“Proxy Disclosure Conference” & “16th Annual Executive Compensation Conference”

Course Materials

September 16-17, 2019

CompensationStandards.com & TheCorporateCounsel.net

Proxy Disclosure Conference

Monday, September 16, 2019

Full-Day Agenda & Schedule

(Times are Central – but all panels will be archived & available at your discretion)

9:00 - 9:50 am **"The SEC All-Stars: A Frank Pay Disclosure Conversation"**

Speakers:

- **Mark Borges** - Compensia
- **Meredith Cross** - WilmerHale
- **Alan Dye** - Hogan Lovells
- **Keith Higgins** - Ropes & Gray
- **Dave Lynn** - TheCorporateCounsel.net and Morrison & Foerster

9:50 - 10:00 am **"The SEC All-Stars: Post-Panel Commentary"**

Speakers:

- **Ning Chiu** - Davis Polk
- **Renata Ferrari** - Ropes & Gray

10:00 - 10:40 am **"Hedging Disclosures & More"**

Speakers:

- **Dave Lynn** - TheCorporateCounsel.net and Morrison & Foerster
- **Ron Mueller** - Gibson Dunn
- **Amy Wood** - Cooley

10:40 - 10:50 am **"Hedging Disclosures & More: Post-Panel Commentary"**

Speakers:

- **Howard Dicker** - Weil Gotshal
- **Kyoko Takahashi Lin** - Davis Polk

10:50 - 11:10 am **Break**

11:10 - 11:50 am **"Section 162(m) Deductibility (Is There Really Any Grandfathering)"**

Speakers:

- **Mark Borges** - Compensia
- **Renata Ferrari** - Ropes & Gray
- **Scott Spector** - Fenwick & West

11:50 - 12:00 pm **"I Like It Like That"**

Speakers:

- **Marty Dunn** - Morrison & Foerster
- **Dave Lynn** - TheCorporateCounsel.net and Morrison & Foerster

12:00 - 1:05 pm **Lunch**

1:05 - 1:30 pm **"Comp Issues: How to Handle PR & Employee Fallout"**

Speakers:

- **Mark Borges** - Compensia
- **Brian Breheny** - Skadden Arps
- **Amy Wood** – Cooley

1:30 - 2:00 pm "**Proxy Disclosures: 20 Things You've Overlooked**"

Speakers:

- **Brian Breheny** - Skadden Arps
- **Marty Dunn** - Morrison & Foerster
- **Beth Ising** - Gibson Dunn
- **Dave Lynn** - TheCorporateCounsel.net and Morrison & Foerster

2:00 - 2:20 pm **Break**

2:20 - 2:55 pm "**Clawbacks: #MeToo & More**"

Speakers:

- **Keith Higgins** - Ropes & Gray
- **Mike Melbinger** - Winston & Strawn
- **Ron Mueller** - Gibson Dunn
- **Scott Spector** - Fenwick & West

2:55 - 3:10 pm "**Dealing with the Complexities of Perks**"

Speakers:

- **Mark Borges** - Compensia
- **Alan Dye** - Hogan Lovells

3:10 - 3:25 pm **Break**

3:25 - 3:45 pm "**How to Handle Negative Proxy Advisor Recommendations**"

Speakers:

- **Ning Chiu** - Davis Polk
- **Beth Ising** - Gibson Dunn

3:45 - 3:55 pm "**My Story**"

Speakers:

- **Keir Gumbs** - Uber
- **Broc Romanek** - TheCorporateCounsel.net

3:55 - 4:20 pm "**Director Pay Disclosures**"

Speakers:

- **Ning Chiu** - Davis Polk
- **Renata Ferrari** - Ropes & Gray
- **Blair Jones** - Semler Brossy

4:20 - 5:00 pm "**The Big Kahuna: Your Burning Questions Answered**"

Speakers:

- **Bindu Culas** - FW Cook
- **Howard Dicker** - Weil Gotshal
- **Bob McCormick** - PJT Camberview
- **Reid Pearson** - Alliance Advisors

5:00 - 7:00 pm **Welcome Reception**

<u>16th Annual Executive Compensation Conference</u>

Tuesday, September 17, 2019

<u>Full-Day Agenda & Schedule</u>

(Times are Central – but all panels will be archived & available at your discretion)

7:30 - 8:45 am **<u>Registration & Continental Breakfast</u>**

8:45 - 9:45 am **<u>Keynote: Josh Linkner on "The Music of Business: Translating Improvisational Thinking from Jazz to the Business World</u>"**

9:45 - 10:30 am **Break**

10:30 - 11:30 am **"<u>The SEC All-Stars: The Bleeding Edge</u>"**

Speakers:

- **Brian Breheny** - Skadden Arps
- **Meredith Cross** - WilmerHale
- **Marty Dunn** - Morrison & Foerster
- **Keir Gumbs** - Uber
- **Dave Lynn** - TheCorporateCounsel.net and Morrison & Foerster

11:30 - 1:00 pm **Lunch**

1:00 - 2:00 pm **"The Top Compensation Consultants Speak"**

Speakers:

- Bindu Culas - FW Cook
- Howard Dicker - Weil Gotshal
- Blair Jones - Semler Brossy
- Tara Tays - Deloitte Consulting

2:00 - 2:45 pm **Break**

2:45 - 3:45 pm **"Navigating ISS & Glass Lewis"**

Speakers:

- Ning Chiu - Davis Polk
- David Kokell - ISS
- Bob Lamm - Gunster
- Bob McCormick - PJT Camberview

3:45 - 4:00 pm **Break**

4:00 - 5:00 pm **"Hot Topics: 50 Practical Nuggets in 60 Minutes"**

Speakers:

- Era Anagnosti - White & Case
- Bob Lamm - Gunster
- Katy Murray - Activision
- Kyoko Takahashi Lin - Davis Polk
- Amy Wood – Cooley

Proxy Disclosure Conference

Monday, September 16, 2019

Detailed Master Agenda & Talking Points

(Times are Central – but all panels will be archived & available at your discretion)

9:00 - 9:50 am **"The SEC All-Stars: A Frank Pay Disclosure Conversation"**

Speakers:

- **Mark Borges** – Compensia
- **Meredith Cross** - WilmerHale
- **Alan Dye** - Hogan Lovells
- **Keith Higgins** - Ropes & Gray
- **Dave Lynn** - TheCorporateCounsel.net and Morrison & Foerster

1. What is the SEC's new proxy advisor guidance? Is the SEC (or Congress) considering any changes to the pay disclosure requirements in the near term (including the status of the remaining Dodd-Frank pay-related proposals)?

2. What to consider about the use of non-GAAP measures in compensation plans

3. How do you think the pay ratio disclosures went in Year 2?

4. What are the remaining biggest areas of ambiguity for pay ratio – what parts of the pay ratio rule were the hardest to comply with?

5. How do you think the battle over the future of the shareholder proposal rule relates to pay disclosures?

6. What's the debate over stock buybacks & executive pay all about?

Talking Points: Use of Non-GAAP Financial Measures in Proxies & Executive Compensation Plans

By Keith Higgins, Ropes & Gray

- Regulation S-K, Item 402(b), Instruction 5
    - Disclosure of target levels that are non-GAAP financial measures will not be subject to Regulation G and Item 10(e); however, disclosure must be provided as to how the number is calculated from the registrant's audited financial statements.
- Compliance & Disclosure Interpretations, Regulation S-K, Question 118.08
    - Instruction 5 applies only to the CD&A
    - Staff will not object, however, if non-GAAP financial measures are used elsewhere in the proxy statement if reconciliation and other information is included in an annex to the proxy statement, or with a cross reference
- *Wall Street Journal*, Op-Ed – "Executive Pay Needs a Transparent Scorecard," April 10, 2019 by Commissioner Robert J. Jackson, Jr. and Robert C. Pozen
    - Cites prevalence of non-GAAP financial measures used in compensation arrangements
    - Critical of instruction 5 and the ability to omit the otherwise required reconciliation when non-GAAP financial measure is being used as a target
    - Committees using non-GAAP numbers are not required to "explain why an adjusted version of earnings is the right way to determine incentive pay . . . ."
        - Increases the risk of "windfalls to underperforming managers."
    - Asks SEC to require companies to "explain why non-GAAP measures are driving compensation decisions" and "quantify any differences between adjusted criteria and GAAP."

- Petition for Rulemaking Regarding Disclosures on Use of Non-GAAP Financials in Proxy Statement CD&As, Council of Institutional Investors, April 29, 2019
    - Asks the SEC to eliminate Instruction 5, so that reconciliation and purpose/use statements would be required
        - The comparable GAAP number would be required to accompany the non-GAAP disclosure, presumably in the CD&A itself
    - Change the CD&I and require the reconciliation in the CD&A itself, an appendix to the proxy statement or include a hyperlink to the 10-K
        - The CD&I applies to non-GAAP financial measures that are not targets for executive compensation arrangements. Not sure what problem the second request is solving.
- Is this a solution is search of a problem?
    - The fact that companies use adjusted GAAP numbers should not come as any surprise.
        - Analysts use non-GAAP financial measures to evaluate company performance
        - Managers use non-GAAP financial measures to assess company performance
        - The fact that the adjusted numbers are usually greater than the GAAP numbers should also not come as a surprise.
            - The real questions should be are the adjustments appropriate and what is the right target?
    - Although instruction 5 frees the company from providing the reconciliation, it does require disclosure about how the non-GAAP financial measure is calculated
        - CII rulemaking petition cites examples where it was not clear what was being adjusted.
        - But if that is the case, the rule currently requires this disclosure.

- Will requiring disclosure about why the GAAP was not the appropriate measure for executive compensation purposes result in helpful disclosure?
    - CD&A already requires the company to explain "[w]hat specific items of corporate performance are taken into account in . . . making compensation decisions."
        - Will it be helpful to explain what measures were **not** used and why?
        - A well-written CD&A should make clear the relationship between executive pay and company performance **however that performance is measured**.

Talking Points: Stock Buybacks & Executive Compensation

By Keith Higgins, Ropes & Gray

- S&P 500 companies on a pace to buy back $940 billion of stock in 2019
    - In 2018, Senator Baldwin, along with three Senators who are currently seeking the Democratic nomination of President, introduced the Reward Work Act
        - Would have prohibited companies from conducting open market purchases of their stock
        - Would have repealed the safe harbor in Rule 10b-18
        - Reintroduced in March 2019; no action to date.
    - Other proposals to require additional disclosure about stock buybacks, give the SEC the authority to reject buyback plans, and require boards and CEOs to certify that buybacks are in the long-term "best interest" of their companies have also been unsuccessful
    - In February 2019, two senators announced they planned to introduce legislation that would have prohibited a company from purchasing its stock unless it paid its workers a specified minimum wage, provided sick leave, and offered pensions and health plans.

- In July 2019, Senator Sherrod Brown announced that he would introduce legislation to curb stock buybacks and require companies to pay a "worker dividend" equal to $1 for each $1 spent on stock buybacks, dividend increases and special dividends.

- June 2018 – Commissioner Jackson gave a speech he called "Stock Buybacks and Corporate Cashouts"

    - His research identified that twice as many companies had insiders selling in the period following announcement of a buyback than on a "normal" day

    - Commissioner Jackson asserted that executives were using stock buybacks as a way of cashing out

    - Called for a review of Rule 10b-18

    - Urged boards to pay closer attention to the implications of buybacks for the link between pay and performance

- What's the problem?

    - Are executives not permitted ever to sell any shares? Do we know whether the shares sold were received as compensation in any event?

    - How much of the volume of shares bought back did the executive's shares represent? Is it fair to say that the executives engineered the buybacks to cash out their shares?

- Compensation Committees need to pay attention to the possible impact of stock buybacks on metrics used in compensation plans

    - Most long-term incentive arrangements are tied to performance metrics. Frequently the metrics can have an earnings per share component that is sensitive to buybacks.

    - Buybacks can also have an impact on capital efficiency metrics such as return on assets and return on invested capital, and committees need to be sensitive to the impact buybacks could have on these measures.

    - Disclosure from IBM's 2019 proxy statement

        - Targets are established at the beginning of each three-year performance period. These targets are based on IBM's financial model, as shared with investors, and the Board-approved annual budget. The Committee's longstanding practice is that the Company's share repurchase activities have no effect on executive compensation. To formalize this practice, for Performance Share awards starting in 2016 and thereafter, actual operating EPS results are adjusted to remove the impact of any difference between the actual share count and the budgeted share count, while simultaneously ensuring that executive compensation targets are normalized for any planned buybacks that are incorporated into the Operating EPS target. Additionally, the scoring for the Performance Share Unit Program takes into account extraordinary events. For the 2016–2018 performance period, there were no such events.

- Executive Compensation and Share Buybacks were even a subject of a shareholder proposal in 2019
    - Merck 2019 Proxy Statement – Proposal by Oxfam America
        - RESOLVED that shareholders of Merck & Co., Inc. ("Merck") urge the Board of Directors to adopt a policy that the Compensation and Benefits Committee (the "Committee") must approve a proposed sale of Compensation Shares by a senior executive during a Buyback and, for each such approval granted, explain in writing, for inclusion in Merck's proxy statement for the relevant period, why the Committee concluded that approving the sale was in Merck's long-term best interest.
        - Proposal received 4% of the votes cast

9:50 - 10:00 am "**The SEC All-Stars: Post-Panel Commentary**"

Speakers:

- **Ning Chiu** - Davis Polk

- **Renata Ferrari** - Ropes & Gray

10:00 - 10:40 am "**Hedging Disclosures & More**"

Speakers:

- **Dave Lynn** - TheCorporateCounsel.net and Morrison & Foerster
- **Ron Mueller** - Gibson Dunn
- **Amy Wood** - Cooley

1. Overview of the New Hedging Disclosure Rule

   A. When is the disclosure required?

   B. What constitutes "hedging" for purposes of the rule?

   C. Equity securities covered by the rule

   D. Scope of employees and directors covered

   E. Instruments and transaction covered

   F. Is disclosure about individual hedging transactions required?

2. Substance of Disclosure

   A. Required disclosure if you have a hedging policy

   B. Required disclosure if you do not have a hedging policy

   C. What constitutes a "fair and accurate" summary?

   D. Are there benefits to disclosing the policy in full?

   E. Should you adopt a written hedging policy for the persons covered by the rule?

3. Disclosure Mechanics

   A. Location of the disclosure

B. How does the hedging disclosure relate to disclosure about hedging in the CD&A?

4. What are the Typical Terms of Hedging Policies?

5. Does the Rule Require Disclosure Regarding Pledging?

A. How should companies think about pledging in the context of a hedging policy?

6. How Will Investors React to Hedging Policy Disclosure?

Talking Points: Hedging Disclosure

By Dave Lynn, Morrison & Foerster

Background

- On December 18, 2018, the SEC adopted new paragraph (i) of Item 407 of Regulation S-K to implement Section 955 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act"), which added new Section 14(j) to the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Effective Date

- Issuers that are not foreign private issuers, listed closed-end investment companies, smaller reporting companies or emerging growth companies must begin complying with the new disclosure requirement specified in Item 407(i) of Regulation S-K in proxy statements or information statements with respect to the election of directors during fiscal years beginning on or after July 1, 2019.

- Issuers that qualify as smaller reporting companies or emerging growth companies must comply with the new disclosure requirement specified in Item 407(i) of Regulation S-K in proxy statements or information statements with respect to the election of directors during fiscal years beginning on or after July 1, 2020. The disclosure is not required for foreign private issuers and listed closed-end investment companies.

Disclosure Requirements

- Item 407(i) of Regulation S-K requires an issuer to describe any practices or policies it has adopted (whether written or not) regarding the ability of its employees (including officers) or directors of the issuer, or any of their designees:

  - to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars and exchange funds),

  - or otherwise engage in transactions that hedge or offset, or are designed to hedge or offset,

  any decrease in the market value of issuer equity securities granted as compensation of the employee or director, or held, directly or indirectly, by the employee or director.

- An issuer is required to provide either:

  - a fair and accurate summary of the practices or policies (whether written or not) that apply, including the categories of persons covered and any categories of hedging transactions that are specifically permitted and any categories that are specifically disallowed; or

  - disclosure of the practices or policies in full.

- If an issuer does not have any practices or policies regarding hedging, then the issuer must:

  - disclose that the issuer does not have any practices or policies regarding hedging; or

  - state that hedging transactions are generally permitted.

- Item 407(i) does not require disclosure of any hedging transactions that have occurred.

- Item 407(i) of Regulation S-K is broader in application than Item 402(b)(2)(xiii) of Regulation S-K, which is limited to disclosure of hedging policies applicable to the issuer's named executive officers.

Definitions

- The term "financial instruments" includes, but is not limited to, prepaid variable forward contracts, equity swaps, collars and exchange funds. The rule is not limited to transactions in financial instruments, however, and in fact extends to any transactions "that hedge or offset, or are designed to hedge or offset, any decrease in the market value of registrant equity securities."

- The SEC did not define the terms "hedge" or "hedging" in the final rule amendments. In the adopting release, the SEC referred to the language of Exchange Act Section 14(j), and noted that, for purposes of the disclosure requirements, "hedging" should be applied by issuers "as a broad principle," and that the term applies to transactions with the same economic effects as the transactions specified in Exchange Act Section 14(j). As such, an issuer must "make its own judgments" when determining whether transactions are subject to the new disclosure requirements.

- "Registrant equity securities" for the purpose of the rule includes equity securities issued by the issuer and its parents, subsidiaries or subsidiaries of the registrant's parents.

    - In the adopting release, the SEC notes that the required disclosure is not limited to registrant equity securities that are registered under Section 12 of the Exchange Act.

    - If an issuer has a practice or policy with respect to different classes of equity securities, the issuer's disclosure should reflect those distinctions.

Location of the Disclosure

- The disclosure specified in Item 407(i) of Regulation S-K is required to be disclosed in a proxy statement or information statement when action is to be taken with respect to the election of directors.

- The disclosure is not required in Form 10-K Part III disclosure, even if that disclosure is incorporated by reference from the issuer's definitive proxy statement or information statement.

- Instruction 6 to Item 402(b) of Regulation S-K indicates that an issuer may satisfy the Item 402(b) disclosure requirement by cross-referencing the information disclosed pursuant to new Item 407(i), to the extent that the information disclosed pursuant to new Item 407(i) satisfies the requirement.

10:40 - 10:50 am "**Hedging Disclosures & More: Post-Panel Commentary**"

Speakers:

- Howard Dicker - Weil Gotshal
- Kyoko Takahashi Lin - Davis Polk

10:50 - 11:10 am **Break**

11:10 - 11:50 am "**Section 162(m) Deductibility (Is There Really Any Grandfathering)**"

Speakers:

- Mark Borges - Compensia
- Renata Ferrari - Ropes & Gray
- Scott Spector - Fenwick & West

1. The fallacy that deductibility is no longer relevant when making compensation decisions

2. Larger salaries and smaller bonuses

3. Impact on future grants of performance awards and options

4. The nightmare of covered employees to serial acquirors - the tracking problem

5. Material modifications - extension of exercise period, acceleration of vesting

6. Exercise of negative discretion - M&A transaction non-assumption provisions and clawback provisions

<u>Talking Points: Excerpt from May-June 2019 issue of "The Corporate Executive"</u>

<u>One Positive Aspect of the Repeal of Section 162(m)'s Performance-Based Exception: Inducement Awards More Viable</u>

Around this time of year, many companies find themselves close to exhausting the authorized share pool approved by stockholders in their stock incentive plans. One of the best strategies for extending the duration of the pool has always been, when possible, to make significant equity awards to any new executives using the "inducement award" exception to the NYSE and NASDAQ stockholder approval requirements. The inducement award exception allows a company to make equity awards outside of the stockholder-approved plan, thus leaving the precious authorized share pool untouched.

In the past, one drawback of an inducement award was that it would not qualify for the stock option/SAR or qualified performance-based compensation exemption from the $1 million deductibility limit of Code Section 162(m) because the award was not made under a plan approved by stockholders. However, since the 2017 Tax Cuts and Jobs Act repealed the performance-based compensation exception, this drawback no longer exists! To be clear, inducement awards are still subject to the deduction limitation under Section 162(m), but because the TCJA eliminated the exemption for performance-based compensation, all other awards are now equally disadvantaged.

