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Hot Topics for Compensation Committees

In her regular column on corporate governance issues, Holly Gregory considers the key topics for compensation committees and their advisors to focus on in the coming year.

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Holly counsels clients on a full range of governance issues, including fiduciary duties, risk oversight, conflicts of interest, board and committee structure, board leadership structures, special committee investigations, board audits and self-evaluations, shareholder initiatives, proxy contests, relationships with shareholders and proxy advisors, compliance with legislative, regulatory and listing rule requirements, and governance best practice.

With the 2015 proxy season largely over, now is the time for compensation committees and their advisors to take stock of developments that will likely impact the agendas of compensation committees and their efforts in the year ahead. Key areas of focus for compensation committees as they prepare for the 2016 proxy season include:

- Issues associated with director compensation.
- Developments in disclosure, particularly disclosure regarding:
  - pay for performance;
  - CEO pay ratios; and
  - hedging policies.
- Clawback policy developments.
- The increasing complexity of compensation and compensation metrics.
- CEO succession planning.
- Shareholder and proxy advisory firm influence, particularly issues related to:
  - say on pay votes;
  - Institutional Shareholder Services Inc.'s (ISS's) evaluation of equity compensation plans; and
  - shareholder engagement.

DIRECTOR COMPENSATION

It is fairly typical for the compensation committee (or the governance committee) to determine or make recommendations to the board regarding director compensation. Director compensation has been under increased scrutiny over the past several years, particularly since the 2012 Delaware Court of Chancery's decision in *Seinfeld v. Slager* (*2012 WL 2501105 (Del. Ch. June 29, 2012)*). A recent case from the Delaware Court of Chancery serves as a reminder that, by their nature, director compensation decisions involve a matter in which the directors are interested, and therefore business judgment rule protection does not apply (*Calma v. Templeton, No. 9579-CB (Del. Ch. Apr. 30, 2015)*).

Calma v. Templeton involved a shareholder challenge to awards of restricted stock units (RSUs) to eight outside directors of Citrix Systems, Inc. under an equity incentive plan that had been approved by shareholders. The plan imposed no limits on grants to non-employee directors other than a limit of one million shares or RSUs per plan participant per calendar year. Based on the company's stock price when the action was filed, a grant of one million shares would have had a value of over $55 million.

From 2011 to 2013, the compensation committee awarded each non-employee director 4,000 RSUs plus cash compensation each year, for an aggregate value of over $1 million for the three-year period. None of the awards were approved by shareholders. The plaintiff contended that the board breached its fiduciary duties and wasted corporate assets because the grants of RSU awards were "excessive" in comparison to the compensation received by directors at certain of Citrix's peer companies.

The court dismissed the waste claim, finding that the allegations failed "to support an inference that Citrix's non-employee director compensation was so one-sided that no reasonable business person could conclude that the Company received adequate consideration." However, the court denied the defendants' motion to dismiss the claim that the directors had breached their duties in awarding compensation to non-employee directors under Citrix's equity incentive plan.

The court applied the entire fairness standard of review because the directors making the compensation decisions were not disinterested, as they would receive the awards. The court declined to find that shareholders ratified the awards at issue because the plan did not specify the amount or form of compensation to be issued to Citrix's non-employee directors.

Under the entire fairness standard, a defendant must establish that the transaction was a product of fair dealing and fair price. The factual basis of this standard makes it very difficult to meet on a motion to dismiss. The issue in this case revolved around whether Citrix's non-employee director compensation practices were in line with those of its peer group. The court found that the plaintiff had raised valid questions, which could not be answered at this procedural stage, as to whether companies with considerably higher market capitalizations, revenue and net income should be included in the peer group used to determine the fair value of compensation for Citrix's non-employee directors.

This case emphasizes that any shareholder-approved equity plan should impose reasonable limits on the maximum size of director awards. It also highlights that benchmarking data for director compensation must be carefully considered and will not provide a clear defense in early stages of litigation involving a similar claim. Companies should take care to ensure that compensation committee minutes reflect the rationale for director compensation awards, especially regarding any significant one-time awards.

Search Delaware Court of Chancery Applies Entire Fairness to Breach Claim Relating to Non-employee Director Equity Awards for more on this decision.

DISCLOSURE DEVELOPMENTS

Compensation committees and their advisors should anticipate final rules from the SEC on long-awaited Dodd-Frank Act disclosure mandates concerning:

- Pay for performance.
- CEO pay ratios.
- Hedging policies.

While it is uncertain when final rules will be adopted, it is fairly likely that there will be SEC activity on these matters within the next several months.

