THE

# COMPENSATION COMMITTEE HANDBOOK

FOURTH EDITION

JAMES F. REDA STEWART REIFLER MICHAEL L. STEVENS

WILEY

# The Compensation Committee Handbook

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**Fourth Edition** 

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## **Foreword**

Not too long ago, the general consensus among independent directors was that the chairman of the audit committee had the most challenging position in the boardroom, and audit committee members had the hardest jobs. That consensus has unraveled as, post–Sarbanes Oxley, the necessary and appropriate audit committee tasks have become more generally agreed to and committee member qualifications more demanding. Boards have generally, as well, upgraded the quality of their audit committee membership. Furthermore, audit committee work—while subject to the usual changes from time to time—has not undergone the upheavals common in the past in the audit world.

Now, in the aftermath of the financial meltdown of 2008 and enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, the compensation committee chair is now widely considered the most difficult role on the board, and compensation committee members the least envied by their fellow directors. One reason is that the compensation committee chair and committee members may often find themselves in a difficult tug-of-war with management on pay matters. In the worldwide hunt for executive talent, the compensation committee needs to be vigilant in assuring that management is adequately compensated (though far fewer CEOs change employers due to tough compensation requirements than compensation committees sometimes fear). But as trustees or fiduciaries for the shareholders, the first task of the compensation committee is to get the best management and the best business results at the least compensation cost to the shareholders. Managements, conversely, for themselves and their families, seek the highest pay they can get. As a result, and inevitably, compensation committees and managements can-and should-at least start out with different points of view when approaching executive compensation issues. If the compensation committee is performing its job for the shareholders, it must, at some point, tell management "no." That is no fun even if management is not performing at a high level; it is tougher by far if management is doing well. This proper and necessary back-andforth between the compensation committee and management can make X Foreword

compensation committee meetings stressful and unhappy events for committee members.

Another reason why the compensation committee's task is challenging is that there are few roadmaps for deciding what compensation is "right." Audit committee members can at least refer to voluminous and detailed (though often ambiguous) formal rules stating how books and records should be kept and how transactions should be accounted for. There is, however, no equivalent body of "generally accepted compensation principles" to guide the work of the compensation committee. While nearly everyone can agree on compensation truths at a very high level of generality— "pay for performance," for example—application of that bromide to a specific company at a specific time in its history and with a particular management in place is another matter entirely. Not only are there few concrete guideposts in reaching pay decisions, there are no compensation police to curb the wilder inclinations of the compensation outliers. The work of audit committees and audit firms is overseen by the Public Company Accounting Oversight Board and the Securities and Exchange Commission at the federal level; in contrast, no one in particular has the legal responsibility to oversee compensation committees or the compensation consultants on which compensation committees have come to so heavily rely. Without firm principles to guide them, compensation committees are at hazard of drifting into some very muddy waters.

If this is not enough to make the compensation committee's job hard, public attention to compensation issues has continued to increase—from shareholders legitimately concerned about pay levels and practices and special interest groups using compensation matters to hide other agendas, to the sensationalistic business and general media and politicians eager to score easy points with their constituents, to self-appointed guardians of politically correct pay. Even compensation committees made up of hardworking, thoughtful board members who understand their responsibilities can find themselves on the wrong end of an ugly controversy about pay decisions.

The consequences of bad compensation decisions can be severe. They range from ill-advised legislative initiatives to shareholder revolts. How should directors who want to do the right thing with executive pay proceed? While there are no guarantees of a trouble-free compensation result, several rules are preeminent for those on or considering joining a compensation committee:

 Do not join a compensation committee unless you are willing to do the necessary work. Much of the effort of the compensation committee requires great attention to what may appear to be (and often are) mind-numbing details. If a director isn't willing to engage, work hard, Foreword Xi

and learn the details of compensation matters, he or she shouldn't be on the compensation committee. For example, is a director willing to read and understand the details of the CEO's employment contract? The stock option plan that the shareholders are being asked to approve? The terms of executive benefit plans? Has the compensation committee member analyzed the data that the committee's consultant has offered up? Does he or she know what Sections 162(m), 409A, and 280G are? Directors answering "no" to such questions should consider seeking another committee assignment or going back to school.