Background

Both the NYSE and NASDAQ rules require that any plan or other arrangement that provides for the delivery of equity (either newly issued or treasury shares) of a company to any employee, director, or other service provider as compensation for services (and any material revisions to the terms of such plans) to be subject to stockholder approval "to provide checks and balances on the potential dilution resulting from the process of earmarking shares to be used for equity-based awards." However, both exchanges provide an exemption (NYSE Listing Company Manual Rule 303A.08 and NASDAQ Listing Rule 5635(c)(4)) to the stockholder approval rules, including those for so-called employment inducement awards.

[Note that the NYSE and NASDAQ also exclude certain employee stock plans, such as a typical dividend reinvestment plan, from the definition of "equity compensation plan," and stockholder approval is not required for those plans.]

Requirements of the Inducement Award Exemption

In order to qualify for the inducement award exception, the award must meet the following requirements under NASDAQ and NYSE listing rules:

<u>New Employees Only</u>. The inducement grant exception is available only for someone joining the company as a new employee or someone who was previously an employee or director but is rejoining the company following a bona fide period of nonemployment. The exception is not available to induce an individual to join the company as a nonemployee director, consultant, advisor, or independent contractor. Inducement awards cannot qualify as incentive stock options under Code Section 422.

<u>Material Inducement</u>. The award must be a material inducement to the individual accepting the job. In other

words, the company communicates the award terms prior to job acceptance, and the grant is discussed in connection with the hiring process. To comply, companies ensure that offer letters or employment agreements contain the specific terms of the inducement award, including the actual number of shares to be granted, and often explicitly state that the proposed award is intended to be a material inducement to the individual's employment by the company prior to the candidate's acceptance of a job offer. In M&A transactions, the offer letter with this information should be delivered prior to closing the deal.

<u>Independent Director Approval of Awards</u>. Any inducement award must be approved by the company's independent compensation committee or by a majority of the company's independent directors, as determined under the NASDAQ and NYSE standards of independence.

<u>Press Release</u>. Promptly following a grant of any inducement award in reliance on this exemption, the company must disclose in a press release the material terms of the award, including the recipient(s) of the award and the number of shares involved.

<u>Notice to the Exchange</u>. Both the NYSE and NASDAQ require the company to provide written notice to the exchange with the issuer's listing representative "as promptly as practicable following the action." For NASDAQ, the notice must be provided no later than the earlier of (i) five calendar days after an offer of employment is accepted (or other agreement made) or (ii) the date the company discloses the award in a press release. The NYSE does not specify a bright-line requirement. Both exchanges permit the company to provide this notice electronically.

Securities Law Requirements for an Inducement Award

In addition to the requirements of the stock exchanges, a company that makes an inducement award must take certain other steps to comply with federal securities laws.

<u>Form S-8</u>. Unless the company is relying on an exemption under Regulation D or Section 4(a)(2), the issuer would be required to file a Form S-8 for the employment inducement award.

<u>Form 8-K</u>. If the inducement grant is made to a named executive officer, a Form 8-K must be filed within four days of the grant.

<u>Forms 3 and 4</u>. If the newly hired employee will be a Section 16 insider, a Form 3 must be filed for the employee within ten calendar days of achievement of this status. In many cases, the sequence of events is such that the insider is hired and becomes subject to Section 16 prior to grant of the inducement award. If this is the case, the inducement award will be reported on a Form 4 within two business days of the grant date rather than included among the insider's holdings on his/her Form 3. The result is that a Form 4 reporting the inducement grant may need to be filed in advance of the deadline for filing the insider's Form 3. The SEC has indicated that the Form 3 can be filed concurrently with the Form 4, but this is not required. [Note that the Section 16 reporting requirements here are no different than for new-hire grants issued under a shareholder-approved plan.]

<u>Form 10-K and Proxy Statement</u>. The disclosure of inducement awards must be included in a company's 10-K or proxy statement. The company must disclose the award in the Equity Compensation Plan Information Table in a separate row titled "Equity Compensation Plan Not Approved by Stockholders," and if the inducement award was made to an NEO, the company must describe the award in the CD&A and list it in the tabular

disclosures. The company should include a footnote stating that the award was an inducement award.

Prospectus. Where an award is registered on Form S-8, the company may need to prepare a separate Section 10(a) prospectus to be delivered to the recipient of the inducement award. One condition for relying on Form S-8 is that a prospectus summarizing the material terms of the plan must be provided to plan participants.

Proxy Advisory Firms

As you would expect, ISS and Glass Lewis will include inducement grant overhang and usage in their applicable dilution and burn rate calculations. ISS has expressed concern in its policy manual that "some companies may abuse the inducement grant provision and use it to avoid shareholder approval." However, ISS does not automatically object to a company's use of inducement awards as long as they are used "sparingly" and "for a few specific identified individuals instead of a broad range of employees." Thus, while the inducement exception helps extend the life of a company's authorized share pool, the company could feel its impact in a subsequent year when seeking stockholder approval for new allocations to the share pool.

Tax Accounting for Stock Compensation Subject to Section 162(m)

When a company's corporate tax deduction for equity awards is limited under Section 162(m), it affects how the awards are accounted for in the company's income tax provision. [The term "tax provision" refers to the tax expense recorded in the P&L, which includes both the current tax liability (*i.e.*, what the company has to pay to the tax authorities in the current year) and any deferred taxes recorded in the current period.] We originally covered this in our May–June 2011 issue (at pg. 1). Since then, however, two key changes have made it worth revisiting this topic.

The first was the issuance of ASU 2016-09 in March 2016. The second was the passage of the Tax Cut and Jobs Act in December 2017. Both these developments have been covered in past issues, and both have a good news/bad news element to them, which we summarize below, before suggesting practical approaches to managing the tax accounting required under Section 162(m).

ASU 2016-09 Simplifies Stock Plan Accounting

The most significant change under ASU 2016-09 was the requirement to record excess tax benefits and shortfalls from stock plan transactions in earnings instead of paid-in-capital (see our May–June 2016 issue at pg. 2). Along with this change, the ASU eliminated the need to track the amount of paid-in-capital from previously recognized excess tax benefits from stock plan transactions (the "ASC 718 APIC Pool") as well as complicated calculations that were necessary in certain circumstances to determine when excess tax benefits were considered "realized" and thus available for the ASC 718 APIC Pool, which was used to offset shortfalls (see our November–December 2012 issue at pg. 7). Before ASU 2016-09, shortfalls (*i.e.*, situations in which a company's actual tax benefit for a stock plan transaction exceeds the benefit expected based on the expense recorded for the award—see our November–December 2005 issue at pg. 2) increased tax expense only if they exceeded the company's realized ASC 718 APIC Pool. Now, under ASU 2016-09, shortfalls almost always increase tax expense.

[An exception applies only in situations where companies cannot anticipate sufficient taxable income in the future to benefit from the anticipated future tax deductions that are represented by the DTA. These companies record a valuation allowance against their DTA, which eliminates the tax benefit represented by the DTA. Any shortfalls incurred while the valuation allowance is in place reduce the size of the valuation allowance, rather than increasing tax expense.]

The good news is that ASU 2016-09 greatly simplifies the tax accounting for stock plan transactions and increases earnings (by reducing tax expense) for companies when their stock appreciates in value. The bad news is that the ASU increases volatility in a company's tax expense and earnings. In effect, the old method bypassed earnings, with excess tax benefits and shortfalls typically going straight to the equity section of the balance sheet.

Changes to Section 162(m) Under the Tax Cut and Jobs Act

We'll start with the bad news, which is the greatly expanded reach of Section 162(m) under the TCJA, effective for tax years beginning in 2018. The two biggest changes to Section 162(m) were the elimination of the performance-based compensation exception and the expanded definition of which executives are subject to the $1 million limitation on corporate tax deductions (see our January–February 2018 issue at pg. 1).

The elimination of the performance-based compensation deduction means that all forms of compensation, including all types of equity awards, are now subject to the $1 million deduction limitation (unless they qualify for the exception for written binding contracts in place as of November 2, 2017, that are not subsequently materially modified—see our September–October 2018 issue at pg. 4).

The expanded definition of who is a "covered employee" is discussed in more detail in our September–October 2018 issue (at pg. 2). For purposes of this article, it is sufficient to know that covered employees now include any CEO or CFO who serves for any part of the taxable year and anyone who has ever met the definition of a covered employee for any taxable year beginning after December 31, 2016, based on the rules in effect for that year. It is also no longer necessary for an officer to be employed on the last day of the taxable year to be covered. This means that severance payments, deferred compensation, and even death benefits are subject to the limit. The new rules also require that companies include the three highest-paid executives during the taxable year (other than the CEO and CFO, who are included regardless of level of pay), whether or not their compensation is required to be disclosed in the summary compensation table in the proxy statement. The determination of which three executives are the highest paid is not based on taxable income but rather on the SEC's rules for executive compensation disclosures in the annual proxy statement. As you can imagine, companies should expect the list of covered employees to grow from year to year, especially if they have turnover in the executive ranks.

Did we mention the good news? Overall, companies benefit from the lowering of the top corporate tax rate from 35% to 21% under the TCJA. Specific to Section 162(m), the repeal of the performance-based exception eliminates a number of detailed requirements that companies previously had to meet and allows the board of directors much more discretion around the timing and structure of incentive-based compensation.

Tax Accounting Ramifications and Practical Approaches

The changes under ASU 2016-09 and the TCJA affect companies' tax provisions, in terms of both their deferred tax balances and the tax expense they record on a quarterly basis. Two main calculations are required each year.

Current Year Tax Deduction Limitation. The first calculation is necessary to determine the current year's limitation on the company's tax deduction for each covered employee. This calculation is based on the taxable compensation paid to each covered employee for the year, excluding any exempt amounts. Prior to the TCJA, most stock options and performance vesting RSUs (PRSUs) were exempt. Going forward, for the most part, only those awards that are grandfathered under the written binding contract exception will be exempted.

For example, assume an executive's total W-2 compensation for 2019 is $4,500,000 million, of which $1,000,000 million is cash compensation that is subject to Section 162(m). The remaining $3,500,000 is from equity awards that settled in 2019: $1,500,000 from an NQSO granted prior to November 2, 2017 and exercised in 2019, $1,000,000 from time-based RSUs also granted prior to November 2, 2017, and $1,000,000 from PRSUs granted in 2018. Only the NQSO wages are exempt, assuming that they originally met the Section 162(m) performance-based requirements and were not materially modified after November 2, 2017. Time-based RSUs were never eligible for the performance-based exception, and the PRSUs were granted after the November 2, 2017 cutoff for grandfathering protection. Thus, $3 million ($4,500,000 in total wages less the $1,500,000 million for the NQSO) is subject to the $1 million limitation under Section 162(m), and the company must reduce its tax deduction by $2,000,000.

[One further exemption to be aware of relates to newly public companies. As of the publication date, the grace period for companies that have recently gone public (see our July–August 2015 issue at pg. 9) is still operable. This amounts to a special transition exemption from Section 162(m) for three years (plus the part of the fourth year prior to the shareholders meeting) following the IPO year. Though the IRS has indicated that it may repeal the regulations that grant this exemption, we believe it will take a future regulatory project to do so and will only apply prospectively. We hope to learn more about this at the upcoming 27th Annual NASPP Conference in September.]

DTA Haircut. The second calculation is needed to determine the proper amount of deferred taxes to record for equity compensation. If the DTA for stock-based compensation is material to the financial statements, companies may true up their balance quarterly. Otherwise, companies typically true up their deferred taxes only at year-end, which we are assuming is the case for this discussion.

To the extent that the tax deduction for an award is expected to be limited in the future, the company should not record the full DTA. How to go about limiting the DTA involves some judgment and practical considerations.

<u>Top-Side Adjustments for 162(m)</u>. Practically speaking, most companies find it easier to make top-side adjustments for Section 162(m) than to adjust amounts for individual grants. In other words, companies typically start with the aggregate amounts required for their tax provision (*i.e.*, tax deductions for equity award transactions, DTA reversals, excess tax benefits, and shortfalls) and then perform their analysis for Section 162(m) and adjust the aggregate tax provision amounts for the computed limitations.

For Section 162(m), considerations include determining whether there are any newly covered employees, new grants, and/or modifications, as well as cash compensation and equity award settlements for each executive. For example, the company would compute the necessary reduction in the ending DTA balance for its covered employees for the year and haircut the aggregate DTA balance accordingly.

Under this approach, the prior year's ending DTA haircut should be reversed, as the total amounts for the current year will not reflect those prior year adjustments. Not doing so would lead to overstatement of the haircut amounts.

Alternatively, companies may want to identify the individual awards and assign an individual tax rate to each award depending on the anticipated Section 162(m) limitation. While this approach is less common, it may be appropriate for companies that perform their tax accounting calculations quarterly and/or on a tax-effected basis.

Which Comes First: The Salary or the Award? Our readers may recall that various approaches can be used to determine which compensation element should be limited when multiple elements are involved, such as base salary, bonus, and equity awards. Accounting firm guidance generally allows for three methods (see our May–June 2011 issue at pg. 2). In the "salary-first" method (also known as "cash first"), the company assumes that any available deduction under Section 162(m) will first be used for cash compensation, and equity awards will be deductible only to the extent that an executive's cash compensation in the year the awards settle is less than $1 million. In the "equity first" method, the same concept applies, except that the company assumes that any available deduction will first be used for equity awards that settled during the year. Under the "pro-rata" method, the company assumes that a pro-rata portion of both cash and equity will be treated as deductible.

The selection of one of these methods is considered the election of an accounting policy, so companies that have previously elected a method should continue that approach. Companies that have not yet elected a method, possibly because they have been granting mostly performance-based compensation in prior years, have the ability to select their method once it becomes necessary.

Most companies use the "salary-first" method, which includes any cash compensation, so we'll assume that approach for the rest of this discussion. The basic concept is the same regardless of which approach is used, although the other two methods will generally allow more DTAs to be recorded over the vesting period for equity awards, with a corresponding reduction in the recorded tax benefits for cash compensation. When cash compensation is expected to exceed $1 million annually, however, the salary-first method is administratively easier because the company simply doesn't record any DTA for that executive's equity awards. The choice of a method is important only in the context of the tax provision. For purposes of the tax return, it doesn't matter which element is limited, as long as the total tax deduction for nonexempt compensation doesn't exceed $1 million.

As noted, under the salary-first method, a company records deferred taxes for the equity award only to the extent that cash compensation, including salary and bonus, doesn't add up to $1 million. Usually, deferred taxes are recorded pro rata over the vesting period based on how much is expected to be deductible.

For example, if a covered employee's cash compensation is expected to be $400,000 in the year an RSU is going to vest, that leaves room for a tax deduction of $600,000 for the RSU. Where the grant date value of the RSU is $2,000,000, a DTA would be recorded on $.30 of every dollar expensed, based on the ratio of allowable deduction under Section 162(m) ($600,000) to total cost ($2,000,000). If, at the end of the year, the cumulative compensation cost recorded for the RSU is $1,000,000, the DTA would be recorded on only $300,000 of cost. No deferred taxes would be recorded for any other equity awards held by the executive, such as stock options, because the cash compensation and the RSU will have already depleted the $1 million of allowable deductions. [Note that projections of tax deductions for equity awards should always be based on the grant date value of the awards. For tax accounting purposes, changes in the value of equity awards are accounted for only when the awards are settled.]

Anticipating the Timing of Tax Deductions for Equity Awards. The above example brings up another practical issue: what to do when different types of equity awards are involved. Assume that a company grants NQSOs, RSUs, and performance awards to its executives. It is easy to determine when the RSU tax event will occur in order to estimate whether the tax deduction will be limited because you know when the award vests (assuming that delivery of the stock is not deferred). With the performance award, you may know when it will settle, but the number of shares paid out may vary. With the NQSO, the timing of the tax event is unknown because it is triggered by the executive's exercise, so you would need to rely on the expected life and adjust based on actual exercise behavior. Thus, for purposes of the DTA calculation, it is easiest to assume that the most predictable award, in this case the RSU, will use up any remaining allowable deduction after cash compensation. Then you can assume that any deduction for other forms of equity will be disallowed in whole and not record any deferred taxes for those awards.

This process is more complicated if there are several outstanding awards and you can't assume that time-based RSUs will use up the full $1 million of allowed deduction (or if an executive has been granted a combination of only stock options and performance awards). Another way to determine the DTA reduction at year-end when there are multiple outstanding equity awards is to haircut DTAs based on the total anticipated taxable amount each year. The haircut is applied to the total cumulative compensation cost as of the reporting date for each covered employee's outstanding awards.

For example, assume that a covered employee has $2,000,000 (based on grant date value) of non-grandfathered/nonexempt equity awards that are expected to settle in 2020. The executive is also expected to receive $600,000 of non-grandfathered cash compensation in 2020. Under the salary-first approach, the company can deduct an additional $400,000 for the equity awards. In other words, $1,600,000 worth of the equity awards is expected to be disallowed. The DTA would be haircut by 80% ($1,600,000 divided by $2,000,000).

Now assume that the cumulative cost at year-end for these outstanding awards is $1,000,000, which means that the unadjusted, pre-tax DTA is also $1,000,000 (the actual DTA would be recorded on a post-tax basis, *i.e.*, $1,000,000 multiplied by the company's corporate tax rate, but we are skipping this last step for simplification purposes). Applying the DTA haircut of 80%, the company would need to reduce the ending DTA for this executive by $800,000, down to $200,000 (multiplied by the company's tax rate).

This process is more complicated for companies that use a graded or "accelerated" attribution method for recording compensation cost (see our September–October 2005 issue at pg. 4) and have multiple awards outstanding with multiple vesting tranches. In this situation, companies may need to project cash compensation and schedule out tax settlements for multiple years and may have to haircut DTAs by a different amount for each year's bucket of compensation cost corresponding to each year's settlements.

<u>Simplifying Assumptions</u>. A company that uses a salary-first approach and pays cash compensation equal to or greater than $1 million to each of its covered employees

has it relatively easy. The company would just not record DTAs for any awards granted to its list of covered employees and would limit its tax return deduction for cash compensation to $1 million for each executive. However, this is not likely to be the case for very many companies, especially with a growing list of covered employees, due to the TCJA's new requirement that, once covered, employees are always covered (see our September–October 2018 issue at pg. 3).

Regardless of what approach is used, the deferred tax assets recorded for equity awards are trued up for actual outcome. If a DTA of only $200,000 is recorded for an award that ultimately produces a tax deduction of $300,000, tax expense is reduced by an additional $100,000 in the year of settlement. For this reason, when a covered employee's cash compensation is close to $1 million, it still might be appropriate to assume that no amount of equity compensation will be deductible and simply not record any deferred taxes for any equity awards.

In each year that a deduction for equity compensation is allowed (the difference between the cash compensation and the $1 million limit under Section 162(m)), that amount would give rise to a tax benefit in that year's tax provision (as opposed to recording deferred taxes over the vesting period). In other words, the same amount of tax benefit is ultimately recorded in the P&L, but the timing is shifted to the year the deduction is claimed on the tax return instead of over the vesting period. ASU 2016-09 eliminated the need to account for excess tax benefits through paid-in-capital, so the entire allowable deduction would give rise to a tax benefit.

This approach is similar to the tax accounting for incentive stock options, in which no deduction can be anticipated (so recording a DTA is prohibited), but any deduction triggered by a disqualifying disposition is recorded as a tax benefit in that year. The difference is that this treatment is required for ISOs, while for Section 162(m), the amount of the unrecorded DTA would need to be small enough so as not to distort the company's financial statements.

Conversely, some companies with relatively small adjustments under Section 162(m) may be able to assume that all equity awards will be deductible and therefore record deferred taxes for all compensation costs. This would eliminate any DTA haircuts. Instead, any actual deduction limitation each year would be treated as additional tax expense, again essentially trueing up to the ultimate tax benefit in the year the awards are settled. This is the opposite of the approach mentioned above. Companies using an equity-first method are more likely to fall into this camp, but they may also have to reduce or eliminate any tax benefit for their cash compensation.

