The Adaptive Borders of the Compensation Committee

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In earlier decades, the common understanding of the central role of the Compensation Committee was straightforward: «deliberation about and the determination of top management pay».[1] Over time a considerable widening of this understanding has taken place, creating new challenges for Compensation Committees across industries.

The expansion has been essentially around the «why», «who», and «what» of the Committee's responsibilities. This trend is escalating the Committee's workload and the kind of competencies its members require. Looking ahead, newer topics—such as the next phase of digitalization, ESG, and evolving societal attitudes toward work—will further stretch Compensation Committees, intensifying their need to focus on their own skillsets, performance, and succession planning.

1. The Why

The original raison d'être for a Compensation Committee was to bring objectivity to executive pay decisions.[2] This was meant to address the inherent conflict when executives determine, shape for approval, or otherwise unduly influence their own pay.[3]

In the course of the years other principles have come to be accepted as equally fundamental. This includes the notions of «pay transparency»[4] and, in some jurisdictions, shareholder «say-on-pay». Each of these has added significantly to the workload of the Compensation Committee.

For example, transparency means that the Compensation Committee must review and sign off on disclosures relating to the Committee's work, including the various pay figures it has approved.

1 M. J. Conyon and S.I. Peck «Board Control, Remuneration Committees, and Top Management Compensation», The Academy of Management Journal , Apr. 1998, Vol. 41, No. 2.
2 Typically, unless otherwise required by local regulations, the Compensation Committee is also tasked with the pay of Board members.
3 Even when the Board ultimately approves the CEO's pay, it can be problematic if the CEO, for example, takes the lead in shaping his / her pay package or the means for measuring the appropriateness of the proposed pay, or the selection of peers for comparison.
4 The reference here is to pay transparency on executive compensation, which has been the historical focus. For more general pay transparency developments, see footnote 24 and the article "Pay Transparency: Status Quo and Competitiveness in Switzerland" at page 38 of this booklet.

The volume of these disclosures can be significant, with compensation reports in some industries well exceeding 30 pages. Some jurisdictions may require or recommend further disclosures, such as the ratio of CEO pay to the median employee.[5]

Say-on-pay regimes, whether consultative or otherwise, are also resulting in increased labor for Compensation Committees and, like disclosures, leading to higher scrutiny of their work.[6] These regimes in effect add «stakeholder management» to the Compensation Committee's job description.[7]

2. The Who

There is no dispute that the Compensation Committee's mandate is to provide oversight of pay at the company. But whose pay? Where not specifically prescribed by regulation, market practice shows considerable variance.

In earlier decades it had been generally accepted that the key concern was the CEO's remuneration.[8] If the Compensation Committee dealt with the CEO's pay, it was thought, the CEO in turn would take care of the pay of his / her executive team members. After all, is not the CEO—as their direct manager—in the best position to know how much each should be paid?

Today, the clear view is that the Compensation Committee's realm goes beyond the CEO's pay. Some codes and regulations are specific as to which persons exactly, but others use less precise terms.

For example, they may say that the Committee approves the pay of the CEO and of «senior management» or «top management.[9] In practice, there is no consensus on whether the latter means only the Executive Committee, Executive Board, or similar, or whether it means one, two, or more managerial levels below.

In financial services additional demands are made on the Compensation Committee by those regulators who work with the concept of «key risk takers», «material risk takers», or similar. Under these notions, an institution is to apply a rigorous process to identify those employees—irrespective of title or hierarchy—who make important risk decisions or who otherwise have material impact on the company's risk profile. Once these employees are identified, the institution is to give them focused attention, including on how they are compensated. Thus, the Compensation Committee in such institutions typically also has to review the nature and level of remuneration for these employees, being particularly watchful for any incentives creating potential risks.

Even more far reaching is when the Compensation Committee takes the view that within its purview is also the company's overall approach to pay. Here the Committee's goal is not to set or supervise the pay of employees at all levels, but to be involved in formulating and approving the company's overall pay strategy, sometimes referred to as the pay philosophy.[10]

Since a company must choose how it will position itself in the market on remuneration the idea is that this too should benefit from the input and oversight of the Compensation Committee.[11]

5 For an example of data on CEO pay ratios in the U.S, see GECN firm Farient Pay Ratio Tracker https://farient.com/trackers/pay-ratio-tracker.

