

WACHTELL, LIPTON, ROSEN & KATZ

# COMPENSATION COMMITTEE GUIDE

2017



### *About This Compensation Committee Guide*

This Compensation Committee Guide (this “Guide”) provides an overview of the key rules applicable to compensation committees of listed U.S. companies and practices that compensation committees should consider in the current environment. This Guide:

- outlines a compensation committee member’s responsibilities;
- reviews the composition and procedures of the compensation committee;
- considers important legal standards and regulations that govern compensation committees and their members; and
- recommends specific practices to promote compensation committee effectiveness in designing appropriate compensation programs that advance corporate goals.

Although generally geared toward directors who are members of a public company compensation committee, this Guide also is relevant to members of a compensation committee of a private company, especially if the private company may at some point consider accessing the public capital markets.

This Guide also contains sample compensation committee charters as Exhibits, which have been updated to reflect the changes required to be made as a result of the implementation by the exchanges of certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”). These Exhibits are intended to assist a compensation committee in performing its designated functions. However, it would be a mistake for any public company to simply copy published models. The creation of charters requires experience and careful thought. It is not necessary that a company have every guideline and procedure that another company has to be “state of the art” in its governance practices. When taken too far, an overly broad or detailed committee charter can be counterproductive. For example, if a charter explicitly requires the compensation committee to review a particular type of compensation arrangement, meet a stated number of times each year or take other action, and the compensation committee has not taken that action, the failure may be considered evidence of lack of due care. Therefore, we recommend that each company tailor its compensation committee charter and written procedures to what is necessary and practical for the particular company.

This Guide is not intended as legal advice, cannot take into account particular facts and circumstances (including the extent to which certain federal fiduciary laws may apply to a given compensation committee) and generally does not address individual state corporate laws.

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# Compensation Committee Guide

## TABLE OF CONTENTS

	<u>Page</u>
Introduction.....	1
I. Key Responsibilities of Compensation Committee Members .....	5
A. Responsibilities Imposed by the Securities Markets and Dodd-Frank .....	5
1. New York Stock Exchange Requirements.....	5
2. NASDAQ Requirements.....	7
B. CEO and Executive Officer Compensation .....	8
C. Non-Executive Officer Compensation and Broad-Based “ERISA” Plans .....	9
D. Development of Compensation Philosophy.....	10
E. Compensation-Related Disclosure Responsibilities .....	10
1. Compensation Discussion and Analysis .....	10
2. Compensation Committee Report.....	11
3. Additional Annual Disclosure Regarding NEO Compensation .....	11
4. Director Compensation Table .....	12
5. Compensation Committee Governance .....	12
6. Compensation Consultants and Advisors .....	13
7. Risk and Broad-Based Compensation Programs .....	13
8. Remaining Dodd-Frank Disclosure Requirements .....	14
9. Conclusion .....	17
F. Internal Controls .....	17
G. Equity Compensation Grant Policy .....	17

H.	Management Succession.....	18
I.	Role of Risk in Compensation Programs.....	19
1.	The Role of the Compensation Committee in Risk Oversight of Incentive Compensation .....	19
2.	Management’s Risk Analysis .....	21
II.	Fiduciary Duties of Compensation Committee Members .....	25
A.	Fiduciary Duties Generally.....	25
1.	Business Judgment Rule .....	25
a.	Duty of Care.....	25
b.	Duty of Loyalty.....	26
2.	Adopting or Amending Compensation Arrangements in the Context of Corporate Transactions .....	28
B.	Fiduciary Duties Under ERISA .....	31
III.	Methods of Compensation .....	35
A.	Understanding and Pursuing Compensation Goals and Objectives.....	35
B.	Equity Compensation.....	36
1.	Stock Options.....	36
2.	Stock Appreciation Rights .....	37
3.	Restricted Stock .....	38
4.	Restricted Stock Units.....	39
C.	Retirement Programs .....	41
D.	Perquisites.....	42
E.	Clawback Provisions.....	42
IV.	Laws and Rules Affecting Compensation.....	45
A.	Section 162(m) of the Internal Revenue Code.....	45
1.	General.....	45
2.	“Covered Employees” .....	45

3.	Performance-Based Compensation Exception .....	46
4.	Section 162(m) Compliance Procedures.....	46
B.	Section 409A of the Internal Revenue Code.....	47
C.	Stock Exchange Rules Regarding Shareholder Approval of Equity Compensation Plans.....	47
1.	General Rules.....	47
2.	Material Revisions .....	48
D.	Dodd-Frank Proposed Pay Versus Performance Rules .....	49
E.	Dodd-Frank Proposed Compensation Clawback Rules .....	51
V.	Change in Control Compensation Arrangements .....	55
A.	Addressing Executive Uncertainty in a Deal Environment.....	55
B.	Forms of Compensatory Arrangements .....	55
1.	Change in Control Protections .....	55
2.	Stock-Based Compensation Plans.....	58
3.	Separation Plans.....	59
4.	Deferred Compensation Plans.....	59
5.	Retention Programs.....	60
VI.	Special Considerations Applicable to Financial Institutions .....	61
A.	Safety and Soundness Guidance .....	62
B.	Section 956 of Dodd-Frank.....	64
1.	Covered Financial Institutions .....	64
2.	Covered Persons.....	65
3.	Prohibitions Under the Proposed Rule.....	66
4.	Additional Requirements Applicable to Level 1 and 2 Covered Financial Institutions .....	67
5.	Policies and Procedures .....	68

C.	FDIC Golden Parachute Regulations.....	69
VII.	Shareholder Proposals, Relations and Litigation .....	71
A.	Say-on-Pay .....	71
1.	The Say-on-Pay Vote .....	71
2.	The Say-When-on-Pay Vote .....	75
3.	The Golden Parachute Say-on-Pay Vote .....	76
B.	Shareholder Proposals.....	77
C.	Shareholder Advisory Firms.....	78
D.	Executive Compensation Litigation.....	87
1.	Section 162(m) Related Suits.....	87
2.	Say-on-Pay Suits.....	88
3.	Compensation Disclosure Suits .....	89
VIII.	Compensation Committee Membership .....	93
A.	Independence Standards of the Major Securities Markets .....	93
B.	Internal Revenue Code Section 162(m) Membership Requirements .....	98
C.	Membership Requirements for the Short-Swing Profit Exemption of Rule 16b-3 Under Section 16(b) of the Exchange Act .....	99
1.	Non-Employee Director .....	100
2.	Ensuring Compensation Committee Membership Compliance .....	100
3.	Ensuring Independence Under State Law.....	101
IX.	Compensation Committee Meetings.....	103
A.	Meetings and Agenda .....	103
B.	Quorum Requirements .....	103
C.	Minutes .....	104
D.	Shareholder and Director Right of Inspection .....	105
E.	Access to Outside Advisors .....	106



F.	Compensation Committee Chairperson .....	107
X.	Compensation Committee Charters .....	109
A.	NYSE Listed Companies Charter Requirements .....	109
B.	NASDAQ-Listed Companies Charter Requirements .....	112
XI.	Director Compensation, Indemnification and Directors and Officers Insurance .....	115
A.	Director Compensation .....	115
1.	Responsibility for Determining Director Compensation .....	115
2.	Considerations for Determining Director Compensation .....	116
B.	Director Compensation Litigation .....	118
C.	Indemnification and Directors and Officers Insurance .....	119

## **EXHIBITS**

*Exhibit A*      Compensation Committee Charter (NYSE-Listed Company)

*Exhibit B*      Compensation Committee Charter (NASDAQ-Listed Company)

## Introduction

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* client [memorandum](#), 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 Guide 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 Guide 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 Guide 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 (*Chapter I*). We then review the fiduciary duties of compensation committees and their members under various applicable laws (*Chapter II*).
- This Guide 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 this Guide 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, this Guide 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*.



## I.

### **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<sup>1</sup> with a written committee charter that addresses all of the duties described in this section.<sup>2</sup> 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.<sup>3</sup>

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,

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<sup>1</sup> The NYSE definition of “independent” is explored in detail in Chapter VIII of this Guide.

<sup>2</sup> Under the NYSE corporate governance rules, an NYSE listed company is required to maintain a website that must include, among other things, a printable version of its compensation committee (and any subcommittee thereof) charter. *See* NYSE Listed Company Manual Section 303A.05.

<sup>3</sup> A listed company of which more than 50% of the voting power for the election of directors is held by an individual, a group or another company (known as a “controlled company”) is exempt from these requirements.

and (3) the awards given to the CEO in past years.<sup>4</sup> 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

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<sup>4</sup> The NYSE clarifies that a compensation committee is not precluded from approving awards so as to comply with applicable tax laws, such as Section 162(m) of the Internal Revenue Code of 1986, as amended (the "Code"), with or without ratification by the board of directors. A further discussion of certain implications of Section 162(m) of the Code is set forth in Chapter IV of this Guide.



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.<sup>5</sup>

## **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 this Guide.

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.<sup>6</sup> A compensation committee or a company's independent

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<sup>5</sup> For a brief discussion of the factors a compensation committee should consider in its annual self-evaluation, *see* the Wachtell, Lipton, Rosen & Katz, Nominating and Corporate Governance Committee Guide, found [here](#).

<sup>6</sup> The specific conditions that must be met for such exemption to be available, as well as the precise contours of the NASDAQ definition of "independent," are discussed in Chapter VIII of this Guide.

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.<sup>7</sup>

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 Chapter I, 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 this Guide.

## **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 this Guide.

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 this Guide, it may be necessary for a compensation committee to certify satisfaction of such performance criteria

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<sup>7</sup> The shareholder approval requirements and the relevant exemptions for certain compensation committee approved plans are discussed in Chapter IV of this Guide.

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 Chapter I, 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 this Guide, 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.<sup>8</sup>

#### **4. Director Compensation Table**

The SEC rules<sup>9</sup> 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 below, 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

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<sup>8</sup> See Chapter VI of this Guide.

<sup>9</sup> See Item 402(k) of Regulation S-K, 17 C.F.R. 229.402(k) and the Instructions related thereto.

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 this Guide). 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 this Guide). 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.<sup>10</sup> 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

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<sup>10</sup> See Pay Ratio Disclosure; Final Rule, 80 Fed. Reg. 50103 (August 18, 2015) (amending 12 C.F.R. Parts 229, 240 and 249), available [here](#).



comments on it. However, as of the publication date of this Guide 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 full-time, 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 client [memorandum](#) 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.<sup>11</sup>

## **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

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<sup>11</sup> For additional discussion regarding CEO succession planning, *see* Wachtell, Lipton, Rosen & Katz, Nominating and Corporate Governance Committee Guide, found [here](#).

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 this Guide, 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**  
Fewer participants

**More Risk**  
More participants

- The plan metrics

**Less Risk**  
Risk-adjusted  
metrics (*e.g.*,  
economic profit)

**More Risk**  
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**

Smaller aggregate and individual payouts

**More Risk**

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**

Small revenue, potential losses, liabilities or payout

**More Risk**

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.<sup>12</sup> 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 this Guide).

- *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.

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<sup>12</sup> For more on clawbacks, see Chapter IV of this Guide.



## II.

### Fiduciary Duties of Compensation Committee Members

#### A. Fiduciary Duties Generally

Decisions by members of compensation committees with respect to executive compensation, generally, are subject to the business judgment rule.<sup>13</sup>

##### 1. Business Judgment Rule

Under the business judgment rule, directors' decisions are presumed to have been made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Under this presumption, directors' decisions will not be disturbed unless a plaintiff is able to carry its burden of proof in showing that a board of directors has not met its duty of care or loyalty.<sup>14</sup>

##### a. Duty of Care

The core of the duty of care may be characterized as the directors' obligation to act on an informed basis after due consideration of the relevant materials and appropriate deliberation, including the input of experts.<sup>15</sup> To show that a

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<sup>13</sup> See, e.g., *In re Goldman Sachs Group, Inc. Shareholder Litigation*, C.A. 5215-VCG (Del. Ch. Oct. 12, 2011); *Campbell v. Potash Corp. of Saskatchewan, Inc.*, 238 F.3d 792, 800 (6th Cir. 2001) (“evaluating the costs and benefits of golden parachutes is quintessentially a job for corporate boards, and not for federal courts”).

<sup>14</sup> See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). Under 8 Del. Code Ann. § 102(b)(7), a Delaware company may in its certificate of incorporation either eliminate or limit the personal liability of a director to the company or its shareholders for monetary damages for breach of fiduciary duty, but such provisions may not eliminate or limit the liability of a director for, among other things, (1) breach of the director's duty of loyalty to the company and its shareholders or (2) acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law. Many Delaware corporations either have eliminated or limited director liability to the extent permitted by law. The Delaware Supreme Court has ruled that the typical Delaware corporation charter provision exculpating directors from monetary damages in certain cases applies to claims relating to disclosure issues in general and protects directors from monetary liability for good-faith omissions. *Arnold v. Society for Sav. Bancorp, Inc.*, 650 A.2d 1270 (Del. 1994). Similar provisions have been adopted in most states. The limitation on personal liability does not affect the availability of injunctive relief.

<sup>15</sup> *Smith v. Van Gorkom*, 488 A.2d 858, 874 (Del. 1985) (holding that, in the context of a proposed merger, directors must inform themselves of all “information . . . reasonably available to [them] and relevant to their decision” to recommend the merger); see also *Aronson*, 473 A.2d at 812 (“under the business judgment rule director liability is predicated upon concepts of gross negligence”).

board of directors has not met its duty of care, a plaintiff must prove that directorial conduct has risen to the level of “gross negligence.” In addition, Delaware statutory law permits directors in exercising their duty of care to rely on certain materials and information.<sup>16</sup> Accordingly, directors charged with approving compensation arrangements should be familiar with the purpose of the arrangements and the nature of the benefits and should reasonably understand the costs; in so doing, directors may reasonably rely on the reports of their committees and advisors.

### **b. Duty of Loyalty**

The duty of loyalty requires directors to act in the best interests of the company. Subsumed within this duty of loyalty is the directors’ duty to act in good faith. In the landmark *Disney* case,<sup>17</sup> shareholders filed suit alleging that the board of directors did not act in good faith in approving the roughly \$140 million employment and termination package of former Disney president Michael Ovitz. While the Delaware Court of Chancery ultimately exonerated the board of directors, the Court caused a great deal of controversy in the initial stages of the case when it denied the directors’ motion to dismiss. According to the Court’s initial opinion, if the facts alleged in the complaint were proven at trial, the directors would have been found to have breached their fiduciary duty of “good faith” in approving the hiring and termination. While some academics and corporate gadflies applauded the Court’s initial decision, the business world wondered whether the Court’s decision served as a harbinger of potentially massive personal liability for disinterested directorial business decisions—when analyzed under the lens of 20-20 hindsight—even though the directors derived no personal benefit from those decisions. The Court’s ultimate decision exonerating the Disney directors quieted these concerns.

The *Disney* decision helps delineate the scope of protection of directors against personal liability for claimed breach of fiduciary duty. Negligence—that is, a failure to use due care—should not result in personal liability unless the director failed to act in “good faith.” The Court ruled that an appropriate measure for determining that a director has acted in good faith is whether there is an “intentional dereliction of duty, a conscious disregard for one’s responsibilities.” The Court ruled that a director fails to act in good faith when the director (1) “intentionally acts with a purpose other than that of advancing the best interests of the corporation,” (2) “acts with intent to

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<sup>16</sup> 8 Del. Code Ann. § 141(e).

<sup>17</sup> *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693 (Del. Ch. 2005).

violate applicable positive law,” or (3) “intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.”<sup>18</sup>

The *Disney* decision also made clear that, although directors are encouraged to employ evolving best practices of corporate governance, directors will not be held liable for failure to comply with “the aspirational ideal of best practices.” In other words, directors will have the benefit of the business judgment rule if they act on an informed basis, in good faith and not in their personal self-interest, and, in so doing, protect themselves from “*post hoc* penalties from a reviewing court using perfect hindsight.” As the Court noted, shareholder redress for failures that arise from faithful management “must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court.”<sup>19</sup>

In the *Disney* case, the Delaware Court also rejected a claim that the Ovitz pay package amounted to corporate waste because the contract providing for his severance pay had a rational business purpose—that of attracting Mr. Ovitz to join Disney. The rational business purpose test is a high hurdle for claims based on waste. Nevertheless, the Delaware Court of Chancery refused to dismiss a corporate waste claim against the Citigroup board arising from the payment of \$68 million to the retiring CEO, Charles Prince.<sup>20</sup> In return for the \$68 million payment, Prince agreed to sign non-compete, non-disparagement, and non-solicitation agreements and a release of claims against Citigroup. The Chancellor’s refusal to dismiss the waste claim was based on his desire to review information regarding the value of the various promises made by Prince relative to the payments he received.

In October 2011, the Delaware Court of Chancery reaffirmed the traditional principles of the common law of executive compensation in dismissing a wide-ranging shareholder challenge to compensation practices at Goldman Sachs, which included claims based on waste and the board’s failure to act in good faith, to be adequately informed and to monitor the company.<sup>21</sup> In particular, the Court noted that “[t]he decision as to how much compensation is appropriate to retain and incentivize employees, both individually and in the aggregate, is a core function of a board of directors exercising its business

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<sup>18</sup> *Id.* at 755.

<sup>19</sup> *Id.* at 698.

<sup>20</sup> *In re Citigroup Inc. Shareholder Deriv. Litig.*, 964 A.2d 106, 138 (Del. Ch. 2009).

<sup>21</sup> *In re The Goldman Sachs Group, Inc. Shareholder Litigation*, C.A. No. 5215-VCG (Del. Ch. Oct. 12, 2011).

judgment”<sup>22</sup> and, if the shareholders disagree with the board’s judgment, their remedy is to replace board members through directorial elections.<sup>23</sup>

It should be noted that the Delaware Court of Chancery recently ordered YAHOO! Inc.<sup>24</sup> to produce certain books and records under Section 220 of the Delaware General Corporation Law to Amalgamated Bank, as trustee for certain stockholders, regarding the hiring and subsequent firing of Yahoo’s Chief Operating Officer, Henrique de Castro. In its opinion, the Court found similarities to the *Disney* case: a CEO hiring a number-two executive, poor performance by the number-two executive and a no-fault termination that resulted in a large payment to the terminated executive (*i.e.*, approximately \$60 million in cash and accelerated equity awards). According to the Court, based on publicly available information and certain information provided by YAHOO!, there was a credible basis to suspect wrongdoing, including possible breach of fiduciary duties, by the board and the CEO, and possible corporate waste. Although the opinion does not represent a finding by the Court that there has in fact been a breach of fiduciary duty or corporate waste, it highlights the importance of providing material information to a board of directors in executive compensation determinations and of facilitating a meaningful review and evaluation of such information before approval of compensation actions.

## **2. Adopting or Amending Compensation Arrangements in the Context of Corporate Transactions**

Adopting or amending compensation arrangements in the context of takeover activity or certain negotiated transactions can result in heightened judicial scrutiny. If the adoption or amendment of a compensation arrangement is deemed a defensive measure taken in response to an actual or threatened takeover, the adoption will be subject to judicial review under an “enhanced scrutiny” standard,<sup>25</sup> which looks both to the board of directors’ process and its action. That said, a compensation arrangement will not be subjected to enhanced scrutiny merely because a board of directors adopts a compensation arrangement in the face of a takeover threat; in order for enhanced scrutiny to apply, a board of directors must have entered into the compensation

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<sup>22</sup> *Id.* at 38.

<sup>23</sup> *Id.* at 39.

<sup>24</sup> *Amalgamated Bank, Trustee for the Longview LargeCap 500 Index Fund and the LongView LargeCap 500 Index VEBA Fund v. YAHOO! Inc.*, C.A. No. 10774-VCL (Del. Ch. Feb. 2, 2016).

<sup>25</sup> *See, e.g., Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Gilbert v. El Paso Co.*, 575 A.2d 1131 (Del. 1990) (analyzing the “golden parachute” employment arrangement among target’s defensive measures subject to enhanced scrutiny).

arrangement as a defensive measure.<sup>26</sup> If the arrangement was adopted as a defensive measure, the directors carry the burden of proving that their process and conduct satisfy a two-pronged test (known as the *Unocal* standard):<sup>27</sup>

- a board of directors must show that it had “reasonable grounds for believing that a danger to corporate policy and effectiveness existed,” which may be shown by the directors’ good faith and reasonable investigation; and
- a board of directors must show that the defensive measure chosen was “reasonable in relation to the threat posed,” which may be demonstrated by the objective reasonableness of the course chosen.<sup>28</sup>

If directors can establish both prongs of the *Unocal* test, their actions will receive the protections of the business judgment rule. While the *Unocal* standard still provides a board of directors reasonable latitude in adopting defensive measures,<sup>29</sup> executive compensation plans adopted in response to a takeover threat may result in a court more closely examining a board of directors’ process and actions.<sup>30</sup> Therefore, adopting or amending change in control *employment* arrangements in advance of an actual or threatened takeover may be advisable whenever possible.<sup>31</sup>

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<sup>26</sup> See, e.g., *Moore v. Wallace Computer Servs.*, 907 F. Supp. 1545, 1556 (11th Cir. 1994) (“In addition . . . the facts [sic] that such agreements are commonplace among chief executives of major companies and that Cronin’s severance package was identical to that of his predecessor persuade this Court that the adoption of the golden parachute agreement was not a defensive measure.”).

<sup>27</sup> *Unocal*, 493 A.2d at 946.

<sup>28</sup> *Id.* at 955.

<sup>29</sup> See, e.g., *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1362 (Del. 1995).

<sup>30</sup> See *Gilbert*, 575 A.2d at 1141 (applying *Unocal* standard in reviewing defensive measures, including golden parachutes and ESOPs, where “everything that [defendant directors] did was in reaction to [the] tender offer”); *Int’l Ins. Co. v. Johns*, 874 F.2d 1447 (11th Cir. 1989) (stating that the intent of the company’s board in enacting a golden parachute is determinative of the standard used; when enacted in response to a takeover threat, the *Unocal* enhanced scrutiny standard applies).

<sup>31</sup> See *Buckhorn, Inc. v. Ropak Corp.*, 656 F. Supp. 209 (S.D. Ohio), *aff’d*, 815 F.2d 76 (6th Cir. 1987) (applying *Unocal* scrutiny to ESOPs and golden parachutes enacted in response to a tender offer, but applying the business judgment rule to protect amendments to those employment contracts enacted before the tender offer); *Moore Corp. Ltd. v. Wallace Computer Servs., Inc.*, 907 F. Supp. 1545 (D. Del. 1995) (refusing to apply *Unocal* scrutiny to golden parachutes negotiated before a tender offer, but applying *Unocal* enhanced scrutiny to the failure to redeem a poison pill); and *In re Western Nat’l Corp. S’holder’s Litig.*, 2000 WL 710192 (Del. Ch. May 22, 2000) (applying business judgment rule to board-approved

(footnote continued)

When an actual conflict of interest that affects a majority of the directors approving a transaction is found, Delaware courts apply the most exacting standard, the “entire fairness” review, which requires a judicial determination of whether a transaction is entirely fair to shareholders.<sup>32</sup> Such conflicts may arise in situations where directors (1) appear on both sides of a transaction, as in adoption of compensation arrangements for the directors themselves, or (2) derive a personal financial benefit that does not generally benefit the company and its shareholders.<sup>33</sup> In determining whether a transaction is entirely fair, “the court must consider the process itself that the board followed, the quality of the result it achieved and the quality of the disclosures made to the shareholders to allow them to exercise such choice as the circumstances could provide.”<sup>34</sup>

In the context of director and executive compensation, entire fairness scrutiny is most likely to apply where directors have approved a compensation plan specifically for themselves. Even if the compensation arrangements directly benefit insider directors, their approval should be protected by the business judgment rule if approved by an independent committee or by the disinterested directors.<sup>35</sup> However, when directors who directly benefit from a proposed plan are delegated the responsibility of approving such a plan, a court will refuse the protection of the business judgment rule and scrutinize the overall fairness of the plan as it relates to the company’s shareholders.<sup>36</sup> In light of this treatment, it is generally advisable that the responsibility for adopting director compensation be delegated to a company’s corporate governance and nominating committee, subject to the approval of the entire board of directors.

