

Compensation Committee Effectiveness

NAW Billion Dollar HR Roundtable

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Introduction

- Executive compensation is a controversial, high-profile issue
 - Source of competitive advantage when appropriately designed (e.g., pay for performance)
 - Possible source of inefficiency, liability, and embarrassment when poorly designed or administered



*"I'm actually the CEO of a major corporation...
but they tied my pay to performance."*



Introduction

- The Board Compensation Committee has primary oversight responsibility for executive pay
 - Representatives of shareholders
 - But typically meet only three to six times a year for two hours
 - With often disparate views among members based on personal experience
- As CHRO, how can you help ensure your company's Compensation Committee is as effective as possible?

Take A Moment

- Write down all of the different people you coordinate with in regard to executive compensation
- How do you work with these different “players” to facilitate smooth and effective Compensation Committee meetings?

The Players

- Compensation Committee
- Management
- Independent Consultants
- Institutional Investors
- Proxy Advisors
- Regulators (FASB, SEC, IRS)



The Players: The Compensation Committee

- All publicly traded companies are required (and many privately-held companies choose) to maintain a separate compensation committee
 - Generally composed of two or more independent directors who also qualify as “non-employee” directors under SEC Rule 16b-3 and as “outside” directors under Section 162(m) of the tax code
- Key responsibilities include:

<ul style="list-style-type: none">✓ Approve executive compensation strategy including establishment of peer frame, competitive positioning, levels and mix of compensation✓ Approve base salaries and variable annual and long-term incentive opportunities for senior executives✓ Approve employment agreements, severance arrangements, change-in-control provisions, and any special or supplemental benefits✓ Administer cash- and equity-based incentive plans, including approval of actual awards and/or delegation of authority to management to make grants	<ul style="list-style-type: none">✓ Select performance metrics, establish goals in variable compensation plans, determine the degree to which goals have been achieved, and approve payouts at conclusion of measurement periods<ul style="list-style-type: none">✓ Evaluate the performance of officers and other senior executives against selected metrics✓ Monitor compliance with executive stock ownership guidelines✓ Approve the engagement of any independent compensation consultants
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The Players: Others

Management

- Administer plans and policies
- Present proposals on variable incentive plan design, performance goals and payout ranges
- Recommend changes to senior executive compensation levels and opportunities, except CEO

Independent Consultants

- Engaged by and report directly to the Compensation Committee
- Work collaboratively and in cooperation with management
- Available, as requested,
 - To attend meetings of the Committee or Board,
 - To provide advice and counsel on recommendations under consideration,
 - To present and defend proposals, and
 - To assist Committee in matters related to CEO and other senior executive pay

Institutional Investors

- Vote for or against compensation-related proposals presented in proxy statements, as well as re-election of Committee/Board members
 - Stock incentive plans, Say-on-Pay, change-in-control benefits, stock option repricings
- Required by SEC rules to establish and publish voting policies

Proxy Advisory Firms

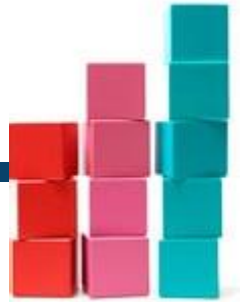
- Provide vote recommendations to institutional investors on proxy proposals
- Two major firms – ISS and Glass Lewis

Building Blocks of Committee Effectiveness

1. Membership
2. Charter
3. Support
4. Annual calendar and agendas
5. Clear statement of philosophy
6. Appropriate pay opportunities
7. Linkage of pay to performance
8. Communication, transparency and clarity
9. Member Education
10. Annual Performance Evaluation



