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NOT JUST ANSWERS. THINKING.

ADVANCING THE DIALOGUE

Aiming for Best-in-Class Decision Making

INTRODUCTION

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The pressure to "get it right" with executive pay is more intense than ever in the new Say-on-Pay era. Not only do compensation committees have to bear the scrutiny of shareholders and proxy advisors. They have to bear an ever-bigger workload to review, understand, and act on more information than ever before. How can a committee under these circumstances move itself to best-in-class decision-making?

One imperative today is thoughtful planning—planning the full year's activities, as well as each meeting's agenda. Too often we hear from committee members: If only we spent more time on succession planning, we'd be in better shape when vacancies pop up. Or if only we spent more time on incentive design, we'd execute annual pay decisions quicker. The message behind such comments is simple: If we could spend our time only—or at least most of our time—on matters of strategic importance, we'd put ourselves at the top of our game in decision-making.

Most committees, of course, want to highlight and focus on strategic issues. But they too often become overwhelmed with the day's menu of tactical or administrative issues. Consider a 2013 meeting of the compensation committee of a large industrial firm. The meeting was scheduled for 90 minutes, and it was intended to cover three significant strategic topics and two tactical ones. The meeting agenda called for directors to start with two "easier" tactical items. The result: The "easy" discussion soon ballooned to 45 minutes, leaving only just enough time to scratch the surface of the three larger topics.

WHAT'S THE BIG IDEA?

Beset by growing workloads, compensation committees are speeding and improving decision-making. Here are some principles for moving to best-in-class:

- Supplement best-in-class people with best-in-class processes that give priority to strategic agenda items
- Give priority to four strategic issues
  1. pay levels
  2. pay design
  3. investor communications
  4. talent strategy
- Commit to an annual calendar that raises strategic issues at the right times—so as not to allow tactical issues to consume time better spent

Of course, all five agenda items required coverage. But the committee found itself in a corner, the victim of its own agenda. Management—with the best of intentions—had intended to pick the low-hanging "easy" fruit quickly, leaving most of the meeting for the strategic topics, including two decisions related to incentive design. But in the end, the committee chair had to schedule a special telephonic meeting for the following month to close the incentive discussion and keep to the company's larger timeline.

To be sure, striking the right balance between strategic and tactical/administrative items cannot, on its own, enable best-in-class decision-making by compensation committees. Having the right caliber and balance of committee members is most important, and the quality of committee materials counts for a lot as well. (See sidebar.) But experience shows that compensation committees have a big opportunity to improve their performance by simply structuring the bulk of their work around key strategic topics/questions. The most effective committees take great care with the sequencing of these topics, in both scheduling them at the most effective time during the full year and within each meeting.

The Pitfalls Are Common, Solutions Straightforward

This might seem like a simple tip on meeting management: Don't let the tactical and administrative items overwhelm the strategic. But the frequency with which compensation committees find themselves giving short shrift to the questions with the broadest implications makes it worthy of special emphasis. Taking the opportunity to adopt a strong process—a process that brings forward the most strategic issues—can help a committee to make the best possible decisions.

One too-common cause of this problem is easy to pinpoint: committee members get too much material. Board books grow year on year: Current page counts can be staggering, and while new electronic formats lighten the physical load, they have also done away with a natural governor—the capacity of the three-ring binder to limit page counts.

Key Success Factors for Best-in-Class Decision Making

People, process, and materials—these three factors determine the quality of decisions by compensation committees. They also assure decisions are balanced—both as to what's right for shareholders and what's right for the business.

1) People: Seasoned, independent board members with diversity of experience and perspective—combined with credibility, frankness, and trustworthiness. Key success factors: Capable of managing the workload and managing across multiple stakeholders.

2) Process: Disciplined agendas to give priority to strategic issues of pay levels, pay design, investor communications, and talent strategy. Key success factors: Initiating strategic items at right time, sequencing them to allow discussion and make timely choices.

3) Materials: Materials winnowed to a manageable level. Key success factors: Marking—and potentially separating—meeting materials into "information only" and "action only," to focus attention and bring forward those items requiring decision.

Some companies are combatting information overload by clearly marking—and even separating—what is nice to know (information-only) and what committees need to know (action-required). Other companies are enhancing the analysis that accompanies the information, tailoring the materials with greater intention to informing the board of needed choices—sometimes hard choices.

