

Serving on — and chairing — the compensation committee



Governance Insights Center | May 2023

Taking a closer look at the workings of the compensation committee can shine a light on areas that are working well — and those that need improvement.

Serving on a board's compensation committee is a challenging job. CEO pay makes for splashy headlines. Executive pay plans are complicated and seem to be getting more so every year. By breaking down committee service, we help directors get to the root of the job — balancing risk and reward.

Introduction

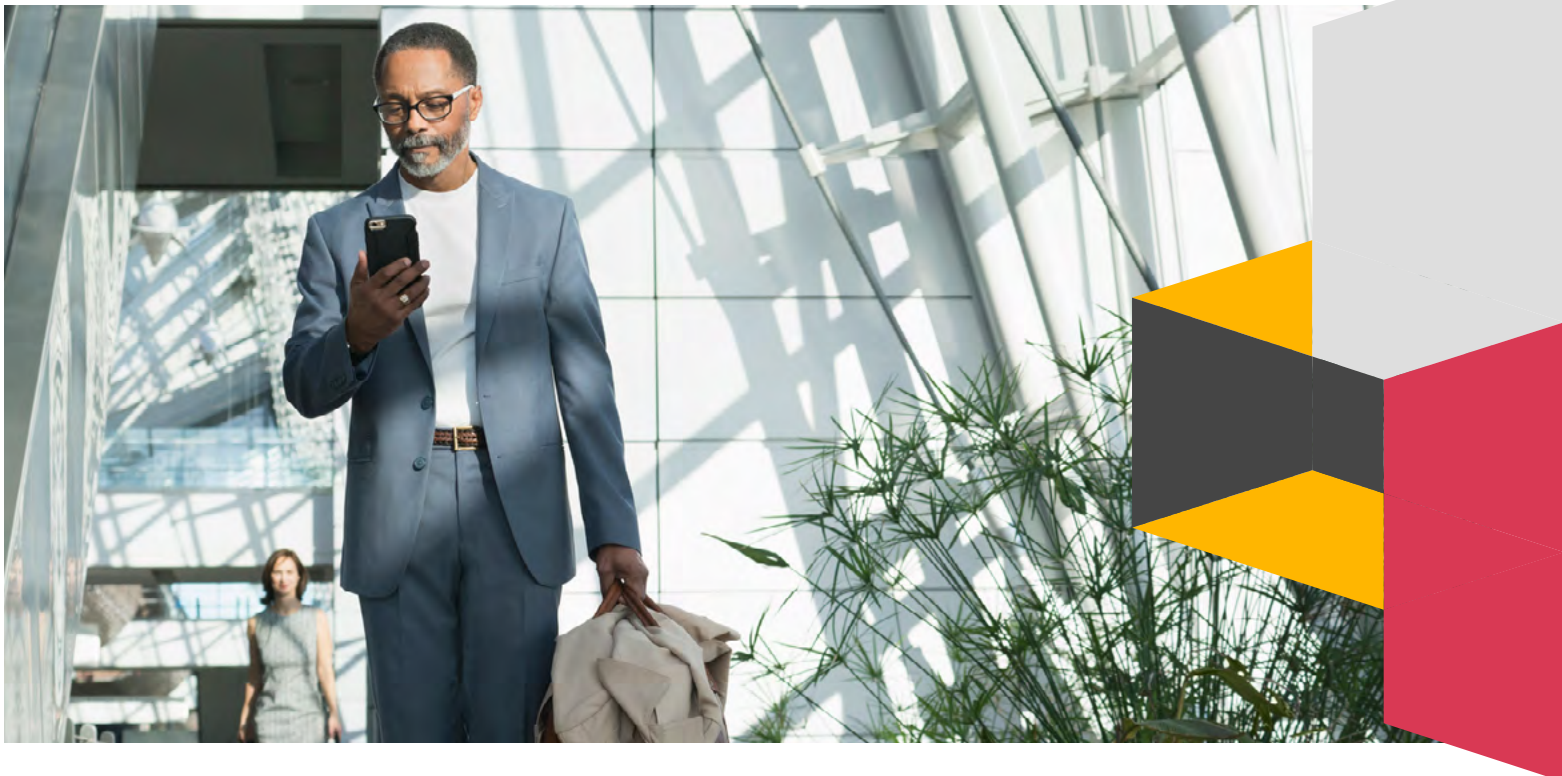
The work of a compensation committee is much more than just deciding how much money executives make. Many investors see pay decisions as a reflection of the company's strategy. They know it can have an impact on the company's culture. And they use it as a window into the board's oversight role.

