Follow the Money

A new wave in executive compensation

*The **National Association of Corporate Directors** Blue Ribbon Commission on the Compensation Committee recently released its third report on executive compensation*. Below is an interview with the leader of that effort, **Barbara Hackman Franklin**, who also co-chaired the Commission in 2003. Her remarks have been edited for length and style.*

MCC: Let's begin broadly. What does it mean to align executive pay with corporate strategy?

Franklin: First, let's talk about strategy in the boardroom. An earlier NACD Blue Ribbon Commission as well as this one believes that the best practice today is for strategy formulation to be a far more collaborative effort between the CEO and the board than it ever was before. At the time I began to serve on public company boards in the late 1970s, strategy was very definitely the CEO's purview. The board had an opportunity to ask questions and to review and concur, but that was it. That's not what we want to be doing now. Ideally, there is ongoing collaboration between the CEO and the board throughout the year so that strategy is discussed at every meeting.

Then, against that background, the compensation committee should at least once a year carefully review the balanced scorecard and the metrics on it and ask, "Do these metrics incentivize the kind of performance we want from management in support of the company's strategy?" This means that the compensation committee members must understand the strategy and be able to link the metrics to it. In the past, that step has often been missing or not fully articulated.

Choosing the right performance metrics takes thought – they should be a blend of both financial and non-financial measures. The specific metrics chosen should reflect the company's strategy at that point in time. In other words, one size does not fit all. For example, if innovation is a key tenet of strategic direction, then a metric that measures growth rate of R&D spending or numbers of patents approved might be useful metrics. Or, if grooming talent for the future is a key strategic concern, then a metric that measures the number of candidates ready for key executive decisions could be helpful.

But fundamentally, in order to select the best blend of metrics, the compensation committee must understand the strategy, be able to articulate it, and choose the right metrics to give management the proper incentives. This is not necessarily so easy or obvious, but it is critically important.

MCC: There are various executive compensation issues arising from Dodd-Frank yet to be resolved by final regulations. What are the hot-button issues?

> ***Institutional investors are concerned about excessive CEO compensation, especially if stellar performance doesn't go with it.***

Franklin: First, I want to make a point about regulatory activity. It's one of the things that really has changed over the years – certainly since NACD's 2003 compensation committee report. The whole area of executive compensation is getting much more scrutiny from shareholders, other stakeholders, public policy makers, the media and the general public. And sometimes that scrutiny and concern causes a political response in the form of legislation. The financial crash of 2008 triggered increased scrutiny about compensation and one result was Dodd-Frank. I'm willing to predict right now that if there is another series of financial downturns or scandals, such as Enron and WorldCom, then there will be another response from our political process that will undoubtedly make many CEOs and board members unhappy.

And so today, there are rules requiring compensation committees and their advisers to be independent. Another result is the required say-on-pay vote. There were some concerns at first, but I believe this has been constructive. That non-binding shareholder vote has caused companies and compensation committees to think harder about their pay plans and in some cases to revise them, but certainly it has caused much better disclosure about what is in those plans and what the incentives and payouts are.

You asked about regulations required by Dodd-Frank that are still in process. The pay ratio rule is one that is most concerning. I assume that the impetus behind this idea is the so-called pay gap between what the CEO makes compared to that of the average worker in the organization. I think the idea was to highlight this gap, and, by so doing, shrink it.

Here are the problems: How is this ratio to be calculated? Exactly what is the "median" salary – how is that to be defined? How do our many global companies handle such a calculation, which represents a lot of different pay scales in different countries around the world? This gets complicated. And the next question is: What relevant new information is generated?

We already know what the CEO makes. Couldn't those who want to know simply eyeball the situation and make some educated guesses about what others down the line make? That's not very scientific. But really, are investors and others going to learn enough that is new to justify the expenditure of company resources trying to figure this out?

NACD tells me that, according to their surveys, the majority of investors are not particularly interested in pay ratio information. So, the question remains – can we justify making this calculation if investors really aren't interested in it? Surely there are much better uses for the resources that would be used in the process.

MCC: When it comes to executive compensation, institutional investors have certainly jumped into the debate. What are your thoughts on their role and their direction?

Franklin: What I hear from institutional investors is that they are most concerned about *excessive* CEO compensation. Especially if stellar performance doesn't go with it. The $64,000 question is: when is compensation "excessive"? In many cases, it's in the eye of the beholder. However, some institutional investors are coming up with their own formulaic calculations about what CEO compensation should look like. That's one approach that takes thought and resources. But this can be a slippery slope because, again, one size does not fit all. What is fair CEO compensation at one company at one point in time may not be the same at another company in a different circumstance. Still, I believe as a consequence of more shareholder scrutiny, the issue of how much is too much will have to be focused on more forcefully by compensation committees and boards. It's a tough issue.

We who have sat on compensation committees have watched CEO compensation ratchet up. There are a variety of reasons for this, including the fact that CEOs look around to see what their compatriots in other companies are making and then demand the same thing. The dilemma is that in order to "ratchet down," it would take a consensus among boards in corporate America, and I don't see such a consensus emerging. However, perhaps talking about the problem will cause changes over time. I should emphasize that I am talking about situations where compensation is not aligned with performance. Let's hope boards can make any adjustments themselves and not have to be pressured by another scandal and spate of regulations.

MCC: Reporting to the full board and management is a key responsibility of the compensation committee. There were some recommendations in the report about educating employees and increasing transparency. Also, about broadening the role of the compensation committee.

