Top 10 Compensation Committee Issues for Tax-Exempts

The intense scrutiny of executive compensation at public companies has spilled over to the tax-exempt world, with non-profit pay practices now similarly regarded as a litmus test of good governance and Director independence. Compensation Committees can meet this challenge by ensuring the programs they oversee are grounded in sound and defensible rationales and administered within accepted good governance standards. Compensation Committees should be re-examining every nuance of every executive compensation program with an eye to whether it is appropriate and effective, as well as its likely perception within and outside the organization.

Based on our assessment of market practices and the current environment, we recommend the following **Top 10 Compensation Committee Issues for Tax-Exempts**:

1) Revisit Your Executive Compensation Strategy and Philosophy
2) Address Potential “Red Flag” Practices
3) Take Advantage of Improved Form 990 Reporting Requirements
4) Validate and, Where Needed, Clarify the Role of Variable Pay
5) Validate Compliance with Section 4958 of the Internal Revenue Code
6) Strengthen Governance
7) Create a More Rigorous CEO Evaluation Process
8) Assess Executive Benefits
9) Evaluate the Adequacy and Independence of Compensation Advice
10) Prepare to Retain Top Talent

1. Revisit Your Executive Compensation Strategy and Philosophy

Compensation Committees can easily become overwhelmed by comparator data and percentile positioning relative to a peer group or the broader market. We recommend members periodically step back from the minutia of data analyses and re-assess the fundamental philosophical principles that underlie their decision-making around executive pay.

For example, public company Boards have long been criticized for treating their executives as superior performers deserving of above-average compensation. This phenomenon, some would say, has gradually spread to the tax-exempt boardroom, where more aggressive executive pay packages are drawing negative attention from regulators, legislators, stakeholders and the media. Non-profits are also constrained by a challenging economy, greater executive pay transparency under Form 990 reporting requirements and an increasingly vigilant IRS. In this environment, continuing to *target* executive pay above the market median – absent validation of genuinely stellar performance may raise questions regarding the appropriateness of compensation.

With that in mind, we recommend non-profit Compensation Committees take the following actions:

Validate Your Peer Group
The perfect peer group is rare, but it should closely resemble the competition with respect to your mission and executive talent and be reasonably similar in size and complexity. The Committee should determine the key selection criteria and parameters for inclusion before conducting a robust evaluation of current and alternate peer groups. Revenue or operating budget are the

most appropriate measures of size for most tax-exempts, while complexity is usually best reflected in factors such as the constituencies served, technological requirements and government regulation.

Consider Additional Survey Sources
Most peer groups include 15 to 20 entities – sufficient to capture the most similar organizations. However, it may not fully reflect competitive positioning against a broader market definition, especially for functional roles, such as human resources and finance, which are not industry-specific. A comprehensive look at the labor market may also require inclusion of reputable, industry-specific survey data that can be adjusted to reflect the size of your organization.

Review and Validate Your Pay Positioning Strategy
Many organizations find it useful to maintain a specified market target for pay, such as the 50th percentile. Organizations with variable pay plans may prefer a "performance leveraged" pay strategy that targets incentive opportunities at higher levels than base salary (e.g. the 75th percentile). In those cases, the Committee should ensure the relative target pay positioning is supported by the relative target performance positioning – for example, that aggressive performance goals are set when targeting pay above the median.

Once the proper market definition and pay targeting strategy are decided, the Committee needs to consider the appropriate role and weight the market data should have in the overall pay determination process. While data is an important component of decision-making, other factors and judgments specific to the organization and its executives should be considered in making fully informed and effective decisions.

2. Address Potential "Red Flag" Compensation Practices

A relatively small difference in executive compensation practices or program design can provoke an outsized reaction from regulators, stakeholders and the media. Committee members should regularly take a long, sober look at any pay or benefit practices that could be perceived as egregious. Do such practices warrant "going to the mat" with stakeholders or could they be modified or eliminated without sacrificing the program's overall competitiveness or effectiveness? Often, relatively small reforms can go a long way toward mitigating media and stakeholder objections.