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PAY FOR PERFORMANCE DISCLOSURE

In a split three-to-two vote, the SEC finally proposed rules in April 2015 mandated by Section 953(a) of the Dodd-Frank Act for public company disclosure in the annual meeting proxy statement and Form 10-K on how the executive compensation actually paid is related to the company's financial performance (*SEC Release No. 34-74835*). The proposed rules are intended to improve the information investors rely on when making investment and voting decisions.

Proposed Item 402(v) of Regulation S-K would require disclosure showing for each of the last five fiscal years:

- The total compensation as disclosed in the summary compensation table for the company's principal executive officer.
- The compensation "actually paid" to the principal executive officer (excluding unvested stock grants and options) and, for equity-based compensation, using the fair market value on the date of vesting.
- The average compensation as disclosed in the summary compensation table for the company's other named executive officers.
- The average compensation actually paid to the other named executive officers.
- Total shareholder return (TSR) for the company.
- TSR for the company's peer group.

Based on this information, the company must also describe in narrative or graphic form the relationship between:

- The executive compensation actually paid and the company's cumulative TSR.
- The TSR of the company and its peer group.

The information in the table and the corresponding description must be provided in tagged data format using XBRL to allow investors to easily compare data across companies and years. The five-year look-back would be phased in, starting with a three-year look-back increased by one year in each of the next two years. Smaller reporting companies will only be required to look back three years and will not be required to disclose a peer group TSR. Foreign private issuers and emerging growth companies are excluded from these requirements.

CEO PAY RATIO DISCLOSURE

The SEC released proposed rules in September 2013 regarding CEO pay ratios, as required by Section 953(b) of the Dodd-Frank Act (*SEC Release No. 33-9452*). As proposed, the rules will require public companies to disclose in the annual meeting proxy statement and Form 10-K the CEO's annual total compensation in relation to the median annual total compensation of all other employees of the company, including foreign, part-time and temporary employees.

Rather than prescribe a specific methodology for companies to use, the proposed rules give companies flexibility to determine the median total annual compensation of employees in a way that best suits their particular circumstances (for example, through the use of statistical sampling).

Search SEC Proposes Dodd-Frank Pay Ratio Disclosure Rules for more on the proposed pay ratio disclosure rules.

The proposed rules are intended to provide investors with information to assess the relationship between the compensation of the CEO and the typical employee. According to an Economic Policy Institute report by Alyssa Davis and Lawrence Mishel, *CEO Pay Continues to Rise as Typical Workers are Paid Less*, the ratio of CEO pay to the average worker's pay was approximately 300-to-1 in 2013, up from approximately 20-to-1 in 1965.

The SEC's Division of Economic and Risk Analysis issued in June 2015 additional analysis regarding the proposed rules for pay ratio disclosure. The analysis is intended to provide information about the potential effect on pay ratio disclosure of the exclusion of different percentages of employees (for example, foreign, part-time or temporary employees) at a range of thresholds. The analysis supplements the proposed rules.

Search SEC Staff Provides Additional Analysis Related to Dodd-Frank Pay Ratio Disclosure Proposal for more on the SEC's analysis.

It remains unclear when final rules will be issued. The proposed rules have generated a large number of comments. Not surprisingly, the disclosure is favored by unions. According to Richard Trumka, president of the AFL-CIO, large pay gaps between CEOs and employees "inhibit teamwork and lead to lower job satisfaction and morale, higher employee turnover, reduced productivity and inferior product quality" (*Richard Trumka, Op-Ed, Investors Should Know Pay Gap Between C.E.O.s and Workers, N.Y. Times, Feb. 9, 2015*).

HEDGING POLICIES

The SEC proposed rules in February 2015 regarding hedging disclosure to implement Section 955 of the Dodd-Frank Act, which require annual meeting proxy statement disclosure of whether employees or directors are permitted to engage in transactions to hedge or offset any decrease in market value of equity securities of the company granted as compensation or held directly or indirectly (*SEC Release No. 33-9723*).

Currently, Item 402(b) of Regulation S-K mandates that CD&A disclosure contains material information necessary to understand the company's compensation policies and decisions regarding named executive officers. This includes company policies on hedging the economic risk of stock ownership.

Under the proposed rules, companies will be required to disclose in any proxy statement or information statement relating to an election of directors whether they permit employees, officers or directors, or any of their designees, to purchase financial instruments or engage in transactions that are designed to hedge or offset a decrease in the market value of the company's equity securities. Because the SEC views this disclosure as related more to corporate governance, rather than to executive compensation, the proposed rules are located in Item 407 of Regulation S-K.

Search SEC Proposes Requirement to Disclose Hedging by Employees and Directors, as Required by Dodd-Frank for more on the proposed rules.

CLAWBACK POLICIES

Section 954 of the Dodd-Frank Act requires the SEC and stock exchanges to adopt rules requiring listed companies to implement and disclose clawback policies. These are policies requiring the recovery of compensation paid to executive officers during the three-year period prior to an accounting restatement that is based on material noncompliance with financial reporting requirements.