How can compensation committees support long-term shareholder value? By reviewing the internal workings of the committee, and examining the committee members, the meeting agendas, materials and how the meetings are run. And, just as importantly, by looking at how the committee interacts with others. This includes interactions with compensation consultants, the full board, other committees and shareholders — as well as with management.

Directors think the negative media attention on executive compensation is unfair, but agree that executives are overpaid



Q: To what extent do you agree with the following regarding executive pay in the US? Indicates percentage answering very much or somewhat.
Base: 805-806
Source: PwC, 2021 Annual Corporate Directors Survey, October 2021.



Compensation committee composition

Who sits on the committee?

On average, S&P 500 compensation committees have four members.¹ But unlike on audit committees, where at least some members must have specific areas of expertise, neither Congress nor the listing agencies have dictated what type of background compensation committee members need to have. Instead, the rules focus on independence. This comes from the view that, for a director responsible for setting management's pay, the most important thing is not being overly influenced by management.

Without specific skill requirements, boards have more flexibility in selecting committee members. But they also have less guidance to look to. What kind of expertise does a compensation committee really need?

Executive compensation programs today are complex. They often include different types of short- and long-term incentive plans. They may pay out in various mixes of cash and equity with accompanying tax, accounting and disclosure issues. They could be tied to many different goals with different time horizons. Each of these decisions impacts the incentive structure, which ultimately ties to company culture and strategy. Given the complexity, and the impact on the company as a whole, it can be helpful to have someone with experience in human resources or total rewards on the committee.

Much of the work of a compensation committee relates to aligning executive rewards with business outcomes. Committee members with strong people skills may be better suited to thinking through how compensation plans can motivate the right behavior and avoid incentivizing the wrong behavior, which can have a negative effect on the corporate culture. The committee needs to understand how people are motivated and how compensation fits into the picture.

Financial expertise also comes in handy. A large part of the job of the compensation committee is setting the right goals for incentive plans. What metrics will accurately measure performance in ways the company most values? Committee members need to understand the nuances of the different measures. And they need to be able to distinguish between goals that focus on short-term performance versus those that promote long-term growth and aim for an appropriate balance of the two.

Helpful skills and experience on a compensation committee include:

- Risk management expertise
- Human resources/total rewards expertise
- Talent management experience
- Executive experience
- Legal expertise
- Financial expertise

¹ BoardEx as of November 2022.

Who chairs the committee?

The chair of the committee is responsible for keeping meetings on track and making sure the committee fulfills its duties. He or she is the main liaison with management and with the full board. And the chair has to walk the potentially fine line between having too close of a relationship with management — and having one that is too adversarial. So like any other chair, strong leadership skills are important.

But the compensation committee chair is also one of the directors commonly called upon to engage directly with shareholders. (See “Reaching out to shareholders” on page 16). When a shareholder has questions about the company’s pay programs — which they often do — they usually don’t want to talk to the CEO. They want to talk to the chair of the committee that makes many of those decisions.

And they need to be ready to answer questions about why those decisions are right for the company. So the chair needs to be “camera ready” and comfortable speaking with shareholders about the company’s compensation plans, philosophy and strategy.

Refreshing the committee

Boards and committees alike sometimes struggle with director refreshment. Longer-tenured directors can bring deep experience and knowledge of how things work at the company. As compensation programs evolve, they hold the institutional knowledge of how different metrics impact incentives. But newer directors may have different ideas, and they may ask probing questions or bring up topics that help everyone in the room to see things in a new way.

One way to promote refreshment on the compensation committee is to rotate membership. Some boards have standard periods for committee service, such as five to seven years — with flexibility for special circumstances. More often, boards put in place a process to regularly review committee assignments. They examine committee needs and the expertise and availability of their directors to ensure that committee assignments continue to make sense. This may be effective for some boards, but others find that a formal policy on rotation gives the board a much better opportunity to encourage the refreshment they need.