1. Compensation Committee Membership



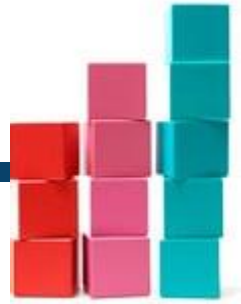
- Composition varies, but basic precepts should govern...
 - Promote diverse background and experience
 - Limit redundancy (e.g., all academics, all CEOs, or all real estate developers)
 - Periodic rotation of members
- Independence is the bedrock of Committee effectiveness
 - Committee decisions informed by, but independent of CEO or management
 - Executive sessions without management
- Long-standing independence requirements under NYSE and Nasdaq listing standards, plus new requirements implemented in 2013 pursuant to Dodd-Frank Act
 - Board must consider “all factors” including but not limited to:
 - Sources of compensation, including any consulting, advisory or other compensatory fees paid to committee members
 - Under Nasdaq rules, only compensation for board/committee service is permitted for an independent director; NYSE permits judgment
 - Any affiliate relationship between Committee member and Company and its subsidiaries

2. Compensation Committee Charter



- Written charter required under NYSE and Nasdaq stock exchange listing standards; “best practice” for all Compensation Committees
- Typical Committee Charter items:
 - Committee composition and qualifications
 - Minimum number of meetings and recordkeeping/reporting procedures
 - Duties and responsibilities
 - Approve CEO compensation, including setting performance goals and objectives and evaluating performance in light of those goals and objectives
 - Recommend non-CEO executive compensation and other equity and incentive plans subject to Board approval
 - Review CD&A with management and recommend to Board its inclusion in proxy statement; prepare annual report on executive compensation for proxy statement
 - Review compensation risk assessment (typically prepared by management)
 - Consider most recent Say-on-Pay vote
 - Conduct an annual performance evaluation of the committee
 - Ability to engage consultants and advisors

3. Committee Support Management



- Input from management clearly needed
 - “Independence” from management, not “insulation”
- CHRO role may include...

Working with the Board

- Management Development & Succession Planning
- CEO Performance Objectives and Performance

Working with the Compensation Committee

- As Management’s representative (responsible to whom?)
- Balance competing interests
- Help set agendas and prepare materials
- Keep records

Working with the Committee’s Advisor

- Support advisors’ work (same client; different perspectives)
- Provide background information and context
- Collaborate to prevent surprises
- Assure HR alignment between top and rest