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(footnote continued)

employment agreement granting large severance payment and accelerated vesting of options because applicable employment agreement was adopted before potential acquirer was a shareholder and agreement was negotiated and recommended by disinterested directors).

<sup>32</sup> See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

<sup>33</sup> See, e.g., *Ivanhoe Partners*, 535 A.2d at 1334.

<sup>34</sup> *Cinerama, Inc. v. Technicolor*, 663 A.2d 1134, 1140 (Del. Ch. 1995).

<sup>35</sup> See *Tate & Lyle PLC v. Staley Continental, Inc.*, 1988 Del. Ch. LEXIS 61, \*20 (Del. Ch. May 9, 1988) (permitting outside directors to approve compensation for insider directors after conducting reasonable inquiry and obtaining full board of directors approval); *Puma v. Marriott*, 283 A.2d 693 (Del. Ch. 1971) (applying the business judgment rule instead of *Unocal* to review a company transaction with a controlling shareholder where the transaction was approved by independent directors).

<sup>36</sup> See, e.g., *Tate & Lyle PLC*, 1988 Del. Ch. LEXIS at \*20-22 (invalidating rabbi trust covering both inside and outside directors because of conflict of interest).



## **B. Fiduciary Duties Under ERISA**

ERISA is the federal law governing employee retirement and welfare benefit plans. Although its original enactment was spurred by a Congressional concern for adequate funding of traditional defined benefit pension plans, ERISA has imposed from its inception a comprehensive set of requirements for many types of broad-based benefit plans, including retirement plans such as defined benefit pension plans (including cash balance plans), the well-known “401(k)” plan, employee stock ownership plans (“ESOPs”), and medical and other insurance-type plans. A key component of ERISA is the imposition of fiduciary duties and liabilities on individuals and entities that become fiduciaries in respect of such plans under ERISA. ERISA fiduciary duties are said to be the highest of such duties known to the law. It is critical, therefore, for compensation committee members to understand the extent to which they themselves may be liable as ERISA fiduciaries.

A person may become a fiduciary under ERISA by being specifically named as such in a plan document, by being identified as such under a procedure set forth in the plan document, or by exercising responsibilities that ERISA considers to be fiduciary in nature. Note that a named fiduciary may delegate fiduciary responsibilities to another person, who thereby becomes a fiduciary. However, a person who appoints a fiduciary is himself or herself a fiduciary with respect to that appointment. Compensation committees may, therefore, be considered ERISA fiduciaries for many reasons, including as a result of language in their charters or in plan documents, as a result of exercising administrative responsibilities for ERISA plans, by virtue of involvement in managing the assets funding ERISA plans, or because the compensation committees appoint plan fiduciaries (which may include employees of the company as well as third-party institutions such as trust companies or investment managers).

The decision to adopt or terminate a particular compensatory arrangement, even if the arrangement is itself subject to ERISA, is generally considered a “settlor function” and is not subject to ERISA’s fiduciary duty rules. However, once an ERISA plan is adopted, fiduciary duties may attach to determinations made pursuant to that plan. ERISA requires that fiduciaries exercise their fiduciary duties prudently and solely in the best interests of plan participants.

In general, fiduciary duties under ERISA fall under the statutorily mandated “prudent man standard of care.” Such standard requires a fiduciary to act solely in the interest of the ERISA plan participants, for the exclusive purposes of providing benefits to the plan participants and of defraying reasonable expenses of administering the plan, all with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would

use.<sup>37</sup> A wide body of law has developed under this standard, which includes duties to disclose material information to plan participants, to operate ERISA plans in accordance with their terms and applicable law, and duties to avoid conflicts of interest. Consequently, while it is not impermissible for an individual or entity that acts as a plan fiduciary also to have another role that affects the plan, fiduciaries must be alert to the possibility that their ERISA duties and their responsibilities to the shareholders may conflict, presenting special legal issues that must be addressed.

Consider, for example, the common situation in which a person who has responsibility for selecting the investment choices to be offered to 401(k) plan participants—including company stock—learns, in his or her capacity as a member of a board of directors, of confidential information that may, when announced, cause a significant and long-term drop in the company's stock price: the individual's fiduciary duty under ERISA to offer only prudent investment choices to plan participants could come into conflict with the individual's duty under the federal securities laws not to use confidential information before it is made public and with a business strategy being pursued on behalf of shareholders generally. This type of fact pattern has generated many lawsuits against directors and executives with respect to actions taken in respect of ERISA plans, where an effective legal defense was often times a judicially created presumption of prudence.<sup>38</sup> However, in June 2014, the U.S. Supreme Court eliminated this presumption in favor of a fact-specific approach in the evaluation of such claims.<sup>39</sup> This fact-specific approach creates a high bar for claims involving non-public information, by requiring that (1) the complaint contain a plausible allegation that an alternative action could have taken consistent with securities law and (2) a prudent fiduciary in like circumstance would not have viewed such alternative action as more likely to harm the fund than to help it.

Many companies have chosen to have company employees and/or independent third parties, rather than members of their board of directors, serve as ERISA fiduciaries. In such cases, however, the responsibility to appoint those fiduciaries often rests with the full board of directors or the compensation committee. As noted above, those persons who appoint fiduciaries are themselves fiduciaries, and, while such persons do not have the same breadth of ERISA fiduciary responsibility, they must still exercise their appointment powers prudently and solely in the best interests of plan participants (*e.g.*, the appointees must be qualified to serve as ERISA fiduciaries). This continued ERISA fiduciary responsibility also includes

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<sup>37</sup> See 29 U.S.C. § 1104(a).

<sup>38</sup> See *Moench v. Robertson*, 62 F. 3d 553 (3d Cir. 1995).

<sup>39</sup> See *Fifth Third Bancorp v. Dudenhoeffer*, 134 S. Ct. 2459 (2014).

exercising some oversight over the performance of the appointees, generally through a duty to monitor the activities of the appointees.

The satisfaction of ERISA fiduciary duties relies heavily on “procedural prudence,” so it is important for all ERISA fiduciaries to follow appropriate procedures, to have full access to all necessary information and expert advice pertaining to their duties, and to keep careful records of their deliberations, decisions and actions when acting in a fiduciary capacity. Boards of directors and compensation committees who have delegated ERISA fiduciary duties to qualified appointees also should receive periodic reports regarding the plans being administered by their appointees and satisfy themselves that the appointees are fulfilling their delegated functions. Obtaining and maintaining an appropriate level of ERISA fiduciary insurance for all persons acting as fiduciaries is highly recommended. Although ERISA fiduciaries may not be indemnified by the assets of ERISA plans, companies may be permitted to further indemnify its ERISA fiduciaries through bylaws or corporate resolutions.



### III.

#### Methods of Compensation

##### A. Understanding and Pursuing Compensation Goals and Objectives

“Pay-for-performance” has been the past decade’s mantra for “best practices” in executive compensation. While compensation programs should be designed so that compensation increases as corporate or individual performance metrics are met or exceeded, the financial crisis has highlighted the challenges and risks of measuring performance on a short-term basis and produced an increased emphasis on the forms of compensation that preserve and enhance the long-term value of the company.

The highest priority for a company in designing a compensation program should be to create economic incentives and encourage particular behavior. Companies should balance the need to retain employees and incentivize them, by compensating employees in a manner that rewards growth and appropriate risk-taking with the need to preserve the business. With respect to performance-based compensation, companies should select performance criteria that reflect true measures of operating performance and long-term value creation and a compensation committee may consider preserving some negative discretion to adjust downward award amounts in the event of anomalous results.

Careful thought should go into the structure and design of compensation programs to help ensure that they protect against the creation of short-term windfalls for employees that do not match long-term sustained benefits for shareholders. Moreover, a compensation committee should seek programs that it believes are in the best interests of shareholders generally, not programs that are merely intended to appease individual shareholder critics and the media at any given moment. These groups may have short-term interests that do not take into account the future well-being of the company and may have interests that are inconsistent with the interests of shareholders generally.

The different types of compensation described below are not mutually exclusive alternatives. Companies can and should consider granting a mix of types of compensation based on their business needs. A compensation committee should determine, in its business judgment based on the particular needs of the business, the appropriate mix of fixed compensation (*e.g.*, annual base salary) and variable compensation (*i.e.*, short- and long-term performance incentives), as well as the form of compensation (*e.g.*, stock options, restricted shares, restricted stock units or cash-based payments). No particular compensation vehicle (*e.g.*, stock options) should be off the table

simply because it has been criticized in the media or by shareholder activists, although committees should understand how awards will be considered by proxy advisory firms in connection with the “say-on-pay vote” recommendation.

## **B. Equity Compensation**

The manner in which most companies provide executives with equity compensation continues to evolve. We have set forth below the material characteristics of various types of equity compensation awards to aid committee members in understanding the issues involved in the design of equity compensation alternatives. To facilitate decision-making with respect to the granting of equity compensation awards, compensation committees should familiarize themselves with the economic, tax and accounting implications of granting different forms of equity compensation.<sup>40</sup> The discussion below is limited to considerations regarding equity awards granted by U.S. corporations to U.S. taxpayers, but consideration should also be given to the securities and disclosure and tax implications of granting different forms of equity compensation to in non-U.S. jurisdictions.

### **1. Stock Options**

Stock options provide employees with the opportunity to buy shares of company stock at a fixed price during a specified period of time, allowing the employee to benefit from appreciation in the value of company stock. Stock options typically have an exercise price equal to the fair market value of the underlying stock on the date of grant. Vesting of stock options generally is contingent upon an employee’s continued employment for a specified period of time (service-based options) and/or upon the achievement of specified performance goals, which may be an additional condition to vesting (performance-based options) or may result in vesting at an earlier point in time (performance-accelerated stock options).

The benefits and drawbacks to granting stock options are as follows:

<i>Benefits</i>	<i>Drawbacks</i>
<ul style="list-style-type: none"> <li>• Generally deductible under Section 162(m) of the Code without the need to establish additional performance goals if strike price is equal to or greater than fair market value on grant</li> </ul>	<ul style="list-style-type: none"> <li>• An accounting charge must be recognized following the grant even though no economic benefit may be derived by the optionee (although it is possible that the value ultimately achieved by the</li> </ul>

<sup>40</sup> The U.S. Internal Revenue Code provisions and the stock exchange rules referenced in the charts in this Chapter III are outlined and discussed more fully in Chapter IV of this Guide.

### *Benefits*

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date.

- Generally not subject to Section 409A of the Code if strike price is equal to or greater than fair market value on grant date, it is based on “service recipient” stock and there is not otherwise any deferral feature.
- Because stock options are not considered outstanding shares until exercised, they are not counted in the denominator for calculating earnings per share.
- Optionees only realize a benefit from the award if the value of the stock exceeds the exercise price and do not realize any loss if the stock price never exceeds the exercise price.

### *Drawbacks*

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optionee will exceed the charge recognized).

- Because stock option holders receive a benefit if the stock price increases, but have no downside protection if the price decreases, stock option holders may be incentivized to pursue riskier strategies.
- Potential disconnect between amount of pay received by optionee and amount of expense to company.
- Because optionees typically have a long period during which to exercise their stock options, a well-timed exercise can result in significant gain even where the company’s stock does not provide commensurate long-term gain for shareholders.
- The grant of stock options results in an increase of so-called “overhang,” which ultimately can result in dilution of existing shareholders if the stock options are exercised. We note that institutional shareholders often measure dilution taking into account outstanding stock options and/or even reserved option shares.
- In a falling stock market, underwater stock options may lose retentive value.
- Internal controls surrounding the grant of stock options have increased in complexity.
- ISS does not consider time-based stock options as performance-based compensation for purposes of its “pay for performance” analysis.

## **2. Stock Appreciation Rights**

Stock appreciation rights (“SARs”) provide employees the right to receive an amount equal to the appreciation in value of company stock over a certain

price during a specified period of time. Upon exercise of a SAR, the company pays the employee cash, stock or a combination thereof equal in value to the underlying stock's appreciation.

The benefits and drawbacks of granting SARs generally are the same as granting stock options, except:

<i>Benefits</i>	<i>Drawbacks</i>
<ul style="list-style-type: none"><li>• SARs that may be settled only in cash are not equity compensation under the NYSE and NASDAQ rules. Accordingly, no shareholder approval under such rules is required with respect to plans under which only these awards may be granted.</li><li>• Like stock options, SARs generally are not subject to Section 409A of the Code if the strike price is equal to or greater than fair market value on the grant date and a SAR is based on service recipient stock.</li><li>• The exercise of SARs does not require the holder to tender an exercise price for which he or she may need to borrow against the exercise proceeds or engage in a broker-assisted cashless exercise, either of which must be carefully structured to avoid a violation of Section 402 of Sarbanes-Oxley.</li><li>• SARs settled in cash instead of stock will not result in equity dilution.</li></ul>	<ul style="list-style-type: none"><li>• SARs settled in cash instead of stock will not increase the employee's holdings of company stock.</li><li>• SARs settled in cash are treated as liability awards for accounting purposes (requiring quarterly adjustments to the compensation charge based on the price of the stock underlying the SARs).</li><li>• SARs settled in cash will require an outlay of cash by the company.</li><li>• ISS does not consider time-based SARs as performance-based compensation for purposes of its "pay for performance" analysis.</li></ul>

### **3. Restricted Stock**

Restricted stock is a grant of shares of company stock subject to specified vesting provisions and limitations on transfer. Vesting of restricted stock typically is contingent upon an employee's continued employment for a specified period of time (service-based restricted stock) and/or upon the achievement of specified performance goals, which may be an additional condition to vesting (performance-based restricted stock) or may result in vesting at an earlier point in time (performance-accelerated restricted stock).



The benefits and drawbacks of using restricted stock are as follows:

<i><b>Benefits</b></i>	<i><b>Drawbacks</b></i>
<ul style="list-style-type: none"> <li>• Holders of restricted stock share in the upside and the downside of an increase or decrease of share price, which directly aligns the interests of restricted shareholders and shareholders.</li> <li>• From the perspective of employees, restricted stock may represent a more tangible benefit than stock options.</li> <li>• Holders of restricted stock can vote and receive dividends.</li> <li>• The ability of employees to make a Section 83(b) election may enable an employee to achieve a favorable tax result if the value of the restricted stock appreciates during the vesting period (although such elections are uncommon at public companies).</li> <li>• Restricted stock generally is not subject to Section 409A of the Code.</li> <li>• Holders of restricted stock will realize value even if the price of company stock decreases during or after the vesting period. Accordingly, restricted stock may have greater retentive value than stock options in a down market, and may not encourage risky strategies as could be the case with stock options or SARs.</li> </ul>	<ul style="list-style-type: none"> <li>• Employees will receive some value from restricted stock even if the stock performs poorly.</li> <li>• Certain institutional shareholders have requested that companies limit the number of “full value” awards such as restricted stock that companies grant to their employees and directors.</li> <li>• ISS will subtract points from the Equity Plan Scorecard of a plan that allows dividend equivalents to be paid on unvested equity awards; companies should be aware of this when granting restricted stock and may decide that dividends instead will accrue and not be paid unless and until the underlying shares become vested.</li> <li>• Shares of restricted stock are outstanding and are included in the denominator for computing “diluted” earnings per share.</li> <li>• Restricted stock does not qualify for the “performance-based compensation” exception to the deduction limit imposed by Section 162(m) of the Code unless its grant or vesting is performance-based (within the meaning of Section 162(m) of the Code).</li> </ul>

#### **4. Restricted Stock Units**

Restricted stock units (“RSUs”) consist of awards in the form of phantom shares or units, which generally are valued based on company stock. RSUs may be settled in cash, stock or both. As is the case with restricted stock, vesting of RSUs may be service-based, performance-based and/or performance-accelerated. The benefits and limitations of using RSUs as a means of compensation are the same as restricted stock, except:

### *Benefits*

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- RSUs that can be settled only in cash are not equity compensation under the NYSE and NASDAQ rules. Accordingly, no shareholder approval is required with respect to cash-based RSUs under such rules.
- RSUs that can be settled only in cash are not equity securities under U.S. securities laws, and so no registration statement is required to be maintained.
- RSUs that are ultimately settled in cash instead of stock will not result in shareholder dilution.
- Because RSUs are not “property” under Section 83 of the Code and merely represent a general unsecured promise to pay a future amount, an employee may postpone taxation beyond vesting (the company’s deduction is similarly delayed) until such time as the RSUs are settled. Accordingly, RSUs can allow employees to retain an interest in company stock and, consequently, company performance for an extended period of time without triggering a tax liability.
- Because RSUs are not property (making a Section 83(b) election unavailable), companies do not have the difficulty of administering Section 83(b) elections for broad employee populations.
- RSUs could be structured (if done in advance) to delay delivery of stock to a future date post-termination of employment, which could help align executives’ interests with shareholders and ease enforcement of clawbacks.

### *Drawbacks*

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- If RSUs may be settled only in cash, or in stock or cash at the company’s election, RSUs are not reportable in the proxy statement beneficial ownership table.
- Because RSUs are not property, grantees cannot make a Section 83(b) election.
- As with restricted stock, ISS also will subtract points from the Equity Plan Scorecard of a plan that allows dividend equivalents to be paid on unvested restricted stock units.
- RSUs settled in cash instead of stock require a cash outlay by the company, and unless such settlement could jeopardize the company as an ongoing concern (a high standard), Section 409A of the Code does not allow the company to delay payment even if such a cash outlay could significantly impair the company financially (*e.g.*, cause it to be in default under its credit facility).
- RSUs settled in cash instead of stock will not increase the employee’s holdings of company stock and generally do not count towards share ownership requirements.
- RSUs do not qualify for the “performance-based compensation” exception to the deduction limit imposed by Section 162(m) of the Code unless their grant or vesting is performance-based (within the meaning of Section 162(m) of the Code) or the receipt of income from the award is deferred until the executive is no longer subject to Section 162(m) of the Code.
- RSUs settled in cash are treated as liability awards for

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***Benefits***

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***Drawbacks***

accounting purposes (requiring quarterly adjustments to the compensation charge based on the price of the stock underlying the RSU).

- RSUs which provide for the deferral of payment post-vesting may be subject to Section 409A of the Code, depending on their terms, which can limit a company's flexibility to modify such awards (*e.g.*, accelerate settlement, or further delay settlement, of previously vested RSUs).

**C. Retirement Programs**

In addition to the other compensation programs described above, compensation committees often provide executives with retirement benefits under either defined contribution plans (*e.g.*, 401(k) plans) or defined benefit plans (*e.g.*, pension plans that provide a fixed retirement benefit based on years of service and final pay). These arrangements can either be (1) "qualified plans," which provide the company with tax benefits but generally must be provided to a large portion of the employees and are subject to limitations on, among other things, the aggregate benefit payable to participants under the plans and complex rules under the Code and ERISA or (2) "nonqualified plans," which may be limited to senior executives and provide them with additional retirement benefits that are not subject to the limitations imposed under the Code and ERISA.

When establishing and designing qualified retirement plans, companies should be sure to understand the applicable funding and contribution requirements. The obligations under these plans, as well as the value of assets funding those obligations, are disclosed in a company's financial statements, although a company's management should be aware that the manner in which these obligations are calculated for accounting and reporting purposes differ from the manner in which these obligations are calculated under ERISA for purposes of determining funding obligations. And as discussed in Chapter II, boards of directors should understand the ERISA fiduciary law implications of maintaining qualified retirement plans.

When designing nonqualified retirement plans, companies should be sure to understand the cost of the arrangements, including any implications that increases in annual compensation may have on that cost. Moreover, as these programs generally represent a general unsecured promise by the company to

pay amounts to executives in the future, which constitute accrued liabilities that show up in a company's financial statements, they effectively result in executives being creditors of the company. As creditors of the company, executives with large nonqualified retirement benefits may be incentivized to act more conservatively with regard to risk-taking and capital investment, especially as they approach the stated retirement age when their pensions become payable.

#### **D. Perquisites**

No perquisites should be provided to executive officers without full disclosure to the compensation committee. Any compensation or other benefit received by any officer from any affiliated entities (using a low threshold for the definition of an affiliated entity) should be carefully reviewed to confirm compliance with the company's code of business conduct and ethics and applicable law. Perquisite programs and company charitable donations to any organizations with which an executive is affiliated should be carefully scrutinized to make sure that they do not create any potential appearance of impropriety.

Regulators and institutional shareholders are giving intense scrutiny to executive compensation. While the rhetoric may, in many cases, be overblown, procedure and disclosure are often as important as the substance of underlying compensation packages. And while criticism cannot always be avoided, actions taken by a well-informed and objective compensation committee, which are then appropriately disclosed to shareholders, will be shielded from liability. Some companies have modified perquisite programs by increasing annual base salaries and eliminating perks, by limiting the aggregate value of perquisites to less than the proxy disclosure threshold and/or by entering into arrangements whereby the company is reimbursed by the executives for perks that the company provides.

#### **E. Clawback Provisions**

Clawback policies provide companies with the ability to recoup incentive-based compensation in certain circumstances, such as a financial restatement or commission of an act detrimental to the company. Clawback policies provide a number of benefits to a company, including enhancing shareholder confidence in executive accountability, promoting the accuracy of financial statements and alignment of risks and rewards. In addition, many institutional investors favor clawback policies, and the adoption of such a policy can result in favorable press and public perception. Of course, there are also countervailing considerations. If inappropriately designed, clawback policies can result in unfair treatment of executives and put pressure on compensation committee members to enforce the policies, even where directors do not believe that it is appropriate to do so.

Over the past several years, clawback policies have increased dramatically in prevalence. According to a recent study, clawback policies are maintained at 90% of 250 large publicly traded companies, but the typical policy is discretionary and not mandatory.<sup>41</sup> When the July 1, 2015 proposed regulations imposing the mandatory compensation clawback policies included in Dodd-Frank (discussed in more detail in Chapter IV of this Guide) are finalized, all public companies will be required to impose mandatory clawbacks.

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<sup>41</sup> See Meridian Compensation Partners LLC, 2015 Corporate Governance & Incentive Design Survey (November 16, 2015).



## IV.

### Laws and Rules Affecting Compensation

#### A. Section 162(m) of the Internal Revenue Code

##### 1. General

Section 162(m) of the Code (“Section 162(m)”) generally disallows a publicly traded company’s federal income tax deduction for compensation paid to “covered employees” in excess of \$1 million during a company’s taxable year. This \$1 million deduction limit covers all types of compensation, including cash, property and spread on the exercise of options. However, there are important exceptions to the deduction limitation, including “performance-based compensation” keyed to a pre-established, objective, nondiscretionary goal and formula, which are described in detail below.

