THE

COMPENSATION COMMITTEE HANDBOOK

FOURTH EDITION

JAMES F. REDA
STEWART REIFLER
MICHAEL L. STEVENS

WILEY

The Compensation Committee Handbook

Fourth Edition

JAMES F. REDA STEWART REIFLER MICHAEL L. STEVENS

WILEY

Cover image: © iStockphoto / Dansin Cover design: John Wiley & Sons, Inc.

Copyright © 2014 by John Wiley & Sons, Inc. All rights reserved.

Published by John Wiley & Sons, Inc., Hoboken, New Jersey. Previous editions published by Wiley in 2001, 2005, and 2008. Published simultaneously in Canada.

No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording, scanning, or otherwise, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without either the prior written permission of the Publisher, or authorization through payment of the appropriate per-copy fee to the Copyright Clearance Center, Inc., 222 Rosewood Drive, Danvers, MA 01923, (978) 750-8400, fax (978) 646-8600, or on the Web at www.copyright.com. Requests to the Publisher for permission should be addressed to the Permissions Department, John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, (201) 748-6011, fax (201) 748-6008, or online at http://www.wiley.com/go/permissions.

Limit of Liability/Disclaimer of Warranty: While the publisher and author have used their best efforts in preparing this book, they make no representations or warranties with respect to the accuracy or completeness of the contents of this book and specifically disclaim any implied warranties of merchantability or fitness for a particular purpose. No warranty may be created or extended by sales representatives or written sales materials. The advice and strategies contained herein may not be suitable for your situation. You should consult with a professional where appropriate. Neither the publisher nor author shall be liable for any loss of profit or any other commercial damages, including but not limited to special, incidental, consequential, or other damages.

For general information on our other products and services or for technical support, please contact our Customer Care Department within the United States at (800) 762-2974, outside the United States at (317) 572-3993 or fax (317) 572-4002.

Wiley publishes in a variety of print and electronic formats and by print-on-demand. Some material included with standard print versions of this book may not be included in e-books or in print-on-demand. If this book refers to media such as a CD or DVD that is not included in the version you purchased, you may download this material at http://booksupport.wiley.com. For more information about Wiley products, visit www.wiley.com.

Library of Congress Cataloging-in-Publication Data

Reda, James F.

The compensation committee handbook / James F. Reda, Stewart Reifler, Michael L. Stevens.—Fourth edition.

pages cm

Includes bibliographical references.

ISBN 978-1-118-37061-2 (hardback)—ISBN 978-1-118-42083-6 (ebk)—ISBN

978-1-118-41718-8 (ebk) 1. Compensation management—United States—Handbooks, manuals, etc. 2. Wages—Law and legislation—United States—Handbooks, manuals, etc. I. Reifler, Stewart. II. Stevens, Michael L. III. Title. HF5549.5.C67R435 2014 658.3′2—dc23

2013046693

CONTENTS

<u>Diversity</u>

<u>Foreword</u>
<u>Preface</u>
Acknowledgments
About the Authors
PART One The Modern Compensation Committee
CHAPTER 1 The Compensation Committee
Board Structure: The Focus on Independence
Compensation Committee Composition and Multiple Independence Requirements
Compensation Committee Size
Compensation Committee Charter
Role of the Compensation Committee
Role of the Compensation Committee Chair
<u>Duties and Responsibilities of the Compensation</u> <u>Committee</u>
Compensation Benchmarking
The Importance of Compensation Committee Meeting Minutes
Call to Action
<u>CHAPTER 2 Selecting and Training Compensation</u> <u>Committee Members</u>
The Role of the Nominating Committee
Nomination and Selection of New Compensation Committee Members
Time Commitment

