Morgan Lewis

2017 SECURITIES AND EXECUTIVE COMPENSATION UPDATES

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2017 PROXY DISCLOSURE ISSUES

Overview of 2017 Proxy Season Issues

- Most companies will need to submit “Say on Frequency” this year, if last submitted in 2011
- Begin preparing for pay ratio disclosure in 2018
- If you are approving or amending an equity compensation plan, consider adding non-employee director compensation limits
- Be mindful of SEC guidance requiring “appropriate” descriptions of shareholder proposals on proxy cards in compliance with “clear and impartial” requirements of the proxy rules

2016 Shareholder Proposals – Likely to Continue in 2017

- Proxy Access – 76
  - 2017 includes requests for "amendments"
- Appoint Independent Board Chair – 47
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2016 Proxy Disclosure Trends to Continue in 2017

- Emphasis on shareholder engagement and telling the story in the proxy statement
  - How many shareholders were contacted and responded
  - Types of feedback received
  - Changes made in response
- Ongoing use of proxy and CD&A summaries
- Increased use of graphical presentations to show formulas and trends
- Increased use of alternative pay measures such as realized and realizable pay
- Focus on the integration of the compensation committee's work with the company's strategic plan – explaining the connection

2016 Proxy Disclosure Trends to Continue in 2017 (cont.)

- Continued increase in use of Board skills matrices
- Board tenure
- Sustainability and commitment to the environment disclosure continue to increase
- Increased use of CD&A tables of contents and navigational technology
- General improvement in readability and usability, particularly in CD&A, but not shorter disclosure; more companies turning it into a "marketing document"; hiring consultants to assist in design
- Discussions of how director compensation decisions are made (peer group(s) used and how competitive market analysis was used to determine pay)

Say on Frequency Vote

- Under Section 951 of Dodd-Frank and SEC final regulations, shareholders must have the opportunity to cast an advisory vote on whether the company's Say on Pay vote should be held (1) every year, (2) every other year, or (3) every three years
- Vote must occur no later than the annual meeting held in the sixth calendar year after the last vote (for most companies, this is 2011)
- Most companies hold the Say on Pay vote annually
- For many companies, Say on Frequency vote will be required at their 2017 annual meeting
- Results of the vote and the company's decision on frequency of the Say on Pay vote must be disclosed in Form 8-K reporting annual meeting results

TRENDS IN 2017 EXECUTIVE COMPENSATION

Non-Employee Director Compensation Litigation

- Recent lawsuits have challenged director compensation under Delaware law at several public companies (claiming breach of fiduciary duty, unjust enrichment, corporate waste)
- Core issue is that outside directors are viewed as interested parties with respect to their own compensation
- The directors received their grants under an equity plan that did not specify the amount or the form of compensation to be granted to non-employee directors, and the non-employee directors who received the grants also approved them
- A director equity program may lose the protection of the business judgment rule under Delaware law due to that arguable self-interest, making it subject to the much higher "entire fairness" standard

Non-Employee Director Compensation Litigation (cont.)

- Most companies do not want to subject their compensation arrangements to that scrutiny or run the risk of defending the claim at trial
- As a result, companies may choose to settle
- Recent settlements indicate where the trend may go; sample size is very small, but the following may be part of the mix:
  - dollar-amount cap on director equity (not share cap)
  - submission of cap to shareholder vote
  - compensation committee commitment and charter amendment to hire independent consultant to advise annually on cash and noncash director compensation
  - enhanced disclosure on outside director compensation, including philosophy and process
- Consider proactively adopting some or all

Non-Employee Director Compensation Litigation (cont.)

Recommendations

- Review how outside director compensation practices compare to proxy peers' practices
- Hard cap on director equity
  - Implement through a plan amendment and express as a dollar-amount limit, not as a number of shares
- Submission of the cap amendment for shareholder vote
  - Shareholder approval is generally not required by the NYSE rules, but approval is needed to secure the protection of the business judgment rule
  - Because the amendment is a hard cap, the provision will need to be resubmitted for a shareholder vote each time a company wants to increase it
- Enhanced disclosure on outside director compensation
  - Proxy disclosure should include (a) a philosophy on outside director compensation, (b) the process that the company, committee, and board followed to arrive at the amounts for the year, and (c) the specific annual award for each outside director

