a change yet, but we are seriously considering it,"* one member said.

If there is misalignment, Mr. Poole urged members to own up to it. *"The best defense is a good offense. Own what has happened and demonstrate the quality of the board's oversight,"* he said.

Should we add a letter from the compensation committee to shareholders?

A growing number of US companies have added a more conversational letter from the compensation committee or committee chair to their proxies, either in addition to or in place of the CD&A's executive summary. Mr. Poole said, *"Letters like this can personalize the committee and the chair and highlight for your audience that the board is very engaged."* The letters can help frame the company's pay story in a more compelling way than simply including charts and graphs that demonstrate the company's pay-for-performance alignment. *"Whether in a letter or simply as part of a summary, including more information about the breadth and complexity of both the business and the CEO's job is important,"* Mr. Poole said. Although many companies add a letter like this to assuage shareholders' concerns following a difficult event, some members said they were considering the voluntary disclosure as a preventative measure. *"I cannot see any downside to including a letter like this,"* one member said.

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[4] Equilar, *Innovations in Proxy Design*, 19.

[5] Equilar, *About One-Sixth of Companies Disclosed Realized Pay in 2016* (Redwood City, CA: Equilar Inc., Dec. 9, 2016).

Pay ratio disclosure

Under the final pay ratio rule, registrants must disclose the ratio between CEO and median employee pay for the first fiscal year beginning on or after January 1, 2017. Meridian's Annette Leckie said, *"Although some companies were cautiously optimistic that the ratio would be repealed or delayed, it is clear now that is not going to be the case. Most are now asking two questions. First, should we disclose anything beyond the bare minimum requirement in the proxy? Second, and more important to many companies, what should we communicate internally?"* One member said, "*Right now, everything is on the table for us. The public-relations aspect to this is going to be huge. For some companies in the room, the criticism we'll face here could be among the greatest challenges we have experienced."*

Some of the criticism will be external, as it becomes part of a narrative about income inequality. But some members were more concerned about employee reaction to the numbers, both for companies with unionized work forces and for companies with professionals who will be surprised to see they are being paid below the median. One member said, *"We are very aware of the potential employee reaction. We're not planning to do a big publication effort, but we are preparing management to be comfortable explaining the calculations when asked."*

Effectively organizing the disclosure drafting process

The CD&A drafting process is similar at most members' companies, with company professionals responsible for revising the prior year's draft and explaining the rationale for all suggested changes. The committee chair may be involved more at the initial stage, providing direction to management before the creation of the first draft. One member said, *"I share a few proxies that I think look good to our team, some that might be better than ours. I look for those that win awards for their documents and try to identify what we can do to get closer to perfect."*

Many professionals play a role in drafting the CD&A, including the company's legal and compensation experts, the compensation committee and chair, and the committee's compensation consultant. Some companies also seek advice from internal and external design and communications experts. Whatever the breadth of the team, several CCLN members said that the document is fundamentally the committee's responsibility. One member said, *"I view the CD&A as the compensation committee's document, not management's. I take accountability for it."*

Members discharge their CD&A oversight responsibilities with different procedures, but many acknowledged spending a substantial amount of time reviewing and editing CD&A drafts. One member compared reviewing the CD&A to reading a prospectus as an investor. Another member said it was hard to imagine devoting more time to the CD&A: *"I spend days reviewing the CD&A. I wonder whether we spend more attention on the CD&A than we do on the 10K."*

The guiding principle for many members is to make the document as useful to the company's owners as possible. *"Others review the document for legal and risk issues. It is my job to make sure it satisfies* *shareholders,"* one member explained. *"We are trying to say more not about what we do but why we do things,"* another said. Some members are focused on making the documents more succinct to satisfy investors, who have limited time to review the CD&A. In particular, some look to reduce repetition. One shared a view that *"if this CD&A isn't* shorter *than the last one, we need to revisit it."* Mr. Poole cautioned members against measuring success by length. *"Remember how your audience – your investors – use the document. Not everyone is reading this from cover to cover. Repetition is not inherently problematic."*

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Communicating about the compensation committee's work can be challenging, whether the audience is a company's shareholders, customers, employees, or other directors, because not all parties always agree with the committee's decisions. Clear communication – before, during, and after making critical decisions – can go a long way toward making better decisions and quelling criticism. In particular, CCLN members that the cadence and clarity of their communications with management and their fellow directors goes a long way towards improving committee performance.

The following CCLN members participated in the meeting:

- John Anderson, Meridian Compensation Partners
- Ramani Ayer, XL Group
- Erroll Davis, Union Pacific
- Kathy Hill, Moody's
- Jim Kennedy, United Continental Group
- Bill Kerr, IPG
- Annette Leckie, Meridian Compensation Partners
- Karen Maidment, TD Bank Group
- Maria Otero, Herbalife
- Steven Reinemund, Marriott International and Wal-Mart Stores, Inc.
- Joyce Roché, AT&T
- Virginia Ruesterholz, The Hartford and Frontier
- Samme Thompson, American Tower

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

- Roxanne Decyk, Orbital ATK
- Mel Lagomasino, The Coca-Cola Company
- Marianne Harris, SunLife
- Ron Rittenmeyer, QuintilesIMS
- Laurie Siegel, CenturyLink