BOARD ROOM

Governing REIT Compensation

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By James B. Wright

The spotlight shone on corporate governance by investors and analysts doesn't appear to be going away any time soon. Recent regulatory actions, while necessary, may not be sufficient to assure investors that future problems stemming from improper corporate practices will be prevented. Although most discussions surrounding governance have dealt with board structure and composition, or the integrity of accounting practices and financial reporting, an emerging issue is the independence and effectiveness of a company's compensation committee—the group responsible for determining compensation for the chief executive and senior management.

Helping to usher in this new focus on compensation committee activities has been the most sweeping series of reforms in decades; the Sarbanes-Oxley Act of 2002 addresses several compensation governance issues, the Financial Accounting Standards Board has issued revised standards for stock option accounting and disclosure that will alter the design of long-term compensation, and the Securities and Exchange Commission will soon adopt changes in the NYSE listing standards that may include shareholder approval of certain stock-based plans.

Responsibility for executive compensation is a delicate balance between competing interests. Despite the extent of independence among any board, the CEO (as a board member or chairman) is placed in the often-difficult role of balancing effective governance with the pressures of compensation expectations, appropriate incentives and employee retention. In the REIT sector, some compensation committee relationships with the CEO and senior management are already well structured and strongly interactive, resulting in relatively independent decisions derived from mutual review and analysis of market information and issues. For others, achieving this level of corporate board practices is a work in progress.

As recent well-publicized REIT proxy/management battles have demonstrated, REIT governance issues are no longer under the radar. In time, shareholder concerns (and any REIT vulnerabilities) relative to independent compensation decisions will also receive scrutiny, and potentially challenge. One of the defining responsibilities of independent corporate compensation governance is responding to the negative public perception generated by misunderstanding of the issues, fueled by the scandals in broader corporate America. The test of effective independent compensation governance is clarity regarding the real and perceived issues, and their risks of appropriate executive pay decisions on behalf of all stakeholders.

Success at this objective may eliminate frequent questions of board independence arising from structural issues such as: size and makeup of committees, frequency of meetings, dilution of director attention from serving on too many (or all) committees, interpretation of "independent" status, experience with compensation issues, meetings without management, or potential business conflicts among members or with consultants. Ultimately, REIT trends and REIT leadership drive change and establish effective governance, and are the cause of its potential advantage in the industry and investor marketplace.

Status	In a new era of market acceptance portfolio managers and investment advisors are increasingly focusing on REITs, and expanding their long-term commitment.
Exposure	Scrutiny of governance, including compensation/performance correlation, is increasing, and REIT structure will not prevent challenge, and may encourage it.
Communication	Advantage from proactive disclosure/strong governance has been demonstrated, and for compensation, has every advantage vs. defending a challenged decision.
Value	Investors voice concerns financially – on the sell side due to poor governance – but McKinsey & Co. surveys find 80% would pay a premium for leading practices.

Compensation Committee Trends

Public company compensation committees face their own set of governance issues that must be addressed. For investors, the most nagging question is the perception (or reality) of the relationship between compensation and performance. This rationale is the biggest challenge CEOs and boards face relative to compensation governance. However, other issues also are topics of scrutiny, including large awards of stock options to CEOs and boards, expensing of stock options, retention of executive talent, expanding retirement benefits, peer group definition and peer performance, among others. Another frequent challenge is managing the ”ratchet effect” on compensation levels, in which the most recent market survey of “what everyone else is paid” raises the baseline for compensation regardless of its relationship to performance.

For REITs, the transition from entrepreneurial-based real estate owners/developers to public company managers focused on long-term operational efficiency and cash flow growth in a public forum is essential for building investor confidence and enhancing shareholder value. The mandate of contemporary corporate governance standards is a part of this transition, incorporating REIT compensation committees and compensation practices. In the near term, the catalyst for change will center on committees needing to be more independent, more involved, more strategic and more proactive.

More Independent	Scrutiny will test independent Board of Director members, and require Compensation Committee (including Chairman) from only such Directors.
More Involved	Expanding and empowering greater Committee participation in the review process and Plan design options, while maintaining their oversight role.
More Strategic	Shift from annual to longer-term decision framework able to define clear performance/compensation linkages and integrate corporate objectives.
More Proactive	Seizing the opportunity to address issues and build investor confidence by including compensation in industry leadership and strong governance.

REITs have generally hired a single compensation consultant, working with the board and management to provide independent assessment, analysis, conclusions and recommendations regarding compensation. This traditional “compensation consultant” is usually hired by management to assess industry market levels of compensation for specific positions, trends in compensation policy/practices, and the review/design of recommended plans or changes to existing plans.

However, an alternative and complementary approach to capture the trends for more effective governance may be to engage a separate advisor, reporting directly to the compensation committee, supporting and coordinating their responsibility and mandate in both content and process.

Retaining A Committee Advisor

Beyond the traditional outside compensation consultant retained by management, this additional category of independent support may offer the compensation committee the opportunity to engage its own advisor to assist them in fulfillment of their governance charter and mandate. A separate advisor for the committee could insure independence, and provide a vehicle to facilitate all committee members' ability to fully understand all aspects of their decisions, and to allow them an independent opportunity to ask questions, clarify impact and risk, and challenge information, concept, structure or recommendations.

