Client Update
2017 Public Company Compensation Checklist: A Look at What's New, Interesting (and Uncertain) for 2017

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It's that time again. As U.S. public companies and their compensation committees assess their 2017 compensation programs and prepare their proxies, this checklist provides an overview of key matters to consider now, and uncertain areas where a wait-and-see approach may be advisable.

UPDATED ISS PROXY GUIDELINES

In late 2016, proxy advisory firm Institutional Shareholder Services (ISS) released its updated FAQs regarding U.S. public companies' executive compensation practices.[1] Although most of the Q&As in the FAQs remain the same as last year, the latest FAQs feature several new policies and clarifications. When evaluating their existing compensation practices, considering the adoption of a new plan or reviewing their peer group, companies should consider these updated ISS guidelines:

- ***New "Relative Pay and Financial Performance Assessment" for the Russell 3000E Index***. ISS will evaluate a company's performance relative to peers on

[1] In the compensation arena, ISS reviews a company's proxy disclosure and advises investors as to how to vote. ISS maintains a list of "problematic" compensation practices that may lead it to recommend a "no" vote to investors with respect to a say-on-pay vote or on a compensation plan approval or to withhold their vote for one or more directors. Individual compensation practices that ISS views as objectionable (but not necessarily problematic) are taken into account in ISS' scoring methodology and do not necessarily lead ISS to recommend a "no" vote on say-on-pay or a compensation plan unless a number of negative factors in ISS' quantitative and qualitative assessment lead ISS to an overall "no" vote recommendation. If there is no say-on-pay or compensation plan proxy vote in a given year, ISS may recommend a vote against the chair of the compensation committee or all of the compensation committee members.

total shareholder return (TSR) and up to six new financial metrics assessed over three years—return on equity; return on assets; return on invested capital; revenue growth; EBITDA growth; and cash flow (from operations) growth—with the applicable metrics selected based on industry or business. This new assessment will be used to compare long-term CEO pay and financial/operational performance relative to the ISS-defined peer group for a subject company as part of ISS' "qualitative" review of compensation practices, and will not be rolled into its quantitative benchmarking.

- ***Updated List of "Problematic Pay Practices."*** ISS now includes as problematic compensation practices the following new items that may lead ISS to recommend a "no" say-on-pay vote or, if applicable, a "no" vote on a plan approval proposal:
    - employment contracts with multi-year guarantees for salary increases, non-performance based bonuses, or equity compensation;
    - CEO packages with excessive "make-whole" provisions lacking sufficient rationale and problematic termination-related equity vesting provisions;
    - abnormally large bonus payouts without justifiable performance linkage or proper disclosure;
    - pension and retirement plan payouts (i) covering years of service not worked that result in significant benefits provided in new arrangements or (ii) that include long-term awards in the pension calculation;
    - excessive change-in-control payments upon termination in connection with performance failure and liberal change-in-control definitions which could result in payments without an actual change-in-control;
    - dividends paid on unvested performance shares; and
    - excessive differential between CEO pay and that of the next highest-paid name executive officer.

These factors are in addition to ISS' existing list of problematic compensation practices: (i) repricing or replacing of underwater stock options/stock appreciation rights without prior shareholder approval; (ii) excessive perquisites or tax gross-ups for former and/or retired executives, including home loss buyouts; (iii) change-in-control agreements that provided for payments exceeding three times base salary plus target/average/most recent bonus; (iv) change-in-control payments without loss of job or substantial diminution of duties; and (v) excise tax gross-ups on change-in-control payments.

- ***Frequency of Say-On-Pay Votes; Consequences of No-Vote.*** ISS will generally recommend in favor of annual say-on-pay votes, which it believes

provide the highest level of accountability and clearest channel for shareholder communication. This is in line with its 2016 Policy Survey, which found that two-thirds of all investor respondents prefer annual say-on-pay votes. The updated FAQs further clarify that ISS will generally recommend a vote against the compensation committee chair (or the full committee, as appropriate) if there is no say-on-pay or say-on-pay frequency vote on the ballot where one would otherwise be expected, and there is no explanation for the omission.

- ***Negative Evaluation of Single-Trigger Vesting of Equity Awards in a Change-in-Control.*** ISS considers automatic full vesting of equity awards upon a change-in-control to be a poor practice and factors this into its overall evaluation of a company's compensation practices. The updated FAQs emphasize that, in ISS' view, vesting acceleration should require both a change-in-control and qualifying involuntary termination.
- ***Non-Employee Director Pay.*** ISS specifically highlights that the presence of a meaningful limit on annual director pay is considered a positive feature of a company's director compensation practices (see discussion below).

SAY-ON-PAY FREQUENCY VOTE

The Securities and Exchange Commission (SEC) rules require U.S. public companies to conduct a say-on-pay frequency vote every six years.[2] Many U.S. public companies held their first frequency vote in 2011 and will be required to hold their next frequency vote at their 2017 annual meetings. This vote is required even if a public company is already conducting its say-on-pay vote annually and must allow shareholders to approve a choice of holding a say-on-pay vote every year, two years or three years. In line with the practice of the vast majority of U.S. public companies, ISS reports in its recent FAQs that it will recommend in favor of annual say-on-pay votes. A biennial or triennial say-on-pay vote provides investors fewer opportunities to voice any concerns they may have regarding compensation practices and may result in greater ISS scrutiny.

