Experts Discuss the Evolving and Expanding Demands on Compensation Committees

Low unemployment and steep competition for digitally savvy directors and employees, along with recurring issues such as the gender pay gap and the ratio of CEO-to-worker pay, provided fertile ground for Leading Minds of Compensation, an NACD-hosted peer exchange held in April at the chic Mandarin Oriental in Boston's Back Bay. *NACD Directorship* Publisher Christopher Y. Clark moderated a panel discussion for the first hour before opening the floor to questions from the audience. Directors sought comparative answers to questions from the panel comprised of compensation consultants from four leading advisory firms and one intrepid director. The panel was composed of **Robin A. Ferracone**, founder and CEO, Farient Advisors; **R. David Fitt**, partner, Pay Governance; **Daniel Laddin**, founding partner, Compensation Advisory Partners; and **Melissa Means**, managing director, Pearl Meyer. Providing a director's perspective to the panel and insights gleaned from her experiences as a certified public accountant and human resources professional was **Jeri L. Isbell**. She retired as vice president of human resources at LexMark International, and now serves as the compensation committee chair on the boards of Atkore International Group and SiteOne Landscape Design. Isbell also serves on the compensation committee of Spartan Motors. What follows are select questions from directors and the panelists' answers, chosen and edited by *NACD Directorship* Editor-in-Chief Judy Warner.

How do we make sure we are not creating a social problem when a CEO is making so much more money than the average employee?

Means: Let's be honest: Executives make a lot of money, there is a market for their talent, and we can tell you what that market is worth. Then there are times when we review the market data and we know it's not a year for a pay increase. The data may have gone up, the company may have done reasonably well, but the base salaries of the executives are already positioned very well against the market. And yet the executives get salary increases. We all as individuals, including myself, determine our value to an organization based on what we're paid. I think we can all do a better job of managing the expectations of our executives around annual raises.

Ferracone: I also think this comes down to values—not value, but values. Yes, we need to change the mind-set around the expectation that there will be a raise every year. Another point: succession. If you have CEO succession planned, that's really useful because it helps diffuse how reliant you are on one person—the CEO. The more reliant you are on one person who has a lot of star power, the higher the pay could be.

Laddin: The difference in pay will likely always exist. I think we are seeing pressure to make sure we are paying people deeper in the organization fairly, and that will likely continue. We should also be asking if we are focusing on keeping our high performers. Do we have tools for leadership and [human resources] to really recognize top performers? We are seeing committees raise the curtain a bit to get into what the compensation philosophy for the company is far deeper in the organization, and [ask], are we true to it?

Fitt: This is where the compensation committee's job has expanded dramatically. The nuts and bolts of designing the right compensation program are still there, but it's the governance, the context, and the business judgment around compensation decisions where the job has changed for both consultants and board members.

What are the pros and cons of a combined compensation and governance committee?

Ferracone: Charters should define the roles and responsibilities of each committee. Whether you have joint meetings or provide a division of labor, compensation is going to only do compensation-related governance and governance is going to do all the rest. There should be coordination between committees, and coordination on calendars is really important. We sometimes do a governance update for the whole board. So those are the kinds of choices you have.

Fitt: I only have one client that has a joint committee. However, it's only a joint committee as it pertains to director pay. The two committees come together just for that particular topic because they believe that the comp committee adds value, given their depth of knowledge and expertise in the subject matter. But from a governance perspective, they prefer to have director compensation overseen by the nominating and governance committee. So they bring the two together for that particular topic.

Means: I have some organizations who have the chair of the nominating and governance committee serve as a member of the compensation committee, and vice versa, so that you've got integration and interaction between the two committees.

How should boards address managers whose behavior isn't so egregious that they warrant being fired but that nevertheless contribute to a toxic work environment?

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Isbell: That really has to be a discussion between the CEO and the CHRO [chief human resources officer], and then, of course, with the toxic individual. From a board standpoint, you can't always know who those people are, right? Somebody can come in and just be charming in the one or two hours that you see them in a board meeting and you really don't know what's going on underneath. So you really do have to rely on your management team to handle these situations appropriately, have the hard discussions with the individual, and hold them accountable for the behavior you expect.

Means: I think sometimes this is a compensation issue and sometimes it's not. Sometimes it might just be the messaging that goes with an incentive payout. For example, we're going to pay out at target, but here's the message we want the manager to hear: "What we didn't like about this particular year is our lack of focus on X, Y, and Z, or various behavioral issues." If the messaging isn't getting through and the next year there is the same problem and we're staying on top of it as a board, then we can start to say, "Okay, now this is really going to impact compensation." Or, "We need to change our process in totality around this particular issue." Sometimes it can also be softer things: "Do our leaders have the right opportunity to learn and grow? Not everybody's perfect or perfect at every aspect of leadership. Are we giving them the right development opportunities to learn and improve?" Oftentimes, I find myself asking, "What about a coach for a senior executive? What are we doing to help them grow and develop?" Sometimes it's more than compensation program—are we giving people the right tools to be the best leaders? Boards need to use all of the various tools at their disposal and remember that good communication is key.

How should boards be thinking about attracting the new generation of talent?

