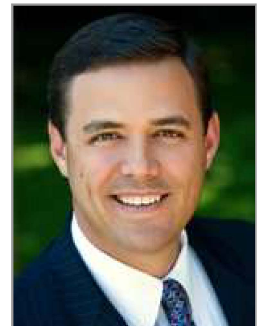
2019 Annual Meeting And Reporting Considerations: Part 2

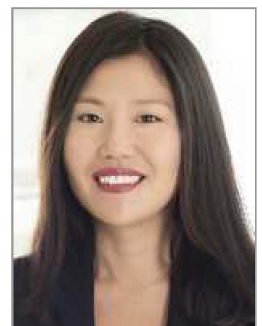
By **Brian Breheny, Joseph Yaffe, Caroline Kim, Hagen Ganem and Andrew Brady** (January 15, 2019, 2:58 PM EST)

Each company faces important decisions in preparing for its 2019 annual meeting and reporting season. This four-part series covers essential areas on which companies should focus as they plan for 2019, including corporate governance, executive compensation and disclosure matters. Part 2, below, focuses on executive compensation matters, with a discussion of pay ratio disclosures, say-on-pay votes, changes in pay practices due to the Tax Cuts and Jobs Act, new hedging policy disclosure rules and recent director compensation litigation. See part 1 **here**.

Brian Breheny



Joseph Yaffe



Caroline Kim

Prepare for 2019 Pay Ratio Disclosures

As a result of the U.S. Securities and Exchange Commission's pay ratio rules that went into effect last year, companies began providing pay ratio information in their registration statements, annual reports on Forms 10-K or proxy statements filed in 2018, based on 2017 compensation.

The pay ratio rules require applicable companies[1] to disclose the ratio of the annual total compensation of the median company employee to the annual total compensation of the CEO. In addition, companies are required to provide a brief description of the methodology used to identify the median employee, as well as any material assumptions, adjustments or estimates used to determine the median employee or annual total compensation.

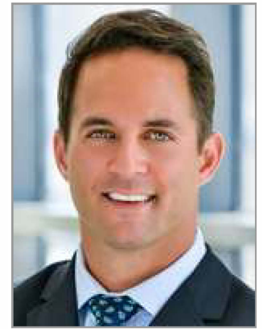
As companies prepare for the second year of mandatory pay ratio disclosures, three questions are top of mind:

- What were the key findings from the 2018 pay ratio disclosures?
- Can the same median employee be used this year?
- What else do companies need to know for 2019?

Key Findings From the 2018 Pay Ratio Disclosures

Many stakeholders eagerly awaited last year's initial pay ratio disclosures, from proxy advisory firms to investors, the press, special interest groups and employees themselves. However, the results, once released, received less attention than anticipated. That being said, it is possible that the focus on pay ratio results will increase in future years. Stakeholders recognize that a company's pay ratio will become more useful once it can be analyzed over

time and against a company's industry peers.



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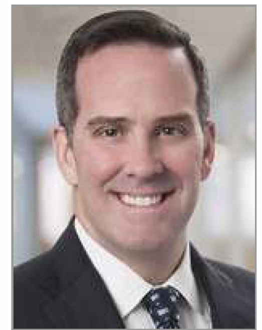

Andrew Brady

For example, both Institutional Shareholder Services, or ISS, and Glass Lewis began displaying CEO pay ratio information in their research reports, but neither used it as a determinative factor in its 2018 voting recommendations. Employees themselves were especially interested in 2018 pay ratio data, but they largely focused on how their compensation compared to the median employee's compensation, rather than their company's pay ratio as a whole.

Companies that disclosed their numbers in 2018 may wonder how they measured up. In the wake of the 2018 proxy filing deadline, Equilar analyzed 2,000 pay ratio data points that were available on May 10, 2018, and found that the median pay ratio was 166:1 for Equilar 500 companies[2] and 70:1 for Russell 3000 companies.[3]

Pay ratio varied significantly by market capitalization, employee headcount and industry sector:

- Higher market capitalizations were linked to higher pay ratios. Companies with market capitalizations that exceeded $25 billion had a median ratio of 213:1, while those with market capitalizations under $1 billion had a median pay ratio of 32:1.

- Companies with more employees tended to have lower median employee compensation, higher CEO pay and higher pay ratios. The median employee at a Russell 3000 company, which typically employs between 1,000 and 5,000 employees, earned approximately $14,024 more than the median employee who worked for a company with more than 10,000 employees.

