2002 HANDBOOK OF BUSINESS STRATEGY

A Comprehensive Resource Guide to Strategic Management: From Long-Range Planning to Tactical Business Development

FROM THE PUBLISHERS OF

JOURNAL OF BUSINESS STRATEGY

EC MEDIA GROUP

THOMSON FINANCIAL™

Eight Secrets of Highly Effective Compensation Committees

MYRNA HELLERMAN

Today's compensation committees need great organizing principles, great knowledge, and a great mind-set.

Myrna Hellerman, Ph.D., is a principal of Nextera Enterprises, Sibson Consulting Group. She is an expert in human resource and reward strategy development and their integration into an organization's broader global business objectives. Dr. Hellerman's particular focus is on the human capital management and performance challenges that are precipitated by a major financial transaction (e.g., IPO, spin-off, and merger).

Some companies just seem to do everything right. They keep growing profitably (even during difficult economic times), their shareholders are happy, and, like powerful magnets, they attract and retain an exceptional executive leadership group focused on performance. These companies are the darlings of analysts and institutional investment advisors.

Furthermore, when the press launches its annual attacks on CEO pay levels or stock option use/misuse, such companies emerge unscathed and are frequently singled out as exemplars rather than egregious abusers. Of course, there are many obvious factors that, when combined, contribute to such a desirable positioning for a company (such as clearly articulated and executed business strategy, robust financial structure, hot industry, hot product/service, good timing, charismatic leader, to name but a few). But there are also several inconspicuous, but nonetheless important, factors.

One of these inconspicuous factors is often a highly effective board-level compensation committee that efficiently and, with informed, thoughtful discipline, exercises its governance and fiduciary responsibilities. There are eight secrets—including tools, techniques, and approaches—of highly effective compensation committees. These secrets fall under three banners:

Great Organizing Principles. The committee's operational infrastructure supports efficient and effective decision making

Great Knowledge. The committee members have an intimate understanding of the information they require to exercise their governance and fiduciary responsibilities

Great Mind-Set. The committee members reflect in their commitment and their thoughtful, decisive decision making a fair and balanced view of the interests of all the constituencies they serve.

The first three secrets fall under "great organizing principles." The committee that follows these principles has an operational infrastructure that supports efficient and effective decision making.

SECRET #1: THE "DEAL" IS IN WRITING

Highly effective compensation committees articulate in writing their role, their charter, and their work plan. There is no ambiguity about the committee's responsibilities and how the committee will fulfill them. Committee members know the "deal" from the onset.

The basic role of a compensation committee is to be accountable to shareholders regarding executive and director compensation. This accountability generally includes levels and competitiveness of pay, the vehicles employed, and the compliance and financial implications associated with pay delivery. The role can vary significantly from one company to the next. Some compensation committees have an expanded role that might include benefits and executive talent management. At other companies the committee's role might be smaller in scope and not include, for instance, equity programs.

The charter of the compensation committee provides the administrative structure for fulfilling the role. It typically describes the membership of the committee, the committee's activities and responsibilities, and the protocol that members will follow. Because committee members generally serve on several boards, the written role and charter keeps members focused on fulfilling the expectations for the specific company they are serving at that meeting.

The "work plan" for the highly effective compensation committee typically takes the form of an annual calendar. The calendar includes fixed agenda items and frequently is supplemented by special topics for each meeting. The fixed agenda items included in the calendar of a Midwest recreational equipment manufacturer are as follows:

Meeting #1: Performance results and payout determination for incentive plans, proxy statement, salary actions, and equity awards for CEO and key executives.

Meeting #2: Annual review of committee's role and charter, directors' remuneration, semiannual executive talent review.

Written specifications are important in the member selection process.

Meeting #3: Open agenda used for education, discussion of new plan designs, and update on changes in the regulatory or accounting rules affecting compensation programs.

Meeting #4: Competitive pay positioning update, salary budgeting, executive compensation funding review, total compensation plan design review, plan modifications.

Meeting #5: Performance criteria for next year's incentive plans, CEO self-assessment and committee's initial evaluation, compensation committee member self-assessment and peer evaluation, semiannual executive talent review.

