Executive Pay and the Boardroom After Dodd-Frank

By Jack L. Lederer

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Directors grappling with the sweeping governance implications of the Dodd-Frank Act face an unprecedented series of new rules on executive pay. Among other things, the law requires boards to provide detailed new disclosure on their compensation decisions. And, this spring, for the first time, more than 10,000 public companies will be required to allow shareholders to cast an advisory vote on executive pay.

For many directors, Dodd-Frank's pay provisions represent an unwise intrusion into America's boardrooms, motivated by public outrage rather than sound economics. But at a recent conference, policy-makers argued that, rather than saddle directors with unnecessary new burdens, the law was designed to empower the compensation committees responsible for executive pay at the nation's largest companies.

In an appearance with me at the recent NACD annual meeting in Washington, D.C., Professor Robert J. Jackson, Jr., the lawyer who helped draft the Administration's pay proposals, noted that compensation committees came under fire for their decisions during the financial crisis. "The crisis showed that directors courageous enough to sit on these committees are soon going to find themselves answering tough questions about the hard decisions they have to make," Jackson said. "We wanted to give them the tools they need to completely oversee, control and own the decisions they'll have to defend."

Section 952 of Dodd-Frank grants compensation committees "sequential powers" over all executive pay matters: first, the power to set their own budgets; second, the ability to interview, vet and hire pay consultants; and, third, the power to oversee consultants without interference from management. "This gives directors the authority and the funding to hire the advisors they need at their own discretion," Jackson said.

Indeed, the provision takes the extraordinary step of specifying that the committee is "directly responsible" for the appointment, compensation and oversight of the work of any compensation consultant. "We wanted to make clear that, if you are a pay expert working for a public company in the United States, you work for the directors on that compensation committee," Jackson asserted. "They pay you, they review your work and they're accountable for your analysis and recommendations."

The new law also requires that directors explain how they used these new powers in the annual proxy. Compensation committees will have to detail how they oversaw the selection, compensation and management of those who advised them. And they will have to analyze and disclose if those advisors— whether they are consultants or attorneys who help them set pay—are fully independent of management.

Emphasizing that Dodd-Frank gives directors the freedom to hire the advisors they need to bargain hard with executives, Jackson has noted that the law does not prohibit committees from hiring consultants and lawyers with ties to management. But, he cautions, directors who do so will find themselves "having to do special types of explaining. The committee will have to set forth in the proxy why it made the choices it made and why those choices were best for shareholders."

One participant in our session questioned how directors, most of whom serve on a part-time basis with limited support staff, could discharge the new powers that Dodd-Frank gives them. These directors are now expected to establish their own budgets and hire advisors—on their own. They will need to operate independently from management but will often require information and cooperation that only management can provide. And they will have to develop processes that reflect the extraordinary diligence on pay decisions shareholders and the public now expect. What should the directors who serve on compensation committees be doing in light of these new powers—and the responsibilities that come with them?

In my view, compensation committees must begin to think of themselves as operating business units—responsible for decisions critical to the company's future with customers, investors and the public. As such, they may need a broader set of resources, for support in:

- Building consensus among committee members on key pay issues and priorities;
- Sourcing and evaluating compensation consultants, lawyers, benefit and defined-plan experts and other advisors;
- Assessing and evaluating committee and consultant performance;
- Establishing best practices and strategies regarding communication with institutional investors, shareholders and proxy advisory firms; and
- Setting guidelines and processes to work effectively with management.

The notion that a compensation committee should think of itself in this way may seem unprecedented. And, indeed, many of these reflect dramatically new governance methods. The directors who sit on these committees might not know where to begin in light of these extraordinary changes.

My firm spends a great deal of time educating committees on their powers and responsibilities under Dodd-Frank. We are now also working directly with committees in developing operating guidelines to ensure that they comply with the new law. Compensation committees work with us in diagnostic sessions to see how a committee stacks up against the new rules and where changes need to be made.

Committees may also need support in developing and implementing searches for pay advisors, rating various advisors' independence and gauging any conflicts that may exist between the advisor and management. In addition, we help committees appoint the best advisor for the company's needs, determining appropriate pay for advisors and evaluating their performance.

Dodd-Frank gives directors extraordinary new powers to oversee the executive pay decisions they will ultimately have to defend. Our work helps ensure that directors execute these new powers in ways that guarantee transparency and accountability, which is what the compensation provisions of Dodd-Frank are designed to achieve.