

THE DIRECTOR'S GUIDE

TO  
Executive  
Compensation

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# New Rules Give Power To The Compensation Committee

Compensation committee chairs seek education and independent advisors to bullet proof their pay decisions.

By Judy Warner

The Sarbanes-Oxley Act of 2002 (SOX) empowered audit committees to take greater control of financial reporting oversight. Nearly a decade later, passage of the Dodd-Frank Act of 2010—and the subsequent regulations being written by the Securities and Exchange Commission—has transformed the role of the compensation committee in much the same way. Just as SOX rules for greater independence, expertise and auditor-hiring clout increased the power and visibility of audit committee members, so too do the new rules on approving and justifying pay put compensation committee members in a new and influential light.

Directors like to joke that in the “old days” before Dodd-Frank, the audit committee handled most of the board’s heavy work. Not any more. Some compensation committee members, investors and their advisors believe the most profound and lasting impact of Dodd-Frank is to shift the balance of power from management to the shareholder, as new and pending regulations empower compensation committees as never before.

“We have to keep the intent of Dodd-Frank front and center,” says Robin Ferracone, the founder and executive chair of the compensation consulting firm Farient Advisors. “The intent was to encourage shareholder communication more directly, frequently and openly with their directors and Dodd-Frank is the catalyst for that. The law is not trying to become the dominant force. The law is trying to facilitate this communication. And we should not lose sight of that.”

There’s no doubt, however, that the effect of Dodd-Frank on boardrooms—more specifically the pay-for-performance proxy disclosures effective last year and the new rules expected this year for “say on pay,” clawbacks, and compensation committee and advisor independence—“is a seminal change,” says Catherine R. Kinney, a public company director who retired from NYSE Euronext in 2009 as presi-

dent and co-chief operating officer and now serves on the boards of MetLife, MSCI (the parent company of ISS Governance Services) and NetSuite. “I think it’s a huge power shift in the boardroom... The fact that an investor can look at the CD&A and vote against a director is one of the biggest changes relative to performance around the boardroom table.” She sees it as one more step in the direction of progress, that is, “management and the board working together to find the right performance for the shareholder.”

Says one *Fortune* 100 director, who asked not to be quoted by name, “Management can no longer ask the HR person and the top three directors they like to serve on the compensation committee. Today, the compensation committee is chosen by the independent directors and working on behalf of the shareholder. It’s dramatically different and as a result, most compensation committees today are scrambling for information and education.”

Stephen W. Sanger, retired chairman of General Mills and a prominent public company director whose board service currently includes Target, Pfizer and Wells-Fargo, concurs. He says Dodd-Frank dramatically transforms the compensation committee role from “compliance to advocacy.” David Lynn, a partner at the law firm Morrison Foerster, notes that in addition to new disclosure, “what shows up in the proxy statement is more important because of the environment we’re in.”

Most compensation committee chairs are seeking direction and education on implementing both new and pending rules, and how the language of disclosure in the annual proxy statement should read. Like their audit committee brethren, compensation committee members are being encouraged to set their own budgets and retain independent compensation consultants and advisors.

“There’s a lot of trial and error—and learning—in the compensation process right now,” observed Fer-



## NACD Advisory Council on Compensation

**Andrew Berger**, director and compensation committee chair, Thermadyne Holdings

**Stephen L. Brown**, head of corporate governance, TIAA-CREF

**Carlos C. Campbell**, director, PICO Holdings, Herley Industries, Resource America

**Randi Caplan**, director of marketing and business development, Farient Advisors

**Robin Ferracone**, executive chair, Farient Advisors

**Peter Gleason**, managing director and CFO, NACD

**Gary Hourihan**, SVP, Farient Advisors

**Robert J. Jackson Jr.**, associate professor of law, Columbia Law School

**Steve Kalan**, associate publisher, NACD Directorship

**Lynn Krominga**, lead director, Sunrise Senior Living; director, Avis Budget Group

**Catherine R. Kinney**, director, MetLife, MSCI, NetSuite

**Jack Lederer**, principal, Curcio Webb

**David Lynn**, partner, Morrison Foerster

**Judy Warner**, managing editor, NACD Directorship and directorship.com

racone during a meeting of the NACD Advisory Council on Compensation (*See sidebar for complete participants' list*). "As a compensation committee member, you have to be sensitive and attuned to the issues being faced from an emotional and dynamic standpoint. It takes a lot of skill to not let the mechanics of the discussion overwhelm the process and leave you with a dysfunctional result."