3. Committee Support

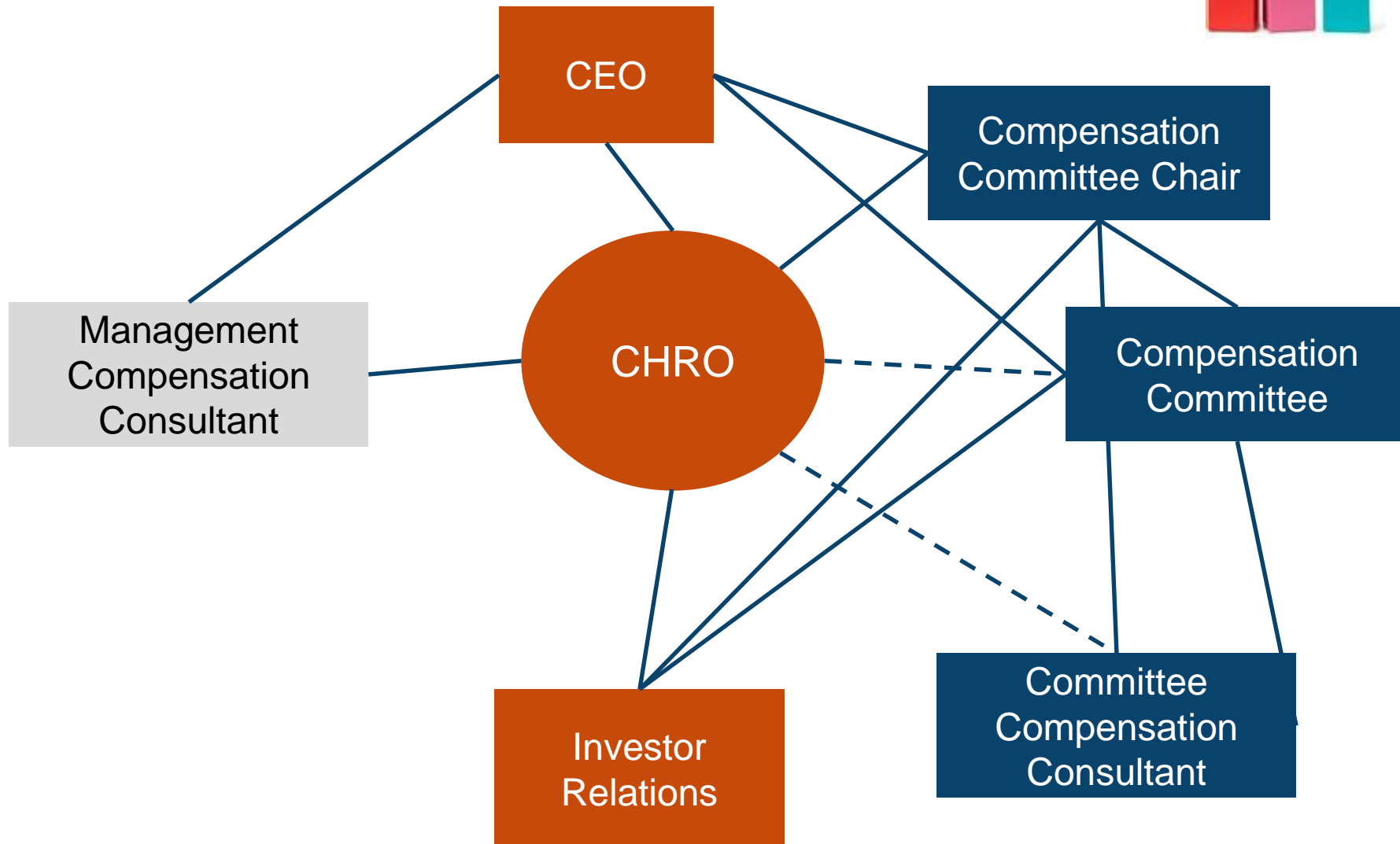
Committee Consultant



- Committee must have sole authority for appointment, compensation and oversight of work of any compensation consultants and other external advisers retained by Committee
 - Committee must evaluate independence of consultants and advisers based on factors specified by the stock exchange listing standards, as well as any other factors relevant to assessing independence from management
 - Company is required to provide adequate funding for compensation of such consultants and advisers
 - Charter must include foregoing rights and responsibilities
- Guidelines for using compensation consultants
 - Retained by and report to committee
 - Terms of engagement, including fees, determined by committee
 - Interaction with management determined by committee
- Collaborative working relationships among all parties essential

3. Committee Support

CHRO Compensation Committee Relationships

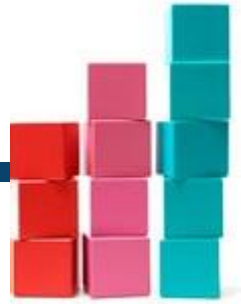


4. Annual Calendar and Agendas



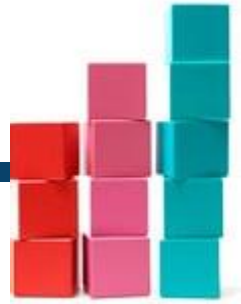
- Committee Chair and management (CHRO) set agendas for scheduled Committee meetings to ensure Committee meets responsibilities under charter
- For each meeting agenda, determine necessary supporting materials, and who is responsible for preparing
 - Management? Committee advisor?
- Ample review of materials in advance of meeting
- Typical decision-making process at the meeting:
 - Chair leads meeting and reports actions to full Board
 - Secretary (corporate officer) serves as record keeper
 - Final approval of major items decided in executive session

5. Clear Statement of Philosophy



- Clear philosophical platform needed to guide compensation decision-making
 - For the Board/Committee, as well as management in administering and communicating the program
 - Clarifies the values and goals of the company
 - Required under SEC proxy disclosure rules
- Key elements should include...
 - Fixed compensation and incentive/variable pay
 - Short-term versus long-term time horizons
 - Cash versus stock
 - Current versus deferred
 - External benchmarking and competitive positioning