6 Some earlier commentators pointed to the paradoxes involved when shareholders or proxy advisors, having less information, nonetheless form a strong view on what the right pay should be, compared to the process that a well-working Compensation Committee typically goes through which takes into account «varying and often conflicting factors...and the company's overall risk profile.». J. Fisher, et. al. «Say-on-Pay: Less Maybe More» in New York Law Journal, 30.11.2009. Today Compensation Committees must simply accept these cross-pressures as part of the course.

7 In jurisdictions with some form of «say-on-pay», this means the Compensation Committee must also take a position on shareholder proposals relating to pay and deal with other shareholder and proxy advisor demands.

8 See, e.g., M. C. Jensen and K. J. Murphy, «CEO Incentives—It's Not How Much You Pay, But How» in Harvard Business Review May-June 1990.

9 See, e.g., the 2002 edition of Swiss Code of Best Practice for Corporate Governance that specified that Compensation Committee «should draw up the principles for remuneration of members of the Board of Directors and the Executive Management». The 2021 Malaysian Code on Corporate Governance refers to the «remuneration of the board and senior management». For a general discussion on the work of the Compensation Committee, see e.g., «Role of the Compensation Committee», in Society for Human Resource Management, Oct. 2022.

10 In effect, the pay philosophy is a logical starting point of the Committee's responsibilities. The work includes coming to a shared view with management on whether and how the company will use incentives to help steer the organization and motivate and reward talent. Pay philosophies should be reviewed periodically.

11 The Compensation Committee's involvement in developing the company's pay philosophy also sends an important cultural signal. It communicates that the Committee is not just interested in the «critical few» but in the «critical many» at the company, acknowledging the importance of each employee, not just those occupying the top of the hierarchy.

While desirable, the above results in more time demands on the Committee. Getting the pay philosophy right and keeping it right is a complex and continuous task. It requires reflection on how to translate it into the right pay architecture and how to connect it to topics such as company purpose, company culture, employee engagement, desired performance ambitions (like innovativeness), risk appetite, and competitive landscape. The pay philosophy may also require calibrations or exceptions as market circumstances change, calling in certain cases for Compensation Committee approval. For example, given the high demand for cyber risk specialists in recent years, some companies have had to depart from normal pay scales to attract or retain high performing talent in this area.

3. The What

«Compensation» or «Remuneration» Committees can evoke by their very name the impression that pay is their primary concern, while those who receive the pay are only of secondary concern.

In the market various efforts can be observed aiming to counter this impression. This includes re-branding efforts from «Compensation Committee» to names such as the «Personnel Committee», the «Compensation and Human Capital Committee», and «the Compensation and HR Committee».[12] Each of these names broadens the perspective and conveys more recognition of the human factor underneath salaries and bonus figures.

But this type of appellation has other implications. It amounts to an amplification of the Compensation Committee's responsibilities to include talent and related matters. In fact, some committees have explicitly incorporated this in their name as in the example of the «the Compensation and Talent Management Committee» of an industrial technologies player and «the Compensation and Leadership Development Committee» of a major consumer products multinational.[13] New names such as these of course translate into an expectation that the Compensation Committee will provide sustained oversight of the company's talent strategy and the means for attracting, developing, and retaining talent.[14]

12 The examples are from Allianz, Bank of America, and United Health Group.
13 The examples are from Wabtec Corporation and Procter & Gamble.
14 A recent U.S. study suggests that the following percentage of Boards provide some oversight of talent management at the company below the C-Suite level: senior managers (78%), mid-level managers (66%), other employees (58%). M. Nolen, "Turnover at the Top" (CBM Research), Corporate Board Member, Fourth Quarter 2023.

Another significant development, particularly over the last decade, is also contributing to the growth of the Compensation Committee's agenda: higher market interest in how the company assesses the performance of executives, not just in how it pays them.[15] This intensifies the imperative for the Compensation Committee, before approving remuneration, to look «underneath» to gain a deeper understanding of how the performance was assessed in the first place.