The calendar ensures that the committee addresses all areas of governance within its purview on a regular basis. It also creates a welcomed orderliness, predictability, and efficiency to the meetings.

SECRET #2: THE TEAM ROSTER IS ROBUST

One of the reasons some compensation committees can be so highly effective is that their "team roster" includes talented "players" who are above reproach. The committee's membership is selected and annually evaluated through a disciplined and formal process.

Highly effective compensation committees are unfazed by such headlines as one recently found at *www.aflcio.org/paywatch*: "Steps You Can Take to Put the Heat on Boards of Directors That Approve the Big Pay Packages." The site suggests close scrutiny of those who make compensation decisions. It argues that pay decisions must be made by individuals independent from the CEO and in an environment free from "the rife of cronyism, lavish perks, conflicts of interest, and poor attendance. For example, you might find that your CEO approved a big pay plan for an executive who sits on your board and approves your

CEO's compensation. ... If a director has a big contract with the company, he or she may not want to oppose a CEO's big pay package." Highly effective compensation committees know they easily comply with the expectations of corporate watchdog groups, because the committees are vigilant in their selection and evaluation processes.

Written position specifications are an important element in the membership selection process highly effective compensation committees use. Typically, all members of the committee must meet the IRS "independent director" definition and have demonstrated integrity, leadership, business acumen, and objectivity. Additionally, individuals selected for membership on a highly effective compensation committee must show a strong understanding of how to design and finance compensation plans to support corporate strategy. The actual selection process for committee membership frequently is as rigorous as the hiring of a new executive officer.

Each year, highly effective compensation committee members assess their own performance. At one large health care provider, the committee evaluations consist of a combination of self-assessments by each member and peer evaluations of each member on key areas of expected contribution. Among the self-assessment questions (rated on a one-to-five scale) are:

- I attend all or most scheduled meetings of the committee.
- I am well prepared for each meeting (assuming I receive appropriate materials in advance).
- I contribute in a meaningful way to the deliberations of the committee.
- I exhibit sound judgment and integrity in all committee deliberations.

The peer evaluations use similar questions. An outside third party compiles the evaluations and shares with each member his or her evaluation. The third party shares only with the committee chair all the evaluations. The committee's charter outlines a process for removing underperformers.

SECRET #3: THE PLAY BOOK IS UNAMBIGUOUS

Highly effective compensation committees have clearly delineated, in writing, the decision-making scope and responsibilities of the committee and of management. There is no ambiguity as the "team" takes the field.

Consider reward programs within the context of the employee value proposition.

The newly promoted CEO of a Midwest financial services organization had observed her predecessor's tense and often dysfunctional relationship with the compensation committee. Management made pay decisions that the compensation committee believed were in its purview and vice versa. The lack of clarity about which member was responsible for what resulted in redundant efforts and conflicts. The CEO resolved to permit only one more high-tension management/compensation committee face-off. At a specially called meeting, after much debate, management and the compensation committee agreed upon the content of a decision-responsibility matrix. This matrix clearly identified the role of each entity in critical committee decisions. In this way the CEO and the committee were assured that the appropriate entities would contribute in the appropriate way to compensation decision making.

In general, a decision-responsibility matrix describes an entity's engagement in, and accountability for, making decisions. It represents a set of mutual agreements about who has authority for what actions. The matrix distinguishes among specific types of decision roles. Among the roles included in a decision-responsibility matrix are:

Review. Examine and understand an item's critical aspects after-the-fact.

Oversee. Watch over the management of an item, without becoming involved in action.

Monitor. Check an item and regulate as the item progresses.

Contribute. Advance or donate opinions, facts, etc., in addressing and/or resolving an item.

Develop. Build and enhance the concepts that support and constitute an item.

Recommend. Suggest and propose the organization's approach to an item.

Approve. Confirm and sanction final decisions related to an item.

Adjudicate. Resolve disputes related to an item.

Table 1 illustrates a segment of a compensation decision-responsibility matrix for a publicly traded financial services organization. The company used five "buckets" to blend the various decision roles.

