

NACD Blue Ribbon Commission Report on Executive Compensation and the Role of the Compensation Committee

Summary: The National Association of Corporate Directors (NACD)'s Blue Ribbon Commission released a report on "Executive Compensation and the Role of the Compensation Committee" in December 2003. The report sets forth five principles for compensation committees to follow when establishing the company's compensation philosophy: independence, fairness, linkage to performance, long-term value for shareholders and transparency. While the recommendations made in the report are not binding, suggestions made by NACD Blue Ribbon Commissions in the past have influenced common practice. This memo summarizes the recommendations presented in the report.

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Introduction

The National Association of Corporate Directors (NACD)'s Blue Ribbon Commission released their report on "Executive Compensation and the Role of the Compensation Committee" in December 2003. The 32-member commission panel was chaired by William George, Former Chairman and CEO of Medtronic, Inc., and Barbara Hackman Franklin, Former US Secretary of Commerce. The commission included several experts including business executives, government officials, corporate board members, compensation consultants and academics.

The commission's report sets forth best practice principles for compensation committees and boards of public and private companies. The NACD issued a Blue Ribbon Commission report on this topic ten years ago which was updated in 2000. The 2003 report is intended to address recent governance reforms and "discuss ways compensation committees and boards of directors can enhance their effectiveness and help restore public confidence in executive compensation – and in corporate governance, generally." While the commission's suggestions are not binding, the NACD's Blue Ribbon Commission reports have historically had an impact on practices.

Specific Recommendations

The following are the most notable recommendations made by the commission regarding compensation practices:

- Consider alternatives to employment contracts for the CEO
- Tie severance pay to base pay, with a suggested multiple of 2X or 3X, based on length of tenure
- Use both qualitative and quantitative performance measures
- Decrease reliance on stock price as a performance measure
- Honor performance goals (without revision during the performance period)
- Include all independent board members in performance goal-setting process
- Implement stock ownership requirements and stock holding periods for managers

Add at least one other active or recently retired CEO to compensation committee (while avoiding interlocks)
Consider making interim public announcements regarding important compensation developments
Oversee senior officer stock trades by requiring use of a single brokerage firm
Ensure that committee has access to appropriate independent expertise
Consider factors other than external benchmarking in making pay decisions
Define the relevant marketplace with care, considering multiple criteria (e.g., employees, market value, and revenues)
Monitor dilution and overhang carefully

The remainder of this memo summarizes each of the four chapters of the 2003 report.

CHAPTER 1: Challenges Faced by the Compensation Committee

The commission calls upon the compensation committee and the board to address concerns regarding excessive executive compensation. The commission points out that compensation committees face several challenges as they address these concerns.

“The dynamics of the group process needed for committee and board effectiveness”

Boards and compensation committees should employ what the commission calls “constructive skepticism” when considering compensation-related issues. The commission feels that the new independence standards called for by the NYSE and Nasdaq listing requirements will increase the likelihood that directors will “speak their minds, examine assumptions, thoroughly discuss the issues, and arrive at appropriate decisions.”

“The difficulty of measuring performance”

The commission acknowledges that finding appropriate performance measures can be very difficult. The commission’s view is that financial indicators which can be manipulated have been too often used in the past decade. They suggest that performance measures “should be comprehensive enough to withstand the test of time and changes in circumstance.” More on the commission’s suggestions for performance measurement can be found later in this memo.

“The complexity of the modern pay package”

Another significant challenge pointed out by the commission is the complexity of pay packages. The compensation committee should have a thorough understanding of each component of the pay packages for the CEO and other senior executive officers, including the:

- “role of each element in motivating short-term and long-term performance
- cost of each element
- total cost of all elements combined in each package”

In addition to the direct financial costs of the pay package, the committee should consider the potential impact on the company’s reputation.

CHAPTER 2: Guiding Principles for Compensation Philosophy

The commission recommends that compensation committees develop a philosophy to guide them in making decisions. Several benefits are pointed out in the report:

The process of formalizing the compensation philosophy allows the committee to “discuss the relative merits of each element of compensation, and to actively decide which ones help promote the board’s vision for the company.”