New rules for all publicly traded companies—including say on pay and say-on-pay frequency in effect for the upcoming proxy season—stipulate greater disclosure, while opening the door for boards to communicate more often with shareholders. By one count, Dodd-Frank requires regulators to create 500 rules, conduct 81 studies and issue 93 periodic reports. The stated objective of the legislation is "to promote the financial stability of the United States by improving accountability

and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices and for other purposes."

One of the "other" purposes is to rein in risk-taking promoted by excessive compensation or by compensation that is tied too closely to short-term financial performance—especially in the financial services sector, the main focus of the law.

### A Long Way to Go

A recent study commissioned by the Council of Institutional Investors (CII) found that while the pay-for-performance link on Wall Street has strengthened somewhat since the global financial crisis, banks still are not tying compensation to long-term gains in performance. CII commissioned

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the report, "Wall Street Pay: Size, Structure and Significance for Share-owners," to gain a better understanding of pay at big Wall Street banks and how it differs from executive compensation at other large U.S. companies. "While many banks have strengthened their pay practices, there's still a long way to go," says Ann Yerger, CII executive director. "The report suggests they need to do more to make sure that executive compensation rewards performance over the long term."

CII's report notes that "more vigorous federal oversight of Wall Street does not appear to have changed compensation on the Street for the better" and encourages shareowners to address outstanding pay issues by "engaging directly" with firms

where compensation is most out of line with best practice, voting against management say-on-pay resolutions at annual meetings and filing shareowner proposals seeking better pay practices. CII also recommends that investors lobby Congress and regulators for more effective reforms. "Such steps," the CII reasons, "could include mandatory deferral of a percentage of incentive compensation, over specified periods, and clawbacks of deferred compensation if certain long-term performance targets are not met."

While primarily targeting the excesses of the financial services sector, Dodd-Frank establishes a number of new rules for all publicly traded companies, including some pertaining to compensa-

tion. As the argument goes, the balance of risk to reward was not aligned, particularly in America, where boards signed off on compensation packages that rewarded top executives as their businesses tanked. By July 2011, the SEC must issue rules that direct the national securities exchanges such as NYSE Euronext, Nasdaq OMX and other associations to prohibit the listing of any security of an issuer not in compliance with the requirements of the compensation sections. Among the Act's other requirements:

- A public company is required to submit to shareholder vote at least once every six years the frequency of say-on-pay votes. As this article was being written in early January, ISS had begun to analyze

## Aligning Performance and Pay

Farient Advisors believes it has created metrics to accurately assess how companies compensate management and whether that pay aligns with performance. The independent compensation advisory practice, founded four years ago by Robin Ferracone, has correlated 10 years of performance data with compensation for every company by sector in the Standard & Poor's 1500 where a CEO has been in place for a minimum of three years.

"Directors need a clear picture of how pay and performance look against one another and against other companies in their sector," Ferracone says. "There has not been an easy way to see if pay and performance is aligned. There are other methods out there, but they are not as clear."

Weighted by size, overall sector analysis shows companies whose pay is "completely aligned" and those that are not. Outliers are revealed both for over- and under-compensating management

based on total shareholder return – that's the measure of corporate performance that Farient opted to go with. The analysis also shows whether the company's pay package falls within a "reasonable" range for the size of the company and the industry and how "sensitive" pay is to performance over the last 10 years. Companies whose pay is not aligned will be revealed as outliers.

The result is a vivid portrayal of how companies' compensation programs compare to industry peers, which may cause some directors to pause and think: How will this information be used against me? The intent is to see now whether your pay is aligned, so when pay-for-performance disclosures are fully in place for the 2012 proxy season, companies and boards are ready.

