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NACD RELEASES BLUE RIBBON REPORT ON EXECUTIVE COMPENSATION AND THE ROLE OF THE COMPENSATION COMMITTEE

The National Association of Corporate Directors has released a Blue Ribbon Report on *Executive Compensation and the Role of the Compensation Committee*. The report provides recommended best practices regarding a variety of issues related to executive pay and reflects the input of almost 40 experienced Commission members, who include active and retired business executives, corporate board members, government officials, compensation consultants, and academics.

Highlights

The Report is intended to assist compensation committees in establishing a set of formal principles to guide their deliberations related to executive compensation. Primary issues addressed in the Report include the development of a formal compensation philosophy, establishment and maintenance of independence in the decision-making process, creating the right balance of internal and external fairness, encouraging a long-term commitment to the creation of shareholder value, linking earned compensation to achievement of meaningful performance objectives, and creating transparency in disclosure. While the report follows in the footsteps of those released by other business organizations (e.g., Conference Board, Business Roundtable), the NACD Report is very comprehensive and, similar to past NACD initiatives, is likely to exert considerable influence over emerging best practices.

A summary of the major recommendations and suggested best practices included in the Report is presented below:

- <u>Group dynamics</u> – committee members should approach executive compensation with "constructive skepticism" and resist the tendency to "go along" simply to create harmony or avoid controversy. Further, reliance on competitive precedent set by other companies should not drive the decision-making process

- <u>Complexity and understanding</u> – committee members must work hard to understand the true cost of executive pay and the impact of various programs in motivating short- and long-term performance

- <u>Compensation philosophy</u> – companies should develop a formal compensation philosophy, which articulates the fundamental principles that should guide the committee in making its decisions. These should include independence, fairness, linkage to performance, linkage to long-term shareholder value creation, and transparency

- The Report makes clear that reference to "market-based" compensation is intentionally not included among the key principles, since competitive benchmarking and relative positioning versus the market are viewed as a root cause in the upward "ratcheting" of executive pay

- Committee composition – committee membership should be diverse in background and experience. Members should be fully independent and willing to commit the time necessary to make fully informed and thoughtful decisions. Further, members must have the resolve to ask difficult questions and be courageous in challenging new proposals or the continued appropriateness of past practices

- Committee duties – key duties of the committee include developing and adopting a formal committee charter, establishing a clear set of administrative processes, overseeing and developing the compensation plans and systems for top officers, establishing objectives and evaluating performance, managing and overseeing the succession planning process for the CEO and other top executives, and overseeing the public disclosure process

- Committee support – recognizing that not all committee members are experts on compensation and that practices are constantly evolving, the Report recommends that committees should seek the help of qualified professionals

  - Compensation consultants – the Report suggests that committees should engage the assistance of an independent compensation consultant that does no work for management

    - If a single consultant is employed by both management and the committee, the Report suggests that the arrangement should be approved by the Board and disclosed to shareholders

  - Other resources – the Report emphasizes the importance of the committee's relationships with in-house experts, including the human resource, legal and finance staff. However, it also recommends that the committee should have access to other experts, such as independent outside legal counsel, which would be available to draft employment contracts, separation agreements, and other similar items

  - Education – committee members should have access to continuing education programs and other resources intended to increase their knowledge and compensation expertise

- Self-evaluation – the Committee should have a process for evaluating its performance against predetermined standards, which should aid in identifying its strengths and quantifying areas in need of improvement

- <u>Compensation effectiveness</u> – to ensure that compensation systems are effective in supporting organizational objectives, the Report sets forth four fundamental principles or objectives that should form the foundation of the decision-making process:

  1. **Internal and external fairness** – a fundamental objective should be establishing pay packages that are perceived as fair both internally and externally. To ensure fairness, the committee must understand the economic implications of each of its decisions and the potential rewards under all scenarios. Importantly, the committee should understand its potential liabilities to the CEO and other senior executives under all termination scenarios

