Harvard Law School Forum on
Corporate Governance and Financial Regulation

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2017 Compensation Committee Guide

Posted by Michael J. Segal, Wachtell, Lipton, Rosen & Katz, on Wednesday, March 29, 2017

Editor's note: Michael J. Segal is the senior partner in the Executive Compensation and Benefits Department of Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton publication.

The past year has been marked by a continued focus by shareholders and investor groups on executive compensation, and a related continued need for compensation committees to proactively manage their companies' communications with shareholders and proxy advisory firms—both in the context of the nonbinding, advisory "say-on-pay" votes required by Dodd-Frank and also as preemptive actions against possible shareholder activists seeking the means by which to challenge board composition. While 2015 witnessed finalization by the U.S. Securities and Exchange Commission (the "SEC") of the Dodd-Frank pay ratio disclosure rules and the issuance of proposed rules regarding clawbacks and pay vs. performance disclosure, the 2016 election has thrown the continued viability of those rules into doubt. Additionally, the plaintiffs' bar continues to challenge compensation decisions, often with little success but great annoyance.

Against this backdrop, the key challenge for compensation committee members continues to be to approve compensation programs that directors believe are right for their companies, while maintaining an understanding of shareholder views and an ability to communicate the appropriateness of their compensation decisions sufficient to avoid criticism that could undermine directors' abilities to act in their company's best interest. In our *Compensation Season 2017* post, we identified the following key considerations for compensation committees in the upcoming compensation season:

- Say-when-on-pay voting, which is required at least every six years since 2011. Consequently, 2017 may be the first time that many companies are holding this vote since the first time it was required. Absent extraordinary circumstances, an annual vote is the prevailing (and perhaps most prudent) approach, as it provides shareholders, Institutional Shareholder Services ("ISS") and Glass-Lewis with an avenue to express concerns with a company's compensation program, other than by taking action against compensation committee members.
- The continued need to proactively engage with large investors in order to provide them the opportunity to voice concerns they may have over a company's compensation programs, in connection with any upcoming say-on-pay vote. Clear communication in the proxy statement's Compensation Disclosure and Analysis regarding any changes made in response to such discussions can help dilute negative vote recommendations that could be made by ISS or Glass Lewis. Companies should be mindful that ISS and Glass-Lewis have updated their say-on-pay and other voting guidance regarding compensation matters.

- Companies also should be mindful that the controversial Dodd-Frank regulations regarding pay ratio disclosure are already final, with the first proxy statements to include such disclosure slated for 2018. The President and Congressional leaders have proposed an ambitious agenda to reduce business regulations and, in what could be the first step toward changing the pay ratio rule, in February 2017 the SEC reopened public comments on it. However, at the time of this publication the final pay ratio rule remains in place and the Administration has just begun its initiatives to review and rollback Dodd-Frank regulations, so companies will want to carefully monitor statutory and regulatory developments this coming year. At the very least, the new Administration's activities likely delays implementation of the already proposed regulations regarding disclosure of pay for performance, clawbacks of executive compensation and the potential for proposed regulations regarding disclosure rules for employee and director hedging.
- Companies will also need to continue to monitor shareholder activism and how any such activity can impact compensation arrangements, especially if an activist obtains a significant equity stake in the company, and consideration of appropriate employee retention incentives and protections to ensure that management remains focused on shareholder interests, including ensuring sufficient equity plan share reserves are available for long-term incentive grants. The time to adopt appropriate management protections with the least shareholder pushback is before an activist shows up.
- Directors should bear in mind the heightened sensitivity to pay packages that could be deemed "excessive." This is particularly true in today's environment, which has witnessed a marked increase in litigation on executive compensation matters, a trend we expect will continue at least in the short run. To that end, companies may wish to consider including in new or amended equity plans provisions specifying the precise amount and form of director compensation (which might include both cash and equity), or a meaningful director-specific individual award limit. Such limits may help avoid and defend claims challenging the level of director compensation, whether by shareholders or, increasingly, firms such as ISS. Given the ongoing shift in the corporate governance landscape, there is also a continuing focus by directors on the proper role of a compensation committee.

These challenges notwithstanding, a compensation committee that follows normal procedures and considers the advice of legal counsel and an independent consultant should not fear being second-guessed by the courts, which continue to respect executive compensation decisions so long as the directors act on an informed basis, in good faith and not in their personal self-interest. In the final analysis, the ability to recruit and retain highly qualified executives is essential to the long-term success of a company. The primary objectives of this post (and the complete publication, available here) are to (1) describe the duties of public company compensation committee members and (2) provide information to enable compensation committee members to function most effectively. Like our prior Guides, this post continues to be structured in a manner intended to first provide compensation committee members an overview of their responsibilities, before delving in more detail into the primary substantive issues with which compensation committees most often deal, as follows:

- This post begins with a discussion of the responsibilities of the public company compensation committee and its members, including those imposed by the various securities markets and Dodd-Frank, including disclosure requirements regarding executive and director compensation. The complete publication then reviews the fiduciary

duties of compensation committees and their members under various applicable laws (Chapter II).