In addition to the items included in the example, highly effective compensation committees typically use an expanded matrix to clarify roles with respect to such items as salary increase budgets, management incentive plan design, performance measures, thresholds for incentive compensation, and performance evaluation, terms of employment agreements, salary determination, and annual/long-term incentive awards (levels and vehicle) for the CEO and key executives.

Secrets 4 through 7 fall under the heading of "great knowledge." The committee members have an intimate understanding of the information they require to exercise their governance and fiduciary responsibilities.

SECRET #4: MEMBERS UNDERSTAND THE GAME PLAN

A highly effective compensation committee has studied what success "looks like" for the company. The committee members know in detail the company's strengths, challenges, and performance imperatives. The committee constantly tests to be sure the design and economics of the compensation programs support a winning game plan for the company.

Each year as part of its annual review of the company's compensation programs, the compensation committee of a Midwest manufacturing company uses the following sequence of questions to evaluate the consistency of the compensation program as a whole (and of each of its components) with the company's "game plan:"

- What is the company's mandate? How has it changed since last year?
- How does the company document its success in fulfilling the mandate (such as with productivity improvements, market share, revenue/profit growth)?
- Who are the key stakeholders in the company's success (such as investors, employees, customers, vendors)?
- What does "success" look like to these stakeholders? How has stakeholders' vision of success changed since last year?

Table 1. Decision-Responsibility Matrix

	Develop	Modify, Revise, Recommend	Approve, Ratify	Monitor	Adjudicate
Executive Compensation Structure/Plans/Policies/Philosophy	HR, CEO	CEO	CC, BD	HR	CC
Proxy Statement	HR, O	CEO, CC	CC, BD	HR, O	BD
Director Compensation	HR, CC	CC, BD	CC, BD	HR	BD
Mgt. Salaries, Incentive Awards, Stock-Based Grants	HR	CEO, CC	CC, BD	HR	CC
Performance Goals/ Funding for Incentive Plans	HR, O	CEO, CC	CC	CEO, HR	CC

Board of Directors (in total) . . . . . .BD
Human Resources . . . . .HR
Compensation Committee CC
Other Management . . . . .O
CEO . . . . .CEO

• What messages do the design and/or focus of the compensation programs send employees? Do these messages support the culture and behaviors the company requires in order to deliver the success stakeholders demand?

Over the years, this annual process has led to constant scrutiny of the performance measures the company uses in its incentive plans and in its expansion of variable pay and equity ownership opportunities beyond the executive group.

SECRET #5: EMPLOYEES UNDERSTAND THE "DEAL"

Highly effective compensation committees consider direct financial reward programs within the context of the company's employee value proposition (EVP). They recognize that if the other components of the EVP are not working, "fixing" compensation alone will only mask larger issues that affect employee retention and motivation.

The employee value proposition represents the employee's deal—what he or she gets in exchange for working at the company. Table 2 summarizes the components of the EVP (it is based on the Rewards of Work model). Highly effective compensation committees use the EVP to understand the distinctive "deal" for employees. They recognize that pay alone does not attract and retain talent.

The management of a privately held niche player in the service industry despaired that there was no equity ownership opportunity: "We just can't compete for the people we need because we don't have stock options in our package." The compensation committee used the employee value proposition to sort out the strengths and challenges in the "deal" the company offered employees and compared it to the "deal" at the chief competitor for talent (illustrated in Table 2).

The Committee concluded that despite the "deficiencies" in the direct financial component of the EVP, the company could attract talent by emphasizing the distinct attractiveness of the other EVP components. Additionally, the committee approved a redesigned annual incentive plan that used measures that rewarded key contributors as "owners" in the immediate and longer term success of the company (See Figure 1).