     -- To illustrate the concept of fairness, the report presents some ground rules with regard to the use of employment contracts. First, committees should decide whether contracts are truly necessary, and if so, the contract should include "sunset" provisions that encourage periodic re-evaluation of specific terms and/or renegotiation. Contracts should not be perpetual, and failure to renew should not automatically result in payment of severance benefits

     -- Examples of internal fairness include ensuring that all members of an organization benefit when the company does well and share in sacrifices when it does not, avoiding large disparities in pay between different organization levels, and avoiding special, exclusionary benefits and perquisites for executives that are not business-related

     -- Examples of external fairness include establishing an appropriate peer frame for competitive comparisons, resisting the pressure to provide restitution of benefits forfeited by a new hire when it results in total compensation that is outside of predetermined parameters or excessively costly, and ensuring that succession planning is a key metric in measuring CEO performance

       → With regard to competitive comparisons, the Report emphasizes the importance of the committee overseeing the selection of peer companies, defining the "market" at the outset of the process, and using multiple criteria for considering possible peers

  2. **Performance and pay** – the report emphasizes a fundamentally critical objective in designing effective compensation systems – that the performance metrics used to trigger incentive payments must be "logically related to the strategy and financial circumstances of the particular company" and must be realistically achievable

     -- The metrics must be selected in advance and documented so that all parties understand what constitutes success, and the metrics must be part of a meaningful executive evaluation process

- -- Once determined, the metrics and the performance standards should be honored. Failure to achieve the goals should not result in re-evaluation and/or payment despite the failure, even when failure is due to factors outside the executive's control (e.g., general economic trends, catastrophic events, etc.)

3. **Long-term shareholder value** – to ensure that executives are truly committed to the creation of long-term shareholder value, the Report stresses the importance of requiring executives to buy or own stock and for creating disincentives to sell it. It also stresses the importance of balancing shareholder dilution relative to delivery of meaningful stock-based incentives for executives, and for retaining the right to recapture previous payments if hindsight results in the realization that financial targets were not actually met

   -- Of note, the report encourages companies to require executives to purchase stock with their own funds (as opposed to simply holding shares acquired through exercise of options or incentive plan payouts), to place minimum holding periods on shares acquired through company plans, to require executives to pre-announce stock sales at least 30 days in advance, and to require that executives hold stock for at least 6 months after leaving the company

   → The Report also notes, however, that "commitment, not dependency, is the goal," and that committees should avoid requirements that result in executives having too much of their net worth tied to company stock

   -- With regard to share dilution, the Report emphasizes the need for committees to carefully monitor overhang levels and to understand the value of options granted, including both exercised and unexercised awards

4. **Transparency in disclosure** – the Report clearly articulates that transparency in disclosure involves not only following the letter of the law, but also the spirit of intent. Specifically, the Report suggests that:

   -- Compensation plan design should be kept as simple as possible to ensure understanding among participants, committees, and investors

   -- The full board should receive complete reports of committee actions to ensure that all directors understand the implications of committee decisions

   -- Shareholder disclosure should include the specific metrics used to determine performance in incentive plans, as well as the costs and details of the entire compensation program, including deferred compensation and supplemental retirement plans, even if not required by the SEC

-- Companies should consider making public announcements of all important compensation developments

In addition to the suggested best practices, there are seven appendices and other assorted resources to assist committees with a variety of issues discussed throughout the Report.

We anticipate that the principles espoused by the Report will encourage more considerate and thoughtful decisions within compensation committees with regard to all aspects of the executive compensation process. However, some of the specific policies recommended in the Report may be rejected as administratively cumbersome, economically inefficient, or redundant with current regulatory requirements and established practices.

For more information about the Report and the NACD, visit their website at www.nacdonline.org.

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This letter is intended to alert compensation professionals about developments that may affect their companies. Specific questions regarding regulatory requirements and corporate governance issues related to executive compensation should be discussed with appropriate counsel. General questions about issues addressed in this letter may be directed to Daniel Ryterband in our New York office at 212.986.6330 or by email at djryterband@fwcook.com. This letter and other published materials are available on our website, www.fwcook.com.