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PLANNING FOR THE 2013 ANNUAL MEETING AND REPORTING SEASON: PART 1

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As companies prepare for the 2013 annual meeting and reporting season, an overview of the corporate governance and disclosure matters that companies should consider as they draft this season's disclosure materials is provided below. Some of these matters are requirements of new Dodd-Frank Act rules and others are based on lessons gleaned from the 2012 annual meeting and reporting season.

The items discussed below do not apply equally to all companies. Whether a particular item applies and how a company should address it will depend on, among other things, the company's business, shareholder base and executive compensation plans and programs.

Incorporate lessons from 2012 say-on-pay results

In the 2012 proxy season, approximately[1]:

- 69 percent of say-on-pay proposals passed with more than 90 percent support;
- 21 percent passed with between 70.1 percent and 90 percent support;
- 7 percent passed with between 50 percent and 70 percent support; and
- 3 percent (61 companies) obtained less than 50 percent support.

While the overall proportions generally are similar to last year's results, it should be noted that in 2011 only 37 say-on-pay proposals obtained less than 50 percent support.

Based on the insights gathered from the 2012 proxy season, there are a number of considerations companies should make as they make compensation decisions and plan for the related disclosure. It is important to note, however, that while some of these recommendations are based on the views of Institutional Shareholder Services (ISS), Glass Lewis and other advisory firms, their views are not the only relevant factors (or perhaps not even one of the most relevant factors) when making these decisions.

In some cases, the interests of the company and its shareholders may best be served by making a decision that is contrary to the views of the advisory services. This is a complex and nuanced area with a tremendous amount of media scrutiny, and companies should consult internal and external advisers as early in the process as possible in order to make the most appropriate and strategically intelligent decisions with respect to their executive compensation programs.

As a first step, companies should analyze the reports issued by ISS, Glass Lewis and other advisory firms in 2012 with respect to the company's 2011 executive compensation, in order to better understand the concerns of those firms and to consider addressing these concerns. Companies should also consider any feedback they received from their shareholders. If a company makes changes based on the concerns raised, the company will be viewed favorably by shareholders, ISS and other advisory firms.

Next, any such changes should be described in some detail in the 2013 proxy materials and explicitly linked to the concerns that were raised. Even if changes are not made in response to any concerns raised, companies should consider including a description of the concerns, as well as a declaration that the concerns were reviewed and considered, in the 2013 proxy materials.

Companies also should consider conducting a shareholder outreach initiative to discuss any perceived or noted concerns regarding compensation plans or decisions. ISS made clear that it expects any company whose say-on-pay proposal failed (or passed without extremely strong support) to conduct shareholder outreach efforts and to describe these efforts thoroughly in the next proxy statement.

Companies in this situation should engage their largest shareholders to solicit reactions to the company's existing executive compensation program, as well as views regarding any concerns raised by ISS and others. Such outreach could include making presentations via teleconference, providing written materials regarding the company's current program and the proposed changes or holding in-person meetings. Of course, companies should be mindful of SEC rules and regulations, such as Regulation FD and the proxy filing requirements that may apply to these outreach efforts.

Finally, companies also should consider whether their proxy materials should be revised to better "tell the story" of the company's executive compensation programs in a coherent and compelling manner. Companies should consider using charts, graphs and other reader-friendly tools to achieve maximum clarity of the company's message. One example of a recent change that a number of companies have made is to include a summary section in the proxy statement.

These summaries are generally included in the beginning of the proxy statement and highlight key points about the disclosures, such as the date, time and location of the meeting, the agenda for the meeting, the nominees to the board (including summary biographical information for each nominee), business highlights and key compensation elements, features and decisions. It is important to begin the proxy drafting process as early as possible since there are a number of individuals, including representatives from legal, human resources, finance, stock administration and other departments, as well as external legal counsel, compensation consultants and accounting firms, who may need to be involved in the preparation of proxy materials.