Isbell: One way that you can come at this might be through succession planning and talent development inside the company, which really is in the purview of the compensation committee. So you can start reaching in a little bit there. Directors can ask to see the employee surveys—and hopefully the company is doing

The panelists (from left): Robin A. Ferracone, Jeri L. Isbell, Daniel Laddin, R. David Fitt, and Melissa Means.

surveys—to find out how results are turning out. Boards are being criticized now for not understanding the culture inside a company, so we can't flip all the way over and say, "We need to know everything that's going on inside the company." But we need to know enough. There are ways to gather information from inside the company without taking over and making management feel like, "Wait a minute, this is what I'm paid to do."

Fitt: That depth [compensation committees becoming more engaged further down in the organization] started a few years back with risk assessments, which are not solely about executive pay—they cover all incentives company-wide. In that specific example, it's broadly in the compensation committee's purview to understand risk assessment results and implications. Beyond that, as the role of the compensation committee expands and you begin to ask questions and look to understand the dynamics of the organization beyond executives, I see mostly an "eyes and ears in, but hands out" approach. Commitees are asking questions for briefings but not getting involved in the details. For example, get a debriefing once a year on employee opinion survey results or updates on a pool of high-potenial employees so that you as a committee and a board member have a sense of what's going on without micromanaging the specifics.

Means: To that point, as a good consultant, we can tee those discussions up before it becomes an issue or before a board member reads it in a newspaper and says, "Gosh, should we be paying attention to this?" Many of us do trends reports on what's coming and what we are seeing in our crystal ball to help identify such topics.

Should "known unknowns" be incorporated into evaluating and compensating CEO performance, and if so, how?

Ferracone: We're working right now with an organization that's converting from coal to gas generation, which is a huge transformation with a large cost. How do you set goals against that? We've tried a couple of things. One is to strip out one-time items or things really associated with a transition that will not be recurring as part of the fundamental part of the business. To the extent that we can segregate items and say, "This is a one-time event and not part of how investors might look at the ongoing health of this business," is important. And it's really important to add in a qualitative piece, like 30 percent of the bonus, which is big enough to be meaningful and aligns compensation against performance to make the transition.

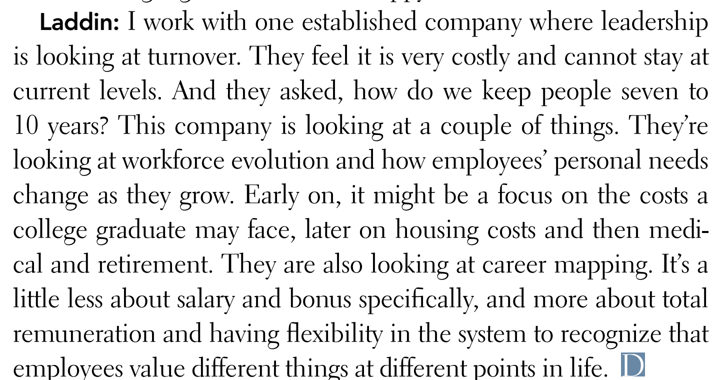
Laddin: We should allow the committee to use its judgment to modify payouts for the CEO and others. Sometimes it's less about what's unknown than knowing the timing of something. For example, with respect to a company in transformation, we may know where we want to get and have specific goals, but we may not know whether it will take three, four, or five years. We've gone to this framework where three years is long term. Private equity might see a somewhat longer time frame. We have migrated from options, which allowed flexibility for "time to achievement," to performance plans that almost universally have a three-year performance period. This has put pressure on not only needing to predict what is going to happen, but being fairly precise in when it will happen, too. We need to rethink this three-year, long-term paradigm, and consider whether we strike the right balance between short, medium, and true long term.

Isbell: How do you scenario plan? What are the worst-case, decent, and fantastic performance scenarios? Then you have three lines you can graph to see a range of possibilities of performance. Again, now we're looking into our crystal balls and trying to forecast out three years or longer. This can be another way of trying to understand the range of potential outcomes and help set a threshold target and metrics for the year's incentive plan.

What specific pay-plan changes are you seeing companies make to attract millennials, or the next generation?

Ferracone: There's got to be a complete and compelling package. You've got to provide time off, provide time for charitable activities, fun in the office, and those kinds of things, but there's a shortage of talent, and some companies are restructuring their work spaces to be more collaborative. There are a lot of things being tried, but I would add that those are not substitutes for compensation.

Means: This also goes back to the value proposition. What are people placing value on, and how can we tap into that and use our dollars most effectively? We can't let this compensation piece slip. We are also seeing a compensation clash right now between older employees who have been with a company for 20, 30, or 40 years and the younger talent needed for the digital transformation. Another point: As we adjust to being in this digital age, we are seeing more workforce planning and the different age groups. Generation Z just entered the workforce. What are they valuing, and how is that different from other generations? It's going to take all of the generations working together to create a happy, effective workforce.



Laddin: I work with one established company where leadership is looking at turnover. They feel it is very costly and cannot stay at current levels. And they asked, how do we keep people seven to 10 years? This company is looking at a couple of things. They're looking at workforce evolution and how employees' personal needs change as they grow. Early on, it might be a focus on the costs a college graduate may face, later on housing costs and then medical and retirement. They are also looking at career mapping. It's a little less about salary and bonus specifically, and more about total remuneration and having flexibility in the system to recognize that employees value different things at different points in life.