The philosophy provides the committee the chance to “underscore the values and goals of the corporation” by highlighting those performance criteria which lead to financial rewards. The commission also claims that “a well-stated philosophy, if put into action, can blunt criticism of generous pay that is, in fact, effectively linked to outstanding individual and company performance.”

The following are the compensation principles set forth by the commission:

Principle 1: Independence

The commission points out that the members of the compensation committee must be independent from the CEO and management. The approach and processes of the committee must also be independent. “Each member of the compensation committee should have the capacity for objective judgment, and the courage and integrity to ask probing questions, to speak honestly, to set and adhere to appropriate limits, and to be an advocate for change when current practice results in negative outcomes.”

Principle 2: Fairness

Although the commission acknowledges that the definition of “fair” will differ, they suggest that companies consider both the internal and external “fairness” of their pay packages. Internally, the pay packages should reward all in the organization when the company does well, and vice versa. Additionally, there should not be large differences between pay levels (i.e., no “wide gaps between the CEO’s pay and the pay of other senior managers – or between executives and other employees – unless these are justified and explained.”)

Externally, the commission recommends that pay “relate to performance measured against true peer companies selected by the compensation committee.” The commission emphasizes that their report does not endorse reliance on competitive analyses for determining compensation. In fact, the commission states that “so-called market-based compensation is a root cause of the current problem.”

Principle 3: Linkage to Performance

It is recommended that the entire board be involved with setting performance goals and measuring against these goals. Both quantitative and qualitative performance measures should be considered and emphasis should not be placed on stock price performance. The commission further states that “companies need to honor agreed-upon performance metrics and not change those metrics after the fact in order to provide additional compensation despite failure to achieve stated goals.”

Principle 4: Long-Term Value for Shareholders

The committee acknowledges that executives should be rewarded for achieving short-term goals, but suggests that short-term incentives “not amount to a large percentage of total compensation.” Awards should focus on “achieving key metrics over an extended period of time.” The commission advocates long-term stock ownership as a means to tie executives’ interests with those of the shareholders.

Principle 5: Transparency

Providing timely information to shareholders regarding compensation is an important responsibility of the compensation committee. Disclosures should be clear and complete, including all aspects of compensation “even if such disclosure is not required.”

CHAPTER 3: The Compensation Committee: Composition, Duties, and Support

Composition of the Compensation Committee: An independent nominating or governance committee should be responsible for ensuring that all members of the compensation committee are independent of company management. The commission suggests that, in addition to the requirements set forth by the NYSE and Nasdaq, the following relationships are taken into account when determining a committee members’ independence:

- Personal friendships
- Prior business relationships
- Ties from philanthropic activities

The nominating or governance committee should also consider the experience of committee members to ensure that there is a balance of professional backgrounds in the group. The commission suggests that the committee include an active or recently retired CEO, “since a CEO can add ‘on the ground’ intelligence based on face-to-face operating experience in setting compensation for company executives.” The commission is careful to point out that the presence of an active CEO on the compensation committee should not lead to an interlocking committee situation.

In addition to independence and diversity of background, compensation committee members should “show evidence of diligence, understanding, and courage.” According to the commission, a committee member’s courage can be evidenced by the following actions:

- Asking probing questions
- Speaking honestly
- Setting and adhering to necessary limits
- Being an advocate for change when current practice results in the wrong outcome
- Asking “why” – and if necessary saying “no” – to questionable proposals

The commission points out that each committee member must also be willing and able to put in the time necessary to fulfill the duties of the committee. Each member must be willing and able to understand all of the complexities and ramifications of compensation packages. However, the commission states that the “committee members do not need to be experts in compensation.”