- 2. Do not join a compensation committee unless you understand your role on that committee. Too many directors are unwilling or unable to challenge management or their fellow directors over compensation issues. From one point of view, this is completely understandable: Few people enjoy conflict, particularly with individuals whom they may generally like, respect, and need to work with on a continuing basis. In addition, the boardroom and committee room culture is generally one of compromise and consensus, and there is much to be said on behalf of collegiality. But it is possible to both disagree with someone and be supportive of them. Some directors, unfortunately, act as if their only task on the compensation committee is to make management happy and avoid conflict, rather than to get the best performance from management at a reasonable cost.
- 3. Do not join a compensation committee unless the committee maintains strict independence of its processes from management. For example, the compensation committee—not management—should choose the committee's compensation consultant. More importantly, the committee, or at least its chairman, needs to monitor communications between the compensation consultant and management, so that the consultant does not become co-opted by management and retains its independence of viewpoint and judgment. Compensation committee members often fail to understand that human resource departments are not neutral observers of compensation decision making, but interested parties aligned with executives. And while offering management an opportunity to present its views, the compensation committee should be willing to decide compensation matters in executive session so that all committee members feel comfortable in voicing candid opinions.

Though we have little hard data, my guess would be that nearly every recent public company compensation mess leads back to committee members who were too eager to please management, too unwilling to challenge the assumptions underlying compensation plans, too busy with their BlackBerries, or too distracted by other obligations to delve into the details of compensation plans, and too careless with the shareholders' money.

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Though the vast majority of compensation committees appear to be made up of intelligent and hardworking directors, a minority of compensation committees that don't perform their jobs reasonably end up attracting negative public comment and adverse shareholder reaction to all compensation committees. The resulting counterproductive legislative and ill-thought-through activist compensation agendas harm all public corporations by limiting their flexibility and distracting them from more urgent tasks at hand.

Which brings us to this *Handbook*. It is designed to help the compensation committee member understand his or her duties and roles, and to remind him or her of both the general and the technical determinants of good compensation committee decision making. No compensation committee will make the right decisions all the time, but a good compensation committee should make the right decisions on average over the long term, and should always make sensible and defensible decisions, even if in hind-sight they may appear to be disadvantageous. This *Handbook* will help willing compensation committee members end up at the right place. It will make good compensation committees better and will help the rest catch up.

Philip R. Lochner, Jr.

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Philip R. Lochner, Jr. is a former commissioner of the U.S. Securities and Exchange Commission. He serves or has served on the boards of directors and compensation committees of a variety of public companies, including Adelphia Communications Corporation; Apria Healthcare Group, Inc.; Brooklyn Bancorp; CLARCOR, Inc.; CMS Energy Corporation; Crane Co.; GTech Holdings, Inc.; Monster Worldwide, Inc.; and Solutia, Inc. He has also served as a member of the Board of Governors of the National Association of Securities Dealers and of the American Stock Exchange, as a member of the Legal Advisory Committee of the New York Stock Exchange, and as a member of the boards of directors of the National Association of Corporate Directors. Prior to his retirement, he was vice president, general counsel, and secretary of Time Incorporated and later was senior vice president and chief administrative officer of Time Warner, Inc.

## **Preface**

Concern about executive pay is hardly a new phenomenon. Historically, it has tended to ebb and flow with overall economic conditions. Attention tends to decline in periods of economic plenty—as long as most Americans perceive themselves as doing well, they worry less that chief executive officers (CEOs) might be doing better still. Likewise, as general economic fortunes subside, the relatively large earnings of corporate leaders invoke public ire.

Executive compensation "controversies" are not unique to the 21st century and can be traced back to the days of the corporate robber barons. But most people see the modern trend beginning during the recession of the early 1980s when Congress enacted the golden parachute tax law. After a booming economy at the end of the 1980s, scrutiny was again focused on executive compensation during the 1991-1992 recession, resulting in the enactment of new tax, disclosure, and accounting rules. Then, at the end of the bull market of the 1990s, the pendulum once more swung from an attitude of "anything goes" to widespread negative attention again focused on executive pay. Adding to the sense of public distrust was the round of high-profile corporate failures and fraud that took place in the early 2000s, resulting in the enactment of the Sarbanes-Oxley Act of 2002. This was followed by another period of robust domestic economy, with the Dow Jones Average ascending to historic highs. But this led only to the financial meltdown of 2008, which became the worst economic crisis since the Great Depression, and which resulted in the enactment of the Dodd-Frank Act of 2010.

Sarbanes-Oxley, along with the establishment of the Public Company Accounting Oversight Board and new rules from the stock exchanges, responded to the notorious corporate failures by focusing on measures that make it more difficult for corporate officers to commit fraud and that strengthen the ability of corporate boards to detect misconduct. New accounting rules requiring expensing of stock options, an expansive principles-based compensation disclosure regime, a new overlay of laws regulating deferred compensation, and a push for various Say on Pay proposals

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round out the corporate reforms started in the early 2000s. Then, Dodd-Frank codified Say on Pay voting and required clawback policies, compensation committee independence, hedging and pledging policies, and even a CEO-to-employee pay ratio disclosure. Between 2002 and 2010, the crosshairs seem to have shifted from the audit committee to the compensation committee. In fact, many say that what Sarbanes-Oxley did to the audit committee, Dodd-Frank is now doing to the compensation committee.