Acting to provide distinction and separation between the work of compensation review and the responsibility for effective governance, this additional resource is not intended to promote confrontation, "dueling" consultants, or create overlap. Rather, its intent is to facilitate greater dialogue, effective communication among members, an independent forum for questions and clarifications, increased accountability, stronger decision rationale, and greater assurance of fairness, thoroughness, independence, consensus, as well as shareholder representation–and thereby greater enterprise value.

Although the compensation committee advisor may well be an appropriate and permanent aspect of industry leading REIT governance, specific situations that could benefit from an independent consultant would be when the committee has new members or chairmanship, when member compensation knowledge and experience is limited, when investor issues have been raised, where members are located with great distance and meetings are difficult to coordinate, where retention is an issue, when merger, strategy, market changes or performance issues are occurring, CEO/leadership change, or where conflicts of control, philosophy, policy or practice are apparent.

In the current economic downturn for many REIT sectors, such a resource could be proactively utilized to support a committee's—and ultimately the board's—understanding of the overall relationship between pay and performance, their essential responsibility. If found to be at risk (too high or too low over time), the committee (and company) could make adjustments to the compensation recommendations. If not at risk, the company could proactively enhance their investor relations. Additionally, the independent committee advisor will inspire greater creativity in compensation design, and may offer more financial opportunity over the long term.

An ideal "committee advisor" would provide a platform of REIT executive compensation and real estate experience, and the capacity to work directly with the chairman and committee members to assist in: an effective and independent process, clarifying and embellishing issues and results, reviewing compensation assessment, enhancing the execution of committee responsibility, providing independent technical review, balancing competing opinion and interests, and defining and validating the strategic rationale for decisions and recommendations to the board. Although vital, the scope is smaller, the cost less, and the focus are governance and oversight, rather than specific design and implementation.

In the area of executive compensation, where very personal and carefully reviewed decisions are both reflections as well as perceptions of executive value and success, the committee advisor concept offers significant incremental independent support for both the content and process of industry leading governance policy.

Transitioning Concept to Reality

Future shifts toward greater participation and involvement in compensation review and recommendations by the committee will occur in various ways and in various degrees.

The concept of an advisor, separate and apart from the traditional compensation consultant, and reporting directly to the compensation committee chairman, may offer REIT leadership a potentially compelling and significant strategy for achieving greater market recognition and confidence in REIT ownership, while allowing the committee needed support for greater independence and involvement. The rewards of proactive action outweigh the risks of defending a challenged practice or decision.

Moreover, corporate governance measurement is already being used to evaluate investments, and the future may soon incorporate metrics of corporate compensation to performance relationships in the same vein as P/E ratios or price/FFO multiples measure relative market value. Structured properly, an independent resource for compensation committees can provide support in a more participative environment without jeopardizing current trusted relationships or the arms length "distance" for appropriate oversight. It will also foster greater understanding of compensation issues between board and company management, stimulate creative compensation design to motivate the achievement of strategic objectives, strengthen the overall rationale for decisions, and likely offer greater executive compensation opportunity, all which will make a lasting contribution to greater enterprise value.

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Rationale for a Compensation Committee Advisor

Committee Imperatives – CONTENT	
Governance	Fulfill Board Compensation Committee mandate … seek, validate, clarify and communicate the strongest rationale for recommendations.
Strategy	Sustain a decision framework that achieves the long-term validity of compensation decisions relative to all stakeholders.
Insight	Provide Committee members, and compensation consultants, who may not be real estate experts with this invaluable perspective.
Breath	Incorporate responsibility for recommendations beyond CEO/Senior Executive compensation … to company-wide compensation policy/practices.
Accountability	Understand that governance exposure lies with Board of Directors … not compensation consultants …and supplemental advice provides insurance.
Expertise	Independent opportunity to clarify and fully understand the methods of compensation analysis, equity valuation techniques, or Plan design.
Judgment	Assure the capacity to fairly determine market competitiveness, Plan structure, strategic alignment, issues and alternative interpretations.
Committee Imperatives – PROCESS	
Empowerment	Clarify expectations to all Committee members, as well as any changes or transition to a more direct (or expanded) role for compensation review.
Separation	Insure the distinction between overall Committee governance responsibility, and the technical process of developing competitive compensation Plans.
Oversight	Maintain the course, sequence and direction of the steps, conclusions, issues and decisions required to conduct a compensation review.
Conflicts	Prevent “compensation consultant” company relationships or analytical interpretation, from an independent Committee interpretation.
Dialogue	Allow for an independent resource for questions or interpretation of the potential outcome of often dynamic and complex proposals.
Independence	Achieving satisfaction of the neutrality and integrity of both the competitive compensation recommendations, and the process itself.
Consensus	Ability to effectively facilitate resolution of differences among constituencies; CEO, Management, Committee, Board, shareholders or consultants.
Communication	Provide effective information flow/issue resolution among geographically diffused Committee members with competing commitments/obligations.