New FASB Standard on Stock Withholding to Satisfy Tax Obligations

- The prior rule:
  - To maintain favorable equity classification treatment for a share-based award, cash settlement of the award for tax-withholding purposes could not exceed the minimum statutory withholding requirement
- The new rule:
  - Permits tax withholding on share-based awards up to the maximum statutory rate
  - Effective for annual reporting periods beginning after December 15, 2016 and interim periods within those annual periods (public companies)
- Many equity compensation plans have the minimum statutory tax rate "hardwired" into the plans, so that an amendment is required to effect this change

Share Withholding for Taxes

- NYSE rules require shareholder approval of any “material revision” to an equity plan
- Under recent NYSE guidance, a plan amendment to provide for the withholding of shares based on the participant’s maximum tax obligation (or compensation committee discretion to authorize such withholding) is not a material amendment if the shares withheld were never issued
- Special rules apply if the plan allows shares withheld to cover taxes due on restricted stock grants to be added back to the plan

Share Withholding for Taxes (cont.)

- In order to exempt the disposition of shares through share withholding from being a "sale" of shares under Section 16 (insider trading rules), Rule 16b-3(e) requires <u>advance</u> approval by the Compensation Committee or the Board
- The Compensation Committee should approve the resolutions before any shares are withheld for Section 16 officers
- The company should not retain discretion to determine whether shares will be withheld, or the amount of share withholding, for Section 16 officers
- Rule 16b-3(e) requires that the advance approval be specific, but there is no guidance from the SEC as to how much specificity is needed

Share Withholding for Taxes (cont.)

- An SEC CDI indicates that share withholding for Section 16 officers should not exceed the participant's estimated federal state, local, and foreign tax obligations attributable to the underlying transaction

Share Withholding for Taxes (cont.)

- Federal tax withholding on equity awards can be determined in one of two ways:
  - By treating the payment as a supplemental wage payment subject to the 25% withholding rate on supplemental wages up to $1 million (39.6% on supplemental wages of greater than $1 million); or
  - By applying the withholding amount generated by an employee’s Form W-4

Share Withholding for Taxes (cont.)

- An employee may file a revised Form W-4 claiming a reduced number of exemptions or entering a specific dollar amount of increased withholding as a means of increasing the withholding rate toward the 39.6% level
- The IRS process does not allow an employee to specify a percentage rate for federal income tax withholding on Form W-4
- The Form W-4 must apply to all wages paid to the employee while the Form W-4 remains in effect
- Procedures should be implemented to ensure that an employee who increases tax withholding through Form W-4 does not direct withholding of amounts in excess of the maximum applicable tax rate or, in the case of Section 16 officers, the estimated taxes on the equity award distribution

Share Withholding for Taxes and Exercise Price Payment – New Section 16 Disgorgement Claim

- New Section 16 disgorgement claims are being made that seek to match open-market purchases by Section 16 insiders with exempt-reported tax and exercise price withholding transactions elected by Section 16 insiders
- Letters were sent to dozens of companies and the claimants have filed multiple lawsuits following company refusals to disgorge profits from insiders

ISS AND GLASS LEWIS UPDATES: CORPORATE GOVERNANCE

Director "Overboarding"

- In 2016, ISS and Glass Lewis both announced lower overboarding thresholds with a one-year transition period, during which time they would only include cautionary language. For 2017, both ISS and Glass Lewis will begin issuing negative recommendations when overboarding is present.
- ISS will recommend withholding votes from:
  - Directors who are not CEOs of public companies who serve on more than **five** public company boards (the prior threshold was six public company boards)
  - Directors who are CEOs and serve on more than **three** public company boards (including their own (no change from 2016))
- Glass Lewis will recommend withholding votes from:
  - Directors who are not public company executive officers who serve on more than **five** public company boards
  - Directors who are public company executive officers (not just CEOs) of more than **two** public companies (including their own)

Board Evaluation and Refreshment

- Glass Lewis has clarified its policy regarding board evaluation, succession planning, and refreshment to focus on a qualitative assessment and alignment of director skills with company strategy
- This policy eschews a quantitative or hard line approach to sole reliance on age or tenure limits
- Glass Lewis has indicated that it strongly supports:
  - Routine director evaluations, including through independent external reviews
  - Periodic board refreshment, in order to foster the sharing of diverse perspectives and the generation of new business ideas

Unilateral Bylaw and Charter Amendments

- For 2017, ISS has added more specificity to the types of provisions contained in a newly public company's charter or bylaws that will lead to an adverse or withhold vote recommendation
- If a company implemented a multiclass capital structure in which classes have unequal votes, ISS will generally issue against or withhold recommendations for director nominees, at least in the first year following the IPO
- ISS has indicated that unless the "adverse provision and/or problematic capital structure" is reversed or removed, its recommendation on director nominees will be on a case-by-case basis in subsequent years

Unilateral Bylaw and Charter Amendments (cont.)

