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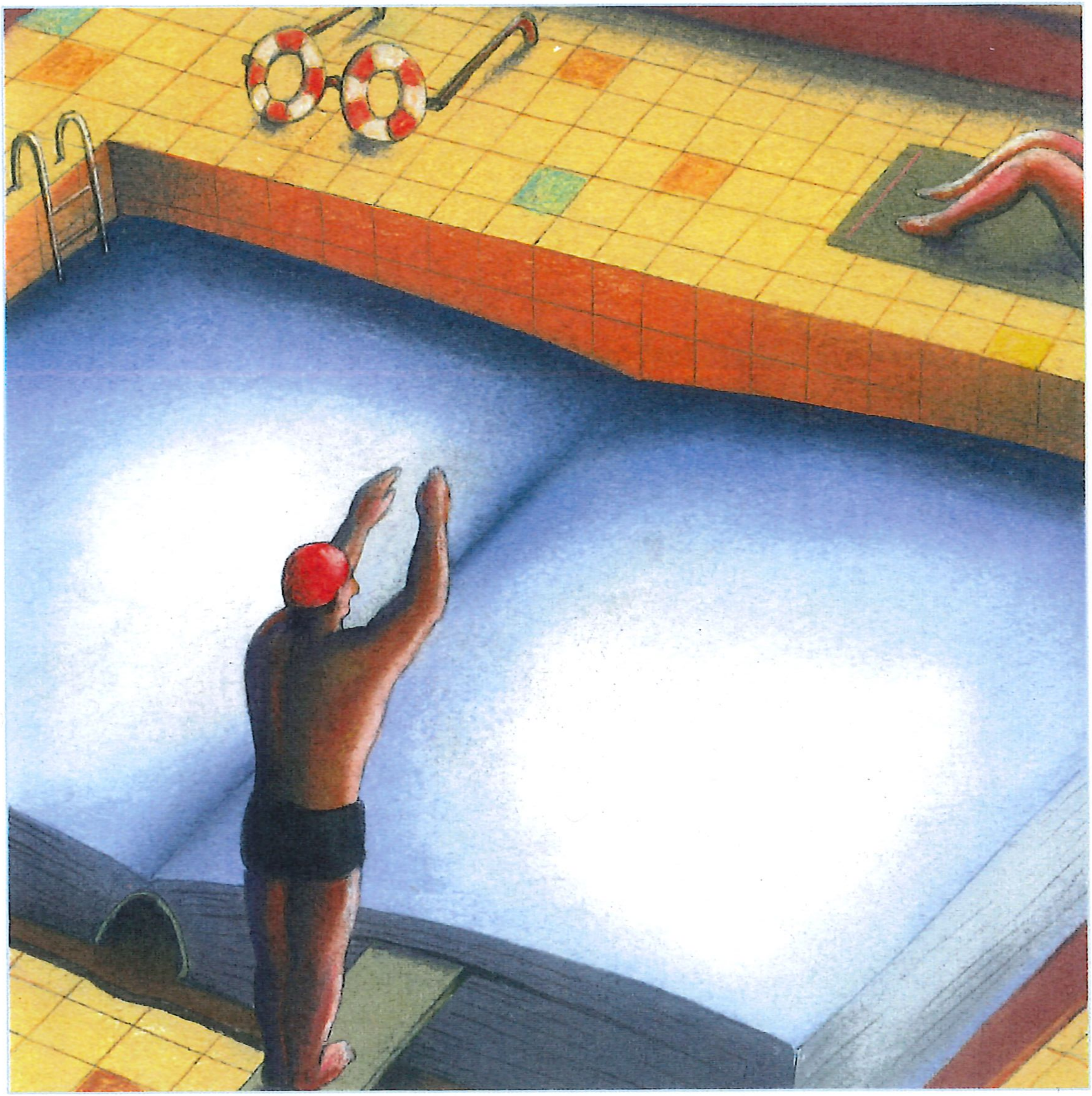

Dive Into Letters and Books

Experts Consider Clawbacks, How to Select a Compensation Advisor

Edited by Judy Warner

The week before the National Association of Corporate Directors (NACD) convened a panel of leading executive compensation consultants before an audience of directors, the board of Wells Fargo & Co. voted to rescind pay from executives who were in charge during a years-long sales scandal in its community banking operation. The clawback of an excess of $180 million from Wells Fargo executives is among the largest ever in corporate America. (The largest, according to *The New York Times*, involved UnitedHealth Group's then-CEO William McGuire, who in 2007 surrendered stock options and other benefits with a total value of more than $600 million as part of an options backdating derivative lawsuit settlement.) So it seemed appropriate that among the first questions posed to the panel was what would constitute a good clawback policy.

