Get Smart: An Effective First Year on the Compensation Committee

By Jannice Koors and Lianne Chew

Ed. Note: This is the first of a three-part series on "competence to excellence" for compensation committees. Part II will appear in October, and Pt. III will appear in January 2009.

Director Summary: It is a challenge to be the rookie on the team. For new members of the compensation committee, the challenge can be pronounced, as executive compensation is increasingly in the public spotlight. The authors outline how new committee members can hit the ground running with the tools necessary to understand how the board operates, and what their role should be in order to have a successful first year.

There are more new faces in the boardroom today, as companies reach beyond the corner office to a wider and deeper pool of candidates with specialized skills. Expanded recruitment is driven by a variety of governance and regulatory changes, from heightened independence standards to the increased time and effort demanded by board service. More incoming members lack experience as a director and/or member of a key board committee, posing a particular challenge for compensation committees, where directors face a broad range of new technical, regulatory, and accounting requirements in recent years.

In the past, the public focus on executive compensation was generally limited to the few weeks of the annual proxy season. In that relatively benign environment, new compensation committee members could afford to learn on the job. The current environment is not so forgiving. Executive compensation decisions, and the directors making those decisions, are under intense, year-round scrutiny. That requires new committee members to quickly get up-to-speed and familiarize themselves with the issues, practices, and programs likely to be scrutinized by institutional investors, proxy ratings agencies, the media, and other increasingly activist constituencies. This changing dynamic is complicated by the inherently "grey" nature of executive compensation itself. Unlike their colleagues on the audit committee, compensation committee members must make their decisions without the benefit of a "rule book."

This article provides practical guidance for new compensation committee members in their initial year of service regarding what to expect and the preparation required to become fully contributing members. Directors with prior compensation committee experience will find useful information on how to help new colleagues smoothly transition to their new roles and responsibilities.

Preparation

A new committee member's first responsibility is to become familiar with the structure and rationale behind the company's compensation programs and the key compensation issues facing the company and the marketplace. While the full board receives overviews and updates about pay programs, committee members should have an in-depth understanding of their history and rationale, based on both objective and subjective information.

As a basic first step, we recommend compensation committees create and maintain a reference guide for new members containing key information about the company's compensation policies, practices, and programs. Such a briefing book should include information on: committee operations, including the charter; past agendas and contact information for members and outside advisors; company information, such as recent public filings and organizational charts; pay programs, including the compensation philosophy, program documents, performance goals, equity information, tally sheets and contracts; and competitive/market data, including the peer companies' programs and performance.

To add color to that data, we recommend new committee members schedule one-on-one sessions with the head of the human resources department (HR) and the committee chair to shed light on the evolution of the compensation programs and to provide context for assessing background materials and data. These sessions are critical to understanding committee dynamics. A new committee member walking into a contentious situation may need to tread more lightly than one whose committee is operating in a status quo mode. A new member should probe the chair and top HR executive on issues such as non-routine items on the horizon (e.g., CEO contract re-negotiation) and recent items or topics that may have sparked "lively debate" among committee members. A new committee member may also find it useful to speak directly with the committee's outside consultant/advisor. While the chair and HR can offer insights into the history of the committee and corporate pay programs, the outside advisor can add a competitive context for assessing current programs. The outside advisor can also address questions regarding technical aspects of plan designs, or executive compensation and benefits programs in general.

Also worth mentioning is the unique and evolving role of the committee's outside advisor. The compensation committee is the only standing committee of the board that routinely, but voluntarily, retains an outside advisor. The audit committee's relationship with its own outside auditor varies in several respects, not least the fact that retaining an outside auditor is mandatory. Over the past five years, increased scrutiny and criticism of executive pay levels and the process by which pay is set has dramatically changed the relationship between companies and their compensation consultants. A decade ago, an outside compensation consultant usually would be hired on an ad-hoc basis for a specific assignment (i.e., to "fix a problem") and be retained by, and report to, management. Today, most public company compensation committees directly retain their own outside consultant to serve as their ongoing advisor. That same consultant may also work with management to assist in the implementation of the committee's directives, or management may retain a different firm. It is important for a new committee member to understand the nature of the specific relationship in place at the company.

New committee members also should plan to participate in ongoing, formal director education courses on critical compensation issues. According to the NACD, which offers many such programs:

> Education is a vital component of governance—and is now expected of public companies. Under current listing requirements, NYSE companies must address director education in their governance guidelines. Also, both the NYSE and NASDAQ have announced initiatives to provide education for listed companies. Continuing education is particularly important in the field of compensation, in light of the complexity and importance of this subject.
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> – *NACD Blue Ribbon Commission Report on Executive Compensation & the Role of the Compensation Committee.*

New committee members should be prepared. Executive compensation decisions, and the directors making those decisions, are under intense, year-round scrutiny.

