



## Compensation Committee Best Practices

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## What Constitutes Compensation Committee Best Practices?

Best practice for Compensation Committees, like other aspects of corporate governance, is evolving. Among the events signaling changes, some mandated by the Dodd-Frank Act, are:

- Say on Pay
- Adoption of clawback policies
- Compensation Committee consultant and advisor independence
- Increasing influence of institutional advisors like ISS and Glass Lewis
- Continued attention to equity grant practices
- Continued press exposés relating to excesses in executive compensation
- Consideration of internal pay equity principles
- Say on Pay and other compensation related litigation

**Best practices include:**

- Sole discretion to engage/terminate consultants and advisors
- Frequent meetings
- A Compensation Committee comprised of independent, outside directors (SEC and national stock exchange rules mandate this) with no interlocking committee memberships with committees of other companies
- Review of all components of compensation for consistency with stated compensation philosophy, including review of total compensation where implied by compensation philosophy
- Financial analysis of the long-term cost of compensation and severance packages (*i.e.*, use of a tally-sheet in arriving at executive compensation)
- Attention to required compensation disclosures in annual and periodic securities filings such as the proxy and 8-Ks (including the exercise of final authority on such disclosures)
- Conduct annual risk assessment of compensation policies and practices
- Conduct independent assessment of all compensation advisors (including legal advisors providing compensation advice to the Compensation Committee)
- Annual self assessments and review of charter

Members of Compensation Committees who fail to take the foregoing factors into account and fail to function as an independent force within a company are not fulfilling their role in corporate governance or leadership and are at risk of being replaced or subject to legal action.

## What are the best practice “take aways” from recent developments and future trends?

The Dodd-Frank Act, SEC and national stock exchange rules mandate significant changes to corporate governance, disclosure and executive compensation rules for public companies in all industries. In addition, SEC rules mandate significant additional disclosures involving compensation risk management programs, disclosure of advisor independence and fee arrangements and analysis of compensation decision-making. Finally, recent court cases, SEC announcements and other events foreshadow stricter scrutiny of Compensation Committees, their composition, decision-making procedures and the policies they establish or perpetuate.

**The Compensation Committee should consider the following goals and address the following issues:**

- Function as an independent force in determining compensation
- In addition to considering the relevant factors for determining independence and meeting the standard adopted in the applicable national stock exchange rules, Compensation Committee members should be truly independent (not “cronies” of management); this may translate into rotation onto the Compensation Committee of new Board members who do not have long service as Board/Committee members
- Avoid appearance of quid pro quo (*i.e.*, increases in director compensation in exchange for executive compensation)
- Chairman should control agenda, timing and scope of meetings
- Establish guidelines for equity grants to minimize perception of market timing
- Measure company and executive performance by meaningful and measurable long-term criteria consistent with overall compensation philosophy
- Maintain an annual calendar for meetings and timetables for ensuring compliance with disclosure obligations and sound compensation policy decisions, with a process for updating the calendar as needed
- Engage outside compensation consultant and evaluate whether additional assistance is needed from legal counsel
- Require appropriate questionnaires and certifications to be completed on an annual basis by compensation advisors relating to their potential independence as mandated by the national stock exchanges
- Be aware of all statutory deadlines on compensation-related decisions, including bonus-setting deadlines, 8-K disclosure and Form 4 filings
- Obtain full information on compensation currently paid to executives through tally sheets
- Determine whether historical wealth creation while working at the company is relevant to current compensation decisions
- Assure that there are proper and appropriate executive sessions
- Actively monitor and assess potential risks that arise from the company’s compensation practices and policies, and disclose and/or mitigate such risks as necessary

## **Education of the Compensation Committee**

- Regularly assess its own level of compensation knowledge (especially related to fast-evolving compensation or governance trends)
- Ensure a regular source of updated information on compensation developments and demand such information from legal counsel to the company and the Compensation Committee
- Attend director colleges or conferences on compensation trends annually
- Direct access to advisors to answer compensation questions as they arise

## **Consider the Following Risk-Mitigating Practices**

- The use of different types of compensation that provide a balance of short-term and long-term incentives, with fixed and variable components
- Stock ownership guidelines for executive officers, including requirement for named executive officers to obtain permission from the company before selling any shares, even during an open trading period
- A clawback policy which, in the event of a restatement of the company's financial results, allows the company to recover or cancel performance-based bonuses and awards to the extent that performance goals would not have been met under such restated financial results (if appropriate in the context of a particular company, consideration of such a policy in some form is advisable even in the absence of SEC adoption of the rules required by Dodd-Frank)
- Caps on bonus awards to limit windfalls
- The Compensation Committee's consideration of ethical behavior as integral in assessing the performance of all executive officers

## What should the Compensation Committee charter include?

Compensation Committee charters should, at a minimum, comply with the NYSE and NASDAQ rules. The “purpose” and “authority” clauses should track the rules with respect to the Board of Directors’ responsibilities relating to compensation of the company’s executives and the production of an annual report on executive compensation to be included in the company’s proxy statement or other annual report. Consideration also should be given to whether the Compensation Committee’s authority should extend to all aspects of employee compensation or just compensation of executives.



