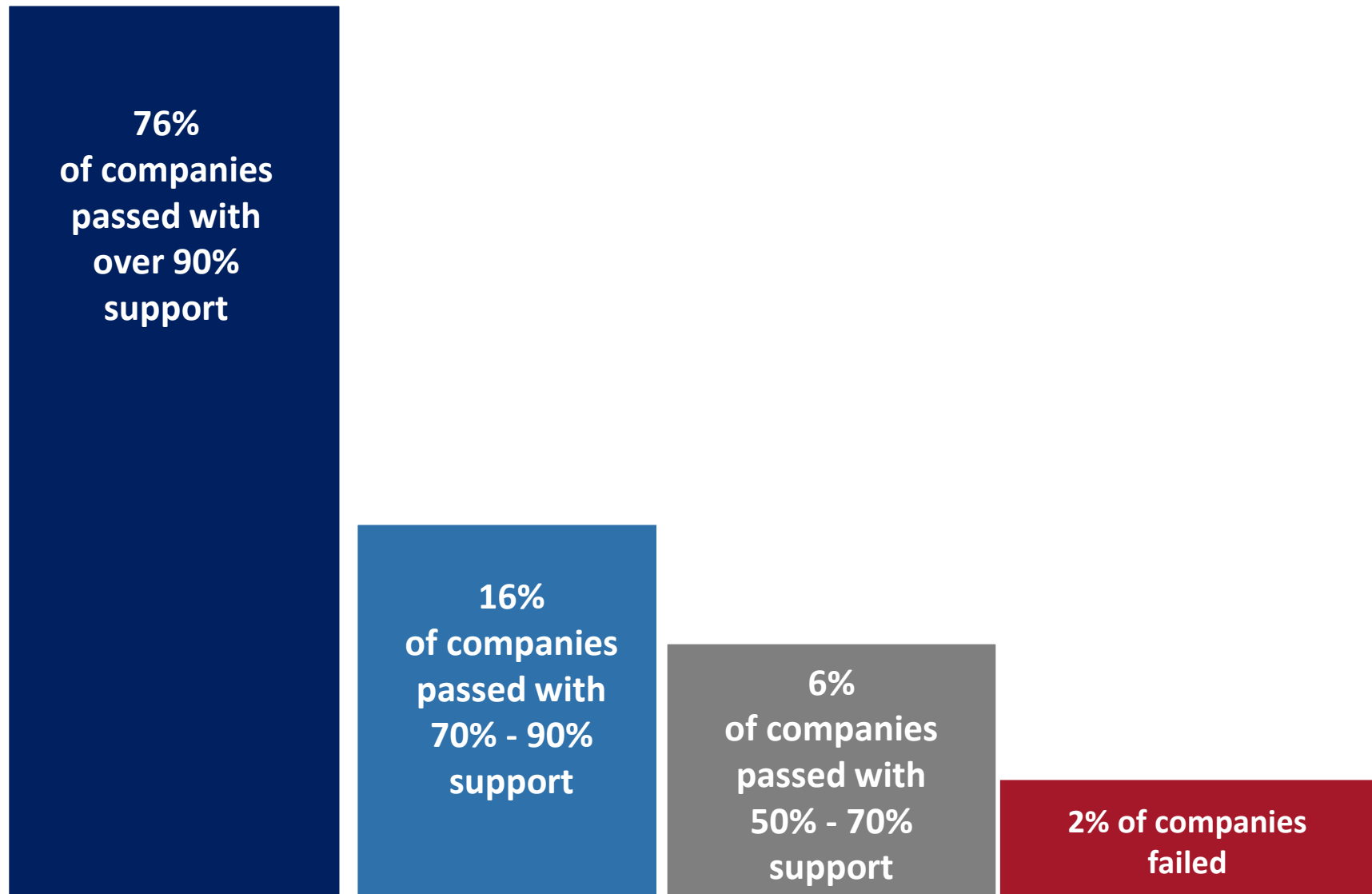


# Executive Compensation 2016

# 2015 Say-On-Pay Results

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- 2,157 Russell 3000 companies reported Say-on-Pay results for 2015