"We're not trying to alienate Corporate America. We're trying to be helpful here," says Ferracone, who founded Farient in 2007 and began to research

methods that demonstrated pay and performance. The alignment model was detailed in the recently published book *Fair Pay, Fair Play*. Ferracone could not at that time foresee Dodd-Frank and the growing mandate for publicly traded companies to fully explain how executive pay relates to performance, but in light of the new regulations, her work now seems particularly prescient. Ferracone reports meeting with regulators at the Securities and Exchange Commission, who she says were "enthusiastic" about how the disclosure was displayed.

While the underlying methodology to the alignment model is a proprietary algorithm, Farient intends to release to the public some of the top view results and may sell more detailed analysis to corporations, boards and investors.

One of the first proxy statements to cite the alignment model in its CD&A was filed by Air Products and Chemicals (APC). It details in a section titled "Pay

2011 proxy statements containing corporate recommendations on say on pay and say-on-pay frequency. Companies to publicly support annual votes on the issue include Visa, Beazer Homes, Torvec and New Jersey Resources. Hormel, which manufactures Spam among other food products, supports biennial votes. Hormel wrote in its proxy that a vote on pay every two years “strikes the right balance between having the vote too frequently with an annual vote and being less responsive to stockholders with a vote every third year.”

So far, at least four companies—Johnson Controls, Monsanto, Emerson Electric and Costco—have advised shareholders to support triennial votes.

■ Shareholders may also reject any golden parachute compensation. Although all of these votes are nonbinding, there is general consensus that boards should act at the shareholders discretion or face peril at election time.

■ New rules to be issued this year will require that shareholders be informed of the relationship between executive compensation that is actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions. In addition, a new rule may require disclosure of the ratio between CEO and employee pay.

■ All public companies shall also

disclose whether any employee or member of the board is permitted to purchase financial instruments designed to hedge or offset any decrease in the market value of equity securities that are part of a pay package.

■ Members of the board’s compensation committee must be independent, and their consultants—whether compensation or legal—must be independent as well. The SEC is currently defining what “independence” will mean.

### Director Empowerment

So what’s a compensation committee member to do?

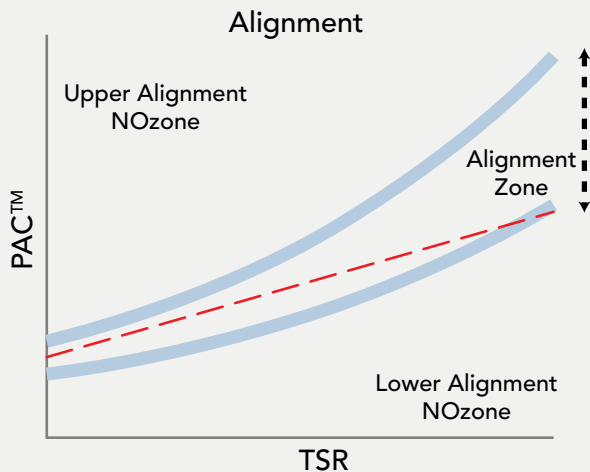
From the investors’ standpoint, Dodd-Frank may have finally ended the debate

for Performance Results” the company’s record of “providing an Executive Officer compensation program that is strongly

aligned with both absolute and relative performance.” The statement also contains two charts that show the “strength”

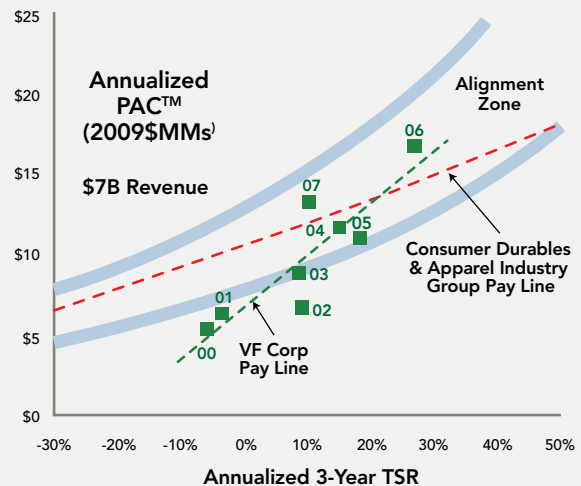
of the alignment and both a “recent and a longer-term historical perspective on the effectiveness” of APC’s pay programs.