In the face of ISS "against" recommendations during the 2012 proxy season, many companies issued supplemental filings as a rebuttal. In 2013, companies should take advantage of the knowledge gleaned from these supplemental filings in order to both preemptively address known ISS concerns with respect to 2012 proxy disclosures and to make effective decisions with respect to 2013 compensation. Some ideas to consider are as follows:

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Realizable pay: Many supplemental filings focused on the perception by companies that ISS had materially overstated CEO pay by focusing on the grant date value of awards. For example, including the full grant date value of a stock option ignores the fact that the option has no actual value unless the company's stock price increases following the date of grant (which would generate gains for stockholders as well). At an extreme, stock options that expire "out of the money" (that is, if the stock price does not increase from the date of grant) would, in fact, expire with no realized value.

Companies have noted that ISS's historical methodology allocates to one year (the year of grant) a lump sum amount based on the option's grant value for accounting purposes. This is an amount that potentially is both vastly overstated as well as allocated in a lump sum to a single year prior to the year (if any) that any value is, or can be, realized.

To illustrate these arguments, companies often have presented charts showing realizable pay based on various assumptions. ISS made a brief, general statement in its 2013 policy update that for "large cap" companies it will add consideration of realizable pay to its research reports. At this point, the only details provided by ISS are that realizable pay for a particular performance period will consist of the value of cash and equity-based awards "made" during the performance period being measured according to the following: (i) for actual earned awards, the actual equity award value using the stock price at the end of the period (or cash value, presumably); and (ii) for ongoing awards, the target value, calculated using the stock price at the end of the performance measurement period.

In addition, stock options and stock appreciation rights will be subject to revaluation using the remaining term and updated assumptions. Companies should consider whether and to what extent additional disclosure regarding realizable pay will assist in explaining company pay practices, while continuing to monitor how realizable pay is being evaluated as ISS begins issuing reports under its new policies.

Peer groups: One of the most controversial issues during the past proxy season was the degree to which the peer groups chosen by ISS were different from the peer groups chosen by companies. Company-chosen peer groups tend to be selected based on nuanced analysis that takes into account companies with which the company competes for market share and executive talent. ISS, on the other hand, selected peer groups based on an industry classification code, and in some cases the ISS-selected peer group shared only one or two companies in common with the company-chosen peer group.

In its 2013 policy updates, ISS indicated that going forward, and in order to address concerns about the composition of its selected peer groups, it will take into account a company's self-selected peer group when identifying companies to include in the ISS-selected peer group, primarily focusing on whether there are additional Global Industry Classification Standard (GICS) codes that may be relevant.

ISS has stated that its new methodology will prioritize peers that maintain the company near the median of the peer group, are in the company's peer group and also have chosen the company as a peer. In addition, while ISS has indicated that it will continue to use the GICS system to choose peers, its updated selection process will focus initially on the eight-digit GICS sub-code level in order to more precisely target the industry of potential peer group members. As a result, the average company will have more than 80 percent of its peers selected from its eight-digit GICS group or the eight-digit GICS groups of its self-selected peers. No peers will be chosen based on the more general two-digit GICS code.

By contrast, under the methodology used by ISS in 2012, only 40 percent of peers were chosen based on an eight-digit GICS code and 12 percent were chosen based on a two-digit code. ISS has also indicated that it will slightly relax its requirements relating to size of companies considered, particularly when constructing peer groups for very large and very small companies, and will use assets instead of revenue for certain financial companies. ISS notes that while under the 2012 methodology 82 percent of peer groups resulted in the subject company falling within 20 percent of the peer group median size by revenue, that number rises to 90 percent under the 2013 methodology.

It is hoped that ISS's changes in peer-group selection methodology will address previous concerns about disparity with company-selected peers. Companies should still consider providing detailed information regarding their peer-selection process, in order to provide meaningful context for shareholders to make decisions regarding say-on-pay proposals.

Bonus disclosure: A number of negative ISS comments in 2012 addressed disclosure of incentive compensation. ISS indicated that it views vague descriptions of the manner in which annual and long-term bonuses are calculated as problematic, and companies should take a fresh look at whether the narrative description of such plans is detailed sufficiently. In addition, if the same performance measurement (e.g., earnings per share or EBITDA) has been used for more than one plan, the company should provide its reasoning for that decision, since the use of the same measure across plans was commented on negatively by ISS in a number of its reports.