ISS may issue adverse vote recommendations if the charter and bylaws contain provisions "materially adverse to shareholders rights" after considering the following factors:

- the level of impairment of shareholders' rights;
- disclosed rationale for the adverse provision;
- ability to change governance structure;
- annual director elections or classified board structure;
- reasonable sunset provisions; and
- other relevant factors

Binding Shareholder Proposals

- ISS has adopted a new policy under which it generally will recommend voting against or withholding votes from members of a governance committee on an ongoing basis as long as the company imposes "undue restrictions" on the ability of shareholders to amend the bylaws
- Such restrictions include, but are not limited to:
  - an outright prohibition on the submission of binding shareholder proposals
  - Share-ownership requirements or time-holding requirements in excess of Rule 14a-8

Stock Dividends and Splits

- ISS has clarified that it generally will vote for management proposals to increase the common share authorization for a stock split or stock dividend, provided that the effective increase in authorized shares is equal to or less than the allowable increase calculated in accordance with ISS's Common Stock Authorization Policy
- The update is meant to take into account instances in which proposals to increase authorized shares may be tied to the implementation of a planned stock split or stock dividend

ISS AND GLASS LEWIS UPDATES: EXECUTIVE COMPENSATION

Hot-Button Items for ISS

- From a review of ISS 2016 proxy reports, two issues stood out:
  - Discretionary elements in annual pay programs. Some SEC comment letters in which the SEC Staff is pressing companies to say, when you have discretionary compensation and list the factors considered, how those factors actually weighted into the compensation decisions.
  - How "rigorous" are the performance goals. If goals are lowered year over year, the company should describe why the goal is a **real** performance goal.

Executive Compensation Policy FAQ Updates

- **Relative Pay and Financial Performance Assessment**. Financial performance will be measured over the trailing 12 quarters (16 for growth metrics) for each company based on:
  - Return on invested capital
  - Return on assets
  - Return on equity
  - EBITDA growth
  - Cash flow growth
  - Revenue growth
- **Total Compensation Calculation**. As of December 2016, all stock-based awards will be calculated by multiplying the number of underlying shares (at target) by the closing stock price on the grant date, instead of the grant date fair value as reported in the Grants of Plan-Based Awards table

Executive Compensation Policy FAQ Updates (cont.)

- **Problematic Pay Practices**.
  - ISS has added a new factor for problematic pay practices under its policy
  - Payment of bonuses, despite failure to achieve pre-established threshold performance criteria, will be considered a problematic pay practice
- **Absence of Say on Pay Vote**. Unless the company provides a sufficient explanation for the omission of a Say on Pay or Say on Frequency vote, ISS will recommend voting against the compensation committee chair (or entire committee) until the vote is presented to shareholders
- **Advisory Vote on Golden Parachutes**.
  - There are new criteria for ISS evaluation of equity award treatment upon a change in control
  - New factors include maintaining vesting criteria for converted awards and magnitude of accelerated awards

US Executive Compensation Policy FAQ Updates

Other Questions.

- How does ISS evaluate management advisory proposals seeking shareholder approval of non-employee director pay?
- How does ISS approach US-listed companies with multiple executive compensation proposals on the ballot as a result of the companies' incorporation in a foreign country?

Equity Compensation Plan FAQ Updates

- Burn rate calculation for performance-based awards
- ISS evaluation of equity plan proposal seeking approval of one or more plan amendments
- ISS evaluation of Section 162(m) re-approval proposals
- ISS evaluation of plan amendments to increase the tax withholding rate upon award settlement
- Changes to Equity Plan Scorecard (EPSC) policy for 2017
- EPSC factors for 2017
- ISS assessment of plan minimum vesting requirements
- Updates to evaluation of equity plan proposals at newly public companies

ISS Evaluation of Equity Plan Proposals

- Continue to be evaluated on a case-by-case basis
- Note that while proposals seeking only approval to ensure tax deductibility of awards pursuant to Section 162(m) generally will receive favorable recommendations, ISS will not grant a favorable recommendation if the Section 162(m) proposal is "bundled" with plan amendments contained in the same proposal
- This position is in direct contrast to guidance by SEC Staff that they will not object to the presentation of multiple changes to an equity incentive plan in a single proposal, even if the changes can be characterized as material in the context of the plan and the rules of a national securities exchange would require shareholder approval of each of the changes if presented on a standalone basis