- Analyzing pay ratio by industry reveals that use of seasonal or part-time workers and collective bargaining impacts pay ratios. For example, the consumer goods and services industries rely heavily on part-time workers and had the highest pay ratios, at 142:1 and 127:1, respectively. In contrast, Semler Brossy's recent report[4] revealed that the utilities industry had relatively low pay ratios, at 47:1 for the Russell 3000 and 94:1 for the S&P 500, because union efforts boost median employee compensation.

SEC guidance issued in September 2017 provided companies with flexibility on their pay ratio calculations. Companies' computations reflect varying inputs and methods accordingly:

- Common inputs to companies' consistently applied compensation measure, or CACM, included base salary, annual bonus/incentive pay, overtime and equity grants. Other benefits, such as health or retirement benefits, were included less frequently.[5]

- 24.5 percent of Russell 3000 companies took advantage of the de minimis exception, which allows a company to exclude non-U.S. employees when identifying their median employee, if excluded non-U.S. employees constitute 5 percent or less of their workforce.

- Companies disclosed supplemental ratios to mitigate concern over high CEO payouts, especially when CEOs were offered unusual compensation, such as signing bonuses.

- Only 6.8 percent of Equilar 500 companies and 2.9 percent of Russell 3000 companies used statistical sampling to pinpoint their median employee.

Determining Whether to Use the Same Median Employee

Under Item 402(u) of Regulation S-K, companies only need to perform median employee calculations once every three years, unless they had a change in the employee population or compensation arrangements that could significantly affect the pay ratio. This requires companies to assess annually whether their workforce composition or compensation arrangements have materially changed.

Even if a company uses the same median employee in Year 2 as in Year 1, it must disclose that it is using the same median employee and briefly describe the basis for its reasonable belief that no change occurred that would significantly affect the pay ratio.

To determine whether a material change occurred, companies should evaluate the following:

- How has workforce composition evolved over the past year?
    - Review hiring, retention and promotion rates.
    - Consider the applicability of exceptions under the pay ratio rules:
        - Determine whether to incorporate employees from recent acquisitions or business combinations into the CACM. For example, a company may exclude employees from a 2017 business combination from its 2018 pay ratio calculations, but those excluded employees should probably factor into the company's 2019 median employee calculations.
        - Determine whether the de minimis exception applies within the context of the company's 2018 workforce composition. Under this exception, non-U.S. employees may be disregarded if the excluded employees account for less than 5 percent of the company's total employees or if a country's data privacy laws make a company's reasonable efforts insufficient to comply with 402(u).
    - Finally, analyze how the workforce used for the CACM is distributed across the pay scale, and how the distribution has changed since last year.
- How have compensation policies changed in the past year, compared to the workforce composition? For example, an across-the-board bonus that benefits all employees may not materially change the pay ratio, while the introduction of special commission pay limited to a company's sales team would do so.
- Have the median employee's circumstances changed since Year 1? Consider changes to the employee's title and job responsibilities alongside any changes to the structure and amount of the employee's compensation, factoring in the company's broader workforce composition. Additionally, if the median employee was terminated, companies must identify a new median employee.

Other Points to Keep in Mind

In addition to determining whether to select a new median employee, we also recommend that companies consult Item 402(u) and carefully consider whether their CACM will reflect the following:

- Annualized pay for new hires (but not seasonal or part-time workers).
- Personal benefits that amount to less than $10,000 per employee, such as health or retirement benefits, derived from nondiscriminatory benefit plans.
- Cost-of-living adjustments.
- A new date for identifying the median employee.

The SEC provides companies substantial flexibility in calculating their pay ratios. To remain in the SEC's good graces and engage investors, employees and other stakeholders, we recommend that companies diligently document and thoughtfully disclose their pay ratio methodology, analyses and rationale. Companies should also clearly disclose any changes to their pay ratio methodology, and be thoughtful about electing to make optional disclosures, such as alternative pay ratios or comparisons to peer pay ratios.

Finally, companies should keep an eye on pending state and local legislation. Some states, including California, Connecticut, Illinois, Massachusetts, Minnesota and Rhode Island, have proposed legislation that would impose additional taxes or fees on corporations that report a pay ratio in excess of certain thresholds. Several cities are considering similar measures.