Another simplifying assumption would be to apply the same DTA haircut for all future compensation (in the case of accelerated attribution), but this should be considered only if the cumulative compensation cost attributable to future years is not significant or if the anticipated haircut factor is reasonably consistent.

<u>Timing versus Permanent Differences and the Impact on the Effective Tax Rate</u>. In addition to the current year tax deduction and year-end DTA, companies need to consider the impact of Section 162(m) and ASU 2016-09 on their tax provision. It's helpful here to distinguish between timing differences and permanent differences. A timing difference involves any item of income or expense for which the amount is the same for both the P&L and the tax return but where the timing differs. A good example of a timing difference is stock compensation recorded in the P&L over the vesting period that is expected to result in a tax deduction at a later date. As such, the compensation expense gives rise

to a DTA reflecting the fact that a tax deduction is expected at a future date.

Income or expense items that differ in amount on a permanent basis are known as "permanent differences" in tax accounting parlance. A good example is the compensation expense for equity awards for which the tax deduction will be disallowed under Section 162(m). This particular permanent difference is a permanent *addback* (sometimes referred to as a "bad perm") because it increases taxable income without a corresponding increase in earnings. This in turn increases the tax expense and should be factored into a company's estimated annual effective tax rate. The annual effective tax rate is used to determine the tax expense on a quarterly basis. With the elimination of performance-based compensation and the expanded definition of covered employees under the TCJA, companies should review whether their annual effective tax rate should be increased due to anticipated disallowed compensation cost.

Under ASU 2016-09, excess tax benefits and shortfalls are also treated as permanent differences because they reduce (excess benefits) or increase (shortfalls) tax expense but have no effect on the compensation expense recorded on the P&L (assuming that the awards are accounted for as equity, not liabilities). As previously noted, prior to the ASU, excess benefits and shortfalls were usually recorded in paid-in-capital, with no impact on tax expense.

In addition to being permanent differences, under the ASU, excess tax benefits and shortfalls are considered discrete items for purposes of quarterly tax reporting. This means that they are not considered when determining a company's annual estimated effective tax rate. Instead, they must be recorded as a tax benefit or expense in each quarter in which they arise. Thus, tax expense can fluctuate significantly depending on changes in stock price and the level of stock plan transactions each quarter. Because of this, some companies have started modeling future tax settlements at various stock prices to help forecast this volatility. Other companies are less concerned about the volatility, especially if the analysts that follow their company are focused on non-GAAP measures that eliminate stock-based compensation and the related tax effects.

A change in a company's expectation around Section 162(m) limits would likewise be treated as a discrete item, as it represents a change in estimate that is recorded in the period of the change. For example, where a company has recorded deferred taxes for an employee who is promoted to CFO during the year, the company would have to write off any existing DTA to the extent that future tax deductions will be disallowed under Section 162(m). The write-off would increase tax expense in the period in which the employee is promoted to CFO. Future compensation cost for the CFO's awards that are expected to be limited should be factored into the estimated annual effective tax rate.

Action Items

<u>Review Covered Employees and Grandfathered Status at Least Annually</u>. With the expanded coverage of Section 162(m), companies need to be diligent in tracking their covered employees and outstanding awards that are expected to be subject to the deduction limit. Each year, at a minimum, companies should review any changes to award terms to consider whether a material modification has occurred that eliminates the grandfather protections.

<u>Consider Materiality</u>. As discussed above, where amounts are not material to the financial statements, companies have more leeway to rely on simplifying assumptions and/or not worry about factoring amounts into their calculations, such as the estimated annual effective tax rate. Of course, even assumptions around

immateriality should be reviewed regularly to make sure those simplifying assumptions are still appropriate.

Discuss the Approach and Assumptions with Your Auditors. It probably goes without saying that it is always a good idea for companies to discuss their approach and any simplifying assumptions with their auditors before year-end or at least before calculations are being finalized. This will help avoid last-minute surprises and extra work when the timing is already tight.

11:50 - 12:00 pm **"I Like It Like That"**

Speakers:

- **Marty Dunn** - Morrison & Foerster
- **Dave Lynn** - TheCorporateCounsel.net and Morrison & Foerster

12:00 - 1:05 pm **Lunch**

1:05 - 1:30 pm **"Comp Issues: How to Handle PR & Employee Fallout"**

Speakers:

- **Mark Borges** - Compensia
- **Brian Breheny** - Skadden Arps
- **Amy Wood** – Cooley

1. What type of press is executive compensation getting these days (and to what extent is it an issue for the next Presidential election)?

2. Types of approaches in dealing with reputational issues (internal vs. external communications; direct education of all employees vs. management training, etc.)

3. How it may vary by industry

4. When – and what - you need to file with the SEC if you do message employees

1:30 - 2:00 pm **"Proxy Disclosures: 20 Things You've Overlooked"**

Speakers:

- **Brian Breheny** - Skadden Arps
- **Marty Dunn** - Morrison & Foerster
- **Beth Ising** - Gibson Dunn
- **Dave Lynn** - TheCorporateCounsel.net and Morrison & Foerster

1. Dealing with a floor proposal and preserving discretionary authority
2. Hyperlinks – do we really want to include them (especially on ESG issues)?
3. Don't forget to file the Notice of Internet Availability of Proxy Materials
4. Properly calculating and disclosing the deadline for Rule 14a-8 proposals
5. What you have to disclose about existing awards when seeking shareholder approval to amend an equity plan
6. Confirming that a proposal really is (or is not) routine under Rule 452
7. Remember when you are required to mail or furnish a copy of the annual report to the SEC
8. Providing shareholder proponents with a timely draft of the statement of opposition to a proposal that may be included in the proxy materials, regardless of whether the company has submitted a no-action request
9. Notifying the SEC of when securities will be registered or what exemption applies when shareholder approval of an equity plan is sought
10. Key data points that plaintiffs' firms will be happy to "help" remind you to add to your equity plan proposal (for a fee)

11. What did companies do in response to Corp Fin's February '19 CDI on board diversity disclosures

12. Revising a shareholder proposal's title – in either the proxy statement or on the form of proxy – in a manner that doesn't comply with Staff guidance

13. When you have to attach to the filing - or send an equity plan as an appendix - to the proxy statement

14. Checking that the proxy card, the notice of internet availability and the proxy statement are synched

15. How did the SEC amend the Section 16 delinquent filing disclosures requirements in the proxy statement?

16. Providing the proper amount of guidance in the proxy statement regarding the office to which shareholders should submit a Rule 14a-8 proposal

2:00 - 2:20 pm **Break**

2:20 - 2:55 pm **"Clawbacks: #MeToo & More"**

Speakers:

- **Keith Higgins** - Ropes & Gray
- **Mike Melbinger** - Winston & Strawn
- **Ron Mueller** - Gibson Dunn
- **Scott Spector** - Fenwick & West

1. How to deal with #MeToo & other "reputational" harm issues involving clawback provisions in board policies, employment contracts, compensation plans and merger agreements
    - Drafting issues
    - Company policies
    - Enforcement
    - Shareholder proposals

- Negotiation with executive's counsel

2. Contested shareholder proposals over compensation clawback policies at Mylan & Alphabet (and others)
   - Historical trends
   - 2019 proposals and results
   - Practical suggestions
3. Enforcing clawback provisions in court
   - *Hertz* , *United*, *Barnes & Noble*, and other cases
   - Indemnification and D&O insurance issues

2:55 - 3:10 pm **"Dealing with the Complexities of Perks"**

Speakers:

- Mark Borges – Compensia
- Alan Dye - Hogan Lovells

Checklist: Executive Compensation Disclosure - Perks

By Mark Borges, Compensia & Alan Dye, Hogan Lovells

1. **Brush Up on the Details of the Disclosure Requirement:** While we all know the general requirement for disclosing perquisites and other personal benefits as part of a company's executive compensation disclosure, it's always a good idea to review Instruction 4 to Item 402(c)(2)(ix) on an annual basis. A few of the more commonly underappreciated (and potentially overlooked) aspects of the disclosure requirements include:

   a) **Perquisites and other personal benefits must be described with particularity.** Where perquisites are subject to identification, they must be described in a manner that identifies the particular nature of the benefit received. As the SEC noted in the 2006 Adopting Release, it is not sufficient to characterize generally as "travel and entertainment" different company-financed benefits, such as clothing, jewelry, artwork, theater tickets and housekeeping services. We've noticed that some of these descriptions have become very general and, as a result, not very helpful in describing the nature of the personal benefit received.

b) **Where quantification of a perquisite is required, be sure to describe your methodology for determining its aggregate incremental cost.** This is another area where satisfaction of the specific disclosure requirement is sometimes overlooked or incomplete. While in many cases the valuation methodology will be entirely straightforward (typically, representing the item's actual cost to the company), in some instances – particularly involving the use of corporate transportation – this won't be the case.

c) **Tax payments related to perquisites and other personal benefits are subject to disclosure separate and apart from the related perquisites.** Remember, tax payments related to perquisites are considered a separately disclosable item in the "All Other Compensation" column of the Summary Compensation Table. Consequently, they must be separately quantified and identified as tax reimbursements (under Item 402(c)(2)(ix)(B)) even if the related perquisite or other personal benefit is not required to be disclosed because the total amount of all perquisites and personal benefits is less than $10,000 or the perquisites and personal benefits are required to be identified but not separately quantified.

2. **Be Sure to Address Your Perquisites Policy in the CD&A:** Although companies tend to focus much of their attention on the disclosure of perquisites and other personal benefits in the Summary Compensation Table, don't forget to address your overall policy on the use of perquisites and other personal benefits in the Compensation Discussion and Analysis.

   While it's unlikely that the value of any perquisites provided to your named executive officers will comprise a material portion of their executive compensation package (at least from a dollar standpoint), this remains an important subject for shareholders. If perquisites do not represent a material component of your executive compensation program (or you have a policy of not providing perquisites), you should say so in the CD&A. To the extent that you provide some level of perquisites or other personal benefits, it is important to identify the category of benefits provided, explain why they are provided, and describe any parameters or conditions that you apply to this compensation component.

3. **<u>Our Top Disclosure Tips:</u>** The following specific disclosure tips are an effective way to ensure that your perquisites disclosure is both complete and accurate.

   a) **<u>Identify all benefits that might be considered perquisites.</u>** When compiling your executive compensation amounts for the last completed fiscal year, cast a wide net in looking for possible perquisites and other personal benefits. The SEC has taken a broad view of what constitutes a perquisite. The Commission's guidance in the 2006 Proposing and Adopting Releases provide a lot of useful information (as well as an explanation of the SEC's "two-prong" analysis) for determining which benefits may be considered perquisites, as do its periodic enforcement actions on this topic.

      Also remember that the value of the benefits ultimately identified as perquisites, if they exceed $10,000 in the aggregate, will need to be taken into account in determining which executive officers will be considered named executive officers for disclosure purposes.

   b) **<u>Establish disclosure controls and procedures to track perquisite use.</u>** The reportable value of a perquisite or other personal benefit is based on the aggregate incremental cost to the company of providing the perquisite. For non-cash perquisites that involve personal use of company assets (for example, corporate aircraft, company-owned automobiles, or tickets to entertainment events), calculating the "incremental" cost of an executive officer's personal use will require tracking the extent of such use and the cost associated with that use. You should develop procedures for tracking personal use, and incorporate these procedures into your company's disclosure controls and procedures.

   c) **<u>Elicit information about perquisites from the Director and Officer questionnaire.</u>** The annual D&O questionnaire should be regularly updated to elicit information about possible perquisites and other personal benefits. The questionnaire should provide examples of what might constitute a perquisite, to trigger recollection of infrequently provided benefits that might be subject to disclosure and that sometimes are difficult to track through internal controls (for example, a spouse's travel to company-sponsored event or a director's use of a stadium skybox).

   d) **<u>Have the Compensation Committee approve individual perquisites or an executive perquisite policy.</u>** Stock exchange listing standards may require that the compensation of a company's executive officers be approved by the Compensation Committee of the Board of Directors or a comparable committee of independent directors. This body should approve in advance any perquisites and other personal benefits to be received by your executive officers, including any limits that are adopted and imposed on specific benefits (for example, personal use of corporate aircraft) to ensure that it is fully aware of the extent and cost of its executive compensation program.

e) **Develop a methodology for calculating the aggregate incremental cost of each perquisite.** Determining the aggregate incremental cost to the company of non-cash perquisites may require difficult calculations and/or judgments about the allocation of costs between the company and the executive officer receiving the benefit. Determining the cost of the personal use of corporate aircraft or company-owned automobiles, for example, may involve calculation of the cost of a particular trip, adjustments for "deadhead" legs, and allocation of the fixed costs of ownership of the aircraft or automobile.

   You need to develop a comprehensive and consistent methodology to value the perquisites and other personal benefits provided to your executive officers for purposes of the Summary Compensation Table. The methodology should be reasonable, since it will have to be explained in your proxy statement (in plain English) if the benefit to which it relates has to be separately quantified in a footnote.

f) **Don't forget the foregone income tax deduction when computing the aggregate incremental cost of the personal use of corporate aircraft.** Internal Code Section 274(e) limits the deductibility of expenses associated with the personal use of corporate aircraft to the amount recognized as income by the executive officer using the aircraft. Since the aggregate incremental cost of a perquisite received by a n executive officer may need to encompass the indirect, as well as the direct, costs to the company of the item, any foregone tax deduction may need to be factored into the cost calculation.

g) **Remember that the identification and quantification requirements for perquisites only apply to the most recent fiscal year covered in the Summary Compensation Table.** Remember that you have to describe each perquisite or other personal benefit or quantify perquisites that exceed the greater of $25,000 or 10% of an individual executive officer's total perquisites only for the most recent fiscal year covered in the Summary Compensation Table. This will help save space when preparing the

Summary Compensation Table and make the supplemental disclosure to the "All Other Compensation" column easier to read.

h) **<u>Don't need to disclose a perquisite for which the executive officer has fully reimbursed the company.</u>** The SEC Staff has taken the position that the company's incremental cost in providing a perquisite or other personal benefit to an executive officer is not reportable compensation to the extent that the executive officer has fully reimbursed the company for that cost. A personal benefit such as personal use of corporate aircraft, country club dues, or use of the company's suite at a sports stadium or concert hall, for example, need not be disclosed or quantified if the executive officer fully reimburses the company's cost for such use.

3:10 - 3:25 pm **Break**

3:25 - 3:45 pm **"<u>How to Handle Negative Proxy Advisor Recommendations</u>"**

Speakers:

- **Ning Chiu** - Davis Polk
- **Beth Ising** - Gibson Dunn

1. Be prepared for the possibility in advance (<u>consider whether to include any additional disclosure before you file</u>, know the timing of when the reports are issued, have a team assembled, spot potential problems in advance)

2. Start planning for an investor outreach right away (schedule calls as soon as possible since during the height of the season it's hard to get their attention)

3. Double check to make sure your disclosure was very clear and there was no ambiguity or misunderstanding (this is particularly true for equity plans)

4. Consider whether the company / board can take action to have the recommendation reversed

5. Prepare a response with key rebuttal points (consider whether or not to file it as there are pros and cons if it's not required, but will need talking points for investors anyway)

6. Prepare the board and management for a lower vote than usual on the issue

Checklist: Proxy Advisors – Handling Negative Recommendations

By Broc Romanek & Liz Dunshee, TheCorporateCounsel.net

Proxy advisors are retained by many institutional investors to make recommendations about how to vote their shares for directors and other shareholder meeting proxy proposals. Proxy advisors research & analyze volumes of company data in accordance with their policies to formulate voting recommendations to assist their clients in voting these shares. In the US, Institutional Shareholder Services – also known as "ISS" – and Glass Lewis dominate the proxy advisor sector. But there are also other providers – e.g. Egan-Jones.

The proxy advisory business and influence on the voting process has grown substantially over the past decade. Receiving a negative recommendation on a proxy statement proposal could have significant negative consequences. Companies should have a process in place for handling negative recommendations.

1. Negative Recommendations Inevitable: Since companies act in what they believe are the best interests of shareholders – according to their own fiduciary duties – they sometimes will take actions that run afoul of proxy advisor policies and wind up with a negative recommendation.

It's important that companies be aware of a negative recommendation as soon as they can since they might have to engage in damage control – ranging from campaigning with investors to explain why the company's position is different than a proxy advisor's position to fixing a possible error by a proxy advisor.

In most cases, companies will have a pretty good notion that a negative recommendation is forthcoming and will want to start campaigning even before they get the bad news – including making disclosure in their proxy statement explaining why they took the position that caused the negative recommendation.

2. Engaging With ISS: It's difficult to get ISS to change a recommendation once made – but they will listen to reasons why you think the negative recommendation should be reversed. ISS will also consider if it made a material error or had incomplete information when it made its recommendation. To fix an error, companies must ensure the corrective information is publicly available (often in a proxy statement or additional soliciting material) and in some cases, verifiable.

In some non-error cases, ISS might reverse a negative recommendation if the company sufficiently addresses a concern that ISS raised. However, ISS won't reverse a recommendation in most cases just based on a conversation with you. In other words, any kind of update or change that a company makes as part of its argument to ISS needs to be publicly filed so that all shareholders can benefit from it.

Sometimes, this means that a company will need to publicly disclose that it will make a change in the future. ISS won't change a recommendation based on a mere promise to make that change – and ISS will not rely on information that's not publicly disclosed.

Another reason why proxy advisors won't commit to a change in position until that public filing is made is so they can actually review and evaluate it. Companies will be required to publicly disclose the change or promise for future change in a SEC filing right away. This SEC filing could come in the form of a Form 8-K or additional soliciting material (or both), depending on what is being disclosed. ISS will not issue a report with the reversed recommendation until this SEC filing is made.

This can cause tension as some companies don't want to file until they know for sure that ISS will make the reversal. On rare occasion, a proxy advisor will review draft disclosure and hint at what they might do (this is a practice that ISS will rarely engage in) – but even then, ISS will not make its new determination until after it reviews the public filing.

3. Engaging With Glass Lewis: Glass Lewis maintains a "report inaccuracies" website where companies can report errors, as well as an "Issuer Data Report" service. Companies that sign up for the service are able to verify the key data points used by Glass Lewis, prior to the time Glass Lewis issues its analysis and voting recommendations.

The IDR is usually emailed 3-4 weeks before the annual meeting; you then have 24-48 hours to review it & correct any errors. Like ISS, Glass Lewis requires any corrections to be based on publicly-available information. The IDR doesn't contain

Glass Lewis's analysis or recommendations – those are only in the final Proxy Paper research report, which can be purchased. Glass Lewis also won't comment on its policies as part of the IDR process – engagement meetings may be scheduled outside of the proxy solicitation period.

After the data in the IDR is confirmed, Glass Lewis typically won't further engage with companies – with an exception if it reaches out to a company to ask a clarifying question. It's extremely rare for them to overturn a negative recommendation.

4. <u>Act Fast:</u> ISS & Glass Lewis both give companies a short window of 24-48 hours to correct errors in the draft voting report (ISS) or IDR (Glass Lewis). To correct errors with ISS, immediately submit the error to the ISS Help Center. You may also contact the analyst identified as the author of the voting report, but those analysts are often too busy during proxy season to field questions. ISS also prefers to handle errors through the central portal because its policies are not intended to be open to subjective individual interpretation.

To correct errors with Glass Lewis, follow the instructions contained in the IDR to mark up the PDF & return it to Glass Lewis.

Due to voting deadlines and to ensure that votes are properly counted at a meeting, ISS generally will not issue a change to a vote recommendation closer than five business days before the meeting, & it's rare for Glass Lewis to issue a change once its final Proxy Paper is published.

For ISS, this means that if a company is filing additional information with the SEC (or issuing a press release for non-SEC filers), ISS must be informed of this filing at least five business days before the meeting. For example, for a Thursday meeting, ISS will need to know of the filing no closer to the meeting than 5 p.m. eastern the Thursday before (assuming no holiday during that week.)

Any new information received closer than five business days before the meeting will be mentioned by ISS in an informational alert if it is deemed to be material to the analysis, even if there is no change to its voting recommendations. While rare, ISS may issue an alert to change a vote recommendation closer than five business days before the meeting only under extraordinary circumstances.

Companies not in the S&P 500 don't receive a draft voting report from ISS as a matter of course, but can also try to have ISS overturn a negative recommendation. It can be more challenging since the timeframe for acting is even shorter than the very short window that larger companies have.

