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A New Model For Compensation Disclosure

What pay messages are you really sending to your shareholders?

by Myrna Hellerman

 **SIBSON CONSULTING**
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Editorial Office

The Corporate Board
4440 Hagadorn Rd.
Okemos, MI 48864
Phone: (517) 336-1700
Fax: (517) 336-1705
Web site: www.corporateboard.com

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A New Model For Compensation Disclosure

by Myrna Hellerman

The disclosure required on how and how much your company pays its top executives is steadily increasing. Investor and media anger over executive pay is likewise surging. Your compensation committee puts great effort into crafting fair, effective pay plans, but somehow that message is being lost in disclosure. Do you really understand the compensation story you are telling investors—and the message they are actually receiving?

“Executive compensation as we knew it has precipitously and irrevocably changed. Forget balancing company, executive, and shareholder perspectives. The scale is tipped toward the investor.”

— A chairman’s remarks to the compensation committee.

Compensation committees traditionally have attempted to balance the perspective of the company, the executive, and the shareholder. Today, however, investor activism, supported by legislative and regulatory actions, have changed the equation. Increasingly, committee decisions, and directors themselves, are judged based on investors’ expectations with respect to executive pay.

Seemingly, committees must set aside such factors as business strategy, the competitive market for talent, and the company’s need for reasoned risk-taking and investments in order to grow. The message: Conform to “outsiders’” standards for executive pay or suffer negative consequences at the proxy ballot box.

If there is any doubt about the investor-focused fervor in this country, compensation committees should consider the implications of the Obama Administration’s pay czar interventions, proposed actions of the SEC and the Treasury department, and the provisions (and even the titles) of legislation being considered by Congress:

- Corporate and Financial Institution Compensation Fairness Act
- Investor Protection Act
- Shareholder Bill of Rights Act
- Excessive Pay Shareholder Approval Act
- Excess Pay Capped Deduction Act
- Shareholder Empowerment Act
- Consumer Financial Protection Agency Act
- Corporate Governance Reform Act
- Ending Excessive Corporate Deductions for Stock Options Act

Furthermore, going against institutional advisors’ good pay practice standards increasingly results in embarrassing withhold/against votes for many directors, particularly compensation committee members. Such withhold/against votes are expected to have even greater impact on director elections outcomes now that the traditionally pro-management broker votes have been eliminated.

Today’s CD&A needs to boldly, yet thoughtfully, address the concerns and issues of those who have the loudest say-on-pay.

In the upcoming proxy season, compensation committees should consider a preemptive strike. Instead of a safe, plain vanilla Compensation Discussion and Analysis (CD&A), the CD&A now needs to boldly, yet thoughtfully, address head-on the concerns and issues of those who have the loudest say-on-pay.

To successfully accomplish this transformation, directors need to acquire an in depth knowledge of how their decisions will be evaluated by outsiders,

Myrna Hellerman is a senior vice president in the Chicago office of Sibson Consulting. She advises management and boards in the design and implementation of innovative, effective and sustainable reward strategies that lead to improved business results. [www.sibson.com]

and evaluate their pay decisions with the outsider's lens. Then, they must develop a strategic approach to reconsider executive pay decisions, and shareholder communications about those decisions.

An "outside-in/inside-out" approach provides a framework for compensation committees to respond to today's executive pay decision-making and shareholder communication challenges. There are three steps.

□ *Step one: Outside-In.* First, the committee needs a comprehensive understanding of how its executive pay decisions, pay practices, design and policies will be evaluated by outsiders.

An outside-in audit examines the overarching question: What do outsiders say about our company? It incorporates outsiders' perspectives and evaluation of the company's business strategy, financials and leadership as well as the design, payouts and governance of the executive pay program.

The investors' voice is obviously an important input for the audit. However, there are other outsiders whose opinions, analysis, and insights shape this external evaluation including business/industry analysts, lawmakers, regulators, institutional investment advisors, and the media.