Even after Dodd-Frank, public policy makers, public and private oversight bodies, and shareholder groups continue to focus on enhancing the ability of corporate boards of directors to ensure that businesses operate ethically and effectively. The Conference Board, the National Association of Corporate Directors, the Society of Corporate Secretaries and Governance Professionals, the Business Roundtable, the Council of Institutional Investors, and a variety of institutional shareholders and institutional investor advisory groups continue to provide comments and leadership on issues of executive compensation and the role of the compensation committee. Furthermore, there are many major U.S. public corporations that have contributed to the good-governance movement and have themselves provided leadership in this area. We rely substantially on this leadership to provide the best-practice guidance throughout this Handbook. While recognizing that there is no single "correct" model for executive pay that will fit every business organization, there is an identifiable set of evolving best practices that compensation committees and boards of directors can apply. The practices discussed in this new edition reflect current and pending regulations, including new rules by the Securities and Exchange Commission, the Internal Revenue Service, the Financial Accounting Standards Board, the New York Stock Exchange, and the NASDAQ Stock Market. They also reflect the experience of compensation committee members and the knowledge gained in careers as business executives, government officials, corporate board members, governance experts, compensation consultants, and academics engaged in the study of business history and practices. Our hope is that this Handbook will stimulate useful and vigorous dialogue within compensation committees and boards of directors on valid measurements of executive performance, the appropriate level of compensation, and the proper mix of compensation elements and incentives, including base pay, performance bonuses, equity grants, retirement benefits, welfare benefits, perquisites, and other benefits.

We also hope that the best practices identified in this *Handbook* will encourage compensation committees to establish a set of values that guides compensation discussions. This process should include identifying the goals that the pay package is designed to achieve, carefully examining each element of compensation, and considering the potential costs of the package in a variety of scenarios. Our fundamental point is that every company should

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have a compensation system based on a core set of clearly established principles, not one based on ad hoc decision making. However, more important than any best practice is the attitude and rigor that the compensation committee brings to its task. What is needed most is courage, leadership, and a spirit of independence—the willingness to ask uncomfortable questions, test the assumptions that underlie traditional past practices, strengthen accepted practices that work, say *no* when the situation warrants, and chart new courses when the rationale for old habits falls short. These characteristics, combined with the best practices discussed in this *Handbook*, will ensure best-in-class performance for compensation committees.

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# PART One

# The Modern Compensation Committee

## The Compensation Committee

One of the most important determinants of a successful corporate strategy is the quality of the compensation committee. The committee is charged with designing and implementing a compensation system that effectively rewards key players and encourages direct participation in the achievement of the organization's core business objectives.

Outstanding, well-integrated compensation strategy does not just happen. Rather, it is the product of the hard work of independent, experienced compensation committee members. The most effective pay strategies are simple in design, straightforward in application, and easy to communicate to management and investors. The pay program for the chief executive officer (CEO) should be in line with pay programs for the company's other executives and with its broad-based incentive programs. In other words, there should be no conflict in the achievement of objectives, and the potential rewards should be as meaningful to all participants as to the CEO.

The United States is unique in its vast number of high-earning entrepreneurs, entertainers, athletes, lawyers, consultants, Wall Street traders, bankers, analysts, investment managers, and other professionals. Yet, it is the pay levels of corporate executives, in particular CEOs, that stir the most heated debate and controversy. It is estimated that the bull market of the 1990s created over 10 million new millionaires whose wealth was derived almost solely from stock options. During this period, many CEOs made hundreds of millions in option gains and other compensation—often making as much as 400 times the earnings of the average workers in their companies. Beginning in late 2001, the business world changed dramatically. Now, with the public's and investors' direct focus on corporate governance and compensation philosophy, and recent changes in accounting rules affecting equity-based compensation, CEOs and other executives should not expect to sustain historic rates of wealth accumulation, absent

substantial performance that is no longer linked solely to the price of the company's stock.

While the proxy statement compensation tables provide historical information and raw data about the company's compensation of its top executive officers, the new Compensation Discussion and Analysis (CD&A) provides a window into the company's compensation philosophy and a means for investors to assess whether and how closely pay is related to performance. A thoughtfully prepared CD&A is good evidence of a well-functioning compensation committee that takes its work seriously.