Incorporate Lessons Learned From the 2018 Say-on-Pay Votes and Compensation Disclosures

We recommend that companies consider recent annual say-on-pay votes and disclosure best practices when designing their compensation programs and communicating about their compensation programs to shareholders. This year, companies should understand key say-on-pay trends, including overall 2018 say-on-pay results, factors driving say-on-pay failure, say-on-golden-parachute results and equity plan proposal results.

In this section, we discuss recent proxy firm guidance from ISS and Glass Lewis and proxy advisory firm takeaways, including details about ISS' revised metrics for evaluating say-on-pay.

Overall Results of 2018 Say-on-Pay Votes

Below is a summary of the results of the 2018 say-on-pay votes from Semler Brossy's annual survey[6] and trends over the last seven years since the SEC adopted the say-on-pay rules:

- Despite stock market gains across all industries in 2017,[7] average support for the 2018 season was near 90.3 percent, which is the lowest since 2012.
- Approximately 97.3 percent of companies received at least majority support, with approximately 93 percent receiving above 70 percent.

- Approximately 2.7 percent of say-on-pay votes failed in 2018, which is higher than year-end failure rates for the past three years. The year 2017 had the smallest failure rate ever, at 1.3 percent.

- 8 percent of Russell 3000 companies and 7 percent of S&P 500 companies surveyed have failed to receive a majority support for say-on-pay at least once.

- Almost one-third of companies with annual say-on-pay votes have received less than 70 percent support at least once during the preceding seven years.

- ISS approval continues to sway say-on-pay votes. Say-on-pay results were 31 percent lower for companies that received an ISS "against" recommendation in 2018, exceeding the historical average of 25 to 30 percent and suggesting increased alignment between institutional shareholder voting and ISS recommendations. Moreover, ISS' "against" recommendation rate increased from 12.2 percent in 2017 to 13.9 percent in 2018.

Factors Driving Say-on-Pay Failure

Overall, the most common causes of say-on-pay failure were a disconnect between pay and performance, problematic pay practices, use of nonperformance-based equity, shareholder outreach and disclosure issues, special awards and mega grants, perceived problems with the rigor of performance goals, and challenged benchmarking practices, as summarized in the following chart:

When evaluating pay practices, proxy advisory firms tend to focus on whether a company's practices are contrary to a performance-based pay philosophy. In December of each year, ISS publishes frequently asked questions documents to help stakeholders understand changes to ISS compensation-related methodologies. In December 2018, ISS published FAQs[8] that added the following to its list of particularly problematic pay practices that are most likely to result in an adverse vote recommendation:

- Excessive termination payments (no longer just change in control severance) — i.e., generally those exceeding three times base pay and annual bonus; and

- A "good reason" termination definition that presents windfall risks, including but not limited to definitions triggered by potential performance failures, such as a company bankruptcy or delisting.

The following items remain on ISS' list of particularly problematic pay practices:

- Repricing or replacing of underwater stock options/SARs without prior shareholder approval (including cash buyouts and voluntary surrender of underwater options).

- Extraordinary perquisites or tax gross-ups.

- New or materially amended executive agreements that provide for (1) change in control payments exceeding three times the executive's base salary and bonus, (2) change in control severance payments that do not require involuntary job loss or substantial diminution of duties, (3) change in control payments with excise tax gross-ups, including modified gross-ups, (4) multi-year guaranteed awards that are not at-risk due to rigorous performance conditions or (5) a liberal change in control definition combined with any single-trigger change in control benefits.

- Any other egregious practice that presents a significant risk to investors.[9]

- ISS stated that shifts away from performance-based compensation to discretionary or fixed pay elements would constitute a problematic pay practice, including changes made in light of the repeal of the performance-based compensation exception under Section 162(m) of the Internal Revenue Code.

- For the first time, ISS reported that it is unlikely to support "front-loaded" awards that cover more than four years, and that companies should make firm commitments to refrain from granting additional awards over the covered period.

Other issues contributing to low say-on-pay support include:

- Inadequate disclosure around incentive goals and lowered incentive goals without explanation.

- High-target incentives for companies that are underperforming relative to their industries.

- Special bonuses and mega equity grants without sufficient rationale or risk-mitigating design features.

- Targeting compensation above the 50th percentile of peer compensation groups, especially when using outsized peers.