In light of Section 162(m), a publicly traded company generally is left with two choices: (a) forego a federal income tax deduction for compensation during a taxable year in excess of \$1 million to any one of its “covered employees,” or (b) adopt compensation practices so that any compensation in excess of \$1 million either (1) consists of performance-based compensation structured to comply with the requirements of the performance-based compensation exception or (2) is deferred to a time when the recipient is no longer one of the company’s “covered employees.” For financial institutions receiving government assistance under the Troubled Asset Relief Program (“TARP”) and for certain health insurance providers, the deduction limitation has been lowered from \$1 million to \$500,000 and there is no exception for performance-based compensation.

##### 2. “Covered Employees”

“Covered employees” for purposes of Section 162(m) are a company’s principal executive officer and the three other most highly compensated executive officers who are required to be named in the company’s executive compensation disclosure under the SEC disclosure rules (other than the principal financial officer (“PFO”). As such, the term “covered employee” does not currently include a PFO, regardless of whether the PFO is among the other three highest compensated officers for the taxable year, except in the case of a smaller reporting company where the CFO is one of the two most highly paid executive officers (not including the CEO).<sup>42</sup>

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<sup>42</sup> See IRS Chief General Counsel Memorandum 201543003, dated August 24, 2015.

While the exclusion (generally) of the PFO from Section 162(m) may be beneficial to companies whose PFOs receive compensation in excess of \$1 million that does not otherwise comply with the performance-based exception of Section 162(m), the limitations of Section 162(m) generally apply to a company in the taxable year in which the compensation would otherwise be deductible, and Congress may ultimately amend the statute to provide that CFOs are covered employees. Indeed, the Emergency Economic Stabilization Act of 2008 amended Section 162(m) for financial institutions participating in TARP to be more stringent and to apply to PFOs. Accordingly, even though there are only four executive officers potentially covered by Section 162(m), companies should cast a broad net when determining the executive officers who potentially could be considered “covered employees” when designing their compensation programs.

### **3. Performance-Based Compensation Exception**

The \$1 million deduction limit does not apply to compensation that meets the following requirements:

- the compensation is payable solely on account of attaining one or more pre-established, nondiscretionary and objective performance goals (options and SARs granted with a strike price at or above fair market value meet this requirement);
- the performance goal(s) is established no later than 90 days after the beginning of the service period to which the goal relates and within the first 25% of the period, and achievement thereof is determined, by a compensation committee, or a subcommittee thereof, of the board of directors comprised solely of two or more “outside” directors;
- the material terms of the performance goal(s) under which the compensation is to be paid are disclosed to shareholders and approved by a majority of the shareholders voting in a separate vote before any compensation due in respect of such performance goal is payable; and
- before the compensation is paid, the compensation committee certifies that the performance goals and any other material terms were satisfied.

### **4. Section 162(m) Compliance Procedures**

Compensation committees should have their incentive compensation plans and arrangements and the manner in which they are administered reviewed by counsel to determine whether they are in fact complying with the requirements of the performance-based exception from Section 162(m),



where such compliance is intended. Compensation committee members should familiarize themselves with the basics of Section 162(m) and take them into account in structuring executive compensation. Moreover, a compensation committee should confirm that the proxy statement disclosure relating to Section 162(m) is accurate and that the proper internal controls to ensure compliance in this area have been implemented. In particular, a compensation committee should consider designating an individual at the company as the compliance person for Section 162(m) and should request periodic compliance updates so that the Section 162(m) requirements are fully understood.

## **B. Section 409A of the Internal Revenue Code**

Section 409A of the Code (“Section 409A”) imposes penalties on participants in deferred compensation arrangements that do not comply with the strict requirements of the rules published under Section 409A. “Deferred compensation” for these purposes can, perhaps unexpectedly, include severance payments and reimbursement rights. Given the far-reaching impact of Section 409A, companies have rightly devoted, and continue to devote, a great deal of time and resources to implementing and operating programs to comply with Section 409A. While a compensation committee should satisfy itself that the company is aware of and is complying with the legislation, the committee need not spend inordinate amounts of time trying to understand the intricacies of the technical rules that have no impact on the arrangements’ commercial terms.

## **C. Stock Exchange Rules Regarding Shareholder Approval of Equity Compensation Plans**

### **1. General Rules**

NYSE and NASDAQ listing standards require listed companies to obtain shareholder approval of most equity compensation plans. A compensation committee should be aware that these rules may require shareholder approval of proposed plans and material plan amendments. NYSE and NASDAQ rules exclude the following types of plans from this shareholder approval requirement:

- arrangements under which employees receive cash payments based on the value of shares rather than actual shares (*e.g.*, cash-settled phantom stock);
- arrangements that are made available to shareholders generally (such as a typical dividend reinvestment plan);

- arrangements that merely provide a convenient way for employees, directors or other service providers to purchase stock at fair market value;
- plans intended to qualify under Section 401(a) of the Code (qualified pension, profit-sharing and stock bonus plans) or Section 423 of the Code (employee stock purchase plans);
- “parallel excess plans,” a narrowly defined category of excess benefit plans;
- equity grants made as a material inducement to an individual becoming an employee of the company or any of its subsidiaries;
- rollover of options and other equity awards in connection with a merger or acquisition; and
- post-acquisition grants to those who are not employees of the acquirer at the time of acquisition of shares remaining under a target plan that had been approved by the target’s shareholders (although use of such share reserves in connection with the transaction will be counted by the NYSE and NASDAQ in determining whether the transaction must receive shareholder approval as an issuance of 20% or more of the company’s outstanding common stock).

## **2. Material Revisions**

The NYSE and NASDAQ rules provide the following examples of revisions to equity compensation plans that are considered “material” and, therefore, require shareholder approval:

- a material increase in the number of shares available under the plan, other than an increase solely to reflect a reorganization, stock split, merger, spin-off or similar transaction;
- an expansion of the types of awards available under the plan;
- a material expansion of the class of individuals eligible to participate in the plan;
- a material expansion of the term of the plan;
- a material change to the method of determining the strike price of options under the plan; and

- a deletion or limitation of any provision prohibiting repricing of options.

In light of the requirement that material amendments be approved by shareholders, a compensation committee should consider requesting that newly adopted plans be drafted to ensure maximum flexibility in the types of awards that can be granted and the terms and conditions thereof.

#### **D. Dodd-Frank Proposed Pay Versus Performance Rules**

Dodd-Frank requires that the SEC promulgate rules requiring most listed companies (foreign private issuers, registered investment companies and emerging growth companies are exempt) to disclose the relationship between compensation actually paid to executives and the financial performance of the company in the proxy or information statements in which executive compensation disclosure is required under applicable rules. On April 29, 2015, the SEC issued its proposed rules on this “pay for performance” disclosure mandated under Dodd-Frank.<sup>43</sup> Highlights of the proposed rule are as follows:

The proposed rules would require companies to disclose in a new table the following information:

- the 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, which compensation would be as disclosed in the summary compensation table already required in the company’s proxy statement (with adjustments to the amounts included for pensions and equity awards, discussed in more detail below);
- the total compensation reported in the summary compensation table for the CEO and an average of the reported amounts for the remaining named executive officers; and
- the company’s total shareholder return (TSR) on an annual basis, as well as the TSR, on an annual basis, of the companies in the company’s peer group (as identified by the company in its stock performance graph or in its CD&A).

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<sup>43</sup> See Pay Versus Performance; Proposed Rule, 80 Fed. Reg. 26329 (May 7, 2015) (amending 17 C.F.R. Parts 229 and 240), available [here](#).

Using the information presented in the tables described above, companies would be required to describe the relationship between the executive compensation “actually paid” and the company’s TSR, and the relationship between the company’s TSR and the TSR of its selected peer group. This disclosure could be described as a narrative, graphically, or a combination of the two.

As mentioned above, under the proposed rules, executive compensation “actually paid” would be calculated using compensation that companies report in the summary compensation table already required in the proxy statement as a starting point, with adjustments relating to pension amounts and equity awards. Companies would be required to disclose the adjustments to the compensation as reported in the summary compensation table.

- Pension amounts would be adjusted by deducting the change in pension value reflected in that table and adding back the actuarially determined service cost for services rendered by the executive during the applicable year. Smaller reporting companies would not be required to make adjustments in pension amounts because they are subject to scaled compensation disclosure requirements that do not include disclosure of pension plans.
- Equity awards would be considered “actually paid” on the date of vesting and at fair value on that date, rather than fair value on the grant date as required in the summary compensation table. Both of these amounts would be disclosed in the new table. A company would be required to disclose the vesting date valuation assumptions if they are materially different from those disclosed in its financial statements as of the grant date.

This new disclosure would be required for the last five fiscal years, except that smaller reporting companies would be required to provide disclosure for only the last three fiscal years. Smaller reporting companies would not be required to present a peer group TSR performance graph or a CD&A. Note that once the rules are final, there will be a “phase-in” for all companies. Companies, other than smaller reporting companies, would be required to provide the information for three years in the first proxy or information statement in which they provide the disclosure, adding another year of disclosure in each of the two subsequent annual proxy filings that require this disclosure. Smaller reporting companies would initially provide the information for two years, adding an additional year in their subsequent annual proxy or information statement that requires this disclosure.

As mentioned above, it remains to be seen whether this rule is finalized or abandoned under the new Administration.

## **E. Dodd-Frank Proposed Compensation Clawback Rules**

Dodd-Frank requires that the SEC promulgate rules requiring listed companies to adopt a policy mandating clawbacks of compensation that was paid to a current or former executive officer during the three-year period preceding the date on which the company is required to prepare an accounting restatement as a result of material noncompliance with the securities laws, if the compensation is determined to have been based on erroneous data. The SEC is further required to direct the securities exchanges to prohibit the listing of companies that do not comply with those rules.

On July 1, 2015, the SEC issued its proposed rules on the clawback of compensation as mandated under Dodd-Frank.<sup>44</sup> As of the date of this Guide, the SEC had not yet finalized these rules. Once the final rules are published (the “SEC Publication Date”), each securities exchange will have 90 days to file proposed listing standards that must become effective within one year of the SEC Publication Date. Listed companies would be required to (1) adopt a compliant recovery policy no later than 60 days following the effective date of the applicable listing standards and (2) recover excess incentive-based compensation received on or after the SEC Publication Date if that compensation was based on financial information for any fiscal period ending on or after the SEC Publication Date. The additional proxy statement disclosures (described below) would apply immediately following the effective date of the applicable listing standards.

As expected, the proposed Dodd-Frank compensation clawback rules are much broader than the only currently existing statutory clawback rule, which is the one provided under Section 304 of Sarbanes-Oxley. Most significantly, the Dodd-Frank clawback (1) requires each listed company to adopt a written policy, whereas the Sarbanes-Oxley clawback operates on its own as a matter of law, (2) does not require there to have been any misconduct for compensation to be subject to clawback, as does Sarbanes-Oxley, and (3) covers all current and former executive officers of a listed company, whereas Sarbanes-Oxley only covers the chief executive officer and chief financial officer.

Generally, the proposed rules answer the questions we have posed in our prior Guides as questions to be considered when implementing a clawback policy:

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<sup>44</sup> See Listing Standards for Recovery of Erroneously Awarded Compensation; Proposed Rule, 80 Fed. Reg. 41143 (July 14, 2015) (amending 17 C.F.R. Parts 229, 240, 249 and 274), available [here](#).

- *Which companies would be covered?* With very limited exceptions, the rules would apply broadly to all companies with listed securities, including foreign private issuers, emerging growth companies, smaller reporting companies, controlled companies and issuers of listed debt whose stock is not also listed.
- *What type of restatements would trigger application of the recovery policy?* A restatement to correct an error that is material to previously issued financial statements would trigger application of the recovery policy. The determination regarding materiality would be based on facts and circumstances and existing judicial and administrative interpretations.
- *Which individuals would be covered?* The recovery policy would apply to a company's current and former executive officers who served in that capacity at any time during the applicable look-back period. Under the proposed rules, "executive officer" means the company's president, principal financial officer, principal accounting officer, any vice president in charge of a principal business unit, division or function and any other person (including executive officers of a parent or subsidiary) who performs similar policy-making functions for the company.
- *What types of incentive-based compensation would be covered?* Under the proposed rules, "incentive-based compensation" means any compensation that is granted, earned or vested during an applicable look-back period, and that is based wholly or in part upon the attainment of any financial reporting measure. "Financial reporting measures" include measures that are determined and presented in accordance with the accounting principles used in a company's financial statements, as well as a company's stock price and total shareholder return. Importantly, stock options and other equity awards that vest exclusively on the basis of service, without any performance condition, and bonus awards that are discretionary or based on subjective goals or goals unrelated to financial reporting measures, would not constitute incentive-based compensation.
- *How would the applicable look-back period be determined?* Incentive-based compensation *received* during the three completed fiscal years immediately preceding the date that a restatement is required to correct a material error would be subject to the recovery policy. Incentive-based compensation would be deemed received in the fiscal period during which the financial reporting measure specified in the incentive-based compensation award is attained, even if the payment or grant occurs before or after that period.

- *How would the recovery amount be determined?* The recovery amount would equal the amount, calculated on a pre-tax basis, of incentive-based compensation received in excess of what would have been paid to the executive officer upon a recalculation of such compensation based on the accounting restatement. For incentive-based compensation that is not subject to mathematical recalculation based on the information in an accounting restatement (*e.g.*, compensation based on stock price goals or total shareholder return), the recoverable amount may be determined based on a reasonable, documented estimate of the effect of the accounting restatement on the applicable measure.

For equity awards that are incentive-based compensation, if the shares or options are still held at the time of recovery, the recoverable amount would be the number of shares or options received in excess of the number that should have been received after applying the restated financial reporting measure. If options have been exercised, but the underlying shares have not been sold, the recoverable amount would be the number of shares underlying the excess options applying the restated financial measure. If shares have been sold, the recoverable amount would be the sale proceeds received by the executive officer with respect to the excess number of shares.

- *Would the board have discretion whether to seek recovery?* Board discretion would be very limited. A company would be required to recover compensation in compliance with its recovery policy *except* to the extent that pursuit of recovery would be impracticable because it would impose undue costs on the company or would violate home country law based on an opinion of counsel. Before concluding that pursuit is impractical, the company would first need to make a reasonable attempt to recover the incentive-based compensation. Finally, a board would be required to apply any recovery policy consistently to executive officers, and a company would be prohibited from indemnifying any current or former executive officer for recovered compensation.
- *What additional disclosure requirements would the new proposed rules impose?* A listed U.S. company would be required to file its recovery policy as an exhibit to its Form 10-K. In addition, the proposed rules would require disclosure in the company's annual proxy statement regarding the application of the recovery policy if, during the prior fiscal year, either a triggering restatement occurred or any balance of excess incentive-based compensation was outstanding. Required disclosure would include, for the prior fiscal year, (1) the names of individuals from whom the company declined to seek recovery, and (2) the name of and amount due from, each person from whom excess incentive-based compensation had been

outstanding for 180 days or longer. In addition, any amounts recovered would reduce the amount reported in the applicable Summary Compensation Table column for the fiscal year in which the amount recovered initially was reported as compensation.

Note that a company could always choose to impose a clawback policy that is broader than the foregoing clawback policy (*e.g.*, in the event of acts of misconduct by an executive), but in such an event, a board of directors may also wish to consider other questions, such as:

- During what period of time will the right to clawback exist (*i.e.*, will it be perpetual or sunset)?
- What compensation will be covered by the clawback policy?
- Will amounts clawed back be repaid on a pre-tax or after-tax basis?
- Will “due process” protections apply (*e.g.*, an executive’s right to be heard before the board of directors prior to enforcement, supermajority vote of the board of directors required to enforce and/or reimbursement of the executive’s legal fees if he or she prevails in a dispute over the clawback)?
- Will the clawback be in the form of a policy adopted by the board of directors or the compensation committee (in which case enforcement typically would be through a lawsuit against the executive claiming unjust enrichment), or one or more agreements between the company and the executive giving the company contractual clawback rights?
- Is there a reasonable expectation that the clawback policy is enforceable under applicable state laws, to the extent the clawback policy is broader than that currently described under Dodd-Frank?

There is no “right” answer to each of the foregoing questions and each company should tailor its clawback policy to address company-specific needs. However, it is important to give due consideration to each feature of a policy to optimize its effectiveness for the company, and also to recognize that the SEC’s proposed compensation clawback rules do not leave much room for flexibility with respect to the compensation clawback policy that will be required to be imposed on listed U.S. companies.

Once again, the new regulation-adverse Administration may take its time finalizing this rule, if ever.



## V.

### **Change in Control Compensation Arrangements**

#### **A. Addressing Executive Uncertainty in a Deal Environment**

As institutions face industry consolidation amid regulatory, competitive and business model challenges, employees are understandably anxious about the future should their employer be acquired by or merge with another entity—whether in a friendly, distressed or hostile deal. To offset these pressures and to permit successful recruitment and retention of executives, many companies have adopted arrangements containing change in control provisions. These typically include change in control severance or employment agreements providing enhanced severance, acceleration of equity compensation awards and accelerated payment and/or vesting of deferred compensation in the event of a qualifying termination in connection with a change in control.

Change in control severance and other arrangements are not intended to deter combinations, but, by reducing the personal uncertainty and anxiety arising from a merger, such arrangements can help to assure full and impartial consideration of takeover proposals by a company’s management and aid a company in attracting and retaining key executives. Careful attention must be paid, however, to the applicable statutes and regulations to make sure that all tax and other legal concerns are properly reflected in any arrangement that is adopted.

Issues surrounding compensation, such as the treatment of equity awards, severance protection and retention, continue to be of critical importance in transactions. Changes in compensation arrangements stemming from the influence of proxy advisors, including the trends of eliminating “golden parachute” excise tax gross-ups and single-trigger vesting, and the increasing prevalence of equity awards that are performance-based and deferred, requires companies to understand and consider in careful detail the consequences and tax implications of a change in control. Severance and other change in control protections should be reevaluated periodically in light of the changes in a company’s compensation programs from year to year.

#### **B. Forms of Compensatory Arrangements**

##### **1. Change in Control Protections**

Many companies have adopted change in control protections for senior management. Typically, these protections include change in control severance or employment agreements or, increasingly, severance protection plans. A change in control employment or severance protection agreement or plan often becomes effective only upon a change in control or in the event of

a termination of employment in anticipation of a change in control. A standard form of agreement or plan usually provides for a two- or three-year term after the change in control during which time the status quo is preserved for the executive in terms of duties, responsibilities and employee benefits. In general, in the event that the status quo is not preserved and the executive resigns or the executive's employment is terminated by the company, the executive would be entitled to severance pay (typically, a multiple of base salary plus an annual bonus amount).

Most change in control employment or severance protection agreements and plans also contain provisions addressing the so-called "golden parachute" excise tax. The federal golden parachute tax rules subject "excess parachute payments" to a dual penalty: the imposition of a 20% excise tax upon the recipient and nondeductibility of such payments by the paying company. Excess parachute payments result if the aggregate payments received by a "disqualified individual" that are "contingent on a change in control" equal or exceed three times the individual's "base amount" (the average annual taxable compensation of the individual for the five years preceding the year in which the change in control occurs). In such case, the excess parachute payments are equal to the excess of (a) such aggregate change in control payments over (b) the employee's base amount. In other words, the excise tax and nondeductibility rules apply not just to the excess over three times the base amount, but, once triggered, apply to the whole amount in excess of the base amount.

Three approaches generally are taken to dealing with golden parachute tax penalties in change in control agreements and plans:

- payments can be "grossed up" so that the employee is in the same after-tax position as if there were no excise tax;
- payments that are contingent on a change in control can be "cut back" to 299.9% of the base amount, so that no payments are considered parachute payments; and
- payments that are contingent on a change in control are cut back only if the result is to give the employee a larger after-tax return than if the payment were not cut back (a so-called "better-off cutback").

After an analysis of the amounts involved, many companies historically adopted a "gross-up" provision in order to ensure that the excise tax does not undo the intended goals of the arrangement. In addition, gross-ups often were provided for reasons of equity because the excise tax punishes promoted employees in favor of those who are not promoted, newly hired employees in favor of longer-term employees, employees who do not exercise options in favor of those who do and employees who elect to defer

compensation in favor of those who do not. Moreover, the tax is more likely to apply to employees who receive change in control acceleration of performance-based compensation than it is to those who receive acceleration of time-based awards.

ISS has identified the adoption of golden parachute excise tax gross-ups in new, extended or materially modified agreements, or executive change in control plans as a “problematic” pay practice that is likely to result in a negative recommendation on a say-on-pay vote or, where there is no say-on-pay vote, or where concerns expressed by ISS on a say-on-pay vote are not addressed in the following year, a “withhold the vote” recommendation for the compensation committee or even the entire board of directors. Companies that have implemented golden parachute excise tax gross-ups in preexisting agreements and plans and have determined that such gross-ups are in the best interests of the company and its shareholders need not eliminate them to avoid scrutiny by ISS, as ISS generally will make its recommendations regarding the periodic “say-on-pay” vote (but not the “golden parachute say-on-pay” vote) taking into account only agreements and plans that are new, extended or materially amended. Those companies that wish to preserve such gross-ups should only amend the arrangements that contain the gross-ups with great care, as such amendments could de-grandfather the arrangements and result in ISS review for these purposes. While an extension of an existing agreement will trigger ISS review, the automatic renewal of an agreement with an “evergreen” provision (itself a feature that ISS does not consider a “best practice”) generally will not be deemed an “extension” for that purpose.<sup>45</sup>

In light of ISS’s position on golden parachute excise tax gross-ups, many companies have elected to implement “better-of net after-tax” cutbacks, which provide the executive with as much of the intended benefit as he or she would receive if no excise tax applied without providing a gross-up. And, while the acquiring company will lose the deduction if an executive is better off receiving all payments and paying the tax, we have not been involved in any transactions where the costs associated with the lost deduction were considered a deal issue. In the past few years, there has been a trend for target companies to reinstate excise tax gross-ups in connection with the change in control transaction.

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<sup>45</sup> See Chapter VII of this Guide for a more detailed discussion of say-on-pay votes and ISS and other proxy advisory firms generally.

## 2. Stock-Based Compensation Plans

In addition to employment and severance protection agreements and plans, companies should review the status of their stock-based compensation plans for change in control provisions. Plans often contain provisions for acceleration of stock options, lapse of restrictions on restricted stock and deemed achievement of performance goals on performance stock awards upon a change in control or upon a severance-qualifying termination thereafter. Stock plans also often provide an extended post-termination exercise period for stock options and SARs upon terminations of employment following a change in control (*e.g.*, the lesser of three years or the remainder of the original term). Since these provisions may result in parachute payments, plan amendments should be considered and implemented in the context of an overall review of change in control employment protections, and the associated costs should be analyzed in that context. While ISS encourages double-trigger change in control vesting (which is a factor in the ISS EPSC as described in Chapter VII of this Guide), single-trigger vesting provisions in an equity plan will not automatically result in a negative recommendation for the equity plan, although equity plans that include both single-trigger vesting and a liberal change in control definition “are likely to receive a negative recommendation.”