A company may wish to consider diversifying the measures used in its incentive plans so as not to give the impression that individuals are being compensated twice for the same performance. In addition, companies should consider whether their incentive plans have multiple performance measures but permit payout if only a subset of those measures are met. ISS was critical of such arrangements during this past proxy season, particularly when the subset of measures that could trigger payout were qualitative rather than quantitative in nature.

Finally, it should be noted that ISS has not hesitated to analyze the actual payment thresholds and measurements in plans and deem them insufficiently challenging. Companies should take care to use analytical rigor in setting goals and provide a description of the process via which any payment thresholds were set.

Equity awards: ISS, despite many complaints by companies in their supplemental filings, does not consider stock options to be performance-based pay, and a large grant of stock options can skew dramatically the ISS determination of CEO pay in the year of grant. Furthermore, equity-based awards with time-based (rather than performance-based) vesting schedules are viewed extremely negatively by ISS, particularly when they comprise all or substantially all of the awards made under a company's equity award program. Companies should keep this fact (among other relevant factors) in mind in considering the terms of future grants.

Total shareholder return: ISS considers total shareholder return (TSR) to be the most important measure of a company's performance in determining whether there is a "pay for performance disconnect." A number of companies argued strongly against using a single measure in this manner. If a company believes that measures other than TSR are more relevant to its shareholders – such as quality of assets held (in the case of financial institutions), safety (in the case of industrial companies), or low volatility and consistent dividends (in the case of utilities) it should discuss this point in the CD&A to provide shareholders with that context.

Pay disparity: ISS indicated to a number of companies that it views a significant disparity between the pay of the CEO and the other executive officers to be problematic because it suggests inadequate succession planning and may impact executive morale. Companies with significant pay disparity should consider providing disclosure regarding the reasons for the disparity and a general description of any succession planning processes in order to show that the company has considered the issue.

Retention bonuses: Based on ISS reactions during the 2012 proxy season, companies providing retention bonuses, stay bonuses or similar awards, should provide a detailed explanation of how it was determined that such an award was appropriate, the conditions under which it was to be paid and any other relevant information.

CEO transitions and tenure: For companies that have gone through a CEO transition, companies should consider providing detailed disclosure concerning the rationale for any payments made to the exiting CEO and any special payments or grants made to the new CEO in connection with the transition, together with any relevant factors considered in making any of their payments and grants. Conversely, companies with a long-tenured CEO who is highly compensated should consider highlighting the CEO's years of experience.

Excise tax gross-ups: ISS reserves its most negative comments for "golden parachute" excise tax gross-ups in new or renewed agreements and arrangements. The inclusion of such a provision can be sufficient on its own to draw a negative vote recommendation. In at least one case, the rescinding of the provision was sufficient to trigger a change in the ISS voting recommendation to "for." While most companies are well aware of the issue in the context of new arrangements, they should be careful to monitor the renewal or extension of existing arrangements, without the elimination of any existing provision for an excise tax gross-up.

Corporate performance: A decline in corporate performance in and of itself is not sufficient to trigger a negative recommendation if pay is decreased, for example by exercising discretion to decrease or eliminate a bonus payout or changing the compensation benchmarking percentage to something lower than 50 percent. ISS provided a "for" recommendation in some cases of poor company performance when accompanied by lower compensation.

In some circumstances, ISS provided an "against" recommendation where performance was excellent but pay was too high even given that performance. Accordingly, when making decisions for 2013, companies should consider, as always, the relationship between compensation and the company's historical and predicted performance to avoid the perception of a disconnect.

Ensure compliance with new proxy disclosure rules concerning use of compensation consultants and related conflicts of interest

The SEC adopted a new disclosure requirement in June 2012[2] that is applicable to any proxy or information statement for an annual meeting of shareholders (or a special meeting in lieu of the annual meeting) at which directors will be elected occurring on or after Jan. 1, 2013. This new disclosure requirement is generally triggered when a compensation consultant is identified in a company's disclosures because it plays a role in determining or recommending the amount or form of executive and director compensation and that role "has raised any conflict of interest." In those situations, companies will be required to disclose the nature of the conflict and how the conflict is being addressed in the proxy or information statement.