### Fairient’s Definition of Alignment and Alignment Zone



SOURCE: Fair Pay, Fair Play: Aligning Executive Performance and Pay

For example, VF Corp earns an Alignment Score of 100%; CEO PAC is both reasonable and sensitive to TSR over time



Rating: Reasonableness: 100% Sensitivity: 100% Overall Alignment: 100%

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on what rights shareholders should have, according to Stephen L. Brown, director of governance at TIAA-CREF. “The traditional way that American companies are run has not changed: management runs it, boards oversee it and investors have a vote. That’s corporate democracy.”

Carlos C. Campbell, a public company director for more than 20 years, begs to differ. The rise in ownership and activism by institutional shareholders over the past two decades has changed the outside world and the dynamics of that world, he argues. Add to that an active plaintiffs’ bar for private securities litigation and you can end up with derivatives action if “you’re even a little out of sync.”

Still, Campbell sees the effects of Dodd-Frank, like SOX before it, as a “tremendous change for the better.” But improvement will not happen by itself.

different arenas,” he says.

The onset of greater disclosure of director qualifications and the possibility of annual director elections is part of the “long march of the evolution of governance,” Kinney says. “The need for our own advisors and for a fully engaged board that works very closely with management—but is not run by management—is what’s important.”

Compensation can sometimes be difficult to talk about, especially when there is dissent. Faced with a strong say-on-pay “no” vote, Lynn says, is “a license to sit down with the CEO and address the issue.” Say on pay, he reasons, “empowers directors to have that conversation and with that vote in hand the conversation becomes less difficult.”

All things considered, said Lynn Krominga, “this conversation has made

Group, offered some reassurance: “The role of the compensation advisor is to help companies and boards define pay for performance and make them comfortable with their decisions.”

To Krominga’s point, Robert J. Jackson Jr., now an associate professor at Columbia Law School who was deputy special master for TARP Executive Compensation under former pay master Kenneth Feinberg, helped draft the Obama Administration’s proposed Dodd-Frank provisions on pay, offered his perspective. “Although many directors feel that Dodd-Frank reflects criticism of director-driven governance, the pay provisions are designed to strengthen directors as regulators of compensation,” Jackson told the Advisory Council. “Directors are entitled to their own compensation advisors. We want you to have your own lawyer and to set the budget for your own resources. Those who advise directors on pay must report only to directors, and must be independent from management. Those are really the tools we wanted directors who sit on compensation committees to come away with.”

Jackson also offered advice, providing both a suggestion and a word of caution to directors. “What’s happening now affirms the fundamental basic principle that directors have a responsibility to make decisions according to their best judgment, and that judgment is given enormous deference. Dodd-Frank strengthens this principle. It doesn’t undermine it.

“But here’s my caution: Because we live in a world in which politics and media direct so much of our thinking, directors will be held responsible for the compensation decisions they make,” he asserted. “And there is some danger that a decision that is poorly explained or a judgment that is not fully thought through will put directors in a very difficult position in



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*—Robin Ferracone*

To create compelling CD&As that align pay with performance, Campbell says, requires “responsive shareholder-centric board leadership and a diligent team made up of the compensation committee, counsel and a bona fide, credible independent consultant.”

Jack Lederer, whose company, Curcio Webb, advises compensation committees on Dodd-Frank implementation, recommends that compensation committees take a step back “at a clean chalkboard” to consider multiple compensation advisory resources. “There are different experts for

me a bit more optimistic...I realize this is all very new and the consultants are learning along with us, but I’m still concerned about unintended consequences. The large institutional shareholders may create an industry of consultants that we will all grow dependent on. I support shareholder rights, but I’m not sure this is the right way to do that.”