- The complete publication then outlines different means of compensating executives and the tax and other rules that apply to compensation arrangements (Chapters III and IV), followed by a discussion of change in control arrangements (Chapter V). We next examine regulation of compensation at financial institutions (Chapter VI).
- Chapter VII of the complete publication focuses on shareholder proposals, relations and litigation, including a discussion of say-on-pay votes and the ongoing influence of proxy advisory firms.
- The discussion then shifts to compensation committee composition, meetings and charters (Chapters VIII, IX and X).
- Finally, the complete publication addresses the compensation of directors (Chapter XI).
- Examples of compensation committee charters for both NYSE and NASDAQ listed companies are also included as Exhibits A and B.

Key Responsibilities of Compensation Committee Members

The U.S. Securities and Exchange Commission (the "SEC"), the New York Stock Exchange (the "NYSE") and the NASDAQ Stock Market ("NASDAQ") require a publicly held company to have a compensation committee that assumes a number of compensation-related responsibilities. It also is advisable for compensation committees to assume certain additional responsibilities. It is important, therefore, that a compensation committee understand what is expected of it, and that it be diligent in ensuring that it appropriately and faithfully fulfills its mandate.

A. Responsibilities Imposed by the Securities Markets and Dodd-Frank

1. New York Stock Exchange Requirements

The NYSE requires that all listed companies subject to its corporate governance listing standards have a compensation committee composed entirely of independent directors with a written committee charter that addresses all of the duties described in this section. The NYSE further requires that the compensation committee carry out a number of minimum responsibilities. While the responsibilities of a compensation committee may be delegated to subcommittees, each subcommittee still must be composed entirely of independent directors and also have a published charter.

Under the NYSE rules, a compensation committee must (a) review and approve goals and objectives relevant to the chief executive officer's ("CEO") compensation, (b) evaluate the CEO's performance in light of such goals and objectives, and (c) either as a committee or together with the other independent directors determine and approve the CEO's compensation based upon such evaluation. In determining the long-term incentive component of CEO compensation, the NYSE suggests that a compensation committee consider (1) the company's performance and relative shareholder return, (2) the value of similar incentive awards to CEOs at comparable companies, and (3) the awards given to the CEO in past years. Compensation committee responsibilities regarding CEO compensation do not preclude discussion of CEO compensation with the board of directors generally.

In addition, under the NYSE rules, a compensation committee must recommend non-CEO executive officer compensation to the board of directors. This requirement means that a listed company's compensation committee must recommend compensation of the president, principal financial officer (the "CFO"), principal accounting officer (or, if there is no principal accounting officer, the controller), any vice president of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function or any other person who performs similar policy-making functions. A compensation committee also is charged with recommending to the board of directors the approval of incentive and equity-based compensation plans that are subject to board of directors approval. Additionally, the NYSE reiterates and adopts the SEC requirement that a compensation committee produce a report on executive officer compensation required to be included in the listed company's annual proxy statement or annual report on Form 10-K.

Under the NYSE listing standards adopted in response to Dodd-Frank, the compensation committee may, in its sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser, and is directly responsible for the appointment, compensation and oversight of that adviser's work. The company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to the adviser. Prior to retaining an adviser (other than in-house legal counsel or an adviser that consults on broad-based plans that do not discriminate in favor of executive officers or directors), the compensation committee must, subject to limited exceptions, take into consideration all factors relevant to that adviser's independence from management, including (1) whether the adviser's firm provides other services to the company; (2) the amount of fees from the company received by the adviser's firm relative to the total revenue of the adviser's firm; (3) conflict-of-interest policies of the adviser's firm; (4) any business or personal relationships between the adviser and members of the compensation committee; (5) any stock of the company owned by the adviser; and (6) any relationships between the adviser or the adviser's firm and an executive officer of the company. These rules do not require the compensation committee to retain only independent advisers; rather, they mandate that the compensation committee consider the above six factors (and any other factors, if relevant) before selecting an adviser.

Lastly, a compensation committee must conduct an annual self-evaluation of its performance. Many consulting firms have published their recommended forms and procedures for conducting these evaluations. Consultants also have established advisory services to assist a committee with the evaluation process. A compensation committee must decide how to conduct its evaluation. In making the decision, it is not required that the directors receive outside assistance, and no specific method of evaluation is prescribed. A compensation committee may elect to do the evaluation by discussions at meetings. Documents and minutes created as part of the evaluation process are not privileged, and care should be taken not to create ambiguous records that may be used in litigation against the company and its directors.