For example, in the case of banks, the Basel Committee on Bank Supervision expects the Board of a company not just to set remuneration standards but the underlying performance standards.[16] In furtherance of this, the Financial Stability Board conducted in 2021 a study where the key theme was increasing compensation practices effectiveness by giving more focus to how institutions manage and measure performance.[17]

The above trend is requiring Compensation Committee members to intensify their acquaintance with the many options a company has today for tracking and measuring the performance of talent. This includes choices on performance management metrics, systems, and tools, including which assessment scale to use or whether to use one at all.[18]

Equally important to what systems and tools to use in performance assessments is the question of who determines an employee's ultimate performance assessment or rating. Since this will directly influence the pay to award the employee, many questions arise on which the Compensation Committee will need to have clarity:

- How is objectivity and consistency assured in performance assessments?
- Are there effective checks-and-balances or does the assessment of an employee's performance reflect the view of only one manager?
- How is calibration carried out to prevent members of a team with a particularly generous manager receiving higher ratings than those of a team whose manager is more rigorous in the assessments?

15 See, Swiss Board Forum and Network for Innovative Corporate Governance, «Handbuch für den Verwaltungsrat», 2024, chapter 5.2.6 [3rd edition, forthcoming publication by G. S. Varges].
16 BCBS Corporate Governance Principles for Banks, July 2015.
17 FSB Progress Report, November 2021.
18 See, e.g., «Why More and More Companies Are Ditching Performance Ratings», Harvard Business Review, Sept. 2015.

- Can the CEO or other senior executive overrule the performance assessments conducted through the system?

Today a further «what» is landing on the Compensation Committees' agenda. It relates to how the compensation system can serve the goal of holding managers and employees accountable for insufficient performance or outright failures, also in the personal conduct area.

Known, particularly in financial services circles as «consequence management», the effort involves devising the range of tools—besides at one end simply «talking to the employee» or at the other end firing him or her—that can be used to deal with outcomes not matching the expected performance or representing some breach in company policy or values.[19]

Since some of these tools can include the reduction or cancelling of a bonus, or the forfeiting of a scheduled base salary increase or promotion, the topic is directly pertinent to the work of the Compensation Committee. As such, the Committee has to become well versed in how the accountability system works, what kind of governance applies to it, and what severity levels are set to trigger certain pay consequences.

Of particular challenge for the Compensation Committee in this regard is another market development. In multiple jurisdictions—by virtue of corporate, stock exchange, or financial or securities regulations—companies are increasingly being expected to have mechanisms to recoup or «clawback» compensation that already has been paid out to an executive. This is to protect against erroneously awarded compensation, such as for a sales figure that in retrospect turns out to have been inflated or for other achievement tainted by newly discovered fraud or misrepresentation.

Clawback mechanisms represent for the Compensation Committee a sizeable task. To start, the Committee needs to review and approve the exact wording of the clawback clause that management proposes to use.

19 The higher interest in consequence management and disciplinary processes relates as well to the growing expectation that compensation be aligned with expected conduct and thus with the compliance program of the institution. While regulatorily driven in some cases, this area represents an additional dimension of Compensation Committee responsibility. For example, at Deutsche Bank, the Committee is called the «Compensation Control Committee» whose mandate includes ensuring alignment of compensation to the bank's internal controls and compliance system.

This is a primordial task that nonetheless some Compensation Committees take up only after the fact, i.e., after such clause has already been made part of executive contracts.

Here the biggest risk is that management may attempt to draw the clause as narrowly as possible (such as to be triggered only when a wrongful act leads to the need to restate the company's financials), whereas the Committee, wearing its governance hat, may wish the clause to have wider application, such as for the clause to apply also when a violation of a material part of the company's code of conduct has taken place.

But the most work comes in the monitoring and application of the clawback clause. Clawback clauses are controversial as their enforceability is surrounded by considerable legal uncertainty in many jurisdictions.

Financial regulators nonetheless may require institutions to have such clauses and may push them to apply them anytime the trigger criteria have been met, despite the uncertain outcome should the executive in question choose to challenge the matter in court. Newer developments are creating further incentives for companies to have and make use of such clauses when undesired conduct arises.[20]

Another new task falling upon the Compensation Committee (sometimes jointly with the Audit or Risk Committee) relates to the so-called «control functions». It involves ensuring that the compensation arrangements for these functions (Risk, Compliance, and Internal Audit) do not create any inappropriate incentives, while at the same time not making the remuneration for their occupants unattractive.