Also note that ISS doesn't allow preliminary review of its voting analysis for special meetings or any other meetings where the agenda includes an M&A proposal, proxy fight, or any item that ISS considers controversial – such as a vote-no campaign.

5. Consider Potential Resolicitation: If a company agrees to make a change in order to convince ISS to reverse a negative recommendation, it must consider whether the change alters the substance of a proposal or plan that is to be approved by shareholders. If so, the company should also consider whether its shareholders need to be resolicited.

The analysis includes consideration of whether shareholders have sufficient information to vote on the proposal that is consistent with the information in the proxy statement and proxy card that was originally delivered. A resolicitation can be quite expensive – and may include a postponement of the shareholders meeting date. To learn more, see the "Proxy Solicitation" Practice Area on TheCorporateCounsel.net.

6. Continue Shareholder Engagement: Negative recommendations shouldn't stop you from engaging with shareholders directly. There are many cases when proxy advisors will recommend one way on a proposal – but actual voting results fall the opposite way. So there could be a disconnect between negative proxy advisor recommendations versus proposals that actually fail.

If you're conducting year-round engagement, you shouldn't be caught by surprise if things are going against you. And chances are – if things are going against you in the engagement – things probably will go against you in the proxy advisor reports once they are issued. Even if you're caught completely off-guard, you should reach out to your top shareholders and have a dialogue with them – and articulate as best as possible why the proxy advisor was wrong.

To make your arguments with investors, don't focus on why you disagree with the proxy advisors. Investors are often insulted with that approach, particularly if they have their own policies. Instead, you should focus on your own circumstances and explain why the company did what it did. Focus on the investor's policies as they may well differ from those of the proxy advisor – and you may be able to make a cogent argument based on that difference.

These discussions should also highlight the positive components of your pay practices – and provide context to demonstrate the link between pay & performance. You should carefully consider what company representatives will be best able to communicate these nuances – often it's a cross-functional team that includes HR, IR, finance, in-house counsel, and/or members of senior management. Members of the compensation committee may also be effective at explaining the decision-making process.

7. Using Additional Soliciting Material: Responses to negative recommendations can be made through the filing of supplemental materials filed with the SEC. Companies may file additional soliciting material with the SEC once they receive a negative recommendation in an effort to draw attention to factors that they believe weren't fully considered, highlight positive pay practices, and/or set a foundation for further shareholder engagement. Companies aren't obligated to deliver these supplemental materials to shareholders – they can deliver them to a subset of investors or not deliver them at all (which means the content is publicly available so that the company can use them as talking points in conversations, etc.).

- **No Prescribed Format:** There is no prescribed format for these supplemental materials. They typically are short 1-2-page documents, often in the form of a letter. The letter can come from the board or management, and even occasionally from a company's compensation consultant.

- **Build Your Case:** The goal is to build your case in these materials. So you want to focus on your argument and not overly restate the background already disclosed in your proxy statement.

- **Response Tactics:** One decision point is whether to even bother mentioning the negative recommendation in the supplemental materials. Doing so helps bring focus to your arguments. But doing so also makes the materials seem defensive – as well as makes it seem that the proxy advisor's position is more important than the positions of your shareholders. Remember that the proxy advisor voting reports are not publicly available – so although there may be leaks, the news of a negative recommendation isn't always in the public domain.

To learn more, see the "Proxy Solicitation" Practice Area on TheCorporateCounsel.net.

8. <u>Don't Slam Proxy Advisor:</u> For the first few years under say-on-pay, companies filed supplemental letters with the SEC if they received a negative proxy advisor recommendation, particularly if they received one from both ISS & Glass Lewis. Those supplemental materials initially addressed all of the flaws with ISS & Glass Lewis and their methodology – but that approach didn't prove to be effective with shareholders. So most supplemental materials have now evolved into more positive filings that explain the company's story.

9. <u>Don't Complain:</u> Since your top 25 investors are likely going to have their own policies, avoid haranguing about Glass Lewis or ISS when you engage them. They're really not interested – and in fact, they might be insulted because they have their own policies.

The bottom line is that they want you to understand where they're coming from. Focus on what your investors want to hear; not on what you want to complain about.

10. <u>Be Proactive:</u> Companies are more frequently incorporating the content that would be included in their additional soliciting material in their proxy statement. The thinking is that investors are too busy during proxy season to keep track of multiple filings where you make a case.

Often you know going in – based on conversations with investors and because you can run some proxy advisor modeling in advance – that you're going to receive a negative recommendation from the proxy advisors. And that's when you should really spend time explaining why your governance practices are properly structured in your proxy disclosure the first time around.

Of course, it's also helpful to engage in year-round dialogue with shareholders and proxy advisors. If concerns about the company's pay program persist, the compensation committee may want to consider making substantive changes.

For more information, see our "Proxy Advisors Handbook" - posted in the "Proxy Advisors" Practice Area on TheCorporateCounsel.net.

3:45 - 3:55 pm "**My Story**"

Speakers:

- **Keir Gumbs** - Uber
- **Broc Romanek** - TheCorporateCounsel.net

1. What are your duties at Uber?
2. How does working at Uber compare to working in a law firm?
3. How does it compare to working at the SEC?
4. What were the biggest challenges of working on Uber's IPO?
5. What were the biggest surprises of working on the IPO?

3:55 - 4:20 pm "**Director Pay Disclosures**"

Speakers:

- **Ning Chiu** - Davis Polk
- **Renata Ferrari** - Ropes & Gray
- **Blair Jones** - Semler Brossy

1. Trends in director pay (form, amount, additional fees for chairs and committee service, meeting fees, use of peers)
2. Recent proxy advisor & investor scrutiny around director pay
3. Setting & disclosing director pay, especially if "above" peers (have companies been providing more information in light of concerns from proxy advisors and litigation)
4. Director pay litigation

4:20 - 5:00 pm "**The Big Kahuna: Your Burning Questions Answered**"

Speakers:

- **Bindu Culas** - FW Cook

- Howard Dicker - Weil Gotshal
- Bob McCormick - PJT Camberview
- Reid Pearson - Alliance Advisors

1. Human Capital Management: Compensation Committee's Role for Company-Wide Comp Oversight

2. Equity Award Modification Issues

3. Controls Over S-8 Share Counting

4. Shareholder Approval of Compensation Plans: Is ISS Support Always Necessary?

5. Gender Pay Gap: Reporting & Shareholder Expectations

6. Spinoff Equity Treatment

7. Avoiding Litigation & SEC Enforcement Due to Your Disclosures

8. Compensation-Related Shareholder Proposals

Talking Points: Human Capital Management - Compensation Committee's Role for Company-Wide Comp Oversight

By Bob McCormick, PJT Camberview

- The responsibilities of compensation committees have steadily been broadening beyond the traditional focus on NEO compensation and now encompass company-wide compensation and employee development practices as part of overall human capital management
- This includes oversight of employee recruitment, retention and advancement opportunities as well as ensuring equal pay across the entire employee population
- Overseeing human capital management policies and practices is a significant component of the overall responsibility of the board in overseeing company culture, an area that shareholders are increasingly focused on

Talking Points: Equity Award Modification Issues

By Bindu Culas, FW Cook

- **<u>Three Core Issues</u>**

    — <u>Issue 1 – Contract Terms</u>

    - What does the amendment section of the equity plan and award agreement provide?
    - Can the modification be effected unilaterally by the Company or does it require participant consent?

    — <u>Issue 2 – Accounting</u>

    - Will the modification trigger incremental accounting expense?

    — <u>Issue 3 – Disclosure</u>

    - Will the modification trigger Form 8-K reporting?
    - With respect to proxy named executive officers, what are the CD&A and Summary Compensation Table implications?

<u>Controls Over "Share Counting": What, Me Worry?</u>

By Howard Dicker, Weil Gotshal

"He's a nice young man, but are you <u>sure</u> he's an M.B.A.?"

Yes, you worry. If your company does not have appropriate controls and procedures relating to "share counting" of its plans and related Form S-8, bad things can happen, like: inability to make grants, allow option exercises or issue shares under plans; unregistered securities offerings; costly rescission offers with plan participants; additional contingent liabilities (and possible financial restatements); SEC inquiries and enforcement, violation of stock exchange procedures or shareholder approval requirements, invalid issuances of shares under state corporate law, inaccurate Form 10-K/proxy disclosure – and of course, litigation.

<u>What Needs Counting?</u>

Plans

- Keeping track of shares that count against the share pool of each of the company's compensation plans (and in some cases, keeping track of dollar amounts)
    - Cannot exceed overall limit and sublimits (e.g., by award types or individual caps)
    - Cannot exceed IRC 162(m) grandfathered limits
- Keeping track of share usage to know when the company will need to obtain stockholder approval to seek an additional authorization of shares (NYSE and Nasdaq stockholder approval requirements)

Form S-8

- Keeping track of shares (or in some cases, dollar amounts) that need to be registered on a Form S-8.
    - Offers and sales of securities under an employee benefit plan are required by the Securities Act of 1933, unless an exemption is available.
    - Need to determine how many shares (or dollars) to register on Form S-8 initially and when additional shares (or dollars) need be to registered later.
        - 401(k) plans and stock purchase plans can pose particular challenges

<u>Some Sources of Problems</u>

- *Different Methodologies*. The methodology for counting share usage against a plan's share pool is **<u>not</u>** going to be the same as counting shares for Form S-8 purposes.

- e.g., Share recycling – Generally, a plan provides for the "recycling" of shares into the pool, but for securities law purpose there typically is <u>**no**</u> recycling for the S-8 registration statement.
    - Example: A restricted stock award of 1,000 shares is made that cliff vests in three years (at grant, subtract 1,000 shares from both the plan pool and 1,000 shares from the S-8). After one year the award is forfeited because the grantee leaves the company (add back 1,000 shares to the plan pool (and thus available for re-grant) <u>but</u> do <u>not</u> add back to the S-8).
        - **Punchline**: Consequently over time, due to forfeitures of restricted stock awards, the number of shares registered on the Form S-8 will have been depleted earlier than the plan share pool. Therefore, assuming a company initially registered on Form S-8 the maximum number of shares authorized under the plan, as odd as it may seem, a company may need to file additional Form S-8s during the life of a plan even if the company never amends the plan to increase the share cap. [We can tackle a discussion of possibly relying on an exemption from registration or on the "no-sale" theory on another day.]
- e.g., Timing – Generally, a plan will count against its plan limit on the date of grant the number of shares underlying an option; however, for Form S-8 counting purposes, a company might not need to count option grants against the S-8 until (and only if) the option is exercised.

- *Lack of Regulatory Guidance*. There is little guidance on share counting from the SEC staff for S-8 purposes and from the NYSE or Nasdaq for purposes of stockholder approval. As a result, practice from company to company varies. Thus, the bad news is that there is uncertainty, but the good news is that there is wiggle room.

- *Questions and More Questions*. In light of need for different methodologies (between the plan and Form S-8) and due to the lack of guidance, questions abound, like:
    - Should the company count the shares on the grant date or at the time of option exercise or stock vesting?

    - How to count performance-based grants, where the number of shares earned, if any, will not be known until a later date?

    - Should awards be counted on a gross or net basis (e.g., based on the number of underlying shares or based on the number of shares actually delivered to the grantee)?

    - How to handle "fungible share" pools?

- *Plan and Proxy Not Clear*. Sometimes the plan language is not clear on how to count shares for plan purposes. Or, the text of the proposal in the proxy statement used to obtain stockholder approval did not accurately describe the plan language.

- *Lack of Adequate Controls and Procedures within the Company*. Who has responsibility for share counting: is it the legal department, finance/accounting, benefits/HR, or someone else (like an external service provider)? Often the problem is that "all of the above" need to be involved, but no one takes ultimate responsibility for it and creating a process. Or, the person responsible changes jobs, and the "process" gets lost somewhere.

- *401(k) Plans and Stock Purchase Plans*. 401(k) plans and stock purchase plans deserve special attention. The company first must determine whether a Form S-8 is needed (not always a simple analysis) and determine whether stockholder approval is required (e.g., stock exchange or tax reasons).

  For example, assuming that an S-8 is needed for a 401(k) plan, determining the amount to initially register on Form S-8 and share counting is not straightforward because there usually is no specified maximum number of shares available under the plan, but there is a finite number of shares that can be offered pursuant to the S-8. Next, a company would register an estimated initial number of shares, and then, based on a counting methodology of usage, determine when it will need to register additional shares, and file additional registration statements, from time to time, before the S-8 is depleted.

    - Share counting practice varies.

        - Gross vs Net method. Example: 401(k) plan participant transfers 100 shares of value <u>out of</u> the company stock fund and deposits the value into another investment alternative in the plan. On the same day, a different plan participant transfers value <u>into</u> the company stock fund and is allocated 300 shares.

These are the only company stock fund transactions that day, and consequently the plan trustee re-allocates the 100 shares among the participant accounts within the plan, and only goes into the market and purchases 200 shares. On this day, should the company count 300 shares against the S-8 ("gross") or 200 shares ("net")? Even though the net counting method might seem a reasonable approach, the SEC might take the view that the gross method is more appropriate because under the Securities Act, technically, it is the transaction (i.e., the offer and sale of shares) that is being registered on Form S-8 and not the shares themselves.

    - If this all seems confusing -- it is, and counting for "unitized" 401(k) company stock funds is even more confusing because the number of units credited to a participant's account does not exactly correlate to the same number of shares.

  - When things go wrong. When a company offers or sells to employees more shares than were required to be registered on Form S-8, it may have violated the securities laws and determine that it is in its best interest to conduct of rescission offer as a means of limiting liability. Among other things, this involves preparing and filing with the SEC a Form S-1 or Form S-3, if eligible, and offering plan participants who purchased unregistered shares the opportunity to sell all of such shares they hold back to the company at their original purchase price plus interest (or, if they already sold the shares at a loss, to be made whole by the company plus interest). Most rescission offers filed with the SEC that involve plans, relate to 401(k) plans. An example is available here: https://www.sec.gov/Archives/edgar/data/1130713/000104746910007711/a2199181zs-1a.htm

- *Deferred Compensation Plans*. Believe it or not, even compensation arrangements that only pay out cash, plus some additional return, to participants may need registration with the SEC if they constitute offers or sales of securities (and no exemption from registration is available). Companies that register these arrangements register a dollar amount of "deferred compensation obligations" on Form S-8. Like the 401(k) plan, there is no specific method for determining how much should be registered on the Form S-8 initially. The amount is usually based on the terms of the plan, and projected compensation levels and deferral rates over a period into the future. Instead of counting shares for the S-8, the company must count dollars. Therefore, a company must monitor the amount of deferrals and register additional amounts based on actual deferrals and future projections.

Practice Pointers – So That You Don't Need to Worry

1. Get the right team together. Representatives from legal, finance/accounting, benefits/HR, and, if applicable, the external service provider. Utilize outside counsel as needed. Ensure that the persons responsible for preparing the Regulation S-K Item 201(d) disclosure are included (that's the table of securities authorized for issuance under equity compensation plans, which appears annually in the Form 10-K or proxy statement).
2. Review and evaluate existing controls and procedures relating to plan approvals (Board and stockholder), counting methodologies, documentation, review processes and audits, SEC filings, and stock exchange notices or listing applications. Questions to ask yourself include:
    a. Are the counting methodologies documented and approved, do they past muster from a legal perspective, and have they been applied consistently?
    b. Are there documented processes in place to ensure that information is accumulated and communicated to the appropriate people in management to allow timely decisions regarding compliance with the plan (e.g., share limits and aggregate cap), when to seek stockholder approval (e.g., forecasting plan share usage), and when to file additional Form S-8s (e.g., forecasting Form S-8 share usage (or dollar usage as applicable).
3. Document the logic for choosing a particular counting methodology.
4. Track share (dollar) usage in a consistent manner and maintain appropriate documentation. This will require at least two tracking systems – one for the plan and the other for the Form S-8.
5. On a quarterly basis (coordinated with Form 10-K and 10-Q preparation), prepare a report for the general counsel and corporate secretary (and possibly also the compensation committee).
    a. for each plan, there should be a "dashboard" of key data and early warning indicators:
        i. Is a plan (or sublimit) getting low on shares (e.g., expected to need re-submission for stockholder approval within the next 18

months) and whether more shares (or dollars) need to be registered on Form S-8 (e.g., expect to need to file additional Form S-8 within the next 12 months)?

  ii. Is a plan expiring within the next 24 months?
  iii. Key data may include: plan name; expiration date; last stockholder approval date; plan limits and sublimits and current and forecasted availability; Form S-8 registered limit and current and forecasted availability; Form S-8 registration statement dates, numbers and amounts; date of last S-8 prospectus; NYSE listing application or Nasdaq information; and corporate matters such as date of board approvals any scope of any delegation authority including a description of any limitations on delegation.

6. When a plan is submitted to stockholders for approval, pay extra attention to the description of the plan in the proxy statement. It should accurately explain how shares are counted and the circumstances under which shares can be added back to the plan limit or sublimit (and how the amounts may be adjusted, for example, by stock splits or stock dividends). Material misstatements or omissions in this area are ripe for shareholder litigation.

Talking Points: Shareholder Approval of Compensation Plans - Is ISS Support Always Necessary?

By Reid Pearson, Alliance Advisors

- Compensation plan proposals by the numbers
- Comp plan stats for Vanguard, BlackRock, and State Street
- Understand the influence of ISS and Glass Lewis has with your shareholders
- Know which of your shareholders do not follow ISS or Glass Lewis and can you count on their support
- What plan factors are important to shareholders not influenced by ISS
- Do a vote projection using knowledge of your shareholder base and plan data before making a final decision on paying ISS

Talking Points: Gender Pay Gap - Reporting & Shareholder Expectations

By Bob McCormick, PJT Camberview

- Campaign to have companies disclose global median pay gap
    - "Raw" figure makes no allowances for different job titles or functions
- Companies respond that raw median figure does not accurately reflect company efforts promoting gender equality or initiatives to recruit, retain and promote female employees
- Shareholders want more information but not all are convinced the pay median is the most informative measurement
- Required disclosure in the UK for employers with 250 or more employees, including US employers with operations in UK

Talking Points: Equity Treatment in Spin-Off Transactions

By Bindu Culas, FW Cook

The goal is to create market-relevant compensation programs to support achieving a successful spin-off and long-term business success; provide sufficient incentive to the management team to support achievement of robust performance goals while ensuring appropriate retention; and ensure that ParentCo and SpinCo compensation programs are competitive for these organizations based on their size and business focus.

- **Three Core Issues**
    - Issue 1 - Parent Company Issues
        - What, if anything, should be done for employees who will remain with ParentCo following the spin-off?
    - Issue 2 - Spin Company Issues
        - How should SpinCo's compensation program be structured?
    - Issue 3 - Treatment of Outstanding Equity Awards
        - How should outstanding ParentCo equity awards held by ParentCo continuing employees and SpinCo transferred employees be handled?

- Issues 1 and 2 are highly fact specific
- With respect to Issue 3, there are two common approaches as discussed on the next page

- **Treatment of Equity Awards**
  - Basket Method – All ParentCo awards (regardless of whether employee is continuing or being transferred) are converted into two awards: (a) an adjusted ParentCo award and (b) a new SpinCo award
    - Recognizes that equity award holders have contributed to the value of both companies
    - Ensures that employees reap the benefit of the value that they have helped create regardless of the company they will work for post-spin
    - Treats employees like stockholders who receive shares in both companies
  - Concentration Method – ParentCo awards held by SpinCo employees are converted into SpinCo awards, while awards held by continuing ParentCo employees will remain awards based on ParentCo equity but equitably adjusted to reflect the decrease in ParentCo value as a result of the spin
    - Ensures that employees are specifically incentivized to maximize the value of the company for which they will perform services on a going forward basis
    - Generally viewed as preferable practice because it results in a "line of sight" incentive in which awards are focused on company for which executives can influence performance
  - Conversion Methodology – Can be complicated and care needs to be taken to avoid adverse tax and accounting consequences

Talking Points: Avoiding Litigation & SEC Enforcement Due to Your Disclosures

By Howard Dicker, Weil Gotshal

Although stockholder litigation relating proxy statement disclosure is uncommon (except in the context of M&A), it certainly would be no laughing matter for you if a lawsuit was filed against your company one week after it was mailed alleging that it contained materially false and misleading statements (and maybe that the directors breached their fiduciary duties and that the CEO has been unjustly enriched). Sometimes the lawsuit even seeks an injunction to prevent annual meeting from being held. That's enough to bring anxiety (and some sense of panic) to most corporate secretaries and in-house securities counsels.