The outside-in audit should answer the questions shown on page 13. Based on the compensation committee's evaluation of the data, it can begin to prioritize the issues that may require specific focus in subsequent decision making and disclosure.

□ *Step two: Inside-Out.* Next, the committee needs an unbiased, fact-based evaluation of the validity of the outsider's view. How does it square with the internal reality of the company's strategy and talent requirements?

The "inside-out" audit examines the outsiders' opinions which have been gathered in the light of data and facts that the company possesses. This audit involves testing the company's compensation plans and committee decision-making against the outsiders' standards and expectations. The goal is to determine whether outsiders' opinions are based on inadequate disclosure of critical information in the CD&A—or on real weaknesses in plan design and decision-making. (See page 14.)

As one might expect, the back-up analysis in support of the inside-out answers is more complex than the rather straightforward data and facts associated with the outside-in audit. However, the committee's evaluation of the data and back-up analysis allows further prioritization of pay policies. Four analyses may be particularly valuable to support the answers to the inside-out questions:

□ *Compensation architecture inventory.* This visually organizes all of the executive pay arrangements so it is clear who gets what. The inventory serves as a lightning rod, answering such questions as: Why do we use this structure? Do we have legacy plans that no longer serve a purpose? Are there redundancies in the pay opportunities? Do we have the "right" programs? Are the participant groupings appropriate?

Examination of individual executives' wealth accumulation, tally sheets and "walk-away" numbers will also give insights into the deficiencies, adequacy, or excessiveness of the compensation architecture.

A simplified example of a compensation architecture inventory is shown on page 15. A complete inventory would include every plan and policy that forms the total rewards received by any member of the targeted executive group. In many cases, such inventories will include 40 to 50 items.

The outside-in audit may uncover comments like: "The company sets pay based on peer comparators that don't make sense."

□ *Peer group defensibility analysis.* The outside-in audit frequently uncovers comments about the peer group such as: "The company sets pay based on peer comparators that don't make sense." Or, "The company's peers are much larger and more complex operations. They obviously were chosen by the company to inflate comparative pay levels."

A peer group defensibility analysis examines the validity of such observations. It examines both the peer companies selected by the company, and the peer group outsiders suggest as appropriate comparators.

The “Outside-In” Audit

How Does Our Pay Look From The Outside?

Purpose: Identify the “outsider” context in which the committee’s executive compensation decisions and corresponding disclosure are evaluated.

Degree of immediate focus required: High Medium Low

“Outsiders” Perspective — What is said about us	Focus
<i>Headline news:</i> Which of our pay decisions have made the “news?” Why? What remediation was required?	<input type="radio"/>
<i>Poor pay practices:</i> To what extent have we been cited for poor pay practices? By whom? In what context?	<input type="radio"/>
<i>Inadequate disclosure:</i> What have the SEC and other outsiders said about the transparency and quality of our pay disclosure? What remediation was required?	<input type="radio"/>
<i>Comparative success:</i> Against whom do outsiders compare our company’s performance? What is the assessment of business analysts as to our execution of our strategy relative to these comparators?	<input type="radio"/>
<i>Metrics:</i> According to outsiders what are the key financial and operational measures of success for our company? What is the external assessment of our company’s performance relative to these measures?	<input type="radio"/>
<i>Pay-for-performance:</i> What is the outsiders’ assessment of our pay for performance relationship? What are the variances identified by outsiders compared to peers? Who said what?	<input type="radio"/>
<i>Risk-taking:</i> What “investments” do outsiders believe are required to ensure sustainable, profitable performance? What risks are associated with these investments? Have our pay programs been cited because they reward or encourage unreasoned risk-taking? Who said what?	<input type="radio"/>
<i>Investor context:</i> Who are our company’s largest shareholders? What are their investment objectives? Which institutional advisors provide recommendations to them? What policies influence their votes?	<input type="radio"/>
<i>Voting power:</i> What is the voting power balance among the company’s voting constituencies— institutional investors, retail investors that vote, retail investors represented by broker voting, other constituencies?	<input type="radio"/>
<i>Director qualifications and committee membership:</i> Have institutional advisors recommended a “withhold/against” vote for our directors? On what basis? What was the outcome of the final vote? What post-vote remediation did the company take?	<input type="radio"/>

Source: Sibson Consulting

Specialized niche businesses can face problems selecting the peer group. Many competitors for talent and business may be either privately held or divisions of large corporations that do not publicly report pay data. Thus, comparative data is difficult to obtain. Many companies must “settle” for a less than optimal publicly-traded peer group, and need to explain in the CD&A why that peer group makes

sense despite the lack of comparability on several key metrics.