Special attention should be paid to two particularly problematical program areas:

Employment Contracts/Severance
Because they are contractual in nature, employment and severance practices tend to evolve more slowly, as new agreements are signed. Arrangements for *incoming* executives that are "lightning rod" practices – among them multi-year guarantees, excessive "make whole" provisions and extraordinary relocation benefits – should be avoided. The *business rationale* for continuing any such practices for incumbents should also be carefully assessed.

Executive Perquisites
Despite their often relatively small dollar value, perquisites can be enormously costly in terms of lost political capital and goodwill with key stakeholders and influencers. Regardless of competitive practice, it is increasingly difficult to justify employer-paid perquisites for the most highly compensated employees. Moreover, the apparent tone-deafness of some organizations to criticism fuels support for additional regulatory oversight and intervention in executive pay matters. As with employment arrangements, Committees at a minimum can pre-empt problems by excluding controversial perquisites from new executive agreements and reconsidering their *business rationale* for incumbents.

3. Take Advantage of Improved Form 990 Reporting Requirements

IRS Form 990 has significantly increased the visibility of executive compensation programs at tax-exempts. While less extensive than SEC requirements for public companies (which include detailing the "how, what and why" of executive pay), the IRS's mandate to disclose executive pay levels opens a new window into non-profits' compensation practices.

On the positive side, however, the significant "white space" of Part III of Schedule J is a way for organizations to give readers additional insight into executive pay programs. To date, most non-profits have not taken advantage of this opportunity. Many are concerned that providing such supplemental information will simply highlight the level of executives' compensation, or draw attention to particular practices. We disagree. Providing more in-depth information helps the Committee frame the public discussion around important aspects of the programs, such as the organization's compensation philosophy, its benchmarking process and performance standards.

4. Validate and, Where Needed, Clarify the Role of Variable Pay

The use of variable pay, either in the form of annual incentives or discretionary bonuses (or in rare cases, long-term incentives) varies widely among tax-exempts. For instance, while relatively commonplace among membership or trade organizations, the use of variable pay among social service or religious organizations is fairly limited and usually in the form of modest discretionary bonuses. However, variable pay is likely to become a bigger part of programs as organizations strive to manage costs and deliver expected results. We recommend Committees focus on the following issues in adopting such programs:

Clarify Position on Variable Pay
The slowly recovering economy is an opportune time to rethink the role of variable pay, especially at organizations where past precedent or cultural values historically precluded its use. But organizations must first create clarity around the purpose and use of variable pay: simply put, is the plan designed to incent and direct performance, or to reward executive performance after-the-fact?

Determining the Right Level of Pay
Compensation opportunities under variable pay programs should be *influenced by* competitive practice and market benchmarks, but take into account other factors specific to the organization: the pay mix philosophy; each executive's contribution to performance; and the aggregate relationship between payouts and performance. Ultimately, the *actual* level of pay will be evaluated relative to performance – not to a target pay opportunity relative to market benchmarks.

Ensuring a Sound Framework
Organizations should not take an autopilot approach to the selection of performance measures, re-using metrics year after year regardless of changes in their organization's circumstances or overall "business" conditions. Instead, we recommend that Compensation Committees thoroughly assess whether the measures under consideration:

- Are central to the organization's mission and "business" strategy
- Can be influenced by management actions in an appropriate time-frame
- Can be reliably measured and monitored

Furthermore, Committees should ensure the goal-setting process has integrity, is tied to "business plans," and aligns pay with the desired performance level. While tax-exempts have fewer performance metrics to choose from than for-profits, a simple analysis of the past payout history (e.g., 3, 5, 10 year) can help validate that the goal-setting process is sound.

Finally, the increased focus on transparency make this a good time for organizations that use a discretionary or ad hoc approach to bonuses to create some parameters for payouts. While a formal plan may not be desired, Compensation Committees should ensure there is a well-defined and documented process and criteria for awarding executive bonuses.

5. Validate Compliance with Section 4958 of the Internal Revenue Code

No “Top 10” list for tax-exempt organizations would be complete without recognizing the importance of Section 4958 of the Internal Revenue Code established by The Taxpayer Bill of Rights II in 1996, more commonly referred to as “intermediate sanctions.” This rule has gained importance as the heightened scrutiny and regulation of public company pay programs has led to closer examination of tax-exempt practices. Tax-exempt employers can establish a "rebuttable presumption" that compensation transactions are reasonable for those disqualified individuals covered by intermediate sanctions by meeting three criteria: independent Board approval of compensation transactions; approvals based on appropriate comparability data; and adequate Board documentation of the bases for their determinations.