NON-EMPLOYEE DIRECTOR COMPENSATION

Court opinions in recent years highlight the importance of establishing a meaningful process for determining the compensation they award to themselves.[3] To reduce the risks of shareholder litigation relating to director

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[2] Different rules apply to emerging growth companies.

[3] *See* "Facebook Settles Director Compensation Litigation," Debevoise & Plimpton LLP Governance Round-up, Issue 4, March 2016 at http://www.debevoise.com/insights/publications/2016/03/governance-round_up-issue-4.

compensation, companies should consider including a share limit for nonemployee directors in their equity plan (which can be established above current compensation levels to allow for future increases), or consider adopting a separate plan with its own share reserve for nonemployee directors. In each case, companies would be better served to have shareholders approve these limitations on director compensation. As noted above, ISS considers a meaningful limit on annual director pay to be a positive feature of a company's director compensation practices. In the absence of a shareholder-approved director compensation limit, boards should conduct a thorough process for setting director compensation to support a determination that the compensation is fair.

CONFIDENTIALITY AND NONDISPARAGEMENT CLAUSE REVIEW

In recent years, the SEC (pursuant to authority granted by the Dodd-Frank Act) has cracked down on public companies for provisions in severance and other employee agreements that impede or discourage employees from reporting potential legal violations to the SEC and other governmental agencies. The fate of this whistleblowing enforcement activity under the incoming Trump Administration remains unclear. However, companies should take this opportunity to review their severance agreements, employment release forms, employment agreements, confidentiality agreements and employee handbooks to ensure that (i) any confidentiality and nondisparagement clauses include a carve-out for SEC and other agency communications and (ii) these agreements do not require employees to waive rights to collect whistleblower awards for reporting securities law violations.

CEO PAY RATIO DISCLOSURE

The SEC's final CEO pay ratio rules, mandated by the Dodd-Frank Act, require U.S. public companies to disclose the ratio between the CEO's annual total compensation and the median annual total compensation of all company employees (other than the CEO). Although the SEC's rules are not effective until fiscal years beginning on or after January 1, 2017 (and the rule is on some congressional lists for repeal), companies should begin this year to internally model their calculations of the median employee's compensation and mock up their CEO pay ratio disclosure. In October 2016, the SEC issued five new compliance and disclosure interpretations (C&DIs) providing additional clarification on identifying and calculating the annual compensation of the median employee.

WHAT MAY BE COMING . . .

In the last two years, the SEC issued a number of proposed compensation rules under the Dodd-Frank Act, the fate of which remains uncertain, especially in the

current political landscape. The incoming Trump Administration has signaled a desire for deregulation, and that many provisions of Dodd-Frank may be repealed or revisited and, although we believe a complete repeal of the Dodd-Frank Act by Congress is unlikely to occur, we think the prospects for substantial changes are good.[4] The below proposed rules, along with the final CEO Pay-Ratio rule discussed above, would likely be impacted by a repeal of some or all of the Dodd-Frank Act or any action (or inaction) by the SEC under the Trump Administration.

- ***Clawbacks***. The SEC issued proposed rules in July 2015 that would require national securities exchanges to establish listing standards requiring companies to develop, implement and disclose a policy providing that, in the event of an accounting restatement to correct a material error, the company will recover from its current and former executive officers, excess incentive-based compensation received in the three years preceding the restatement. Under the proposed rules, recovery would be nondiscretionary and without regard to misconduct or responsibility for the error. Even in the absence of SEC regulation, a clawback policy is generally considered an important tool to more properly align management incentives with performance. Many companies have already adopted clawback policies, and we expect this trend to continue, whether or not the SEC adopts final rules.
- ***Pay vs. Performance Table***. The SEC published proposed rules in April 2015 to require companies to include a new Pay-versus-Performance table and related disclosure that shows and describes the relationship between executive compensation "actually paid" and company financial performance.
- ***Employee and Director Hedging Disclosure***. The SEC published proposed rules in February 2015 requiring proxy disclosure as to whether the company allows any employee, officer or director to engage in any transaction to hedge or offset any decrease in the market value of equity securities held by the individual.
- ***Financial Institution Incentive Compensation***. In the spring of 2016, the SEC and other U.S. federal financial regulators issued proposed regulations under the Dodd-Frank Act that restrict certain incentive compensation practices at banks, broker-dealers, investment advisors and other financial institutions covered by the regulations.

Companies should be aware of these proposed regulations, but given the uncertainty of the current regulatory landscape, a watch-and-wait approach may,

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[4] *See Debevoise & Plimpton Explores the Outlook For Financial Reform Under Trump*, http://clsbluesky.law.columbia.edu/2016/12/21/debevoise-plimpton-explores-the-outlook-for-financial-reform-under-trump/.

for many clients and depending on the regulation, be more efficient than incurring the costs of compliance at this time. If clients have questions about whether or how to prepare for these pending regulatory changes, please do not hesitate to contact us. As usual, we will update our clients of any significant legal and regulatory changes to compensation that are coming down the pike.

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Please do not hesitate to contact us with any questions.