ISS: Equity Plan Scorecard Updates

ISS has revised the factors and weightings under its EPSC policy to include an additional factor – an evaluation of the payment of dividends on unvested awards

- Full points will be earned if the equity plan expressly prohibits the payment of dividends before the vesting of the underlying award (with no deduction of points if the plan permits the accrual of dividends payable upon vesting)
- No points will be earned if such prohibition is absent from the text of the equity plan
- Depending on other plan features, companies may not need to eliminate payment of dividends on unvested awards in order to obtain a favorable recommendation from ISS

ISS: Equity Plan Scorecard Updates (cont.)

In addition, the EPSC policy has been revised with respect to the minimum vesting factor

- Full points will be earned if the equity plan specifies a minimum vesting period of one year for all award types
- No points will be earned if the plan allows individual award agreements to provide for less than a minimum of one year of vesting

ISS Pay-for-Performance Methodology

- Effective February 1, 2017, ISS will include relative evaluations of return on equity, return on assets, return on invested capital, revenue growth, EBITDA growth, and cash flow from operations growth in its pay-for-performance reviews
- These additional financial measures are in addition to ISS's continued use of TSR as a key metric for its evaluation of executive compensation
- ISS has indicated that this information will not impact the quantitative screening results during the 2017 proxy season, but it may refer to the new metrics in its qualitative review and its consideration may mitigate or heighten identified pay-for-performance concerns
- The metrics and weightings will be based on a company's four-digit GICS industry group

ISS: Non-Employee Director Pay

- ISS has expanded its framework for evaluating non-employee director pay and certain non-employee director pay proposals submitted to shareholders for approval
- These types of proposals have become more common as a result of recent litigation alleging excessive non-employee director compensation, which is what caused ISS to publish its new voting policy on this topic
- ISS indicated that this new policy was simply formalizing the criteria that ISS previously used to evaluate these proposals and, as a result, companies should expect ISS to take the same approach that it took in 2016

ISS: Non-Employee Director Pay (cont.)

ISS will consider the following qualitative factors relating to management proposals seeking shareholder approval of non-employee director compensation:

1. the relative magnitude of director compensation as compared to companies of a similar profile;
2. the presence of problematic pay practices relating to director compensation;
3. director stock ownership guidelines;
4. equity award vesting schedules;
5. the mix of cash and equity-based compensation;
6. meaningful limits on director compensation;
7. the availability of retirement benefits or perquisites; and
8. the quality of disclosure of the director compensation

ISS: Non-Employee Director Pay (cont.)

- ISS has also updated its policy to clarify and broaden the factors that it will consider when evaluating non-employee director equity plans
- Two new factors: relative pay magnitude and meaningful pay limits
- On a case-by-case basis, ISS will evaluate the total estimated cost of the company’s equity plans relative to industry/market cap peers, measured by the following factors:
  - the company’s estimated SVT, based on new shares requested plus shares remaining for future grants, plus outstanding unvested/unexercised grants
  - the three-year burn rate relative to industry/market cap peers
  - the presence of any “egregious” plan features (e.g., option repricing provision)
- ISS will take into account additional qualitative factors in cases where the plan will exceed the plan cost or burn rate benchmarks when combined with other company employee or executive stock plans

EQUITY PLAN DEVELOPMENTS

Trends and Considerations

- Increasing, or permitting the Compensation Committee to approve an increase in, the share withholding limit beyond the minimum amount
- Non-employee director share limits
- Fresh look at performance goals for Section 162(m) performance-based compensation
- ISS EPSC methodology
  - Overall considerations of where willing to sacrifice points for flexibility (e.g., discretionary amendment authority balanced against minimum vesting schedules)
  - At least one-year minimum vesting schedules
  - Compensation Committee discretion to amend
  - Special vesting triggers (death, disability, retirement, change in control, etc.)
  - Change in control definition and providing expressly for double-trigger vesting
  - Share recycling
  - Update to repricing provision

Trends and Considerations (cont.)