Among the topics covered in this chapter are:

- Board and board committee structure
- Independence measures
- Compensation committee size
- Compensation committee charter
- Role of the compensation committee and its chair
- Duties and responsibilities
- Precepts for responsible performance
- Compensation benchmarking
- The importance of meeting minutes

#### **Board Structure: The Focus on Independence**

Much of the recent public scrutiny of corporate governance issues has focused on structural issues as they relate to corporate boards—questions related to independence from management; separation of the chair and CEO positions; issues related to the composition and function of board committees; and renewed efforts to create a framework in which outside directors can obtain impartial advice and analysis, free of undue influence from corporate management.

While it has always been desirable to have a healthy complement of outside directors on the board, corporate governance rules adopted by the New York Stock Exchange (NYSE) and the NASDAQ Stock Market (NASDAQ) in 2003 require that a majority of a listed company's board consist of independent directors and, with limited exceptions, that such board appoint fully independent compensation, audit, and nominating/corporate governance committees. The NYSE and NASDAQ rules also prescribe standards for determining the independence of individual directors, which, when layered over the director independence standards under Section 162(m) of the Internal Revenue IRC (IRC) and Rule 16b-3 of the Securities Exchange Act of 1934 (Exchange Act), make the nomination and selection of compensation committee members a challenging exercise.

# Compensation Committee Composition and Multiple Independence Requirements

When selecting directors to serve on the compensation committee of a public company, the nominating committee should choose only those persons who meet all the relevant independence requirements that will permit the committee to fulfill its intended function. For example, a compensation committee member must be an "independent director," as defined under NYSE or NASDAQ rules, where applicable. In addition, a public company is well served to have a compensation committee consisting solely of two or more directors who meet (1) the definitional requirements of "outside director" under IRC Section 162(m), and (2) the definitional requirements of "non-employee director" under Rule 16b-3 of the Exchange Act. This often leads to a lowest-common-denominator approach of identifying director candidates who satisfy the requirements of all three definitions. Unfortunately, the three tests are not identical, and it is indeed possible to have a director who meets one or more independence tests but not another.

#### NYSE/NASDAQ Independence Tests

Under the 2003 NYSE listing rules, an *independent director* is defined as a director who has no material relationship with the company. NASDAQ defines independence as the absence of any relationship that would interfere with the exercise of independent judgment in carrying out the director's responsibilities. In both cases, the board has a responsibility to make an affirmative determination that no such relationships exist. The rules list specific conditions or relationships that will render a director nonindependent. These are summarized in Exhibit 5.1 in Chapter 5.

As of January 2013, NYSE and NASDAQ listing standards require two new factors for determining eligibility to serve on the compensation committee. In addition to the rules summarized in Exhibit 5.1 in Chapter 5, boards of listed companies now also need to take into account two additional eligibility factors:

- 1. A prohibition against acceptance, directly or indirectly, by any compensation committee member of any consulting, advisory, or other compensatory fee from the listed company or any subsidiary of the listed company (referred to as the "Fees Factor").
- 2. Whether the director is affiliated with the listed company, a subsidiary of the listed company, or an affiliate of a subsidiary of the listed company (referred to as the "Affiliation Factor").

#### Rule 16b-3 Independence Test

Awards of stock options and other equity awards to directors and officers of a public company, generally referred to as "Section 16 insiders," are exempt from the short-swing profit provisions of Section 16 of the Exchange Act if such awards are made by a compensation committee consisting solely of two or more "non-employee directors" (as defined in Rule 16b-3 under the Exchange Act). In addition to such compensation committee approval, there are three alternative exemptions under Rule 16b-3: (1) Such awards to Section 16 insiders can be preapproved by the full board of directors, (2) the awards can be made subject to a six-month holding period (measured from the date of grant), or (3) specific awards can be ratified by the shareholders (which alternative is, for obvious reasons, rarely taken).

Disadvantages of relying on full board approval for the Rule 16b-3 exemption are that (1) it is administratively awkward to single out awards to Section 16 insiders for special full board approval, and (2) if the full board takes on that role, the CD&A may need to address that anomaly. Therefore, prevalent practice is for the compensation committee to be staffed exclusively with directors who meet the Rule 16b-3 definition of "non-employee director," and to have the compensation committee approve all equity awards to Section 16 insiders.

To qualify as a "non-employee director" under Rule 16b-3, a director cannot (1) be a current officer or employee of the company or a parent or subsidiary of the company; (2) receive more than \$120,000 in compensation, directly or indirectly, from the company or a parent or subsidiary of the company for services rendered as a consultant or in any capacity other than as a director; or (3) have a reportable transaction under Regulation S-K Item 404(a) of the Securities and Exchange Commission (SEC), as outlined in Exhibit 1.1.