One of the most fundamental responsibilities for a board's compensation committee, especially in light of a Securities and Exchange Commission (SEC) rule that requires public companies to work with an independent compensation consultant, is to hire one. So how does a board go about selecting a compensation consultant?

The six experts on the Leading Minds of Compensation panel, who represent some of the top firms in executive compensation consulting, shared some pointers. They included **Margaret Engel**, founding partner, Compensation Advisory Partners; **Steven Hall**, founding partner and managing director, Steven Hall & Partners; **Diane Lerner**, managing partner, Pay Governance; **Barry Sullivan**, managing director, Semler Brossy; **David Swinford**, president and CEO, Pearl Meyer; and **John V. Trentacoste**, partner, Farient Advisors.

PHOTO BY DAVID NICHOLAS/LONGVIEW

What would you put into a world-class clawback policy?

Diane Lerner: The Wells Fargo situation has been an eye-opener and raises the question whether situations that create reputational harm should be factored into a clawback policy. The SEC rule under Dodd-Frank stipulates only that compensation can be clawed back in a material restatement. Now, if you were overpaid because somebody else cooks the books and there was a material restatement, the whole executive team needs to give it back because it was based on a fictitious result. The SEC has left it at a material restatement only. The only place where you see heavy use of misconduct-related clawbacks, at least in my experience, is on Wall Street. Wall Street has always had many categories of misconduct built into their clawbacks. I think the Wells Fargo situation is going to cause [boards to take a second look] at what to claw back. And I believe that a clawback policy should include misconduct.

David Swinford: I would cite Exxon Mobil's approach. Their incentive plan provides the board with total discretion to withhold or recoup payments. A number of directors taught me years ago that when you decide a controversial issue, you should do what is fair for the executives and fair to the shareholders. The other thing to remember is the old rule that the bank error is never in your favor. The idea that you get a payout because somebody made a mistake and you shouldn't have to give it back is a little inconsistent with how the rest of our lives tend to work.

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A number of years ago, I was working with an aerospace company that has since been acquired. One year there was a miscalculation of the long-term incentive payout as a result of some misreporting from a European operation. The CEO came into the compensation committee in executive session one day and explained what had happened. There were some 25 participants whose overpayments had ranged from a few thousand to a few hundred thousand dollars. The comp committee chair said, "Well, that's really a shame. I will have to think about how we're going to affect future compensation for that because we can't get it back." The CEO pulled 25 checks out of his pocket. He said, "I had to convince one guy to write this check. The others all volunteered to write it." He gave back all the money that was overpaid. If the company is harmed, the participants in the plan should not profit from it.

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Steven Hall: It's the same idea if I walk into the supermarket and hand the cashier a 20 and he gives me back change for a 10—you've got to give me the rest of the money. You can't just say it was a mistake. It has to be cleaned up properly. I think you need to collect it from everybody. Now, I think there are two different situations we're looking at here. One is where there's been some kind of an error in terms of how someone has been paid. That's pretty clear. The other one is a little fuzzier because it's a reputational issue. I think the reputational issue in the past has not been handled all that well, but I know of a lot of situations where you'd sit down at the end of the year and go through bonuses, and the comp committee would say, "The CEO is not getting a bonus because this situation happened." They punished the CEO quietly. I honestly don't know what the best way of handling it is. I don't know if it's going out and banging the drums saying we're clawing back from somebody because they did something wrong. That makes it tough for that person to go forward, which is one of the reasons why I think when we look at the compensation discussion and analysis, one of the requirements is explaining why you're not going to pay an executive. Well, everybody's pretty reluctant to say we think the CFO didn't do that good a job this year so we only paid him 50 percent of what his payout should've been because he was slacking on the job. No, they get paid the full amount because I don't want to have to make that explanation. The other reputational piece that we try to deal with is share-ownership guidelines—if we push equity into the hands of people, we make them hold it. When the reputation of the organization—and therefore the stock price—is damaged, they're going to hurt that way.