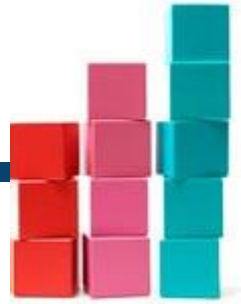
6. Appropriate Pay Opportunities



- Executive compensation takes many different forms, which makes apples-to-apples comparisons difficult
 - Important to understand all elements of compensation (direct and indirect)
- Key determinants of executive pay levels include...
 - Size of company and scope of responsibility
 - Industry economics and pay levels
 - Performance (company and individual)
 - Experience and degree of seasoning
- Internal comparisons would typically include...
 - Review of individual total compensation levels for all members for the senior leadership team
 - Differentials between executives and other levels of employees
 - Existence of special benefits or arrangements for only executives

6. Appropriate Pay Opportunities

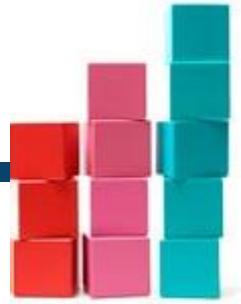
External Benchmarking



- Consideration of external pay data is obviously needed to maintain a competitive compensation program
 - Caution should be taken to avoid setting pay levels solely to be “at market,” if not otherwise justified by solid business reasons or basic fairness
 - Also, a 75th percentile market position has declined in practice (except to the extent supported by relative performance) as it tends to ratchet pay up due to statistics rather than labor market economics
- Primary source of competitive pay data is proxy statements of selected “peer” companies
 - Reliable source of information as filed with SEC, with ability to fully assess pay against performance
- Other sources of data are published compensation surveys or “club” surveys conducted in a particular industry
 - But generally less “transparency”

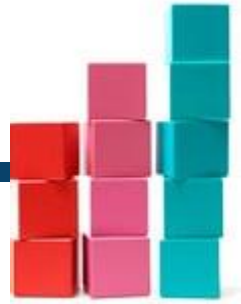
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External Benchmarking



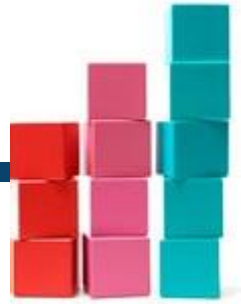
- Guidelines for selecting external “peer” companies include...
 - Final list approved by the Committee
 - Companies selected before looking at pay levels (no “cherry picking”)
 - “Size” should be based on factors other than revenues or assets alone, with market capitalization being a key consideration
- Analysis and presentation of competitive information should include...
 - Size and performance comparisons
 - All elements of total compensation
 - Stock ownership to interpret data (“Bill Gates” or “Sam Walton” effect where no long-term incentives to high-ownership CEOs)
 - Equity incentive run rates, dilution, and “shareholder value transfer” (i.e., total value of awards expressed as a percentage of market capitalization)

7. Linkage of Pay to Performance



- Linking compensation to performance is perhaps the most challenging issue facing management and Compensation Committees
 - Broad range of performance measures
 - Measurement issues (particularly against competitors)
 - Alternative delivery vehicles
 - Complex technical considerations (tax, accounting, SEC)
- Key principles...
 - Down-weight “fixed” pay elements (salaries, perks, benefits)
 - Emphasize “variable” pay tied to performance...payments and costs tied to results
 - Maintain accountability for failures...avoid resets
 - Tie to operational results and stock price

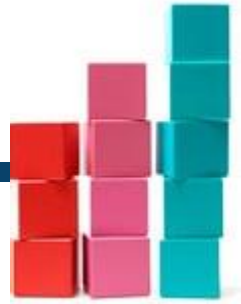
7. Linkage of Pay to Performance



- Key challenges...
 - Selecting metrics...ensuring balance
 - Financial versus strategic or non-financial goals
 - Short-term versus long-term
 - Capital efficiency
 - Linkage to shareholder value
 - Setting target goals
 - Defining “reasonably achievable”
 - Particularly challenging for multi-year periods
 - Setting range of performance (avoid “feast or famine”)
 - Ensuring affordability
 - Defining “market competitive”

