

Compensation Committees: What They Do, How They are Structured, and Best Practices

Compensation Committees are vital for company boards to fulfill their compensation governance responsibilities. They allow a subset of directors from the board to focus on specific compensation-related issues and implement a compensation philosophy that embodies the company's requirements and goals. Often, having a well-crafted compensation philosophy will make compensation decisions more manageable, as the potential outcomes of a compensation-related action can be run through the philosophy to determine which does the best job of supporting that philosophy.

What Compensation Committees Do

Typically, a company's Board of Directors grants compensation committees authority to handle compensation matters related to executives and directors, including determining, reviewing, and analyzing base salaries, incentive compensation, perquisites and severance pay. Public companies also delegate additional duties and responsibilities to their Compensation Committees, including preparing a Compensation Committee Report for inclusion in the annual proxy statement, reviewing the Compensation Discussion and Analysis section for inclusion in the proxy statement, ensuring the compliance of executives and directors with stock ownership guidelines, and administering and interpreting incentive compensation plans for executives and, generally, all equity compensation plans.

Key Compensation Committee Functions

Compensation Committees generally have three key functions:

- **Support Achievement of Strategic Goals and Objectives:** The Committee must ensure that the company's executive compensation plans and programs support the company's strategic goals and objectives, as well as the company's compensation philosophy.
- **Administer Plans and Programs:** The Committee must administer short- and long-term incentive compensation plans for executives and equity compensation plans for employees and directors.
- **Compensation Governance Oversight for Board:** The Committee takes on the Board's executive and director compensation responsibilities. Accordingly, the Committee will keep the Board advised concerning compensation developments, decisions, and the CEO's compensation.

Compensation Committee Charters

Public companies must have a written charter for their compensation committees to comply with applicable listing requirements. The requirements differ slightly depending on which exchange a company's securities are listed on. Still, several vital items need to be addressed, including membership requirements, the committee's authority, and the committee's duties and responsibilities.

Membership

Most charters will indicate the qualifications for a director to be a member of the Compensation Committee. Typically, these include being an "independent director" under the listing exchange rules and a "non-employee director" under Rule 16b-3 under the Securities Exchange Act of 1934, as amended.

For a director to be deemed "independent," it generally means the director's only connection to the company is through the Board seat he/she holds. Proxy advisory firms have more stringent requirements and would also require that the director not have ever served as the company's CEO or was any of the other named executive officers during the past five years.

Authority of the Compensation Committee

Generally, a charter will delegate to the Compensation Committee the authority of the Board to fulfill the purposes for which the Committee was created and the duties and responsibilities it has been entrusted to carry out.

Some of the specific types of authority that could be mentioned in a charter include:

- Conduct investigations into any matter within its scope of authority
- Retain legal counsel, compensation consultants, and other advisors and set such advisors' pay
- Delegate its responsibility and authority to any member or subcommittee

Duties and Responsibilities

Some of the typical duties and responsibilities include:

- Exercising oversight concerning all matters of executive compensation
- Developing, reviewing and updating the company's compensation philosophy
- Reviewing and approving the peer companies used for compensation benchmarking
- Reviewing and approving corporate goals and objectives relevant to compensation of the executive officers
- Review and recommend to the Board for approval the Company's executive compensation program
- Evaluate the CEO's performance and, in consultation with the CEO, that of the other executive officers and submit an annual evaluation to the Board
- Either determine and approve or recommend to the full Board for approval the compensation for the CEO based on the evaluation of the CEO's performance
- In consultation with the CEO, set the compensation for the other executive officers based on the evaluation of their performance
- Review and discuss the CD&A to be included in the proxy statement with management and determine whether to recommend to the Board that it be included in the proxy statement or annual report
- Prepare a Compensation Committee report to be included in the proxy statement or annual report
- Review and recommend to the Board how frequently the company should submit to shareholders an advisory vote on executive compensation ("Say on Pay" vote)
- Review the results of any Say on Pay vote and consider whether to recommend any adjustments to the company's executive compensation policies and practices
- Oversee management's engagement with shareholders and proxy advisory firms on executive compensation matters
- Recommend to the Board for adoption and then administer the company's clawback policy
- Review and make recommendations to the Board concerning incentive compensation plans and equity compensation plans
- Review the Company's equity compensation plans to determine when shareholder approval of such plans is necessary or desirable following exchange listing requirements and corporate governance guidelines.
- Annually review director compensation and recommend to the Board any changes in the form or amount of such compensation
- Review and approve any company stock transaction by Section 16 officers
- Review the company's compliance with employee and director compensation and benefits
- Receive and review periodic reports on the company's compensation plans, policies and programs
- Oversee the assessment of risks related to the company's compensation policies and programs

