TOP TAKEAWAYS

Public Company Executive Compensation Hot Topics

The following top takeaways are drawn from the Public Company Executive Compensation Hot Topics Roundtable moderated by Foley & Lardner LLP Partner Jessie Lochmann Allen on November 10, 2016 as part of the NDI Executive Exchange, a segment of Foley's National Directors Institute. Featured participants in the roundtable were Amy Jennings, Partner, Talent & Rewards with Aon Hewitt; Patrick McGurn, Special Counsel, Institutional Shareholder Services; Eric Gonzaga, Partner, Grant Thornton; Peter Underwood, Senior Vice President, General Counsel & Secretary, Fortive Corporation; and Josh Agen, Partner, Foley & Lardner LLP.

1. Say-on-Pay Frequency Votes in 2017. Votes on the frequency of future say-on-pay votes (otherwise known as "say when on pay") will be required for many companies in 2017. Panelists including Pat McGurn noted that many investors – 66% of those surveyed for the 2016-2017 ISS Global Policy Survey – prefer that companies hold say-on-pay votes on an annual basis, rather than on a biennial or triennial basis. While some investors are open to determining frequency on a company-by-company basis (17%), annual votes are generally seen as a best practice.

2. Potential Adverse Consequences of Say-on-Pay Frequency Other Than Annual. Panelists noted a concern that, during the "off" years at a company that holds say-on-pay votes less frequently than annually, investors may choose to voice displeasure with a company's compensation program by withholding votes from, or voting against, compensation committee members in the binding annual vote for directors in the absence of the opportunity to do so through the non-binding advisory say-on-pay vote.

3. Measuring Performance in Pay for Performance – Selection of Performance Measures. The objective of paying for performance is a common goal for companies in setting compensation for executives. The panelists observed that, although total shareholder return (TSR) and relative TSR have become increasingly popular metrics to use, investors have expressed discomfort with companies putting all of their eggs in the TSR/relative TSR basket. TSR is potentially uncontrollable, as TSR may be tied more to market performance than to executive performance, especially for larger companies. Some companies have introduced return on invested capital (ROIC) and other performance goals, while investors are open to additional metrics, including ROA, ROE, EPS, EBITDA, cash flow metrics and other metrics. However, TSR remains an important measure for several reasons, including its status as part of ISS's quantitative evaluation of executive compensation in the say-on-pay context, its simplicity and its ability to align closely management's incentives with shareholder interests (increased stock price). In short, panelists observed that compensation committees need to take an active approach to design compensation programs that are best suited to their companies' unique circumstances.

4. Proposed SEC Clawback Rules. Panelists discussed the proposed executive compensation "clawback" rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The proposed rules would require companies to "claw back" incentive-based compensation received by current or former executive officers based on financial results that are subsequently restated. The clawback would apply to such compensation received during the three fiscal years preceding the date on which the company is required to prepare the accounting restatement. The

rules are "no fault" – executive officers are subject to the rules regardless of whether they were involved in preparing the financial statements subject to the restatement. If the rules become final in the same form as they were proposed, they will require companies to file their clawback policies as exhibits to their annual reports, and disclose certain information about their clawback policies in their proxy statements and Form 10-Ks under certain circumstances. In the period before final rules are adopted, the panelists recommended that companies ensure their incentive compensation arrangements include a contractual right to enforce any clawback that is eventually required.

5. Clawbacks Beyond Dodd-Frank. Panelists discussed the recent high-profile example of Wells Fargo, which caused its CEO to forfeit $41 million in restricted stock following allegations that employees had misused customer information. The alleged misconduct did not result in a financial restatement, so would not have triggered a clawback under a Dodd-Frank style clawback. However, Wells Fargo had adopted a clawback policy covering conduct resulting in "significant financial or reputational harm," regardless of whether a financial restatement was required, and it appeared to rely on this clawback policy to cause the forfeiture. The example of Wells Fargo suggests that there may be situations in which it is desirable to have clawback policies that go further than the Dodd-Frank requirements.

6. Discretion in Performance Goals. The panelists observed that it is often desirable for compensation committees to retain some discretion over performance goals to take into account unanticipated events or incentives. However, any discretionary adjustments of performance goals may result in disqualification of awards as "performance-based compensation" under Section 162(m) of the Internal Revenue Code of 1986, as amended, and the loss of the corresponding exemption from the $1 million limit on deductible compensation. Such a change also may trigger a current disclosure obligation under Form 8-K. Panelists suggested that incentive programs may be structured to accommodate discretion without losing deductibility under Section 162(m) by using an "umbrella" structure for the program under which the performance goal used to qualify the award is separate from the factors used to determine the actual payout and not affected by any use of discretion to make appropriate adjustments to performance.

7. CEO Pay Ratio. The SEC issued final CEO pay ratio rules on August 5, 2015. Companies will need to disclose the ratio of CEO pay to that of the median employee beginning in the 2018 proxy season. The key to preparing this disclosure will be the determination of the median employee for the purposes of calculating the ratio. Many companies began the process of determining that median employee already, especially those that had concerns about obtaining the necessary data including from operations in countries throughout the world. Companies are also now considering what their disclosure under the rules will look like in their proxy statements and how they might address any concerns over how their investors or other constituencies will perceive the ratio. For example, if the median employee is a non-U.S. employee in a low-wage position, resulting in a high ratio, the company may wish to highlight the circumstances of the median employee to explain the reason for the ratio. Companies may also wish to discuss this topic with their internal human resources team to determine what potential employee morale or other unintended consequences could flow from this disclosure.

8. Proposed SEC Pay for Performance Disclosure Rules. The proposed pay for performance rules under Dodd-Frank will, if adopted as proposed, require disclosure of the relationship between

executive compensation actually paid to executive officers and the cumulative TSR of the registrant and the relationship between a company's TSR and the TSR of a peer group chosen by the registrant. Compensation "actually paid" would be based on the summary compensation table, except that the value of equity awards would be determined at vesting (rather than the grant date) and pension plan value would be limited to changes attributable to the applicable year of service.

9. Impact of Election on Dodd-Frank Rules. Panelists discussed the impact that the new Presidential administration and the Republican majority in Congress may have on the Dodd-Frank rules relating to executive compensation, including the CEO pay ratio and pay for performance disclosure requirements described above. Legislation has been circulated that would modify or reverse these rules, which has given some companies pause in evaluating how much time and how many resources to invest in preparation. Companies and their advisors should continue to monitor the status of the legislation and related rulemaking to avoid investing unnecessary resources.

10. Say-on-Pay 2016. Management say-on-pay proposals generally received high levels of shareholder support in 2016, consistent with prior years. Average support was 91% across all companies, with only 31 failed votes. However, more companies landed on ISS' radar for lack of responsiveness to say-on-pay concerns (23%, up from 13% in 2015).

For more information on Public Company Executive Compensation Hot Topics, please feel free to contact the moderators directly:

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