In 2015, ISS issued updated “Frequently Asked Questions” (“FAQs”), which require that full credit under the EPSC will only be given if, in a change in control where awards are not assumed, (x) time-vested awards fully vest and (y) performance-based awards only vest based on actual performance as of the change in control and/or on a pro rata basis for time elapsed during the relevant performance period. If awards are assumed by the acquirer in the change in control, they should not single-trigger vest under EPSC standards. On December 16, 2016, ISS expanded on how ISS views equity vesting provisions when making recommendations in connection with a “say-on-golden parachute” vote to enumerate its positions: (1) maintaining existing criteria is a “good practice”; (2) pro rata vesting based on actual goal achievement for performance awards and/or based on partial completion of the vesting period is a “best practice”; (3) acceleration of awards granted shortly before a change in control is viewed as a greater windfall; and (4) auto-acceleration concerns are greater when awards make up the majority of named executive officers’ golden parachutes, or where accelerated awards granted in the cycle before the change in control are larger than in prior cycles.

In designing employee stock plans, as well as other types of benefit and compensation plans, companies should be sensitive to the need to retain key personnel through the closing of a transaction to help ensure that the board of directors is delivering to the acquirer an intact management team.

### **3. Separation Plans**

In addition to change in control employment and severance protection agreements with, and/or plans covering, senior executives, many public companies have adopted change in control separation plans, or so-called “tin parachutes,” for less senior executives, sometimes covering the entire workforce. These separation plans either formalize informal policies or provide enhanced severance in the event of a layoff occurring within one or two years after a change in control. These plans generally provide for severance benefits determined on the basis of seniority/position, pay and years of service or some combination of these factors, and may provide continuation of benefits with the company paying all or a portion of the expense and outplacement services. Severance usually is payable following an involuntary termination without cause or a constructive termination, such as relocation, decrease in base salary or wages, or material diminution in duties.

Due to the large numbers of people involved, separation plans should be adopted after a careful review of the estimated costs, including an analysis of the potential impact of golden parachute excise tax and deductibility provisions of the Code on the payments and benefits provided under the plan. The last-minute addition of enhanced severance costs may drive up the cost of a merger. Further, targets should be sensitive to the fact that in an in-market merger involving facility closings or similar reductions in force, an acquirer may be forced to adopt the target’s severance policies so that employees of the acquirer who are laid off are not treated worse than similarly situated target employees.

### **4. Deferred Compensation Plans**

Due to the credit risk associated with the payment of deferred compensation and other unfunded nonqualified plan benefits, plans often provide for, or participants elect, an immediate lump-sum payment of the entire account balance upon a change in control without regard to prior elections as to timing and method of distribution. Any such election should be reviewed to ensure that it complies with Section 409A of the Code. The definition of “change in control” applicable to change in control distribution provisions in, or individual elections under, deferred compensation plans for employees and directors should be reviewed and understood prior to a transaction, since Section 409A of the Code imposes significant limitations on the ability to alter distribution provisions or elections after they are established. Although some companies may prefer the administrative ease of having only one change in control definition for all purposes, a change in control definition that mirrors the definition in Section 409A of the Code is not required for all change in control provisions in all compensation arrangements. In general, companies should use definitions that they believe indicate a true transfer of

control of the company and should provide, only to the extent required by Section 409A of the Code, that the definition will be triggered if such event also constitutes a “change in control event” within the meaning of Section 409A of the Code.

## **5. Retention Programs**

A retention program is a helpful tool to ensure that the employees who are necessary to the completion of a transaction and the transition following closing are retained and incentivized to stay focused and committed. Retention is an issue for both the seller and buyer, with the seller often most concerned about retaining key employees through closing and the buyer focused on the transition beyond the closing. The specific terms of the retention program, such as total amount and general payment timing and terms, are negotiated in connection with a transaction among the management teams. Individual awards are usually made during the period between signing and closing. The impact of the excise tax under Section 280G of the Code and the application of Section 409A of the Code should be understood and considered when developing retention programs and allocating awards thereunder. For purposes of evaluating merger proposals, ISS is less concerned about “completion bonuses” than severance, recognizing the value of management continuity and post-transaction integration and transition needs. Companies should understand the disclosure obligations relating to the adoption of a retention program, which could require filing a Form 8-K depending on the individuals receiving the awards.

## VI.

### **Special Considerations Applicable to Financial Institutions**

Executive compensation and broad-based incentive compensation matters at financial institutions continue to be sensitive subjects that are scrutinized by the media and shareholders, and the regulatory requirements and standards relating to the design and administration of compensation arrangements at financial institutions continue to become more complex. While much of the public attention has been focused on executive compensation that is deemed excessive in amount, there has also been a critical assessment of the interplay among compensation and governance policies, corporate risk-taking and short-termism.

Following the financial crisis, regulators have increasingly focused on the structure of compensation deep into the organization as it relates to risk management and the corporate governance practices relating to compensation decisions. Large banking organizations continue to be in dialogue with regulators regarding the implementation of supervisory expectations relating to compensation design, governance and controls. Outside of the United States, newly effective and highly prescriptive E.U. regulations on incentive compensation, such as a cap on bonuses to bankers, is leading to higher fixed compensation (generally through increased salary, since in October 2014, European regulators determined that periodic allowances should be treated as incentive compensation) at European financial institutions as they seek to remain competitive in retaining talent.

In the pursuit of good corporate governance and risk management, and as strongly encouraged by regulatory guidance, design changes in compensation programs at financial institutions include longer deferral periods and vesting schedules—changes that result in ongoing and growing deferred compensation expenses, which at some point will need to be paid. It is unclear whether the design changes that are intended to promote safety and soundness will accomplish their intended effect or will prove adequate to retain and incentivize a committed and stable leadership team—critical to any well-run organization.

In February of 2017, after a meeting between the new administration and Wall Street executives, President Trump signed an executive order aimed at revisiting and possibly rolling back financial regulations implemented pursuant to Dodd-Frank. As we enter 2017, it seems unlikely that additional compensation-related regulations for financial institutions, including the new proposed rule under Section 956 of Dodd-Frank, will become effective.

Set forth below is a brief summary of the final guidance on the safety and soundness of incentive compensation policies, the re-proposed final rule

under Section 956 of Dodd-Frank and the Federal Deposit Insurance Corporation's (the "FDIC") golden parachute limitations. This summary generally identifies where the compensation committee has a specific responsibility or obligation and notes that the complexity of the regulatory framework surrounding the compensation arrangements of financial professionals will likely result in increased responsibilities and challenges for compensation committee members at financial institutions.

#### **A. Safety and Soundness Guidance**

In June 2010, the bank regulatory agencies jointly issued final guidance for financial institutions on incentive compensation. All banking organizations are expected to evaluate incentive compensation and related risk management, control and governance processes, and to address deficiencies or processes inconsistent with safety and soundness. This evaluation is to be done with a view to the three core principles described in the guidance—that incentive compensation should:

- provide employees incentives that appropriately balance risk and reward;
- be compatible with effective controls and risk management; and
- be supported by strong corporate governance, including active and effective oversight by the board of directors.<sup>46</sup>

The third principle is of primary importance to compensation committee members of banking organizations. The guidelines emphasize governance and board-level oversight and provide that the board of directors of an organization is ultimately responsible for ensuring that the organization's incentive compensation arrangements ("ICAs") for all covered employees—not just senior executives—are appropriately balanced and do not jeopardize the safety and soundness of the organization. The guidance makes clear that the organization, composition and resources of the boards of directors of banking organizations should permit effective oversight of ICAs. In particular, the guidance requires that a compensation committee take the following actions with respect to a company's ICAs:

- actively oversee ICAs and directly approve ICAs for senior executives;

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<sup>46</sup> As used in the proposed guidance, the term "board of directors" refers to the members of the board who have primary responsibility for overseeing the incentive compensation system of a banking organization and, for purposes of this discussion, it is assumed that the compensation committee serves this function.



- monitor the performance, and regularly review the design and function, of ICAs; and
- for banking organizations that are significant users of ICAs, review the arrangements on both a backward-looking and forward-looking basis.

The guidelines expressly call for the involvement of functions, such as compliance, internal audit and risk management in the incentive compensation process. It is, therefore, likely that both management and the compensation committee will need to evolve towards a more consultative and multidisciplinary approach, in particular during the adjustment period, as new compensation best practices evolve from the increased regulatory scrutiny on incentive compensation. The guidance also indicates that the compensation committee should have access to a level of expertise and experience in risk management and compensation practices in the financial services industry that is appropriate to the nature, scope and complexity of the organization's activities.

The restructuring of ICAs has been an iterative process. At this stage, compensation committee members of financial institutions should be ensuring that management is implementing the final guidance and considering it when evaluating proposed compensation arrangements. To date, favored design changes have included:

- decreasing incentive compensation payout opportunities to 125% of target opportunity (previously, 200% was common);
- deferring a portion of the payout of incentive compensation, both cash and long-term incentives, over at least three years to better understand the risk outcomes, with payment of the deferred amounts to be contingent on achieving performance-based measures; and
- increasing the portion of incentive compensation paid in equity-based instruments, such as performance and restricted shares, with stock options disfavored other than in limited amounts.

These design changes generally contract the upside opportunity and provide for *ex post* adjustments to address negative tail risk. In addition, regulators expect companies to have a framework for the exercise of discretion in compensation matters so that discretionary decisions may be audited, and recoupment and clawback provisions should be in place for all forms of incentive compensation. Financial institutions are working to balance regulatory expectations with the “pay for performance” demands of shareholders and the need to attract, retain and incentivize executives and key employees.

As the regulation of compensation arrangements at banking organizations increases, the duties of compensation committee members are expanding. It is important for compensation committee members to understand these duties and take the action necessary to see that the organization has adequate resources to respond to the requests of the various regulators and implement compliant compensation programs. The consequences of failing to meet the standards of the compensation guidelines are not insignificant, as the guidelines provide that supervisory findings on incentive compensation will be included in exam reports and incorporated into supervisory ratings. In addition, supervisory or enforcement action may be taken if incentive compensation or related controls, risk management or governance pose a risk to safety and soundness, and acceptable curative measures are not being taken.

## **B. Section 956 of Dodd-Frank**

Section 956 of Dodd-Frank prohibits incentive-based compensation arrangements at “covered financial institutions” with assets of \$1 billion or more that provide excessive compensation or could expose the institution to inappropriate risks that could lead to a material financial loss, and requires such covered financial institutions to report their incentive-based compensation arrangements. In April of 2016, federal regulators (including the Federal Reserve, the FDIC and the SEC) re-proposed a rule regarding incentive-based compensation under Section 956 of Dodd-Frank that was far more proscriptive for large financial institutions than the original proposed rule. The 2016 proposed rule under Section 956 of Dodd-Frank would supplement existing rules and guidance of the bank regulatory agencies, imposing additional standards and reporting obligations that overlap, but are not entirely consistent with, existing requirements. The comment period for the 2016 proposed rule ended in July of 2016, and there had been no further action with respect to the proposed rule by the regulators as of February 2017. Financial institutions covered by the rule would be required to comply no later than the beginning of the first calendar quarter that begins at least 540 days after a final rule is published in the Federal Register. Any incentive-based compensation plan with a performance period that begins before such date would not be required to comply with the requirements of the proposed rule.

There is considerable uncertainty as of this writing as to whether Section 956 of Dodd-Frank and the proposed rule will survive the regulatory reforms that have been discussed by the new Administration and, if so, in what form.

### **1. Covered Financial Institutions**

The proposed rule applies to covered financial institutions that have \$1 billion or more in average total consolidated assets. The definition of

“covered financial institution” includes depository institutions and their holding companies (including the U.S. operations of a foreign bank), broker-dealers registered under Section 15 of the Exchange Act, investment advisors under the Investment Advisors Act of 1940 (whether or not registered), credit unions, Fannie Mae, Freddie Mac and Federal Home Loan Banks. The methodology for determining total consolidated assets under the proposed rule varies depending upon the category of the institution and the applicable regulator, and for depository institutions that are not investment advisors, it is generally determined based on a rolling average.

The 2016 proposed rule introduced subcategories of covered financial institutions based on the amount of average total consolidated assets as follows: (1) Level 1 covered financial institutions would be covered financial institutions with average total consolidated assets of \$250 billion or more and subsidiaries of such institutions that are themselves covered financial institutions; (2) Level 2 covered financial institutions would be covered financial institutions with average total consolidated assets of between \$50 billion and \$250 billion and subsidiaries of such institutions that are themselves covered financial institutions; and (3) Level 3 covered financial institutions would be covered financial institutions with average total consolidated assets of between \$1 billion and \$50 billion.

## **2. Covered Persons**

The proposed rule applies to “covered persons,” which include executive officers, employees, directors and principal shareholders. While all employees are potentially covered persons, the proposed rule is intended to apply to the incentive compensation arrangements for covered persons or groups of covered persons that could encourage inappropriate risk-taking to the detriment of the covered financial institution. The 2016 proposed rule also introduces additional limitations on the incentive compensation of “senior executive officers” and “significant risk-takers” of Level 1 and 2 covered financial institutions. The “executive officers” of a covered financial institution include any person who is a “senior executive officer” as defined in the proposed rule (*i.e.*, any person who holds the title or performs the function of one or more of the following positions: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief legal officer, chief lending officer, chief compliance officer, chief risk officer, chief audit executive, chief credit officer, chief accounting officer or head of a major business line or control function and other individuals designated as executive officers by the covered financial institution). The proposed rule also provides guidance on who is considered a significant risk-taker with the primary factor being whether the individual’s incentive compensation is at least one-third of their total compensation.

### **3. Prohibitions Under the Proposed Rule**

Under the proposed rule, a covered financial institution would be prohibited from establishing or maintaining any incentive-based compensation arrangements for covered persons that encourage inappropriate risks by providing excessive compensation. “Incentive-based compensation arrangement” means any variable compensation that serves as an incentive for performance, including equity-based compensation. Excessive compensation means amounts that are unreasonable or disproportionate to the value of the services performed.

In evaluating whether compensation is excessive, the agencies will consider, among other factors, the following:

- the combined value of all compensation, fees or benefits provided to the covered person;
- the compensation history of the covered person and other individuals with comparable expertise at the covered financial institution;
- the financial condition of the covered financial institution;
- compensation practices at comparable institutions;
- for post-employment benefits, the projected total cost and benefit to the covered financial institution; and
- any connection between the covered person and any fraudulent act or omission, breach of trust or fiduciary duty or insider abuse with regard to the covered financial institution.

Accordingly, while the proposed rule would apply directly only to incentive-based compensation, regulators will consider all compensation and benefits arrangements in the evaluation of the incentive-based arrangements.

The proposed rule would prohibit a covered financial institution from establishing or maintaining any incentive-based compensation arrangements that encourage a covered person to expose the institution to a material financial loss. To comply with this standard, an incentive-based compensation arrangement must balance risk and financial rewards (*e.g.*, through payment deferrals, risk adjustment of awards, and/or longer performance periods), be compatible with effective risk management and controls and be supported by effective corporate governance, namely through board of directors oversight of incentive-based compensation arrangements.

#### 4. Additional Requirements Applicable to Level 1 and 2 Covered Financial Institutions

Level 1 and 2 covered financial institutions would also be subject to several additional, prescriptive requirements with respect to incentive-based compensation arrangements, including, among others:

- *“Maximum Opportunities” (i.e., Caps on Incentive-Based Compensation).* Level 1 and 2 covered financial institutions would not be permitted to award incentive-based compensation to senior executive officers and significant risk-takers in excess of 125% and 150%, respectively, of the target amount for the incentive-based compensation.
- *Relative Performance Measures.* Level 1 and 2 covered financial institutions would not be permitted to use incentive-based compensation performance measures that are solely based on industry peer performance comparisons.
- *Volume Driven Measures.* Level 1 and 2 covered financial institutions would not be permitted to award incentive-based compensation to covered persons that is based solely on transaction revenue or volume without regard to transaction quality or compliance of the covered person with sound risk management.
- *Minimum Deferral (Level 1).* Level 1 covered financial institutions would be required to defer a specified portion of the short- and long-term incentive-based compensation awarded to its senior executive officers and significant risk-takers (60% and 50% for senior executive officers and significant risk-takers, respectively) for each performance period for a minimum period of time (at least four years for short-term incentive compensation and at least two years for long-term incentive compensation). No more than 15% of a senior executive officer or significant risk-taker’s total incentive compensation awarded in stock options would count toward the deferral requirements.
- *Minimum Deferral (Level 2).* Level 2 covered financial institutions would be required to defer a specified portion of the short- and long-term incentive-based compensation awarded to its senior executive officers and significant risk-takers (50% and 40% for senior executive officers and significant risk-takers, respectively) for each performance period for a minimum period of time (at least three years for short-term incentive compensation and at least one year for long-term incentive compensation). The same limitation on options as described above for Level 1 covered financial institutions would also apply to Level 2 financial institutions.
- *Vesting During the Deferral Period.* During a deferral period described above, incentive-based compensation may not vest faster than on a pro rata annual basis beginning on the first anniversary of the end of the

performance period for which the amount was awarded, and the vesting of the deferred incentive-based compensation may not be accelerated other than in the case of the death or disability of the covered person.

- *“Downward Adjustment.”* Deferred incentive-based compensation awarded to Level 1 and 2 senior executive officers and significant risk-takers would need to be subject to “downward adjustment” (*i.e.*, forfeiture) if any of the following adverse outcomes occurred at the covered financial institution: (1) poor financial performance attributable to a significant deviation from the risk parameters set forth in the covered financial institution’s policies and procedures; (2) inappropriate risk-taking, regardless of the impact on financial performance; (3) material risk management or control failures; (4) noncompliance with statutory, regulatory or supervisory standards that results in enforcement or legal action against the covered financial institution brought by a federal or state regulator or agency or a requirement that the covered financial institution report a restatement of a financial statement to correct a material error; and (5) other aspects of conduct or poor performance as defined by the covered financial institution.
- *Clawback.* Incentive-based compensation awarded to Level 1 and 2 senior executive officers and significant risk-takers would be subject to a minimum seven-year clawback period following the date on which the compensation vests. Events triggering clawback include (1) misconduct that resulted in significant financial or reputational harm to the covered financial institution; (2) fraud; or (3) intentional misrepresentation of information used to determine the senior executive officer or significant risk-taker’s incentive-based compensation.
- *No Hedging.* Level 1 and 2 covered financial institutions would not be permitted to engage in transactions on behalf of covered persons to hedge or offset any decrease in the value of the covered person’s incentive-based compensation.

## **5. Policies and Procedures**

To help ensure compliance with the proposed rule, covered financial institutions would be required to implement policies and procedures with respect to incentive-based compensation, including recordkeeping obligations for all covered institutions to ensure the ability to disclose records relating to the incentive arrangements to their primary regulator upon request. The 2016 proposed rule also incorporates several additional, more burdensome requirements for Level 1 and 2 covered financial institutions with respect to oversight, risk management, controls, and governance policies and procedures, including, among others, (1) recordkeeping requirements that mandate that the covered financial institution maintain detailed records with respect to its incentive-based compensation arrangements for senior executives and significant risk-takers for at least seven years in a manner that

allows for an independent audit; (2) requirements that the compensation committee obtain annual written assessments with respect to the institution's incentive-based compensation program from both management and an independent third party; and (3) a requirement to develop and adopt a risk management framework for its incentive-based compensation program that is independent of any line of business and includes an independent compliance program for internal controls, testing, monitoring and training.

### **C. FDIC Golden Parachute Regulations**

Payments to executives of "troubled" financial institutions may be limited under the "golden parachute" rules of the FDIC. Subject to certain exceptions, the FDIC rules prohibit troubled insured depository institutions (or their holding companies) from making golden parachute payments to any "institution-affiliated party" ("IAP"), which includes the institution's directors, officers and employees, among others. The FDIC rules generally define "golden parachute payments" as compensatory payments (or agreements to make compensatory payments) to an IAP by a troubled insured depository institution that are contingent on, or payable after, the termination of the IAP's primary employment or affiliation with the institution, with exceptions for certain bona fide deferred compensation payments, qualified retirement plan payments, limited payments under nondiscriminatory severance pay arrangements and payments under certain employee welfare benefit plans. As a general matter, there are three exceptions for permissible golden parachute payments by troubled institutions: (a) payments that receive the regulator's concurrence; (b) payments for a "white knight" (as defined in the FDIC rules) hired pursuant to an agreement when the entity is troubled or to prevent it from becoming so; and (c) reasonable payments not to exceed 12 months' salary in the event of a change in control of the institution not resulting from an FDIC-assisted transaction or the institution being placed in receivership or conservatorship.





## VII.

### Shareholder Proposals, Relations and Litigation

The enactment in 2010 of mandatory say-on-pay shareholder votes, even though such votes are nonbinding, represented the most tangible result of the prior decade's push by shareholder advocacy groups for a more direct shareholder role in executive compensation matters. Because most large companies have opted for an annual say-on-pay vote, 2016 witnessed the sixth year of say-on-pay voting for most companies. As in prior years, the overwhelming majority of companies received a favorable say-on-pay vote. However, concern over say-on-pay support levels continues to influence company action, both in terms of compensation design and shareholder outreach strategy. This Chapter VII discusses the evolution of say-on-pay, as well as other notable developments in the area of compensation-related shareholder proposals, the compensation policies of proxy advisory groups (notably ISS) and executive compensation litigation.

#### A. Say-on-Pay

Dodd-Frank mandated three different types of nonbinding shareholder votes on compensation matters.

- No less frequently than once every three calendar years, each public company must submit the compensation of its NEOs to a nonbinding shareholder vote (the say-on-pay vote).
- No less frequently than once every six calendar years, each public company must submit for a nonbinding shareholder vote the question of whether the say-on-pay vote should be held annually, biennially or triennially (the say-when-on-pay vote). As noted, this vote will be required in 2017 for most companies.
- In any proxy statement or consent solicitation for a shareholder meeting to approve an acquisition, merger, consolidation or sale of substantially all of a company's assets, a public company must submit all golden parachute arrangements covering any of its NEOs to a separate nonbinding shareholder vote, unless the arrangements have already been "subject to" a say-on-pay vote (the "golden parachute say-on-pay" vote).

##### 1. The Say-on-Pay Vote

The say-on-pay vote must cover the compensation of a company's NEOs, as disclosed in accordance with Item 402 of Regulation S-K, including the CD&A; it does not cover director compensation, nor does it cover the portion

of the proxy disclosure related to compensation and risk with respect to broad-based programs. The vote is a single line-item on the relevant compensation arrangements in their entirety. The SEC rules do not require companies to use specific language or a prescribed format in “say-on-pay” resolutions, although they include a nonexclusive example of a resolution that would satisfy the applicable requirements. The proxy statement must include an explanation of the effect of the vote (*i.e.*, that it is nonbinding), and future proxy statements must address whether (and if so, how) the company has considered the results of the most recent vote in determining compensation policies and decisions.