Independent Board Approval
Independence is simply good governance, tax-exempt or not. It is also healthy to conduct a comprehensive review of all decisions relative to executive compensation and promote clarity around the full Board’s role. For example, while the Board is responsible for approving “compensation transactions” (salary increases, bonus payouts, SERPs, etc.), what is its proper role in the steps leading up to the transaction (such as peer group selection)? Clearly defining and documenting the Board’s role and responsibilities in decision-making will improve the entire decision-making process.

Comparability Analysis
The cornerstone of Section 4958 is the identification and use of appropriate comparability data. Most organizations develop an organization-specific peer group and use the improved data reported in Form 990s to conduct analyses. The organizations selected should be comparable in size (e.g., budget, revenue, assets), as well as mission and “industry.” For example, a membership organization should be careful about comparing itself to a “trade” association, since their “business” model, executive roles, skill sets and compensation practices are different. When published survey sources are used to supplement the Form 990 analysis, similar care should be taken to ensure the participant base is relevant from an “industry” and size perspective as well. If the competitive market for certain executive roles and/or specific industry niches includes for-profit entities, it may be appropriate to include for-profits in assessing overall market pay rates.

Documentation
Finally, Boards must thoroughly document their decision-making process, including the specific data relied upon and any other relevant factors (such as performance) that were considered. Strong documentation is more likely to emerge when there is a thoughtful and reasonable compensation philosophy in place that clearly states the rationale for all significant aspects of the executive compensation program.

6. Strengthen Governance

We recommend five key practices and processes to promote good governance around pay practices at non-profit organizations:

Enhance the Decision-Making Process
A well-planned process begins with a Compensation Committee Charter that clearly defines its purpose, responsibilities and specific authorizations from the Board, including which recommendations or changes require the approval of the full Board. The compensation strategy should state the program objectives, targeted compensation levels, mix of compensation and the inputs used to make compensation decisions (such as performance, survey data, or tenure). Finally, the Committee should maintain an annual compensation calendar that specifies the deadlines and responsibilities for various tasks over the course of the year, as well as who will report findings and recommendations to the full Board.

Committee agendas should build in ample time for discussion and review prior to any vote. Generally, we recommend presenting information twice to the Compensation Committee – the first time for members' review and questions, and a second time for a decision based on any subsequent changes and recommendations. Additionally, a Committee Chair review of materials before distribution to the Committee helps to keep meetings on track and to pinpoint issues that may be particularly sensitive.

Continuity
Boards should require and strive for reasonable continuity in Compensation Committee membership. Compensation programs evolve over time and having institutional knowledge of past decisions provides additional context and clarity around the organization's pay practices. Frequent turnover in membership can result in the Committee making decisions with insufficient understanding of how and why existing programs were developed.

Adopt a Holistic Perspective on Pay to Avoid Surprises
Committees should thoroughly understand the ramifications of every decision they make around the compensation program. That includes being familiar with the full range of all potential incentive payouts as well as the *combined* value of all elements of compensation – base salary, bonus, perquisites, deferred compensation and severance.

Strive for Improvement
Committees should regularly evaluate their own performance, as well as that of individual members, the independent compensation consultant and the overall governance process. Members should be encouraged to participate on an ongoing basis in formal Director education programs, which can provide valuable insights and feedback from other Committee members about emerging issues and practices. Finally, the Committee should have a formalized "on-boarding" process that quickly gets new members up to speed about programs and issues so they can more quickly become involved in decision-making.

Be Proactive About Anticipating Issues
Specific time should be set aside annually for the Committee to discuss the organization's compensation strategy and programs in the context of the current and expected "business" environment.