- Insufficient shareholder outreach and disclosure, including inadequate response to compensation-related concerns raised by shareholders.

When companies have not changed their compensation plans or programs in response to major shareholder concerns, a best practice is to include the following in the proxy materials: (1) a brief description of those concerns; (2) a statement that the concerns were reviewed and considered; and (3) if appropriate, an explanation why changes were not made. In addition, many companies incorporate useful features into their executive compensation disclosures, including executive summaries, charts, graphs and other reader-friendly tools. A number of companies also have added a summary section to the proxy statement, generally located at the beginning of the document, that highlights, among other things, business accomplishments and key compensation elements, features

and decisions.

In the year following a say-on-pay vote, proxy firms conduct a thorough review of companies whose say-on-pay approval votes fall below a certain threshold: below 70 percent approval for ISS and below 80 percent approval for Glass Lewis. In its FAQs, ISS explained that this review involves investigating the breadth, frequency and disclosure of the compensation committee's stakeholder engagement efforts, disclosure of specific feedback received from investors who voted against the proposal, actions taken to address the low level of support, other recent compensation actions, whether the issues raised were recurring, and the company's ownership structure.

Overall, companies that fell below ISS' and Glass Lewis' thresholds in 2018 should provide enhanced disclosure of their stakeholder engagement efforts in 2019 and actions they took to address concerns. Companies who fail to conduct sufficient stakeholder engagement efforts, and to make these disclosures, may receive negative vote recommendations from proxy advisory firms on say-on-pay and compensation committee member re-election.

Say-on-Golden-Parachute Proposal Results

Say-on-golden-parachute votes have historically received lower support than annual say-on-pay votes, but approval rates are increasing among shareholders and ISS. As of August 2018,[10] average support for golden parachute proposals rose to 86 percent, the highest in the past five years. The 2017 failure rate of 17 percent was the highest since the advent of the vote and more than double the failure rate of 7 percent in 2016.

Fortunately, in 2018, the failure rate dropped to 4 percent, and ISS "against" vote recommendations dropped from 49 percent in 2017 to 20 percent in 2018. Improvements in say-on-golden-parachute approval rates can be credited to investors voting along their own guidelines and lower opposition from advisers.

Equity Plan Proposal Results

Equity plans continue to be widely approved, with less than 1 percent of equity proposals receiving less than a majority vote in 2018 and since 2011. However, the percentage of equity proposal votes that received above 90 percent support dropped from 65 percent in 2017 to 59 percent in 2018.

Companies with low say-on-pay approval rates should brace for lower equity plan approval rates. Data over the past five years shows that companies with say-on-pay votes lower than 70 percent received approximately 11 percentage points less support on equity plan votes that same year.[11]

The year 2018 marked the fourth year in which ISS applied its Equity Plan Scorecard, or EPSC. ISS' application of the EPSC changed in important ways in 2018 and continues to evolve in 2019:[12]

- In 2018, for companies subject to the S&P 500 scoring model, the passing score for the EPSC increased to 55 points. For other companies, the passing score remained at 53 points. These passing scores will remain the same for 2019.

- In 2018, the change in control vesting factor was simplified, scoring companies on a basis of full or no credit. A company earned full credit if its equity plan contained both of the following provisions: (x) for performance-based awards, acceleration is limited to actual performance achieved, a pro rata of the target based on the performance period, or a combination of both and (y) for time-based awards, acceleration upon a change in control cannot be discretionary or automatic single-trigger. However, effective for meetings on and after Feb. 1, 2019, equity plans that disclose with specificity the change in control vesting treatment for both performance- and time-based awards will earn full credit. Credit is earned based on quality of disclosure, rather than based on actual vesting treatment of awards. Plans that fail to address change in control vesting treatment for either type of award or provide merely for discretionary vesting will earn no credit.

- In 2018, the holding requirement factor was simplified, permitting a company to earn either full or no credit. The timeline for receiving full credit on this factor changed from a 36-month holding period to a 12-month holding period. Accordingly, any holding period of less than 12 months results in no credit.

- In 2018, the CEO vesting requirement factors were also simplified, scoring full credit or no credit. To receive full credit, the vesting requirement threshold decreased from greater than four years to at least three years from the date of grant until all shares from the award vest.