Planning the meeting calendar and the agenda

A compensation committee's essential functions include:

- Determining and periodically approving the company's compensation philosophy
- Approving the CEO's pay package
- Consulting with the CEO on compensation packages for other executives
- Recommending the adoption of new incentive plans
- Setting/approving annual and long-term incentive plan goals and grant levels
- Determining whether and to what extent plan goals have been met after the performance period
- Overseeing compliance with disclosure requirements (e.g., CD&A disclosure, relevant 8-K filings)
- Overseeing talent management
- Approving the composition of the peer group to be used for benchmarking purposes
- Monitoring shareholder views of executive compensation, and discussing any concerns
- Engaging and monitoring independent compensation advisors, as appropriate, to study and make recommendations regarding director or executive compensation matters

Compensation committee ESG responsibilities

Increasingly, the compensation committee is being called on to take responsibility for ESG issues that align with core competencies of the committee, such as diversity, equity and inclusion (DEI) and human capital more broadly. Shareholders, and other stakeholders, are looking for deeper data and information on how the company is integrating these issues into strategy and how the board is overseeing that effort. As such, the committee should consider including the issues that are most important to the company as standing issues on the meeting calendar.



On average, S&P 500 compensation committees meet six times per year.

Much of the committee's timeline follows the company's fiscal year. Results from just-closed fiscal years are needed to determine bonus amounts and incentive plan payouts. And projected compensation numbers are required for the internal budget-setting process.

As for what topics are on the agenda — that list seems to grow every year. Setting plan goals and targets, approving any salary increases and approving disclosures continue to be key items. But compensation committees are also tackling many more issues — particularly on talent management.

Agenda planning: tips for the chair

Balancing all of the tasks on a compensation committee's agenda each year requires careful agenda planning. Some best practices include:



Designate a management liaison. The compensation committee chair may need help managing the agenda, especially when changes and last-minute issues arise. Designate a specific person (e.g., corporate secretary, chief human resources officer) to liaise with other members of management and coordinate changes to the agenda.



Comply with the charter. The compensation committee charter should be the starting point for planning the year's agenda. The charter reflects the committee's commitment to take required actions. Agenda planning should confirm each item included in the charter is addressed.



Plan the topics annually. Map out the agenda topics and time allotments — by meeting, for all scheduled meetings — at the start of each year. Most topics are recurring, although unexpected items will likely come up throughout the year. You may also want to leave time for “deep dives” on selected hot topics.



Confirm agenda topics before each meeting. Touch base with other committee members and management before the agenda is distributed. That gives the chair the opportunity to adjust the timing or topics, if needed.



Changing committee names reflect shifting roles

Approximately two-thirds of public companies have either changed their charters or renamed their compensation committees to reflect the expanding scope of their duties. Some examples of new names include: “Compensation and Leadership Resources Committee” and “Compensation and Talent Management Committee.”

A sample compensation committee annual calendar

Agenda item	February	April	May	July	October	Ongoing/ as needed
I. Chief executive officer compensation						
Establish goals and objectives for CEO compensation	✓					
Complete CEO performance review					✓	
Determine and approve CEO compensation award					✓	
II. Executive officer/management compensation						
Verify company performance metrics and the figures from management supporting performance levels	✓					
Approve incentive-based compensation awards and equity grants for management under implemented plans	✓					
Set bonus targets for the upcoming fiscal year	✓					
Recommend to board incentive-based compensation and equity-based plans for all executive officers						✓
Evaluate post-service arrangements of CEO and senior management				✓		
Review contracts for executive officers				✓		
Review results of say-on-pay vote				✓		
III. Review of compensation disclosure						
Review CD&A and related disclosure and discuss with management	✓					
Recommend to board inclusion of CD&A and related disclosure in proxy	✓					
Prepare committee report to be included in proxy	✓					

Agenda item	February	April	May	July	October	Ongoing/ as needed
IV. Employee compensation and arrangements/other						
Assess the company's diversity and inclusion and fair pay strategies		✓				
Identify policies to promote a pay-for-performance culture			✓			
Gauge the effectiveness of executive talent management and review the performance, potential, development and retention of current and future leadership			✓			
Review/recommend to board any changes to compensation policies and practices for all employees				✓		
Discuss executive succession planning						✓
Review trends in shareholder views on executive compensation		✓				
Discuss shareholder concerns on executive compensation issues, and participate in shareholder engagement if requested				✓	✓	
V. Director compensation						
Recommend to board any changes to board or committee compensation or perquisites	✓		✓			



Building on the basics

Proper procedures and documentation

Having the right processes in place for compensation committee functions is crucial. Proper documentation preserves a written record for each significant judgment. That record should reflect the reasons why the committee acted, and on whose advice. Without a complete record, the committee may open itself up to challenges of its decisions. This could involve the time and expense of a lengthy trial, and could open the door to the possibility of a finding that the business judgment rule has not been satisfied.