- Balancing Board discretion against potential negative accounting impacts
- Providing for deferrals of equity compensation
- Beyond ISS and Glass Lewis, consider investor reaction to plan provisions—the most common compensation-related shareholder proposal in 2016 related to preventing vesting of equity awards upon a change in control or seeking double-trigger change in control vesting

UPDATE ON NON-GAAP FINANCIAL MEASURES

SEC's Strategic Priorities

- SEC announced that, in its fiscal year-end September 2016, it filed 868 enforcement actions:
  - New single-year high
  - Orders totaled more than $14B in disgorgements and penalties for a third year in a row
- SEC continues to prioritize issuer reporting and disclosure matters as well as awareness of cyber risks, and focus on the role of auditors and other gatekeepers.
- Whistleblower program continues to have a tremendous impact – since inception, the SEC has awarded more than $111M to 34 whistleblowers.

Top Trends in SEC Comment Letters

- MD&A – "Tell your story" comments
  - Results of operations – trends and uncertainties and quantify changes in f/s line items
  - Liquidity
  - Critical accounting policies and estimates
  - Contractual obligations
- Non-GAAP measures
- Fair value
- Segment reporting
- Income tax
- Revenue recognition
- Intangible assets and goodwill
- Signatures, exhibits, or agreements
- Acquisitions, mergers, and business combinations
- Internal control over financial reporting

SEC Focus on Non-GAAP Measures

- Several factors have led to this SEC focus:
  - Increased use and prominence of non-GAAP financial measures
  - Nature of adjustments
  - Increasingly large difference between GAAP amounts reported and non-GAAP measures
- New non-GAAP CDIs issued in May 2016
- In 2016, comments on non-GAAP measures were included in 23% of reviews with comment letters, compared with 17% in 2015. This is expected to rise in 2017.

Focal Areas of Non-GAAP Comments

- Undue prominence of a non-GAAP measure
  - Headlines, highlights, bullets
  - Executive summaries
- Use of “tailored” non-GAAP revenue
- Inappropriate reconciliations
- Disclosures about the purpose and use of non-GAAP measures and clear labeling
- Liquidity versus performance measures
  - Per-share liquidity measures
- Nature of reconciling adjustments and related disclosures
- Selective adjustments
- Normal, recurring adjustments
- Tax effects

Themes Emerging with Non-GAAP Comments

- For earnings releases, comments on:
  - Specific adjustments and whether those adjustments may be considered normal, recurring expenses that may be prohibited under the CDIs
  - Certain industry metrics to ensure that they do not use individually tailored accounting principles

Non-GAAP Measures and Proxy Disclosure

- With the new non-GAAP CDIs, the SEC did not change its view regarding disclosure relating to the use of non-GAAP measures in executive compensation programs
- Instruction 5 to S-K, Item 402(b) continues to provide that target levels of non-GAAP financial measures will not be subject to Regulation G and S-K, Item 10(e); however, disclosure must be provided as to how the number is calculated from the audited financial statements
- In non-GAAP CDI 108.01, the SEC reiterated this instruction and also that non-GAAP measures presented in the CD&A or any part of the proxy for any other purpose, such as to explain the relationship between pay and performance, are subject to Regulation G and Item 10(e)

IMPLEMENTING DODD-FRANK

Dodd-Frank Implementation Overview

- The Trump Factor?

Provision	Proposed	Final	Effective	Applicable to
CEO Pay Ratio	September 18, 2013	August 5, 2015	W/r/t compensation in fiscal years beginning on or after January 1, 2017 (reported in 2018 proxy statement). Transition for newly public companies	Reporting companies other than emerging growth companies, smaller reporting companies and foreign private issuers
Clawback	July 1, 2015	TBD	SEC – TBD; exchanges have one year to adopt rules following effectiveness of SEC rule; companies then have 60 days to adopt policy	All issuers listed on a national securities exchange. Covers compensation based on financial info for periods ending on and after SEC effectiveness
Pay for Performance Disclosure	April 29, 2015	TBD	TBD; phase-in for number of covered years in the new table	Reporting companies other than emerging growth companies and foreign private issuers
Hedging Disclosure	February 9, 2015	TBD	TBD	Reporting companies other than foreign private issuers

Brief Overview of the CEO Pay Ratio Rule

- Disclosure will be effective for the 2018 proxy season but covers 2017 data
- Requires a company to disclose in its proxy statements the ratio of the CEO’s total pay to the median total pay of all US and non-US employees
- Although effective for 2018 proxy disclosures, some companies will include a version of a CEO pay ratio in their 2017 proxy statements
- May include:
  - Ratio of CEO pay to all US-only employees
  - Ratio of CEO pay to all corporate headquarters’ employees
  - CEO pay relative to other NEOs’ pay