- Effective for meetings on and after Feb. 1, 2019, ISS may apply a new negative overriding factor relating to excessive equity dilution. This factor will be triggered when a company's equity compensation program is estimated to dilute shareholders' holdings by over 20 percent for S&P 500 companies or 25 percent for Russell 3000 companies.

As of July 2018, ISS recommended against approximately 36 percent of all share plan requests that came to a vote in 2018, while Glass Lewis advised against approximately 20 percent. Companies have nevertheless largely gained shareholder approvals for these plans, in part because they invest in shareholder engagement and often seek reasonable share requests over a limited time period.

Companies should continue to pay careful attention to the EPSC. If a company pursues a share plan that is not compliant with proxy advisory standards, it should conduct robust stakeholder engagement efforts and make a persuasive case for the plan in the proxy statement, to increase the chances of approval.

Other Proxy Advisory Firm Takeaways

ISS' FAQs for 2019[13] confirmed that there are no further changes to the quantitative screens for pay-for-performance calculations for the 2019 proxy season. Key changes that took effect in 2018 and carry through to 2019 include the following:

- A Financial Performance Assessment, or FPA: Through the FPA, ISS' quantitative screen now measures relative alignment between CEO pay and key financial metrics on a long-term basis, relative to the company's ISS peer group. This analysis was previously limited to ISS' qualitative evaluation. The FPA uses three or four financial metrics, which it selects and weights depending on the company's industry. Potential metrics include return on invested capital, return on assets, return on equity, EBITDA growth and cash flow growth from operations. Although ISS continues to study economic value added, or EVA, measures and may display EVA results in its research reports, it will continue to use only U.S. generally accepted accounting principles/accounting performance measures in the FPA in 2019. The FPA can be a tipping factor for the final quantitative concern level if at least one of the initial quantitative measures (relative degree of alignment, multiple of median or pay-TSR alignment) triggers a medium concern finding or borders the medium concern threshold. When the initial three measures do not border a medium concern threshold, the overall quantitative concern level may not be modified by the FPA. ISS anticipates that the FPA will modify less than 5 percent of companies' overall quantitative concern levels.

- Revised Screen Thresholds: S&P 500 companies' multiple of median, or MOM, threshold for a medium level of concern dropped from 2.33, the median pay of peer companies, to 2.00. The MOM threshold for non-S&P 500 companies remains at 2.33.

- Adjustments to Total Shareholder Return, or TSR, Calculations: ISS now averages the daily closing prices for the first and last months of the TSR measurement period, smoothing the calculations.

- Acknowledgment of CEO Pay Ratio: The new CEO pay ratio disclosure requirement did not impact ISS vote recommendations in 2018. ISS will continue to assess the pay ratio's usefulness and application as data becomes available. Additionally, ISS' research reports will display pay ratio data, including the company's median employee pay figure and the pay ratio for both the current and prior year, if the data is available.

ISS also added a new consideration to its qualitative screen — the emphasis of objective and transparent metrics. However, ISS does not endorse or prefer the use of total shareholder return or any other specific metric.

In 2017, ISS provided guidance about its 2018 policy for evaluating whether nonemployee director pay is excessive. Under that policy, an ISS finding of excessive nonemployee director pay over two or more consecutive years without a compelling rationale or mitigating factors could result in an adverse vote recommendation starting in 2019. However, in November 2018, ISS announced that it would revise its methodology for identifying nonemployee director pay outliers and delay the first possible adverse vote recommendations under the policy until 2020.[14]

The December 2018 FAQ outlined ISS' updated methodology for evaluating nonemployee director pay:[15]

- Pay outliers will be nonemployee directors with pay that exceeds the top 2-3 percent of all comparable directors (rather than the top 5 percent, which was proposed by ISS in 2017).
    - Individual nonemployee director pay totals will be evaluated within the context of a company's index (e.g., S&P 500) and sector (two-digit Global Industry Classification Standard group).
    - Nonexecutive chairmen and lead independent directors will be compared against other board leaders.
    - One mitigating factor may be the lack of a pronounced difference in pay between the top 2-3 percent of nonemployee directors and the median director in a given sector-index grouping.
- If ISS determines that a nonemployee director's pay is a quantitative pay outlier, it will perform a qualitative evaluation of the company's disclosed rationale to determine if concerns are adequately mitigated. Payments such as new director onboarding grants clearly identified as one-time in nature, special payments related to corporate transactions or special circumstances (e.g., special committee service) or payments made for necessary, specialized scientific expertise would typically mitigate concern, while payments to reward general performance typically would not be considered a compelling mitigating factor.