While the Sarbanes-Oxley Act provides for the SEC to seek the return of compensation from the CEO and CFO, the Dodd-Frank Act provision is broader. For example:

- Clawback provisions only apply to the CEO and CFO under the Sarbanes-Oxley Act, but under the Dodd-Frank Act apply to any current or former executive officer.
- Misconduct by the CEO or CFO is required to claw back compensation under the Sarbanes-Oxley Act, but under the Dodd-Frank Act compensation must be clawed back if an accounting restatement is required due to material noncompliance with any financial reporting requirements.
- The look-back period is only one year under the Sarbanes-Oxley Act, as compared to three years under the Dodd-Frank Act.
- The SEC takes action under the Sarbanes-Oxley Act, rather than the company being required to do so under the Dodd-Frank Act.

On July 1, 2015, the SEC issued proposed rules that would direct the national stock exchanges to establish listing standards regarding clawback policies in accordance with the Dodd-Frank Act (*Sidley Austin LLP, SEC Proposes Compensation Clawback Rules*). A number of companies have already adopted clawback policies and provide disclosure on these policies in the annual meeting proxy statement.

Search SEC Proposes Rules Requiring Companies to Adopt Executive Compensation Clawback Policies for more on the SEC's proposed rules.

COMPENSATION COMPLEXITY AND METRICS

Ever greater reliance on performance-based compensation is adding complexity to the work of the compensation committee. Creating a pay for performance program that works as intended is difficult. Efforts to improve on compensation programs have led to more structure and increasingly complicated program design features, and less compensation committee discretion. This in turn makes disclosure and the explanation of how program design choices relate to award values more challenging.

According to ISS, performance-based pay now accounts for over half of total CEO compensation, and is continuing to grow in proportion to other pay elements. The shift from stock options and stock appreciation rights to awards based on achieving specific performance goals requires compensation committees to identify:

- The performance metrics to be used.
- The performance goals associated with the performance metrics.
- How the performance metrics are related to driving the sought-after performance.

Changes in performance metrics from year to year are common, occurring at more than half of companies. This adds to the complexity of long-term awards that span multiple years. In addition, the number of metrics that compensation programs rely on is growing, and companies are increasing their use of

NACD Recommendations for Compensation Committees

The National Association of Corporate Directors' (NACD's) *Blue Ribbon Commission Report on Compensation Committees (2015)* provides the following recommendations:

- The compensation committee should broaden its scope beyond CEO succession to include oversight of talent development at multiple levels of the company, especially the leadership pipeline.
- Compensation committee composition should represent a range of diverse perspectives and skill sets, as well as evidence of diligence, expertise, courage and communication skills.
- Consider a retainer for the compensation committee chair that is in line with that of the audit committee chair.
- Executive compensation plans should balance long-term incentives with short-term operational goals, clearly reflecting and supporting the company's strategic plan.
- Peer group and market data should be used as a "reasonability test" for executive pay plan design. It should not drive decisions.
- The compensation committee should be able to exercise discretion in evaluating and rewarding performance, as long as it clearly discloses its rationale.
- The compensation committee has a responsibility to inform and educate the full board on an ongoing basis about the link between performance and pay outcomes.
- The board should view the CD&A as the company's primary vehicle for communicating compensation matters to shareholders.
- Disclosures should clearly explain (in plain English and with key metrics defined) how compensation decisions are tied to performance.
- The compensation committee chair should be prepared and "presentation ready" for shareholder communications.

combined metrics (for example, by using one metric to modify, reduce or amplify an award that is based on other metrics). Companies are also increasing their use of relative metrics that benchmark company performance against a peer group. Additional complexity is provided through different payout structures, such as variations in payout levels that go beyond the standard threshold, target and maximum.

Compensation committees need to understand the elements of compensation and apply their compensation philosophy to ensure those elements accomplish the intended goal. Determining the appropriate metrics for performance is a key issue for compensation committee discussion.

Companies are under significant pressure to focus on TSR due to ISS's policies and the shareholder view that TSR aligns the interests of shareholders and executives (and now the SEC's proposed use of TSR as a measure of performance for purposes of pay for performance disclosure). However, there is growing recognition that relative TSR may be flawed as an incentive measure given that it is subject to temporary stock price swings and manipulation through repurchases. Additionally, it does not provide any incentive for the behaviors that drive performance, such as growing profits, innovating, expanding markets, cutting costs and executing operationally.

Other metrics that companies may also rely on are earnings per share and return on invested capital, in addition to profitability, revenue, cash flow and growth metrics. Key metrics should relate to measures that are within management's control. Compensation committees should consider the value of simplicity and year-over-year consistency, as well as the balance of short-term and long-term metrics.