**It may be appropriate to include the following additions to the duties and responsibilities section of the Compensation Committee charter:**

- Assure Compensation Committee independence standards are met and maintained
- Sole or concurrent authority with other Board committees over compensation risk management programs, including assessing and mitigating (as necessary) potential risks created by the company's compensation practices, policies and programs
- Sole authority to engage, at the company's expense, compensation consultants and other advisors, including legal advisors
- Sole authority to consider the independence of corporate advisors to the Compensation Committee (including legal advisors) although it should be noted that the SEC and national stock exchange rules do not require that such advisors be independent, only that the Compensation Committee consider relevant independence factors
- Sole authority to approve CEO compensation, including determining the corporate goals and objectives relevant to their compensation, and evaluating their performance in light of those goals and objectives
- Approval of other executive compensation, including determining the corporate goals and objectives relevant to their compensation, and evaluating their performance in light of those goals and objectives
- Extend committee authority to all forms of executive compensation
- Make recommendations to the management and the Board with respect to non-CEO and non-executive compensation, including equity-based and cash-based compensation plans and provide guidance with respect to design of such plans
- Make recommendations to the Board regarding compensation of directors
- Review and approve employment agreements, severance arrangements and change in control agreements relating to executives
- Monitor compliance with disclosure obligations
- Establish policies for equity compensation (including grant-timing practices and executive ownership requirements) and monitor executive compliance with rules and guidelines of equity-based plans
- Annual evaluation of the Compensation Committee's performance

## What procedural guidelines should the Compensation Committee adopt?

Adoption of the following suggestions would avoid procedural flaws highlighted by recent court cases.

- Distribute meeting agendas and materials well in advance of regularly scheduled meetings (and try to break into two components: first distribution and meeting is for consideration of the item; at the next meeting, a decision is made (*i.e.*, bifurcate the decision-making process))
- Require management to promptly produce material requested by the Compensation Committee, including tally sheets showing bonuses, stock grants, wealth creation, and severance and change of control scenarios, and produce timely minutes of prior meetings for review and approval by the Compensation Committee
- Avoid reliance on telephonic meetings and written consents in favor of regular face-to-face meetings
- Avoid meetings consisting only of “canned” presentations
- Hold regular sessions with the company’s senior HR executives
- Hold “executive” sessions without management present (including CEO) except where presence is deemed necessary and appropriate, at the end of each meeting and otherwise as appropriate
- Have legal counsel (inside or outside) attend meetings regularly and be responsible for keeping minutes
- Consider retention of independent outside legal counsel to the Compensation Committee (if appropriate for providing advice where regular company counsel is likely to have conflicts)

**With respect to executive contracts and arrangements, the Compensation Committee should maintain and follow procedural guidelines:**

- Determine whether the CEO or other executive who is negotiating the new arrangement on behalf of the company has a prior personal relationship with the candidate
- Become involved early in the process and stay involved through its completion
- Review a summary of key terms of the arrangement and receive regular updates on negotiations
- Receive and approve proposed and final term sheet and agreement
- Use outside consultants and appropriate peer and industry comparisons
- Analyze the financial impact of the compensation package, including severance and change of control packages (*i.e.*, use a tally sheet)
- Know if and to what extent management has provided input into any recommendations by outside consultants
- Use inside legal counsel to assist the Compensation Committee and ensure availability of outside legal counsel at meetings and decision-making events (where appropriate, use independent or outside legal counsel)
- Insist on full disclosure in SEC filings and timely advice on when Form 8-Ks are required for compensation decisions
- Prepare timely minutes documenting length and content of deliberations, nature of questions and key elements of decision-making process and approve such minutes on a regular and orderly schedule

## Are there specific approaches that should be taken in the Compensation Committee's practices?

In addition to the policy-based recommendations above, the Board of Directors or the Compensation Committee may wish to consider its practices in the context of the following:

### Composition, Role and Philosophy

- The Chairman of the Compensation Committee should attend and answer questions at the annual meeting of shareholders
- Avoid interlocking directorates
- Rotate Compensation Committee chairman and members periodically
- Compensation philosophy and practice that encapsulates: shareholder value (long-term), independence, transparency to shareholders, fairness, and is performance driven
- Timely and substantive attention to Say on Pay votes and annual review of the prior year's Say on Pay Season