<u>Attracting Candidates</u>
Conducting the Search
How to Approach Candidates
CEO Involvement in the Selection Process
Making the Final Selection
How to Say No
What if the New Director Does Not Work Out?
Benefits of an Educated Board
Orientation of New Members
Ongoing Training
Outside Experts and Advisors
CHAPTER 3 CEO Succession and Evaluation
The Relationship Between Pay and Succession Planning
The Advantages of Effective Succession Planning
The Succession Planning Process
CEO Evaluation
<u>Notes</u>
CHAPTER 4 Director Compensation
<u>Overview</u>
Elements of Director Compensation
<u>Disclosure</u>
Trends in Director Compensation
Conducting a Director Compensation Study
PART Two Legal and Regulatory Framework
CHAPTER 5 Corporate Governance
<u>Fiduciary Duties of Directors</u>
Practical Applications of Fiduciary Duty Rules

9	Stock Exchange Corporate Governance Rules
	External Compensation Policies and Guidelines
	APTER 6 Disclosure of Executive and Director
	npensation
	<u>Background</u>
	Compensation Discussion and Analysis
_	<u>The Tabular Disclosures</u>
· <u> </u>	Option Grant Practices
	Director Compensation
	Disclosure of Material Compensation Risk
_	Compensation Disclosure Requirements for
_	Smaller Reporting Companies
<u>(</u>	Golden Parachute Compensation
]	Pending Dodd-Frank Disclosure Requirements
]	Beneficial Ownership Reporting
]	Disclosure of Related Person Transactions
]	Director Independence and Governance Disclosure
]	Disclosure of Equity Compensation Plans
]	<u>Plan Filing Requirements</u>
]	Form 8-K
(Selected Provisions of Regulation S-K
	APTER 7 Other Securities Issues
	Selected Dodd-Frank Provisions Relating to
_	Executive Compensation
<u>.</u>	Special Rules Regarding Stock Transactions
]	NYSE/NASDAQ Rules: Approval of Equity
<u>(</u>	<u>Compensation Plans</u>
_	Selected Sarbanes-Oxley Provisions Relating to
]	Executive Compensation

CHAPTER 8 Tax Rules and Issues	
<u>Overview</u>	
Organizations Responsible for Federal Tax	
Major U.S. Tax Law and Issues	
CHAPTER 9 Accounting Rules and Issues	
<u>Overview</u>	
Organizations Responsible for Accounting Standards (Past and Present)	
New Equity-Based Compensation Accounting Rules	
<u>Previous Equity-Based Compensation Accounting</u> <u>Rules Under U.S. GAAP</u>	
Other Current and Past Accounting Standards	
CHAPTER 10 ERISA and Labor Law, Rules, and	
<u>Issues</u>	
ERISA Law and Regulations	
<u>Labor Laws and Regulations</u>	
ADEA Law	
PART Three Practical Applications	
<u>CHAPTER 11 Executive Employment, Severance, an Change-in-Control Arrangements</u>	<u>d</u>
<u>Background</u>	
<u>At-Will Employment Arrangements</u>	
Contractual Employment Arrangements	
<u>Fundamental Elements of a Written Employment</u> <u>Arrangement</u>	
<u>Process</u>	
Types of Employment Arrangements	
<u>Terms and Conditions Contained in Employment</u> <u>Arrangements</u>	

CHAPTER 12 Incentive Compensation
<u>Useful Definitions and Abbreviations</u>
<u>Cash versus Equity</u>
Typical Plan Features and Designs
Shareholder Approval Requirements
Retention-Only Plans
CHAPTER 13 Equity-Based Compensation
Equity-Based Incentive Awards
Stock Ownership and Retention Guidelines
CHAPTER 14 Executive Pension-Benefit, Welfare- Benefit, and Perquisite Programs
<u>List of Programs</u>
Pension-Benefit Arrangements
Welfare-Benefit Arrangements
Perquisites
APPENDIX A Selected SEC Rules, Regulations, Schedules, and Forms
Securities Act of 1933, as Amended
Securities Exchange Act of 1934, as Amended
<u>Forms</u>
Sarbanes-Oxley Act of 2002
Dodd-Frank Wall Street Reform and Consumer Protection Act
<u>Other</u>
APPENDIX B List of Organizations and Periodicals
APPENDIX C List of Director's Colleges and Other
<u>Training Opportunities</u>
APPENDIX D Sample Compensation Committee
<u>Charters</u>