□ *Cost of leadership analysis.* This looks at the competitiveness of the company’s total pay commitment for the proxy officer group, rather than just the individual executives. It shows competitiveness of pay opportunities by each component, as well as in total. This analysis tees up such questions as:

The “Inside-Out” Audit

Why Are We Paying The Way We Do?

Purpose: Test the company’s pay plan designs, decision-making process, and disclosure against the outsiders’ standards and expectations.

Degree of immediate focus required: High Medium Low

“Insiders” Perspective — What we do

Focus

Compensation architecture: How unassailable are our pay designs and practices? Which legacy plans or plan provisions are redundant with other components?

Peer group defensibility: How does the peer group we use differ from the peers used in outsiders’ analyses? Which are the relevant metrics to validate our peer group selection (revenue, EBITDA, operating income, ROI, etc.)? How do we explain significant ranking differences from the median?

Poor pay practices: What pay practices are criticized by the outsiders who influence our shareholders? Which of these poor pay practices exist in our pay arrangements? Why?

Cost of leadership: How does the “total spend” for our proxy officers compare to our peers? In total? By pay components?

Metrics selection: What is the rationale for the specific financial and operational metrics used in our incentive plans? Which measures are the same as/different from our peers?

Pay-for-performance alignment: What evidence do we have to support a linkage between the pay realized by our executives in the past three years and our company’s short and long-term financial performance over the same period?

Risk management: Do our incentive plans encourage unreasonable risk-taking? What plan provisions allow the company to recoup ill-gotten gains? What processes do we have in place to manage potential risk associated with our pay plans?

Equity: How adequate is our share reserve? At our current run rate, when will we need additional authorization? If needed *today*, would we pass the RiskMetrics/ISS tests?

Voting power: What was the composition by each shareholder constituency of the votes *actually* cast in the last proxy season? Would the elimination of brokers’ votes have changed the outcome?

Disclosure versus optics: How robust and transparent is the CD&A disclosure of the “what, why, how much” of our pay programs and practices? If faced with a “say-on-pay” vote, have we adequately explained the rationale behind our pay practices which have poor optics from the investors’ view?

Source: Sibson Consulting

Are we committing too much or too little to our pay opportunities? Do we have enough pay opportunity “glue” and the right delivery vehicles? What is our rationale for paying differently from our peers?

□ *Pay-for-performance alignment analysis.* A frequent headline news theme that emerges from a company’s outside-in audit is: “Big investor losses.

Big executive payouts.” A pay-for-performance analysis allows the committee to test the validity of such concerns. It provides two key data comparisons: the percentile position of the officer’s three-year total cash compensation and total direct compensation, compared to similarly ranked peer executives; and the company’s performance percentile compared to

Compensation Architecture Inventory Analysis

The Essential “Who Gets What”

	Senior Executives			Executives	
	CEO	4 Proxy	EVP	SVP	VP
Cash	Base salary				
	Annual incentive				
	Long-term cash				
	Matched deferral				
Equity	Stock options				
	Restricted stock				
	Special grants				
Other	Pension				
	Enhanced pension				
	Severance/change in control				

Source: Sibson Consulting

the peer group’s for such measures as earnings per share growth, return on assets, return on invested capital, return on equity, total return to shareholders and revenue growth.

□ *Step three: Reset.* The third step for the compensation committee is to reconcile and prioritize the findings from the outside-in and inside-out audits.