When every director has a firm grasp of the strategic topic, chances are the tactical items can be determined and dispatched much more quickly. And when time does run short, the more tactical items can be more easily addressed by email or phone. More routine items—like ratifying meeting minutes or reviewing share ownership level—simply don't have to consume so much precious time.

The Big Four Strategic Items

Strategic questions fall into essentially four buckets: pay levels, pay design, investor communications, and executive talent strategy. The guiding principle for more effective meetings is a corollary to what we've already covered: Take care of strategic items first and the tactical will take care of themselves (more or less).

With respect to pay levels, the key strategic questions that need answering throughout the year include the following: 1) What is our competitive market definition? Said simply, What peer companies and surveys do we reference to develop our sense of the market? 2) Where do we want to position pay relative to the market—for the executive group, for the workforce overall, and for each position/incumbent?

For pay design, the key questions include the following: 1) How much pay should executives have at-risk with performance, and over what time periods? That is, how much should be tied to annual incentives versus longer-term incentives? 2) What's the right mix of cash versus equity compensation? 3) What performance counts? That is, what levels of performance are we willing to pay for, and how much at each executive level?

When compensation committees consider performance, the concern is not just whether the company obtained the desired result. What's also important is that executives achieved the result in the right way, and did so such that the company is positioned to achieve those results in the future. This is where the committee has to do some deep thinking, to get the principal focus of performance measurement and goal-setting properly calibrated.

Consistency in incentive design is generally important year to year. On the other hand, pay design requires time and attention annually—even if only to test and affirm the current approach. This can help to avoid the "set it and forget it" trap that some companies fall into, in which incentive programs that worked for a time lose efficacy as the business and organizational context change.

As for investor communications, companies and committees are both faced today with new choices, and in some cases, demands. In response to the new Say-on-Pay context, many companies are communicating more frequently with shareholders on the subject of pay, and they are giving the subject greater intention and focus. The compensation committee's role is to help craft the company's external message. The compensation committee members, or chair, may have a direct role in discussions with major investors (less common today), or act more in the background.

The CD&A remains the principal communication tool. Committees are often best positioned when involved throughout the drafting process. This includes first drafts, to help set the foundational messages, as well as final drafts, to help affirm the overall story. Today, too many committees are brought into the process too late to provide their most meaningful input. One way to avoid this challenge is to schedule a formal and comprehensive postmortem after investor reaction to each year's CD&A. With the benefit of feedback and/or a reading of other company's CD&As, the committee can put its best foot forward the next year.

While talent strategy is last in this list, it remains of paramount importance. With responsibility for performance management, compensation committees today naturally also focus on succession planning for the executive team. Many committees feel this topic gets short shrift, in part because the subject sometimes lacks the urgency of the others—there are simply fewer hard deadlines to meet. That said, compensation committees are best positioned to keep the conversation about succession alive throughout the year, so that they are ready when the need arises. Some committees are on the leading edge in this regard—focusing deeper into the organization today than ever before, well beyond the executive team and the next level down. Some committees are even reaching into the organization's thirty-something crowd, targeting high-potential employees with development plans tailored intentionally to future C-suite positions.

Sequencing Agenda Items Remains Critical

As for the sequencing of agenda items in each meeting, one emerging practice can help committees emphasize the strategic: Hold an executive session at the front-end of each meeting. Such a kick-off session can allow directors to prioritize and even re-sequence agenda items to be sure strategic questions get first attention. Further, up-front executive sessions also give directors time to gain familiarity—and consensus—on the more complex or more controversial issues before opening the broader meeting. Directors are often then better positioned to initiate and structure the open discussion, especially with more meaty or sensitive topics.

Committees will find there is a season to all strategic issues. The question is, when is the best time to raise each issue annually? When do you best debate the details and when do you decide on them? What is that right sequence for the year? Figure 1 shows a sequencing timeline that includes the four categories of strategic issues.

Of course, big-picture strategic items will come up at many meetings, as they require ongoing discussion, debate, and approval. Incentive design, for example, begins with goal setting for the next year. It often continues throughout the year, with regular updates on performance, and it concludes with a final assessment against goals for the year while setting goals for the coming year (the cycle continues). The big-four strategic topics often require several bites at the apple, and committees that sequence information, consideration, and decision-making over time can be very effective. Sequencing is a big help in successfully designing and administering pay programs that are (1) supportive of the business and (2) responsive to shareholders.