Examples of best practices include:

- Providing committee members with all of the relevant documents before a meeting in which binding decisions are being made. Documents should include all material terms, with key issues highlighted. Committee members should be given ample time to review the documents in advance of the meeting.
- When possible, making major decisions over the course of two meetings (for example, preparing competitive analysis of CEO pay levels at one meeting, followed by recommending CEO pay actions at a second meeting).
- Consulting outside advisors. Advisors (including consultants and counsel) with the requisite expertise and experience can advise on major executive compensation decisions (including termination decisions). And they can advise committee members on fulfilling their fiduciary obligations to the company.
- Providing training to new compensation committee members on best practices and processes for executive compensation decision making.



Tying compensation to strategy

Compensation is deeply connected to the company's strategy, and it's largely up to the compensation committee (together with management) to make sure the two are aligned.

The committee may set a variety of goals using different metrics, or the plans may be based on just a few performance measures. Either way, the compensation committee needs to have a clear sense of why the goals are the right ones, and how they connect to the company's strategy.

The new pay versus performance (PVP) disclosure rules require companies to disclose the link between pay and net income as well as a company-selected financial metric. It also requires listing out the metrics that are most important to compensation decisions (see the regulatory update on page 18), which should be consistent with strategy.

Talent management

Talent management and succession planning are important jobs for compensation committees. The employees, from the executives to the workers on the factory floor, can be a tremendous asset for companies. The nature of the workforce is shifting today, with advances in technology and automation. The board needs to be informed about how executives are managing their talent assets and adjusting to these changes.

The compensation committee is also involved in managing the company's top talent — the C-suite. Filling the role of the CEO, and preparing for CEO succession, are issues that are so integral to the company that responsibility resides with the entire board. But many boards ask either their nominating and governance committees, or their compensation committees, to spearhead the efforts.

Succession planning is not limited to the CEO role. Many compensation committees do a deep dive at regular intervals into the entire executive group, and even one or two levels below that. They want to be familiar with the human capital the company is developing and be able to spot and cultivate promising talent.

Compensation committee's role in CEO succession

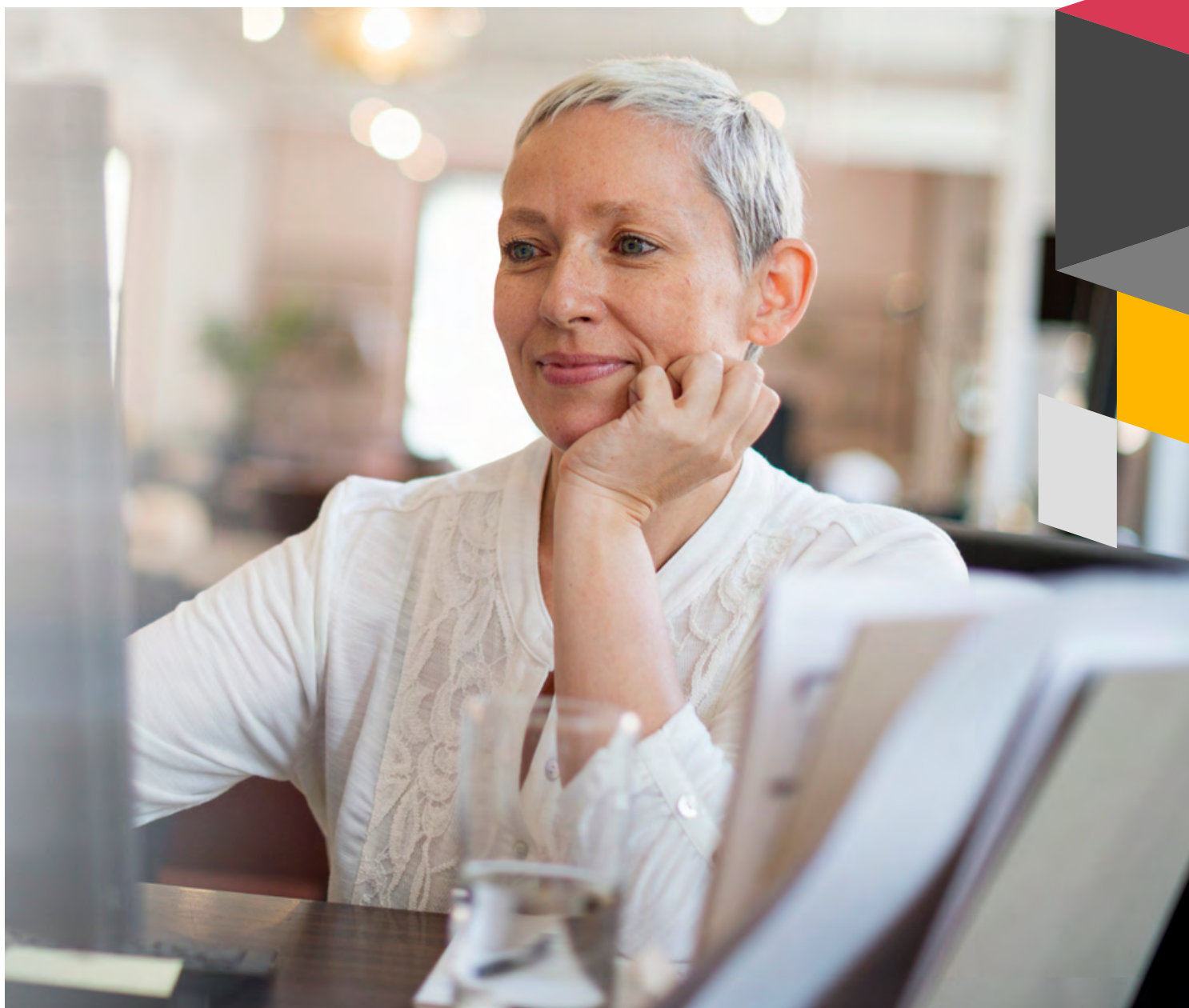
Ultimately, decisions about CEO succession lie with the full board. But many boards task their compensation committee with some of the advance work. The committee might create an initial draft of a formal succession plan — including how successors are chosen and how the process is run. The committee can outline some of the key capabilities and experience it is looking for in a candidate — an outline that may change as the company's strategic direction shifts. The committee can work with management to identify potential internal candidates and provide the candidates exposure to the full board. And they can maintain a list of possible external candidates as well.