The say-on-pay vote serves as an important barometer of shareholder views of a public company’s compensation practices. As discussed below, ISS has indicated that it intends to utilize say-on-pay votes, where offered, as its primary vehicle for expressing dissatisfaction with compensation practices. While the say-on-pay vote is nonbinding, companies are quite focused on receiving a favorable outcome, and poor results have the potential to trigger significant investor pressure and even litigation.<sup>47</sup>

In 2016, over 98% of Russell 3000 companies that submitted a say-on-pay vote received majority support, with average support levels at approximately 91%, and with approximately 93% of such companies receiving over 70% support. These support levels are quite close to the corresponding results from 2014 and 2015. ISS recommended a vote against approximately 12% (a percentage consistent with prior years) of the proposals, so a favorable vote was achieved even in a significant majority of the cases where ISS had made a negative recommendation. However, an ISS negative recommendation correlated with lower support levels. Average support at companies with a favorable ISS recommendation was 94%, while average support at companies with a negative recommendation from ISS was 66%.<sup>48</sup>

While overall results have thus far been fairly positive, companies should approach each proxy season with a fresh perspective, as changes in company performance, company compensation programs, and investor guidelines can have significant impact. As discussed below, ISS engages in extra scrutiny of company responses to say-on-pay for those that did not achieve 70% support in the prior year’s say-on-pay vote.

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<sup>47</sup> See Chapter VII of this Guide.

<sup>48</sup> See Semler Brossy, *2016 Say on Pay Results: End of Year Report (February 1, 2017)*, available [here](#).

Each company's situation is unique, but, as a general rule, a company can take certain steps that will best position the company for the say-on-pay vote, including the following:

- *Analyze Prior Year's Results and Shareholder Policies.* Companies should periodically review the voting policies of major shareholders and understand the ways in which compensation practices may deviate from those policies. As part of that review, companies should revisit the prior year's vote results and proxy advisory firm recommendations in order to understand issues that may be particularly sensitive for the advisory firms. While companies should not make substantive compensation decisions that they do not believe are in the best interests of shareholders merely in the hopes of increasing support for their say-on-pay proposals, changes may be appropriate where a company determines, upon reflection, that its compensation arrangements could be improved based on feedback from its shareholders.
- *Communicate With Shareholders Through the CD&A.* The CD&A represents a critical communication tool in the effort to win say-on-pay votes. Companies should use an executive summary to highlight key points and key developments since the prior year, shareholder-favored practices that the company maintains and hot button practices that the company does not maintain. Given the large number of proxy statements that the typical institutional shareholder must review each proxy season, ease of readability is critical. Liberal use of graphs, tables and bullet point lists is preferable to paragraphs of prose.
- *Directly Engage With Shareholders.* Companies that received low support in the prior year or have reason to be concerned about low support at their next annual meeting (*e.g.*, its three-year TSR is low) should consider commencing a direct dialogue with institutional shareholders before ISS issues its report. This is a process that requires careful consideration, and involves:
  - identifying significant shareholders that should be approached and, if available, their voting policies;
  - determining the person at each identified shareholder who should be contacted, with the goal being to gain the ear of a decision maker and recognizing the delineation at most large institutions between the investment management team and the proxy voting team;
  - deciding who should make the approach to the identified shareholders, understanding that some shareholders prefer to meet

with Compensation Committee members (particularly, the Chair), while others prefer meeting with in-house subject matter experts in the executive compensation, human resources or legal functions (but not the CEO, as the discussion is often about his or her own compensation) and outside advisors;

- figuring out the ideal time to approach the identified shareholders, with the understanding that telephone calls and meetings that occur outside of proxy season are most likely to gain focused shareholder attention and also provide an opportunity for a second approach to the shareholders after the issuance of the ISS report if it is problematic; and
  - crafting a section of the CD&A to describe the shareholder engagement process, including any changes in compensation programs based on shareholder feedback.
- *Respond to ISS's Recommendations.* As noted above and discussed below, ISS wields significant influence in the say-on-pay process.
    - ISS Corporate Solutions can be engaged, for a fee, to analyze, among other things, elements of equity plans being proposed for approval to shareholders, as well as compensation arrangements that may be up for approval in any say-on-pay advisory vote. The purpose of obtaining such a review in advance of a company filing its annual proxy is to allow companies to address any issues that ISS Corporate Solutions may identify as problematic, either through shareholder engagement, enhanced proxy disclosure, or both.
    - After the proxy has been filed, ISS will issue its report regarding the say-on-pay proposal. While smaller companies will not be given an opportunity to comment on ISS's report before it is finalized, S&P 500 companies will be given a draft report no more than a few days before it is finalized and will have a chance to comment on it. To be in a position to respond promptly to the report, S&P 500 companies should anticipate the timing of the report's release and assemble a task force in advance that will be available to respond on short notice. Regardless of whether ISS is responsive to comments provided by a company to ISS on any report, companies should, as noted above, take their cases directly to shareholders, through in-person meetings, by filing supplemental proxy materials or both.

## 2. The Say-When-on-Pay Vote

Dodd-Frank requires a nonbinding vote, at least once every six calendar years, to determine the frequency of say-on-pay votes. SEC rules require that shareholders receive the option to vote for one of four choices (annual, biennial, triennial or abstain). Thus, a company cannot offer a “yes” or “no” vote on its preferred option, although the company may make a vote recommendation.<sup>49</sup> In 2011, when most companies were required to conduct a frequency vote, the annual option received the most support at approximately 80% of companies, the triennial option at approximately 19% and the biennial option at approximately 1%. In response, over 70% of Russell 3000 companies elected to conduct votes annually. Most public companies will need to take their second frequency vote during the 2017 proxy season.

Although from a policy perspective a triennial vote offers several advantages, the market appears to have spoken in support of an annual vote, at least for larger companies, and an annual vote is generally the prudent approach for large companies with a diverse shareholder base. For smaller and lower-profile companies, the decision may be more nuanced. From a policy standpoint, a triennial approach permits shareholders, directors and managers to evaluate the effects of a company’s pay program on long-term performance and is less likely to subject a company’s compensation plans to the whims of constituencies seeking to apply pressures unrelated to long-term corporate performance. In addition, the triennial approach allows shareholders to engage in more thoughtful analysis and voting by providing more time between votes and provides management with the time necessary to implement improvements and changes to address concerns reflected by a negative vote. For such reasons, companies that are controlled or that are for other reasons less sensitive to potential investor criticism of a less frequent vote choice may wish to elect a triennial approach.

At the same time, an annual vote offers many practical benefits. Providing shareholders with an annual say-on-pay vote gives shareholders an avenue other than director elections to express their dissatisfaction with pay practices at the company and, therefore, may save directors the embarrassment of receiving a significant number of “no” votes. In addition, holding an annual

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<sup>49</sup> Note that, under SEC rules, companies may vote uninstructed proxy cards in accordance with management’s recommendation for the frequency vote only if the company (1) includes a recommendation for the frequency vote in the proxy statement, (2) permits abstention on the proxy card, and (3) includes language in bold regarding how uninstructed shares will be voted on the proxy card.

say-on-pay vote may ultimately help the company avoid antagonizing shareholders that favor an annual vote.

Ultimately, each company should weigh the policy benefits of a triennial vote against the practical advantages of an annual vote. The determination will, of course, depend in part on whether a triennial vote will result in negative consequences for a company. Both ISS and Glass Lewis have announced that they will generally recommend in favor of an annual vote for companies submitting a say-when-on-pay vote to shareholders. In fact, ISS will recommend an “against” or “withhold” vote on the entire board if a company implements a say-on-pay vote on a less frequent basis than the frequency of timing that received the majority of votes cast at the most recent shareholders meeting.

Before making a final determination on the frequency vote, a company should take into account its particular circumstances, including: (1) year-over-year consistency of pay structures and amounts; (2) relationships with shareholders; and (3) the nature of its shareholder base and its positions on the frequency vote and say-on-pay generally. For most companies, the likelihood of adverse shareholder reaction to a less frequent than annual vote will outweigh the policy benefits of a less frequent vote, although companies that have successfully implemented a less frequent vote without adverse shareholder reaction need not make a change simply to conform to the general trend.

A company must disclose on Form 8-K its decision regarding the frequency of the say-on-pay vote in light of the results of the say-when-on-pay vote. The Form 8-K must be filed no later than 150 calendar days after the date of the applicable meeting, and in any event no later than 60 calendar days prior to the deadline for submission of shareholder proposals for the subsequent annual meeting. Companies must include in their proxy materials disclosure of the current frequency of say-on-pay votes and when the next scheduled say-on-pay vote will occur.

### **3. The Golden Parachute Say-on-Pay Vote**

Under Dodd-Frank, the golden parachute say-on-pay vote applies to any proxy statement or consent solicitation for a shareholder meeting to approve an acquisition, merger, consolidation or sale of substantially all of a company’s assets.

SEC rules require disclosure in a prescribed tabular format of all golden parachute compensation arrangements in connection with the transaction. For this purpose, SEC rules define “golden parachute” fairly broadly to encompass all agreements and understandings between the target or the acquirer and each NEO of the target or the acquirer that relate to the

transaction. However, the shareholder advisory vote with respect to golden parachute arrangements applies solely with respect to those arrangements between a soliciting party (typically the target) and its NEOs. If a company previously has submitted golden parachute arrangements to a say-on-pay vote and has not modified those arrangements, the company will not be required to submit those arrangements to the golden parachute say-on-pay vote so long as the company's disclosure for the prior say-on-pay vote satisfied the tabular disclosure and other requirements applicable to golden parachute say-on-pay votes.<sup>50</sup>

In the first half of 2016 (the latest period for which statistics are available as of the date of this publication), 92% of companies that disclosed results of golden parachute votes received more votes in favor than against.<sup>51</sup> Significantly, the vote results from the first several years of golden parachute say-on-pay votes do not appear to indicate any correlation between levels of support on the golden parachute say-on-pay vote and on the underlying transaction. See Chapter VI for a discussion of elements that ISS and Glass Lewis considers when making its recommendation for a company's golden parachute say-on-pay vote.

## **B. Shareholder Proposals**

The advent of say-on-pay has reduced, but not eliminated, compensation-based shareholder proposals from individual shareholder activists and academic gadflies. Many institutional shareholders subscribe to the services of shareholder advisory firms who provide blanket voting policies on such issues, and, in many cases, rely heavily on those firms' proxy voting guidelines, regardless of an individual company's performance or governance fundamentals. As a result, many shareholder votes are foreordained by a voting policy that is applied to all companies without regard to the particulars of a given company's situation. Shareholder advisory firms are discussed in detail in the following section of this Guide.

In the 2017 proxy season, we expect activists will continue to push their agendas through shareholder proposals as part of their efforts to maintain focus on corporate governance matters. The appropriate course of action with respect to any particular proposal will depend upon the facts and circumstances. In some cases, it may be possible to exclude a proposal under

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<sup>50</sup> Note that the rules applicable to annual proxy disclosure of termination and change-in-control arrangements, unlike the golden parachute say-on-pay rules, do not prescribe a mandatory tabular disclosure format.

<sup>51</sup> See Pearl Meyer, *Updated: Say on Golden Parachute Votes* (September 2016), available [here](#).

applicable SEC rules. In other cases, a company might resolve a proposal by engaging in dialogue with the shareholder proponent. In still other instances, it may make sense to implement a particular proposal. In formulating responses to shareholder proposals, companies should recognize that activists and shareholder advisory firms carefully monitor company action in this area and may shine a spotlight on those companies that they view as uncooperative. Ultimately, however, executive compensation is a core responsibility of the board, and directors must bear in mind that they are best positioned to establish optimal company-specific compensation programs.

### **C. Shareholder Advisory Firms**

Over the past several years, the influence of shareholder advisory firms in compensation matters has expanded as a result of their widely followed public shareholder voting recommendations on compensation matters put to shareholders.

*Institutional Shareholder Services – In General.* The most influential of these firms is ISS. The compensation committee should regularly review updates regarding ISS’s positions on pay practices, as a means of understanding the potential shareholder reaction to, and the best means of explaining, compensation decisions. We describe in Section VII.A. above some of ISS’s positions on the say-when-on-pay and golden parachute say-on-pay advisory votes.

The say-on-pay vote will be the primary vehicle through which ISS will express its view on a company’s pay practices. ISS will evaluate, on a case-by-case basis, its recommendation regarding say-on-pay proposals and compensation committee member elections where a company’s say-on-pay proposal in the previous year received the support of less than 70% of the votes cast. ISS’s evaluation will be based on the company’s response to the concerns expressed by shareholders in the previous year, including disclosed engagement efforts with major institutional investors and specific actions taken to address the issues that led to the lack of support. ISS has stated that cases where support was less than 50% will “warrant the highest degree of responsiveness.” Given the low threshold of opposition votes triggering the more stringent review, companies may treat a say-on-pay vote with majority, but less than 70%, support as effectively a lost vote.

In its most recent compensation policy guidelines,<sup>52</sup> ISS has advised the following regarding its recommendations regarding a say-on-pay vote (or, in

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<sup>52</sup> See ISS U.S. *Executive Compensation Policies* (Updated December 16, 2016), available [here](#), and ISS U.S. *Equity Compensation Plans* (Updated December 16, 2016), available [here](#).



the absence of a say-on-pay vote, recommendations on compensation committee or director reelection votes):

- ISS will not object to pay practices through “withhold” recommendations on compensation committee or director reelection votes, *unless* the company’s so-called “problematic pay practices” are, in its view, “egregious” or there are “recurring problematic issues or responsiveness concerns” (*i.e.*, not only if concerns raised by ISS in connection with a say-on-pay vote are not, in its view, sufficiently addressed in the subsequent year).
- ISS generally will issue an adverse say-on-pay vote recommendation if there is what it terms a “misalignment” between pay and performance.
- If no say-on-pay vote is on the ballot, any adverse recommendations related to executive compensation may apply to compensation committee members.

In developing its recommendations, ISS generally has taken an “integrated, holistic” approach in reviewing a company’s executive compensation program, which includes an overall evaluation of pay-for-performance and pay practices, rather than evaluating each pay program and pay practice separately. ISS will: (1) determine what, if any, problematic pay practices are maintained by the company; (2) grade the company on its pay-for-performance; and (3) through the foregoing analysis, develop a positive or negative recommendation on a company’s say-on-pay vote.

*ISS – Problematic Pay Practices.* Pay elements that are not directly based on performance are evaluated on a case-by-case basis, including whether executive perquisites or benefits are a poor use of company assets, which could have a detrimental effect on the company (*e.g.*, promote an “imperial CEO culture”). For this reason, companies should remain aware of, and remain current on, the list of problematic pay practices. That list is long, and includes:

- “egregious” employment contracts containing multi-year guarantees for salary increases, nonperformance-based bonuses and equity compensation;
- an “overly generous” new hire package for a CEO (*i.e.*, excessive “make whole” provisions without sufficient rationale, problematic termination-related equity vesting provisions or any other “problematic pay practices” listed in ISS’s policy);

- “abnormally large” bonus payouts without justifiable performance linkage or proper disclosure (*i.e.*, includes performance metrics that are changed, canceled or replaced during the performance period without adequate explanation of the action and the link to performance);
- “egregious” pension or supplemental executive retirement plan payouts (*e.g.*, inclusion of additional years of service not worked that result in significant benefits provided in new arrangements, inclusion of performance-based equity awards in the pension calculation);
- “excessive” perquisites (*e.g.*, perquisites for former and/or retired executives, such as lifetime benefits, car allowances, personal use of corporate aircraft or other “inappropriate” arrangements, extraordinary relocation benefits, including home loss buyouts or “excessive” amounts of perquisites compensation);
- “excessive” severance and/or change in control provisions (*i.e.*, change in control payments exceeding three times base salary plus target/average/most recent bonus or that include equity gains or other pay elements in the calculation, or that provide payments without loss of job or substantial diminution of job duties or that could trigger on a liberal change in control definition where no actual change in control has occurred, new or materially modified agreements that include the right to resign for any reason and collect severance or an excise tax gross-up, “excessive” payments upon an executive’s termination in connection with performance failure);
- tax reimbursements;
- dividends or dividend equivalents paid on unvested performance shares or units;
- repricing or replacing underwater stock options or stock appreciation rights without prior shareholder approval;
- liberal “change in control” definition in an individual contract or equity plan, which could result in payments being made to an NEO without an actual change in control occurring; and
- “internal pay disparity:” an “excessive differential” between CEO total pay and that of the next-highest paid NEO.

Note that engagement in a small number of these practices may not, in itself, result in an adverse recommendation from ISS. However, there is a list of other pay practices that ISS deems sufficiently problematic individually to

warrant a recommendation to vote against a company's say-on-pay proposal or, in specified circumstances, a director "withhold" vote recommendation. The list of these "egregious" practices includes:

- repricing underwater options/stock appreciation rights without prior shareholder approval;
- "excessive" perks or tax gross-ups; and
- new or extended agreements that provide for change in control payments that are single trigger, exceed three times salary plus target/average/most recent bonus or include an excise tax gross-up. An agreement which automatically renews due to an "evergreen" provision will be evaluated on a holistic basis.

ISS has also advised that a liberal "change in control" definition (such as shareholder approval of a change in control transaction, irrespective of whether or not the transaction actually is completed), combined with automatic full vesting of equity awards on a change in control, is likely to receive a negative recommendation.

It is also important to recall that, beginning in the 2015 proxy season, ISS advised it will not consider a company's commitment to eliminate a problematic pay practice in the future as a way of preventing or reversing a negative vote recommendation. Previously, many companies received a positive ISS recommendation even in the face of plan documents containing provisions that could be viewed negatively by ISS, if combined with a publicly announced commitment that future agreements would not contain a gross-up. Such a strategy no longer works, even as to commitments made before the policy change was announced.

*ISS – Misalignment Between Pay and Performance.* Given the importance of the pay-for-performance test and the focus by ISS on companies whose say-on-pay support falls below 70%, compensation committees will be well-served by understanding this test, and may wish to consider having a "dry run" of it performed prior to proxy season in order to understand whether the vote might be at risk. Moreover, in the case of such a misalignment that is a result of a problematic equity compensation practice when there is an equity plan on the ballot, ISS may recommend voting against an equity plan proposal if a significant portion of CEO pay is attributable to nonperformance-vesting equity awards.

ISS has provided significant detail about how it runs the pay-for-performance test, including changes to its pay-for-performance methodology.<sup>53</sup> In 2016, ISS performed a quantitative analysis of CEO pay versus total shareholder returns (TSR) of the CEO's company. If the results of that analysis indicated significant misalignment between CEO pay and TSR, ISS then performed a qualitative assessment of the subject company's pay practices, to determine either the likely cause of the misalignment, or identify mitigating factors. Now, effective for proxies covering shareholder meetings on or after February 1, 2017, in addition to the historic TSR measure, the CEO pay-for-performance analysis in ISS's proxy research reports will analyze corporate performance against compensation levels based on a weighted average of the following six financial metrics (using data from S&P Compustat): return on equity, return on assets, return on invested capital, revenue growth, EBITDA growth and growth in cash flow from operations. The particular metrics applicable to a company and the weighting of each metric will be determined by ISS based on the company's four-digit GICS industry group. A company's ISS proxy research report will include the company's three-year performance on both TSR and each of the six financial metrics, relative to its ISS peer group, and produce a new number called the "overall weighted financial performance metric." This new metric will not impact the quantitative screening results for the 2017 proxy season, but may be considered in the qualitative review as a factor that mitigates or heightens identified pay-for-performance concerns.

The ISS quantitative analysis attempted to measure: (1) the relative degree of alignment between CEO pay and total shareholder return (TSR) within the subject company's peer group for a three-year period; (2) the prior year's CEO pay as a multiple of the median pay of its peer group for the same period (a second "relative" test); and (3) the absolute alignment between CEO pay and the company's TSR over a five-year period. ISS will focus initially on an eight-digit GICS resolution to identify peers that are closely aligned with the subject company in terms of industry. After the application of this GICS code process, ISS will populate the peer group with 14 to 24 companies, prioritizing peers that maintain the subject company near the median of the peer group, based on revenues, assets and market capitalization. For purposes of comparing a company's TSR performance and CEO pay against the members of that group, annual revenues, assets and market capitalizations will be determined as of June 1 or December 1 (presumably the relevant year is the year prior to the year in which the proxy is definitively filed).

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<sup>53</sup> See, e.g., *ISS U.S. Executive Compensation Policies* (Updated December 16, 2016), available [here](#) and the ISS guidance, "Pay for Performance Mechanics" (December 2016), available [here](#).

If the results of the quantitative analysis indicate, in ISS's view, a significant misalignment between pay and performance, then ISS will perform a quantitative evaluation of the company's pay program, focusing on items such as: (1) the ratio of performance-to-time-based equity compensation; (2) overall ratio of performance-based compensation; (3) completeness of disclosure and rigor of performance goals; (4) the company's peer group benchmarking practices; (5) actual results of financial/operational metrics; (6) one-time or periodic events, such as the recruitment of a new CEO or anomalous equity grants; and (7) "realizable" pay versus grant date pay for S&P 500 companies, with realizable pay based on amounts paid or earned, or gains realized (or the current value of ongoing incentive grants made), during a specified measurement period, generally of three fiscal years.

*ISS – Equity Plan Proposals.* Beginning with the 2015 proxy season, ISS adopted a new Equity Plan Scorecard (EPSC) method of analyzing whether to recommend "For" or "Against" an equity plan proposal, as an alternative to its prior series of standalone tests focused on costs and certain problematic pay practices. Under this approach, recommendations on equity plan proposals are based on a combination of weighted factors related to plan costs, plan features and company grant practices, with relative weights varying by index group. A score of 53 or higher (out of 100 points) generally results in a positive recommendation (ISS Corporate Solutions (the consulting division of ISS) recommends achieving "at least" a score of 58). ISS has continued to refine the elements of the EPSC, most recently for meetings on or after February 1, 2017, which refinements are incorporated into the discussions below.

The EPSC approach continues to weight factors relating to three key categories (weighting the various factors for S&P 500 and Russell 3000 companies as described below):<sup>54</sup>

- *Plan Cost (45% weighting):* the total potential cost of the company's equity plans, measured by the company's estimated Shareholder Value Transfer (SVT), relative to its industry/market cap peers, with SVT calculated for both: (1) new shares requested, plus shares remaining for future grants, plus outstanding unvested/unexercised

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<sup>54</sup> Since February 1, 2016, the weighting of these factors vary for certain other companies, as follows: (1) "Special Cases" (*i.e.*, generally, companies that have recently become public or have emerged from bankruptcy, that do not disclose three years of grant data) in the S&P 500 and Russell 3000: Plan Cost, 50%; Plan Features, 35%; Grant Practices, 15%; and (2) "Special Cases," non-Russell 3000: Plan Cost, 60%; Plan Features, 30%; Grant Practices, 10%.

grants; and (2) new shares requested, plus shares remaining for future grants.

- *Plan Features (20% weighting)*: the following features that may have a negative impact on the Equity Plan Scorecard results: (1) automatic, single-trigger award vesting upon a change in control (*i.e.*, full vesting for time-based awards and above-target vesting for performance-based awards); (2) discretionary vesting authority; (3) liberal share recycling on various award types; (4) minimum vesting period of less than one year for all types of awards; and (5) the discretion to pay dividends on any type of unvested award.
- *Grant Practices (35% weighting)*: (1) three-year burn rate relative to peers; (2) vesting requirements in most recent CEO equity grants (to be at least three years for full credit); (3) the estimated duration of the plan; (4) the proportion of the CEO's most recent equity grants/awards subject to performance conditions; and (5) whether the company maintains clawback and shareholding requirements of at least 12 months (and a 36-month holding period is required for full credit under the EPSC).