The new disclosure rule does not define "conflicts of interest" and does not specifically dictate the information that a company would be required to provide as to the nature of the conflict or how the conflict is being addressed. The new rule does, however, include an instruction requiring that the following six factors, at a minimum, be considered when determining whether a conflict of interest exists:

- the provision of other services to the company by the person that employs the compensation consultant, legal counsel or other adviser;
- the amount of fees received from the company by the person that employs the compensation consultant, legal counsel or other adviser, as a percentage of the total revenue of the person that employs the compensation consultant, legal counsel or other adviser;
- the policies and procedures of the person that employs the compensation consultant, legal counsel or other adviser that are designed to prevent conflicts of interest;
- any business or personal relationship of the compensation consultant, legal counsel or other adviser with a member of the compensation committee;
- any stock of the company owned by the compensation consultant, legal counsel or other adviser; and
- any business or personal relationship of the compensation consultant, legal counsel, other adviser or the person employing the adviser with an executive officer of the company.

These six factors were adopted by the SEC as part of the rules that required the national securities exchanges to amend their listing standards to address the role of compensation committees and their advisors, as more fully described below.

Compensation committees should consider whether their existing relationships with any compensation consultants may require disclosure under the new rule and, if so, whether a conflict of interest exists and how any conflict of interest is being addressed. Companies will then need to determine the disclosures required under the new rules. Although not required, companies may want to disclose that they reviewed these relationships and did not identify any conflicts.

Comply with IRC Section 162(m)

Internal Revenue Code Section 162(m) generally limits a public company's deduction for compensation paid to its chief executive officer and its next three most highly compensated officers (excluding the CFO) to $1 million each per year. Performance-based compensation (PBC), however, or compensation paid pursuant to a plan or other arrangement and is only payable upon the attainment of objective performance targets set in advance by a committee of two or more outside directors based on shareholder approved performance goals, is not subject to the $1 million cap.

Stock options and stock appreciation rights will constitute PBC without satisfying the otherwise applicable rules under Section 162(m) if (i) they are granted by outside directors (as that term is defined in the rule and explained more fully below) under a shareholder-approved plan that contains a limit on the number of awards that an individual can receive in any specified period and (ii) the grants have an exercise price that is not less than the fair market value of the stock subject to the award on the grant date.

Shareholder reapproval of Section 162(m) plans approved in 2008 or earlier. Importantly, the Section 162(m) regulations require that shareholders reapprove their performance goals every five years with respect to which PBC is paid. This means that companies that obtained shareholder approval of such goals in 2008 or earlier must resubmit their goals for shareholder approval in 2013. This five-year re-approval requirement does not apply to stock options and stock appreciation rights. Many public companies grant performance-based equity awards, however, such as restricted stock or restricted stock units, under the same equity incentive plan adopted in 2008 or earlier and used for stock option and stock appreciation right grants.

Unless a company's equity incentive plan's performance goals are reapproved in 2013, future performance-based grants of restricted stock or restricted stock units under the plan will not qualify as PBC under Section 162(m). Likewise, performance goals applicable to cash bonus awards intended to qualify as PBC under Section 162(m) (which awards may be authorized under omnibus incentive plans or paid under separate plans) must also be reapproved every five years.

Consider adopting Section 162(m) compliant plans. Companies intending to compensate executives with cash bonuses or equity-based compensation other than options and stock appreciation rights should consider adopting plans designed to comply with the requirements of Section 162(m) and submitting them to shareholders for approval in 2013. If a company is submitting other option equity incentive plan amendments to shareholders for approval in 2013, it should consider adding provisions sufficient to qualify other cash bonuses and equity compensation payable under the plans as PBC under Section 162(m).

Review outside director status. Compensation only qualifies as PBC if it is awarded and administered by outside directors, generally defined as board members who are not employees or current or former officers and who do not receive remuneration other than director compensation from the company (directly or as paid to entities of which such directors are employees or owners), unless it qualifies as "de minimis remuneration" under narrow and complex rules. Public companies should make certain at least annually that the directors administering their PBC plans continue to qualify as outside directors.