Human Resources Committee of the Board of Directors of AT&T Inc. Citigroup Inc. The Coca-Cola Company **Intel Corporation** The Home Depot Inc. Appendix E Sample Compensation Discussion and Analysis (CD&A) Google **Prudential Financial** 3M Berkshire CD&A 2013 <u>Glossary</u> **Bibliography** Index End User License Agreement

List of Illustrations

Appendix A

EXHIBIT B.1 List of Organizations

EXHIBIT B.2 Periodicals

Appendix C

EXHIBIT C.1 The Conference Board

EXHIBIT C.2 Corporate Directors Forum

EXHIBIT C.3 Drexel University

EXHIBIT C.4 Harvard Business School Compensation Committees **EXHIBIT C.5** Harvard Business School Corporate Boards

EXHIBIT C.6 Millstein Center for Global Markets

EXHIBIT C.7 National Association of Corporate Directors

EXHIBIT C.8 NYSE Euronext

EXHIBIT C.9 Terry College of Business

Appendix E

CEO Total Direct Compensation

Chapter 1

EXHIBIT 1.1 Regulation S-K Item 404(a)

Transactions with Related Persons

EXHIBIT 1.2 Outside Director Requirements under IRC §162(m) Regulations

EXHIBIT 1.3 Board/Compensation Committee Responsibility Matrix

EXHIBIT 1.4 Checklist for the Compensation Committee

EXHIBIT 1.5 Illustrative Compensation Committee Agenda

EXHIBIT 1.6 Sample Form for Board Evaluation

EXHIBIT 1.7 CEO Benchmarking Study Template

Chapter 2

EXHIBIT 2.3 Illustration of a Candidate Evaluation Summary

Chapter 3

EXHIBIT 3.1 Quantitative versus Qualitative Performance Goals

EXHIBIT 3.2 CEO Succession Planning Steps

EXHIBIT 3.3 Outgoing CEO Circumstances: Internal versus External Candidates

EXHIBIT 3.4 Sample CEO Job Description

EXHIBIT 3.5 Illustrative CEO Evaluation Form

Chapter 4

EXHIBIT 4.1 Director Compensation Benchmarking Study Template

Chapter 5

EXHIBIT 5.1 NYSE and NASDAQ Governance Rules Chapter 6

EXHIBIT 6.1 Equity Compensation Plan Information
Chapter 9

EXHIBIT 9.1 Straight-Line Vesting vs. Accelerated Vesting

EXHIBIT 9.2 Accounting for Awards with Service, Market, and/or Performance Conditions

Chapter 12

EXHIBIT 12.1 Example of Payout Percentages Using Multiple Performance Measures

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-and-forth between the compensation committee and management can make 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:

1. 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, 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. 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 hindsight 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.

Philip R. Lochner, Jr.

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 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-toemployee 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 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-inclass performance for compensation committees.

Acknowledgments

Each of the authors would like to thank certain individuals who contributed to this fourth edition of the *Compensation Committee Handbook*.

Jim Reda thanks his wife, Deborah Reda, who has supported him in every way over the past 22 years; as well as Stewart Reifler, who agreed to revise the second, third, and fourth editions of this *Handbook*; Laura Thatcher, who helped revise the second and third editions; and now Mike Stevens, who has helped revise the fourth edition. He would also like to thank outstanding directors and compensation committee chairs such as Burl Osborne and William H. Gray III, who passed away in 2012 and 2013 respectively, and made corporate America a better place with their time and energy in designing and implementing shareholder-friendly performance plans that encourage outstanding corporate performance. The knowledge gained in working with these outstanding directors is the basis of this *Handbook* and his consulting practice. Finally, he would like to thank Molly Kyle for her paramount assistance in reviewing and editing four chapters and working with him and other authors in the process of revising the *Handbook*.

Stewart Reifler expresses his appreciation to all of the boards of directors, compensation committees, chief executive officers, chief operating officers, chief financial officers, general counsels, senior human resource executives, and other executives whom he has advised over his many years of practice and who have indirectly but immeasurably contributed to this book. In addition, he wishes to thank the executive compensation attorneys at Vedder Price who have all—in one way or another—directly

affected the observations, commentary, analysis, and substance of this book. Finally, he would like to thank Alan Nadel and Kevin Hassan for their input on Chapter 9 and Jessica Winski and Allegra Wiles for their time and attention spent in meticulously reviewing selected chapters of this *Handbook*.