Gary Hourihan, who joined Farient as senior vice president in December from Korn/Ferry International where he was founder and chairman of that firm’s International Leadership & Talent Consulting

# An Investor's Point of View

## TIAA-CREF's Stephen L. Brown

*As a director of corporate governance for one of the country's largest institutional investors, Stephen L. Brown and his colleagues sit in judgment of governing practices at more than 8,000 portfolio companies around the globe. The corporate and associate general counsel for TIAA-CREF, which has some \$434 billion under management, started his career as a financial analyst at Goldman Sachs, then entered private practice as a securities attorney at Skadden and WilmerHale, where he represented corporate boards of directors and hedge funds. As Brown points out, "I've walked in the shoes of issuers." In an interview with NACD Directorship's Jeff Cunningham, Brown spoke about the implications for boards resulting from the Dodd-Frank Act and the need to raise their governance IQ.*

**What do you like most about the changing boardroom landscape?**

The passage of the corporate governance reforms included within Dodd-Frank was a watershed event that affects boards, management and shareholders alike. Boards and management will now have to take more interest in investors' viewpoints. And shareholders must take on greater responsibility in monitoring boards with the tools provided to them by Congress.

**Are the new requirements being embraced or resisted?**

Both. The best practitioners—issuers who have always addressed governance into their road shows, for example—are

continuing to do the right thing, and I don't think Dodd-Frank has raised their blood pressure much. You have another category of issuers who are new to engaging with shareholders and they've embraced the challenge and are sincerely attempting to understand how to be more responsive to shareholders. And



Stephen L. Brown

then there is this third category of what I like to call "the governance cavemen and cavewomen." These are folks who are still in the Stone Age about the need for regular dialogue with their key shareholders.

**Why did it come to the necessity of enacting a law?**

Many would have preferred private ordering to achieve reform. However, when market participants can't find consensus, regulation follows. With respect to say on pay, a few years ago we approached some of our largest portfolio holdings and asked them to voluntarily adopt an advisory vote with hopes that the rest of the market would follow. Many responded that they preferred to wait for legislation; not wanting to be a first mover. The lack of widespread voluntary adoption mixed with public angst over executive compensation, and the onset of a financial crisis, yielded an inevitable response by public policymakers. So, here we are.

**Do governance practices differ among companies according to market capitalization?**

The fact is that over the last decade the larger-cap companies have been the focus of large institutional investor activism; so those companies have responded to the various viewpoints of shareholders with respect to governance best practices. However, most of the mid- and small-cap companies have had the cover of the large caps.

It's likely to be different now. No more cover. The mid and small caps will have to raise their governance IQs and address governance more proactively.

**How often do problems in corporate governance relate to CEO compensation?**

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It's often a red flag rather than a cause. We define problems not by the absolute amount of compensation, but focus on whether or not the compensation program is aligned with our interest in creating long-term sustainable shareholder value. Compensation issues can be indicative of misaligned risk/reward incentives, lack of long-term focus, or simply show that there's not enough counter balance in the boardroom.

*You might have read that Rob Feckner [president of the California Public Employees Retirement System] said CalPERS would no longer publish its watch list and that they would approach companies privately because they thought it would be more effective. Do you agree with this kinder, gentler activism?*

We absolutely agree that it's more effective. Quiet diplomacy has always been TIAA-CREF's style of issuer engagement. In our experience, you can achieve optimal outcomes when you can get a company to focus solely on key governance issues and avoid public embarrassment over being targeted. A sense of partnership and respect are elements that should exist when engaging with issuers to bring about changes aimed at long-term value creation. More aggressive approaches may be warranted at times, but it is certainly not the starting point for long-term focused institutional shareholders.

*What are the means or methods that you've seen in which directors are effectively communicating with TIAA-CREF?*

We appreciate clear and meaningful proxy disclosures. Disclosure should not simply be viewed as regulatory mandates,

but rather as an opportunity for directors and management to make their case to shareholders. TIAA-CREF takes care to intelligently execute our proxy-voting duties and we can do so effectively and efficiently when we are able to understand with confidence how directors exercised their duties on our behalf. Providing clear, concise and meaningful disclosure in the [Compensation Disclosure & Analysis] section of the proxy is one such opportunity with respect to compensation. The newly required enhanced disclosure related to board leadership, director qualifications, risk oversight and other related corporate governance issues is another

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opportunity to tell your story. The arrival of mandatory say-on-pay votes this proxy season heightens the importance of providing good disclosure.