Sometimes plaintiff lawyers pick on the smallest of things. For example: your company is seeking shareholder approval of a new or amended omnibus equity plan. Your proxy discloses that subject to selection by the compensation committee, all employees (including approximately 30 members of senior management) are eligible to participate.

Looks good? Not according to the plaintiff attorney, who will decry that the approximate number of employees should also have been disclosed (pointing to Item 10(a)(1) of Schedule 14A, which requires that the company "identify each class of persons who will be eligible to participate therein, indicate the approximate number of persons in each such class). No, I am not kidding. See, for example, Freedman v Intel (complaint available http://business.cch.com/srd/FreedmanvIntel042517.pdf).

You never hear about many of these lawsuits because they are settled with the plaintiff, without a decided court opinion issued.

Things to Consider

- Usually more at risk for a lawsuit when a compensation plan is also on the ballot.
- Be very careful in describing plans, share usage, award limits, and performance measures and adjustments.
- Be very careful in describing whether and to what extent performance goals were attained. Plaintiffs sometimes claim the goals were not attained, based on the numbers disclosed in the proxy statement.
- Plaintiffs have recently begun to focus on strict compliance with non-GAAP financial measure disclosure requirements. So while your company may not have received a comment letter from the SEC staff, the plaintiff lawyers are reading too and looking for a ($$) settlement for improving the company's disclosures.

- Do not make a "flat" (i.e., unqualified) statement in the proxy statement when there could be circumstances when the statement might not be true (e.g., the company does not provide any perks; all of our incentive compensation is performance-based). Tailor the statement for facts.
- Remember that most proxy statement disclosures are usually incorporated by reference into the previously filed Form 10-K (and are therefore covered by the CEO and CFO certifications) and into registration statements. And this means more exposure to the risk of greater liability.

What should *my company* be doing?

- Regularly review competitors' disclosures and SEC comment letter correspondence.
- Regularly review industry disclosure trends – usually good sources are Big 4 accounting firm publications.
- Listen to investors and analysts – ask them (really) – how could we improve disclosures?
- Disclosure committee – is it doing all it could be?
- Dialogue with auditor

What should *I* be doing?

- Be knowledgeable with the "technical" compliance areas over which you are responsible. Reach out to outside counsel as needed (preferably not after, or the day before, the document is being sent to the audit committee or the compensation committee).
- If when you read disclosures, you don't understand it, there could be a problem. If when you write disclosures and others don't understand it, there could be a problem. Reread the SEC's Plain English Handbook for pointers. https://www.sec.gov/pdf/handbook.pdf
- Regularly review thecorporatecounsel.net and compensationstandards.com ☺
- Ensure good processes.

Upcoming Proxy Statement

Areas of potential focus include:
- Non-GAAP financial measures

    - Review SEC staff CDIs and be aware of situations where "equal prominence" requirement of Item 10(e) of Regulation S-K may be applicable
- Perquisites and personal benefits under Regulation S-K Item 402
    - Subject of recent SEC enforcement; remember, these terms are not defined in the rule – must see SEC Release No. 33-8732A (August 29, 2006) at page 73 available athttps://www.sec.gov/rules/final/2006/33-8732a.pdf)
- New Hedging disclosure
    - Follow the disclosure requirement – Regulation S-K Item 407(i) (e.g., fair and accurate summary, and a description of categories)
- Non-Employee Director compensation
    - Greater interest by institutions; consider more fulsome disclosure around process; reaction to *In re Investors Bancorp Stockholder Litigation* (Delaware) – possibly limiting non-employee director discretion in setting their own compensation: see JP Morgan Chase & Co 2018 proxy statement at p. 125 available at https://www.sec.gov/Archives/edgar/data/19617/000001961718000077/jpmc2018definitiveproxy.htm
- Voting standards
    - Get it right – disclosure of required vote, treatment of abstentions and broker non-votes).

Talking Points: Compensation-Related Shareholder Proposals

By Reid Pearson, Alliance Advisors

- Compensation shareholder proposals by the numbers
- Clawback proposals make a comeback – FleetCor, Mallinckrodt, Mylan
- Gender pay equity proposals saw rising support in 2019
- Linking pay metrics to social issues

5:00 - 7:00 pm **Welcome Reception**

"16th Annual Executive Compensation Conference"

Tuesday, September 17, 2019

Master Detailed Agenda & Talking Points

(Times are Central – but all panels will be archived & available at your discretion)

7:30 - 8:45 am **Registration & Continental Breakfast**

8:45 - 9:45 am **Keynote: Josh Linkner on "The Music of Business: Translating Improvisational Thinking from Jazz to the Business World"**

9:45 - 10:30 am **Break**

10:30 - 11:30 am **"The SEC All-Stars: The Bleeding Edge"**

Speakers:

- **Brian Breheny** - Skadden Arps
- **Meredith Cross** - WilmerHale
- **Marty Dunn** - Morrison & Foerster
- **Keir Gumbs** - Uber
- **Dave Lynn** - TheCorporateCounsel.net and Morrison & Foerster

1. Non-GAAP
2. Governance Disclosures
3. Risk Factors
4. Cyber Disclosures
5. Shareholder Proposals
6. Corp Fin Comment Trends

Talking Points: Non-GAAP

By Meredith Cross, Wilmer Hale

- Endless roller coaster of SEC Staff interest – just when you thought you had figured out what they want or don't want, the staff pivots to something new.

- Most recent area of staff interest is morphing from "individually tailored accounting principles" (ITAPs) to measures the staff decides are misleading.

- As a reminder, a classic "ITAP" is adjusting a revenue number to accelerate revenue that is deferred under GAAP. The SEC Staff's interpretations in 2016 (Non-GAAP CDI 100.04) basically said that an adjusted revenue number would violate Reg G and could not be used anywhere.

    - This had a significant impact on the disclosure practices in specific industries, including, for example, the video game industry.

    - Impacted companies had to stop using specific measures.

- In the aftermath of this interpretation, the SEC Staff raised the specter of measures not being allowed because they were impermissible "ITAPs".

    - Often it was hard to predict which adjustments would survive and which would not.

    - Mostly, the debate focused on whether the measure was misleading.

- More recently, the Staff has been objecting to measures on the grounds that they are misleading – not that they are ITAPs.

    - Non-GAAP CDI 100.01, also from 2016, reminds that some adjustments that are not explicitly prohibited, are prohibited because they result in a non-GAAP presentation that is misleading.

    - The example in the CDI – a performance measure that excludes normal, recurring, cash operating expenses necessary to operate a registrant's business could be misleading – is one of the types of measures the Staff has been challenging. Think of "profit before expenses."

- It is very difficult to win these battles. There is not a lot of process.
  - Worth pushing hard if important.
  - You do not win just because you have been reviewed before and had that measure, and they challenged it, and they dropped the comment.
  - You also do not win just because your measure has the impact of making your results look worse.
  - Push the rock up the hill based on not-misleading.
- SEC Enforcement Division continues to look at non-GAAP measures, so pay attention to a few basic points:
  - Failing to comply with equal or greater prominence is an easy Enforcement case – ADT (December 2018)
  - Inconsistent treatment of items also gets you in trouble – MDC Partners (January 2017)
  - For "metrics" – a close cousin to non-GAAP measures – be careful to avoid undisclosed changes impacting the numbers – Constant Contact (June 2018)

<u>Talking Points: Risk Factors</u>

By Meredith Cross, Wilmer Hale

- Risk factors are a hot topic these days:
  - SEC has proposed to change the disclosure rules on risk factors.
  - Risk factors are a central focus for the SEC for issues de jour, such as LIBOR and Brexit.

    - SEC brings enforcement actions if the SEC decides they are misleading "hypothetical" risk factors.

- Proposed changes would change "most significant" to "material," require a summary if the risk factors exceed 15 pages, and require the grouping of risks under headings.

    - Somewhat surprising that this part of the release did not get into concerns about "hypothetical" risk factors.

    - Very little new in the release on what risk factors should convey; more focus on just getting them shorter.

    - The discussion of the proposed summary references a Form S-11 release from the 90's – this shows it can be done.

- Constant struggle to make sure your risk factors are up-to-date on key issues like the transition away from LIBOR and the impact of Brexit.

    - The trend seems to be to add more information since it is so difficult to predict how these items will play out or impact companies.

    - SEC Chairman and Senior SEC Staff push on these, with the goal of making sure investors know what management knows.

- Another risk factor like LIBOR and Brexit, but that is happening to companies now, is GDPR – the new privacy laws in Europe.

    - Expect to see significant refreshment of this one in next year's 10-Ks as fines become bigger and bigger.

- SEC enforcement cases about "hypothetical" risk factors require a relook at how you draft risk factors generally – look for places you say something "may" happen if it has already happened in the past or is currently happening.

    - Recent Facebook case focused on disclosure that customer data "may" be misused – SEC characterized the disclosure of risk of misuse as "merely hypothetical."

- Yahoo (Altaba) case focused on disclosure of "possible" data breaches, when the company was already experiencing a data breach.

- SEC (and prior Staff) guidance on cybersecurity disclosures noted that it likely would not be sufficient to disclose an event may happen in the future if it has happened in the past, without disclosing that is has.

- Very challenging to draft risk factors against this backdrop; should scrub your risk factors with next 10-K (or earlier if you include them in 10-Qs).

    - Rather than saying something "may" happen, consider "has in the past, and may in the future" (if true).

    - Consider adding facts – for example, for a risk factor about Brexit, include specific examples about the impact to date before saying it "may" have a negative impact.

    - If something is already happening and is having a negative impact worthy of a risk factor, it is more likely appropriate for MD&A, with a reference in risk factors to the risk of continuing negative impact.

<u>Talking Points: Corp Fin's Areas of Focus</u>

By Dave Lynn, Morrison & Foerster

<u>SEC Comment Trends</u>

- An overall decline in comments from the Staff of the Division of Corporation Finance and an increase in the materiality thresholds for the comments raised.

- A perennial focus on MD&A:

    - Non-GAAP financial measures;

    - Results of Operations disclosures;

    - Critical Accounting Policies and Estimates;

    - Tax issues;

    - Liquidity and Capital Resources disclosures; and
    - Contractual Obligations
- Accounting Standards disclosure:
    - A focus on disclosure of the impact of recently issued accounting standards and the impact that such standards will have on a company when adopted in a future period.
    - Addressing the impact of a recently adopted accounting standard through incremental disclosures as more information comes to light through the implementation process.
    - Need for disclosure of a known trend, demand, commitment, event or uncertainty.
- The Staff continues to comment on segment disclosures
    - When reviewing segment reporting, the SEC staff considers public information available from a registrant's earnings calls, website and industry or analyst presentations.
    - The Staff has asked registrants to explain any inconsistencies between how the business is described in public information and how it is described in their segment footnote.
    - The Staff has requested an explanation when there are inconsistencies between the description of the business in other sections of a registrant's public filings and its segment footnote.
    - The Staff expects registrants to continually monitor business developments.
    - We continue to see a high level of Staff focus in this area, even when the staff has previously commented on a registrant's segment reporting.
- Little "r" restatements – a focus on materiality assessments and implications for controls.
- Cybersecurity disclosure.

    - The 2018 SEC guidance builds on Staff guidance from 2011.
    - Existing disclosure requirements, including MD&A, may require disclosure about potential and actual cybersecurity breaches or other related events.
    - Need for disclosure of a known trend, demand, commitment, event or uncertainty
    - Hypothetical risk factors – SEC enforcement trends.
    - Continued focus on cybersecurity disclosures through the disclosure review program.

Other Disclosure Considerations for 2020

- New Auditor Reporting Model
    - Audit report will include discussion of critical audit matters.
    - Critical audit matters are matters that are communicated or required to be communicated to the audit committee and that:
        - Relate to accounts or disclosures that are material to the financial statements; and
        - Involved especially challenging, subjective or complex auditor judgment.
    - How will critical audit matters relate to critical accounting estimate disclosure in MD&A?
- Sustainability disclosure – where do we go from here?
    - SASB has pivoted, focusing on promoting voluntary adoption of standards based on materiality rather than waiting for SEC-imposed rules.
    - No uniform set of standards for reporting sustainability information has emerged, and much of the information is reported outside of SEC filings.

On the Horizon

- In connection with adopting changes to Rule 701, the SEC issued a Concept Release seeking public comment on ways to modernize compensatory securities offerings and sales, which solicits comment on:
  - "Gig economy" relationships, in light of issuers using internet platforms to provide workers the opportunity to sell goods and services, to better understand how they work and determine what attributes of these relationships potentially may provide a basis for extending eligibility for the Rule 701 exemption.
  - Whether the Commission should further revise the disclosure content and timing requirements of Rule 701(e).
  - Whether the use of Form S-8 to register the offering of securities pursuant to employee benefit plans should be further streamlined.
- The Commission held a roundtable in November 2018 to obtain updated feedback on the 2010 proxy plumbing Concept Release, and a number of issues are under consideration:
  - The quality and mix of information provided to shareholders and how that information is provided;
  - Shareholder proposals;
  - The role of proxy advisory firms and withdrawal of the ISS and Egan Jones letters;
  - The costs and burdens of the proxy system on companies and shareholders; and
  - Whether the voices of long-term retail investors "are being underrepresented, misrepresented or selectively represented in corporate governance."
  - The SEC's Investor Advisory Committee has been considering proposals to discuss the U.S. proxy voting infrastructure.
- Disclosure effectiveness proposals – the SEC has several outstanding proposals seeking to revise Regulation S-X and Regulation S-X.

- The SEC has outstanding rulemaking proposals and required actions from the Dodd-Frank Act that have not yet moved forward, including:
    - Pay versus performance disclosure
    - Requirements for listing standards mandating compensation recovery policies.
    - A proposed revision of the proxy rules that would require issuers and dissident shareholders to use universal proxy cards naming all board nominees in contested elections of directors.
    - The U.S. District Court for the District of Columbia remanded the conflict minerals disclosure rule to the SEC to determine how to address the opinion of the U.S. Court of Appeals for the District of Columbia Circuit in the case of *National Association of Manufacturers, et al. v. Securities and Exchange Commission.*
    - In a joint resolution, the House of Representatives and the Senate nullified the resource extraction issuer payment disclosure rule, requiring the SEC to go back to the drawing board on that rule.

11:30 - 1:00 pm **Lunch**

1:00 - 2:00 pm **"The Top Compensation Consultants Speak"**

Speakers:

- **Bindu Culas** - FW Cook
- **Howard Dicker** - Weil Gotshal
- **Blair Jones** - Semler Brossy
- **Tara Tays** - Deloitte Consulting

1. What type of ESG metrics are being included in incentive arrangements? What do shareholders what to see? What about proxy advisor firms?
2. Expanding role of the Compensation Committee related to Human Capital Management topics

3. LTI performance metrics: prevalence and trends

4. When a company goes through a CEO transition, what is the role of the compensation committee? How do you ensure the change aligns to the overall compensation strategy?

5. Compensation design considerations in times of change

6. Equity plan features that balance investor considerations while optimizing flexibility

7. Culture/Employee engagement – How much/what type of information should be provided to the Board?

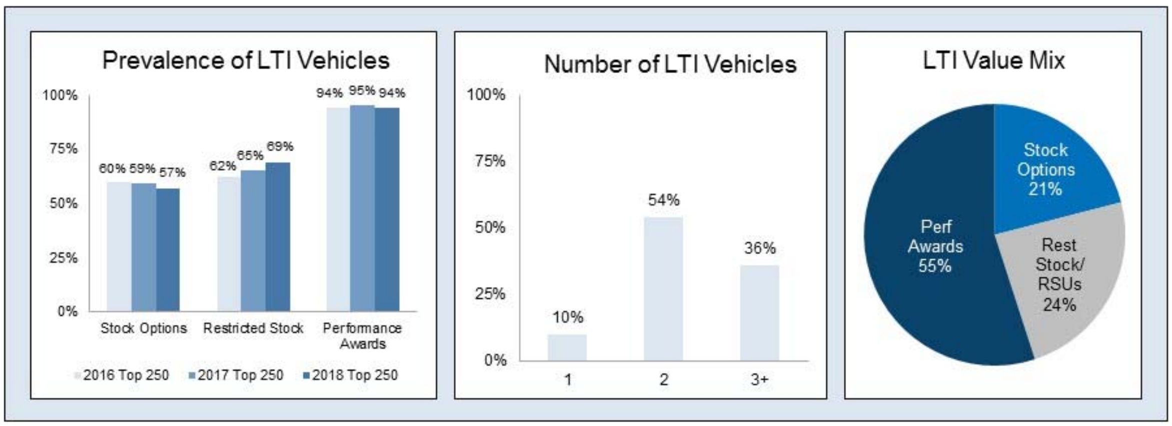
[Talking points begin on next page]

Talking Points: LTI Performance Metrics

By Bindu Culas, FW Cook

Broad Market Practice – LTI Vehicles and Mix

- Majority practice among general industry companies continues to be the use of multiple long-term incentive vehicles to balance the benefits and drawbacks of each type of vehicle
  - In 2018, 90% of companies used at least two long-term incentive vehicles
  - While stock option use remains high, it has declined modestly over the last three years from 60% to 57%
  - The prevalence of performance awards has remained constant at 94%-95%
  - Use of time-vesting restricted stock/units has increased over the last three years

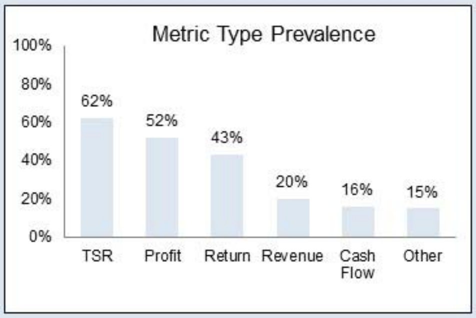


Source: FW Cook 2018 Top 250 Report of Long-Term Incentive Grant Practices for Executives (represents the 250 largest companies in the S&P 500)

FW COOK 1

Broad Market Practice – LTI Performance Metrics

- The majority of companies with performance awards rely on either one or two metrics for determining payout
  - — Total Shareholder Return ("TSR"), measured on a relative basis, is the most prevalent LTI metric (used in over half of all performance awards)
  - — Although no longer the most common, profit measures remain highly prevalent (used in roughly half of all performance awards); these are most often measured on an absolute basis (i.e., against internal goals)
- Most companies with performance awards use a 3-year performance period (prevalence has increased to 92%)
  - — This length balances the challenge inherent in setting long-term performance goals with best practices and external expectations of using multi-year performance periods

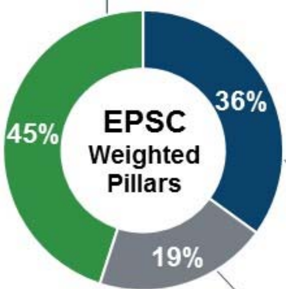


Metric		Measurement Approach		
Category	Examples	Abs.	Rel.	Both
Shareholder Returns	TSR	1%	91%	8%
Profit	EPS, Net Income, EBIT/EBITDA	85%	12%	3%
Return	ROE, ROA, ROIC	77%	14%	9%
Revenue	Revenue (Growth)	85%	13%	2%
Cash Flow	Cash Flow (Growth)	95%	5%	0%
Other	Safety, Quality	--	--	--

Source: FW Cook 2018 Top 250 Report of Long-Term Incentive Grant Practices for Executives (represents the 250 largest companies in the S&P 500)

ISS Equity Plan Scorecard

- Under ISS Equity Plan Scorecard, case-by-case evaluation of stock plan proposals consists of three weighted categories:



Plan Cost: Shareholder Value Transfer (SVT)
- SVT measures value transferred from shareholders to award recipients through equity grants
- Plan cost includes all equity (outstanding, available for grant and new shares requested) and is expressed as a percentage of market cap
- A company's plan cost is compared to the average amount paid by companies performing in the top quartile of its industry (allowable benchmark)

Grant Practices
- Burn Rate (3-year average share usage compared to industry competitors)
- CEO Equity Vesting Provisions and Performance-Based Grant Ratio
- Plan Duration (expected life of requested share authorization)
- Holding Requirement (mandatory hold beyond vesting period)
- Clawback Policy

Plan Features
- Change in Control (CIC) Vesting provisions
- Discretionary Non-Death/Disability Vesting
- Liberal Share Counting/Share Recycling
- Minimum Vesting (at least 12 months)
- No Payment of Dividends on Unvested Awards

S&P 500 companies need at least 55 of 100 points for ISS support

Non-S&P 500 companies need at least 53 of 100 points for ISS support

FW COOK

2:00 - 2:45 pm **Break**

2:45 - 3:45 pm **"Navigating ISS & Glass Lewis"**

Speakers:

- **Ning Chiu** - Davis Polk
- **David Kokell** - ISS
- **Bob Lamm** - Gunster
- **Bob McCormick** - PJT Camberview

A. Past 2019 Proxy Season

1. What is the key issue you saw during the 2019 proxy season in terms of executive compensation

B. ISS-Specific Questions

2. Background on how proxy statements are reviewed (analyst initially and then additional layers of review)

3. Stats on the number of proxy statement reviewed; number of "for" and "against" recommendations for say-on-pay and equity plan proposals; number of "for" and "against" recommendations when quantitative test is at (a) high; (b) medium; (c) low concerns

4. Biggest issues ISS saw this year in terms of structural pay for performance and disclosure of pay for performance

5. Advice on disclosure (Do's and Don'ts)

6. Advice on engagement with ISS (Do's and Don'ts)

C. Lightning Round

7. What does pay for performance mean for the proxy advisory firms, and how does that correlate to what it means to companies

8. What are the biggest good and bad trends you are seeing in exec comp disclosure

9. What is the most confusing or misunderstood element that your clients have about proxy advisory firms

10. What's your best advice for dealing with a negative recommendation

11. Supplemental filings after a negative recommendation (yes or no)

D. Upcoming 2020 Proxy Season

12. Any insight into 2020 policy changes and how will the director pay policy be implemented

13. What is the biggest issue to anticipate for the 2019 proxy season and how do we deal with it (could be the same old things...)