As an example, a major industrial company recently undertook a restructuring. The committee was faced with two key incentive compensation issues. First, what impact would restructuring figures have on performance calculations and incentive outcomes for the year about to close? Second, what part of the figures should be in, and what part out, of setting performance goals for the coming year?

Figure 1. **The Compensation Committee's Calendar**

For compensation committees, best-in-class decision-making requires finding an effective annual cadence for handling strategic issues. When should committees initiate discussion of each issue? When should they call for decisions? Sequencing strategic items over multiple meetings allows time for people to grasp the topic, ponder management's proposals, and consider unintended consequences. The timeline below gives a scheme to assure the right strategic conversations take place at the right times.

	Q1 in-person	Q1 telephonic	Q2 in-person	Q3 in-person	Q4 in-person
Executive Compensation *for prior fiscal year*					
Prepare for CEO evaluation: CEO progress report; affirm form, process, and timing				●	
Finalize CEO evaluations: review results; determine summary messages	●				
Executive pay actions: annual incentive results and payments; long-term performance plan results and payments	●				
for new fiscal year					
Review benchmark data for executive pay levels and practices					●
Set executive pay opportunities: annual incentive and long-term performance plan performance goals, and base salaries and individual incentive award targets	●				
Finalize CEO goals and priorities for new year		●			
Annual and longer-term incentive plans					
Review incentive design (metrics; goals), including equity incentives (vehicle mix; key provisions; burn rate)				●	
Succession Planning					
Review key talent and discuss succession planning			●		●
Board Compensation					
Review benchmark data for director pay levels and practices				●	
Consider program changes, if any					●
Other Committee Activities *more strategic*					
Review the Company's compensation philosophy, strategy, programs, and practices (for next fiscal year)				●	
Review the Company's competitive market definition (peer group and pay surveys)				●	
Review and discuss the Compensation Discussion and Analysis		●			
Annual review of risk within context of incentive pay			●		
more administrative					
Review progress to executive share ownership requirements			●		
Review executive benefits			●		
Conduct annual committee self-assessment				●	
Annual committee charter and agenda review				●	
Recurring activities (at each meeting)					
Approve minutes from prior meeting(s)	●	●	●	●	●
Approve any off-cycle equity grants	●	●	●	●	●
Ratify any special actions (eg, promotions; new hires)	●	●	●	●	●

Sequencing these questions over two meetings allowed for the right conversations to take place at the right times, with the right supporting information. Ultimately, the current-year calculations were made to let stand, owing to the impact of the restructuring being fairly minor. For the coming year, the decision was made to exclude the restructuring from the performance goals, given the relative difficulty of forecasting restructuring costs/benefits (both the dollar amount and the timing) as compared to the company's core operations. To address the restructuring directly, the committee created a special, separate mechanism to adjust incentives at the end of the year, based on both a quantitative and qualitative review of performance against expectations for the restructuring.

This outcome—a budget-based program with an explicit side program for restructuring—was made possible because the compensation committee had built a strong process to keep the focus on big-picture strategic items. Of course, the foundational piece that enabled success was the board's close knowledge and understanding of the business itself : The committee was able to digest the situation, request the necessary information to inform its choice, and ultimately, make a reasoned determination as to what a successful restructuring would look like, and just as important, where it might fall short.

Don't Forget Continuous Improvement

Best-in-class decision-making is what every compensation committee wants. How do committee members move themselves from feeling overwhelmed by the tactical to making the tactical seem routine? One route to improvement ranks high: committees that insist on a robust annual self-assessment of their performance—performance along three key dimensions: people, process, and materials. (See sidebar.)

Most important, the committee's self-assessment needs to focus on outcomes—did we get it right for the year? A secondary focus should be on process—how did it work, and how could it be improved? Committees that undertake written assessments are often best served. Written comments can fully capture the committee's high- and lowlights and provide a strong basis for an open dialogue.

Another route to improvement ranks at the very top. It is a final piece in the best-in-class puzzle: The committee, as part of its written self-assessment, should give special attention to the four strategic priorities—pay levels, pay design, investor communications, and talent strategy. At a time when outsiders expect more of compensation committees every year, a focus on this strategic quartet provides the basis for committees that run smoothly and deliver strong outcomes.

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