Compensation Committee

Fear of the Unknown

Mitigating comp-related risks takes deliberate action.

By Theo Sharp

As with many aspects of board service, the biggest personal and financial risks facing compensation committees are often the unknowns: embarrassing revelations that blindside directors and undermine shareholder confidence. Mitigating those risks calls for processes to recognize, track, and ultimately minimize uncertainty, while preparing for the range of possible outcomes. Compensation committees can start by addressing the following fundamental questions.

1. Is there a director-driven process for making decisions?

Comp committees must be able to demonstrate that decisions are made in a deliberate and informed manner that helps ensure important considerations are not overlooked. Among those issues:

- Who controls the committee's agenda? Ideally, there is a healthy collaboration between management, which is most familiar with how plans are working, and the committee, which has ultimate responsibility for those programs. When management alone controls the agenda, the committee is likely to be more reactionary and defensive.
- Does the committee have all relevant information? Directors must take the lead in obtaining all materials needed for decision-making.
- Do members thoroughly review supporting information in advance and make adequate time during meetings to discuss? When data and other supporting materials is given to members the day before or the day of meetings, too much time is spent explaining the materials, rather than discussing the issues involved.
- Are executive sessions regularly scheduled? Routine discussions in the absence of management best promote a candid airing of sensitive issues.

2. Do committee members understand how programs work?

Along with being familiar with the metrics and principles underlying executive compensation programs, committee members should be well grounded in critical nuances of plan design, such as the tax treatment of payouts or the extent to which differences in stock price affect the value of performance-based awards. Other issues to consider include:

- How is competitive data used? Expanded proxy disclosure makes it more likely that committees will have to defend the peer companies used to gauge pay.
- Exactly how much will it cost? The precise value of payouts for all possible performance scenarios must be known, in case the committee is later called upon to defend payouts.
- How will the plan be perceived? Even appropriate compensation programs can sound overly simplistic when reported in the media, so members must be more attentive than ever to how plans will come across in disclosures.
- How sensitive are payouts to stock price? A tally sheet or other up-front analysis is essential for modeling how variations in performance and stock price will impact pay levels.
- What will the company's total liability amount to if an executive is terminated, including the cost of any change-in-control gross-up?

3. Is there an easily accessible institutional memory?

Committee members need a means to readily revisit their thinking about issues, which is difficult if memories fade and supporting materials are hard to track down. Among the practices that promote continuity:

- Do meeting minutes fully describe what took place?
- Are minutes and backup information readily accessible? A central (ideally, online) repository should exist.
- Can absent members catch up? Absent members need ready access to the materials and discussion that took place so they can participate in decision-making.

Thoughtful and thorough processes alone will not immunize committees from risk or criticism. But influencing the agenda, ensuring members have a thorough understanding of programs, and institutionalizing their decision-making, can go a long way toward limiting their downside.

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