### Nature of Compensation

- Decrease reliance on equity arrangements that do not directly relate to performance
- Work with outside compensation consultants and legal counsel to structure an appropriate package that implements (and illustrates to shareholders) the company's compensation philosophy
- Consider mandatory share ownership guidelines for directors and executives
- Adopt clawback policies, as appropriate

## Substantive Resources

- Retain and consult with outside consultant(s), including legal counsel, on a regular basis (best practice would be to retain different compensation consultants than normally used by the company)
- Ensure availability of independent consultants and outside legal counsel at meetings and decision-making events; treat attendance as mandatory
- Require and permit management to meet with and assist the compensation consultants in a way that does not compromise the Compensation Committee's authority over, or their relationship with, the consultants
- Proactively seek updates on the latest executive compensation developments
- Sponsor or obtain continuing education for Compensation Committee members
- With new rules regarding executive compensation disclosure (which require "plain English" disclosure), ensure that securities filings are timely and easily understood by shareholders and disclosure is transparent and full

## Pay-for-Performance

- Work with management and compensation consultants to develop performance metrics that support corporate strategies and meet short- and long-term shareholder interests with consideration of appropriate risk-mitigation practices
- Ensure a strong and easily describable link between executive compensation and company performance
- Differentiate short-term and long-term performance factors taken into account in analyzing short and long-term compensation
- Become comfortable with mix between guaranteed compensation (base salary, time-based equity awards, etc.) and at-risk performance compensation

- Ensure severance and change-in-control agreements are reasonable – providing appropriate protection but not rewarding for termination due to poor performance
- Committee is fully engaged in incentive goal setting process and goals are set before the performance period begins
- Analyze all executive compensation decisions to determine if fair and proportional to performance relative to shareholder expectations/results and industry peers
- Understand the concerns raised by ISS, Glass Lewis and stockholders in Say on Pay voting

### **Executive Oversight**

- Control or monitor negotiations with executives (even where the chief executive officer is taking the lead)
- Limit evergreen equity programs (ISS will categorically not support equity plans with evergreen provisions): consider year-to-year stock plans approved by shareholders
- Establish regular equity grant dates in order to minimize perception of market timing
- Move away from solely “market-driven” or “competitive” peer compensation benchmarking and move toward compensation programs that use both internally and externally focused benchmarking with appropriate companies (often times this will involve using different peer groups for different compensation components)
- Consider internal pay equity

## Executive Compensation and Corporate Governance Group

The Executive Compensation and Corporate Governance Group counsels technology and Fortune 500 companies on complex compensation and governance issues. Our Compensation and Corporate Governance Group includes an active group of public company compensation and corporate governance specialists who advise public and private companies and their management, officers, and directors, on:

- Compensation Committee “best practices”
- Compensation governance requirements of various exchanges, including NYSE and NASDAQ
- Director-and-officer duties and responsibilities
- Compensation and risk management programs
- Public company disclosure issues and related liability considerations
- Shareholder relations (including shareholder communications, responding to shareholder proposals, dealing with shareholder activities, institutional corporate governance advisors, and shareholder advisory firms) and executive succession planning
- Committee charters, codes of conduct, governance guidelines, and other governance-related programs and policies
- Proxy contests and other corporate control efforts

**The Compensation and Corporate Governance Group also provides day-to-day advice on:**

- Defining and structuring stock or other equity plans and cash compensation incentive arrangements
- Drafting executive employment, severance and change of control agreements
- Handling the issues that regularly arise with equity plans, executive compensation agreements and other employment benefit arrangements when clients are involved in mergers, acquisitions, private equity transactions and public securities offerings
- Advising on complex 409A deferred compensation and 280G parachute payment issues

**Our Corporate Governance Practice**



Our Corporate Governance Practice is headed by **Scott P. Spector**, whose practice emphasizes the compensation issues that arise in connection with mergers and acquisitions, and corporate governance matters involving executive compensation. He also specializes in serving high technology and life science clients in designing and implementing executive compensation, equity compensation and other employee benefit arrangements. He is an expert on Section 409A and 280G matters. Mr. Spector also represents numerous chief executive officers of technology in contract negotiation. Mr. Spector has chaired numerous committees and programs relating to executive compensation, including committees of the American Bar Association.



**Shawn E. Lampron** advises clients on a wide range of benefit and compensation programs, as well as the tax, securities and accounting issues related to these programs. Ms. Lampron works with clients to structure compensation and benefit programs covering the full spectrum of equity and cash compensation arrangements, including all types of employee stock options, restricted stock, employee stock plans, employment agreements, deferred compensation, and other fringe benefit arrangements.



**Blake W. Martell** negotiates and drafts employee benefits and equity compensation-related components of mergers and acquisition transactions. Mr. Martell has particular expertise in equity-based plans; corporate governance and disclosure; tax, securities and accounting treatment with respect to equity awards and plans; pension plans; welfare plans and retention/bonus plans.



