TOP TAKEAWAYS

Public Company Executive Compensation Hot Topics Roundtable

The following top takeaways are drawn from the Public Company Executive Compensation Hot Topics Roundtable moderated by Foley & Lardner LLP Partner Jessica Lochmann Allen on November 4, 2015 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; Eileen Kamerick, Director, Legg Mason Closed End Mutual Funds, Associated Banc Corporation and Westell Technologies, Inc.; and Joshua Agen, Senior Counsel, Foley & Lardner LLP.

1. **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. The panelists observed that, although relative total shareholder return (TSR) has become increasingly popular, the performance goals used by companies should be based on those companies' individual circumstances, including their specific business plans, industries and growth stages. Panelists noted that all performance metrics generally result in some unintended consequences, and recommended implementing several measures designed to mitigate those consequences. Such measures include focusing on both growth and shareholder return, benchmarking potential goals against peers, considering the performance metrics in the context of all of the company's incentive plans and using multiple performance metrics. The panelists also advised companies to monitor their peer groups and performance metrics for potential changes over time as the company's circumstances evolve.

2. **Pay for Performance – Limitations on Relative TSR.**

Panelists observed that, despite its widespread use, relative TSR is not a silver bullet for establishing pay for performance. One potential drawback is the potential for a company's peers that have historically performed poorly to demonstrate high TSR despite mediocre performance, resulting in a lower-than-expected payout under the company's incentive program despite solid performance by its management team. Market circumstances and changing objectives might also necessitate a change in metrics. For example, when cash flow becomes vital for keeping a company afloat, as in the 2007-2008 financial crisis, metrics tied to free cash flow may be better options than TSR. Panelists recommended using TSR as only one of several performance metrics, or in a limited role as a performance modifier, in a company's incentive compensation programs.

3. **Choice of Compensation Metrics in Light of Regulatory Changes.**

As noted, a company's long-term strategy, rather than changing regulatory conditions, should inform the company's compensation decisions. Regulatory changes (including proposed clawback rules) may make time-vesting awards or discretionary awards more attractive to executives, but moving to these types of compensation and away from performance-based awards may trigger adverse reactions from proxy advisory firms and institutional investors. Any deviations from performance-based awards should be discussed prominently in the company's proxy statement.

4. **Use of Non-GAAP Compensation Metrics.**

Investors may view the use of adjusted performance metrics as acceptable, depending on the nature and extent of adjustments and the rationale provided for their use, though both investors and analysts are likely to "see through" attempts at using adjusted metrics to make a company look like it is performing better than it really is. Discontinued operations, non-recurring or extraordinary charges and foreign exchange volatility adjustments are examples of adjustments that shareholders may find appropriate, while goodwill write-downs, litigation expenses and compensation expenses are more typically seen as problematic adjustments for determining compensation. If adjusted or non-GAAP metrics are used, companies should disclose why such metrics are preferable, provide a reconciliation to GAAP and include any other disclosures required by the non-GAAP disclosure rules in their proxy statements.

5. **Performance Goals – When to Change.**

Panelists recommended resisting the urge to modify performance goals in the middle of performance cycles unless either there is a clear turning point based on the company's circumstances, such as completion of an integration following an acquisition or a one-time accounting charge that was not anticipated when the performance goals were established. Any mid-performance-period change in 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 exclude one-time accounting charges without losing deductibility under Section 162(m) by identifying charges that will be excludible in an objective manner in advance or 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 is less likely to be affected by such charges.

6. **CEO Stock Ownership Requirements.**

Panelists noted that CEOs should generally have a large stake of their compensation and net worth tied to company performance to ensure their interests are closely aligned with the interests of shareholders. Companies should be cautious about accommodating requests from CEOs to permit diversification of their portfolios significantly away from company stock, as investors might feel that the CEO does not have enough "skin in the game."

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 main difficulty in disclosing the CEO pay ratio will be in determining the median employee for the purposes of calculating the ratio. Companies should start the process of determining that median employee now, especially if there are concerns about record-keeping practices or if a company has operations in countries throughout the world. It may also be advisable for companies to consider how their disclosure under the rules will appear 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.

8. **Proposed SEC Clawback Rules.**

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 proposed rules are adopted, companies must 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.

9. **Proposed SEC Pay for Performance Disclosure Rules.**

The proposed pay for performance rules 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.

10. **Say on Pay 2015.**

Management say on pay proposals generally received high levels of shareholder support in 2015, consistent with prior years. Average support was 91% across all companies, with a 2% failure rate. Shareholder engagement worked for companies with failed votes in 2014 – 38% of companies with a failed vote in 2014 received greater than 80% support in 2015. Conversely, of the 49 companies that lost pay votes in 2015, 31% received over 80% in 2014.

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For more information

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

Jessica Lochmann Allen
Foley & Lardner LLP
jlochmann@foley.com

Joshua A. Agen
Foley & Lardner LLP
jagen@foley.com

FOLEY
FOLEY & LARDNER LLP