# ISS Developments

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- ***First full year of “Equity Plan Scorecard” for equity plan proposals***
  - More than 80% of S&P 500 and Russell 3000 companies that submitted equity plans for approval in 2015 received a favorable ISS recommendation. This approval rate is not meaningfully different from prior years
  - Burn rates and Share Value Transfer remain critical to a favorable recommendation. Problematic pay practices that negatively impact the EPS score include liberal share counting rules, evergreen provisions, single trigger vesting and option/SAR repricing
- ***New FAQs issued in late 2015.*** ISS continues to modify its criteria for evaluating compensation arrangements. Highlights include:
  - The “Equity Plan Scorecard” has been refined to require, among other things, that:
    - Change-in-control double trigger vesting provisions of performance-based awards will only receive full points if awards that are not replaced vest based on actual performance as of the closing and/or are prorated; and
    - Full points will only be awarded if holding periods imposed on shares received by executives through equity awards are at least 36 months
  - Problematic pay practices revised to include excessive equity vesting upon termination of employment that is included in new CEO packages
- ***Focus on Say-on-Pay vote concerns even if no Say-on-Pay vote***
  - If Say-on-Pay is not on the ballot, an adverse ISS reaction to executive compensation may translate into a negative recommendation on compensation committee members up for re-election

# Other Voting Guideline Developments

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- ***Glass Lewis*** has expanded its voting guidelines regarding executive compensation in recent years, including:
  - Providing a non-exhaustive list of issues, similar to ISS' problematic pay practices, which when weighed together could result in a negative recommendation against a company's Say-on-Pay vote
  - In reviewing equity plan proposals, using both quantitative (plan cost, plan limits relative to peers, dilution and annual cost relative to financial performance, etc.) and qualitative (plan and grant features and terms, etc.) analyses to determine whether to recommend a vote in favor
  - Affirmatively stating that it expects a company that receives less than 75% shareholder approval for its Say-on-Pay vote to actively engage with its shareholders and respond to shareholder concerns
- ***Institutional investors***, as varied as BlackRock and CalPERS, have in recent years issued their own voting guidelines on executive compensation matters, which may emphasize factors that are different than those outlined by ISS, Glass Lewis and each other
  - For example, BlackRock's guidelines are more principles-based in nature and focus on shareholder engagement, whereas CalPERS' guidelines contain more objective standards, such as that salaries should not exceed \$1 million annually, and equity awards should not vest in any change in control (regardless of the structure of the transaction)
- ***It is important for companies to be well-informed as to the voting guidelines to which their company's shareholders look for guidance***
  - Maintaining an open dialogue regarding director and executive compensation practices should be part of any shareholder outreach program throughout the year, not just during proxy season, and can help neutralize any negative recommendations of proxy advisory firms

# Collaboration Between Management and the Compensation Committee

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- Our experience is that management and the Board (and its committees) of the best companies work together on all significant matters
- Why is collaboration important, particularly in the compensation process?
  - A failure of the Compensation Committee and its advisors to collaborate with management can result in a rift between management and the Board, and in the weaknesses and vulnerabilities which may be exploited by an outsider
  - Management knows the business best and can give valuable insight to the Compensation Committee and its advisors about matters, such as adopting performance goals consistent with the long-term business plan, selection of peer group members, and the best types of motivational tools
  - A collaborative process will always promote effective Compensation Committee functioning, management buy-in and better results

# 2017 Say-on-Frequency of Say-on-Pay Vote

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- Non-binding Say-on-Frequency-of-Say-on-Pay votes are required to be held not less frequently than once every six years to determine whether the Say-on-Pay vote will occur every one, two or three years
- Because the “Say-on-Frequency” vote first occurred in 2011, for most companies, the next Say-on-Frequency vote is scheduled to occur at the 2017 annual shareholder meeting
- Most companies currently hold their Say-on-Pay votes on an annual basis; some companies hold their Say-on-Pay vote on a triennial basis, with only approximately 1% of companies holding their Say-on-Pay vote biennially
- As discussed above, companies should be aware that if they do not hold Say-on-Pay votes on an annual basis, during years when Say-on-Pay votes are not held, ISS will run its regular Say-on-Pay analysis when considering whether to recommend the re-election of Compensation Committee members

