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2013 Proxies and Compensation Discussion and Analysis: Managing the Risk of Litigation and Evaluating Best Practices

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Managing Proxy Litigation Concerns
“Say on Pay”

The Dodd-Frank Act

- Requires a separate, nonbinding shareholder vote to approve the compensation of the named executive officers (i.e., say on pay) at least every 3 years.
- Requires, at least every 6 years, a shareholder vote on how often the say-on-pay vote will occur (every 1, 2, or 3 years).

Say-on-Pay Litigation

- Dodd-Frank has resulted in three main types of litigation: (1) litigation after negative say-on-pay votes; (2) proxy litigation regarding say-on-pay disclosures; and (3) "gotcha" litigation alleging that companies issued stock options that exceed the limits of the stock plan.
- Negative say-on-pay vote litigation: Usually these complaints are derivative in nature and consist of allegations that the directors breached their fiduciary duties by approving executive compensation awards and wasted corporate assets. This litigation is usually preceded by a negative say-on-pay vote, and the business judgment rule in Delaware makes these cases challenging for the plaintiffs to prevail in.
- Proxy litigation: These cases usually seek to enjoin shareholder say-on-pay votes and allege that the proxy does not provide adequate information for shareholders to make an informed vote.
  - Litigation in this area increased.
- Litigation that company issued stock awards in excess of their plans.

Similarities to Merger Litigation

- Brought by the same plaintiff law firms
- Seek to enjoin shareholder vote
- Plaintiffs attempt to settle the cases for enhanced disclosures and attorneys' fees
- One recent study found that merger litigation is brought in more than 90% of mergers over $100 million

Anatomy of Say-on-Pay Litigation

- Venue
  - Plaintiffs (like in merger litigation) may seek to avoid Delaware and file suit in the state of the company's principal place of business
- Precomplaint demand is sometimes made on the company's board of directors
  - Demand is required under Pennsylvania law
- Choice of law
  - Delaware law applies if the issuer is a Delaware corporation
  - Section 14(a) of the Securities and Exchange Act

Delaware Proxy Disclosure Law

- To state a disclosure claim under Delaware law, plaintiffs “must allege that facts are missing from the [proxy] statement, indentify those facts, state why they meet the materiality standard and how the omission caused injury.” *Skeen v. Jo-Ann Stores, Inc.*,750 A.2d 1170, 1173 (Del. 2000) (citing *Louden v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 142 (Del. 1997)).
  - The burden of demonstrating the disclosure violation and of establishing materiality rests with the plaintiffs. *In re CheckFree Corp. S’holders Litig.*, C.A. no 3193-CC, 2007 WL 3262188, at *2 (Del. Ch. Nov. 1, 2007).
  - It is not sufficient that information prove helpful; to be material, it must “significantly alter [] the total mix of information made available.” *Id*. at 2

A Typical Say-on-Pay Complaint

- Alleges the following “material” information should have been disclosed in the proxy:
  - Reasons for selecting or changing the company’s compensation consultant.
  - Summary of the compensation consultant’s analysis provided to the company’s board of directors.
  - Reasons that the company selected the compensation mix that it did.
  - Reasons for selecting certain companies as members of the company’s peer group for purposes of benchmarking compensation.
  - Details regarding the financial and compensation metrics used by the company’s peer group companies.
  - How the various performance measures were weighted by the compensation committee in order to determine executive officer compensation.

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Some Cases Based on Allegedly Inadequate Disclosures

- Favorable for Defendants
  - *Gordon v. Symantec*
  - *Noble v. AAR Corp.*
  - *Wenz v. Globecomm Sys., Inc.*
- Favorable for Plaintiffs
  - *Knee v. Brocade Commc'ns Sys. Inc.*
  - *St. Louis Ret. Sys. v. Severson*

Settlements

- Risk and cost vs. settlement
- Settlement amounts have similar “going rates” to merger litigation settlements

Considerations Going Forward

- While decisions suggest that courts view annual meeting proxy disclosure claims with skepticism, companies should be vigilant in ensuring that their proxy disclosures provide a “fair summary” of material information relied on by the board of directors in deciding to make the recommendation.
- Will this be a wave of litigation?
- Preventable litigation in this area.