Review status of grandfathered plans. Under certain circumstances, compensation plans that are effective before a company becomes publicly held are subject to special transition rules that defer compliance with Section 162(m) for between one and three years after the company becomes publicly held, depending on whether the company becomes public through an initial public offering, spin-off or otherwise. Adoption of material amendments to such grandfathered plans can shorten the transition period. Companies that went public in 2012 or earlier should check to see whether compliance is now required for 2013 and thereafter.

Consider potential impact from final revised listing standards related to compensation committees and advisors

On January 11, 2013, the SEC approved the revised listing standards adopted by the New York Stock Exchange (NYSE) and the Nasdaq Stock Market (Nasdaq), which largely track the SEC's rules requiring the exchanges to revise their standards as mandated by new Exchange Act Section 10C(c)(2). Additional information about the revised listing standards is available on the Skadden website.

The revised listing standards address (i) independence requirements for compensation committee members, (ii) the authority and responsibility for the selection, compensation and oversight of advisers to the compensation committee, and (iii) factors to be considered in evaluating the independence of advisers to the compensation committee.

The final listing standards require that the compensation committees of companies subject to the standards:

- may, in their sole discretion, retain or obtain the advice of a compensation consultant, independent legal counsel or other adviser;
- shall be directly responsible for the appointment, compensation and oversight of the work of any compensation consultant, independent legal counsel or other adviser retained by the compensation committee; and
- may select a compensation consultant, legal counsel or other adviser to the compensation committee only after taking into consideration the same six factors that the companies should consider when determining whether a conflict of interest exists under Regulation S-K Item 407(e)(3)(iv) (as described above).

Companies also are required to provide for appropriate funding, as determined by the compensation committee, for payment of reasonable compensation to a compensation consultant, independent legal counsel or other adviser retained by the compensation committee.

A company must comply with the exchange listing standards' provisions regarding independence of compensation committee members by the later of the company's first annual meeting after Jan. 15, 2014, or Oct. 31, 2014. The exchange listing standards relating to authority of the compensation committee to retain advisers and review the independence of advisers to the committee under the factors set forth in the standards must be complied with by July 1, 2013.

In light of these deadlines, companies that are required to comply with the exchange listing standards and their compensation committees should consider the revised listing standards to identify any changes to their practices and procedures that may be necessary to comply with the final listing standards. For instance, compensation committees should implement processes with their current or prospective advisers to elicit the information necessary to consider the factors the exchanges have listed regarding potential conflicts of interest, in time to satisfy the July 1, 2013, deadline. Likewise, the final exchange listing standards will necessitate revisions to most companies' compensation committees' charters to address the final standards, which should be adopted before July 1, 2013.

Brace for litigation

Companies should be aware of the recent wave of lawsuits alleging breaches of fiduciary duties by management and directors in connection with compensation-related decisions. More than 20 of these suits have been brought to date, alleging deficient disclosure with respect to compensation-related proxy proposals and seeking to enjoin the company's annual meeting until supplemental disclosures are made. These lawsuits primarily target proposals to increase the amount of shares reserved for equity compensation plans and advisory votes on executive compensation (say-on-pay). There have also been a handful of suits relating to proposals seeking to amend certificates to increase the total number of authorized shares. Additional information about these lawsuits is available on the Skadden website.

Although there is no single approach to avoiding these lawsuits, companies should be aware of this threat of litigation and determine whether proactive disclosure with respect to any equity compensation plan proposals may be warranted. For example, several of these lawsuits allege that the dilutive effect of the equity plan proposal under consideration was not properly disclosed, an allegation which may be addressed via fulsome disclosure regarding the dilutive impact of a requested increase in the number of shares reserved under an equity compensation plan. As always, companies should also pay particular attention to the requirements of Items 402 and 407 of Regulation S-K and Item 10 of Schedule 14A to ensure full compliance with those rules.

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[1] Percentages follow the (For/(For + Against + Abstain)) formulation and have been rounded to the nearest percentage.

[2] Item 407(e)(3)(iv) of Regulation S-K.

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