# Update on Dodd–Frank Act (DFA) Executive Compensation Mandates



In 2015, the  
SEC Proposed  
Rules under DFA on:

- Pay versus Performance disclosure
- Compensation Clawbacks

In 2015, the SEC  
Finalized Final Rules  
under DFA on:

- Pay Ratio disclosure, which requires disclosure in 2018 proxies in respect of 2017 compensation

What to do now?

- Plan for expected disclosures
- Review current clawback policies
- Plan for 2017 Say-on-Frequency of Say-on-Pay Vote

# Pay Versus Performance Disclosure – Proposed Rules

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- *DFA requires the SEC to issue rules requiring listed companies to disclose annually the relationship between compensation actually paid to executives and the financial performance of the company*
- The SEC proposed rules would require the following information to be disclosed in a new proxy table, updated annually:
  - compensation “actually paid” to the company’s CEO and the average compensation “actually paid” to the company’s named executive officers other than the CEO; and
  - The company’s total shareholder return (TSR) and the proxy peer group’s TSR, and the relationship between executive compensation actually paid and company TSR
- Compensation “actually paid” would be based on the compensation already reported in the summary compensation table, with adjustments relating to pension amounts and equity awards, including using the fair value of equity awards on their vesting (not grant) date
- The proposed rules provide for a phase-in of disclosure: in the first year, disclosure would be in respect of the three prior years, with another year added in each of the two subsequent proxy filings
- These rules could be finalized as early as 2016 and could apply during the 2017 proxy season



# Compensation Clawbacks – Proposed Rules

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- *DFA requires the SEC to issue rules requiring listed companies to adopt policies that recoup from executive officers incentive compensation resulting from specified accounting restatements. Failure to comply with these rules would result in delisting by the applicable exchange*
- The SEC proposed rules would require the following provisions to be included in compensation clawback policies:
  - Clawbacks would be triggered by a restatement to correct an error that is material to prior financial statements
  - Clawbacks would apply to current and former executive officers who served in that capacity at any time during the three completed fiscal years preceding the date a restatement is required
- All equity and cash incentive compensation that was granted, earned or vested based wholly or in part upon the attainment of financial reporting measures (i.e., not solely time-vested awards) that is in excess of what would have been paid based upon the restated information, is subject to clawback
- These rules could be finalized as early as 2016

# Pay Ratio – Final Rules

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- *DFA requires the SEC to issue rules requiring listed companies to disclose annually:*
  - *the amount of annual total compensation of the company's CEO;*
  - *the median annual total compensation of all employees (excluding the CEO); and*
  - *the ratio of the annual total compensation of the median employee to the CEO's annual total compensation*
- Companies must comply in respect of the first fiscal year beginning on or after January 1, 2017, i.e., in 2018 proxies
- Highlights of these rules include:
  - All world-wide employees (excluding up to 5% of non-U.S. employees generally) must be taken into account for purposes of calculating the median pay
  - Reasonable estimates, including statistical sampling, may be used to identify the median employee
  - Once the median employee is identified, annual total compensation is determined based on the rules for calculating the annual proxy summary compensation table

# Section 162(m) in the Limelight

## What is Section 162(m)?

- IRC Section 162(m) disallows tax deductions for compensation to certain executive officers in excess of \$1,000,000 in any year
- An exception applies to “performance-based compensation,” which must be:
  - granted under a plan approved by shareholders containing performance metrics and certain limits on awards
  - subject to achievement of an objective performance goal
  - approved by a committee of outside directors

