# Executive Summary

## Report of the NACD Blue Ribbon Commission on the Compensation Committee


NACD

**Acknowledgments**

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# Executive Summary

In 1993, the National Association of Corporate Directors (NACD) issued its first Blue Ribbon Commission report, choosing the topic of executive compensation and emphasizing "pay for performance," a term that would become a key goal for today's compensation committees. A decade later, NACD formed a new commission on executive compensation and the role of the compensation committee. At that time, executive compensation packages were receiving extensive political and media attention, and trust in boards of directors, executives, and even the free-enterprise system was low. Compensation plans were overly complex and often difficult for the average reader to comprehend. To help compensation committees shore up public confidence in capitalism, NACD recommended five principles: independence, fairness, linkage to performance, long-term value for shareholders, and transparency.

Dramatic changes have occurred since the 2003 report was released. As a result of the 2010 passage of the Dodd–Frank Wall Street Reform and Consumer Protection Act (hereafter referred to as Dodd–Frank) and additional rules related to compensation disclosure, there is now an even sharper focus on the work of the compensation committee. Some of these changes have been positive: public company compensation committees today are composed entirely of independent directors who are working with a higher degree of accountability than ever before. And although received with mixed reactions, say on pay has led to stronger links between pay and performance and has even improved board-shareholder engagement.

Yet despite this progress, many issues remain the same. Executive compensation is subject to harsher criticism and more stringent regulation—often focused on the absolute level of total CEO pay, which continues to grow in a booming stock market. Transparency and simplicity in compensation-plan design has remained elusive (for supporting evidence, read the often lengthy compensation analysis and discussion [CD&A] section of any proxy statement). While say on pay has brought about the aforementioned benefits, the desire to gain shareholder (and proxy advisory firm) approval of pay plans may encourage some boards to adopt plans that value short-term gains over long-term value creation.

The compensation committee has transitioned to a position of significance. Of the many responsibilities shouldered by boards, executive compensation may well be the most important and the most challenging. Through pay, boards can attract and reward the talent needed to lead the company into the future. Compensation plans communicate not only what goals the company wants to achieve but also how it wishes to accomplish them.

With several major regulations mandated by the Dodd–Frank Act yet to be finalized—including those related to disclosures of pay for performance and pay ratios, and policies regarding clawbacks and hedging—uncertainty looms. The scrutiny and expectations of compensation committees is not expected to decrease in the near future. There will be continued emphasis on the work of the committee, including linking pay to performance, selecting appropriate performance metrics, communicating pay philosophy and plans, and the composition of the committee itself. In the future, the caliber and composition of the compensation committee will be critically important, as these are essential aspects of committee effectiveness.

### About the Report

The core concepts identified by the 2003 commission still hold true. Using the 2003 guidance as a starting point, this report expands the scope of the discussion by drawing on the experience of the Blue Ribbon Commission members; research from NACD and Pearl Meyer & Partners; as well as the thoughtful work and writings of others in the business, executive compensation, and governance arenas. In the report, we explore how compensation committees can fulfill their evolving responsibilities in an environment of greater transparency and greater complexity. Topics addressed include

- how expectations of the compensation committee have changed following the Dodd–Frank Act;
- compensation committee composition—caliber, necessary skill sets, and succession planning;
- key considerations for setting executive compensation; and
- effective communications—both internal and external—regarding executive compensation.

Practical guidance throughout the report includes the following tools:

- an annotated glossary of compensation terms,
- format considerations for the compensation discussion and analysis (CD&A),
- an updated list of compensation committee composition and function requirements from Sidley Austin LLP, and
- sample compensation committee charters.

The report also contains 10 specific recommendations for the compensation committee, which are included in this executive summary.

# Recommendations for the Compensation Committee

1. **The compensation committee should broaden its scope beyond CEO succession to include oversight of talent development at multiple levels of the organization, especially the leadership pipeline.** Having the right leadership in place beyond the CEO to drive strategy, manage risk, and create long-term value is essential. At the most fundamental level, every director should understand the talent and skills necessary to execute the company's strategy, and the talent development plan required to meet those needs. The compensation committee should ensure that pay plans incorporate incentives, financial or otherwise, that are designed to drive performance and reward executives for promoting the development of talent internally.

2. **Compensation committee composition should represent a range of diverse perspectives and skill sets, as well as evidence of diligence, expertise, courage, and communication skills.** Beyond independence and diversity of experience, compensation committee members should possess several core skills to ensure that executives are compensated fairly and thoughtfully. In the face of scrutiny, committee members should have the conviction to make compensation decisions that match their own independent assessment.

3. **Consider a retainer for the compensation committee chair that is in line with that of the audit committee chair. Increased workload is no longer limited just to the audit committee.** Compensation committees generally spend more time on committee matters, meet more frequently, and need a deeper technical knowledge than was required in the past. Boards should therefore review the pay of all committees to ensure that pay for compensation committee members is commensurate with the scope of their responsibilities and resulting time commitments.

4. **Executive compensation plans should balance long-term incentives with short-term operational goals, clearly reflecting and supporting the company's strategic plan.** Compensation plan design should be conducted in conjunction with strategic planning. Compensation packages communicate to employees where the company wants to go—and how it wants to get there.

5. **Peer group and market data should be used as a "reasonability test" for executive pay plan design; it should not drive decisions.** Compensation committees should use external benchmarks to inform, but not to drive, their decision-making process. The true drivers of an effective compensation plan (including peer group selection) should be the unique strategic drivers of the company.

6. **The compensation committee should be able to exercise discretion in evaluating and rewarding performance, as long as it clearly discloses its rationale.** No single formula can adequately take into account the wide variety of factors that might affect performance, including industry or external events. As a matter of fairness, boards should regularly consider whether circumstances call for the use of either positive or negative discretion, always clearly disclosing rationale if employed.

7. **Compensation committees have a responsibility to inform and educate the full board on an ongoing basis about the link between performance and pay outcomes.** It is critical that every director understand the compensation program's various elements and underlying philosophy, as well as possible payouts under varying circumstances. The compensation committee can hold education sessions, led by the chair, with the full board.

8. **The board should view the CD&A as the company's primary vehicle for communicating compensation matters to shareholders.** The introduction of say on pay has resulted in the CD&A becoming the primary communication vehicle between the board and investors. A well-crafted CD&A that clearly describes how the board has linked compensation to strategic goals and performance metrics can help investors to evaluate—and appreciate—the board's intentions and to assess whether pay results ultimately fulfill them.

9. **Disclosures should clearly explain (in "plain English" and with key metrics defined) how compensation decisions are tied to performance.** The technical nature of pay plans and the growing number of required disclosures following Dodd–Frank has resulted in CD&As that are exceedingly lengthy and often written in jargon or legal language. All disclosures related to compensation plans should clearly explain how decisions are tied to corporate performance in language that is comprehensible to all—not just to those on the compensation committee.

10. **The compensation committee chair should be prepared and "presentation ready" for shareholder communications.** Increasingly, investors are asking to speak with compensation committee chairs on executive pay issues. The compensation committee chair should work closely with the designated executives to develop the firm's messages, including how the organization's compensation philosophy is linked to strategy and, most important, how the pay program supports long-term value for shareholders.

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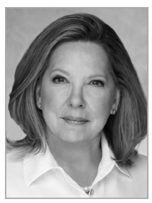

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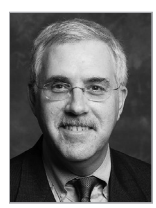

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