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Best Practices for Your Compensation Committee

By: *Susan O'Donnell* | NOVEMBER 13TH, 2013

Compensation committees today face increased responsibilities, time commitments and risks. **The Dodd Frank- Act, the Securities and Exchange Commission (SEC) and the stock exchanges are mandating new governance standards and disclosure rules.** Bank regulators, shareholders and their advisory firms (e.g. Institutional Shareholder Services, Glass Lewis) create pressures to conform to their requirements, which often conflict. As external pressures continue to evolve, compensation committees need to address more complex issues and change their practices to ensure proper oversight.

Committee Governance

Establishing appropriate governance structures is critical to enabling compensation committees to make effective decisions in this complex environment. The SEC recently approved new independence requirements for compensation committees listed on NASDAQ and NYSE. In consideration of these requirements and other trends, below is a list of some best practices related to compensation committee governance. A compensation committee should have:

- Composition comprised solely of independent board members, willing to encourage discussion, debate and challenge the status quo.
- A charter that provides clear definition of authority and meets new SEC requirements.
- Clear definition of its authority to manage compensation risk.
- An annual calendar defining activities/actions to be taken throughout the year.
- Oversight that includes CEO and top executives.
- Agendas and meeting materials sent well in advance of meeting with clearly define topics for review, discussion and approval.
- A two-review process for major decisions (e.g. one meeting to review materials and discuss; second meeting to approve).
- Executive sessions without management at every meeting.
- Annual self-assessments of the committee's performance.
- Annual assessments of independent advisors.
- Ongoing director/committee education (through advisors, conferences).

Compensation Program Design

Compensation program designs and practices are changing as a result of the increased influence of bank regulators, shareholders and advisory firms such as ISS and Glass Lewis. Best practice compensation programs should:

- Align and drive the bank's strategic goals and business plans.
- Reflect the bank's unique compensation philosophy and guiding principles.
- Provide a balance of or between:
    - Performance measures (e.g. return, operational, shareholder).
    - Fixed and variable/performance based programs.
    - Short and long-term performance.
    - Cash and equity-based compensation.
    - Bank, division and individual performance.

  - Formula versus discretion.
  - Absolute and relative performance.

- Include a mechanism for risk-adjusted compensation. (Approaches vary but might reflect inclusion of risk metrics in the incentive plan, such as risk-adjusted returns, or deferral of incentive pay.)
- Embrace meaningful stock ownership for executives and board members through ownership guidelines, holding requirements, payment in stock and outside purchases.
- Include a clawback policy (which may need to be revised as rules are finalized implementing the Dodd Frank Act).

Compensation committees today need to conduct more rigorous analyses and testing to ensure total compensation programs are effectively meeting objectives and complying with today's requirements and best practices. Some examples of good analyses include:

- Compensation history and tally sheet of executives' total compensation.
- Pro forma illustration of the range of potential total compensation resulting from a variety of performance results.
- Realizable pay analysis (total compensation likely to be paid based on performance).
- Updates on progress toward annual and long-term performance goals.
- CEO and executive performance and pay relative to peer group.
- Current stock ownership and progress toward ownership guidelines.
- Value of retention tools (e.g. stock awards, Supplemental Executive Retirement Plans).
- Annual review of compensation risk assessment.
- The ratio of CEO pay to median employee pay (this is required by the Dodd-Frank Act with an estimated implementation in the year 2015).

All of these analyses can provide helpful perspective for committees when designing programs and making pay decisions.

Communication and Disclosure

Communication with shareholders and regulators is more critical than ever, as both groups are seeking to determine if compensation programs align with their expectations. Best practices include the following:

- Enhance your compensation disclosure and analysis on your proxy statement with an executive summary to tell your story and communicate to shareholders the objectives of your pay program and the resulting pay-performance relationship.
- Understand the influence and perspectives of shareholder advisory groups (e.g. ISS, Glass Lewis) but don't try to emulate them. Their policies evolve and their analysis is a one-size-fits-all approach.
- Provide clear documentation of your incentive plans and be prepared for the formal documentation that will result as required by Section 956 of the Dodd Frank Act.
- Engage in ongoing communication with shareholders; not just during annual say-on-pay voting.

These checklists provide a starting point for assessing the effectiveness of governance practices and could help a compensation committee review their own practices and see what they would like to change.

Tags: Compensation Committee, Governance Structures, Communication

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