

AGENDA

Opinion: New Director Group Takes Charge of Exec Comp Debate

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Deeply concerned about the current state of executive compensation, more than 100 independent directors have been meeting in small groups to address the problem. These meetings have given rise to a fledgling effort known as the **Independent Directors' Executive Compensation Project (IDEC)**.

Some of those involved in the project held a meeting recently where they reached consensus that there's a dire need for a set of principles to guide boards. They agreed that it's imperative for corporate boards to voluntarily embrace and abide by a set of principles that would serve as a lodestone of responsibility for setting executive compensation.

The need for principles-based compensation is painfully apparent. Repeated instances of high pay without performance have been eroding the faith of shareholders and engendering a call for public action. Adding insult to injury, Americans who have been hurt by the global economic crisis have ended up seeing their tax dollars spent on bailing out some of the same companies they hold responsible. Legislators, regulators and shareholder groups are lining up to propose a variety of rules intended to limit perceived and real excesses.

The idea behind IDEC is to help boards increase accountability to restore the faith of the investing public and preclude emerging government intervention.

At last week's meeting, there was agreement that:

- Independent directors should take a leadership role to do something about compensation problems.
- An ongoing effort should be undertaken to continuously define, research, develop and communicate principles and best practices.
- Those principles and best practices should stem primarily from a series of meetings of independent directors.

Thus far, four key principles have emerged:

- **Accountability.** Boards must account for their pay-setting decisions.
- **Alignment.** Executive compensation should be precisely aligned with performance.
- **Fairness.** The amounts paid to a given executive should be fair to the individual and, above all, to shareholders.

- Transparency. Boards should make decisions on pay in an open manner and make the bases for these decisions accessible.

In addition, IDEC is considering including the principle of objectivity and that of optimization — the effective use of incentives to motivate innovation that results in creating wealth for shareholders.

The independent directors have expressed interest in fostering a voluntary peer-led process that would establish and expand these principles and encourage boards to incorporate them into their practices and proxy statements.

Something akin to this has been accomplished in Germany, where the corporate governance community took a direct approach. The German Corporate Governance Code, adopted in June 2006, has three levels of guidelines: requirements that must be followed; recommendations that “shall” be followed; and suggestions that “should” be followed. Companies that adopt the code agree to disclose the reasons behind any failures to follow recommendations or suggestions. This initiative has been successful as it has resulted in considerable peer pressure among companies to adopt and abide by the code.

Directors who attended last week’s IDEC meeting agreed that this kind of positive peer pressure for compensation principles could take hold in the U.S. This would create positive public compensation scenarios to replace the succession of negative ones that we’ve seen in recent months. This way, instead of fearing public reprisals for irresponsible compensation practices, more boards would be taking credit for the fairness of their decisions.

The goal would be to create a contagion of better and better practices. Companies would voluntarily abide by the principles and other companies would follow suit, lest they be left out of the positive limelight and look bad by comparison. So, ultimately, positive compensation practices would edge out negative practices. And, as extensive research shows, effective compensation practices can translate into enhanced shareholder value as surely as negative practices can destroy it.

The widespread adoption of key compensation principles would be an important step toward restoring public faith, thus keeping regulators out of boardrooms.

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Editor's note: The above column is a follow-up to an opinion piece from April by the same authors in which they explored the possibility of an executive compensation standards board.

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