

Compensation

Pay Governance Guidelines for Compensation Committees to Consider

By Deborah DeHaas and Tara Tays

Balancing executive pay with executive performance is an emotionally charged issue often faced by compensation committees. The tension surrounding these decisions has intensified in the face of ongoing market volatility, new regulations, and rising shareholder activism. It's important that compensation committees focus on and, when needed, adapt to a core set of principles to guide compensation decisions.

The following guidelines can help to determine compensation committee priorities and what gaps need to be addressed.

1. Ensure the compensation program supports the business strategy. In the context of the entire competitive landscape, consider whether the compensation program is aligned with both the short- and long-term goals of the organization. To make that determination, committee members need relevant metrics from management, an understanding of how the metrics support business objectives, and how incentive goals align with earnings guidance and peer group performance. Directors should also consider whether the compensation structure reflects the talent, succession, and risk appetite goals that support the strategy.

2. Understand how shareholders perceive the compensation program. It's not only the decisions that compensation committees make that are important, but how those decisions are communicated to all interested parties, starting with shareholders. Boards should consider encouraging management to establish an active shareholder engagement program, particularly one focused on large and influential shareholders, with executive compensation as a key

agenda item. In addition, proxy statements should be viewed as communication tools. Compensation committees can lead the charge to make these statements more understandable by encouraging management to use charts, tables, and clear language to convey compensation structures.

3. Understand the views of proxy advisory firms. Many shareholders rely on the views of proxy advisory firms when judging an organization's compensation program. Therefore, it's vital for the compensation committee to consider how their decisions are viewed by proxy advisors. Among the issues worth understanding is how proxy advisory firms set proxy voting guidelines and other policies. It can be especially valuable to understand how proxy advisors weigh compensation programs and how they determine their judgments, both in favor of and against decisions of the organization.

4. Determine the potential impact of regulatory requirements. Four separate Securities and Exchange Commission (SEC) rulemakings required by Dodd-Frank—covering clawback policies as well as disclosures on pay ratios, pay for performance, and hedging—have either been approved or proposed. It's not too soon for compensation committees to engage management to determine their potential impacts. Complying with the new rules will require compensation committees to focus on disclosure practices, including how disclosures are communicated and the internal and external implications of the disclosures.

5. Consider a CEO pay ratio strategy. The SEC's CEO pay ratio rule will provide employees with visibility into median pay at

their organizations for the first time, as well as the ratio between the median paid worker and the CEO. Compensation committees should ask management how it intends to comply with the new rule, how the results could be perceived within the organization and among shareholders, and how the company will respond to potential criticism. Employee morale is a significant risk with such disclosures. Therefore, compensation committees should consider helping to lead management in planning the strategy around this sensitive topic.

Depending on the industry, some of these principles may take precedence over others. At their core, each provides a framework for compensation committees to help address today's challenges while helping prepare them for future governance issues.



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