Talking Points: Plan Approval Disclosure Practices & Strategies

By Howard Dicker, Weil Gotshal (assistance from Erika Kaneko is greatly appreciated)

1. Take proxy advisor guidelines into account when preparing a plan or amendment – and the related proxy statement disclosures.

    – The most common reasons for a company to receive an "against" recommendation from ISS are:

    1. Failing the "Shareholder Value Transfer" test
    2. Including liberal share counting provisions
    3. Including liberal change in control vesting
    4. Permitting repricing or cash buyouts

    – Plan features for which companies receive favorable "credit" from ISS:

    1. Prohibited Reloading
    2. Prohibited Repricing
    3. Prohibited Cash
    6. Contains Clawback
    7. Prohibited Automatic CIC Single Trigger
    8. Prohibit Liberal Share Counting

Buyout of Underwater Awards
4. Prohibited Evergreen
5. Prohibited Liberal CIC Vesting

9. Ensure Minimum Vesting Restrictions
10. Prohibit Broad Authority To Accelerate Awards

2. Proxy disclosure should articulate why shareholders should approve the new plan or plan amendment – despite the presence of negative factors or potential negative recommendations from ISS or Glass Lewis

3. Include a copy of the new or amended plan with the proxy statement.

   - This is required by Instruction 3 to Item 10 of Schedule 14A.

   - According to ISS' new 2018 policies, when a company submits a plan amendment for shareholder approval, in cases where a company does not include the entire plan, as amended, in the proxy statement or does not indicate in the proxy statement where the revised plan document is filed, ISS may recommend "against" the plan amendment proposal, as the company has not provided sufficient information to enable shareholders to fully evaluate the revised plan.

4. Although burn rate disclosures are often important in evaluating plans, beginning in 2018 ISS no longer considers burn rate commitments made by companies in making its recommendation.

5. Plaintiffs' suits are becoming more common. These suits may seek to enjoin a vote to approve the new or amended plan, and typically claim that disclosure is inadequate & misleading – or a breach of directors' state law fiduciary duties. Demands for additional disclosure typically include:

   - A summary of any compensation consultant analysis of the proposed increase in the number of shares provided to the company's board of directors.

   - Any projections or forecasts of future awards considered by the board of directors.

- The reasons for the company's determination that additional shares are needed and how the company determined the specific number of additional shares requested to be approved for issuance.

- The share overhang and burn rate.

6. To reduce the risk of plaintiffs' suits, comply with all line-item disclosure requirements about the plan and executive pay.

Companies should decide whether to include "extra" disclosure based on their own circumstances. If the compensation committee or board has considered analyses of share usage or projections of future grants, consider summarizing that information in the proxy statement.

3:45 - 4:00 pm **Break**

4:00 - 5:00 pm **"Hot Topics: 50 Practical Nuggets in 60 Minutes"**

Speakers:

- **Era Anagnosti** - White & Case
- **Bob Lamm** - Gunster
- **Katy Murray** - Activision
- **Kyoko Takahashi Lin** - Davis Polk
- **Amy Wood** - Cooley

Talking Points: 50 Practical Nuggets

By Era Anagnosti, White & Case

1. **Don't Be Afraid of Plain English** – While graphics and a lot of colorful tables and statistics have replaced text as a way of capturing a reader's attention, there is plenty of disclosure out there that remains convoluted, repetitive and ineffective. For example, do not make the reader "suffer" through 30 pages of fairly complex disclosure of performance metrics and target achievement, while the final determination regarding an NEO's compensation represents a discretionary decision of the board.

This is key for effective communication with your investors. As a former Corp Fin Staffer who has reviewed hundreds of these filings, I can tell you that it is not a good idea to "bury the lead" – especially when it comes to performance targets, quantifying those targets and disclosing the level of target achievement should not be a "gymnastics exercise." Proxy disclosure is your "conversation piece" with your investors and simplicity and relatedness should take precedent.

2. **<u>You're No Longer an EGC or an SRC</u>** – Form check has never been more important, especially when this is your first year when you no longer can take advance of the reduced reporting requirements. This could also be the first year that you may be subject to an SEC Staff review, therefore starting the process early and getting the NEOs informed and prepared for the additional and more granular level of disclosure is very important.

   You want to take steps early in the process so that you have the appropriate disclosure controls and procedures in place to ensure that information flows to the appropriate collection and disclosure points in a timely manner, and if you have a disclosure committee, the committee is creating a clear roadmap of the new disclosure requirements and how they will be fulfilled – the disclosure committee should have written processes for the collection, retention, and handling of information that may need to be disclosed, and that they regularly update it in light of the changing and expanding disclosure requirements.

3. **<u>Do I Need to File a Preliminary Proxy Statement</u>**? – Do that analysis early so you do not run into any timing issues since Corp Fin will usually take all the 10 calendar days to screen it and make a review determination.

   That 10-day deadline is watched extremely closely by the staff. I have been on calls with many nervous registrants that have not heard from the SEC Staff by the 7th day and they are worried about timing and the need to file the definitive proxy statement. The SEC Staff is not required to call you on the 10th day to confirm that you can file your definitive proxy. Once that time lapses, you can push the Edgar button on the definitive proxy!

4. **<u>Presentation of Non-GAAP Financial Measures</u>** – Please be mindful of compliance with Regulation G and Item 10(e) of Regulation S-K if your description of the company's financial performance for the last year contains the use of non-GAAP measures.

Prominence and reconciliation are areas that plaintiff law firms as well as the SEC Staff still focus on. Considering also how dynamic the area of non-GAAP financial measures is, as the Corp Fin comments in this area ebb & flow, that aspect of disclosure should always be looked at with a fresh pair of eyes.

5. **<u>SEC Staff Reviews Your "All Other Compensation Column" and Perquisites Disclosure</u>** – While everyone is aware of the SEC's enforcement actions in this space, disclosure about perquisites, however, should not be driven by what your peers are doing (or not doing) in their proxy disclosures, but rather by what's required to be disclosed.

   Given that the disclosure requirements of Reg S-K Item 402 are prescriptive rather than principled-based, the emphasis should be on compliance with the disclosure requirements as it applies to your specific facts and circumstances, rather than solely on the market practice that has developed around this area.

6. **<u>Board Oversight of Cyber Security Risk</u>** – The SEC's February 2018 guidance in the subject of cybersecurity is not new, but companies should be reminded that the guidance encouraged reporting companies to adopt comprehensive policies and procedures related to cybersecurity and assess their compliance regularly, including sufficiency of their disclosure controls and procedures as they relate to cybersecurity disclosure.

   Item 407(h) of Regulation S-K requires among other things, disclosure about "how the board administers its oversight function…" As such, reporting companies should be aware that the systems created for tracking and reporting relevant information about cybersecurity risks and incidents to enable senior management to make disclosure decisions and certifications and to facilitate policies and procedures to prohibit insiders from trading on the basis of material nonpublic information, may end up being captured as part of the proxy's Item 407(h) disclosure.

   Investors are looking for directors who understand the nature of cybersecurity risk and prioritize their oversight of cyber preparedness, detection, response, and disclosure. Board oversight of cyber risk management, including how the board engages with management on cybersecurity issues, should be disclosed to the extent cybersecurity risks are material to the business.

7. **Managing Shareholder Proposals**– In light of the SEC Staff's current statements that it is considering to back away from the 14a-8 shareholder proposal process, the change could impact proxy disclosures in a number of ways, including inclusion in the proxy of a larger number of shareholder proposals and statements in opposition, and potential disclosure relating to compliance with 14a-8(g) as part of the company's obligation to meet the burden of proof for excluding a shareholder proposal.

   In addition, as the change in the 14a-8 process could result in companies receiving a greater number of proposals despite the current downward trend, you may want to think about whether implementing a broader proponent engagement plan as part of an overall strategy of the board's role in risk oversight, maybe necessary depending on the nature of the company's business.

8. **Pay Ratio Stuff** – As indicated by both ISS and Glass Lewis, pay ratio information would not impact their voting recommendations. This begs the question whether pay ratio disclosure has fallen flat. There have been no comments from the Corp Fin in this area as the SEC Staff is not in a position to evaluate whether disclosure accurately captures a specific company's facts and circumstances. However, the unintended consequence of pay ratio disclosure may have been the institutional investors' desire to get additional disclosure behind those pay ratio numbers and put them into the broader context of a company's policies related to employee benefits and compensation.

   As we saw in our latest survey[1], human capital management experienced the largest increase in E&S disclosures in 2019, including disclosure on employee pay and benefits. It remains to be seen if pay ratio disclosure would be used as the catalyst for how the company would disclose human capital management it its broader context of corporate culture and success. It is no secret that investors are pushing for more ESG disclosure in SEC filings and finding perhaps creative ways to get there.

   In the new era of Certified B Corporation status companies, companies disrupting the old fashion - legacy businesses such as lending and banking, and the social responsibility culture of millennials which is already weaved into the corporate values of young public companies, we may also experience some form of disruption in the corporate governance space,

[1] https://www.whitecase.com/publications/alert/es-disclosure-trends-sec-filings-2018-2019.

especially given the open and creative ways these young companies communicate with their investors and their greater willingness to share more information.

9. **Anticipating Hedging Disclosures** – Item 407(i) disclosure applies to any employee, not just officers and directors. If you already have a hedging policy in place that you have disclosed in prior proxy statements, consult with counsel whether in light of the new SEC disclosure requirement you may need to make any changes to your existing disclosure.

   For example, if your current policy applies to all employees, officers and directors, but your disclosure is framed such that it leads one to believe that the policy covers only directors and NEOs, you need to consider whether revising your disclosure would be a required step.

10. **Clawback Policies & Reputational Harm** - We have seen the addition of reputational harm as another trigger added to clawback policies that would enable a comp committee to have discretion to claw back compensation.

    To manage the potential risk of non-enforceability of clawback provisions, companies should first understand the boundaries of what is considered to be legally enforceable under the applicable governing laws, as those limitations may significantly impact how you draft the different aspects of the policy for maximum impact.

Talking Points: 50 Practical Nuggets

By Bob Lamm, Gunster[2]

1. **Pay Attention to Corporate Formalities**

In case you think that corporate minutes and other corporate formalities are for wimps, think again. And read the opinion in the case of KT4 Partners vs. Palantir, decided by the Delaware Supreme Court in January 2019.

KT4 had submitted a demand under Section 220 of the Delaware General Corporation Law, seeking to inspect Palantir's books and records. Because such an inspection must be for a "proper purpose," KT4 noted that, among other things,

[2] Some of these discussions originally appeared in substantially the same form in postings on The Securities Edge, Gunster's securities and corporate governance blog.

Palantir had failed to hold stockholder meetings and to give proper notice under stockholder agreements.

The demand ended up in the Delaware Court of Chancery, which granted some of KT4's demands but rejected demands for emails exchanged among directors and officers relating to an investor rights agreement. KT4 appealed to the Delaware Supreme Court, which reversed that rejection.

The Supreme Court opinion, authored by one of our favorite jurists, Delaware Supreme Court Chief Justice Leo Strine, had some choice words, including the following:

> "KT4 discharged its evidentiary burden by presenting evidence that Palantir did not honor traditional corporate formalities… and had acted through email in connection with the same alleged wrongdoing that KT4 was seeking to investigate. Faced with that evidence, Palantir failed to present any evidence of its own that more traditional materials, such as board resolutions or minutes, even existed. And although the Court of Chancery may have credited Palantir's implicit suggestion that more formal books and records would be adequate for KT4's purposes, **Palantir concedes on appeal that no such documents exist**." (Emphasis added)

Justice Strine continued:

> "Ultimately, if a company observes traditional formalities, such as documenting its actions through board minutes, resolutions, and official letters, it will likely be able to satisfy a § 220 petitioner's needs solely by producing those books and records. But **if a company instead decides to conduct formal corporate business largely through informal electronic communications, it cannot use its own choice of medium to keep shareholders in the dark about the substantive information to which § 220 entitles them.**" (Emphasis added)

Just to be clear, this decision means that emails exchanged among the directors and officers regarding the matters in question had to be provided under Delaware law.

I don't know about you, but as someone who's seen his share of emails exchanged among directors and officers on the implicit assumption that they would never be seen by third parties, this case created a bit of indigestion. And if you haven't ever seen those sorts of emails, I can assure you that you don't want to.

Every so often, people who do what we do wish they had a cautionary example of the trouble a company can get into if it ignores minutes and other formalities. Perhaps we should be careful what we wish for.

2. **Plan Ahead for CEO Illnesses**

In April, Marriott International announced that its CEO had been diagnosed with stage 2 pancreatic cancer. It is interesting – and, in my view, a good thing — that Marriott announced the illness even though the name of its CEO, unlike Jamie Dimon, who announced a few years ago that he was being treated for cancer, or Steve Jobs, whose fatal illness went unannounced until the bitter end, is not synonymous with the company. It's hard to imagine too many people asking which companies were headed by Dimon and Jobs, but if one were to drop the name "Arne Sorenson," it's not clear that too many people would say "oh, you mean Marriott's CEO."

Determining whether and what to disclose when a CEO is diagnosed with a serious illness, or when there is some other arguably personal news about the CEO, is very challenging for executives, companies, and their securities lawyers. First, there isn't any rule – or even any literature (at least to my knowledge) – that tells us whether and what to disclose in this situation. So when a client says, "show me the rule that says we have to disclose this," there's nothing to show. Second, and more important, the issue pits the need to disclose against information that is quintessentially personal. It's also not just an issue between the executive and the company; often, the executive's family and, possibly, his/her medical team and others are equally involved. And even when there's agreement to disclose, it's very difficult to know what to say about the prognosis, if and when the executive can return to work, and so on."

Marriott's stock price actually rose following the announcement. I am in no way attributing a cause and effect connection between the announcement and the stock price increase, but I'd like to think that in this case, doing the right thing may have been its own reward.

3. **Don't Just Report ICFR Problems – Fix Them**

As securities lawyers know, disclosure is generally regarded as the best disinfectant. However, in one of the first enforcement actions of 2019, the SEC determined that disclosure is not always enough. Specifically, when it comes to internal controls over financial reporting, or ICFR, companies need to actually fix the problems they disclose.

In the action, the SEC cited four companies for failing to maintain ICFR for periods ranging from seven to 10 consecutive annual reporting periods. That's right – seven to 10 years, even after being contacted by the SEC, and despite the fact that they continued to provide disclosure of the material weaknesses. As noted in the SEC's press release on the action, "[c]ompanies cannot hide behind disclosures as a way to meet their ICFR obligations. Disclosure of material weaknesses is not enough without meaningful remediation."

Others have noted that the cases in question are outliers. That's undoubtedly true — at least I hope so, because it's hard to imagine hearing from the SEC and doing nothing about it, much less over a period of years). However, the moral of the story remains unchanged: if you're going to disclose an ICFR problem, you better fix it, too.

4. **Pay Attention to Non-GAAP Disclosures**

Lest you think that the SEC's focus on the use of non-GAAP financial metrics is so, well, 2018, think again. One day after Christmas, 2018, the SEC issued a cease-and-desist order against a company for using non-GAAP metrics without giving "equal or greater prominence [to] the most directly comparable financial measure or measures calculated and presented in accordance with GAAP…", as required by Item 10(e)(1)(i)(A) of Regulation S-K.

According to the SEC order, the company – ADT, the security company based in my home town of Boca Raton, Florida – issued earnings releases for fiscal 2017 and the first quarter of fiscal 2018 that prominently included such non-GAAP metrics as adjusted EBITDA, adjusted net income, and free cash flow before special items, without giving equal or greater prominence to the comparable GAAP data. For example, the order states: "In the headline of the FY 2017 earnings release, ADT presented its adjusted EBITDA for fiscal year 2017 and stated that adjusted EBITDA was up 8% year-over-year, without mentioning ADT's net income or loss (the comparable GAAP financial measure) in the headline"

And in the release covering results for the first quarter of fiscal 2018,

> "On the top of the first page, ADT then listed "FIRST QUARTER 2018 HIGHLIGHTS" in nine bullet points, including bullet points that state ADT's adjusted EBITDA of $620 million was up 7%, adjusted net income of $249 million was up 26%, and adjusted net income per share of $0.34 was up 10%. These three measures are all non-GAAP financial measures. ADT did not

> include comparable GAAP financial measures for net income or loss in the HIGHLIGHTS section. Instead, ADT reported in the second and sixth full paragraphs that its GAAP net loss had increased from $141 million for Q1 2017 to $157 million for Q1 2018."

Maybe it's just me, but these examples seem pretty obvious. In other words, if you're going to include non-GAAP metrics in a headline, that headline needs not only to include the comparable GAAP metric, but also to list the GAAP metric first (or to otherwise give it prominence). Similarly, it seems only logical that if you're going to use bullet points – as is often the case – to set out the period's highlights – you shouldn't limit the data in those bullet points to non-GAAP data.

However, I've had conversations with otherwise eminently sensible people who don't seem to understand what "equal or greater prominence" means. If you fall into that group, here are some suggestions:

- List the GAAP data first, even if the non-GAAP data make the numbers look better. This seems obvious.
- Don't show non-GAAP data in bold face or italics, or in a larger font, while showing GAAP data in regular font.
- Don't have three paragraphs about the non-GAAP data followed by a sentence covering the GAAP data.
- When you provide the required reconciliation between the GAAP and non-GAAP numbers, consider explaining why the non-GAAP numbers look better; after all, if they didn't, you probably wouldn't be using them.
- When you explain why you're using non-GAAP data, don't give a lame reason like "investors may find this useful". There's a good chance your investors find lots of things useful that you don't provide, so this seems to me to be a weak reed indeed. It's fine to say, "many investors who follow our company and our peers have asked us to provide this number" or "this is the way we look at the company" and so on. And if you still don't believe me, think how you feel when the SEC proposes a particularly silly disclosure requirement on the grounds that "investors may find the information useful."

In any case, the SEC clearly continues to be interested in this topic, so proceed accordingly.