Obviously, a good deal of data will have been gathered in the first two steps. This must be reconciled and prioritized to determine what the company actually is doing with respect to its executive pay, versus what outsiders say the company is or is not doing; what outsiders expect the company to be doing; and the implications/consequences and urgency associated with any change decision in order to meet outsider expectations.

Using these audits and analyses, the committee must: engage in fact-based, robust discussions about pay design, levels, and practices; vet alternative solutions; and then determine how to “reset” the plan design and what is communicated in the CD&A.

Typically, this reset unfolds over a two- to three-meeting cycle. First, the overarching issues and implications are discussed and prioritized. Then, possible solutions are vetted and preliminary decisions are identified. Finally, the decisions are affirmed.

Before affirming their final decisions, some compensation committees request that a draft of the CD&A be prepared to include their tentative decisions and the rationale behind them. The recast CD&A generally includes a preface with a very explicit description of what decisions were made and why, as well as the analyses and supporting graphics.

In summary, executive compensation decision-making has entered a new era. Decisions and disclosure of pay design, practices and protocol must explicitly recognize the strong influence of outsiders’ views, and at the same time incorporate the interests and needs of the company and its executives. Using the outside-in/inside-out approach will help the compensation committee successfully address this challenge. ■

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www.sibson.com

Myrna Hellerman *Senior Vice President* *Midwest Regional Leader, Chicago*

Ms. Hellerman advises management and boards in the design and implementation of innovative, effective, and sustainable people and reward strategies that lead to improved business results. Ms. Hellerman has particular expertise in the areas of executive compensation, governance, and the leadership challenges that are precipitated by financial transactions. She frequently serves boards and compensation committees as an independent advisor. Ms. Hellerman has served as an elected member of the Board of Directors of The Segal Group and currently serves as Sibson's Midwest Regional Leader.

Ms. Hellerman has consulted to over 100 publicly traded and privately held organizations from a wide variety of industries, including insurance, brokerage, financial services, private equity, hedge funds, real estate, health care, hospitality, retail, technology and manufacturing.

Prior to joining the firm in 1994, Ms. Hellerman was the Chief Human Resource Executive for Hyatt Corporation, an international corporation. Previously, she worked at Continental Bank as the Vice President responsible for global compensation and benefits functions, and at Hewitt Associates, where she led both domestic and international total compensation **assignments**.

Ms. Hellerman received an MBA from the University of Chicago, and an MA and a PhD from Stanford University. She graduated Phi Beta Kappa from the University of Michigan, was a Fulbright scholar in Peru, and completed academic studies in Mexico and Argentina. Ms. Hellerman is a Certified Compensation Professional (CCP).

Ms. Hellerman is a member of the Business Advisory Council of the University of Illinois (Chicago). She has served as an officer of the Human Resource Management Association of Chicago (HRMAC), the International Foundation of Employee Benefit Plans (IFEBP), and the Council of Personnel Officers. Ms. Hellerman has served as Chair of the Pension and Benefits Committee of the American Hotel and Lodging Association and as Chair of the Long-Range Planning Committee of Prevent Child Abuse Illinois. She is a member of the Chicago Compensation Association (CCA), WorldatWork and the National Association of Stock Plan Professionals (NASPP).

Articles and commentary authored by Ms. Hellerman have appeared in publications including the Wall Street Journal, Business Finance, Forbes.com, the Handbook of Business Strategy, Human Resource Executive, Financial Executive, IOMA's Guide to Best Practices in Pay and Performance and WorldatWork's Workspan.

Ms. Hellerman has presented at a variety of conferences and events, including national and regional conferences and webinars organized by CEO Connection, Corporate Leadership Council (CLC), Society for Human Resource Management (SHRM), WorldatWork, Beyster Institute for Employee Stock Ownership, the Human Resource Planning Society (HRPS), the National Association of Stock Plan Professionals (NASPP), the Human Resource Management Association of Chicago (HRMAC), and the Chicago Compensation Association (CCA).

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Myrna Hellerman
mhellerman@sibson.com
312.456.7914
www.sibson.com