7. Create a More Rigorous CEO Evaluation Process

Generally the Committee or the full Board evaluates the CEO's performance and the executive's pay will be based in part on that review. Despite the importance in the current environment of getting CEO pay right, we find many organizations still lack a robust and structured process for performance assessment. Among the areas that are typically weak:

Process Leadership
While the Board Chairman or Lead Independent Director ideally should lead the CEO performance evaluation process, at many organizations the Compensation Committee Chair is in charge. Whoever leads the process, it is critical that the process leader hold a leadership role and have credibility with the CEO.

Process Participants
Most CEO evaluations include feedback from all members of the Board, with some organizations expanding the process to incorporate direct reports to the CEO (i.e. 360-degree feedback). Involving a broader group in the performance review can provide more holistic feedback, but with the drawback of increased administrative complexity and confidentiality concerns.

Evaluation Content
A CEO performance evaluation should be sufficiently broad to capture all aspects of current and future job performance, including overall organizational performance, leadership, communication and Board relations. Within each of those areas, specific performance criteria, key strengths and development opportunities should be evaluated.

Evaluation Focus
Some components of the CEO's evaluation review will be very relevant to decisions on future pay levels. However, the Committee should focus the process on providing constructive feedback to improve the CEO's performance, effectiveness and professional development.

Administration
A relatively simple evaluation process in which only Board members provide feedback can sometimes be administered by the Board Chair/Lead Director. Where the process and forms are more complex, and certainly where 360-degree feedback is included, a third-party administrator may be needed to handle the greater administrative burden and ensure participant confidentiality.

Feedback
Following the performance review, the Board Chair/Lead Director should meet with the CEO to provide summary feedback. Where rating scales are used, the aggregate average rating on each performance dimension can help communicate the executive's key strengths and development opportunities. After a few years, trend lines will emerge that help highlight areas of performance that have strengthened or weakened over time.

8. Assess Executive Benefits

Executive benefits are often the least-understood element of compensation and Compensation Committee members may therefore not realize the potential liabilities they face (e.g., deferred compensation retirement benefits). The use of any executive benefit should be evaluated based on the extent to which it drives the organization's mission. Some benefits are targeted to genuine retention needs; for example, an executive's current cash compensation may be balanced with deferred compensation (such as a retirement benefit) to provide an attractive package until retirement. Conversely, it is considered less appropriate in the current environment for the organization to purchase supplemental life insurance or a car for a highly paid executive.

Executive Retirement Benefits
One of the most common executive benefits is a supplemental executive retirement program, or SERP. Such programs come in a variety of forms including a defined benefit plan (where the benefit is a function of annual compensation and years of service); defined contribution (based on annual contributions); or targeted benefit (where a specific fixed benefit is promised). The tax treatment of various SERP arrangements is also a critical consideration. The IRS continues to change the taxation requirements for executive retirement benefits and so the Committee should be aware of the relevant tax ramifications for the employer and the employee in order to implement an efficient program.

The Committee must first decide whether to give executives a benefit not available to other employees. A case can be made that such benefits help compensate executives for other benefits that are restricted under the tax code, such as limits on matching contributions to a retirement plan or contributions restricted to a certain compensation level. Additional retirement benefits also can promote retention and make up for the lack of a long-term incentive program. Whatever the rationale, the Committee must clearly explain to stakeholders why the additional compensation is appropriate, ensure its structure and size are reasonable and understand the eventual value and cost of the deferred compensation under all potential scenarios. It is very possible the total amount of the deferral will eventually end up as a media headline.

Executive Medical Benefits
While some organizations still provide post-retirement medical benefits and/or current supplemental medical benefits to their executives, these also are minority practices. As with SERPs, such benefits can be a useful element of an organization's overall compensation strategy, but the Committee must consider if they are worth the administrative hassle and additional public scrutiny.

Other Executive Benefits
As with other executive benefits, perquisites such as supplemental life insurance, spousal travel, club membership or a car should be a legitimately important component of the organization's overall compensation strategy and mission.

9. Evaluate the Adequacy and Independence of Compensation Advice

Public companies are now required to disclose the fees paid for executive compensation services and "all other" services *when the same firm provides multiple services to the company*. There is likely to be a cascading effect as tax-exempt organizations recognize the need to re-assess the adequacy and independence of their compensation advice. Given the complexity and scrutiny of executive compensation, the consultant should pass muster in both areas.