2. NASDAQ Requirements

Under NASDAQ listing standards adopted in response to Dodd-Frank, NASDAQ-listed companies are now required to have a compensation committee consisting of at least two independent directors. The independence requirements under the NASDAQ rules are discussed in Chapter VIII of the complete publication.

The CEO is prohibited from attending meetings while the compensation committee members are deliberating or voting on the CEO's compensation. NASDAQ places no such restriction on other executive officer attendance and does not prohibit the attendance of the CEO during compensation committee discussions concerning other executive officer compensation.

NASDAQ provides, however, that if a compensation committee is composed of at least three members, then, under exceptional and limited circumstances and if certain conditions are met, one director who is not independent under its rules may be appointed to the compensation committee without disqualifying the compensation committee from considering the compensation matters that could ordinarily be entrusted to it had it been fully independent. A compensation committee or a company's independent directors must approve equity compensation arrangements that are exempted from the NASDAQ shareholder approval requirement as a prerequisite to taking advantage of any such exemption.

As with the NYSE rules, NASDAQ rules provide that the compensation committee may, in its sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser, and is directly responsible for the appointment, compensation and oversight of that adviser's work. The company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to the adviser. NASDAQ rules require the compensation committee to consider the six factors described in Section A.1 of this post, but do not expressly require the compensation committee to take into consideration all of the factors relevant to an adviser's independence from management.

NASDAQ now requires the compensation committee to have a formal charter, as described in greater detail in Chapter X of the complete publication.

B. CEO and Executive Officer Compensation

While both the NYSE and NASDAQ only require that a compensation committee recommend to the full board of directors non-CEO executive officer compensation, vesting complete authority in the compensation committee for such individuals is advisable given the requirements of Section 162(m) of the Code, the insider trading short-swing profit safe harbor of Rule 16b-3 under Section 16(b) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and state law fiduciary duty jurisprudence, all of which provide substantial incentives for the compensation of executive officers to be determined by a committee of independent directors. A detailed discussion of the requirements of Section 162(m) of the Code and Rule 16b-3 under the Exchange Act is set forth in Chapters IV and VIII of the complete publication.

In evaluating and setting executive officer compensation, a compensation committee should be deliberative and guided by its established compensation policy. If compensation levels are linked to the satisfaction of predetermined performance criteria, a compensation committee should discuss whether, and to what degree, the criteria have been satisfied. In addition, as more fully discussed in Chapter IV of the complete publication, it may be necessary for a compensation committee to certify satisfaction of such performance criteria to comply with the tax deductibility requirements of Section 162(m) of the Code.

Further, to help ensure that compensation and severance packages are justifiable, members of a compensation committee should fully understand the costs and benefits of the compensation

arrangements that they are considering. Particular attention should be paid to severance arrangements and to all benefits provided to senior management in connection with termination of employment, as well as the impact of a change in control of the company on equity incentives and other compensation arrangements. It may be useful for a compensation committee to utilize a tally sheet, which provides a concise breakdown of the various components of a given executive officer's compensation package in scenarios which include continued employment, termination of employment and change in control of the company.

C. Non-Executive Officer Compensation and Broad-Based "ERISA" Plans

There is no particular allocation of responsibilities for the compensation and benefits of a company's employees that is right for every company. Companies should consider whether the compensation committee will have responsibility for employee compensation beyond that of executive officers. In addition, companies should consider whether the compensation committee will have responsibility for risk oversight in incentive compensation plans for all employees, as discussed in Section I of this post, below. Limiting a compensation committee's responsibility to executive officer compensation may make sense for many companies so that directors can concentrate their limited time and resources on establishing proper incentives for those employees who are most likely to influence company performance. However, companies should be mindful that due to increased focus on pay ratios and shareholder litigation surrounding compensation issues generally, it may be useful for compensation committees to increase their oversight of total compensation expenditures (e.g., bonus compensation in financial institutions). Ultimately, the full board of directors is charged with allocating compensation responsibilities, but the compensation committee may be best equipped to make recommendations to the full board of directors concerning the compensation committee's scope of responsibility.

As noted in Chapter II of the complete publication, a compensation committee also may have fiduciary responsibilities under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), for certain broad-based employee benefit plans, either as a result of language in plan documents or the compensation committee's own charter, or by virtue of actually exercising such responsibilities. It is possible for a plan to state that the full board of directors or the compensation committee is responsible for administering ERISA plans or for managing the investment of their assets, either of which will implicate ERISA's fiduciary duty rules, which in most instances require the fiduciary act exclusively for the benefit of the plan participants. It may or may not be appropriate for a compensation committee to assume such responsibilities—like shareholder litigation surrounding compensation issues generally, it may be more useful to limit the responsibility of boards of directors and their committees with respect to employee benefit plans—but, in any event, companies should ensure that the documentation and actual exercise of fiduciary responsibilities are consistent, and that all who are ERISA fiduciaries are aware of that fact and understand the legal responsibilities it entails.