4. The Future Compensation Committee Agenda

In light of the augmentation over the years of what is expected of Board of Directors in general, it is not surprising that Compensation Committee responsibilities have also grown.

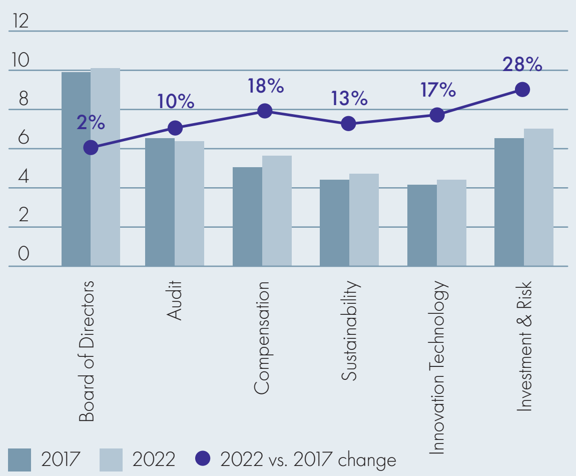
20 Authorities in the U.S., for example, are creating more incentives for companies to have and apply clawbacks as part of what constitutes an effective compliance program. If a company, among other things, can demonstrate having clawbacks, this will be taken positively into account in prosecutorial decisions on whether to formally investigate or charge a company in the face of a suspected violation. See Department of Justice Evaluation of Corporate Compliance Programs (revised), March 2023.

Already in the early 2000's some commentators conjectured that greater public interest in corporate governance would impact human resource functions, which in turn would affect what Compensation Committees had to supervise. One former HR director and subsequent Board member speculated at that time that the new environment «will make things tougher for HR» as «Board directors will be asking more questions and requiring more-detailed explanations about HR programs and the data HR collect».[21]

As one looks ahead, the ambit and strategic importance of the Compensation Committee will go far beyond what one could have imagined 20 years ago. At one level the challenge will be about coping with the sheer volume of topics. This may explain why Compensation Committee meetings have tended to become longer and more numerous.

In the past five years in Switzerland, for example, there has been an increase in the number of Board and Board Committee meetings in general. As far as the Compensation Committee itself, the increase in the number of meetings has been of some 18% in companies having a distinct committee on the subject.[22]

Figure 1: Change in Board / Committee Meetings



21 Quote of Jill Kanin-Lovers, a former HR executive at Avon (now serves as a director on several corporate boards), in R. Grossman, «HR & the Board», HR Magazine, January 1, 2007.

22 Analysis based on data of HCM International with regard to Swiss-quoted companies. The graphic does not show all committees found in these companies and it combines certain committees for convenience into given categories. The Compensation Committee figures are only of the companies having a distinct Compensation Committee, not combined with another subject. For companies having a combination of Compensation and Nominations Committee, the observed increases are lower.

Since Compensation Committee members attend all Board meetings, it is relevant to also look at the total meeting burden. The average number of Compensation Committee meetings in 2022 was 5.7. When combined with average number of Board meetings in 2022 (10.1), this means that the average Compensation Committee member attended 15.8 meetings in such year.

An additional phenomenon has to be taken into account. It is an emerging best practice for the Compensation Committee to have periodic joint meetings with other Board committees so as to delve deeper into subjects overlapping among committees. In the market one observes, for example, periodic meetings of the Compensation Committee with the Risk Committee or the Sustainability Committee.

But beyond increased volume and meetings, the future will bring further complexity to the Compensation Committee's sphere of work. Three areas will bring particular challenge:

- Digi+: The latest phase of digitalization is being characterized by wider use of artificial intelligence and by the «democratization» of AI through generative artificial intelligence. The latter is embodied in a number of platforms that, in effect, give the average person (and thus also the average employee) ready access to an AI tool that not only learns but generates new content.[23] One may refer to this new phase as «Digi+» and it will bring to Compensation Committees—particularly those dealing with employee and HR topics—additional challenges. It will raise a myriad of risks (e.g., relating to privacy and intellectual property protection) as well as ethical tensions (may one exclude a job applicant solely on the basis of an algorithm or a «robot» interview?). But it will also create new opportunities for rendering the compensation and performance management processes more efficient.