Director compensation

Often, the board as a whole will approve director compensation programs. But the compensation committee may make recommendations to the board.

Director compensation has been a target for shareholder litigation in the last several years, with some shareholders arguing that directors are “self-dealing” in setting their own pay. To try to avoid these suits, some companies are adding “meaningful limits” to their director equity plans, which are approved by shareholders.

Reflecting the growing spotlight on non-employee director pay, proxy advisory firm Institutional Shareholder Services (ISS) [recommends votes against compensation committee members](#) if it sees a pattern of excessive non-employee director pay without a compelling rationale or mitigating factors.



Tackling the intangibles — culture, fairness and promoting excellence

Some of the biggest challenges for compensation committees are also the hardest to evaluate. Confronting how compensation contributes to the culture and tone at the company — and how it helps or exacerbates issues of pay fairness — are not simple tasks.

Most companies and boards struggle to define and evaluate the tone and culture of a company. Although compensation programs don't define these elements, they do contribute to them. And when incentive plans drive the wrong behavior, the company can suffer.

Goal setting communicates how the company views success and failure. Goals consistently set at unreasonable targets might motivate some to take unreasonable steps to hit them. Goals too focused on a certain metric might drive one element of performance at the expense of a stronger and more resilient culture.

Spotting red flags in company culture

Red flags may include:

- Overly-scripted board presentations
- Lack of transparency about a company's compensation program
- Hitting maximum targets more than three times in a 10-year period
- Internal pay disparity (e.g., an excessive differential between the CEO's total pay package and those of other senior executives)
- Excessive perquisites for former and/or retired executives, such as lifetime benefits, car allowances or personal use of corporate aircraft

A focus on pay fairness

As part of the talent review process, many compensation committees are also doing work on human capital issues like diversity and inclusion and pay fairness (including pay equity), which are top of mind for many investors. By examining larger employee populations and the leadership pipeline, they have a better view as to whether and how efforts at diversity are succeeding or failing. Pay equity issues may also come into focus.

Being out of step on diversity and inclusion and pay fairness issues may be seen as a red flag; investors may assume that the board's leadership and oversight may be lacking in other ways as well. By proactively confronting these matters, boards can get a handle on issues before they become bigger problems.

Working with others — board committees and consultants

How the compensation committee runs itself is important, but the committee also interacts with a number of other committees, compensation consultants and — more and more — with shareholders.