SECRET #6: MEMBERS UNDERSTAND THE "RULES OF THE GAME"

Compensation committees "play" a complex "game" on an ever-changing regulatory playing field. Highly effective compensation committees hold management accountable to provide them with regular updates (see Secret #1, regarding an annual calendar) and comprehensive information (see Secret #7, regarding a resource guide) the committee needs to exercise its fiduciary responsibility. In particular, highly effective compensation committees have an excellent knowledge of current tax laws, security laws, ERISA implications, and accounting rules that affect base salaries, annual incentives, long-term cash

Table 2. Competing for Talent

	Us	Them
Affiliation	• "Best practices" niche player • Privately held	• High profile, national player • Publicly traded
Direct Financial	• Base/bonus—at/slightly above median	• Base/bonus—low side of fair • Huge upside from large stock grants
Indirect Financial	• "Family friendly" competitive benefits	• Competitive benefits
Work Content	• Long hours • Good deal of trust/ autonomy to "do" what's right" • Regular performance feedback	• Long hours • "Prescribed" work tasks
Career	• Lots of opportunity, grow as company grows • Promote/develop from within • You can spend a full career here	• Lots of opportunity but must follow predetermined progression (i.e., 6 mos in position A, 12 mos in position B, etc.)

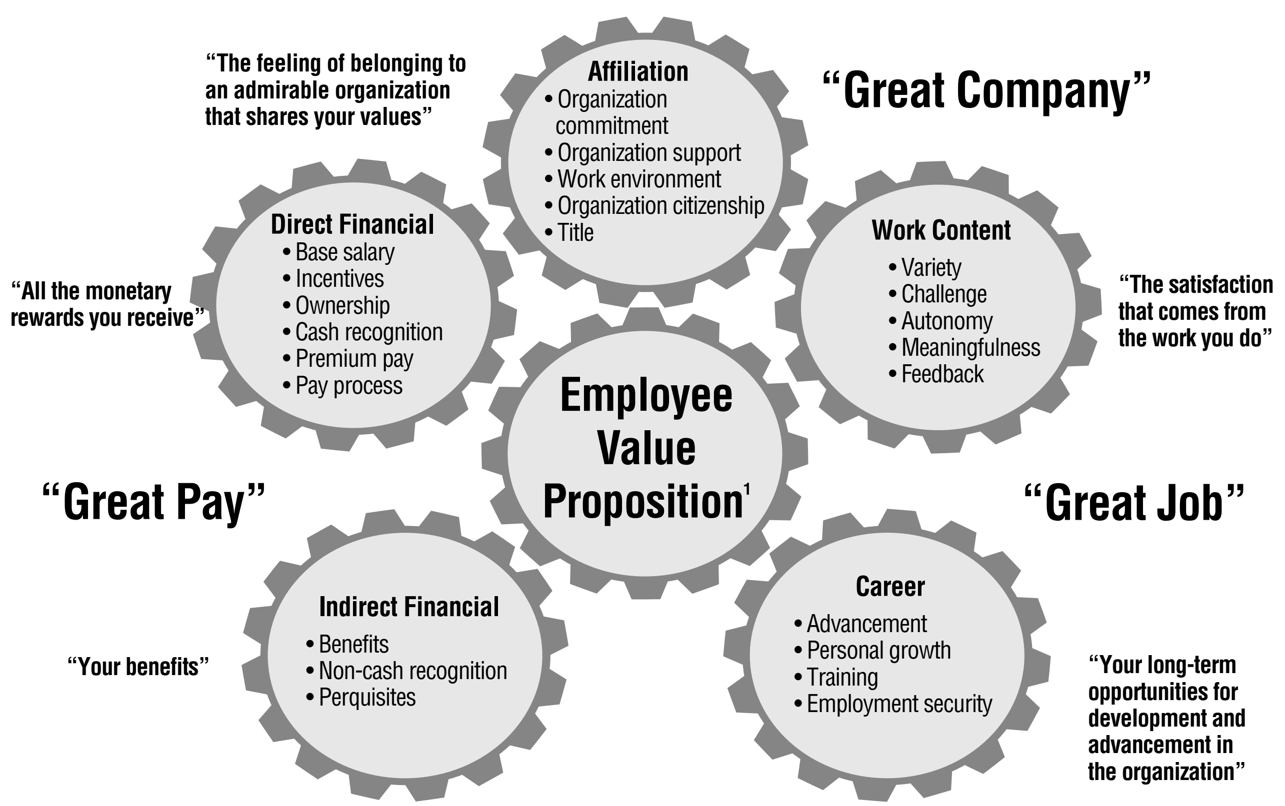
incentives, equity grants, deferred compensation, golden parachutes, and executive benefits.