Evaluating Compensation Committee Independence and Compensation Adviser Conflicts of Interest

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SEC's Rule 10C-1

- On June 20, 2012 the SEC adopted Rule 10C-1 under the Securities Exchange Act of 1934.
- Rule 10C-1 mandated that exchanges develop listing standards that prohibit listing of securities of any company that does not comply with the following specified compensation committee requirements:
  - Members must be independent;
  - Compensation committee must have authority to retain and obtain the advice of a "compensation adviser" and oversee and direct their work;
  - Companies must provide sufficient funding to enable compensation committees to reasonably compensate compensation advisers; and
  - In selecting a compensation adviser, compensation committees must consider certain factors relating to the independence of the adviser.
- Compensation advisers include compensation consultants, legal counsel, or other advisers.

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NYSE and NASDAQ
Final Listing Standards Under Rule 10C-1

- On January 11, 2013, the SEC approved proposed amendments to the listing standards originally proposed by NYSE and NASDAQ in September 2012 implementing Rule 10C-1.
- The final NYSE and NASDAQ listing standards generally become operative on July 1, 2013, but compensation committee member independence requirements become effective on the earlier of (i) the first annual meeting after January 15, 2014, or (ii) October 31, 2014.

NYSE Final Listing Standards on Committee Member Independence

- Requires compensation committee to be composed solely of independent directors (subject to cure period).
  - No bright-line test for independence.
- Requires board to consider all factors “specifically relevant” to determining whether a director is independent from management, including the two specified factors enumerated in Rule 10C-1:
  - Any compensation received by the director from any person or entity (including any consulting, advisory, or other compensatory fee paid by the company to such director); and
  - The director’s affiliate relationship with the company and its subsidiaries and affiliates.

NASDAQ Final Listing Standards on Committee Member Independence

- New rules require that each NASDAQ listed company:
  - Have a compensation committee consisting of at least two independent directors; and
  - The committee must adopt a charter
- Unlike NYSE, NASDAQ adopted a bright-line test to determine committee member independence (subject to cure period):
  - Each director on the compensation committee must not accept, directly or indirectly, any consulting, advisory, or other compensatory fee from the listed company or any of its subsidiaries.
  - Board must consider the affiliate status of each director and whether such affiliation would impair the director’s judgment as a member of the compensation committee.

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NYSE and NASDAQ Final Listing Standards on Compensation Adviser Independence

- The compensation committee may retain or obtain the advice of a compensation adviser.
- The compensation committee is responsible for the appointment, compensation (issuers must provide funding), and oversight of the work of a compensation adviser that it retains.
- The compensation committee may select a compensation adviser only after taking into consideration Rule 10C-1 independence factors.
  - NYSE includes a catch-all—consider "all" relevant factors, including the six factors
- Committee charter to include the committee's additional powers and responsibilities with respect to retention and assessment of the independence of compensation advisers.

Rule 10C-1 Independence Factors

- Provision of other services to the issuer by the employer of the compensation adviser;
- Amount of fees from the issuer paid to the adviser’s employer as a percentage of the employer’s total revenue;
- Policies and procedures of the adviser's employer that are designed to prevent conflicts of interest;
- Business or personal relationship of the compensation adviser with a member of the compensation committee;
- Stock of the issuer that is owned by the compensation adviser; and
- Business or personal relationship between the compensation adviser or adviser’s employer and the executive officers of the issuer.

NYSE and NASDAQ Compensation Adviser Independence

- Nothing in the NYSE or NASDAQ rules requires that an adviser be independent.
  - All that is required is that the compensation committee assess an adviser's independence before selecting or receiving advice from the adviser.
- Compensation advisers are not subject to the independence assessment if their roles are limited to the following:
  - Providing advice as in-house counsel;
  - Consulting only on nondiscriminatory, broad-based compensation arrangements; or
  - Providing information only on certain types of noncustomized survey data.