D. Development of Compensation Philosophy

A compensation committee must develop a compensation policy tailored to the company's specific business objectives in order to evaluate, determine and meet executive compensation goals. It should be noted that a compensation policy not only makes good business sense, but the SEC requirements for the Compensation Discussion & Analysis section of the annual proxy statement (the "CD&A") require discussion of such a policy.

E. Compensation-Related Disclosure Responsibilities

A compensation committee should oversee compliance with all compensation-related disclosure requirements. Such compliance presents a significant challenge in light of the comprehensive SEC rules regarding disclosure of executive officer and director compensation. Compensation committee members should request that management review with them (1) potential disclosures that may be required in connection with compensation-related actions, including the timing requirements for any such disclosure, and (2) the nature of the information to be disclosed in upcoming public filings, including information relating to the compensation committee members themselves. Importantly, under current SEC guidance, a company that receives an SEC comment letter due to noncompliance with executive compensation disclosure rules will have to amend any materially noncompliant filings. Set forth below are the principal components of the executive compensation disclosure required each year.

1. Compensation Discussion and Analysis

The CD&A provides investors with material information necessary for an understanding of a company's compensation policies and decisions regarding the named executive officers ("NEOs"), which generally include the CEO, the CFO and the three most highly compensated executive officers other than the CFO and CEO. In particular, the CD&A must explain the rationale behind all material elements of "Named Executive Officer" (NEO) compensation, including the overall objectives of the compensation programs and the rationale underlying and method of determining specific amounts for each element of compensation. Under Dodd-Frank, a company also must address in its CD&A whether (and if so, how) the company has considered the results of the most recent say-on-pay vote in determining compensation policies and decisions.

The CD&A is considered "filed" with the SEC; accordingly, misleading statements in the CD&A expose a company to liability under Section 18 of the Exchange Act. In addition, to the extent that the CD&A is included or incorporated by reference into a periodic report, the disclosure is covered by the CEO and CFO certifications required by the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"). If forward-looking information is included in the CD&A, a company may rely on the safe harbors for such information.

2. Compensation Committee Report

A company must include a Compensation Committee Report in its proxy statement and its annual report on Form 10-K (incorporation by reference into the Form 10-K from the proxy statement is permitted). The Compensation Committee Report recites whether a compensation committee has reviewed the CD&A, discussed it with management and recommended it to the board of directors. The names of the compensation committee members must appear below the report. To help ensure the accuracy of the Compensation Committee Report, the compensation committee should have detailed discussions with management concerning the CD&A in advance of the filing deadline.

3. Additional Annual Disclosure Regarding NEO Compensation

The SEC rules require quantitative elements of executive compensation of NEOs to be disclosed in tabular format, together with narrative explanations and footnotes that describe the quantitative disclosure. The central component of the tabular disclosure is the Summary Compensation Table, which discloses, by category, all compensation earned by each NEO during the prior fiscal year, including compensation attributable to salary, bonus, equity awards, change in pension value, earnings on nonqualified deferred compensation, and perquisites.

Other required tables provide detailed information regarding:

- equity awards and bonus award opportunities granted to NEOs during the last fiscal year;
- outstanding equity awards at the end of the last fiscal year, including vesting schedule and exercise price, to the extent applicable;
- stock options that NEOs have exercised during the last fiscal year and NEO stock awards that have vested during the last fiscal year;
- pension plan participation by NEOs, including accumulated benefits and any payments during the last fiscal year; and
- NEO participation in deferred compensation plans, including executive and company contributions, earnings, withdrawals, distributions, and the aggregate balance at the last fiscal year end.

Finally, companies must describe the circumstances in which an NEO may be entitled to payments and/or benefits upon termination of employment and/or in connection with a change in control and quantify the value of those payments and benefits as of fiscal year end. As discussed in greater detail below, companies may wish to consider utilizing in their annual proxy statements the format prescribed by Dodd-Frank for disclosing and quantifying change in control protections in proxy statements relating to corporate transactions.

4. Director Compensation Table

The SEC rules also require a Director Compensation Table that must provide disclosure regarding director compensation during the prior fiscal year that is comparable to the Summary Compensation Table for NEOs, including disclosure with respect to perquisites, consulting fees and payments or promises in connection with director legacy and charitable award programs. Additionally, the company must provide narrative disclosure of its processes and procedures for the determination of director compensation. As discussed in Chapter XI of the complete publication, recent shareholder litigation regarding director compensation has increased focus on expanding this disclosure.