Companies had the opportunity to make updates to the compensation benchmarking peers included in ISS' database. ISS uses these company-selected peers when it determines the peer group it will use for evaluating a company's compensation programs. ISS accepted these updates through Friday, Dec. 7, 2018.[16]

Consider the SEC's New Hedging Policy Disclosure Rules

On Dec. 18, 2018, the SEC adopted final rules[1]7 regarding hedging policy disclosures that will be

reflected in Item 407(i) of Regulation-S-K. Most companies will be required to include hedging disclosures in proxy statements for fiscal years beginning on or after July 1, 2019. However, smaller reporting companies and emerging growth companies have an additional year before they are required to provide such disclosures.

The new rules will not require disclosures from listed closed-end funds or foreign private issuers. Impacted companies should plan for upcoming disclosures of their hedging policies by reviewing their policies and determining whether any changes should be made to them in light of the final rules.

Companies will be required to disclose policies or practices that allow employees — including, but not limited to, officers — or directors to hedge equity securities they hold in the company (as well as the company's subsidiaries, the company's parent or the parent's subsidiaries), regardless of whether the equity securities are granted to employees or directors as part of compensation or held by them directly or indirectly. The new rules also will require disclosure of policies or practices that allow employees, directors 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 are designed to hedge or offset decreases in the equity securities' market value.

Companies will be able to satisfy the new requirements by (1) disclosing the practices or policies in full or (2) fairly and accurately summarizing them, including the categories of people affected and types of hedging transactions that are specifically permitted or forbidden. If a company does not have hedging policies, it will be required to disclose that it lacks such policies, or to state that hedging transactions are generally permitted.

Plan for Grandfathering and Other Potential Changes in Pay Practices Due to the Tax Cuts and Jobs Act

On Dec. 22, 2017, the Tax Cuts and Jobs Act became law, altering Section 162(m) of the Internal Revenue Code for taxable years beginning on or after Jan. 1, 2018. On Aug. 21, 2018, the Internal Revenue Service issued Notice 2018-68[18] to clarify how the TCJA amended Section 162(m) and impacts many compensation arrangements. However, the TCJA has a transition rule that allows certain existing compensation arrangements to remain subject to the pre-TCJA version of Section 162(m) (in other words, to be "grandfathered"). Companies should assess the impact of the changes to Section 162(m) on their compensation arrangements, including the application of the transition rule.

Key Amendments

Important highlights of the Section 162(m) amendments include the following:

- Performance-based compensation counts toward the $1 million deduction limit per employee, because the performance-based compensation deduction was eliminated.

- The definition of a covered employee was expanded to include principal financial officers and the three most highly compensated officers for the taxable year, regardless of their year-end titles and SEC disclosure rules. Covered employee status carries forward each year.

- Section 162(m)'s reach extended to companies with publicly traded debt issuers and foreign private issuers that meet the new definition of a publicly held corporation.

Grandfathered Arrangements

Certain existing compensation arrangements fall within the scope of Section 162(m)'s transition rule and are grandfathered under the pre-TCJA version of Section 162(m):

- Section 162(m) does not apply to compensation under written binding contracts in effect as of Nov. 2, 2017, so long as the contracts are not materially modified thereafter. Awards are not grandfathered if companies are permitted to exercise negative discretion to reduce or eliminate the award amount, regardless of whether the discretion is exercised, unless the employee is entitled to the amount under applicable state law.

- A written binding contract that was in effect on Nov. 2, 2017, and is materially modified on or after that date, is treated as a new contract entered into as of the date of material modification. Amounts an employee receives under the contract before the material modification remain grandfathered, while amounts received after are not grandfathered.

- Not all modifications are material, including the following: accelerating a payout under a grandfathered contract as discounted to reflect the time value of money; deferring payment under a grandfathered contract with earnings based on a reasonable rate of interest or predetermined actual investment; or paying increased or additional compensation under a grandfathered contract that is paid on substantially the same elements or conditions and limited to a reasonable cost-of-living increase.

- Grandfathered performance-based compensation generally includes stock options and stock appreciation rights that were outstanding on Nov. 2, 2017. Performance stock units, performance shares and other long-term incentive awards that were outstanding on Nov. 2, 2017, should qualify as grandfathered, except to the extent the plan or the award (and state law) permits the company to reduce or eliminate the payout.

