Compensation Committee Chair
Advisory Council

Summary of Proceedings

May 14, 2013
About the Compensation Committee Chair Advisory Council

With a focus on the common goal of a sustainable and profitable corporate America, the National Association of Corporate Directors (NACD) and partners Farient Advisors and Gibson, Dunn & Crutcher created the Compensation Committee Chair Advisory Council. Since 2011, this council has brought together experienced compensation committee chairs from Fortune 500 companies with key shareholder representatives, regulators, and other stakeholders to discuss ways to strengthen corporate governance in general—and compensation committee oversight in particular.

Delegates of the council have the opportunity to engage in frank, informal discussions regarding their expectations for compensation committee practices, processes and communications, and to share observations and insights on the changing business and regulatory environment. The goal of the council is threefold:

- Improve communications and build trust between corporate America and its key stakeholders.
- Give voice to directors engaged in the compensation arena and improve the quality of the national dialogue on compensation matters.
- Identify ways to take compensation committee practices to the “next level.”

NACD believes that the dialogue facilitated by this advisory council is vital to advancing the shared, overarching goal of all boards, investors, and regulators: a sustainable, profitable, and thriving corporate America.
Advisory Council Participants

May 14, 2013 Meeting

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RadioShack Corp.

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Compensation Committee Chair,  
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Introduction
On May 14, 2013, NACD and partners Farient Advisors and Gibson, Dunn & Crutcher co-hosted the third meeting of the Compensation Committee Chair Advisory Council. The session brought compensation committee chairs from Fortune 500 companies together with influential stakeholders from the compensation and governance communities to share views and identify leading and “next practices” regarding the most pressing issues facing compensation committees.

The following summary captures the spirit of the day’s discussion, as well as key messages and general perspectives. NACD is sharing this summary with directors—and the governance community—to help guide and inform the ongoing dialogue concerning important board issues.

For several years, executive compensation has received significant scrutiny from investors, regulators, and the public. New and pending rules from the Securities and Exchange Commission (SEC), as well as shareholder activity, have driven increased communication from directors on the link between executive compensation and performance. Against this backdrop of increased engagement among stakeholders on compensation matters, advisory council delegates met to discuss ways to advance compensation committee practices even further.

Discussion at the meeting covered three areas: perspectives on recent regulatory activity in both Europe and the United States, strengthening the boardroom discussion on compensation, and enhancing external communications.
Regulatory Update

Reflections on the Third Year of Say-On-Pay Voting

In 2010, analysts and commentators projected that Dodd-Frank would have widespread effects on corporate governance, especially with respect to the compensation committee. While approval rates on advisory say-on-pay votes have generally been high, delegates observed that it is important to look beyond the numbers to understand Dodd-Frank’s broader impact on compensation matters. For the last three years, a relatively small number of companies have failed to receive majority shareholder support for executive compensation packages. As of mid-June 2013, 88 percent of Russell 3000 companies had received a say-on-pay approval rate of 80 percent or higher, and the percentage of companies with approval votes under 50 percent and those between 50-80 percent were lower than in 2012.1

Notwithstanding the low number of failed votes, however, say-on-pay voting has significantly affected the design and communication of executive pay packages. To explain the increased levels of shareholder support, delegates discussed two possible rationales: improved communications and norming. Most delegates concurred that say on pay has enhanced and strengthened engagement between the board and investors. After several years of increased investment in terms of time and resources, boards have continued to raise the bar on linking and communicating pay with performance, and shareholders are responding with supporting votes. Nevertheless, some delegates also suggested the possibility that compensation committees are adjusting plans due to pressure from proxy advisory firms and institutional investors, and thus foregoing some opportunities to tailor compensation plan design to company strategy. One delegate commented: “I'm concerned we are seeing committees norming [compensation plans] to the median.”

Regulatory Trends in Europe

Regardless of the driving forces behind votes, the majority of American investors appear to be generally content with the current advisory form of say on pay. In comparison, social pressures in several jurisdictions of Europe have resulted in a move to binding shareholder votes on executive compensation. In 2014, binding say-on-pay votes will go into effect in the United Kingdom, and the Minder Initiative2 will be implemented in Switzerland. In addition to binding say on pay, the Minder Initiative calls for the elimination of senior executives’ sign-on bonuses, as well as severance packages and extra incentives for completing merger transactions. As a result of the public outcry across the continent against executive pay, more countries—including Germany and Spain—have adopted shareholder votes that are expected to be binding.

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Outlook for Compensation Regulation in the United States

In the United States, public backlash against executive compensation has increased in the period of slow recovery following the financial crisis, although not to the same extent as in Europe. This may change though, as guidance on compensation disclosures mandated by Dodd-Frank is expected to come from the SEC this year that may put pay disparities back in the spotlight. These include disclosures on the recovery of executive compensation, or “clawbacks,” the ratio of CEO to median employee compensation, and the relationship between executive pay and company performance.

The latter two disclosure requirements in particular are generating a good deal of debate due to the lack of specific definitions in the legislation. For example, Dodd-Frank does not establish a standard for calculating compensation “actually paid,” or instruct companies on how to calculate “median employee compensation.”

In the absence of clear standards, companies are increasingly providing supplemental disclosures on the connection between pay and performance in their proxy statements. The result has been widely divergent approaches to defining and measuring “actual pay.” At a previous meeting, advisory council delegates agreed that NACD could play a helpful role in establishing consensus in these areas. At this meeting, delegates provided feedback on a draft survey intended to benchmark board members’ views on pay definitions, which is expected to be released to the director community this summer. With the guidance of the Compensation Committee Chair Advisory Council, NACD expects to use the results of this survey to inform comments to the SEC on the considerations it should take when issuing guidance on pay and performance disclosures.