5. Compensation Committee Governance

Narrative disclosure regarding the governance of a compensation committee is also required by SEC rules. The narrative disclosure must describe a company's processes for determining executive and director compensation, including: the scope of authority of the compensation committee; the extent to which the compensation committee may delegate its authority; and any role of executive officers and/or compensation consultants in making determinations regarding executive and/or director compensation. If compensation consultants play a role in determining executive and/or director compensation, a company must identify the consultants, state whether

they are engaged directly by the compensation committee, and describe the nature and scope of their assignment.

6. Compensation Consultants and Advisors

SEC rules require annual disclosure of the role of compensation consultants in determining or recommending executive and director compensation, including:

- the identity of consultants engaged;
- whether the consultants were engaged directly by the compensation committee;
- the nature and scope of the assignment; and
- under certain circumstances, the value of the services provided.

Dodd-Frank added another layer of requirements relating to compensation consultants, and the SEC has adopted related rules. Under these rules, a company must disclose whether the work of a compensation consultant who played any role in determining or recommending the form or amount of executive and director compensation raised any conflicts of interest, the nature of any such conflicts and how the conflicts are being addressed.

7. Risk and Broad-Based Compensation Programs

To the extent that risks arising from a company's compensation programs for employees generally (not just executives) are reasonably likely to have a material adverse effect on the company, the SEC rules require a stand-alone discussion in the annual proxy, independent from the CD&A, of the company's compensation programs as they relate to risk management and risk-taking incentives. The threshold under the rules—reasonably likely to have a material adverse effect—sets a high bar for disclosure. A company should engage in a systematic process involving participants from its human resources, legal and finance departments, in which it (1) identifies company incentive compensation plans, (2) assesses the plans to determine if they create undesired or unintentional risk of a material nature, taking into account any mitigating factors, and (3) documents the process and conclusions. If a company concludes that its programs are not reasonably likely to have a material adverse effect, no disclosure is required; although, as a practical matter, it may be advisable to provide such disclosure because ISS has encouraged disclosure about the review process and the company's conclusions and, to the extent no disclosure is provided, the SEC may seek confirmation from the company that the risk review was done and that the company determined that disclosure was not required. While the compensation committee need not be involved in the evaluation of risk as applied to incentive compensation arrangements themselves, the compensation committee should satisfy itself that management has designed and implemented appropriate processes to make such evaluations.

8. Remaining Dodd-Frank Disclosure Requirements

In 2015, the SEC issued either proposed or final rules regarding certain compensation-related disclosure requirements mandated by Dodd-Frank. On February 9, 2015, the SEC issued proposed rules regarding annual disclosure as to whether employees or directors may engage in hedging transactions on company stock, and on April 29, 2015, the SEC issued proposed rules regarding annual disclosure of the relationship between executive compensation actually paid to

executive officers of a listed company and the financial performance of such company (so-called "pay-for-performance" disclosure, discussed in more detail in Chapter IV of the complete publication). On July 1, 2015, the SEC also proposed rules regarding the recovery of executive compensation (so-called "compensation clawbacks," discussed in more detail in Chapter IV of the complete publication). These rules await finalization by the SEC, although they may turn out to be on the new Administration's chopping block.

Dodd-Frank also requires annual disclosure of the ratio between the CEO's annual total compensation and the median compensation of all other employees. In August 2015, the SEC adopted final rules implementing this mandate (originally proposed in 2013), with an effective date of October 19, 2015. These rules require pay ratio disclosure to be included in annual proxy statements to be filed in respect of the first fiscal year beginning on or after January 1, 2017. Accordingly, a company with a calendar year fiscal year must first include the disclosure in its Form 10-K or annual meeting proxy statement filed in 2018. Due to the potential complexity of compliance, particularly for large, multi-national corporations, consideration of the impact of this disclosure should be given to taking steps during 2017 toward computing the first pay ratio, rather than waiting for next year's proxy season. In what could be the first step toward changing the pay ratio rule under the new Administration, in February 2017 the SEC re-opened public comments on it. However, as of the publication date of this post the rule remains in effect, and companies need to continue to prepare for its implementation.

Below is a brief summary of the final pay ratio rules:

- *Covered Filings and Companies*: Subject to limited exceptions, SEC reporting companies will be required to include the pay ratio disclosure in annual reports on Form 10-K, registration statements and proxy and information statements, whenever these forms require other executive compensation disclosures under Item 402 of Regulation S-K. Emerging growth companies, smaller reporting companies, foreign private issuers, U.S.-Canadian Multijurisdictional Disclosure System filers and registered investment companies are not subject to these rules.
- *Measuring the Employee Population*: For purposes of calculating the pay ratio, companies are required to consider the annual total compensation of "all employees" (other than the CEO and contract/leased workers), which term includes all worldwide fulltime, part-time, temporary and seasonal workers employed by the company and its consolidated subsidiaries. The employee population may be measured as of a date selected by the company within the last three months of its most recently completed fiscal year (as opposed to the last day of the company's most recently completed fiscal year). In addition, the final rules include a handful of exclusions that companies may find useful (as described in more detail in our post on these rules, dated August 6, 2015).
- *Identifying the Median Employee*: The final rules provide companies with flexibility when identifying the median employee. First, companies may narrow the employees to be included in the determination of the median by using statistical sampling or other reasonable methods. Second, to identify the median of the employees included in the calculation, the rules permit the company to use either (a) annual total compensation (as described further below) or (b) any other compensation measure that is consistently applied to all employees included in the calculation, such as information derived from the company's payroll or tax records (e.g., W-2 reportable wages). Third, the final rules