Interacting with other board committees

A number of duties that are primarily the responsibility of the compensation committee are also closely tied to the whole board and to other board committees.

Working with the nominating and governance committee. While the whole board has the ultimate responsibility for CEO succession decisions, much of that work and preparation is done in committee. It's often done in the compensation committee, but occasionally sits with the nominating and governance committee. Even when the nominating and governance committee deals with CEO succession, the compensation committee usually handles other succession decisions in consultation with management. So close coordination between the two committees can be key.

The duties of the compensation committee also tend to overlap with the nominating and governance committee when it comes to board composition. The nominating and governance committee is often responsible for recruiting new directors and shepherding candidates through the evaluation process. These tasks can go hand in hand with director pay issues handled by the compensation committee.

Overlapping committee membership

Given the level of financial detail overseen by the compensation committee, having a committee member who also serves on the audit committee may be helpful. And since many of the talent recruitment and management issues overlap with the job of the nominating and governance committee, overlapping committee membership can also be helpful there. If that's not possible, members from those committees can sit in on compensation committee meetings when they are available.



Working with the audit committee. There is a great deal of synergy between the work of the compensation committee and the audit committee. The compensation committee is responsible for determining and certifying performance evaluations for incentive compensation awards. But these goals often relate to financial performance. They almost always require calculations that are different from what is in the audited financial statements of the company — including adjustments for certain items, and determining which items are eligible for adjustment and which are not. Oftentimes, these are judgment calls that can be difficult to make.

How can the compensation committee get comfortable that the performance numbers they are using can be relied upon? The compensation committee chair needs to work with the chair of the audit committee. Together, they can determine how the compensation plan results will be supported. Sometimes, they might be tied closely enough to the financial statements to make the chairs comfortable. In other cases, they may possibly engage an audit firm to conduct an Agreed-Upon Procedures engagement in which the auditors tie the numbers to the financial records. Or the compensation committee might ask internal audit to take a look at the calculations. Regardless of the procedures, it's crucial to have a method in place — and for all members of the compensation committee to know how the figures are being supported internally — so they can be sure that the numbers are correct.

The SEC has also proposed new clawback rules (see the regulatory update on page 18). As the rules are codified by the listing exchanges, it is likely that the compensation committee and audit committee will need to work together closely on (1) designing and implementing a compensation program that can comply with the rule and (2) acting if a restatement is necessary.



Working with independent advisors

Independent advisors (consultants and counsel) can be a great resource for compensation committees. They can provide benchmarking data and keep the committee informed about pay trends. They know what plan design elements might send up red flags for the proxy advisors, and they can provide advice about new ways to structure packages to achieve the committee's goals.

But many directors feel that compensation consultants have too much power. When we asked directors about their views in our *2021 Annual Corporate Directors Survey*, 71% agreed that compensation consultants have too much influence on executive compensation. We often hear complaints that the benchmarking process simply drives pay up. Presented with the data, committees feel pressure to offer compensation in line with, or just above, their peers.

Some observers target cozy ties between management and the independent advisors as another force driving executive pay up. Listing agency rules require compensation committees to have the right to engage their own advisors, separate from any retained by management. These committees are also required to evaluate whether the advisors they hire are independent. Though there is no prohibition against non-independent advisors, most committees prefer to work with advisors that meet their independence tests. They want to know that the advice given is not influenced by a desire to please management.

Compensation committees have no duty to rotate their compensation advisors. But it is worth at least re-evaluating those relationships every few years.

The right compensation advisor

- Should have technical expertise and access to relevant competitive data and practices
- Should display and encourage creative thinking and problem solving in the committee
- Should proactively keep the committee informed of emerging issues
- Should be comfortable pointing out potential drawbacks to decisions

Trust and transparency are key

Reaching out to shareholders

The idea of directors (other than the CEO) talking directly with shareholders is a fairly new one. Traditionally, “shareholder engagement” meant earnings calls and perhaps meeting with the investor relations team. But, more and more, directors are also involved in direct talks with institutional investors.

The shift coincided in large part with the advent of say-on-pay in 2010. Once shareholders were given the right to vote on a company’s executive compensation programs — and express their displeasure with some arrangements — the need to discuss executive compensation became clear. But investors did not feel empowered by bringing that topic up with the investor relations team or with the executives themselves. To meaningfully discuss executive compensation, they wanted to talk to the directors who approve the programs.

