Executive Compensation

Should Compensation Committees Seek CEO Input When Deciding CEO Pay?

By Daniel Rodda and Dan Kaufman

Determining CEO pay is one of the most visible decisions the compensation committee and board will make. CEO pay decisions communicate the board's perspective on both the CEO's and the company's performance to employees, shareholders, and other external observers. Shareholders and proxy advisory firms primarily focus on CEO pay when evaluating whether to support the company's say-on-pay vote—and this year's new CEO pay ratio disclosures will invite additional scrutiny.

The CEO typically has significant input on the compensation committee's pay decisions for senior executives, as the committee wants to understand the CEO's view of each executive's performance, potential, and retention risk. However, committees may struggle with how much input the CEO should have into his or her own compensation. While some may suggest that the CEO should not have any involvement in the process, we have found that the CEO's perspective can be useful when all parties understand the limits of his or her input.

While the approach can vary based on each company's culture and the personalities involved, in our experience the following are important guidelines for compensation committees as they consider their process for CEO pay decisions.

- The CEO should not be present when the compensation committee is making decisions about his or her compensation. It is an essential governance practice for independent directors to discuss and determine the CEO's compensation during an executive session on its own or with the assistance of its compensation advisor.
- Prior to receiving any input from the CEO, the compensation committee chair, board chair, or lead independent director should set clear expectations about the process and that the committee or board will make the final pay decisions.
- Directors should get the CEO's view of his or her individual and company performance. The compensation committee's agenda should ensure that the CEO has the opportunity to discuss his or her self-assessment before the committee meets independently to determine the CEO's pay.
- The CEO can offer insight into the messages he or she is trying to deliver internally through compensation decisions. Compensation provides a valuable communication tool, and directors should evaluate whether the decisions they are considering for the CEO will be viewed as consistent with those being made for executives and other employees.
- Understanding the CEO's expectations of his or her own compensation can be an important part of the process; however, this information is likely best obtained through informal conversations rather than formal board discussions. The head of human resources also may have valuable insights to share. Managing these conversations informally allows for the directors to better understand how their decisions will be received, while maintaining clarity that the decision will ultimately be made independently by the committee or the board.
- Determination of CEO compensation adjustments should not be treated as an annual negotiation with the CEO, but rather a decision of the committee or the board. There is not an expectation that the CEO negotiate with his or her direct reports when determining their compensation adjustments, so why would the CEO process be any different?
- Once decisions on CEO compensation have been made, the compensation committee chair should be transparent with the CEO about the committee's rationale. In many cases, we have observed that during (but not before) this conversation it can be useful to share broad perspectives on the market data used by the committee. The chair should also communicate the internal and external considerations that went into their decisions.

While the appropriate process of setting CEO pay will differ by organization based on culture and other internal and external factors, maintaining important guardrails around the CEO's involvement is essential to ensure the compensation committee's independence and a strong governance process. In making its decisions, it is important for this committee to consider the messaging of those decisions to employees, shareholders, and the CEO, while ensuring the outcomes are consistent with the compensation philosophy and strongly align with company performance.

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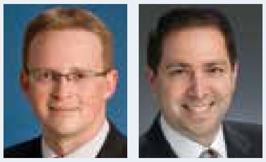

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