Compensation Committee Best Practices

Current best practices for compensation committees are often reflected in their charters. For example, many compensation committee charters indicate that the committee will abide by a calendar and indicate a minimum number of meetings that will be held each year. The charters also sometimes detail how the agendas for

committee meetings will be developed, typically at the direction of the committee chair with input from management and the other committee members. Finally, charters often state how meetings will be run and that the committee shall meet in executive sessions without management present to discuss compensation matters periodically.

Compensation Committee Calendars

One of the best practices for compensation committees is to have an established committee calendar that details the usual items that will be taken up at each meeting, with the knowledge that any special topics or time-critical issues that pop up will get scheduled to be taken care of by the committee as soon as possible. A typical calendar might include the following items by quarter:

- First Quarter
 - Approve merit budgets, salary increases, and other changes to pay opportunities
 - Evaluate CEO and executive performance
 - Determine appropriate payout of incentives based on performance
 - Review CD&A and other executive pay-related proxy disclosures
- Second Quarter
 - Pay-for-Performance analysis vs. peer companies
 - Tally sheet reviews
 - Annual compensation risk assessment
 - Dilution and equity incentive run rate study
 - Change-in-Control severance eligibility and design review
 - Legislative, regulatory, and proxy advisory firms' policy updates
- Third Quarter
 - Peer group review
 - Market data refresh (data on CEO position to be reviewed in executive session)
 - Market trends presentation
 - Short-term/long-term incentive design changes
 - Committee charter review
 - Legislative, regulatory, and proxy advisory firms' policy updates
- Fourth Quarter
 - Finalize short-term/long-term incentive design for next year
 - Evaluate committee performance
 - Evaluate executive compensation consultant performance
 - Review executive progress toward stock ownership guidelines
- Other Annual or More Frequent Items
 - Approve promotions, new employment agreements/term sheets, hire-on grants
 - Succession planning and leadership development
 - Review incentive payout projections
 - Approve changes to benefit plans
- Periodic but Less Frequent Items
 - Comprehensive reevaluation of incentive designs
 - Benefits and perquisites review
 - Review of employment agreement or severance template/plan document, clawback policy, anti-hedging policy
 - Change-in-Control provision review and costing

Compensation Committee Agendas

Best practice is to have the compensation committee meeting agendas developed by and/or at the direction of the committee chair. Typically, management and the committee's executive compensation consultant will aid in developing meeting agendas, but the chair should ultimately approve the agenda.

Compensation Committee Meetings

Generally, most committees will have a pre-meeting meeting between the chair, management, and the executive compensation consultant to discuss business items that must be addressed at the next meeting. Any materials for the meeting are then reviewed with the chair. To the extent that the materials raise any sensitive issues, the chair may also have pre-meetings with the other committee members to seek their input on the topic ahead of the meeting. Crafting the meeting materials in this fashion helps eliminate surprises in committee meetings or, at the very least, kept to a minimum.

Additional Resources

Be sure to check out our podcast, [*Navigating the Nuances of Executive Compensation Governance*](#), an interview with Diligent's Inside Today's Boardrooms, [*How Should Compensation Committee Balance SEC Disclosures with Pay-for-Performance*](#), and this article, [*Beyond the Numbers: The Role of Compensation Committees in the Era of Human Capital Management*](#), which appeared in the NACD's *Directorship* (2023 Q4).