- If an employment agreement was entered into on or before Nov. 2, 2017, and provides for grants after Nov. 2, 2017, which are subject to approval by the company's board of directors, the potential grants do not constitute a written binding contract and therefore are not grandfathered.

- Employment, severance, change in control and similar agreements that were entered into on or before Nov. 2, 2017, should qualify as grandfathered, except if they are subject to "renewal," which is broadly defined in Notice 2018-68. Grandfathered status is lost upon occurrence of the applicable renewal date.

Practical Implications

The TCJA is causing some leading companies to reconsider the timing and form of their incentive compensation payouts. Section 162(m)'s new definition of covered employee may inspire companies to implement longer vesting schedules for equity awards, or to extend the timing for other awards by spreading payments over multiple years. Companies may also consider changing the mix of fixed and variable compensation or moving compensation into a supplemental executive retirement plan or other nonqualified deferred compensation plan.

In addition, the elimination of the qualified performance-based compensation exception comes with a silver lining: Companies now have greater flexibility to design new performance awards with goals that are aimed entirely at achieving business objectives. For example, companies can now establish performance goals and adjustment provisions for new awards that are not objectively determinable and pre-established, and they can retain discretion to adjust payouts based on actual performance and unforeseen events.

Performance-based awards remain important to incentivizing executives, and continue to be a key focus of shareholders and proxy advisory firms. ISS recently indicated that it does not expect to

change its framework for analyzing pay-for-performance as a result of the changes to Section 162(m). Therefore, the mix of time-based and performance-based awards to executives will likely remain largely the same, despite the recent changes under Section 162(m).

Key Takeaways to Consider

Companies should consider the following key takeaways for the annual reporting season:

- Monitor covered employees and the extent to which their covered compensation may exceed $1 million per year.
- Take inventory of performance-based compensation arrangements in effect on Nov. 2, 2017, and determine which ones may be grandfathered. Companies should consult with legal advisers to determine how the transition rule applies to the company's arrangements, and avoid inadvertent material modifications that jeopardize the deductibility of compensation paid to covered employees for current and future taxable years.
- Review existing equity and cash incentive plans to assess flexibility to grant performance awards that are not intended to qualify as performance-based compensation under Section 162(m) and changes to make to plan designs. To protect grandfathered status for outstanding awards, some companies are adopting new plans reflecting the Section 162(m) changes rather than amending existing plans.
- Continue to comply with operational requirements for awards that are intended to be grandfathered. For example, companies with outstanding grandfathered awards should retain old performance award provisions in their equity and cash incentive plans.
- Make a thoughtful disclosure about Section 162(m)'s impact on executive compensation policies in the compensation discussion and analysis section of the proxy statement. For example, consider noting that the compensation committee has assessed and will continue to assess the impact of the changes on executive compensation while retaining discretion to establish nondeductible compensation.
- Companies may also state that compensation programs are no longer being designed to comply with repealed Section 162(m) provisions while accurately describing compensation programs in their proxy statements. We advise companies to avoid specifying that any particular payments are in fact grandfathered, given the uncertain and complex application of the rules in certain circumstances.
- Companies should plan to eventually update equity plans, prospectuses and compensation committee charters to eliminate references to Section 162(m) performance-based requirements.
- Companies should consider the extent to which compliance with independence requirements for compensation committee members under the NYSE and Nasdaq listing standards and the rules under Section 16(b) of the Exchange Act is still required, notwithstanding the changes to Section 162(m).

Consider Recent Director Compensation Litigation

On Dec. 13, 2017, the Delaware Supreme Court issued its opinion in In re Investors Bancorp Inc. Stockholder Litigation,[19] opening the door for more stringent review of director compensation awards and costly litigation.

Delaware courts generally review director decisions about their own compensation under one of the following standards of review: (1) the business judgment standard, which is deferential to directors, or (2) the more onerous entire fairness standard, where courts consider whether the decision is entirely fair to the corporation. Director compensation is typically reviewed under the entire fairness standard, because directors derive personal financial benefits from their decisions about their own compensation.

Prior to Bancorp, courts typically applied the business judgment standard of review instead of entire fairness if a director compensation decision was ratified by a vote of fully informed shareholders, even if the compensation plan in question gave directors discretion to award themselves compensation, as long as the plan had meaningful limits. Shareholder ratification therefore also made it easy for courts to dismiss director compensation suits early in the litigation process.