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Exemptions from NYSE and NASDAQ Final Listing Standards

- Both NYSE and NASDAQ exempt from these new listing standards requirements for certain entities such as foreign private issuers and limited partnerships.
- Smaller reporting companies:
  - NYSE:
    - *Exempt from heightened independence standards of compensation committee members and the requirement to assess compensation adviser independence.*
    - *Not exempt from standards relating to authority, responsibility, and funding of compensation advisers.*
  - NASDAQ:
    - *Exempt from all of the compensation–related requirements.*
    - *Not exempt from having independent compensation committee and a charter.*

Compensation Committee Adviser Conflict of Interest Disclosure

- On June 20, 2012, the SEC also amended Item 407(e)(3) of Regulation S-K by adding a new Item 407(e)(3)(iv).
- For the 2013 proxy season, companies must evaluate whether their compensation advisers used in determining executive or director compensation during the last fiscal year involved a conflict of interest
- Disclosure is required for any compensation adviser that is required to be identified under the existing proxy disclosure rules—regardless of whether a compensation adviser was retained by the compensation committee or by management.
- If a conflict of interest exists, the company must disclose in the proxy statement:
  - The nature of the conflict and
  - How the conflict is being addressed.
- There is no bright-line test, but the six factors should be used.

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Compensation Committee Adviser Conflict of Interest Disclosure

- Disclosure is <u>not</u> required if:
  - The company determines that there is no conflict. Consider providing “negative assurances”.
  - There is a potential conflict of interest or an appearance of a conflict of interest; only actual conflicts of interest must be disclosed.
  - A conflict of interest exists with certain exempt consultants or advisers not subject to the independence assessment.

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Practical Considerations

- Review and assess compensation committee composition to ensure independence under new listing standards.
- Review and update compensation committee charter to include independence requirements and adviser assessments now required.
- Review and update D&O questionnaire to reflect new independence requirements and adviser assessments now required.

Practical Considerations

- Analyze compensation adviser independence and potential conflict of interest based on six factors to determine if there is a current conflict of interest and whether there was one for 2012.
- Discuss with the company's compensation advisers what processes the compensation advisers may already have in place to assess the factors identified in the new rules.
- Consider adopting a policy that includes the committee's review of the policies of its advisers or prospective advisers to ensure that they will be able to comply with the independence requirements.
- Prepare and send questionnaire to compensation advisers to evaluate independence.
- If a conflict exists, consider how to address it, and how to disclose it.

ISS and Glass Lewis
2013 Voting Policy Updates
(Executive Compensation)

ISS 2013 Voting Policy Updates

- Pay-for-Performance Evaluation – Peer Group Selection
  - ISS reviews company pay and performance relative to ISS-selected peer group pay and performance
  - Peer group was based on company's GICS industrial classification
  - Peer group methodology revised to incorporate companies' self-selected compensation benchmarking peer groups

ISS 2013 Voting Policy Updates

- Pay-for-Performance Evaluation – Realizable Pay Analysis
  - Realizable pay will be considered as part of its assessment for a large-cap company (i.e., an S&P 500 Company) if the initial quantitative review finds a misalignment between pay and performance
  - Realizable pay based on specified measurement period and consist of sum of base salary, bonus, earned value or target value of long-term awards, net value realized from option exercises (or Black Scholes), change in pension value and deferred compensation earnings and other reported compensation

ISS 2013 Voting Policy Updates

- Say-on-Golden-Parachutes Proposals:
  - ISS will no longer grandfather preexisting problematic change-in-control severance practices.
  - The presence of problematic features could lead to an “against” vote (single trigger cash/equity severance, excessive cash severance and golden parachute payments, gross ups and recent amendments or actions (such as extraordinary equity grants)).