With regard to the *adequacy* of executive compensation advice, we believe Compensation Committees should expect the following from their consultant:

Information, Not Just Data
Data alone is not a sufficient deliverable. The consultant also should provide the Compensation Committee with information and insights gleaned from the analysis to help members make more informed and effective decisions. This requires that the consultant be able to synthesize complex data into simple, actionable advice for a Director audience.

Proactive Recommendations, Not Just Alternatives and Reactive Advice
Because executive compensation is so complex, staying ahead of the curve requires the identification of relevant issues and trends early in the process to avoid rush decisions later on that may have unintended consequences. In addition to providing a range of alternative

approaches to compensation issues, consultants to Compensation Committees should offer a viewpoint on the best option(s). The consultant will need to have sufficient experience and confidence to make a strong recommendation, rather than presenting just the pros and cons of each option. Because the consultant's advice must be supported by sound analytics, the consultant should possess the thought leadership and technical resources necessary to be at the forefront of emerging practices.

With regard to the *independence* of executive compensation advice, we believe Compensation Committees should:

Consider an Independent Firm
Using an independent consultant helps guard against any real or perceived conflict of interest in the governance process and the pay advice given. In most cases, the consultant should be engaged by and report to the full Board or its Compensation Committee. If reporting to the Board, the consultant should be able to work effectively with management to ensure a sound understanding of the organization's mission and key strategic goals.

10. Prepare to Retain Top Talent

As the economy improves, there is a growing need and competition for top executive talent among both tax-exempt and commercial enterprises. Non-profit Boards should be reviewing the competitiveness of compensation levels for all executives, particularly those who have been identified as being most critical to the organization. The design and administration of any performance-based plans should also be reviewed to ensure they provide appropriate performance measures and award opportunities. Special attention should be given to the long-term retention of key executives, balanced with the organization's increased liabilities and the impact on public disclosure.

Finally, the Committee should monitor compensation trends and practices in the tax-exempt world. These are likely to include a continuation of conservative salary increases, greater use of variable compensation, and non-qualified deferred compensation plans targeted at executive retention in response to IRS limitations.

In Closing

Non-profit organizations have made incremental changes to their executive pay programs in reaction to challenging economic conditions, new regulatory needs, and increased governance expectations. We believe it is now time to consider more robust, *proactive* changes to better ground compensation programs in the strategies and needs of non-profits. This will require that their Compensation Committees take a step back and seek fresh perspectives before moving forward diligently and deliberately.

This Top 10 list provides insight into the areas we believe should be key near-term priorities for Compensation Committees. We hope to have the privilege of joining you on this journey.

About Pearl Meyer & Partners

For 25 years, Pearl Meyer & Partners (www.pearlmeyer.com) has served as a trusted independent advisor to Boards and their senior management in the areas of compensation governance, strategy and program design. The firm provides comprehensive solutions to complex compensation challenges for multinational companies ranging from the Fortune 500 to not-for-profits as well as emerging high-growth companies. These organizations rely on Pearl Meyer & Partners to develop global programs that align rewards with long-term business goals to create value for all stakeholders: shareholders, executives, and employees. Pearl Meyer & Partners maintains U.S. offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, Los Angeles, San Francisco and San Jose, as well as an office in London.

Pearl Meyer & Partners
Comprehensive Compensation®

www.pearlmeyer.com

NEW YORK
570 Lexington Avenue
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA
One Alliance Center
3500 Lenox Road, Suite 1708
Atlanta, GA 30326
(770) 261-4080
atlanta@pearlmeyer.com

BOSTON
132 Turnpike Road, Suite 300
Southborough, MA 01772
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE
3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO
123 N. Wacker Drive, Suite 860
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON
Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LONDON
Clifford House
15 Clifford Street
London W1S 4JY
+44 (0)20 3384 6711
london@pearlmeyer.com

LOS ANGELES
550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com

SAN FRANCISCO
595 Market Street, Suite 1340
San Francisco, CA 94105
(415) 651-4560
sanfrancisco@pearlmeyer.com

SAN JOSE
2880 Zanker Road, Suite 203
San Jose, CA 95134
(408) 954-7399
sanjose@pearlmeyer.com