Direct dialogues should complement good disclosure. While we do speak with companies during proxy season, the most constructive dialogues occur at governance "road shows" outside of proxy season when there is more time.

*How can a company prepare for a governance road show?*

It's common for issuers to create an agenda with us prior to the meeting. That way both sides can manage expectations and ensure that the issuer has the right people in the room. The right people include those senior executives who can

speak knowledgeably about issues on the agenda—we are starting to see more heads of executive compensation in these meetings in order to address detailed compensation questions. Although we know it is not always feasible all the time, having independent directors as part of these meetings is an invaluable emerging best practice. Finally, prior to embarking on a road show, it can be helpful for issuers to host their own mock dialogue with their outside advisors such as compensation consultants.

*That's an excellent idea. Tell me, what do you think of say on pay?*

We think a shareholder vote on executive compensation policies empowers both investors and boards. It allows board members to use investor sentiment as expressed through its advisory votes in their conversations with the C-suite. It arms the compensation committee chairs with real feedback. Directors could take the outcome of a say-on-pay vote and bring it in with them to a meeting with the CEO saying, "Listen, this is what shareholders are thinking." And by the way, these shareholders have the power to vote directors off the compensation committee and out of office, particularly if directors are elected by a majority of votes in uncontested elections.

*Are there areas of frustration for you that were not addressed in Dodd-Frank?*

I think many people are unhappy that majority voting was taken out of the corporate governance provisions of Dodd-Frank. But the vast majority of your large-cap companies have already adopted this best practice. And the rest of the issuers who have yet to adopt will likely see significant shareholder pressure to do so this year.

# New Risks and Rewards

By David M. Lynn

Today, members of the compensation committee are making decisions against a backdrop of public outrage over executive compensation and a lingering perception that there is little accountability for boards of directors. This heightened focus means increased risk for members of the compensation committee, as their actions—or inactions—are closely scrutinized by investors, regulators, the media and the general public. As calls for accountability mount, it becomes increasingly important for the members of the compensation committee to evaluate their overall approach, the tools that they are using in their decision-making process, the advisors that they engage and the integration of the compensation committee into the overall risk-management process, all as a means to limit the potential risks arising for the members of the compensation committee.

**Seeking Accountability: Increasing Activism Leads to Harsh Consequences.** The consequences for any perceived failings or missteps on the part of compensation committees have become increasingly more severe. Institutional investors (and their advisors) have used the director election process to express displeasure with the performance of compensation committee members, the overall executive compensation policies and practices of a company, or even individual components of executive pay. With an ever-increasing number of public companies moving to a majority voting standard for director elections, compensation committee members are increasingly at risk of losing their board seats through a withhold

vote campaign targeting the individual members of the compensation committee and the compensation committee chair.

Moreover, executive compensation concerns could compel “activist” investors to target a board of directors with a proxy contest, a “poison pen” letter-writing campaign, or other hostile techniques to put pressure on the compensation committee to change its policies or decisions (or to ultimately unseat them). These same investors may soon have access to the company’s proxy statement to conduct a contested election, if the SEC prevails in its court fight to implement the “proxy access” rules adopted in August 2010. Companies will also be closely watching the results of the advisory votes on executive compensation required by the Dodd-Frank Act, because these high-profile votes will serve as a referendum on the performance of the compensation committee and the pay programs that the company has implemented. Finally, the current environment may ultimately lend itself to litigation, where investors resort to the courts to allege a breach of fiduciary duty on the part of the members of the compensation committee in making what are viewed as egregious executive pay decisions.