Considerations in recommending against an equity plan proposal may include: (1) the severity of the pay-for-performance misalignment; (2) whether problematic equity grant practices are driving the misalignment; and (3) whether equity plan awards have been heavily concentrated to the CEO and/or other NEOs (rather than being broad-based). This latter "concentration ratio" test is triggered if the proportion of equity awards granted in the most recent three years to NEOs is greater than 60% (and to the CEO alone, greater than 30%). Note also that ISS will continue to recommend a vote against an equity plan proposal if the plan includes certain egregious features, such as option repricing without shareholder approval or a liberal change in control definition.

Finally, ISS has clarified its positions on two equity plan proposal topics of interest:

- If an equity plan is being proposed solely for purposes of obtaining shareholder approval of the performance metrics to be used to deliver "performance-based compensation" as required under Section 162(m) of the Internal Revenue Code, and no other amendments to the equity plan are being proposed, ISS will generally give a favorable recommendation to the equity plan proposal, but if the proposal to approve the equity plan for Section 162(m) purpose is "bundled" with other amendments (*e.g.*, multiple amendments voted under one agenda item), the proposals will be analyzed collectively; and

- Standalone director equity compensation plans will not be evaluated under the EPSC or taken into account for purposes of determining the company's three-year burn rate for its employee equity compensation plans, unless the amount of director equity grants is larger than employee equity grants.

Additionally, in response to the increased scrutiny of director compensation arrangements, new for 2017, ISS has advised that if a company proposes an advisory shareholder vote to ratify non-employee director compensation, ISS will evaluate the following: (1) if the equity plan under which director equity grants are to be made is on the ballot, whether the plan warrants support; (2) the mix of cash and equity, and if equity is a much larger component, whether director stock ownership and holding requirements are meaningful; (3) the quality of disclosure of the director compensation; and (4) the magnitude of director pay, most importantly whether there is a "meaningful limit" on annual director pay. It is also important to note that performance-vesting equity awards, retirement benefits and other perquisites are all considered problematic pay practices for non-employee directors.

Finally, with respect to golden parachute say-on-pay advisory votes, ISS's current policy is to make recommendations on a case-by-case basis on proposals to approve golden parachute compensation, consistent with policies on problematic pay practices related to severance. ISS's golden parachute say-on-pay analysis includes an evaluation of existing arrangements, as well as new ones.

*Glass Lewis.* Glass Lewis continues to apply a "highly nuanced approach" in analyzing say-on-pay advisory votes, reviewing such vote proposals on both a qualitative and quantitative basis, and may recommend against a say-on-pay vote if, generally, the company fails to demonstrably link compensation with performance (*i.e.*, if there are deficiencies in a company's compensation program's design, implementation or management). Glass Lewis grades each company's pay-for-performance on a school letter system (*e.g.*, A, B, F).

Specifically (although not an exhaustive list), Glass Lewis may recommend voting "Against" a say-on-pay vote when the following issues are weighted together:

- Inappropriate peer group and/or benchmarking issues and inadequate or no rationale for changes to peer groups;
- "Egregious or excessive" bonuses, equity awards or severance payments, including golden handshakes and golden parachutes;
- Problematic contractual payments, such as guaranteed bonuses;

- Targeting overall levels of compensation at higher than median without adequate justification;
- Performance targets not sufficiently challenging, providing for high potential payouts, and/or performance targets lowered without justification;
- Discretionary bonuses paid when short- or long-term incentive plan targets were not met;
- Executive pay being high relative to peers is not justified by outstanding company performance; and
- “Inappropriate” terms of the long-term incentive plans (as described in more detail in the voting guidelines).<sup>55</sup>

Glass Lewis also continues to disfavor out-of-plan and one-off equity grants and option/stock appreciation right repricing. In reviewing equity plan proposals, Glass Lewis utilizes a quantitative analysis to assess the plan’s cost and the company’s pace of granting equity awards, comparing plan limits relative to the peer group as chosen by Glass Lewis, and taking into account dilution and projected annual cost relative to the company’s financial performance (weighted and scored based on relevant factors in a manner not specifically identified in the Glass Lewis voting guidelines). Glass Lewis also utilizes a qualitative analysis, including plan and grant features and terms, and performance metrics.

If a company receives 25% or greater shareholder opposition to a say-on-pay vote, Glass Lewis expects the company’s board of directors to actively engage with its shareholders and respond to shareholder concerns.

Finally, with respect to golden parachute say-on-pay votes, Glass Lewis’s current policy is also to analyze each golden parachute arrangement on a case-by-case basis, taking into account, among other things, the nature of the change in control transaction, the ultimate value of payments compared to the value of the transaction, any excise tax gross-ups, the tenure of the executives receiving the payments in the transaction, any new or amended employment arrangements being entered into, and the type of triggers involved.

*Conclusions.* We recommend that compensation committees remain cognizant of the advisory firms’ current policies and take them into account

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<sup>55</sup> See 2017 Proxy Paper Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice (United States), available at [here](#).



in structuring pay programs. However, because of the “one-size-fits-all” nature of their evaluation processes, in the final analysis, a compensation committee should make decisions that comport with its company’s individual circumstances and needs.

#### **D. Executive Compensation Litigation**

One of the biggest executive compensation-related developments of recent years is the marked increase in litigation over executive compensation arrangements and related disclosure. As described below, these suits have been brought in federal and state courts, have sought monetary and injunctive relief and have covered many of the “hot button” topics in today’s compensation environment. Familiarity with the increasing litigation is helpful; however, directors should take comfort that a 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 compensation decisions so long as the directors act on an informed basis, in good faith and not in their personal self-interest.

##### **1. Section 162(m) Related Suits**

A number of derivative suits have been filed in recent years, alleging that the senior executive compensation plans at public companies do not comply with Section 162(m) of the Internal Revenue Code and the regulations promulgated thereunder (collectively, “Section 162(m)”). As described more fully in Chapter IV.A. of this Guide, Section 162(m) provides that any compensation paid to the CEO and the next three highest compensated proxy officers (other than the PFO) in excess of \$1 million per year is not tax deductible unless, among other things, the compensation is subject to objective performance metrics that have been disclosed to and approved by shareholders. These derivative complaints have generally alleged that the performance goals established by the plans are not sufficiently objective to comply with Section 162(m) and that the purported failure of the plans to comply with Section 162(m) renders the required proxy disclosure false and misleading, in violation of Section 14(a) of the Exchange Act. In addition, the complaints have alleged that the provision of nondeductible compensation to senior executives constitutes corporate waste, unjust enrichment of the executives and a breach of the directors’ duty of loyalty.

We view these suits as meritless and symptomatic of the excesses that led to reform in other areas of shareholder litigation. In almost all of these cases, the terms of the plans have, in fact, complied with Section 162(m), and, in most cases, the disclosure relating to the plans has expressly stated that nondeductible compensation may be granted if the compensation committee determines that doing so is in the best interest of the company. Moreover, many of these complaints, in alleging that performance goals are

not sufficiently objective to comply with Section 162(m), have reflected a basic lack of understanding of the operation of typical public company incentive plans, whereby a compensation committee establishes an objective Section 162(m) goal which, if met, would then provide the committee with the discretion to make an award below the amount authorized by the plan. This “plan-within-a-plan” structure is expressly permitted by Section 162(m). In addition, there is no legal obligation for compensation committees to grant only compensation that is deductible under Section 162(m). The courts have largely gotten this right by ruling against the plaintiffs on motions to dismiss (*See, e.g.*, Justice Stark’s well-reasoned opinion in [Seinfeld v. O’Connor](#), 2011 WL 1193212 (D. Del. 2011)).

These lawsuits nonetheless serve as a reminder that careful attention must be paid to the design and administration of plans intended to comply with Section 162(m) and that the disclosure relating to tax deductibility must be carefully drafted. Companies should design plans to make compliance with Section 162(m) as easy and straightforward as possible. Equally important, proxy disclosure should not guarantee that all compensation awarded will comply with Section 162(m). Instead, proxy disclosure should say that plans are “intended to” comply with Section 162(m), that compensation intended to comply may fail to do so if the requirements of Section 162(m) are not met and that the company may elect to provide nondeductible compensation.

## **2. Say-on-Pay Suits**

Following the 2011 proxy season, the first season of mandatory say-on-pay, shareholders brought a host of lawsuits against companies that failed their “say-on-pay” votes. These suits were largely unsuccessful, either failing outright or resulting in nominal settlements.

Characteristic of this first round of lawsuits was a decision by the United States District Court for the District of Oregon in which the Court ruled that an action against directors of Umpqua Holdings Corporation arising out of a negative “say-on-pay” vote should be dismissed. The Court determined that plaintiffs failed to raise a reasonable doubt that the challenged compensation was a reasonable exercise of the board’s business judgment. *Plumbers Local No. 137 Pension Fund ex rel. Umpqua Holdings Corp. v. Davis*, 2012 WL 602391 (D. Or., Feb. 23, 2012), *adopting* decision in *Plumbers Local No. 137 Pension Fund v. Davis*, 2012 WL 104776 (Jan. 11, 2012).

At issue in *Davis* was a decision by the compensation committee of Umpqua to pay increased compensation to certain executive officers for 2010—a year in which the bank’s performance had improved and met predetermined compensation targets, but total shareholder return was allegedly negative. In the subsequent advisory “say-on-pay” vote, a majority of the shares voted disapproved of the 2010 compensation. Plaintiffs claimed that it was

unreasonable for the Umpqua board of directors to increase compensation and that the shareholder vote rejecting the compensation package was *prima facie* evidence that the board's action was not in the company's or shareholders' best interest.

The Court rejected both of plaintiffs' arguments. Applying Delaware and Oregon law, the Court determined that plaintiffs' "essential position . . . that if a simple comparison reveals a level of compensation inconsistent with general corporate performance, the business judgment presumption is necessarily overcome, [is] a position that is unsupported by the applicable standards." The Court also held that Dodd-Frank did not alter directors' fiduciary duties and that a negative "say-on-pay" vote alone does not suffice to rebut the business judgment protection for directors' compensation decisions. In so holding, the Court expressly declined to follow a prior federal court decision that had denied a motion to dismiss in a "say-on-pay" action in the Southern District of Ohio, *NECA-IBEW Pension Fund v. Cox*, 2011 WL 4383368 (S.D. Ohio, Sept. 20, 2011).

*Davis* and other cases like it are powerful reminders that directors of companies may base compensation on long-term goals and choose the yardsticks by which to measure executive performance with confidence that courts will respect their good faith business judgment.

### 3. Compensation Disclosure Suits

Another set of claims has alleged inadequacy of executive compensation disclosure. In some cases, the allegations regarding say-on-pay disclosure accompanied other allegations regarding disclosures in connection with amendments to equity compensation plans requiring shareholder approval. Following earlier and largely unsuccessful fiduciary duty challenges like *Davis*, these suits were disclosure actions that sought to leverage the threat of enjoining the shareholder vote from taking place.

For the most part, plaintiffs in these cases alleged that the directors breached their duty of disclosure to shareholders under Delaware (or other state) law—as distinct from violations of the compensation disclosure requirements imposed by the federal proxy rules and Regulation S-K<sup>56</sup>—and sought to

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<sup>56</sup> In connection with an activist shareholder's challenge to Apple's 2013 proxy, another purported shareholder plaintiff alleged that Apple's CD&A disclosures were insufficient under SEC's say-on-pay rules in Item 402(b) of Regulation S-K. The Court rejected this challenge, concluding that "because [the plaintiff] failed to identify *any* material omission in the Proxy statement" and because Apple's detailed, 16-page compensation disclosures "appears to be wholly compliant with Item 402(b) of Regulation S-K, the Court finds that

(footnote continued)

enjoin a company's annual meeting until the company makes additional disclosures. By filing complaints after a company has mailed its proxy statement and before the meeting date, these plaintiffs attempt to leave companies with little time to react, thereby maximizing pressure on companies to agree to a settlement that involves additional disclosure and an award of attorneys' fees.

In 2012, plaintiffs were able to obtain injunctions against equity plan votes in two cases. However, we are unaware of any injunctions since 2012, although other cases have settled based on additional proxy statement disclosures and the payment of plaintiffs' legal fees. We believe that the claims asserted in the equity plan suits are largely without merit and call for disclosures that are not required by the SEC. Nevertheless, directors should be aware of the nature and existence of these claims and the risk of injunctive relief and/or a settlement that involves additional disclosures and payment of legal fees.

Given the amorphous nature of the claims, it is questionable whether prophylactically including additional disclosure of the nature requested in the complaints filed to date will discourage plaintiffs from filing suit. No matter what disclosures a company provides, plaintiffs can invent new disclosure deficiencies and argue that omitted matter is "material" under state corporate law. We nevertheless recommend that companies consider including the following disclosures in the section of the proxy statement describing any newly adopted equity plan, if they determine that such disclosure is material:

- all material terms of the plan;
- the methodology used to determine the requested number of shares under the plan that will be made available for future grants to participants;
- the dilutive impact of the additional shares, including historical and expected share usage rates and historical and expected share repurchases. It may be helpful to provide hard data regarding items like burn rate, share overhang and fair value transfer;
- a summary of the analysis of a compensation consultant of the proposed plan;

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(footnote continued)

[plaintiff] is unlikely to succeed on the merits of his claim. . . ." *Greenlight Capital, L.P. v. Apple, Inc.*, 2013 WL 646547 (S.D.N.Y. Feb. 22, 2013).

- the number of shares available under existing plans as of the latest practicable date prior to the proxy filing;
- the reasons for adopting a new plan as opposed to amending an old plan (*e.g.*, administrative ease, clarification of provisions);
- in addition to the list of permissible performance measures, information regarding the performance goals established or expected to be established under the plan or a statement that such goals have not yet been selected, as well as the list of permissible adjustments that may be made to performance measures; and
- a statement along the lines of “while the plan is intended to comply with Section 162(m) of the Code, the Company may elect to provide nondeductible compensation under the plan.”

Consideration should also be given as to the description of the equity plan and any amendments that are being made to the plan, if the plan being proposed for approval is an amendment and restatement of a prior plan, as well as to the description of the shareholder actions proposed to be taken in connection with the proposed approval of a plan or any amendments thereto.

Plaintiffs have had considerably less success with disclosure claims addressed solely to say-on-pay votes. Part of the *modus operandi* of plaintiffs’ lawyers in these say-on-pay disclosure claims is to evaluate the disclosures of the companies listed as peers in the target company’s proxy, looking for instances in which a peer company has disclosed more executive compensation information than the target company has disclosed, and claiming that any company that discloses less than its identified peers is withholding material facts from its shareholders.

To date, no court has enjoined a nonbinding say-on-pay vote based on the theory that state corporate law required more disclosure than the say-on-pay disclosure requirements imposed by federal law. Numerous courts, both state and federal, have denied motions for injunctions against say-on-pay votes, and several other such motions have been withdrawn or voluntarily dismissed by plaintiffs. While the failure of say-on-pay and other compensation disclosure claims thus far will hopefully lead to fewer such actions in the future, to minimize the likelihood of such litigation, we recommend that companies study the proxies of their peers to identify what, if any, additional disclosures they make regarding compensation and consider whether such additional disclosures may be appropriate.



## VIII.

### Compensation Committee Membership

In enlisting qualified directors to sit as members on a compensation committee, attention must be paid to the various membership requirements imposed by the company's securities market, Section 162(m) of the Code, Rule 16b-3 under the Exchange Act and state law.

#### A. Independence Standards of the Major Securities Markets<sup>57</sup>

The NYSE and NASDAQ generally require that members of listed company compensation committees be independent.

Both the NYSE and NASDAQ have adopted rules as to who can qualify as an independent director. Both markets require that the board of directors of a listed company make an affirmative determination, which must be publicly disclosed, that each director designated as "independent" has no material relationship with the company that would impair his or her independence, and also include a specific list of relationships that disqualify a director from being considered independent. Such disqualifying relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. However, ownership of a significant amount of stock, or affiliation with a major shareholder, should not, in and of itself, preclude a board of directors from determining that an individual is independent.

As a general matter, a director will be viewed as independent only if the director is a non-management director free of any material family relationship or any material business relationship, other than stock ownership and the directorship, with the company or its management, and has been free of such relationships for three years. The following relationships bar a director from satisfying the independence standards of the NYSE or NASDAQ, as applicable:

- the director is, or has been within the last three years, an employee<sup>58</sup> of the company or of any parent or subsidiary of the company;<sup>59</sup>

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<sup>57</sup> For additional discussion of the NYSE and NASDAQ independence requirements, *see* Wachtell, Lipton, Rosen & Katz, Nominating and Corporate Governance Committee Guide, found [here](#).

<sup>58</sup> Both the NYSE and NASDAQ provide that former employment as an interim executive officer does not, in and of itself, disqualify a director from being considered independent following such employment. Under the NASDAQ rules, however, such interim employment

(footnote continued)

- an immediate family member<sup>60</sup> of the director is, or has been within the last three years, an executive officer of the company or of any parent or subsidiary of the company;
- the director is a current partner (or employee, under the NYSE rules) of a firm that is the company's external auditor (or internal auditor, under the NYSE rules);
- an immediate family member of the director is a current partner of a firm that is the company's external auditor (or internal auditor, under the NYSE rules);
- under the NYSE rules, an immediate family member of the director is a current employee of the company's internal or external auditor and personally works on the company's audit;
- the director or an immediate family member was, within the last three years, a partner or employee of a firm that is the company's external auditor (or internal auditor, under the NYSE rules) and personally worked on the company's audit at any time within that time;
- under the NYSE rules, the director or an immediate family member of the director is, or has been within the last three years, an executive officer of another company where any of the company's present executive officers at the same time serves or served on that other company's compensation committee;
- under the NASDAQ rules, the director or an immediate family member of the director is an executive officer of another entity where, at any time during the past three years, any of the executive

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(footnote continued)

cannot last more than one year. The NASDAQ rules stress, however, that the board still must consider whether such former employment and any compensation received would interfere with a director's exercise of independent judgment in carrying out the responsibilities of a director.

<sup>59</sup> Both the NYSE and NASDAQ define "company" to include a parent or subsidiary in a consolidated group with the company.

<sup>60</sup> General Commentary to Rule 303A.02(b) of the NYSE Listed Company Manual defines "immediate family member" as a person's spouse, parents, children, siblings, mothers - and fathers-in-law, sons - and daughters-in-law, brothers - and sisters-in-law, and anyone (other than domestic employees) who shares such person's home. NASDAQ Rule 5605(a)(2) defines "family member" as a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home.



officers of the company served on the compensation committee of such other entity;

- under the NYSE rules, the director is a current employee, or an immediate family member of the director is a current executive officer, of a company that has made payments to, or received payments from, the company for property or services in an amount that, in any of the last three fiscal years, exceeds the greater of \$1 million or 2% of such other company's consolidated gross revenues;<sup>61</sup>
- under the NASDAQ rules, the director or an immediate family member of the director is a partner, controlling shareholder or an executive officer of any organization to which the company made, or from which the company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year or \$200,000, whichever is more;<sup>62</sup>
- under the NYSE rules, the director or an immediate family member of the director has received during any 12-month period within the last three years more than \$120,000 in direct compensation<sup>63</sup> from the company (other than in director and committee fees and pension or other forms of deferred compensation for prior service (*provided* that such compensation is not contingent in any way on continued service))

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<sup>61</sup> The NYSE specifies that both the payments and the consolidated gross revenues to be measured shall be those reported in the last completed fiscal year of such other company. The look-back provision for this test applies solely to the financial relationship between the listed company and the director or immediate family member's current employer; a listed company need not consider former employment of the director or immediate family member.

<sup>62</sup> The NASDAQ rules exclude from the calculation payments arising solely from investments in the company's securities and payments under nondiscretionary charitable contribution matching programs.

<sup>63</sup> The NYSE rules focus on direct compensation. Consequently, investment income from the company (such as dividend or interest income) would not count toward the \$120,000 threshold. In addition, the NYSE's focus on "direct" compensation means that *bona fide* and documented reimbursement of expenses also may be excluded. Note, however, that the NYSE considers payments to a director's solely owned business entity to be direct compensation.

and compensation received by an immediate family member for service as a non-executive employee);<sup>64</sup>

- under the NASDAQ rules, the director or an immediate family member of the director received any compensation<sup>65</sup> from the company in excess of \$120,000 during any 12-month period within the last three years (other than director or committee fees, benefits under tax-qualified retirement plans or nondiscretionary compensation and compensation paid to an immediate family member for service as a non-executive employee);<sup>66</sup> and
- under the NASDAQ rules, the director, while serving as an interim executive officer, participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years.

When evaluating the independence of any director who will serve on the compensation committee, the NYSE rules require a board of directors to consider all relevant factors that could impair independent judgments about executive compensation, including, but not limited to: (1) the source of compensation of such director, including any consulting, advisory or other compensatory fee paid by the company; and (2) whether the director is affiliated with the company or one of its subsidiaries or affiliates. The NASDAQ rules prohibit compensation committee members from accepting any consulting, advisory or other compensatory fees from the company or its subsidiaries (other than directors' fees).

Independence determinations must be based on all relevant facts and circumstances. Thus, even if a director meets all the bright-line criteria set out above, a board of directors is still required to make an affirmative

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<sup>64</sup> The NYSE rules also permit companies to exclude from the \$120,000 threshold compensation received by a director for former service as an interim executive officer of the company.

<sup>65</sup> Unlike the NYSE rules, the NASDAQ rules are not limited to direct compensation. Accordingly, even indirect compensation must be included in the calculation of the \$120,000 threshold. For instance, NASDAQ provides that political contributions to the campaign of a director or an immediate family member of the director would be considered indirect compensation, and, as such, must be included for purposes of the \$120,000 threshold.

<sup>66</sup> The NASDAQ rules permit companies to exclude from the \$120,000 threshold compensation received by a director for former service as an interim executive officer of the company as long as such interim employment did not last longer than one year. The NASDAQ rules stress, however, that the board still must consider whether such compensation would interfere with the director's exercise of independent judgment in carrying out the responsibilities of a director.

determination that the director has no material relationship with the company. Under the NYSE rules, the principles underlying the determination of independence also must be publicly disclosed in the company's annual report or proxy statement. In addition, under SEC disclosure rules, for each director that is identified as independent, the company must describe, by specific category or type, any transactions, relationships or arrangements (other than transactions already disclosed as related-party transactions) that were considered by a board of directors under the company's applicable director independence standards (*e.g.*, the NYSE or the NASDAQ independence rules).

In limited circumstances, NASDAQ permits one director who does not meet its independence rules to serve on the compensation committee without disqualifying the compensation committee from considering the compensation matters that ordinarily would be entrusted to it had it been fully independent. Specifically, if a compensation committee is comprised of at least three members, one non-independent director (who is not a current officer or employee or a family member of an officer or employee) may be appointed to the compensation committee if the board of directors, under exceptional and limited circumstances, determines that such individual's membership on the compensation committee is required by the best interests of the company and its shareholders. If the board of directors takes this approach, it must disclose either on or through the company's website or in the proxy statement for the next annual meeting subsequent to such determination (or, if the company does not file a proxy, in its annual report on Form 10-K or Form 20-F) the nature of the relationship and the reasons for the determination. A member appointed under this exception may serve a maximum of two years. The NYSE does not provide a similar exemption.