permit the company to make certain cost-of-living and annualizing adjustments in identifying the median employee and annual total compensation. Finally, the final rules permit the use of the same median employee for three consecutive years, unless there has been a change in the employee population or employee compensation arrangements that the company reasonably believes would result in a significant change in the pay ratio disclosure.

- *Determination of Total Compensation*: Once identified, the median employee's and the CEO's annual total compensation is to be determined in accordance with the disclosure rules that prescribe the calculation of total compensation for the named executive officers for purposes of the annual proxy Summary Compensation Table. In recognition of the potential for valuation difficulties in respect of certain types of benefits, the rules permit a company to use reasonable estimates to calculate annual total compensation or any elements of total compensation for the median employee. In addition, whether a company exercises the discretion allowed under the executive compensation disclosure rules to include or exclude from the calculation of the CEO's annual total compensation personal benefits that aggregate to less than $10,000 and compensation under nondiscriminatory benefit plans, the company must take the same approach for the median employee; because such amounts are likely to constitute a relatively larger portion of the median employee's annual total compensation, excluding such amounts could increase the ratio. If a company replaces its CEO mid-year, the final rules permit the company to either (1) combine the total compensation of each CEO as reported in the Summary Compensation Table or (2) annualize the compensation of the person serving as CEO as of the date that the employee population is measured.
- *Pay Ratio Disclosure*: The final rules require that the pay ratio be expressed either (1) as a ratio in which the annual total compensation of the median employee is equal to one (e.g., 1 to 268), or (2) narratively in terms of the multiple that the CEO's total compensation amount bears to the annual total compensation of the median employee (e.g., the CEO's annual total compensation is 268 times that of the annual total compensation of the median employee). In addition, the final rules require a company to briefly describe its methodology for identifying the median employee, including any material assumptions, adjustments or estimates used to identify the median employee or to determine total compensation or any elements of total compensation. Further, to promote comparability from year to year, if a company changes the methodology or material assumptions, adjustments or estimates from those used in the previous period, and if the effects of any such change are significant, the company must briefly describe the change and the reasons for the change.

9. Conclusion

The importance of clear, thorough compensation disclosure that effectively conveys the business rationale for executive compensation decisions is greater than ever, due to the significant attention from the SEC, media and corporate governance activists, and the imposition of mandatory say-on-pay. Companies should expect heightened focus on, and accordingly clearly explain the basis for, pay levels relative to total shareholder returns, termination and change in control payments, benchmarking practices, the existence and nature of compensation clawback policies and the relationship between particular compensation arrangements and risk.

F. Internal Controls

As part of the compensation committee's responsibility to oversee compliance with legal rules affecting compensation, it should oversee compensation disclosure procedures and the company's compensation-related internal controls. Companies should supplement disclosure controls and internal controls with a system to track and gather the information required under the compensation disclosure rules. Individuals to be included in the Summary Compensation Table must be determined by reference to total compensation (excluding the amounts included in the change in pension value and nonqualified deferred compensation columns). Note that these individuals (other than the Chief Financial Officer) constitute "covered employees" within the meaning of Section 162(m) of the Internal Revenue Code. As such, companies should make sure that they have systems in place to track all of the includible components of compensation for their executive officers, including the value of perquisites, tax gross-ups and amounts paid/accrued in connection with a termination of employment or a change in control, as well as to track "specified employees" within the meaning of Section 409A of the Internal Revenue Code.

G. Equity Compensation Grant Policy

Companies should review the manner in which equity compensation awards are granted to employees and directors. While any given company's equity grant practices will be tailored to the company's particular business and administrative needs, each company should consider establishing a written equity compensation award grant policy that complies with, and specifies that grants will be made in accordance with, state law, the compensation committee charter and the applicable equity compensation plans. While it may be tempting to provide a high level of specificity regarding the timing of equity grants, and there may be utility in doing so, consideration also should be given to preserving the flexibility to make off-cycle grants under exceptional circumstances. All parties involved in the granting of awards should be provided with copies of the policy and should familiarize themselves with its key terms. Note, however, that certain shareholder advisory firms, such as ISS, no longer take into account policies (such as burn rate commitment policies or guidelines proffered by companies) in analyzing compensation-related shareholder proposals.