## Section 162(m) Lessons

- Cast a wide net in determining which executives are subject to Section 162(m) programs
- Establish objective parameters for adjusting performance goals when setting the goals
- Consider use of a “162(m) umbrella plan” when granting performance-based awards
- Be mindful of plan limits, especially in volatile markets
- Refresh shareholder approval of performance metrics at least once every five years
- Reserve the ability to grant nondeductible awards in any proxy discussion of performance-based compensation

# Litigation Developments

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- ***Executive compensation continues to be a significant target for shareholder lawsuits***
- ***Areas of particular focus*** over the last several years have included:  
(1) disclosure claims relating to equity compensation plans submitted for shareholder approval; (2) director equity grants/plan limits; and  
(3) Section 162(m) plan violations
- ***Two recent instances*** of legal actions involve complaints relating to  
(1) insufficient disclosure and approval actions relating to director compensation (*Facebook*) and (2) insufficient disclosure and review of proposed executive compensation terms by a board of directors (*YAHOO!*)
- ***Preventative steps*** to help reduce the likelihood that a company could become a target of shareholder lawsuits:
  - Review with outside counsel terms for new and amended incentive plans to be put to a shareholder vote
  - Review with outside counsel the proxy disclosure related to plans to be put to a shareholder vote
  - Provide clear and complete communication with compensation committee members regarding all proposed actions relating to executive and director compensation

# Change in Control Preparedness

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- *Review change in control (CIC) definitions and protections in executive compensation arrangements periodically*
  - *Is a change in control triggered by:*
    - Proxy contests
    - Mergers of equals (e.g., “top hat”/“double dummy” structures)
    - Spin-offs
    - PIPE investments
  - *Key protection issues*
    - Confirm all essential employees are covered at the appropriate severance levels
    - Confirm equity incentive plans have either single- or double-trigger protections
    - Use tally sheets and be aware of potential payout amounts
    - Understand the possible impact of the golden parachute excise tax on all compensation that could be payable in connection with a CIC
- *Other issues*
  - All of the foregoing consequences of CIC arrangements should be reviewed with the compensation committee
  - Consider the disclosure requirements of any changes to such arrangements (or adoption of any new arrangements) as well as the disclosure requirements at the time of any CIC (including in connection with the non-binding say-on-golden-parachute vote)

# Appendix A: 2015 Say-on-Pay Results\*

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- 2015 Results
  - 2,157 Russell 3000 companies reported Say-on-Pay results for 2015 (average vote result was 91%)
  - 76% of companies passed with over 90% support
  - 16% of companies passed with between 70% and 90% support
  - 6% of companies passed with between 50% and 70% support
  - 2.8% of companies failed (vs. 2.4% in 2014)
  - 92% of S&P 500 companies passed with over 80% support
- Impact of ISS Recommendations
  - ISS recommended a vote “against” for approximately 12% of companies that it assessed in 2015
    - The most common reasons for failing Say-on-Pay have remained the same over the past three years (i.e., problematic pay practices and pay-for-performance relationship)
  - 23% of companies with a negative ISS recommendation actually failed (i.e., received less than 50% of the vote in favor; this is up from 18% of companies in 2014)
  - A Say-on-Pay vote above 70% leads to minimal impact on compensation committee member election results the following year. However, members and chairs receive 13% and 18% lower support, respectively, in the year following a failed Say-on-Pay vote

\*See Semler Brossy 2015 Say on Pay Results End of Year Report (January 27, 2016).

# Appendix B: 2015 Say-on-Golden Parachute Results\*

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- Say-on-Golden Parachute vote at the time of a transaction is separate from the vote on the transaction and is non-binding
- 2015 Results
  - 111 companies reported Say-on-Golden Parachute results for 2015
  - 42% of companies passed with over 90% support
  - 41% of companies passed with between 70% and 90% support
  - 12% of companies passed with between 50% and 70% support
  - 5% of companies failed
- On average, 80% or more of companies have received higher than 75% support on Say-on-Golden Parachute votes in the last five years (2011-2015)

\*See Semler Brossy 2015 Say on Pay Results End of Year Report (January 27, 2016).