Participation

Clearly, the overriding goal of all compensation committees is to operate in a manner consistent with good corporate governance standards. Not surprisingly, however, implementation of those standards can vary from company to company. Part of a new member's discussions with the chair, head of HR, and outside advisor should focus on understanding the committee's operating procedures—such as how members communicate with one another, who sets agendas, etc. While there are no hard and fast rules, there are benchmarks that new members can reference as reasonable expectations of what they can expect and what others will expect in return.

Like all standing committees, the compensation committee should maintain an annual calendar that, in addition to setting tentative dates for regular meetings, provides members with a high-level overview of standing agenda items (e.g., noting that annual pay actions are approved at the annual February meeting or that performance evaluations and succession planning are discussed at the May meeting). These agendas will be supplemented as additional issues arise, but members should know in advance when key issues typically will be addressed by the committee. In our experience, a public company compensation committee requires at least four meetings per year to meet all of its charter responsibilities. In fact, Pearl Meyer & Partner's (PM&P) findings for the *NACD 2008 Director Compensation Report** found that, on average, committees at the largest U.S. companies meet six times per year. Whatever the agenda, every meeting should include time for an executive session. **Ed. Note: The report is available for free download to NACD members. Visit www.nacdonline.org, and click on Governance Resources.*

Board materials should be provided by the company's HR team and/or compensation consultant at least a week in advance of meetings to allow ample time for review. Members will be expected to have read all supporting materials, focusing on specific action items that will be discussed in more depth and/or voted on at the meeting. Committee members also may be offered the opportunity for one-on-one discussions about especially technical or data-intensive issues in advance of meetings.

As a best practice, the compensation committee should spread decision making about key issues over the course of two meetings: the first for discussion; the second for follow up review and voting. This process allows members to digest the information and points discussed at the first meeting, then follow up with any additional questions prior to a vote. From a governance perspective, documentation by the committee of such a two-step process can serve as evidence of careful deliberation if a decision is subsequently challenged from a governance or legal standpoint.

New committee members may feel unduly hesitant about voicing an opinion if it conflicts with the status quo. In fact, asking "Why do we do things that way?" can prompt a reconsideration of long-time practices that may no longer be ideal. Similarly, new members can quickly become value-added team members by providing a fresh perspective or suggesting new ideas for agenda topics or committee procedures. Generally, a new member who is concerned by, or disagrees with, findings or materials provided to the committee should speak directly with the chair or raise the matter in executive session.

Assessment

At the end of the year, committee members should conduct a formal evaluation. At most companies, this consists of a process-oriented review of the overall committee function. Typical questions might include whether supporting materials were provided sufficiently in advance of meetings, whether enough time was allotted for in-depth discussion of all agenda items, or whether there were enough or too many meetings.

New members also may benefit from a personal evaluation following the end of their first year of committee service. Having been through a full compensation cycle, he or she should feel comfortable in the position and fully versed on the programs in place. These are among the kinds of questions a compensation committee member should be able to answer by the end of their first year:

1. What is the rationale behind the company's compensation philosophy, including the reasoning behind aspects of compensation such as the mix of pay elements and competitive positioning?
2. What makes the company's compensation structure unique? Compensation can provide a competitive advantage, but only if the company can identify how the program is tailored to the organization's particular needs.
3. What performance measures are used in the incentive plans and why? All board members should be familiar with the company's business strategy and key performance drivers, but committee members are expected to have a deeper understanding of how they are incorporated into its incentive programs.
4. How is the company responding to the changing regulatory environment? Committee members need to understand the market forces likely to affect program designs.
5. What are the company's plans for future leadership? While succession planning and/or executive search are often the full board's responsibility, the compensation committee plays a vital role. Pay and performance management programs are key to identifying and retaining internal candidates, while an appreciation of the competitive marketplace and executive employment agreement trends are critical to attracting external candidates.

In addition to the qualitative understanding implied by the questions above, committee members must ensure that they know enough about the data to never be caught by surprise when year-end compensation reports come out. While they need not commit to memory every detail of a CEO's pay package, members should be familiar with the kind of standard information reported annually, from year-end pay levels to the value of executives' severance liabilities. Beyond those numbers, committee members also should understand the upside and downside opportunities embedded in program designs, such as the maximum potential level of pay, or the impact on performance-based incentives of incremental changes in stock price.

As Warren Buffet expressed, executive compensation is now widely viewed as a litmus test of good corporate governance—which means that compensation committees will remain in the limelight for some time to come. While that responsibility and scrutiny may seem daunting, even new committee members can have an immediate impact on the company that is available to few other directors. The next article in our three-part "competence to excellence" series will focus on how the committee as a whole can move beyond compliance and approval to become a more active partner with management in utilizing compensation and benefits to effectively promote business strategy. ■

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