- ESG: With concerns about climate and social issues climbing on corporate agendas, this too will have more direct impact on the work of the Compensation Committee. Already one of the most pressing questions is whether and to what degree the company should incentivize ESG performance through the remuneration system.

23 Among others, Chat GPT, Google Bard, Pi, and Bing Chat.

This will require the Compensation Committee to become more fluent in the language of sustainability and more prepared to make judgements as to whether, for example, a particular emissions target is the right metric to use as part of the short-term or long-term incentive plan of the company. Other topics will relate to issues such as diversity and inclusion (also at the Board level), pay equity, and new forms of pay transparency. [24]

- Evolving Societal Views on Work: Covid gave prominence to topics such as employee wellbeing and adaptation for virtual work. The years ahead will bring thorny challenges to the Compensation Committee such as how to cope with mutating societal views on the workplace, work, and careers. Compensation, reward, and performance management systems will require adjustments as larger number of employees demand more flexibility on the nature, quantum, timing, and location of work. In these efforts, the Compensation Committee may need to intensify its oversight of the HR and other functions and address notions such as psychological safety, workplace equity, and the multiple forms of the «burn-out» syndrome.[25]

5. Conclusion

The enlargement overtime of Compensation Committee responsibilities could be interpreted as a classic example of «mission creep». But this would be the wrong conclusion. Compensation Committees are undertaking more today not due to a desire to encroach upon management but to be responsive to larger societal developments impacting what is expected of companies and of those who provide their oversight.

What cannot be denied is that the taking on of new tasks, and the deeper handling of existing tasks, can strain the Compensation Committee. To cope, Compensation Committees will need to work on four priorities:

- Planning: This involves sharpening the Committee's yearly and multi-year work plans as well as optimizing its work methods (potentially with the use of digital tools) for higher efficiency. This can also help the Committee with prioritization.

- Own-assessments: This involves carrying out more effective and frequent assessments of the Committee's performance to identify improvement areas, skill-set gaps, and topics on which the Committee needs external help. Well-executed assessments can also inform training and succession planning.[26, 27]

- Training: This involves more than occasional «briefings» but meaningful capability-enhancement sessions where Committee members elevate their know-how and decision-making abilities in emerging areas.

- Succession planning: This involves having a well-designed process to facilitate internal Board succession planning (i.e., the rotation of existing Board members among committees) and external succession planning (i.e., the recruitment of new Board members as the term of existing members expires).

All the foregoing will be instrumental in increasing the readiness of the Compensation Committee, and of the entire Board, for the inevitable further market changes ahead.

24 «Pay transparency» has taken on a further dimension in recent years as more jurisdictions encourage or require companies to disclose matters such as their pay scales to prospective applicants, statistics on pay differences across categories of employees, and other pay data. These initiatives, which take various forms, usually are part of a larger effort to reduce unjustified pay disparities based on gender, race, or other such criteria. In the EU companies of over 100 employees will need to make a number of disclosures as of 2027. EU Directive 2023/970, European Parliament and Council, May 10, 2023.

25 Some studies and polls are providing insights suggesting, for example, that burn-out is not always related to excess work and that it may be becoming more prevalent among younger employees. See, for example, L. Wiseman «Is Your Burnout From Too Much Work or Too Little Impact?», Harvard Business Review, December 10, 2021. The Future Forum's February 2023 survey suggests higher burnout rates among Generation Z. Future Forum Pulse February 2023, https://futureforum.com/research/future-forum-pulse-winter-2022-2023-snapshot/.

26 See, G. S. Varges, «Board Assessments: Von «Compliance-Übung» zu Leistungsbeurteilung» in Schulthess, Recht Relevant für Verwaltungsräte», 3.2020, and G.S. Varges «Leadership des Vergütungsausschusses bei Performance Management von Führungskräften und Verwaltungsräten», op. cit. at footnote 15.

27 In the past decade, the best practice has become for the Compensation Committee to have an independent advisor selected and appointed by the Committee. In addition, the Committee may wish to consult additional experts on specific subjects. What can help in this regard is for the Board of Directors to have its own budget. This enhances independence in securing external advice. See, G.S. Varges, «Do Boards Need Their Own Resources and Budgets?» in L. Staub, Beiträge zu aktuellen Themen an der Schnittstelle zwischen Recht und Betriebswirtschaft, Schulthess, 2017.