5. **Don't Forget to Have Your Interim Financials Reviewed by Your Auditor**

Quarterly financial statements do not need to be audited. Rather, quarterly financial statements must be reviewed by the independent accounting firm. Specifically, Rule 10-01(d) of Regulation S-X states that "[p]rior to filing, interim financial statements included in quarterly reports on Form10-Q…must be reviewed by an independent public accountant using professional standards and procedures for conducting such reviews, as established by generally accepted auditing standards, as may be modified or supplemented by the Commission."

Some companies seem to have forgotten about this requirement (apparently, so did their auditors), because in a 2018 enforcement action – the first of its kind – the SEC went after five companies (three in Florida!!!) for failing to have their auditors review interim financial statements. Aside from accepting cease and desist orders, the companies in question were fined in amounts ranging from $25,000 to $75,000.

6. **Be Aware of SEC Rule Changes**

Hooray for the SEC!!! The Division of Corporation Finance has been making lots of changes in the rules governing both Securities Act and Exchange Act filings. The changes are generally small or incremental, but they really do streamline disclosures and reduce filing burdens.

However (you knew there would be a "however," right), you need to be careful when complying with the new rules. For example:

- Companies must now list on the cover page of Form 10-Q and Form 8-K each class of securities registered under Section 12(b) of the Exchange Act, the trading symbol, and the exchange(s) on which the securities trade, similar to the current requirements for the Form 10-K cover page. The cover page of Form 10-K was also modified to require the inclusion of the trading symbol for each class of registered securities, which previously was not required to be provided. The new Form 10-K cover page will also no longer include the checkbox related to delinquent filers under Section 16.

- Item 102 of Regulation S-K was revised to encourage disclosure regarding only material properties, plants and mines. The new rules make clear that it is acceptable for a company to determine that none of its properties are material for purposes of Item 102. However, the amendments do not alter disclosure requirements for companies engaged in the real estate, mining, and oil and gas industries, in which physical properties may be of particular importance.

- Companies will no longer need to include discussion and analysis for the earliest of the three years in the MD&A if that year was covered in a prior filing. However, companies omitting this information must reference where readers can find the discussion and analysis pertaining to that year.

- Companies must now include hyperlinks for required information that is incorporated by reference into a filing, similar to the links that are currently required for exhibits that are incorporated by reference. For example, these amendments will require companies to include active hyperlinks to the filings listed in the section of their Securities Act registration statements on the incorporation of information by reference.

- Companies must now include a new exhibit which includes a description of its securities based on Item 202 of Regulation S-K. Note that the initial exhibit must be filed with the Form 10-K and may not be incorporated by reference to another filing. Thereafter, a company may incorporate the exhibit by reference to the Form 10-K with which it was filed so long as there is no change. If there is a change, even if immaterial, an amended exhibit must be filed.

- Delinquent Section 16 filings must now be reported in the proxy statement under a new heading – "Delinquent Section 16(a) Reports." If a company does not have any delinquent filings to report, the new rules encourage that companies omit this section entirely from their proxy statement. (And for heaven's sake, don't include this stuff if you don't need to. More on that later.)

- There are also significant – and helpful – changes in making confidential treatment requests. At a May meeting with the Society's Securities Law Committee, Bill Hinman made a somewhat self-effacing comment that this change was not something a lot of people got excited about, but I pointed out that anyone who has ever had to submit a CTR is breathing a sigh of relief.

The bottom line is that you need to carefully read the SEC's 252-page release to make sure you comply with the good, the bad, and the ugly (though there's nothing that seems ugly) about these new rules.

7. **<u>Disclose Your Strategy (and More)</u>**

Companies always say, "we pay for performance." At least I've never seen any company that says it *doesn't* pay for performance. But saying it isn't enough. You need to prove it, and the best way I know how is to explain, somewhere in the compensation disclosures in your proxy statement, what your company's strategy is. Once you do that, you can go on to discuss the metrics on which your compensation is based, and how those metrics relate to your strategy (hopefully they do), and from there how those metrics worked out in your last fiscal year. It's hard to prove that you pay for performance if you don't disclose your strategy – and how your performance metrics link to that strategy.

I've heard some great excuses for not disclosing strategy in the proxy statement. My favorite is "everyone knows what our strategy is." That may – just may – be true about the analysts who follow your company, but it's almost definitely not true for anyone else, particularly the people at your major institutional investors who vote their organizations' proxies. And it's also not true for your retail owners, who can be the difference between a passing or failing vote on say on pay and other proposals.

Once you decide to disclose your strategy, disclose it. Saying, in effect, "we achieved our strategic objectives for the year" says nothing if you haven't disclosed what those objectives are. And in one case, after reluctantly admitting that his company should disclose its strategy to avoid another failing vote on say on pay, the GC of a public company told me "our strategy is to be profitable." Well, I suppose you can't argue with that, but is that all there is?

8. **<u>Kill Your "Compensation Committee Interlocks" Disclosure</u>**

This is a repeat item, because I keep seeing so many proxy statements that include this silly disclosure when it's not required. I know that S-K Item 407(e)(4) says that you're supposed to provide a bunch of information "[u]nder the caption 'Compensation Committee Interlocks and Insider Participation'," but the SEC has issued an interpretation that this disclosure can be omitted if there are no such interlocks or participation. If you don't believe me, here's the citation: https://www.sec.gov/divisions/corpfin/guidance/execcomp407interp.htm.

9. **<u>Stop Responding to Old (Ancient?) SEC Comments</u>**

There's no reason to keep addressing SEC comments made years or ago that no longer apply. For example, when I suggested that a client omit the Compensation Committee Interlocks disclosure, I was told that the company got a comment to include that disclosure. When I pursued it, it turns out that the comment was received in 2004. (The interpretation above was issued in 2007.) Even the staff of Corp Fin has said that you needn't include things added in response to SEC comments if the comments no longer make sense. Duh!

10. **Fix Your Proxy Statement**

Another repeat comment, because I continue to see so many proxy statements that suck. And when I look at those companies' proxy statements for years gone by, it turns out they haven't changed anything in years…or decades. There are lots of easy fixes that can make your proxy statement not just more readable, but also more effective as communications and advocacy documents. For example:

- Move the stuff often found under the heading "Questions and Answers about the Annual Meeting and Voting" to the back of the book. Don't waste valuable proxy statement real estate on something nobody looks at.
- Include a proxy summary. It really isn't all that hard to prepare.
- Explain why your shareholders should vote for your proposals. Most companies are pretty good at explaining why shareholders should vote against shareholder proposals, but why not put your best foot forward on the board proposals? This is particularly true of "say on pay" proposals. You can say all you want that shareholders should read the CD&A, but let's face it – few shareholders will do that. So instead of just saying "here it is, vote on it," give a few key reasons, in bullet point or some other easy-to-follow format, that explains why your shareholders should vote your way.

Talking Points: 50 Practical Nuggets

By Kyoko Takahashi Lin, Davis Polk

1. **Consider Voluntary Disclosure – Economic Value Added**

This past proxy season, ISS added Economic Value Added (EVA) metrics in its proxy research reports, as an informational matter (and not for purposes of making "say on pay" recommendations). EVA is a profitability measure of a company's residual profit after accounting for the cost of capital. The theory is that, if a company's net operating profit exceeds its cost of capital, it is creating value. If not, then there is value loss. ISS believes that EVA is a better indicator of performance than pure GAAP-based metrics.

The three inputs for calculating EVA are:

- Net operating profit after-tax
- Weighted average cost of capital
- Total invested capital

In its research reports, ISS had two categories of EVA measurement: EVA margin and EVA momentum. The margin metrics are intended to measure the company's operational efficiency, asset management and management of the company's capital base. The momentum metrics are "rate of growth" metrics. Typically, the margin metrics will trend in the same direction, and so will the momentum metrics; however, the two categories may or may not necessarily trend in the same direction. For example, a company in a low-growth industry could have strong EVA margins but low EVA momentum, and a company in a high-growth industry could have low EVA margins but high EVA momentum.

For the 2020 proxy season, ISS has committed to using EVA metrics as part of the Financial Performance Assessment screen, which is a secondary pay-for-performance screen that is used to assess a narrow subset of companies where the primary pay-for-performance screens indicate a borderline result between Low and Medium concern levels. ISS has made it clear that its use of EVA does not imply that companies should use EVA as a performance metric for their annual or long-term incentive plans.

That said, given that EVA will be part of its actual analysis, rather than merely informational, companies (even those companies that do not use EVA or its formulaic inputs as a performance metric) may want to consider adding voluntary disclosure that relates to their EVA, whether it is to address why their EVA inputs are the way they are or why their EVA margins and momentum are the way they are. Also, if the company has engaged in business activities that increases absolute EVA or accelerates EVA growth, it may be helpful to be express about that in the proxy statement.

And, as is always the case, it is important for companies to explain why they are using the performance metrics that they are using. If they have nothing to do with EVA, ISS and, more importantly, institutional shareholders will at least know why.

2. **Remember Non-GAAP Reconciliations**

Since proxy statements are filed with the SEC, they are subject to Item 10(e) of Regulation S-K (use of non-GAAP financial measures in Commission filings) and Regulation G. The SEC has continued to take a close look at the use of non-GAAP financial metrics and whether such metrics are afforded "equal or greater prominence to comparable GAAP financial measures."

If a non-GAAP metric is discussed strictly as an incentive or other target under a compensation plan, that usage is not required to conform to Item 10(e) and Reg G, but the proxy is required to provide narrative disclosure as to how that number is calculated from the company's audited financials (see Instruction 5 to Item 402(b) of Regulation S-K). For example, if the CD&A says "The CEO was entitled to a bonus if adjusted operating profit exceeded $100; since adjusted operating profit was $120, the CEO earned a bonus," then Item 10(e) and Reg G would not apply, but the company would be required to disclose, for example, that "'adjusted operating profit' means operating profit within the meaning of generally accepted accounting principles, plus non-cash compensation expense."

However, if the CD&A (or other disclosure outside of the CD&A, including the executive summary of the proxy statement) were to use a non-GAAP measure not specifically in reference to a performance target, then Item 10(e) and Regulation G (including the "equal prominence" rule) would apply. In addition, a GAAP reconciliation would be required.

An example of non-GAAP disclosure along those lines is: "Our adjusted operating profit in 2019 was $120" or "Our compensation program in 2019 was undergirded by our strong financial performance for the year, in which adjusted operating profit reached a record $120." The latter sentence could be revised to read, "Our compensation program in 2019 was undergirded by our strong financial performance for the year, in which operating profit reached a record $105 and adjusted operating profit reached a record $120. See Annex A for a reconciliation of operating profit to adjusted operating profit and for additional information about the non-GAAP measures we use in this proxy statement."

Non-GAAP numbers can often be identified by use of the term "adjusted," or the use of such terms as "EBITDA" (and similar terms) or "free cash flow."

3. **Consider Voluntary Disclosure – Human Capital Management**

Earlier this spring, the SEC's Investor Advisory Human capital management (HCM) voted to ask the SEC to further investigate and evaluate whether public companies should be required to disclose information related to human capital management (HCM) – in other words, how companies manage workplace issues, such as training, talent development, retention, employee engagement and diversity and inclusion. Their recommendations included the following potential disclosures: (i) an augmented current executive compensation disclosure to cover a broader workforce; (ii) worker productivity measurements; and (iii) the number of full-time, part-time and contingent workers.

While the SEC itself does not appear close to adopting a rule that would mandate such disclosure, institutional investors continue to focus on HCM. Earlier this year, BlackRock declared HCM a 2019 engagement priority for the companies in which the firm invests. Similarly, this year, State Street expressly advised companies that the firm will be focusing on "corporate culture as a driver of a company's ability to execute on its long-term strategy." Each asset manager encouraged its respective companies to utilize guidelines provided by the asset manager. Meantime, a number of large public pension plans have been requesting more information about workforce demographics and pay practices for rank-and-file employees.

This is all to say that, even in the absence of SEC rulemaking, companies, especially those that tout that their employees are their most important assets, may wish to consider voluntary disclosure in this regard. As we have said in the past, the proxy statement is not just a SEC compliance document, but an advocacy piece through which companies can communicate with their shareholders in a document that they will actually read. The good news is that many public companies are already doing a lot and, whether or not they have identified their efforts as human capital management, there is much to say that can be quite positive.

4. **Consider Voluntary Disclosure – ESG**

Similar to considerations regarding HCM, companies may wish to consider including broader ESG disclosure regarding issues such as the company's efforts to mitigate climate change, contribute to local communities, minimize political spending, ensure that the supply chain follows fair and ethical practices, etc. This is a good opportunity for companies to ensure that their proxy statement disclosures in this regard are consistent with what they say on their website, corporate social responsibility reports and other outlets for external communication (and vice versa).

5. **Consider Voluntary Disclosure – Stock Buybacks**

There are many good and valid reasons why companies engage in stock buybacks.

It can be a key way to return wealth to shareholders, especially if management believes that the market has undervalued its shares. It may be an effective way to manage dilution. And, based on a buy-side study by Corbin Advisors, an investor relations and strategic consulting firm whose research has been cited by *Institutional Investor*, institutional investors tend to think that stock buybacks represent a wise deployment of capital, even ahead of stock dividends.

That said, stock buybacks have been under scrutiny and it does not appear to be abating. In June, an AFL-CIO led coalition filed a rulemaking petition with the SEC on requesting repeal and reform of buybacks, primarily requesting a repeal of the safe harbor under Rule 10b-18, which currently allows companies to repurchase their shares on the open market without violating the market manipulation laws, and also requesting that the SEC develop a comprehensive framework with more restrictions and disclosure requirements.

In addition, SEC Commissioner Rob Jackson has spoken frequently regarding his research findings to the effect that corporate insiders cash out much more of their personal stock immediately after announcing a buyback than on an ordinary day. A number of members of Congress, including Presidential candidate Bernie Sanders and Senators Chuck Schumer and Marco Rubio, have introduced legislation that would limit stock buybacks.

Especially for companies that tout their stock buyback efforts in their proxy statement, it may be helpful to provide voluntary disclosure as to why stock buybacks are important to the company (including relative to other uses of capital that may have been considered). And, if the buyback has a consequence on incentive compensation performance metrics, it may be helpful to explain what the consequence was, whether the compensation committee excluded its effects (and, if it did not, why) and other issues that the board or management considered with respect to the buyback.

6. <u>Equity Plans – Advocating for Your Equity Plan</u>

As critical as a company's "say on pay" vote is, an equity plan vote is even more critical – it's a binding vote and, if it does not achieve the requisite approval, then the company may not be able to grant equity compensation in the future. As with the "say on pay" vote, ISS holds a tremendous amount of sway. ISS uses what it calls an "equity plan scorecard," which considers a range of positive and negative factors, rather than a series of "pass/fail" tests, to evaluate equity plan proposals. The scorecard takes into account the plan cost, the plan features and grant practices:

- Plan cost: Measures the total potential cost of the company's equity plans relative to industry/market cap peers, measured by Shareholder Value Transfer (SVT), which represents the estimated cost of shares issued under a company's equity incentive plans, differentiating between full value shares and stock options.

- Plan features: Measures the plan's actual design and looks at factors such as the consequences of a change in control of the company, share recycling, minimum vesting provisions and dividend equivalents on unearned awards.

- Grant practices: Measures the historical grant practices of the company and looks at factors such as burn rate, vesting schedules for the CEO, plan duration, clawbacks and post-termination/retirement holding periods.

The actual detail regarding the scorecard is different depending on whether the company is a S&P 500 company, a Russell 3000 company, a non-Russell 3000 company or in a special category (*e.g.*, recently IPOed). In the interest of full disclosure, stand-alone director compensation plans and employee stock purchase plans are evaluated using a different methodology.

While ISS tweaks its scorecard from year to year, the most recent year's scorecard and FAQs that provide further color are available on ISS' website and any updating tends to be available in mid-December. If your company is intending to take an equity plan to shareholders, it will be helpful to review ISS' materials and, in the plan proposal that discloses the material terms of the plan, it is important to address these points as much as possible. This may call for voluntary disclosure regarding burn rate, overhang, etc. Note that, if this kind of quantitative data is provided, it is important to provide this data as of the company's year-end, even if more updated information is additionally provided.

7. Equity Plans – A Few Compliance Points

Here are a few compliance points to remember:

- Especially with equity plans, it is critically important to form-check the proxy disclosure. This is an area where the plaintiff's bar is actively trolling for potential disclosure foot faults. A few points that can be easily forgotten – remember to identify the class of persons who are eligible to participate in the plan and include an approximate number of individuals in each such class; state the basis for participants' participation in the plan (this is different than the "purpose" provision of the plan); and consider whether new plan benefits disclosure is required.

- In addition, it is important to make sure that the equity plan complies with the rules of the relevant stock exchange – whether it is the New York Stock Exchange or Nasdaq. For example, if the plan has an evergreen feature, it is generally required to have a 10-year term.

- Consider whether a Form S-8 is required to be filed with the SEC and, if so, consider whether a prospectus needs to be prepared or updated.

- For companies listed on the NYSE, consider whether a supplemental listing application is required to be submitted to the NYSE.

One compliance reminder for companies that have an evergreen plan – if the evergreen is used to refresh the number of shares available under the plan, that will typically trigger a Form S-8 filing and, for NYSE companies, a supplemental listing application.

8. Equity Plans – Executive Departures

When an executive officer terminates his or her employment with the company, the equity plan may provide for vesting of outstanding equity awards, either full and immediate vesting, continued vesting, prorated vesting or some other variation. Even if it is not required under the terms of the equity plan, the executive may have bespoke terms that are mandated by his or her award agreements, an employment agreement, an offer letter or an executive severance plan. It is important to consider all bases for an executive's contractual entitlements. Even if there is no such requirement at all, that may be a request by the departing executive.

This gives rise to a number of considerations, including:

- Does the acceleration of outstanding equity compensation trigger a Form 8-K? If the acceleration was provided for all along, then an 8-K might not be required. However, if the acceleration is being agreed to in the context of the departure, then the requirement might be triggered.

- Will the acceleration of outstanding compensation trigger an additional accounting expense? If so, and if the executive is a named executive officer in the following year's proxy statement (or this incremental accounting expense is what puts him or her into the Summary Compensation Table), then, in the case where the acceleration is optional, that may be a factor that goes into the decision. Consider how the acceleration will be explained in the proxy statement and how institutional investors and proxy advisory firms may react.

- Is the acceleration permitted under Section 409A (and, for companies that are subject to Section 457A, that provision of the Internal Revenue Code)? Depending on how the outstanding equity compensation is designed, it may not be able to be accelerated, without incurring adverse tax consequences.

- Will the acceleration cause the equity award to lose its grandfathered status under Section 162(m)? While this is becoming less of a concern for companies, given that each passing year means that there are fewer and fewer grandfathered awards, companies may still have them and, if so, an acceleration can result in a loss of that grandfather.

In the interest of full disclosure, these considerations are not limited to equity compensation – they also apply to annual incentive programs, as well as cash-based long-term incentive plans.

9. Director Composition – Potential Overboarding

This past proxy season, a number of companies were caught off-guard when Vanguard tightened its overboarding policies mid-season, at a time when a number of companies had filed their proxy statements or when their nominating and governance committees had already finalized their director slate for the coming year. What Vanguard had done was to update its proxy voting guidelines to provide that it will vote against:

- Named executive officers who sit on more than one outside public company board (for a total of two public company boards).

- For non-executive directors, directors who sit on more than four total public company boards.

Vanguard might cast its vote for an otherwise overboarded director if there is a public commitment to stepping down from a sufficient number of boards that would fall within the proxy voting guidelines.

In addition, in its most recent benchmarking policy survey, ISS indicated that it is revisiting its overboarding policies for non-executive directors and CEOs. ISS noted that, where local recommendations provide upper limits, ISS generally applies these limits. In the absence of local limits, the survey asked survey participants what the appropriate overboarding standard should be for non-executive directors and CEOs For non-executive directors, ISS included multiple options with one being a maximum of six total board seats, which is above ISS and Glass Lewis's current cap for non-CEO directors, but consistent with State Street's current cap for non-CEO directors. When a CEO serves on boards other than the CEO's "home" board, ISS provided options up to a maximum number of three, including the "home" board.