EXHIBIT 1.1 Regulation S-K Item 404(a) Transactions with Related Persons

What	Any financial transaction, arrangement, or relationship, including indebtedness or guarantee of indebtedness
When	Occurred in the last fiscal year or is currently proposed
Between Whom	<ul><li>(1) The company or its subsidiaries, and</li><li>(2) the director or nominee or his or her immediate family member</li></ul>
Threshold Amount	\$120,000
Nature of Interest	Direct or indirect material interest in the transaction or other entity
Exceptions	Instructions provide guidance as to whether an indirect interest is material

#### IRC Section 162(m) Independence Test

For any performance-based compensation granted to a public company's CEO, or its next three (or four) most highly compensated executive officers ("covered employees") to be excluded from the \$1 million deduction limit of IRC Section 162(m), such compensation must have been approved in advance by a compensation committee consisting solely of two or more "outside directors" (as defined under the IRC Section 162(m) regulations). (See Chapter 8 for detail about the evolving definition of *covered employee* under IRC Section 162(m).) Full board approval of such compensation will not suffice for this purpose, unless all directors who do not qualify as outside directors abstain from voting. Therefore, prevalent practice is for the compensation committee to be staffed exclusively with directors who meet the IRC Section 162(m) definition of *outside director*, and to have such compensation committee approve all performance-based awards to executive officers and others who might reasonably be expected to become *covered employees* during the life of the award.

To qualify as an outside director under IRC Section 162(m), a director (1) cannot be a current employee of the company, (2) cannot be a former employee of the company who receives compensation for services in the current fiscal year (other than tax-qualified retirement plan benefits), (3) cannot be a current or former officer of the company, and (4) cannot receive compensation from the company, directly or indirectly, in any capacity other than as a director. Exhibit 1.2 outlines the IRC Section 162(m) independence test, including a summary of what constitutes "indirect" compensation.

#### **State Law Interested Director Test**

To further complicate the analysis, the concept of independence is also applied in determining whether a director is "interested" in a particular transaction under consideration by the board or the committee. A director who meets all of the regulatory definitions of independence under the NYSE/NASDAQ rules, Rule 16b-3 and IRC Section 162(m), can still have a personal interest in a particular transaction that can interfere with his or her ability to render impartial judgment with respect to that transaction. This type of nonindependence will not render the director unsuitable to serve on the compensation committee, but he or she may need to be excused from voting on the particular matter. An example of this might be a situation in which the compensation committee is determining whether to hire a particular consulting firm to advise the committee with respect to a particular matter and one of the committee members has a relative at such consulting firm. This relationship would not necessarily bar the committee member from satisfying any of the regulatory definitions of

EXHIBIT 1.2 Outsid	e Director Re	quirements under	· IRC §162(m)	) Regulations
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Current Employee	The director cannot be a current employee of the publicly held company.
Former Employee	The director cannot be a former employee of the publicly held company who receives compensation for services in the current fiscal year (other than tax-qualified retirement plan benefits).
Officer	The director cannot be a current or former officer of the publicly held company.
Remuneration	The director cannot receive remuneration from the company, directly or indirectly, in any capacity other than as a director. See categories 1–4 for what constitutes "indirect" remuneration.
Category 1	If remuneration is paid directly to the director, he or she is disqualified. No <i>de minimis</i> exception.
Category 2	If remuneration is paid to an entity of which the director is a 50% or greater beneficial owner, he or she is disqualified. No <i>de minimis</i> exception.
Category 3	If remuneration (other than a <i>de minimis</i> amount) was paid in the last fiscal year to an entity in which the director beneficially owns between 5% and 50%, he or she is disqualified. See below for definition of a <i>de minimis</i> amount.
Category 4	If remuneration (other than a <i>de minimis</i> amount) was paid in the last fiscal year to an entity by which the director is employed (or self-employed) other than as a director, he or she is disqualified. See below for definition of <i>de minimis</i> amount.
De minimis amount other than for personal services	Payments not for personal services are <i>de minimis</i> if they did not exceed 5% of the gross revenue of the other entity for its last fiscal year ending with or within the company's last fiscal year.
De minimis amount for personal services	Payments for personal services are <i>de minimis</i> if they do not exceed \$60,000.

independence (particularly if the amount of the consultant's fee is less than \$120,000), but the director might have a personal interest in having the committee hire that consulting firm over another. In that case, the interested director should disclose the nature of his or her interest in the matter and abstain from voting on the hiring question. Once that consulting firm has been hired to represent the committee, the matter is over, and the originally interested director may resume active participation in the business of the committee.