Duties of the Compensation Committee: The following are the duties of the compensation committee listed by the commission:

- Establish, write and regularly review compensation philosophy
- Establish a set of committee procedures
- Adopt compensation committee charter
- Determine compensation of company’s top officers
- Retain compensation experts
- Establish performance objectives for CEO
- Evaluate performance of CEO (along with all of the other independent board members)
- Recommend incentive-compensation plans and equity-based plans for senior executives to the board

- Produce compensation committee report on executive compensation for proxy statement (or other annual report as required by the SEC)
- Conduct annual self evaluation of committee's performance
- Ensure there is a plan for executive succession

The committee should keep the full board "engaged and informed" regarding all of the duties, especially those which impact company performance. A list of suggested procedures for the compensation committee is provided in the report.

Support for Compensation Committees: The commission suggests that compensation committees "consider engaging an independent compensation consultant, who does no work for management" to help the committee with its compensation philosophy and to advise regarding specific pay packages. The commission recommends that compensation consultants be hired by the compensation committee and report directly to the committee. Further, the commission states that "if a compensation committee does not follow this best practice and uses the same compensation consultant as management, this arrangement should be approved by the board and disclosed to shareholders." The commission specifically recommends that the committee disclose the advisors they use and their level of independence ("i.e., state whether they were hired by the committee or by management, and whether they do any work for management"). The committee should also have the authority to hire other advisors, such as attorneys, accountants and tax experts, who do no work for management.

In addition to external advisors, the compensation committee should effectively use the company's internal resources. The committee members should have access to the people in the human resources department who deal with compensation issues. The commission suggests that the company "consider giving the company's director of human resources and/or compensation a direct reporting relationship to the committee on matters that come before the committee." It is also recommended that the committee call on the CFO for the following:

- Descriptions of financial metrics used to manage business and make operating decisions
- Confirmation of achievement of corporate performance goals
- Reconciliation of performance metrics used for bonus purposes with GAAP numbers

The commission emphasizes the importance of director education, pointing out that compensation is a complex area which requires continuing education. It is also recommended that the board establish "a set of measurable objectives and a process for evaluating its performance."

CHAPTER 4: Steps for Compensation Committees to Build Effective Pay Packages

The report sets forth four steps for the compensation committee to take to build an effective pay package:

- Establish the right ground rules
- Link pay to performance
- Motivate creation of long-term value of shareholders
- Strive for full and transparent disclosure

These steps parallel the principles discussed in Chapter 1. The commission provides several specific suggestions for implementing these steps in accordance with the principles.

Establish the Right Ground Rules: The commission suggests that compensation committees “consider alternatives to contracts at the CEO level.” If a contract is used, “sunset” provisions should exist to allow the committee to decide to not continue the contract or to make changes.

As discussed above, pay packages should be designed so that they are perceived as “fair” both internally and externally. Along those lines, executive benefits and perquisites should not be different than those offered to other employees, unless there is a specific performance-related reason.

The compensation committee should be involved in the determination of the peer group used for compensation decisions. Committee members should have a clear understanding of how the peer group was determined, and ensure that multiple criteria are considered (e.g., employees or market value in addition to revenues).

The commission recommends that external benchmarking not be the only method used to determine pay levels. When it comes to recruiting a new CEO, or retaining an existing CEO, the commission cautions against giving in to pressure to match pay levels offered by other companies. Instead, the committee should “determine a realistic estimate of the actual value and then determine” the appropriate pay package “in light of all other pay elements.” Establishing parameters for these situations before they come up can help committees make sound decisions.

Link Pay to Performance: Determining the appropriate performance measures for use in incentive programs is an important responsibility of the committee and the board. The performance measures selected should:

- be realistically achievable
- reflect the company’s strategy
- take account of financial circumstances

Before the performance period begins, the performance measures should be documented and agreed upon by all relevant parties. The commission suggests that compensation committee “honor agreed-upon performance metrics; except under circumstances carefully weighed by the committee, do not change performance metrics after the fact in order to provide additional compensation despite failure to achieve stated objectives.” In fact, the commission states that the CEO’s pay should not be adjusted, even for events which are out of his or her control (e.g., geopolitical developments, new laws and regulations, currency exchange rate fluctuations).