CEO Pay Ratio – Final Rule

- Executives, board members, and companies' HR and legal functions are studying these rules
  - The information companies must collect is extensive and the calculations are likely to be complicated
  - Most companies will require a combination of services from internal functions, including HR and legal, and external providers, including counsel, compensation consultants, and accountants
  - Press coverage has been extensive and we can expect much more when disclosure starts coming out
  - Some institutional investors and pension funds have expressed the desire to see this disclosure before 2018

Calculating the Ratio: Suggested Action Steps

- Brief the Board and/or Compensation Committee on the rule requirements
- Organize a team of internal professionals to comply with the rules
- Develop an action plan for compliance. Implementation of the new rule will require certain decisions:
  - **Evaluate Alternative Methodologies for Identifying the Median Employee**. Each company may select a methodology to identify its median employee based on the company's facts and circumstances, including total employee population, a statistical sampling of the population, or other reasonable methods. For example, a company could identify the median of its population or sample using any consistently applied compensation measure from compensation amounts reported in its payroll or tax records.
  - **Consider Cost-of-Living Adjustments**. The rules explicitly allow a company to apply a cost-of-living adjustment to the compensation measure it uses to identify the median employee.

Calculating the Ratio: Suggested Action Steps (cont.)

- **Determine Total Compensation**. Assess your ability to calculate precisely all items of compensation or whether *reasonable estimates* may be appropriate for some elements. Companies may use reasonable estimates when calculating any elements of the annual total compensation for employees other than the CEO (with disclosure).
- **Select a Testing Date**. The rules allow a company to select a date *within the last three months of its last completed fiscal year* on which to determine the employee population for purposes of identifying the median employee.

Calculating the Ratio: Suggested Action Steps (cont.)

- **Non-US Employees**. The rules allow a company to exclude non-US employees from the determination of its median employee in two circumstances:
  - Non-US employees that are employed in a jurisdiction with data privacy laws that make the company unable to comply with the rules without violating those laws. The rules require a company to obtain a legal opinion on this issue.
  - Up to 5% of the company's non-US employees, including any non-US employees excluded using the data privacy exemption. Under this exception, if a company excludes any non-US employee in a particular jurisdiction, it must exclude all non-US employees in that jurisdiction.

Calculating the Ratio: Suggested Action Steps (cont.)

- **New Employees**. The rules allow a company to exclude certain new employees from its calculation
  - A company may exclude any employees obtained in a business combination or acquisition for the fiscal year in which the transaction becomes effective
  - Companies may annualize the total compensation for a permanent employee who did not work for the entire year, such as a new hire or an employee on an unpaid leave of absence
  - Companies may not annualize the compensation of part-time, temporary, or seasonal workers when calculating the required pay ratio

Calculating the Ratio: Suggested Action Steps (cont.)

- **Independent Contractors**. Individuals employed by unaffiliated third parties or independent contractors would not be considered employees of the company. However, the rules do not appear to allow companies to exclude many of the individuals that other areas of the law would recognize as independent contractors.
  - Companies should re-examine the workers they currently characterize as independent contractors
- **Other Benefits Provided to Employees**. The rules allow a company to include personal benefits that aggregate less than $10,000 and compensation under non-discriminatory benefit plans such as health and retirement plans in calculating the annual total compensation of the median employee as long as these items are also included in calculating the CEO's annual total compensation.

Preparation for New Internal Pay Ratio Disclosure

- A Mercer spot survey performed in August 2016 found the following:
  - Companies are making significant progress toward compliance. Three-fourths of respondents had identified a method to identify the median employee or are considering one or more methods.
  - 60% of respondents had estimated their ratio – more than half reporting ratios under 200:1 and only 20% reporting ratios of more than 400:1.
  - Ratios vary by industry. Sectors with the lowest ratios are in banking, technology, and non-financial services. The highest ratios are in retail and consumer goods.

Preparation for New Internal Pay Ratio Disclosure (cont.)