In addition, newly listed companies on the NYSE or NASDAQ need only one independent member of the compensation committee at the time of the company's initial public offering, a majority of independent members within 90 days of listing,<sup>67</sup> and a fully independent committee within one year of listing.

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<sup>67</sup> If a newly listed NASDAQ company chooses not to have a compensation committee and to have, instead, a majority of the independent directors discharge the duties otherwise associated with a compensation committee, the company may rely on NASDAQ's phase-in of one year for its separate requirement that there be a majority of independent directors on the board of directors.

## **B. Internal Revenue Code Section 162(m) Membership Requirements**

As more fully discussed in Chapter IV of this Guide, compensation paid to a company's CEO and the three other highest paid executive officers (other than the CFO) is not deductible to the extent such compensation exceeds \$1 million, unless, among other things, the compensation is approved by a compensation committee consisting entirely of two or more "outside directors."

A director is an outside director if the director: (1) is not a current employee of the company; (2) is not a former employee of the company who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year; (3) is not a former officer of the company (whether or not he or she receives compensation for prior services); and (4) does not receive "remuneration" (including any payments in exchange for goods or services) from the company, either directly or indirectly, in any capacity other than as a director.

A director is deemed to have received remuneration in either of the following situations:

- Remuneration is paid, directly or indirectly, to the director personally or to an entity in which the director has a beneficial ownership interest of greater than 50%. For this purpose, remuneration is considered paid when actually paid (and throughout the remainder of that taxable year of the company), and, if earlier, throughout the period when a contract or agreement to pay remuneration is outstanding.
- The company has paid remuneration, other than *de minimis* remuneration, in its preceding taxable year to: (1) an entity in which the director has a beneficial ownership interest of at least 5% but not more than 50%; or (2) an entity by which the director is employed or self-employed other than as a director. Remuneration is considered paid when actually paid or, if earlier, when the company becomes liable to pay it. Generally, payments are *de minimis* if they do not exceed 5% of the gross revenue of the entity receiving the payments for the entity's taxable year.
- Notwithstanding the foregoing, remuneration is not *de minimis* if it is in excess of \$60,000 and either: (1) paid to an entity described in clause (1) above, or (2) if it is paid for "personal services" to an entity described in clause (2) above.
- Remuneration is for personal services if:

- the remuneration is paid to an entity for personal or professional services performed for the company, including legal, accounting, investment banking and management consulting services, but is not for services that are incidental to the purchase of goods or to the purchase of services that are not personal services; and the director performs significant services (whether or not as an employee) for the company, division or similar organization (within the entity) that actually provides the services to the company, or if more than 50% of the entity's gross revenues (for the entity's preceding taxable year) are derived from that company, subsidiary or similar organization.

Whether a director is an employee or a former officer is determined on the basis of the facts at the time that the individual is serving as a director on the compensation committee. Thus, a director is not precluded from being an outside director solely because the director is a former officer of a company that previously was an affiliate of the company.

**C. Membership Requirements for the Short-Swing Profit Exemption of Rule 16b-3 Under Section 16(b) of the Exchange Act**

Section 16(b) of the Exchange Act provides that a company insider, such as a director or officer, is liable to the company for any profits resulting from his or her purchase and sale of the company's equity securities within any period of less than six months. The statute and the rules promulgated thereunder are quite broad, such that, absent an exemption, the granting of equity compensation to an officer or director of the company may be considered a "non-exempt" purchase for this purpose and subject the officer or director to liability for short-swing profits if the officer or director has a non-exempt sale that can be matched against that purchase. In an effort to address this issue, the SEC adopted Rule 16b-3 of the Exchange Act, which exempts, among other things, grants and awards by the company of its securities to an officer or director if approved by a committee composed solely of two or more "non-employee directors."<sup>68</sup>

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<sup>68</sup> In 2016, plaintiffs' lawyers began to target the commonplace practice of the withholding of shares upon settlement of an award in order to satisfy taxes (and, in some cases, an applicable exercise price), alleging that the Rule 16b-3 exemption is available only if the specific withholding event is approved by non-employee directors and challenging as inadequate provisions in various plan or award instruments that authorize withholding in shares but do not make it automatic. Language in the SEC's notes to Rule 16b-3 (as well as in the adopting release to the Rule) clearly refutes such claims, so long as the withholding provision is properly approved by the Board or a good Rule 16b-3 "non-employee director" committee.

## **1. Non-Employee Director**

Under Rule 16b-3, in order to qualify as a non-employee director, the director cannot: (1) be an officer or employee of the company (or of a parent or subsidiary of the company); (2) receive in excess of \$120,000 in compensation, either directly or indirectly, from the company (or from a parent or subsidiary) for services rendered as a consultant or in any capacity other than as a director, or; (3) have an interest in any “related party” transaction for which disclosure in the proxy statement would be required pursuant to Item 404(a) of Regulation S-K.

Disclosure under Item 404(a) is required for any “transaction” since the beginning of the company’s last fiscal year or any currently proposed transaction in which the company is a participant, if the amount involved exceeds \$120,000 and any “related person” had or will have a direct or indirect material interest in the transaction. Under the disclosure rules, the term “related person” means any person who was at any time during the relevant period: (1) a director or executive officer of the company; (2) any nominee for director (but only if the disclosure is being presented in a proxy or information statement relating to the election of that nominee for director); (3) an immediate family member of a director, executive officer or nominee for director (if the proxy or information statement in which the disclosure is being made relates to the election of that nominee for director) of the company; or (4) a beneficial owner of more than 5% the company’s voting securities or an immediate family member of such owner. “Transaction” for purposes of the rule includes any financial transaction, arrangement or relationship (including any indebtedness or guarantee of indebtedness) or any series of similar transactions, arrangements or relationships. Employment relationships and director compensation otherwise disclosed under Item 402 of Regulation S-K (*i.e.*, the executive compensation disclosure rules) need not be disclosed.

The SEC disclosure rules also make clear that, even if the company disclosed a relevant related-party transaction in the company’s filings for the most recent fiscal year, such transaction will not disqualify the director under Rule 16b-3 if the transaction was terminated prior to the director’s proposed service as a non-employee director.

## **2. Ensuring Compensation Committee Membership Compliance**

It is possible that a compensation committee member will be independent under the NYSE or the NASDAQ rules, but will not be an outside or non-employee director under Section 162(m) of the Code and/or Rule 16b-3 under the Exchange Act. In the event the compensation committee has directors that are independent but are not outside and/or non-employee

directors, full compliance with Section 162(m) of the Code and/or Rule 16b-3 is still possible. As long as a compensation committee possesses at least two directors meeting the definitional requirements of outside and/or non-employee directors, the compensation committee can create a subcommittee consisting solely of two or more outside directors and delegate responsibility with respect to matters falling within the ambit of Section 162(m) of the Code and/or Rule 16b-3 to the subcommittee. Compliance with Section 162(m) of the Code also might be accomplished without the formal creation of a subcommittee if the non-outside directors recuse themselves from the deliberations and decisions falling within Section 162(m) of the Code.

### **3. Ensuring Independence Under State Law**

Transactions between a company and its directors are subjected to intense judicial scrutiny under state law because of the inherent conflict between the corporate insiders' personal financial interests and the insiders' fiduciary duty to a company and its shareholders. In order to avoid such heightened judicial scrutiny of compensation arrangements, compensation arrangements should be approved by, and negotiated with, directors who are disinterested with respect to the compensation decision at issue.

While Delaware courts have, in some instances, appeared receptive to arguments that economically independent directors were disqualified by alleged non-economic conflicts of interest, the determination of independence under state law generally requires only economic independence based on a facts-and-circumstances analysis. In one opinion, the Delaware Supreme Court, addressing the independence of certain directors of Martha Stewart Living Omnimedia, Inc.,<sup>69</sup> specifically addressed claims that social connections and personal friendships can result in disqualification from a finding of independence. In deciding *Martha Stewart*, the Court held that allegations of a mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence. The Court also reiterated its rejection of the concept of "structural bias," the supposition that the professional and social relationships that naturally develop among members of a board of directors impede independent decision making.

No doubt, each case of alleged directorial conflict of interest is different. Nonetheless, the *Martha Stewart* decision represents an important restatement of the fundamental principle of corporate governance—the presumption that non-management directors are independent (even if they

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<sup>69</sup> *Beam v. Martha Stewart Living Omnimedia, Inc.*, 845 A.2d 1040 (Del. 2004).

occasionally play golf with the CEO or attend his or her child's wedding)  
unless there is real evidence to the contrary.



## **IX.**

### **Compensation Committee Meetings**

#### **A. Meetings and Agenda**

A compensation committee must meet with sufficient frequency to perform its duties, and should devote adequate time for planning the timing, agenda and attendees at its meetings. A compensation committee should schedule at least one of its meetings before the company's annual report and proxy statement are filed to discuss the proposed CD&A and other compensation-related disclosures. The number of meetings a compensation committee should hold per year depends upon various factors, including the scope of the compensation committee's responsibilities, the size and business of the company and the nature of the compensation arrangements implemented (or to be implemented) by the company. The SEC requires that companies disclose the number of compensation committee meetings held during the prior fiscal year in their annual proxy statements. Compensation committee meetings, like board of director meetings, should be sufficiently long to allot adequate time to carry out the duties of the compensation committee. Compensation committees should consider scheduling their meetings for the day before full board of director meetings to permit adequate time to consider and discuss agenda items.

A compensation committee should set aside sufficient time, without the presence of the CEO and other executive officers, to deliberate and determine the officers' compensation levels. For NASDAQ companies, the CEO may not be present during discussions of his or her compensation, but a similar requirement is not imposed for other executive officers. A compensation committee should have access to management as it deems appropriate.

A compensation committee should be active in setting its agendas for the year as well as for each compensation committee meeting. While management, rather than the board of directors, sets the strategic and business agenda for the company, including regulatory and compliance goals, directors should determine the bounds of their oversight and responsibilities. The compensation committee meetings and annual agendas should reflect an appropriate division of labor and should be distributed to the compensation committee members in advance.

#### **B. Quorum Requirements**

For a compensation committee to conduct official business at a compensation committee meeting, a quorum of its members must be legally present. Unless otherwise restricted in a company's charter, most states consider a director who participates via telephone or video conference to be legally present (as

long as all those present at the compensation meeting can hear and speak to each other). A company's bylaws or a board of directors resolution should set the minimum number of compensation committee members necessary to establish a quorum. If no minimum number is set by a company, then, absent a state law to the contrary, the default minimum quorum requirement for a compensation committee is a majority of its members.<sup>70</sup> Neither the SEC nor the major securities markets have specific guidelines in this regard, although the SEC does require that the proxy statement disclose the number of compensation committee meetings held during the prior fiscal year, as well as the name of any director who attended fewer than 75% of the aggregate number of meetings of the full board of directors and the committees on which such director served.

Actions undertaken by a compensation committee in the absence of a quorum are voidable. Thus, the minutes should clearly reflect the presence of a quorum in order to protect valid decisions from attack. To help ensure that a quorum is present: (1) compensation committee meeting notices should be sent sufficiently in advance of a compensation committee meeting and responses promptly reviewed, and (2) the chairperson of the compensation committee should consult with the corporate secretary in advance of the compensation committee meeting. In the event a compensation committee meeting takes place without a quorum, it should be noted in the minutes.

### **C. Minutes**

Typically, minutes are prepared of compensation committee meetings, but not of their executive sessions. It is common and prudent practice for such minutes to identify the topics discussed at compensation committee meetings rather than attempt to include detailed summaries. Enough information should be recorded, however, to establish that the compensation committee sought the information it deemed relevant, reviewed the information it received, understood each element of the compensation and otherwise engaged in whatever actions and discussions it deemed appropriate in light of the then-known facts and circumstances. The minutes also should indicate which directors attended, whether they attended in person or via telephone or video conference and whether individuals other than the compensation committee members were present.

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<sup>70</sup> This principle flows from the general default rule that a committee of the board of directors is subject to the same corporate process requirements applicable to the entire board of directors. *See, e.g.*, § 8.25(c) of the Model Business Corporation Act (2002). Since the default quorum of the entire board of directors generally is a majority of its members, the same holds true for a board committee, such as the compensation committee.

A compensation committee should approve the minutes at the compensation committee meeting following the meeting for which the minutes were prepared. The minutes should be attached to the agenda for the next compensation committee meeting and circulated in advance so that the compensation committee members have time to review them before they are approved. If the minutes have not been attached and adequately reviewed before the next compensation committee meeting, it may be advisable for the corporate secretary to read the minutes to the committee members before approval to ensure that they are aware of the actions that were taken at the last compensation committee meeting and approve of their characterization in the minutes. Unless otherwise required by state statute or a company's charter or bylaws, it is neither necessary for the minutes to identify the director presenting a motion or resolution nor to separately identify the directors voting for or against a motion or resolution. However, a dissenting or abstaining director should be identified if he or she so requests.

A compensation committee should consider providing a report or a copy of the minutes of each compensation committee meeting to the full board of directors. Directors who do not serve on the compensation committee should have the opportunity to ask the compensation committee questions relating to the compensation committee's charter or the topics covered at the compensation committee meetings.

#### **D. Shareholder and Director Right of Inspection**

Careful drafting of minutes is especially important because shareholders may inspect the books and records of the company, including committee meeting minutes. In Delaware, for instance, any shareholder may inspect board of director and committee minutes upon making a written demand under oath and stating a "proper purpose" for making the request. While the proper purpose requirement ensures that shareholders do not have carte blanche, activist shareholders increasingly are using this right, and a court's willingness to entertain such a demand cannot be foreclosed.<sup>71</sup> The recent

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<sup>71</sup> At least one Delaware Court of Chancery decision, *Polygon Global Opportunities Master Fund v. West Corp.*, 2006 WL 2947486 (Del. Ch. Oct. 12, 2006), did announce several important limitations on the use of this tool in the transactional context and possibly beyond. In *West Corp.*, an activist hedge fund (Polygon Global Opportunities Master Fund) demanded access to West Corporation's books and records after West Corporation announced its intention to undertake a going-private transaction. In denying Polygon Global Opportunities Master Fund's demand, the Court held that, in certain circumstances, public information may be sufficient for the shareholder's stated purpose, the books-and-records statute "is not intended to supplant or circumvent discovery proceedings, nor should it be used to obtain that discovery in advance of the appraisal action itself" and Polygon Global Opportunities Master Fund's desire to investigate alleged board of director misconduct

(footnote continued)

Delaware Court of Chancery opinion in *Amalgamated v. Yahoo!, Inc.*<sup>72</sup> discussed above in Chapter II of this Guide, demonstrates the utility of books and records demands in compensation-related claims. A 2005 Delaware Supreme Court order,<sup>73</sup> remanding a lower court decision allowing a company to demand confidential treatment before divulging sensitive information to dissident shareholders, illustrates the scrutiny companies may face when attempting to prevent public disclosure of even ostensibly confidential information. In its order, the Delaware Supreme Court held that the Court of Chancery must balance a company's interest in confidentiality against a shareholder's communication interest and establish that the confidentiality interest "outweigh[s]" the shareholder's interest.<sup>74</sup>

In litigation, minutes carry added significance given that both Delaware and New York accord corporate minutes a presumption of accuracy. Minutes have been cited in a number of high-profile cases as evidence of directors' alleged lack of care and/or good faith in exercising their fiduciary duties. It is especially important that minutes are carefully and thoughtfully drafted so that an ambiguous litigation record is not created.

#### **E. Access to Outside Advisors**

Under stock exchange listing standards established pursuant 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 advisor (after considering factors described in Section A.1 of Chapter I of this Guide). The rules require compensation committees to be directly responsible for the appointment, compensation and oversight of the advisors they retain and the company to provide for appropriate funding, as determined by the compensation committee, for payment of reasonable

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(footnote continued)

cannot be a proper purpose because Polygon Global Opportunities Master Fund would not have standing to pursue any claims (given that it purchased shares in West Corp., only after the announcement of the transaction).

<sup>72</sup> *Amalgamated Bank, Trustee for the Longview LargeCap 500 Index Fund and the LongView LargeCap 500 Index VEBA Fund v. YAHOO! Inc.*, C.A. No. 10774-VCL (Del. Ch. Feb. 2, 2016).

<sup>73</sup> *Roy E. Disney v. Walt Disney Co.*, No. 380, 2004 (Del. Mar. 31, 2005) (ORDER).

<sup>74</sup> On remand, however, the Delaware Court of Chancery engaged in the prescribed balancing and concluded that the company's interest in confidential treatment outweighed the shareholder's interest, and, thus, that the provision of the requested information could properly be conditioned on confidentiality. See *Roy E. Disney v. Walt Disney Co.*, 2005 Del. Ch. LEXIS 94 (Del. Ch. June 20, 2005). Thus, it appears that, at least at the Delaware Court of Chancery level, confidential treatment, under appropriate circumstances, still will be available.

compensation to the advisors. Additionally, the charter of a compensation committee must address these rights and responsibilities. As noted above, disclosure requirements mandate detailed disclosure of fees and services in respect of consultants who are not independent.

Notwithstanding this heavy emphasis on consultant independence, retention of separate advisors for each of the compensation committee and management when considering issues of executive compensation may not always serve the company's best interests. Such an approach can give rise to inefficiencies in compensation discussions, put a board of directors in the awkward position of receiving conflicting advice, create a bad record if litigation subsequently arises and, perhaps most importantly, create an adversarial relationship between management and the board of directors. While directors should have full access to any consultants that are ultimately retained by the company and have the ability and time to ask focused questions of them, the use of consultants is not legally required, and a consultant's judgment should not be viewed as a substitute for a board of directors' exercise of judgment after careful and informed deliberation. As a matter of good corporate governance, a compensation committee should understand the nature and scope of services that consulting firms and their affiliates provide to the company in order to evaluate any actual or perceived conflicts of interests.

#### **F. Compensation Committee Chairperson**

While each member of a compensation committee contributes to its effectiveness, the compensation committee chairperson has a unique role. The compensation committee chairperson is responsible for ensuring that compensation committee meetings run efficiently and that each agenda item receives the appropriate level of attention. The compensation committee chairperson also often serves as the key contact between the compensation committee and other directors and senior management.

Consequently, in choosing the compensation committee chairperson, a board of directors should seek to select a director with leadership skills, including the ability to forge productive working relationships among compensation committee members and with other directors and senior management. No matter who is appointed compensation committee chairperson, as part of the annual review of the compensation committee, the compensation committee and the board of directors should review the combination of talent, knowledge and experience of the compensation committee members to assure that the compensation committee has the right mix of people.

The time commitment resulting from the current regulatory and shareholder activist environment may require additional compensation for directors, and this pressure is especially acute with respect to service on a compensation

committee. Although some companies would prefer not to discriminate in compensation among directors, reasonable additional fees for compensation committee members are legal and may be appropriate. Additional compensation for committee chairs is another way to give fair compensation for those members most burdened with responsibilities. Although, as noted in Chapter XI of this Guide, we generally recommend that the responsibility for director compensation be delegated to the corporate governance and nominating committee, in many public companies the compensation committee reviews the compensation for directors, including the compensation of directors serving on the compensation committee. In either case, the relevant committee's decision with respect to non-employee director compensation should be subject to full board review and approval.

## X.

### **Compensation Committee Charters**

Under the SEC's executive compensation disclosure rules, a public company must disclose whether or not it has adopted a compensation committee charter, and any such compensation committee charter must be made publicly available on the company's website or attached to the proxy or information statement at least once every three years. In addition, as described below, the NYSE and NASDAQ require a listed company to adopt a compensation committee charter that must include specified provisions. In light of these requirements, the compensation committee of a publicly held company should have a charter that complies with applicable regulations and securities market requirements rules. That said, any such compensation committee charter should not over engineer the operation of the compensation committee. If a compensation committee charter requires review or other action and the board of directors or compensation committee has not taken that action, the failure may be considered evidence of lack of due care. The creation of compensation committee charters is an art that requires experience and careful thought; it is a mistake to copy blindly the published models.

Each company should tailor its compensation committee charter to address the company's particular needs and circumstances, limiting the charter to what is truly necessary and what is feasible to accomplish in actual practice. In order to be state of the art, it is not necessary that a company have everything other companies have. A compensation committee charter should carefully be reviewed each year to prune unnecessary items and to add only those items that will, in fact, help the compensation committee members in discharging their duties.

#### **A. NYSE Listed Companies Charter Requirements**

The compensation committee of a company listed on the NYSE must have a written compensation committee charter that, at a minimum, contains the required provisions specified by the NYSE listing standards.<sup>75</sup> The compensation committee charter must be approved and adopted by the board of directors and should provide:

- a description of the compensation committee's purpose. In this regard, the compensation committee charter should indicate that the

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<sup>75</sup> A listed company of which more than 50% of the voting power is held by an individual, a group or another company is exempt from these requirements.

compensation committee is appointed by the board of directors in order to discharge the responsibilities of the board of directors relating to compensation of the company's CEO, as well as the other executive officers (including making recommendations to the board of directors regarding such compensation). In addition, as applicable, it should indicate that the compensation committee is charged with overall responsibility for approving and evaluating all compensation plans, policies and programs of the company as they affect the CEO, other executive officers and significant company compensation matters and policies in general;

- that the compensation committee annually will review and approve corporate goals and objectives relevant to CEO compensation, evaluate CEO performance in light of those goals and objectives and determine and approve the CEO's overall compensation levels based on this evaluation. It also should be noted that, in determining the incentive-based components of CEO compensation, the compensation committee will consider the company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies and the awards given to the CEO in past years;
- that the compensation committee will review and discuss with management the CD&A and, based on this review and analysis, determine whether or not to recommend to the board of directors the CD&A's inclusion in the company's proxy statement and annual report on Form 10-K;
- that the compensation committee has a duty to furnish the compensation committee report required by the SEC;
- that the compensation committee may, in its sole discretion, retain advisers only after taking into consideration all factors relevant to adviser independence, including the six factors set forth in Section 303A.05(c) of the NYSE Listed Company Manual and will be directly responsible for the appointment, compensation and oversight of the adviser;
- that the company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to any advisers retained by the compensation committee;
- the compensation committee's membership requirements, including the need for member independence;



- how compensation committee members are appointed;
- how compensation committee members may be removed;
- the qualifications for compensation committee membership;
- the compensation committee's structure and operations, including authority to delegate to subcommittees;
- the procedures for compensation committee reporting to the board of directors; and
- that the compensation committee will perform an annual self-evaluation of its performance.

It also may be advisable for the charter to provide:

- that the compensation committee will, at least annually, review and approve the annual base salaries and annual incentive opportunities of the CEO and other senior executives. In particular, it should be noted that the compensation committee will review and approve the following as they affect the CEO and other senior executives: (1) all other incentive awards and opportunities, including both cash-based and equity-based awards and opportunities, (2) any employment agreements and severance arrangements, and (3) any change in control agreements and change in control provisions affecting any elements of compensation and benefits;
- that the compensation committee will receive periodic reports on the company's compensation programs as they affect all employees;
- that the compensation committee will review and approve any special or supplemental compensation and benefits for the CEO and other senior executives and individuals who formerly served as the CEO and/or as senior executives, including supplemental retirement benefits and the perquisites provided to them during and after employment;
- that the compensation committee will review and reassess the adequacy of the compensation committee charter annually and recommend any proposed changes to the board of directors for approval; and
- that the compensation committee has oversight responsibility with respect to shareholder approval of compensation plans.