John V. Trentacoste: When we look at materiality and the financial statement, there's another side of that that's often more asymmetric, and that's the factor of how shareholder value has eroded. For Wells Fargo, they'll pay out, say, $200 million in fines related to this, but the decrease in market cap and shareholder value exceeded those fines by a multiple of nearly a hundred. Billions of dollars of shareholder value were instantly eviscerated following that scandal. If you look at that versus something like United [Airlines], then we have to ask, is there permanent erosion here? What's the actual, fundamental mistrust in the system created as the result of a systemic incident versus a one-time "oops." The United example can be confounded as a one-time "oops," whereas the situation at Wells Fargo will cast a specter of doubt over the bank's practices for years to come. With Wells Fargo, you have to look at all the levers you have to pull in addition to a clawback. There's downward discretion on the bonus and there also is—and should be—enough of an ownership of the stock so that a person's net worth is commensurately reduced to the shareholders' as well. I think that last piece—the fact that so much of executives' net worth is tied up in company stock—is underplayed. They're hurting just as much as the shareholder, if not more in some cases.

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What should a compensation committee be looking for in a compensation consultant?

Barry Sullivan: You want to make sure that your consultant is bringing to the table what you need brought to the table. That might change from time to time depending on the needs of the business. Generally speaking, you want to make sure in today's world that you've got somebody that knows all the process points. The process around executive compensation today is more rigorous and more comprehensive than ever before. Also, you want somebody with an analytical orientation—there is so much data available today on competitive pay and performance. And the level of sophistication of the investor base—and of the external critic's perspective—is higher than it's ever been. You want to have that sophistication in the boardroom, and you want it not only from management, but also from the consultant so that you can get different perspectives when you need them.

Trentacoste: Compensation planning is no longer a perfunctory exercise, so it does take a lot of analysis—and the pressure is certainly on the committees. When it comes to finding a consultant, the word "partner" always comes to mind. You're looking for a partner who will invest in understanding your business and your strategy, meeting with management, understanding their needs, plans, and goals, and will use that as the foundation of their work. You also want someone who presents the pros and cons of each approach. Ultimately, the decision is yours, but you should have someone who shows you choice points and the associated risks of each decision. You want someone who could see what's coming next, and understands institutional investors. The best offense is a really good defense. If you make a decision, make sure that you are aware of how you need to engage and where you need to engage. Finally, someone who gives you the confidence to do your job as comp committee chair is crucial. You can make informed decisions but to give you the backbone to stand up

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against ISS and say, "You know what, that's great that you have this policy, but I have this company, I have employees, I have shareholders, and I'm going to do right by them rather than the proxy advisors."

Margaret Engel: There are a couple of traits that I think are very important. Certainly your compensation consultant should add value and enhance informed decision making because that's fundamentally the job of the compensation committee. I think client service is very important—being available, answering the phone, and being there when issues arise. I also think good judgment and common sense are critical, just good gut judgment about when things may go off track. I think those are the three key things.

Swinford: I would add that understanding the business strategy and the leadership development strategy is more important to the design of your compensation program than ISS market practices and what your peer group does. Hire a consultant in part for war stories. What are the other things they've run into that are similar to this and what did they learn from them, and how can we learn from that? And that consultant has to match up psychologically with the management team. I think it's somebody that has enough life experience that when they're sitting in the room with the compensation committee, they integrate well with the members of the compensation committee—they've got to have enough experience to be credible in the room and offer good support. All good executive compensation people are terribly busy people. As a result, you need to have the right kinds of support teams so that you know the work is getting done and that there is somebody available to you immediately even if the lead consultant is off in another board meeting.

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—STEVEN HALL

Lerner: I think that wisdom versus knowledge brings perspective and experience as well as an understanding of the content. I definitely agree that resources are important and that you want to hire not only a lead consultant who you're very comfortable with, but know that there is a qualified number-two person when you need to call on in a pinch and that it's not just a one-person team.

Hall: Personality is critical. Being a facilitator is critical. This doesn't mean you sit there and dictate what the rules are, saying, "This is the way it should be." You should be trying to work with both sides to understand their issues while also being comfortable to tell either side if you disagree with their position. That can mean telling management quietly before going into a meeting that you think a certain position they are taking is problematic. I have been in situations where if I can't support a decision, I want it to be known ahead of time, but I will also suggest an alternative approach that I can get behind. Likewise, and I'm not saying you set fire to the committee in front of management, but prior to the comp committee meeting, you alert the committee that the tack they're taking may not be the best way to do it and management is suggesting something that isn't all bad. I'll try to get them to rethink it a little bit more and figure out how we can make it work, as opposed to just being a henchman for the compensation committee, or someone who's trying to carry out management's bidding. I think it's standing in the center and saying what's right for shareholders.