- About 1/3 of respondents are using or considering statistical sampling as a method to identify the median employees
- More than 80% of respondents believe their systems are ready or, with some manual effort, adequate to identify the median employee

- Compensation Committee Discussions
  - Compensation committees are expressing concern regarding income inequality that may be demonstrated by the ratio
  - Companies should prepare their committees for this disclosure and put it into context
  - Companies should consider whether additional information/analysis or other internal pay equity disclosure may be helpful as they evaluate their ratio disclosure

Mitigate Negative Reaction to CEO Pay Ratio Disclosure

- Ensure that competitive compensation opportunity levels are monitored annually against the median of an appropriate peer group
- Ensure that the executive compensation program design provides pay-for-performance linkage, including challenging goals and with a majority of target compensation in the form of long-term equity
- Apply “best practice” compensation policies, including robust stock ownership guidelines, clawbacks, and policies, and prohibit hedging and pledging in company stock
- Consider how the company will address and explain disclosure of the CEO pay ratio

Pay Versus Performance

- Proposed April 29, 2015; still no final rules, and timing uncertain
- Will require companies to disclose information in their proxy statements (not 10-K) showing the relationship between executive compensation actually paid and the companies' financial performance
- Required for the last 5 fiscal years; 3 fiscal years for smaller reporting companies
- Transition rules will require information for only 3 fiscal years for the first annual filing, and 4 for the second annual filing; smaller reporting companies start with 2 years then go to 3

Pay Versus Performance (cont.)

- Each company must provide the following information for each year in a new table:
  - CEO's total compensation as shown in the Summary Compensation Table (SCT)
  - Compensation "actually paid" to the CEO (devil is in the details)
  - Average total compensation from the SCT and as actually paid for the remaining NEOs
  - Company's total shareholder return (TSR) (same data as in the stock price performance graph in the 10-K)
  - TSR for the company's peer group (except smaller reporting companies)

Hedging Policy

- Proposed February 9, 2015; no final rules, and timing uncertain
- Requires proxy disclosure of:
  - whether the company permits any employees, officers, or directors to engage in hedging transactions or to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds)
  - categories of transactions/persons permitted to engage in hedging
  - categories of transactions/persons prohibited from engaging in hedging
- Review your current policies and prepare for disclosure

Clawback Policy

- Proposed July 1, 2015; no final rules, and timing uncertain
- Listed companies must adopt, disclose, and comply with a written policy to recoup "incentive-based compensation" in the event of an accounting restatement due to "material noncompliance" with any financial reporting requirement (no-fault rule)
- Applies to any compensation "granted, earned or vested" based wholly or in part on any financial reporting measure
- Covers any current or former executive officer who "received" erroneously awarded incentive-based compensation
- Covers last three completed fiscal years preceding the date on which the company determined or should have determined that a restatement would be required (actual payment date is irrelevant)
- Recovery amount equals the excess over what would have been paid giving effect to the accounting restatement

CORPORATE GOVERNANCE ISSUES

Proxy Access

- In 2016, more than 200 companies received proposals
- Companies adopting proxy access, usually in response to shareholder proposals, are including disclosures regarding shareholder engagement
- Many companies adopted proxy access bylaw provisions that were different than shareholder proposals
  - In many cases, this disclosure has led to ISS and Glass Lewis not recommending a vote against directors for provisions in the bylaws that were discussed (and not objected to) with institutional shareholders
  - At least one activist is using proxy access for its nominee
    - It appears to relate to a strategic matter regarding the spin-off of the company's utility business
  - This procedure could also be used for perceived corporate governance failures, including relating to executive compensation
    - In June 2016, compensation standards reported that, of 20 activist campaigns that were tracked, 9 had a criticism of company executive compensation-related matters

Corporate and Social Responsibility

- Companies are increasingly under pressure from shareholders to consider corporate and social responsibility matters as part of business operations, including emissions, other sustainability, etc.
- Companies are increasingly incorporating environmental and safety metrics into their compensation programs, particularly annual bonus programs (often ranging from 15%-30% of award formula)
- SEC disclosure concept release and speeches by former SEC Chair White also indicate a trend toward additional disclosures regarding environmental and sustainability matters in 10-Ks and 10-Qs
  - Given Trump's de-regulation emphasis, it is unlikely that there will be additional rule-making requiring more CSR disclosures

Shareholder Engagement

- Proxy statements are increasingly dedicating space to discussion regarding shareholder engagement on a range of topics, including executive compensation
- With management Say on Pay votes, many companies are annually having discussions with major shareholders regarding their executive compensation programs, particularly in years of poor stock performance and related risk of negative vote recommendations by ISS and Glass Lewis
- Major shareholders are increasingly being solicited for design ideas, or reactions to proposed compensation design features
- Shareholders and proxy advisors are pushing formulaic compensation design