Franklin: This Commission recommends that compensation committees broaden their activities beyond CEO succession planning and the formulation of pay plans to include oversight of talent

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development at various levels of the organization. That means keeping an eye on the direct reports to the CEO and the bench strength to move up into those positions. And then go down as far into the organization as makes sense, again looking for bench strength. It's good to be watchful of new hires and high-potential employees to make sure they get career development that would help them understand the business and rise to the top. This process helps with CEO succession too, because the committee and the board get to know who the future leaders are. What generation are they? Are they developing their careers in the right way? Are they being compensated properly? All of those questions should be asked by compensation committees. Talent is such an important element to maintaining competitiveness. As far as transparency is concerned, the main method of disclosure is the compensation discussion and analysis (CD&A) in the proxy statement. Given the sometimes hard-to-understand language often used in these reports, it's no wonder people don't understand the issues and, as a result, the media doesn't report compensation matters the way we would like. Instead, we recommend that the CD&A be written in plain English and that it articulate in a clear and digestible manner the connection between compensation and strategic direction, the metrics used to measure performance, and the payouts that would result.

In addition, the committee should ensure that management educates employees about the compensation plans, but it's up to the committee to make sure that the full board understands the compensation philosophy, plans and outcomes.

MCC: You're an advocate for more equitable compensation for the compensation committee itself. Tell us your thoughts.

Franklin: Another thing that has changed since the last time we looked at this is what I would call the sophistication surrounding the compensation committee's entire process. It's a far cry from what it was. More professionalism must be brought to the table – to understand and articulate strategy, to create pay plans with appropriate metrics linked to performance, to oversee talent development, and of course, to take the lead on CEO succession. There is simply more brainpower, time and energy needed. Therefore, the Commission recommends that the board consider a retainer for the compensation committee chair that's the equivalent of that given to the audit committee chair.

I've chaired six public company audit committees – that was the hot committee after the Enron and WorldCom scandals and the arrival of Sarbanes-Oxley. In my experience, the compensation committee now is at least on par with, or may even have outstripped, the audit committee in the amount of energy and diligence and wisdom that is required. That's the rationale for this recommendation.

MCC: Let's talk about diversity. I know you feel strongly about it.

Franklin: I have seen the power of diversity and I believe in it. I believe in diversity at the board level and on committees as well. I've been on boards during the time when the compensation committee was composed solely of CEOs or former CEOs. Today we need some individuals who have this experience and expertise foundation, but the whole committee should not be populated that way.

When there are some on a comp committee who have different backgrounds – entrepreneurial, academia, not for profit – they often ask the proverbial "dumb question," which is really a wonderful question that goes to the very heart of an issue. I've participated in that kind of discussion, and I've seen what comes out of it. The diversity of viewpoints inevitably strengthens whatever is on the table.

I am a believer in diversity in a broad sense – gender, ethnicity, skill set, and experience. I think it's beneficial to any organization, and certainly to boards of directors where companies are global and have diversity in their customer bases, their employees, and their communities. The smartest companies reflect the diversity of those stakeholders in the diversity of the board and the comp committee.

MCC: We came across the word "courage" in the report. Why that word?

Franklin: That's a word I like to use, and it comes out of my experience. I have been in situations where courage is important. It usually takes the form of pushing back when there is an aggressive CEO. One reason they're CEOs is they have strong personalities and strong views. They can be very definite about what they want in terms of compensation, either for themselves or their management teams. Sometimes there is overreach. A comp committee has got to be able to determine for itself what is appropriate and have the courage to say, "No," if the situation warrants that. Sometimes it does. And I might add that it's difficult to push back in some of these situations, and that's why courage is an appropriate word.

MCC: Let's close with your involvement with NACD over the years. You've participated with the organization for decades. What has NACD meant to you?

Franklin: I'm quite proud of what NACD has done over the years in thought leadership, in doing these Blue Ribbon Commissions, in providing a lot of other resources for boards, and in providing networking opportunities for directors to learn from each other. NACD is working every minute to help directors be the best they can be and is committed to inspiring the entire board to become more effective. That's what this is all about at the end of the day. The entire package makes NACD a unique and much-needed organization. If it didn't already exist, it would have to be created. And NACD's work helps to strengthen our capitalistic system.

** To read NACD's Blue Ribbon Commission Report on the Compensation Committee, visit www.nacdonline.org/Store/ProductDetail.cfm?ItemNumber=15035.*

NACD Blue Ribbon Commission Report

Recommendations for the Compensation Committee

1 The compensation committee should broaden its scope beyond CEO succession to include oversight of talent development at multiple levels of the organization, especially the leadership pipeline.

2 Compensation committee composition should represent a range of diverse perspectives and skill sets, as well as evidence of diligence, expertise, courage and communication skills.

3 Consider a retainer for the compensation committee chair that is in line with that of the audit committee chair.

4 Executive compensation plans should balance long-term incentives with short-term operational goals, clearly reflecting and supporting the company's strategic plan.

5 Peer group and market data should be used as a "reasonability test" for executive pay plan design; it should not drive decisions.

6 The compensation committee should be able to exercise discretion in evaluating and rewarding performance, as long as it clearly discloses its rationale.

7 Compensation committees have a responsibility to inform and educate the full board on an ongoing basis about the link between performance and pay outcomes.

8 The board should view the CD&A as the company's primary vehicle for communicating compensation matters to shareholders.

9 Disclosures should clearly explain (in "plain English" and with key metrics defined) how compensation decisions are tied to performance.

10 The compensation committee chair should be prepared and "presentation ready" for shareholder communications.