*Exhibit A* to this Guide is a model compensation committee charter for NYSE listed companies. This compensation committee charter is only a model intended to reflect required and recommended provisions for a compensation committee charter of an NYSE listed company. Companies should customize the model to address their particular needs and circumstances.

## **B. NASDAQ-Listed Companies Charter Requirements**

The NASDAQ rules require the compensation committee of a NASDAQ-listed company to have a formal written charter. On an annual basis, the compensation committee must review and reassess the adequacy of the charter. The charter must specify:

- the scope of the compensation committee's authority and responsibilities, and how it carries out those responsibilities, including structure, process and membership requirements;
- the compensation committee's responsibility for determining, or recommending to the board of directors for determination, the compensation of the CEO and all other executive officers of the company;
- that the CEO may not be present during voting or deliberations on his or her compensation;
- that the compensation committee may, in its sole discretion, retain advisers only after taking into consideration factors relevant to adviser independence set forth in NASDAQ-Listing Rule 5605(d)(3) and will be directly responsible for the appointment, compensation and oversight of the adviser;
- that the company must provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to any advisers retained by the compensation committee; and
- that the compensation committee has oversight responsibility with respect to shareholder approval of compensation plans.

In addition to the provisions required by the NASDAQ rules to be included in the compensation committee charter, the provisions recommended above for inclusion in an NYSE listed company charter may be a helpful blueprint. However, because every company is different, a board of directors, in conjunction with the compensation committee, should carefully consider whether inclusion of any provision is helpful in furthering the performance of the compensation committee's duties.

*Exhibit B* to this Guide is a model compensation committee charter for NASDAQ listed companies. This compensation committee charter is only a model intended to reflect recommended provisions for a compensation committee charter of a NASDAQ listed company. As with the model compensation committee charter provided for an NYSE listed company, each company should customize the model to address its particular needs and circumstances.



## XI.

### **Director Compensation, Indemnification and Directors and Officers Insurance**

#### **A. Director Compensation**

Director compensation is one of the more difficult issues on the corporate governance agenda and is the subject of increased attention. On the one hand, more is being expected of directors today in terms of time commitment, responsibility, exposure to public scrutiny and potential liability. On the other hand, the higher a director's pay, the greater the likelihood that such pay can be used against the director as evidence of a lack of true independence.

##### **1. Responsibility for Determining Director Compensation**

The NYSE and NASDAQ rules do not specify that responsibility for director compensation must be assigned to any particular committee. However, it should be made the responsibility of either a committee of the board of directors or the full board of directors.

As discussed in Chapter II of this Guide, when directors who would directly benefit from a proposed plan are delegated with the responsibility of approving such a plan, a court will refuse the protection of the business judgment rule and scrutinize the overall fairness of the plan as it relates to the company's shareholders.<sup>76</sup> In light of this framework, we generally recommend that responsibility for adopting director compensation be delegated to a company's corporate governance and nominating committee, subject to the approval of the entire board of directors. However, in our experience, many companies choose to allocate these duties to the compensation committee rather than the nominating committee. In either case, the committee's decision with respect to director compensation should always be subject to overall board of director review and override. Care also should be taken that, under normal circumstances, the compensation and benefits of management are not increased at the same time as that of directors, lest doubt be cast on the validity of both actions.<sup>77</sup>

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<sup>76</sup> See, e.g., *Tate & Lyle PLC*, *supra*, at \*20-22 (invalidating rabbi trust covering both inside and outside directors because of conflict of interest).

<sup>77</sup> See *Tate & Lyle PLC v. Staley Continental, Inc.*, C.A. No. 9813, 1988 Del. Ch. LEXIS 61 (Del. Ch. May 9, 1988).

## **2. Considerations for Determining Director Compensation**

Director pay has historically been limited by the view of the director as holding an independent trust and, once upon a time, the relatively limited time commitment that board service was thought to entail. Boards had generally been wary of increasing their own pay in light of the downturn in the economy and public perception. The result is that levels of director compensation have not kept pace with the realities of the current marketplace. While directors are not employees and compensation is not the main motivating factor for public company directors, given the importance of board composition and the competition for the best candidates, it is important to evaluate whether these programs are appropriate to the company's needs. Accordingly, as boards go through their self-evaluations, it is worthwhile to evaluate whether director compensation programs need adjustment consistent with the increased demands of board service, and whether they are adequate to secure best-in-class directors.

Companies also should give careful thought to the mix between individual meeting fees and retainers. Business and regulatory demands have deepened director involvement and technology has changed the way directors meet. In view of these developments, many companies have de-emphasized per-meeting fees and instead increased retainers. Such an approach offers the dual benefits of simplifying director pay and avoiding issues that arise from electronic forms of communication and frequent, short telephonic meetings. As companies move away from per-meeting fees to retainer structures, they should consider whether additional retainer pay is appropriate for directors serving on committees that impose substantial extra demands. It is both legal and appropriate for basic directors' fees to be supplemented by additional amounts to chairs of committees and to members of committees that meet more frequently or for longer periods of time. It is also appropriate to consider the level of time commitment required outside of meetings, including for members of audit and compensation committees who must frequently review substantial written material to be properly prepared for their meetings.

The increased responsibility imposed on directors generally is especially pronounced for non-executive board chairs, lead directors and committee chairs. Accordingly, particular attention should be paid to whether these individuals are being fairly compensated for their efforts and contribution. We expect the pay of non-executive board chairs and lead directors to increase significantly as pay practices catch up to the demands of the responsibilities of these positions.

The board of directors, a compensation committee, nominating committee or other responsible board of director committee, as applicable, should determine the form and amount of director compensation to be paid, with

appropriate benchmarking of such compensation against peer companies. In our experience, most compensation consultants can provide assistance in such benchmarking exercises, as well as in the design of director compensation programs. Survey data will prove useful in considering appropriate director compensation.<sup>78</sup> The committee tasked with determining director compensation should also consider the stock ownership guidelines applicable to the directors, both in terms of the number of shares and the period of time over which a new director is required to achieve the guideline requirement. Additionally, as with executive officers, any perquisites or other forms of compensation that may be provided to directors should be carefully considered, especially in light of the positions taken by shareholder advisory firms such as ISS in certain circumstances.<sup>79</sup> Finally, in light of litigation of the kind described in Section B below, boards of directors may also wish to consider including within the applicable equity incentive plan an annual limit on non-employee, equity-based awards, and should be aware that total pay limits (cash and equity) are also being considered by some public companies.

As discussed in Chapter I of this Guide and as a reminder, the SEC's compensation disclosure rules require tabular and narrative disclosure of all director compensation. The required tabular disclosure is comparable to the extensive disclosure that is required for executive officer compensation, except that only information concerning the last fiscal year needs to be disclosed. The narrative disclosure requires a description of the company's processes and procedures for the consideration and determination of director compensation.

In all instances, the importance of collegiality to the proper functioning of a board of directors must be kept in mind; director compensation should not promote factionalism on the board. Differences in compensation among directors should be fair and reasonable and reflect real differences in demands placed on particular directors.<sup>80</sup>

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<sup>78</sup> For a recent survey of director compensation arrangements, see the F.W. Cook & Co., *Inc. 2016 Director Compensation Report*, available [here](#).

<sup>79</sup> See Chapter VII.C for a discussion of the ISS guidelines in the event of a management proposal for an advisory vote on non-employee director compensation plans.

<sup>80</sup> For additional discussion regarding director compensation considerations, see the Wachtell, Lipton, Rosen & Katz, *Nominating and Corporate Governance Committee Guide*, found [here](#).

## B. Director Compensation Litigation

In recent years, plaintiffs have begun to focus on director compensation arrangements, and have achieved some limited successes in the Delaware courts. However, it remains the case that properly designed director compensation arrangements approved after appropriate process should not prove vulnerable to challenge.

In April 2015, the Delaware Chancery Court in *Calma v. Templeton* allowed a claim that Citrix Systems' board of directors had breached their fiduciary duties in awarding compensation to its outside directors under a compensation plan that had been approved by shareholders, to proceed.<sup>81</sup> The suit challenged awards under the existing equity incentive plan, which had been approved by a majority of shareholders a few years earlier. Potential participants in the shareholder-approved plan included all employees, directors, and officers of Citrix; the plan contained a general limit of 1,000,000 shares per participant per year (worth over \$55 million at the time of the litigation), but no sub limit for directors.

The Court determined that the entire fairness standard of review (less deferential than the usual business judgment standard) was applicable because the awards to the outside directors were made by the recipient directors themselves: “[D]irector self-compensation decisions are conflicted transactions that ‘lie outside the business judgment rule’s presumptive protection.’”<sup>82</sup> The directors’ primary defense was that the equity plan had been ratified by shareholders; however, in light of the lack of meaningful limits or specific guidelines for awards to non-employee directors, the Court held that shareholder approval of the plan as a whole did not constitute approval of the specific decision of the board to make the grants in question.

The *Calma* decision built on a 2012 Delaware Chancery Court decision, *Seinfeld v. Slager*,<sup>83</sup> involving director equity awards under a plan with an individual share limit (worth approximately \$30 million at the time of the litigation). The *Seinfeld* Court held that “there must be some meaningful limit imposed by the stockholders on the Board for the plan to . . . receive the blessing of the business judgment rule. . . . A stockholder-approved *carte blanche* to the directors is insufficient.”

In 2016, Facebook settled a shareholder derivative complaint alleging breach of fiduciary duty, waste and unjust enrichment in connection with the board’s

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<sup>81</sup> *Calma v. Templeton*, Case No. 9579-CB (Del. Ch. Apr. 30, 2015).

<sup>82</sup> *Calma v. Templeton*, at text accompanying n.54 (citation omitted).

<sup>83</sup> 2012 WL 2501105 (Del. Ch. June 29, 2012).



approval of annual cash and equity compensation program for non-employee directors in 2013 by committing to several governance steps, most notably an agreement to submit various elements of its director compensation program to a shareholder vote that would not otherwise be required, and by agreeing to pay the plaintiff's legal fees reported to be \$525,000. Most practitioners are of the view that the Facebook plaintiffs would not have succeeded on the merits, and presume that Facebook settled in order to avoid the cost and distraction of litigation. Nonetheless, the case serves as a cautionary example of the desirability of taking steps to decrease the likelihood of attracting claims related to director compensation, particularly because the size of the attorney's fees may inspire further such claims.<sup>84</sup>

Directors and company executives can draw several important lessons from these cases, most notably that including meaningful and realistic director-specific limits, particularly those approved by shareholders, in the company's equity compensation plan will bolster any argument in support of director compensation decisions. Consequently, companies may wish to consider including in new or amended equity incentive plans otherwise being put to a shareholder vote provisions specifying the amount and form of individual grants to directors or a meaningful director-specific individual award limit, as well as a limit on overall director compensation. Where director pay is particularly high and therefore likely to be a target of plaintiffs' lawyers, consideration may even be given to amending an existing plan to include a director grant limit and putting the plan to a shareholder vote even if such a vote otherwise would not be sought. Such limits are not required under any rule but may help to deter, or bolster a defense against, claims challenging the amount or form of director compensation. As discussed in Section 2 above, it may be desirable for the board to rely on a compensation consultant to assist in constructing the appropriate peer group for benchmarks and to advise on the amount and design of any proposed director compensation, as this may also assist in the protection against claims attacking director compensation.

### **C. Indemnification and Directors and Officers Insurance**

Whatever the directors' compensation program, all directors should be fully indemnified by the company to the fullest extent permitted by law and the company should purchase a reasonable amount of insurance to protect the directors against the risk of personal liability for their services to the company. Bylaws and indemnification agreements should be reviewed on a regular basis to ensure that they provide the fullest coverage permitted by law. Directors also can continue to rely on their exculpation for personal

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<sup>84</sup> *Espinoza v. Zuckerberg, et al.* (,2015 WL 6501521 (Del. Ch. Oct. 28, 2015).

liability for breaches of the duty of care under charter provisions put in place pursuant to Section 102(b)(7) of the Delaware General Corporation Law and similar statutes in other states.

Directors and Officers (“D&O”) insurance coverage, of course, provides a key protection to directors. D&O policies are not strictly form documents; they can and should be negotiated. Careful attention should be paid to retentions, exclusions, and the scope of coverage. Care also should be given to the potential impact of a bankruptcy of the company on the availability of insurance, particularly the question of how rights are allocated between the company and the directors and officers who may be claiming entitlement to the same aggregate dollars of coverage. To avoid any ambiguity that might exist as to directors’ and officers’ rights to coverage and reimbursement of expenses in the case of a bankruptcy, companies should purchase separate supplemental insurance policies covering only directors and officers but not the company (so-called side-A coverage) in addition to the policies that cover both the company and the directors and officers individually.

## EXHIBIT A

### COMPENSATION COMMITTEE CHARTER<sup>85</sup> (NYSE-Listed Company)

#### **Purpose**

The Compensation Committee (the “Committee”) is appointed by the Board of Directors (the “Board”) to discharge the Board’s responsibilities relating to compensation of [Name of Company] (the “Company”) Chief Executive Officer (the “CEO”) and the Company’s other executive officers (collectively, including the CEO, the “Executive Officers”). The Committee has overall responsibility for approving and evaluating all compensation plans, policies and programs of the Company as they affect the Executive Officers.<sup>86</sup>

#### **Compensation Committee Membership**

The Committee shall consist of no fewer than three members. The members of the Committee shall meet the independence requirements of the New York Stock Exchange (the “NYSE”). At least two members of the Committee also shall qualify as “outside” directors within the meaning of Internal Revenue Code Section 162(m) and as “non-employee” directors within the meaning of Rule 16b-3 under the Securities Exchange Act of 1934, as amended.<sup>87</sup>

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<sup>85</sup> A compensation committee charter must be adopted by the board of directors.

<sup>86</sup> While the NYSE’s Listed Company Manual provides that all CEO-related compensation must be determined either by a compensation committee alone or by a compensation committee together with the other independent directors (as directed by the board of directors), the NYSE Listed Company Manual expressly permits discussion of CEO compensation with the board of directors generally. *See* NYSE Listed Company Manual, Section 303A5(b) and Commentary.

<sup>87</sup> Only two members need to conform to the membership requirements of Internal Revenue Code Section 162(m) and/or Rule 16b-3 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), because satisfaction of such membership requirements may be accomplished by the delegation of the relevant decisions to a conforming two-person subcommittee or by the recusal or abstention of the non-conforming members if at least two conforming members remain. *See* PLR 9811029 (Dec. 9, 1997); American Society of Corporate Secretaries, 1996 SEC No-Act, LEXIS 910 (Dec. 11, 1996).

In addition, compliance with the membership requirements of Internal Revenue Code Section 162(m) is only necessary to the extent that the board of directors determines that it is in the best interests of the Company to qualify for the performance-based exemption to the non-deductibility of individual compensation payments in excess of \$1 million made to the CEO and the next four highest paid officers (other than the principal financial officer). In addition, compliance with the membership requirements of Rule 16b-3 of the Exchange Act is not the only means available to the board of directors to ensure that grants or awards to

(footnote continued)

The members of the Committee shall be appointed by the Board on the recommendation of the Nominating & Governance Committee. One member of the Committee shall be appointed as Committee Chairman by the Board. Committee members may be replaced by the Board.

### **Meetings**

The Committee shall meet as often as necessary to carry out its responsibilities. The Committee Chairman shall preside at each meeting. In the event the Committee Chairman is not present at a meeting, the Committee members present at that meeting shall designate one of its members as the acting chair of such meeting.

### **Committee Responsibilities and Authority**

1. The Committee shall annually review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives and determine and approve the CEO's compensation level based on this evaluation. In determining the incentive components of CEO compensation, the Committee may consider a number of factors, including, but not limited to, the Company's performance and relative shareholder return, the value of similar incentive awards to CEOs at comparable companies and the awards given to the CEO in past years.
2. The Committee shall, at least annually, review and approve the annual base salaries and annual incentive opportunities of the Executive Officers.
3. The Committee shall, periodically and as and when appropriate, review and approve the following as they affect the Executive Officers: (a) all other incentive awards and opportunities, including both cash-based and equity-based awards and opportunities; (b) any employment agreements and severance arrangements; (c) any change in control agreements and severance protection plans and change in control provisions affecting any elements of compensation and benefits; and (d) any special or supplemental compensation and benefits for the Executive Officers and individuals who formerly served as Executive Officers, including supplemental retirement benefits and the perquisites provided to them during and after employment.

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(footnote continued)

company officers fall within the Rule 16b-3 short-swing profit safe harbor from Exchange Act Section 16(b) liability. The safe harbor also is available if the grants or awards are approved by the full board of directors if the securities issued to the officers are held by the officers for at least six months or if a majority of the shareholders approve or ratify the grants or awards by the next annual meeting of shareholders.

4. The Committee shall review and discuss the Compensation Discussion and Analysis (the “CD&A”) required to be included in the Company’s proxy statement and annual report on Form 10-K by the rules and regulations of the Securities and Exchange Commission (the “SEC”) with management, and, based on such review and discussion, determine whether or not to recommend to the Board that the CD&A be so included.
5. The Committee shall produce the annual Compensation Committee Report for inclusion in the Company’s proxy statement in compliance with the rules and regulations promulgated by the SEC.
6. The Committee shall oversee the Company’s compliance with SEC rules and regulations regarding shareholder approval of certain executive compensation matters, including advisory votes on executive compensation and the frequency of such votes, and the requirement under NYSE rules that, with limited exceptions, shareholders approve equity compensation plans.
7. The Committee shall make regular reports to the Board.
8. The Committee shall annually review its own performance.
9. The Committee shall have the sole authority to retain and terminate (or obtain the advice of) any adviser to assist it in the performance of its duties, but only after taking into consideration all factors relevant to the adviser’s independence from management, including those specified in Section 303A.05(c) of the NYSE Listed Company Manual. The Committee shall be directly responsible for the appointment, compensation and oversight of the work of any adviser retained by the Committee, and shall have sole authority to approve the adviser’s fees and the other terms and conditions of the adviser’s retention. The Company must provide for appropriate funding, as determined by the Committee, for payment of reasonable compensation to any adviser retained by the Committee.
10. The Committee may form and delegate authority and duties to subcommittees as it deems appropriate.



## EXHIBIT B

### COMPENSATION COMMITTEE CHARTER<sup>88</sup> (NASDAQ-Listed Company)

#### **Purpose**

The Compensation Committee (the “Committee”) is appointed by the Board of Directors (the “Board”) to discharge the Board’s responsibilities relating to compensation of [Name of Company] (the “Company”) Chief Executive Officer (the “CEO”) and the Company’s other executive officers (collectively, including the CEO, the “Executive Officers”). The Committee has overall responsibility for approving and evaluating all compensation plans, policies and programs of the Company as they affect the Executive Officers.

#### **Committee Membership**

The Committee shall consist of no fewer than three members. The members of the Committee shall meet the independence requirements of the NASDAQ Stock Market.

At least two members of the Committee also shall qualify as “outside” directors within the meaning of Internal Revenue Code Section 162(m) and as “non-employee” directors within the meaning of Rule 16b-3 under the Securities Exchange Act of 1934, as amended.<sup>89</sup>

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<sup>88</sup> A compensation committee charter must be adopted by the board of directors.

<sup>89</sup> Only two members need conform to the membership requirements of Internal Revenue Code Section 162(m) and/or Rule 16b-3 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), because satisfaction of those membership requirements may be accomplished by the delegation of the relevant decisions to a conforming two-person subcommittee or by the recusal or abstention of the non-conforming members if at least two conforming members remain. See PLR 9811029 (Dec. 9, 1997); American Society of Corporate Secretaries, 1996 SEC No-Act, LEXIS 910 (Dec. 11, 1996).

In addition, compliance with the membership requirements of Internal Revenue Code Section 162(m) is only necessary to the extent that the board of directors determines that it is in the best interests of the Company to qualify for the performance-based exemption to the non-deductibility of individual compensation payments in excess of \$1 million made to the CEO and the next four highest paid officers (other than the CFO). In addition, compliance with the membership requirements of Exchange Act Rule 16b-3 is not the only means available to the board of directors to ensure that grants or awards to company officers fall within the Rule 16b-3 short-swing profit safe harbor from Exchange Act Section 16(b) liability. The safe harbor also is available if the grants or awards are approved by the full board of directors, if the securities issued to the officers are held by the officers for at least six months or if a majority of the shareholders approve or ratify the grants or awards by the next annual meeting of shareholders.

The members of the Committee shall be appointed by the Board on the recommendation of the Nominating & Governance Committee. One member of the Committee shall be appointed as Committee Chairman by the Board. Committee members may be replaced by the Board.

### **Meetings**

The Committee shall meet as often as necessary to carry out its responsibilities. The Committee Chairman shall preside at each meeting. In the event the Committee Chairman is not present at a meeting, the Committee members present at that meeting shall designate one of its members as the acting chair of such meeting.

### **Committee Responsibilities and Authority**

1. The Committee shall, at least annually, review and approve the annual base salaries and annual incentive opportunities of the Executive Officers. The CEO shall not be present during any Committee deliberations or voting with respect to his or her compensation.
2. The Committee shall, periodically and as and when appropriate, review and approve the following as they affect the Executive Officers: (a) all other incentive awards and opportunities, including both cash-based and equity-based awards and opportunities; (b) any employment agreements and severance arrangements; (c) any change in control agreements and severance protection plans and change in control provisions affecting any elements of compensation and benefits; and (d) any special or supplemental compensation and benefits for the Executive Officers and individuals who formerly served as Executive Officers, including supplemental retirement benefits and the perquisites provided to them during and after employment.
3. The Committee shall review and discuss the Compensation Discussion and Analysis (the "CD&A") required to be included in the Company's proxy statement and annual report on Form 10-K by the rules and regulations of the Securities and Exchange Commission (the "SEC") with management, and, based on such review and discussion, determine whether or not to recommend to the Board that the CD&A be so included.
4. The Committee shall produce the annual Compensation Committee Report for inclusion in the Company's proxy statement in compliance with the rules and regulations promulgated by the SEC.
5. The Committee shall monitor the Company's compliance with the requirements under the Sarbanes-Oxley Act of 2002 relating to loans to directors and officers, and with all other applicable laws affecting employee compensation and benefits.



6. The Committee shall oversee the Company's compliance with SEC rules and regulations regarding shareholder approval of certain executive compensation matters, including advisory votes on executive compensation and the frequency of such votes, and the requirement under the NASDAQ rules that, with limited exceptions, shareholders approve equity compensation plans.
7. The Committee shall make regular reports to the Board.
8. The Committee shall have the authority, in its sole discretion, to retain and terminate (or obtain the advice of) any adviser to assist it in the performance of its duties, but only after taking into consideration factors relevant to the adviser's independence from management specified in NASDAQ Listing Rule 5605(d)(3). The Committee shall be directly responsible for the appointment, compensation and oversight of the work of any adviser retained by the Committee, and shall have sole authority to approve the adviser's fees and the other terms and conditions of the adviser's retention. The Company must provide for appropriate funding, as determined by the Committee, for payment of reasonable compensation to any adviser retained by the Committee.
9. The Committee may form and delegate authority and duties to subcommittees as it deems appropriate.