**The Best Defense is Good Offense: Protecting the Compensation Committee with the Right Tone and Tools.** The calls for accountability—and the substantial risks arising from the efforts employed today to compel that accountability—will increase the pressure on the board of directors and the members of the compensation committee to set the right “tone at the top” when it comes to matters of compensation. Compensation

decisions should not be an afterthought, or unduly influenced by management’s expectations. Rather, the members of the compensation committee need to focus on making their own independent judgments based on the best available data and independent, unbiased advice. Much like the move toward independence and engagement that we have seen with audit committees over the past 10 years, compensation committees are rapidly moving toward an increasingly independent and analysis-intensive role in the board process, all as a means to set the right tone, ensure fulfillment of the members’ fiduciary duties and ultimately protect the members from the expanding list of risks arising from the public outcry over executive compensation.

The independence of compensation committee members was the subject of recent legislative action under the Dodd-Frank Act, and exchange listing standards will need to be amended in order to implement those provisions. As contemplated by Dodd-Frank, compensation committee members would be subject to the independence standards that are comparable (but not identical) to the standards applied today to audit committee members of a listed company. Notwithstanding this legislative directive, compensation committees have become more and more independent over the past several years, such that in many cases it will not actually be necessary to change the composition of the compensation committee when new standards are adopted. However, while compensation committee members are increasingly likely to be free from any material ties to management or the company, it is also incumbent on the com-

pensation committee, in setting the right tone, to act independently in fulfilling its duties. This translates into having the appropriate resources so as to not rely too much on management's data, analysis or judgments, and to confer with all appropriate members of the board of directors, management and advisors (both company and board advisors) when making important compensation decisions.

To further this move toward independence, the members of the compensation committee need unfettered access to their own unquestionably independent advisors. The advisors (which could include compensation consultants, legal counsel, valuation experts and others) do not in and of themselves fully protect the members of the compensation committee from risks associated with the compensation committee's actions, but rather can serve as a valuable source of unbiased advice concerning compensation matters that is less susceptible to be questioned down the road.

Further, the advisors can provide valuable insights into what others are doing from a compliance and "best practice" standpoint, so that it is less likely that the compensation committee's actions would be seen as out of line with norms of good governance and oversight.

While every company espouses a philosophy of "pay for performance"—and indeed the implementation of that philosophy is the most important concern for investors when evaluating a company's executive compensation program—the actual implementation and ongoing evaluation of the relationship between pay and performance is a difficult task that must remain the highest priority of the compensation committee. Compensation committees need to utilize their available tools and make sure that the company lives the "pay for performance" philosophy, and that the results achieved

when executing on that philosophy are clearly communicated to investors. Finally, an important means for compensation committees to address the risks that they now face is to ensure that they and the compensation-setting process are fully integrated into the overall risk-oversight activities of the board and the company. The financial crisis and its legislative and regulatory aftermath have focused considerable attention on the relationship between incentives in compensation programs and the risks that arise for companies, and as a result the compensation committee has become a crucial component of the risk-oversight process. The compensation committee's attention to risks—through a periodic evaluation of the compensation program and how pay elements could create risks—has now become a regular part of the analytical framework.

**A New Era for Compensation Committee Leadership.** Events of the past three years have reshaped the role of the compensation committee, raising its profile and adding to its burdens. With the enhanced role, members of the compensation committee face significant new risks. These risks can be managed, however, with the presence of an engaged, independent compensation committee that is cognizant of its risk-oversight responsibilities and has access to the independent advisors and fulsome data necessary for informed decision-making and policy formulation. With these attributes, the members of compensation committees can lead the efforts toward restoring investor confidence and improving the adverse perceptions about executive compensation.



David M. Lynn is co-chair of the public companies and securities practice at the law firm Morrison Foerster.

## Executive Pay

By Jack L. Lederer

Directors grappling with the sweeping governance implications of the Dodd-Frank Act face an unprecedented series of new rules on executive pay. Among other things, the law requires boards to provide detailed new disclosure on their compensation decisions. And, this spring, for the first time, more than 10,000 public companies will be required to allow shareholders to cast an advisory vote on executive pay.

For many directors, Dodd-Frank's pay provisions represent an unwise intrusion into America's boardrooms, motivated by public outrage rather than sound economics. But at a recent conference, policy-makers argued that, rather than saddle directors with unnecessary new burdens, the law was designed to empower the compensation committees responsible for executive pay at the nation's largest companies.