H. Management Succession

The board of directors' role in selecting and evaluating the CEO and senior leadership, and planning for succession, is a critical element of the company's strategic plan and should be approached with an "expect the unexpected" mindset. A leadership gap can undermine confidence in the future of the company as well as in the company's ability to navigate immediate and evolving challenges. Boards of directors should also take note that succession planning is not only relevant to the CEO position. Boards of directors should regularly consider the succession of all key executives.

To the extent that a company has not given responsibility for succession issues to its nominating and governance committee, companies should consider charging the compensation committee with the responsibility of ensuring the existence of an appropriate management development and succession strategy. In addition to safeguarding against a leadership vacuum, careful succession planning is an excellent way to meet compensation challenges, as studies indicate that it is considerably more expensive to recruit senior talent from outside an organization than from inside, and pay packages for outside recruits are often more publicized and scrutinized than

compensation arrangements for internal candidates. This can be especially true if CEO succession arises out of a reaction to a crisis, rather than as a result of controlled planning.

In the case of CEO succession, there are two key corporate governance- related elements that should be near the top of a board's list for evaluating potential CEO candidates. The first is that the new CEO should be a good fit culturally with the board and the company. The tone set by the CEO helps to shape corporate culture and permeates the company's relationships with investors, employees, customers, suppliers, regulators, local communities and other constituents. The second key element is that the CEO should have a long-term vision for the company that accords with that of the board. A crucial aspect of this is the ability to resist the powerful forces of short-termism.

Once a decision has been made to replace a CEO, it will typically be necessary to implement the decision on a very compressed timetable, as institutions cannot long tolerate uncertainty regarding the identity of top leadership or the source of authority. Accordingly, once a decision is taken, the board must be prepared to decide immediately how and when to communicate the decision to the outgoing CEO. If the board has a view on the manner of separation (e.g., retirement or other alternatives), it should be prepared to communicate that view and implement it. The board also must be prepared to articulate a clear decision regarding the identity of the successor and must take steps to ensure as smooth a transition as possible, including socializing the decision with the company's senior leadership team. Finally, the board will need to consider the disclosure obligations under the Form 8-K rules and applicable exchange rules regarding the decision to remove its CEO, which require prompt disclosure to the company's stockholders.

There are no prescribed procedures for planning succession; therefore, a board of directors should review succession plans on a regular (at least annual) rather than reactive basis. Ultimately, the integrity, dedication and competence of the CEO and senior management are critical to the success of a company, and the board of directors should take care to implement a sensible, company-specific succession plan.

I. Role of Risk in Compensation Programs

1. The Role of the Compensation Committee in Risk Oversight of Incentive Compensation

The public and political perception that undue risk-taking was central to the financial crisis has fueled an extensive legislative and regulatory focus on risk management and risk prevention. The SEC has adopted disclosure rules that require discussion in proxy statements of the board of directors' role in overseeing risk and the relationship between a company's overall employee compensation policies and risk management. Risk management and compensation have also received heightened focus from shareholder activists and other "good governance" proponents, such as ISS. In addition, the regulatory framework applicable to financial institutions requires all financial institutions to evaluate incentive compensation and related risk management, controls and governance processes, and to address deficiencies or processes inconsistent with safety and soundness.

Given these developments, risk oversight of incentive compensation arrangements should be a priority for all compensation committees. While the compensation committee cannot and should not be involved in actual day-to-day risk management as applied to incentive compensation

arrangements, directors should, through their risk oversight role, satisfy themselves that management has designed and implemented risk-management processes that (1) evaluate the nature of the risks inherent in compensation programs, (2) are consistent with the company's corporate strategy, and (3) foster a culture of risk-aware and risk-adjusted decision-making throughout the organization.

As noted above, the compensation committee generally is responsible for setting compensation of executive officers. However, the potential for excessive risk in incentive compensation programs is not limited to programs that cover executive officers. Accordingly, we generally recommend that the compensation committee receive reports related to the identification and mitigation of excessive risks in programs for non-executive officers as well as executive officers, and, as described in Chapter VI of the complete publication, the regulations applicable to financial institutions require board approval on a broader scale.

Risk in incentive compensation programs cannot be examined in isolation. In overseeing risk in incentive compensation programs, the compensation committee should take into account the company's overall risk-management system and tolerance for risk throughout the organization and should discuss with members of the committee charged with risk oversight the most material risks facing the business. Companies may wish to consider including on the compensation committee a member of the audit or other committee that oversees risk generally. Through a coordinated approach, the board of directors can satisfy itself as to the adequacy of the risk oversight function and understand the company's overall risk exposures.