The highly effective compensation committee's understanding of the "rules of the game" can enable it to avoid costly, untenable compensation commitments such as those that occurred at a large retailer. The retailer's compensation committee was responsible for the design of the CEO's new five-year contract. The chair, drawing upon his experience on other boards, and unwilling to bring in internal or outside advisors, replicated a contract used at another company, on whose board he had served five years earlier. On its face, the design was solid. However, it was not practical at the company. Several impediments stood in the way: There were not enough shares currently available to cover the promised grant, the grant exceeded the plan's maximum for a single participant, and, given the current "overhang," it was unlikely investors would authorize a new program with additional shares. Unfortunately, the committee chair had communicated the preliminary deal to the CEO and later had to renege. The broken "promise" created tension between the CEO and the board. Eventually, the CEO negotiated a deal that satisfied him as being equivalent to the "lost promised deal." The final deal had significant variable accounting implications and golden parachute provisions that turned out to be extremely costly when the company had a change in control. There was a shareholder suit that delayed the consummation of the change in control.

SECRET #7: MEMBERS HAVE ALL THE NEEDED EQUIPMENT

The highly effective compensation committee has assembled, in one place, the informational tools the committee needs to fully dispatch its role. This compensation committee guide book, typically on paper but more recently at an electronic,

Figure1. The Employee Value Proposition



[1] Based on Rewards of Work[sm] model.

secured, intranet site, provides the facts to support the committee's discussion and decisions.

The compensation committee of a manufacturing company with a large management group and many complex plans asked management to prepare a compensation committee resource guide. The committee insisted that the guide not be a "dump" of information. Instead, members wanted a comprehensive, orderly document that was easy to use and keep current. The result was a secured intranet site. The site was updated in real time. Committee members also had a "hard copy" of the data they most frequently used. The resource guide included:

People Information. Organization chart; compensation, career, and performance evaluations; histories for the executive group; employment contracts; general demographics of company's employee group.

Compensation Program Information. Compensation committee charter; decision-making matrix; employee value proposition analysis; compensation philosophy; summary specifications for all compensation/benefit programs; complete text documents; trust documents; funding arrangements; contracts with outside service providers; recent survey data and competitive assessment of total compensation program across all employee groups; salary structure and policies; performance management system; stock award guidelines; option grant history (aggregate and individually for executive group); stock price and "overhang" history; three-year summary of company performance against performance measures used in incentive plans.

Company Information. Strategic plan, three years of proxies and 10-Ks; security analyst reports; peer group analysis; "current press;" industry reports; D&O policy; last three years of the committee minutes.

Legal, Regulatory, and Accounting Information. Summary of relevant tax laws, accounting rules, SEC and stock exchange requirements, and other federal and regulatory rules—annotated for relevancy to company plans.

Once the site was up and running, the committee found that its meetings were more efficient. Members did not have to table issues for lack of ready data to address the "but what about...?" type questions that had previously slowed down deliberation. Committee members and management presenters could get the answers immediately and deliberations could continue.

Highly effective committees believe talent matters.

The final secret falls in the third category—"great mind-set." The committee members reflect, in their commitment and their thoughtful, decisive actions, a fair and balanced view of the interests of all the constituencies they serve.

SECRET #8: DESIRE AND COMMITMENT TO "WIN" ARE STRONG

Highly effective compensation committees recognize that they can determine whether they are "winning" by measuring the company's success in attracting, retaining, and motivating the talent the company needs to deliver the business results its stakeholders expect. The programs for which the committee has responsibility are the lynchpin in a winning talent management strategy.

Thus, highly effective compensation committees approach their responsibility with a "talent matters" mind-set combined with a focus to serve all stakeholders in a fair and balanced way. They are willing to take the time to really understand the issues and implications (from multiple perspectives) of the decisions they make. Rubber stamps never see the light of day.

Generally, compensation committees believe they can easily raise the "great organizing principles" and the "great knowledge" banners. One could mistakenly view the secrets underlying these banners as just best practice "mechanics." But these banners will lie limply on the flagpole if you adopt only the "mechanics" of the underlying secrets. It takes the secrets of the "great mind-set" banner to turn the other more "mechanical" secrets into the behaviors and actions of a highly effective compensation committee. ●