

Tips for More Effective Compensation Committees

So much has changed in recent years for Compensation Committees that many Directors find themselves lost in the whirlwind of adjustments. The complexities of new accounting rules for equity compensation, new proxy disclosures and marketplace trends moving away from stock options as the sole long-term incentive vehicle have added significant complexity to the oversight responsibilities of Compensation Committees.

In simpler days, before the Sarbanes-Oxley Act of 2002 and recent accounting and security rules, Compensation Committees typically took actions based on well-massaged reams of tables depicting various percentile levels of “competitive data.” In today’s environment where this is no longer possible, the time and effort to provide meaningful oversight requires Compensation Committees to meet new challenges.

The following list provides 9 tips for Compensation Committees to become more effective. The tips explain best practice ideas aimed at using tools and techniques frequently used by well-run Committees.

1. Standardize Continuous Committee Training

There are more alternatives, more issues and more complexity than just a few years ago, so practices that seemed “tried and true” are being challenged. The rapid movement to using restricted stock and the recent scandals related to stock option award timing, for example, clearly show the changing landscape. Competitiveness of pay packages is being redefined and design of performance-based pay has supplanted the routine use of data tables.

The Compensation Committee needs to understand the mechanics and ramifications of emerging equity vehicles, such as stock appreciation rights and restricted stock units, trends in executive compensation practices, and evolving regulatory and shareholder concerns. Training sessions may include scheduling Committee time for non-decision actions to hear from consultants or outside counsel. Also, companies and journals should provide newsletters and journals to keep members of the Committee up-to-date.

2. Define Who’s the Boss

As a practical matter, most companies are averse to having different advisors (both consultants and legal counsel) for the Compensation Committee and the management team. While it is vital to select advisors who are appropriately knowledgeable and professional, it is also necessary that these advisors have the confidence of all parties to be independent and fair in their recommendations.

It should be no surprise that the historical process where the management team “assists” advisors by vetting recommendations has occasionally led to decisions that do not balance the interests of shareholders and executives. The Compensation Committee chair therefore needs to assume the lead role in the advisor/executive relationships.

The Compensation Committee should be responsible for the selection of the advisors, as well as giving direction and oversight to the advisor’s work. The management team should support the advisors by providing required information, performing other instrumental duties, such as coordinating scheduling, and providing key background and trends on the company’s business and employment environments. Both the Compensation Committee and the management team need to embrace the relationships with advisors as



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truly independent, thereby promoting appropriate analyses and decisions.

3. Establish a Schedule

Typically, historical practice has been to schedule meetings as needed to approve salary increases, pay bonuses and stock options. Recently, the number of meetings has increased as Committees spend more time discussing actions in addition to making decisions.

By scheduling the approximate dates of meetings a year in advance, the Committee will gain more control of the overall process of managing executive compensation. The Committee will be able to schedule time for training, updates on compensation trends and reviewing progress reports on performance versus targets and corresponding payments.

4. Create a Compensation Committee Sourcebook

One of the best practices for Compensation Committees is to have a confidential sourcebook of plans, contracts, agreements, resolutions and a history of key actions. The Compensation Committee Sourcebook serves as a reference for each member and eliminates unreliable sources of information such as current conversations or presentations when deliberating.

The appendix of the Sourcebook could contain the Committee charter, plan documents, sample stock option agreements, Committee resolutions, etc. The Sourcebook would be updated for each meeting with important current information such as statistics on equity compensation usage and salary increases versus budget.

5. Set (or Reset) an Executive Compensation Strategy

For many companies, the testimony about executive compensation strategy is limited to “we want to be at the X percentile of comparable pay levels of companies of our size and our industry.” This common statement reflects a one-sided strategic approach that does not optimize the potential true value of executive compensation as a prominent linkage to corporate goals and results. In addition, and even more seriously, this approach does not comply with the intent of the new proxy disclosure rules.

A more robust statement of strategy used as guidance by the Committee can include: the Committee’s philosophies related to specifically linking pay with shareholder interests, the relationship between short-term and long-term performance and rewards, how pay levels should be determined, and auditing of pay practices. Also, the establishment of a clear strategy is an opportunity to set forth key ancillary tenets of executive compensation, such as stock ownership guidelines and the use of insider trading programs.



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6. Rethink the Arithmetic

In the wild days of the dot-com boom and its high demand for executive talent, the single most-used tool for reviewing the competitiveness of pay levels was a tome of tables depicting the 50th, 60th, 75th and 90th percentiles of two or more subsets of a Peer Group of “comparable” firms. In many cases, Compensation Committees looked at the data and moved pay up, guaranteeing next year’s pay would be substantially higher.

In today’s atmosphere, pay levels may still increase from year to year, but the arithmetic should not be the sole consideration. Sarbanes-Oxley, expensing stock options, and shareholder and employee optics of the new proxy disclosures require Compensation Committees to consider cost effective performance-based compensation. High executive compensation levels that are non-performance-related could be problematic for Committees.

7. Audit the Decisions of the Committee

The recent wave of stock option scandals should prompt Compensation Committees to establish proper procedures to carry out their decisions. They should further ensure that the procedures are conducted according to all required rules and regulations. Merely making awards or increasing salary levels does not guarantee that the Committee has exercised full fiduciary responsibility.

Examples of Compensation Committee audits would be post-equity assessments by an independent review, requiring updates of year-to-date compensation statistics in the Committee Sourcebook, and developing an impact analysis of equity grants in relation to stock prices and corporate news releases.

8. Use More Executive Sessions

Compensation Committees in many cases only use exclusive executive sessions for determining such matters as a CEO’s salary. Other decisions are left for larger meetings that include members of the Compensation Committee, members of the executive staff, other key employees and advisors. However, this large meeting format may not be conducive to a forthright discussion and decision process for key executive compensation decisions.

Time set aside for exclusive executive sessions at the beginning of a meeting agenda helps Compensation Committees set the ground rules among members as to how they are going to proceed with the business items being presented and allow them, as a group, to focus on important questions on such issues as clarifications of materials and alternatives being presented.

Additional time for executive sessions before key deliberations establishes an environment that permits more “comparing notes” among members. Short executive sessions after the formal agenda items gives a Compensation Committee the occasion to assess how the meeting went, set the framework for the next meeting, and discuss any additional actions to be taken.



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9. Self-Evaluate the Committee

Very few Compensation Committees evaluate their performance levels. This is most likely related to the general aversion of CEOs and Board members to undergoing the process.

Compensation Committee evaluation is an opportunity for members to review the processes around exercising their fiduciary responsibilities, including the relationships with the management team and advisors, the quality of materials presented to them, the effectiveness of their decisions and their training needs. Evaluations further emphasize their commitments to better serving shareholders.