7. Linkage of Pay to Performance

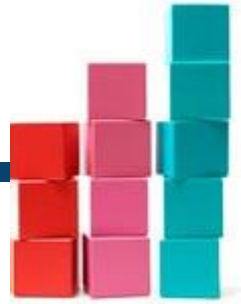
Alignment with Shareholders



- Alignment of the long-term interests of executives and investors is essential to an effective executive compensation program
- Paying compensation in stock which is earned by continued service over several years is a common method of gaining alignment
 - Stock options, which have no value unless stock price appreciates after grant, was most common approach historically
 - However, many factors have caused a shift away from options (expense for stock options, concern about encouraging excessive risk, share availability, low/no perceived value among employees with underwater options)
 - Restricted shares provide both shareholder alignment and retention; considered least performance-based equity grant type
 - Performance shares (same as restricted stock but with performance-vesting requirements) are favored by institutional investors as they are both “performance-based” and aligned with shareholders

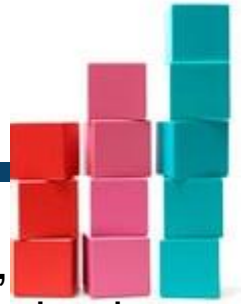
7. Linkage of Pay to Performance

Stock Ownership Policies



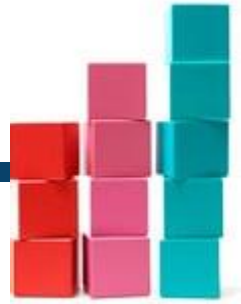
- Ownership requirements also provide long-term alignment of management and shareholder interests
 - Formal stock ownership guidelines for executives virtually ubiquitous among public companies
 - Typically expressed as multiples of salary, but may include retention ratios and holding periods
- Ownership guidelines for outside directors also prevalent
 - Typically expressed as multiple of retainer
 - Increasingly required to hold shares until retirement from Board

8. Communication, Transparency & Clarity



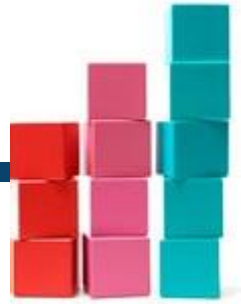
- Compensation policies are closely monitored by institutional investors, as well as competitors and employees, and should be clearly and completely communicated
- Say-on-Pay under Dodd-Frank Act provides public company shareholders ability to vote “for” or “against” the executive compensation program
 - Non-binding advisory vote on pay of named executive officers as reported in CD&A and supporting tables of annual proxy statement
 - Proxy statements are becoming “marketing” tools for companies to communicate their executive compensation strategy, how it supports business strategy, and the rationale for the Committee’s decision-making
- Proxy statement is carefully reviewed by multiple internal and external parties before presenting to Compensation Committee for review
 - Internal: HR, legal, accounting/finance
 - External: SEC counsel, committee’s consultant, proxy solicitor

9. Member Education



- Onboarding - HR typically responsible for conducting orientation
 - Ensure materials are readily available to summarize current program
 - Compensation Philosophy
 - Incentive Plan Measures and Mechanics
 - Equity Incentive Plans
 - Stock Ownership Guideline Compliance
 - Competitive Compensation Positioning
 - Also, legal and regulatory primer can be useful tool
- Ongoing education and networking opportunities
 - National Association of Corporate Directors (NACD) is a good source
 - Committee Materials

10. Annual Performance Evaluation



- Directors must conduct annual self-evaluations of their performance
 - To identify what is working well and what can be improved
- Outside assistance not required, but can sometimes be useful
- Open-ended questions or numeric rating forms
- Written records versus conversational
 - Documents and minutes created are not privileged
 - Litigation / discovery