In Bancorp, the Delaware Supreme Court limited the shareholder ratification defense, making it more difficult to secure business judgment review and easier for plaintiffs to sustain breach of fiduciary duty claims against directors regarding their compensation. Specifically, the court found that, where shareholders have approved an equity incentive plan that gives directors discretion to grant themselves awards within general parameters, and a shareholder properly alleges that that discretion was inequitably exercised (the Bancorp plaintiff had alleged that directors' compensation exceeded pay at peer companies), then the shareholder ratification defense is unavailable to dismiss the suit and the entire fairness review applies.

However, shareholder ratification remains a viable director defense and grounds for business judgment review in two scenarios, where shareholders approve (1) specific director awards or (2) a plan with a self-executing formula, so directors have no discretion as to their awards.

Companies should reduce their risk of director compensation litigation by:

- Working with a compensation consultant to conduct a peer review of director compensation, being mindful of the choice of peers, which plaintiffs frequently criticize.
- Separating employee and nonemployee director compensation decisions and reevaluating compensation decision-making processes to mitigate self-dealing concerns. Boards should consider using separate plans for director and executive awards.
- Carefully documenting the review of director compensation programs and considering expanded proxy disclosure about both the process for determining compensation and the actual amount of compensation paid to directors.
- Considering whether to grant director compensation equity awards pursuant to a shareholder approved formula plan or seek shareholder approval of specific awards.

Part 3 of this series will focus on corporate governance best practices, including updates to D&O questionnaires; ISS and Glass Lewis proxy advisory voting guidelines; environmental, social and governance reporting; board diversity and related disclosures; and shareholder proposals.

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[1] Emerging growth companies, smaller reporting companies and foreign private issuers are exempt from the pay ratio disclosure requirement. Transition periods are also available for newly public companies.

[2] The Equilar 500 is an index that consists of the largest revenue-grossing companies trading on the NYSE, Nasdaq or NYSE American, adjusted to reflect a proportionate industry mix. More information on the industry breakdown is available here.

[3] Unless otherwise noted, pay ratio statistics discussed in this section come from Equilar's report "CEO Pay Ratio: A Deep Data Dive" (May 22, 2018), available here.

[4] Semler Brossy's report "2018 Say on Pay and Proxy Results" (Oct. 4, 2018) is available here.

[5] This data comes from Pearl Meyer's research report "The CEO Pay Ratio: Data and Perspectives From the 2018 Proxy Season" (2018), available here.

[6] Semler Brossy's report "2018 Say-on-Pay and Proxy Results" (Oct. 4, 2018) is available here.

[7] Aon's article "Lessons From the 2018 Proxy Season for Say-on-Pay and Equity Plan Votes" (July 2018), available here, discusses the link between stock market performance and say-on-pay results in greater depth.

[8] ISS' Frequently Asked Questions (FAQ) "U.S. Compensation Policies" (Dec. 14, 2018) is available here.

[9] See id., FAQ #47.

[10] Say-on-golden-parachute data comes from Willis Towers Watson's report "U.S. Executive Pay Votes — 2018 Proxy Season Review" (Aug. 2018), available here.

[11] Semler Brossy's report "2018 Say on Pay and Proxy Results" (Oct. 4, 2018) is available here.

[12] ISS' Frequently Asked Questions "U.S. Equity Compensation Plans" (Dec. 14, 2017) is available here.

[13] ISS' Frequently Asked Questions "U.S. Compensation Policies" (Dec. 14, 2018) is available here.

[14] ISS' Preliminary Frequently Asked Questions "U.S. Compensation Policies for 2019" (Nov. 21, 2018) is availablehere.

[15] ISS' Frequently Asked Questions "U.S. Compensation Policies" (Dec. 14, 2018) is available here.

[16] ISS' article "Company Peer Group Feedback" (2018) is available here.

[17] The SEC's press release "SEC Adopts Final Rules for Disclosure of Hedging Policies" (Dec. 18, 2018) and adopting release are available here.

[18] The IRS Notice 2018-68 (Aug. 21, 2018) is available here.

[19] In re Investors Bancorp Inc. Stockholder Litig. , 177A.3d1208 (Del. 2017).

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