The use of multiple performance measures is recommended, including both qualitative and quantitative metrics. The commission provides suggested performance metrics:

Quantitative Metrics

- Revenues
- Net income
- Profit margins
- Cash flow
- Earnings per share
- Reduced debt
- Return on equity, capital, or assets
- Market share (if not accompanied by decline in return on equity)
- Stock market performance

Qualitative Metrics

- Achievement/advancement of company strategy
- Compliance with the highest ethical standards and with legal requirements
- Community relations
- Customer satisfaction
- Leadership development and team building
- Ethics and leadership
- Product development milestones
- Product quality
- Risk assessment, management, and oversight
- Succession planning
- Workforce morale, diversity, and stability

Specifically, the commission suggests that the compensation committee ensure that succession planning is a performance measure used when evaluating CEO performance. Overall, the committee should “ensure that the company’s compensation framework helps to identify, develop, and motivate internal candidates for executive positions.”

In addition to ensuring the appropriate performance measures are used, the compensation committee should thoroughly “understand fully the mathematical implications of each plan, including the potential rewards under all likely scenarios.” Periodically, the committee should look at the total compensation the company could owe to the CEO and senior executives under a variety of scenarios (e.g., voluntary termination, retirement, involuntary termination, and change in control).

Motivate Creation of Long-Term Value for Shareholders: The commission recommends that stock ownership requirements and holding periods be in place for managers. They suggest that compensation committees consider the following practices to achieve stock ownership:

- require executives to purchase stock outright
- set ownership guidelines as a multiple of salary
- put holding requirements on stock acquired through option exercises
- restrict executive’s ability to exercise options and/or sell stock in less than a 12-month period
- require executives to pre-announce stock sales
- require executives to hold stock at least six months after leaving the company

However, the committee should ensure that executives do not hold too much company stock and have a disproportionate amount of their net worth is tied up in the company. The commission states that “commitment, not dependency, is the goal.”

Compensation committees must also monitor the dilution and overhang caused by equity-based awards. The commission points out that both the NYSE and Nasdaq require shareholder approval of new equity-based compensation programs, and suggests that committees “set sensible limits on the amount of stock and stock options awarded to executives.”

In order to ensure that value is created for shareholders, the commission recommends that final incentive award payments be based on audited financials. The commission acknowledges that, under the Sarbanes-Oxley Act of 2002, compensation will be recaptured in the case of a restatement following misconduct. However, they suggest that committees consider recapturing incentive awards that are paid based on financials which are later restated, even if no misconduct occurred.

In a sidebar discussion, the commission refers to “frustration for shareholders and boards alike” from severance payments made to CEOs who leave organizations after short and/or unsuccessful tenures, specifically citing a court case regarding this issue involving the Walt Disney Company. The commission makes several suggestions regarding severance pay:

Severance should be based on a multiple of base pay only (as opposed to including incentive payments in the calculation)

A multiple of 2 or 3 times base pay is sufficient

The package should be reduced when the CEO leaves for performance reasons

No payment should be made when the “CEO resigns for another position or for other reasons”

Tie the size of the package to tenure, requiring a minimum length of service to receive maximum benefit

Strive for Full and Transparent Disclosure: It is recommended that the compensation committee go beyond the requirements necessary for compliance with the SEC requirements regarding disclosure of compensation issues. The committee should make regular reports to the entire board, and make complete and clear information available to shareholders and the investing public. The following are specific ideas suggested by the commission regarding disclosure:

“Design plans that are as simple as possible and spell them out in a brief summary that describes company goals, executive performance objectives, and potential payouts under various scenarios”

“Make full and timely disclosures of compensation plans to shareholders and the investing public”

— Include full details on compensation and benefits plans for executives, including the value of the entire pay package

— Consider making interim public announcements regarding important compensation developments

Identify advisors to the committee, and describe their level of independence

— State whether they were hired by the committee or by management

— If the advisor does work for management, include the ratio of fees paid to the advisor for work done for the committee vs. fees paid for work done for management.

Copies of the full report can be purchased from the NACD by visiting their website at www.nacdonline.org or calling them at (202) 775-0509.



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