ISS 2013 Voting Policy Updates

- Pledging or Hedging Company Equity:
  - ISS will consider (on a case-by-case basis) the failure to prohibit hedging or significant pledging as a potential failure in overall board-level risk oversight.
  - May warrant an "against vote" recommendation for directors.
  - Any hedging is considered problematic
    - *hedging includes writing covered calls on stock*

ISS 2013 Voting Policy Updates

- “Significant pledging” is considered problematic
  - *Based on number of shares pledged relative to outstanding shares or market value or trading volume*
  - *Consider other factors disclosed in the proxy (policy prohibiting pledging, decline number of pledged shares)*
- If pledging/hedging is permitted, consider whether to continue or prohibit
- Consider what disclosure to make

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Glass Lewis Voting Policy Updates

- Equity Plan Share Counting: Equity plans up for shareholder approval will be examined for share-counting provisions that understate the potential dilution or cost to shareholders.
- Board Responsiveness: Board responsiveness to a negative shareholder vote will be under scrutiny any time 25% or more of shareholders vote against the recommendation of management on any proposal (abstentions and broker nonvotes are not included).

Glass Lewis Voting Policy Updates

- Board Committees: A new section describes the firm's approach to the role of directors who chair committees of the board and how Glass Lewis formulates committee-specific recommendations.
  - Provides that the chairman of each committee bears primary responsibility for the actions of the committee, and therefore committee-specific recommendations will often focus on the chairman of the committee as opposed to other individuals serving on the committee.
  - Policy applies to all committees, including the compensation committee.

2013 Proxy Best Practices

Proxy and CD&A Structure Considerations

- Executive Summary (CD&A):
  - Not a “must have” but fairly common practice
  - Focus on key accomplishments and/or significant events for the year and tell the pay-for-performance story
  - What is your compensation message?
- Proxy Summary:
  - Snapshot of entire proxy
  - Overall summary but focus on executive compensation changes
  - Highlight pay-for-performance philosophy
  - Balanced approach—both positive and negative

Proxy and CD&A Structure Considerations

- Pay For Performance:
  - The new executive compensation buzzword
  - What is the best way to disclose compensation (realizable, realized, W-2)
  - Be consistent—don't just disclose what looks good this year
- Long-Term Awards:
  - Why did company chose a type of award?
  - What are the performance metrics, if applicable?
  - Link to pay for performance and why criteria established?
  - How did company perform against peers?

Proxy and CD&A Structure Considerations

- Peer Group:
  - Focus on the who, what, and why?
  - Benchmark? What elements of compensation?
  - How does the company rank relative to other companies in the peer group by various measures? (Is there a chart that could be used in the CD&A?)
- Table/Chart Disclosure (Realized/Realizable Pay):
  - Performance relative to peers on key metrics, CEO 2012 pay relative to peer group based on direct and total compensation
  - CEO pay relative to TSR
  - Percentage of CEO variable pay to total pay

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Other Proxy Considerations

- Compensation Consultant Independence:
  - Where to include disclosure
  - What we are seeing companies disclosure
  - How to determine/analyze (questionnaires)

Dodd-Frank Pending Rules

- Hedging/Pledging (Section 955 of Dodd-Frank):
  - Existing rules require disclosure of any hedging policy that applies to NEOs, if material, but this does not require a company to have such a policy
  - The SEC has yet to adopt rules under Section 955 of Dodd-Frank that would eliminate the materiality threshold to require disclosure if employees or directors are permitted to purchase financial instruments that are designed to hedge or offset a decrease
  - ISS has begun to focus on hedging and pledging for NEOs

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Dodd-Frank Pending Rules

- Clawbacks: Section 954 of Dodd-Frank proposed rules regarding recovery of executive compensation and requires the SEC to adopt rules to require national securities exchanges to each adopt a clawback policy. These rules are not final.
  - Policy must include recovery of incentive-based compensation, including all annual and long-term incentive compensation.
  - Policy to include current and former executives covering a three-year look-back period preceding the date the company is required to prepare an accounting restatement (does not include rank-and-file employees).
  - Will require the company to disclose the policy in the proxy statement

Questions?

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