Strengthening the Boardroom Dialogue on Compensation

As noted by one delegate, technical complexity can be a roadblock to robust boardroom dialogue on compensation: “How do we balance understanding with accuracy?”

Despite increasingly complex pay plans and extended periods of time between meetings, compensation committee members need to discuss the intricacies of executive compensation at each meeting and then provide succinct reports to the full board. This issue can be further complicated when directors rotate on and off the committee. In order to effectively explain pay packages, it is critical that all directors are knowledgeable about the various components of compensation—and how they may play out under different scenarios.

Several delegates outlined the efforts their compensation committees undertake to help all board members fully comprehend the complexities of some compensation plans:

- **Set aside time for deep dives.** At one company, the compensation committee meets for an additional day outside the full board meeting to address and discuss compensation matters.
- **Develop educational materials.** Others suggested providing supplemental materials as a refresher on the technical issues. One delegate said: “Every year, we give the compensation committee and the full board a primer about the components of these plans and how they work.”

Additionally, as another delegate explained, the compensation committee can maintain tally sheets for the CEO and named executive officers: “We put together tally sheets twice a year. Everyone can see what is in the plans and where they stand at that point in time.”
- Schedule periodic look-backs. “Our committee conducts a review of what we intended to pay versus what was actually paid out, over time,” stated a delegate.

**EXTERNAL COMMUNICATIONS**

After the compensation committee and the full board have become versed in the components of the compensation plans, directors are faced with the difficult task of disclosing the philosophy underlying compensation decisions in a clear, straightforward manner. If a compensation committee can effectively communicate the links between strategy, performance metrics, and executive pay, then investors can develop a perspective on whether they believe pay results ultimately match the board’s intentions. Most delegates agreed that the increasing length of the compensation discussion and analysis (CD&A) sections in proxy statements demonstrates the challenge compensation committees face in this area. As one delegate observed: “So much of the CD&A is just explaining the summary compensation table.” Another delegate summarized how the compensation committee could communicate its philosophy in three steps: “First, what pay is possible if all targets are hit over a period of time? Second, what is achievable given actual economic conditions? Third, what was the executive actually paid?”

In discussing how to simplify and clarify communication on executive compensation, delegates suggested boards could consider ways to make the language they use with investors more consistent with that used with executives. To illustrate, in compensation discussions with executives, the long-term plan is communicated with potential payouts based on scenarios. Notably, compensation is not reduced to a single number: “Clarify the thought process when the program was designed…it mirrors reality,” said one delegate. “Why not have the same discussion with the owners of the company as we have with the CEO?”

For disclosures that effectively communicate the intent behind compensation programs, delegates pinpointed three areas requiring further attention: the use of discretion, metrics, and peer group selection.

**Use of Discretion**

The use of discretion in pay decisions is a perennial issue in executive compensation. From the boardroom perspective, the compensation committee should have the ability to adjust compensation—up or down—for a variety of reasons, such as industry or exogenous events. For example, a utility company’s performance is directly related to weather and other natural phenomena. In other cases, the company may be in a turnaround. Most agreed with one delegate who said: “You cannot write a formula or logarithm that takes all this into account.” In such situations, the board and compensation committee will need to use business judgment.

Proxy advisory firms have generally been critical of the use of discretion by compensation committees, while institutional investors tend to object to discretion only when it is used without restraint or explanation. Essentially, as one delegate observed, the compensation committee should “use discretion with full transparency.” From their experience, delegates agreed that it is possible to disclose the board’s intent behind executive pay packages, including the use of discretion and the areas that impacted performance, without revealing information of a competitive or sensitive nature.
Metrics

In recent years, what appear to be large compensation payouts have received negative attention from investors, media, and the public—especially, though not exclusively, at financial institutions. In response, delegates raised the question: Did these plans pay for driving performance, or were they riding the bullish stock market? As observed in the use of discretion, often the areas that drive performance are not only technically difficult to explain, but also largely subject to external forces: “It's critical to separate real performance from changes in the S&P [Standard & Poor's Index] or commodity prices.” One delegate suggested: “Compensation committees need to look at how the management team coped with exogenous factors in comparison to the competition.”

Peer Group Selection

In the discussion of pay levels and performance, peer groups serve a critical comparison function. Not only does the peer group help a board benchmark its compensation practices, but it allows shareholders to compare performance and pay to peer companies. Boards and proxy advisory firms, however, frequently differ in opinion on what a company’s peer group should comprise. As one delegate observed, the differences between companies may be more apparent to those who work in the industry as opposed to a proxy firm analyst. In order to preempt a “no” recommendation from proxy firms as a result of peer group selection, delegates said the board should explain the rationale behind its selected group.

Delegates also discussed the growing trend among companies of using multiple peer groups. For example, a smaller peer group can be used to set pay levels, while a broader group can be used to compare performance. A delegate described a situation at one company where: “We have three peer groups based on different [senior executive] positions. The key is to explain that.” When filling the peer groups, the compensation committee can also look to management’s sources for new hires. Another delegate commented: “We looked at who is recruiting talent from us, and we are recruiting from our peer group. Where are we getting our talent?”

Conclusion

Throughout the rest of the year, the Compensation Committee Chair Advisory Council will continue to discuss the issues facing compensation committees across the nation. With the input of delegates, NACD plans to submit comment letters to the SEC in the coming months on outstanding rules on compensation disclosures. Further, the guidance of this group—along with NACD’s other advisory councils—will shape the discussions in the continuing dialogue surrounding NACD Directorship 2020™, an initiative which will help define performance requirements and resource needs for future boards and directors.