Director-shareholder engagement today covers a range of topics. But executive compensation remains close to the top of the list.

When shareholders want to talk about executive compensation, they usually want to meet with the chair of the compensation committee. Sometimes the shareholder wants to better understand how the company thinks about certain pay programs or metrics. Or they may want to voice their concerns. Often, both parties tell us that the meetings are more productive when the directors do more listening, and less talking.

Engagement disclosure. Some boards and compensation committee members do the hard work of shareholder outreach, but leave it at that. Others take it further by describing that work in their proxy.

Some companies disclose the number or proportion of shareholders they met with and whether directors were involved. They may list topics or items discussed. Some also describe changes the company is making (or planning to make) as a result of the discussions, or their reasons against making changes. By offering shareholders a view of the company’s engagement process and the outcome of those discussions, the work that goes into the meetings can have an impact beyond just that one investor.

When they meet with directors, investors want to talk about pay



Q: On which of the following topics did a member of your board (other than the CEO) engage in direct communications with shareholders? (Select all that apply.)

Base: 443

Source: PwC, 2021 Annual Corporate Directors Survey, October 2021.

For more on how to improve shareholder engagement, see our paper: **Director-shareholder engagement: getting it right**

Assessments of committee performance

For NYSE-listed companies, annual assessments of the board and its committees are required. For others, annual assessments are considered a good governance practice.

A compensation committee's charter should include annual performance self-evaluation. These assessments help the committee chair and members focus on whether they are fulfilling all of their legal and regulatory requirements and the other duties in their charter. They can reflect on whether meetings are as efficient as they could be. Do they encourage open communication? Do they allow for enough discussion time? And it also gives committee members a chance to reflect on the materials they are reviewing. Are they receiving enough information and is it in the right format?

For more on committee and board assessments, see our paper:
[Conducting effective board assessments](#)



Regulatory update

After years of stability in compensation disclosure, in 2022, the SEC released two rules that could have significant impacts on compensation practices.

Pay versus performance (PVP) rule

In an effort to improve transparency, the SEC finalized a rule in the fall of 2022 requiring disclosure of executive compensation paid compared to company financial performance, or pay versus performance (PVP). A rule on this topic was prescribed by the Dodd-Frank Act signed into law in 2010.

The new PVP disclosure is required in 2023 proxies of most public companies² and requires three main disclosure elements: (1) a pay versus performance table, (2) a narrative or graphical representation tying total shareholder return (TSR) and company financial metrics to executive pay and (3) a tabular list of the most important metrics used for determining executive pay.

The disclosure is not required to be included in the CD&A, which the compensation committee has an obligation to review. However, when reviewing the CD&A, it is also prudent to consider other elements of the proxy, including the new PVP disclosure, even if it is not embedded within the CD&A, for consistency.

For more information on the new rule, see our paper:
Pay versus performance disclosure and the board's role: what you need to know

² The PVP rules do not apply to emerging growth companies, registered investment companies or foreign private issuers. Smaller reporting companies have scaled back disclosures.



Listing Standards for Recovery of Erroneously Awarded Compensation (clawback) rule

The Dodd-Frank Act also required the SEC to adopt a rule related to clawing back executive compensation that was received erroneously, which they did in 2022. In addition to adopting the rule, the SEC also asked that the exchanges prohibit the listing of an issuer that does not develop and implement a clawback policy.

A compensation recovery analysis would be triggered in the event that an issuer is required to prepare an accounting restatement due to the issuer's material noncompliance with any financial reporting requirement under the securities laws. In the adopting release the SEC describes the restatements as both "Big R" restatements, correcting previous financial statements, and "little r" restatements, those that are not material to the past financial statement, but could be going forward.

The terms of the rule, such as what compensation is subject to clawback, the lookback period, which executives are covered and required disclosures may impact compensation committee decisions going forward. For instance, some companies may choose to structure their compensation programs in a way that will make it easier to act should it be determined that a clawback is necessary.

For more information on the new rule, see our paper: ***In depth: SEC adopts executive incentive compensation clawback rule***



Conclusion

With executive pay frequently in the media spotlight, serving on the board's compensation committee can be challenging — and chairing the committee is even tougher. It takes the right mix of people, effective leadership and efficient processes to do it well. With a well-functioning committee and the right chair at the helm, the compensation committee can help set the tone and the goals for the success of the entire company.



How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner or one of the PwC specialists below.

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