While compensation decisions have become far more complicated, compensation committee responsibilities have not changed. The focus of compensation committees continues to be:

- Adopting and implementing a compensation philosophy.
- Establishing and providing oversight of executive compensation programs.
- Communicating the compensation philosophy and programs to shareholders.
- Compensating and providing appropriate incentives for the CEO in line with corporate strategy.
- Attending to internal controls and risk oversight in relation to compensation.
- Determining or recommending director compensation.

Each individual compensation committee member owes the duties of care, loyalty and good faith and should fully understand:

- The key principles underpinning executive compensation policies and decisions.
- The goals of the compensation program and the outcome it is designed to reward.
- The elements of compensation and why those elements are included.
- How each compensation element fits into the overall compensation program.
- How payout amounts are determined.

Periodically, the compensation committee should step back and assess how well compensation decisions have supported the compensation philosophy and intended goals.

Given the increase in complexity in the work of the compensation committee, and the additional time that is required to fulfill those responsibilities, it is imperative that the compensation committee be comprised of the right members and is performing effectively. Compensation committee composition and performance should therefore be a key focus of the board's and committee's annual self-evaluation process.

CEO SUCCESSION PLANNING

According to a recent National Association of Corporate Directors (NACD) survey, nearly a quarter of public company directors are "not satisfied" with their company's CEO succession plan (*2014-2015 NACD Public Company Governance Survey*). The compensation committee (or governance committee) is typically responsible for reviewing CEO succession and working with the board in evaluating potential successors to executive officer positions.

The compensation committee should ensure that it allocates appropriate time in its agenda each year to developing and refining a CEO succession plan to take effect in the event of an emergency or planned transition, and getting to know potential

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internal candidates (for example, through presentations at board meetings).

SHAREHOLDER AND PROXY ADVISORY FIRM INFLUENCE

SAY ON PAY VOTE

According to a June 10, 2015 report on say on pay from Semler Brossy (Say on Pay Report), for the 2015 proxy season to date, 32 companies in the Russell 3000 (or approximately 2%) had failed to achieve majority support for management's say on pay proposal. A disconnect between compensation and performance is the most prevalent explanation for say on pay failure, but it appears to be less common than in prior years. According to the Say on Pay Report, 1,574 Russell 3000 companies have had their say on pay votes and:

- 78% passed with support of 90% or more.
- 93% passed with support of 70% or more.

If these results hold as expected, the vast majority of companies will pass say on pay in 2015. Approximately 98% of companies received majority support for their executive pay packages in 2014. Additionally, 91.7% of companies have passed say on pay in all five years that it has been mandated pursuant to the Dodd-Frank Act. As in prior years, however, the compensation committee cannot become complacent. Unexpected performance problems can quickly expose failures in the pay for performance alignment, even where careful attention has been paid.

ISS EVALUATION OF EQUITY COMPENSATION PLANS

ISS amended its approach to its equity compensation plan analysis this year, moving to what it terms a "balanced scorecard." Compensation committees and their advisors need to understand this approach. The new scorecard incorporates a range of positive and negative factors relating to the cost of the plan, plan features and the company's historical grant practices. How the factors are weighted is based on company size and status.

Using ISS's Equity Plan Data Verification portal, companies have approximately two business days to review and verify key data points that ISS uses to evaluate an equity plan proposal and to make its voting recommendation regarding a plan.

SHAREHOLDER ENGAGEMENT

Compensation committees need to understand the concerns of their largest shareholders on compensation and related issues. This should be an ongoing exercise throughout the year. It is not a matter to leave until the proxy statement is being prepared. Although the say on pay vote is advisory, it is highly influential in its reputational impact. Shareholder engagement is even more critical when a company anticipates needing shareholder approval of an equity compensation plan that may not be supported by ISS.

A negative vote can generate publicity or lower governance ratings, and if not addressed may lead to votes against directors. According to the Say on Pay Report, compensation committee chairs are five times as likely to receive a negative ISS recommendation for reelection the year following a failed say on pay vote and compensation committee members are four times as likely to receive a negative ISS vote recommendation.

Proxy advisory firms continue to influence vote outcomes. ISS has recommended negative votes on say on pay at approximately 10% of companies. Where ISS has recommended "against," on average shareholder support is 32% lower.

Companies must disclose how they respond to say on pay votes in the following year's annual meeting proxy statement. It is becoming increasingly common for not only companies that fail the say on pay vote, but for those companies that pass with below average support, to reach out to their large institutional shareholders shortly after the annual meeting to try and identify what concerns may have led to the negative votes. This information can then be considered by the compensation committee as it determines whether to adjust the compensation program.

The views stated above are solely attributable to Ms. Gregory and do not necessarily reflect the views of Sidley Austin LLP or its clients.