Mike Stevens thanks his wife and kids for their love and support and his colleagues at Alston & Bird for their inspiration and good humor. Special thanks go to Kyle Woods and Stacy Clark for their invaluable assistance in reviewing and improving portions of this book. Finally, he acknowledges with appreciation Laura Thatcher, a friend and mentor for over 20 years, for her guidance and her amazing work on prior editions of the *Handbook*.

Finally, the authors want to thank Tim Burgard, Helen Cho, and Natasha Andrews-Noel at John Wiley & Sons for all of his time and effort in making possible the fourth edition of this *Handbook*.

About the Authors

JAMES F. REDA

Managing Director, Executive Compensation Consulting

Arthur J. Gallagher & Co. | Human Resources Consulting Practice

Mr. Reda has served for more than 26 years as advisor to the top managements and boards of major corporations in the United States and abroad in matters of executive compensation, performance, organization, and corporate governance. Mr. Reda has played an integral role in the field of executive compensation and the formation of the role of the compensation committee. As a recognized authority on corporate governance, he also serves as expert witness in executive compensation litigation and is typically retained by compensation committees as an outside independent advisor. Mr. Reda has a BS in industrial engineering from Columbia University, and an SM in management from Massachusetts Institute of Technology, Sloan School of Management. He is a member of the Society of Corporate Secretaries and Governance Professionals; WorldatWork; the National Association of Stock Plan Professionals; the National Association of Corporate Directors (NACD); and the New York Society of Security Analysts, for which he serves on the corporate governance committee. He is past chair of the Atlanta Chapter of NACD and was a commissioner member of the NACD Blue Ribbon Commission entitled "Executive Compensation and the Role of the Compensation Committee." He was also a member of the Conference Board Task Force on Executive Compensation.

STEWART REIFLER

Shareholder, Vedder Price PC

Stewart Reifler is a shareholder of Vedder Price and heads its executive compensation practice in New York City. He has extensive experience in representing companies, their boards and compensation committees, and senior executives, both as an attorney with Vedder Price and formerly with Weil, Gotshal & Manges and the Law Offices of Joseph E. Bachelder and formerly as a compensation consultant with PricewaterhouseCoopers. He has been quoted in BusinessWeek, Fortune, Wall Street Journal, Journal of Accountancy, International Tax Review, and Practical Accountant, and he is a frequent speaker on executive compensation topics. His articles have appeared in National Law Journal, Metropolitan Corporate Counsel, The Tax Executive, Journal of Compensation and Benefits, Mergers and Acquisitions, Director's Monthly, Directors & Boards, Securities Regulatory Update, Corporate Business Taxation Monthly, Estate Tax Planning Advisor, and Journal of Taxation of Employee Benefits. He is a member of the Advisory Board of Corporate Business Taxation Monthly and Compensation Standards.com Executive Compensation Task Force.

MICHAEL L. STEVENS

Partner, Alston & Bird LLP

Mike Stevens is a partner in Alston & Bird LLP's executive compensation practice. He represents companies, executives, and compensation committees in matters relating to executive compensation, with a particular emphasis on tax, securities, and corporate governance issues. Mr. Stevens frequently advises clients with respect to executive compensation issues relating to mergers and acquisitions and other corporate transactions. He has

served on the faculty of the Institute of Applied Management and Law and has spoken for numerous organizations, including the National Association of Stock Plan Professionals, the National Center for Employee Ownership, the Society of Corporate Secretaries and Governance Professionals, and the National Investor Relations Institute. Mr. Stevens received his JD, with distinction, from Emory University School of Law in 1993, where he was an editor of the *Emory Law Journal*; was elected to the Order of the Coif; and received the Lexis Excellence in Writing Award. He received his undergraduate degree, with high honors, from Emory University in 1990. Mr. Stevens is listed in the 2014 edition of *The Best Lawyers in America*.

PART One The Modern Compensation Committee

CHAPTER 1 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").