Compensation Committee: 10 Best Practices

BY JACK L. LEDERER, SUSAN G. LOWRY AND DENNIS C. CAREY

In the past, shareholders and the press were concerned with the "how much" regarding executive compensation. Today shareholders and the press are focused on the "how": How is pay structured to create the most value for shareholders?

As a result, compensation committees are facing increased pressure to disclose specific decision criteria, performance evaluation processes, and design principles regarding executive compensation plans to communicate the committees' involvement in these areas.

We believe that a well-functioning compensation committee is best positioned to address the increasing scrutiny of shareholders and the press. Based on our years of experience in working with compensation committees, we have developed the following 10 best practices of well-functioning compensation committees.

1. Committee members understand the following:

• Company's industry.

• Company's strategic plan.

• Shareholders' perspective (i.e. stock performance, dilution, and use of peer group).

• Company's compensation plans.

2. Committee meetings are conducted in a manner that ensures open communication, meaningful participation, and timely resolution of issues. Each member participates in committee meetings in an active, objective, and constructive fashion.

3. The Committee has eliminated any insiders and interlocking directorships from the committee. (Note: An interlocking directorship would occur if a Company A executive served on the board of Company B and an executive of Company B served on the board of Company A.)

4. A formal charter has been adopted to include the following:

• Description of the committee's structure — typically three to five members.

• Responsibilities of the compensation committee — for example:

— regularly review the company's performance;

— review, assess, and approve all compensation and benefits for executive officers; and

— annually prepare the compensation committee's report for the proxy statement.

• Goals of the committee — for example:

— align compensation with performance of the company;

— review and approve compensation philosophy;

— review annually the performance goals/assessments and pay levels of the CEO and direct reports versus peer companies to ensure competitiveness;

— administer the company's long-term incentive program;

— determine and monitor the equity allocation between shareholders and employees and the allocation of equity among employees.

5. Committee procedures include, but are not limited to, the following:

• Meetings are scheduled to coincide with the company's performance calendar (e.g., fiscal year-end financial performance, earnings announcements, annual shareholder's meeting) and compensation process calendar (e.g., review of executives' compensation, annual grant date for options).

• Meeting materials are mailed to committee members five to 10 days in advance of the meeting and contain the right amount of information.

• Minutes are prepared.

• Administrative guidelines are thought-out and appropriate based on the complexity and number of executives and compensation plans.

• A specific list of priorities and a timetable with tentative meeting dates for the coming 18 months is reviewed and updated at each meeting.

• A pre-plan proxy disclosure process has been developed.

6. The committee has developed a compensation philosophy based on pay for performance that is

From left, **Jack L. Lederer** is principal and national practice leader at PricewaterhouseCoopers. He advises senior executives on compensation, organization effectiveness, and performance improvement strategies. **Susan G. Lowry** is a director in the Rewards and Performance Management Practice at Pricewaterhouse-Coopers. She has extensive experience in compensation and organizational consulting projects. **Dennis C. Carey** is vice chairman of Spencer Stuart U.S. and co-head of the recruiting firm's Board Services Practice. He is co-founder of The Directors' Institute at the Wharton School of the University of Pennsylvania.

tailored to the company's particular industry and strategy, recruiting and retention needs, and mission, vision, and values.

7. Committee members deliberate and resolve, with special consideration, the items that need to be presented in the compensation committee report to ensure full and clear proxy disclosure. These items typically include a description of the following:

• Compensation philosophy.

• Summary of the company's compensation plans and how they link pay to performance.

• Assessment of the most recent year's company performance versus pay levels.

• Evaluation process and resulting pay levels for the CEO.

• Methodology utilized for assessing competitiveness of pay levels and performance levels based on an independent review.

8. The committee can recognize performance goals that are "stretch" versus "incremental." (The committee considers performance outlined in the company's strategic plan, historical company performance, and peer performance when setting performance thresholds and targets for incentive plans.)

9. The committee employs an outside party skilled in employment contracts to review and aid in negotiating employment and/or severance arrangements with top executives. (Top executives employ their own agents to negotiate for them; these agents, in many cases, are lawyers skilled in contracts and compensation arrangements.)

10. The committee has a standard process in place to have board compensation reviewed by an outside third party to coincide with any extensive reviews of executive compensation. Other triggers for reviewing board compensation include situations where there has been a change in the company's strategy or a major capital transaction (e.g., merger, change in composition of the board). Also, in terms of compensation, the committee members advocate:

• Performance, then pay. (Competitive performance is assessed first before assessing competitive pay.)

• Director compensation delivered in stock and/or options and the development of director stock ownership guidelines to demonstrate the alignment of board interests with shareholder interests.

• The development of a board of directors performance review process to evaluate board performance and effectiveness.

• At a minimum, excluding directors and senior executives from any repricing of options. ■