Commonsense Principles of Corporate Governance

- Jaime Dimon, Warren Buffet, and institutions have issued strong statements supporting long-term investment (and criticizing short-termism)
- They have expectations that the design of executive compensation will encourage and reward executives for achieving business goals in furtherance of the long-term strategy
  - Compensation should be tailored to the business
  - It should have current and long-term components
  - Disclose performance goals
  - Not entirely formula based, with discretion for qualitative factors
  - 50% or more of pay in stock for management
  - Explain clear linkage between pay and performance
  - Companies should have clawback policies

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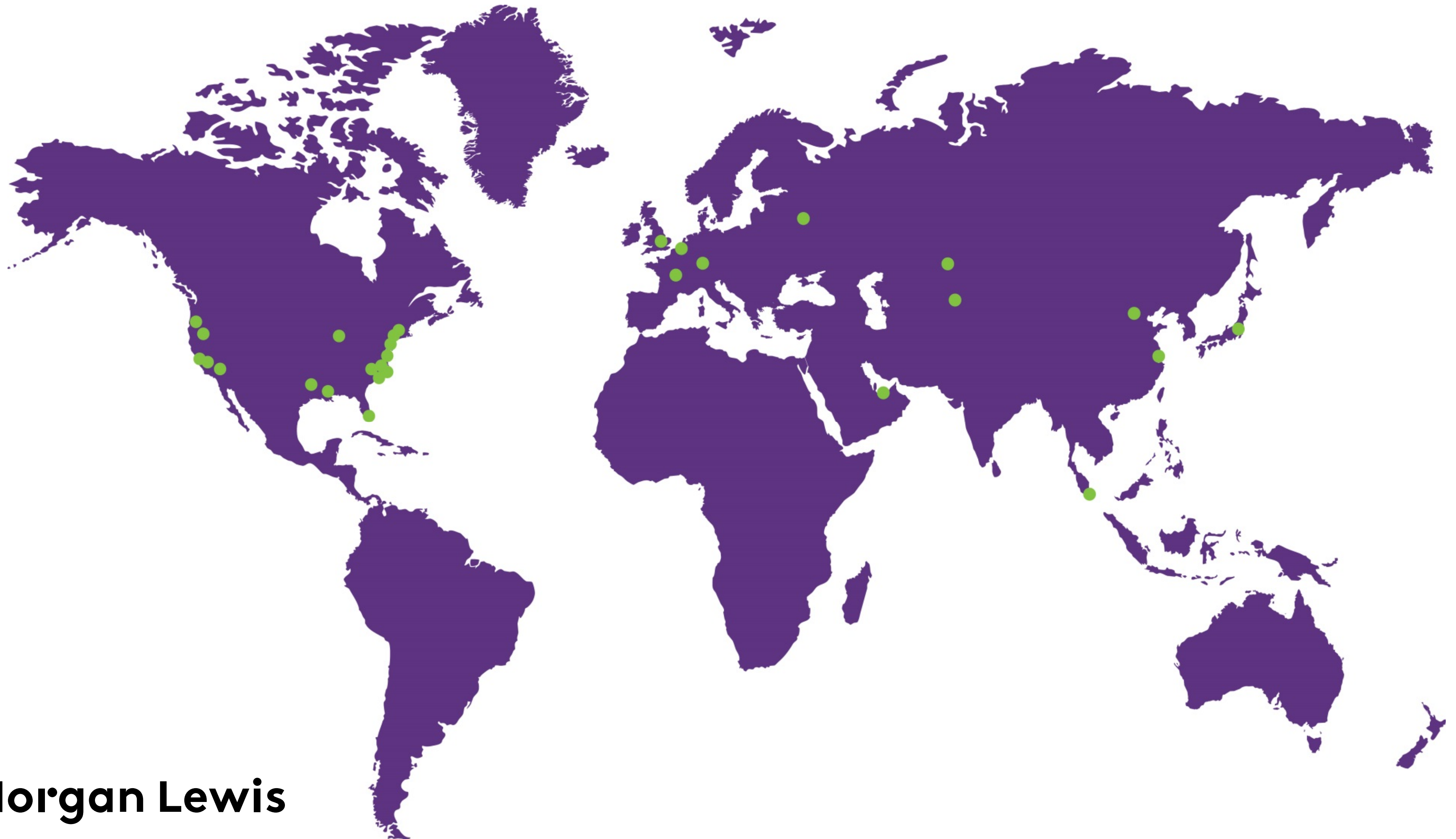

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