TOP TAKEAWAYS

Public Company Executive Compensation Hot Topics Roundtable

1. ISS Policy Changes for 2015 Proxy Season. ISS released its 2015 voting policy updates on November 6, 2014. The only pay-related change related to ISS's evaluation of equity-based and other incentive plan proposals. Previously, ISS based its voting recommendations regarding such proposals on an evaluation of whether the plan passed or failed a series of factors. In its 2015 policy updates, ISS indicated it will in the future apply a "scorecard" model that will assign points based on a range of positive and negative factors in three categories. The total score under this model will generally determine whether ISS recommends voting for or against the proposal. The three categories of factors in the ISS scorecard are: (1) the total estimated cost of the company's equity plans relative to industry/market cap peers; (2) plan design features; and (3) the company's grant practices. In addition to the scorecard, the new approach preserves some of the "bright line" tests that may trigger an automatic recommendation to vote against a plan under the existing model, such as the plan's inclusion of a liberal change of control definition that may trigger accelerated vesting, permitting or failing to prohibit repricing of underwater options or serving as a vehicle for problematic pay practices or a pay for performance disconnect.

2. Expectations for Say on Pay in 2015 Proxy Season. Say on pay votes in the 2014 proxy season fared similarly in the aggregate to similar votes in the 2013 proxy season, with generally high rates of shareholder support. A similar outcome is expected for say on pay proposals in the 2015 proxy season. The advisory vote on the frequency of say on pay, known as "say when on pay," will next be required for most companies in the 2017 proxy season, but in light of the increasingly routine quality of many say on pay votes, some companies may consider seeking shareholder approval prior to 2017 to switch from annual say on pay votes to a less frequent biennial or triennial schedule for say on pay.

3. Coca-Cola's Equity Stewardship Policy. Coca-Cola adopted an equity stewardship policy following some high-profile opposition to its equity plan proposal in 2014. The stewardship policy pledged to reduce the rate of Coca-Cola's equity award use in the future to such a degree that the share reserve under the company's equity plan was expected to last for most or all of the plan's 10-year term. Although Coca-Cola's example in actively responding to shareholder concerns over its use of equity incentive awards may be instructive and may encourage other investors to seek a reduction in the rate of companies' equity award use, panelists did not view the stewardship policy as changing investor expectations that equity plan share reserves proposed to shareholders should consist of a number of shares projected to last approximately 3-4 years.

4. Shareholder Engagement Over Executive Compensation Shareholder Proposals. In recent years, pay-related proposals, such as proposals to eliminate golden parachute payments or certain severance benefits, have more frequently been brought by professional or institutional investors as opposed to retail investors. These professional or institutional investors have in some cases been more receptive to shareholder outreach and negotiation with companies than other classes of proponents. Accordingly, companies who receive a pay-related shareholder proposal from such an investor may be well advised to focus their initial efforts in responding to the proposal on engagement and negotiation rather than on potential grounds to exclude the proposal.

5. 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.

6. 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. Panelists recommended using TSR as only one of several performance metrics in a company's incentive compensation programs.

7. 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 the company incurs 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.

8. Succession Planning. In planning for CEO succession, panelists recommended that boards identify potential candidates based on a "blank slate" evaluation of the company's strategy and the skill set required to accomplish that strategy, rather than basing the search on the current CEO's background. They also recommended focusing on first-generation CEO candidates within the company and evaluating at the board level whether such candidates are developing. Some participants had experienced success in including CEO succession planning as an element in the board's evaluation of the CEO. Participants expressed the view that this practice may be most effective if the CEO's compensation is based in part on CEO succession planning. One approach to involving the CEO in succession planning highlighted by a participant was to use a green-line/red-line/yellow line evaluation of the CEO's direct reports and establishing a goal for the CEO to move all of the participants to green-line status.

9. Status of Dodd-Frank Rules Relating to Compensation. The SEC has yet to finalize several compensation-related rules required by the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010. These rules relate to the disclosure of the "pay ratio" of the company's CEO to its median employee (discussed below), the disclosure of the relationship between the company's compensation and its performance and a requirement to adopt mandatory "clawback" policies that would require a company to recoup previously paid incentive compensation in the event of certain financial restatements. Proposed rules have been issued concerning the CEO pay ratio, but not for the disclosure on pay and performance or for clawback policies. Participants speculated that the outcome of the November 2014 election could affect the timing of these rules or even lead to the repeal of some of the Dodd-Frank reforms.

10. **Proposed SEC Rules on CEO Pay Ratio Disclosure.** Commissioner White of the SEC recently indicated that she hoped for the publication of final rules on CEO pay ratio disclosure by the end of 2014, but, as noted above, some participants expressed the view that the outcome of the elections in the November 2014 election might delay that timeline. However, the SEC has not to date indicated that it has altered its previously disclosed timetable for final pay ratio rules. Under the proposed SEC rules, the ratio disclosure would comprise three elements: (1) the median of the annual total compensation of all employees of the issuer, except the CEO; (2) the annual total compensation of the CEO; and (3) the ratio of those two amounts. For purposes of identifying the median employee, the employee pool would include all employees of the registrant and its subsidiaries on the last day of the most recently completed fiscal year, and all domestic and foreign full-time, part-time, seasonal or temporary workers employed on that day. Companies would be permitted to use their entire employee population or statistical sampling to identify the median employee. Although final rules are not expected to be effective until annual meetings in 2017, it may be advisable for companies to consider how their disclosure under the proposed 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.

For more information

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

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