The ability of the compensation committee to perform its oversight role effectively is, to a large extent, dependent upon the flow of information among the directors, senior management and the risk managers in the company. Compensation committee members need to receive sufficient information with respect to the material risk exposures affecting the company and the risk-management strategies, procedures and infrastructure designed to address them.

Businesses necessarily incur risk in the pursuit of profits, and excessive risk aversion can be harmful to essential corporate goals. Moreover, the field of risk analysis as applied to compensation programs is an emerging one in which the most successful techniques are still evolving and disagreement exists as to some of the most fundamental questions. Nevertheless, the assessment of risk in incentive compensation arrangements, the accurate calculation of the appropriate way to reward risk, and the prudent mitigation of risk should be incorporated into the design of all incentive compensation arrangements. Risk reviews of incentive compensation arrangements should attempt to ensure that the level of risk embedded in incentive compensation arrangements is not excessive and is consistent with the company's articulated strategy.

2. Management's Risk Analysis

Risk analysis of incentive compensation programs often begins with assembling a risk-identification team. The team should include representatives from business units, as well as the human resources, legal, audit, finance and, if applicable, risk-management departments. By establishing an integrated cross-disciplinary team, management can help ensure that there is adequate expertise and information flow across different corporate functions and business units.

Once a company establishes its risk identification team, the team should inventory existing incentive compensation programs. As noted above, plans subject to risk review should include those that cover individuals or groups of employees, whether or not they are executive officers, who have the ability to materially influence financial results.

After identifying the relevant incentive compensation programs, management should consider the range of material risks inherent to its businesses, as well as the time horizons over which those risks may materialize. Relevant risks may include risks related to operations, finance, liquidity, markets, counterparties, legal issues, compliance and misconduct, among others. Management should understand risks that have a small probability of being realized but would be disastrous if they occurred.

Once management has identified risk factors, a company can consider the individual variables of the relevant compensation programs that may increase or decrease risk. The following is a non-exhaustive list of some of the features that may impact the risk profile of an incentive compensation program.

The number of participants in each program

Less Risk	More Risk
Fewer participants	More participants

The plan metrics

Less Risk	More Risk
Risk-adjusted metrics (e.g., economic profit)	Revenue or transaction-based metrics
Multiple metrics	Single metric
Negative discretion	No discretion
Based on general performance of company or business unit	Based solely on revenue or profit generated by employee

Measurement, determination and adjustment of payout

Less Risk	More Risk
Smaller aggregate and individual payouts	Larger aggregate and individual payouts
Tiered goals and award levels with narrower bands and/or increments	All or nothing goals, larger increments and narrower range between threshold and maximum performance
Capped payout	Uncapped payout

Longer performance period	Shorter performance period
Deferred payout	No deferral of payout

The maximum amount of potential revenue and potential losses or liabilities that could result from the businesses covered by the program and/or the plan

Less Risk	**More Risk**
Small revenue, potential losses, liabilities or payout	Large revenue, potential losses, liabilities or payout

After management has identified any programs that could incentivize employees to assume excessive risks, management should consider risk mitigation techniques to calibrate those programs to the risk profile of the organization. Management should periodically update the compensation committee on its efforts in this regard. Below is a non-exhaustive list of potential mitigation tactics:

- *Lengthen Performance Period and/or Implement Clawbacks*. Consider implementing a performance and/or vesting period that is as long as the time horizon of risk. Alternatively, or in conjunction with such extended periods, impose compensation clawbacks beyond those required by applicable law. Note that vesting of at least one year for at least 95% of all awards granted under a plan, and clawbacks, are both factors that ISS considers when making voting recommendations under its new "Equity Plan Scorecard" ("EPSC") approach (discussed in Chapter VI of the complete publication).
- *Deferral of Payment/Transferability of Stock*. Consider deferring payment, or implementing holding periods or transferability restrictions on stock, until after the time horizon of risks has elapsed. Consider adjusting compensation during the deferral period to reflect actual losses or other manifestations of bad performance. Deferral of awards may be most effective where risks, or the time horizon of risks, are difficult to identify or quantify. Stock ownership requirements imposed on senior executives are another factor ISS considers under its EPSC.
- *Calibrate Payouts to Account for Risk*. If two activities generate the same amount of revenue or profits and the risk associated with one activity is materially different from the other, consider whether the payouts under the incentive programs generated by each of the activities should differ, all else being equal. This method of adjustment may be most effective where risks associated with a particular activity are easily quantified.
- *De-Leverage Payouts*. The rate at which compensation increases for attainment of goals in excess of threshold performance should be decreased such that there are payouts for a broader range of results but payouts are not supercharged for above-target performance or completely denied for below-target performance.
- *Governance Adjustments*. Companies should strengthen internal controls and governance processes in the design, implementation and monitoring of incentive compensation arrangements.

The complete publication, including footnotes, is available here.