In an appearance with me at the recent NACD annual meeting in Washington, D.C., Professor Robert J. Jackson, Jr., the lawyer who helped draft the Administration's pay proposals, noted that compensation committees came under fire for their decisions during the financial crisis. "The crisis showed that directors courageous enough to sit on these committees are soon going to find themselves answering tough questions about the hard decisions they have to make," Jackson said. "We wanted to give them the tools they need to completely oversee, control and own the decisions they'll have to defend."

Section 952 of Dodd-Frank grants compensation committees "sequential powers" over all executive pay matters: first, the power to set their own budgets; second, the ability to interview, vet and

## and the Boardroom After Dodd-Frank

hire pay consultants; and, third, the power to oversee consultants without interference from management. “This gives directors the authority and the funding to hire the advisors they need at their own discretion,” Jackson said.

Indeed, the provision takes the extraordinary step of specifying that the committee is “directly responsible” for the appointment, compensation and oversight of the work of any compensation consultant. “We wanted to make clear that, if you are a pay expert working for a public company in the United States, you work for the directors on that compensation committee,” Jackson asserted. “They pay you, they review your work and they’re accountable for your analysis and recommendations.”

The new law also requires that directors explain how they used these new powers in the annual proxy. Compensation committees will have to detail how they oversaw the selection, compensation and management of those who advised them. And they will have to analyze and disclose if those advisors—whether they are consultants or attorneys who help them set pay—are fully independent of management.

Emphasizing that Dodd-Frank gives directors the freedom to hire the advisors they need to bargain hard with executives, Jackson has noted that the law does not prohibit committees from hiring consultants and lawyers with ties to management. But, he cautions, directors who do so will find themselves “having to do special types of explaining. The committee will have to set forth in the proxy why it made the choices it made and why those choices were best for shareholders.”

One participant in our session questioned how directors, most of whom serve on a part-time basis with limited support staff, could discharge the new powers that Dodd-Frank gives them. These directors are now expected to establish their own budgets and hire advisors—on their own. They will need to operate independently from management but will often require information and cooperation that only management can provide. And they will have to develop processes that reflect the extraordinary diligence on pay decisions shareholders and the public now expect. What should the directors who serve on compensation committees be doing in light of these new powers—and the responsibilities that come with them?

In my view, compensation committees must begin to think of themselves as operating business units—responsible for decisions critical to the company’s future with customers, investors and the public. As such, they may need a broader set of resources, for support in:

- Building consensus among committee members on key pay issues and priorities;
- Sourcing and evaluating compensation consultants, lawyers, benefit and defined-plan experts and other advisors;
- Assessing and evaluating committee and consultant performance;
- Establishing best practices and strategies regarding communication with institutional investors, shareholders and proxy advisory firms; and
- Setting guidelines and processes to work effectively with management.

The notion that a compensation committee should think of itself in this way may seem unprecedented. And, indeed, many of these reflect dramatically new

governance methods. The directors who sit on these committees might not know where to begin in light of these extraordinary changes.

My firm spends a great deal of time educating committees on their powers and responsibilities under Dodd-Frank. We are now also working directly with committees in developing operating guidelines to ensure that they comply with the new law. Compensation committees work with us in diagnostic sessions to see how a committee stacks up against the new rules and where changes need to be made.

Committees may also need support in developing and implementing searches for pay advisors, rating various advisors’ independence and gauging any conflicts that may exist between the advisor and management. In addition, we help committees appoint the best advisor for the company’s needs, determining appropriate pay for advisors and evaluating their performance.

Dodd-Frank gives directors extraordinary new powers to oversee the executive pay decisions they will ultimately have to defend. Our work helps ensure that directors execute these new powers in ways that guarantee transparency and accountability, which is what the compensation provisions of Dodd-Frank are designed to achieve.

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Jack L. Lederer, principal at Curcio Webb, LLC, an independent human resources



consulting firm, heads its executive compensation advisory services practice. Contact him at [jlederer@curciowebb.com](mailto:jlederer@curciowebb.com).