Given the greater focus on overboarding (as well as other governance issues such as director independence and related person transactions), it has becoming increasingly important to monitor board members' external commitments, particularly outside board commitments. If a board member is "overboarded," it is important to see if there may be mitigating explanations to include in the proxy statement and to make sure that the director understands why his or her approval rating may be lower than that of others.

10. Director Composition – Diversity

Another director composition that has gotten increasing focus is the diversity of the members of the board. From a pure disclosure perspective, companies have already been required to disclose in their proxy statements the director nomination process, including relevant nominee qualifications, attributes or skills under Items 401(e) and 407(2)(2)(vi) of Regulation S-K. Then, this past spring, the SEC Staff issued two related C&DIs on how to disclose if the board or nominating committee takes into consideration "self-identified" diversity characteristics when selecting a nominee. For this purpose, diversity characteristics include race, gender, religion and military background. The C&DIs noted that the nominee must consent to the disclosure of his/her "self-identified" diversity characteristics.

Where we have seen a lot of governmental activity is with state legislatures:

- California: In September 2018, California became the first state to require any corporation with (i) a principal executive office in California and (ii) shares listed on a major U.S. stock exchange to include female directors on its board. Affected corporations must include at least one female director by the end of 2019 and, by the end of 2021, if the corporation has a board size of 6 or more directors, 3 must be female (otherwise 2 must be female). Noncompliant companies could be subject to a monetary fine. On July 1, 2019, California published a list of companies subject to the law and a list of companies in compliance, although the accuracy of these lists has been questioned. The next scheduled list update is March 1, 2020.

- New Jersey, Michigan and Massachusetts: Bills are pending in these states that would impose similar requirements as the California law.

- Other state initiatives: Colorado and Pennsylvania have non-binding resolutions that encourage board diversity.

Most recently, starting with the 2020 proxy season, ISS will recommend voting against the nominating committee chair (or other members as appropriate) at S&P 500 and/or Russell 3000 companies that do not have at least one female director. Before ISS issues a negative recommendation on this basis, ISS intends to consider mitigating factors and its latest benchmarking survey asked what those mitigating factors should be.

Given the trend line, which is only going in one direction, it has become increasingly important to consider a board's existing make-up and anticipated openings, as well as to have a strong pipeline of possible director candidates. This is an effort that is important regardless of diversity issues, given the need for directors who strike the right balance of skill sets, experiences and backgrounds.

Talking Points: 50 Practical Nuggets

By Katy Murray, Activision

1. **Prepare the Proxy Tables for All EOs Every Year**. If you have more than five executive officers, prepare the proxy tables for all of your executives as you prepare them for that year's NEOs. This is especially important for the Summary Comp Table, as you may need to report that information in future proxy statements, for individuals that ultimately become NEOs.

   But we find it helpful to do the GPBAT and PPUTT, as well, as we're often asked questions throughout the year about an executive's compensation that are easily answered by reference to the tables.

2. **Explain the "What" to Data Providers**. We attempt to regularly educate providers of the data underlying our proxy disclosure as to the disclosure requirements—e.g., to explain to payroll that we need information with respect to any cash compensation, even if it's not of the type that the payroll group, itself, considers to be "salary" or "bonus."

   Further, we regularly remind our data providers that we don't have insight into exactly what the scope of their reports. That is to say, we remind that them when we are asking for information (e.g., with respect to related party transactions), we are looking for all payments, worldwide (and may not know, for example, that the person from whom we are getting data only has access to North American data).

3. **Business Considerations Trump**. You are not obligated to do more than satisfy the SEC's disclosure requirements, even if you're penalized for not doing so by, for example, a shareholder advisory service. We are "dinged" every year for failing to disclose the specific goals underlying our annual bonus plan but feel strongly that it's not in our best interests to do so, notwithstanding.

4. **Leverage Others as "Perk" Gatekeepers**. We ask our payroll team, the individuals within our finance group responsible for reviewing and approve expense submissions by our executive officers and the administrative support team in our CEO's office (who, among other things, handle gifts made by the CEO) to flag potential perquisites before they are given to our executive officers, so we can consider the disclosure implications contemporaneously.

5. **You Can't Start Drafting Your Proxy Statement Too Early**. We get a Word readback of the proxy statement promptly after filing and start a draft for the next year's proxy statement right away, doing whatever changes we can right away. As painful as it is to do it, I'm always glad I did when the next proxy seasons gets started in earnest.

6. **Sync with Annual Report**. To tell the story of your executive compensation, it's helpful to have a summary of your corporate strategy, to demonstrate how the former drives towards the latter. When we draft our "corporate strategy" summary we begin with the letter to our shareholders in that year's annual report and draw the themes from there, mimicking the language to the extent possible.

7. **Independently Verify Information in D&O Questionnaires**. Do not rely on the questionnaires your directors and officers complete as your sole—or even primary—source of information for things like beneficial ownership, perks and related party transactions. We treat our D&O questionnaires as confirmation only. We provide a populated questionnaire which includes beneficial ownership information from Section 16 filings and our stock administration's files and perk information from our payroll files.

We review all expense reports from our executives for potential perks. We also ask a group of company employees which includes the CLP, CFO, CAO, head of IA, Corporate Secretary and individuals in Finance and Executive Comp to affirmatively sign off on what we believe to be the universe of perks provided to, and related party transactions with, executive officers, before filing the proxy statement.

8. **Have a Single Person Hold the Pen**. While it's tempting to divide the work of drafting the proxy statement, it's clear to a reader when that's done. The document is much more readable when a single person's choice of syntax, etc. is used throughout.

9. **Integrate Your Proxy Team & the Team Responsible for Compensation Committee Materials**. If the individuals in Legal and HR are not directly involved in preparing materials regarding executive compensation and other matters that will ultimately be disclosed in your proxy statement, a close working relationship with those who do prepare for Board meeting should be forged. As part of that, the proxy team should be asked to mock up disclosure with respect to anything that Compensation Committee is considering that may hit the proxy statement, so that the Compensation Committee can consider the disclosure implications while making the substantive decision.

10. **Don't Protest Too Much**. There will invariably be compensation decisions you will need to explain in your proxy statement that you know, or believe, will be viewed unfavorably by a shareholder advisory firm or one or more of your shareholders. While in no way should you try to hide the controversial decision, nor should you try to "over defend it." State your company's reasoning, and move on.

Talking Points: 50 Practical Nuggets

By Amy Wood, Cooley

1. **Human Capital Management as a Significant Investor Concern & the Need for Additional Disclosure (Including Board Oversight)**

According to the Sustainability Accounting Standards Board ("SASB"), human capital management "addresses the management of a company's human resources" as "key assets to delivering long-term value." According to BlackRock, human capital management is, among other things, "employee development, diversity and a commitment to equal employment opportunity, health and safety, labor relations, and supply chain labor standards."

The EY Center for Board Matters describes human capital management as "comprising a wide range of topics such as attracting, retaining, training and engaging the entire range of the workforce, the relationship of company culture to hiring and retention, and diversity and inclusiveness." Specific human capital issues may include addressing the changing definition of work for millennials, technology-driven displacement of workers, worker training and broader company efforts to address projected skills shortages.

Human capital management has become a significant concern to most institutional investors, and many have encouraged companies to provide more transparency on this topic. Ultimately, most investors want to know that *management* is making the most of human assets (i.e., the talent that drives innovation and growth) and how the *board* is overseeing human capital risks. State Street, for example, emphasizes that it does not believe it is the responsibility of the board to manage a company's culture (because that is the responsibility of senior management) or that there is a one-size-fits all answer for all companies.

However, State Street further emphasizes that human capital management is a material issue that must be addressed by companies and investors and when engaging with directors and management on corporate culture, State Street seeks to understand the following: whether the director(s) articulate the current corporate culture, what the board values about the current culture, what the board sees as strengths, how the corporate culture can improve, how senior management is influencing or effecting change in the corporate culture and how the board is monitoring the progress.

The March 2019 Recommendation of the Investor Advisory Committee Human Capital Management Disclosure provided that "[m]odernizing the Commission's framework for corporate reporting generally should reflect these facts, subject to the standard of materiality" and that while "there are wide range of potentially material [human capital] disclosures and ways to integrate that information into current reporting . . . issuers could be required to comply with a principles-based disclosure requirement asking them to detail their [human capital management] policies and strategies for competitive advantage and comment on their progress in meeting their corporate objectives."

2. **<u>Clearly Articulate Your ESG Strategy (Including Risks & Board Oversight of Strategy Execution & Formulation)</u>**

Companies should review the environmental, social and governance ("ESG") priorities of their shareholders and tell their stories in public disclosures, taking credit any for positive ESG initiatives. Boards should also identify material environmental and social sustainability issues relevant to the business. The SASB classification system can be quite helpful – it has 11 sectors that it subdivides into 77 industries and through industry working groups of companies, investors and intermediaries, it has identified what the material issues are for each sector, out of a list of 26 potential ESG issues.

State Street has been steadily calling on boards to incorporate material sustainability factors into a company's long-term strategy, including providing a framework to help boards think of the ways ESG risks might impact their businesses. State Street believes that over time, the SASB reporting framework will increasingly drive the ESG scores of companies and as a result, companies should begin to report their activities in accordance with SASB's framework.

In the meantime, State Street's framework reviews and categorizes company's according to three criteria: (1) has the company identified material environmental and social sustainability issues relevant to its business? (2) has the company assessed and, where necessary, incorporated the implications of relevant environmental and social sustainability issues into the company's long-term strategy? and (3) has the company adequately communicated its approach to sustainability issues and its influence on strategy?

3. **<u>Consider Incorporating ESG Metrics Into Pay Arrangements (And Be Prepared to Explain Why)</u>**

Consider whether it's appropriate to link a portion of executive pay to quantitative or qualitative environmental and/or social goals. Well-designed incentives can respond to investors' priorities as well as align management with the company's ESG strategy and reinforce a company's commitment to sustainability and belief that sustainability efforts can have both financial and nonfinancial results.

It may be that efforts to realize payoffs from relevant ESG initiatives do not fit neatly into annual or two- to three-year incentive plan timeframes. In those cases, it may be necessary to move beyond traditional targets and timeframes and tie awards to the milestones or behaviors expected of executives, in addition to the final results. To the extent that is the case, additional disclosure should be provided to explain the rationale for the ultimate metric(s) and performance period.

4. **<u>Know Your Investors' Overboarding Policies (And Address in the Proxy)</u>**

Investor policies on what constitutes director overboarding are continuing to evolve, at least in part due to a belief that the time commitment needed to effectively fulfill board duties has further increased in recent years. Until a few years ago, ISS and Glass Lewis deemed a non-director overboarded if he or she was on *more than six* public company boards; in 2017, both proxy advisory firms lowered their limits to deem a non-executive director overboarded if he or she was on *more than five* public company boards.

Over the last couple years, investors have been shifting toward an overboarding standard of *no more than four* public company boards and during the 2019 proxy season, there was an increase in significant opposition to the election of directors serving on more than four public company boards. This issue contributed to the highest levels of significant opposition to Russell 3000 director elections in 2019 seen since 2011.

Specifically, Vanguard announced in April 2019 a revised policy to vote against *executives who sit on more than two* public company boards and against *other directors who sit on more than four* public company boards during the 2019 proxy season. Several other institutions, including BlackRock, already had a policy with a limit of *two boards for public company CEOs* and *four boards for other directors*.

While Glass Lewis and ISS maintained their limits of five board seats for non-executive directors, other investors, such as CalPERS and Putnam also reduced their limits from five to four in 2019. As previewed in its 2019 policy survey, ISS is revisiting the appropriate upper limit on public company boards based on "the evolving views of some large institutional investors" and presumably Glass Lewis will also be considering further reducing its limit during its annual policy update process.

Companies should monitor their investors' overboarding policies, pay close attention to the proxy advisory firm policy updates for 2020 and determine whether any of their directors could be at risk under currently or newly applicable overboarding policies.

To effectively monitor this issue, companies should solicit information about other public company and private company board (particularly to watch for overboarding that may arise from board service on private companies anticipating an IPO) in annual D&O questionnaires and consider a policy that would require notice of changes in employment or directorships.

To the extent a director is overboarded under investor or proxy advisory firm policies, companies should provide comprehensive proxy disclosure to enable shareholders to evaluate the scope of an overboarded director's other commitments and his or her contributions to the company (e.g., specialized knowledge of the company's industry, strategy or key markets, the diversity of skills, perspective and background they provide) as well as other factors that explain how the director is effectively able to serve on the number of boards he or she serves.

In particular, Glass Lewis may not recommend against certain overboarded directors if the company provides that type of information and an adequate rationale for the director's continued board service. Glass Lewis also considers the size and location of the other companies where the director serves on the board, the director's board duties at the companies in question, whether the director serves on the board of any large privately held companies, the director's tenure on the boards in question, and the director's attendance record at all companies. These factors may be persuasive to Glass Lewis and certain investors; however, other institutional investors, such as Vanguard, will likely only make an exception if the director makes a public commitment to step down from other directorships.

5. **Explain How Your Performance Measures for Pay Align With Your Long-Term Strategy (Because Investors Are Becoming More Sophisticated)**

Although most companies now provide thoughtful disclosure regarding performance goals and the reasons for selecting specific performance criteria, it is not always apparent how such performance criteria align with the company's long-term strategy and creation of shareholder value.

Consider first presenting a brief description of the business as context for a specific discussion about how the compensation program is linked to corporate strategy. BlackRock's policy specifically states that it may vote against say on pay when they "determine that a company has not persuasively demonstrated the connection between strategy, long-term shareholder value creation, and incentive plan design" and State Street's policy specifies that it seeks, among other things, "adequate disclosure of . . . alignment of pay structures with shareholder interests as well as with corporate strategy."

Without explicit disclosure describing the relationship between performance criteria and corporate strategy, shareholders may not understand the depth of decisions.

6. Consider Clawbacks That Are Broader Than Restatements

The clawback provision in the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") is, in most ways, broader than the mandate of the Sarbanes-Oxley Act of 2002 ("SOX"). Both requirements apply in the event that a company is required to prepare an accounting restatement to correct an error that is material to previously issued financial statements, but under the Dodd-Frank Act there is no culpability on the part of the company or the executive necessary to trigger a clawback (while SOX requires that the company's material noncompliance be the result of its misconduct, although not necessarily misconduct of the executive subject to the forfeiture).

The SEC issued a proposal to implement the Dodd-Frank Act clawback provision in July 2015, but final rules have not yet been issued. In the meantime, the proxy advisory firms and certain investors have continued to express interest in companies voluntarily adopting clawback policies and in some cases, have proposed terms extending beyond what is required under the Dodd-Frank Act.

For example, BlackRock's policy "favor[s] recoupment from any senior executive whose behavior caused direct financial harm to shareholders, reputational risk to the company, or resulted in a criminal investigation, even if such actions did not ultimately result in a material restatement of past results" and CalPERS provides that "[c]ompanies should develop and disclose policies to recapture compensation made to executives during periods of fraudulent activity, inadequate oversight, misconduct including harassment of any kind such as sexual harassment, or gross negligence, which impacted or is reasonably expected to impact financial results or cause reputational harm."

Further, for 2019 Glass Lewis updated its guidelines to clarify that it is "increasingly focusing attention on the specific terms of recoupment policies beyond whether a company maintains a clawback that simply satisfies the minimum legal requirements" and goes to on to say that "where a company maintains only a bare-minimum clawback, the absence of more expansive recoupment tools may inform our overall view of the compensation program."

Based on uncertainty about the adopting and timing of Dodd-Frank Act rules, feedback from investors and boards' views on good governance and appropriate risk mitigation, companies are increasingly implementing clawback policies that extend beyond financial restatements and reconsidering whether fault is required in the case of financial restatements.

In 2019, two clawback policy-related shareholder proposals passed for the first time since 2013. One of the targets—FleetCor Technologies—had recurring say-on-pay failures in recent years and lacked a clawback policy for cases of misconduct or a financial restatement. The second target—Mallinckrodt—who was asked to annually disclose any recoupment of executive incentive pay, was part of a package of proposed reforms related to the company's manufacture of opioids.

A similar resolution filed at Johnson & Johnson received 46.1% support. A clawback resolution at Mylan also registered majority backing in an unofficial tally after the proposal was included as a discussion only item given that the proponent did not have standing to submit the proposal under Dutch law or the company's articles).

7. **Beware of Pay-for-Performance Problems Exacerbated by Equity Awards Being Approved/Shares Being Determined Prior to Grant Date**

The *grant date fair value* of an annual equity award can be significantly higher than the *value targeted* for grant by the compensation committee if there is an increase in the stock price in the period between the approval/share number determination date and the grant date.

It is important in this scenario to explain the reason for the difference in timing between compensation committee approval/share determination and the grant date and the value targeted by the compensation committee. A significantly higher value can lead to a quantitative pay-for-performance disconnect in the proxy advisory firms' quantitative models and resulting heightened qualitative review, which increases the likelihood of a negative recommendation for say on pay

8. **You Likely Address the "Why" in Your CD&A - But Don't Forget to Also Address the "How"**

Most companies provide good CD&A disclosure about the factors considered in determining compensation decisions, but fall short explaining to investors and proxy advisory firms *how* specific forms of compensation are structured and implemented to reflect the company's and each individual's performance.

BlackRock's policy specifically provides that "[c]ompanies should explicitly disclose *how* incentive plans reflect strategy and incorporate drivers of long-term shareholder value; this discussion should include the metrics and time frames by which shareholders should assess performance" and Vanguard's policy specifically calls for understating *how* the compensation committee sets goals for measures that align with long-term company strategy, *how* it determines that the goals are set at rigorous performance levels, *how* it seeks to align executive pay with the company's performance relative to peers and the market and *how* it selects the company's peer group.

9. Get to Really Know the EVA Results Displayed in Your ISS Report (And Consider Additional Disclosure Accordingly)

In February 2018 ISS acquired EVA Dimensions LLC, a business intelligence firm that measures and values corporate performance based on the Economic Value Added ("EVA") framework. EVA measures, analyzes, projects, values and discounts a firm's underlying economic profit rather than its bookkeeping profit.

ISS provided EVA results for information purposes only in 2019 reports; ISS did not incorporate EVA into its quantitative pay-for-performance screen for 2019. Instead, it continued to use the financial performance assessment screen based on GAAP/accounting performance measures. However, ISS noted that it would continue to explore future use of EVA measures to add additional insight into a company's financial performance.

ISS currently has *seven* white papers posted on its website as well as a link to a webcast touting the benefits of EVA and its 2019 policy survey confirms that ISS plans to incorporate EVA metrics into the secondary financial performance assessment screens for the U.S. pay-for-performance model.

Companies should review the EVA results in their 2019 ISS reports to prepare for ISS incorporating EVA metrics into the 2020 quantitative pay-for-performance screen. Even though EVA is only anticipated to be part of the secondary quantitative pay-for-performance screen and the quantitative screen is used to determine where further qualitative review is necessary (which then may or may not result in a recommendation to vote against say on pay), it will be important to further understand these metrics and consider potential outcomes, as well as any additional disclosure that could be helpful in the event the ISS screen triggers a heightened review of compensation program.

10. Consider the Impact of Stock Buybacks on Your Pay Performance Metrics (And Whether Additional Disclosure is Prudent)

If incentive plans contain performance metrics that can be affected by share buybacks, such as EPS and potentially ROE, ROA, and ROIC, companies should be prepared to explain the reason the compensation committee determined such metrics were appropriate. Expanding the disclosure of performance measures used, the values associated with those measures, and how they are expected to drive performance is important to avoid unwanted scrutiny.

If a share buyback program could impact performance metrics and that is addressed at the time the plan is adopted (e.g., by preserving the ability of the compensation committee to use negative discretion to reduce awards based on appropriate considerations), those terms should be fully described in the CD&A and companies should explain the reasoning behind such choices.

Companies should also consider any investor policies on point, such as State Street which categorizes “[c]hanging pay drivers in C-Suite compensation plans by incorporating earnings per share (EPS) as the primary determinant of CEO compensation, which we believe can overly focus management on short-term stock performance and often favors activities such as share buybacks over allocating capital for the long term” as a red flag.